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Why does the United Kingdom (UK) have inconsistent preferences on financial regulation? The case of banking and capital markets

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Abstract: What explains national preferences concerning international and regional financial regulation? This article focusses on one of the main financial jurisdictions worldwide, the United Kingdom (UK). It is puzzling that since the crisis this jurisdiction has pursued stringent harmonised regulation in certain areas (banking), but not others (capital markets). We explain this in terms of how the demands of powerful economic interests are mediated by the political process and regulatory institutions. In banking, there was strong political pressure to restore financial stability, and regulatory institutions were significantly strengthened. This enabled UK regulators to resist industry lobbying and pursue more stringent harmonised rules at the international and European Union levels ("trading up"). In the case of capital markets, by contrast, UK regulators lacked political support for tougher regulation and were institutionally much weaker. As a result, the industry was far more effective in shaping UK preferences aimed at protecting the sector's competitiveness ("trading down").

Key words: EU financial regulation, finance international standards, banking national preferences, United Kingdom (UK)

Introduction

Since the international financial crisis, significant regulatory reforms have been enacted at the international, regional and national levels. This has spawned important new research examining the response of policymakers through bank bail-outs (Grossman and Woll 2013; Culpepper and Reinke 2014; Woll 2014) and regulatory changes (e.g. Moschella and Tsingou 2013),

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especially in the main jurisdictions. Other works have analysed post-crisis international harmonisation in finance (e.g. Young 2012; Quaglia 2017). However, we know relatively little about how the financial crisis has changed (or not) national preferences towards international or regional [European Union (EU)] financial regulation, and the political dynamics underpinning that process.

This article focusses on one of the main financial jurisdictions worldwide, the United Kingdom (UK). Before the crisis, it favoured a "light touch" regulatory approach, which prioritised the competitiveness of the financial industry. These preferences have been explained with reference to the national variety of capitalism, which in the UK is predominantly based on finance (Fioretos 2011, 2010; Howarth and Quaglia 2013, 2016), the lobbying activities and the structural power of the financial industry (Culpepper and Reinke 2014; Bell and Hindmoor 2015), or the "market-making" regulatory paradigm held by UK policymakers (Busch 2004; Quaglia 2010; Mügge 2012). All these (different) theoretical explanations point in the same direction, which fitted well with the empirical record before 2007. However, since the crisis, the UK has adopted inconsistent regulatory preferences, pursuing more stringent harmonised financial regulation for some financial services (banking), but not others (capital markets). This article sets out to explain the shift in post-crisis UK financial regulatory preferences, and the strategy it has adopted at the international and regional (EU) levels in pursuit of these.[1]

Our aim is to better understand the process of national preference formation in financial regulation, drawing lessons applicable to other jurisdictions. The UK offers a valuable case study in several respects. First, UK preferences on financial regulation have changed significantly in several areas, confounding pre-crisis narratives about the UK as a champion of light touch regulation. This provides an important opportunity to assess the causal mechanisms of regulatory preference change. Second, as host to one of the world's leading international financial centres, the UK offers an important test case of how and why powerful domestic interests shape national preferences concerning international and EU regulation. Third, the UK has been at the forefront of regulatory reform efforts since the international financial crisis. Understanding the regulatory preferences and strategies of the UK is critical to understanding the changes to the international financial regulatory landscape over the past decade.

[1] The UK is represented by independent financial regulators in international regulatory fora. In EU fora, the UK is represented by government ministers, finance ministry officials and independent financial regulators. For simplicity, however, when referring to UK representatives at the international and EU levels, we refer to UK "regulators".

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Finally, our research is increasingly relevant in view of the UK's decision to leave the EU. Unpacking the incentives and constraints faced by national policymakers may provide valuable clues as to the UK's position on financial regulation during the Brexit negotiations and beyond.

The article is organised as follows. We first review the literature on national preferences concerning international and EU financial regulation, and highlight their limited analytical leverage with reference to the UK post-crisis. We then outline our own theoretical framework, which draws on domestic theories of international regulation. This is assessed through a structured focussed comparison of two cases of international and EU financial regulation: one case of banking regulation (capital requirements) and one case of capital market regulation (hedge funds). Our central argument is that the demands of powerful economic interests are mediated by the political process and regulatory institutions. In banking, there was strong political pressure to restore financial stability, and regulatory institutions were significantly strengthened. This enabled UK regulators to resist industry lobbying and pursue more stringent harmonised rules at the international and EU levels ("trading up"). In the case of capital markets, by contrast, UK regulators lacked political support for tougher regulation and were institutionally much weaker. As a result, the industry was far more effective in shaping UK preferences aimed at protecting the sector's competitiveness ("trading down"). We conclude by reflecting on the wider significance of our argument.

