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The Ideational Shaping of State Power and Capacity: Winning Battles but Losing the War over Bank Reform in the US and UK

This article extends a recent line of research arguing that the power and capacity of political actors (including states) is not just the product of particular fixed attributes but is also the outcome of political *relations* between key interlocutors, including ideational relations. State elites, especially government leaders, have persisted with a mindset that still values the economic centrality of a large and complex banking sector. This way of thinking has conditioned the relationship between, on the one hand, the US and UK governments and, on the other, Wall Street and the City of London and has led to a form of ‘dysfunctional embeddedness’. Government leaders may have been able to win high-profile policy victories over the banking sector in the post-crisis period, but in accepting a large, complex and constantly evolving financial system with high levels of systemic risk, they have unwittingly placed themselves at a continuing disadvantage in the regulatory arena.

THIS ARTICLE EXTENDS A RECENT LINE OF RESEARCH ARGUING THAT the power and capacity of political actors (including states) is not just the product of particular fixed attributes but is also the outcome of political *relations* between key interlocutors, including ideational relations. Bell (2012) has argued that the ideas of state policymakers can shape the structural power of business interests. Bell and Hindmoor (2014) apply this approach to argue that the ideas held by state leaders in the UK helped them successfully confront structural power threats by UK banks in a battle over reform. This article continues this research to probe questions about the ideational shaping of state

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capacity, with a focus on bank reform in the US and UK: the ‘heartlands’ (Gowan 2009) of the Anglo-liberal capitalist model.

State capacity is a broader concept than state power and can be defined as the ability of a state to carry through a policy programme. The literature on state capacity highlights Weberian components, including the degree of state authority and administrative capacity as well as the ability of state elites to interact productively with key societal interlocutors. The productive or cooperative interaction between state and societal actors, where it occurs, is assumed to provide a basis for state authority or the legitimate exercise of state power. Evans (1995) has coined the term ‘embedded autonomy’ to describe this combination of state attributes, whilst Weiss (1998) refers to ‘governed interdependence’ to convey a similar notion that close relationships between state and societal actors, far from eroding state capacity and heralding a shift from ‘government to governance’, can actually enhance state capacity (Bell and Hindmoor 2009: 63–6).

This article develops an ideational complement to this form of analysis. We briefly reprise Bell and Hindmoor (2014), which shows how revised ideas held by state elites helped strengthen their hand in specific power contests with the banks during the post-crisis reform period between, approximately, 2009 and 2012. The ideational shift which has occurred in politicians’ minds since the crisis, although real, is limited, however. State elites, especially government leaders, have persisted with a mindset that still values the economic centrality of a large and complex banking sector. This way of thinking has conditioned the relationship between politicians and bankers and led to a form of ‘dysfunctional embeddedness’. Government leaders may have been able to win high-profile policy victories over the banking sector in the post-crisis period, but in accepting a large, complex and constantly evolving financial system with high levels of systemic risk, they have unwittingly placed themselves at a continuing disadvantage in the regulatory arena.

We apply this argument about the limitations of the post-crisis reform process in three parts. First, we discuss the process by which legislative principles in relation to bank reform are currently being translated into regulations and rules. Because reform measures have been agreed which seek to protect the financial interests of the largest banks, lobbyists have been given a standing opportunity to influence the process of implementation by arguing that draft regulations are inconsistent with the spirit of reform proposals.

Second, we argue that, once implemented, the banks have strong incentives to game new regulations. Just as sports anti-doping authorities are endlessly chasing the next generation of drugs and evasion strategies, banking regulators will face a similar challenge, one where their administrative capacities, resources and expertise will be severely tested. Third, although agreed reforms are substantial, they do not do enough to address the problems that caused the 2007–8 crisis: risky trading activity and systemic risk within the financial system. Indeed, reform measures, we argue, may have the unintended effect of encouraging risk-taking within banks and the growth of the ‘shadow’ banking system. Acceptance by the government of the centrality of finance implies a high level of interdependence, but the capacity to govern this relationship effectively is in question. The problems stem not just from limitations to administrative capacity but more fundamentally from ideas about the value of finance held by state authorities.

WINNING BATTLES

The close relationship between the City of London and the British political establishment has evolved over hundreds of years (Kynaston 2011). As Johal et al. (2014) argue in their contribution to this special issue, a distinctive constitutional narrative, a hegemonic regulatory narrative and an economic narrative centred on a belief in the capacity of markets, especially financial markets, to operate as automatic self-maintaining entities, effectively shielded the City from democratic scrutiny in the post-war period. A series of financial scandals culminating in the collapse of Barings Bank in 1995 destroyed the legitimacy of self-regulation. When New Labour entered office in 1997, Chancellor Gordon Brown announced that a new statutory body, the Financial Services Authority (FSA), would henceforth be given responsibility for both prudential and conduct-of-business regulation. The apparent end of self-regulation marked, in many ways, a significant extension of state authority over the market (Moran 2003). Yet, at the same time, ministers, who, in opposition, had launched a ‘prawn cocktail offensive’ to woo City bankers, committed themselves to a system of ‘principles-based’ or, as it was frequently and publicly described, ‘light’ or ‘limited touch’ regulation (Davies 2010: 88–9) whilst also expressing their repeated

determination to do nothing to endanger London's position as a leading global finance centre. Prior to the financial crisis, the typical starting point of the government's policy deliberations was the question, asked here by the economic secretary, Ed Balls (2006): 'what more can I do . . . to support and enhance the critical role that the Banking Industry plays in our economy?'

