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Regulating finance after the crisis: Unveiling the different dynamics of the regulatory process

1. Introduction

It is now widely recognized that regulatory failures have contributed to the onset of the global financial crisis. (1) Redressing these failures has thus been a key policy priority since the onset of the crisis at both the domestic and international levels. The regulatory reforms launched in the aftermath of the crisis call upon the scholarly community to assess the causes of regulatory failures and to examine resulting change in the governance of finance in terms of the orthodoxy that underpins it and the modalities in which the transition is taking place (Coen & Roberts 2012).

The articles in this special issue take up these research challenges by investigating the factors that help explain variations in the post-crisis regulatory processes and thus shedding light on an often understudied aspect in the regulation literature: the pattern of regulatory change. Established studies have provided many and important insights on the specific mechanisms that drive regulatory change, from market structures to domestic institutions and regulatory ideas (Braithwaite 2008; Braithwaite & Drahos 2000; Cohen & Héritier 2005; Jabko 2004; Levi-Faur 2005; Thatcher & Coen 2008; Vogel 1996). They have also focused on the actors and the resources used in shaping regulatory policies (Héritier, Knill & Mingers 1996; Knill & Lenschow 2000; Posner 2009). In contrast, the variety in the dynamics of regulatory change(s) has not been studied systematically and therefore its nature, causes, and sources remain somewhat obscure. The purpose of this special issue is to fill this gap by focusing on the different dynamics of the regulatory process in the issue area of finance in the aftermath of the global financial crisis.

In particular, the empirical cases that follow examine different dynamics of regulatory change and explain them in light of the interaction between institutional factors and the activity of change agents and veto players involved in the regulatory reform process. The institutional factors, which are explained at greater length below, relate to: the resources that change agents and veto players possess; the characteristics and boundaries of the regulatory setting; and the meaning attributed to regulatory ideas and the degree of consensus surrounding them. Focusing on the interaction between these factors and the activity of the actors involved in the regulatory process, we engage with the debate on agency and structure, and on macro and micro changes in the study

of social and political institutions (Blyth *et al.* 2011). (3) Indeed, although the agency of actors is critical to the regulatory process, in particular that of technical bureaucracies (Vogel 1996; Levi-Faur 2006), the degree of control that regulators have over the process also varies according to several institutional factors (see also Haines 2011).

We apply these insights to the study of a number of crucial cases of financial governance including the rules and arrangements that govern financial regulation, offshore financial centers and shadow banking, the financial industry's involvement in global regulatory processes, and, in linking up to the real economy, macroeconomic modeling. While these case studies do not exhaust the regulatory reform agenda, they are selected because they cover important or contentious reforms which highlight activity at various levels of governance, provide a contrast between pre and post-crisis debates, and call for a reassessment of the role and capacity of private actors and the official community. Furthermore, they provide a comparison of the dynamics of change across global finance issue areas while going beyond the usual banking/securities/insurance subsector analyses often employed when studying financial regulation (e.g. Singer 2007). Indeed, if it is true that capitalism varies not only across nations but also across sectors (Levi-Faur 2006), we also want to know whether significant differences exist among these subsectors- (4)

The special issue's approach to regulatory change reveals three overall conclusions in addition to many specific insights. First, the essays collectively demonstrate the limits of explanations that link regulatory developments to a common set of exogenous forces or market pressures. A market-based explanation may well account for the elements of convergence among the sectors that have been the object of reform. For instance, it can explain the common rhetoric of re-regulation adopted in many different sectors of financial governance. However, a market-based explanation cannot address the most remarkable variance in how financial rules and arrangements have been transformed since the start of the crisis. Facing similar challenges, government officials, technocrats, and the private sector have nevertheless responded differently across subsectors. Hence, we submit, what explains the variation in the dynamics of the regulatory process is not exogenous but *endogenous* to the subsector and issue area that is the object of transformation. (5)

Second, although the financial sector offers special evidence of incremental over rapid and radical change (Moschella & Tsingou 2013), incremental change does not necessarily mean minor change. Rather, as the most recent literature on institutional change has amply demonstrated (Mahoney & Thelen 2010; Streeck & Thelen 2005), a slow process of change may also lead to more profound changes in policy outcomes, especially if we do not necessarily conflate the temporal dimension of change with the substantive dimension (Baker in this issue). Furthermore, whereas the conventional wisdom holds that incremental changes are closely associated with the activity of veto players and conservative societal forces – such as financial industry groups and technocrats – the evidence in this special issue suggests that those forces that usually hinder change are not necessarily the primary factor that slows down regulatory reforms (Rixen in this issue). This means that the role actors play – be it the role of promoter of or opponent to change – cannot be determined *ex ante* but are a matter of empirical investigation.