State of the art on national preferences and financial regulation

National preferences on financial regulation have been explained using a variety of approaches, which we review here. In each case we highlight how existing explanations provide insufficient analytical leverage concerning the empirical puzzle outlined at the outset – namely, the UK's post-crisis preferences on financial regulation.

Comparative political economy offers important insights into regulatory developments in finance. These approaches emphasise the institutional configuration of national economic systems, such as the "varieties of capitalism" and especially the "varieties of financial capitalism" (Fioretos 2010, 2011; Howarth and Quaglia 2013, 2016). According to the explanation provided by this approach, the UK and the United States (US) oppose the tight regulation of hedge funds because these countries have a liberal market economy, a market-based financial system and hosts a large number of hedge fund managers (Fioretos 2010). Similarly, the UK and the US support strict banking regulation because this does not penalise credit provision to the real economy in their jurisdictions. By contrast, continental

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countries, which have a bank-based financial system where banks provide most of the credit to the real economy, resist strict banking regulation (Howarth and Quaglia 2016). However, these countries support strict regulation of hedge funds, which are hosted in a limited number in these jurisdiction (Fioretos 2010; Woll 2013).

Yet, comparative political economy approaches leave important blind spots concerning the explanation of national preferences on financial regulation because they tend to provide a "static" picture and overlook political dynamics. For example, US and UK regulators, despite the market-based financial systems in their jurisdictions, were the main promoters of the Basel II accord, which de facto lowered capital requirements for banks. However, these regulatory preferences were reversed post-crisis, during the negotiations of Basel III and the implementing EU legislation. Moreover, the position of UK's and US's regulators were fiercely opposed by their respective banking industry on competitiveness grounds (James 2016). Shifting regulatory preferences and national industry's opposition to the proposed rules do not sit well with accounts-based national varieties of financial systems. Comparative approaches also provide little insight into why, at the height of the financial crisis, UK regulators pushed for much stricter regulation of hedge funds. More generally, these explanations tend to overlook the domestic political pressures faced by policymakers, which are frequently at odds with the demands of powerful economic interests.

A second set of explanations examine the lobbying activities and the structural power of the financial industry, which result in "regulatory capture" (Baker 2010). Consequently, national preferences on international regulatory negotiations are shaped by interest groups that "have succeeded in becoming embedded in the relevant regulatory decision-making structure" (Farrell and Newman 2010, 620), or are able to form powerful transnational alliances (Newman and Posner 2016). Some authors also pay attention to business-government relations and the capacity of interest groups to mobilise successfully. For example, Culpepper and Reinke (2014) argue that business must assert its structural power strategically, as in the case of the bank bail-outs in the UK and the US. Some studies also highlight the heterogeneity of preferences and divisions among interest groups (Young 2012; Pagliari and Young 2014).

Yet, business power explanations fit less well in the UK context. Paradoxically, the UK has continued to prioritise the competitiveness concerns of the hedge fund industry at the international and EU levels, even though the sector is highly fragmented and comparatively weakly organised (Woll 2013). By contrast, the UK banking industry, which is highly internationalised and enjoys extensive transnational linkages, has been unable to prevent the imposition of some of the highest capital and liquidity

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requirements in the world, despite its extensive lobbying capacity (Baker 2010; Young 2012) and the significant structural power wielded by the UK's largest global banks (Bell and Hindmoor 2015).

Partisan explanations would consider the effects of party preferences on financial regulation. The expectation is that left-wing parties pay more attention to financial stability and therefore demand more stringent regulation, whereas right-wing parties favour lax regulation as they are more sensitive to financial industry competitiveness (Way 2000; Westrup 2007). However, in the UK case, prior to the financial crisis, the two main parties on the left and right, namely Labour and Conservatives, privileged the competitiveness of the financial industry (Hopkin and Shaw 2016). Counter-intuitively, the tightening of post-crisis banking regulation took place under a Conservative-led government from 2010, and was supported by the opposition Labour party. Moreover, there was no discernible difference in the willingness of Labour and Conservative ministers to defend the interests of the hedge fund industry. Partisan accounts therefore provide limited explanatory power for post-crisis regulatory reform in the UK.