In the US the Great Depression, widely blamed on financial speculation and banking greed, resulted in a political and regulatory backlash against the banking sector. Key measures included the introduction of deposit insurance for commercial banks registered with and regulated by the Securities Exchange Commission (SEC); a strict prohibition on commercial banks engaging in investment bank trading activity (the Glass–Steagall Act); restrictions on interstate banking; and interest rate caps to limit price competition and risky mortgage lending. In the 1970s this regime came under increasing pressure as a result of the remorseless growth of the largely unregulated non-bank financial sector and, in particular, the growth of the eurodollar market. Amidst concerns that the US banking sector was in decline, the largest commercial banks pressed for financial deregulation (Suarez and Kolodny 2011). In 1996 the Gramm–Leach–Bailey Act undid the Glass–Steagall Act by allowing large financial institutions to operate, simultaneously, as commercial banks, investment banks and insurance firms. In the same year the Economic Growth and Regulatory Paperwork Reduction Act required federal regulators to review their rules every decade and solicit comments on 'out dated, unnecessary or unduly burdensome rules' (Financial Crisis Inquiry Commission 2011: 53). All of this occurred during a period in which faith in the efficiency of markets and the economic costs of regulation had become a part of the 'working ideology' of Washington (Johnson and Kwak 2010: 5). Simon Johnson (2009), the former chief economist of the International Monetary Fund (IMF), argues that, during this period, 'the American financial industry gained political power by amassing a kind of cultural capital . . . the attitude took hold that what was good for Wall Street was good for the country . . . and that large financial institutions and free-flowing capital markets were crucial to America's position in the world.'

The 2007–8 financial crisis and its associated government bail-outs imperilled the embedded ideational relationship between the state and the banking industry in the US and UK. As *The Economist* (2009)

observes: whilst ‘economists continue to debate the ultimate causes of the collapse of the financial crisis . . . the public and most politicians, however, are clear: the blame lies with bankers, venal and incompetent in equal measure’. The crisis ‘forced a fundamental reconsideration of financial regulation’ (Goodhart 2010: 173). It also produced a ‘fairly complete train wreck of a predominant theory of economics and finance’ (Turner 2009). Alan Greenspan (2008) admitted to the US House of Representatives that the ‘whole intellectual edifice’ of ‘modern risk management’ had ‘collapsed’. In his 2009 Mansion House speech to the City, the Chancellor of the Exchequer, Alistair Darling (2009), told his audience, ‘we cannot go back to business as usual. If there is anyone in this room, or in the industry, who thinks that they can carry on as if nothing has happened, they need to think again.’ Echoing this assessment, the deputy treasury secretary, Neil Wolin (2009), told the American Bankers’ Association that, ‘in the wake of this financial crisis, one thing is clear: we cannot go back to business as usual’.

In the US, President Obama entered office in January 2009 with a mandate to reform Wall Street and a determination, in the words of his Chief of Staff, Rahm Emanuel, quoting Churchill, to ‘never let a serious crisis go to waste’. In the UK, a close political relationship between New Labour and the City together with the politics of incumbency retarded reform. The Treasury’s 2009 White Paper and the subsequent Banking Act of 2010 drew heavily on two reports by City grandees Robert Wigley and former Citi chairman Sir Win Bischoff to reaffirm the ‘pivotal’ role of finance in the British economy and rejected calls to formally separate retail and investment banking. The governor of the Bank of England, Mervyn King (2009: 3), complained that ‘never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform.’

Yet significant reform measures have been approved. The UK and US governments have both accepted the Basel III measures, which seek to raise minimal capital standards and lower overall leverage. Under the new Basel III accord, total bank capital must increase to at least 10 per cent of risk-weighted assets by 2019. Basel III also requires that at least 75 per cent of bank capital be high-quality Tier 1 capital. Basel III also introduces new additional capital buffers, including a ‘capital conservation buffer’ of 2.5 per cent and a further counter-cyclical capital buffer of up to 2.5 per cent, the latter to be used in

periods of ‘excessive aggregate credit growth’. This means that by 2016 total required bank capital could be as high as 13 per cent, rising to 15 per cent in 2019.

In the UK in 2010 the newly elected coalition government, partly for reasons of electoral advantage and partly because of pressure from its Liberal Democrat partners, adopted a more aggressive reform stance than its Labour predecessor. This included repudiating the traditional ‘light touch’ regulatory arrangement and abolishing the Financial Services Authority. The government also resolved that systemically important banks should hold more capital than recommended under Basel III, with the 2012 Treasury White Paper committing to a primary loss-absorbing capacity of 17 per cent of risk-weighted assets for large systemically important institutions, composed of 4.5 per cent minimum equity capital, topped up by further equity and non-equity capital buffers (HM Treasury 2012: 35). More controversially, the government also endorsed proposals from the Independent Commission on Banking (ICB) chaired by Sir John Vickers for institutionally separating – that is, ‘ring-fencing’ – normal high-street or retail banking from riskier investment banking activities. Under this arrangement, ring-fenced banks will have their own capital, a separate board of directors and be constituted as a distinct legal entity. The commercial or retail entity will thus be required to be operationally separate from the other entities within a banking group to ensure that it will be able to continue providing services irrespective of the financial health of the rest of the group. The *Financial Times* argued that this proposal constituted the ‘biggest shake-up of British banking in a generation’ (Goff 2011).