Finally, our collective study provides some insights on the prospects for global financial governance, particularly in light of its pre-crisis emphasis on market discipline, and transnational, technical and private authority (Djelic & Sahlin-Andersson 2006; Graz & Nölke 2008). The crisis and the reactions in its aftermath, marked by political activism and calls for re-regulation, have led a number of commentators to identify a general reorientation in the philosophy that underpins global financial governance (Germain 2010, Pagliari 2012, Foot & Walter 2011, 249). (6) The argument is that the pendulum has moved away from deregulation, self-regulation and market discipline to a more assertive and interventionist role for the public sector. However, the evidence assembled in this special issue does not provide clear-cut support for these propositions. While it is true that the activity and competence of the technical and expert policy communities analyzed in the case studies that follow was initially discredited, their grip on the regulatory process has not been seriously dented (Young, Henriksen in this issue).

Before proceeding, two clarifications are in order. First, the articles in this special issue focus on the stages of rules formulation, negotiation, and decision. (7) Considering that much of the post-crisis global regulatory and economic reforms are ongoing, the articles do not analyze rule implementation, monitoring, and diffusion. Issues related to implementation, however, such as the presence of necessary organizational capacity and networks to implement a specific regulatory reform, loom large during the stages of rule formulation, negotiation, and decision too (cf. Bach

and Newman 2010): the actors involved in regulatory reform processes are aware of the potential obstacles that a specific regulation may encounter at the stage of formulation and this influences selection among regulatory options (Baker in this issue). (8)

Finally, for the purposes of this study, we adopt a broad definition of regulation. Under the rubric of “regulation” we include not only the measures adopted by governments or other public regulatory authorities but also “all mechanisms of social control,” including both state and non-state processes (Jordana & Levi-Faur 2004, p. 5; also Baldwin, Scott & Hood 1998, p. 4). The adoption of this broad definition reflects two key characteristics of global financial governance. The first is the role of private authority in defining governance rules (Graz & Nölke 2008). Specifically, the private sector plays a prominent role in the development of global financial regulation not only through its lobbying efforts (Johnson 2009) but also because private sector associations often provide the rules or help public sector regulators in the formulation and implementation of policies (Porter 2005; Tsingou 2008). The second characteristic is the soft and voluntary nature of most global financial rules (Helleiner & Pagliari 2010, p.3).

In the next section, we introduce the factors that, combined with the activity of change actors and veto players, may help account for different regulatory dynamics. Finally, we conclude by summarizing the contributions and delineating their implications for the study of financial governance and reform.

2. Explaining varieties of regulatory change

Since the early articulation of the economic theory of regulation (Stigler 1971), several factors have been identified as key in shaping domestic regulation, including market forces, interest group pressures, and ideologies (for a review, see Levi-Faur 2011). Some scholars have been cautious in attributing pride of place to one causal factor over the others, suggesting instead that some factors (market failure, democratic responsiveness and interest group pressures) together explain the main elements of a regulatory regime (Hood, Rothstein & Baldwin 2001). Others have been bolder in their quest for the causal factor of regulation, by pointing out to mechanisms such as lesson drawing (Rose 1991), the influence and support of international organizations (Henisz *et al.* 2005; Babb 2004), the legacy of past regulation (Thatcher & Coen 2008), domestic administrative

traditions and market structure (Coen & Héri-tier 2005; Vogel 1996) and regulatory ideas (Jabko 2004). Having unveiled the way in which each factor shapes regulatory regimes, these studies have provided important insights on the politics of regulatory change. Nevertheless, they have been somewhat less successful in explaining variation in the pattern of regulatory reform.

We do not suggest that existing scholarship is silent on the dynamics of regulatory change. On the contrary, the literature contributes key ideas for exploring the puzzle in our study. For instance, in his work on regulatory reform in advanced economies, Steven K. Vogel (1996, p. 23) explains the degree of regulatory change as a function of the gap between goals and capabilities, and reads the transformation in UK financial regulation in the late 1980s as an example of quick and dramatic change that virtually took place “in the space of two weeks in the autumn of 1986” (Vogel 1996, p. 93). Likewise, Christopher Way (2005) suggests that the speed with which regulatory changes occur primarily depends on the characteristics of the reforming sector. He finds that politically insecure leaders may focus on domestic financial market reforms because they generate long-term risks but short-term benefits. Important work has also been developed to account for different types of regulation in terms of stringency (Vogel 1997) and private sector organization (Newman & Bach 2004). We do find, however, that more work needs to be done in order to systematically assess differences in the processes of regulatory change.

The same shortcoming affects much of the scholarship on the transformation of global financial governance and the rules that underpin it. Although this scholarship has certainly succeeded in granting the study of global finance a distinctive research agenda, it has been somewhat less explicit in explaining what causes variation in the dynamics of international financial regulatory reform. The literature tends to focus more on questions of *who* shapes international financial rules and less on questions of *how* to account for differences in the process of rule-creation (for a review see Helleiner & Pagliari 2011; Moschella & Tsingou 2013).