Finally, ideational and constructivist explanations posit that national preferences are shaped by causal ideas, or policy paradigms, held by policymakers. For example, Quaglia (2010, 2012) contrasts the "market-making" versus "market-shaping" approaches to financial regulation in the EU. Yet, this pre-crisis perspective needs updating to reflect the fact that, since the crisis, the UK has shifted from being a "market-maker" to a "market-shaper" in many areas of financial regulation. To this end, Bell and Hindmoor (2015, 2016) argue that regulatory preferences have shifted because of declining threat perceptions among policymakers and the enhanced capacity of the state, which has diminished the power of organised economic interests.

Theory, research design and overall argument

We set out to explain national preferences concerning the stringency of financial regulation: in other words, whether the UK chooses to "trade up" or "trade down" financial regulatory standards by pursuing international or EU rules that are more or less strict than existing rules. We define national preferences as the revealed policy positions of UK representatives in international and EU regulatory negotiations. International standards are "soft law" that constrain all major jurisdictions, whereas EU regulation is "hard law" that constrains only those in the EU, and indeed may disadvantage them with respect to external competitors. However, EU financial regulation is often based on international standards and is therefore used to make them legally binding across the EU.

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Our analytical framework starts with a traditional "dilemma" in financial regulation, namely the need to safeguard financial stability, as well as the competitiveness of the financial sector (Kapstein 1989). Stability and competitiveness are frequently in contradiction. Regulations that promote high-risk financial activities, for example, may increase competitiveness at the expense of long-term stability. Conversely, overly stringent regulation can stifle innovation and place domestic industry at a competitive disadvantage. International and EU financial harmonisation can often provide a way to reconcile these competing incentives (Singer 2004, 2007). By "trading up" financial regulation through international or EU agreements, national authorities can implement more stringent regulation at home without putting domestic firms at a competitive disadvantage (Singer 2004, 543). Trading up can also contribute to addressing negative cross-border externalities that transmit financial instability across borders (Quaglia 2017). The nature of this trade-off is particularly acute with respect to financial regulation in the UK. In the wake of the financial crisis, for example, the UK government explicitly alluded to the "British dilemma" between restoring the stability of the domestic banking system and protecting the international competitiveness of the City of London (Osborne 2010).

The analysis draws on theories of liberal intergovernmentalism (Moravcsik 1993, 1998) to provide a critical reading of how regulatory preferences are formed at the national level. These are based on a liberal understanding of state-society relations, according to which societal "groups articulate preferences and governments aggregate them" (Moravcsik 1993, 482). It explains national preference formation by looking at the configuration of *interests* in a particular policy domain, and the *institutions* through which they are aggregated.

With respect to interests, national regulators must remain attentive to the views of powerful economic interests as they provide important sources of political support, legitimacy, technical knowledge and expertise. These are valuable resources that regulators need in order to formulate their preferences, and which strengthen their capacity to shape financial regulatory reforms in multilevel negotiations. The financial industry is a particularly powerful voice capable of mobilising vast resources for or against regulatory agreements based on the anticipated costs of regulatory change. In the UK context, the City of London has historically enjoyed close links to Westminster and Whitehall, giving it a prominent role in economic policymaking (e.g. Moran 1991; Baker 1999).

The next step is to consider how powerful economic interests are aggregated and mediated by institutions, which we define in terms of both the *political process* and *regulatory institutions*. During periods of economic

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stability, the political process rarely impinges on regulatory policymaking as highly technical, day-to-day decisions are delegated to autonomous regulatory agencies. The influence of powerful economic interests is high as decisions are made in the realm of "quiet" politics and informal modes of governance, and thus largely insulated from day-to-day political pressures (Culpepper 2011). In response to regulatory failures or economic crises, the influence of industry declines as decisions are escalated to more formal political decision-making arenas, such as ministerial or legislative committees, which face greater public exposure. In this context, the political process serves as a direct source of pressure on regulatory institutions to respond to voters' concerns.

Regulatory institutions relate to the policymaking competences, resources and ideas that are embedded within regulatory organisations (Busch 2004; Bell and Hindmoor 2016). In financial regulation, regulatory agencies (central banks and independent financial regulators) are responsible for negotiating international standards in transnational networks, such as the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board. Commonly, these nonbinding standards are then translated into hard EU legislation: at this level, national finance ministers and finance ministry officials lead the negotiations in the Council working groups, supported by the relevant regulatory agency. Different institutions are equipped with varying levels of technical expertise and informational resources, and internalise different ideas about regulation. Institutions are therefore not neutral arenas for aggregating interests, but have considerable power to shape, resist or promote the interests of different groups.