In the US House of Representatives and Senate banking reform proposals were distilled into the omnibus Dodd–Frank Wall Street Reform and Consumer Protection Act, passed in July 2010 (US Congress 2010). This is a vast piece of legislation containing new prudential and macro-prudential regulation, structural reforms and a range of other measures. The Act requires enhanced prudential requirements for larger banks and financial entities with assets of more than \$50 billion. Section 165 of Dodd–Frank requires a tighter leverage ratio than Basel III, specifying a debt-to-equity ratio of no more than 15:1. The Act also tackles the ‘too big to fail problem’ through insisting on living wills or resolution plans for systemically important financial institutions, ruling out taxpayer support and instead proposing bail-ins for shareholders and creditors and ex-post

levies on large surviving financial firms to assist with any bailouts. In terms of regulatory architecture, Dodd–Frank has established a 10-member Financial Stability Oversight Council charged with monitoring and dealing with systemic risk. The Dodd–Frank Act contains an amended version of the so-called ‘Volcker rule’, which aims to restrict US banks from making certain kinds of speculative proprietary trading investments that do not benefit customers but generate systemic risk.

These reform measures have been agreed despite intense objections from the banks themselves. In the UK individual banks and banking and financial sector lobby groups have led a sustained public campaign to warn against excessive additional regulations. In particular, the banks fiercely resisted structural reform, arguing that ‘ring-fencing’ will threaten UK banking and the City’s role as a global financial centre, raise the costs and reduce the supply of credit, and threaten economic recovery (Ahmed 2013). Newspapers carried stories that, fearful of their future profitability, the banks HSBC and Standard Charter were considering moving their headquarters and stock market listing from the UK to, respectively, Hong Kong and Singapore, and that Barclays was also planning to move parts of its operations offshore (Jenkins et al. 2011). These were typical ‘structural power’ threats. In a classic contribution to the academic literature on business power, Lindblom (1977) argued that business is in a uniquely ‘privileged’ position. Businesses possess considerable financial resources and lobbying expertise and can use these resources to secure their goals. But business is not simply another pressure group. Business *also* exercises a structural form of power. Within a capitalist system governments and the wider society depend on a healthy economy and hence on the willingness of business to produce and invest. The UK banks and their supporters were able to exploit this fact in the post-crisis period to attempt to stymie regulatory reform.

The US banking and finance industry has invested an estimated \$2.3 billion in lobbying since 2009 (Schwartz 2011). It has argued that the 2007–8 crisis was caused by poorly designed regulations which, for example, gave banks an incentive to hold securitized assets on their balance sheets and that new regulations will be equally counterproductive. It has also argued that new capital rules will reduce lending capacity and threaten economic recovery. Lobbyists have already met with some success. The original version of the Volcker rule accepted that large systemically important banks could

engage in commercial and investment banking activities but attempted to restrict the scope of the latter, specifically by banning proprietary trading, hedge fund activity, commodity speculation and private equity fund management from the activities of federally insured deposit-taking banks. These banned activities would need to move to *separate* institutions with which the main banks could not have holdings or links – a move not too dissimilar to the original Glass–Steagall intent of separating commercial from investment banking. However, after much political contestation and opposition from the major banks, a substantially watered-down version of the rule was adopted. This allowed the main banks to hive off proprietary trading and the investment banking activities to separately capitalized subsidiaries or affiliates, a change which raises questions about whether such offshoot entities can be effectively ring-fenced from the capital of the main bank in a crisis. Under Section 619 of Dodd–Frank, the amended Volcker rule also allows main banks to engage in securities and derivatives trading if these are conducted for the ‘near term demands of clients, customers, or counterparties’. The rule also allows main banks to trade in areas such as foreign exchange derivatives and high-grade credit default swaps.

It would, however, be a mistake to think that the banks were able to exercise a veto over reform efforts during this period. The notion of banks exercising a ‘structural’ power is, in this respect, a potentially misleading one. Structures do not come with an ‘instruction sheet’ (Blyth 2003) which determines the behaviour of individual agents. The meaning and ramifications of structural power need to be interpreted and worked out ‘on the ground’ by key agents concerned. Various scholars have shown how ideas can mediate structural power relations, either increasing or decreasing the salience of such power (Bell 2012; Hay 2006; Hay and Rosamond 2002). Structural power thus works through the real or potential benefits or costs of real or threatened business or financial activities in relation to state actors who must *perceive* such benefits, costs or threats as significant and meaningful (Bell 2012; Bell and Hindmoor 2013). In the pre-crisis period, government and state leaders in the US and UK came to identify strongly with the goals of the financial sector. In the post-crisis context, investment threats by the banks were *reinterpreted* by government leaders to produce far less challenging assessments, thus modifying threat perceptions normally associated with structural power or investment veto threats. Politicians in the

US and UK faced-down banking opposition to proposed reform measures because their ideas about the value and financial resilience of the banking industry and the credibility of the representatives of the banking industry had changed.

In the UK, Bank of England officials responded to arguments that reforms would endanger the global standing of Britain's largest banks by arguing that the banking crisis showed that Britain might benefit from having a smaller banking sector. The scale of that crisis weakened the structural bargaining position of the banks, casting them in part as an economic liability. Paul Tucker (2011: 3–4), at that time a deputy governor at the Bank of England, argues that the shift from a 'default assumption that core markets are more or less efficient most of the time', to 'thinking of markets as inefficient, riddled with preferred habits, imperfect arbitrage, herding and inhabited by agents with less than idealised rationality', constitutes a substantial 'gestalt flip'. As Deputy Prime Minister Nick Clegg put it, 'we cannot ever again allow the banking system to blow up in our face in the way that it did before' (quoted in Mulholland and Quin 2011). In this context, criticisms by the banks of the costs of reform tended to pale by comparison with memories of the costs of the bank bailouts amidst the crisis and of subsequent huge costs to the economy. The credibility of the banks' threats to exit the UK was also questioned. Critics pointed out that if major UK banks were to move to Asia they would be just as heavily regulated, and that if HSBC moved to Hong Kong it would be required to undertake delicate regulatory negotiations with the Chinese government. As the *Financial Times* (2011) put it, amidst the showdown with the UK banks, 'threats [to exit] should be faced down, not just because they are unreasonable but because they are of questionable credibility'.

