The ‘ebb and flow’ of transatlantic regulatory cooperation in banking

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Abstract

What explains the intensity and the forms of transatlantic regulatory cooperation in banking over the last three decades? This paper defines regulatory cooperation as information exchange; mutual recognition; and international regulatory harmonisation. It argues that the intensity of transatlantic regulatory cooperation has been subject to ‘ebb and flow’ and has taken different forms over time. When EU-US preferences are broadly aligned, all the main forms of transatlantic regulatory cooperation are intense. When preferences are different, especially in the context and aftermath of exogenous shocks of financial crises, cooperation is less intense. Moreover, the US and the EU privilege different forms of regulatory cooperation, depending on their ability to pursue the desired outcomes in different institutional venues.

Keywords: Basel III; financial regulation; banks; capital requirements; European Union; United States

Introduction

The United States (US) and the European Union (EU) have very large banking sectors and are the main trading partners in banking services. Thus, transatlantic cooperation is crucial if there is to be any form of effective global governance in banking. According to Ahearns,[2] transatlantic regulatory cooperation can take three main forms: information exchange; mutual recognition,[3] which takes place when two or more jurisdictions agree to recognize each other's rules in lieu of domestic rules,[4] and regulatory harmonisation,[5] which refers to the establishment of similar (harmonised) rules,[6] mainly through international standard setting.[7]

Has transatlantic regulatory cooperation in banking intensified and/or taken different forms over time, especially in the context and aftermath of the recent international financial crisis? More generally, what explains the variation of intensity in transatlantic regulatory cooperation and the different forms it has taken over the last three decades? This paper contends that transatlantic regulatory cooperation in banking has been subject to 'ebb and flow'. Its overall intensity increased in the late 1990s and early 2000s, only to decline after the international financial crisis. Although information exchange has increased, in the aftermath of the crisis there have been steps backwards on mutual recognition and the emergence of US-EU regulatory disputes. Moreover, US-EU disagreements have become apparent in international regulatory fora as well as in the domestic implementation of internationally agreed rules. Recently, the EU has attempted to embed discussions on financial regulation in transatlantic trade negotiations, a move that was resisted by the US.

These trends are explained by the alignment or misalignment of regulatory preferences amongst the two jurisdictions and by their attempts to seek forms of cooperation that better enable each of them to pursue its regulatory preferences. When US and EU preferences are similar, all forms of transatlantic regulatory cooperation are intense. In contrast, when preferences are different, especially after the exogenous shocks of financial crises, cooperation is more problematic. Moreover, the US and the EU privilege different forms of cooperation, depending on their ability to pursue the desired outcomes in different institutional venues.

2. State of the art and explanatory framework

This paper sets out to investigate the intensity and the forms of transatlantic regulatory cooperation in banking — namely information exchange, mutual recognition and international harmonisation — over time. Here the main focus is on the latter two, because information exchange is a very 'light' form of cooperation and to a large extent it is a precondition for the other two. The intensity of cooperation is gauged by the extent to which these two jurisdictions agree on the mutual recognition of each other's rules (or, at the very least, they are willing to grant exemptions) and prevent (or, at least, quickly resolve) cross-border regulatory disputes; and the extent to which they agree (or disagree) in the process of standard-setting in international regulatory fora, followed by the implementation of these agreements domestically.[8]

The international political economy literature has so far paid scant attention to transatlantic regulatory cooperation in banking over time.[9] However, there is an extensive literature on international standard setting by the Basel Committee on

Banking Supervision (BCSB),[10] whereby researchers have examined the negotiations of the so-called Basel I accord in 1989,[11] the Basel II accord in 2005,[12] and the Basel III accord in 2010.[13] A second strand of international political economy literature has examined the bilateral regulatory relations in finance between the US and the EU, albeit not with specific reference to banking, but rather to accounting and securities markets.[14]

The literature mentioned above postulates that the main rationale for transatlantic cooperation is the attempt by US and EU officials to solve the 'dilemma'[15] between the need to secure domestic financial stability and protect the competitiveness of their national financial sector in globalised markets. In the banking sector, the dilemma becomes a 'trilemma' because banks provide credit to the real economy. Hence, economic growth is the third objective that policy makers seek to secure (or at least not to impinge upon) through banking regulation.[16]

In setting the terms for regulatory cooperation, each jurisdiction favours international or bilateral rules that do not pose significant domestic adjustment costs[17] — that is, that do not place the national financial industry at a competitive disadvantage or impose an overhaul of the domestic regulatory framework in place. Hence, the configuration of national financial systems[18] and domestic regulatory frameworks shape the preferences of the various jurisdictions concerning the terms (that is, the content and scope) of transatlantic cooperation.[19] We follow this insight in the empirical sections of the paper in order to tease out the main regulatory preferences of the US, the EU and the main member states therein. Moreover, we expect that whenever US and EU preferences are similar or at least not competing, transatlantic

regulatory cooperation will be intense. By contrast would expect that whenever US and EU regulatory preferences differ significantly, transatlantic regulatory cooperation will be more problematic and hence less intense.