Our framework leads us to predict that when political pressure is high and regulatory institutions are strong, regulators are able to resist powerful economic interests and pursue more stringent regulation aimed at restoring financial stability. However, when political pressures are absent and regulatory institutions are relatively weak, economic interests wield greater influence in shaping regulation designed to protect their competitiveness. The two cases we examine below illustrate this argument.

Case study selection

We assess the analytical leverage of this framework through a structured focussed comparison and within case analysis of two case studies that provide contrasting examples of the UK's post-crisis financial regulatory preferences at the international and EU levels. In the banking sector, UK regulators pushed strongly for the "trading up" of regulation concerning bank capital requirements – namely, the Basel III international accord and

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the EU Capital Requirements Directive IV (CRD IV). By contrast, the UK remained keen to "trade down" regulation of capital markets – for example, with respect to the regulation of hedge funds through the principles issued by the IOSCO, and the EU Alternative Investment Fund Managers directive (AIFMD).

Methodology and sources

We engage in a structured comparative analysis of two cases, mapping and explaining the formation of UK preferences in each case. The empirical analysis draws on a variety of sources, including 10 interviews with senior officials from the UK Treasury, the Bank of England and the Financial Services Authority (FSA), and 10 interviews with senior representatives of UK-based trade associations and representatives of individual banks in London. The interviewees were selected on the basis of their institutional position and involvement in relevant financial regulation. All the interviews were conducted on a confidential basis. We also cross-checked the information gathered with publicly available policy documents and a systematic survey of press coverage. The article begins by summarising the impact of the financial crisis on voter confidence in the financial industry, and explains how this elicited political pressure to restore financial stability and led to the reform of UK regulatory institutions.

The international financial crisis and the reform of domestic regulatory institutions

The financial crisis severely dented voter confidence in the financial services industry (see Bennett and Kottasz 2012). In surveys, 66% of the UK public thought there had not been enough reform of the financial sector (ComRes 2014), 73% rated the reputation of banks as "bad" and 60% supported the view that government should impose "tougher" financial regulation (YouGov 2013). The fiscal burden of bailing out two of the UK's largest banks (RBS and Lloyds) sent shockwaves through the political establishment. Addressing the concerns of the median voter (Downs 1957), the priority for both main UK parties was the restoration of financial stability and the protection of taxpayers. Government ministers signalled clearly to bank regulators and industry that in the event of further bank failures there would need to be a "serious downsising" of the City of London.[2]

The financial crisis was followed by a reform of financial regulatory institutions in the UK. Before the crisis, under the "tripartite" regulatory

[2] Interview with UK lobbyist, May 2013.

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system put in place in 1997, responsibility for financial stability was shared between three institutions: the Bank of England, which managed monetary policy; the FSA, a single supervisory agency for banking, insurance and securities; and the Treasury, the government department responsible for legislation. The institutional design of the FSA embodied a particular set of pre-crisis ideas about "light touch" or "risk-based" financial regulation (Westrup 2007). The FSA subscribed to the pre-crisis orthodoxy that financial stability rested on the soundness of individual institutions. This "microprudential" approach reflected the view that greater transparency, disclosure and effective risk management by firms was necessary to regulate efficient markets, and that firms should abide by the spirit of high-level principles rather than the letter of detailed rules (Baker 2013).

The FSA's supervisory failings led to mounting parliamentary criticism of the tripartite system. In 2009, the Conservative opposition announced its intention to abolish the FSA and transfer the bulk of its regulatory and supervisory powers to the Bank of England, based on the recommendations of Sir James Sassoon (Conservative Party 2009, 14–16). Following the election of a Conservative-led Coalition government in May 2010, responsibility for microprudential supervision of individual banks was transferred from the FSA to the Bank, housed in the new Prudential Regulatory Authority (PRA), while responsibility for supervising all other financial firms, together with conduct regulation, was moved to the independent Financial Conduct Authority (FCA). These institutional reforms resulted in a doubling of staff numbers in the Bank, with the headcount increasing from 1,769 in 2010 to 3,948 in 2016 (Bank of England 2017).