In this section, we thus advance a number of propositions that encourage researchers to think more seriously and systematically about differences in regulatory change. These differences can pertain to the scope of the regulatory change as suggested by Buch-Hansen (2012, p. 6) who argues that it is possible to distinguish between shallow and deep regulatory changes. However,

they may also be linked to the process itself, giving rise to different regulatory dynamics that can be distinguished based on timing (quick or slow).

In order to account for variation in regulatory dynamics, we suggest concentrating on the relationship between the actors involved in the regulatory process and the institutional constraints these actors face. (9) In particular, we identify two distinct categories of actors that help explain processes of change in global financial regulation: change actors and veto players. The identity of these actors, we submit, is diverse: in different times and different circumstances, governments, societal interests, or transnational technocrats can play the roles of change agents and veto players. Assigning roles is therefore a matter of empirical investigation and is not defined *ex ante* in our theoretical framework.

Whereas change agents lead the process of change by being explicit advocates or discreet supporters of specific changes, veto players, in principle, aim at maintaining the status quo in order to preserve their privileges and safeguard their interests or those of their constituencies (Héritier, Knill & Mingers 1996). These actors may sustain the reproduction of existing institutions over time, vetoing or opposing change that negatively affects them (Tsebelis 2000). Although veto players generally oppose change, veto players can also expressly promote types of change. This happens when veto players realize that regulatory change is a way of maintaining their privileged position. Similarly to change agents, veto players may also pursue their cause for change more or less explicitly.

Moving from the actors to the institutional factors that are relevant to the dynamics of regulatory processes, we can identify three sets of important factors in the governance of global. The first cluster of factors focuses on the resources that change agents and veto players possess to influence the regulatory process, including information and expertise, organizational capacity, financial resources (Black 2010, p. 15) and even prestige and “esteem” (Baker in this issue). For instance, when technical knowledge on a specific regulatory issue is not well-developed or when organizational capacity to implement a specific regulatory decision is poor or absent, regulatory reform is more likely to follow a slow and incremental process. The opposite is likely to take place when regulators possess analytical purchase and implementation capacity.

Change actors and veto players also face a series of factors related to the characteristics and boundaries of the regulatory settings. These include both the number of actors involved in the regulatory process and the distribution of power among them. Indeed, regulatory sectors with numerous relevant actors are more likely to follow slower dynamics of change than is the case in sector with a more limited number of actors (c.f. Tsebelis 2000, p. 464). This hypothesis speaks to the problem of collective action (Olson 1965). Indeed, the dynamic of regulation may be hampered by the difficulties of forging collective action among the actors involved in the regulatory process, especially when competition issues are at stake (Rixen in this issue). The distribution of authority among institutions and potential turf fights over influence can also affect the process of regulatory reform. So can the distribution of power among the actors more generally, especially in state-based analyses (c.f. Drezner 2007, 28). The expectation is that when financial power is concentrated among a few states, they may exercise veto power and slow down the process of change (10). At the same time, change agents are unlikely to support reforms that significantly depart from great powers' existing rules and practices, so as to avoid the potential of a veto action.

The third set of factors investigated in the articles of this special issue relate to the role of ideas in influencing the pattern of regulatory dynamics. It is widely recognized that the presence of ideas and their content may slow down or speed up regulatory transformations (c.f. Vogel 1996, p. 264). The consensus around specific normative frameworks is also a key factor explaining patterns of financial and macroeconomic cooperation (McNamara 1998), the expectation is that the stronger the consensus, the more substantive the regulatory change will be (Baker in this issue). Furthermore, ideational changes may contribute to alter the policy-making context and, consequently, the social groups that mobilize (Young in this issue). At the same time, the institutionalization of certain economic ideas, may also delineate the parameters of potential change (Henriksen in this issue).

In the essays that follow, contributors examine the interaction of actors (change agents and veto players) with one or more of the constraining factors identified above. It is important to note, however, that these propositions are probabilistic rather than deterministic in nature: they suggest that the likelihood of a specific dynamic of regulatory change increases in the presence of

certain institutional factors, but not that regulatory dynamics will always be the same when these factors are present.

3. Conclusions

While it is too early to assess the ultimate outcome of the regulatory drive prompted by the crisis and its effects, the reform process thus far already offers a laboratory for scholars interested in regulation. Specifically, the global financial regulatory reform process has brought to the surface an interesting puzzle that is too often implicitly rather than explicitly addressed in studies of regulatory regimes: the variation in the *dynamics* of regulatory change.

The theoretical propositions developed in the preceding section aim to suggest ways in which to understand variations. While we do not claim that they can systematically account for all specific dynamics of regulatory change, we nonetheless identify them with the aim of developing a research agenda that encourages serious thinking about variation in regulatory change: how and why change can at times be quick and dramatic and in other times and other contexts, slow, gradual and incremental.