In the US, as well, lobbying by the banks in relation to, for example, minimal capital requirements, was sometimes dismissed. In March 2010 US Treasury Secretary Tim Geithner (2010) advised the American Enterprise Institute on Financial Reform that:

Our legislators and their staffs often look to the financial industry for advice as they try to sort out what makes sense. This is important to get right but be careful whose voice you listen to. Listen less to those whose judgments brought us to this crisis. Listen less to those who told us all they were the masters of financial innovation and sophisticated risk management. Listen less to those who complain about the burdens of living with smarter regulation or who oppose having to pay a fee for the costs of this or future crises.

Signing the Dodd–Frank Act into law, President Obama (2010) decried the ‘furious lobbying of an array of powerful interest groups’ and argued that the ‘primary cause’ of the ‘severe recession’ was a ‘breakdown in our financial system . . . born of a failure of responsibility from certain corners of Wall Street to the halls of power in Washington’ which resulted in ‘antiquated and poorly enforced rules that allowed some to game the system and take risks that endangered the entire economy’.

LOSING THE WAR? THE QUIET POLITICS OF IMPLEMENTATION

Substantial reforms of the banking sector have been approved. This does not mean that the post-crisis story has now reached its conclusion. In the following sections we express a number of concerns about the reform process. Central to each of these concerns is an argument about the limits of the ideational change which has occurred in the post-crisis period. In the UK, in the aftermath of the £117 billion cash bailout of the banking sector (National Audit Office 2009), Alastair Darling (2008) committed Labour to banking reform but also expressed his ‘determination’ to work with the banking sector to ‘maintain the UK’s position as the world centre for financial services’. His Conservative successor as chancellor of the Exchequer, George Osborne (2010), has, for his part, spoken about the ‘British dilemma’: the need to ‘preserve the stability and prosperity of the nation’s entire economy’, whilst also protecting London’s status as a ‘global financial centre’. The UK government’s 2012 White Paper on bank reform thus insists on the need to ‘enhance the UK’s reputation as the world’s leading financial centre’, pointing out that ‘the financial services sector is an important part of the UK’ (HM Treasury 2012: 3). Even a critic such as Lord Turner (2009: 3–4) thinks that ‘London will continue to be a major financial centre’, despite agreeing that ‘the whole financial system has grown bigger than is socially optimal’. The prime minister, David Cameron (2012), has argued that ‘pursuing a modern industrial strategy doesn’t mean being anti-finance . . . those who think the answer is just to trash the banks would end up trashing Britain. I say – recognise the enormous strength and potential of our financial sector – regulate it properly and get behind it.’ In the US, proposed reform measures, whilst substantial, nevertheless recognize a need to maintain the overall

competitiveness of the US banking system (US Congress 2010: 30D), the centrality of the banks to the process of economic recovery and, as we have seen, the value in securities, derivatives trading and credit default swaps.

Because reform measures are predicated on a recognition of the need to balance the long-term and legitimate interests of the banking sector against the interests of the taxpayers and others in preventing a future banking crisis, they are vulnerable to ongoing lobbying. As one banker told *The Economist* (2011), the ‘banks don’t think the war is over yet’. The Basel III rules are scheduled to be implemented by 2016. The ring-fence in the UK banking system will not come into final force until 2019. In the US, where a number of regulatory bodies, led by the Securities Exchange Commission, were given responsibility to draft detailed rules in relation to the implementation of Dodd–Frank, restrictions upon proprietary trading are currently scheduled to take effect in July 2014 although the timetable has already slipped. Part of the reason for this delay is to give the banks time to adjust their business strategies and balance sheets. In the case of new measures relating to macro-prudential regulation and bank resolution regimes, it also reflects the fact that new approaches are still largely at the concept stage. The details of how to measure systemic risk over the cycle have yet to be worked out and the metrics here can be fraught (Bell and Quiggin 2006). The development, implementation and operation of counter-cyclical policy instruments are also in their infancy (Baker 2013; Giustiniani and Thornton 2011: 327).

Throughout this transition process, where draft rules are subject to public scrutiny, legislative oversight and ministerial approval, banks can argue that the detailed rules and regulations being promulgated by regulators are not faithful to the spirit of legislators’ intentions, will unreasonably harm their financial interests and ought to be amended. In 2011 the Securities and Exchange Commission published a draft set of rules in relation to the Dodd–Frank Act. These were then the subject of over 18,000 public comments and detailed hearings within the House of Representatives and Senate. One of the most contentious issues related, once again, to securities and derivatives trading. Here, opponents want regulators to expand the definition of activity which can be said to be market-making and so of benefit to consumers and, conversely, narrow further the definition of what counts as proprietary trading. Financial services company UBS (2012) has argued that Dodd–Frank charged regulators with ‘drafting