What enable jurisdictions to pursue their regulatory preferences internationally? The existing literature has mostly focused on 'institutional complementarities';[20] 'regulatory capacity';[21] market size;[22] the 'cohesiveness' of a jurisdiction;[23] and the support or opposition from the financial industry.[24]

With the exception of Drezner[25] — who explains why the 'great powers' prefer different types of international regulatory regimes — less attention has been paid to how different forms of cooperation and the institutional venues through which transatlantic cooperation takes place can affect the ability of the main jurisdictions to pursue their preferences. For example, the US has traditionally had a prominent role in international regulatory fora in finance.[26] By contrast, the EU is by now considered a 'trade power',[27] even though the inclusion of financial regulation in trade deals is subject to the so called 'carve out'.

We expect that the US and the EU will privilege the forms of cooperation that better enable each of them to pursue (though not necessarily achieve) their preferences, especially if their preferences are not aligned. By contrast, if transatlantic regulatory preferences are aligned, cooperation will be intense in all the main forms. There are two main limits to our analysis. First, given its long timeframe and the number of policy episodes examined, space constraints prevent us from engaging in an in-depth analysis of domestic preference formation in the main jurisdictions. What we present

here is a first cut explanation of the 'revealed' preferences of policy-makers in the main jurisdictions, mainly on the basis of the configuration of national banking systems. Second, on several occasions, there was not an EU position as such. Hence, our analysis investigates in a concise way the preferences of the main EU member states, even though reference to the EU as a whole is often used as shorthand in the overall discussion.

3. Limited transatlantic regulatory cooperation in banking in the 1980s and early 1990s

In the 1980s and 1990s, the intensity of transatlantic regulatory cooperation was relatively low because the preferences of the US and the EU (as well as within the EU) were not aligned. Internationally, the US, later joined by the UK, instigated the Basel I accord, which was initially resisted by other European countries that worried about the implications that higher capital requirements would have for the real economy. Bilateral cooperation mainly concerned the terms of access of US and EU banks to each other's markets on the basis of the principle of national treatment.

3.1 US-EU (difficult) cooperation on international harmonisation: Basel I

In 1988, the BCBS issued the Basel I accord 'International convergence of capital measurement and capital standards', which set in place capital rules for internationally active banks. In the negotiations on the accord, the US and later the UK were 'pace-setters', whereas continental countries reluctantly followed.[28] This 'divide' in the negotiations suggests that transatlantic regulatory cooperation on the harmonisation of

capital rules was limited: different members of the BCBS had different preferences, mostly rooted in the configuration of national financial systems and domestic regulatory frameworks.

In the 1980s, part of the US banking system was highly internationalised. Several big US banks operated abroad, mainly in Europe (especially in London) and had invested in South America, where they suffered heavy losses as a result of the debt crisis of the 1980s.[29] Several under-capitalised US banks (see Table 1) were unable to withstand these losses and were resolved. Moreover, the US was host to subsidiaries of a number of large European and Japanese banks. The increasing market share of the (under-capitalised) Japanese banks was of particular concern for US banks and policy-makers alike, as was the concern about the (unreliable) measurement of capital positions for Japanese banks,[30] as suggested by the bloated Japanese figures in Table 1, which predate the adoption of the Basel 1 definition of captial. In the late 1980s, after several bank failures, US policy-makers decided to impose higher risk-based capital requirements, which represented a cost for US banks, damaging their competitiveness vis-à-vis foreign banks that operated with lower capital.[31] Hence, US policy-makers called for the introduction of risk-weighted capital standards internationally, with a view to creating a level playing field.

Like the US, the UK had been plagued by a series of domestic bank failures, the most well-known of which was that of Johnson Matthey Bankers Limited in 1984.[32] Moreover, the UK hosted the subsidiaries of a large number of foreign banks, many of which were under-capitalised. Like their American counterparts, British policy-makers reacted to domestic bank failures by increasing risk-based capital

requirements, which weakened the competitiveness of British banks vis-à-vis foreign competitors. Hence, British policy-makers joined US policy-makers in calling for international capital requirements.[33]

By contrast, the main European continental countries had not suffered major bank failures in the 1980s. Unlike in the US, banks provided the bulk of the credit to the real economy in all the countries of continental Europe (see Table 1). Moreover, the regulatory frameworks in place in continental countries had distinctive features including the definition of what counted as bank capital, that could not be easily taken into account in the formulation of international capital rules. Hence, France and Germany were lukewarm towards the proposed international agreement. The EU (at that time it was still the European Community) as a whole did not have its own capital rules, which varied considerably across the member states.[34] There was no EU attempt to coordinate the positions of its, then, eight member states sitting in the BCBS.

The US-UK alliance won over Japanese policy-makers. After an agreement was reached among the officials of these three countries, the other members of the BCBS reluctantly decided to join in and the Basel I accord was signed. The accord was a non-legally binding gentlemen's agreement. Its rules became legally binding only when incorporated into the national legislation of the member countries.[35] The implementation of the accord was rather straightforward in the US, since most of its content had been 'uploaded' from the US regulatory framework. In the EU, the accord was 'downloaded' into legally binding legislation, the Capital Requirements directive (CRD) (1993), which applied to all banks and investment firms, regardless of size —

given concerns that the directive would create distortions in the European Single Market.