Since 2010, the Bank has been granted important new macroprudential powers and increased resources to execute its strengthened mandate for maintaining financial stability. These changes have been underpinned by a wider macroprudential ideational shift that emerged from the financial crisis (Baker 2013; Baker and Widmaier 2014; see also Borio 2011; Haldane 2013). The macroprudential perspective reverses many of the core assumptions of the efficient markets hypothesis, by highlighting the inherent procyclical tendencies of financial markets, the propensity for herd behaviour amongst investors and the destabilising effects of financial complexity (Baker 2015, 351). It justifies new forms of regulatory intervention through the use of countercyclical policy measures to restrain and direct market activities on a system-wide basis (Haldane 2013). The centrepiece of these reforms in the UK was the creation of a powerful new Financial Policy Committee (FPC), chaired by the Bank Governor and supported by a new macroprudential strategy division (see Bell and Hindmoor 2016). The FPC was given broad oversight of financial stability and systemic risk, and was granted a range of new macroprudential

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policy-making powers. These include the legal authority to set the countercyclical capital buffer introduced through Basel III; to set sectoral capital requirements; make “comply or explain” recommendations to the PRA; and make recommendations to the Treasury on the setting of the boundary between regulated and nonregulated financial activities (Tucker et al. 2013, 195).

We argue that political pressure for tougher regulation of banks, combined with greatly strengthened domestic regulatory institutions, have curtailed the influence of powerful banking interests. The development of a new macroprudential regulatory paradigm has enabled the Bank of England to serve as the intellectual driving force behind the UK’s push for more stringent international and EU banking regulation (Bell and Hindmoor 2016; James 2016). By contrast, there has been no equivalent shift in the realm of capital market regulation where the legacy of microprudential supervision continues to prevail. Although the FSA attempted to challenge the pre-crisis orthodoxy by highlighting the need to include the shadow banking system in macroprudential regulation, it was weakened by a lack of political support and diminished institutional resources. Consequently, the hedge fund industry was highly effective in defining the UK’s regulatory preferences at the international and EU levels in defence of the sector’s competitiveness. Our argument is illustrated below with respect to bank capital requirements and hedge fund regulation.

Banking regulation: trading up

The UK’s regulatory preferences on capital requirements have undergone a marked change. This is underpinned by a recognition that the country is uniquely vulnerable to financial instability owing to the concentrated and highly leveraged nature of its banking sector (Alessandri and Haldane 2009). It also reflects the belief among leading UK regulators that capital ratios should be set far above the losses likely to be incurred by the failure of an individual bank, in order to protect the macro systemic stability of credit supply (Miles et al. 2011; Turner 2011). Armed with new countercyclical policy tools, the PRA therefore forced UK-based banks to deleverage by raising capital requirements “tenfold” (Carney 2015), through the use of higher equity capital requirements, tougher liquidity rules and by introducing a new gross leverage ratio (King 2010). The FPC strictly enforced these new rules, using stringent stress tests and scrutinising bank risk-weights, to assess the adequacy of capital buffers. This culminated in a regulatory regime for banking, which is among the toughest in the world (Bell and Hindmoor 2016).

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Given the scale of the UK financial services sector, the extent to which bank capital requirements needed to be tightened to restore financial stability risked damaging the sector's competitiveness. This was vocalised by the UK's largest global banks (HSBC, Barclays and Standard Chartered), all of whom threatened to relocate overseas in response to the UK's deteriorating regulatory outlook (James 2017). In response, UK regulators actively pursued a strategy of trading up, seeking international and EU level regulatory harmonisation around more stringent standards to minimise the potential competitive disadvantage to UK banks.

Internationally, the Bank of England and the FSA allied with US and Swiss counterparts, adopting "trench warfare" to push for a stricter definition of capital, higher capital requirements, new liquidity rules and the introduction of a leverage ratio.[3] The intellectual driving forces during the Basel negotiations were the US Federal Reserve and the Bank of England/FSA, not least because they occupied a disproportionate share of the chairmanships of key subcommittees. Indeed, the FSA cochaired the BCBS Working Group on the Definition of Capital, whereas the Bank of England and Federal Reserve cochaired the BCBS Working Group on Liquidity. The UK achieved most of its objectives in the Basel III accord, which included significantly higher equity capital requirements, agreed in December 2010.