regulations that ensure vibrant and liquid markets so that investors continue to have access to a broad range of transactions' and that, in a number of technical respects, the proposed draft did not meet this obligation. Similarly, lawyers representing Deutsche and Bank of America sought to remind the Securities and Exchange Commission that 'in implementing the Volcker rule' it must 'give effect to legislative intent' and that draft rules 'ignore Congress's intent to exempt market-making and underwriting activities' (Cleary Gottlieb Steen & Hamilton 2012). JP Morgan, for its part, argued that 'in some areas [the Securities and Exchange Commission's draft rules] turned the statute's narrow prohibition [on proprietary] into a more general prohibition on risk-taking' (JP Morgan Chase 2012). The Securities and Exchange Commission was unable to dismiss these arguments out of hand because its own draft proposals were, in the words of its chair, Mary Schapiro (2012), 'intended to . . . strike an appropriate balance between preserving important market functions and preventing proprietary trading unrelated to such functions'. According to *The Economist* (2012), a banker close to the action in the US has predicted 'a decade of grind, with constant disputes in courts and legislatures, finally producing a regime riddled with exemptions and nuances that may, because of its complexity, exacerbate systemic risks rather than mitigate them'.

In the UK, the former chair of the Independent Commission on Banking, Sir John Vickers, and former Bank of England governor, Mervyn King, have warned that certain elements of the Independent Commission on Banking reforms have already been watered down due to lobbying (Treanor 2012a). Ring-fenced banks have successfully argued that they should be allowed to engage in certain derivatives trades such as interest rate and currency swaps. Small banks have been granted exemption from ring-fencing requirements. The government also proposes exempting the overseas operations of UK banks from holding additional capital. Lord Turner (2009: 6) worries that 'there is a danger that after the crisis, everyone gives up, either because of financial sector lobbying or because it's all very exhausting'.

Lobbying over the precise details by which reforms will be implemented is likely to favour the banking industry. Culpepper (2011) argues that business interests often come off second best in open and direct high-stake battles with governments. Seething public anger over the banking crisis gave elected politicians a strong incentive to promulgate reform measures in the immediate post-crisis period.

Since then, a series of high-profile scandals, including Libor, the payment of bonuses to executives at AIG, and the losses incurred by 'rogue' traders at JP Morgan and UBS, have kept the banks on newspaper front pages and ensured that reform would continue to be, to use Culpepper's phrase, a 'noisy' political issue in which politicians had an incentive to resist bank lobbying. Business lobbying is more likely to be effective in 'quiet' arenas marked by low visibility, technical complexity and informality; arenas where the business resources of focused lobbying, networking and expertise have typically often paid off. This, of course, is a perfect description of the long-standing traditions of politics surrounding bank regulation, where rules were written and enforced in a cloistered world well beyond the public gaze, where the supposedly expert judgements, technical acumen and market efficiency of bankers were largely accepted by the authorities and where the latter trusted the former to be prudent. This secluded relationship was disturbed by the crisis and the high politics that ensued but may well dominate once again as regulatory authorities, under pressure to reflect the competing objectives of reform measures, come under continuing pressure from the banks to revise their interpretations and guidance. Bart Naylor, a lobbyist for the consumer-rights coalition Americans for Financial Reform, argues that debate about market-making and proprietary trading is 'the subject of a very quiet, closed-door battle right now, not just between us and Wall Street, but among the agencies as well' (Reuters 2011). Mark Plotkin, a lawyer at the large corporate law firm Covington & Burling, suggests that 'during the run-up to the legislation, while it was very active, there was a limit to how much people could really influence the statute . . . the implementation phase is really industry's opportunity to influence what the final product looks like' (quoted in Becker 2010).

The success bankers have typically had in domestic arenas of quiet politics is also mirrored at the international level. As Tsingou (2008) argues, major international banks and international bank lobby groups such as the Institute for International Finance (IIF) have traditionally had substantial input into the Basel deliberations. Lall (2012) argues that even after the crisis this influence persists, pointing out that the Basel Committee for Banking Supervision (BCBS) is an insulated, technocratic arena generally shielded from public scrutiny or clear lines of accountability. Organizations such as the Institute for International Finance, the International Swaps and

Derivatives Association (ISDA) and the European Securitisation Forum (ESF) are all well-resourced lobby groups and all have close contacts with the Basel Committee for Banking Supervision. Senior financial officials in government and in central banks have often ended up working for the Institute for International Finance (Lall 2012: 627). Negotiations over Basel III saw major international banks and the Institute for International Finance successfully argue for a reduction in the size of the proposed increase in capital buffers, as well as for a long phase-in period.

LOSING THE WAR: GAMING THE RULES

The rules and regulations which are eventually agreed on and implemented to give effect to legislative proposals are likely to be voluminous and detailed. The rules for Basel I with its basic risk weightings ran to 30 pages. Basel II's rules, with its more complex risk weighting had rules spanning 347 pages. Basel III now has 616 pages of rules and with domestic implementation provisions the rules have expanded to over 1,000 pages in the US and UK. In the US, the Glass–Steagall Act was only 37 pages long, but the Volcker rules within the Dodd–Frank Act span 300 pages and the Dodd–Frank Act itself over 800 pages. The reforms will apparently require more than 400 new regulations to be formulated by 11 regulatory agencies. Sheila Blair, the former head of the Federal Deposit Insurance Corporation, told Congress in late 2011, ‘I fear that the recently proposed regulation to implement the Volcker rule is extraordinarily complex’ (*The Economist* 2012). Once fully finalized, the Dodd–Frank Act could entail 30,000 pages of rules (Haldane 2012: 10). Dennis Kelleher, who runs Better Markets, a financial regulatory reform group in the US, argues that ‘most of the length, complexity and questions are in there because of industry lobbying’. He describes the Securities and Exchange Commission rulebook as ‘the bastard child of the lobbying industry . . . you can’t demand and insist and lobby for all these rules and exemptions and then complain that it’s too long and complex’ (quoted in Eisinger 2012).