3.2. US-EU cooperation in bilateral regulatory relations: challenging the principle of national treatment

In the 1980s and 1990s, bilateral regulatory relations in banking were based on the principle of national treatment, whereby EU banks that wanted to operate in the US (and vice versa) were subject to the same domestic rules applied to US-headquartered banks (and vice versa). In the US, investment banking and commercial banking were separated. Indeed, the Glass-Steagall Act (1933) limited the range of financial services that a (US or foreign) bank could provide in the US, and prohibited commercial banks from participating in the investment banking business. Moreover, geographical restrictions were imposed on US banks and foreign banks operating in the US.[36]

Unlike in the US, in the EU the 'universal bank' model was widespread, at least from the late 1980s onwards.[37] Universal banks can provide a variety of financial services, such as securities trading and underwriting, besides banking activities. Moreover, banks in the EU were not subject to geographical restrictions because the First Banking directive (1977) removed obstacles to the provision of services and to the establishment of branches across the EU according to a set of harmonized rules. For this reason, bilateral cooperation based on national treatment was unsatisfactory for the main EU member states whose banks operated in the US. They argued that EU

banks operating in the US were subject to a host of restrictions, whereas US banks operating in Europe were not subject to similar restrictions.

When negotiations began in 1988 on the Second Banking Directive, which was designed to promote banking integration in the EU, the large European banks operating in the US and their home member states argued that the new passport regime would provide considerable benefits to US banks operating in Europe, and therefore they expected a more accommodating stance from US policy-makers.[38] In contrast, US banks argued that European banks operating in the US should be subject to the same rules applied to US-headquartered banks, so as to avoid an uneven playing field. US policy-makers were also opposed to the introduction of exemptions for European banks operating in the US.

In order to exert some influence on US policy-makers, when the European Commission put forward the initial draft of the Second Banking Directive in 1988, it envisaged that banks from third countries would be allowed to benefit from the single passport in the EU, only if EU banks received reciprocal (mirror) treatment in these third countries.[39] The European Commission would undertake the reciprocity examination for each bank that applied to establish a subsidiary in the EU. For US banks, this interpretation posed the direct threat of discrimination, since mirror treatment was not given in the US. The US policy-makers threatened retaliation, which was particularly worrisome for the UK, given the scale of operations of several British banks in the US and several US banks in the City of London. Following significant compromise, the Second Banking Directive eventually adopted included only a national treatment test, not reciprocity.[40]

4. Intense 'market-friendly' transatlantic regulatory cooperation in banking in the late 1990s and mid 2000s

From the late 1990s to the outbreak of the international financial crisis, the intensity of transatlantic regulatory cooperation was high because the regulatory preferences in the US and the EU (and within the EU) were broadly aligned. Internationally, the Basel II agreement was negotiated without the deep-seated divisions between the US and the EU (or, to be precise, continental European countries) that characterised the negotiations on Basel I. Bilaterally, the US and the EU continued to apply to each other's banks the principle of national treatment or non-discrimination. Furthermore, the Federal Reserve issued some exemptions for European banks operating in the US – it was a tentative step towards mutual recognition.

4.1 US-EU cooperation in international 'market-friendly' harmonisation: Basel II

The 1990s and early 2000s were characterised by the absence of major banking crises in the US and the EU. Several large banks that had complex risk management models in place began to lobby hard to convince policy-makers that this should be taken into account in setting (lowering, in their case) capital requirements.[41] The US and UK that hosted several large cross-border banks were particularly sympathetic to this view which, however, was also widely accepted by the other BCBS members. It should also be noted that by 2003 US banks had improved their capital positions, as compared to European banks, including the UK (see Table 1).

The negotiations on Basel II, the successor of Basel I, gained momentum in June 1999, and the accord was eventually agreed in 2004. It based capital requirements on three pillars. Pillar One was concerned with minimum capital requirements, covering three types of risk: 'credit risk', 'market risk', and, innovatively, 'operational risk'. Pillar 2 was based on a supervisory review process, aimed at covering external factors that were not fully taken into account when computing the minimum capital requirements. Finally, Pillar 3 was to be the discipline imposed by the market, facilitated by transparency requirements.

Unlike Basel I, which was largely based on the US regulatory template, Basel II contained a new set of rules that was not uploaded by any national jurisdiction. Whereas it partly built on Basel I, the new rules were informed by proposals and studies from large cross-border banks and banking associations, first and foremost the Institute for International Finance.[42] The influence of large banks was strengthened by the fact that the BCBS had insufficient expertise and had to rely on the banks and banking associations to provide technical input into the process.[43] As opposed to the negotiations on Basel I, on Basel II there was no clear cut division between the US and UK on one side and continental European countries on the other.

