# *US and EU Cooperation on Financial Regulatory Reform during the Financial Crisis: The Role of Interdependence*

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# ABSTRACT

After progressively deepening political, security, trade and financial ties over successive decades, at the time the financial crisis hit Europe in 2008, the level of financial and economic interdependence between the United States and the European Union was highly developed. Examining several case studies on US and EU cooperation on financial regulatory reforms in the early stages of the financial crisis — the convergence of accounting standards across the Atlantic, the regulation of credit default swaps, the regulation of credit ratings agencies and a reinforced role for the International Monetary Fund and the Financial Stability Board — this thesis considers the role that financial and economic interdependencies played in policy decision-making. It follows an approach outlined by Keohane and Nye, considering the political processes involved in situations of complex interdependence.

This research shows how, in an effort to save, protect and reinforce their respective and common financial and economic interests in each other's markets and around the world, they developed a coordinated agenda for bilateral and international financial regulatory reform. The result was not only a deeper relationship, intensification of the transgovernmental decision-making policy process, but also greater policy convergence in several financial regulatory issue-areas.

This research finds there are several important theoretical and policy implications of this cooperation. It shows how financial markets and economic interdependencies had a direct causal effect on the decisions by regulators and policy-makers to cooperate on policy reform. US and EU financial and economic interdependencies were found to have constrained the agenda of political actors and diminished their alternatives. The policy implications are that closing existing gaps in transatlantic financial governance, sustaining political will for close policy cooperation and maintaining a robust regular and effective dialogue to contain the risks of financial contagion in the transatlantic market remains imperative.

# DECLARATION

This thesis contains no material which has been accepted for the award of any other degree or diploma at any university or equivalent institution and, to the best of my knowledge and belief, this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

[redacted]

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# LIST OF ABBREVIATIONS

| | |
|---|---|
| BCBS | Basel Committee on Banking Supervision |
| BIS | Bank for International Settlements |
| CDOs | Collateralised Debt Obligations |
| CDS | Credit Default Swaps |
| CESR | Committee of Securities Regulators |
| EBA | European Banking Authority |
| ECB | European Central Bank |
| ECJ | European Court of Justice |
| ECOFIN | Economic and Financial Affairs Council |
| ESCB | European System of Central Banks |
| ECSC | European Coal and Steel Community |
| EEC | European Economic Community |
| EFSF | European Financial Stability Facility |
| EFSM | European Financial Stability Mechanism |
| EMDC | Emerging Market and Developing Economy |
| EPU | European Payments Union |
| ESM | European Stability Mechanism |
| ESMA | European Securities and Markets Authority |
| ESRB | European Systemic Risk Board |
| FMRD | Financial Markets Regulatory Dialogue |
| FSB | Financial Stability Board |
| FSF | Financial Stability Forum |
| FSIC | US Financial Stability Oversight Council |
| G20 | Group of 20 Nations |
| G8 | Group of 8 Nations |
| GAAP | Generally Accepted Accounting Practices |
| GFC | Global Financial Crisis |
| IAIS | International Association of Insurance Supervisors |
| IASB | International Accounting Standards Board |
| IBRD | International Bank for Reconstruction and Development |
| IFRS | International Financial Reporting Standards |
| ISDA | International Swaps and Derivatives Association |
| IMF | International Monetary Fund |
| IMFC | International Monetary and Financial Committee |
| INGO | International Non-Governmental Organisation |
| IOSCO | International Organization of Securities Commissions |

| | |
|---|---|
| MDBs | Multilateral Development Banks |
| NAFTA | North American Free Trade Agreement |
| NATO | North American Treaty Organisation |
| NTA | New Transatlantic Agenda |
| OECD | Organisation for Economic Co-operation and Development |
| OEEC | Organisation for European Economic Co-operation |
| OIA | US Office of International Affairs |
| OMTs | Outright Monetary Transactions |
| OTC | Over the Counter Trading |
| PWGFM | US President’s Working Group on Financial Markets |
| SCIMF | Sub-Committee on IMF |
| SEC | US Securities and Exchange Commission |
| SDRs | Special Drawing Rights |
| SGP | Stability and Growth Pact |
| TABD | Transatlantic Business Dialogue |
| TACD | Transatlantic Consumer Dialogue |
| TALD | Transatlantic Legislators Dialogue |
| TEC | Transatlantic Economic Council |
| TEP | Transatlantic Economic Partnership |
| TEU | Treaty on European Union |
| TFEU | Treaty on the Functioning of the European Union |
| TTIP | Transatlantic Trade and Investment Partnership |

# INTRODUCTION

In September 2008 as a stock market downturn in the US escalated into a financial system crisis with the collapse of the investment bank Lehman Brothers, the interconnectedness of the US and EU financial markets were laid bare. Huge losses generated by risky and highly leveraged financial products on one side of the Atlantic translated into simultaneous losses on the other side. The effects were carried across the Atlantic literally at the speed at which computers and the internet could transmit data. As one financial institution after another collapsed in the US and the EU, liquidity in the banking markets dried up on both sides of the Atlantic, with banks unsure which other banks also teetered on the brink of collapse.

The crisis was the result of a perfect storm, involving the proliferation of risky financial products linked to poorly collateralised mortgage loans, mostly in the US but also in Europe, and the immense growth of leveraged risky stock derivatives products (notably credit default swaps) that were largely unregulated in both the US and Europe. The growth of these product areas had been facilitated by innovation in the financial markets and the proliferation of communication technologies in the previous decade. Credit ratings agencies, which were also largely unregulated, had given these products their top AAA ratings. Over the following months, the implications of the extensive transatlantic marketplace that the US and the EU had built over several decades became apparent. The US and the EU had formed a series of major transatlantic agreements since the 1990s — the Transatlantic Declaration in 1990, the New Transatlantic Agenda in 1995 and the Transatlantic Economic Partnership in May 1998 — to promote and facilitate transatlantic economic integration. These had brought significant benefits but had also created a highly connected market where financial contagion could be easily transmitted from one side of the Atlantic to another. It also intensified financial and economic interdependencies that made US and EU cooperation on a response to the financial crisis absolutely imperative.

The crisis triggered a period of intense detailed policy cooperation between the US and the EU unseen in years. Important areas of financial regulation that had been overlooked in the haste to build closer transatlantic economic ties had to be addressed quickly and in a coordinated manner. The US Government bought toxic loans directly off US banks and the UK Government bought preferential shares of troubled banks. It was the same strategy to bail out the "too big to fail" banks, but different tactics. Key European governments also moved to bail out their banks, as balance sheets deteriorated rapidly and as confidence in the banking sector collapsed. The US and the EU negotiated and established an agenda to reform a range of financial areas, including credit ratings agency regulations, accounting standards, securitised financial products, credit default swaps and over the-counter derivatives trading among others.

On a bilateral level, as the financial crisis progressed, the US and the EU cooperated closely on a range of reforms through existing institutional arrangements. At the intergovernmental level discussion took place on special state visits and at US-EU summits and, at the transgovernmental level, discussion took place in regular meetings and frequent communication as well as the more formalised Financial Markets Regulatory Dialogue (FMRD), a forum comprised of US and EU regulators. The US and the EU collaborated closely on myriad aspects of reform, from credit ratings agencies, derivatives, accounting standards to banking prudential reforms. They also sought to establish a common reform agenda for the international financial environment to ensure global financial stability and secure their own financial, economic and political interests abroad.

The initial forum chosen to coordinate the international regulatory response was the G20 process where the US and the EU dominated. The International Monetary Fund (IMF), whose role in providing international assistance had been waning at the time, was given a central role in responding to the crisis and in providing financial assistance to countries in financial difficulty, notably EU member states that were unable to find funding from the private markets. The US and the EU also saw it as important to continue the role of the then-Financial Stability Forum (FSF) and the existing various international financial standards-setting bodies.

The contagion of the financial crisis from the US to the EU highlights the extent to which the transatlantic markets were highly interconnected. However, as Keohane and Nye argued in 1977 there is a distinct difference between interconnectedness and the more profound bind that affects the way states approach policy in respect to other states[1]. The latter, coined as interdependence, can be defined in broad terms as "mutual dependence"[2]. As the literature review explores, the degree to which this mutual dependence has affected state policy behaviour has been a focus of significant scholarly research by political scientists in the postwar era, amid growing levels of transatlantic trade, foreign investment and capital flows and amid widespread technological change and industrialisation. The spread of financial contagion and the quick efforts on the part of the US, the European Commission and key EU member states to coordinate financial reform raises questions about the extent to which interdependence may have played a role in affecting state behaviour, specifically the decision on the part of the US and the EU to coordinate their policy response and even converge their regulatory regimes. This thesis seeks to explore this question, examining the plausibility of complex interdependence theory, as outlined by Keohane and Nye, as an explanation for the US and the EU's response on financial reform.

[1] Keohane, Robert and Nye, Joseph S. (1977), *Power and Interdependence: World Politics in Transition*, Little Brown and Company, Boston, pp. 8-9.
[2] *Ibid.*

# LITERATURE REVIEW

As a concept that recognises the interconnectedness of states in international relations, interdependence has been used since Machiavelli's time[1], but expanding world trade and foreign investment levels after World War II led to considerable scholarly analysis on the topic. Economists and political scientists alike have since used the term to describe and understand connectedness between states. The postwar period has seen considerable expansion and development of the idea, with greater attempts to define it, measure it and gauge its effect on state behaviour and world politics.

After considerable scholarly discussion on the subject in the 1960s and 1970s, Keohane and Nye developed the first comprehensive theory of what they termed complex interdependence, even though, as discussed later, both they and other scholars have shied away from referring to it as a theoretical explanation for state behaviour per se. Conceptions of interdependence have since become situated in the broader school of neoliberal thinking about international relations particularly since the 1980s and yet, as Rosamond argues, interdependence remains politically significant because it contributes to understanding of the policy behaviour of actors[2].

This chapter outlines the development of the idea of interdependence in the postwar period and specifically Keohane and Nye's theory of complex interdependence. It describes their approach to defining the concept, their models for analysing it and their approach to understanding how it affects state behaviour. It further outlines key criticisms of the theory and its usefulness in understanding world politics.

## Background to Conceptions of Interdependence

Interdependence as a concept developed in the mid part of the last century. Deutsch in the mid-1950s defined it broadly in terms of "interlocking relationships" that bound parties together in a more compelling way than just being responsive to each other's concerns[3]. In the postwar era in which transatlantic trade and foreign investment levels were growing rapidly and in which technological developments were making doing business easier and faster, scholars examined interdependence in distinctly economic terms. Deutsch and Eckstein conducted a study in 1961 that attempted to measure interdependence by examining the ratio of foreign trade to gross national product

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[1] Baldwin, David A. (1980), "Interdependence and Power: A Conceptual Analysis", *International Organization*, Vol. 34, No. 4 (Autumn, 1980), pp. 484.
[2] Rosamond, Ben (2000), *Theories of European Integration*, Palgrave, Houndmills/New York.
[3] Deutsch, Karl W. (1954), *Political Community at the International Level: Problems of Definition and Measurement*, Doubleday, New York, p. 37

between 1890 and 1959[4]. However, arguing that while the ratio of foreign trade to GNP rose during the earlier years of industrialisation, they found it had decreased in later years. This, they said, undermined the argument that interdependence between nations was growing. Critics criticised the study as flawed, with Rosecrance pointing out for example that their study used current US dollar terms to calculate trade values[5]. Lipsey later recalculated the ratio of American exports to GNP in 1913 constant dollars and found trade levels had gone up.

In the late 1960s the argument moved away from measuring it in terms of volume, with Cooper developing concepts of interdependence further, measuring it not just in terms of volume, but of the "sensitivity" of economic transactions between two or more nations to economic developments within those nations[6]. While acknowledging growing levels of transatlantic trade, greater international travel, higher levels of capital movement and the evolution of communications technologies, he emphasised the "sensitivity" to economic developments of one nation to another.

Significantly Cooper questioned the actual political implications of such changes, suggesting that greater transatlantic interdependence compromised national autonomy. It did so not only by affecting a country's balance of international payments, forcing countries to take policy action in this area that they would otherwise "find objectionable", but also by affecting a country's ability to regulate tax and banking[7]. In an effort to find a solution to such problems, he suggested interdependent countries could either accept greater integration and the loss of national autonomy and engage in joint decision-making on economic policy; accept integration but preserve autonomy by compensating financially for prolonged deficit payments; or reject integration and re-impose trade and capital barriers[8].

Cooper's analysis not only acknowledged the growing interdependence between the US and Europe, but highlighted its importance to policy decision-making. Moreover his conclusion that interdependence had important foreign policy implications, in terms of conceptualising the character of the relationship between government and the world economic and political order, raised big questions about the origins of power in policy decision-making.

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[4] Deutsch, Karl and Eckstein, Alexander (1961), "National Industrialization and the Declining Share of the International Economic Sector, 1890-1959", *World Politics*, Vol. 13, No. 2, January.
[5] Richard Rosecrance & Arthur Stein (1973), "Interdependence: Myth of Reality", *World Politics*, Vol. 26, No. 1 (October 1973), pp. 1-27
[6] Cooper, Richard N. (1968), *The Economics of Interdependence: Economic Policy in the Atlantic Community*, Columbia University Press, New York, pp. 5-6.
[7] *Ibid*, p. 6.
[8] *Ibid*, p. 262.

In an introduction to a special issue of the journal *International Organization* in 1971, Keohane and Nye argued that the growth of transnational interactions among unions, multinationals, bankers, nongovernmental organisations, farmers and other non-state actors meant "the state-centric paradigm" of understanding international politics was becoming rapidly outdated[9]. They contended that while transnational relations were not a new phenomenon, the rise in sensitivity as a result of technological changes and the greater role of non-state actors was new[10]. Transnational relations, they argued, affected interstate politics by altering the "choices open to statesmen and the costs that must be borne for adopting various courses of action"[11].

In the following year, Cooper noted that economic interdependencies were posing bigger challenges for governments on monetary policy, taxation and regulatory policy around business such as anti-trust regulation, capitalisation requirements, disclosure requirements and trading regulations[12]. His more profound claim was that interdependence challenged the viability of the nation-state as the principal unit of decision-making[13]. His argument followed that not only could governments control interdependence through their own policy decisions, but also that interdependence was controlling them. Rosecrance and Stein, also criticising the earlier critics' dismissal of the significance of growing interdependence, similarly pointed out the implications of growing interdependence for politics, noting it was forcing government elites together[14] amid heightened transnational cooperation and greater policy "spill-over" from one policy area to another — in a way akin to Ernst Haas' conceptions of policy spill-over in what was then the European Community[15].

The writings of scholars like Cooper, Rosecrance and Stein and others came at a time of observations about how non-government actors were increasingly shaping national policies. Scholars like Huntington considered the growing role of transnational organisations in world politics, including intergovernmental organisations like the World Bank and non-government organisations like multinational corporations, churches and transnational interest groups, as well as US government agencies like the Central Intelligence Agency and the United States Agency for International Development[16].

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[9] Keohane R, and Nye S. J. (1971), "Transnational Relations and World Politics", *International Organization*, Vol. 25, No. 3, p. 345.
[10] Keohane, Robert O. and Nye, Joseph S. Jr (1987), "Power and Interdependence Revisited", *International Organization*, Vol. 41, No. 4 (Autumn, 1987), p. 725.
[11] *Ibid*, p. 727.
[12] Cooper, Richard N. (1972), "Economic Interdependence and Foreign Policy in the Seventies", *World Politics*, Vol. 24, No. 2, pp. 164-165
[13] *Ibid*, p. 161.
[14] Rosecrance, Richard and Stein, Arthur (1973), "Interdependence: Myth or Reality?", *World Politics*, Vol. 26, p. 19.
[15] *Ibid*, p. 22.
[16] Huntington, S. (1973), "Transnational Organizations in World Politics", *World Politics*, XXV, April. See also Keohane, Robert O. and Nye, Joseph S (1974), "Transgovernmental Relations and International Organisations", *World Politics*, Vol. 27, No. 1, pp. 39-62.

Several years later, in an effort to determine the conditions under which interdependence might affect policy decisions, Rosecrance et al distinguished between two types of interdependence. They suggested two measurements: horizontal interdependence (based on transactions, whether the flow of money, or people and goods), or vertical interdependence, as measured by the responses "of one economy to another in terms of changes in factor prices"[17]. They suggested three definitions. The first was that interdependence "in its most general sense" consists of a relationship of interests such that if one nation's position changes, other states will be affected by that change[18]. Another meaning, based around the economic notions, was that interdependence exists when there is an "increased national sensitivity" to external economic development, or the third and strictest definition, that of Waltz, who argued that interdependence entailed a relationship that would be costly to break[19].

## An Outline of Complex Interdependence Theory

The early part of the 1970s saw the oil crises and the collapse of the Bretton Woods system of pegged exchange rates, characterised by a distinct "leaning" towards a more globalised society without a dominant structure of cooperation (and conflict) or, as Keohane and Nye noted, a more polyarchical world order[20]. The growing levels of interdependence and changes in decision-making in world politics raised even bigger big questions about the effect of interdependencies on government behaviour. As discussed later, the effect of the collapse of the Bretton Woods system was a major factor in motivating the then-European Community to hasten plans for monetary independence from the US and down the path of economic and monetary union.

At the same time, the growing scholarly examination of transnational actors challenged thinking about how government policy was formulated. Scholars like Heclo considered the growing influence of "policy communities" — networks of skilled like-minded policy experts working in a particular policy field — in shaping policy outcomes, either directly through actual decision-making capacity or through influence[21]. Heclo for example argued that public policy was the result of the interaction of policy specialists within a specific policy area, as they gradually learned more about various aspects of the problem over time. This highlighted the fact that governments were not entirely in control of rules and

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17 Rosecrance, Richard; Alexandroff, Alan; Koehler, W., Kroll, J., Liqueur, S. and Stocker, J. (1977), Whither Interdependence?", *International Organization*, Vol. 31, No. 3 (Summer 1977), pp. 428-429.
18 *Ibid*, p. 426.
19 Waltz, *op. cit.*, p. 208.
20 Keohane, Robert O. and Nye, Joseph S. Jr. (1987), Power and Interdependence Revisited, *International Organization*, Vol. 41, No. 4 (Autumn, 1987), p. 726.
21 See Heclo, H. (1978), "Issue Networks and the Executive Establishment", in A. King (ed.), The New American Political System, Washington DC, pp. 87-124; Heclo, H. and Wildavsky, A. (1974), The Private Government of Public Money, Macmillan, London.

procedures and the shaping of international regimes.

Building on earlier work on interdependence, transnationalism and the changing role of international organisations, Keohane and Nye took their analysis of interdependence to a new level. Responding to the observation that during the 1960s Realists were slow to adapt and explain new developments that did not centre on military-security concerns (like technological developments, the growth of transnational decision-making, ground roots movements for example around environmentalism etc.), they sought to challenge traditional theories of international relations. In examining changes in power structures, they considered how interdependencies affected government behaviour and, as a result, policy outcomes.

**Keohane and Nye's Approach to Analysis of Interdependence**

Keohane and Nye approached their analysis of interdependence in three ways: with a power-oriented analysis of the politics of interdependence based on ideas of bargaining theory; through the development of a theory of what they coined "complex interdependence" and its effects on political processes; and by explaining changes in international regimes or "sets of governing arrangements that affect relationships of interdependence"[22]. They posed two major questions in their book, *Power and Interdependence*, namely what were the features of world politics when interdependence — particularly economic interdependence — was extensive, and how and why did international regimes change?[23]

In addressing the first, an important feature in their definition of interdependence was the cost to parties involved in interdependent relationships, notably the costs of withdrawing mutual dependency. Where there were costly effects, there was interdependence, but where there was not, there was simply some form of interconnectedness[24]. Another important point they noted was that mutual dependency does not need to be symmetrical or equal. One party could more be dependent on the other. Keohane and Nye also avoided any normative analysis, preferring to focus solely on the way interdependence affected political behaviour[25].

They suggested two dimensions to interdependence: sensitivity and vulnerability. The former was measured not so much by the volume or flows across borders, but instead by

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[22] Keohane, Robert O. and Nye, Joseph S. Jr. (1987), Power and Interdependence Revisited, *International Organization*, Vol. 41, No. 4 (Autumn, 1987), p. 728.
[23] *Ibid.*
[24] Keohane, Robert and Nye, Joseph S. (1977), Power and Interdependence: World Politics in Transition, Little Brown and Company, Boston, pp. 8-9.
[25] *Ibid*, pp. 9-10.

the impact of transactional dependency, however large or minor it was[26]. In contrast vulnerability was a measure of the ability of one party to break its dependence on the other. A party is sometimes more readily able to cope and adapt to a change of one party's policy but in other cases a party has few choices and incurs significant costs. Given the difference between sensitivity and vulnerability, one county might be highly sensitive to a change in policy on the part of a mutually dependent partner, but not necessarily highly vulnerable.

As an example Keohane and Nye cited the difference in vulnerability to oil price changes in the oil crisis of 1973-5. While the US, Europe and Japan were all highly sensitive to a change in price, the US was able to adapt much more easily due to the lower proportion of oil imports in its overall domestic consumption. This made it less vulnerable than the others[27]. Vulnerability could arise in numerous circumstances — both military and non-military and both economic and non-economic[28]. It could, Keohane and Nye suggested, be more relevant in the politics of raw materials, for example, where some parties simply do not have the policy flexibility in the event of price changes.

They also suggested there were three distinct characteristics of complex interdependence. The first was the existence of multiple channels — multiple interstate, transnational and transnational ties that connect societies, including formal ties between government elites; non-formal ties among non-governmental elites via face-to-face meetings and telecommunications and a web of transnational organisations such as multinational banks and corporations[29]. This manifested in a growing level of transactionalism and the growing power of multinational corporations — a characteristic that undermined Realist assumptions about state-centric power.

Secondly, the relationships between these groups were increasingly multi-issue in nature, with an absence of a clear issue hierarchy and the blurring of domestic and foreign policy realms[30]. Issues in this increasingly large pool of multiple trans-state issues were not arranged in any particular hierarchy, leading to a kind of global policy agenda anarchy. Finally military force was a less significant policy tool that states employed to influence policy change. Instead, other sources of power drove policy change[31]. In a world in which states were increasingly interdependent, there was a greater reluctance to use military power to secure outcomes.

[26] *Ibid*, pp. 12-16.
[27] *Ibid*, p. 12.
[28] *Ibid*, p. 17.
[29] *Ibid*, p. 24.
[30] *Ibid*, p. 25.
[31] *Ibid*.

**Table 1: The Three Characteristics of Complex Interdependence**

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|---|
| Multiple channels comprised of formal and informal connections between government elites and formal and informal connections between transnational organisations |
| Relationships between groups are increasingly multi-issue in nature |
| The diminished role of military force as a policy tool |

**Interdependence and its Effects on State Behaviour**

The changing nature of power in the world in the 1960s and 1970s posed changes to Realist conceptions of regime change. While Realism assumptions defined (and explained) some outcomes, the reality was much more complex. Keohane and Nye called into question the core Realist assumptions that states were the dominant actors in world politics, that military force was the most effective tool to effect policy, and that military and security politics were the dominant paradigms in a hierarchy of issues, with economic and social affairs for example placed lower on the hierarchy[32]. In seeking to develop an alternative understanding of why international regimes change, Keohane and Nye also examined how interdependence affected power structures and state behaviour[33]. It is this aspect of their framework that challenged Realist conceptions of change in power structures and the existing "international regimes" that comprised of rules, norms and procedures[34].

The three characteristics of complex interdependence gave rise to distinct political processes. One was that in the absence of a clear hierarchy of issues, political leaders pursue sets of goals that conflict with each other, with compromise involved but also the challenge of maintaining a coherent pattern of policy[35]. A second was the use of issue-specific instruments of state policy, the manipulation of interdependence and a greater role for transgovernmental and transnational actors in policy formation. As Pollack argued, international relations was no longer the prerogative of foreign services but increasingly took place at several levels. These included, as Pollack categorised them, not only the intergovernmental (heads of state level), but also the transgovernmental (or bureaucrat/regulator level; and the transnational level (involving private actors). The lack of issue hierarchy led to the predominance of transnational relations over direct state-to-state discussion. The nearer a situation was to complex interdependence, Keohane and Nye argue, the more outcomes of political bargaining were shaped by transnational relations between non-state actors like multinational corporations[36]. In the area of financial regulation, Baker for instance argues transgovernmentalism has become a much

[32] *Ibid*, p. 24.
[33] *Ibid*, p. 5.
[34] *Ibid*, p. 19.
[35] *Ibid*, p. 30.
[36] *Ibid*, p. 34.

more "complex and multifaceted" activity that takes several forms, while acting as a mechanism through which state bureaucracies can construct alliances and coalitions to influence world order, including the actions of international institutions[37].

A third was that in situations of complex interdependence amid a diffusion of power and with a greater complexity of issues it was more difficult for states to link one issue in their own state to a particular issue in another; for example linking trade to security matters. Keohane and Nye suggested the multiplicity of issues and the complexity of the web of interdependence in connected states undermined the ability of states to control outcomes by linking issues[38]. A fourth political process that arose was that agenda setting and agenda formation became more and more important[39]. This is also driven by the lack of issue hierarchy and a complex set of issues. Under complex interdependence, the international discussion agenda between interdependent states is significantly shaped by international and domestic problems created by economic growth and issues that give rise to sensitivity to interdependence, as discussed earlier. Political agitation and controversy surrounding a particular issue will tend to elevate it to the top of an agenda[40] and at the international level states and actors tend to forum shop to get issues raised in international organisations[41]. A fifth political process sees international organisations playing a greater role in world politics[42].

**Table 2: Political Processes that Arise in Situations of Complex Interdependence[43]**

| | |
|---|---|
| A wide variation of the goals of actors | The goals of states will vary by issue area; transgovernmental politics will make goals difficult to define; transgovernmental actors will pursue their own goals |
| The use of issue-specific instruments of state policy and a greater role for transgovernmental an transnational actors | Power resources specific to issue areas will be most relevant; manipulation of interdependence, international organisations and transnational actors will be major instruments |
| The diffusion of power and consequent difficulties for states in linking issues | Linkages by strong states will be more difficult to make since force will be ineffective; linkages by weak states through international organisations will erode rather than reinforce hierarchy |

[37] Baker, Andrew (2009), "Deliberative Equality and the Transgovernmental Politics of the Global Financial Architecture", *Global Governance*, Vol. 15, No. 2, pp. 195–218.
[38] *Op. cit.*, p. 31.
[39] *Ibid*, p. 32.
[40] *Ibid*, p. 33.
[41] *Ibid*, p. 33.
[42] *Ibid*, p. 35.
[43] *Ibid*, p. 37.

| | |
|---|---|
| A greater importance of agenda-setting as a result of the lack of hierarchy of issues involved | Agendas will be affected by changes in the distribution of power resources within issue areas; the status of international regimes; changes in the importance of transnational actors; linkages from other issues and politicisation as a result of rising sensitivity of interdependence |
| An elevated role for international organisations characterised by coalition-formation | Organisations will set agendas, include coalition-formation, and act as arenas for political action by weak states; ability to choose the organisational form for an issue and to mobilise votes will be an important political resource |

Each process had an effect on state behaviour, they argued, but in world politics the rules of the game were not as well ordered as in domestic systems[44]. The paradox was that state behaviour affects interdependence but interdependencies also affected state behaviour. However, understanding the processes that led to the development and breakdown of regime changes is critical to understanding the dynamics involved in situations of complex interdependence.

**Models of Complex Interdependence**

The wide variety of processes involved in situations of interdependence meant developing one model to explain and predict outcomes was difficult. In response to this dilemma Keohane and Nye developed several different models (or dimensions) to explain change in international regimes in world politics, seeking to determine the conditions under which each model would likely accurately explain (and predict) outcomes[45]. The development of these models provides insight into the way situations of complex interdependence affect political decisions. Keohane and Nye presented four models that explain outcomes: (1) economic processes (2) the overall world power structure (3) the power structure within issues (4) and the power capacity of international organisations[46].

The first model, the economic process model, considers the effects of changes in technology, industrialisation and trade and assumes that such changes will undermine international regimes (although not necessarily lead to their deconstruction)[47]. In other words, it predicts that technological and economic change will lead to regime breakdown and that regimes will be established or re-established to ensure the benefits that

[44] *Ibid*, p. 19.
[45] *Ibid*, p. 4.
[46] *Ibid*, p. 38.
[47] *Ibid*, p. 40.

interdependence brings[48]. Such change will, however, lead to changes in power structures and changed relationship patterns. The second model, the eroding hegemony model, examines the changes in international rules (international agreements and the rules and agreements made in international bodies such as the Organisation of Petroleum Exporting Countries and the International Monetary Fund) and how these affect overall power structures[49].

The third, the issue structure model, considers how changes in issues that develop in world politics affect the structure of world power[50]. Sometimes such issues are driven by states but that was not always the case. While Keohane and Nye were writing in the 1970s, a modern example might be the development of climate change as a significant issue in world politics and the degree to which it has affected relationships between states. The fourth, the international organisation model, assumes a set of networks, norms and institutions affect world power plays and shapes outcomes.

The complexity that is inherent of situations of complex interdependence, however, means no one model can be applied in all situations to predict the effects of interdependence on world politics[51]. One model (for example the economic dimension) might apply in certain situations, Keohane and Nye suggested, but not in others. Indeed several models might be appropriate in explaining how interdependence shapes political outcomes. Keohane & Nye's approach was to start analysis with the simplest explanation for regime change and consider other dimensions where necessary. The simplest place to start was with economic processes.

To explore how these models might predict state behaviour Keohane & Nye in their 1977 book focused on two case studies in particular: the politics of oceans management and the politics of international monetary affairs. They specifically examined the major events in these issue-areas during 1920s to 1975, looking at the rules and norms during these periods and how well politics in each of these issue-areas conformed to the conditions outlined in their theory of interdependence[52]. They finally assessed on how well expectations (predictions) of interdependence fitted patterns of behaviour in the respective issue-areas.

Examining the growth in the multiple channels of contact, the growing complexity of issues involved in each area and the diminishing role of military force as a policy tool, they concluded that complex interdependence was a plausible explanation for regime change in

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[48] *Ibid*, p. 131.
[49] *Ibid*, p. 43.
[50] *Ibid*, p. 49.
[51] *Ibid*, p. 58.
[52] *Ibid*, p. 99.

both cases[53]. They noted that in both cases, the political processes that arose from situations of complex interdependence applied — the setting of multiple conflicting political goals, the challenges for states in linking issues to political goals, a greater significance of agenda setting and agenda formation, the important role of transnational relations over direct state-to-state discussion and a greater role for international organisations. In both, the political processes were closer to those expected under complex interdependence than expected under realist conditions (although the results were more pronounced in the issue-area of oceans policy)[54].

Overall, the politics of international monetary policy, they concluded, much more closely conformed to complex interdependence than Realist explanations for changes in regimes; as did the politics of oceans management (but more so after the period of 1967). Keohane and Nye then examined the applicability of each of their four models of analysis to the results, finding that although their international organisation model explained some of the changes in the area of world monetary politics, with international organisations playing a greater role, their issue structural model explained changes more fully, with states responding to a range of important issues that need to be addressed. In the area of oceans policy, Keohane and Nye found that their international organisations model was most important, with the procedures and rules of international organisations overwhelmingly shaping regime changes in this area.

## Criticisms

A number of criticisms have been levelled at complex interdependence as a theory to explain government behaviour in world politics. Firstly, some critics have disputed that interdependence is not a significant force on world politics at all, with historical trade, economic and other ties much greater in previous centuries in world history. One of the earliest critics of the argument that interdependence was a significant force was Kenneth Waltz who in 1970 argued that US interdependence with European nations in particular, was "a myth"[55]. Deutsch and Eckstein and Waltz's dismissal of the potency of economic relations in influencing foreign policy were criticised and countered by subsequent studies that measured interdependence in a different way (for example the studies by Rosecrance and also of Lipsey as mentioned above). Further, Waltz's argument that "each state regulates its own affairs" and retains the ability to do so — citing as an example the US' ability to disentangle itself from other world economies during WW2 to develop new large-scale industry with great ease while fighting a war on two fronts — has continued to resonate with Realists.

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[53] *Ibid*, pp. 103-105.
[54] *Ibid*, p. 126.
[55] Waltz, Kenneth N. (1970), "The Myth of National Interdependence", in Kindleberger, Charles P. (ed.), *The International Corporation*, MIT Press, Cambridge, Mass., p. 206.

Another argument concerns definitions, with the claim that the term is ill-defined and as having a normative bias[56]. However, as Baldwin argued in a comprehensive article in the 1980s that sought to clarify the various usages of the term, few scholarly discussions of international interdependence from the time of Machiavelli to about 1960 can be characterised as ill-defined. Rosecrance et al's distinguishing between vertical and horizontal interdependence but particularly Keohane and Nye's comprehensive theory of complex interdependence in the 1970s clarified the term to an even greater degree, at least among political scientists. The alleged normative bias involved with the term does have substantial basis. It is true that Cooper's 1968 article sought to tackle some of the "damaging consequences" of greater interdependence, focusing on negatives, rather than focusing on measuring its effects[57]. However, scholarly support for Realism and other theories of international relations has been similarly critical and avoided the label as being normative for doing so.

A further argument raised by Rosecrance et al in the late 1970s was that high interdependence says "very little about the actual state of relations between nations"[58]. Debate about the difficulties and methodologies for measuring interdependence aside[59], some scholars suggested complex interdependence was not a theory at all. Baldwin argued that Keohane and Nye's theory of complex interdependence was not a comprehensive replacement for traditional theories like Realism[60]. But Keohane and Nye themselves declined to define complex interdependence as a theory, but rather as "a thought experiment about what politics might look like if the basic assumptions of Realism were reversed"[61].

The nature of theory is open to debate and it has been defined as "a supposition or a system of ideas intended to explain something, especially one based on general principles independent of the thing to be explained"[62]. Broadly George Sabine defines political theory in his seminal historiography of political science as humanity's "disciplined investigation of political problems"[63]. Following both these definitions, complex interdependence is arguably a theory.

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[56] Baldwin, David A. (1980), "Interdependence and Power: A Conceptual Analysis", *International Organization*, Vol. 34, No. 4 (Autumn, 1980), pp. 482.
[57] Cooper, Richard N. (1968), *The Economics of Interdependence: Economic Policy in the Atlantic Community, Columbia University Press*, New York, p. 6.
[58] Rosecrance, Richard; Alexandroff, Alan; Koehler, W., Kroll, J., Liqueur, S. and Stocker, J. (1977), Whither Interdependence?", *International Organization*, Vol. 31, No. 3 (Summer 1977), pp. 426.
[59] Tetreault, Mary Ann (1980), Measuring Interdependence, *International Organization*, Vol. 34, Issue 03, June, pp. 429-443.
[60] Baldwin, David A. (1979), "Power Analysis and World Politics: New Trends Versus Old Tendencies," *World Politics*, Vol. 31 (January 1979), pp. 169-194.
[61] Keohane, Robert and Nye, Joseph S. (1987), "Power and Interdependence Revisited", *International Organization*, Vol. 41, No. 4, autumn, p. 731.
[62] Oxford Dictionary, Oxford
[63] Sabine, George (1973), "A History of Political Theory", fourth edition, revised by Thomas Landon Thorson, Holt, Rinehart and Winston, Fort Worth/Tokyo, p. 4.

The variety of models developed in Keohane and Nye's outline of complex interdependence does weaken its predicative capacity however. While Keohane and Nye examined four case studies of how interdependencies with other nations affected particular government policies, even they admitted that one model could not fit all situations. Even though they noted that an issue-area approach to the study of international politics was an important analytical problem, they conceded they had failed to develop a "theory of linkage" that could specify under what conditions linkages between issues would occur[64].

**Conclusion**

Complex interdependence has since the 1990s tended to be viewed as a phenomenon and part of the broader neoliberal explanation of change in international politics. While economists have continued to seek to measure economic interdependence from a purely quantifiable point of view, political science scholars have looked towards institutionalism and other neoliberal explanations to explain state behaviour. Indeed it was Keohane and Nye whom some scholars credit as laying the groundwork for institutionalist research[65]. Keohane and Nye argued that their theory of complex interdependence was never presented as an alternative to the Realist view of international relations, but rather sought to highlight interdependencies as a source of power and sources of influence[66]. In this respect it made a valuable contribution to understanding political behaviour.

Even so, growing interdependencies have played a significant role in affecting state behaviour. Despite the criticisms that interdependence as a theory has shortcomings in terms of predictive capacity, Rosamond argues interdependence is politically significant because it can change the power dynamics between connected nations and changes the policy behaviour of actors[67]. It has constrained the agenda of authoritative political actors and, faced with somewhat diminished alternatives, governments have sought closer cooperation through the construction of new political institutions designed to capture and control economic processes[68].

While some political science seeks to understand specific phenomena or even provide a normative analysis of political events, other examination in political science has aimed to establish causal explanations. The role of causal reconstruction is to explain a

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[64] Keohane, Robert O. and Nye, Joseph S. Jr (1987), Power and Interdependence Revisited, *International Organization*, Vol. 41, No. 4 (Autumn, 1987), p. 735.
[65] Rosamond, Ben (2000), Theories of European Integration, Palgrave, Houndmills/New York, p. 167.
[66] Keohane, Robert O. and Nye, Joseph S. Jr (1987), Power and Interdependence Revisited, *International Organization*, Vol. 41, No. 4 (Autumn, 1987), p. 728.
[67] *Ibid.*
[68] Rosamond, Ben (2000), Theories of European Integration, Palgrave, Houndmills/New York, p. 13.

phenomenon — whether it is an event, structure or development — and causal link is established by identifying the processes through which the phenomenon is generated[69]. To be causal, it has been argued, the cause in question "must generate, create, or produce the supposed effect"[70]. In this respect complex interdependence is highly useful in understanding why states behave the way they do.

[69] Mayntz, Renate (2003), "Mechanisms in the Analysis of Macro-Social Phenomena", MPIfG Working Paper 03/3, Max Planck Institute for the Study of Societies, p. 2.
[70] Gerring, John (2005), "Causation: A Unified Framework for the Social Sciences", *Journal of Theoretical Politics*, Vol. 17, No 163, p. 170.

# THEORETICAL FRAMEWORK & METHODOLOGY

In the course of scholarly examination of economic interdependence in the postwar period, arguably the most studied relationship has been that of the United States and Europe. As discussed in the following chapter, US-European relations have evolved significantly since World War II. The US has maintained an intimate relationship with key transatlantic political allies and trade partners, but also the supranational European institutions, the European Coal and Steel Community (ECSC), the later European Community (EC)[1] and more recently the European Union (EU).

The connectedness between the US and the EU at numerous levels — political, economic and cultural — has expanded consistently and yet the intensity of cooperation has ebbed and flowed over the decades. US enthusiasm reached heights under Presidents Eisenhower and Kennedy for example[2], but lows during the Reagan Administration[3]. While Kennedy presented an optimistic and embracing "grand design" for a transatlantic partnership in the early 1960s[4], de Gaulle's political posturing and the subsequent economic challenge to the US by a more politically and economically integrated Europe in the 1970s prompted concerns about growing European supranational authority in successive US administrations[5].

In the 1990s, amid Western Europe embracing plans for a single market and monetary union, the US and the then-European Community consolidated and institutionalised their economic ties. The Transatlantic Declaration on EC-US Relations in 1990, the later New Transatlantic Agenda (NTA) and an associated Joint Action Plan in 1995, and the even more in-depth Transatlantic Economic Partnership (TEP) of May 1998 created even closer arrangements for policy cooperation. The latter agreement committed both sides, among other matters, to in-depth bilateral cooperation on a wide range of regulatory matters. Explored in greater detail in the subsequent chapter, these agreements have

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1 The term "European Community" has been used to refer to the European Economic Community or to the three European Communities as a group (the EEC, Euratom and the European Coal and Steel Community). In 1993, with the implementation of the Maastricht Treaty, the term European Economic Community (EEC) was changed to the European Community, abbreviated as "EC", and referred to only one of the three Communities. Then in 2009, with the adoption of the Lisbon Treaty, the European Community became the European Union (EU). Additionally, the abbreviation "EC" is also sometimes used to refer to the European Commission.

2 Winand, Pascaline and Philippart, Eric (2001), "From Equal Partnership to the New Transatlantic Agenda: Enduring Features and Successive Forms of the US-EU Relationship", in Philippart, Eric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policymaking in US-EU Relations*, PIE Peter Lang, Brussels; McGuire, Steven and Smith, Michael (2008), "European Integration and the United States", in McGuire, Steven and Smith, Michael (eds), *The European Union and the United States: Competition and Convergence in the Global Arena*, Palgrave McMillan, Hampshire and New York.

3 Winand, Philippart, *op. cit.*

4 Winand, Pascaline (1993), *Eisenhower, Kennedy, and the United States of Europe*, Macmillan, London, p. 139.

5 Lundestad, Geir (1998), *Empire by Integration: The United States and European Integration 1945-1997*, Oxford University Press, London, p. 97.

coincided with a significant deepening of economic ties, intensifying the level of interdependence between the two, as is argued later.

When growing financial systemic problems intensified significantly in late 2008, triggering what became known as the global financial crisis, the US and the EU immediately began to coordinate their financial and political response. When the financial crisis descended on the US and Europe the implications of the interconnected transatlantic markets were laid bare. High levels of banking and financial cross-border exposure and the extensive trade relationship between the US and the EU developed and promoted over decades meant the US and EU economies were highly interdependent. It was this interdependence that laid the basis for cooperation when the global financial crisis broke.

## Research Question

Given the heightened level of cooperation between the two partners in the early months of the financial crisis, an examination of the role that financial and economic interdependence may have played in decisions to coordinate policy response could have important theoretical and political implications. There has been significant discussion of the causes and nature of the financial contagion that spread from one side of the Atlantic to the other during the crisis, but little examination of the way it affected changes in US and EU policy decisions.

The core question this thesis poses is: to what extent did financial and economic interdependence play a role in shaping US and EU cooperation on financial regulatory reform during the financial crisis?

## Choice of Topic

Given the connectedness of the US and EU financial markets and economies, and given the scale of US and EU cooperation on a wide range of policy areas, the crisis is the perfect case study to assess whether interdependence affected political decisions. The financial crisis was an all-consuming phenomenon that took on many dimensions — financial, economic, political and even cultural. It threw the world into the greatest financial peril since the Great Depression, generated the largest financial losses in decades and threatened to bring the world's financial system to a standstill.

It was the political response to financial regulatory reform that US and EU regulators saw as the greatest priority. Their decisions to coordinate their policy responses, and to mount a common response in the global financial market as well, were aimed at protecting their own but also their common interests. US-EU cooperation on financial regulatory reform provides some of the most illuminating answers as to how interdependencies affected US and EU political behaviour.

There was intense cooperation on a range of financial markets responses and regulatory reforms. After the first G20 Leader's Summit in Washington in November 2008, the US and the EU cooperated on reform on a very wide range of financial system-related issue-areas: accounting standards, the regulation of credit ratings agencies, the regulation of credit default swaps (which were blamed as having significantly contributed to the scale of the financial losses incurred on both sides of the Atlantic), derivatives trading, banking capital standards and insurance standards among other areas.

European leaders proposed a financial transactions tax, the International Monetary Fund (IMF) was given a significant funding boost and a renewed role in global financial supervision and the Financial Stability Forum (FSF), a global regulatory body that developed and coordinated policy on a range of financial regulatory initiatives internationally, was given a strengthened mandate in global financial governance. A wide range of issue-areas and forms of international relations makes for a good set of case studies. It provides variety and a bigger pool of potential behavioural responses under conditions of interdependence than if all case studies were similar.

## Theoretical Framework

The significance of Keohane and Nye's complex interdependence as a theory is that it helps to explain state behaviour. Interdependence changes the power dynamics between connected nations and changes the policy behaviour of actors. Their theory emphasised the role of international and transnational exchange in shaping relationships and policy outcomes and placed importance on the mutual dependence among countries characterised by "reciprocal effects" among countries or among actors[6].

Moreover, according to Rosamond, interdependence actually constrains the agenda of authoritative political actors. Faced with somewhat diminished alternatives, governments seek closer cooperation through the construction of new political institutions designed to capture and control economic processes[7]. At the same time it constrains the choices of private actors such as corporate entities, which tend to alter their corporate production processes and review their corporate strategies to adapt[8].

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6 Robert O. Keohane and Joseph S. Nye (1977), *Power and Interdependence: World Politics in Transition*, Little, Brown, and Company, Boston, pp. 8-9.
7 Rosamond, Theories of European Integration, 2000, p. 13.
8 *Ibid*, p. 13.

Another consequence is the greater collaboration between a range of transnational actors in respect to policy-making. Fioretos argues that higher levels of international economic interdependence change the preferences of domestic actors and shifts power resources, resulting in new domestic and international coalitions, specifically in a closer relationship between export-oriented firms and governments[9]. Such shifts also serve to undermine government autonomy further and elevate the role of business and transnational actors in the political process.

While some political science seeks to understand specific phenomena or even provide a normative analysis of political events, other examination in political science aims to establish causal explanations. The role of causal reconstruction is to explain a phenomenon — whether it is an event, structure or development — and causal link is established by identifying the processes through which the phenomenon is generated[10]. To be causal, it has been argued, the cause in question "must generate, create, or produce the supposed effect"[11]. Examining causal relationships are thus important in political science. Héritier suggests that several causal factors can be found when accounting for a complex political or social macro-phenomenon[12].

Nevertheless if one causal link can be established between levels of economic and financial interdependence between the US and the EU and their political behaviour (that is, their political compromises to each other in respect to policy negotiations on financial regulatory reform), there are important policy implications about the ability of highly interdependent states to maintain policy autonomy. A corollary is that, as long as a highly interdependent relationship exists, policy autonomy will be compromised. It is for this reason that Keohane and Nye's examination of interdependence and the way it affects state behaviour can provide valuable insights into political change. This implication is discussed further in chapter 7 that discusses the findings of this research.

## Methodology

To tackle this question it is necessary to narrow the scope, both in terms of the issue-areas examined and the timeframe. The US and EU financial regulatory reform agenda in the early stage of the financial crisis was very wide. Not all of these areas can be examined in one thesis and it is for this reason that a number of case studies have been chosen. The

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9 Fioretos, Karl-Orfeo (1997),"The Anatomy of Autonomy: Interdependence, Domestic Balances of Power, and European Integration", *Review of International Studies*, Vol. 23, p. 294.
10 Mayntz, Renate (2003), "Mechanisms in the Analysis of Macro-Social Phenomena", MPIfG Working Paper 03/3, Max Planck Institute for the Study of Societies, p. 2.
11 Gerring, John, (2005), "Causation: A Unified Framework for the Social Sciences", Journal of Theoretical Politics, Vol. 17, No 163, p. 120.
12 Héritier, Adrienne (2008), "Causal Explanation", in Della Porta, Donatella; Keating, Michael, Approaches and Methodologies in the Social Sciences: A Pluralist Perspective, Cambridge University Press, Cambridge, p. 75.

examination of specific case studies was a similar approach taken by Keohane and Nye in their discussion of complex interdependence in their book, *Power and Interdependence*[13].

After defining interdependence, they outlined their theory of complex interdependence and how international regimes shaped interdependence, but also how interdependence affected political processes. They specifically examined case studies on oceans policy and monetary policy, describing the major events in policy in these areas and then assessing the extent to which the political processes observed in those cases accorded with their conceptions of complex interdependence.

This research takes a similar approach, examining just four of the financial regulatory areas tackled at the early stage of the financial crisis: accounting standards, the regulation of credit ratings agencies, the regulation of credit default swaps and a boosted role for the IMF and FSB. US-EU cooperation in these issue-areas has taken different paths and forms in recent decades, with different patterns of cooperation, different actors involved in decision-making, and very different outcomes. The extent to which the US and the EU compromised on their own policy preferences and amended their positions on these issues varied greatly. As discussed in later chapters, constructive outcomes on accounting standards in recent decades — and the extent to which the US has amended its own rules to accommodate the EU and vice versa — has been mixed. It is an area in which policy convergence can be described as poor at best in the years leading up to the start of the financial crisis in 2008. Credit ratings agencies and credit default swaps are areas where there has been very limited regulation in both the US and within the EU.

In the area of international organisations, US and EU cooperation on matters to do with the IMF has been shaped to a large degree in the multilateral environment in which the organisation operates and, as such, US-EU cooperation and their respective policy positions have been much more complicated. In the area of international financial governance in which the Financial Stability Board (FSB) (and its predecessor the FSF) worked, US-EU cooperation has similarly been more complicated.

Taking a qualitative approach, this research draws upon interviews with key people involved in or close to the US/EU cooperative negotiations, as well as public documents and other material and data. Interviewees were chosen on the basis of their direct involvement in or close intimate knowledge of the policy-making process of the financial regulatory reforms examined, whether this was at the agenda-setting stage, the policy development stage or the policy implementation stage.

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[13] Keohane, Robert O. and Nye, Joseph, S. (1977), Power and Interdependence: World Politics in Transition, Little, Brown and Company, Boston & Toronto, p. 99.

## Timeframes

In addition to cooperation between the US and the EU on a wide range of issue-areas, an intense level of cooperation was also maintained for several years, from the moment the financial problems in the US that were developing throughout 2008 (and even earlier in 2007) became a systemic banking crisis with the collapse of Lehman Brothers in September to 2008, throughout 2009 and 2010.

As discussed in a brief overview of the progression and causes of the crisis in the subsequent chapter, the financial crisis moved from being one involving the US and EU banking systems, to the broader transatlantic financial system and, then later in the EU, a crisis of confidence and state debt in the Eurosystem, referred to as the Eurocrisis. The latter developed as already heavily indebted EU member states bailed out their respective financial systems, exaggerating losses in the process, and as particularly indebted member states such as Latvia, Portugal, Ireland and Greece suffered from acute balance of payments problems.

This progression from effectively one crisis to another blurs the line between the "global financial crisis" that in reality affected mostly the US and EU financial systems (despite the use of the word "global"), to the "eurocrisis" that affected the EU only (although of course US markets were affected by the financial markets concern about the degree to which US stocks and companies would suffer).

Given this it is important to focus on political bargaining and policy behaviour research in the space of several years only. Cooperation was particularly intense between the collapse of Lehman Brothers in September 2008, through to the G20 Leaders' Summit in Washington in November 2008, the next G20 Leaders' Summit in London in April 2009 and the following one in Pittsburgh in September 2009. I focus primarily on the first two years of the crisis: mid 2008 to mid 2010. In the various case studies, the regulatory reforms initiated during this period extended beyond these two years and it is for this reason that I examine the reforms and policy cooperation through the implementation of reforms concerned.

## Thesis Structure

In the following chapter, I start out with a "base line" assessment of the state of play of interdependence between the US and the EU *prior to* and *at the time* the financial crisis intensified in late September 2008, as well as an outline of the major developments in US-EU economic and financial relations since 1990. After a brief background in chapter 2 that highlights the distinct transatlantic dimension to the global financial crisis, chapter 3 examines the way the transatlantic powers approached reform of their respective (and global) financial markets. It considers particularly the role of interdependence in several specific areas: the start of the G20 process at the first G20 Leaders' Summit in Washington in November 2008 and the subsequent Leaders' Summit in London in April 2009.

The subsequent three chapters examine the way interdependence affected the US and EU's approach to financial reform in several specific areas: the reform of accounting standards, credit default swaps and credit agency regulations. The following chapters examine the US and EU's negotiation for a greater role for the International Monetary Fund (IMF) and the Financial Stability Board (FSB) in global finance governance.

Following a similar path as Keohane and Nye, in the analytical discussion in chapter 7, I examine how well financial regulatory politics have conformed to the three conditions of complex interdependence. These conditions are the existence of multiple issues not arranged hierarchically, multiple channels of contact and the diminished role for military as an instrument to control policy outcomes. I further consider how the patterns of state behaviour observed in the case studies accord with expectations about politics in situations of complex interdependence. As outlined in the literature review, these can be summarised as: a wide variation in the goals of actors involved; the use of issue-specific instruments of state policy and the greater role for transgovernmental and transnational actors in policy formation; the diffusion of power and consequent difficulties for states in linking issues; a greater importance of agenda-setting as a result of the lack of hierarchy of issues involved; and a greater role for international organisations characterised by coalition-formation[14].

Once assessed, the thesis finally concludes by commenting on the extent to which economic and financial interdependencies played a role in shaping US and EU decisions to coordinate financial regulatory reform in their respective markets, as well as in the international arena.

The results will have significant political implications either way. As Keohane and Nye themselves argued: the major contribution of their theory was to stress that the analysis of the politics of interdependence requires sophisticated conceptions of bargaining and that patterns of economic interdependence have implications for power and vice versa[15]. If interdependencies can constrain state behavior, then the implication is that threats to the mutual benefits that come with interdependence can undermine state autonomy. As

[14] Keohane, Robert O. and Nye, Joseph, S. (1977), Power and Interdependence: World Politics in Transition, Little, Brown and Company, Boston & Toronto, p. 37.
[15] Keohane, Robert O. and Nye, Joseph S. Jr (1987), Power and Interdependence Revisited, *International Organization*, Vol. 41, No. 4 (Autumn, 1987), pp. 736-737.

discussed below, there are two broad dimensions of interdependence: sensitivity and vulnerability.

The former refers to the degree to which a nation is affected by a change in another nation's policy on a particular issue, while the latter refers to a government's ability (or inability) to insulate itself from effects of policy change in the other state[16]. A finding that neither the US or the EU were in good positions to insulate themselves from the adverse effects of interdependencies has political implications about the measures states can or should take to mitigate the risks involved and the adequacy of existing measures to mitigate transatlantic financial system risk.

## Some Definitions

Before proceeding with a discussion of the state of play in respect to interdependence in the US and the EU prior to the collapse of Lehman Brothers in September 2008, a few definitions are important. In all research it is important to specify and define concepts[17], or what Mair calls identifying the "what is" question[18].

Building on Rosecrance's suggestion that interdependence in its most general sense consisted of a relationship of interests such that if one nation's position changes other states will be affected by that change, Keohane and Nye later fine-tuned this, referring to dependence as "a state of being determined or significantly affected by external forces" and interdependence simply as "mutual dependence"[19]. In the context of world politics this meant situations characterised by reciprocal effects among countries or among actors on different countries[20]. These effects could have, Rosecrance suggested, a horizontal dimension (that is one based on transactions, whether this is the flow of money, or men and goods), or a vertical dimension, as measured by the responses "of one economy to another in terms of changes in factor prices"[21].

An important feature in Keohane and Nye's definition of interdependence was the cost to parties involved in interdependent relationships, notably the costs of withdrawing mutual dependency. Where there are costly effects, there was interdependence, but where there

[16] Keohane, Robert O. and Nye, Joseph S. (1977), Power and Interdependence: World Politics in Transition, Little Brown and Company, Boston.
[17] Sartori, Giovanni, 1984, "Guidelines for Concept Analysis" in Giovanni Sartori (ed.), Social Science Concepts: A Systematic Analysis, Sage, London, p. 9.
[18] Mair, Peter (2008), "Concepts and Concept Formation", in Approaches and Methodologies in the Social Sciences: A Pluralist Perspective edited by Porter, Donnatella Donna and Keating, Michael, Cambridge University Press, New York, p. 179.
[19] Keohane, Robert O. and Nye, Joseph, S. (1977), Power and Interdependence: World Politics in Transition, Little, Brown and Company, Boston & Toronto, p. 8.
[20] Keohane, Robert and Nye, Joseph S. (1977), *Power and Interdependence: World Politics in Transition*, Little Brown and Company, Boston, p. 8.
[21] Richard Rosecrance, 1973, "Interdependence: Myth or Reality?", *World Politics*, Vol. 26, p. 1.

was not, there was simply some form of interconnectedness[22]. While economists have tended to define interdependence in terms of the volume of transactions (trade, foreign investment, capital flows etc.), another important feature of the term as understood by political scientists is, as noted in the literature review, the sensitivity and vulnerability of one country to another. Since the 1960s political scientists have measured interdependence in terms of both, with the former referring to the sensitivity of one nation to events occurring in another and the latter referring to the vulnerability of one state to another state's policy change[23].

In line with the characteristics of interdependence outlined by Keohane and Nye above, interdependence in the political science sense can be defined as a state of mutual dependence, characterised by multiple channels of interconnectedness, multiple issue-areas and a reduced role for military, as measured by both the sensitivity of one state to another's policy as well as its vulnerability. It is this definition that is referred to in subsequent chapters.

There is a further definition that is important to add. There are of course differences of opinion over whether the EU is in fact a state, but Caporaso argues that the answer depends on definition one adopts of a "state" or "nation"[24]. While some have grappled to describe the EU — with former European Commission President Jacques Delors once calling it an "unidentified political object"[25] and others using Latin concepts to characterise the EU polity like *condominium, consortium, confederation* and *stato/federation*[26] — many scholars recognise that it does in fact have "state-like" qualities[27]. In a thesis where the intention is to examine the effects of interdependence upon political decision-making (rather than decisions of "states" per se), it is the decisions made by elected or appointed authorities that are important. The EU derives its authority from the member states and as such for the purposes of examining the role of interdependence in shaping political decisions, it is assumed that the EU is in fact a state, or at least possesses state-like authority.

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22 Keohane, Robert and Nye, Joseph S. (1977), *Power and Interdependence: World Politics in Transition*, Little Brown and Company, Boston, pp. 8-9.
23 *Ibid*, pp. 12-16.
24 Caporaso, James A. (1996), "The European Union and Forms of State: Westphalian, Regulatory or Post-Modern?" *Journal of Common Market Studies*, Vol. 34, p. 34.
25 Drake, Helen (2000), "Jacques Delors: Perspectives on a European Leader", Routledge, London, p. 1864.
26 Schmitter, Philippe C. (1996), "Imagining the Future of the Euro-polity with the Help of New Concepts," in Gary Marks et al (eds), *Governance in the European Union*, Sage, London, pp. 132-6.
27 Richardson, Jeremy (2015), "The EU as a policy-making state: A policy system like any other?", in Richardson, Jeremy and Mazey, Sonia (eds.), *European Union: Power and Policy-Making* (4th edn.), Routledge, London, pp. 6-7.

# CHAPTER 1: US AND EU FINANCIAL AND ECONOMIC INTERDEPENDENCE AT THE OUTSET OF THE FINANCIAL CRISIS

In the postwar era mutual dependence between the US has grown significantly — both in economic and political terms. The US and the EU have become increasingly interconnected to such a degree that any change in policy in the US or Europe would have significant effects across the Atlantic to the other.

This chapter seeks to provide a baseline understanding of the effect that economic interdependence had on the response of the US and the EU to the global financial crisis. It does so by providing an overview of the deepening economic and associated political ties between the US and the EU in the postwar period. It discusses the background to the construction in recent decades of a more integrated transatlantic marketplace and highlights how US and EU connectedness led to economic interdependence — a factor that made a coordinated US-EU response to the financial crisis imperative.

It concludes by providing a picture of the level of economic interdependence between the US and the EU *at the time* the financial crisis descended on the US and the EU in late 2008.

## The US-European Monetary Relationship in the Post-war Period

The end of WWII saw the construction of a very different world. With Europe ravaged by war and the UK in financial ruin, it was a world dominated by the US. The establishment of the Bretton Woods institutions, including the International Monetary Fund (IMF), firmly placed the US at the centre of post-war international monetary and financial cooperation. The US dominance of the IMF from its inception (see previous chapter), the central position of the US dollar internationally, the strength of US financial institutions and the role of US market in the emerging global financial order led to US hegemony in the international financial system[1]. The US' post-war central role not only gave it a centre position in the global and the transatlantic economy but also at the centre of Europe's political and economic future.