As the debate shifted to the EU level, the Bank of England was determined to ensure that the rules were implemented in full. Worryingly, however, the European Commission's draft proposal for implementing Basel III, through the CRD IV, threatened the Bank's objectives in two respects. First, the CRD IV was significantly less stringent than Basel III. At the insistence of France and Germany, capital definitions were to be diluted to allow state support ("silent participations") and insurance subsidiaries ("double counting") to be excluded in the calculation of regulatory capital. Second, the Commission's insistence on "maximum harmonisation" would prevent the FPC from imposing higher capital requirements on UK retail banks than international or EU standards, rendering the new body "completely toothless".[4]

The Bank of England's position was at odds with the UK-based financial industry, and strained relations with the Treasury. The British Bankers Association (BBA) initially opposed Basel III on the grounds that this would hit profitability, damage lending to the real economy and place UK banks at a competitive disadvantage *vis-à-vis* the US and China (*Financial Times*, "Basel rewrites capital rules for banks", 12 September 2011). During the negotiations, for example, the BBA and six large UK banks commissioned the professional services firm, Price Waterhouse Cooper, to produce a

[3] Interview, UK official, April 2013.
[4] Interview, UK official, June 2013.

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report compiling the likely impact of the Basel rules on the supply of credit in the economy. Yet, the initiative, known as Project Oak, was regarded as "futile and inaccurate" and largely ignored by UK regulators.[5] At the EU level, industry's fallback position was to lobby strongly in favour of maximum harmonisation to create a level playing field in the EU.[6] UK-based banks deliberately distanced themselves from the views of UK negotiators and instead sought to build support among finance ministries and regulators in other EU member states.

The Treasury was not viewed as having a strongly held view on bank capital requirements, or banking reform more generally, because it was "seriously inadequate in terms of resources and basic understanding".[7] As a result, they were "very keen to understand from all the banks involved what the impact of these rules would be. It was quite considerable in terms of volume and quality of information throughout".[8] A regulator suggested that this lack of expertise meant that the Treasury was considerably more willing to engage with industry than the Bank of England: "Certainly what I've seen is that the Treasury goes to the banks and says 'well how does this work, can you teach us how this works?' … So the banks can push certain arguments in the Treasury that we [the Bank] would slap down very quickly".[9]

As a result, the Treasury's preferences are generally perceived to be much closer to that of industry. Although broadly supportive of the Bank's determination to strengthen bank capital, Treasury officials expressed mounting concern about the pace and severity of deleveraging and its impact on the UK economy. For example, one official was critical of "jihadist" elements in the Bank for forcing banks to comply with leverage ratio early, whereas Vince Cable referred to the capital "Taliban" for damaging lending (*Financial Times* "Vince Cable attacks Bank of England's 'capital Taliban'", 23 July 2013). On CRD IV, the Treasury wanted to avoid damaging the competitiveness of the City of London and was therefore more sympathetic to the principle of maximum harmonisation on the grounds that this would create a level playing field.[10]

Industry lobbyists tried to exploit these institutional divisions by lobbying the Treasury and No. 10 against the Bank's hardline position. Senior lobbyists confirmed that while lobbyists found the Bank of England to be largely impervious to industry pressure, the banks sought to exploit

[5] Interview with UK regulator, April 2013.
[6] Interviews with trade associations officials, March 2013 and June 2013.
[7] Interview with industry lobbyist, September 2013.
[8] Interview with industry lobbyist, August 2013.
[9] Interview with Bank regulator, July 2013.
[10] Interview with UK regulator, November 2011.

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"regular contacts and existing relationships" with the Treasury and were given "remarkable access" to ministers by No. 10.[11] In a sign of how strained relations had become, the Bank Governor publicly denounced industry's attempts to influence ministers, whereas Robert Jenkins, a member of the FPC, claimed that industry lobbying tactics were intellectually dishonest (Jenkins 2011).

The Bank was pivotal in defining the UK's negotiating position on CRD IV. Before the crisis, it had tended to leave EU matters to the FSA, but the centralisation of financial supervision in the Bank transformed its role and strengthened its capabilities.[12] It sought to defend the UK's achievements in strengthening international capital rules, forced UK banks to comply years ahead of schedule and championed the capacity of UK regulators to gold plate global standards to reflect the size of its financial sector. In response, leading UK regulators made a series of public interventions aimed at keeping the Treasury's "feet to the fire".[13] As the debate shifted to Brussels in 2011, the FPC issued interim recommendations urging the government to defend regulators' flexibility, whereas Mervyn King told Parliament that Basel III did not go far enough and cited the support of the International Monetary Fund (IMF), European Central Bank and European Systemic Risk Board for its position (*Financial Times*, "IMF supports UK push on bank rules", 6 June 2011).