Overall, the US and the EU had similar (or at least compatible) preferences, with the main exception concerning the implications of the new capital rules for the real economy and to be precise for bank credit to small and medium-sized enterprises (SMEs). In the US and to some extent in the UK, the bank-industry relationship was weak in comparison to that found in continental European countries, where banks provide the main source of funding to industry (see Table 1), especially to SMEs

which produce a comparatively large part of national output in Germany, France and Italy.[44] The changes that were agreed during the negotiations to the rules regarding the risk weight for lending to SMEs can largely be ascribed to the activity of the representatives from the main European countries.[45]

What accounts for the alignment of preferences across the Atlantic unlike during the previous period? The explanation is two-fold. First, although the configuration of the banking systems in the US and across the EU did not substantially change or converge over the 1990s, it was easier for regulators on both sides of the Atlantic to agree on making rules more market friendly, than it had been for them to agree on the tightening up of rules in Basel I and later on in Basel III. Moreover, the absence of major financial upheavals in developed countries in this period facilitated the convergence of national regulators towards the US-UK sponsored market-friendly approach to financial market regulation.[46]

The Basel II accord was subsequently downloaded, with some modifications, into EU legislation — the so-called CRD III (2006) — which applied to banks and investment firms of all sizes.[47] By contrast, towards the end of the Basel II negotiations, US policy-makers made clear that they intended to apply Basel II rules to only 15 or so internationally active banks.[48] Local community banks complained that the application of Basel II in the US would reduce capital requirements for big banks, giving them a comparative advantage vis-à-vis community banks.[49] Some members of Congress shared these concerns,[50] which substantially delayed the implementation of Basel II in the US.[51] Hence, even though EU-US cooperation was intense during the

Basel II negotiations, it weakened in the context of the domestic implementation phase in the US.

4.2 Building US-EU cooperation in bilateral regulatory relations: limited exemptions

The bilateral regulatory approach based on national treatment in the US and the EU was maintained when Congress passed the Gramm-Leach-Bliley Act of 1999, which removed most restrictions on affiliations between commercial banks and other kinds of financial firms for both domestic and foreign banks operating in the US.[52] The Act also permitted a foreign bank to become a financial holding company. These changes reduced the divergence between the US and EU regulatory frameworks. Subsequently, in 2001, the Federal Reserve issued an exemption whereby a foreign bank holding company operating in the US but owned by a well-capitalised and well-managed foreign bank was not required to meet the capital requirements normally applicable to bank holding companies.[53] This exemption was an important step towards mutual recognition.

5. The conundrum of post crisis transatlantic cooperation in banking

The international financial crisis was followed by waves of regulatory reform in the US and the EU. The intensity of transatlantic regulatory cooperation decreased in comparison to the pre-crisis decade because the preferences of the US and the EU were not aligned, and within the EU certain countries, notably the UK and Sweden, shared several preferences with the US. International harmonisation was fraught with difficulty, and the negotiations on Basel III were characterised by a division between

the US and UK on one side, and continental European countries on the other. In bilateral relations, the US and the EU backtracked on mutual recognition and some regulatory disputes emerged. Finally, transatlantic cooperation in financial (including banking) regulation was also discussed in the context of the Transatlantic Trade and Investment Partnership (TTIP).

5.1 Limited US-EU cooperation in ratcheting–up international harmonisation: Basel III

The global financial crisis brought into sharp relief the inadequacy of existing capital requirements and therefore the need to revise the content of the Basel II accord. The BCBS put forward concrete proposals in December 2009 and the final agreement was reached in September 2010. The new rules will be phased in gradually from January 2013 until 2019. The Basel III accord built on the Basel II Accord rather than reinventing it altogether.

In the negotiations on Basel III, the 'old' (i.e., Basel I) divide re-emerged between the US and the UK on the one side, and continental European countries on the other.[54] The US and the UK wanted a stricter definition of capital, to be limited to ordinary shares; higher capital requirements, including capital buffers; a leverage ratio; liquidity rules; and a short transition period.[55] Continental countries, in particular France and Germany, wanted lower capital requirements and a broader definition of capital, including hybrids — that is, capital which has some features of both debt and equity, including silent participations (long term loans). They opposed the leverage ratio, asked for a modification of certain aspects of the liquidity rules, and pushed for

a longer transition period.[56] The main bone of contention was the effect that the tightening up of prudential rules for banks would have on economic growth, especially in continental countries where banks provide most of the credit to the real economy.

As during the previous periods, the different, and at times incompatible, preferences of the US and the UK on one side and continental European countries on the other were rooted in the different configuration of their national financial systems and their domestic regulatory frameworks. The US and the UK had been badly hit by the international financial crisis. Hence policy-makers in these jurisdictions were keen to set in place measures that would avoid another crisis. Partly as a result of state capital injections (and de facto nationalisation of certain banks in the UK), UK banks and especially US banks were well positioned to meet higher capital requirements (see Table 1).[57] As for the definition of capital, banks in these two countries mostly had ordinary shares, which was what US and UK policy-makers advocated for the definition of capital in Basel III. There was far less bank reliance on hybrids. The leverage ratio was already used in the US, and so were liquidity rules that the UK had unilaterally introduced in the midst of the crisis.[58]