In fact the war tipped the international financial order clearly in the US' favour. While London had been the financial capital prior to the war, the cost of fighting Germany saw it move from an economy in surplus to a net borrower. While some had already viewed

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[1] Eichengreen, Barry (1987), "Hegemonic Stability Theories of the International Monetary System", NBER Working Paper No. 2193, National Bureau of Economic Research Cambridge MA, at http://www.nber.org/papers/w2193.pdf, viewed 18 February 2014.

the US as "arbiter of Europe's fate"[2] over its pivotal role in WW1 of thwarting German efforts to dominate Europe, after its additional funding of European reconstruction after WW2 through the Marshall Plan, officially the European Recovery Plan, signed under President Harry Truman in 1948, Europe's financial fortunes became even more closely dependent on US financial and military support. As the European Community evolved, Lundestad argues, the US supported the formation of the OEEC and NATO (and later GATT) to control Europe, notably to "contain" Germany and the then Soviet Union[3].

Throughout the 1950s and 1960s the US continued to dominate the international monetary and financial system. The US dominance of the IMF from its inception, the central position of the US dollar internationally, the strength of US financial institutions and the role of large US market in the emerging global financial order subsequently led to US hegemony in the international financial system[4]. With European currencies pegged to the US dollar, the dilemma of linking long-term European stability to the short-term financial fortunes of one country — the US — was coined in the Triffin Paradox, after the Belgian economist Robert Triffin, a critic of the Bretton Woods system, a supporter of European integration and proponent of the European monetary system. He in fact warned in the 1960s of the vulnerability of the transatlantic link and over-reliance on the US dollar[5].

His warnings turned out to have significant merit, with instability and wild currency fluctuations in the EC prompting the Commission in 1968 to propose a review of the policy on economic and monetary coordination. The problems had undermined the EC's common agricultural policy common price system[6]. The consequent Barre Report in 1969 proposed greater economic coordination, with EC heads of government agreeing at the summit in The Hague in 1969 to a several stage approach to economic union "with a view to the creation of an economic and monetary union"[7].

The result was the creation of a High Level Group under the then Luxembourg Prime Minister Pierre Werner to report on how union could be achieved by 1980. The Werner Committee submitted a final report in October 1970, recommending a three-stage process over a ten-year period and although the report was shelved, there was a realisation among

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2 Stirk, Peter (1996), *A History of European Integration Since 1914*, Pinter, London, p. 1.
3 Geir Lundestad, Empire By Integration: The United States and European Integration 1945-1997, Oxford University Press, 1998, p. 38.
4 Eichengreen, Barry (1987), "Hegemonic Stability Theories of the International Monetary System", NBER Working Paper No. 2193, National Bureau of Economic Research Cambridge MA, at http://www.nber.org/papers/w2193.pdf, viewed 18 February 2014.
5 Triffin, Robert (1960), *Gold and the Dollar Crisis: The Future of Convertibility*, Yale University Press, New Haven.
6 European Commission, "Phase 1: The Werner Report", at http://ec.europa.eu/economy_finance/euro/emu/road/werner_report_en.htm, viewed 16 September 2014.
7 Heads of State or Government of the Member States (1969), "Final communiqué of the Hague Summit", 2 December, at http://www.cvce.eu/content/publication/1997/10/13/33078789-8030-49c8-b4e0-15d053834507/publishable_en.pdf, viewed 28 February 2015.

many policymakers and some intellectuals that monetary independence for Europe was both a priority and inevitable. There were calls for a European Reserve Fund to ward off future shocks and detach Europe from, as Dyson argues, the "cracks that were opened by a reluctant and retreating US hegemon"[8].

US President Richard Nixon's announcement to temporarily abandon the dollar's convertibility into gold was a highpoint in the collapse of the Bretton Woods exchange rate pegging system. The consequent debt crisis in Europe prompted European governments to renew the priority for an alternative.

With Europeans looking for solutions to the intensifying economic problems, an agreement was reached in April 1972 called the Basel Agreement that sought to stabilise exchange rate relations between currencies. Under the agreement the six EEC members agreed to peg their currencies to the US dollar, allowing a fluctuation of just 2.25%. However, what subsequently became known as the "Snake in the Tunnel" agreement[9] barely functioned as further crisis triggered further efforts to seek an independent European solution. Again, the answer was seen as greater integration. The 1973 oil crisis, that started in October 1973 when the Organization of Arab Petroleum Exporting Countries announced an oil embargo in response to US support of Israel, and the later US-led stock market crash in 1973-74, contributed to aggravating inflationary pressures and balance of payments problems in Europe[10].

After the US then floated its dollar in 1973 and countries in Europe started to leave the system — the Italian Lira in 1973, the French Franc in 1974 and, after re-integration in 1975, again in 1976, the Swedish Kronar in 1977 and the Norwegian Kroner in 1978 — there was a dawning that the peg system was not the long-term solution. After the collapse of the Bretton Woods system, particularly during 1973-76, European public finances and employment rates deteriorated, leading to a second attempt at economic and monetary integration in 1979 with a system that aimed to set up a zone of monetary stability.

A new proposal for economic and monetary integration was put forward in 1977 by the then president of the European Commission, Roy Jenkins. This led to the European Monetary System in March 1979 that created the European Currency Unit, a currency unit based on a weighted average of EMS currencies — which formed the basis of the monetary union today. European economic and financial outcomes have been both

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[8] Dyson, Kenneth (2008), "50 Years of Economic and Monetary Union: A Hard and Thorny Journey", in Phinnemore, David and Warleigh-Lack, A. (eds), *Reflections on European Integration*, Palgrave, London, p. 148.

[9] The "snake" referred to the European currencies and the tunnel referred to the narrow limits of the US dollar.

[10] Papaspyrou, Theodoros (2004), "EMU Strategies: Lessons from Greece in View of EU Enlargement", paper presented at the Hellenic Observatory, The European Institute, London School of Economics, 20 January.

dependent on and to a large degree a product of US fortunes, with crisis binding them together.

## US Support for European Integration

US financial support for Europe in the immediate aftermath of the war and Europe's dependence on the US for monetary stability was just one of the ways the US became a major actor in postwar Europe. Amid funding the reconstruction of Europe on the basis that European stability was in its own best interests, the US also supported the first act of political integration: the Treaty of Paris (officially the Treaty establishing the European Coal and Steel Community). Signed on 18 April 1951, it aimed to control the coal and steel making resources in the Ruhr area that Germany had drawn upon for the war. The US was also supportive of the Treaty Establishing the European Economic Community signed in 1957. Jean Monnet, in his instrumental role in creating the European Community, is said to have observed that the US had been the first power in history to back the creation of a larger power instead of ruling by dividing[11]. In return, US official representatives of the US Government "co-conspired" on the European integration project with Monnet, Winand argues, because they all "believed fervently" in the dream of the long-held United States of Europe. This, they felt, was "as important to Americans as it was to Europeans"[12].

Throughout the 1980s and 1990s the US continued to support European integration. Despite skepticism towards the idea of European integration during and immediately after WWII, the US gradually came to support integration as its policy. The aims was to, as Lundestad argues, extend its sphere of influence in the western world and more specifically to achieve the "double containment" of the Soviet Union and the recovering West Germany[13]. A consequence was that it could protect its economic interests in Europe. Yet at the same time the Americans felt, he argued, that Europe would not be entirely independent but would be "fitted into a wider Atlantic framework"[14]. This support has been maintained by successive US administrations, although with varying degrees of enthusiasm and varying degrees of reciprocity from key European states. While Kennedy presented an optimistic and embracing "grand design" for a transatlantic partnership in the early 1960s[15], de Gaulle's political posturing, but particularly the

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[11] Duchene, Francois (1994), *Jean Monnet: The First Statesman of Interdependence*, WW Norton and Company, New York, p. 386.
[12] Winand, Pascaline (1993), *Eisenhower, Kennedy, and the United States of Europe*, Macmillan, London, p. 146-7.
[13] Lundestad, Geir (1998), *Empire By Integration: The United States and European Integration 1945-1997*, Oxford University Press, p. 38.
[14] *Ibid.*
[15] Winand, *op. cit.*, p. 139.

economic challenge to the US by Europe in the 1970s, prompted concerns in successive US administrations[16].

## The US European Economic Relationship

Economically in the postwar period, the US and European ties have grown more intense with the passing decades. The support the US has shown for the EU is more than just one of avoiding war and supporting the construction of a long lasting stability in Europe; it is also one of economic interdependence and political choices on the part of both US and EU policy to facilitate and promote economic integration between the two.

In the post-war era, Featherstone and Ginsberg characterise the evolving US-EU economic relationship in three distinct phases[17]. The first, from 1945 to 1965, saw the US as the world's dominant economic power. There was very little cross-border investment between the US and Europe at the time. The second, from around 1966 to 1986, came amid declining US economic dominance. Cross-border flows picked up, as did US protectionism, with around one third of US manufactured goods protected by non-tariff barriers. At the same time, transatlantic investment accelerated with foreign direct investment between the US and the then European Community growing fivefold between 1977 and 1984 from US$34.6 billion to US$159.6 billion. The third phase, since 1986, was characterised by the relative strength of the US increasingly being matched by the growing strength of a politically and economically united Europe.

## The Transatlantic Declaration on EC-US Relations

In the 1990s, amid western Europe embracing plans for a single market and monetary union, the US and then European Community continued to consolidate their economic ties. The relationship was given a significant boost in 1990 under the Transatlantic Declaration on EC-US Relations[18]. The agreement was forged between the US and the then-European Community at a time when significant political changes were reforming Europe.

Proposed and driven primarily by the US, the declaration mostly aimed to reaffirm European solidarity in the wake of the collapse of the Soviet Union and the end of the

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16 Lundestad, *op. cit.*, p. 97.
17 Kevin Featherstone, and Roy Ginsberg (1996), The United States and the European Union in the 1990s: Partners in Transition, Macmillan Press Ltd, London
18 US Mission to the EU, "The US-EU Partnership", at http://useu.usmission.gov/transatlantic_relations.html, viewed 12 August 2014.

Cold War[19]. For Europeans, the Berlin Wall had fallen and the Cold War was coming to an end. The EU was keen to maintain security but also economic ties and avoid a widening of a "transatlantic drift"[20]. There was a general uneasiness in key states such as the UK, France and Poland (as well as in the Soviet Union) about the reunification of Germany and the threat it could potential pose in Europe[21]. Both sides saw the declaration as "essential for the preservation of peace and freedom and for the development of free and prosperous economies"[22].

While the security considerations featured prominently, the agreement came at a time when the then European Community was implementing one of the most ambitious projects in European integration: the Single Market. The Single European Act that entered into force in 1987 established the "four freedoms": freedom of movement of goods, services, people and capital. There was significant concern at the time that US firms' access to the European market might be compromised.

There were a number of specific legislative actions of concern to the US including the Second Banking Directive that was set to "profoundly" change the way non-EEC banks did business in the US. It aimed to promote the growth of EEC banks and make them stronger in the world market and, importantly, established a reciprocity test for non-EEC banks before they could do business in Europe[23]. This was of concern to the US given the numerous federal and state restrictions on non-US banks operating in the US market. Europe was the largest market for EU exports and investment and concerns about "Fortress Europe" were acute[24]. The US was keen to build European support for its international trade agenda and its efforts to shape the multilateral trade environment[25].

The declaration created a framework under which numerous issues, political and economic, transatlantic and global, were discussed in regular meetings and summits[26]. It established the basis for a "New Transatlantic Marketplace" under which barriers that hinder the flow of goods, services and capital would be progressively reduced or

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19 Pollack, Mark A. and Shaffer, Gregory (2001), *Transatlantic Governance in the Global Economy*, Rowman & Littlefield, Maryland US, p. 290; Pollack, Mark A. (2003), *The Political Economy of the Transatlantic Partnership*, Robert Schuman Centre for Advanced Studies, European University Institute, Florence, Italy, p. 5.
20 Gardner, Antony (2001), "From the Transatlantic Declaration to the New Transatlantic Agenda: The Shaping of Institutional Mechanisms and Policy Objectives by National and Supranational Actors", in Philippart, Éric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policy-making in US-EU Relations*, PIE Peter Lang, Brussels, p. 96.
21 Larres, Klauss (2004), "West Germany and European Unity in US Foreign Policy" *in* Junker, Detlef (ed), *The United States and Germany in the Era of the Cold War, 1945–1990: A Handbook: Volume 2: 1968–1990*, Cambridge, New York, p. 67; and Gilbert, Mark (2010), "Partners and Rivals: Assessing the American Role", in Kaiser, Wolfram and Varsori, Antonio, *European Union History: Themes and Debates*, Palgrave Macmillan, London and New York, p. 171.
22 European External Action Service, "Transatlantic Declaration on EC-US Relations, 1990", at http://eeas.europa.eu/us/docs/trans_declaration_90_en.pdf, viewed 11 September 2012.
23 Gruson, Michael and Nikowitz, Werner (1988), "The Second Banking Directive of the European Economic Community and Its Importance for Non-EEC Banks", *Fordham International Law Journal*, Vol. 12, Issue 2, p. 207.
24 Peterson, John (1996), *Europe and America: The Prospects for Partnership*, Routledge, New York, p. 45.
25 *Ibid.*, pp. 102-103.
26 Philippart, Éric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policymaking in US-EU Relations*, PIE Peter Lang, Brussels

eliminated. The agreement also established the basis for transatlantic regulatory cooperation "to address technical and non-tariff barriers to trade resulting from divergent regulatory processes"[27]. It led to the creation of what Pollack describes as "a new form of international governance" as a way to cope with the growing levels of transatlantic and global interdependence[28].

The declaration started a process of gradual institutionalisation of the US-EU relationship, established regular high-level political summits and outlined plans for biannual US-EU summits between the US and European Council and Commission presidents. As the 1990s started to progress the US and the EU developed vastly different positions on a number of issues, including the Bosnian conflict from 1992 to 1995, NATO's eastwards expansion as well as a range of important trade issues[29]. But the Transatlantic Declaration on EC-US Relations was a mixed bag of successes, with some degree of trade policy and regulatory convergence taking place and yet some failures.

At the same time US and European economic ties were consolidating, with Featherstone and Ginsberg arguing in 1996, the US and the EU had become "profoundly interdependent" economically[30]. By 2001 transatlantic direct investment was worth US$700 billion.

The declaration was thus followed up by a more detailed work agenda that focused on specific areas of cooperation. The New Transatlantic Agenda (NTA) and an associated Joint Action Plan were launched at the Madrid Summit in 1995 and were designed to intensify cooperation, both on trade policy and security issues. The NTA was based on four broad objectives for US-EU collaboration: to promote peace and stability, democracy and development around the world; respond to global challenges; contribute to the expansion of world trade and closer economic relations; and build bridges across the Atlantic[31].

The agreement was a way for the US to bolster support from the EU to shape the terms of future WTO accession for Russia and China, as well as other priorities like international investment liberalisation. The Office of the Trade Representative, the US Department of Commerce and the National Economic Council were key forces behind the NTA and saw it as an opportunity to contain transatlantic trade disputes and reduce trade barriers[32]. There was a distinct focus on trade and economic benefits. It too, however, had mixed

27 US Mission to the EU, "Transatlantic Relations", 5 December 1995, at http://useu.usmission.gov/new_transatlantic_agenda.html, viewed 24 May 2014.
28 Pollack, Shaffer, 2001, *op. cit.*
29 Philippart, Winand, *op. cit.* p. 97
30 Featherstone, Kevin, and Ginsberg, Roy (1996*), The United States and the European Union in the 1990s: Partners in Transition*, Macmillan Press Ltd, London.
31, US Mission to the EU, *op. cit.*
32 Gardner, *op. cit.*, pp. 98-102.

outcomes, with a "highly variable pattern of effectiveness in transgovernmental regulatory cooperation" one of the results[33].

## The Transatlantic Economic Partnership

The NTA was followed up even further three years later at the London US-EU Summit in May 1998, with the first formalised relationship between the US and the EU: the Transatlantic Economic Partnership (TEP). The TEP pledged cooperation in a range of matters, including regulatory cooperation, but particularly trade. The agreement importantly established a strategy for US-EU cooperation not only on a bilateral level but also at a multilateral level in the international environment. The US saw it as an agreement to "intensify cooperation in the area of trade", specifically the liberalisation of trade within the WTO[34]. It was intended to cover areas including trade barriers, trade rules, public procurement and intellectual property law. It heralded, however, an era of closer cooperation in a range of international forums, from the G7, G8, G20, WTO, GATT, the IMF and other international financial organisations and standards-setting bodies.

For the EU the agreement came at a time when the EU was preparing to roll out economic and monetary union and the common currency and saw the TEP as an opportunity to give a "major new impetus" to EU-US co-operation in the field of trade and investment under the framework of the New Transatlantic Agenda[35]. The TEP also committed both sides to in depth bilateral cooperation on regulatory matters. This meant regular meetings, reviews of regulatory differences, jointly defined government principles/guidelines for effective regulatory cooperation, mutual recognition processes on technical matters, interagency regulatory procedures and convergence of standards[36].

It meant a greater institutionalisation of the relationship and another step in the construction of transatlantic governance. But it also saw the promotion of closer ties fall under the supervision of the US and the EU's respective trade bureaucracies. The NTA established institutional mechanisms including a Senior Level Group of US and EU officials, comprised of the US Undersecretary of State for Economic Affairs, representatives from the Commission DGs for external affairs and trade and representatives from the Council presidency. It also established a lower level task force to

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[33] Pollack, Mark A. (2005), "The New Transatlantic Agenda at Ten: Reflections on an Experiment in International Governance", *Journal of Common Market Studies*, Vol. 43, Issue 5.
[34] US Mission to the EU, "The US-EU Partnership", at http://useu.usmission.gov/transatlantic_relations.html, viewed 12 August 2014
[35] European Commission, DG Trade and Enterprise, "Transatlantic Economic Partnership: Overview and Assessment", October 2000, at http://trade.ec.europa.eu/doclib/docs/2003/october/tradoc_111712.pdf, viewed 14 July 2014.
[36] US Mission to the EU, "Transatlantic Economic Partnership Agreement", 9 November 1998, at http://useu.usmission.gov/transatlantic_economic_partnership.html, viewed 5 August 2014.

monitor, coordinate and implement measures. Bilateral US-EU Summits were the primary forums for discussion under the NTA[37].

The summits created deadlines for progress reports and placed pressure on low-level bureaucrats to produce results. In addition, industry and business were given important places at the table. The NTA created other important institutional forums, including the Transatlantic Business Dialogue (TABD), a regular forum established in 1995 that brings together annually hundreds of CEOs from US and EU firms and high level government officials to exchange views on regulatory and standards matters[38]. Also established under the NTA was the Transatlantic Legislator's Dialogue, a parliamentary relationship created in 1999 that involved bi-annual meetings of the European Parliament and the US Congress on specific topics of mutual concern[39].

This even more intimate bilateral cooperation and higher level of institutionalisation came at a time of significant regulatory changes in both the US and the EU that affected the US' financial — and hence economic — interests. As part of the Single Market the EU had proposed to more closely integrate its own financial markets. Its centrepiece policy was the Financial Services Action Plan (FSAP) that aimed to create a single European capital market. Involving a legislative program of 42 specific reform actions[40] it was adopted by the European Council in December 1998 and launched by the European Commission in May 1999. The FSAP reforms included new EU-wide rules on banking, insurance, securities, mortgages, pensions and other forms of financial transactions, with the key objective to create a single wholesale market, an open and secure retail market, common prudential rules and a pan-EU supervisory framework.

At the heart of the FSAP was a proposed Markets in Financial Instruments Directive (MiFiD), which would not only overhaul but also harmonise securities regulation throughout the EU. There was concern in the US, however, that US financial services providers operating in the EU might be disadvantaged by standards that would discriminate against foreign firms[41]. US firms were also concerned about the cost of implementation of the new MiFiD rules[42]. The TEP led to even greater institutionalisation of the US-EU relationship. A TEP Steering Group was established in 1999 along with expert working groups that discussed particular issues. These included pushing for a

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37 Pollack, 2003, *op. cit.*
38 Transatlantic Business Dialogue, "History and Mission", at http://www.transatlanticbusiness.org/about-us/history-mission/, viewed 1 June 2014.
39 European Parliament, "Transatlantic Legislators' Dialogue", at http://www.europarl.europa.eu/intcoop/tld/default_en.htm, viewed 12 June 2014.
40 Communication of the Commission, Implementing the Framework for Financial Markets: Action Plan, COM(1999)232, 11 May 1999.
41 US House of Representatives Committee on Financial Services (2002), "The European Union's Financial Services Action Plan and its Implications for the American Financial Services Industry", Washington DC, 22 May, at http://www.gpo.gov/fdsys/pkg/CHRG-107hhrg82397/pdf/CHRG-107hhrg82397.pdf, viewed 21 May 2014.
42 *Ibid.*

common US-EU agenda for the Doha round of WTO trade talks, identifying new areas for regulatory cooperation and taking steps to reduce transatlantic trade barriers[43]. A further measure was an "early warning system" to flag potential trade problems between the US and the EU before they became trade disputes.

The Transatlantic Declaration on EC-US Relations in 1990 triggered a new round of scholarly debate on the developing US-European relationship. Pollack and Shaffer characterised the evolving US-EU relationship as being of three types: intergovernmental, where heads of government and other high-level officials negotiate; transgovernmental, were lower level domestic officials with on specific issues to coordinate and harmonic respective policies; and transnational, where private actors, including business and industry, coordinate efforts to further their respective interests[44].

## The Financial Markets Regulatory Dialogue

It was in this largely trade-focused agenda that a regulatory institutionalised arrangement was established to facilitate, hasten and encourage ongoing regulatory cooperation between the US and the EU. The Financial Markets Regulatory Dialogue (FMRD) was formed at the EU-US Summit in Washington in May 2002 and, while it was built on earlier pledges for regulatory cooperation under the TEP[45], the FMRD became the primary forum for regulatory discussion on financial reform between the US and the EU[46].

In the EU the responsibility for regulatory cooperation fell within the purview of the Commission's director-general for internal markets, DG MARKT. In the US it involved the US Treasury. Both DG MARKT and the Treasury officially co-chaired the forum[47]. Other US regulators, such as the US Federal Reserve Board, the US Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and the Federal Deposit Insurance Corporation, have since attended, as have representatives of the various EU financial supervisory committees on the EU side[48].

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43 Transatlantic Economic Partnership Steering Group (2001), "Report of the Transatlantic Economic Partnership Steering Group EU-US Summit", Brussels, 14 June, at http://useu.usmission.gov/media/pdfs/jun1401_tep_report.pdf, viewed 26 October 2014.

44 Mark A. Pollack, Gregory C. Shaffer, "Transatlantic Governance in the Global Economy", Rowman and Littlefield, Maryland, 2001

45 European Commission (1991), "Joint Statement on the Establishment of Improved Cooperation between the United States Securities and Exchange Commission and the European Commission of the European Communities", 23 September, at http://europa.eu/rapid/press-release_IP-91-852_en.htm, viewed 1 February 2013.

46 Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.

47 *Ibid.*

48 Prior to 2011, there were three EU-level committees that played a role in supervising EU financial markets, namely the Committee of European Banking Supervisors, the Committee of European Securities Regulators and the Committee of European Insurance and Occupational Pensions Supervisors. These "level 3" committees as they were known were established under the Lamfalussy process of financial supervision. Named after Alexandre Lamfalussy who chaired the EU advisory committee that created it, the process was designed to coordinate regulatory harmonisation throughout the EU but in line with the EU treaty principle of subsidiarity. However, this system was superseded by a new European System of Financial Supervisors that came into effect on 1 January 2011 and now comprises three regulatory agencies

Originally the US saw the FMRD as a way to identify SEC proposals that conflicted with foreign laws and foreign stock exchange requirements and cooperate with trading partners to create a regulatory environment conducive for US firms. The SEC also established other dialogues with foreign counterparts in Asia and Latin America, similarly to secure the interests of US business abroad. While the US had a keen interest in the ongoing FSAP program, the EU had an interest in greater regulatory cooperation in the US as well. The Europeans were concerned about the extraterritorial effects for EU businesses of the Sarbanes-Oxley Act, enacted in 2002 as a response to the Enron, Arthur Andersen and the other US financial scandals[49].

The Act was a landmark overhaul of US corporate and capital market legislation and applied to all companies listed on US stock exchanges, including many of Europe's largest companies whose shares were traded on US exchanges in the forms of American Depository Receipts (ADRs)[50]. The Act imposed among other things new auditing, corporate governance, internal control and financial disclosure requirements and European companies were concerned about the costs and access to the US market[51]. For example it required audit committees to be independent and auditors to be registered with the new US Public Company Accounting Oversight Board[52].

European companies were also concerned about requirements for EU companies that wanted to deregister from US exchanges, and the need for convergence of quite different US and international accounting standards, the latter of which had been embraced in Europe. The European Commission saw the FMRD as having two functions: to create an informal channel to anticipate potential regulatory conflict areas and avoid disputes; and to discuss concerns and resolve conflicts on matters such as the Sarbanes-Oxley Act. It sought to mitigate what it saw as "unwarranted effects" of such legislation and identified seven categories of issues to be resolved, namely: registration of EU audit firms, US access to EU audit working papers, auditor independence, audit committee requirements, loans to directors, certification of financial reports and certification of internal controls[53].

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with greater authority, namely the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA) .

49 Securities and Exchange Commission (2002), The Office of International Affairs, Annual Report 2002, Washington DC, at https://www.sec.gov/pdf/annrep02/ar02intaffs.pdf, viewed 11 April 2013.

50 ADRs are "mirror" stocks that are often underwritten by US banks and effectively allow US investors to buy and trade shares in foreign companies on US stock exchanges.

51 Edser, Nick (2002), "Fraud Law Set to Hit UK Firms", *BBC News*, 15 August 2002, at http://news.bbc.co.uk/2/hi/business/2195451.stm, viewed 12 August 2014.

52 Hellwig, Hans-Jurgen (2012), "The Transatlantic Financial Markets Regulatory Dialogue", in Hopt, Klaus J.; Wymeersch, Eddy; Kanda, Hideki; Baum, Harald, *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US*, Oxford Scholarship Online, March.

53 European Commission (2002), "Meeting the Barcelona Priorities and Looking Ahead: Implementation", Seventh Report, Brussels, 3 December, at http://ec.europa.eu/internal_market/finances/docs/actionplan/index/progress7_en.pdf, viewed 12 April 2013.

After the first FMRD meeting in March 2002, subsequent meetings took place roughly every four to six months, with participants discussing ongoing matters of concern as the FSAP legislative program proceeded with haste[54]. One of the strategies that were developed to tackle differences was the idea of "regulatory equivalence". On a trip to the US to allay concerns about the EU's overhaul of financial services, Alexander Schaub, the Director-General of the Commission's DG Internal Market, told US legislators that their country's access to the EU market would be maintained.

Speaking before US Congress in May 2003 he said "regulatory equivalence" meant a change in practice on the part of regulators and market supervisors on both sides of the Atlantic[55]. "Before compelling service providers or businesses to comply with the full set of local rules — including ones which may even contradict those which they are asked to meet in their home jurisdiction — regulators and supervisors should follow a rule of reason approach", he said. "They should ask themselves whether the ways in which those companies are regulated in their home jurisdiction meet comparable or equivalent prudential and investor protection standards to those achieved by local rules." In the EU's view, convergence alone was "not the solution". Setting the scene for a process of mutual regulatory recognition, he said recognition of equivalent approaches with the same goal should supersede separate and identical approaches to legislating[56].

By July 2003, of the 42 original measures in the FSAP, 36 had been finalised and three were still under negotiation, with three proposals still to be made[57]. The work program included a range of issues including regulation of credit ratings agencies, convergence of accounting standards, insurance solvency rules, derivatives regulation and alternative investment fund managers[58]. Some of the earlier meetings were criticised as having achieved very little. It is true that a meeting in December 2005 discussed among other issues "monitoring" developments relating to hedge funds and policies regarding the conduct of credit rating agencies while another issue discussed in 2005 was "promoting" convergence of accounting standards". Yet changes to EU policy or changes to US policy to accommodate each other's positions were lacking in coming over this period.

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54 Schaub, Alexander (2004), "Testimony of Alexander Schaub, Director-General, DG Internal Market of the European Commission before the Committee on Financial Services", Committee on Financial Services, US House of Representatives, Washington DC, May 13, at http://financialservices.house.gov/media/pdf/051304as.pdf, viewed 14 May 2014.

55 *Ibid.*

56 *Ibid.*

57 HM Treasury, the Financial Services Authority and the Bank of England (2003), "The EU Financial Services Action Plan: A Guide", London, 31 July, at http://www.bankofengland.co.uk/archive/Documents/historicpubs/qb/2003/qb030309.pdf , viewed 2 February 2013.

58 European Commission, DG Internal Market, "Third Countries Dialogues Update: Note to the Financial Services Committee", Brussels, 11 November 2009, at http://ec.europa.eu/finance/general-policy/docs/global/third_countries_dialogues_en.pdf, viewed 12 February 2013.

However, early discussions under the FMRD did lead to accommodation on the part of the EU of US concerns[59]. For example concern over the proposed Markets in Financial Instruments Directive led to an extension of the EU's implementation deadline to January 2007 for US companies[60]. The directive, which was finalised in 2004, created detailed rules throughout the EU that affected the whole securities trading cycle and covered hedge fund managers, asset fund managers, retail investors, investment advisers and stock exchanges themselves. Despite the sometimes lack of obvious concession from either sides in the first decade of operation, the FMRD did generate policy convergence. As such it was an important channel for the US to access EU policymakers at the time the financial crisis hit Europe.

### From Cooperation to Transatlantic Integration

In mid 2005 the US and EU relationship moved from discussion about transatlantic cooperation to transatlantic economic "integration". The US-EU Summit in 2005 launched an Initiative to Enhance Transatlantic Economic Integration and Growth. One of the 11 priorities was to promote EU-US regulatory cooperation, with the aim "to build effective mechanisms to promote better quality regulation, minimize unnecessary regulatory divergences to facilitate transatlantic trade and investment and increase consumer confidence in the transatlantic market"[61].

While such measures were discussed at the FMRD meetings in 2005 and 2006 the EU-US Summit in 30 April 2007 took the process even one step further — explicitly committing to advance economic integration between the EU and the US. To this end, European Commission President Barroso, German Chancellor Merkel (who chaired Germany's presidency of the EU at the time) and US President Bush signed a "Framework for Advancing Transatlantic Economic Integration between the United States of America and the European Union" that outlined a detailed work program for economic integration around areas such as financial markets reform, regulatory cooperation and investment to name a few areas[62].

### The Transatlantic Economic Council

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[59] European Commission (2003), "Financial Services Nine Months Left to Deliver the FSAP", Eighth Report, Brussels, 3 June, at http://ec.europa.eu/internal_market/finances/docs/actionplan/index/progress8_en.pdf, viewed 10 June 2013.

[60] Moloney, Niamh (2006), III, Financial Market Regulation in the Post-Financial Services Action Plan era, *International and Comparative Law Quarterly*, Vol. 55, No. 4.

[61] Council of the European Union, "EU-US Declaration: Initiative to Enhance Transatlantic Economic Integration and Growth", 20 June 2005, at http://www.europarl.europa.eu/document/activities/cont/201004/20100427ATT73625/20100427ATT73625EN.pdf, viewed 16 November 2014.

[62] European Commission (2008), "Framework for Advancing Transatlantic Economic Integration between the United States of America and the European Union", April 2008, at http://ec.europa.eu/enterprise/policies/international/cooperating-governments/usa/transatlantic-economic-council/index_en.htm, viewed 4 April 2013.

The commitment was institutionalised with the Transatlantic Economic Council, an intergovernmental political body established to specifically "accelerate government-to-government cooperation" and "push regulatory convergence in nearly 40 areas"[63]. Agreed at the EU-US Summit in 30 April 2007 its explicit aim was to advance economic integration between the EU and the US. To this end, European Commission President José Manuel Barroso, German Chancellor Angela Merkel, who chaired the EU Council Presidency at the time, and US President George Bush signed a "Framework for Advancing Transatlantic Economic Integration between the United States of America and the European Union" that outlined a detailed work program around areas such as financial markets reform, regulatory cooperation and investment to name a few areas[64].

Meeting for the first time in Washington DC on 9 November 2007, the council comprised members of the European Commission and US Cabinet members with the political responsibility for the policy areas covered by the framework as well as a group of advisors on both sides. The priority areas in terms of financial regulatory cooperation were accounting standards, capital markets regulation and auditing and the EU-US Financial Markets Regulatory Dialogue[65]. The council has met just four times since its establishment. Some scholars have consequently criticised the New Transatlantic Agenda as being largely ineffectual although a "noteworthy experiment in international governance"[66]. Even so it was, according to Pollack, a departure from the US-EU history of "shallow integration". Indeed it led to the progressive reduction of border impediments, tariffs, quotes and the move towards free movement of goods. The agreement was a milestone in US-EU relations.

## Transatlantic Regulatory Cooperation

Arising from it was a forum designed to focus specifically on regulatory reform: the High-Level Regulatory Cooperation Forum. Involving regulators in a range of areas, it aimed to share and coordinate respective experiences with regulatory cooperation approaches. Its agenda included developing mutual recognition agreements on a range of issues from import safety regulation, as well as discussing approaches to regulation (such as the use of standards and self-regulation) to nanotechnology and animal welfare. Regulatory affairs was one of the areas of cooperation between the EU and the US, with the various

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63 US Whitehouse (2007), "US-EU Summit in Washington on April 30, 2007", 30 April, at US Mission to the EU, http://useu.usmission.gov/washington-summit-07.html, viewed 16 September 2014.
64 European Commission (2008), "Framework for Advancing Transatlantic Economic Integration between the United States of America and the European Union", April 2008, at http://ec.europa.eu/enterprise/policies/international/cooperating-governments/usa/transatlantic-economic-council/index_en.htm, viewed 4 April 2013.
65 TEC meetings during 2008-2010 were held on 9 November 2007 in Washington; 13 May 2008 in Brussels; 12 December 2008 in Washington; 27 October 2009 in Washington; and on 17 December 2010 also in Washington.
66 Pollack, 2005, *op. cit.*

Directorates-Generals in the Commission having their own arrangements with US counterparts in their particular policy sectors as well. It was in this existing framework that the financial crisis emerged and intensified the need for cooperation even further.

US financial markets regulators embraced a specific bi-focal strategy: to strengthen bilateral ties with key partners and work with those partners through the multilateral environment to shape outcomes according to their priorities. The SEC's international reach for example is now promoted through its Office of International Affairs (OIA) whose official goal is to improve domestic investor protection and facilitate cross-border securities transactions through international regulatory and enforcement cooperation and promoting the adoption of high regulatory standards worldwide[67]. The OIA explicitly states it advances the SEC's interests through two means: a number of specific international organizations and bilateral dialogues with key economies (including the EU).

The EU has embraced an identical strategy to shaping international financial governance outcomes: through its bilateral regulatory dialogues with key economic partners "currently the US, Japan, China, India, Russia and Brazil", as well as through international forums and international organisations. The latter include the G20, the FSN and the various financial standards bodies. Its stated objective is not only to mould the shape of converge of international standards to represent EU interests but also to develop a "consistent policy for EU financial services market" itself[68].

## US and EU Interdependence at the Emergence of the Global Financial Crisis

No matter how interdependence is viewed — in terms of commercial transactions, trade or foreign investment or vertically in terms of transactions or horizontally in terms of political responses — there is ample evidence to highlight the greater connectedness of the US and the EU economically and, as a consequence, politically at the time the financial crisis emerged across the Atlantic.

In terms of trade in 2008 the EU was overwhelmingly the US' most important trade partner. The EU represented US$639 billion in trade (imports and exports) with Canada second at US$600 billion; trade with the EU represented 18.85% of all US foreign trade[69]. The EU exported significant goods to the US, with roughly 59% of US imports coming from the EU. Around 65% of US imports from Germany in 2007 consisted of related-

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67 Securities and Exchange Commission, "Advancing the SEC's Mission through International Organizations", at http://edgar.sec.gov/about/offices/oia/oia_intlorg.shtml#monitoring, viewed 12 September 2014.
68 European Commission, DG Internal Market and Services, "International Relations", the EU Single Market, at http://ec.europa.eu/internal_market/finances/global/index_en.htm, viewed in 22 August 2014.
69 US Department of Commerce International Trade Administration, "Top US Trade Partners", (using figures compiled from the US Department of Commerce, Census Bureau, Foreign Trade Division), 2009, at http://www.trade.gov/mas/ian/build/groups/public/@tg_ian/documents/webcontent/tg_ian_003119.pdf, viewed 12 November 2012.

party trade, or trade between company operations on each side of the Atlantic, highlighting how investment drives transatlantic trade[70].

In respect to commercial transactions, US-EU trade generated US$3.75 trillion in total commercial sales a year and employed up to 14 million workers in mutually onshored jobs on both sides of the Atlantic[71]. In respect to the US and EU financial services industries specifically, in 2008 the two markets together comprised nearly $4.1 trillion (€2.8 trillion) in direct investment and had stock and bond flows worth more than US$51.3 trillion (€35 trillion) a year. They accounted for 70% of global financial services business and had a collective consumer base of 800 million people[72].

In the area of foreign investment, despite a growing focus on emerging economies and the much-heralded growth of China as an important partner for the US, Europe remained much more significant. US firms invested US$26.4 billion in China between 2000 and mid-2008 — but this was less than US investment in small Belgium and less than half of US investment in Ireland. US investment in the BRICs countries (Brazil, Russia, India and China) totalled US$57.6 billion from 2000 to mid-2008, on par with US investment in Germany alone and 14% of total US investment in the EU[73].

The US-EU relationship remained the most important for the US despite a more recent focus on emerging economies. During the decade six of the top ten US investment markets were in Europe. In fact US investment in either the Netherlands or the UK in the decade was greater than total US investment in all of South and Central America, the Middle East and Africa. America's cumulative investment in Brazil in the decade to 2009 (U$12 billion) was roughly half US investment in Spain. US investment in Russia over the same period (US$9 billion) was 40% of US investment in Italy; and US investment in India (US$10.4 billion) was half US investment in Sweden and roughly the same as US investment in Poland, the Czech Republic and Hungary[74].

Europe's interest in the US was reciprocally also significant. European investment in the US totalled a record US$1.5 trillion in 2007 (on an historic cost basis) — 12% more than 2006 and more than triple the level of a decade earlier[75]. The EU's investment stock in the US rose by over 21% between 2002 and 2006, with the US accounting for roughly 35% of

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70 Forster, Katrin; Vasardani, Melina; Ca' Zorzi, Michele (2011), "Euro Area Cross-Border Financial Flows and the Global Financial Crisis", Occasional Paper No. 126, European Central Bank, Frankfurt, July, at http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp126.pdf, viewed May 2013.
71 Hamilton, Quinlan, *op. cit.*
72 EU-US Coalition on Financial Regulation (2008), "Mutual Recognition, Exemptive Relief and "Targeted" Rules' Standardisation: The Basis for Regulatory Modernisation", Securities Industry and Financial Markets Association, March 2008, at http://www.sifma.org/uploadedfiles/newsroom/2008/us-eucoalition-fin-regualtion-reportmar08.pdf, viewed 13 November 2015
73 *Ibid.*
74 *Ibid.*
75 *Ibid.*

extra-EU FDI stock abroad. US services exports to the European Union more than doubled between 1997 and 2007, rising from around US$75 billion to nearly US$180 billion in 2007. There is also substantial evidence to suggest that market links intensified between the US and the EU in the years before the crisis. Between 2002 and 2007, US affiliate earnings from the EU rose more than threefold, from US$26.7 billion in 2002 to over US$82 billion in 2007[76].

These figures highlight how there has been progressive consolidation of deep financial and economic ties between the US and the EU over many decades on multiple levels, in the areas of banking, financial services, trade in good and services and foreign investment.

As has been the case historically in the postwar period, Europe's dependence on the US was somewhat greater than the US' dependence on Europe. One study that aimed to quantify the interdependence between banking in Europe and cross border stability found that the allocation of European banks to the US was "much larger than justified by the size of the United States" and that the EU had disproportionately lower exposure to China and Japan for example[77]. The EU's over-exposure to the US was partly because European banks favoured a large presence in the major markets of the US. This helps explains why the largely US-originated financial crisis had such a significant impact on European banks.

## Conclusion

At the time the global financial crisis broke in 2008, the US and the EU were highly interdependent — politically and economically. Considering Keohane and Nye's conceptions of complex interdependence, the US and EU were mutually dependent, with the cost of disentanglement extremely high. A range of multiple interstate, transnational and transnational channels connect their respective economies (2) there were a wide range of issues not arranged in any particular hierarchy that bound their relationship (3) and with the exception of the role of NATO in Europe, there was diminished role for military force as a policy tool in the relationship.

The high level of interdependence between the US and the EU markets meant there was little rational choice for policymakers but to collaborate closely in a policy response. Given the close economic ties, the consequences of the collapse in world markets at the end of 2007 were grave, for both the US and the EU. In their annual survey of the transatlantic economy in 2009, the Center for Transatlantic Relations at the Johns Hopkins University found that while the transatlantic economy remained "the foundation of the global

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[76] *Ibid.*

[77] Schoenmaker, Dirk and Wagnerz, Wolf (2013), "Cross-Border Banking in Europe and Financial Stability", *International Finance*, Vol. 16, No. 1.

economy", it had slipped into "what could be perhaps its deepest recession since World War II"[78].

The financial crisis had made a transatlantic response a necessity. As Mervyn King, the governor of the Bank of England at the time noted, it was "hard to imagine a solution that does not involve actions in more than one country"[79]. This is precisely the course of action that the US and the EU chose to take at the very outset of the financial crisis. Coordinating an early response to the financial crisis became imperative as did coordinating financial regulatory reform efforts in the US and EU domestic markets when it became clear that reform was critical.

78 Hamilton, Quinlan *op. cit.*

79 King, Mervyn, Governor of the Bank of England (2011), "Monetary Policy Developments", speech to the Institute of Directors, St George's Hall, Liverpool, 18 October.

# CHAPTER 2: BACKGROUND TO THE GLOBAL FINANCIAL CRISIS IN THE US AND THE EU

## From Housing Crisis to Banking Crisis

The financial crisis of 2007-09 was the end of a sustained period of financial market and economic growth in the US and Europe. While stock market falls, banking crises and economic recessions had come and gone in previous decades, the financial crisis that emerged in the US and Europe at the end of the last decade was the most severe seen since the Great Depression. The US economy enjoyed good times in the mid 2000s, with rising property prices, rising household wealth and contained unemployment levels. After sustained housing price growth in the US since 2002[1], in early 2006 the US housing market started to head downwards[2].

US housing data shows that the housing market started to take a clear turn for the worse in early 2006, even though some financial industry executives suggested they were concerned about "serious signs of bubbles" as early as 2005[3]. As the housing market contracted, more borrowers were left vulnerable, pushing up delinquency rates. In early 2007 the housing markets continued to fall and, while delinquency rates typically rise when housing markets contract, there were particularly worrying signs this time. The foreclosure rate on subprime loans[4] rose from 4.5% in the fourth quarter of 2006 to 8.7% a year later[5]. Mortgage Bankers Association data shows absentee owners accounted for almost one in five loans entering foreclosure in the third quarter of 2007[6].

As the market went from bad to worse, the problems started to more seriously affect the financial markets, particularly banks that had heavy exposure to the mortgage market and some of the newer risky mortgage-based products. Some mortgages were packaged into new types of residential mortgage-backed securities, including Collateralised Debt Obligations (CDOs), a new type of securitised product that comprised some higher quality and some poorer quality mortgages. Large banks, including investment banks Merrill Lynch, Bear Stearns, and the later bankrupt Lehman Brothers, and commercial banks and thrifts such as Citibank, Wells Fargo, and Washington Mutual, had packaged the loans into securities and sold them around the world.

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[1] Financial Crisis Inquiry Commission (2011), "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States", Washington DC, January, at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, viewed 13 October 2012, p.444.
[2] The NAHB/Wells Fargo Housing Market Index, at http://www.nahb.org/reference_list.aspx?sectionID=134, viewed 12 July 2011.
[3] Financial Crisis Inquiry Commission, *op. cit.* p.33.
[4] Subprime loans are loans that are extended to people who would not qualify for loans under tighter lending standards.
[5] *Ibid.,* p.22.
[6] *Ibid.*, p.4.

Concerns over the level of US subprime mortgages and the degree to which exposure to them had permeated the entire banking system started to cause shortages of liquidity in money markets around the world, causing inter-bank lending to dramatically slow in mid 2007. It also severely weakened capital standards at major banks and led to the upward repricing of risk across a broad range of financial instruments[7]. The mounting mortgage markets losses had a big impact on banks — and this led to a second phase of the crisis during which financial institutions, notably US investment banks, incurred large losses.

## The Transatlantic Dimension

With many of the largest banks having transatlantic operations, and with many of the riskier financial products having been sold throughout Europe, the effects started to reverberate cross the Atlantic. After troubled UK lender Northern Rock was forced to turn to the Bank of England for emergency financial support on 13 September 2007, triggering the first run on a UK bank since 1866[8], a series of other banking collapses followed. In August 2007 France's BNP Paribas froze three of its investment funds, announcing it had no way of valuing the complex assets inside them. There was a widespread plummet in interbank lending. Banks not only conserved their own liquidity to absorb losses but there was widespread confusion, suspicion and nervousness in the banking market about lending. Banks were unsure which of them had exposure to the largest losses and some of them were even unsure about their own exposure.

The drop in interbank market liquidity prompted the US Federal Reserve, the European Central Bank (ECB), central banks in EU member states and central banks around the world to continue to inject liquidity into the market to maintain lending and confidence. Central banks in the US, the EU, Canada and Switzerland in late 2007 intervened in the market with a plan to buy at least US$90 billion in short-term financing to banks[9]. The crisis had moved from being mainly a housing market crisis to one that affected the entire banking system.

Many European policymakers early on in the crisis were under the impression that Europe might not be as affected by the rapidly escalating problems as the US. In early 2008, even though the US had been in recession for some months and markets had been on a downward spiral for over a year, the European Commission downplayed the risk of recession in January 2008. The European Commissioner for Economic and Monetary

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[7] International Monetary Fund (2008), "Global Financial Stability Report", Washington DC, April, at https://www.imf.org/External/Pubs/FT/GFSR/2008/01/index.htm, viewed 16 September 2014.
[8] House of Commons Treasury Committee (2008), "The Run on the Rock: Government Response to the Committee's Fifth Report of Session 2007–08", London, at http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/918/918.pdf, viewed 14 November 2013.
[9] "Casualties of the Financial Crisis", *The New York Times*, 1 October 2008, at http://www.nytimes.com/imagepages/2008/10/01/business/20081001_GLOBAL_GRAPH.html, viewed 10 August 2012.

Policy Joaquín Almunia said the EU economy had been "less exposed than others to deep or protracted recessions"[10]. The ECB was even sufficiently optimistic to raise interest rates during the summer. German finance minister Peer Steinbruck proclaimed that the financial crisis was an "American problem" and the product of American greed and inept and inadequate regulation[11]. This is despite the fact that earlier in summer 2007 IKB Deutsche Industriebank, which was heavily loaded with US subprime securities, was bailed out by its parent company and a German banking association.

As 2008 progressed it became clear that problems were not just an ordinary downturn, however, and that the potential for both financial crisis and serious economic percussion was real. In April 2008 the International Monetary Fund proclaimed the financial market crisis had developed into "the largest financial shock since the Great Depression, inflicting heavy damage on markets and institutions at the core of the financial system"[12]. US investment bank Bear Stearns got into serious financial difficulty and was acquired by JP Morgan and then, in July 2008, the US Government was forced to bail out Fannie Mae and Freddie Mac.

## The Turning Point

In September 2008 events took a dramatic turn for the worse, with the collapse of Lehman Brothers, the fourth largest US investment bank in the US at the time. With a history that dated back to 1850 and having survived the Great Depression, it was crippled by debts and was unable to find a buyer. It filed for bankruptcy on 15 September 2008 and had no cash when administrators took over[13]. At the same time Merrill Lynch, another of the big banks, had agreed to be acquired by Bank of America[14]. This marked a new depth in the crisis and came amid concerns that American International Group, one of the country's largest insurers, might also collapse. The Dow Jones Industrial Average, which was at a peak of 14,163 points on 9 October 2007, had fallen by 29.74% on 15 September 2008. The result was widespread financial panic.

Faced with the prospect of a run on banks, the US Government was compelled to act, as the scale of losses in the US mortgage markets became apparent and as the mood in the financial markets continued to deteriorate. Andrew Sorkin argues in his book that Wall

[10] European Commissioner for Economic and Monetary Policy (2012), European Commissioner for Economic and Monetary Policy (2012), "Reinforcing EMU after the first decade", press release, at http://europa.eu/rapid/press-release_SPEECH-08-20_en.htm?locale=en, viewed 1 August 2012.
[11] Hamilton, Daniel S. and Quinlan, Joseph P. (2009), "The Transatlantic Economy 2009: Annual Survey of Jobs, Trade and Investment between the United States and Europe", Center for Transatlantic Relations, Washington DC, at http://transatlantic.sais-jhu.edu/transatlantic-topics/transatlantic-economy-series.htm, viewed 29 September 2014.
[12] International Monetary Fund (2008), "World Economic Outlook", Washington DC, April, at http://www.imf.org/external/pubs/ft/weo/2008/01/pdf/text.pdf, viewed 12 June 2014.
[13] "Lehman Bros Files for Bankruptcy", *BBC News*, 16 September 2008, at http://news.bbc.co.uk/2/hi/business/7615931.stm, viewed 12 August 2012.
[14] Sorkin, Andrew Ross (2008), "Lehman Files for Bankruptcy; Merrill is Sold", *The New York Times*, 14 September, at http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all&_r=0, viewed 16 November 2012 .

Street financiers succeeded in convincing US officials that the top banks in the US were "too big to fail"[15]. The US Treasury's objective was to remove the most toxic debt from bank balance sheets, notably the mortgage-linked securities that no-one wanted to buy[16]. The goal of what was known as the Troubled Asset Relief Program was to help to remove uncertainty and re-focus the markets on fundamentals[17].

Just days later, on 20 September, the US Treasury Secretary Henry Paulson proposed a federal fund to buy US$700 billion worth of those illiquid assets from the banks. Paulson worked closely with Federal Reserve Chairman Ben S. Bernanke and then-New York Fed President Timothy Geithner in formulating the government response[18]. The Dow plummeted another 29.18% over the next four weeks to 8451.19 points on 10 October 2008. The markets continued to fall over the next month another 12%. After the failure of Lehman Brothers, there was a widespread collapse of confidence in the banking systems across the Atlantic[19]. US investment manager Warren Buffet proclaimed that the US economy and market confidence had "fallen off a cliff"[20].

## The Common Causes of the Financial Crisis

There were a number of conditions that had made this crisis much worse than many previous crises — in both the US and in the EU. There is a consensus among scholars that two broad types of financial system systemic risk exist: common shocks and contagion[21]. The former includes developments such as rapid asset price growth, poor lending practices, poor regulation, financial innovation, global imbalances and regulatory capture etc. The causes related to contagion, however, arose from losses from one market that directly affected the other. These included losses incurred by US banks from CDOs and other risky financial transactions for example. Contagion requires interconnectedness of markets and economies.

There were a number of conditions common to both the US and the EU in the lead up to the financial crisis. The US Government's Financial Crisis Inquiry Commission, which handed down its report in January 2011, pointed to a build up of warning signs including

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[15] Sorkin, Andrew Ross (2009), *Too Big to Fail*, Penguin, London.
[16] "Text of Draft Proposal for Bailout Plan", *The New York Times*, 20 September 2008, at http://www.nytimes.com/2008/09/21/business/21draftcnd.html?_r=0, viewed 16 December 2012.
[17] Almunia, Joaquín, European Commissioner for Economic and Monetary Policy (2008), "Situation of the World Financial System and its Effects on the European Economy", speech in European Parliament Plenary Debate, Brussels, 24 September, at http://europa.eu/rapid/press-release_SPEECH-08-456_en.htm?locale=en, viewed 14 August 2013.
[18] Paulson, Henry M. (2010), *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, Hachette Book Group, New York.
[19] King, Mervyn, Governor of the Bank of England (2009), CBI Dinner, Nottingham, at the East Midlands Conference Centre, 20 January, at http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech372.pdf, viewed 14 September 2013; and Landler, Mark (2008), "The US Financial Crisis is Spreading to Europe", *The New York Times*, 30 September, at http://www.nytimes.com/2008/10/01/business/worldbusiness/01global.html, viewed 12 November 2012.
[20] "Warren Buffett's Complete CNBC One Year Later Interview", *CNBC*, 16 September 2009, at http://www.cnbc.com/id/32873440, viewed 14 November 2013.
[21] Trapp, Monika and Wewel, Claudio (2013), "Transatlantic Systemic Risk", *Journal of Banking and Finance*, Vol. 37, No. 11.

"an explosion in risky subprime lending and securitisation, an unsustainable rise in housing prices, widespread reports of egregious and predatory lending practices (and) dramatic increases in household mortgage debt"[22]. A paper published later for the IMF in December 2010 identified inadequate supervision and regulation contributed significantly to the problems. Dagher and Fu found that lightly regulated non-bank mortgage originators in the US contributed disproportionately to the boom-bust housing cycle by lending to borrowers who fundamentally could not afford to repay their loans[23].

Many of these problems had also afflicted Europe. A report into the causes of the crisis in Europe by the European Commission found that the crisis was preceded by a long period of rapid credit growth, abundant liquidity, strong leveraging, soaring asset prices and the development of bubbles in the real estate sector of some member states. Stretched leveraged positions and maturity mismatches rendered financial institutions very vulnerable to corrections in asset markets, deteriorating loan performance and disturbances in the wholesale funding markets. A lack of supervision and regulation was also a problem. The De Larosière Group, a EU-commissioned committee formed in October 2007 to review the previous committee-based regulatory and supervisory structure, made similar observations. The group in its report argued that market liquidity and low interest rates were "the major underlying factor behind the present crisis", with financial markets and product innovation amplifying and accelerating the consequences of excess liquidity and rapid credit expansion[24].

It also became clear that the financial architecture in the EU was flawed. The De Larosière Report found a range of inadequacies in the financial and supervisory framework of the EU as a whole. It identified inadequate prudential supervision, ineffective early warning mechanisms, and uncertainty over intra-EU supervisory competences, failures to challenge supervisory practices on a cross-border basis and a range of other supervisory challenges. "What is clear is that market participants, but also regulators and supervisors were unable to properly understand the risks of this situation and therefore could not prevent the consequences that we see today", it found[25].

Additionally for both the US and Europe, one of the problems giving rise to a lack of regulation was regulatory capture. Regulatory capture is when a regulatory agency that is charged with acting in the public interest advances the interests of the industry instead of restraining industry activity. Some scholars argue that European banks started promoting widespread capital markets innovation in the mid-1990s to try and make industry become

[22] Financial Crisis Inquiry Commission, *op. cit.*, p xvii.
[23] Dagher, Jihad and Fu, Ning (2011), "What Fuels the Boom Drives the Bust: Regulation and the Mortgage Crisis", IMF Working Paper WP/11/215, Washington DC, June, at https://www.imf.org/external/pubs/ft/wp/2011/wp11215.pdf, viewed 9 August 2014.
[24] The High Level Group on Financial Supervision in the EU" (2009), "Report", chaired by Jacques de Larosière, Brussels, 25 February, at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf, viewed 1 September 2011.
[25] *Ibid.*

more competitive but that this had the effect of exposing Europe to vulnerabilities in the US financial sector[26].

The problems that can arise when government becomes too intimate with industry have been well chronicled[27]. For example in South Korea prior to the Asian Financial Crisis, the Bank of Korea's Monetary Board and the Office of Banking Supervision supervised commercial banks, while the relevant ministry supervised specialised and non-bank financial institutions. At the time supervisors had the authority to waive requirements — and not always in a transparent manner — and this not only opened the door to regulatory arbitrage but also undermined market confidence. The lack of transparency was also an issue identified in Japan's banking supervisory system — a factor partly blamed for financial sector weakness in the late 1990s. Political interference in supervisory practices was also identified as a common theme in the regulatory practices of several countries in Asia prior to the Asian Financial Crisis of 1997-99.

In addition to these largely US and EU domestic factors, some economists have blamed external imbalances in the broader global economy, namely rising global imbalances and monetary policy that was too loose (in other words cheap money at low interest rates)[28]. The IMF found surges in capital flows and an over-reliance on wholesale banking funding, an over-reliance on leveraging in a range of investment classes and strong growth of newer markets such as some equity derivatives, including the proliferation of instruments such as the much-maligned CDOs. There was also a heavy reliance on wholesale banking, with many banks borrowing to buy some of the more exotic instruments in the financial system[29].

## The Causes of Transatlantic Contagion

The causes of contagion, however, largely derived from the US market. While European banks, particularly UK banks, had also engaged in high levels of subprime lending, subprime mortgage debt levels were particularly high in the US market notably. In the early part of the decade, the Federal Reserve cut interest rates successively, pulling down the cost of mortgages. The percentage of subprime mortgages rose dramatically after 2003, up from 8% of all mortgage originations in 2003 to just over 18% in 2004, and 20% in 2005 and 2006[30].

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[26] Mügge, Daniel (2011), "From Pragmatism to Dogmatism: European Union Governance, Policy Paradigms and Financial Meltdown", *New Political Economy*, Vol. 16, No. 2, pp.185-206.

[27] Quintyn, Marc and Taylor, Michael (2002), "Regulatory and Supervisory Independence and Financial Stability", IMF Working Paper WP/02/46, Washington DC, March, at http://www.imf.org/external/pubs/ft/wp/2002/wp0246.pdf, viewed 12 December 2014

[28] Merrouche, Nier, *op. cit.*

[29] King, *op. cit.*

[30] Joint Center for Housing Studies of Harvard University (2008), "The State of the Nation's Housing 2008", Harvard University, Cambridge, MA, at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2008.pdf, viewed 12 November 2012, p.4.

Subprime mortgages were given a range of names — some were called "liar loans", others ninja loans (no income, no job, no assets), and then the more common Alt-A loans (generally riskier loans), I-O (interest-only) loans, low-doc loans (loans where the borrower does not satisfy the usual documentation) and no-doc loans (where the borrower has no documentation)[31]. While some types existed before the mid-2000s, there was significant expansion in 2004 and 2005. This took place in an environment in which efforts to boost homeownership had broad political support from Presidents Bill Clinton and George W. Bush as well as successive Congresses[32].

Home refinancing generally also surged, much of it using equity from existing property. US home refinancing climbed from US$460 billion in 2000 to US$2.8 trillion in 2003, allowing people to withdraw equity built up over previous decades and to "consume more, despite stagnant wages"[33]. By refinancing their homes, Americans extracted US$2 trillion in home equity between 2000 and 2007, including US$334 billion in 2006 alone, more than seven times the amount they took out in 1996. At the same time the proportion of interest-only and payment-option loans rose from 2% in 2003 to 20% in 2005. The levels of mortgage debt overall exacerbated the debts of mortgage originators when the property market went sour.