The director of financial stability at the Bank of England, Andy Haldane (2012: 10), argues that this complexity raises serious questions about ‘regulatory robustness’, ‘near limitless scope for arbitrage’ and ‘over-reliance on probably unreliable models’. The notion of

'embeddedness' within the state capacity literature often implies cooperative relations between the state and key societal interlocutors as one of the foundations for state capacity. Mann (1990) refers to this as 'infrastructural power' or the power to effect change through functional cooperation between the state and important social actors. Prior to the crisis, the historical relation between the state and the City was one of close cooperation. This produced a trust-based approach embedded in 'light touch' regulation that was one ingredient of the crisis. In relation to the passage of regulatory reform measures which they regard as excessive and, in specific instances, inconsistent with the intention of legislators, bankers have an incentive not only to lobby for the regulations' dilution but to sidestep their enforcement.

Mervyn King (2009) has warned about the 'sheer creative imagination of the financial sector in dreaming up new ways of taking risks', leading him to conclude that 'the belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion'. The danger here is that regulators and supervisors will be forced into an endless game of catch-up, attempting to keep abreast of such complexity and the evolving minutiae and innovations in the financial world. The president and CEO of the Federal Reserve Bank of Dallas, Richard Fisher (2013), argues that 'regulatory supervision, by definition, is always at least one step behind the actions taken by market participants. The more complex the rules, the more difficult it is to bridge the gap due to the complexities of financial markets. None of this is helpful for financial stability.' Tim Geithner (2012a) accepts this state of affairs when he writes that the regulations are 'no more complex than the problems they are designed to solve'. Both the City and Wall Street have historically been one jump ahead of regulators in the game of regulatory arbitrage. They have been able to outspend the regulators in political and court battles and have often poached key regulators. As Kenneth Rogoff (2012) argues, 'as finance has become more complicated, regulators have tried to keep up by adopting ever more complicated rules. It's an arms race that underfunded regulatory agencies have no chance of winning.' In 2010 a bankruptcy court examiner found, for example, that the collapsed financial services company Lehman Brothers had been able to evade capital regulations prior to the crisis through 'Repo 105' transactions in which it had temporarily 'sold' loans on its balance sheet for short periods of time

with the intention of buying the loans back once it had then reported that it was in full compliance with minimal capital standards. In the first two quarters of 2008 Lehman Brothers undertook \$50 billion of such transactions (Merced and Sorkin 2010).

Administrative capacity, including coherent policy, skilled officials and effective policy tools and administrative institutions, are key elements of wider state capacity (Bell and Hindmoor 2009). Here, the relevant question is whether state authorities have the administrative or regulatory capacity to tame finance. The issue of regulatory ineptitude and capture were major problems prior to the crisis (Baker 2010). Yet now, in the post-crisis era, heroic assumptions are being made about the capacity of regulators to stay ahead of the banks and the shadow banking sector.

In relation to the proposed ring-fence, Haldane claims that current attempts to ring-fence or quarantine the effects of risky banking within commercial banks are likely to be problematic. As he argues:

The Volcker rule separates only a fairly limited range of potentially risky investment banking activities, in the form of proprietary trading. The [UK Independent Commission on Banking] Vickers proposals mandate only a limited range of basic banking activities to lie within the ring-fence, namely deposit taking and overdrafts . . . As the history of the Glass–Steagall Act demonstrates, today’s loophole can become tomorrow’s bolt hole . . . In the go-go years, will these reforms be sufficient to prevent the grass always looking greener on the riskier side of the (ring)-fence? (Haldane 2012: 10–11)

Martin Wolff (2012), who sat on the Independent Commission on Banking, is also worried: ‘I fear this blurred line will be breached repeatedly under pressure from banks until the ring-fence is almost totally permeable.’ Former Federal Reserve chairman, Paul Volcker, has similarly warned of such manoeuvring. In testimony to the Parliamentary Committee on Banking Standards in the UK, he stated, ‘when you adopt a ring-fence, pressure from inside the organisation tends to weaken the restrictions . . . I’m not saying it will be totally ineffective, but the Vickers Report says it’s going to have a ring-fence with exceptions, and once you go down that road of having exceptions the organisation is going to push for more exceptions and widen the limits’ (Inman 2012). The limits of the ring-fence are also increased because it applies only to activities within the UK. As the International Monetary Fund (2012: 88) comments, ‘As retail ring-fencing is limited to the United Kingdom, it may have little, if any, effect on the cross-border activity of internationally active UK banks.’

In other words, risky activities could simply migrate to another jurisdiction. Speaking in the House of Lords, the economist Lord Eatwell (2013) also raised concerns about ‘regulatory arbitrage’ and the possibility of European banks in the UK undermining ring-fencing.

The failure of the ring-fence is not inevitable. In late 2012, the chair of the Parliamentary Commission on Banking Standards, the Conservative MP Andrew Tyrie, argued that ‘over time the ring fence will be tested and challenged by the banks’ (Treanor 2012b). Tyrie called for ‘electrification’ of the ring-fence by adding new legislation that could invoke reserve powers for full separation if needed. After initially expressing some scepticism about this measure, George Osborne (2013) announced in February 2013 that the ‘government will go further than previously announced and that if a bank flouts the rules, the regulator and the Treasury will have the power to break it up all together – full separation, not just a ring fence’. In July 2013, and in response to the high-profile publication of the Banking Commission’s final report and recommendations, the government announced that it would introduce a criminal offence for reckless misconduct for senior bankers; work with regulators to ensure bankers’ pay is aligned with their performance and reverse the burden of proof so that bank bosses are held accountable for breaches within their areas of responsibility (HM Treasury 2013). Yet the government resisted a recommendation that the Treasury be given the reserve authority to impose a full separation of all commercial and investment banks across the UK industry rather than simply the authority to separate the activities of particular banks (Deighton 2013).