In comparison to their US and UK counterparts, most continental European banks were less well capitalised (see Table 1). Hence they would have faced serious difficulties in meeting higher capital requirements. Many continental banks had distinctive sources of funding and did not issue equity; thus continental policy-makers called for a 'broad' definition of what would count as Core Tier 1 and Tier 1 capital. Indeed, hybrids, and specifically silent participations, were included in the definition

of Core Tier 1 capital according to the domestic regulatory framework in several continental countries, even though they lacked the loss absorbing character of equity.[59] Policy-makers in these countries resisted a leverage ratio, arguing that the riskiness of the activities of their traditional universal banks was lower than that of (largely Anglo-Saxon) investment banks[60] and that this feature would not be captured by a crude leverage ratio. Continental policy-makers opposed strict liquidity rules, which was the weak spot especially of French banks which relied more heavily than most of their European competitors on short-term funding on wholesale markets.[61] Finally, continent policy-makers called for a prolonged phase-in period, given their concerns about the potential impact of these measures on lending on the bank-based continental financial systems (see Table 1), where banks were the main source of finance for firms, especially for SMEs.[62]

Despite attempts by the European Commission to forge a common position, the EU presented a disjointed stance during the Basel III negotiations. As in Basel I and II, the EU was unable to project a common set of preferences on Basel III. Unlike Basel I, in which the influence of the US and the UK was predominant, Basel III was a compromise between the positions of the two coalitions at play. In particular, continental Europeans were able to secure longer transition periods and lower capital requirements, as evidenced by the comparison of the initial document issued by the BCBS in December 2009 and the (less ambitious) document eventually agreed in December 2010.[63] In the domestic implementation of the accord, the EU was criticised for not implementing Basel III properly because the CRD IV differed in several important respects from the internationally agreed standards.[64] In the US, the

Basel III rules were considered as a floor, not a maximum, as explained in the following section.

5.2 Going its own way: US rules on foreign-owned banks

The Dodd-Frank Act, which was the main regulatory response in the US to the global financial crisis,[65] instructed the Federal Reserve to implement enhanced prudential standards for large foreign banks as well as for large domestic bank holding companies and nonbank systemically important financial institutions. The Act also extended the well-capitalized and well-managed requirements beyond US bank subsidiaries to the top-tier US and foreign holding companies.[66] The so-called Collins Amendment, named after the Congressman who championed it, removed the exemption from the bank holding companies' capital requirements granted by the Federal Reserve to foreign banks in 2001.[67] Certain foreign banks, such as Barclays and Deutsche Bank, circumvented this provision by dropping the bank holding company status.[68]

The Fed responded by putting forward a proposal in December 2012 whereby foreign banks that had more than $50 billion in US assets and also exceeded that level via their non-US operations would have to place all their US subsidiaries into an intermediate holding company, a provision that challenged the established principle of national treatment. These intermediate holding companies would be expected to comply with Basel III's capital and liquidity standards on their own terms, and would be subject to the Fed's stress-testing regime.[69] Foreign-owned banks with less than

$50 billion in US assets would be required to set up intermediate holding companies, but would face less onerous regulations.

Deutsche Bank, which was reported to need to inject $20bn into Taunus to meet these requirements, complained to US policy-makers, arguing it was put at a competitive disadvantage compared to American banks that operated overseas.[70] The European Commission and some European policy-makers also complained to US policy-makers, arguing that the proposed rules ran counter to the principle of consolidated supervision by the home authorities, and imposed additional costs for EU banks operating in the US. Michel Barnier, the European Commissioner for the Internal Market, wrote to Chairman of the Federal Reserve, Ben Bernanke and warned that:

> certain elements of the 'Foreign Banking Organizations' Notice of Proposed Rulemaking' … could spark a protectionist reaction from other jurisdictions.[71]

Despite the EU's call for exemptions based on the principle of equivalence, in July 2013, the Federal Reserve approved a final rule on the banks' capital framework, as part of the domestic implementation of the Basel III rules. The legislation asserted that US subsidiaries of foreign-owned banks had to comply with the US implementation of the Basel rules, whereby the US policy-makers wanted to make sure that enough capital was available in the US to deal with foreign-owned banks experiencing financial difficulties.

5.3 Seeking new forms of transatlantic cooperation: the Transatlantic Trade and Investment Partnership (TTIP) (2013-15)

In early 2013, the European Commission and US Government agreed to launch negotiations on a free trade agreement called the Transatlantic Trade and Investment Partnership (TTIP).[72] The main aims of the partnership were to increase trade and investment between the US and EU by reducing tariffs (particularly on agricultural products), aligning regulations and standards, improving protection for overseas investors, and increasing access to services and government procurement markets by foreign providers.