During this period the securitisation markets grew significantly, with new variants of mortgage products growing in popularity, including the much-maligned CDOs. These were essentially financial products labelled as assets whose underlying collateral were mortgages — some good and some bad. Not only had subprime mortgages been packaged into this new type of securitised product, but they were mostly stamped with triple-A ratings by the credit rating agencies and sold to investors around the world. Even many central banks around the world had bought CDOs believing them to be sound investments. Some buyers borrowed and highly leveraged themselves to buy these products, believing them to be much less riskier than they were.

At the same time, there had been over the previous decade "exponential growth" in financial firms' trading activities, unregulated derivatives, and short-term 'repo' lending markets[34]. The rapid pace of financial innovation in the previous decade had helped facilitate this growth. Some of this innovation was driven by the search for higher yields in financial markets in the midst of an environment on which global interest rates were at very low levels[35]. As CDOs had proliferated widely and sold on a large scale to funds, banks, investment vehicles, insurers and investors around the world, there were wide

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[31] Financial Crisis Inquiry Commission, *op. cit.*, p.35.
[32] *Ibid.*, p.38.
[33] *Ibid.*, p.34.
[34] *Ibid.,* p xvii.
[35] King, *op. cit.*

implications when the underlying assets (mortgages) went sour. They resulted in a dramatic amplification of leverage and, when the property markets contracted, the losses for banks and financial institutions were amplified.

A report by the IMF on the causes of the financial crisis contagion found losses spread to a number of other advanced economies "through a combination of direct exposures to subprime assets, the gradual loss of confidence in a number of asset classes and the drying up of wholesale financial markets" [36]. The Basel Committee on Banking Supervision apportioned blame on too much leverage and inadequate liquidity buffers for banks around the world. Poor governance and risk management accompanied these defects, it found, as well as inappropriate incentive structures for bankers[37]. The IMF found the banking crisis "came to expose home-grown financial imbalances in a number of advanced economies, typically characterised by an over-reliance on wholesale funding sources by the banking system and asset bubbles in residential property markets".

In short a wide range of common factors as well as contagious losses had created a perfect storm in both the US and the EU to trigger, exaggerate and then proliferate the losses that started with the downturn in the housing markets. Poor lending practices, poor regulation, financial innovation, global imbalances, regulatory capture among other factors had triggered a financial tsunami.

[36] Merrouche, Nier, *op. cit.*
[37] Bank for International Settlements, "A Brief History of the Basel Committee", July 2013, http://www.bis.org/bcbs/history.pdf, viewed 25 October 2013.

# CHAPTER 3: US-EU COOPERATION THROUGH THE G20 PROCESS

The realisation that both sides of the Atlantic were equally embroiled in the fast developing financial crisis made cooperation over the response imperative. The crisis however had more than domestic implications for the US and for the EU; it also had transatlantic implications and global implications for both the US and the EU. The US and the EU recognised the need to cooperate on a financial regulatory reform agenda for the transatlantic marketplace and also to coordinate their agenda for reform in the broader international environment.

Their common agenda included not only addressing short-term problems, like buoying banking market liquidity, maintaining financial system stability and inspiring market confidence, but also other critical longer-term issues. These included tightening regulation of financial markets, regulating some of the largely unregulated aspects of the market like over-the-counter derivatives trading (which takes places out of the gaze of public scrutiny), curbing some of the more risky trading in certain types of derivatives (like credit default swaps) and improving supervisory oversight of credit ratings agencies. The latter in both the US and the EU at the time of the financial crisis were largely unregulated and yet had given their top AAA credit ratings to the high-risk financial instruments that were responsible for the huge financial losses.

US and EU interests lay beyond their respective domestic borders and beyond the transatlantic economy to the global economy where they had significant cross-border interests. Both were also concerned that raising standards in just the transatlantic economies would leave them at a disadvantage in a rapidly changing globalised world. US regulators particularly impressed the need to raise standards globally. US Treasury Secretary Timothy Geithner elaborated on the need to create a "level playing field" that should be supplemented by a system of enforcement and monitoring that ensures "people play by those rules"[1]. This would make compliance with regulatory standards easier for US firms but more importantly it would mean the US was not at a disadvantage in the global economy at a time the US Congress had an ambitious schedule for financial reform.

This chapter discusses how both the US and the EU sought to pursue their respective interests by shaping the direction of the response to the crisis and the reform of financial governance internationally. It highlights how the primary forum to pursue an agenda for

[1] US Whitehouse (2009), "Press Briefing by Treasury Secretary Timothy Geithner on the G20 Leaders Meetings", G20 Pittsburgh Summit, 24 September, at http://www.whitehouse.gov/the_press_office/Press-Briefing-by-Treasury-Secretary-Geithner-on-the-G20-Meetings, viewed 11 November 2014.

reform was the G20 — a choice that supplemented the decision on the part of the US and the EU to work together on a bilateral basis on reforms for the transatlantic marketplace.

## The Political Response: US-EU Cooperation from G7 to G20

While the US crisis was wreaking havoc in the US, it became clear in the US that the implications went way behind US shores. The financial crisis triggered a rush of panic in not only the financial markets but in the halls of government on both sides of the Atlantic. The high level of US-European interdependence had acted as the facilitator, washing domestic problems in both the US and the EU from one side of the Atlantic to the other and vice versa. Not only did the developing crisis have major implications for US interests domestically but it also had the potential to seriously impair US interests abroad, including the important transatlantic economy.

As the transatlantic dimensions became clear, political impetus on the part of the US and the EU to tackle the problems and coordinate a solution grew quickly. As the crisis moved from one of a largely housing crisis to one enveloping the broader banking and financial system on both sides of the Atlantic, EU and US leadership hastened their efforts to act closely. Cooperation to coordinate a common response to a common problem was seen as imperative. As the scale of the unfolding crisis became apparent there was recognition on both sides that the problems had distinctly transatlantic dimensions to them and that the implications were global in nature. This meant the US and the EU would need to work together through both multilateral forums as well as bilateral channels to address the problems — both in the short-term and the longer-term.

The US' first move to broaden action beyond its own shores was to liaise with the Europeans. Among the first efforts to obtain broader support for an international response was a decision to hold a conference call of G7/8 finance ministers and central bank governors on 22 September 2008 in an effort to reassure markets.

## US and European Dominance of Club Governance

The decision to raise the problems with the G7 economies first was significant. The G7/8 is heavily laden with European economies, including the UK, France, Germany and Italy, as well as the EU, represented by the European Commission[2], the ECB and the President of the Eurogroup[3]. One of the most notable features of the development of financial governance in the post-war period is the emergence of what has been referred to as "club

[2] The Commission has been represented in all meetings since the 1981 Ottawa Summit.
[3] The Eurogroup is comprised of the finance ministers of Eurozone member states. They meet at various times to discuss a range of issue relevant to the member states that use the euro. Since the financial crisis it has become particularly influential, meeting and coordinating a common position on various matters just prior to every EU Leaders Summit.

governance" — that is the regular intergovernmental forums that set the financial reforms agenda such as the G7/G8 and more recently the G20[4]. The US and the EU have dominated this intergovernmental decision-making process from the outset.

In 1962 an ad-hoc group of countries, the G10, formed to tackle imbalances in the international payments system and try and resolve and avoid conflicts between countries[5]. Forming from the countries originally involved in the earlier General Arrangements to Borrow it established conditions for leading economies to lend to the IMF[6]. With the OECD, BIS and IMF providing support services to the meetings of central bank and finance ministers from leading countries, the G10 effectively assumed responsibility for coordination of international monetary issues. It too was dominated by the US and Europe, although the US was reluctant to agree to G10 peer surveillance and avoided discussion of issues to do with the dollar.

In 1971 when President Nixon ended the convertibility of the US dollar to gold, leading to the collapse of the Bretton Woods system, the consequent economic turmoil and European dominance of the G10 prompted the US to invite the finance ministers of the US, the UK, France and West Germany to meet in the Whitehouse library in Washington to form what became known as the Library Group[7]. Japan was invited to join to become the group of 5 and then Italy to make it the G6 and in 1976 Canada to make it the G7. In 1997 Russia joined to create a G7+1 or the G8[8]. A further organisation, the G30, somewhat broadened the input when formed in 1978 to include private sector actors and academia[9]. The G7/8 remained the dominant intergovernmental forum up until the Asian Financial Crisis of 1997-99 when the G20 was born.

President Bush's conference call with the G7 on 22 September 2008 effectively represented an effort by the US to establish a position on a range of approaches to global action prior to an even broader later effort to obtain consensus from the G20. Specifically European members and the EU were the most vocal in their support for both the idea of international coordination and the US plans to bail out banks. One of the outcomes of the G7/8 was an obvious gesture of support for the US Treasury US$700 billion bailout plan. The G7/8 statement noted "we strongly welcome the extraordinary actions taken by the United States to enhance the stability of financial markets and address credit concerns, especially through its plan" to remove illiquid assets destabilizing financial institutions[10].

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[4] Tsingou, Eleni (2014), "Club Governance and the Making of Global Financial Rules", *Review of International Political Economy*, 19 March.
[5] The G10 comprised the US, Belgium, Netherlands, Canada, Sweden, France, Switzerland, Germany, the UK, Italy and Japan.
[6] Meltzer, Allan H. (1991), "US Policy in the Bretton Woods Era", Federal Reserve Bank of St Louis, St Louis, May/June, at https://research.stlouisfed.org/publications/review/91/05/Bretton_May_Jun1991.pdf, viewed 12 September 2014.
[7] Baker, Andrew (2006), *The Group of Seven: Finance Ministries, Central Banks and Global Financial Governance*, Routledge, New York
[8] G8 Secretariat, "History of the G8", at http://www.g8.co.uk/history-of-the-g8, viewed 13 May 2014.
[9] Tsingou, *op. cit.*
[10] G7 Finance Ministers (2008), "Statement by G7 Finance Ministers and Central Bank Governors on Global Financial Market Turmoil", 22 September, at http://www.g8.utoronto.ca/finance/fm080922.htm, viewed 30 August 2013.

This is despite the fact the US plan had not yet been approved but was still being considered by Congress — and was highly controversial.

The US Treasury received considerable resistance the next day before the Senate Committee on Banking, Housing and Urban Affairs, which described it as "stunning and unprecedented in its scope and lack of detail"[11]. After the G7/8 call, Joaquín Almunia, European Commissioner for Economic and Monetary Policy, said events had made it clear that internal European action was not sufficient to confront global challenges. "The interconnectedness of global financial markets, the high level of leverage and the use of innovative and complex financial techniques and instruments, which were only poorly understood, caused this risk to spread across the international financial system on an unprecedented scale," he told the European Parliament on 24 September" [12].

The next day, in anticipation of a meeting between the US and the UK, the UK's Gordon Brown also publicly came out in support of the bailout plan, again even though the Senate was still debating the proposal. Pledging to do whatever was necessary to "get these bad assets out of the system as quickly as possible", he said the UK would do the same if needed[13]. The next day on 26 September 2008 there was a meeting between Brown and US President George Bush in Washington to discuss the response of the US[14]. Brown had originally planned to visit the UN in New York to talk about economic development and poverty issues and had no plans to meet treasury officials let alone the President[15]. The UK and the US later agreed that action needed to be taken to remove the bad assets from the banking system[16].

While the US and the UK were able to formulate specific policy responses in concert, the EU itself had yet to coordinate its own internal position. EU member states moved independently during this week to respond to the crisis by supporting their own banks. On 30 September France and Belgium bailed out Belgian-French lender Dexia with US$9 billion and Belgium, the Netherlands and Luxembourg joined in for a US$16.2 billion rescue of Fortis[17]. The British Treasury seized the lender Bradford & Bingley, after no

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[11] "Senate Committee on Banking, Housing and Urban Affairs Holds Hearing on US Credit Markets", Hearing Transcript, *Washington Post*, 23 September 2008, at http://www.washingtonpost.com/wp-dyn/content/article/2008/09/23/AR2008092301664.html, viewed 16 December 2012.

[12] Almunia, Joaquín, European Commissioner for Economic and Monetary Policy (2008), "Situation of the World Financial System and its Effects on the European Economy", speech in European Parliament Plenary Debate, Brussels, 24 September, at http://europa.eu/rapid/press-release_SPEECH-08-456_en.htm?locale=en, viewed 14 August 2013.

[13] Porter, Andrew (2008), "Gordon Brown in Surprise Visit to Discuss Economic Crisis with US President George Bush", *The Telegraph*, 25 September.

[14] Paulson, Henry M. (2010), *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, Hachette Book Group, New York, p.335.

[15] Porter, *op. cit*.

[16] US Whitehouse (2008), "Press Briefing by Dana Perino", 26 September, at http://georgewbush-whitehouse.archives.gov/news/releases/2008/09/20080926-11.html, viewed 10 December 2014.

[17] Landler, Mark (2008), "The US Financial Crisis is Spreading to Europe", *The New York Times*, 30 September, at http://www.nytimes.com/2008/10/01/business/worldbusiness/01global.html, viewed 12 November 2012.

private buyer emerged[18]. As such on 4 October 2008, France, Germany, Italy and the UK met in Paris to discuss the quickly escalating crisis, agreeing to work "cooperatively and in a coordinated way within the European Union and with our international partners"[19].

They met not in the framework of the EU, but as the "European G8 members". Despite their agreement, the next day Germany moved quite independently to support troubled lender Hypo Real Estate with a US$68 billion rescue package and announced plans to guarantee personal savings in a move that, by some estimates, would be worth US$1 trillion. This angered the UK that felt it had been given no warning, despite the agreement, and felt it was a move that could destabilise the banking system in Europe by forcing other European governments to do the same[20]. It also concerned the US that felt it would have to follow suit[21]. One corollary of European disunity was that the Europeans were not in the same position as the US at this point to decisively choose the venue for further discussion (and eventual reform). The ability of Europeans to shape the quickly developing agenda at this stage was thus diminished.

During this week there was much discussion in Congress about Paulson's proposed bailout in the US[22] but eventually, after political compromise (and with vocal support from the UK), Congress approved and enacted Paulson's US$700 billion bailout plan, in the form of the Emergency Economic Stabilization Act of 2008, on 3 October 2008. (The Dodd-Frank Wall Street Reform and Consumer Protection Act later rolled the total funding back to US$475 billion. Overall approximately US$250 billion was committed to stabilize banking institutions, US$27 billion to restart credit markets and US$70 billion to stabilize American International Group (AIG) among other expenditure[23].)

The UK decided to take a slightly different approach, injecting capital into its banking system not by directly buying "toxic" assets off banks as the US had opted to do, but by buying UK bank preferred stock, which had the effect of bolstering bank balance sheets. Paulson's amended plan eventually came to fruition. The US also later ended up amending its bailout plan to buy fewer toxic assets directly from the banks and instead decided to buy the preference shares of banks as a way to provide them with funding. This is the way the UK had chosen to extend funding to its banks.[24] As such the US and the UK had

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[18] Dougherty, Carter (2008), "Authorities Aid Banks in Europe", *The New York Times*, 30 September, at http://www.nytimes.com/2008/09/30/business/worldbusiness/30euro.html, viewed 16 October 2014.
[19] European G8 Countries (2008), "International Financial Situation", joint statement of the Summit, Paris, 4 October, http://www.ambafrance-uk.org/International-financial-situation, viewed 16 September 2014.
[20] Hodson, Dermot and Quaglia, Lucia (2009), "European Perspectives on the Global Financial Crisis", *Journal of Common Market Studies*, Vol. 27, No. 5.
[21] Paulson, *op. cit.*, p.333.
[22] US Whitehouse (2008), "President Bush Meets with Bicameral and Bipartisan Members of Congress to Discuss Economy", at http://georgewbush-whitehouse.archives.gov/news/releases/2008/09/images/20080925-9_v092508db-0111-515h.html, viewed 12 January 2015.
[23] US Treasury, "RAEP Programs", at http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx#, viewed November 2014.
[24] "Bretton Woods II – Five Key Points on the Road to a New Global Financial Deal", *The Guardian*, 14 November 2008.

closely collaborated on their respective plans for bank bailouts, coordinating their approaches where possible.

The US-initiated conference call on 22 September 2008 with G7 ministers to discuss the escalating problems was followed by a US decision to hold a formal G7 meeting on 10 October 2008 in Washington[25]. While stock markets in Europe fell further in response to the European banks' problems, the markets fell further in the US again. It prompted Bush to consider calling a meeting of world leaders although Paulson felt a broader leaders' summit was not the way to do it and that it should be held after the upcoming Presidential election. He suggested Bush call fellow heads of state and urged them to send finance ministers to the upcoming G7 meeting of 10 October 2008[26].

EU leaders had been calling for an international "mini-summit" to develop a coordinated solution in September; however, EU member states were still acting independently. Not only had Germany circumvented the European G8 meeting agreement by bailing out Hypo Real Estate the day after, but also the UK parliament on 8 October used anti-terrorism legislation to freeze the assets of ailing Icelandic bank Landsbanki, which had gone bankrupt the day before[27]. While there had been an agreement by the European G8 members the previous week, there was still no agreement at this stage in the framework of the EU. As the EU had not yet agreed to coordinate efforts in the EU itself, it was not in a position to steer the trans-Atlantic or international agenda at an intergovernmental level. The US remained in the best position to lead the venue and the agenda.

On 10 October 2008 a meeting of the G7 ministers took place. As the IMF and World Bank were holding their respective annual meetings the next weekend, at which representatives of China, Russia and India would attend, a broader meeting would be viable. When the G7 finance ministers met in person in Washington they developed a more solid "action plan" that comprised action in several areas, including taking steps to "unfreeze" credit and money markets and ensure that banks and other financial institutions had broad access to liquidity and funding[28]. It was after this meeting that, according to Paulson, President Bush "revived" the earlier idea of a broader heads of state summit[29].

At this point, the Europeans finally agreed on a common plan of action. On 12 October 2008 an emergency meeting of Eurozone countries was held in Paris under the French

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[25] Paulson, *op. cit.*, p.334; US Whitehouse (2008), "President Bush Meets with G7 Finance Ministers to Discuss World Economy", 11 October, Washington DC, at http://georgewbush-whitehouse.archives.gov/news/releases/2008/10/20081011-2.html, viewed 12 January 2015.
[26] *Ibid.*, p.336.
[27] Teather, David (2008), "Iceland Government Seizes Control of Landsbanki", *The Guardian*, 8 October, at http://www.theguardian.com/business/2008/oct/07/iceland.banking, 18 September 2014.
[28] G7 Finance Ministers (2008), "G7 Finance Ministers and Central Bank Governors Plan of Action", 10 October, http://www.g8.utoronto.ca/finance/fm081010.htm, viewed at 2 August 2014.
[29] Paulson, *op. cit.*, p.373.

EU Presidency. It was the first such meeting since the launch of the euro and, unusually, UK Prime Minister Gordon Brown was invited to attend[30]. The summit, just prior to the full EU Summit, developed a coordinated action plan entitled "Declaration on a Concerted European Action Plan of the Euro Area Countries"[31]. It outlined plans for coordinated bank bailouts throughout the Eurozone and endorsed the UK's proposal to restore liquidity to the market by acquiring bank preferred shares or other similar instruments. In addition to this measure, Eurozone ministers agreed to guarantee the medium-term debt (bonds with up to five years maturity) issued in the EU. It gave countries the option to target particular types of debt, depending on their own domestic situations. The ministers also agreed to recapitalise banks by acquiring their preferred shares or other instruments and restructure those banks (in other words nationalise or semi-nationalise) at their discretion[32].

They further agreed to allow flexibility over interpreting accounting rules and to share information between them and with the European Council, the Commission, the European Central Bank and the President of the Eurogroup on crisis management. Now armed with a EU mandate, the Europeans decided to visit Bush apparently in an effort to try and steer the direction of the solution. The next week, following the 12th Francophone Summit in Quebec on 17 October, French President Sarkozy, representing the EU Presidency, and accompanied by Commission President Barroso, made an impromptu visit to Bush[33]. Sarkozy had been sparing with Brown over who in Europe would lead the reform efforts.

**Behind the first G20 Leaders' Summit**

The decision to hold a G20 summit was a US decision[34]. Having broad agreement from the G7 (effectively meaning the Europeans), the US took the need to respond to the financial crisis to an even broader audience. The G20 forum of finance ministers and central bank governors, created in response to the financial crises of the late 1990s and to a growing recognition that key emerging-market countries were not adequately included in the core of global economic discussion and governance, superseded the G7 as the primary international agenda-setting grouping of countries[35]. Formally born on 25 September 1999

[30] Mason, Paul (2008), "A Last Chance", *New Statesman*, 6 November.
[31] Council of Ministers (2008) "Declaration on a Concerted European Action Plan of the Euro Area Countries", 12 October, at http://ec.europa.eu/economy_finance/publications/publication13260_en.pdf, viewed 16 July 2014.
[32] *Ibid.*
[33] Paulson, *op. cit.*, p.374.
[34] US Whitehouse (2008), "President Bush Meets with President Sarkozy of France and President Barroso of the European Commission", 18 October, http://georgewbush-whitehouse.archives.gov/news/releases/2008/10/20081018-1.html, viewed 1 July 2014; US Whitehouse (2008), "President Bush Hosts Summit on Financial Markets and the World Economy", 15 November, at http://georgewbush-whitehouse.archives.gov/infocus/financialmarkets/, viewed 11 August 2014; Paulson, *op. cit.*, p.374.
[35] G20, "What is the G20", at http://www.g20.org/docs/about/about_G20.html, viewed 5 January 2015.

at a meeting of the G7 finance ministers meeting, it was created "to broaden the dialogue on key economic and financial policy issues among systemically significant economies"[36].

Criticism around the formation of the G20 included that because it had no secretariat or independent staff it was entirely political and hence would lead to a US-dominated "G7-isation" of the world[37]. Some criticism suggested that the G20's creation highlighted the fact that the G7 specifically did not want to put reform of the international financial system in the hands of the IMF or the World Bank where developing countries had an institutionalised role[38]. It is true that ever since its formation, unlike international institutions such as the Organisation for Economic Co-operation and Development (OECD), the IMF or the World Bank, the G-20 has had no permanent staff.

The G20's formation came amid concerns that under-developed economies were under-represented in financial and economic global governance decision-making. China particularly was the big emerging global player invited into the G20 that had not been represented in G7 meetings. Criticisms persisted around the G20's formation that the south was under-represented and it was also felt by some that institutions such as the IMF and World Bank provided an environment with greater protection of the south's interests than the soft law environment of an informal finance minister's meeting[39]. The IMF and the World Bank were also invited to join the G20 "to ensure effective liaison" with these international organisations. However, the broadening of the G7 was in line with efforts to broaden the decision-making of institutions like the IMF and World Bank and reflected greater policy interdependence between industrial countries and major emerging market economies[40].

While the G20 includes a broader grouping of nations, the US and the group's European economies are its largest economies. Together the US and the four European member economies (the UK, France, Germany and Italy) represent 75% of the grouping's GDP[41]. The EU is also represented in the EU and together the US and the EU are the world's leading economies and roughly on par in terms of size. The US in 2013 generated 19.2% of the world's GDP and the EU generated 18.2% (US$16.7 trillion and US$15.8 trillion respectively out of a total world GDP of US$87.2 trillion)[42]. As with the G20, the Financial Stability Forum (FSF) that was formed to develop technical standards, monitor

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[36] G7 Finance Ministers (1999), "Statement of G7 Finance Ministers and Central Bank Governors", September 25, Washington DC, at http://www.g8.utoronto.ca/finance/fm992509state.htm, viewed 1 September 2014.
[37] Bradford, Colin I. and Linn, Johannes F. (2004), "Global Economic Governance at a Crossroads: Replacing the G-7 with the G-20", Policy Brief #132, The Brookings Institution, Washington DC, April, at http://www.brookings.edu/research/papers/2004/04/globaleconomics-bradford, viewed 12 July 2013.
[38] Kirton, John (2004), "Toward Multilateral Reform: The G20's Contribution", G8 Research Group, University of Toronto, Toronto, June 25, at http://www.g8.utoronto.ca, viewed 16 June 2014.
[39] *Ibid.*
[40] Bradford, Linn, *op. cit.*
[41] G20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.
[42] CIA Factbook data, at https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html, extracted January 2015.

implementation and facilitate central bank and regulatory cooperation, has similarly been dominated by the US and Europe.

When it was created, in addition to the G7 (whose only non-US/European members are Canada and Japan) it included Australia, Hong Kong, Singapore, Switzerland, and the Netherlands, as well as the Basel Committee on Banking Supervision, the IAIS, IOSCO, the IASB, the IMF, the World Bank and the European Central Bank. This gave rise to legitimacy concerns from the start with a stark divide between the developed country "rule-makers" and the lesser developed "rule-takers"' — the latter of which were reluctant to embrace rules they had little input into[43]. The G20 has since become a kind of steering committee for the work of organisations in the current system, including the existing standards bodies and the existing multilateral institutions like the IMF and multilateral development banks.

### The US Push for a G20 Summit

On 18 October 2008 the European leaders met with Bush at Camp David and urged a leaders' summit, although Sarkozy's strong preference was for a G8 summit. They did not want a full G20 meeting but Bush "insisted" on a G20 that included China and India[44]. According to Paulson's account of the meeting afterwards, Sarkozy "had won agreement on a meeting, which we had already decided to hold, but little beyond that"[45]. The three leaders agreed to take steps to set up a series of international meetings to review efforts to address the crisis and seek agreement about how to prevent a reoccurrence. After the meeting Barroso issued a statement explaining that "Europe wants the calling of an international summit as soon as possible to launch an effective world response to world crisis"[46]. At the same time President Bush issued a statement saying world leaders "will be consulted about the idea of a first summit" [47].

In the meantime there were further bailouts in Europe. On October 23, to avert the collapse of the UK banking sector, the Government bailed out several banks, including the Royal Bank of Scotland, Lloyds TSB, and HBOS. These followed British bank Northern Rock that had been nationalised earlier in the year. Ireland's Anglo Irish Bank was also nationalised.

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[43] Helleiner, Eric (2010), "The Financial Stability Board and International Standards", The Centre for International Governance Innovation, Ontario, Canada, CIGI G20 Papers, No. 1, June.
[44] Paulson, *op. cit.*, p. 375.
[45] *Ibid.*, p.374.
[46] European Commission (2008), "Transcript of President Barroso's statement at the joint press conference with President of the United States George W. Bush and President of the French Republic Nicolas Sarkozy following their meeting in Camp David shortly after beginning of the financial crisis", 18 October, at http://europa.eu/rapid/press-release_MEMO-08-812_en.htm, viewed 14 August 2014.
[47] US Whitehouse (2008), "President Bush Meets with President Sarkozy of France and President Barroso of the European Commission", 18 October, http://georgewbush-whitehouse.archives.gov/news/releases/2008/10/20081018-1.html, viewed 1 July 2014.

Even as the preparations for the G20 continued, the Europeans still "resisted" the idea of a full G20 meeting so, as a concession, the US suggested Spain and the Netherlands could attend as invitees of the EU Presidency[48]. UN Secretary-General Ban Ki-Moon offered the UN's New York headquarters as the summit site but the US chose Washington[49]. The task of official invitation was given to the G7 ministers. They were asked to invite "counterparts from a number of systemically important countries from regions around the world" for the first G20 Heads of Government meeting in Washington on 14-15 November 2008[50].

## The G20 in Washington and the US and EU Lead

In the lead up to the G20, at the very earliest stage the US and the EU dominated the list of issues to be discussed by the G20 Leaders' Summit. Both the US and the EU were publicly keen to take the lead. The EU referred to the G20 leaders' process as "a joint EU-US initiative" that was established by both sides "to tackle the global financial crisis effectively" [51]. The US meanwhile argued that "a big proportion of what's happened has been down to the US and we recognize our responsibility and the need for us to take the lead" in solving the crisis[52]. In his invitation to leaders on 15 November 2008, US President Bush said leaders would review progress being made to address the current financial crisis, advance a common understanding of its causes and, in order to avoid a repetition, agree on a common set of principles for reform of the regulatory and institutional regimes for the world's financial sectors. Working groups at later summits would further develop these principles[53].

The title and the theme of the summit itself summarised the issues list well. The summit was dedicated solely to tackling the financial markets crisis and, entitled the "G20 Leaders Summit on Financial Markets and the World Economy", it was the first of its kind dedicated to an international financial or economic crisis. The announcement of the summit in late October came amid EU agreement to address the intensifying problems. Among the top issues was regulation and supervision of financial markets. Canadian Finance Minister Paul Martin, who would chair the forum for the first two years, publicly called for the G20 to promote better supervisory and self-regulation arrangements.

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48 Paulson, *op. cit.*, p.374.
49 G20 Information Centre, "Commitments Contained in the Documents Issued at the Summit on Financial Markets and the World Economy", at http://www.g20.utoronto.ca/analysis/commitments-08-washington.html, viewed 15 November 2013.
50 G7 Finance Ministers, 2008, *op. cit.*
51 European Council, "What does the European Council do?", at http://www.consilium.europa.eu/en/european-council/, viewed 12 May 2012.
52 Wheatley, Jonathan (2008), "G20 Calls for Expanded Role to Combat Economic Crisis", *FT.com*, 10 November, at http://www.ft.com/intl/cms/s/0/30802654-aec9-11dd-b621-000077b07658.html, viewed 12 December 2012.
53 US Whitehouse (2008), "Statement by Press Secretary Dana Perino", 22 October, at http://georgewbush-whitehouse.archives.gov/news/releases/2008/10/20081022.html, viewed 12 August 2014.

For the Washington Summit, a draft agenda, originating from Washington, was negotiated between senior officials from government departments of G20 member states. The US wanted a number of measures, including a round of fiscal stimulus to stimulate the market, working through existing international financial institutions (the IMF, the World Bank, the regional development banks), coordinated monetary policy and an expansion of the role of the Financial Stability Forum. On the other hand, Europeans (particularly the French which held the EU Presidency at the time), wanted regulation of the derivatives markets, credit default swaps, tax havens, bankers' bonuses and credit ratings agencies[54]. The EU also wanted measures including "supervisory colleges" to regulate the 30 biggest banks and wanted agreement on accounting standards developed by the IASB bought forward. The US had until now famously dragged its feet on implementing the latter standards[55].

At the summit, the EU played a central role. Unlike the G7/8, the EU is full member of the G20[56]. The EU was party to all the negotiations and attended the summits, represented by both Commission President José Manuel Barroso and Council President Herman Van Rompuy[57]. Indeed representatives from the EU Presidency (France held the Presidency at the time), the European Commission and the European Central Bank were also invited to attend the Washington Summit (as they have since) as effectively heads of state. A delegation led by the European Commission's Sherpa Antonio Cabral, who was also economic advisor to Barroso, represented the Commission in extensive pre-summit negotiations.

Prior to the summit these took place between countries due to attend, with the details of many of the proposals deemed likely to proceed coordinated by the G20 sherpas and research staff from respective governments[58]. G20 sherpas met every month for approximately two days leading up to the summit to negotiate positions[59]. This liaison usually takes place between representatives of finance ministries and central banks, as most G20 summits (as with previous G7/8 summits) were meetings of finance ministers and central bank governors. In the G20 there are no formal votes or resolutions on the basis of voting shares or economic criteria and as such all matters are determined by consensus. Countries tend to choose their issues carefully, investing their political capital wisely, given there are a wide range of potential issues to discuss and with very little true consensus on any issue[60]. The agenda was very much a US-EU wish list of reforms

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54 US Whitehouse (2008), "President Bush Hosts Summit on Financial Markets and the World Economy", 15 November, at http://georgewbush-whitehouse.archives.gov/infocus/financialmarkets/, viewed 11 August 2014; Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012.
55 Parker, George (2008), "EU Leaders Press US to Speed up Reforms", *FT.com*, 10 November, at http://www.ft.com/intl/cms/s/0/e05f776a-aec8-11dd-b621-000077b07658.html, viewed 12 April 2013.
56 European Commission, "The EU at the G8/G20", at http://ec.europa.eu/archives/commission_2010-2014/president/g20/index_en.htm, viewed 13 December 2014.
57 Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012.
58 *Ibid.*
59 *Ibid.*
60 *Ibid.*

although, according to a representative of the European Commission who attended G20 meeting, the US "dominated" the G20 Washington agenda in "most respects"[61].

### The Washington Summit Outcome

The outcome of the first summit dedicated to financial reform and crisis management was a US-EU led focus and a dramatic expansion of the number of agenda items and agreed commitments. The G20 Finance Ministers and Central Bank Governors meeting in Sao Paulo in early November agreed on only a broad approach to responding to the crisis[62]. In contrast a total of 95 commitments were negotiated before and agreed at the first ever G20 Leaders' Summit in Washington[63]. Broadly the summit confirmed the need to coordinate a response and work through a multilateral framework. It noted that while regulation was "first and foremost the responsibility of national regulators" financial markets were "global in scope" and that therefore intensified international cooperation among regulators, stronger international standards and their consistent implementation was "necessary to protect against adverse cross-border, regional and global developments affecting international financial stability"[64].

More specifically and importantly, the US and the EU were successful in achieving agreements for future coordinated fiscal stimulus and achieved agreement for G20 countries to provide additional funding to the existing financial institutions, the IMF and the World Bank. The summit agreed to review "the mandates, governance, and resource requirements" of those international financial institutions and further define "the scope of systemically important institutions and determining their appropriate regulation or oversight". It was also successful in getting agreement to "expand urgently" the role and membership base of the Financial Stability Forum[65]. The Europeans were successful in obtaining agreement at the G20 summit for reform of accounting standards, credit derivatives reforms, regulating over-the-counter markets and credit default swaps.

A notable outcome of the action plan was that it was much more specific and based around coordination than the outcomes of G7 or G8 summits previously. The rather technical and detailed measures revolved around accelerating reforms to accounting standards in countries, reviewing credit rating agency practices, reviewing banks capital standards, reviewing the regulation and supervision of financial markets and specifically some kinds of financial instruments (like credit default swaps and over-the-counter derivatives transactions), instructing regulators to review banks' risk management practices,

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[61] *Ibid.*
[62] G20 Finance Ministers (2009), "Communiqué of the Meeting of the G20 Finance Ministers and Central Bank Governors", Sao Paulo, 9 November 9, at http://www.g8.utoronto.ca/g20/2008/2008communique1109.html, viewed 12 July 2014.
[63] G20 Information Centre, *op. cit.*
[64] G20 countries (2008), "Declaration Summit on Financial Markets and the World Economy", 15 November, at https://www.g20.org/sites/default/files/g20_resources/library/Washington_Declaration_0.pdf, viewed 1 June 2014.
[65] *Ibid.*

and asking the Basel Committee on Banking Supervision to study the need for and help develop firms' new stress testing models.

There were also numerous measures to enhance international cooperation including regulatory cooperation between jurisdictions on a regional and international level and to establish supervisory colleges for the supervision of major cross-border financial institutions. There was also agreement to enhance cooperation between the IMF, with its focus on surveillance, and the expanded Financial Stability Forum, with its focus on standard setting. Such a detailed response was notable for a heads of government meeting[66], especially in policy areas that affected the regulation and supervision of banking and financial markets. Although the summit was criticised as being insufficiently detailed (it fell below the G8's annual average of about 9,000 words between 1975 and 2008 for example[67]), the G20 response to financial markets regulation represented a highly detailed initial policy response to the crisis.

It is clear from official G20 documents the degree to which G20 governments agreed to draw upon the use of policy experts in designing the specific legislative, regulatory measures or policy to be taken. The pre-summit commitments document states that "in consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations"[68]. Governments agreed to "instruct our Finance Ministers, as coordinated by their 2009 G20 leadership [...] to initiate processes and a timeline to [implement] an initial list of specific measures"[69].

## The Agenda-Setting Significance of the US-EU Collaborative Lead

The US initial effort to launch international action through the G20 and the EU support for this response gave the US and the EU an important first mover advantage in the area of international financial governance reform. Their early action enabled them to seize public support for financial reform and yet steer the process in directions that were amenable to their common needs. The US was able to lead the financial reform agenda in two key respects.

Firstly it was able to shape the future reform agenda by choosing the institutional and the physical venue for the first broad meeting to coordinate an international response. The choice of institution matters because with each venue comes a distinct set of norms, values, pre-conceptions and procedures. Baumgartner and Jones describe how political

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[66] "Not a Bad Weekends Work", *The Economist*, 16 November 2008.
[67] Kirton, John and Guebert, Jenilee (2009), "A Summit of Substantial Success: The Performance of the G20 in Washington in 2008", G20 Research Group, 7 March.
[68] G20 countries, 2008, *op. cit.*
[69] *Ibid.*

actors can steer the policy outcome in several respects. They can "try and control the prevailing image of the policy problem through the use of rhetoric, symbols, and policy analysis" but also "try to alter the roster of participants" involved in the issue by seeking out the most favourable institutional venue for consideration of these issues"[70].

While all political actors, including interest groups and business groups, shop for the best venue either domestically or internationally to have their issue heard, governments too have the ability to strategically control policy outcomes through choice of forum for debate[71]. The choice was the G20 — an informal grouping in which the US and Europe dominate. Together the US and the EU generated roughly 37% of the world's GDP as of 2013[72]. In the case of the Washington Summit the US and the EU had established common positions ahead of time and thereby effectively controlled the outcome.

Secondly, as the holder of the G20 presidency, the US had the opportunity to set the summit discussion agenda and therefore the future reform agenda. It is standard practice that the country that holds the G20 presidency hosts the summit. In the G20, as with the previous G7 and G8 meetings, the host country (the country that holds the Presidency) is also tasked with developing the draft discussion agenda[73]. It acts as initiator of the agenda and accepts input from invited countries. The importance of setting the agenda in both negotiation settings and in terms of controlling outcomes has been well noted by scholars. An agenda is a set of issues that are seriously considered in a polity and therefore about the attention given to issues[74].

A number of routes have been described by which issues are progressed through a policy process, including by non-government groups, government insiders and governments themselves[75]. Many of the precipitating events for government mobilisation of an issue are what Birkland describe as "focusing events". This is an event that is "sudden, relatively uncommon, can be reasonably defined as harmful or revealing the possibility of potentially greater future harms". A financial crisis of the magnitude seen in 2007-09 would fit this definition[76].

The importance of choice of venue and setting the discussion agenda in the overall policy process is that those who control these choices have the opportunity to significantly shape

[70] Baumgartner, Frank R. and Jones, Bryan D. (1991), "Agenda Dynamics and Policy Subsystems", *The Journal of Politics*, Vol. 53, Issue 4, November.
[71] Richardson, Jeremy (2006), *European Union: Power and Policy-Making* (3rd edn), Routledge, London and New York.
[72] CIA Factbook data, at https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html, extracted January 2015.
[73] Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012
[74] Princen, Sebastiaan (2007), "Agenda-setting in the European Union: A Theoretical Exploration and Agenda for Research", *Journal of European Public Policy*, Vol. 14, No. 1, pp.21-38.
[75] Cobb, Roger; Jeannie-Keith, Ross; and Ross, Marc Howard (1976), "Agenda Building as a Comparative Political Process, *American Political Science Review*, Vol. 70, No. 1, pp.126–138.
[76] Birkland, Thomas A. (1998), "Focusing Events, Mobilization, and Agenda Setting", *Journal of Public Policy*, Vol. 18, Issue 1, January, pp.53-74.

outcomes. The early stages of a policy process are inherently unstable and can "cycle" from one choice to another[77]. Shepsle examined the agenda-setting power of US Congressional committees for example and argued that certain actors can stabilise the process by controlling it[78]. The control also gave those actors significant power; in the case of US Congressional committees for example representatives, as beneficiaries of their committee's agenda-setting ability, were able to enjoy disproportionate clout in areas of interest to their constituents and were able to be viewed and become experts in a given field. Pollack in studying the policy process in the EU found that the choice of actor as the agenda setter also "matters" by giving greater power over outcomes to those involved[79].

He found that formal agenda-setting power depends on a number of factors that can limit the influence of actors involved in the decision-making process. One limitation on influence is clearly the formal voting and decision-making rules in place. For example, in the EU, despite being one of the EU's legislative institutions, the European Parliament cannot amend all legislation. Further, the European Commission retains to sole right of legislative initiation. In the G20 context there are no formal voting or amendment rules and all decisions are reached on the basis on consensus. The absence of formal voting rules means less influential economies tend to have a diminished opportunity for control over the agenda and indeed decision-making as a whole.

Another limitation of a particular actor's agenda-setting ability, according to Pollack, is the distribution of preferences between the agenda setter and other "legislative principals". Thus if one actor's preferences are shared by many actors in the decision-making process (or indeed an absolute majority of those actors) the ability of a dissenting actor to affect the outcome is limited. Thus when a majority of G20 economies have a common preferred outcome on a particular proposal, the chance of that proposal succeeding as the majority wants is high. At the G20 Leaders' Summit in Washington, the US and the EU had agreed ahead of time on a number of proposals (which are discussed in the subsequent chapter) and this meant their adoption by the G20 was a virtual certainty.

Finally the power of an agenda setter over outcomes also depends on the relative time horizons, or impatience, of the agenda-setter. In other words, if the agenda-setter is impatient, they may not get their own way on outcomes, due to the constantly changing nature of preferences among parties. In the G20 context, leaders sought to highlight need to act quickly. British PM Gordon Brown had set the scene by calling for "a new Bretton

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[77] Pollack, Mark A. (1997), "Delegation, Agency, and Agenda Setting in the European Community, *International Organization*, Vol. 51, No. 1, Winter, pp.99-134.
[78] Shepsle, Kenneth (1987), "The Institutional Foundations of Committee Power", *American Political Science Review*, Vol. 81; Shepsle, Kenneth (1987), "Why are Congressional Committees Powerful?", *American Political Science Review*, Vol. 81.
[79] Pollack, *op. cit.*, pp.99-134.

Woods" that would "create the right new financial architecture for the global age"[80]. Speaking several days before the G20 talks US President George Bush said that keeping markets operating was "especially urgent"[81].

President Bush, speaking after the Washington Summit, said Bretton Woods had taken two years to prepare but that the Washington Summit was prepared under urgent circumstances in just three weeks[82]. The urgency of the financial crisis and the US and European pressure to respond to the crisis urgently restricted the options available to G20 representatives. While agenda setting is but one phase of the policy development cycle, and while the G20 does not set policy per se, it plays a role as an agenda shaper in its respective members that commit to various proposals.

**US-EU Cooperation from Washington to London**

The G20 Washington Summit on November 2008 had barely finished when a high-level meeting under the umbrella of the FMRD between EU and EU regulators took place to discuss and coordinate a program of reform in light of the G20 commitments. The G20 Summit brought new impetus and gave a new sense of purpose to the FMRD. In December 2008 a meeting took place to continue work from previous meetings but also tackle new and acute issues placed on the agenda. The frequency, scope and intensity of bilateral discussion expanded significantly after the G20 meeting.

Up until the Washington Summit the FMRD meetings had taken place every three to four months, however, in 2009 the frequency of meetings hastened with FMRD meetings taking place every month or so[83]. The G20 London Summit expanded the issues on the US-EU agenda even further[84]. With EU member states such as Latvia, Romania and Hungary in acute balance of payments difficulties and the IMF armed with additional resources following G20 agreement in London, the scope of the issues of concern widened.

Meetings with the Trans-Atlantic Business Dialogue (TABD), a regular forum that brings together company executives and high-level government officials on both sides of the Atlantic, also increased in frequency. The relationship entered a period characterised by vigorous communication, formal and informal, via email and phone between a range of US regulatory agencies and the European Commission. It was a period of cooperation

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[80] Peacock, Mike and Ginsberg, Jodie (2008), "Brown Calls for New 'Bretton Woods' Meeting", *Reuters*, 13 October 2008, at http://uk.reuters.com/article/2008/10/13/uk-financial-brown-idUKTRE49C2HV20081013?sp=true, viewed 1 May 2014.
[81] Bush, George W. (2008), "Bush's Speech on the Economic Crisis", Council on Foreign Relations, to Manhattan Institute, New York, November 2008, http://www.cfr.org/financial-crises/bushs-speech-economic-crisis-november-2008/p17767, viewed 1 May 2014.
[82] US Whitehouse (2008), "President Bush Hosts Summit on Financial Markets and the World Economy", 15 November, at http://georgewbush-whitehouse.archives.gov/infocus/financialmarkets/, viewed 11 August 2014.
[83] Interview conducted by Peter O'Shea with DG MARKT representative, European Commission, Brussels, 14 June 2014.
[84] Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012.

described by a US Treasury representative as "extremely deep"[85]. According to one US official, during negotiations on important financial reforms, virtually "not a day went by without some contact of some nature" between the Commission and US officials on reform proposals[86]. The cooperation to coordinate the development of US and EU legislation, rules and technical standards particularly picked up pace in mid 2009, with a further legislative work agenda arising from the Pittsburgh G20 Summit from 24–25 September 2009[87]. By the end of 2009 the FMRD had become the "forum of choice" for the EU[88].

However, the US and the EU regulatory dialogue also extended to other significant decision-making bodies in the EU. US regulators had maintained in the years leading up to the crisis an active dialogue with the Committee of Securities Regulators (CESR), the EU-level committee of member states supervisors established in 2001 to coordinate supervision and harmonise regulation among member states. The SEC's dialogue with the CESR formed part of the broader regulatory dialogue under the Transatlantic Economic Partnership.

The committee comprised representatives from all member states as well as the European Economic Area. While its recommendations to member states and the EU were non-binding, it nevertheless played an advisory role to the Commission and acted in a policy coordinating capacity. The evolution of the CESR from a committee-based structure to form on 1 January 2011 three new EU-level regulatory agencies changed the relationship somewhat. The new agencies were part of an overhaul of the EU financial markets supervisory framework in the EU that had been recommended by the De Larosière Group.

The new agencies — the London-based European Banking Authority (EBA), the Paris-based European Securities Markets Authority (ESMA) and the Frankfurt-based European Insurance and Occupational Pensions Authority (EIOPA) — subsequently acquired new rule-making capacity. They gained greater authority of supervision in their respective areas, becoming quasi-rule-making bodies (nevertheless under the supervision of the Commission) that issued binding rules and subordinate acts (known as delegated acts under EU legislation)[89]. They could make certain non-binding guidelines and recommendations with a view to establishing consistent, efficient and effective supervisory practices within the EU. At the same time EU member state regulatory

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85 Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
86 *Ibid.*
87 *Ibid.*
88 European Commission (2009), "European Financial Integration Report", Brussels, at http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/efir_report_2009_en.pdf, viewed 20 September 2013.
89 Moloney, Niamh (2006), III, Financial Market Regulation in the Post-Financial Services Action Plan era, *International and Comparative Law Quarterly*, Vol. 55, No. 4.

authorities "must make every effort to comply" with them[90]. The agencies could also draft technical standards for legislation, such as the European Market Infrastructure Regulation in July 2012, a regulation designed to regulate derivatives trading in the EU.

Given some EU-level regulatory authority had been delegated to these new agencies, the SEC saw an even greater need to maintain close contact with them. The relationship evolved from an informal one to more formal arrangement as new EU regulations of interest to the US entered into force. For example when credit ratings agencies were required to become registered entities in the EU under new EU legislation in 2011, the new ESMA and the SEC upgraded their informal relationship to a formal Memorandum of Understanding[91]. The MoU outlined procedures for cross-border financial entities and information sharing among other measures.

### A New Role for the European Central Bank

There were other more institutional changes at EU-level that were of importance to US regulators in their ongoing policy cooperation with the EU. Within weeks of the G20 Leader's Summit in Washington in November 2008 the Lisbon Treaty came into effect in the EU and changed the EU institutional dynamics. While the European Parliament gained greater authority (such as the ability to amend more EU legislation), the bigger development of importance to the US was a change in role for the European Central Bank (ECB)[92]. Prior to the financial crisis the bank focused primarily on maintaining price stability through interest rates and dealt with a range of other matters specific to the euro currency. The first decade of its existence was less than challenging amid prolonged and consistent economic growth. Its accountability consisted of an annual report, a non-binding report to the European Parliament every year, after which MEPs would make demands, and the appearance of the ECB President before the EU's economic committee every three months[93].

Under the Lisbon Treaty that came into effect on 1 December 2009 — when the US and the EU were still negotiating sensitive areas of financial reform — the bank gained official status as a EU institution. While the bank had been operating as the central bank for the euro area ever since it was established in 1998, it had no official status per se under the

[90]European Securities and Markets Authority, "ESMA in Short", at http://www.esma.europa.eu/page/esma-short, viewed in 22 August 2014.
[91] Securities and Exchange Commission (2012), "Concerning Consultation, Cooperation and the Exchange of Information Related to the Supervision of Cross-Border Regulated Entities", Memorandum of Understanding, European Securities and Markets Authority and US Securities Exchange Commission, Washington DC, 19 July, at https://www.sec.gov/about/offices/oia/oia_bilateral/esma-mou.pdf, viewed 10 May 2014.
[92] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
[93] "Parliament Bares Teeth on ECB", *EUObserver*, 22 October 2012, at https://euobserver.com/political/117946, viewed 10 November 2012.

provisions of the EU treaties[94]. The Lisbon Treaty entrenched the bank's sole legal competence for the issue of the euro currency, the right to be consulted by other institutions in cases of institutional change that affect its fields of competence, legal independence to exercise its powers and required member states to "respect that independence"[95]. It further spelled out specific matters around the bank's governance, including the appointment of the bank's board and its president. The bank's role also became more critical to responding to the crisis as liquidity in the EU's financial markets froze amid market panic and deteriorating business and consumer confidence levels.

Amid the crisis and acting in concert with other central banks around the world, the bank started to pour billions of euros into the EU financial system through various mechanisms in an effort to provide much-needed liquidity[96]. Later it started to extend its support to Eurozone banks through its Long-Term Refinancing Operations (LTROs) — a process in which it effectively lent money to Eurozone banks. These "non-standard operations", as the ECB describes them, became crucial as some banks teetered on the edge of insolvency[97]. The longest LTRO arrangement prior to early 2008 was three months but the bank started to introduce six-month, one-year and even three-years terms for finance[98].

In addition the bank started to play a key role in other systemic crisis response measures. The European Bank Coordination "Vienna Initiative" for example was established in January 2009 at the height of the crisis to try and stop and prevent flight of capital from banks in Central and Eastern Europe. It bought together all the key stakeholders in the EU-based cross-border bank groups that are active in emerging Europe. These included major banking groups and also the European Bank for Reconstruction and Development, the European Investment Bank, the European Commission, the IMF and the World Bank[99].

The ECB also gained a greater role in overseeing financial stability in the Eurozone through its newfound role in the European Systemic Risk Board (ESRB). Later on, under legislation that entered into force in 2010, the bank was tasked with macro-prudential oversight of the Eurozone financial system as a whole. With a Secretariat in Frankfurt am Main in Germany, not too far from the headquarters of the ECB, management of the ESRB was given to the ECB.

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[94] European Central Bank (2010), "The ECB's Relations with European Union Institutions and Bodies: Trends and Prospects", Monthly Bulletin, Frankfurt, January, at https://www.ecb.europa.eu/pub/pdf/other/art2_mb201001en_pp73-84en.pdf, viewed 14 October 2014; European Parliament, "The Institutions of Economic and Monetary Union", at http://www.europarl.europa.eu/aboutparliament/en/displayFtu.html?ftuId=FTU_4.1.2.html, viewed 30 September 2014.
[95] Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, OJ 2008/C 115/01.
[96] Federal Reserve (2008), "Minutes of the Federal Open Market Committee", 28-29 October, at http://www.federalreserve.gov/monetarypolicy/fomcminutes20081029.htm, viewed 16 April 2013.
[97] Mersch, Yves, Member of the Executive Board of the ECB (2013), "The European Central Bank's Role in Overcoming the Crisis", speech to UniCredit Business Dialogue, Hamburg, 17 June.
[98] One of the reasons for the ECB taking approach was that it is not able to provide direct support to Eurozone governments.
[99] Vienna Initiative, "Vienna Initiative 1.0", EBRD/EIB/EU/IMF/World Bank 2012, at http://vienna-initiative.com/vienna-initiative-part-1/, viewed 16 November 2014.

Given the bank's increasingly critical role in the EU and the importance of European financial stability to the US, the US Treasury increasingly turned to the ECB to discuss issues of common concern. These included efforts to coordinate a common policy response to the evolving crisis, consulting on matters such as market liquidity activity, the deteriorating economic situation in certain EU member states and matters to do with banking market conditions[100]. After the IMF, the ECB President (first Jean-Claude Trichet, then Mario Draghi) became the US Treasury's first port of call. An analysis by Brussels economic think tank Bruegel of phone calls and meetings held by US Treasury Secretary Timothy Geithner between January 2010 and June 2012 — a period that included the bailouts of Eurozone members Greece, Ireland and Portugal — found that the ECB was Geithner's main point of contact[101].

### The Rise of the Eurogroup

Another power shift was also evolving in the EU at the height of the financial crisis that affected the way the US liaised and coordinated policy with the EU. When the EU was planning to adopt the single currency in 1998 an informal grouping of Eurozone finance ministers was created to coordinate matters to do with the impending common currency. The group also aimed to ensure the close coordination of economic policies throughout Eurozone countries and to assist in the informal decision-making of economic and monetary governance of the Eurozone as a whole. The Eurogroup, as it has come to be known, has gained greater influence as Eurozone economies have become increasingly integrated, politically and economically.

It now meets once a month — the day before the meetings of the Economic and Financial Affairs Council (Ecofin) of the Council of the European Union. It is not a decision-making body per se and, rather than "deciding" matters, it tends to "discuss" them instead[102]. Even so it has been described as the EU's unofficial caucus and has been credited with making many of the significant economic and financial decisions the Council approve[103]. Meetings also often involve the UK and Sweden too however. A decision by the Eurogroup is almost always adopted by the Council given that Eurozone member states outnumber non-Eurozone states and given the centrality of the euro to the EU project.

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[100] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
[101] Pisani-Ferry, Jean (2012), "Tim Geithner and Europe's Phone Number", Bruegel, Brussels, 4 November, at http://www.bruegel.org/nc/blog/detail/article/934-tim-geithner-and-europes-phone-number/, viewed July 2013.
[102] Interview conducted by Peter O'Shea with former economic adviser to the president of the European Commission, European Commission, Brussels, 13 July 2014.
[103] Puetter, Uwe (2006), *The Eurogroup: How a Secretive Circle of Finance Ministers Shape European Economic Governance*, Manchester University Press.

Puetter, in an examination of the decision-making of the ministerial group, describes its informal and non-binding form of consensus-based decision-making as "deliberative intergovernmentalism" but also "opaque and secretive"[104]. The Eurogroup Working Group (EWG), an equally as secretive group of policymakers that provide technical assistance and advises the Eurogroup and its President in preparing ministerial discussions, usually meets once a month ahead of Eurogroup meetings[105].

As the financial crisis intensified and as EU member states started to call on the EU and the IMF for financial assistance in late 2008, it was inevitable that the Eurogroup's work would intensify. It became critical in making decisions around financial assistance, including calling in the IMF[106]. Just one day after the G20 Leaders' Summit in London there was a two-day meeting of the Eurogroup in Prague. Having agreed at previous summits to coordinate their positions in responding to the financial crisis, the group agreed on a number of important measures of importance to the US. These included discussions ahead of the IMF spring meetings in Washington on 24-25 April and the G7 Finance Ministers' meeting on 24 April.

The matters included "the coordinated response to the economic crisis and IMF reform"[107]. The Eurogroup's ascendency in the EU decision-making structure came as the US was also changing leadership. The respective EU and US positions and effort to coordinate a position on IMF involvement were discussed just two days later with top US officials, also at a meeting in Prague, at a special meeting between new US President Barack Obama and the Heads of State and Government of the 27 EU member states. Later in the crisis, US Treasury Secretary Timothy Geithner for the first time attended the Eurogroup meeting, taken as a sign that the US was concerned about sovereign debt troubles in the EU affecting the US economy[108].

## A Rise in Informal Visits

In addition there were an increasing number of visits by EU and US officials and regulators to each other's jurisdictions in Brussels and Washington during the crisis. These included a trip to Washington in July 2009 by European Commission senior officials to meet with the SEC and the Treasury and a trip by Treasury officials to Brussels to meet with the European Commission's DG MARKT and Internal Markets and Services

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[104] *Ibid.*
[105] Eurozone Portal, General Secretariat of the Council, "Eurogroup Working Group", at http://online.wsj.com/article/BT-CO-20130718-703975.html, viewed in 20 July 2014.
[106] Interview conducted by Peter O'Shea with DG ECOFIN representative, European Commission, Brussels, 11 February 2014.
[107] European Commission (2009), "Preparation of Eurogroup and Informal Economic and Finance Ministers Council, Prague, 3 and 4 April 2009 (Amelia Torres, Oliver Drewes)", press release, 2 April 2009, at http://europa.eu/rapid/press-release_MEMO-09-148_en.htm?locale=en, viewed 16 April 2014.
[108] Armitstead, Louise (2011), "European Finance Ministers Ignore US Treasury Secretary Tim Geithner's Warning of 'Catastrophic Risk' Over Debt Crisis", *The Telegraph*, 16 September.

Commissioner Charlie McCreevy in September 2009[109]. The Director-General of Internal Market and Services, Jorgen Holmquist, also visited the US in April and September 2009, also to discuss financial regulatory matters.

In addition to transgovernmental exchange between respective US and EU bureaucracies and regulators, discussion at EU heads of state and the highest level of the EU intensified. This was part of an effort to secure political agreement for the ongoing process of convergence and to place new issues on the agenda. The FMRD was supplemented by numerous high-level US-EU political summits. US-EU summits — involving the US President, the Council President, and the President of the European Commission — were held typically biannually from 1993. At all of the three US-EU summits held in 2008 and 2009 financial markets reforms were discussed. These high-level forums also supplemented the meetings of the newly established Transatlantic Economic Council.

The key financial regulatory issues identified by the council at the US-EU Summit in April 2007 — accounting standards, capital markets regulation, auditing — remained a focus of discussion between the US and EU regulators throughout 2008 and 2009, with the G20 process serving as a way to secure political agreement beyond US and EU borders to other systemically financial markets. These were among the issues unresolved by the time of the G20 Leaders Summit in Washington in 2008, with a lack of regulation found to be among the causes of the financial crisis. These three areas highlight the level of deep cooperation between the US and EU. As the following discussions of these areas in more depth highlights, US-EU cooperation created policy convergence in several specific issue-areas and led to policy compromise on the part of both parties in an effort to accommodate each other's preferences.

## The US as Policy Partner

The FMRD had an important role in coordinating the earlier US-EU commitments and the new cooperative work agenda. In its first decade of operation the FMRD had already become an important channel for both the US and the EU. One of the important stated objectives of policy convergence was to avoid regulatory arbitrage. The EU and the US both realised that because of the strategic importance and the high degree of interconnectivity in the transatlantic financial marketplace, a closely aligned financial regulatory reform agenda was necessary to avoid fragmentation[110].

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[109] European Commission (2009), "Joint Report on US-EU Financial Markets Regulatory Dialogue for the TEC Meeting", DG Enterprise, Brussels, 27 October, at http://ec.europa.eu/enterprise/policies/international/files/joint_report_on_fmrd_en.pdf, viewed 2 May 2013.

[110] European Commission, DG Internal Market, "Third Countries Dialogues Update: Note to the Financial Services Committee", Brussels, 11 November 2009, at http://ec.europa.eu/finance/general-policy/docs/global/third_countries_dialogues_en.pdf, viewed 12 February 2013.