In the case of the Volcker rule, similar concerns about the capacity of the largest banks to subvert new rules have been raised. Richardson et al. (2011: 206) argue that ‘the success of the proprietary trading ban will depend on the hard slog of successful implementation and enforcement in the real world of political economy against the smartest guys in the room and their lawyers and lobbyists’. Evasion will also occur through informal channels. As Richardson et al. (2011: 202) comment, ‘some large banks have already moved some of their proprietary traders to client desks that nevertheless use the firm’s own capital. Equally troubling, traders in that position now have privileged insight into client trades and, by stretching the rules, can front-run them.’ The International Monetary Fund (2012: 86) comments that: ‘Implementation of the [Volcker] rule will be a challenge to prudential authorities; and an inability to clearly distinguish permissible activities

(market making and underwriting) from prohibited ones (proprietary trading) may mitigate the impact of the rule.’

More generally, much as before the crisis, firms will seek to evade regulation by migrating to the shadow banking sector or conduct activity in new institutional settings (Acharya et al. 2011: 144; Goodhart 2010: 166). This is especially so since non-bank entities will not be subject to capital standards or face anything like the regulation that currently is being imposed on the main banks. The International Monetary Fund (2012: 77) argues: ‘Tighter regulation and more intense supervision may push bank-like activities into some less-regulated non-bank financial institutions (the shadow banking system).’ Regulators may have new (if untested) powers in relation to the main bank system, but investment migration will pose significant challenges for regulators and supervisors.

It is true that regulators have been chastened by the crisis and are now perhaps more likely than they once were to aggressively pursue banks which they believe are gaming the rules. Nevertheless, the question of regulatory performance and capture has not attracted sufficient attention after the crisis (Baker 2010). In the US the same regulatory agencies that failed before the crisis are still in charge and are now being assailed by anti-reform interests in the banks and the Republican Party. In testimony to Congress, the Securities and Exchange Commission’s chairman, Elisse Walter (2013), has also suggested that Dodd–Frank ‘cannot be handled appropriately with the agency’s previous resource levels without undermining the agency’s other core duties’ and that it has still not been given ‘all the resources necessary to fully implement the law’, and without ‘additional resources . . . many of the issues to which the Dodd–Frank Act is directed will not be adequately addressed’. In the UK, the regulatory system has been overhauled and the Bank of England has been given very substantial new powers, yet key new institutions such as the bank’s Financial Policy Committee within the bank remain untested.

LOSING THE WAR? THE LIMITS OF THE REFORM PROCESS

We have argued that the effectiveness of reform measures may be undermined by lobbying prior to implementation and by gaming once implementation occurs. Yet the limits of the ambitions of the original reforms themselves should also be underlined. Although structural

reform is to be undertaken, the largest banks – which were deemed too large to fail in 2007–8 and have been described as being ‘too large to effectively risk-manage’ by Mervyn King (quoted in Parliamentary Commission on Banking Standards 2013: 333) – have not been broken up because of fears that doing so would fatally undermine New York’s and London’s status as global trading centres. This decision is a particularly important one because a number of the largest banks were able to expand their business significantly through mergers or takeovers during the crisis. Halifax–Bank of Scotland (HBOS) took over Lloyds; Barclays acquired substantial assets from Lehman Brothers; JP Morgan took over Bear Stearns; Bank of America acquired Merrill Lynch; and Wells acquired Wachovia. This process of consolidation has been driven by markets but it also stems from state support and guarantees for the banking system which have generated lower funding costs for major banks. If the largest banks in the world were too large to manage before the crisis, the suspicion must be that they remain too large to manage now. It is true that, relative to their immediate competitors, JP Morgan (McDonald 2009) and Wells Fargo in particular operated a more effective set of risk-management practices prior to the crisis. Yet this is no guarantee of future success. JP Morgan’s reputation was severely tarnished in 2012 when its chief investment officer, Ina Drew (the so-called London Whale), lost over \$6 billion trading in synthetic credit products (Dominus 2012).

While capital levels have been raised within the banks, reforms have done comparatively little to address banks’ dependence on wholesale funding – one of the key drivers of the banking crisis in 2008 once the sub-prime crisis had begun (Gorton 2008). Addressing the House Committee on Banking, Housing and Urban Affairs in February 2013, Daniel Tarullo (2013), a governor of the Federal Reserve, suggested that ‘US and global regulators need to take a hard, comprehensive look at the systemic risks present in wholesale short-term funding markets’. The International Monetary Fund (2012: 101, 102, 104) also warns that ‘overall, banking systems are generally more concentrated and are as reliant on wholesale funding today as they were before the crisis’.