In doing so, our study sets out to make two broad contributions to the literature on regulation and regulatory change. First, it complements existing studies and approaches by alerting scholars to the variation in regulatory dynamics. Second, we aim to provide a systematic, comparative analysis of regulatory changes in global financial regulation that can usefully complement studies on domestic financial regulation. This is especially pertinent as the financial sector provides not only a textbook instance of the globalization of regulation (Braithwaite & Drahos 2000, pp. 103-104) but is also a sector where technical bureaucracies play a key role in line with most regulatory cases studied (Vogel 1996, 1997; Levi-Faur 2006).

In the first article of this issue, Andrew Baker examines the post-crisis change that is taking place in financial regulatory circles with the adoption of principles of macroprudential policy. He demonstrates that even actors that are traditionally understood and treated in analyses as preventing change (transnational bureaucracies) act instead as change agents. The rapid and radical transformation that Baker recounts in the empirical analysis can be explained by the

resources these change actors possess, especially their expertise and reputation. Their central position in the regulatory network is another crucial explanatory factor for the speedy adoption of a macroprudential agenda. In turn, the lack of specific practical ideas on macroprudential regulation explains the incremental pattern of regulatory change.

The next article by Thomas Rixen investigates the post-crisis changes that have taken place in the regulation of offshore centers and the shadow banking sector. Rixen identifies a pattern of incremental regulatory dynamics that is largely the result of the key characteristics of the regulatory context. Faced with jurisdictional competition on the one the hand, and domestic societal pressures on the other, governments have failed to develop a common position in favor of radical regulation. Rixen advances the arguments by examining the formation of regulatory preferences in some of the most important financial jurisdictions, the USA, UK, Germany and France.

The next contribution by Kevin Young investigates the role of private sector actors in the post-crisis financial governance reforms. Specifically, Young examines how private financial industry groups have adapted to the post-crisis regulatory environment in terms of their associability and advocacy strategies. Although the crisis has contributed to weaken the private sector's veto power as compared to the pre-crisis period, the article finds that the evolving regulatory environment has forced private sector groups to adapt and change by forming new alliances in order to overcome rhetoric on the negative impact of finance on the real economy. These new strategies explain the incremental nature of change as the focus has been on embracing reforms that maintain a privileged role for the private sector and affect the process by influencing the pace and timing of implementation.

The last article by Lasse Folke Henriksen moves the attention to the links between financial governance and the real economy and investigates the evolution of macroeconomic policy in a domestic setting. Specifically, Henriksen examines the cumulative incremental changes that have taken place in macroeconomic modeling in Denmark leading to major changes through progressive adjustments to macroeconomic modeling. Explaining the pattern of incrementalism, Henriksen draws attention to small changes that lead to profound transformations and in turn, delimit reform options.

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Notes

- 1 The literature on the causes of the crisis is vast and any overview is inevitably selective. Among the analyses conducted by international supervisory bodies and panels of international experts see Bank for International Settlements (2008), de Larosière (2009), Financial Services Authority (2009) and IMF (2009).
- 2 For an overview of what has been achieved in the reform of the global financial system see the IMF Global Financial Stability Report (January 2011) and the Report of the Financial Stability Board to G20 Finance Ministers and Central Bank Governors (November 2011).
- 3 On these issues, see also the contributions in Silbey (2011).
- 4 For an analysis of cross-sectoral differences in financial regulation, see also Simmons (2001).
- 5 Posner (2009) concedes that the timing and pattern of change in the six case studies he analyzes are highly dependent on the characteristics of the respective subsectors. Nevertheless, he falls short of investigating these endogenous factors by concentrating on the impact of 'policy centralization' in the EU as the main causal factor in patterns of transatlantic regulation.
- 6 For a nuanced analysis of the post-crisis reform in the hedge fund sector, see Woll (2011) who accounts for the type of reforms underway in a framework that links private subsector interests with state regulatory preferences.
- 7 Note that in early scholarly writings on the crisis, this assessment was more widely shared, based in large part to the emerging reform agenda and expectations of legislative activity. For a more sober view, see Froud *et al* (2012).
- 8 For an analysis of the different stages of global regulatory decision-making see Abbott and Snidal (2009).
- 9 Mahoney and Thelen (2010, p. 31) advance a similar point when they argue that 'the interactions between features of the political context and properties of the institutions themselves [are] critically important in explaining institutional change' and that the type of change actors and the different strategies they adopt are likely to differ in specific institutional settings.
- 10 This is likely to be the case if the few, leading states in question have conflicting preferences. Otherwise, these same states would have the capacity to act decisively with their regulatory agenda (e.g. Helleiner 1994).

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