Some scholars have argued that the FMRD was also part of a deliberate strategy by US agencies, including the SEC, to lead in the international regulatory space at a time of rapid change[111]. It was a forum specifically for financial markets regulatory discussion that streamlined communication and coordinated regulatory responses on both sides. It was also a channel by which both the US and EU could influence and shape policy outcomes in each other's respective jurisdictions. For the US, the FMRD was a forum by which EU policymakers (the Commission) and regulators that implemented the rules *specifically* accommodated US preferences. It established a channel by which the US could play a role in constructing EU policy as part of the broader bilateral goal of promoting transatlantic economic integration. It was also a channel by which the US could seek to secure the interests of US firms in EU policy matters.

In 1989 US Secretary of Commerce Robert Mosbacher suggested that the US should be given "a seat at the table" as an observer of internal EU discussions about European standards setting[112]. His comments, delivered at the time when the Transatlantic Declaration on EC-US Relations was being discussed, raised suspicion in Brussels about US intentions. While the US was viewed as having "naked" security and economic intentions[113] in initiating the Transatlantic Declaration on EC-US Relations, these comments highlighted US ambitions in wanting to shape the outcome of EU policy. The degree to which the US and EU intensified their bilateral discussions as a result of the financial crisis moved such a goal closer to reality. The goal of closer economic integration between the US and the EU under the Transatlantic Economic Partnership moved closer to realisation. The US and EU alliance is an even clearer example of transgovernmental governance and similar to what some scholars have referred to as "experimental governance"[114]. It highlights the degree to which the US had a greater role in policy-making than was previously the case.

The financial crisis had elevated the need for US-EU regulatory cooperation in the area of financial markets reform to even greater heights. Transatlantic cooperation in the area, while firmly established in existing cooperative arrangements, accelerated as a result of the common concerns. While the initial impetus was provided through the G20 process, bilateral discussion between the US and the EU intensified significantly. As the financial crisis evolved and intensified in 2008, from the US perspective the meetings facilitated the exchange of information and views, with regulators from various US agencies meeting their EU counterparts.

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[111] See Pollack, Mark A. (2005), "The New Transatlantic Agenda at Ten: Reflections on an Experiment in International Governance", *Journal of Common Market Studies*, Vol. 43, Issue 5; Posner, Elliot (2005), "Market Power without a Single Market: The New Transatlantic Relations in Financial Services", in Andrews et al. (eds) *The Future of Transatlantic Relations: Continuity Amid Discord*, EUI, Florence.
[112] Peterson, John (1996), *Europe and America: The Prospects for Partnership*, Routledge, New York, p.47.
[113] *Ibid.*, p.45.
[114] Sabel, Charles and Zeitlin, Jonathan (2010), "Learning from Difference: The New Architecture of Experimentalist Governance in the EU", in Sabel, Charles and Zeitlin, Jonathan (eds), *Experimentalist Governance in the European Union: Towards a New Architecture*, Oxford University Press, Oxford, pp.1-28; De Búrca, Gráinne; Keohane, Robert O.; Sabel, Charles (2013), "New Modes of Pluralist Global Governance", *New York University Journal of International Law and Politics*, Vol. 45, No. 3, pp.723-86.

The different regulatory institutional structures in the US and the EU made coordination and discussion of policy matters difficult for the US at time however[115]. In the US the right of legislative initiation rests with the US Administration and US Congress and therefore either can draft legislation. In the EU, the right of legislative initiation rests solely with the European Commission where draft legislation always originates. In short the US Congress writes the law and the regulators establish the rules. In the EU the Commission performs both functions, albeit to the degree that the Parliament and the Council have right of legislative review and amendment. In the US regulatory capacity is delegated to various independent regulatory agencies, including the SEC and the US Treasury, whereas in the EU, regulatory authority rests with the Commission. The exceptions are where some capacity is delegated to the aforementioned regulatory agencies (although these are not strictly independent and still answer to the Commission).

The ECB is independent but does not have any direct regulatory capacity. In the US a range of regulatory agencies (state and federal) have capacity in particular areas, such as insurance or accounting standards. As such regulatory cooperation between the US and the EU has tended to involve several US regulatory agencies and Commission representatives. The differences between the regulatory structures in the US and the EU financial markets have led to overlap, duplication and spillover effects of regulatory reforms between jurisdictions on occasions[116]. There were several instances even during the height of the crisis in 2008 to 2010 in which bilateral US-EU discussion, under the FMRD or through other discussion and communication, created market loopholes that warranted (and received) quick response by both EU and US regulators[117]. As such, the FMRD became an important channel for not only dialogue and cooperation but also to coordinate policy cooperation between various US agencies and the Commission.

## Conclusion

In choosing the G20 as the institutional venue to coordinate an international response to the financial crisis the US had placed itself at the centre of the international financial reform agenda. The justification for the G20 as the intergovernmental forum of choice at the G20 Leaders' Summit in London was that a "global crisis" required a "global solution"[118]. The G20 of course is hardly global; it is a limited multilateral forum of 20 states rather than the 195 countries in the global economy[119]. While the US led the process,

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[115] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
[116] European Commission, DG Internal Market, *op. cit.*; Interview conducted by Peter representative, Brussels, 14 February 2014.
[117] *Ibid.*
[118] G20 (2009), "Declaration on Strengthening the Financial System (Annex to London Summit Communiqué)", London, 2 April, at http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf, viewed 16 July 2014; US Treasury (2009), "Prepared Statement by Treasury Secretary Tim Geithner at the G-20 Finance Ministers and Central Bank Governors Meeting", Horsham, UK, 14 March, at http://www.treasury.gov/press-center/press-releases/Pages/tg56.aspx, viewed 12 January 2015.
[119] There are 193 member states of the UN and the Holy See and the State of Palestine are observers, at http://www.un.org/en/members/index.shtml, viewed 12 December 2014.

it could not have led the agenda to the degree that it did without the support of its key EU partner, first through the G7 and then the G20. Together the US and the EU represented a majority in the G20 and the US effort to establish a common agenda early on meant both transatlantic partners dominated the direction of international financial reform as the crisis unfolded.

An important outcome of the US-EU cooperation that extended from the G20 Leaders' Summit in Washington through to the G20 Leaders' Summit in London and in the months after was that by mid 2009 the US and the EU had very similar agendas for financial regulatory reform. As the Commission noted, the transatlantic financial regulatory reform agenda had become "increasingly convergent"[120].

In the lead up to the G20 Leaders' Summit in London in April 2009, while there were differences of opinion between the US and the EU over some priorities for reform, the US and EU agendas for financial regulatory reform had merged through a process of bilateral negotiations. The respective blueprints for reform issued by the EU in March 2009 and the US in June 2009 were closely aligned. An examination of the respective roadmaps put forward by the EU in its "Driving European Recovery" Communication of 4 March 2009 and the US Treasury in its "White Paper on Financial Regulatory Reform" of 17 June 2009 shows the financial reform plans were highly aligned. Furthermore both were in line with the commitments agreed at the G20[121].

The financial crisis and the US and EU's closely interdependent markets had prompted the US and the EU to become more than just stakeholders in each other's markets; they had become "policy partners"[122]. The outcome was a significant convergence of US-EU policy on financial markets reform at bilateral level and on important matters of international financial governance. The collaboration was a milestone in the creation of what US Secretary of State James Baker had called for in the early 1990s — the construction of a new "Euro-Atlantic architecture"[123]. Both the US and the EU saw the benefits as seeking to achieve maximum convergence of policy to avoid fragmentation and regulatory arbitrage between the two highly connected and interdependent financial markets. This was entirely in line with the longstanding US-EU commitment to promote economic integration between the two under the Transatlantic Economic Partnership in 1998. The degree to which this policy partnership extended to particular issue-areas is explored in the following chapter. It discusses how the US and the EU closely

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[120] European Commission, DG Internal Market, *op. cit.*
[121] Communication from the Commission, Driving European Recovery of 4 March 2009, COM(2009) 114; US Treasury (2009), "Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation", Washington DC, 17 June, at http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf, viewed 16 September 2014.
[122] Interview conducted by Peter O'Shea with DG MARKT representative, European Commission, Brussels, 14 June 2014; Interview conducted by Peter O'Shea with representative of the German Marshall Fund, Paris, 13 February 2014.
[123] Baker, James A. (1989), "A New Europe, A New Atlanticism: Architecture for a New Era," speech to the Berlin Press Club, Berlin, Germany, 12 December.

coordinated their response to regulatory reform through bilateral negotiations in three areas particularly: the tighter regulation of credit ratings agencies, the convergence of accounting standards and the regulation of derivatives reform.

# CHAPTER 4: US–EU BILATERAL COOPERATION ON CREDIT RATINGS AGENCIES, ACCOUNTING STANDARDS AND CREDIT DEFAULT SWAPS REFORM

Three issue-areas of financial regulatory reform highlight very well the political processes involved in the policy cooperation between the US and the EU in the wake of the G20 Leaders' Summits as part of their respective strategies to form a common response to the crisis. These include tighter oversight over the activities of credit ratings agencies, greater convergence and inter-operability of accounting standards used in the US and the EU (as well as internationally) and reform of derivatives regulation.

The latter priorities were to tighten regulation of securitised products like Collateralised Debt Obligations (CDOs) (the highly leveraged mortgage-based class of financial products that generated so many of the losses for financial institutions) and credit default swaps (which also generated a great deal of the losses in the financial system). Most of the trading in these product areas in the lead up to the crisis was conducted over-the-counter; that is, in private transactions out of public sight and outside of regulatory scrutiny.

These issue-areas of cooperation were also areas on which both sides not only had a high degree of connectedness but also, as Keohane and Nye suggested in their theory on complex interdependence, mutual dependence characterised by "a state of being determined or significantly affected by external forces"[1]. These aspects of the US and EU financial systems had high levels of complex inert-relationships, with thousands of US companies operating in the EU and thousands of EU companies operating in the US. Most of the credit ratings agencies in the EU were US-based agencies and the highly complex financial instruments of credit default swaps were traded in large levels by financial institutions on both sides of the Atlantic.

This chapter highlights the depth of the evolution of interdependent relationship between the US and the EU — arising from their early commitments under the Transatlantic Economic Partnership agreement in 1998 — but which intensified dramatically as a consequence of the financial crisis and the economic and financial ties across the Atlantic. It highlights how their cooperation in these three areas in particular resulted in a high degree of policy convergence to reinforce their common interests.

[1] Keohane, Robert O. and Nye, Joseph, S. (1977), Power and Interdependence: World Politics in Transition, Little, Brown and Company, Boston & Toronto, p. 8.

## Credit Ratings Agencies Reform

Coordinating respective US and EU regulatory regimes in respect to credit ratings agencies (CRAs) had been discussed between the US and the EU in the years preceding the financial crisis, but its priority took on heightened importance in mid 2007. It was revealed that many of the financial products to which credit ratings agencies had given their top ratings were responsible for much of the havoc inflicted on the banking system. The now infamous CDOs, for example, had been given the top AAA rating by all three leading agencies and sold widely to funds, banks, investment vehicles, insurers and investors around the world. Yet much of the collateral in these structured investments were subprime and simply evaporated when property markets when sour in the US and Europe. These supposed top-quality instruments were suddenly responsible for huge banking and financial industry losses, calling into serious question the scrutiny credit ratings agencies had applied to them.

The US Financial Crisis Inquiry Commission later found the failures of CRAs to properly scrutinise these investments were "essential cogs in the wheel of financial destruction" and that the three leading US-based agencies — Moody's, Standard & Poor's and Fitch — were "key enablers of the financial meltdown"[2]. In the years leading up to the crisis, CRAs had been largely unregulated. In the US the SEC was able to "recognise" agencies but, to address concerns about their role in the growing subprime mortgage problems, the Credit Rating Agency Reform Act of 2006 gave the SEC the ability to register Nationally Recognized Statistical Rating Organizations (or NRSROs) and require them to provide regulators with certain information[3]. This included information relating to procedures and methodologies, policies or procedures to prevent misuse, organisational structure, whether they had an internal code of ethics (but no requirement to have one) and any conflicts of interest. The Act gave the SEC the authority to sanction agencies, but there was no requirement to actually avoid conflicts of interest (for instance when the agency takes consulting fees from the same institution it issues ratings on), no need to differentiate between complex products with hidden risks, such as structured finance products, and no requirement to disclose to the public the procedures or methodologies the agencies employed to rate a company or asset or country.

It was not until June 2008 that, responding to greater concerns around methodologies, disclosure, procedures and conflicts of interest among agencies and amid even greater market turmoil, the SEC proposed further amendments to the existing rules. It proposed

[2] Financial Crisis Inquiry Commission (2011), "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States", Washington DC, January, at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, viewed 13 October 2012.
[3] The Credit Rating Agency Reform Act of 2006 entered into force on 27 June 2007.

a range of measures around public disclosure of information on rated products and methodologies, addressing conflicts of interest and the so-called practice of buying ratings and reporting, among other measures[4]. However its proposals were subject to an industry consultation process and many measures were watered down or failed to materialise.

In Europe, prior to the financial crisis, most member states did not have specific legislation that regulated the activities of CRAs or the conditions around issuing credit ratings. Agencies were subject to EU law only in limited areas, including a directive on insider dealing and market manipulation, a directive broadly relating to credit institutions and a directive on the capital adequacy of investment firms and credit institutions[5]. In member states or at EU level credit rating agencies were not subject to any special registration process (as all the major international agencies were US-based) but they were expected (but not required) to adhere to an international code of conduct for credit ratings agencies established in 2004 by the Madrid-based International Organization of Securities Commissions (IOSCO).

A global industry association that develops rules relating to securities and futures markets for its members from more than 100 different countries, the IOSCO code was introduced in the wake of the Enron and WorldCom corporate scandals in the US. It was non-binding and spelled out principles around issues such as conflicts of interest and disclosure[6]. The code established a framework for self-regulation and most CRAs, including the three leading US-based agencies, implemented it, but there was no European requirement for the code to be adhered to, nor any meaningful oversight by a regulatory or financial authority.

## A US-EU Divergence

Prior to the G20 Leaders' Summit in Washington there was a groundswell of criticisms about the ratings agencies in Europe as well. The European Parliament's Committee on Monetary Affairs called on the Commission in April 2008 to establish its own EU public ratings agency and formulate rules for existing agencies to tackle "the conflicts of interest" inherent in their current business models[7]. Such criticisms centred around three main concerns: the agencies were paid by the issuers of the securities they rated rather than by

[4] Securities and Exchange Commission (2008), "SEC Proposes Comprehensive Reforms to Bring Increased Transparency to Credit Rating Process", press release, SEC, 11 June, at http://www.sec.gov/news/press/2008/2008-110.htm, viewed 10 August 2014.
[5] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, OJ L302/1; See also Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation OJ L 96/16; Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) OJ L 177; and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) OJ L 177.
[6] IOSCOs Code of Fundamentals for Credit Rating Agencies of December 2004 set out principles around quality, monitoring, updating, integrity, analyst independence and transparency but it is not binding. The code was revised in May 2008 and remains non-binding.
[7] European Parliament Committee on Economic and Monetary Affairs (2008), "Draft Report with Recommendations to the Commission on Hedge Funds and Private Equity", Strasbourg, 18 April (2007/2238(INI)), at http://www.europarl.europa.eu/meetdocs/2004_2009/documents/pr/718/718451/718451en.pdf, viewed 12 December 2013.

the investors who used the ratings; their ratings were formed mostly using information provided by issuers of the securities they were rating; and they advised issuers how to structure their products to achieve the best ratings and then rated those same securities[8]. In a speech in June 2008 Internal Markets Commissioner McCreevy, a former Irish politician, attacked the IOSCO code as a "toothless wonder" saying he was "deeply sceptical" the appropriate response lay in strengthening it[9].

The next month in July the Commission proposed far-reaching draft legislation, making it clear in its consultation document that it viewed the existing IOSCO code of conduct was inadequate and needed to be "significantly reinforced"[10]. The Commission proposed a couple of options for supervisory oversight of CRAs, one of which was establishing a dedicated EU-level authority and the other was leaving supervision to member states, but both of which would involve a specific registration process for credit ratings agencies that wanted to operate in the EU. The proposal also outlined other stringent requirements, including banning CRAs from carrying out consultancy or advisory services relating to the design of structured finance instruments (which they had previously), measures to prevent conflicts of interest within agencies (which had been a problem), extra requirements for disclosure (which had been a problem) and provisions linking remuneration to experience and skill. It also suggested more "business invasive" measures like a process for CRAs to periodically review their methodologies independent of their business and even outlining some circumstances in which a CRA would have to withhold from issuing a rating or withdraw an existing credit rating[11].

There was considerable criticism from the markets in the US and Europe, notably the UK, at the time. There were concerns among ratings agencies themselves that because ratings were pan-jurisdictional they would need to apply the EU's rules to all ratings worldwide[12]. There were also complaints about the cost and implementation timetables but it was also clear there would be some fundamental problems. One was that banks might find themselves unable to use the ratings issued by US-based agencies, as those ratings would not satisfy regulatory requirements. In fact ratings are used by government itself and even entrenched in legislation. The Basel III liquidity rules for banks for example provide for favourable treatment to bonds from countries with triple-A or double-A ratings, while central banks frequently depend on the ratings to make their own monetary policy

[8] Helleiner, Eric and Pagliari, Stefano (2009), "Towards a New Bretton Woods? The First G20 Leaders Summit and the Regulation of Global Finance", *New Political Economy*, Vol. 14, No. 2, June.
[9] McCreevy, Charlie, European Commissioner for Internal Market and Services (2008), "Regulating in a Global Market", speech at Inaugural Global Financial Services Centre Conference, Dublin, 16 June, at http://europa.eu/rapid/press-release_SPEECH-08-334_de.htm?locale=de, viewed 26 July 2013.
[10] European Commission (2008), "Consultation by the Commission Services on Credit Rating Agencies (CRAs)", press release, 31 July, at http://europa.eu/rapid/press-release_IP-08-1224_en.htm?locale=en, viewed 16 March 2013.
[11] European Commission (2008), "DG MARKT Services Document", proposal for a Regulatory Framework for CRAs, Brussels, 31 July 2008, at http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-cra-framework_en.pdf, viewed 10 June 2014.
[12] Standard & Poor's (2008), "Proposal for a Regulatory Framework for CRAs and Embedded Ratings Policy Options", submission to European Commission, Brussels, 5 September, at https://circabc.europa.eu/sd/a/432eb53a-d5e3-48c5-bf97-aa7ec449dad3/Standard%20&%20Poor__s.PDF, viewed 16 October 2014.

decisions. Even in the time of crisis ratings can play a role in government action, with the ECB during the Eurozone crisis at one stage basing its decisions on whether to accept Greek collateral for its liquidity (bond-buying) program on ratings downgrades by the major ratings agencies[13].

The US Government also had concerns about the EU proposals. At an FMRD meeting in October, just weeks after the collapse of Lehman Brothers in the US and amid major market turmoil, US authorities expressed the concerns about the impact of US-based ratings agencies being required to register in the EU, future barriers to market entry, as well as recognising the need for greater oversight[14]. The SEC was facing considerable pressure itself. The SEC over the last several months had accepted 61 submissions to its own proposed reforms, mostly against, mainly from the banking and capital markets industries and ratings agencies themselves, many of whom were concerned about the cost of tighter regulation and practical matters. Another common theme was that the changes would unsettle the already fragile capital markets. The EU's response was to assure the US that it would grant regulatory "equivalence" to the US regulatory framework soon, although specific timeframes were not established.

Despite proposals from the main ratings agencies to reform their practices and establish an alternative to regulation (such as a Standards and Poor's proposal to establish an ombudsman for stakeholders and hold a public annual review of governance processes), the EU pushed on with its legislation. Internal Markets Commissioner McCreevy was under criticism for failing to regulate financial services more toughly earlier[15]. There was also political pressure in France and Germany particularly to introduce tough new rules. In the lead-up to the G20 Summit in Washington French President Nicolas Sarkozy attacked the ratings agencies as totally unsupervised as well as "the excesses of a financial capitalism" and urged a complete overhaul of the financial system[16]. The next month, on 12 November 2008, just days before the G20 Leader Summit in Washington, the Commission revealed its draft Regulation, arguing that the existing international IOSCO code of conduct did not to "offer an adequate, reliable solution"[17]. It also placated US concerns promising to "level the playing field between the EU and the US by setting up a regulatory framework in the EU comparable to that applied in the US".

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[13] Milne, Richard (2011), "Credit Rating Agencies Place ECB in a Bind", *FT.com*, 5 July, at http://www.ft.com/intl/cms/s/0/c09f18b6-a71a-11e0-a808-00144feabdc0.html, viewed 14 May 2013.

[14] European Commission, DG Internal Market, "Third Countries Dialogues Update: Note to the Financial Services Committee", Brussels, 11 November 2009, at http://ec.europa.eu/finance/general-policy/docs/global/third_countries_dialogues_en.pdf, viewed 12 February 2013.

[15] Castle, Stephen (2008), "Europe Moves to Tighten Control of Rating Agencies", *The New York Times*, 29 October, at http://www.nytimes.com/2008/10/30/business/worldbusiness/30rating.html, viewed 16 August 2013.

[16] Sarkozy, Nicolas, President of the French Republic (2008), speech at the opening of the Sixteenth Ambassador's Conference, 27 August, at http://www.franceonu.org/france-at-the-united-nations/press-room/statements-at-open-meetings/other-fora/article/27-august-2008-speech-by-nicolas, viewed 2 January 2015.

[17] European Commission (2008), "Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies", COM(2008) 704 final, Brussels, 12 November, at http://ec.europa.eu/finance/securities/docs/agencies/proposal_en.pdf, viewed 16 September 2014.

## The US Positions Itself at the G20

In the lead up to the G20 Leaders Summit in Washington on 14-15 November there were significant differences between the US and EU positions on credit ratings agency reform. Sarkozy and Barroso pushed for tougher regulation but President Bush took a more cautious position arguing that regulation was best left to industry. The outcome of the G20 Leaders' Summit for the Europeans was a distinct defeat of their tough position in respect to ratings agencies.

In disregard of the Commission's well-publicised preference for regulation that was stronger than the IOSCO code of conduct, the G20 opted for the US position and affirmed its commitment to work within the existing "strengthened international code of conduct"[18]. The G20 nevertheless pledged to take steps to "review" credit rating agencies oversight specifically in the areas of conflicts of interest, market disclosure, and the differentiation of ratings for complex products. The EU's preference to heavily regulate ratings agencies with a registration process, as it had proposed in the EU, had lost out to the US preference for industry regulation, although the G20 commitment to "take steps" left considerable scope for national regulators to act in their own ways as well.

The next month the divergent US and EU proposals were discussed among other issues (notably insurance rules) at the FMRD in a videoconference that involved representatives of the Commission, the US Treasury, Federal Reserve and the SEC among other parties where the US discussed its intended rules to EU officials[19]. US (and EU) insurers at the December 2008 meeting were concerned about the use of ratings and the timeframe for implementation. The SEC revealed meanwhile on 3 December its plans to amend its existing rules that would require separation of consulting from rating activities and prevent agencies from accepting gifts over US$25 from the companies whose debt they rate. Its proposal overlooked several issues, including the issue of differentiation of ratings for complex products (as explicitly stated by the G20)[20]. The changes were seen in the US by some media as light-touch and the final document less stringent than its original proposal earlier in June 2008[21]. Even the SEC noted its final proposal included "significant revisions based on the comments received" from industry and other

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[18] G20 (2008), "Declaration of the Summit on Financial Markets and the World Economy", Washington DC, 15 November, at https://g20.org/wp-content/uploads/2014/12/Washington_Declaration_0.pdf, viewed 16 July 2014.
[19] National Association of Insurance Commissioners (2008), "Year-End Review: Highlights of NAIC Regulatory Cooperation Efforts", Washington DC, September/December, at http://www.naic.org/documents/committees_g_int_report_08winter.pdf, as viewed 6 July 2013.
[20] See Federal Register, Vol. 74, No. 25, February 9, 2009, Rules and Regulations at http://www.gpo.gov/fdsys/pkg/FR-2009-02-09/pdf/E9-2513.pdf, viewed 17 August 2013.
[21] "Reforming the Ratings Agencies: Will the US Follow Europe's Tougher Rules?", *Knowledge@Wharton newsletter*, Wharton Business School, May 27, 2009.

submissions. In the rules that came into effect two months later in February 2009 ratings agencies' business models and practices remained largely intact[22].
The EU pushed ahead with its tougher regime amid concerns from industry. In the lead up to the G20 Leaders Summit in London in April some European leaders, notably Sarkozy, continued the call for tougher reform, including on credit ratings agencies. The outcome of the summit was a compromise between the US and EU positions. The G20 felt that all agencies whose ratings would be used for regulatory purposes should be subject to a regulatory oversight regime, including registration[23]. This the US already had at this point and the EU had proposed to do, but the G20 position reflected the US preference to maintain the role of IOSCO in policing its industry code of practice and mandated that IOSCO should coordinate full compliance between countries. Even so, national authorities could enforce compliance too and were given scope to require their own changes to a rating agency's practices and procedures for managing conflicts of interest along other matters. The G20 also referred the matter of ratings relating to bank prudential regulation to the Basel Committee on Banking Supervision.

## EU Credit Ratings Legislation

Days after the London G20 Summit new EU legislation was signed off after passing the European Parliament and the Council. It took the form of a Regulation, a legislative form in the EU that has immediate effect throughout the EU, with the new requirements coming into force on 7 December 2009. Noting that agencies were "considered to have failed" to reflect the worsening market conditions and to adjust their credit ratings in time, the legislation required ratings agencies to register with the CESR although they would be directly subject to regulation by competent member state authorities. New ratings agencies wanting to operate in the EU would have to apply for registration by 7 June 2010 and existing credit rating agencies would have to apply for registration by 7 September 2010.

They would also be subject to a range of new rules. Agencies could not provide advisory services; must disclose the models, methodologies and key assumptions used; must differentiate the ratings of complex products; must publish an annual transparency report; have at least two directors on their boards whose salary does not depend on the ratings agency's business performance; and should create an internal function to review the quality of their ratings[24]. The legislation also established a means by which EU-based credit ratings agencies could use ratings issued outside the EU. EU-based agencies could

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[22] Chung, Joanna and Van Duyn, Aline (2009), "US Rating Agencies Escape Overhaul", *Financial Times*, 22 July.
[23] G20 (2009), "Declaration on Strengthening the Financial System (Annex to London Summit Communiqué)", London, 2 April, at http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf, viewed 16 July 2014.
[24] European Commission (2009), "Approval of New Regulation Will Raise Standards for the Issuance of Credit Ratings Used in the Community", press release, 23 April, at http://europa.eu/rapid/press-release_IP-09-629_en.htm?locale=en, viewed 16 August 2014; Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, OJ L302/1.

endorse ratings issued outside the EU providing they were subject to legislative requirements at least "as stringent as" those applicable in the EU and could provide relevant information to ESMA and that ESMA had a formally cooperation arrangement with the third country's regulatory agencies.

However, while the legislation implemented many of the original requirements in the Commission's earlier draft, there were some significant concessions that alleviated pressure on US industry as well as US regulators. Under the new rules, banks, other financial institutions and insurers could only use credit ratings for regulatory purposes if they were issued by EU-based credit rating agencies but, as a result of their concerns, they were given an extra year and would only be subject to the requirements by 7 December 2010. As a result they could use non-EU issued ratings until then. In addition issuers of a company prospectus would not be required to disclose whether credit ratings mentioned in the prospectus were issued by a ratings agency in the EU until this date as well. This followed concerns by US companies that given the July 2009 deadline for agencies to register, six months was not enough time to make preparations in a company prospectus.

Additionally CRAs were given breathing space until June 2011 to ensure non-EU CRAs were registered and subject to supervision and independent in their own country before endorsing a non-EU credit rating[25]. The requirement for CRAs to ensure that a formal cooperation arrangement existed with a third country's regulatory agency before that country's rating could be used was also extended until June 2011. This gave US and EU regulatory authorities extra time to establish formal agreements[26]. These concessions effectively allowed the uninterrupted use by EU banks of ratings issued by US agencies until June 2011 but it was also a concession that gave the US more time to get its own reforms through US Congress. Credit ratings agencies would still need to register with EU regulatory authorities, however, but they would be able to operate until US "equivalence" was granted — which the EU promised the US would be forthcoming. It gave agencies time to comply with the new tighter requirements such as prohibiting them from providing advisory services, requiring disclosure of methodologies, requiring the clear labelling of complex products with a specific symbol, and publishing an annual transparency report for example.

In addition the legislation watered down the tough position around conflicts of interest, instead merely stating that ratings agencies "should avoid" situations of conflict of interest and "manage those conflicts adequately" and disclose any conflicts of interest "in a timely manner"[27]. There were particular concessions for smaller agencies with fewer than 50 staff.

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[25] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, OJ L302/1.
[26] Specifically see Article 4(3) points (f), (g) and (h) .
[27] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, OJ L302/1.

Ratings issued by smaller non-US agencies could be used in the EU if they were "not of systemic importance" to the EU financial system. They could be used if the non-EU agency that issued them in that third country was subject to a regulatory regime considered "equivalent" by the Commission, and cooperation agreements existed between relevant regulatory authorities[28]. Alternatively they could be exempted from some of the obligations by a competent member state authority.

One of the big problem areas was the requirement for CRAs to establish that a third country's regulatory regime was "as stringent as" the EU regime before endorsing a credit rating from that country. It effectively placed pressure on the US to continue with its financial reforms, which at that stage were still working their way through the US legislative system. Another FMRD meeting between the US and EU took place in June 2009 with the US impressing the need for the EU to push through with its "equivalence" assessment so that US-issued credit ratings would not be locked out of the EU when most new endorsements came into force at the end of the year[29].

In June 2009 the Commission asked the Committee of European Securities Regulators to prepare technical advice for equivalence on the US regime noting that it was a "priority" to avoid disruption in the financial markets[30]. With the new regulations coming into effect at the end of the year, the timetable was tight as comitology procedures[31] had to be put in place in time[32]. The next month in July 2009 Commission officials travelled to Washington to meet with SEC and US Treasury officials to discuss the equivalence procedure and timetable.

The problem was that the US regime was not equivalent and the US administration's reforms were not through Congress. While EU-based EU CRAs now had to register and could endorse non-EU credit ratings, the remaining requirements of the EU legislation — including that the US regulatory regime had to be "as stringent as" the EU system or had been considered "equivalent" by the Commission — were set to kick in at the end of 2010. In technical advice provided to the Commission in May 2010 the CESR identified a myriad of differences between the US and EU regimes and noted that it considered further convergence between the US and the EU could only be achieved by "future regulatory amendments to the Securities and Exchange Commission's rules"[33].

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[28] *Ibid.*
[29] European Commission, DG Internal Market, *op. cit.*
[30] European Commission (2009), "Letter to the CESR Chairman Eddy Wymeersch", 12 June.
[31] Comitology was the process by which proposed EU legislation was negotiated and amended in various committees in the European Commission. The process was established in EU law under the Treaty on the Functioning of the European Union and allowed representatives of member states to have input on various matters of legislative implementation. Such input was restricted by legislation, however, and has since been phased out by provisions in the Lisbon Treaty.
[32] European Commission, DG Internal Market, *op. cit.*
[33] Committee of European Securities Regulators (2010), "Technical Advice to the European Commission on the Equivalence Between the US Regulatory and Supervisory Framework and the EU Regulatory Regime for Credit Rating Agencies", Washington DC, 21 May, at http://www.esma.europa.eu/system/files/10_332.pdf, viewed 10 December 2014.

While concluding the US regime was "broadly equivalent", there were still differences. The US system relied heavily on the ability of the market to make its own judgment about the quality of the credit ratings and of the methodologies used to determine them and gave restricted authority to the SEC to supervise them. Specifically there were concerns in the EU among regulators around the disclosure of credit ratings information, the quality of credit ratings issued and the nature of the methodologies used[34]. The debate then shifted to the Commission's interpretation of the "as stringent as" rule. After the CESR's advice was made public there were concerns that, despite the ability of a credit rating agency to endorse third country ratings, non-EU ratings would not be acceptable when the new system came into effect in the EU because the CESR's advice had made it clear that the US "regulatory system" was not equivalent or adequate[35].

At the same time European banks were concerned about some of the SEC's new rules. One for example related to requirements that they should disclose certain information to other agencies. The banks argued that there might be conflicts with data protection and bank secrecy laws and conflicts with the EU's new legislation[36]. The seeming disagreements led some commentators to argue the relationship had hit a low point[37]. Finally, in July 2010 the US Congress passed the most sweeping legislative reform to financial markets in decades — the US Dodd–Frank Wall Street Reform and Consumer Protection Act in July 2010. Unlike the EU approach to financial regulation, where individual pieces of legislation were brought forward and introduced, the US opted to introduce a single piece of legislative reform. The provisions gave the SEC greater ability to impose sanctions and even suspend agencies' operations.

Among other measures the reforms gave the SEC a mandate to establish a new Office of Credit Ratings that would conduct an annual review of each agency and publish the results. Many of its provisions reflected European concerns and were a result of the negotiations between the EU and the US over the course of the year[38]. The legislation's passage also created a clear path for the US regime to be granted the equivalence the EU had promised. After further discussion between the SEC and the CESR an updated CESR technical advice found that the requirements directly introduced (through "self-executing" provisions) in the Dodd Frank legislation, plus the statutory rules that the SEC could issue from time to time, provided a sufficient basis for the approval of equivalence of the US legal and supervisory framework for credit rating agencies.

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[34] Committee of European Securities Regulators (2010), "Technical Advice to the European Commission on the Equivalence Between the US Regulatory and Supervisory Framework and the EU Regulatory Regime for Credit Rating Agencies", Washington DC, 21 May, at http://www.esma.europa.eu/system/files/10_332.pdf, viewed 10 December 2014.
[35] Tait, Nikki (2010), "Banks Issue Warning About Credit Rating Rules", *FT.com*, 3 November, at http://www.ft.com/intl/cms/s/0/b70e5bb8-e76c-11df-b5b4-00144feab49a.html, viewed 16 June 2013.
[36] European Banking Federation (2010), "SEC rule 240 17 (g) 5 – implications for European securitisation issuers", submission to the Securities and Exchange Commission, 12 May, at http://www.sec.gov/comments/s7-04-09/s70409-77.pdf, viewed 3 May 2014.
[37] Kern, Steffen (2011), "The Real G2: Americans, Europeans, and their Role in the G20", Transatlantic Academy, Washington DC, at http://www.transatlanticacademy.org/sites/default/files/publications/Kern%20G20.pdf, viewed 16 September 2013.
[38] Tait, Nikki (2011), "SEC and EU in Talks to Resolve Ratings Impasse", *FT.com*, 25 April, at http://www.ft.com/cms/s/0/985ad7ae-6f5d-11e0-952c-00144feabdc0.html, viewed 16 July 2013.

The European Securities and Markets Authority Gains Responsibility

The start of the New Year in 2011 saw the operation of the new EU-level supervisory agencies to oversee the financial markets throughout the EU. These new agencies on 1 January replaced the previous EU-level CESR committee-based structure and, under a new EU-wide supervisory framework, were given new albeit limited authority[39]. This included the ability to draft technical standards that could be used in EU legislation, issue binding decisions on certain matters, and launch inquiries into certain areas of market activity. At the same time they could continue to issue non-binding guidelines and recommendations as the CESR had done previously. With the SEC and now ESMA in the EU armed with new supervisory roles and new legislation, albeit with some differences, they continued to work to achieve convergent regulatory regimes and, for the US, equivalence in the EU for the US regulatory regime.

Under new EU legislation that proposed to amend the credit ratings legislation that came into effect only six months earlier, one of ESMA's roles would be to directly supervise credit ratings agencies — taking responsibility from member states[40]. As the June 2011 deadline for ratings agencies to endorse ratings created outside the EU loomed, a problem emerged. Some major US banks revealed just weeks before that they would be unable to meet the registration deadline, saying that the process was taking longer than expected[41]. In addition the SEC was still in the process of working through its actual rules, meaning EU-based ratings agencies were unable to consider the US regime "as stringent as" the EU regime. There were several meetings between Commission and SEC officials to resolve the problem and the EU, while granting a further deadline for the US, argued that the US financial reforms needed to remain on track for equivalence to be granted[42].

In the latter half of 2011, US ratings agencies completed their registration process and all that was left was for the US regulatory framework to be considered equivalent and then for the ratings agencies to endorse ratings created outside the US. The former took place in March 2012 when ESMA deemed the US regulatory framework equivalent. In order to allow EU-based ratings agencies to meet the final requirement — that a third country must have a cooperation arrangement with the EU before that country's ratings could be endorsed — the SEC an ESMA established a formal Memorandum of Understanding for ongoing cooperation[43]. Soon after US-based ratings agencies endorsed EU-based ratings[44].

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[39] The new European System of Financial Supervision (ESFS) framework that came into effect in January 2011 established a regulatory hierarchy where EU-level agencies would establish some binding rules, draft technical standards and investigate certain matters but where individual institutions would remain directly supervised by competent member state authorities.
[40] See Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L145/30.
[41] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
[42] *Ibid.*
[43] Masters, Brooke (2012), "European Banks Allowed to Use US Ratings", *FT.com*, 15 March, at http://www.ft.com/intl/cms/s/0/80e03ed4-6db8-11e1-b98d-00144feab49a.html, viewed 16 November 2013.

It had been more than four years since the US proposed tough new legislation to reform credit ratings agencies, a period characterised by political tussles between the US and the EU over regulatory reform. It was a process of discussion and negotiation — taking place in several forums. In the course of years of negotiations in the Financial Markets Regulatory Dialogue and through informal discussion between the Commission and the SEC, and armed a with mandate from heads of state at US-EU summits, both the US and the EU had made concessions in an effort to create a working transatlantic regime that was as convergent as possible. The end result created two regulatory frameworks for credit ratings agencies — one in the US and the other in the EU — that were "coming from different places but ended up in the same place"[45].

## Accounting Standards Convergence

Another issue-area on which the US and the EU worked closely as the financial crisis accelerated was accounting standards. The US and Europe have historically used different accounting standards. The US has used its own US GAAP (Generally Accepted Accounting Principles), which are based on standards developed by the American Institute of Certified Public Accountants, since 1939. In Europe, the use of accounting standards has historically varied from country to country, largely as a result of cultural differences, differences in legal, financial and taxation systems and in the role and influence of the accountancy profession in various countries[46]. In the 1970s and 1980s a number of European Community initiatives aimed to effectively harmonise standards. The company law directives of 1978 and 1983 for instance and a directive on the annual accounts of public limited liability companies established a requirement for individual companies to prepare harmonised accounts.

Demand from non-US companies that wanted to access the US capital markets played a big role in the push for international accounting harmonisation[47]. The 1980s and 1990s saw the growing use by international companies of the well-established US GAAP, at a time when not only the EU lacked a common standards environment but also foreign companies eagerly sought access to the US market[48]. The European Commission even acknowledged in 1995 that its own standards did not meet the same "more demanding

[44] European Securities Markets Authority (2012), "ESMA Allows EU-registered CRAs to Endorse Credit Ratings Issued in the US, Canada, Hong Kong and Singapore", press release, 15 March 2012, at http://www.esma.europa.eu/system/files/2012-158.pdf, viewed 12 June 2013.
[45] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
[46] Dewing, Ian and Russell, Peter (2008), "Financial Integration in the EU: The First Phase of EU Endorsement of International Accounting Standards", *Journal of Common Market Studies*, Vol. 46. No. 2, pp.243–264.
[47] See Camfferman, Kees and Zeff, Stephen (2007), *Financial Reporting and Global Capital Markets: A History of the International Accounting Standards Committee 1973–2000*, Oxford University Press, Oxford, p.10.; Posner, Elliot (2010), "Sequence as Explanation: The International Politics of Accounting Standards", *Review of International Political Economy*, Vol. 17, No. 4, p.640.
[48] Posner, *op. cit*.

standards" required by the SEC in the US[49]. As part of the plans to adopt monetary union in the EU, the need for common standards in the EU grew. Pressures had been building not only as a result of the EU's single market and the introduction of the euro at the start of 1999 but also the gradual globalisation of financial markets[50]. The efforts to harmonise standards in Europe also had to consider the requirement in the US that any foreign company that wanted to access the US capital markets should file financial statements in US GAAP.

The EU could have simply embraced US GAAP standards but embraced the International Financial Reporting Standards (IFRS) instead. First developed in 1973, the standards were developed by the Board of the International Accounting Standards Committee, a committee comprised of professional accounting association representatives. The standards, also referred to as the International Accounting Standards, are now the responsibility of the International Accounting Standards Board (IASB), a London-based not-for-profit private sector organisation, which has progressively updated them. The EU's Accounting Regulation of 2002 established a process for endorsing IFRS for use in the EU and required, from 2005, single financial reporting standards for the consolidated financial statements of all EU companies whose debt or equity securities trade in a regulated market in the EU[51].

There are a number of factors that played a role in the decision by the EU to turn to IFRS standards[52], but the EU's decision was shaped by a number of political considerations. One was the eruption of some of the biggest accounting scandals in history. The year before the EU's decision the Enron accounting scandal erupted, in which Texas-based energy company Enron Corporation collapsed in October 2001 owing billions of dollars in debt to creditors and exposing accounting loopholes and other major shortcomings in the US standards. Such shortcomings were confirmed by the collapse less than a year later in July 2002 of the telecommunications company WorldCom, which had created billions in illusory earnings and resulted in multiple prosecutions of directors for fraud[53]. The latter has since become known as one of the biggest corporate frauds in US history. In addition to the significant criticisms, some scholars also argue EU policy-makers were simply unable politically to delegate such an important regulatory function to the Americans.[54] Others argue the EU felt it would have greater influence over the London-

[49] Communication from the Commission, Accounting Harmonisation: A New Strategy Vis-a-Vis International Harmonisation, 14 November 1995, COM 95 (508) .
[50] Dewing, Ian and Russell, Peter (2008), "Financial Integration in the EU: The First Phase of EU Endorsement of International Accounting Standards", *Journal of Common Market Studies*, Vol. 46. No. 2, pp.243–264.
[51] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards OJ L 243.
[52] Posner, *op. cit.*, p.640.
[53] Romero, Simon and Atlas, Riva D. (2002), "Worldcom's Collapse: The Overview; Worldcom Files For Bankruptcy; Largest US Case", *The New York Times*, 22 July 2002.
[54] Leblond, Patrick (2011), "EU, US and International Accounting Standards: A Delicate Balancing Act in Governing Global Finance", *Journal of European Public Policy*, Vol. 18, No. 3.

based standards setting body than the US-based Financial Accounting Standards Board (FASB)[55].

The EU's adoption of IFRS saw not only a divergence between the US and EU use of accounting standards in the early part of the decade but a significant transatlantic power shift on the issue. While the EU and the US had committed broadly to greater transatlantic integration and to embrace regulatory and standards convergence, the US wanted the EU to use GAAP and the EU wanted the US to use IFRS. In an effective recognition of the growing importance of IFRS standards, however, the US agreed to a program of convergence between US and EU standards in 2002, with the signing of a Memorandum of Understanding between the US-based FASB and the European-based IASB. In the "Norwalk Agreement" each acknowledged their "commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting"[56]. Despite this, in subsequent years accounting standards became the subject of a tussle between respective US and EU authorities over the applicability of both systems of standards in each other's jurisdictions. The US fiercely defended its use of its own standards, arguing that the US standards, in use for more than 70 years, had been "stress-tested, developed and leavened" for decades, unlike the IFRS standards, and that they were used by more than half of the world's public companies (many of which are in the US) and were well-understood by investors[57].

By the mid part of the decade, a number of factors conspired to continue to undermine the US steadfast position. Not only had the Enron and WorldCom accounting scandals cast doubt over the quality of US GAAP, but other scholars argue a desire to maintain New York's competitiveness in global capital markets and a fear of isolation for US GAAP and American multinational firms' preference for one set of standards also played a role in prompting the US to give ground[58]. Another factor was that the UK, where many US banks and multinationals operate and have deep relationships, adopted IFRS at the beginning of 2005, further undermining the dominance of US GAAP[59].

### The Path towards Mutual Recognition

In August 2006, before the financial crisis started to afflict its heaviest losses on the transatlantic financial system, the SEC in the US and the CESR in Europe agreed to a work plan that would iron out differences in the respective bodies' standards under a type

[55] See Posner, *op. cit.*,who argues EU and US international politics were largely responsible for shaping convergence outcomes; see also see Leblond, *op. cit.*, pp.443-461, where it is argued the International Accounting Standards Board was largely an agent of the EU.
[56] Financial Accounting Standards Board and the International Accounting Standards Board (2002), "The Norwalk Agreement," Memorandum of Understanding, 18 September 18, http://www.fasb.org/news/memorandum.pdf, viewed 10 June 2014.
[57] Tafara, Ethiopis, Director, Office of International Affairs, US Securities and Exchange Commission (2005), "International Financial Reporting Standards and the US Capital Market", speech before the Federation of European Accountants, Brussels, 1 December, SEC, at http://www.sec.gov/news/speech/spch120105et.htm, viewed 2 February 2015
[58] Posner, *op. cit*
[59] Publicly listed companies in the UK have been required to use IFRS since 2011.

of cross-recognition framework. However this was much easier said than done. Some financial instruments were and still are highly complex and harmonisation was a near impossible task, especially at a time when some financial instruments were new and still evolving. For example, while defining "revenue" might be considered one of the lesser complicated terms to define, the valuation of instruments such as credit default swaps, interest rate options and leveraged assets are much more difficult to define. Agreement on methodologies to value such instruments is even more illusive. There were also vastly different fundamental approaches in the two systems. The US standards were based on a rules-based approach, in contrast to the principles-based approach of the IFRS standards (and the UK GAAP standards).

The FASB and the IASB subsequently agreed that trying to eliminate differences in some standards was not the best use their resources and instead tried to develop a common system — namely one set of standards that could be used on both sides[60]. A problem was that neither the US nor the EU was prepared to give ground. There were significant political obstacles in the US to discard US GAAP and replace it with IFRS (or indeed any other standard). US GAAP had attracted heavy criticisms internationally but the SEC also was under heavy pressure from US business and industry to retain US GAAP and not require the adoption of IFRS. US industry complained that any requirement to use IFRS would be costly and even damaging.

In the absence of agreement a new approach emerged: that both sides would use both standards. The SEC in early 2007 proposed that US firms (and foreign firms) could file in either US GAAP or IFRS but the proposal received mixed reactions from industry in the US. At the same time the SEC continued with plans to work closely with the EU on a mutual recognition framework as well. The SEC's Office of Chief Accountant announced plans to work closely with the European Commission and the CESR to develop a framework agreement to this effect[61]. This would eventually mean that EU public companies listed on US stock exchanges would not have to reconcile their accounts and report in the US in GAAP figures and US companies listed on European stock exchanges would not need to reconcile and report in Europe in IFRS figures. Six months after a work plan had been agreed with European regulators for working on differences, in April 2007 the SEC agreed with the UK's Financial Services Authority and the UK Financial Reporting Council to share information to progress the idea[62]. The differences were a central subject of discussion at the FMRD meeting in November 2007. The US still maintained that it wanted to continue to use GAAP but would focus on working towards

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[60] Financial Accounting Standards Board (2006), "Completing the February 2006 Memorandum of Understanding: A Progress Report and Timetable for Completion", Norwalk, Connecticut, September 2008, at http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175819018778&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs, viewed 12 July 2013.

[61] For a full description of the politics behind the US adherence to US GAAP and the EUs use of IFRS see Posner, *op. cit.*

[62] Securities and Exchange Commission (2007), "SEC, UK FSA, and UK FRC Sign Protocol for Sharing Information on Application of IFRS", press release, 25 April, at http://www.sec.gov/news/press/2007/2007-73.htm, viewed 20 August 2014.

mutual recognition arrangements rather than establishing a single set of standards to use on both sides of the Atlantic[63].

## SEC Concessions

For the EU, having embarked on a complicated path of harmonising accounting standards within member states, the discarding of IFRS was not an option. To address European concerns the US offered a significant concession. The SEC decided on 15 November 2007 to abolish the requirement for European companies to reconcile their accounts in US GAAP and allow them to file in IFRS instead[64]. It was a problem the EU had seen as costly and as constituting a competitive disadvantage for European companies for some time[65]. The SEC also saw its decision as one that could "put a shine on the image of the United States in the global capital markets system" and improve capital-raising opportunities for US companies[66]. The Europeans still had concerns about the US GAAP standards and as such US companies still needed to report in IFRS in the EU.

More than two months later on 1 February 2008 the SEC and the Commission formally agreed on first steps towards mutual recognition after a meeting between SEC Chairman Christopher Cox and the European Commissioner for the Internal Market and Services Charlie McCreevy in Washington. The path would include future mutual recognition discussions about respective methodologies and processes and would involve interested member states as well. The two sides also discussed other related issues including sovereign wealth funds, credit rating agencies, XBRL developments and mutual recognition of securities regulation[67]. The SEC also in May 2008 signed agreements to share information about IFRS with financial regulators in four European countries, as it had done with the UK authorities the year before. However, despite the strategy of mutual recognition and information sharing little had been done to close the wide divergences of standards across the Atlantic, particularly in respect to the product areas that were by now starting to wreak havoc in the financial markets.

In August 2008, a month before Lehman Brothers collapsed, more than 85 countries at the time required IFRS reporting for all domestic publicly listed companies and a further 26 countries allowed IFRS reporting[68]. By mid 2008 the SEC came under considerable

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63 European Commission (2009), "Joint Report on US-EU Financial Markets Regulatory Dialogue for the TEC Meeting", DG Enterprise, Brussels, 27 October, at http://ec.europa.eu/enterprise/policies/international/files/joint_report_on_fmrd_en.pdf, viewed 2 May 2013.
64 SEC (2008), "SEC Takes Action to Improve Consistency of Disclosure to U.S. Investors in Foreign Companies", 15 November, at https://www.sec.gov/news/press/2007/2007-235.htm, viewed 16 July 2014.
65 Communication from the Commission, Accounting Harmonisation: A New Strategy Vis-a-Vis International Harmonisation, 14 November 1995, COM 95 (508) .
66 Johnson, Sarah (2007), "SEC Allows Dual Accounting System", *CFO Magazine*, 15 November.
67 Securities and Exchange Commission (2008), "Statement of the European Commission and the US Securities and Exchange Commission on Mutual Recognition in Securities Markets", press release, 1 February, at http://www.sec.gov/news/press/2008/2008-9.htm, viewed 1 August 2014.
68 SEC (2008), "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting

pressure over a range of regulatory shortcomings, including accounting standards[69]. Amid the escalating financial crisis and concerns over the failure of US GAAP to comprehensively deal with financial product areas such as Collateralised Debt Obligations (CDOs) and Credit Default Swaps (CDSs) — that by now had been exposed as significantly contributing to one of the most severe financial crises in decades — the US proposed an actual plan for the use of IFRS in the US. On 27 August 2008 the SEC issued a proposed roadmap for the implementation of IFRS that would be phased in. This did not mean US GAAP would be phased out — both standards could be used[70]. However, it had taken nearly a year and a severely escalating financial crisis between the SEC's publication of rules to accept from foreign private issuers in their filings in November 2008 and the SEC's announcement for a roadmap in for a plan for standards convergence to accelerate. In addition, a roadmap was just a proposal; it still needed to be embraced by industry.

Also, despite a Memorandum of Understanding between the US-based FASB and the European-based IASB in 2006 to develop a plan to try and eliminate differences between the two side's standards it was not until the absolute height of financial markets turmoil, on 11 September 2008, as Lehman Brothers desperately tried to find a buyer for itself[71], that the two standards bodies announced a timetable to follow through with its earlier plan for convergence[72]. After Lehman Brothers filed for bankruptcy on 15 September, the SEC came under even further pressure to hasten accounting standards reform, with the passage of the Emergency Economic Stabilization Act of 2008 (commonly know as the US bailout plan). Enacted on 3 October 2008, among other things it required the SEC to conduct a study of "mark-to-market" accounting applicable to financial institutions and report to Congress with its findings within 90 days. The SEC's report on Mark-To-Market Accounting, eventually released in December 2008, observed that "developments over the past few years necessitate consideration of the international financial reporting landscape"[73]. It noted that of the approximately 113 that required or permitted IFRS reporting for domestic and listed companies, the market capitalisation of exchange listed companies in the EU, Australia, and Israel totaled US$11 trillion or approximately 26% of global market capitalisation. It also noted that the market capitalisation from those

Standards by U.S. Issuers", 14 November, at http://www.sec.gov/rules/proposed/2008/33-8982.pdf, viewed 4 August 2014.
[69] Christopher Cox, SEC Chairman (2008), "Testimony Concerning the Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation", testimony before the Committee on Oversight and Government Reform United States House of Representatives, 23 October, at https://www.sec.gov/news/testimony/2008/ts102308cc.htm, viewed 4 August 2014.
[70] Securities and Exchange Commission (2008), "SEC Proposes Roadmap Toward Global Accounting Standards to Help Investors Compare Financial Information More Easily", 27 August, at http://www.sec.gov/news/press/2008/2008-184.htm, viewed 10 August 2014.
[71] Elliott, Larry and Treanor, Jill (2008), "Lehman Brothers collapse, five years on: 'We had almost no control'", 13 September, at http://www.theguardian.com/business/2013/sep/13/lehman-brothers-collapse-five-years-later-shiver-spine, viewed 3 August 2014.
[72] Financial Accounting Standards Board and the International Accounting Standards Board (2008), "Completing the February 2006 Memorandum of Understanding: A progress report and timetable for completion", 11 September, at http://www.fasb.org/intl/MOU_09-11-08.pdf, viewed 3 August 2014.
[73] SEC (2008), "Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting", 30 December, at http://www.sec.gov/news/studies/2008/marktomarket123008.pdf, viewed 14 August 2014.

countries plus Brazil and Canada, both of which had announced plans to move to IFRS, totaled US$13.4 trillion — or approximately 31% of global market capitalisation[74].

Across the Atlantic, in line with the SEC's move to recognise IFRS standards, the EU's European Securities Committee (an agency that has since been replaced) voted to grant recognition to US GAAP, with the European Parliament passing a similar resolution in October 2008. Implementation issues were also discussed between US and EU regulators at an FMRD meeting in November 2008[75]. The EU formally granting an exemption to US companies to file their statements in the EU in GAAP in a decision and an associated Regulation that established a methodology for determining the equivalence of GAAP[76]. To be effective no later than 31 December 2011, since then, in both the US and the EU, companies have been able to use both. EU companies must file in IFRS in the EU and US companies must file in GAAP in the US, but companies may also file in their own markets in the other standard as well.

## G20 Leaders' Summits in Washington and London

The US and the EU had tried — but failed — to develop a common standard, so instead embraced a strategy of mutual recognition. While this had been discussed and proposed in years leading up the financial crisis, it was not until the height of financial turmoil that efforts were accelerated to speed up plans for transatlantic accounting standards convergence. By the time the G20 Leaders' Summit in Washington took place on 15 November 2008, progress was at a standstill and huge standards gaps in important financial areas were left open, particularly in relation to the treatment of complex financial instruments. There were also ongoing differences in definitions, procedures and risk categorisation and matters relating to the valuation of securities, particularly complex products, disclosure standards for off-balance sheet vehicles and the disclosure to the market of holdings of complex financial instruments. These were among the problems that facilitated the financial crisis in the first place.

As such mutual recognition only addressed some of the fundamental problems. At the same time there were still concerns internationally about the US GAAP standards. In light of concerns arising from the financial crisis that standards were seriously lacking in certain areas, the US and the EU sought to incorporate accounting standards reform in the G20

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74 *Ibid.*

75 European Commission (2009), "Joint Report on US-EU Financial Markets Regulatory Dialogue for the TEC Meeting", DG Enterprise, Brussels, 27 October, at http://ec.europa.eu/enterprise/policies/international/files/joint_report_on_fmrd_en.pdf, viewed 2 May 2013.

76 Commission Decision 2008/961/EC of 12 December 2008 on the use by third countries' issuers of securities of certain third country's national accounting standards and International Financial Reporting Standards to prepare their consolidated financial statements (notified under document number C(2008) 8218) OJ L 340. The Commission's decision also identified as equivalent to IFRS the Japanese GAAPs, and accepted financial statements using GAAPs of China, Canada, India, South Korea within the EU on a temporary basis.

commitments. Particularly of concern was that complex products like Credit Default Swaps (CDSs) and Collateralised Debt Obligations (CDOs) had generated significant losses in the financial crisis[77].

The G20 also pledged to review the governance of the IASB itself, with the US wanting a greater role. The US and the EU agreed before the G20 meeting to form a new monitoring board that would oversee the International Accounting Standards Committee Foundation (IASCF), the IASB's governing body[78]. The board would comprise representatives of the SEC and the European Commission, as well as a representative of the International Organization of Securities Commission (IOSCO), a body the US was keen on having coordinate securities reform internationally. It would also include representatives of Japan's Financial Services Agency, an emerging markets committee and a technical committee. The Basel Committee on Banking Supervision could have observer status. The main intention was to provide political oversight of the IASC Foundation while the IASB and the FASB continued to work on technical and political issues of common concern between the US and the EU.

After the respective mutual recognition by the US and the EU and following the G20 commitments in Washington, the IASB in London and the FASB in Washington updated their agendas. These included tackling off-balance sheet activity, financial instruments and tackling loan loss accounting issues[79]. The goals became once again to pursue the ultimate goal of the development of "a common set of high quality standards" for use globally but in the meantime eliminate or minimise the differences[80]. The SEC later (in February 2010) updated its timeline that saw 2015 as the new date for the use of IFRS by US public companies[81]. The mutual recognition of accounting standards for respective sides' public companies was a significant move for the EU that had stridently pushed for the universal adoption of IFRS. However in July 2012, a SEC report offered no decision as to whether IFRS should be required in the US financial reporting system, or how such

77 Credit default swaps are financial products in which a seller hedges their risk against the risk of the default of a corporate or sovereign bond, and in which the seller effectively buys that risk. Used legitimately as a form of insurance for decades, most of them are traded "over the counter" (in other words out of public scrutiny) but, in the absence of tighter regulation, they became the subject for considerable speculation during the crisis. The insurance giant American International Group had to be bailed out by the US Federal Reserve in September 2008 over its earlier issuance of US$441 billion worth of credit default swaps on collateralized debt obligations that went bad.

78 IFRS Foundation (2009), "Trustees Enhance Public Accountability Through New Monitoring Board, Complete First Part of Constitution Review", press release, 29 January 2009, at http://www.ifrs.org/news/press-releases/Pages/trustees-enhance-public-accountability-through-new-monitoring-board-complete-first-part-of-constitut.aspx, viewed 16 September 2013.

79 Financial Accounting Standards Board (2009), "IASB and FASB Announce Further Steps in Response to Global Financial Crisis", press release, 24 March, at http://www.fasb.org/news/nr032409.shtml, viewed 2 December 2014.

80 Financial Accounting Standards Board (2009), "IASB and FASB Reaffirm Commitment to Memorandum of Understanding", press release, 5 November, at http://www.fasb.org/jsp/FASB/FASBContent_C/NewsPage&cid=1176156535724, viewed 2 December 2014.

81 European Commission (2010), "Report to the European Securities Committee and to the European Parliament on Convergence between International Financial Reporting Standards (IFRS) and Third Country National Generally Accepted Accounting Principles (GAAPs)", SEC(2010)681, Brussels, 4 June, at http://ec.europa.eu/internal_market/accounting/docs/com-2010-292/com-2010-292_en.pdf, viewed 2 September 2014.

incorporation should occur[82]. EU and US companies could continue to file in both standards.