Furthermore, whilst minimal capital levels *have* been raised significantly relative to their anaemic levels prior to the crisis, they are still far below their historical norm. In *The Bankers’ New Clothes*, Anat Admati and Martin Hellwig (2013) argue that bankers have successfully convinced politicians and the media that increased capital requirements imperil bank lending because they require

‘reserves’ to be set aside by banks. It is true that higher capital requirements are likely to reduce bank profits because it is cheaper for banks to raise money through borrowing than through raising additional equity. This is because ‘too big to fail’ banks carry a lower risk premium. Higher capital requirements also threaten return on equity: a key metric of bank performance within the financial industry which executives are under continual pressure to maintain. Capital is not, however, a ‘reserve’ which banks must carry on their balance sheet and has no direct impact on lending capacity.

More fundamentally, the agreed reforms do not squarely address the original source of the crisis – baroque forms of financial innovation and risky investment behaviour in the main banks and in the rapidly expanding shadow banking sector, all in the context of systemic or interconnected risk. Haldane (2012: 22) argues that ‘cross-system complexity has exploded over recent decades due to the growth in opaque, intra-financial system chains of exposure . . . complexity that is currently largely unrecognised and un-priced by regulatory rules.’ In a free-wheeling system, complex new financial instruments will inevitably arise, posing poorly understood risks. Individual balance sheet risks will be linked through market transactions and then compounded into new forms of systemic risk involving complex externalities and knock-on effects involving institutions and markets. Basel III remains focused on the behaviour of individual institutions, not on systemic risk. For example, under the proposed rules, a firm’s capital requirements do not depend on interactions with other financial firms (Acharya et al. 2011: 144).

Furthermore, new regulatory rules in relation to ring-fencing and proprietary trading may, unintentionally, encourage banks to take more risks to compensate for the costs of regulation. According to a senior Fitch analyst: ‘Since it is impossible for regulators to perfectly align capital requirements with risk exposure, some banks might seek to increase returns on equity through riskier activities that maximise yield on a given unit of Basel III capital, including new forms of regulatory arbitrage’ (Treanor 2012c). Similarly, the International Monetary Fund (2012: 103) warns that ‘Basel capital and liquidity rules could be promoting a greater intermediation of new financial products as financial institutions use other avenues to make up for the higher expenses imposed by the Basel rules’. Another industry analyst has argued that new rules on capping investment in private equity funds under Dodd–Frank in the US has ‘forced fund-mangers

to target higher returns on an annualised basis to compensate' for the limits imposed by the regulation (Chipman 2012).

Timothy Geithner (2012b) has complained that a recalcitrant banking industry is suffering from 'financial crisis amnesia'. Morgan Stanley's CEO during the 2007–8 crisis, John Mack, has since admitted that the intensity of the pressure on banks to return ever-higher profits and market shares means that 'I don't think we can control ourselves' (quoted in DealBook 2009). It is true, as Timothy Geithner (2012b) explains, that some of the risk taking has 'been forced out of the financial system' by the currently subdued state of investment banking in the wake of the crisis, especially in securitization markets. Yet, as Geithner admits, 'these gains will erode over time' as new investment opportunities and new forms of risk taking emerge. There is little evidence, then, that financial systems have become less risky or less vulnerable. The International Monetary Fund (2012: 97) reports that trader bank activities, or what it calls 'market-based intermediation', has fallen only in a few advanced economies. The International Monetary Fund (2012: 99) also warns that 'developments in newer types of financial products need careful monitoring'. It notes that a number of banks have been securitizing derivative counterparty risk to get around Basel III credit value adjustment capital charges, for example.

CONCLUSION

In the wake of the crisis, governments have introduced wide-ranging reforms that would have been unthinkable prior to the crisis. They have also prevailed in power contests to institute banking reform. Yet wider questions about state capacity persist. We have argued that a significant limit on state capacity is ideational. Governments have not asked fundamental questions about what banks and finance are for. Governments still value the existing system and have simply tried to fix it. They have accepted the tenet that market-led financial innovation will drive and shape the system. Inevitably, this will mean ever more baroque forms of financial complexity. This will place regulators in a difficult if not impossible position in an endless game of catch-up, attempting to stay ahead of rapidly evolving markets.

It is now time to 'go back to first principles', as Goodhart (2010: 153) puts it. Building a state that is capable of taming finance will require a fundamental rethink of the entire financial system.

Questions about reform should start with a few truisms: namely that large, complex and interconnected financial systems are prone to serial, large-scale crises. However, as Turner (2011: 14) argues, ‘risks could exist even if . . . we broke up large banks into smaller ones. A system of multiple interconnected players could be as risky as one with large specific institutions.’ Again, current reforms are not squarely addressing the key problems that caused the crisis – risky trading and systemic risk. The key solution here is that the financial system needs to be much smaller and much simpler, focused primarily on serving the real economy. Instead of seeing a large, complex banking and financial sector as a major plus for the economy and as a source of ‘international competitiveness’, as governments in the UK and US essentially still do, a different view which sees banking and finance as a basic utility function, an essential service, much like water supply, should be adopted. Such a perspective would aim to simplify and downsize the sector, stripping out much of the risky, speculative and casino-like activity. A stable banking and financial sector that serves the real economy should be the aim; much like the regime of ‘financial repression’ that was put in place during the economic boom after the Second World War.

New rules which focus squarely on risky trading and systemic risk and which seek to restrain them are needed. These will probably require punitive transactions taxation on certain activities as well as outright bans on the riskiest and most socially useless financial activities. Overall, as Kay (2012) argues, ‘We need instead smaller, simpler, financial institutions, which specialise in particular lines of provision of financial services to the non-financial economy, rather than trading with each other. The only sustainable answer to the issue of systemically important financial institutions is to limit the domain of systemic importance. Until politicians are prepared to face down the [City and] Wall St. titans on that issue, regulatory reform will not be serious.’

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