Since both the US and the EU included financial services in prior free trade agreements, they implicitly recognized that the TTIP accord would also cover this sector, but they disagreed about what to include in the financial services chapter. The US preferred to handle financial services as in prior trade negotiations by including market access issues in the TTIP. But US Trade Representative Michael Froman argued that 'that nothing we do in a trade agreement should undermine the ability of regulators on both sides to regulate in the public interest' and that regulatory cooperation should be negotiated within 'existing and appropriate global forums, such as the G-20 and international standard setting bodies, in parallel alongside the TTIP negotiations'.[73] US policy-makers argued that financial regulation was not a trade issue and were concerned that the financial industry in the US would seek to use regulatory convergence with the EU in order to dilute the financial regulation adopted in the US after the global financial crisis.[74]

In contrast, the EU wanted to move beyond what had been included in previous trade agreements. In June 2013, the Council of Ministers' directives for the negotiations on TTIP stated the aims of 'regulatory harmonisation, equivalence, or mutual recognition, where appropriate'.[75] With reference to 'sectors of significant importance to the transatlantic economy, including, financial services' the objectives were 'ensuring the removal of existing NTBs, preventing the adoption of new NTBs and allowing market access' as well as 'common frameworks for prudential cooperation'.[76] With the energetic support of the European Banking Federation, EU officials argued that leaving out any discussion of regulation of the financial services industry in the proposed TTIP would be an omission.[77]

In January 2014, the European Commission produced a position paper proposing that regulatory cooperation between the EU and the US should be based on a number of principles. The most important and unprecedented was the proposal for 'mutual consultations in advance of any new financial measures that may significantly affect the provision of financial services between the EU and the US and to avoid introducing rules unduly affecting the jurisdiction of the other party'.[78] The financial industry on both sides of the Atlantic was keen to have financial services regulation included in TTIP.[79]

In May 2014, a (leaked) document produced by the European Commission for the EU Trade Policy Committee, revealed that the EU offer did not contain any commitment on financial services reflecting the view that 'there should be close parallelism in the negotiations on market access and regulatory aspects of financial services. Given the firm US opposition to include financial services regulatory cooperation in TTIP, it is

considered appropriate not to include any commitment concerning financial services to the general EU's market access offer at this stage. The situation may change in the future if the US shows willingness to engage solidly on regulatory cooperation'.[80] This was clearly an attempt by the EU to put pressure on the US to revise their negotiation position on financial regulatory cooperation in TTIP.[81] However, this attempt to put pressure on the US was not very successful because US financial firms and products already had very good access to the EU market under international agreements dating back 20 years. The EU had also made a services offer in a separate multilateral services trade deal, to which the United States was a party, which did include financial services.[82]

The EU was keen to include financial regulation in TTIP for three main reasons. First, the EU wanted to limit the extra territorial reach of some US rules, for example in banking or OTC derivatives. Barnier explicitly argued in this context that

> …US rules on Foreign Banking Organizations should be revised. They do not recognize non-US prudential rules. And they discriminate against non-US banks. And we need to prove that we trust each other by ensuring equivalence or 'substituted compliance'.[83]

Second, EU policy-makers preferred to negotiate with one set of US policy-makers (namely, trade officials) in the context of the TTIP, rather than negotiating transatlantic financial regulatory issues with a multitude of US financial regulators. Third, EU policy-makers hoped that US negotiators in TTIP would be more amenable to compromise than US financial regulators, whose primary mission was securing

financial stability and consumer protection in the US. By contrast, the US authorities ruled out the inclusion of financial services in TTIP. The main opposition came from US financial regulators, who opposed the discussion of regulatory matters that were their responsibility in the context of trade negotiations and argued that financial regulatory cooperation should continue separately in existing global fora.[84]

Conclusion

This paper contributes to and develops further one of the main themes of the special issue[85] — namely the conundrum concerning post crisis international and transatlantic regulatory cooperation in banking — by considering this cooperation from a broader long term perspective and pointing to its ebb and flow over time. Three broad conclusions can be drawn as to the development of cooperation over the past twenty-five years.

First, transatlantic regulatory cooperation was more intense in the 1990s and mid 2000s when — in the absence of major financial crises in the western world — US and EU preferences converged towards a 'market-friendly' approach, which was based on reducing regulatory constraints. Transatlantic regulatory cooperation was more problematic in the aftermath of the international financial crisis, when international banking guidelines (Basel III) and domestic banking regulation were tightened up — the latter albeit in different ways. Hence, financial crises do not necessarily facilitate regulatory cooperation because even if national regulators might have the same objective, that is to restore financial stability, the configuration of national financial systems and their links to the real economy are different. National

regulators have different preferences on the content of re-regulation after crises. The EU was internally divided on this issue.

Second, the US and the EU privileged different forms of and venues for transatlantic regulatory cooperation. Moreover, the EU was internally divided on this issue. The US and the UK sought international regulatory harmonisation in international financial fora — to be precise the BCBS — for three main reasons. First, the US and especially the UK had many foreign banks operating on their territory. Hence they were particularly sensitive to the need to avoid competitive distortions internationally, and this could be achieved only through international standards.[86] Second, the US and (less) the UK have traditionally been very influential in the BCBS, as well as in other international regulatory fora in finance.[87] Third, since the Basel accords were not legally binding, they did not tie the hands of US regulators that enjoyed extensive regulatory powers domestically. In addition to international regulatory harmonisation, the US pursued a unilateralist approach in banking regulation post crisis because this approach had been used in the past, especially in securities markets.

Third, the EU preferred mutual recognition — particularly with the reinforcement of EU regulatory capacity over time — as the main form of transatlantic regulatory cooperation. Mutual recognition allowed the EU to present a cohesive position based on EU legislation, which, in turn, was often the result of the reconciliation of the different member state preferences. In international fora, the EU was often unable to present a cohesive position because of the different preferences of the member states and the lack of unified representation. By contrast, the European Commission was in the driving seat in negotiating mutual recognition agreements on behalf of the EU as

well as in the TTIP negotiations. The EU was a pace-setter in mutual recognition, which was a core principle of the single European financial market.