Over a period of more than five years the US and the EU had worked closely to effectively negotiate a transatlantic accounting standards regime. When the EU embraced IFRS, at a time when US standards were under fire over their facilitation of major accounting scandals in the US, the ability of the US to insist on the use of its own GAAP standards was significantly undermined. Political imperatives forced the goal of establishing just one common standard for use in both the US and the EU to give way to the goal of mutual recognition.

The process of negotiation that followed, particularly as the financial crisis enveloped on both sides of the Atlantic towards the end of the decade, was characterised by give and take on the part of both the US and the EU to reach a compromise that would work for both sides. This is in line with earlier observations about the negotiating of accounting standards between the two in the decade earlier. Posner for instance argued that a series of "reactions and counter-reactions" first by European and then US companies and political authorities transformed the EU standards landscape[83]. The process also highlighted how the US had not only accepted as a political reality the use of IFRS but had also accommodated the EU's political preferences on accounting standards, notably its preference for IFRS. In addition to exempting European (and other foreign) companies from filing in US GAAP and proposing a US roadmap for the implementation of IFRS, the SEC also conceded its own dominance in the area of global accounting standards setting by working with the EU to establish an oversight board over the IASB. At the same time the EU had accommodated the US position by agreeing on bilateral discussions to a mutual recognition framework and developing it through transgovernmental negotiations.

However, it took financial crisis to accelerate the process of convergence — through a strategy of seeking standards equivalence for US companies in the US and EU companies in the US and with the respective US and EU standards bodies attempting to reach agreement on particular standards. It was not until the midst of crisis that the SEC announced a roadmap for IFRS adoption in the US and not until crisis that the IASB and the FASB sought to accelerate their longstanding commitment to try and eliminate differences in the standards. A significant motivator for the convergence process was the interconnectedness of the US and EU markets. In a speech in New York on financial reporting standards in the midst of crisis SEC Chairman Christopher Cox invoked the words of former US President Benjamin Franklin. "It is precisely because none of us is

[82] Fleming, Jeremy (2013), "EU-US Trade Deal Offers Hope on Reporting Convergence", *Euractiv*, 22 November 2013, at http://www.euractiv.com/specialreport-european-corporate/eu-us-trade-deal-offers-hope-rep-news-531870, 10 August 2014.
[83] Posner, *op. cit.*

sitting untouched by the currents and waves of global finance that we must recognize, as Benjamin Franklin astutely put it, that "we must all hang together, or most assuredly we shall all hang separately," he said.

**Credit Default Swaps Reform**

A further major issue-area arising from the G20 Leaders' Summit was the tackling of the trickier area of derivatives trading[84]. The instruments that generated the largest losses in the financial crisis were forms of derivatives, notably the infamous Collateralised Debt Obligations (CDOs) (which derived from subprime mortgages, and Credit Default Swaps (CDSs), which derived from the issuance of a loan to a corporate or a country[85]. The types of and the markets for derivatives have grown exponentially over the last several decades. In Europe, derivatives transactions generally account for about 20% of all European financial services revenue and about 0.4% of EU GDP[86].

This growth has been the result of deregulation, opening the market to a wider pool of investors and the proliferation of trading technologies, among other reasons. One notable change has been opening the market beyond those who use them for legitimate purposes — whether this is hedging fuel prices, wheat prices or insuring against loan defaults — to a wide range of market participants. In short deregulation has also opened the market up to market participants who can now fairly be categorised as corporate gamblers.

One major issue that regulators have sought to address is the issue of over-the-counter (OTC) derivatives trading — trading between and among banks and financial firms that takes place in private and hence beyond public scrutiny. The scale of this type of trading is extraordinary. At the end of 2013 by some industry estimates the notional total amount of outstanding over-the-trading derivatives contracts was US$710 trillion globally[87]. This meant a very large proportion of financial market transactions were unregulated, not subject to common risk management practices of standards, not transparent and also potentially open to abuse and "rogue" activity. Furthermore, some derivatives contracts are leveraged; that is, buyers borrow money to buy more of them and as such any losses generated can be large. This was the case with a lot of the trading in CDOs and CDSs.

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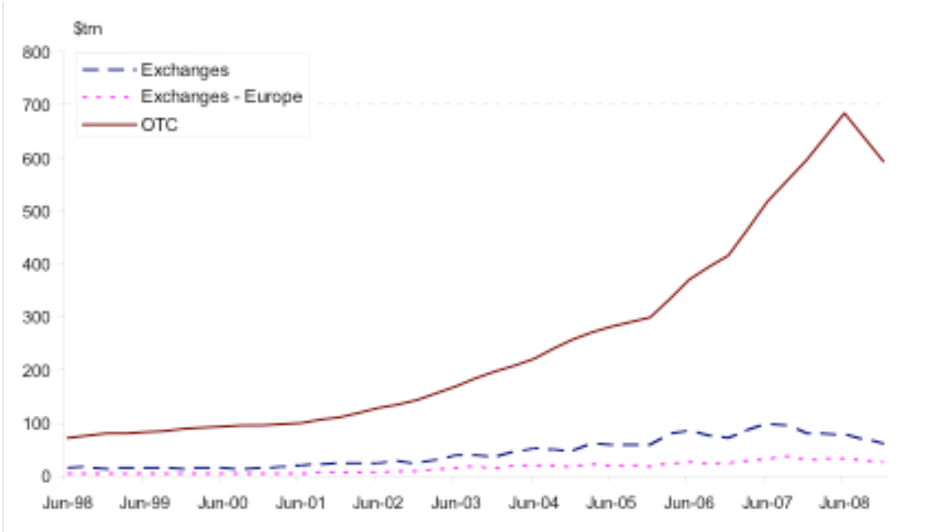
[84] Derivatives is a broad term that refers to financial instruments that derive from another asset, so an option is a contract that allows a buyer to buy or sell an underlying asset (such as a share in a company) at a specified price for example. Such an option derives from the underlying share. There are literally hundreds of derivative financial instruments that are traded in markets around the world – stock options, futures contracts, foreign exchange swaps, commodity options and credit default swaps. Many have been used legitimately for many decades as a form of insurance. For example airlines buy commodity options to set the price of fuel ahead of time and effectively mitigate the risk of fuel price rises over the course of the year.

[85] CDSs can be quasi-insurance policies that provide insurance against default for a range of debt instruments, for example corporate and sovereign bonds, bond indexes and securitisations.

[86] Deutsche Börse Group (2008), "The Global Derivatives Market - An Introduction", white paper, Frankfurt, May 2008, at http://deutsche-boerse.com, viewed 16 October 2014.

[87] Bank for International Settlements (2014), "OTC Derivatives Market Activity in the Second Half of 2013", 8 May, at http://www.bis.org/publ/otc_hy1405.htm, viewed 16 July 2014.

**Table 3: The Size of Derivatives Markets: On- and Off-Exchange**




*Source: Bank for International Settlements (BIS)*[88]

Note: The figure shows the notional amounts outstanding in on- vs. off-exchange market segments in USD trillions in 1998-2008. The trends shows outstanding amounts worldwide, where European exchanges' market share is shown separately (no similar geographic breakdown exists in OTC data).

While the SEC and the Commission had agreed to work towards a plan for mutual recognition of each other's securities regulatory regimes in February 2008[89], it was not until the near-collapse in mid March 2008 of US investment bank Bear Stearns that US regulators saw the need to hasten their efforts to address CDS issue specifically[90]. Bear Stearns had heavily traded in both CDOs and CDSs and exemplified the excesses of the financial crisis and the lack of regulation. Prior to 2008 credit default swaps were, in the SEC's words, "virtually unregulated" in the US[91]. In the EU, despite warnings from the EU's Committee on Payment and Settlement Systems in 1998, the EU had done little to mitigate the risks inherent in the fast-growing OTC derivatives markets.

When Bear Sterns was sold to JP Morgan in mid March, amid revelations about the scale of its risky trading in CDOs and CDS, the SEC and the CFTC started to work on what they called "this burgeoning area of financial innovation" to see how they should be best

[88] European Commission (2009), "Commission Staff Working Paper Accompanying the Commission Communication Ensuring Efficient, Safe and Sound Derivatives Markets", WP 905 final, Brussels, July 2009, at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf, viewed 12 August 2012.

[89] The SEC followed up with plans to form separate mutual recognition arrangement with Canada, whose provinces not federal government regulated financial instruments, and another with Australia, see Securities and Exchange Commission (2008), "SEC Announces Next Steps for Implementation of Mutual Recognition Concept", press release, 24 March, at http://www.sec.gov/news/press/2008/2008-49.htm, viewed 10 June 2013.

[90] US Mission to the EU (2009), "Report of the US Mission to the EU", November, at http://useu.usmission.gov/media/pdfs/financial-markets.pdf, as viewed 12 November 2012.

[91] Securities and Exchange Commission (2008), "SEC Chairman Cox Statement on MOU with Federal Reserve, CFTC to Address Credit Default Swaps", press release, 15 November, at http://www.sec.gov/news/press/2008/2008-269.htm, viewed 15 September 2014.

regulated under federal law[92]. Discussions between the US and the EU in the early part of the year continued to focus on defining the process for carrying out a comparability assessment of EU and US securities regimes but not addressing specific regulatory changes[93]. The EU took a similar approach, with the ECOFIN Council on 3 June 2008 asking the ECB and the pan-EU committee of regulators, the CESR, to simply review standards for derivatives trading in the EU.

## US Moves to Direct CDSs through Clearinghouses

Despite Bear Sterns and ongoing market turmoil months went by and it was not until the collapse of Lehman Brothers in September 2008 and the bailout the week after by the US Government of US insurer AIG that the need to address regulatory reform dramatically intensified on both sides of the Atlantic. Both Lehman Brothers and AIG were masters in risky derivatives trading. In discussions between the US and the EU it was agreed that one of the first targets would be to bring more OTC trading out into the open. CDS trading was one of the first areas targeted.

According to the International Swaps and Derivatives Association (ISDA) the outstanding "notional" value of debt insured by these swaps jumped from less than US$1 trillion in late 2000 to a notional value of around US$62 trillion at the end of 2007[94].The Bank for International Settlements puts the value at US$60 trillion and estimates this was worth about 10% of the total derivatives market[95]. While these figures are disputed (critics argue these figures take into account both the buy and sell sides of a trade among other things), it can be noted that, according to the CIA World Factbook, the gross domestic product of the entire world economy in 2013 was US$84.97 trillion in purchasing power parity terms[96].

Another problem — that had a particularly transatlantic dimension to it — was that some trading in CDSs was subject to much speculation in the market, including arbitrage opportunities that exploited price differences between the US and the EU markets. The markets in both allowed what is referred to as "naked" credit default swap trading, where the party trading the CDS does not even own the underlying asset (i.e. the credit it has issued to another party) but is allowed to trade it as if they do anyway. Some market participants, particularly hedge funds, frequently betted on corporate and sovereign

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[92] Commodities Futures Trading Commission (2008), "CFTC, SEC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivative Products", 11 March, at http://www.cftc.gov/PressRoom/PressReleases/pr5468-08, viewed 16 August 2014.
[93] US Mission to the EU, *op. cit.*
[94] The size of the market can be disputed. For instance these figures include both sides of every trade (the buy and sell sides), which effectively doubles the notional value. Some values are also inflated by CDSs that are leveraged. See Laing, Jonathan R. (2008), "Defusing the Credit-Default Swap Bomb", *The Wall Street Journal*, 17 November, at www.wsj.com/articles/SB122671604643530511, viewed 14 May 2014.
[95] European Commission (2008), "Time for Regulators to get a Better view of Derivatives", press release, 17 October, at http://europa.eu/rapid/press-release_SPEECH-08-538_en.htm?locale=fr, viewed 16 May 2013.
[96] CIA World Factbook, at https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html, data extracted November 2014.

defaults and were accused of intensifying the panic. Naked selling allowed some traders to force prices down much lower than would have been possible if the trader had owned the underlying assets[97].

Several years earlier US billionaire Warren Buffett had called CDSs "time bombs" that could push companies onto a "spiral that can lead to a corporate meltdown"[98]. The SEC at the time, however, was reluctant to intervene aggressively. It proposed a new anti-fraud rule on naked selling in March, intervened more decisively in mid July with a temporary emergency order to require traders to actually own the underlying asset before trading it, extended the order in late July but only for another two weeks and on 17 September, two days after Lehman Brothers collapsed, banned only some aspects of naked selling[99].

**The EU Acts on Credit Default Swaps**

The mounting losses in the US were mirrored in Europe. Numerous European banks heavily bought CDSs in the lead up to the financial crisis. The value of European banks' deals with AIG alone was estimated at US$426 billion in 2007[100]. As of 2007 around 35% of global CDS trades involved at least one party domiciled in the EU and around 39% of CDSs were denominated in euro[101]. The Franco-Belgian bank Dexia, which required US$8.7 billion in government bailouts, was one of the largest buyers. One of the problems that had arisen was that banks also bought CDSs not only to be part of the money making machine but also for regulatory avoidance reasons.

Under the Basel Accords, the prudential standards set by the Basel Committee on Banking Supervision and incorporated into European (and US and many developed countries' domestic laws) banks must set aside a certain percentage of financial reserves to cover potential losses. However, CDSs were technically assets (and only losses if they went bad). As such CDSs allowed banks to make it appear as though they had more assets and this

[97] Securities and Exchange Commission (2008), "SEC Issues New Rules to Protect Investors against Naked Short Selling Abuses", press release, press release, 17 September, at http://www.sec.gov/news/press/pressarchive/2008press.shtml, viewed 15 September 2014.

[98] "Buffett Warns on Investment 'Time Bomb'", *BBC News*, 4 March 2003, at http://news.bbc.co.uk/2/hi/2817995.stm, viewed 6 January 2014.

[99] Securities and Exchange Commission (2008), "SEC Enhances Investor Protections Against Naked Short Selling", press release, 15 July, at http://www.sec.gov/news/press/2008/2008-143.htm, viewed 15 September 2014; Securities and Exchange Commission (2008), "SEC Extends Order Limiting Naked Short Selling Through August 12", press release, 29 July, at http://www.sec.gov/news/press/2008/2008-155.htm, viewed 17 September 2014; Securities and Exchange Commission (2008), "SEC Issues New Rules to Protect Investors against Naked Short Selling Abuses", press release, press release, 17 September, at http://www.sec.gov/news/press/pressarchive/2008press.shtml, viewed 15 September 2014.

[100] Henry, David; Goldstein, Matthew and Matlack, Carol (2008), "How AIG's Credit Loophole Squeezed Europe's Banks", *Bloomberg BusinessWeek*, 15 October, at http://www.businessweek.com/stories/2008-10-15/how-aigs-credit-loophole-squeezed-europes-banks, viewed 20 July 2013.

[101] Freund, Dr. Corinna (2009), "The Role of Europe in the Global CDS Market", presentation to the European Central Bank, 13 February, Frankfurt am Main, at http://www.ecb.europa.eu/events/pdf/conferences/ccp_cds/AGENDA_ITEM2_RoleofEuropeintheglobalCDSmarket.pdf?bb971e4677b9e38333b8abd1706659a3, viewed 11 November 2013.

freed up their capital requirements and allowed them to lend out even more money than the Basel standards allowed[102].

Weeks after the collapse of Lehman Brothers the EU Internal Market and Services Commissioner Charlie McCreevy convened a meeting in mid October of all the main players to respond in line with the US. He initially targeted the end of the year to have developed concrete proposals to manage the risks from credit derivatives[103]. The Commission agreed with the US that OTC — and CDS trading more specifically — should be conducting through clearinghouses. It was the EU's first response to the complex area of derivatives reform for some time. The ECB and the CESR's earlier standards-developing work on the area had been "frozen" in 2005 due to scope, content and uncertainty over the legal basis of its recommendations[104].

Even so in October 2008 the ECB and the CESR issued further (non-binding) recommendations on derivatives trading although these mainly concerned standards around trading, transparency, risk management and competition issues[105]. Even though the broad issue of OTC trading and derivatives regulation had been on the EU agenda, and despite the US response, the EU had still yet to develop a regulatory response[106]. The next month Commissioner McCreevy asked a high-level expert committee, the De Larosière Committee, to recommend measures to reduce the risks in the market as part of a comprehensive review of financial regulation and supervision. While the EU was still considering its response, the US moved ahead and led the agenda through international fora, notably the G20.

### The US Makes CDSs Top Priority

On the first day of the G20 Leaders Summit in Washington on 14-15 November 2008 the US Administration's President's Working Group on Financial Markets announced that ensuring trading in credit default swaps was directed through central counterparty services had become its "top near-term priority"[107]. The SEC, which is a key member of the working group, moved simultaneously to tackle the "virtually unregulated" OTC market in CDSs by teaming up with the Federal Reserve Board and the CFTS and proposing to

[102] Henry et al., *op. cit.*
[103] European Commission (2008), "Time for Regulators to get a Better view of Derivatives", press release, 17 October, at http://europa.eu/rapid/press-release_SPEECH-08-538_en.htm?locale=fr, viewed 16 May 2013.
[104] European Central Bank (2008), "ESCB and CESR Consult on Recommendations for Securities Clearing and Settlement Systems and Central Counterparties in the European Union", press release, 23 October, at http://www.ecb.europa.eu/press/pr/date/2008/html/pr081023.en.html, viewed 4 May 2014.
[105] European Central Bank (2008), "CESR/ESCB Consultation Paper Draft Recommendations for Securities Settlement Systems and Draft Recommendations for Central Counterparties", Consultation Paper, Frankfurt, October 2008, at http://www.ecb.europa.eu/press/pr/date/2008/html/pr081023consulatation.pdf, viewed 16 September 2013.
[106] European Commission (2009), "Commission Staff Working Paper Accompanying the Commission Communication Ensuring Efficient, Safe and Sound Derivatives Markets", WP 905 final, Brussels, July 2009, at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf, viewed 12 August 2012.
[107] US Treasury (2008), "PWG Announces Initiatives to Strengthen OTC Derivatives Oversight and Infrastructure", press release, 14 November, at http://www.treasury.gov/press-center/press-releases/Pages/hp1272.aspx, viewed 11 November 2014.

require all CDS trading to go via clearinghouses[108]. Clearinghouses (or clearing agencies or central counterparties) are services that provide clearing and settlements of trades at central market level. At the prompting of the President's Working Group on Financial Markets several potential central counterparty providers accelerated their efforts to facilitate the change[109].

Four groups were positioned to set up a central counterparty: the US-based Clearing Corporation, which was being acquired by Intercontinental Exchange; the CME Group, the world's largest futures exchange; Liffe, the derivatives arm of the New York Stock Exchange Group; and Eurex, the derivatives arm of Deutsche Börse[110]. Central clearing would mean all trades would be registered, subject to rules and controls, reported and hence more transparent. They would also by subject to the clearinghouses' own risk management procedures. All the clearinghouses that had lined up to provide clearing services were based in the US and the EU and risked being left behind by fast developments.

## The G20 Washington Summit Agenda

After the G20 Leaders' Summit in Washington on 14-15 November the declaration agreed to strengthen the resilience and transparency of credit derivatives markets and reduce systemic risks, including by improving the infrastructure of over-the-counter markets. The specific 47-point action plan had been negotiated between participating countries, including the US and the EU, and agreed among G20 sherpas beforehand[111]. The action plan also required supervisors and regulators to speed up efforts to reduce the CDS and OTC derivatives trading systemic risks, insist that market participants support exchange traded or electronic trading platforms for CDS contracts and expand OTC derivatives market transparency. It also noted that this should take place in the context of the "imminent launch of central counterparty services for credit default swaps" in some countries[112]. The agreement over the broad course of action between the US and the EU, which together dominate the G20, effectively guaranteed the course of action to be taken by the G20. As such the G20 summit served to merely confirm the US and the EU approach. Furthermore the EU's agreement with the US pre-empted the recommendations the Commission had asked the De Larosière Committee to formulate on the reform of financial markets only weeks before.

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108 Securities and Exchange Commission (2008), "SEC Chairman Cox Statement on MOU with Federal Reserve, CFTC to Address Credit Default Swaps", press release, 15 November, at http://www.sec.gov/news/press/2008/2008-269.htm, viewed 15 September 2014.
109 US Treasury, 2008, *op. cit.*
110 "Central CDS Clearing Houses Poised for Approval", *FT.com*, 18 November 2008, at http://www.ft.com/cms/s/0/7de2f4cc-b59e-11dd-ab71-0000779fd18c.html, viewed 20 September 2014.
111 Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012.
112 G20 (2008), "Declaration of the Summit on Financial Markets and the World Economy", Washington DC, 15 November, at https://g20.org/wp-content/uploads/2014/12/Washington_Declaration_0.pdf, viewed 16 July 2014.

While the US and EU had agreed ahead that CDSs would be traded in clearinghouses and that trading would therefore become more transparent, they had not worked out how. Within days of the G20 Summit, US and EU regulatory officials met in Brussels to discuss the details of the G20 commitments, including tackling credit default swaps[113]. European regulators were uncomfortable with the prospect of a US-only clearinghouse outcome and wanted "at least one European solution" for the creation of a central CDS clearinghouse[114]. The meeting on 19 November 2008 considered a range of emergency measures to tackle the crisis and came as US Treasury Secretary Henry Paulson was thrashing out his US$700 billion bailout plan. While Commission staff and a range of US regulators held a further meeting (a videoconference) under the umbrella of the Financial Markets Regulatory Dialogue and discussed a range of initiatives related to reducing or eliminating regulatory differences[115], differences of opinion over tackling CDS trading started to emerge between the US and the EU.

On 2 December 2008 the EU Council backed "as a first step and as a matter of urgency" a Commission proposal to create "one or more" European clearinghouse with clearing capacities in OTC derivatives while working to maintain "coherence with parallel initiatives at global level"[116]. The ECB also weighed into the debate later in the month urging there was a need "for at least one" European clearinghouse for credit derivatives and that, given the systemic importance of securities clearing, it "should be located within the euro area"[117].

The first clearinghouse ready to operate was in London, the largest derivatives trading market in the world. To get CDS transactions going through at least one clearinghouse quickly, the SEC needed to amend its rules, as London was outside its jurisdiction. Not amending its rules meant all US derivatives contracts risked being locked out of the largest derivatives trading centre in the world. So the SEC in late December responded with a temporary exemption for London-based LCH.Clearnet Ltd[118] to operate as a central counterparty for credit default swaps[119].

At a time the EU appeared to be moving towards developing its own regulatory preferences, albeit in "cooperation" with the US as pledged; the US response was to also form a new global forum dedicated to the very specific area of the regulation of credit

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113 "Central CDS Clearing Houses Poised for Approval", *FT.com*, 18 November 2008, at http://www.ft.com/cms/s/0/7de2f4cc-b59e-11dd-ab71-0000779fd18c.html, viewed 20 September 2014.
114 *Ibid.*
115 National Association of Insurance Commissioners, *op. cit.*
116 Council of the European Union (2008), "Council Conclusions on Clearing and Settlement", press release, Brussels, 16212/08, 24 November 2008, viewed 12 May 2013.
117 European Central Bank (2008), "Decisions Taken by the Governing Council of the ECB", 18 December, at http://www.ecb.int/press/govcdec/otherdec/2008/html/gc081219.en.html, viewed 16 July 2014.
118 Majority owned by the London Stock Exchange and the largest derivatives clearing houses globally, LCH.Clearnet Ltd provides clearing and settlement services for both the exchange traded and the OTC commodity markets globally.
119 Securities and Exchange Commission (2008), "SEC Approves Exemptions to Allow Central Counterparty for Credit Default Swaps", press release, 23 December, at http://www.sec.gov/news/press/2008/2008-303.htm, viewed 15 September 2014.

default swaps and central clearinghouses. The OTC Derivatives Regulators' Forum first met at the Federal Reserve in New York in January 2009 and included representatives of the Federal Reserve, the US CFTC, the SEC, as well as the UK Financial Services Authority, the German Federal Financial Services Authority, Deutsche Bundesbank, the New York State Banking Department, with the ECB and the Hungarian Financial Services Authority in their roles as co-chairs of the EU's ESCB-CESR Working Group on Central Counterparties. The aim was to "mutually support" each regulator in carrying out its respective authorities and also apply consistent standards and promote consistent public policy objectives and oversight approaches for all CDS clearinghouses[120]. The forum has continued to meet on an occasional basis ever since. The EU meanwhile continued to push ahead with a European "solution".

**ECB Consultation**

The EU started a process of consulting with industry on their requirements and needs. On 24 February 2009 the ECB hosted a meeting of representatives of the European banking and clearing industry, the Eurosystem, the European Commission, the EU Council, the European Parliament and other stakeholders to discuss the issues involved in establishing a European system for credit default swaps (CDS). The same month the De Larosière Committee handed down its report, recommending the introduction of at least one well-capitalised central clearinghouse for credit default swaps in the EU — in line with the Commission and the Council's already established position[121]. In March nine major banks committed to use one or more clearinghouses, once they were established, to clear CDS trades based on European companies or indexes[122]. In a letter to McCreevy they noted several outstanding technical, regulatory, legal and practical issues to reach the goal set by the Commission of 31 July 2009, including contractual specifications, the process for cash settlement, establishing a dispute resolution mechanism and risk-related issues[123].

In light of the values, volumes and transatlantic nature of electronic derivatives trading, the US and the EU needed to closely coordinate. It had been recognised that derivatives trading was especially mobile and that coordination was imperative[124]. The same month the US SEC gave the go-ahead in March for two US-based clearinghouses to clear CDS trades in the US (ICE US Trust LLC and the Chicago Mercantile Exchange Inc.). Both the US and the EU now had clearinghouses were CDS trade could take place. The SEC later gave the go-ahead for two EU-based clearinghouses, ICE Clear Europe Limited and

[120] Federal Reserve Bank of New York (2009), "A Global Framework for Cooperation among CDS CCP Regulators", press release, 19 February 2009, at http://www.ny.frb.org/newsevents/news/markets/2009/ma090219.html, viewed 12 August 2014.
[121] The High Level Group on Financial Supervision in the EU" (2009), "Report", chaired by Jacques de Larosière, Brussels, 25 February, at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf, viewed 1 September 2011.
[122] The banks were Barclays Capital Citigroup Global Markets Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Morgan Stanley and UBS.
[123] International Swaps and Derivatives Association (2009), "Letter to Commissioner Charlie McCreevy", London, 11 March.
[124] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.

Eurex Clearing AG[125], and the UK's Financial Services Authority gave approval for another clearinghouse, Ice Clear Europe, just two days before the Commission's July 31 deadline.

However, substantial issues remained to be sorted out. While the G20 Leaders Summit in London in April confirmed the idea of establishing central clearing counterparties "subject to effective regulation and supervision"[126], the arrangements between the world's two largest derivatives markets were complex. Industry had impressed the great importance of common standards, procedures, regulatory approaches, capital requirements data privacy and contractual matters[127]. Over the next two months US regulators at the SEC, the Commodity Futures Trading Commission (CFTC) and US Treasury and the Commission and ECB worked closely on coordinating their respective regulatory reform proposals for a wide range of financial reforms, among them derivatives reform. The respective US and EU derivatives reforms were discussed in June of 2009 at the next FMRD meeting.

## The Obama Administration's Proposals

On 17 June 2009 the Obama Administration released a lengthy detailed plan for financial regulatory reform, proposing new supervisory arrangements, including a new Financial Oversight Council, a new National Bank Supervisor, authority for the Federal Reserve to oversee payment, clearing, and settlement systems, a new Consumer Financial Protection Agency, a new bank resolution mechanism for failed banks, and also reforms to require standardized OTC derivative transactions to be executed in regulated central clearinghouses[128]. The US proposals had closely followed by just three weeks the European Commission's own proposals for wide-ranging financial supervisory reform[129].

A week later the ECB and CESR recommended some well overdue measures to improve safety and soundness of clearing and settlement systems in the EU. Still non-binding, they were based on draft recommendations for securities settlement systems proposed nearly eight years earlier in November 2001 and recommendations issued by the global securities body, the International Organization of Securities Commissions, nearly five years earlier in

[125] Securities and Exchange Commission (2009), "SEC Approves Exemptions Allowing ICE Clear Europe Limited and Eurex Clearing AG to Operate Central Counterparties for Credit Default Swaps", press release, 23 July, at http://www.sec.gov/news/press/2009/2009-170.htm, viewed 12 June 2014.
[126] G20 (2009), "Declaration on Strengthening the Financial System (Annex to London Summit Communiqué)", London, 2 April, at http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf, viewed 16 July 2014.
[127] O'Connor, Paul (2009), "CCP for CDS User Requirements", European Banking Federation presentation to the European Central Bank, 24 February, at http://www.ecb.europa.eu/events/pdf/conferences/ccp_cds/AGENDA_ITEM3_EBF.pdf?781250cc48b9eaaeb515e09771474f8d, viewed 16 October 2014.
[128] US Treasury (2009), "Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation", Washington DC, 17 June, at http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf, viewed 16 September 2014.
[129] Communication from the Commission, Communication from the Commission on European Financial Supervision, May 2009, COM(2009) 252.

November 2004[130]. Nevertheless a week after this the European Commission revealed plans for reform of its derivatives markets specifically"[131]. While mirroring the US proposal for central clearing of CDS trades and standardised contracts, the Commission had also proposed other measures, such as requiring central storage in data repositories, the collection of information on the number of transactions and size of contracts, and the public display and disclosure of all price and other trade-related information. However, these were the sorts of things the US preferred to leave to industry to work out[132].

In the EU, by the end of the month — the 31 July 2009 deadline set by the Commission for central clearing of CDS trading to be ready — ten major US and EU dealers had agreed to clear CDS on European reference entities and indices through one or more EU-regulated clearinghouses[133]. The Commission subsequently set up a working group, involving US and EU dealers, clearinghouses and supervisors to monitor the rollout. Meanwhile after discussion with EU authorities, the US Treasury sent legislation (the Over-the-Counter Derivatives Markets Act of 2009) to Congress that would also direct OTC derivatives trading onto exchanges. This legislation was subsequently incorporated into the Dodd–Frank Wall Street Reform and Consumer Protection Act, widely hailed as the most wide reaching reforms to financial regulation in the US since the Great Depression.

However, the negotiations between the US and the EU to direct OTC derivatives trading onto clearinghouses had dealt with one segment of the market. Convergence of the highly complex area of derivatives regulation generally would require further negotiations on a range of other issues, including the standardisation of contracts, data privacy, common standards and regulatory enforcement. In addition there was the issue of how CDS trading and OTC trading was connected to other areas of the derivatives markets. As the Commission noted, the "level of interconnection and hence the spillover effects" between the various segments of the markets was "extremely high"[134]. For example the market prices of CDSs affect the prices of other instruments, some of which were regulated and some of which were not. Most major US and EU banks traded in most if not all of the different product areas.
Furthermore, as CDSs effectively insure the risk of default, CDS prices have a direct impact on the financing costs of companies — and sovereign countries in the case of

[130] European Central Bank (2009), "ESCB and CESR Issue Recommendations to Increase Safety and Soundness of the Post-Trading Infrastructure", press release, 23 June, at http://www.ecb.europa.eu/press/pr/date/2009/html/pr090623.en.html, viewed 16 November 2013.
[131] European Commission (2009), "Commission Staff Working Paper Accompanying the Commission Communication Ensuring Efficient, Safe and Sound Derivatives Markets", WP 905 final, Brussels, July 2009, at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf, viewed 12 August 2012.
[132] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
[133] European Commission (2009), "Major Step Towards Financial Stability: European Market for Credit Default Swaps Becomes Safer", press release, IP/09/1215, 31 July, at http://europa.eu/rapid/press-release_IP-09-1215_en.htm, viewed 16 July 2013.
[134] European Commission (2009), "Commission Staff Working Paper Accompanying the Commission Communication Ensuring Efficient, Safe and Sound Derivatives Markets", WP 905 final, Brussels, July 2009, at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf, viewed 12 August 2012.

country CDS. "These characteristics proved to be the Achilles heel of the OTC market during the current crisis," the Commission noted in a technical paper in July[135]. In addition there was the Basel banking rules to address, as they had allowed many banks to undermine the banking prudential requirements by trading big in CDSs in the first place. Further there was the issue of risk management in the financial system as a whole. These problems set the scene for ongoing close negotiations between the US and the EU in the lead up to yet a further G20 Summit in Pittsburgh in September 2009.

## Pittsburgh Tackles OTC Derivatives

G20 leaders pledged in Pittsburgh that "all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest"[136]. In addition OTC derivative contracts should be reported to trade repositories and non-centrally cleared contracts should be subject to higher capital requirements. The rules agreed virtually mirrored the arrangements the US and EU had already established themselves. The G20 further tasked the Basel-based Financial Stability Board to monitor implementation and assess their adequacy of the measures being adopted by member countries.

Ten days later EU and US regulators, including CFTC Chairman Gary Gensler, sat down in Brussels to specifically discuss OTC derivatives market reform. Organised by the Commission's DG Internal Market, the conference discussed both sides' respective proposals and results of an industry consultation on which direction EU regulation of the derivatives markets should take[137]. Both sides continued to work together to coordinate approaches through the Financial Markets Regulatory Dialogue in a meeting on 27 October 2009[138] and through the new global forum, the New York Federal Reserve-chaired OTC Derivatives Regulators Forum[139]. By October 2009 both the US and the EU had agreed in principle that reporting all OTC derivative contracts to trade repositories, clearing all standardised contracts through central counterparties (or clearinghouses) and shifting trading of standardised contracts onto exchanges/electronic platforms was the best way forward[140]. Other objectives agreed were to reduce systemic risk[141] and protect against market abuse.

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135 *Ibid.*

136 G20 (2009), "Leaders Statement: The Pittsburgh Summit", 24-25 September, at https://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf, viewed 12 October 2013.

137 European Commission, DG Internal Market, *op. cit.*; US Mission to the EU, "US Newsletter from the US Mission to the European Union", Issue 6, September/October 2009, viewed 11 November 2014.

138 European Commission (2009), "Joint Report on US-EU Financial Markets Regulatory Dialogue for the TEC Meeting", DG Enterprise, Brussels, 27 October, at http://ec.europa.eu/enterprise/policies/international/files/joint_report_on_fmrd_en.pdf, viewed 2 May 2013.

139 European Commission, DG Internal Market, *op. cit.*

140 European Commission (2009), "Joint Report on US-EU Financial Markets Regulatory Dialogue for the TEC Meeting", DG Enterprise, Brussels, 27 October, at http://ec.europa.eu/enterprise/policies/international/files/joint_report_on_fmrd_en.pdf, viewed 2 May 2013.

141 This issue was one taken up by the new European Systemic Risk Board and in the US the Financial Stability Oversight Council. The former was established under the new legislation that established the new European Financial supervisory system from January 2011

There was a further US-EU summit in Washington on 3 November 2009 that discussed derivatives reform. The US Treasury's legislation was later revised in Congress and passed on 11 December 2009, as part of the Wall Street Reform and Consumer Protection Act of 2009. It was not until nine months later on 15 September 2010 that the Commission released its legislative proposal: a Regulation on OTC Derivatives, Central Counterparties and Trade Repositories[142]. It set out a range of reporting obligations for OTC derivatives, requirements for all OTC derivatives to be operated through clearinghouses, measures to reduce credit and operational risk for bilaterally, common rules for clearinghouses and rules around the establishment of interoperability between clearinghouses.

It took a further 18 months of negotiation with the European Parliament, with the Commission and Parliament only reaching agreement in February 2012. Finally adopted on July 2012 and entering into force on 16 August 2012, the regulation (known as the European Market Infrastructure Regulation, or "EMIR") was the EU's first package of wide-reaching legislation addressing the derivatives market.

## Conclusion

Throughout the regulatory cooperation on key areas — including accounting standards, credit ratings agencies and credit default swaps reforms among others — the US and the EU worked closely at all stages of the policy making process. In addition to the agenda-setting stage at forums such as the G20, they collaborated at the policy development stage from conception to legislation and the policy implementation stage (notably when it came for rules to be created around the implementation of the legislation). This was a process that was more than just the "shallow integration" that Pollack had considered the New Transatlantic Agenda to be in its early days[143].

While the US and the EU made tangible gains from the cooperation, the entire process — the exchange of ideas, information and regulatory approaches, the series of compromises, the accommodation of each side's preferences and the eventuation of similar regulatory regimes on both sides — was more than just a sophisticated process of intergovernmental policy negotiations. The process contributed to the construction of a highly symbiotic and converged transatlantic governance regime. This highlights a particular type of policy development in which, as Pollack argues, international relations is no longer the prerogative of foreign services but increasingly takes place through transgovernmental

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and the latter was established under the Dodd–Frank Wall Street Reform and Consumer Protection Act. Both organisations continued to consult regularly throughout 2012 on coordinating risk management in the transatlantic financial system.

142 European Commission (2010), "Proposal for a Regulation of The European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories", COM(2010) 484/5, Brussels, at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf, viewed 16 October 2014.

143 Pollack, Mark A. (2005), "The New Transatlantic Agenda at Ten: Reflections on an Experiment in International Governance", *Journal of Common Market Studies*, Vol. 43, Issue 5.

networks of domestic officials interacting directly with their foreign counterparts. These include, as Pollack categorises them, the intergovernmental (heads of state level), the transgovernmental (or bureaucrat/regulator level; and the transnational level (involving private actors)[144]. The US and the EU bureaucracies and regulators were also policy partners — key actors in forming a particular type of transatlantic governance. Such actors are, as Slaughter describes them, the "new diplomats"[145].

In all three areas a common theme was recognition of the interconnectedness of the US and EU markets. There was an understanding that policy action could not be initiated by either the US or the EU unilaterally with no regard to the other party's policy position. In speaking in New York in November 2008, at the height of market turmoil, SEC Chairman Christopher Cox said the most recent and visible proof of interdependence was the financial crisis that had swept the world's economies. "What this means in practical terms," he said, "is that markets in Bangkok are being affected by investment decisions made in Boise. Swings in the Dow may be related to trades originating in Dubai, or Dublin, or Dakar."[146] Shortcomings in the regulation of credit ratings agencies, the lack of convergence in US and EU accounting standards and the regulation of credit default swaps were key areas identified as contributing to the financial crisis and it was seen as imperative by both US and EU regulators act in a coordinated manner to protect their interests in each other's respective markets. This also meant, however, as the subsequent chapters discuss, coordinating their positions on international action.

[144] Pollack, Mark A. and Shaffer, Gregory (2001), *Transatlantic Governance in Historical and Theoretical Perspective*, Rowman and Littlefield, Oxford.
[145] Slaughter, Anne-Marie (2004), *A New World Order*, Princeton University Press, Princeton, ch 1.
[146] Christopher Cox, SEC Chairman (2008), "The Future of International Standards and Cooperation In Light of the Credit Crisis", speech, FEI 2008 Current Financial Reporting Issues Conference, New York, 18 November 18, at http://www.sec.gov/news/speech/2008/spch111808cc.htm, viewed 4 August 2014.

# CHAPTER 5: US AND EU COOPERATION ON A CRISIS RESOLUTION ROLE FOR THE INTERNATIONAL MONETARY FUND

The US and leading European nations have dominated the International Monetary Fund (IMF) ever since it was established in 1944. While its role has evolved considerably in recent decades — from maintaining stability over the international exchange rate system to providing balance of payments relief to nations in financial difficulty — it has remained one of the prominent financial institutions in the international financial governance regime.

When the financial crisis intensified in mid 2008 the IMF's importance was somewhat waning, but with the prospects high that numerous countries would need financial support as the crisis progressed, the US and the EU collaborated to ensure the organisation had a key role in responding to the financial crisis.

This chapter discusses how the US and the EU collaborated closely to ensure the IMF had a central role in sovereign financial bailouts as well as a role in coordinating financial governance reform to come out of the G20 process. The intention on both sides was to secure their respective interests but also their common interests flowing from an essentially interdependent economic relationship. The US and EU alliance on securing a central role for the IMF in resolving the crisis was in line with an existing deep-seated alliance that had trade, economic, financial and regulatory cooperation dimensions and had been strengthened considerably by the New Transatlantic Agenda and Joint Action Plan in 1995 and the Transatlantic Economic Partnership signed in 1998.

This chapter highlights how at the outset of the financial crisis both had too much to lose in failing to collaborate effectively to shape subsequent financial reforms in the international arena. It is argued that the outcome of a negotiated common position between the US and the EU on a role for the IMF was success for their common and interdependent financial and economic interests. It meant a consolidation of EU and European hegemony over international financial governance.

## A History of US and EU Dominance in the IMF

In the midst of WWII the US and UK Treasuries negotiated the construction of what has been coined an effective financial "international constitution" to avoid the perceived interwar mistakes of wildly fluctuating exchange rates, the international transmission of deflation, currency devaluations and trade and exchange restrictions[1]. A resulting draft document in 1943, based on a draft plan prepared by the UK and presented by its lead negotiator John Maynard Keynes and a US draft presented by its lead negotiator Harry Dexter White, formed the basis of the agreement at the Bretton Woods Conference in New Hampshire in 1944[2].

As part of efforts to restore stability after the war and prevent a return to the currency devaluation and trade barriers seen in the Great Depression, the Bretton Woods Conference, officially named the United Nations Monetary and Financial Conference, led to the formation of the IMF and the International Bank for Reconstruction and Development (IBRD), the latter of which has since become part of the World Bank Group. The IMF was tasked to serve three key functions: to oversee the system of pegged exchange rates; provide temporary financial assistance to countries with balance of payments problems (conditional on their adjusting domestic policies appropriately); and work to eliminate restrictions on transactions in foreign exchange that could limit the growth of international trade[3]. The IMF provided assistance to countries in the form of loans primarily to help members address short-term balance of payments problems that put pressure on the members' exchange rates[4].

While the US and the UK were both instrumental in establishing the IMF, the US had a somewhat stronger position. The Bretton Woods meeting was both initiated and hosted by the US, which led the drafting of the terms of the agreement. As the US had the dominant currency, shareholder subscriptions to the IMF were outlined in US dollars. Shareholders in the IMF were required to make payments to the US Government in gold or the US dollar and fix their exchange rates to gold[5]. As the US was the only country that pegged its currency to gold, and as the US held most of the world's gold at the time, other countries effectively tied themselves to the US dollar. The Bretton Woods institutions were designed to establish the "economic foundations of peace on the bed rock of genuine international cooperation"[6] but very much placed the US at the centre.

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[1] Bordo, Michael D. and Eichengreen, Barry (1993), "The Bretton Woods International Monetary System: A Historical Overview", in Bordo, Michael D. and Eichengreen, Barry, *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform*, University of Chicago Press, Chicago.

[2] *Ibid.*

[3] United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire (1944), "Articles of Agreement of the International Monetary Fund", statement, 22 July, at http://www.imf.org/external/pubs/ft/aa/index.htm#a9s6, viewed 12 August 2013.

[4] The World Bank in contrast was established at the International Bank for Reconstruction and Development (IBRD) to provide funding for the reconstruction of Europe. Its role has evolved gradually and its current mandate is to work with its affiliate, the International Development Association, and other members of the World Bank Group, to alleviate world poverty; Hagan, Sean, European Central Bank General Counsel and Director of the Legal Department (2009), "10 Years of the Euro: A Perspective from the IMF", speech delivered at the European Central Bank, Frankfurt, 29 January, at https://www.imf.org/external/np/speeches/2009/012909.htm, viewed 14 August 2014.

[5] United Nations Monetary and Financial Conference, *op. cit.*

[6] Vinson, Fred, US Treasury Secretary (1945), "Bretton Woods Monetary Conference", Bretton Woods NH, 27 December, at World Bank Archives, at http://www.worldbank.org/, viewed 16 February 2015.

This balance — with the US at the lead and Europe in second place — has been maintained in IMF decision-making ever since. The US has maintained the largest voting position, with all IMF voting based on financial contributions to the organisation, and it is the only country with a veto over major decisions. Some decisions at the IMF are taken with an 85% majority vote, other decisions with a 70% majority and other decisions with a 50% vote. Decisions requiring an 85% majority include changes to the IMF's Articles of Agreement, decisions about the number of executive directors, quota changes and withdrawal of member countries from the IMF among others[7]. The US has always been the only country that has a veto on the latter decisions[8].

Decisions to activate New Arrangements to Borrow also require an 85% majority, meaning the US has ultimate control over new lending arrangements under this particular mechanism (although decisions to actually disburse funds are made on the basis of a simple majority vote of the IMF Executive Board). The US position has naturally led to claims that the IMF is little more than a US pawn that reflects US security and economic priorities. The Washington think-tank Centre for Economic and Policy Research in fact argues that the IMF answers "mainly to the US Treasury with some minor influence from Europe"[9].

European powers collectively have held the second largest voting bloc since the formation of the IMF and, with the EU now having exclusive legal competence on monetary affairs and shared competence on international financial affairs, EU member states coordinate their positions at the IMF to present a united voice. At the time of the G20 Summit in London EU member states together held a 32.07% vote. As the US held a 17.69% voting share, this brought the combined US-EU voting position in the IMF to 49.76%. While this is just under the threshold for passage of IMF voting decisions that require a simple 50% vote, the US, Europe and Japan combined (the richest countries of the IMF) held 55.6% and, historically, Europe and Japan have rarely in the IMF's existence voted against the US[10].

In addition to their voting dominance, the US and Europe have always maintained an unofficial claim over the IMF's top job of managing director. As part of an unwritten agreement between the US and Europe, a European has always headed the IMF and an American the World Bank. All IMF managing directors have also been from a EU

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7 Bini Smaghi, Lorenzo, European Central Bank (2006), "Powerless Europe. Why is the Euro Area Still a Political Dwarf", *International Finance*, Vol. 9, No. 2, p.12.

8 Weiss, Martin A. (2011), "International Monetary Fund: Background and Issues for Congress", Congressional Research Service, US Congress, Washington DC, 19 September, at http://fpc.state.gov/documents/organization/174242.pdf, viewed 16 July 2014; Wyeth, Earnest Natalie (2014), "Myth vs. Fact: Why IMF Quota and Governance Reforms are Urgently Needed", US Treasury, Washington DC, 14 March, at http://www.treasury.gov/connect/blog/Pages/Myth-vs-Fact-IMF-Quota-Reforms.aspx, viewed 12 August 2014.

9 Center for Economic and Policy Research (2008), "CEPR Warns of Dangers of IMF Resurgence", press release, 14 November, at http://www.cepr.org/press, viewed 11 August 2014.

10 Weisbrot, Mark; Cordero, Jose; Sandoval, Luis (2009), "Empowering the IMF: Should Reform be a Requirement for Increasing the Fund's Resources?", Centre for Economic and Policy Research, April.

member state, with two exceptions. Sweden's Ivar Rooth was head from August 1951 to October 1956 and Sweden's Per Jacobsson from November 1956 to May 1963. Sweden only joined the EU in 1995[11]. Europe's claim over the top position is not outlined in any of the IMF's articles or bylaws, but is instead a "gentlemen's agreement" established when the institution was set up[12].

At the time the IMF was established, US Treasury Secretary Frederick Vinson, with strong backing from Wall Street, was said to have argued that an American should run the World Bank and it was felt an American could not run both the World Bank and the IMF. So there was "little question that a non-American managing director meant a European one"[13].

**The IMF Waning in Significance**

While the US and Europe have maintained their dominance in the IMF since its establishment, the organisation's role has evolved considerably in recent decades. Of particular importance to the IMF is that the world fixed currency exchange rate system was abandoned in the 1970s. This meant the IMF became more focused on providing balance of payments relief for financially troubled countries instead of mediating the exchange rate system. Coinciding with the rise of emerging economies in the global economy, it has also meant a shift in emphasis on addressing more chronic state problems to under-developed nations through lending-related initiatives such as structural adjustment programs — longer-term programs that involve policy changes and come with greater loan conditionality. This shift has meant the IMF has effectively become more involved in shaping macroeconomic policy in a range of countries, driving regulatory reform in loan recipient countries and significantly shaping international financial markets governance generally.

Another change is that the World Bank has to some degree overtaken the IMF's role. The World Bank's Structural Adjustment Loan program initiated in 1980 distinctly waded into waters that the IMF's Extended Fund Facility established in 1974 occupied. This duplication led the World Bank and the IMF to form an agreement in 1989 under which the IMF would focus on macroeconomic and balance of payments issues and the World Bank on microeconomic and structural issues[14]. The emergence and proliferation of other global development banks have also challenged the IMF. These include the European

[11] International Monetary Fund, "IMF Managing Directors", http://www.imf.org/external/np/exr/chron/mds.asp, viewed 4 October 2014.
[12] Keating, Joshua (2011), "Why is the IMF Chief Always a European?", *Foreign Policy*, 18 May, at http://foreignpolicy.com/2011/05/18/why-is-the-imf-chief-always-a-european/, viewed 19 November 2014.
[13] *Ibid.*
[14] International Monetary Fund (1989), "The IMF-World Bank Concordat" in "Selected Decisions and Selected Documents of the International Monetary Fund Thirty-Seventh Issue Washington, DC December 31, 2013", Washington DC, 31 March, at http://www.imf.org/external/pubs/ft/sd/2013/123113.pdf, viewed 11 September 2014.

Investment Bank in 1958, the Inter-American Development Bank established in 1959, the African Development Bank Group in 1964, the Asian Development Bank in 1966 and the Islamic Development Bank founded in 1973. In addition several international finance functions have been assumed by other organisations in the World Bank Group[15].

Multilateral development banks have not been the only alternative to IMF funding; the growth of private sector capital sources have also given industrialised countries alternatives to the IMF[16]. Governments such as the US and the EU have also effectively played a role in structural economic adjustment through their own bilateral loans to poorer countries. The last IMF loans to major industrial countries in support of adjustment programs were made to Italy and the UK in 1976[17]. The IMF's technical assistance role has also been challenged, notably by the growth of global technical and standards bodies that have gained new responsibilities in recent decades. An example is the Financial Stability Forum (FSF) — now the Financial Stability Board (FSB) — that was formed in the wake of the Asian Financial Crisis of 1997-1999 and assumed a monitoring, coordination and advisory role for the G20. There has also been growth in the number of think-tanks and private advisory and consulting firms.

Countries have in fact frequently ignored the IMF's advice (including the IMF's warnings in the lead-up to the financial crisis that global imbalances urgently needed to be addressed). The IMF's position was bolstered somewhat in 2007 when the top job was given to former French minister Dominique Strauss-Kahn, who has been credited with giving the IMF new life, driving needed reforms[18]. However at the time the financial crisis hit the US and Europe the IMF was fading in significance. Even so the IMF's role as an international financial lender has tended to ebb and flow along with global economic cycles. When economic times are good the IMF's role tends to diminish, with fewer countries gaining loans, and when financial crisis hits, the IMF is reinvigorated. Such reinvigoration is typically led by the US, which for example called on the world during the Asian Financial Crisis to channel loans to debtor countries through the IMF.

One of the events to motivate the US in this case was the near collapse of one of the US' largest hedge funds, Long Term Capital Management. It started incurring losses as a result of the crisis in Asia in 1997 but as the crisis spread to Latin America and Russia it lost US$4.4 billion over five months from May to September 1998 due to excessive leveraging

[15] The World Bank Group (WBG) now encompasses five international lending-related organisations, namely the International Bank for Reconstruction and Development (IBRD) established in 1945, the International Finance Corporation (IFC) established in 1956, the International Development Association (IDA) established in 1960, the International Centre for Settlement of Investment Disputes (ICSID) established in 1965, and the Multilateral Investment Guarantee Agency (MIGA) established in 1988.

[16] Federal Reserve Bank of St. Louis (1993), "The Changing Role of the International Monetary Fund", Economic Report of the President, St Louis, January, at https://fraser.stlouisfed.org/docs/publications/ERP/1993/ERP_1993.pdf, viewed 10 July 2014, p. 308.

[17] *Ibid.*

[18] Stewart, Heather (2009), "Can the IMF Now Feed the World?", *The Guardian*, 26 April 2009 at http://www.theguardian.com/business/2009/apr/26/imf-g20-lending-global, viewed 17 August 2014, quoting Peter Chowla, of the Bretton Woods Project, a UK think-tank that monitors the IMF.

and risk taking[19]. The Federal Reserve Bank of New York took the then-unprecedented step of bailing out the fund amid fears that a forced liquidation would create even more havoc in the world financial markets. It is the rejuvenation of the IMF at times of crisis that has led to criticism that it is merely a "credit cartel" led by the world's dominant economic powers[20].

## The IMF Positioned for Key GFC Role from the Outset

When the financial crisis intensified significantly in mid 2008 a similar pattern emerged. The US led calls for the IMF to be given a central role in responding to the fast developing crisis. A meeting of G7 finance ministers and central bank governors called by the US Treasury on 10 October affirmed to "strongly support the IMF's critical role" in assisting countries affected by the crisis[21]. The next day US President George Bush convened a further meeting of G7 finance ministers in Washington to discuss a range of measures, including boosting market liquidity and providing deposit guarantees, among other measures[22]. The IMF also attended these and was represented by its managing director Dominique Strauss-Kahn. He had earlier discussed a role-sharing arrangement with the Financial Stability Forum's head Mario Draghi to recommend a response to the crisis.

As part of the response the US mounted a US$700 billion fund to bailout its banks. The ability of the Commission to respond in a similar manner was limited, however, with no central fund that could be used to bail out banks throughout the EU. The Commission argued at the time that such a fund would be illegal under the treaties that prohibit member states taking on the debt of other member states[23]. It also argued that a one-size-fits-all plan "would make no sense" because the financial market situations and the nature of the banking systems in each member state were different[24]. Instead member states agreed to assist their own banks but act in a "concerted and coordinated manner"[25]. While some of the larger states were able to launch their own bank bailout plans — on 8

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[19] Donnelly, Shawn (2012), "Institutional Change at the Top", in Mayntz, Renate, *Crisis and Control: Institutional Change in Financial Market Regulation*, Max Planck Institute for the Study of Societies, July; Jorion, Philippe (1991), "The Story of Long-Term Capital Management", *Canadian Investment Review*, Winter 1999.

[20] Weisbrot, Mark (2007), "Wolfowitz and the Bank", *The Nation*, 11 June 2007.

[21] G7 Finance Ministers (2008), "G7 Finance Ministers and Central Bank Governors Plan of Action", 10 October, http://www.g8.utoronto.ca/finance/fm081010.htm, viewed at 2 August 2014.

[22] *Ibid*; US Whitehouse (2008), "President Bush Meets with G7 Finance Ministers to Discuss World Economy", 11 October, Washington DC, at http://georgewbush-whitehouse.archives.gov/news/releases/2008/10/20081011-2.html, viewed 12 January 2015; Lowery, Clay (2008), Temporary Alternate Governor of the Fund and the Bank for the United States, "Statement by the Hon. Clay Lowery, Temporary Alternate Governor of the Fund and the Bank for the United States", speech at the Joint Annual Discussion on Behalf of the Hon. Henry M. Paulson, Jr., Governor of the United States of America to the International Monetary Fund and the World Bank Group, Washington DC, 13 October, at https://www.imf.org/external/am/2008/speeches/pr06e.pdf, viewed 10 September 2014.

[23] Article 125 that states member state "shall not be liable for or assume the commitments of central governments" .

[24] European Commission (2008), "FAQs on Europe's Response to the Financial Crisis", press release, 14 October, MEMO/08/618, at http://europa.eu/rapid/press-release_MEMO-08-618_en.htm?locale=en, viewed 12 June 2013.

[25] Council of Ministers (2008) "Declaration on a Concerted European Action Plan of the Euro Area Countries", 12 October, at http://ec.europa.eu/economy_finance/publications/publication13260_en.pdf, viewed 16 July 2014.

October the UK announced a bank rescue package worth £400 billion[26], France €360 billion on 13 October[27] and Germany €500 billion on 17 October[28] — the plan to coordinate bailouts posed a problem.

It became clear that all EU member states would not be in a position to bail out their banks. In the months before the G20 Leaders' Summit in Washington in November 2008 they started to call on external help for their own sovereign debt obligations. While the crisis at this stage had been one affecting the banking system, the scale of the financial losses would soon take on another dimension. It was clear that a number of EU member states would need assistance paying their sovereign debt let alone bailing out their troubled banks. As of mid 2008 a total of 13 out of 17 Eurozone states had national debt-to-GDP limits that exceeded the limits considered acceptable under the Stability and Growth Pact that governs fiscal discipline in the EU.

Introduced in 1998, the purpose of the agreement between the EU's 28 member states is to ensure fiscal discipline in the EU by setting reference values for annual national budget deficits at 3% of GDP and public debt at 60% of GDP. Above 60% was considered "excessive" and yet current account deficits were particularly large in most countries[29]. This reflected high levels of external sovereign borrowing in some countries, notably Greece, and high levels of borrowing by private sector banks, notably in Spain, Portugal and Ireland[30].

The Commission did have a fund designed to provide short-term balance-of-payments funding for acute external financing problems within the EU, in a similar way that the IMF provided, but its capacity was very limited. Established in 2002 the "Medium-Term Financing Facility" had capacity of just €12 billion[31] and as of late 2008 it had not been used for 15 years[32]. At the time there was no EU intergovernmental agreement to boost the funds dramatically (in fact it was not until later in 2010 when Greece needed financial support that the EU established a rescue fund similar to that established in the US). Hungary's trouble had already led the Commission to call for the facility's capacity to be more than doubled from €12 billion to €25 billion but this would not be enough for several states in difficulty. There was an even further problem: under the treaties balance

[26] "Rescue Plan for UK Banks Unveiled", *BBC News*, 8 October 2008, at http://news.bbc.co.uk/2/hi/business/7658277.stm, viewed 2 February 2013.
[27] "Banking Bail-out: France Unveils €360bn Package", *The Telegraph*, 13 October 2008.
[28] "Germany Responds to Finance Crisis: Parliament Approves Bank Bailout Package", *Spiegel Online*, 17 October 2008, at http://www.spiegel.de/international/germany/germany-responds-to-finance-crisis-parliament-approves-bank-bailout-package-a-584781.html, viewed 12 October 2014.
[29] European Commission, DG ECOFIN, "Stability and Growth Pact", at http://www.eurozone.europa.eu/euro-area/topics/stability-and-growth-pact/, viewed 22 May 2012.
[30] Barkbu, Bergljot; Eichengreen, Barry; and Mody, Ashoka (2012), "Financial Crises and the Multilateral Response: What the Historical Record Shows", *Journal of International Economics*, Vol. 88, p. 425.
[31] European Commission, "Balance of Payments", at http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm, viewed 12 November 2012.
[32] Connolly, Kate and Traynor, Ian (2008), "Hungary Receives Rescue Package, With Strings Attached", The Guardian, 30 October, at http://www.theguardian.com/business/2008/oct/29/hungary-economy-imf-eu-world-bank, viewed 20 August 2012.

of payments assistance from the EU was not available to Eurozone member states[33]. This meant any future funding request from a Eurozone state would need to be provided through intergovernmental agreement and this would be lengthy and politically fraught for the larger member states.

The IMF was, however, in a position to provide assistance quickly. It had established funding mechanisms in place, experience in coordinating and putting in place financial packages, and expertise in surveillance and technical assistance. It had also just ramped up its lending preparedness, creating a new US$100 million Short Term Liquidity Facility for short three-month loans in late October 2009[34]. Around the same time the IMF entered into lending agreements to lend US$2.1 billion to Iceland and the Ukraine US$16.5 billion and then the first EU member state, Hungary (although it never ended up drawing on the funds)[35]. Romania was also in "close dialogue" with the IMF about a loan in late October[36] and it was clear to the Commission that Latvia would need financial assistance too.