The Bank also galvanised wider political support based on the recommendations of the Independent Commission on Banking (ICB 2011), which called for UK retail banks to hold equity capital significantly above Basel III rules to reduce the risk of future state support. A series of bank scandals, culminating with the establishment of the Parliamentary Commission on Banking Standards in 2012, maintained further political pressure on the Treasury to resist fierce industry lobbying. In this way, the Bank constrained the position of Treasury negotiators by publicly denouncing maximum harmonisation and making opposition to it a red line issue. In the end, Treasury officials "held the line" and the EU eventually agreed to a series of legal derogations in the CRD IV, which provided UK regulators with the discretionary powers they sought (James 2016).

Capital market regulation: trading down

During the crisis, starkly divergent views emerged within the UK about how capital markets should be regulated. The senior leadership of the FSA

[11] Interview with UK regulator, July 2013.
[12] Interview with UK official, November 2011.
[13] Interview with UK regulator, June 2013.

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underwent a rapid process of learning and lesson-drawing from the crisis, which, as in the Bank of England, led to a profound ideational shift on financial regulation. As a result, the FSA became a strong supporter of more stringent regulation in 2008 and its head, Lord Adair Turner, was one of the "most forceful and eloquent advocates" of the macroprudential approach (Baker 2013, 125). In March 2009, Turner published his review of financial regulation (Financial Services Authority 2009). It argued that one of the crucial factors in the origins of the crisis was regulatory arbitrage arising from the development of "shadow" financial institutions that performed bank-like functions, but which were not regulated as banks (FSA 2009, 72). It argued that hedge funds had now become "systemically important" and that macroprudential regulation, including stricter capital and liquidity rules, should in future be extended to all investment intermediaries that become "bank-like in nature or systemic in importance" (FSA 2009, 73). The FSA therefore pushed for the adoption of a tough new macroprudential approach to regulating the hedge fund sector at the G20 and the Financial Stability Forum, and made the case forcibly to the Treasury, Bank of England and Cabinet Office.[14]

However, the political authorities in the UK, unlike for example those in France and Germany (Fioretos 2010; Pagliari 2011; Woll 2013), remained reluctant to tighten up regulation of capital markets. A joint document produced by the Treasury and the FSA (2009, 2), under the leadership of the Treasury, articulated the view of industry representatives that "hedge fund activity (either in Europe or elsewhere) has not been shown to have contributed significantly to the crisis". The document also pointed out that "the individual risks they [hedge funds] pose are not unique" and therefore legislation aimed at hedge funds alone would be unwarranted. The Treasury's view was supported by the publication of several official reports (e.g. the report of the de Larosiere Group in the EU, and the report of the Group of Thirty), which did not explicitly identify hedge funds as major culprits of the crisis.

In line with our explanation, the position of the Treasury can be ascribed to the fact that it faced little political pressure from ministers to crack down on the hedge fund industry. Instead, Treasury officials remained firmly wedded to their long-held commitment of defending the competitiveness of the predominantly UK-based sector. While the FSA sought to extend tougher macroprudential regulation to capital markets, its capacity to push back against the Treasury's pre-crisis orthodoxy during 2009–2010 was, however, severely limited by the fact that it was engaged in a bureaucratic fight for survival. We argue below that in the absence of political pressure

[14] Private conversation conveyed to author, quoted in Baker (2013, 125).

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for reform, together with institutional weakness on the part of regulators, industry was therefore highly effective in shaping the UK's regulatory preferences at the international and EU levels.

New regulatory initiatives to curb the activities of hedge funds developed rapidly during 2009. At the G20 London summit in April 2009, political leaders called for the direct regulation of hedge funds for the first time, recommending greater disclosure of information about fund investments to enable regulators to assess their systemic risk (G20 2009). The European Commission responded swiftly by announcing that it planned to introduce a harmonised regulatory framework for AIFM (European Commission 2009, 5). Under pressure from France, Germany and the European Parliament, the Commission hastily produced a draft directive in June 2009, which imposed a number of stringent requirements. These would require the AIFM to register and seek authorisation with national authorities, and meet new reporting, governance and risk management standards, including minimum capital requirements.

From industry's perspective, AIFMD would be highly damaging to the competitiveness of the EU hedge fund industry, 85% of which was based in the UK (TheCityUK 2012). The draft directive was viewed not simply as a politically motivated attack on "Anglo-American" capitalism, but as a deliberate attempt to support the European mutual fund industry, predominantly based in France (23%) and Germany (20%) (Woll 2013). Industry was particularly concerned about the imposition of prescriptive third country equivalence rules that threatened to harm the City of London by locking overseas firms out of lucrative EU markets (Quaglia 2011). In response, the hitherto highly fragmented and weakly organised sector launched a concerted lobbying campaign of UK ministers and regulators.