References and notes

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[2] See Ahearn, R.J. (2009) Transatlantic Regulatory Cooperation: Background and Analysis. CRS Report for Congress, August. Washington, DC: Congressional Research Service. http://fas.org/sgp/crs/row/RL34717.pdf, accessed 31 March 2015. See also Pollack M.A. (2003) The Political Economy of the Transatlantic Partnership. RSCAS, EUI, report. www.eui.eu/Documents/RSCAS/e-texts/200306HMTMvFReport.pdf, accessed 31 March 2015.

[3] US policy-makers prefer the expression 'substituted compliance' instead of 'mutual recognition'. The EU often uses the concept of 'equivalence' (Ferran 2012), whereby if third country rules are deemed to be equivalent to EU rules, foreign firms providing services in the EU are not subject to EU regulation in addition to their home country regulation. Mutual recognition does not necessitate reciprocity, though de facto this is often the case (Verdier 2011). See Ferran E. (2012) Crisis-driven regulatory reform: where in the world is the EU going? In: E. Ferran E. et al. (eds.) *The Regulatory Aftermath of the Global Financial Crisis*. Cambridge: Cambridge University Press; Verdier, P.H. (2011) Mutual Recognition in International Finance. *Harvard International Law Journal* 52 (1): 55-109.

[4] See Verdier, P.H. (2011) Mutual Recognition in International Finance. Harvard International Law Journal, 52, 1: 55-109; Schmidt S.K. (2007) Mutual recognition as a new mode of governance. *Journal of European Public Policy* 14 (5): 667-681.

[5] The use of 'exemptions' is also a weak form of mutual recognition, whereby regulators in one jurisdiction exempt foreign firms operating in their territory from the application of certain domestic rules.

[6] Harmonisation could also take place bilaterally, though this is less frequent and is generally part of the process of mutual recognition.

[7] See Drezner, D. W. (2007) *All Politics Is Global: Explaining International Regulatory Regimes*. Princeton: Princeton University Press; Simmons, B. (2001) The International politics of harmonisation: The case of capital market regulation. *International Organization* 55: 589–620; Singer, D.A. (2007) *Regulating capital: setting standards for the international financial system*. Ithaca: Cornell University Press.

[8] On the one hand, one could argue that the fact that the US and the EU (and its member states) are able eventually to reach an international agreement, despite having very different preferences and after controversial negotiations, is evidence of cooperation. On the other hand, the agreements reached in this way are often based on the minimum common denominator, and are more likely to be implemented with substantial divergence at the level of the jurisdiction. This is transatlantic cooperation of low intensity.

[9] For an exception, see Quaglia, L. (2014), *The European Union and Global Financial Regulation.* Oxford: Oxford University Press and Quaglia, L. (2014) The European Union, the USA and International Standard Setting in Finance. *New Political Economy*, 19 (3): 427-44.

[10] The BCBS brings together national central banks and banking supervisors from the countries in the Group of Twenty (G 20). Prior to the international financial crisis, the BCBS included representatives from the Group of Ten (G 10).

[11] Kapstein, E. (1989) Resolving the Regulator's Dilemma: International Coordination of Banking Regulations. *International Organization* 43 (2): 323–47; Kapstein, E. (1992) Between Power and Purpose: Central Bankers and the Politics of International Regulation. *International Organization*, 46 (1): 265–87; Simmons, B. (2001) The International politics of harmonisation: The case of capital market regulation. *International Organization* 55: 589–620; Singer, D.A. (2007) *Regulating capital: setting standards for the international financial system*. Ithaca: Cornell University Press.

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[13] Howarth, D. and Quaglia, L. (2015). The Comparative Political Economy of Basel III in Europe and regulators' 'trilemma'. Unpublished manuscript; Young, K.L. (2012) Transnational Regulatory Capture? An empirical examination of the transnational lobbying of the Basel Committee on Banking Supervision. *Review of International Political Economy* 19 (4): 663-88.

[14] Posner, E. (2009) Making rules for global finance: Transatlantic regulatory cooperation at the turn of the millennium. *International Organization* 63: 665–99; Posner, E. (2010) Sequence as explanation: the international politics of accounting standards. *Review of International Political Economy*, 14 (4): 639–664; Leblond, P. (2011) EU, US and international accounting standards: A delicate balancing act in governing global finance. *Journal of European Public Policy* 18 (3): 443-461; Pagliari, S. (2013) 'A Wall Around Europe?: The European Regulatory Response to the Global Financial Crisis and the Turn in Transatlantic Relations'. *Journal of European Integration*, 35 (4): 391–408. Quaglia, L. (2014), *The European Union and Global Financial Regulation.* Oxford: Oxford University Press.; for an exception, see Dür, A. (2011) Fortress Europe or open door Europe? The external impact of the EU's Single Market in financial services. *Journal of European Public Policy* 45 (5): 771–787.