In the case of both Hungary and Latvia there was recognition by the EU that any EU financial assistance would need to be supplemented by IMF resources. This was partly due to the magnitude of impending financial needs and partly because the IMF was in a position to move quickly in disbursing the initial instalments[37]. In the initial discussions between the IMF, the Commission and Latvia, the issue of Latvia's peg to the euro was raised[38]. The IMF wanted Latvia to remove it peg and devalue its currency to make it more competitive. But from the EU's perspective this was not negotiable. The banks from the Nordic states, and especially Sweden, had lent heavily to Latvia and would have been hit by any devaluation. Latvia was a candidate to join the euro; not leave it. For the Commission, the Eurozone's credibility and cohesiveness were at stake.

The Commission informed the IMF that EU funds would also be provided and a package of financial assistance that involved funding from the Nordic states was put together. The Nordic states had the greatest financial interest in Latvia's stability and were concerned instability in the region could undermine their interests in other eastern European countries where they also had high exposures. The plan comprised €3.1 billion from EU member states, €1.9 billion from the Nordic countries (Sweden, Denmark, Finland, Norway and Estonia); the Czech Republic, Poland and the European Bank for Reconstruction and Development €0.4 billion; the World Bank €0.4 billion and the IMF

33 Hagan, *op. cit.*
34 Davies, Bob; Walker, Marcus; Lyons, John (2009), "IMF Creates $100 Billion Fund to Aid Crisis Fight", *The Wall Street Journal*, 30 October, at http://www.wsj.com/articles/SB122532318516282167, viewed 16 August 2013.
35 Connolly, Traynor, *op. cit.*
36 Brown, Adam (2008), "Romania in 'Close Dialogue' With IMF, Not About Loan", Bloomberg, 28 October.
37 Interview conducted by Peter O'Shea with former economic adviser to the president of the European Commission, European Commission, Brussels, 13 July 2014; Hagan, *op. cit.*
38 Interview conducted by Peter O'Shea with former Latvian government minister, Canberra, 11 September 2014.

€1.7 billion[39]. The IMF compromised on the issue of Latvia's peg to the euro and a range of other structural measures was negotiated including cuts in public sector wages and other state spending, raising its value added tax rate from 18% to 21% and keeping its budget deficit below 5% of gross domestic product for the following year[40].

## The G20 Places the IMF at the Centre of the Solution

With a succession of European countries facing financial difficulty and with the EU's capacity to assist somewhat limited, it was little surprise that the G20 Leaders' Summit in Washington "stress[ed] the International Monetary Fund's important role in crisis response" and agreed to implement recommendations "drawing on the ongoing work of relevant bodies" including the IMF, an expanded Financial Stability Forum and the various international financial standard setting bodies[41]. Championing the IMF in the EU was the UK. As host for the impending G20 Summit in London in April 2009 and holding the G20 Presidency for the year, the UK was in a position to draft the summit agenda, just as the US did in Washington. British PM Gordon Brown, in pushing for an overhaul of the international financial system the month beforehand, explicitly impressed a role for the IMF, talking up the need for all members to contribute funds[42]. In addition to the desire to further boost market liquidity with another round of economic stimulus measures and provide deposit guarantees to banks around the world, one of Brown's objectives was to deepen the pool of funding contributors to the IMF.

The US and the UK particularly saw the fast developing BRICS countries (Brazil, Russia, India, China and South Africa) as potential contributors. China and other developing countries were willing to contribute funds but were very much aware of US and European dominance of the fund and demanded further changes to the IMF's governance[43]. Media reports also cited Chinese and Russian concern about the dominance of the US dollar and the US itself over the global economy[44]. Brown had notable support from Australia's Prime Minister Kevin Rudd who had also been drumming up support for further allocations of IMF Special Drawing Rights (SDRs)[45].

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39 European Commission, DG ECOFIN, "Post-Programme Surveillance for Latvia", at http://ec.europa.eu/economy_finance/assistance_eu_ms/latvia/index_en.htm, viewed 29 September 2014.
40 Interview conducted by Peter O'Shea with former Latvian government minister, Canberra, 11 September 2014.
41 G20 (2008), "Declaration of the Summit on Financial Markets and the World Economy", Washington DC, 15 November, at https://g20.org/wp-content/uploads/2014/12/Washington_Declaration_0.pdf, viewed 16 July 2014.
42 Peacock, Mike and Ginsberg, Jodie (2008), "Brown Calls for New 'Bretton Woods' Meeting", *Reuters*, 13 October 2008, at http://uk.reuters.com/article/2008/10/13/uk-financial-brown-idUKTRE49C2HV20081013?sp=true, viewed 1 May 2014;"Gordon Brown's Call for a New Bretton Woods Gains Traction", *The Telegraph*, 15 October 2008, at http://www.telegraph.co.uk/finance/3201885/Gordon-Browns-call-for-a-new-Bretton-Woods-gains-traction.html, viewed 10 August 2012.
43 Landler, Mark (2009), "Rising Powers Challenge US on Role in IMF", *The New York Times*, 29 March, at http://www.nytimes.com/2009/03/30/world/30fund.html, viewed 12 November 2012.
44 Stewart, *op. cit.*; Landler, *op. cit.*; Choudhury, Uttara (2008), "US Wants Help from the Cash-Rich Economies", *DNAIndia*, 23 November 2008, at http://www.dnaindia.com/mumbai/special-us-wants-help-from-the-cash-rich-economies-1208618, viewed 12 October 2013.
45 Wintour, Patrick (2008), "Gordon Brown Plans Financial Crisis Talks with George Bush", *The Guardian*, 26 September.

Just a few weeks after the Washington G20 Summit, the UK released a detailed proposed summit agenda. In the document it called for fiscal policy coordination, boosting world trade and rejecting protectionism, addressing the failures in the financial and supervisory architecture by strengthening cross-border co-ordination of financial regulation including a global early warning system, and reforming global financial governance. At one point there was the suggestion that the IMF would supervise and finance a network of bad banks that would take on the worst of the financial system's toxic assets. The idea was to effectively create an international bailout fund that would be run by the IMF. The UK also argued the IMF should have even greater powers of market and economic surveillance and the ability to provide an early warning system about potential vulnerabilities. Brown went on a road trip to Brazil to buffet support for the UK's vision, with one media report citing his spokesperson as saying he had been "working the phones very hard" to obtain a consensus view prior to the summit[46].

Elsewhere in the EU, German Chancellor Angela Merkel was very much in favour of the IMF role although her Finance Minister Wolfgang Schäuble was opposed to it. Germany called a mini-summit for mid February of the EU member states that were in the G20 in an effort to coordinate the EU position ahead of the broader EU Heads of Government summit the following month and ahead of the G20 Leaders' Summit in London in April. The EU's G20 countries, Germany, France, the UK and Italy, plus the two largest European non-G20 members, Spain and the Netherlands, attended the meeting in Berlin on 22 February. The elite group agreed to give the IMF a role in responding to the crisis and placed priority on a number of other important measures, including hedge fund reform, accounting rules reform and financial markets supervisory reform, but rejected the UK and US push for further stimulus measures[47].

The consensus agreement at the mini-summit made it a virtual certainty that a follow-up broader EU Heads of Government Summit in March in Brussels would back their position. Holding a meeting of a smaller group of heads of government first meant that any dissenters at the second would be outvoted by the already established consensus position. Accordingly EU leaders at the Brussels meeting agreed to "very substantially increase IMF resources" so it could help its members swiftly and flexibly in the event of balance of payments difficulties[48]. The official EU Summit in Brussels also endorsed a greater role for the IMF and rejected US pressure to provide a further round of stimulus

[46] "France Threatens Walkout Before G20 Summit", *Agence France Presse*, 31 March 2009.
[47] Sarkozy, Nicolas and Merkel, Angela (2009), "Preparation for the G20 Summit", letter sent jointly by Nicolas Sarkozy, President of the Republic and Angela Merkel, Chancellor of Germany, to Mirek Topolanek, Prime Minister of the Czech Republic and José Manuel Barroso President of the European Commission, 16 March, at http://www.ambafrance-us.org/spip.php?article1281, viewed 20 July 2014; Dougherty, Carter (2009), "EU Leaders Turn to IMF amid Financial Crisis", *The New York Times*, 22 February, at http://www.nytimes.com/2009/02/23/world/europe/23germany.html, viewed 18 October 2014.
[48] Council of the European Union (2009), "Presidency Conclusions 19-20 March 2009", 29 April, at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/106809.pdf, viewed 12 January 2015.

measures as the US had done[49]. They further supported the efforts to cast the net for IMF funding more widely, to China and Saudi Arabia among others.

As such at this point a centre place for the IMF in responding to the financial crisis looked certain. The plan to boost the IMF's resources had the backing of the US and the EU. The UK, Germany, France, and the rest of the EU Heads of Government had agreed to support its key role, as did the Commission[50]. The US and the EU agreed in discussions before the G20 Leaders' Summit in London took place that the IMF should play a central role in the response to the crisis[51]. The agreement between the US and the EU — that together have dominated G20 decision-making from the outset — meant the IMF's place in the post-crisis order was secure[52]. On the priorities for financial reform, however, the US and various EU member states were divided. As the London G20 Summit approached, two camps started to form around a range of issues. On one hand was an Anglo-American alliance and the other a Franco-German camp. The US and the UK were in favour of a second round of fiscal stimulus measures, a lighter approach to regulation and the use of existing forums like the IMF and the Financial Stability Forum to strengthen regulatory co-operation and develop crisis early-warning systems[53].

On the opposing side was the France-Germany alliance. Sarkozy and Merkel presented a united front and days before the G20 Summit in London they issued a joint declaration noting "a totally identical position" on the need for further financial regulation in response to the crisis[54]. They wanted more stringent crackdown on tax havens, hedge funds, banking transparency and bankers' bonuses than the UK had proposed and opposed further fiscal stimulus measures[55]. While there were notable differences in position on a number of financial reform matters, the US and the EU held a clear common position favouring a clear role for the IMF in the post-crisis order.

### A New Lease of Life for the IMF

At the G20 Summit in London itself the efforts to boost the IMF's role and Gordon Brown's efforts to convince developing economies to provide more of the funding paid

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[49] Lopatka, Jan and Prenesto, Frank (2009), "EU Backs Stronger IMF, Eastern Aid Lifeline", *Reuters*, 20 March.
[50] The EU is a member of the G20 and is represented at the G20 summits by the European Commission President and the European Council President.
[51] Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012.
[52] The President of the European Commission and the President of the European Council represent the EU at the G20 at leaders' level. In addition several EU member states are represented at the G20: the UK, France, Germany, Italy and the UK. Spain is also a permanent invitee of the G20. In addition, the G20 presidency host country invites about six guest countries to attend and the Netherlands attended the first four G20 Leaders Summits. See European Commission, "Facts and figures about the European Union and the G20", at http://ec.europa.eu/priorities/docs/g20-brisbane_en.pdf, viewed 12 December 2014.
[53] Parker, George (2009), "PM Enlists Old Friends to Spur G20 prospects", *FT.com*, 5 March, at http://www.ft.com/intl/cms/s/0/ad007e74-0926-11de-b8b0-0000779fd2ac.html, viewed 12 April 2013.
[54] Vucheva, Elitsa (2009), "France and Germany Unite Positions Ahead of Summit", *EU Observer*, 13 March, at https://euobserver.com/political/27770, viewed 16 September 2014.
[55] Landler, *op. cit.*; Chapman, James and Lea, Michael (2009), "Love and Hate: Brown and Obama Enjoy a Very Special Relationship but Man Dies as Violence Explodes on the Streets", *The Telegraph*, 2 April.

off. G20 leaders pledged to treble the IMF lending capacity to US$750 billion, plus create an extra Special Drawing Rights allocation of US$250 billion and a further US$250 billion in trade finance that the IMF could lend[56]. They pledged a further US$100 billion for the multinational development banks to lend. The funding pledges totalled an extra US$1 trillion for the IMF.

This massive pledge gave the organisation a new lease on life. In just the four years to 2008, the IMF's total loan portfolio shrunk from US$105 billion to less than US$10 billion, with more than half of its loan portfolio consisting of loans to Turkey and Pakistan. The IMF even went through its own cost cutting and staff reductions[57]. This meant that in the years leading up to the acute phase of the financial crisis in 2008, when the IMF was called into Iceland, Latvia, Hungary and the Ukraine, the IMF's place in the global financial governance had not only been undermined by the changing nature of international funding but also diminished. At the time of the summit in London the IMF's lending capacity was US$250 billion. But the new funding pledges gave it a substantial boost. The IMF was back in business. But why did the US and EU positions converge and why did they both throw their support behind the IMF?

## A Consolidation of US Geopolitical Interests

The huge support given to the IMF had a number of significant benefits for the US and the EU — financially and politically. Taking the US first, a boost to the IMF's role had the effect of consolidating US political influence over massive amounts of international lending. The IMF has long been criticised as favouring loans to countries that have the greatest geopolitical strategic interest to the IMF's largest lenders. Studies into IMF lending decisions have found the greater the political interest the US has in the country the greater chance of receiving a loan[58] while Oatley and Yackee found the size of the loan corresponds somewhat to the exposure of US banks in the country concerned[59].

More recently the European Central Bank (ECB) concluded in a study that geopolitical considerations were "an important factor in shaping IMF lending decisions", particularly in respect to the use of IMF Stand-by Arrangements[60]. Even a former IMF Managing Director acknowledged concerns that some programs appeared to suggest that a country's

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[56] International Monetary Fund, "Bolstering the IMF's Lending Capacity", 5 August 2013, at http://www.imf.org/external/np/exr/faq/contribution.htm, viewed 3 September 2014.
[57] Weisbrot, Mark (2008), "The IMF's Dwindling Fortunes", *Los Angeles Times*, 27 April at http://articles.latimes.com/2008/apr/27/opinion/op-weisbrot27, viewed 30 November 2014.
[58] Thacker, Strom (1999), "The High Politics of IMF Lending", *World Politics*, Vol. 52.
[59] Oatley, T. and Yackee, J (2004), "American Interests and IMF Lending", *International Politics*, Vol. 1, No. 3.
[60]Reynaud, Julien and Vauday, Julien (2008), "IMF Lending and Geopolitics", European Central Bank, Working Paper Series No. 965, Frankfurt, November, at http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp965.pdf, viewed June 2014.

geopolitical importance was a factor in IMF lending decisions[61]. Indeed an analysis of all IMF loans in the calendar years 2008 to 2011 inclusive shows the biggest recipients of loans from the IMF were three countries with particular strategic importance to the US: Pakistan, Iraq and its NAFTA neighbour, Mexico[62]. Some IMF staff also concede that the political priorities of the largest contributing countries have some influence on the IMF's lending decisions[63].

**Table 4: Top Ten IMF Loans in USD Value 2008 to 2011 Inclusive**

| Country | Date of Arrangement | Year | Total Amount Agreed (USD) |
|---|---|---|---|
| Mexico | January 10 | 2011 | $29,722,313 |
| Greece | May 09 | 2010 | $16,612,681 |
| Ireland | December 16 | 2010 | $12,233,963 |
| Poland | January 21 | 2011 | $12,045,544 |
| Ukraine | July 28 | 2010 | $6,284,850 |
| Pakistan | November 24 | 2008 | $4,547,655 |
| Romania | March 31 | 2011 | $1,942,396 |
| Iraq | February 24 | 2010 | $1,493,783 |
| Colombia | May 07 | 2010 | $1,459,342 |
| Sri Lanka | July 24 | 2009 | $1,039,263 |
| Latvia | December 23 | 2008 | $956,319 |

Note: Grey shading denotes EU member state
*Source: Analysis of IMF Lending data, International Monetary Fund*

The US Treasury is itself upfront about the degree to which the IMF represents US interests. The IMF, it says, is a "vital tool in our national security toolkit" and "keeps our allies and partners strong"[64]. At the time of the financial crisis these allies and partners were located very much in Europe — notably financially.

**Securing US Financial Interests in Europe**

While IMF lending has tended to support the political goals of the largest lenders, it has also reinforced their financial and economic interests. In addition to these countries the other countries that were large recipients of IMF loans were EU member states. The US'

61 De Rato y Figaredo, Rodrigo (2004), "The IMF at 60-Evolving Challenges, Evolving Role", remarks at "Dollars, Debts and Deficits-60 Years after Bretton Woods" Conference Madrid, Spain, 14 June, at https://www.imf.org/external/np/speeches/2004/061404.htm, as viewed 3 May 2014.
62 In respect to Pakistan, the US had various numerous "carrots" to wave when encouraging Musharraf to join the US campaign against terror and there have been accusations that one of those was the vote by the US that affirmed approval of the IMF's loans to Pakistan. See Momani, Bessma (2004), "The IMF, the US War on Terrorism, and Pakistan", *Asian Affairs*, Vol. 31, No. 1, Spring;
Interview conducted by Peter O'Shea with representative of the International Monetary Fund, Brussels, 14 February 2014.
64 Wyeth, *op. cit.*

political and economic interests in Europe were particularly acute at the time. As the financial crisis broke across the Atlantic, first in Eastern Europe and then other EU member states, the US had a huge interest in maintaining financial stability in the region. Credit markets are highly linked and interdependent, and a credit crisis in Europe can have wide reaching effects on a range of markets in the US, from bond markets, foreign exchange markets and derivatives markets.

There was a great deal of concern in the US that any credit crunch or default in Eastern Europe would have a domino effect to other markets[65]. At the time, the Institute of International Finance, a global association that represents a wide range of global financial institutions, including banks, insurers, hedge funds, central banks, and development banks, forecast that net private capital flows to emerging Europe were projected to fall from an estimated US$254 billion in 2008 to US$30 billion in 2009. An IMF forecast in April warned that the situation in Eastern Europe would get much worse and said the financial crisis was putting severe strains on the vulnerabilities of emerging European economies and that credit losses at foreign subsidiaries of western European banks were "threatening to start a downward "vicious cycle"[66].

The risk of "reverse contagion" was significant. Even though many of the financial system losses originated in the US they risked flowing back to the US dramatically because financial support available to Eastern European countries was limited. Not only were many member states unable to bailout their banks and the EU itself unable to do so, but the banking market was so illiquid and paralysed with fears about their exposure to the so-called toxic bank assets at the time, that the market had deserted Eastern Europe. The IMF estimated the "financing gap" in some countries — the money that cannot be found in the market — was particularly large: Romania US$34 billion, Turkey US$40 billion and Poland US$59 billion[67]. Indeed the US Treasury later argued that IMF lending programs in Europe had helped "mitigate the spillover effects of the European crisis on our shores"[68].

The US was concerned that deteriorating conditions in Europe might prompt a political response in Europe that would make matters even worse. The levels of US foreign direct investment in Europe at the time were significant and what the US could not afford was a shift to "fortress Europe" and closed or protectionist tendencies that the US feared during the Reagan Administration[69]. US-EU trade levels are particularly high and the risk of protectionist measures would have potentially severe concretionary effects on the US.

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[65] Schwartz, Nelson D. (2009), "As it Falters, Eastern Europe Raises Risks", *The New York Times*, 23 February.
[66] International Monetary Fund (2009), "Responding to the Financial Crisis and Measuring Systemic Risk", Global Financial Stability Report, Washington DC, April, at http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf, viewed 12 August 2014.
[67] Wagstyl, Stefan (2009), "IMF Warns of Strains Exerted on East Europe", *FT.com*, 5 April, at http://www.ft.com/intl/cms/s/0/f6007b9c-21f9-11de-8380-00144feabdc0.html, viewed 28 October 2014.
[68] Wyeth, *op. cit.*
[69] Lundestad, Geir (1998), *Empire by Integration: The United States and European Integration 1945-1997*, Oxford University Press, London, pp.231-232.

Table 5 US-EU Trade Figures, 2012

| Direction of trade | Goods | Services | Investment | Total |
|---|---|---|---|---|
| EU to US | € 292.80 | € 163 | € 1,655 | € 2,110.80 |
| US to EU | € 206.50 | € 148.90 | € 1,536.40 | € 1,891.80 |

*Source: European Commission, DG Trade and Enterprise*[70]

There was a risk that foreign direct investment might be affected too from the return of protectionist policies. US foreign affiliate income earned in Europe in the first half of 2008 was worth US$47 billion and in total Europe accounted for roughly 55% of the US$1 trillion in global aggregate output of US affiliates in 2006. The risk of an adverse policy environment in the EU further lent support to US interests in seeing an IMF-led Eastern European financial rescue. A reverse contagion and "flow-back" to the US would inevitably have political consequences in the US. The US economy was stabilising, the US mid-term Congressional elections were due in mid-2010 and the US Administration could not risk such a scenario.

The importance the US placed on the deteriorating situation in Europe is highlighted by an analysis of US Treasury Secretary's phone calls in a later period. The Brussels-based economic think tank Bruegel examined a record of the phone calls and meetings of US Treasury Secretary Timothy Geithner between January 2010 and June 2012 when the bailouts of Eurozone members Greece, Ireland and Portugal took place and found that most phone calls were made to the IMF[71].

The US thus had a significant interest in European financial stability and a bailout of EU member states in financial difficulty. The loans made by the IMF between 2008 and 2011 thus also directly supported US geopolitical and economic interests in Europe. As Table 5 above shows, loans to European states Greece, Ireland and Poland represented the second, third, fourth largest IMF loans over the 2008-2011 period respectively.

**Securing US Opportunities**

In addition to securing existing US financial interests abroad, the stakeholders with huge interests in the IMF's lending priorities included the largest institutions on Wall Street. The IMF is part of what Bhagwati calls the "Wall Street–Treasury complex" — a powerful network of "like-minded people" involving the most powerful institutions in America:

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[70] European Commission, DG Trade, "Trade - United States", at http://ec.europa.eu/trade/policy/countries-and-regions/countries/united-states/ viewed in 22 August 2014.
[71] Pisani-Ferry, Jean (2012), "Tim Geithner and Europe's Phone Number", Bruegel, Brussels, 4 November, at http://www.bruegel.org/nc/blog/detail/article/934-tim-geithner-and-europes-phone-number/, viewed July 2013.

Wall Street, the US Treasury, the State Department, the World Bank and also the IMF[72]. One of the notable characteristics of the network is the degree to which key people move from one institution to the other. Former Goldman Sachs co-chairman Robert Rubin became the Treasury Secretary under Clinton, former Goldman Sachs CEO Henry Paulson became the Treasury Secretary under George W. Bush, and Paulson's predecessor Treasury Secretary John Snow later became the chairman of private-equity firm Cerberus Capital Management for example[73].

The network has pursued the interests of the US financial system by promoting pro-market policies that have had the effect of opening opportunities for the US' largest banks. As Bhagwati puts it: "Wall Street's financial firms have obvious self-interest in a world of free capital mobility since it only enlarges the arena in which to make money. It is not surprising, therefore, that Wall Street has put its powerful oar into the turbulent waters of Washington political lobbying to steer in this direction."[74] All these institutions have been primary beneficiaries of the opening of new markets, deregulation, the opening and expansion of capital markets and the liberalisation of cross-border capital flows that typically accompany IMF lending policies.

These policies form part of the "Washington Consensus" prescription for economic restructuring that emerged during the Reagan Administration in the 1980s. Famously coined by US economist John Williamson in the early 1990s, the "Washington" component comprises the top decision-makers at the IMF, the World Bank, the Inter-American Development Bank, the US Executive, "those members of Congress who take an interest in Latin America, and the think-tanks concerned with economic policy". Williamson identified ten typical policy instruments (as opposed to objectives or outcomes) and "orthodox views" about economic management that he perceived "Washington" thought was important[75].

These were namely: a strong belief in fiscal discipline and particularly against large and sustained fiscal deficits; a preference for reducing public expenditure rather than increasing tax revenues to tackle deficits; a general aversion against tax increases (with broad based taxes preferred); a belief in market-determined interest rates; market-determined exchange rates; trade liberalisation and an aversion to protectionism, particularly import licensing; an aversion to restrictive attitudes towards limiting the entry of foreign direct investment (although liberalisation of foreign financial flows is not regarded as a high priority per se); a strong belief in privatization; a belief in market

[72] Bhagwati, Jagdish (1988), "The Capital Myth: The Difference between Trade in Widgets and Dollars", *Foreign Affairs*, Council on Foreign Relations, May/June, pp.7-12.
[73] Johnson, Simon (2009), "The Quiet Coup", *The Atlantic*, May, at http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364/, viewed 1 November 2014.
[74] Bhagwati, *op. cit.*, pp.7-12.
[75] Williamson, John (1990), "What Washington Means by Policy Reform", in *Latin American Adjustment: How Much Has Happened?*, Peterson Institute for International Economics, April.

deregulation (barriers to entry and exit); and strong enforcement of property rights[76]. Numerous countries have carried out such policies as part of their transformation to more market-orientated economies, some of them following the prescription closely and quite successfully, with Chile and Brazil notable examples[77].

The standard prescription perhaps most famously manifested throughout the 1980s and 1990s in the IMF's lending policies for economic restructuring in loan recipient countries. These decades also saw growing criticism of the IMF's policies that development critics saw as counter-productive. These include promoting contractionary policies, like fiscal tightening, interest rate increases, wage freezes for public employees and other measures that reduce demand when the economy needs it most[78]. Such policies have sometimes involved limited controls on financial markets regulation, especially capital mobility. The IMF's policies have been criticised as contributing, at least in some part, to the internationalisation of the financial crisis[79]. For example the IMF was criticised for forcing Thailand and South Korea to further open their capital markets after the Asian Financial Crisis, even though short-term capital inflows played a principal role in their crisis in the first place[80]. In addition to the IMF's promotion and insistence on such policies as part of its conditional lending program, the US Treasury has been one of the most potent purveyors of the prescription.

**The US Economy's Interest in the IMF**

The US economy as a whole has also been a beneficiary of the IMF's role as an international lender. The US enjoys a net financial position due to higher returns on its external assets with the IMF than on its external liabilities. In other words it has made more money on being paid interest on the money it lends through the IMF than it has on the money it borrows abroad. This has contributed to allowing the US to run larger trade and current account deficits without worsening its external position commensurately — a situation Gourinchas, Rey & Govillot refer to as the US' historical "exorbitant privilege" in the IMF[81]. This situation actually reversed at the outset of the financial crisis, with its net foreign asset position deteriorating between the third quarter of 2007 and the first quarter of 2009, largely as a result of massive losses on its assets abroad. This essentially meant that wealth flowed from the US to the rest of the world, thus providing, as Gourinchas, Rey & Govillot put it, "insurance" to the rest of the world.

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[76] *Ibid.*
[77] "A Conversation with John Williamson", *Washington Post*, 12 April 2009, at http://www.washingtonpost.com/wp-dyn/content/article/2009/04/09/AR2009040903241.html, viewed 11 November 2013.
[78] Weisbrot, Mark (2009), "The G20 Should End Rich Country Rule", *The Guardian*, 26 March 2009; Stewart, *op. cit.*
[79] Westmore, Peter (2009), "G20 Summit: End of the Washington Consensus?", *News Weekly*, 18 April.
[80] Bhagwati, *op. cit.*
[81] Gourinchas, Pierre-Olivier; Rey, Hélène; Govillot, Nicolas (2010), "Exorbitant Privilege and Exorbitant Duty", Bank of Japan, Institute for Monetary and Economic Studies, Tokyo.

Yet while US lending to the IMF was beneficial to the rest of the world, it meant the US was keen to turn around the flow of wealth back to the US. One way to do this would be to boost US lending through the IMF significantly[82]. Indeed the financial crisis came at a time a growing power shifts in international lending. Prior to the London G20 Summit China had extended multi-billion-dollar currency swaps to South Korea, Hong Kong, Indonesia, Malaysia and Belarus, while the Association of Southeast Asian Nations (ASEAN) plus 3 countries moved forward with plans to establish a rival Asian Monetary Fund[83]. As such a greater role for the IMF helped the US re-assert its financial dominance over vast amounts of international lending. It helped the Wall-Street Treasury network extend its influence in the international economy when the US needed it most.

### A Reinforcement of EU Financial Interests in Europe

The IMF's rejuvenation aligned not only to US interests but the EU's interests as well. There were in fact several factors involved in the EU's decision to agree to IMF involvement in the response to the financial crisis. While the US' interests were to maintain its influence over IMF lending, maintain and even extend its influence in Europe and reinforce the interests of the US economy and its financial institutions, the EU's support for the IMF was somewhat more divided (at least initially) and more complex. Nevertheless its interests were both financial and political in nature.

Firstly, the last several decades have seen marked growth in the level of cross-border banking activity in Europe. The introduction of the Single Banking License in 1989 under the Second Banking Directive, the consequent convergence in financial legislation throughout the EU and the introduction of the euro in 1999 has seen cross-border banking exposure in Europe expand dramatically[84]. Overall cross-border interbank loans between euro area banks grew from 15.5% of total interbank loans in 1997, to 23.5% in 2008 and euro area banks' holdings of debt issued by banks elsewhere in other euro area grew from 12.1% in 1997, to 31.3% in 2008[85].

The first countries to fall into crisis were Central and Eastern European countries — and it was these countries that benefitted the most from EU cross-border banking in the years leading up to the crisis. According to BIS statistics, the countries whose banks had the most significant exposure to these countries as a whole at the time were Austria, Belgium,

[82] *Ibid.*
[83] Weisbrot, 2009, *op. cit.*
[84] Colangelo, Antonio and Lenza, Michele (2013), "Cross-Border Banking Transactions in the Euro Area", Bank for International Settlements, Basel, at http://www.bis.org/ifc/publ/ifcb36ah.pdf, viewed 1 December 2014; Allen, Franklin; Beck, Thorsten; Carletti, Elena; Lane, Philip R.; Schoenmaker, Dirk; and Wagner, Wolf (2011), "Cross-Border Banking in Europe: Implications for Financial Stability and Macroeconomic Policies", Centre for Economic Policy Research, London, at http://www.cepr.org, viewed 10 October 2013.
[85] Franklin et. al., *op. cit.*

Italy, Portugal, Greece and Sweden[86]. Austrian banks were most exposed, with approximately 55% of Austrian foreign lending directed to Eastern Europe. However, while there was a big drop in cross-border lending when the financial crisis hit it was not as severe in Central and Eastern European countries as it was in some other emerging countries. One of the reasons, according to some analyses, is that many foreign banks were "locked in" because their local subsidiaries had given long-term loans in the host countries that could not be recalled as easily[87]. As such the ability to pull money out was limited, thus heightening the desire for some kind of external intervention.

Among the most exposed to bad debt elsewhere in the EU were German and French banks. While German and French banks had less exposure to Central and Eastern Europe, their potential for losses elsewhere in Europe was even greater. German and French banks were among the most global banks in the world in terms of having assets outside their home countries. The countries in the world in the second quarter of 2009 with the largest proportion of cross-border banking assets (that is assets outside their home countries) were France, Germany, the UK, the US, Switzerland and the Netherlands and together they accounted for 47% of all global cross-border banking assets[88].

German banks were particularly exposed to EU member states in financial trouble. For example as of February 2011, German banks had €18 billion of exposure to the Greek public sector, €10 billion of which was sovereign debt. More than half the total amount was the result of loans to Greece made by Germany's development bank KfW[89]. German banks were most exposed to the sovereign debt of Italy and Hungary of any country and the second most exposed to the sovereign debt of Greece, Portugal, Spain and Italy (after those countries themselves respectively). French banks were particularly exposed to Italy.

**Table 6: German and French Banking Exposure to Sovereign Debt of Greece, Portugal, Spain, Ireland, Italy and Hungary vs. Domestic Banks' Exposure (€ millions)**

| Country | German Banks | French Banks | Domestic Banks |
|---|---|---|---|
| Greece | 18,718 | 11,624 | 56,148 |
| Portugal | 10,888 | 4,864 | 13,707 |
| Spain | 31,854 | 6,592 | 203,310 |
| Ireland | 12,922 | 2,476 | 5,322 |
| Italy | 72,717 | 48,185 | 144,856 |
| Hungary | 8,215 | 1,881 | 4,931 |

[86] Weistroffer, Christian and Mobert, Jochen (2010), "Monitoring Cross-Border Exposure", Deutsche Bank Research, Frankfurt, 26 November, at http://www.dbresearch.com/MAIL/DBR_INTERNET_EN-PROD/PROD0000000000266643.pdf, viewed 20 November 2014.
[87] Franklin et. al., *op. cit.*
[88] *Ibid.*
[89] Bundesbank Statistics, at http://www.bundesbank.de/Navigation/EN/Statistics/statistics.html, data extracted 2 November 2014.

*Source: OECD EU Stress Tests and Sovereign Debt Exposure 2010, using OECD and respective bank data*[90]

At the same time German and French banks followed a different model to many other countries. Unlike the US and Switzerland for example that followed multinational models, where subsidiaries in numerous countries were funded by local operations, German and French banks followed a model under which subsidiaries were centrally funded by head offices. This meant their home country operations incurred losses directly. In some cases these losses were huge. In 2012 for example, at the height of the sovereign debt concerns in Europe, BNP Paribas, France's largest bank, wrote down the value of its holdings of Greek sovereign debt by 75% and substantially reduced its sovereign debt outstanding by 29% — a move that generated €872 million in losses[91].

To make matters worse there was also the potential for massive losses as a result of the growth in cross-border mergers and acquisitions in the years leading up to the crisis. The number of branches EU banks had in other EU countries jumped from 557 in 2003 to 766 in 2009. Cross-border EU bank branches represented 79% of all foreign bank branches in EU countries as a whole, with EU branches holding assets worth €3.2 trillion in 2009 and non-EU bank branches holding assets worth €1.8 trillion[92]. The level of assets EU subsidiaries held was even higher — €5 trillion worth of assets for EU subsidiaries versus €1 trillion for non-EU banks. In summary, EU banks had significant exposure throughout the EU and the value proposition for the EU to intervene to provide external financial support was very high. Germany and France — and the EU as a whole — had very significant financial interests in the future and likely financial rescue of EU member states in sovereign debt difficulties[93].

### Economic Interests

In addition to the implications for the banks of the leading member states, some states' economies had a significant stake in rejuvenating the financially troubled states at all costs. A prime example was Germany. Germany has been an export success story since the introduction of the euro in 1999. While its success has been due to a range of reforms including the reduction in labour costs, its exports to the rest of the EU grew from 1999 to 2008 by 34% and its trade surplus a massive 135%[94]. Its exports grew in every year to 2008 when the financial crisis hit. However in 2009, the year in which the financial crisis

[90] Blundell-Wignall, Adrian and Slovik, P. (2010), "The EU Stress Test and Sovereign Debt Exposures", OECD Working Papers on Finance, Insurance and Private Pensions, No. 4, OECD Financial Affairs Division, Paris, at http://www.oecd.org/finance/financial-markets/45820698.pdf, viewed August 2013
[91] BNP Paribas (2012), "Fourth Quarter Financial Results", press release, 15 February, at http://media-cms.bnpparibas.com/file/77/4/4q11-pr.19774.pdf, viewed 22 May 2013
[92] Franklin et. al., *op. cit.*
[93] Interview conducted by Peter O'Shea with former economic adviser to the president of the European Commission, European Commission, Brussels, 13 July 2014
[94] Analysis of Destatis Database (Statistisches Bundesamt), at https://www.destatis.de/, data extracted 10 November 2014.

spread to EU member states, Germany's exports dropped 18.4% — the biggest yearly drop since 1974. In 2009 exports comprised 42% of Germany's GDP[95] with more than two-thirds of its goods and services traded within the EU (the biggest trading partners in 2009 were France, the US, the Netherlands, Italy, Austria, and China respectively). As such it had a great deal to gain from Eurozone stability. The next year, in 2010 when the IMF was called in to help EU member states in trouble, German exports rebounded a strong 19%.

**The EU's Political Interest**

The interest of the key member states — particularly Germany and France — and the interests of the EU as a whole led to larger funding pledges for the IMF from the EU itself. At the G20 Leaders' Summit in London, G20 countries committed an extra US$1 trillion in funding for the IMF to lend to countries in need; however, pledges are one thing and binding lending agreements are another. In fact the pledges at the summit in London were just that — pledges not commitments. As it turns out, not all of the funding pledges were honoured and, as of August 2013, the IMF had signed lending agreements with various countries worth just over US$500 billion[96] — not the US$1 trillion promised. In fact the largest contributor as of this date was the EU followed by the US.

**Table 7: IMF Signed Lending Agreements as of August 2013**

| Country | Value of Funding Agreement | Proportion of Total Funding |
|---|---|---|
| EU member states (total) | $178 billion | 36% |
| United States | $100 billion | 20% |
| Japan | $100 billion | 20% |
| China | (up to) $50 billion | 10% |
| South Korea | (at least) $10 billion | 2% |
| Russia | (up to) $10 billion | 2% |
| Brazil | (up to) $10 billion | 2% |
| India | (up to) $10 billion | 2% |
| Canada | $10 billion | 2% |
| Switzerland | $10 billion | 2% |
| Australia | $6 billion | 1% |
| Norway | $5 billion | 1% |
| Singapore | $2 billion | 0% |

[95] World Bank exports of goods and services (% of GDP), data at http://data.worldbank.org, data extracted 12 July 2014.
[96] As of 5 August 2013 the following countries had committed funds to boost the IMF lending capacity: Japan $100 Billion, European Union $178 Billion, Norway $4.5 Billion, Canada $10 Billion, Switzerland $10 Billion, United States $100 Billion, South Korea $10 Billion, Australia $5.7 Billion, up to Russia $10 Billion, China up to $50 Billion, Brazil up to $10 Billion, India up to $10 Billion, Singapore $1.5 Billion and Chile $1.6 Billion. From International Monetary Fund, "Bolstering the IMF's Lending Capacity", 5 August 2013, at http://www.imf.org/external/np/exr/faq/contribution.htm, viewed 3 September 2014.

| | | |
|---|---|---|
| Chile | $2 billion | 0% |
| TOTAL | $501.3 billion | |

*Source: International Monetary Fund, 2013*[97]

In total, the IMF's loans to EU member states comprised just under half (46.02%) of the IMF's total US$95,148,075 lending over the four-year period from 2008-2011. EU member states borrowed US$43,790,903. Thus EU member states were both the biggest recipients of the IMF's lending (as the earlier table shows) and the collectively biggest lenders.

## Why the EU Supported IMF Involvement in Europe

There are a number of reasons why the EU chose to work through the IMF to deliver loans to its own member states rather than administering the loans itself. Firstly the EU's own lending ability was limited, as discussed earlier, with the Commission simply not in a fiscal position to lend to individual member states. With many member states looking as though they would soon not be in a position to support their own sovereign debt obligations let alone bail out their banking sectors, and with the larger member states already bailing out their own banks, funds were in short supply. The IMF has become known as "lender of the last resort" because countries typically turn to it when private sources of capital have turned their backs or when other governments or regional trading-bloc partners do not provide adequate help[98]. The IMF technical capacity and the expertise in running assistance programs was a contributing factor to the decision to deliver loans through the IMF[99].

There were also concerns about the legality under the EU treaties of EU member states providing sovereign financial assistance to other member states[100]. Specifically arguments were put forward that such assistance violated Articles 123 and 125 of the Treaty on the Functioning of the European Union (TFEU)[101]. Despite vigorous protests, such as a lawsuit before the German Constitutional Court lodged by a group of law professors who challenged the validity of the initial Greek assistance, the EU Council argued the assistance was justified based on Article 122(2) of the TFEU that allowed financial assistance to a member state under certain conditions[102]. Later, a separate

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97 *Ibid.*
98 Johnson, *op. cit.*
99 Interview conducted by Peter O'Shea with DG ECOFIN representative, European Commission, Brussels, 11 February 2014; Interview conducted by Peter O'Shea with representative of the International Monetary Fund, Brussels, 14 February 2014.
100 Ruffert, Matthias (2011), "The European Debt Crisis and European Union Law", *Common Market Law Review*, Vol. 48, pp.1777–1806.
101 Article 125(1) TFEU states: "The Union shall not be liable for or assume the commitments of central Governments . . . of any Member State ... A Member State shall not be liable for or assume the commitments of central Governments ... of another Member State …" and Article 123 prohibits the purchase of debt instruments from "central Governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States".
102 Article 122(2) of the TFEU states "where a member state is in difficulty or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, union financial assistance to the member state concerned".

intergovernmental treaty that amended the TFEU specifically authorised the establishment of a new EU bailout fund: the European Stability Mechanism (ESM). Entering into force in May 2013, it allowed the "granting of any required financial assistance" under the mechanism "subject to strict conditionality"[103].

**EU Political Considerations**

Secondly, allowing the IMF to play a central role in providing financial support to EU member states served the political interests of the largest member states. The decision to bring the IMF into Greece for example was a controversial one that split EU members. France and Spain, holder of the EU's rotating six-month presidency at the time when it was apparent that Greece needed external help, opposed IMF financial involvement. Finland, the Netherlands, Italy, Poland, Sweden and the UK were for it as was Germany[104]. Involving the IMF meant the largest EU member states were the lenders but avoided the political backlash that accompanied the imposition of IMF loan conditionality, which were destined to be tough.

Many of the larger member states' banks had lent significantly to member states such as Greece, Portugal and Spain and were already suffering huge losses in the market collapse. Should the same larger member states have extended bilateral loans to weaker debtor member states like Greece, Portugal and Spain and the latter governments defaulted, the domestic political backlash in the creditor member states could have been highly potent. As Johnson has argued, the IMF specialises in telling its clients what they do not want to hear[105]. There were also suggestions that Germany's approval — which as the largest and most economically dominant member state was pivotal — was given to avoid domestic political disquiet. In respect to Greece again for example, Chancellor Angela Merkel's decision came at a time when the idea of giving the country assistance was deeply unpopular in Germany and amid concerns about the burden on Germany over any bailout package at all[106]. It also came at a time when her party faced an uphill electoral battle in electorally important parts of the country[107].

As a consequence of its leading economic position in the EU, Germany was able to claim a centre position in the management of the crisis[108]. At the early stages, the EU's first bailout fund, the European Financial Stability Facility (EFSF), a company established in June 2010, based in Luxembourg and owned by Eurozone states, was headed by Klaus

[103] European Council Decision 2011/199/EU of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, OJ L 91.
[104] Barber, Tony (2010), "Eurozone Ditches Doubt to Back IMF Role", *Financial Times*, 3 May.
[105] Johnson, *op. cit.*
[106] "Merkel Stands Firm on IMF Rescue for Greece", *BBC News*, 25 March 2010, at http://news.bbc.co.uk/2/hi/europe/8586465.stm, viewed 14 August 2012.
[107] Peel, Quentin (2010), "Merkel Raises Defence Shields", *FT.com*, 24 March, at http://www.ft.com/intl/cms/s/0/25ad8ce6-3774-11df-9176-00144feabdc0.html, viewed 12 August 2013.
[108] Interview conducted by Peter O'Shea with DG ECOFIN representative, European Commission, Brussels, 11 February 2014.

Regling, a former Director General of the European Commission's Directorate General for Economic and Financial Affairs who had previously worked at the IMF and the German Ministry of Finance. The EFSF had staff of around 60 people, with such a "lean structure", as the Commission puts it, possible because the German Debt Management Office and the European Investment Bank provided direct front and back office support to the EFSF"[109]. As such the German Debt Management Office directly provided critical services such as asset liability management that alleviated the resources pressure on the EU and placed it at the centre of EFSF decision-making.

Importantly the EU bailout mechanisms, the EFSF and another bailout fund, the European Financial Stability Mechanism (EFSM), were the result of intergovernmental decision. The European Stability Mechanism (ESM), which superseded these funds in September 2012, was also formed by intergovernmental agreement under the Treaty Establishing the European Stability Mechanism. This treaty was signed by Eurozone member states on 2 February 2012. The Commission as such has played merely a technical role in these bailout mechanisms[110]. In addition, under the terms of all these funds, decisions on approving a loan, determining interest rates and the terms of conditionality require a unanimous agreement by Eurozone finance ministers. This means each member state has an effective veto over such decisions (unlike the IMF for example where such decisions require a simple majority).

Eventually EU member states collectively agreed to IMF assistance and the IMF agreed to lend Greece funds along with contributions from the EU. In May 2010 the finance ministers of the Eurozone states (the Eurogroup) approved a loan package for Greece to the value of €80 billion[111] and the IMF a week later approved a Stand-By Arrangement for an additional €30 billion. In mid-May the EU and the IMF disbursed €14.5 billion and €5.5 billion respectively. Under the first Economic Adjustment Programme for Greece starting in 2010 further disbursements were made quarterly subject to conditionality.

## An Assertion of German Influence

Certainly one important political outcome of the sovereign debt difficulties was that as some of the creditor states became weaker, the largest debtor states gained stronger positions in the EU. Germany's large economy and large surplus placed it in an increasingly indispensible position to help resolve the sovereign debt crisis in Europe. Germany for example gained the pivotal position in deciding whether the strict austerity

[109] European Financial Stability Facility, "European Financial Stability Facility FAQs", at http://www.efsf.europa.eu/attachments/faq_en.pdf, viewed 23 September 2014.
[110] Interview conducted by Peter O'Shea with former economic adviser to the president of the European Commission, European Commission, Brussels, 13 July 2014.
[111] The EU's €80 billion was later reduced by €2.7 billion after Slovakia decided not to participate in the Greek Loan Facility Agreement and Ireland and Portugal were unable to contribute after requesting financial assistance themselves.

conditions in Europe would be tightened or relieved. For example, later on in the crisis in negotiations prior to a Heads of Government EU summit where an extension to the EU's own bailout funds was discussed, Spain's government told its negotiators to "go easy" on their own demands for austerity relief so as not to upset Germany, whose support for further financial assistance was seen as pivotal[112]. In these particular negotiations, even though Germany had originally argued for tougher conditions, it agreed to ease the conditions for receiving aid from the ESM bailout fund. One media article in the midst of the sovereign debt crisis in 2012 even claimed that "the most important conversations take place with the German government and the European Central Bank in Frankfurt — not the European Commission"[113].

Indeed Merkel saw Germany's role as at the centre of the EU. Speaking in Bruges in October 2011 she said Germany had "a particular responsibility for our continent". She criticised the "community method" of decision-making, saying that "it sometimes seems to me that the representatives in the European Parliament and in the European Commission see themselves as the sole true champions of the community method" and distinct from the intergovernmental method. By the intergovernmental method she meant the decision-making capacity that member states exercise in the EU Council and the European Council. She argued the community method could only be applied in those areas where the EU actually has competence and, as such, intergovernmental decision-making should not be forgotten. The speech was arguably a veiled effort to re-assert member state authority over EU decision-making, notably the Commission. Given Germany is the EU's largest economy, the speech was also an effective assertion of Germany's position at the top of the EU food chain[114].

Perhaps as a side effect, in addition to the political and economic considerations within Europe, boosting the IMF's role reinforced Europe's role abroad as a global lender. Not all IMF loans after the London G20 Summit were made to EU member states. Just as the new IMF funding gave the US influence over the massive funding G20 countries provided it also strengthened the EU's influence. As such Europe's backing of the IMF helped it maintain a co-hegemonic position in the US with the US.

## The Evidence after the G20 Summit

The US and the EU were comfortably in a position to secure their political and financial interests after the G20 summits in Washington and London. The US and the EU held a

[112] Interview conducted by Peter O'Shea with representative of a EU member state Permanent Representation office, Brussels, 25 July 2012.
[113] Rachman, Gideon (2012), "Welcome to Berlin, Europe's New Capital", *Financial Times*, 22 October.
[114] Merkel, Angela (2010), "Speech by Federal Chancellor Angela Merkel at the opening ceremony of the 61st academic year of the College of Europe", College of Europe, Bruges, 2 November, at https://www.coleurope.eu/system/files_force/speech-files/europakolleg_brugge_mitschrift_englisch_0.pdf?download=1, viewed 20 July 2013.

firm control over the IMF in terms of their voting positions in the organisation, plus there is evidence that the IMF lending policies remained firmly in place. Following the G20 Leaders Summit in London the US actually increased its voting quota from 16.7% in March 2011 to 17.9% as of September 2014. The US contributed more than any other country apart from the EU countries collectively and because a country's voting quota is based on financial contributions, the US' voting quota expanded.

As such the US very much retained its grasp on IMF governance. This came despite a push in recent years by developing nations to reform the IMF's voting structure and indeed the voting structure was reviewed after the G20 Leaders' Summit in Seoul in 2010 to give developing nations greater representation[115]. Just 12 months before the big funding boost in London critics had pointed out that the loss of IMF significance in the world economy had been a huge blow to US influence, particularly in Latin America where a region that had once been referred to as the US "backyard" had rejected IMF conditionality and what it saw as US imperialism.

Additionally the Wall Street-Treasury interests remained closely connected to the IMF in the lead-up to the G20 Summits. The US Treasury Secretary in the lead-up to the London Summit was Timothy Geithner, who had been a former IMF director of policy planning from 2001 to 2003, and who had also recruited Edwin Truman, another former Treasury official and an advocate of the fund, as a temporary adviser to develop policies for the G20 meeting[116]. Even though UK Prime Minister Gordon Brown declared the "Washington Consensus was over" when speaking to the media after the G20 Summit in London, the IMF later implemented its same pro-market policies with Greece, Portugal and Ireland. Similarly while IMF head Dominique Strauss-Kahn stressed that countries receiving IMF loans would not be required to sign up to a lengthy list of specific policy conditions[117], with the IMF's annual report in 2009 arguing that it had responded to its reinvigorated role by "modernising IMF program conditionality for all borrowers"[118], there is evidence to show that the same Washington Consensus prescription was applied to European loan recipient countries as usual[119].

The staff at the Irish Department of Finance who negotiated the loans with the IMF and the Commission reported the same sorts of pro-market conditionality that the IMF is

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[115] It should be noted however that any changes to the IMF's voting arrangements need US approval to go through and as decisions relating to the reform of the IMF need to be ratified by US Congress before the US Administration can agrees, this effectively means the US Congress ultimately chooses whether reforms to the IMF's voting structure take place.
[116] Landler, *op. cit.*
[117] Stewart, *op. cit.*
[118] International Monetary Fund (2009), "Annual Report 2009: Fighting the Global Crisis", Washington DC, at http://www.imf.org/external/pubs/ft/ar/2009/eng/pdf/ar09_eng.pdf, viewed 12 August 2014.
[119] Winnett, Robert; Porter, Andrew; Conway, Edmund and Swaine, Jon (2009), "G20 Summit: Gordon Brown Unveils $1.1 trillion Global Recession Fight-Back", *The Guardian*, 2 April, at http://www.telegraph.co.uk/finance/g20-summit/5094824/G20-summit-Gordon-Brown-unveils-1.1trn-global-recession-fight-back.html, viewed 3 September 2014.

known for[120]. An analysis in 2009 of IMF lending after the London Summit by the Washington-based Centre for Economic and Policy Research found IMF programs had hardly changed at all[121]. It found loans still required countries to cut back on government spending and narrow budget deficits. For example, it argued the policy of requiring countries such as Pakistan to cut government spending and reduce its deficit was not wise given the country was suffering from a number of external shocks[122]. As such the IMF's loans in Europe also still bore the hallmarks of the IMF's traditional loan conditionality.

## Conclusion: Convergence of Policy on the IMF

The financial crisis created an urgent need for coordinated action between the US and the EU and, building on the foundation of existing collaboration on international economic matters under the key US-EU milestone agreements over the previous decade and a half, the US and the EU closely coordinated their approach to reform the governance of their respective financial markets as well as their international response to the financial crisis. This involved agreeing to set broad strategy for and to "coordinate approaches" on financial market regulation[123]. One of the measures was a negotiated agreement ahead of the G20 Leaders' Summits to place the IMF at the centre of the financial and regulatory response to the crisis.

The collaboration intended to reinforce common US and EU interests domestically and internationally, both politically and financially. Each side has much to lose from a divergent approach in international governance and cooperating to boost the IMF's role was a way to secure their common interests. It helped maintain US influence in Europe, extend US influence over huge amounts of international lending and reinforce US influence over the direction of financial reform after the G20 summits. The US maintained its grasp on IMF governance and the Wall Street-Treasury complex of Wall Street banks, the IMF and the US administration maintained their open doors to Europe's financially weakest member states.

It also reinforced EU interests in Europe by helping to maintain financial stability in parts of the EU for which emergency funding was not otherwise available and it secured the political and financial interests of the larger member states. However, given the interdependent economic and financial relationship, US and EU collaboration on a boosted role for the IMF also reinforced their common interest. One of those was a strengthened co-hegemonic joint position in the IMF and international financial

120 Interview conducted by Peter O'Shea with representative of Ireland's Department of Finance, Dublin, 10 February 2014.
121 Weisbrot, Cordero, Sandoval, *op. cit.*
122 *Ibid.*
123 US Department of State, Bureau of European and Eurasian Affairs, "Transatlantic Economic Council: Annex 2 -- Joint Report on US--EU Financial Markets Regulatory Dialogue for the TEC Meeting", 27 October 2009, at http://www.state.gov/p/eur/rls/or/131045.htm, viewed 20 October 2014.

governance more broadly. Despite hopes around the G20 Leaders' Summit in Washington in November 2008 that the summit would be a "new Bretton Woods" and result in a new international financial institutional framework, the outcome was far from this expectation[124]. The US and the EU's collaboration ahead of the summits meant, in the IMF's own words, that it was "thrust into the center of … crisis resolution"[125].

[124] Helleiner, Eric and Pagliari, Stefano (2009), "Towards a New Bretton Woods? The First G20 Leaders Summit and the Regulation of Global Finance", *New Political Economy*, Vol. 14, No. 2, June.
[125] International Monetary Fund, *op. cit.*

# CHAPTER 6: US AND EU COOPERATION ON AN INTERNATIONAL FINANCIAL REFORM AGENDA

After the financial crisis emerged in the US and the EU in mid 2008, it became apparent on both sides of the Atlantic that more than immediate measures were needed. Not only did the international banking system need a big boost in liquidity, and not only did banks need to be recapitalised, but a program to reform the regulation of financial markets was needed going forward.

The US and the EU have dominated the global political economy in the last two decades[1] and, building on a longstanding agreement to cooperate on international financial governance to secure their common interests, both sides saw a need to coordinate a response to the crisis. Many of the areas that had been identified as contributing to the financial crisis — poorly regulated securitised financial products, excessive risk-taking in derivatives markets, poorly regulated banking standards, a lack of standards by credit ratings agencies — were areas that affected both the US and the EU. This chapter highlights how the highly interdependent nature of the US and the EU's banking and financial markets was a big motivating factor for regulators and policymakers on both sides to coordinate their approaches on international financial governance reform.

It argues that both sides saw it in their interests to establish a common agenda for international financial reform to not only stabilise international financial markets but also to avoid regulatory arbitrage that could undermine the dominance of the US and EU financial markets. If the US and the EU tightened their own financial regulations, banks and financial institutions might move to lesser-regulated financial centres elsewhere in the world. This was a particularly acute concern given that in the decade beforehand financial centres in Asia had been growing rapidly and emerging economy growth had been outpacing that in the US and the EU. Tightening financial regulations in the US and the EU would have left both at a disadvantage unless regulations were tightened in other major world markets as well.

The US and the EU sought to persuade the other G20 economies (including some of the world's fastest growing emerging economies of Brazil, Russia, India, China and South Africa) to embrace a regulatory reform agenda that was largely of US and EU making. The US and the EU — which were most acutely afflicted by the effects of the crisis and which

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[1] Ginsberg, Roy (2001), "US-EU Relations After Amsterdam: Finishing Europe", in Philippart, Éric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policymaking in US-EU Relations*, PIE Peter Lang, Brussels, p.351

together have enjoyed a lead position in the G7 and G20 — were in an ideal position to shape the international regulatory reform agenda.

## A History of US and EU Dominance in International Financial Standards Making

The US and Europe have long dominated the development of international financial standards making. The first organisation to coordinate international financial standards was the Bank for International Settlements (BIS) formed in 1930. Formed to take over from the Agent General for Reparations the collection, administration and distribution of annuities payable by Germany as reparations for WWI under the US-drafted Young Plan, the bank also aimed to facilitate central bank cooperation generally[2]. During the subsequent Great Depression, the US and European economies were the world's largest economies and the most affected; hence they had the greatest need for technical cooperation on a range of issues like reserve management, foreign exchange transactions, international postal payments, gold deposits and swap facilities.

The bank was overwhelmingly dominated by US and European powers from the outset, with the bank's capital subscription guaranteed in equal parts by five central banks and two banking groups, namely the National Bank of Belgium, the Bank of England, the Bank of France, the Bank of Italy and the Reichsbank[3]. The two banking groups acted for the Bank of Japan and another represented three US banks. Essentially an informal club of central bankers[4], it was the only international financial institution that existed until WWII. Given the US has never taken the board seats it is entitled to, it has tended to be a mostly European organisation[5].

In addition to the International Monetary Fund (IMF) discussed in the previous chapter, a range of other organisations have emerged in the post-war period as part of efforts to coordinate financial standards and facilitate monetary and regulatory cooperation. Again the US and European powers have been at the forefront of developing and expanding them. An acceleration of the pace of European economic integration in the mid-1970s gave rise to intergovernmental cooperation in Europe that led to the emergence of the Basel Committee on Banking Supervision (BCBS). Formed in 1972 amid economic troubles arising from the collapse of the Bretton Woods exchange rate system, it has ever since been at the forefront of developing banking supervision and prudential standards worldwide. It arose from the need for greater cooperation between European monetary

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[2] Bank for International Settlements, "BIS History", at http://www.bis.org/about/history_1foundation.htm, viewed 26 October 2013.
[3] Auboin, Roger (1955), "The Bank for International Settlements 1930 to 1955", *Essays in International Finance*, No. 22, May, Princeton University, Princeton, New Jersey.
[4] Helleiner, Eric (2010a), "A Bretton Woods Moment? The 2007–2008 Crisis and the Future of Global Finance", *International Affairs*, Vol. 86, Issue 3, pp.619–636.
[5] Auboin, *op. cit.*

authorities in the then-European Economic Community on a number of issues, including the growth of the Eurodollar market.

Its basis was entirely European. It formed as the Groupe de Contact, a group established in 1972 by officials in the banking supervisory authorities in the original six EEC countries[6]. It originally focused on European issues and, while it considered foreign matters such as the implications for Europe of the collapse of the National Bank of San Diego, there was no US representation in the group at all[7]. The events that eventually brought the Americans to the grouping were the collapse in June 1974 of West Germany's Bankhaus Herstatt and the collapse just months later in October 1974 of the even larger Franklin National Bank of New York. Both had generated large losses from speculative positions in the foreign exchange market[8]. The Franklin National Bank of New York was New York's largest bank at the time and the 23rd largest in the US. US and European banks had exposure to both collapses and these events raised questions about the quality of banking supervision and the need for even broader cooperation[9].

The implications were taken up in late 1974 by the G10 meeting of central bank governors. It comprised representatives from mostly US and European economies at the time, notably the US, the UK, France, Italy, the Netherlands, Belgium, Germany and Sweden — but also the key US economic and political partners, Canada and Japan[10]. The Groupe de Contact was evolved into a committee comprised of prudential experts as well as supervisory representatives and broader representation to form the BCBS. Notable among these were British representatives, who led the initiatives to broaden the agenda beyond Eurodollar issues and headed the first new committee[11]. The new committee reported to the G10 governors, with all recommendations needing to be endorsed by them before being circulated[12]. The very basis for the development of international banking supervision and prudential standards originated in Europe and involved the US.

Yet while cross-border banking standards setting emerged in Europe, securities standards setting emerged in the US. In the 1980s another important financial standards body was formed: the International Organization of Securities Commissions (IOSCO). A global organisation whose members comprise more than 120 securities regulators and 80 other securities markets participants (stock exchanges, financial regional and international organizations etc.), it now develops, implements, and promotes adherence to internationally recognised standards for securities regulation. The basis for the

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6 Goodhart, Charles (2011), *The Basel Committee on Banking Supervision: A History of the Early Years 1974-1997*, Cambridge University Press, New York, p.12.
7 Goodhart, *op. cit.*, p.21.
8 *Ibid.*, p.33.
9 Bank for International Settlements, "A Brief History of the Basel Committee", July 2013, http://www.bis.org/bcbs/history.pdf, viewed 25 October 2013.
10 Goodhart*, op. cit.*, p.21, p.39.
11 Goodhart*, op. cit*, p.21, p.43.
12 Goodhart*, op. cit*, p.21, p.561.

organisation, however, was the Interamerican Conference of Securities Commissions and Similar Organisations that formed in 1974 in Caracas. Its sole purpose was to hold annual securities conferences[13] but at its April 1983 conference it was evolved to bring securities regulators from outside the Americas, namely France, Indonesia, South Korea and the UK into the US-led association.

Since then IOSCO has played an important role in developing technical standards for the world's securities markets, with its standards now used in more than 95% of the world's securities markets[14]. Its foundation standards are the Objectives and Principles of Securities Regulation that in 1998 established regulatory principles around securities regulation, auditor independence, corporate financial disclosure and transparency, conflicts of interest for financial analysts, and a code of conduct for credit rating agencies. Its standards have been revised several times. The US has maintained its lead position in IOSCO ever since its foundation, a situation attributed to the size of its capital market and the US Securities and Exchange Commission's (SEC) size and reputation[15].

The EU in contrast has had more limited influence, restrained by its regulatory capacity in the areas of securities trading and the lack of a cohesive position on a number of issues amid competing member state preferences, like regulating hedge funds for example[16]. The SEC in contrast has broadly been at the forefront of building networks of financial regulators, constructing what Newman and Posner term a regulatory network "web" that involves dozens of international financial governance organisations and regulator forums[17]. Prior to the financial crisis in 2009, IOSCO's Technical Committee, which oversees the development of regulatory initiatives, included only the G7 countries, Australia, Hong Kong, Mexico, the Netherlands, Spain and Switzerland[18].

Other key organisations have also been either European or US dominated. The International Accounting Standards Board (IASB), formed in 2001 from the previous International Accounting Standards Committee, develops best practice rules for accounting and was formed to effectively set up accounting standards alternatives to those used in the US in the wake of accounting scandals (as outlined in the earlier chapter). The IASB has also been Euro-American dominated[19]. The International Association of

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13 Camfferman, Kees and Zeff, Stephen (2007), *Financial Reporting and Global Capital Markets: A History of the International Accounting Standards Committee 1973–2000*, Oxford University Press, Oxford, p.10.
14 International Organization of Securities Commissions, "About IOSCO", at http://www.iosco.org/about/?subsection=about_iosco, viewed 1 November 2014.
15 Camfferman, Zeff, *op. cit.*, p.10.
16 Quaglia, Lucia (2014), "The Sources of European Union Influence in International Financial Regulatory Fora", *Journal of European Public Policy*, Vol. 21, No. 3, pp.327-345.
17 Newman, Abraham L. and Posner, Elliot (2012), "The International Regime for Financial Regulation: Transnational Feedbacks and Hegemonic Power", paper delivered at Sciences Po, Paris, 20 March.
18 Helleiner, Eric (2010b), "What Role for the New Financial Stability Board? The Politics of International Standards after the Crisis", *Global Policy*, Vol. 1, Issue 3, October.
19 Chiti, Edoardo and Mattarella, Bernardo Giorgio (eds), *Global Administrative Law and EU Administrative Law: Relationships, Legal Issues and Comparison*, Springer, Berlin; Botzem, Sebastian (2012), *The Politics of Accounting Regulation: Organizing Transnational Standard Setting in Financial Reporting*, Edgar Elgar, London.

Insurance Supervisors (IAIS), established in 1994 develops and assists in the implementation of principles and standards around insurance supervision and was established in the US. While the US has been a major shaper of insurance rules, the EU's influence has grown notably since the 2000s, with a number of key topics on the IAIS regulatory agenda reflecting EU preferences[20].

The Committee on Payments and Market Infrastructures, based at the BIS in Switzerland and formed in 1990, develops standards and procedures for the banking payment, clearing and settlement system[21]. Its genesis arose from the need for payments system coordination amid European integration. Another key body is the Joint Forum established in 1996 under the aegis of the BCBS, IOSCO and the IAIS to coordinate issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. While the US and the EU have dominated the development of international financial standards setting, the US has had an edge over its European counterpart. Quaglia argues there are two necessary and complementary conditions for a jurisdiction's ability to influence international regulatory convergence in finance: a large market and a strong regulatory capacity[22]. These the US has in abundance. The EU's influence in contrast was somewhat restrained up until the 2000s, she argues, with the EU in the process of building up its regulatory capacity and legal competence in several areas of financial services and conflicting member state preferences undermining a cohesive EU position.

US regulators on the other hand have for some time actively sought to pursue US regulatory interests abroad in international multilateral forums. The SEC's international reach is promoted through the Office of International Affairs (OIA) whose goal has been to improve domestic investor protection and facilitate cross-border securities transactions through international regulatory and enforcement cooperation and promoting the adoption of high regulatory standards worldwide[23].

The OIA advances the SEC's interests through specific international organizations in key economies (including the EU), including IOSCO, the Financial Stability Board, the Bank for International Settlement-based Joint Forum, the IFRS Foundation Monitoring Board (that oversees the International Accounting Standards Board), as well the IOSCO-based Monitoring Group (that represents the International Federation of Accountants[24]. Its first-mover advantage in several areas has helped it shape the overall template for a particular

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[20] Quaglia, 2014, *JEPP*, *op. cit.,* pp.327-345.
[21] The Committee on Payments and Market Infrastructures was prior to 1 September 2014 called the Committee on Payment and Settlement Systems.
[22] Quaglia, Lucia (2014), "The European Union and Global Financial Regulation", *Oxford Scholarship Online*, August.
[23] Securities and Exchange Commission, "Advancing the SEC's Mission through International Organizations", at http://edgar.sec.gov/about/offices/oia/oia_intlorg.shtml#monitoring, viewed 12 September 2014.
[24] The other international organisations with which the SEC maintains an active engagement are the Financial Action Task Force (FATF), the Organization for Economic Cooperation and Development (OECD) and the Council of Securities Regulators of the Americas (COSRA).

sector[25]. Drezner argues that large markets can have greater sway in shaping standards convergence because smaller states are eager to access their markets and willing to accommodate their preference and because large markets are better able to threaten others with economic coercion[26].

Even so US regulators' involvement in international standards cooperation has tended to ebb and flow over the years depending on the political priorities in the US. While the Bush Administration was somewhat ambivalent towards global financial rules, the US interest in IOSCO intensified significantly after the terrorist attacks of 11 September 2001, when US regulators sought to extend their involvement in a range of multilateral forums as part of their efforts to tackle law enforcement at home. One of the outcomes was IOSCO's primary instrument for cooperation: a multilateral MOU between various global regulators formed after 9/11 to improve cooperation and the exchange of information on cross-border regulatory violations.

The MOU signed in 2002 committed regulators to enforce strict standards on banks, brokerages and other securities firms operating in their markets. It further committed regulators to compel operators to provide certain information, share information, and prohibit domestic banking secrecy laws[27]. The SEC, which was instrumental in its formation and was among the first signatories, saw the MOU as "critical to combating violations of securities and derivatives laws"[28]. Such alterations in priorities have been attributed to both the priorities of regulators themselves as well as the priorities of legislators. Examining the development of the Basel Accords, Kapstein argued that minimum capital standards improved financial system stability and therefore were in regulators' collective interests[29]. At the same time, Singer argued, regulators simply reflect legislator priorities (as part of a principal-agent relationship) and when they act against the interests of those legislators, the latter step in to affect policy change[30].

## The US Leads Charge for Global Standards Reform

The potential for changes in the enthusiasm for global financial rules was clearly reflected in the financial crisis of 2007-09. As discussed earlier, while the US and the EU had discussed regulatory cooperation on a range of issues for several years, the outcomes had

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25 Posner, Elliot (2010), "Sequence as Explanation: The International Politics of Accounting Standards", *Review of International Political Economy*, Vol. 17, No. 4, pp.639–64.
26 Drezner, Daniel (2007), *All Politics is Global: Explaining International Regulatory Regimes*, Cambridge University Press, Cambridge, UK.
27 International Organization of Securities Commissions (2002), "Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information", May, at https://www.sec.gov/about/offices/oia/oia_bilateral/iosco.pdf, viewed September 2013.
28 Securities and Exchange Commission (2003), "SEC Announces IOSCO Unveiling of Multilateral Agreement on Enforcement Cooperation", press release, 31 October, at http://www.sec.gov/news/press/2003-145.htm, viewed 13 July 2013.
29 Kapstein, Ethan (1989), "Resolving the Regulator's Dilemma: International Coordination of Banking Regulations", *International Organization*, Vol. 43, No. 2, pp.323–47.
30 Singer, David Andrew (2004), "Capital Rules: The Domestic Politics of International Regulatory Harmonization", *International Organization*, Vol. 58, pp.531–565.

been described as being of mixed success and with a "highly variable pattern of effectiveness in transgovernmental regulatory cooperation" one of the results[31]. There had been a period of inertia over the development and coordination of international financial standards relative to earlier periods. The US regulatory environment was weak in a number of areas, from mortgage origination, derivatives regulation, credit ratings agencies and bank prudential standards among other areas.

Throughout 2008 as the crisis picked up in severity the political will for a range of regulatory reform on both sides of the Atlantic intensified. Questions were raised about the adequacy of banking prudential standards, the regulatory adequacy of derivatives regulation and the adequacy of international accounting standards, as well as credit ratings agency regulation and a range of other financial standards. The European Commission heavily criticised the IOSCO code of conduct as failing to effectively regulate the conduct of credit ratings agencies prior to the financial crisis.

After EU Internal Market and Services Commissioner Charlie McCreevy labelled IOSCO's credit ratings agency code of conduct as "toothless"[32] (see earlier chapter), the Commission announced plans for an aggressive overhaul of credit ratings agencies, derivatives regulation, hedge funds and banker remuneration among other areas. Congress had placed enormous pressure on US regulators to strengthen their regulatory rules in the US as well[33]. In a speech on financial regulation in September presidential candidate Senator John McCain even said SEC Commissioner Christopher Cox should be fired[34].

## The US and EU Coordinate their Agenda Early On

The trigger for a more closely coordinated US and European response was the collapse of US investment bank Lehman Brothers on 15 September. Congress prepared to develop an aggressive regulatory agenda and in Europe leading EU member states, notably France and Germany, led a loud call for tougher reform. French President Sarkozy called for a complete overhaul of the capitalist system while Germany's Finance Minster Peter Steinbrück slammed what he said was the excesses of US-style "unbridled capitalism"[35].

[31] Philippart, Éric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policymaking in US-EU Relations*, PIE Peter Lang, Brussels, p.47: Pollack, Mark A. (2005), "The New Transatlantic Agenda at Ten: Reflections on an Experiment in International Governance", *Journal of Common Market Studies*, Vol. 43, Issue 5.
[32] McCreevy, Charlie, European Commissioner for Internal Market and Services (2008), "Regulating in a Global Market", speech at Inaugural Global Financial Services Centre Conference, Dublin, 16 June, at http://europa.eu/rapid/press-release_SPEECH-08-334_de.htm?locale=de, viewed 26 July 2013 .
[33] Sirri, Erik R. (2009), "Regulatory Politics and Short Selling", *University of Pittsburgh Law Review*, Vol. 71; Weitzman, Hal (2009), "Financial Reform is Flawed, says CBOE chief", *Financial Times*, 22 December; Lowenstein, Roger (2008), "Long-Term Capital Management: It's a Short-Term Memory", *The New York Times*, 7 September, at http://www.nytimes.com/2008/09/07/business/worldbusiness/07iht-07ltcm.15941880.html?pagewanted=all&_r=0, viewed 1 August 2014.
[34] Sasseen, Jane (2008), "McCain to Cox: You're Fired!", *BusinessWeek*, 17 September, at http://www.businessweek.com/election/2008/blog/archives/2008/09/mccain_to_cox_y.html, viewed 10 August 2014.
[35] "Interview with German Finance Minister Steinbrück", *Der Spiegel*, 29 September 2008, at http://www.spiegel.de/international/business/spiegel-interview-with-german-finance-minister-steinbrueck-we-were-all-staring-into-the-abyss-a-581201.html, viewed 1 September 2014.

US regulators — notably the US Treasury and the SEC — intensified their efforts to coordinate their international regulatory agenda with their European partners, notably with the Commission[36].

The official goal of discussion was to set "a broad strategy for and coordinate approaches on financial market regulation" not just on a bilateral basis but also through international forums, including the G20, the then-Financial Stability Forum and also standards-setting bodies such as IOSCO, the BCBS, the IASB and other bodies[37]. The objective is perhaps best stated in the global policy coordination goals of the Transatlantic Economic Council, the high-level joint US-EU political body established to oversee economic relations: "The US and EU work together in a variety of multilateral fora to set broad strategy for and coordinate approaches on financial market regulation, such as the G20, Financial Stability Board and standard setting bodies (such as IOSCO). These efforts are deepened via extensive bilateral visits and meetings"[38]. It was a crisis that, the SEC noted at the time, demonstrated how "closely capital markets around the globe are interconnected" and showed that "facilitating international cooperation and coordination is critical"[39].

Both the US and EU sought to agree on a number of broad policy areas. The first was to coordinate their own domestic financial regulatory reforms including accounting standards, derivatives reform, credit ratings agencies, insurance, banking standards and other issues. The second was to give the International Monetary Fund a key role in responding to the financial crisis, an issue discussed in depth in the previous chapter. A third issue agreed upon was to promote the need to raise financial standards reforms internationally. On this latter point the US was very much in favour of strengthening the then-Financial Stability Forum's role. The President's Working Group on Financial Markets, which was chaired by the US Treasury Secretary, wanted to work through the forum to implement any reforms[40]. It had worked closely with the G7 and the Financial Stability Forum throughout 2008 as the crisis intensified, with the Financial Stability Forum making a number of recommendations to deal with the escalating crisis earlier in the year[41]. These included stronger prudential oversight of capital, liquidity and risk management; enhancing transparency and valuation; changes in the role and uses of credit ratings;

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36 Interview conducted by Peter O'Shea with DG MARKT representative, European Commission, Brussels, 14 June 2014.
37 US Department of State, Bureau of European and Eurasian Affairs, "Transatlantic Economic Council: Annex 2 - Joint Report on US-EU Financial Markets Regulatory Dialogue for the TEC Meeting", 27 October 2009, at http://www.state.gov/p/eur/rls/or/131045.htm, viewed 20 October 2014.
38 US Department of State (2010), "Framework for Promoting Transatlantic Economic Integration, Annex VI: Financial Markets", 4 March, at http://www.state.gov/p/eur/rt/eu/tec/131908.htm, viewed 12 September 2014.
39 Securities and Exchange Commission, "Office for International Affairs", at http://www.sec.gov/oia/Article/about.html#.VDPd7CmSxEc, viewed 10 September 2014.
40 Paulson, Henry M. (2010), *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, Hachette Book Group, New York; Paulson, Henry M. (2010), "How to Watch the Banks", *The New York Times*, February 15 at http://www.nytimes.com/2010/02/16/opinion/16paulson.html?pagewanted=all, viewed 1 September 2014; The Presidents Working Group on Financial Markets comprises of the US Treasury Secretary, the Chair of the Board of Governors of the Federal Reserve System, the Chair of the Securities and Exchange Commission, and the Chair of the Commodity Futures Trading Commission.
41 International Monetary Fund (2008), "Statement by Secretary of the Treasury of the United States of America at the Seventeenth Meeting of the International Monetary and Financial Committee Meeting", 12 April, at https://www.imf.org/External/spring/2008/imfc/statement/eng/usa.pdf, viewed 1 September 2014.

strengthening authorities' responsiveness to risks; and arrangements for dealing with stress in the financial system[42]. Subsequently endorsed by the G7 in a conference call of G7/8 finance ministers and central bank governors on 22 September 2008[43], the Financial Stability Forum was well positioned to play a central role.

The need for international agreement to coordinate financial reform internationally was high because, while the G20 has effectively become the global financial governance steering committee, the adoption of standards developed by the various standards bodies — IOSCO, BCBS, IAIS and IASB among others — was voluntary. All these bodies' standards are non-binding and adoption in various countries including the US and the EU depends ultimately on intergovernmental will and cooperation. Indeed the whole international financial regulatory landscape is a complex body of rules "written and unwritten, that not only fall under conventional categories of 'conduct of business' and 'prudential' regulation of financial services providers but also that govern entry and operations of firms across borders"[44]. Unlike areas such as trade, financial regulation is not particularly multilateral and, unlike international maritime standards such as the law of the sea, legally binding conventions that govern international finance are rare[45].

The enforcement of existing obligations is perhaps the biggest challenge of all in many areas of global governance at the best of times[46]. So the enforcement of compliance with financial governance rules, in an area of governance mostly characterised by voluntary standards and intergovernmental cooperation, is virtually impossible. Indeed the lack of compliance was a big contributor to the causes of the financial crisis. Both the EU's High-Level Expert Group on EU Financial Supervision in February 2009 (a.k.a. the De Larosière Committee) and the later US Financial Inquiry Commission in January 2011 pointed to fundamental and significant shortcomings in compliance with existing financial standards in the US and EU financial markets respectively[47]. The OECD and the IMF among others also point to significant shortcomings in the international financial governance compliance[48].

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42 Financial Stability Forum "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", Basel, 7 April, at http://www.financialstabilityboard.org/wp-content/uploads/r_0804.pdf?page_moved=1, viewed 18 September 2014.
43 The G7 finance ministers and central bank governors agreed the Financial Stability Forum would "enhance the resilience of the global financial system for the longer term" – see G7 Finance Ministers (2008), "Statement by G7 Finance Ministers and Central Bank Governors on Global Financial Market Turmoil", 22 September, at http://www.g8.utoronto.ca/finance/fm080922.htm, viewed 30 August 2013.
44 Newman, Posner, *op. cit.*
45 Simmons, Beth (2001), "The International Politics of Harmonization: The Case of Capital Market Regulation", *International Organization*, Vol. 55, pp.589-620.
46 Weiss, Thomas G., (2013), "What is Global Governance?", in Thomas G Weiss (ed), *Global Governance: Why? What? Wither?*, Polity, Cambridge Mass., p.58.
47 Financial Crisis Inquiry Commission (2011), "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States", Washington DC, January, at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, viewed 13 October 2012; The High Level Group on Financial Supervision in the EU" (2009), "Report", chaired by Jacques de Larosière, Brussels, 25 February, at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf, viewed 1 September 2011.
48 Interview conducted by Peter O'Shea with representative of the Directorate for Financial and Enterprise Affairs at the OECD, Paris, 22 June 2012.

## The US and the EU Lead the International Reform Agenda

In the lead up to the G20 Leaders' Summit in Washington in November, G20 sherpas in participating countries, the European Commission and the IMF negotiated a common position for the summit[49]. As the US was hosting the summit it had the ability to draft the agenda. As is the usual practice at G20 summits, the host country places issues on the agenda for discussion. Other countries can suggest other issues but all participating countries must agree for any issue to progress[50]. The US had a significant advantage in setting the agenda for the summit. As negotiations progressed, the US and its European partners — the hardest hit by the crisis, the parties with the most to lose and the historically dominant powers in the G20 — dominated the agenda[51].

Other G20 nations had little choice but to go along with decisions that the major powers had also agreed upon[52]. Their collaboration set the foundation for considerable US and European influence over regulatory reforms outcomes agreed at later G20 summits. The outcomes included agreeing to raise financial regulatory standards in key areas such as banking standards, derivatives trading, credit ratings agencies among other areas, giving the International Monetary Fund a central role in responding to the crisis, and giving the then-Financial Stability Forum a role in coordinating the financial reforms internationally. By mid to late 2008 the US and its European partners had effectively collaborated to form the basis of an agenda to take their financial reform agenda to the global stage.

With the agenda for future international regulatory reform starting to take shape there were reports of a spat between the IMF and the Financial Stability Forum over what they envisioned their respective roles would be[53]. But the day before the summit the Financial Stability Forum's chair Mario Draghi and the IMF's Managing Director Dominique Strauss Kahn jointly wrote to the G20 outlining how they saw the division of labor for reforming international financial standards. Pledging to "enhance our collaboration" they recommended that the then-Financial Stability Forum would "elaborate" on the various financial standards and coordinate activity among the standards-setting bodies (i.e. the IASB, IOSCO and BCBS) and that the IMF would monitor the global financial system[54]. The latter would assess the implementation of these standards by national authorities. The former would also assess macro-financial risks and vulnerabilities in the global economy and the latter would monitor the broader financial system risks and vulnerabilities and both bodies would cooperate in conducting "early warning exercises".

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[49] Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012.
[50] *Ibid.*
[51] *Ibid.*
[52] *Ibid.*
[53] Engelen, Klaus (2008), "Rift Barely Avoided: Letter from the G20 Summit", *The International Economy*, Fall, Vol. 22, No. 4.
[54] International Monetary Fund and the Financial Stability Forum (2008), "Letter by Mario Draghi and Dominique Strauss Kahn to the G20", 13 November, at https://www.imf.org/external/np/omd/2008/eng/pdf/111308.pdf, viewed 4 July 2014.

## G20 Spells Out FSF Role

At the summit in Washington over two days of 14-15 November 2008 the G20 economies agreed to develop and implement a range of reforms to "strengthen financial markets and regulatory regimes so as to avoid future crises"[55]. They stressed the International Monetary Fund's "important role in crisis response" and confirmed the Financial Stability Forum's role. In the lead up to the follow-up G20 Leaders' Summit in London in April, the EU position for the summit started to form. Germany hosted a "preparatory summit" in Berlin on 22 February 2009 in an effort to shape the official EU agenda. The meeting was an unusual smaller grouping of EU states, comprising just the EU member states that are part of the G20 — the UK, Germany, France and Italy — as well as Spain and the Netherlands (which were invited as observers to the G20 summits) and the Czech Republic that held the EU presidency at the time.

Also invited were the President of the European Commission and the President of the European Council, both of whom officially represented the EU. The preparatory summit discussed specific issues that the participants particularly felt should be reformed but also agreed on strengthening the roles of the International Monetary Fund and the Financial Stability Forum[56]. The meeting set the scene and the EU's internal agenda for the official EU summit the following month. That summit also agreed on a role for the IMF and Financial Stability Forum in monitoring the G20 action plan's implementation to ensure greater accountability". Successive EU meetings and summits had repeatedly reinforced the preferred approach for post-crisis regulation to raise regulatory standards but to also give the Financial Stability Forum a role in coordinating common standards throughout the world.

The next month, with the EU now holding a common position and the US and the EU aligned on key matters, the G-20 Leaders' Summit in London issued an eight-part declaration outlining a comprehensive plan for financial regulatory reform. Importantly the Financial Stability Forum was given a greater mandate to coordinate the implementation of a range of tightened regulatory standards with the various financial standards bodies and throughout the world. It would be upgraded to the Financial Stability Board and gain a small secretariat in Basel, Switzerland, at the Bank for International Settlements. The new board was given a mandate for several specific tasks.

These were to assess vulnerabilities affecting the global financial system; promote coordination and information exchange among country authorities responsible for

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[55] G20 (2008), "Declaration of the Summit on Financial Markets and the World Economy", Washington DC, 15 November, at https://g20.org/wp-content/uploads/2014/12/Washington_Declaration_0.pdf, viewed 16 July 2014.
[56] European Leaders Meet for Common Position on Crisis", *XinhuaNews*, 22 February 2009, at http://news.xinhuanet.com/english/2009-02/22/content_10871121.htm, viewed 16 September 2014.

financial stability; monitor markets and advise on the implications of market developments for regulatory policy: generate best practices by advising on and monitoring best practice in meeting regulatory standards; undertake joint strategic reviews of the policy development work of the international standard setting bodies; help to establish supervisory colleges; assist cross-border crisis management by supporting contingency planning particularly on systemically important firms; conduct early warning exercises in collaboration with the IMF; and enhance coherence among standard-setting bodies by helping to coordinate their activities[57].

In addition the Financial Stability Board was given powers to develop its own policies. These included policies on closing geographic regulatory gaps around money laundering, terrorist financing and better banking compensation practices. It would also have a role in developing standards for the regulation of derivatives, hedge funds and credit ratings agencies.

One of its most important functions would be its monitoring and surveillance role — in a similar way that the IMF has a surveillance role over global economies. It would "address vulnerabilities" and monitor, advise and undertake joint reviews of member state country policies[58]. This effectively meant the Financial Stability Board was able to check up on the world's leading economies, allowing G20 to place diplomatic pressure on any country considered to be falling behind its implementation of any agreed global standards. The considerable boost to its mandate highlights the determination of the US and the EU to not only extend their own regulatory agenda to the world's other developed economies but also to ensure that those measures would be transposed.

The decisions very much reflected US and European priorities and were the result of the negotiations between the US and the EU mainly over their own priorities for reform. For example IOSCO was given a mandate to "coordinate full compliance" with its code of conduct[59], the adoption of which to date had been only voluntary[60]. The US at least preferred credit ratings agency reform internationally to be based on IOSCO's code of conduct[61]. At the time the US was resisting calls for tougher regulation domestically and faced considerable pressure from both agencies, regulatory agencies that use the credit

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[57] Financial Stability Board, "Financial Stability Board Charter", at http://www.financialstabilityboard.org/wp-content/uploads/r_120809.pdf, viewed in 22 October 2014; G20 (2009), "Declaration on Strengthening the Financial System (Annex to London Summit Communiqué)", London, 2 April, at http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf, viewed 16 July 2014; Financial Stability Board, "FSB Mandate", at http://www.financialstabilityboard.org/about/mandate/, viewed 12 November 2014.
[58] Financial Stability Board, "Financial Stability Board Charter", at http://www.financialstabilityboard.org/wp-content/uploads/r_120809.pdf, viewed in 22 October 2014.
[59] G20, 2009, *op. cit.*
[60] Helleiner, Eric and Pagliari, Stefano (2010), "Crisis and the Reform of International Financial Regulation", in *Global Finance in Crisis: The Politics of International Regulatory Change*, Helleiner, Eric; Stefano Pagliari; Zimmerman, Hubert (eds), Routledge, New York.
[61] Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.

ratings and the banking sector[62]. Some of these were very much a manifestation of the strong position France particularly adopted in the lead-up to the G20 Leaders Summit in London[63].

## The Push to Raise Standards and the Risk of Regulatory Arbitrage

There were significant motivations for the US and EU to agree to a common effort to push for tighter regulatory standards beyond the transatlantic market. One of the important considerations was to protect and reinforce US and EU interests in each other's markets, as well as in other major markets around the world. The potential for regulatory arbitrage, in which banks or financial institutions could exploit the regulatory differences in major financial markets, was a key concern[64].

US banks and financial institutions were keen to see that any tightening of regulations in the US would be accompanied by tighter regulations in Europe. They were concerned that if regulations in the US were tightened they would face significant competitive disadvantages if banking or trading activity was moved to financial centres in Europe[65]. European banks had similar concerns about the EU's own regulatory changes. There were significant differences in the regulatory standards in the US and the EU around a range of issues at the time — banking oversight, derivatives regulation, privacy protection, hedge fund regulation to name a few — making the narrowing of regulatory divergence an economic and financial imperative. At the same time, US and European banks — particularly those large banks with significant operations on both sides of the Atlantic — were concerned that any tightening of both US and EU regulations would place them at a worldwide competitive disadvantage. They were particularly concerned about their competitors in centres such as Hong Kong, Shanghai and Singapore.

There were good reasons for such concerns. While emerging markets broadly accounted for only 18% of global financial stock market value in 2009, they had caught up rapidly over the previous decade. From 2000 to 2009 the total value of equity and debt stock in emerging markets grew by an average of 18.3% a year whereas in developed countries it grew by 5% a year over this period[66]. An ongoing survey of international financial services professionals conducted by the City of London from late 2007 to late 2008 found that

[62] G20 Working Group 1 Enhancing Sound Regulation and Strengthening Transparency (2009), "Report of G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency", published online by the Reserve Bank of India, Mumbai, final report, 25 March 2009, at http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=549, viewed 12 October 2014.
[63] Financial Stability Board (2015), "FSB Member Jurisdictions: National Regulation and Supervisory Guidance on Compensation", Basel, 21 January 2015, at http://www.financialstabilityboard.org/publications/r_120709.pdf, viewed 30 January 2015.
[64] European Commission, DG Internal Market, "Third Countries Dialogues Update: Note to the Financial Services Committee", Brussels, 11 November 2009, at http://ec.europa.eu/finance/general-policy/docs/global/third_countries_dialogues_en.pdf, viewed 12 February 2013; Interview conducted by Peter O'Shea with DG MARKT representative, European Commission, Brussels, 14 June 2014.
[65] Helleiner, Eric (2010b), *op. cit.*
[66] Roxburgh, Charles; Lund, Susan; Piotrowski, John (2011), "Mapping Global Capital Markets", McKinsey Global Institute, New York, August, at http://www.mckinsey.com/insights/global_capital_markets/mapping_global_capital_markets_2011, viewed 2 December 2014.

Asia was where most respondents expected the main challenges to the leading financial centres (London and New York) to come from.

In the 2008 survey, most financial professionals nominated Dubai, Singapore, Shanghai, Mumbai, Qatar and Bahrain in that order as the centres most likely to become more significant[67]. In mid 2009, among the top ten banks in the world by asset size, three were US banks, two UK banks, two Chinese, one Japanese, one French and one Spanish; yet five years earlier there were no Chinese banks in the top ten[68]. These concerns were summed up in a report published in 2010 that was co-chaired by representatives of the European Parliament and the US Senate.

> *Chinese banks, some of which are among the largest in the world now when measured by market capitalization, are likely to follow the path Japanese banks trod several decades ago by transforming from domestic banks into global ones. If Chinese banks in future years were to operate under less stringent capital and other regulations that were designed for domestic Chinese conditions, we could repeat the experience of those Japanese banks. They used their regulatory and other competitive advantages to expand into overseas markets where they took significant market shares.* [69]

The concerns about potential disadvantage were not only financial but also economic. The last two decades have seen big shifts in the global balance of economic power in the world economy. In 1999 emerging economies represented about 37% of global output in purchasing parity power terms (see chart below), whereas 2013 was the year that emerging economies generated a greater share of the global GDP than developed economies for the first time[70].

**Table 8: Share of Global Economic Output of Developed vs. Emerging Economies, 1999-2013**

| | 2000 | 2009 | 2012 | 2013 |
|---|---|---|---|---|
| Advanced Economies | 57.4 | 55 | 50.4 | **49.6** |
| Emerging Market and Developing Economies | 36.8 | 44.7 | 49.6 | 50.4 |

*Source: IMF World Economic Output 2000, 2009, 2012, 2013*

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[67] City of London (2008), "Global Financial Centres Index", September, p.5, at http://www.cityoflondon.gov.uk, viewed 2 December 2014.
[68] The Banker Database, at http://www.thebankerdatabase.com, data extracted 12 September 2014.
[69] Atlantic Council/Thomson Reuters (2010), "The Danger of Divergence: Transatlantic Cooperation on Financial Reform", report co-chaired by Sharon Bowles MEP European Parliament, Senator Chuck Hagel, Chairman, Atlantic Council and Senator Mark Warner of the US Senate Committee on Banking, Housing, and Urban Affairs, Washington DC, October, at http://www.atlanticcouncil.org/images/files/publication_pdfs/403/ACUS_TR_Danger_Divergence_Report.pdf, viewed 10 June 2014.
[70] IMF World Economic Outlook database, at http://www.imf.org/external/ns/cs.aspx?id=29, data accessed 12 September, 2 December 2014; the IMF classifies the developed economies for the purposes of the World Economic Output as the US, Germany, France, Italy, Spain, the UK, Japan, Canada and other developed economies.

In the almost decade leading up to the start of the financial crisis in 2008 emerging economies' share of global economic out had grown quite considerably, by nearly 8%. At the same time the US share of global output had fallen.

**Table 9: Share of Global Economic Output of US and EU, 1999-2013**

| | 1999 | 2008 | 2012 | 2013 |
|---|---|---|---|---|
| US | 21.9 | 20.7 | 19.5 | 19.3 |
| EU | 15.8 | 15.7 | 13.5 | 13.1 |

*Source: IMF World Economic Output 2000, 2009, 2012, 2013*

This trend is not forecast to turnaround quickly. Global banking group HSBC estimates that by 2050 the economies of the world it deemed "emerging" will have grown fivefold and be larger than the current G7 economies in total, with 19 of the 30 largest economies from the emerging world[71]. Similarly the total value of E7 economies (China, India, Brazil, Russia, Indonesia, Mexico and Turkey) in purchasing parity power terms could overtake the collective size of the G7 countries (US, Japan, Germany, UK, France, Italy and Canada) as early as 2017, according to PricewaterhouseCoopers forecasts[72].

As an agenda for financial reform in the EU was negotiated, the UK was particularly concerned about the maintenance of London's competitive position as a global financial centre and the need for a level playing field internationally[73]. However, the risk that the financial crisis posed to the US and European economies and their respective positions in the global economy was also a concern for US and EU leaders during negotiations for regulatory reform throughout 2008 and 2009[74].

## A Coordinated US-EU Strategy

Given the challenge that other financial powers of the world posed to US and European financial dominance, it was in the interests of the US and the EU to seek to raise standards not just in the transatlantic market but also in other leading economies. The common US-EU interest in avoiding regulatory arbitrage made it even more important that they coordinate their efforts at G20 level and in international financial standard

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[71] HSBC Research, "The World in 2050: Quantifying the Shift in the Global Economy", January 2011, Warwick University, UK, at http://www2.warwick.ac.uk/fac/soc/csgr/green/foresight/economy/2011_hsbc_the_world_in_2050_-_quantifying_the_shift_in_the_global_economy.pdf, viewed 10 May 2014.

[72] PricewaterhouseCoopers (2013), "World in 2050: The BRICs and Beyond: Prospects, Challenges and Opportunities", London, January, at http://www.pwc.com/gx/en/world-2050/assets/pwc-world-in-2050-report-january-2013.pdf, viewed 12 December 2014.

[73] See for example UK Financial Services Authority (2009), "The Turner Review: A Regulatory Response to the Global Banking Crisis", London, March, at http://www.fsa.gov.uk/pubs/other/turner_review.pdf, viewed 12 September 2013, p116; HM Treasury (2009), "UK International Financial Services - The Future: A Report from UK based Financial Services Leaders to the Government", May, at http://webarchive.nationalarchives.gov.uk/20100407010852/http:/www.hm-treasury.gov.uk/d/uk_internationalfinancialservices070509.pdf, viewed 2 January 2015; City of London (2009), "Importance of Wholesale Financial Services to the European Union Economy 2009", September, at http://www.cityoflondon.gov.uk/, viewed 12 December 2014.

[74] Interview conducted by Peter O'Shea with representative of the UK's EU Economic and Financial Affairs Sub-Committee, London, 24 May 2012.

bodies. As US Treasury Deputy Assistant Secretary Mark Sobel put it in April 2008, while financial market regulation is undertaken at the national level "one nation's actions clearly don't stop at the water's edge"[75].

The strategy adopted by US and EU regulators was to coordinate their international financial reform priorities, develop a common agenda and promote this agenda through various international forums, starting with the G20. In the goal to secure global financial stability and protect their interests abroad, one consideration was mitigating the risk of regulatory arbitrage. There was a risk that banks and financial institutions might seek to exploit regulatory differences between not only the transatlantic markets but also markets around the world. Raising financial standards in just the transatlantic market could prompt banks, financial institutions and multinationals to move their operations to lesser-regulated markets in other parts of the world where standards would allow them with greater capacity to pursue their interests with a lesser regulatory burden.

Speaking in 2009 US Treasury Secretary Timothy Geithner elaborated that the need to create a "level playing field" should be supplemented by a system of enforcement and monitoring that ensures "people play by those rules"[76]. This would make compliance with regulatory standards easier for US firms but more importantly it would mean the US was not at a disadvantage in the global economy at a time the US Congress had an ambitious schedule for financial reform. Referring to the US financial system, he said: "If we continue to allow risk and leverage to migrate where standards are weakest, the entire US-global financial system (sic) will be less stable in the future."[77]

It was for this reason that the avoidance of regulatory arbitrage was explicitly noted as a priority at the G20 Leader's Summit in Washington in November 2008. Global financial markets were, the G20 leaders noted in the final communiqué, global in scope and therefore "intensified international cooperation" among regulators and strengthening of international standards was necessary to not only maintain financial stability but also to mitigate the effects of other "potentially adverse impacts on other countries, including regulatory arbitrage"[78].

The importance of avoiding regulatory arbitrage was similarly impressed in the declaration issued at the G20 Leaders' Summit in London. Part of the strategy to create a level playing field and raise standards around the world involved strengthening the mandate for the

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[75] Sobel, Mark (2008), "Deputy Assistant Secretary Mark Remarks", speech at Conference on US-EU Regulatory Cooperation, US Chamber of Commerce, Washington DC, 30 April, at http://www.treasury.gov/press-center/press-releases/Pages/hp946.aspx, viewed 5 September 2014.
[76] US Whitehouse (2009), "Press Briefing by Treasury Secretary Timothy Geithner on the G20 Leaders Meetings", G20 Pittsburgh Summit, 24 September, at http://www.whitehouse.gov/the_press_office/Press-Briefing-by-Treasury-Secretary-Geithner-on-the-G20-Meetings, viewed 11 November 2014.
[77] *Ibid.*
[78] G20, 2008, *op. cit.*

then-Financial Stability Forum (renaming it the Financial Stability Board) to coordinate the reform of existing standards and develop new ones in the various global bodies. The European Commission's objective was to "further develop the technical details in cooperation with its G20 partners, the Financial Stability Board, and in particular with the US"[79]. In respect to derivatives reform for example the Commission argued that the market was global and that the risk of regulatory arbitrage should be mitigated "to ensure a robust and convergent international regulatory outcome" [80]. This was a position firmly put forward by industry at the time also. The Federation of European Securities Exchanges argued that certain financial activity — particularly derivatives trading for example — was highly global in nature and, as such, international coordination was essential to "ensure a level playing field across those jurisdictions with derivatives business"[81].

The problems associated with regulatory arbitrage were among the big contributors to the financial crisis in the first place. One of the biggest failures of the financial crisis — the insurer AIG that collapsed in 2009 — had engaged in regulatory arbitrage by setting up a major business in credit default swaps in London out of the gaze of tighter regulation in the US[82]. The UK's inquiry into banking failure, the Turner Review, found in March 2009 that the practice of exploiting global regulatory differences, particularly by the big international banks like HSBC, was widespread in the head up to the financial crisis[83]. The basing of banking certain activities in non-EU subsidiaries allowed them to increase their leveraging without violating EU banking prudential standards.

One example of such a deal involved the Franco-Belgian bank Dexia, which entered into a credit default swap arrangement in February 2007, before the crisis erupted, with several investors through its subsidiary Dexia Crédit Local Dublin Branch. The transaction involved issuing several tranches of infrastructure bonds but enabled Dexia to effectively avoid the prudential banking standards outlined in the Basel Accords. Dexia, which later required US$8.7 billion in government bailouts, even boasted that one of its deals had "freed up regulatory capital" to allow it to "further enhance its leading position in financing" infrastructure investment[84]. CDS deals had allowed it to make it appear as

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[79] Communication from the Commission, Ensuring Efficient, Safe and Sound Derivatives Markets: Future Policy Actions, COM(2009) 563.
[80] *Ibid.*
[81] Federation of European Securities Exchanges (2009), "Response to the European Commission Consultation Enhancing the Resilience of OTC Derivatives Markets", submission to the European Commission, 31 August, at https://circabc.europa.eu/sd/a/049c2580-45ee-478e-9d57-8bcc9fea1459/fese_en.pdf, viewed 26 April 2014.
[82] Financial Crisis Inquiry Commission, 2011, *op. cit.*
[83] UK Financial Services Authority (2009), "The Turner Review: A Regulatory Response to the Global Banking Crisis", London, March 2009, at http://www.fsa.gov.uk/pubs/other/turner_review.pdf, viewed 12 September 2013.
[84] Dexia (2007), "Dexia Closes First Public Securitisation Transaction of Wrapped Infrastructure Bonds", press release, 2 January, at http://www.dexia.com/EN/journalist/press_releases/Pages/dexia-closes-first-public-securitisation-transaction-of-wrapped-infrastructure-bonds.aspx, viewed 12 May 2014.

though it had more assets and this freed up their capital reserves and allowed it to lend more money than the Basel standards allowed[85].

The rationale for tightening financial regulations around the world was also that regulatory fragmentation weakens the resilience of financial markets and makes it much more difficult for economies to recover[86]. Given these concerns US and EU regulators undertook to hasten their bilateral cooperation in existing standards-setting bodies such as IOSCO, the IASB, the BCBS and the CPSS among others. The potential threat of regulatory arbitrage was a particular concern for the UK's markets. As the financial crisis continued to evolve in 2008 and 2009, the UK's then-Financial Services Authority shifted its priorities to not only guide the UK Treasury in its negotiations at EU level, but also at the global level at the new Financial Stability Board, as well as the international standards bodies IOSCO and the CPSS[87]. Overall the advent of the financial crisis prompted a significant change of focus for UK regulators towards global regulatory efforts[88].

Subsequent US and EU efforts to coordinate their agenda were pursued in bilateral negotiations through the US-EU Financial Markets Regulatory Dialogue (FMRD), as discussed in the earlier chapters. The evolving US-EU agenda for reform thus raised the need for ongoing G20 summits. The most intense post-financial crisis financial regulatory activity in the US took place from 2008 to 2010 when the comprehensive Dodd–Frank legislation was signed into law in July 2010[89]. In the EU intense financial regulatory reform extended into 2011 (as discussed in previous chapters). Over this period, in addition to the G20 Leader's Summit in Washington in November 2008 (the first ever actual G20 summit of G20 heads of government), there were two further leaders' summits in 2009 (London in April and Pittsburgh in September), two in 2010 (Toronto in June and Seoul in November) and one in 2011 (Cannes in November). Summits since then have been annual, with financial regulation a lower priority at the summits in Los Cabos in June 2012, St. Petersburg in September 2013 and Brisbane in November 2014.

## The Asian Financial Crisis Precedent

The financial crisis of 2007-09 was not the first time the US had led efforts to raise financial governance standards in other parts of the world when its interests were harmed and threatened by financial crisis. There was an earlier precedent just ten years earlier in

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85 Henry, David; Goldstein, Matthew and Matlack, Carol (2008), "How AIG's Credit Loophole Squeezed Europe's Banks", *Bloomberg BusinessWeek*, 15 October, at http://www.businessweek.com/stories/2008-10-15/how-aigs-credit-loophole-squeezed-europes-banks
86 European Commission (2014), "Economic Review of the Financial Regulation Agenda", Commission Staff Working Document, Brussels, 15 May, at http://ec.europa.eu/internal_market/finances/docs/general/20140515-erfra-working-document_en.pdf, viewed 2 September 2014.
87 UK Financial Services Authority (2010), "The FSA's International Agenda", London, October 2010, at http://www.fsa.gov.uk/pubs/international/agenda.pdf, viewed 13 July 2013.
88 Interview conducted by Peter O'Shea with representative of the member of the UK's EU Economic and Financial Affairs Sub-Committee, London, 24 May 2012.
89 The full Dodd–Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010, was one of the most sweeping reforms to US financial services law in decades.

the wake of the Asian Financial Crisis of 1997-99. That crisis was a particular wake-up call to the US after one of its largest hedge funds, Long Term Capital Management (LTCM), nearly collapsed after incurring huge debts in Asia in 1997. As the financial crisis spread to Latin America and Russia the fund lost US$4.4 billion over five months from May to September 1998 due to excessive leveraging risk taking[90]. The Federal Reserve Bank of New York took the then-unprecedented step of bailing of the fund, fearing a forced liquidation would create even more havoc in the world financial markets. The US President's Working Group on Financial Markets at the time recommended a range of regulatory reforms in the US designed to constrain excessive leverage but the US response was also to broaden the scope of regulatory reform abroad[91].

It was shortly after this that the G7 at its meeting on 22 February 1999, led by the US, formed both the then-Financial Stability Forum and broadened the membership of the "G" club to the G20 as discussed in chapter 3. The former was established after the G7 asked the President of the Deutsche Bundesbank, Hans Tietmeyer, to recommend a structure to enhance cooperation between international supervisory bodies and financial institutions[92]. Germany, which held the G7 presidency at the time, had hosted a summit in Cologne amid the economic turmoil of the financial crisis in Asia, Russia and Latin America[93]. It first established three working groups, one on highly leveraged financial institutions, another on capital flows and another on global offshore financial centres. The forum, whose work was conducted by representatives of participating leading economies, subsequently endorsed a range of measures and promoted their implementation throughout leading industrialised economies. While these remained the focus of its work up until it received a greater mandate from the G20 in London in April 2009, it also addressed other important policy issues[94].

Also arising from the meeting was a decision to broaden the G7 to a G20 to "ensure broader participation in discussions on international financial affairs among countries whose size or strategic importance gives them a particularly crucial role in the global economy"[95]. The US-EU dominated G7 membership (the US, the UK, France, Germany, Italy, Japan and Canada) was expanded to include the so-called emerging economies that represented a growing share of global economic output[96]. The EU and representatives of

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[90] Jorion, Philippe (1991), "The Story of Long-Term Capital Management", *Canadian Investment Review*, Winter 1999; Donnelly, Shawn (2012), "Institutional Change at the Top", in Mayntz, Renate, *Crisis and Control: Institutional Change in Financial Market Regulation*, Max Planck Institute for the Study of Societies, July.
[91] Commodities Futures Exchange Commission (1999), "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management", Report of The President's Working Group on Financial Markets, Washington DC, April, at http://www.cftc.gov/tm/tmhedgefundreport.htm, viewed 10 January 2015.
[92] Financial Stability Board, "Our History", http://www.financialstabilityboard.org/about/history/, viewed 15 July 2014.
[93] G7 Finance Ministers (1999), "G7 Statement", Cologne, Germany, 18 June, at http://www.g8.utoronto.ca/summit/1999koln/g7statement_june18.htm, viewed 2 December 2014.
[94] See various Financial Stability Board press releases at http://www.financialstabilityboard.org/content_type/press/press-releases/
[95] G7 Finance Ministers (1999), "Finance Minister Paul Martin Chosen as Inaugural Chairperson of New Group of Twenty", 25 September, Washington DC, as viewed at http://www.g8.utoronto.ca/finance/fm992509.htm, viewed 12 June 2013.
[96] The additions to form the G20 were Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea and Turkey as well as the EU and representatives of the IMF and the World Bank.

the IMF and the World Bank were also invited into the club. While the first public announcement extolled the virtues of "translating the benefits of globalization into higher incomes and better opportunities for people everywhere" its objective was also to broaden the program of financial regulatory reform to emerging market economies particularly[97].

In the lead up to the Asian Financial Crisis of 1997-99 emerging markets had become a significantly bigger focus for private investment, particularly US and European banks. Net private capital flows to emerging market countries skyrocketed from US$50 billion a year during 1987-89 to more than US$150 billion a year over 1995-97[98]. Markets in Asia, Russia and Latin America had grown in much greater significance in the decade leading up to the crisis. The years 1990 to 1993 were particularly strong, with emerging markets equity funds generating returns for investment managers well above the global average. The year 1989 also saw strong returns, as did the years 2003-2007[99].

There was an even earlier precedent in which the US led efforts after the Mexican Currency Crisis (also known as the Tequila Crisis) of 1994-1995 for the world's financial regulators to cooperate more closely on regulatory reform. Amid a crisis of confidence in the country's currency, massive capital flight prompted the US-led G7 to push for an enhanced role for the IMF as well as the establishment of a new emergency financing mechanism[100]. Mexico later received a US$50 billion bailout through the IMF. Thus there is a pattern in which the US-led G7 or the G20, following crises that affect US interests, pushes for greater regulatory cooperation and a role for the IMF in resolving the crisis of the day. The evolution of the G7 to G20 in 1999 as the effective global steering committee for international financial reform was the result of recognition that some emerging markets in particular were exposed to external economic and political forces, but also recognition of the need to prevent future crises[101]. The US interests at the time related to not just promoting stability in the global financial system for the good of global economies but its own business interests. The US was keen to play a role in shaping the way emerging markets were reformed to improve the stability of those markets and secure its global financial and economic interests.

Further, just as the financial crisis of 2007-09 led to closer US and EU cooperation to develop and implement a regulatory reform agenda internationally, the Asian Financial

97 G7 Finance Ministers, 1999, *op. cit.*
98 Edison, Hali and Warnock, Francis E. (2003), "Cross-Border Listings, Capital Controls and Equity Flows to Emerging Markets", IMF Working Paper WP/03/236, Washington DC, December, at http://www.imf.org/external/pubs/ft/wp/2003/wp03236.pdf, viewed 12 June 2013.
99 Godfrey, Simon (2013), "Emerging Market Equities: Does Faster Growth Translate into Higher Returns?", white paper, BNP Paribas, Paris, June, at http://www.bnpparibas-ip.com/publications/documents/other/IP/documentlist/white-paper/emerging-market-equities-does-faster-growth-translate-into-higher-returns.pdf, viewed 27 July 2014.
100 Porter, Tony (2000), "The G-7, the Financial Stability Forum, the G-20, and the Politics of International Financial Regulation", paper prepared for the International Studies Association Annual Meeting Los Angeles, California, Wednesday March 15, 2000; G7 Finance Ministers (1995), "G7 Halifax Summit Communiqué", 16 June, at http://www.library.utoronto.ca/g7/summit/1995halifax/communique/index.html, , viewed 20 October 2013.
101 Beeson, Mark and Bell, Stephen (2009), "The G-20 and International Economic Governance: Hegemony, Collectivism, or Both?", *Global Governance*, Vol. 15, No. 1.

Crisis a decade earlier also prompted greater US-EU cooperation. While the crisis began in East Asia in 1997, it spilled over into Brazil and the rest of Latin America and affected US and European banks, among other financial institutions. It delivered a strong message to the west that its financial markets were interdependent and intimately affected by crisis in emerging markets. The speed of financial transactions and the increasingly complex and often cross-border nature of many financial instruments meant national regulatory authorities found it increasingly difficult to achieve their goals unilaterally[102].

Subsequently the US and the EU signed the Transatlantic Economic Partnership (TEP) after the US-EU Summit in London in May 1998. The agreement committed the two to both bilateral cooperation as well as cooperation in multilateral fora[103]. A major focus of the agreement's provisions for multilateral cooperation was cooperation at the World Trade Organization; however, the agreement subsequently saw US and EU regulators also collaborate more closely on their agenda to reform and coordinate financial standards globally as well.

## The Maintenance of Club Governance

There was a further benefit to the US and the EU in taking the US-EU regulatory agenda to the world stage. It allowed both to maintain the smaller "club-like" environment of financial standards-setting in the international arena — or what scholars have referred to as the "club governance" as manifested in the G7, the G8 and the G20[104]. It allowed the US and EU to lead the reform of international financial governance. The Financial Stability Board's new tasks meant it had effectively become a coordinator of global financial standards[105]. At the same time it was also given the ability to establish its own policies, including for example the "Principles for Sound Compensation Practices and their Implementation Standards" that were developed in the lead up to the London G20 Summit. These functions gave it a unique and powerful position in international financial governance to shape the global governance landscape. It also, however, meant the international financial governance reform agenda would effectively be steered by a restricted group of central bankers, regulators and finance ministers, the US and a handful of existing standards-settings bodies.

The structure of the now-Financial Stability Board is complex but prior to the London Summit of April 2009 the organisation included representatives of the authorities

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102 Simmons, *op. cit.*, pp.589-620.
103 US Mission to the EU, "Transatlantic Economic Partnership Agreement", 9 November 1998, at http://useu.usmission.gov/transatlantic_economic_partnership.html, viewed 5 August 2014.
104 Tsingou, Eleni (2014), "Club Governance and the Making of Global Financial Rules", *Review of International Political Economy*, 19 March.
105 Griffith-Jones, Stephany; Helleiner, Eric; Woods, Ngaire (eds) (2010), "The Financial Stability Board: An Effective Fourth Pillar of Global Economic Governance?", The Centre for International Governance Innovation, Waterloo, Canada, June, at https://www.cigionline.org/sites/default/files/FSB%20special%20report_2.pdf, viewed 26 October 2013.

responsible for maintaining financial stability from the G7 countries, plus Australia, Singapore, the Netherlands and Hong Kong and Singapore. Several standards setting bodies and international organisations also had seats[106]. There are no hard and fast rules about the number of seats, with the participating countries having between one and three representatives[107]. Those with three representatives tend to be those from G7 and BRIC countries and these countries also send a financial services regulator, usually covering the banking, insurance and securities. After the summit the membership was widened to include the G20 countries but the organisation's membership remained elite.

The Financial Stability Board's decision-making is also complex although major decisions are taken at a plenary meeting that operates on the basis of consensus. The requirement for consensus means that decisions can be reached only where consensus is reached[108]. Further the organisation's membership rules mean that those countries with the greatest combined political and economic weight dominate when it comes to input[109]. This means the US and European countries have greater input than countries with less economic clout in the world economy. Given that the EU member states coordinate their positions on matters in international organisations in which they are represented, it also means that the US and the EU lead the consensus process.

Scholars have examined groupings such as the G20, arguing they exert "atmospheric influence", influence the "medium- or short-term agenda" and affect "micro-policy research"[110]. The development of financial standards by smaller groups of nations naturally tends to reinforce the interests of the parties involved — and marginalises those not involved. The G20 decision to give the Financial Stability Board a strengthened role in international financial governance and affirm the mandate for the existing standards bodies reinforced the role of the US and the EU as leaders in the international financial environment. It confirmed the power balance that has existed between the developed

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[106] Prior to the London G20 Summit of April 2009 the then-Financial Stability Forum had 42 members, including (in addition to the Chairperson, who was appointed in a personal capacity) three representatives of each G7 member country (whether they were a finance minister, a representative of the central bank and a representative from the main supervisory authority), as well as a representative of the Reserve Bank of Australia and the central banks of the Netherlands, Hong Kong and Singapore. In addition the IMF had two representatives, the World Bank two, the OECD one, the BIS one and two representatives of each of the following institutions: the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The International Accounting Standards Board (IASB) had one representative as did the two expert committees of the world's central banks, namely the Committee on the Global Financial System and the Committee on Payment and Settlement Systems. Since the summit the organization has been comprised of the national authorities responsible for maintaining financial stability (finance ministers, central banks and/or market supervisory authorities) of the following countries: Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Japan, Korea, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the UK, the US and the EU (where the later is represented by the European Central Bank and European Commission). In addition, various global standard-setting bodies have seats, namely the Basel Committee on Banking Supervision, the Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS), the International Association of Insurance Supervisors (IAIS), the International Accounting Standards Board (IASB) and the International Organisation of Securities Commissions (IOSCO). Further, the international institutions, the Bank for International Settlements (BIS), the IMF, the World Bank and the OECD also have seats.

[107] Donnelly, *op. cit.*

[108] *Ibid.*

[109] *Ibid.*

[110] Tsingou, Eleni (2003), "Transnational Policy Communities and Financial Governance: The Role of Private Actors in Derivatives Regulation", CSGR Working Paper No. 111/03 January, CORE, Milton Keynes, at http://core.ac.uk/download/pdf/106033.pdf, viewed 14 November 2014 .

economies (the "rule-makers") and the middle or under-developed countries (the "rule-takers")[111]. This outcome confirms criticisms that influences in the G20 are limited to the wealthier nations. This outcome is not as multilateral and inclusive as if the role of coordination of international financial standards and policy development had been given to an organisation like the OECD for example.

## The Maintenance of an Opt-Out

At the same time the non-binding nature of the existing standards bodies' rules and the Financial Stability Board guidelines allowed the US and the EU to maintain their effective opt-out of regulatory cooperation. Any form of governance comprises much more than institutions, it also involves norms, values, standards, rules and practices — both formal and informal[112]. Most of the rules that form global financial governance are based on soft law instruments, including standards, framework agreements, model laws, memoranda of understanding, non-binding recommendations, opinions, action plans, best practice guidelines and principles.

Many of these have been developed and promulgated by transnational networks and other non-government actors, although they have also been developed and promoted on a transgovernmental level by regulators. Notable among these have been US regulators, who have reflected the overall US preference for voluntary standards, guidelines and codes instead of harder more compelling forms of governance such as treaties for example[113]. The EU has been one of the greatest promoters of soft law throughout the European integration process[114]. At the same time its prolific use of such instruments has helped diffuse soft law throughout global financial regulation[115].

An attraction of soft law instruments is that they are not legally binding between states or regulators, so do not require ratification by legislatures. They also provide flexibility in terms of implementation at domestic level. Snyder describes soft law as "rules of conduct which in principle have no legally binding force but which nevertheless may have practical effects"[116]. This has led to criticisms that such instruments represent a regulatory "second best" that lacks the credible commitment needed in international co-operation and inevitably lead to regulation cherry-picking[117]. At the same time they have the effect of setting standards, consolidating norms and diffusing values that facilitate convergence of

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[111] Beeson, Bell, *op. cit.*
[112] Weiss, *op. cit.*, p.31.
[113] Chey, Hyoung-Kyu (2007), "Do Markets Enhance Convergence on International Standards? The Case of Financial Regulation", *Regulation and Governance*, Vol. 1, pp.295–311.
[114] Snyder, Francis (1994), "Soft Law and Institutional Practice in the European Community", in Martin, Stephen (ed.), *The Construction of Europe*, Kluwer Academic Publishers Dordrecht.
[115] Newman, Abraham and Bach, David (2014), "The European Union as Hardening Agent: Soft Law and the Diffusion of Global Financial Regulation", *Journal of European Public Policy*, Vol. 21, No. 3, pp.430-452.
[116] Snyder, *op. cit.*
[117] Newman, Bach, *op. cit.*, pp.430-452.

national laws. Another of the US preferences has been to rely on private sector actors to develop and implement codes and guidelines established by the standards bodies. Historically the US preference for soft law has tended to be pitched against continental Europe and Japan, both of which have favoured more heavy-handed initiatives[118].

The US has been notable in its frequent reluctance for its industry practices to be reviewed by external agencies[119]. For example the US refused to participate in the IMF and World Bank Financial Assessment Program when the Bush Administration was elected in 2000[120]. The US has kept its options open since, choosing sometimes to follow global rules and initiatives and sometimes not. There are several examples of how the US has used its weight to effectively block international financial governance proposals. In 1992 negotiations over appropriate capital requirements for any firm conducting a securities business seemed to be going well, with IOSCO optimistic a final agreement could be reached at a forthcoming meeting.

When it became apparent that agreement among IOSCO participating countries was feasible, the SEC surprised many involved in the negotiations by opposing the requirements saying the stand set was "dangerously low" and that IOSCO should be a "clearing house of ideas" and not a rule maker. IOSCO subsequently abandoned the proposal. The maintenance of a soft law environment where the rules are non-binding has allowed the most influential parties to the process such as the US to maintain an effective opt-out. Various tougher measures to enforce international financial governance have been proposed in recent years, such as Eichengreen's call in 2009 for a World Financial Organization with the power to impose sanctions[121], but such ideas have failed to progress in the absence of US support.