[15] Kapstein, E. (1989) Resolving the Regulator's Dilemma: International Coordination of Banking Regulations. *International Organization* 43 (2): 323–47.

[16] Howarth, D. and Quaglia, L. (2015). The Comparative Political Economy of Basel III in Europe and regulators' trilemma'. Unpublished manuscript.

[17] Drezner, D. W. (2007) *All Politics Is Global: Explaining International Regulatory Regimes*. Princeton: Princeton University Press.

[18] See Hardie I. and Howarth D. (eds.) (2013) *Market-Based Banking and the International Financial Crisis*. Oxford: Oxford University Press.

[19] See Howarth, D. and Quaglia, L. (2015). The Comparative Political Economy of Basel III in Europe and regulators' trilemma'. Unpublished manuscript.

[20] Büthe, T. and Mattli, W. (2011) T*he New Global Rulers: The Privatization of Regulation in the World Economy*. Princeton: Princeton University Press.

[21] See Posner, E. (2009) Making rules for global finance: Transatlantic regulatory cooperation at the turn of the millennium. *International Organization* 63: 665–99. See also Bach, D. and Newman, A.L. (2007) The European regulatory state and global public policy: Micro-Institutions, macro-Influence. *Journal of European Public Policy* 14 (6): 1–20.

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[35] Over time, the standards set by the BCBS came to be applied in over 100 countries, well beyond the limited number of signatories.

[36] To be sure, prior to the International Banking Act of 1978, foreign (including European) banks, where exempted from the geographical restrictions imposed on US banks. Following the International Banking Act of 1978, such restrictions were extended to foreign (including European) banks.

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[38] *Ibid.*

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[40] *Ibid.*

[41] Underhill, G.R.D. and Zhang X. (2008) Setting the rules: private power, political underpinnings, and legitimacy in global monetary and financial governance. *International Affairs* 84 (3): 535-554; Tsingou, E. (2008) Transnational private governance and the Basel process: banking regulation and supervision, private interests and Basel II' in J-C. Graz and A. Noelke (eds.) *Transnational private governance and its limits*. London: Routledge.

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[49] See, for example, Paletta, D. (2005) Backlash on asel Hits Fed – What Now?. *American Banker*, 6 October. Sloan, S. (2006) Why Big Banks' Basel Tactics May Not Work. *American Banker*, 10 October.

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[51] See Herring, R.J. (2007) The Rocky Road to Implementation of Basel II in the United States. *Atlantic Economic Journal* 35 (4): 411-429.

[52] See http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm#fn3.

[53] Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2001). Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies Owned by Foreign Banking Organizations. Supervision and Regulation Letter 01-01, 5 January.

[54] *Financial Times*, 15 February 2011.

[55] *Financial Times*, 22 October 2010; 13 September 2010.

[56] see Howarth, D. and Quaglia, L. (2015). The Comparative Political Economy of Basel III in Europe and regulators' 'trilemma'. Unpublished manuscript.

[57] UK banks were better positioned than it appears on Table 1 if data on Tier 1 capital are considered.

[58] Howarth, D., and Quaglia, L. (2013) 'Banking on Stability: The Political Economy of New Capital Requirements in the European Union'. *Journal of European Integration*, 35 (3): 333–46.
[59] Howarth, D. and Quaglia, L. (2015). The Comparative Political Economy of Basel III in Europe and regulators' 'trilemma'. Unpublished manuscript
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[61] Howarth, D. (2013) 'France and the International Financial Crisis: The Legacy of State-Led Finance. *Governance,* 26(3), 369–39
[62] See Howarth, D. and Quaglia, L. (2015). The Comparative Political Economy of Basel III in Europe and regulators' 'trilemma'. Unpublished manuscript.
[63] Extensive lobbying from the financial industry also accounts for this watering down of the rules. See Young, K.L. (2012) Transnational Regulatory Capture? An empirical examination of the transnational lobbying of the Basel Committee on Banking Supervision. *Review of International Political Economy* 19 (4): 663-88.
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[65] See Woolley, J. T., and Ziegler, J. N. (2012) The Two-Tiered Politics of Financial Reform in the United States. In: R. Mayntz (ed.) *Crisis and Control: Institutional Change in Financial Market Regulation*. Cologne: Max Planck Institute for the Study of Societies; Acharya, V. V., Cooley, T. F., Richardson, M. P. and Walt, I. (2011) *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*. New Jersey: Wiley and Sons.
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[67] See Section 4
[68] See http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm#fn7
[69] Tarullo, D. K. (2011) Capital and Liquidity Standards, Before the Committee on Financial Services, U.S. House of Representatives, Washington, D.C., June 16.
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[76] *Ibid*.
[77] *Financial Times*, 27 January 2013
[78] European Commission (2014), Paper for the Trade Policy Committee, p. 3.
[79] See, for example, Association for Financial Markets in Europe (AFME) and Securities Industry and Financial Markets Association (SIFMA) (2014), Statement of TTIP, http://www.sifma.org/newsroom/2014/sifma_and_afme_statement_on_ttip/ last accesed on 1 April 2015. For further discussion see Jones E. and Macartney, H., this special issue
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