Similarly, despite hopes the G20 summits in Washington in November 2008 and London in April 2009 would lead to a "New Bretton Woods" international financial architecture the outcome was a firm reinforcement of the existing institutional arrangements that have allowed the US and EU to enjoy a high degree of influence[122]. Even the UK proposed "a new Bretton Woods" before the G20 Summit in London to build "a new international financial architecture for the years ahead"[123]. However, the outcome was that G20 governments firmly kept the existing institutional framework. Such reinforcement should not have been a surprise. There were calls for a "new financial architecture" in the wake of

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[118] Helleiner, Eric and Pagliari, Stefano (2009), "Towards a New Bretton Woods? The First G20 Leaders Summit and the Regulation of Global Finance", *New Political Economy*, Vol. 14, No. 2, June.
[119] Walter, Norbert (2000), "The New Financial Architecture for the Global Economy", in Kaiser, Karl; Kirton, John J.; Daniels, Joseph P. (eds), *Shaping a New International Financial System*, Ashgate, London; Financial Crisis Inquiry Commission, 2011, *op. cit.*, p.423
[120] Helleiner, Eric (2010b), *op. cit.*
[121] Eichengreen, Barry (2009), "Out of the Box: Thoughts about the International Financial Architecture", IMF Working Paper WP/09/116, Washington DC, May, at http://www.nber.org/papers/w2193.pdf, viewed September 2014.
[122] Helleiner, 2010a, *op. cit.*, pp.619-636.
[123] Peacock, Mike and Ginsberg, Jodie (2008), "Brown Calls for New 'Bretton Woods' Meeting", *Reuters*, 13 October 2008, at http://uk.reuters.com/article/2008/10/13/uk-financial-brown-idUKTRE49C2HV20081013?sp=true, viewed 1 May 2014.

the Asian Financial Crisis in 1997-99 as well[124]. While that crisis did lead to the creation of the G20 and the formation of the Financial Stability Forum, the global financial governance architecture has remained largely intact ever since.

The global financial governance regime remains based on non-binding rules that guide and facilitate private actor behaviour rather than compel it through harder legislative approaches. Indeed after the G20 Summit in London the Financial Stability Board decided to promote compliance not with detailed rules, but with a limited number of broad principles promoted by other bodies, such as the BCBS, the IAIS and IOSCO. This "principles-based" approach to international coordination and harmonisation gives participating states much greater policy breathing space[125]. It effectively allows the largest players, notably the US and the EU, to avoid the implementation of rules if suits them to do so.

## The G20 Reinforces the Neoliberal Agenda

The promotion of preferences for non-binding softer instruments and the preference for private-actor self-regulation benefits the leading states in other ways. Such preferences form part of a model of what has been coined "regulatory neoliberalism" that is based on the (idealised) Anglo-American experience[126]. Such preferences can lead to problems of accountability, regulatory capture and regulatory arbitrage. In the US for example the weak domestic regulatory environment had allowed financial firms to effectively pick their preferred regulators in what became "a race to the weakest supervision"[127]. These problems were among those that were fundamental to the causes of the financial crisis in the first place, as discussed above.

Such preferences have been fundamental to US-EU cooperation around regulatory cooperation since the milestone Transatlantic Declaration on EC-US Relations in 1990. Both sides to the agreement committed to "promote market principles"[128] while the follow-up New Transatlantic Agenda adopted in 1995 saw both sides pledge to strengthen regulatory cooperation by merely "encouraging" regulatory agencies to give "a high priority to cooperation" with their respective transatlantic counterparts[129]. Regulatory cooperation was just one part of these agreements that also embarked on a broader mission to integrate the transatlantic economies, or what Pollack and Shaffer refer to as the broader "neoliberal project of transatlantic product and financial market

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[124] Beeson, Bell, *op. cit.*, pp.67-86.
[125] Helleiner, 2010a *op. cit.*, pp.619–636.
[126] Helleiner, Eric (2010c), "The Financial Stability Board and International Standards", The Centre for International Governance Innovation, Ontario, Canada, CIGI G20 Papers, No. 1, June.
[127] Financial Crisis Inquiry Commission, 2011, *op. cit.*
[128] European External Action Service, "Transatlantic Declaration on EC-US Relations, 1990", at http://eeas.europa.eu/us/docs/trans_declaration_90_en.pdf, viewed 11 September 2012.
[129] US Mission to the EU (1995), "New Transatlantic Agenda Declaration", at http://useu.usmission.gov/new_transatlantic_agenda.html, viewed 17 October 2013.

integration"[130]. It is notable that these agreements were heavily influenced by the preferences of powerful transnational actors.

One of the forums that facilitated private sector involvement was the Transatlantic Business Dialogue (TABD), established by the US and the EU in 1995 as the official business policy advisory group and which today represents 70 companies. Also closely involved in drafting the latter agreement was AmCham, which today represents of 158 US companies from a broad range of sectors. Officials of the US Mission to the EU regularly participate in its committees. The TABD and AmCham's respective agendas were distinctly orientated towards trade liberalisation, regulatory relaxation and business-orientated investment policies.

The Transatlantic Economic Partnership (TEP) signed after the US-EU Summit in London in May 1998 further consolidated neoliberal preferences by seeking "additional liberalisation" in sectors and areas of common interest for EU and US services suppliers, seeking "the highest possible level of liberalisation" in international multilateral trade forums and removing barriers to trade through regulatory cooperation[131]. It also maintained a wide open door to business interests, specifically noting that in improving private interest and government authority access to each side's regulatory procedures the US and EU would take into account the requirements of "all other interested parties, notably the TABD"[132]. Thus the US-EU alliance that formed the basis for cooperation in the midst of the financial crisis was heavily imbued with neoliberal values that had the effect of facilitating business interests.

Such a system of preferences has also underpinned the G20 process from the start[133]. It is not a surprise then that "neoliberal regulatory" preferences that support US and EU interests can also be found in what Newman and Posner refer to as a broader international financial governance "template" of international financial governance[134]. They argue such preferences are fundamental characteristics of the financial governance regime. The EU and the US have shaped the international regulatory environment not only by uploading their domestic regulatory templates to international standards but also by extending their own laws to third jurisdictions, through extraterritoriality provisions for example (such as the Dodd-Frank Act in the US)[135].

The dominance of US and European roles in global regulatory forums and international financial institutions has also however contributed significantly to the entrenchment of

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130 Pollack, Mark A. and Shaffer, Gregory (2001), *Transatlantic Governance in the Global Economy*, Rowman & Littlefield, Maryland US, p.4
131 US Mission to the EU, *op. cit.*
132 *Ibid.*
133 Helleiner, 2010c, *op. cit.*
134 Newman, Posner, *op. cit.*
135 Quaglia, 2014, *Oxford Scholarship Online*, *op. cit.*; Posner, Elliot and Véron, Nicholas (2010), "The EU and Financial Regulation: Power Without Purpose?", *Journal of European Public Policy*, Vol. 17, No. 3, pp.400-15.

neoliberal ideas in other parts of the world[136]. The US-EU cooperative relationship on developing an international reform agenda and the joint efforts to take this agenda to a broader international stage carried with it a series of neoliberal regulatory preferences that had the effect of reinforcing US and EU interests.

It is important to note that US and EU preferences are not only reflected in their own rules. They are also imbued in global stands that are subsequently transposed into the domestic regulatory regimes of states throughout the world. Some standards such as the Basel Accords for example are incorporated into countries' domestic law — sometimes largely unamended. For instance more than 120 countries had endorsed the Basel Core Principles for Effective Banking Supervision and its Methodology and as of August 2013 and 14 countries had implemented the latest final Basel III-based capital regulations[137].

In respect to other standards, such as the IOSCO guidelines, national regulatory authorities frequently exert considerable "compliance pressure" on industry to implement global standards as part of the drive for "best practice"[138]. Market forces can also play a significant role in encouraging or requiring private financial institutions to embrace international financial standards by penalising those institutions that do not use them[139]. Any international governance tends to reinforce the preferences of the dominant actors and this is even more the case when a governance system does not reflect the preferences of a wide range of actors — as is the case with international financial governance. Such preferences end up effectively "embedded" into the domestic law of multiple countries. This effectively translates into a benefit for the leading actors involved and in respect to international financial governance this means the US and the EU.

## Conclusion: More of the Same

As the financial crisis erupted in mid to late 2008, the US and the EU quickly realised a need to cooperate on developing a common position on international financial regulation. The objective was to not only promote stability in the international financial markets but also to ensure that US and EU financial institutions — and the interdependent US and EU economies — would not be disadvantaged by tightening regulations in their own markets only.

In the lead up to the G20 Summit in London, there were differences of opinion between the US and the EU over the priorities for reform, but the US and EU agreed in key issues

[136]Beeson, Mark and Bell, Stephen (2009), "The G-20 and International Economic Governance: Hegemony, Collectivism, or Both?", *Global Governance*, Vol. 15, No. 1.
[137] Basel Committee on Banking Supervision (2013), "Report to G20 Finance Ministers and Central Bank Governors on monitoring implementation of Basel III regulatory reform", Basel, April, at http://www.bis.org/publ/bcbs249.pdf, viewed 12 September 2014
[138] Chey, Hyoung-Kyu, *op. cit.*, pp.295-311.
[139] Simmons, *op. cit.*, pp. 589-620.

of common concern. The outcome of the G20 summits in 2008 and 2009 was for existing international standards bodies to hasten their work to tighten global financial standards on a range of issues — insurance, accounting, securities and banking. Further, the then-Financial Stability Forum, a global financial standards body established in 1999 to implement the financial work of the G20, was given a strengthened mandate to coordinate as well as promote the reformed standards globally. Ambitious hopes that the G20 process around the financial crisis would "update the global financial rules" were dashed after the US and the EU formed a powerful alliance[140]. An important outcome of the US-EU alliance was that their common interests in the international financial governance environment were protected and reinforced.

Despite the official G20 Leaders' Summit in London in April 2009 famously pronouncing that "a global crisis" requires a "global solution"[141], the G20 process in the early days of the financial crisis can more accurately be described as a transatlantic solution to a mostly transatlantic crisis. It was a solution designed to protect the highly connected US-EU financial and banking markets and highly interdependent transatlantic economies.

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[140] "IMF Official: G20 Summit Unlikely to be Bretton Woods II", *Xinhua News*, 14 November 2008.
[141] G20 (2009), "Declaration on Strengthening the Financial System (Annex to London Summit Communiqué)", London, 2 April, at http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf, viewed 16 July 2014; US Treasury (2009), "Prepared Statement by Treasury Secretary Tim Geithner at the G-20 Finance Ministers and Central Bank Governors Meeting", Horsham, UK, 14 March, at http://www.treasury.gov/press-center/press-releases/Pages/tg56.aspx, viewed 12 January 2015.

# CHAPTER 7: DISCUSSION: THE APPLICABILITY OF INTERDEPENDENCE TO POST-GFC US/EU COOPERATION

At the time the financial crisis descended across the Atlantic, the US and the EU financial markets and their respective economies were highly interconnected and highly interdependent. This chapter assesses the core question considered by thesis, namely to what extent did economic and financial interdependence play a role in shaping US and EU cooperation on financial regulatory reform during the financial crisis.

To do this, as discussed in the chapter that outlined the methodological approach to this thesis, it considers how well the interdependent relationship was one characterised as a situation of complex interdependence as outlined by Keohane and Nye. It also considers to what extent the political processes involved in the policy cooperation between the US and the EU on several case study issue-areas accord with the political processes expected in situations of complex interdependence.

In short this chapter argues that economic and financial interdependencies played a very significant role in motivating, driving and shaping US and EU decisions to coordinate financial regulatory reform in their respective markets, as well as in the international arena. Such cooperation was intended to not only protect their own respective economic and financial interests but also their *common* interests. It argues that US and EU economic and financial interdependencies were so important for these interests that both sides saw it as imperative that they closely coordinate their response to the financial crisis. It concludes by highlighting the theoretical and policy implications of this key finding.

## The State of Interdependence

It may seem self-evident but a first question to ask is whether the relationship between the US and the EU can be characterised as interdependence according to the definition put forward by Keohane and Nye. As discussed earlier, interdependence as a general concept can be broadly defined as a state of "mutual dependence", characterised by multiple channels of interconnectedness, multiple issue-areas and a reduced role for military in pursuing a state's policy goals, as measured by both the sensitivity of one state to another's policy as well as its vulnerability[1].

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[1] *Ibid*, p. 8.

At the outset of the worst of the financial crisis in late 2008 there were a range of channels between the US and the EU for coordination of financial markets and economic policy across the Atlantic. At the intergovernmental level, the G20 meetings and regular US-EU summits highlighted the policy cooperative process at the heads of state level on numerous financial regulatory issues — accounting standards, the regulation of credit ratings agencies and reform to credit default swaps regulations among other areas. In addition, there were regular and multi-channel relationships between the various US regulatory agencies (notably the US Treasury and the Securities and Exchange Commission), as well as the principal regulatory body in the EU, the European Commission. There were also regular dialogues between the US Congress and the European Parliament.

At the transgovernmental level, the primary forum to discuss regulatory matters was the Financial Markets Regulatory Dialogue, where regulatory agencies engaged in policy cooperation on a bilateral basis, with additional forums including multilateral international financial governance organisations such as the Basel Committee on Banking Supervision (BCBS), the then-Financial Stability Forum (FSF), the International Organization of Securities Commissions (IOSCO) among others. There were also ongoing discussions with other EU agencies, notably the European Central Bank (especially as the crisis gathered pace). These channels were supplemented by dialogues between US regulators and the regulators of key individual member states, such as Germany, France and the United Kingdom. The financial and economic ties between the US and the EU took many forms: political and economic policy ties, trade and foreign direct investment, business ties and financial system linkages.

The broad relationship, as well as the discussions on policy matters, crossed a range of issue-areas — from the hastening of the review banking prudential standards, reform of derivatives trading, the regulation of credit rating agencies, the convergence of accounting standards and even the possible introduction of a financial transactions tax. The entire relationship was in fact notable for its regulatory complexity and the inter-relationships between some of these issues. At the same time, the relationship not only had a bilateral dimension but a multilateral dimension, with discussion on a role for the IMF in responding to and helping to resolve the crisis going forward taking place in the context of international forums such as the G20 and within organisations, such as the IMF board and committees.

It is clear that financial reform was an area where military force as a policy tool played a minimal role as an instrument of state policy. It was diplomacy and policy cooperation that were employed to achieve policy outcomes. While the multi-channel and multi-issue relationship between the US and the EU fits well with concepts of complex interdependence, the other features of an interdependent relationship, according to political science understandings of the term, involve both sensitivity and vulnerability to policy change in each other's markets[2].

Under ideas of complex interdependence, mutual dependencies do not need to be evenly balanced and in fact, Keohane and Nye suggest, asymmetries are "most likely to provide sources of influence for actors in their dealings with one another"[3]. Chapters 1 and 4 highlight how the EU had a greater financial exposure to the US than the US had to the EU, with the EU also having a *disproportionately* greater exposure to the US than it had to China and Japan for example[4]. This helps explains why a largely US-originated financial crisis had such a significant impact on European banks.

Both the US and the EU were also highly vulnerable to policy change in each other's markets. Various aspects of the banking and financial markets on both sides of the Atlantic at the time were either unregulated or poorly regulated. Credit ratings agencies were subject to minimal regulations, as was the trading in complex derivative products like the earlier discussed collateralised debt obligations. Trading in other and financial instruments that also generated huge losses, notably credit defaults swaps, was also poorly regulated. There were big differences in US and EU regulatory standards on banking prudential standards, insurance rules, hedge funds and over-the-counter securities trading among other areas. The banking and financial market supervisory frameworks in the US and the EU also were vastly different. In some cases rules were duplicated and some had extraterritorial implications for US and/or EU companies. Some firms were subject to conflicting accounting rules and were able to exploit regulatory differences.

As comments by the US Treasury, Securities and Exchange Commission and European Commission representatives highlight in earlier chapters, both sides realised early on in the crisis that failing to coordinate a response could have devastating effects for both sides' financial markets. Not only this, but both sides realised that failing to create a "level playing field" in the international financial system, as US Treasury Secretary Timothy Geithner put it, would lead to regulatory arbitrage[5], with financial services firms moving to lesser regulated world markets and thereby placing both the US and the EU markets at a significant advantage globally. This was a particular concern for the US and the UK, the world's two biggest financial centres. As chapter 4 highlights, this had already been a problem particularly in relation to trading of credit defaults swaps, an area subject to

[2] *Ibid*, pp. 11-19.
[3] *Ibid*, pp. 10-11.
[4] Schoenmaker, Dirk and Wagnerz, Wolf (2013), "Cross-Border Banking in Europe and Financial Stability", *International Finance*, Vol. 16, No. 1.
[5] US Whitehouse (2009), "Press Briefing by Treasury Secretary Timothy Geithner on the G20 Leaders Meetings", G20 Pittsburgh Summit, 24 September, at http://www.whitehouse.gov/the_press_office/Press-Briefing-by-Treasury-Secretary-Geithner-on-the-G20-Meetings, viewed 11 November 2014.

significant market speculation, where firms exploited price differences between the US and the EU markets.

The US and the EU were in summary extremely sensitive to and vulnerable to changes in each other's markets. Vast differences in regulation in these areas could significantly underline their own positions as well as the position of multinational banks and financial firms that traded on both sides of the Atlantic. This made cooperation, coordination and even convergence of policy on a range of financial regulatory reforms initiatives — including accounting standards, the regulation of credit default swaps, the regulation of credit ratings agencies and a role of the IMF and the FSB in coordinating a response to the crisis — absolutely imperative from the point of view of US and EU regulators and policy-makers.

## The Political Processes of Financial Regulatory Reform

The second (and key) question to consider is to what extent economic and financial interdependence played a role in shaping US and EU cooperation on financial regulatory reform during the financial crisis. As outlined in the literature review earlier, the political processes observed in situations of complex interdependence are: a wide variation in the goals of actors involved; the use of issue-specific instruments of state policy and the greater role for transgovernmental and transnational actors in policy formation; the diffusion of power and consequent complexity for states in linking issues; a greater importance of agenda-setting as a result of the lack of hierarchy of issues involved; and a greater role for international organisations characterised by coalition-formation[6].

### *Goals of Actors*

The first political process that is expected in situations of complex interdependence is that the goals of states vary widely by issue area. At the same time, transgovernmental politics makes goals difficult to define, with actors pursuing their own goals. In an absence of a hierarchy of issues, actors pursue their own goals, with bureaucracies pursuing their own concerns and transnational actors introducing different goals into various groups of issues[7]. This political process was typical in all the case studies examined. At the intergovernmental level, both the US and the EU initially presented competing goals in the G20 process as well as at EU summits, with representatives of US regulatory agencies and the main body in the EU responsible for financial regulation, the European Commission, also presenting competing positions in their bilateral negotiations.

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[6] Keohane, Robert O. and Nye, Joseph, S. (1977), *Power and Interdependence: World Politics in Transition*, Little, Brown and Company, Boston & Toronto, p. 37.
[7] Keohane, Robert O. and Nye, Joseph, S. (1977), Power and Interdependence: World Politics in Transition, Little, Brown and Company, Boston & Toronto, p. 30.

At the outset of policy coordination in the G20 process, the US and the EU held notably diametrically opposed positions on accounting standards reform, with efforts to converge US and EU standards stalling significantly in the years leading up to the crisis. The process of "mutual recognition" between the SEC and the Commission, formalised on 1 February 2008, did little to progress actual convergence until the collapse of Lehman Brothers in September 2008 put the spotlight on the weaknesses of the US GAAP standards.

At the time of the G20 Leaders' Summit in Washington in November 2008, as discussed earlier, there were still big differences in definitions, procedures and risk categorisation and matters relating to the valuation of securities, particularly complex products, disclosure standards for off-balance sheet vehicles and the disclosure to the market of holdings of complex financial instruments. US and EU negotiations that followed were characterised by give and take on the part of both the US and the EU to reach a compromise.

Similarly discussions over the regulation of credit default swaps and credit ratings agencies — two largely unregulated areas prior to the financial crisis — highlight the vastly different positions by the US and the EU on these issues. While the US and the EU agreed that CDS trading should be conducting through clearinghouses, there were divergent opinions on which derivatives trading houses. As discussed earlier, the discomfort held by European regulators with the idea of only US-operated clearinghouses managed CDS trading in the EU saw a clear preference on their part for "at least one European solution"[8].

Discussion was at the same time complicated by issues of defining CDS products and issues of reform timing. Further, differences of opinion on common standards, procedures, capital requirements, data privacy and contractual matters[9], highlight the wide variety of goals concerned. On credit ratings agencies the EU wanted a more aggressive approach to regulation whereas the US preferred an industry-based regulatory code of conduct to prevail. In respect to the role for the IMF in tackling the crisis and the FSB's role for implementing and coordinating reforms agreed to in the G20 process, the US and the EU again presented a wide variety of positions.

At the same time industry had its own sets of goals, complicating the policy process even further. US banks and financial services firms preferred to see an international regulatory

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[8] *Ibid.*

[9] O'Connor, Paul (2009), "CCP for CDS User Requirements", European Banking Federation presentation to the European Central Bank, 24 February, at http://www.ecb.europa.eu/events/pdf/conferences/ccp_cds/AGENDA_ITEM3_EBF.pdf?781250cc48b9eaaeb515e09771474f8d, viewed 16 October 2014.

environment that matched the regulatory environment in the US. European banks on the other hand were focused on maintaining their own liquidity and preserving their independence amid a raft of new regulatory initiatives and a wave of anti-industry sentiment.

At the same time the goals of some actors merged with others. During the crisis, industry was seen as a valuable partner in the policy process, providing technical advice to the Commission and other EU institutions on financial services[10]. This was also the case during the period leading up to the financial crisis, with the industry enjoying easy access to EU policymakers, particularly at the Commission[11]. It was in this environment that the Transatlantic Business Dialogue (TABD) was established in 1995, specifically to give business a voice in the transatlantic regulatory negotiations "at the highest levels"[12].

The TABD, a regular forum that brings together company executives and high-level government officials on both sides of the Atlantic, continued to play an important role in setting the agenda for transatlantic discussions. In this respect the goals of actors became not only diverse and multi-issue in nature, but also blurred with reduced distinction between the goals of the state and the goals on industry. Such variety in goals was typical of the political processes described in situations of complex interdependence.

*Policy Instruments, Transgovernmental and Transnational Actors*

The second political process expected in complex interdependence is the use of issue-specific instruments of state policy and the greater role for transgovernmental and transnational actors in policy formation. The nearer a situation is to complex interdependence, the more the outcomes of political bargaining are likely to be shaped by transnational relations[13]. This was distinctly the case in respect to the bargaining that took place between the US and the EU over important financial regulation reforms areas during the financial crisis. The process was characterised not just by intergovernmental discussion but also by US and EU regulatory agencies. In fact the lead actors were not representatives of the US State Department but the SEC and the US Treasury on the US side, and representatives at the European Commission on the EU side. This is in line with observations by scholars such as Anne-Marie Slaughter who argues that

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[10] Interview conducted by Peter O'Shea with DG MARKT representative, European Commission, Brussels, 14 June 2014.
[11] Interview conducted by Peter O'Shea with former government relations representative at a leading London international bank, Paris, 7 February 2012.
[12] "Transatlantic Council, "About the TABD", at http://www.transatlanticbusiness.org/tabd/about-tabd/, viewed 2 December 2014; also see Eric Philippart and Pascaline Winand (eds) (2001), Ever Closer Partnership: Policymaking in US-EU Relations, PIE Peter Lang, Brussels; and Baldwin et al. *op. cit.*
[13] Keohane, Robert O. and Nye, Joseph, S. (1977), Power and Interdependence: World Politics in Transition, Little, Brown and Company, Boston & Toronto, p. 34.

transgovernmental actors have become the "new diplomats" — actors that dominate in a "new world order" of transgovernmental policymaking[14].

The discussion on important areas in the Financial Markets Regulatory Dialogue was supplemented by frequent and intense discussion on a bilateral basis. As discussed earlier, "not a day went by without some contact of some nature" between the Commission and US officials on reform proposals, according to one US official[15]. As the agenda for reform widened amid the worsening financial crisis and as the US and EU's respective reform plans became firmer, the relations between US and EU representatives intensified. As described by a US Treasury representative, the relationship between US regulators and EU officials became "extremely deep"[16]. With the nature of some reform areas highly complex, industry was also drawn into the policy bargaining process. US regulators, including the SEC's plans to regulate credit ratings agencies, consulted industry far and wide, with the SEC acknowledging that "significant revisions" had been made to its proposals based on the comments received from industry during a consultation process in late 2008 and early 2009[17]. As discussed earlier, meetings with the TABD, also increased in frequency during 2009 as plans for financial reform progressed.

The prominent role given to transgovernmental and transnational actors in policy discussion played a critical role in shaping policy outcomes. It is this role that Keohane and Nye observed in situations of complex interdependence. The close level of engagement between transgovernmental actors, however, was not just merely for convenience: it was part of a concerted strategy by the respective states (the US and the EU) to shape regulatory outcomes. It was, as Keohane and Nye put it, an effort to manipulate situations of interdependence to effect state policy.

*Issue Linkages*

The diffusion of power in situations of complex interdependence, between government, transgovernmental and transnational actors, makes it much more difficult for states to link one issue clearly to another. In situations where one state is stronger than another, military force allows that state to have the clear upper hand. However, in situations of complex interdependence, the ability of a state to link one issue to another, even if they are stronger, is diminished when they are sensitive and vulnerable to another state's policy change.

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14 Slaughter, Anne-Marie (1997), "The Real New World Order", *Foreign Affairs*, Vol. 76, No. 5, September/October.
15 *Ibid.*
16 Interview conducted by Peter O'Shea with US Treasury representative, Brussels, 14 February 2014.
17 Chung, Joanna and Van Duyn, Aline (2009), "US Rating Agencies Escape Overhaul", *Financial Times*, 22 July.

In the complex area of regulating the large and systemically important banking and financial markets, issues become inter-related and complex. The regulation of credit default swaps affect both banks and securities firms. The regulation of credit ratings agencies affects both as well, while the use of accounting standards affects not only banks and securities firms, but also every business operating in the market. They also affect the way firms on one side of the Atlantic with investments in the other operate. The issues are complex and the more interdependent economies are, the greater the difficulties in controlling policy outcomes. The US and the EU found controlling outcomes in the financial crisis extraordinarily difficult, especially given the autonomy accorded to the financial markets in their respective economies.

*Agenda-Setting*

Under complex interdependence, the lack of a hierarchy of issues and the existence of multiple issues means agenda-setting politics becomes much more important[18]. As discussed in the literature review, in situations of interdependence, an agenda is affected by changes in the distribution of power resources within issue areas; the status of international regimes; changes in the importance of transnational actors; linkages from other issues and politicisation as a result of rising sensitivity of interdependence. The complexity of issues involved in reforming financial regulation during the crisis and the divergence in regulation on both sides of the Atlantic meant coordinating the agenda at an international level was seen as critical, especially in the early stages. It was for this reason that both the US and the EU turned to the G20 as the primary forum to set the international agenda.

Under complex interdependence international and domestic issues significantly shape a state's agenda. As discussed earlier, both the US and the EU had on their respective agendas addressing short-term problems in the financial markets, like buoying banking market liquidity, maintaining financial system stability and inspiring market confidence, but also other critical longer-term regulatory reform issues. Chapter 3 highlighted how the US led in setting the agenda for the very first G20 Leader's Summit in Washington in November 2008, playing a pivotal role in the policy cooperation process. As the host of a G20 meeting always sets the agenda for discussion, it was the US that had the ability to take the lead. As relayed earlier, one European Commission representative involved in the G20 meetings suggested that the US "dominated" the agenda in "most respects"[19].

[18] Keohane, Robert O. and Nye, Joseph, S. (1977), Power and Interdependence: World Politics in Transition, Little, Brown and Company, Boston & Toronto, p. 31.
[19] Interview conducted by Peter O'Shea with representative of the G20 Sherpa Office, European Commission, Brussels, 25 July 2012.

In situations of complex interdependence issues are politicised, with agitation and controversy raising an issue to the top of the agenda[20]. This was particularly notable in respect to the agenda for financial reform in the early days of the crisis in the lead up to the G20 Leaders' Summit in London in April 2009. British Prime Minister Gordon Brown was particularly active in lobbying other G20 nations to support his proposed agenda for reform, visiting Washington in early March and then Brazil shortly after in the lead up to the G20 Leaders' Summit in London scheduled for April 2009. As discussed in chapter 3, one of his advisers was quoted in one media report saying the prime minister had been "working the phones very hard" to obtain a consensus view prior to the summit[21].

Given that G20 decisions are reached by consensus, not by a vote, and therefore a majority consensus decision prevails, the US and the UK saw taking the lead on international financial reform at an early stage and in a cooperative manner as critical to their common interests. As Cobb, Roger an Elder describe, an agenda "serves to structure subsequent policy choices"[22]. Some issues are progressed and others do not progress at all. This was precisely the political process of choice in the early days of financial reform in the financial crisis.

## The Role of International Organisations

Finally in situations of complex interdependence international organisations take on a greater role and act as forums for stronger states to control outcomes but also as arenas for political action by weak states. The result is extensive coalition-formation among states and actors and, as such, a state's ability to mobilise votes is an important political resource. The existence of multiple channels raises the importance of multilateral forums to shape policy outcomes and the stronger states will tend to forum shop among international organisations in an effort to shape compel policy outcomes[23].

It is for this reason that the US and the EU, which as discussed in earlier chapters have financial and voting control in the IMF between them, chose that organisation in an effort to control policy directions. The US and the EU (and key EU member states that have seats on the IMF) collaborated closely on forming a common position for the IMF's role in the solution to the financial crisis. The IMF, whose significance as a financier for states with balance of payments problems and as a shaper of global economic governance had been fading somewhat prior to the crisis, was seen as a good choice for the US and the

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[20] Keohane, Robert O. and Nye, Joseph, S. (1977), *Power and Interdependence: World Politics in Transition*, Little, Brown and Company, Boston & Toronto, p. 33.

[21] "France Threatens Walkout Before G20 Summit", *Agence France Presse*, 31 March 2009.

[22] Cobb, Roger and Elder, Charles (1983), *Participation in American Politics: The Dynamics of Agenda-Building*, The Johns Hopkins University Press, Baltimore, p. 171.

[23] As discussed in chapter 2, notwithstanding debate over whether the EU is a "state", for the purposes of examining the effects of interdependence upon political decision-making (rather than decisions of "states" per se), the decisions taken by the EU are the type normally taken by a state.

EU. Both saw giving the IMF an important role as a way to shape broader financial regulatory outcomes in the global economy and serve their respective interests.

The same can be said for the US and EU position on the FSB, which they both saw as an effective organisation to coordinate the implementation of the financial regulatory reforms the US and the EU had themselves been central in steering. The high levels of interdependence between the US and the EU was a potent motivation for the US and the EU to cooperate on a common multilateral agenda, with the result that the FSB was given a greater mandate after the G20 Leaders' Summit in London.

As a direct result, the new FSB has since taken on a role to implement financial rules in the global economy. It is inherently politicised and its ability to effectively monitor and act on risk is somewhat shaped by the political dominance of the US and the EU. With its greater mandate to coordinate the development and implementation of financial regulations with the various international standards bodies, FSB decisions are taken on the basis of consensus. The elevated role for the IMF and the FSB after the financial crisis — driven significantly by the priorities of the US and the EU working in concert — highlights how US and EU interdependence not only affected outcomes in their respective economies but also the shape of international financial governance.

### An Assessment in Summary

In summary it is clear that the political processes involved in the case studies examined — the reform of accounting standards, the regulation of credit ratings agencies, the regulation of credit default swaps, a boosted role for the IMF in the post-financial crisis response and a greater mandate for the FSB — all accord closely to the political processes expected in Keohane and Nye's conception of complex interdependence. The findings of this research show that in all cases state behavior (in the case of the US and the EU) are in line with the behavior of interdependent states. The below table summarises the findings graphically, highlighting that the political bargaining processes in the case studies examined are in line with other situations of interdependence observed by Keohane and Nye.

**Table 10: Summary: An Assessment of Political Processes in Case Studies Examined**

| Political Process | Accounting standards | Regulation of credit ratings agencies | Regulation of credit default swaps | A boosted role for the IMF | A greater mandate for the FSB |
|---|---|---|---|---|---|
| A wide variation of the goals of actors | ✔ | ✔ | ✔ | ✔ | ✔ |
| The use of issue-specific instruments of state policy and a greater role for transgovernmental an transnational actors | ✔ | ✔ | ✔ | ✔ | ✔ |
| The diffusion of power and consequent difficulties for states in linking issues | ✔ | ✔ | ✔ | ✔ | ✔ |
| A greater importance of agenda-setting as a result of the lack of hierarchy of issues involved | ✔ | ✔ | ✔ | ✔ | ✔ |
| An elevated role for international organisations characterised by coalition-formation | ✔ | ✔ | ✔ | ✔ | ✔ |

In summary, the political processes involved in the US and EU discussions on a range of reforms bore the hallmarks of the political processes described by Keohane and Nye in situations of complex interdependence. Economic and financial interdependencies were significant motivators, drivers and shapers of policy cooperation in all areas examined — accounting standards, the regulation of credit ratings agencies, the regulation of credit default swaps and a boosted role for the IMF and the FSB.

**Theoretical Implications: The Role of Interdependence in Political Decisions**

Interdependence has long been viewed as a facilitator of political and economic change and it is apparent that it was an important facilitator of greater policy convergence between the US and the EU in the financial crisis of 2007-09. The findings of this research show that interdependence was a significant factor in the decisions on the part of policy-makers to coordinate their policy response to the effects of the global financial crisis. This was the case both in the immediate response to the crisis (for example decisions to establish an agenda for financial reform) and the ongoing response (for example decisions to continue to coordinate policy in several issue-areas). As outlined in earlier chapters, there was wide recognition by policymakers at all levels of government in the US and the EU — the US Administration, the US Treasury, the Securities and Exchange Commission, EU member state governments and the European Commission — on the need to cooperate arising directly from the interdependent nature of the US and EU financial markets and economies.

In line with Keohane and Nye's assertion that interdependence exists where there are costly "effects" (and not just interconnectedness)[24], the potential costs incurred by *not* coordinating banking and financial markets reform was a potent motivator for US and EU politicians and regulators to cooperate and accommodate each other's respective positions. The prospect of a further massive hit to their respective financial markets and economies by not coordinating their response made cooperation imperative. While both the US and the EU came to the table with different positions on some matters, they decided to cooperate, coordinate and accommodate each other's positions on particular financial reform matters to protect their own and common interests *because of* the highly interdependent nature of their respective markets.

This is important because, as discussed in the chapter that introduces the theoretical framework of this thesis, establishing causal factors plays an important role in political science. The finding that high levels of financial and economic interdependence between the US and the EU were a cause of the decision to intensify policy cooperation not only provides insight into the way policy is made, but it also has implications for conceptions of state autonomy. As evidenced in interviews and policy documents discussed earlier in this thesis, the US and the EU were effectively forced to cooperate and coordinate policy to such an extent that the convergence of financial regulatory reform accelerated.

## Policy Implications

The ability of highly interdependent states (in this case the US and the EU) to maintain policy autonomy in situations of high interdependence consequently also has several policy implications. Firstly, reduced autonomy impresses the need for ongoing and consistent policy coordination. The US and the US have for some time sought to create a transatlantic marketplace. In the course of doing so they have created a form of transatlantic governance.

[24] Keohane, Robert and Nye, Joseph S. (1977), Power and Interdependence: World Politics in Transition, Little Brown and Company, Boston, pp. 8-9.

Yet despite an established pattern of intergovernmental and transgovernmental cooperation between the US and the EU, as highlighted in earlier chapters, there were big gaps in financial regulation on both sides of the Atlantic at the time the financial crisis emerged. Credit ratings agencies were subject to minimal rules in the US and, as most agencies were based in the US, they were only required in the EU to adhere to IOSCO's voluntary international code of conduct. The trading of many complex derivatives like collateralised debt obligations and credit default swaps were also largely unregulated on both sides. The regulatory standards around mortgage origination were poor on both sides, allowing mortgage originators to extend loans to many people unable to afford the loans at the best of times, let alone the worst of times. In addition there were vast differences in regulatory standards between the US and the EU. Accounting standards, banking prudential standards, insurance rules and over-the-counter securities trading rules were different. The banking and financial market supervisory frameworks in the US and the EU were different, leaving the way open for firms to exploit differences, leading to the duplication of rules and extraterritorial implications for companies.

This situation served to create a gap in transatlantic financial governance. The findings in this thesis impress the need to close financial governance gaps in some of these areas (notably accounting standards for example, which remain a point of contention, despite progress on the issue).

There are significant risks of failing to close these gaps. It is apparent from the experience of the financial crisis of 2007-09 that, just as in previous financial crises, interdependence can facilitate contagion quickly. The dangers of contagion delivered a valuable and expensive lesson learned in that crisis. What started as a banking and currency crisis in Thailand, quickly generated panic in Korea and Indonesia and led to a lack of confidence in other emerging markets like Brazil and Russia. High levels of banking and financial markets connectedness led directly to losses in other emerging economies. International financial contracts, including currency forwards and futures and interbank credits, as well as external loans to the private sector became tangled up in the crisis[25].

As Nye & Donohue in their discussion on the connectedness of and interdependence between global markets argue, there are ample precedents. The collapse of stock markets on "Black Monday" on Wall Street in 1929 and the collapse of Austria's Credit Anstalt bank in 1930 also triggered worldwide financial crisis and depression[26].

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[25] Barkbu, Bergljot; Eichengreen, Barry; and Mody, Ashoka (2012), "Financial Crises and the Multilateral Response: What the Historical Record Shows", *Journal of International Economics*, Vol. 88, p. 422.

[26] Nye, Joseph S. and Donohue, John (2000), Governance in a Globalizing World, Brookings Institution Press, Washington DC.

As the UK's Financial Services Authority argues in its report on its international agenda: "The financial crisis has shown that no country can regulate their financial market and firms in isolation. The globally interlinked financial markets mean that, not only is there a need to develop and implement common regulatory standards that enhance financial stability, market confidence and consumer protection, but also interact regularly on firm-specific issues to ensure coordinated and effective day-to-day supervision of globally active firms."[27]

**The Maintenance of Political Will**

Another policy implication is that there are dangers in allowing US and EU policy cooperation on financial regulatory reform to ebb and flow, as has been the case in previous decades. The existence of high levels of interdependence does not necessarily mean there will be greater policy convergence. Instead policy cooperation can come in waves — as historical scholarly accounts of the relationship between the US and the EU have already shown[28]. US and EU interdependence has been building, as chapter 1 shows, progressively over time in the post-WWII period. Historical accounts of the relationship between the US and the EU have shown that enthusiasm on the part of the US and the EU tends to ebb and flow, despite high levels of market connectedness and interdependence.

The enthusiasm for regulatory cooperation and regulatory convergence between the US and the EU has waned over the decades, dependent on the political priorities of the administrations in the US and the EU at the time. As discussed earlier, successive US administrations since the 1990s have approached the idea of closer economic relations and regulatory cooperation with the EU (and the European Community before it) with varying degrees of commitment. The US commitment to closer US-EU relations has ranged from enthusiasm to caution and even suspicion on both sides[29].

Accordingly the successes of the various intergovernmental efforts to facilitate transatlantic regulatory cooperation at transgovernmental level have been mixed. The Transatlantic Declaration on EC-US Relations in 1990 was a mixed bag of successes, with some degree of regulatory policy convergence and information sharing taking place[30]. The

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27 UK Financial Services Authority (2010), "The FSA's International Agenda", London, October 2010, at http://www.fsa.gov.uk/pubs/international/agenda.pdf, viewed 13 July 2013.
28 Winand, Pascaline and Philippart, Eric (2001), "From Equal Partnership to the New Transatlantic Agenda: Enduring Features and Successive Forms of the US-EU Relationship", in Philippart, Eric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policymaking in US-EU Relations*, PIE Peter Lang, Brussels; McGuire, Steven and Smith, Michael (2008), "European Integration and the United States", in McGuire, Steven and Smith, Michael (eds), *The European Union and the United States: Competition and Convergence in the Global Arena*, Palgrave McMillan, Hampshire and New York.
29 Philippart, Éric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policymaking in US-EU Relations*, PIE Peter Lang, Brussels
30 *Ibid*, p. 47.

New Transatlantic Agenda and the associated Joint Action Plan in 1995 designed to improve regulatory cooperation also had its critics.

As also discussed in earlier chapters, some policy cooperation between the US and the EU in the years leading up to the start of the financial crisis in 2007 was successful while in other cases it did not lead to convergent financial regulation. In fact such was the slow progress on critical matters of financial regulatory cooperation — credit ratings agency reform, derivatives regulation, accounting standards convergence among many areas — that the poorly regulated environment was a significant contributor to one of the most severe financial crises since the Great Depression.

The European commitment has also varied over time. One "clear lesson" of the Transatlantic Declaration was that the quality of consultations varies according to the commitment to US-EU relations of the EU presidency at the time[31]. After the 1994 elections in France, Gardner argues, the French Government delayed or blocked all efforts to build on US-EU relations at EU level over Washington's *droit de regard* (or right of review) over European affairs[32]. Such variations in political enthusiasm for international cooperation are not unusual, with international cooperation in the G7 for example observed as "a variable, not a constant"[33]. In any case the lack of sustained efforts to build a stable regulatory framework that reflects the level of interdependence and appropriately addresses systemic risks of regulatory convergence (and also divergence) constitutes a serious risk to the viability of closer transatlantic economic relations.

Essentially, despite efforts to coordinate policy, best efforts can fail and often do. While there have been some successes in the regulatory cooperative framework between the US and the EU in the past, there have also been some failures. Devuyst argues that antitrust regulators in the US and the EU with similar values and similar legal authority had been successful in the 1990s in forging a cooperative framework that had been "fast, flexible and effective[34]. However, Pollack found that the efforts to build an effective transgovernmental framework for food safety regulation between the US and the EU in the 1990s had largely failed[35].

Past failures and ongoing regulatory differences highlight the importance of maintaining a consistent financial regulatory convergence dialogue, in which policymakers responsible for regulatory discussion have a sufficient level of independence from the whims of

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[31] Gardner, *op. cit.*, pp. 89-90.
[32] *Ibid.*
[33] Philippart, Eric (2001), "Assessing, Evaluating and Explaining the Output of US-EU Relations", in Philippart, Eric and Winand, Pascaline (eds) (2001), *Ever Closer Partnership: Policymaking in US-EU Relations*, PIE Peter Lang, Brussels.
[34] Devuyst, Youri (2001), "Transatlantic Competition Relations", in *Transatlantic Governance in the Global Economy* (2001), Pollack, Mark A. and Schaffer, Gregory C (eds), Rowman & Littlefield, Maryland.
[35] Pollack, Mark A. and Shaffer, Gregory C. (2009), "When Cooperation Fails: The International Law and Politics of Genetically Modified Foods", *Oxford Scholarship Online.*

political leadership to maintain the impetus. This can be complex but a lack of process consistency can serve to widen the governance gaps even further.

### A Robust Financial Markets Regulatory Dialogue

Further, as a transgovernmental forum comprised primarily of regulators, the FMRD is particularly prone to the risk of lapses in political will for sustained regulatory convergence. Should enthusiasm for transatlantic regulatory cooperation wane at the highest political levels in the future, it is highly possible that the impetus for cooperation in lower level forums such as the FMRD could also lapse again.

Certainly since the financial crisis the US and the EU have embarked on an aggressive program of financial markets regulatory reform — both in their own markets and, as discussed elsewhere, in the international environment. They have updated regulations on accounting standards, credit ratings agencies, over-the-counter derivatives trading, clearing systems, banking prudential standards, banker remuneration standards, hedge funds, credit default swaps among other policy areas. In addition both the US and the US have reformed their banking and financial markets supervisory arrangements. Yet at the same time significant regulatory differences still remain. There are big differences between accounting standards, differences in the ways risk for systemically important banks are addressed, and regulations on sound banking compensation practices, among other areas[36].

The Deputy Assistant Secretary for International Monetary and Financial Policy in the US Treasury Department notes that the FMRD is an "informal dialogue" not a negotiation. Both the US and the EU "respect the independence of regulatory authorities", recognise that the regulatory structures in the US and EU are different and focus on promoting the common objective of facilitating global financial stability and finding practical solutions "if possible"[37]. Thus regulatory cooperation remains desirable, not imperative.

### Lessons about the Risk of Contagion

Additionally given that it was a financial crisis that intensified the need for cooperation, there are questions around the risk that future financial contagions pose to the integrity of the transatlantic financial markets. Just as previous financial and economic crises — including the European economic crisis in the 1970s that reinvigorated the goal for

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[36] House of Lords European Union Committee (2015), "The Post-Crisis EU Financial Regulatory Framework: Do the Pieces Fit?", 5th Report of Session 2014-15, London, at http://www.publications.parliament.uk/pa/ld201415/ldselect/ldeucom/103/103.pdf, viewed 10 February 2015; Claessens, Kodres, *op. cit.*

[37] Sobel, Mark (2008), "Deputy Assistant Secretary Mark Remarks", speech at Conference on US-EU Regulatory Cooperation, US Chamber of Commerce, Washington DC, 30 April, at http://www.treasury.gov/press-center/press-releases/Pages/hp946.aspx, viewed 5 September 2014.

economic and monetary union in the EU that was discussed in chapter 1 — likewise the financial crisis of 2007-09 drove greater transatlantic policy and political integration. Political action was directly inspired in the US and the EU — the two markets most immediately affected by the developing financial crisis in 2007 — by the acute disturbances to their respective (and interdependent) financial markets. It was crisis that led the US and the EU to protect their respective (and common) interests and crisis that motivated them to negotiate and coordinate financial regulatory reforms for their own markets and the broader international regulatory environment. As Peters notes, "crises can move some issues onto the agenda and through the entire policy process within days" whereas some advocates have to wait years to have their issue considered for the first time[38].

There is scholarly consensus on two broad types of financial system systemic risk: common shocks and contagion[39]. It was the latter category that interdependence played an important role. The financial crisis of 2007-09 was caused by both factors indigenous to the US and the EU markets respectively (rapid asset price growth, poor lending practices, poor regulation, financial innovation, global imbalances and regulatory capture etc.) and financial contagion. In the former category, on both sides of the Atlantic there had been a prolonged period of low interest rates, an extended period of rapid credit expansion and an unsustainable rise in housing prices among other factors.

In the contagion category, in the US there had been an "explosion" in risky subprime lending and securitisation, widespread egregious and predatory lending practices, dramatic increases in household mortgage debt, and exponential growth in financial firms' trading activities, unregulated derivatives, and short-term "repo" lending markets"[40]. Also, just as US banks had traded in high levels of speculative or risky financial product areas, such as Collateralised Debt Obligations and Credit Default Swaps, European banks had also traded extensively in such product areas quite independently to US banks. At the same time, many of the banks involved were transnational with extensive operations on both sides of the Atlantic.

In the EU there had been other problems too, including inadequate banking supervision, ineffective early warning mechanisms throughout the EU for macroprudential risks and the failure of European banks to separate their retail banking from wholesale banking

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38 Peters, Guy (2011), "Agenda-Setting in the European Union", in Richardson, Jeremy (ed.), *European Union: Power and Policy-Making* (2nd edn.), Routledge, London, p. 61.

39 Trapp, Monika and Wewel, Claudio (2013), "Transatlantic Systemic Risk", *Journal of Banking and Finance*, Vol. 37, No. 11.

40 Financial Crisis Inquiry Commission (2011), "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States", Washington DC, January, at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, viewed 13 October 2012.

markets[41]. The exposure of US banks to Europe and European banks to the US meant that financial losses in one market quickly became contagious and affected the other, in some cases simultaneously. European banks were highly exposed to losses that US banks incurred in the early days of the financial crisis in 2007 and vice versa. In addition, banks from EU member states were highly exposed to the banking sectors of the member states that were most vulnerable to sovereign debt problems. In the EU, the lack of the sharing of debt by EU member states and the absence of a fiscal transfer mechanism meant the weaker states that had been unable to access funding from the financial markets at the height of the crisis were vulnerable. Many were forced to turn to the EU and the IMF for funding.

The former issues could have led to market problems in one market independently of the other; however, contagion facilitated the transfer of problems in one market to another. The connectedness of the EU's banking and financial markets to the US and vice versa created a level of interdependence where one market was highly dependent on the other for its stability and viability. As Keohane and Nye point out, interdependence between societies is not new. But what is new in the modern age is the "virtual erasing of costs" of communications in the information age[42]. This observation was made in 1998 when the government, business and consumer use of the internet was only starting to take off. Global financial markets — including the transatlantic markets — have become even more connected since then, with few barriers to global banking. Just as interdependence has played a role in inspiring and driving closer integration in the EU for example, US-EU interdependence was a potent force in motivating policy cooperation and convergence during the financial crisis of 2007-09.

Despite the known risks of contagion, policymakers and regulators frequently ignored the warning signs. One of the stark features of many of history's financial crises is the "this-time-is-different" syndrome[43]. Policymakers frequently ignore warning signs and argue that developments appear to be different from those in earlier times. Even though policymakers like Federal Reserve Chairman Ben Bernanke and his predecessor Alan Greenspan claimed to have missed the warnings signs of the financial crisis[44], there were others who foresaw the risks and warning signs well ahead of time.

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[41] The High Level Group on Financial Supervision in the EU" (2009), "Report", chaired by Jacques de Larosière, Brussels, 25 February, at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf, viewed 1 September 2011; Interview with representative of the Directorate for Financial and Enterprise Affairs at the OECD, Paris, 22 June 2012.

[42] Keohane, Robert and Nye, Joseph S. (1998), "Power and Interdependence in the Information Age", *Foreign Affairs*, September/October, Vol. 77, No. 5, p. 83.

[43] Claessens, Stijn and Kodres, Laura (2014), "The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions", International Monetary Fund, Washington DC, March, WP/14/46, at http://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf, viewed August 2014.

[44] Miller, Rich and Zumbrun, Josh (2010), "Greenspan Takes Issue With Yellen on Fed's Role in House Bubble", *Bloomberg*, 27 March, at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a2REwRrZXTzk, viewed 7 September 2014.

The US Financial Crisis Inquiry Commission in 2011 found house prices were inflated, lending practices had spun out of control and too many homeowners were taking on mortgages and debt they could ill afford years before the crisis erupted in 2007[45]. The managing director of PIMCO, one of the nation's largest money management firms, told the inquiry he saw early warnings in 2005, while the former SEC chairman told the inquiry that "everybody in the whole world knew that the mortgage bubble was there"[46]. Instead many regulators and policymakers — particularly those in the US (and including those at the IMF) — either turned a blind eye or were unable to see the risks. The IMF's own independent evaluation office found the IMF failed to properly warn about the risks growing in the global economy because of a "groupthink" mentality or "intellectual capture"[47]. IMF staff, who were largely in accordance with the "light-touch" US and UK financial regulatory approach, agreed with the US and UK assessments that a financial crisis in large advanced economies was unlikely.

## Conclusion

This chapter took a similar approach to Keohane and Nye's analysis of complex interdependence, considering the political processes that took place in several issue-areas — accounting standards, the regulation of credit ratings agencies, the regulation of credit default swaps and a boosted role for the IMF and FSB. It considered whether the political processes involved in US-EU negotiation on policy cooperation were in line with the political processes expected in situations of Keohane and Nye's theory of complex interdependence. Faced with a collapse in world trade even faster than that in the 1930s, the US and the EU needed little persuasion of the necessity for coordinated policy response. The global financial crisis had extended the pool of actors to across the Atlantic by necessity. As Mervyn King, the governor of the Bank of England at the time noted, it was "hard to imagine a solution that does not involve actions in more than one country"[48]. In cooperating closely at all stages of the policy process in respect to accounting standards reform, the regulation of credit ratings agencies, the regulation of credit default swaps and a boosted role for the IMF in crisis resolution and a greater mandate for the FSB in reforming global financial governance, the EU and the US became intimately involved in each others' policy-making processes.

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45 Financial Crisis Inquiry Commission, 2011, *op. cit.*
46 Richard Breeden, former chairman of the Securities and Exchange Commission, as quoted in Financial Crisis Inquiry Commission (2011), "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States", Washington DC, January, p. 4.
47 International Monetary Fund, "IMF Performance in the Run-Up to the Financial and Economic Crisis IMF Surveillance in 2004–07", at http://www.ieo-imf.org/ieo/pages/ieohome.aspx, viewed 1 September 2014.
48 Mervyn King public address, 18 October 2011.

# CONCLUSION

Since the post-WW2 Bretton Woods Conference established a new financial governance landscape for the global economy, Europe has become much more closely integrated with its transatlantic counterpart, the United States. US support for the nascent European integration project and the funding ties that bound the US and Europe through the Marshall Plan set the US and European economies on a path to developing one of the "closest and most complex of all relationships" in contemporary international relations[1].

After progressively deepening political, security, trade and financial ties over successive decades, at the time the financial crisis hit Europe in 2008, the level of financial and economic interdependence between the US and the EU was highly developed. The speed with which financial transactions took place across the Atlantic and the complex inter-related nature of the US and European banking markets meant financial crisis on one side of the Atlantic had a virtual immediately impact on the other.

This thesis found that high levels of interdependence, developed and fostered over several decades by the US and the EU, created conditions that when financial crisis came, US and EU respective interests — and their common interests — were threatened to such an extent that greater policy cooperation was absolutely imperative. The result was not only a deeper relationship, intensification of the transgovernmental decision-making policy process, but also greater policy convergence in several financial regulatory issue-areas.

In fact the financial crisis reinvigorated the process of policy convergence in several areas of financial markets regulation, after a hiatus in the years leading up the crisis. Several years after the launch of the New Transatlantic Agenda in 1995, an agreement that sought to deepen and consolidate cooperation in a range of areas, there had been only what Pollack describes as "shallow integration"[2]. The agreement had been a "noteworthy experiment in international governance" but largely ineffectual in achieving the deeper transatlantic economic integration it sought[3]. Further, the Financial Markets Regulatory Dialogue (FMRD), a forum for regulatory discussion established after the EU-US Summit in Washington in May 2002, had only been marginally successful by the time the financial crisis emerged in 2007. As the Commission noted, the transatlantic financial regulatory reform agenda became "increasingly convergent" as the crisis progressed and cooperation

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[1] Eric Philippart & Pascaline Winand (2001), Ever Closer Partnership: Policy-Making in US-EU Relations, PIE Peter Lang, Brussels.
[2] Pollack, Mark A. (2005), "The New Transatlantic Agenda at Ten: Reflections on an Experiment in International Governance", *Journal of Common Market Studies*, Vol. 43, Issue 5.
[3] *Ibid.*

intensified[4]. It took financial crisis to drive the US and the EU down a path of intense policy cooperation towards eventual greater policy convergence in key financial reform issue-areas.

This research shows how, in an effort to save, protect and reinforce their interests in each other's markets and around the world, the US and the EU developed a coordinated agenda for bilateral and international financial regulatory reform. The policy objective for the transatlantic marketplace continued to be achieving regulatory "equivalence" on matters of financial regulatory reform — a strategy employed less effectively in the decade leading up to the crisis. Internationally, an important consideration was that, faced with the necessity to raise standards and reform regulations in their own markets, there was a need to avoid regulatory arbitrage. The aim was to mitigate the risk of banks and financial institutions exploiting regulatory differences and move to lesser-regulated markets in other parts of the world. This led the US and EU to intensify efforts to raise financial standards globally to ensure global financial stability, protect their respective and common interests and undermine the danger that they would be placed at a competitive disadvantage in a changing world.

The findings show there are several important theoretical and policy implications of this cooperation. It shows how financial markets and economic interdependencies had a direct causal effect on the decisions by regulators and policy-makers to cooperate on policy reform, with the result that these interdependencies led to the convergence of financial regulatory accelerated *because of* the highly interdependent nature of their respective markets. US and EU financial and economic interdependencies were found to have constrained the agenda of political actors and diminished their alternatives — in line with observations by scholars such as Rosamond[5]. In other words, as long as highly interdependent relationships exist, policy autonomy will be compromised. Further, these interdependencies changed the preferences of domestic actors and shifted power resources — an observation mirroring that of Fioretos[6].

As discussed in the previous chapter, this has important political implications for policy-makers. It highlights the importance of closing existing gaps in transatlantic financial governance, including in the areas of accounting standards, banking prudential standards, insurance rules and banking and financial market supervisory arrangements. It highlights how important maintaining political will remain in a relationship punctuated by ebbs and flows in policy cooperation in this area between the US and the EU in recent decades. Notably it impresses the importance of maintaining a robust regular and effective dialogue

[4] European Commission, DG Internal Market, *op. cit.*
[5] Rosamond, Ben (2000), Theories of European Integration, Palgrave, Houndmills/New York, p. 13.
[6] Karl-Orfeo Fioretos (1997), "The Anatomy of Autonomy: Interdependence, Domestic Balances of Power, and European Integration", *Review of International Studies*, Vol. 23, p. 294.

in the Financial Markets Regulatory Dialogue, the main forum for transgovernmental discussion on financial regulatory policy matters. Finally it highlights the risks of financial contagion in the transatlantic market. As US Treasury Deputy Assistant Secretary Mark Sobel put it in April 2008, while financial market regulation is undertaken at the national level "one nation's actions clearly don't stop at the water's edge"[7]. Where financial and economic interdependencies are high, closely coordinated policy cooperation and high degrees of policy convergence is now imperative.

[7] Sobel, Mark (2008), "Deputy Assistant Secretary Mark Remarks", speech at Conference on US-EU Regulatory Cooperation, US Chamber of Commerce, Washington DC, 30 April, at http://www.treasury.gov/press-center/press-releases/Pages/hp946.aspx, viewed 5 September 2014.

# SCHEDULE OF INTERVIEWS

The following is a schedule of interviews conducted for this research. In accordance with Monash University Ethics Committee rules, interviews have been kept anonymous for reasons of confidentiality. Records of all interviews have been retained.

| | | |
|---|---|---|
| Interview with former government relations representative at a leading London international bank | Paris | 7 February 2012 |
| Interview with member of the UK's EU Economic and Financial Affairs Sub-Committee | London | 24 May 2012 |
| Interview with DG MARKT representative, European Commission | Brussels (phone) | 14 June 2012 |
| Interview with representative of the Directorate for Financial and Enterprise Affairs at the OECD | Paris | 22 June 2012 |
| Interview with former economic adviser to the president of the European Commission | Brussels | 13 July 2012 |
| Interview with representative of the G20 Sherpa Office, European Commission | Brussels | 25 July 2012 |
| Interview with representative of a EU member state Permanent Representation office | Brussels | 25 July 2012 |
| Interview with media adviser to member of the European Parliament involved in economic and monetary affairs | Vienna (by phone) | 15 August 2012 |
| Interview with representative of Ireland's Department of Finance | Dublin (by phone) | 10 February 2014 |
| Interview with representative of a leading EU think-tank | Brussels | 11 February 2014 |
| Interview with DG ECOFIN representative, European Commission | Brussels | 11 February 2014 |
| Interview with representative of the German Marshall Fund | Paris | 13 February 2014 |
| Interview with representative of the International Monetary Fund | Brussels | 14 February 2014 |
| Interview with representative of the US Treasury | Brussels | 14 February 2014 |
| Interview with representative of the EU's member state IMF coordination office | Brussels | 21 February 2014 |
| Interview with former Latvian government minister | Canberra | 11 September 2014 |

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