Because of the public backlash against the financial industry, government ministers were hesitant to appear too supportive of the sector in public. Yet, public awareness and knowledge about the industry was comparatively limited (Treasury Committee 2006, 156). Unlike, for example, in France and Germany (Pagliari 2013; Woll 2014), where the regulation of hedge funds attracted strong political intervention, in the UK ministers saw little electoral advantage in attacking the industry and their own understanding of the role of hedge funds in contributing to the crisis was relatively limited. In private, the government was therefore "quite sympathetic" to industry's concerns and "promised to do all they could to help".[15] Industry executives were given "very good access" to senior ministers in both the Labour and Conservative governments, and they provided "good political support all

[15] Interview with UK regulator, February 2014.

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the way through the process" because they recognised that the sector was important for employment and tax revenue.[16]

Although City Minister Lord Myners had been highly critical of hedge funds in the past, by mid-2009 he was echoing the concerns of industry that the directive was "woefully short-sighted" and "bordering on a weak form of protectionism" (*Financial Times*, "UK knocks EU fund proposal", 7 July 2009). Following the election, Chancellor George Osborne signalled that the sector's competitiveness should be protected, whereas the House of Lords EU Committee called on the government to refuse to support AIFMD (House of Lords 2010). Unlike banking, there was therefore a notable lack of political support for more stringent regulation of capital markets.

UK regulators had failed to anticipate the EU proposal and were initially slow to respond; as in banking, this was attributed to them being severely underresourced. The Treasury had limited resources in the hedge fund sector because it had not been a significant "political issue" before the crisis, whereas the FSA policy team lacked "practical expertise".[17] In addition, the FSA was fatally weakened at this time by mounting speculation that it would be abolished, exacerbated by the Conservatives' strong performance in the 2009 European Parliament elections. According to industry figures, the FSA underwent a "collective nervous breakdown" as its top talent left the institution, and it became a "real nonactor" after the 2010 election.[18]

Consequently, both institutions were heavily reliant on the advice and support of industry lobbyists in formulating the UK's negotiating position.[19] A close relationship with industry subsequently developed, managed through a series of working groups in the Treasury and the FSA, which were used to find out industry's priorities, gather technical advice and to agree negotiating positions.[20] The Treasury had no strong pre-existing view: "They had no clear position. They just wanted to try and make the directive workable. I didn't see any particular strategy, they were just reacting".[21] Under pressure from ministers, Treasury officials assured senior executives that they would fight for changes to be made, and engaged closely with industry "to work out what it thought, on the hoof".[22]

With fate of the FSA sealed by the outcome of the 2010 general election, financial regulators struggled to provide a clear strategy: "The FSA didn't give me any objectives. The message was just to make it technically

[16] Interview with industry lobbyist, April 2014.
[17] Interview with industry lobbyist, February 2014.
[18] Interview with industry lobbyists, December 2013.
[19] Interviews, UK official, February 2014; trade association officials, February 2014.
[20] Interview, UK official, April 2013.
[21] Interview with UK regulator, April 2014.
[22] Interview with industry lobbyist, February 2014.

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workable. That was achieved by setting up these technical working groups, listening to industry, and running policy by them".[23] Regulators openly acknowledged that it was "very easy to buy into the technical advice that you're given by the industry", and that "they probably didn't realise how influential they were on me".[24] Under time pressures and lacking resources, UK negotiators in Brussels often relied on lobby groups to provide suggested text, which could be used when drafting rules.[25] As a lobbyist argued, "we didn't have any problem getting them to take our red lines to Brussels".[26] Equally, UK negotiators helped industry groups, which had little knowledge or experience of the EU policy process, to play a constructive role by engaging with the European Parliament and targeting key Members of the European Parliaments.[27]

In the absence of political support for tougher regulation, and under heavy industry pressure to defend the sector's competitiveness, UK regulators sought to "really go after" the content of proposed new international and EU rules.[28] The two-chairs of the IOSCO working group that drafted in 2009 the *Key Principles for Hedge Fund Regulation* 2009 came from the British FSA and the Italian Consob, and espoused, respectively, a "minimalist" and a "maximalist" approach to the regulation of hedge funds. The minimalists, led by the FSA, were in favour of indirect regulation of hedge funds and argued that only the hedge fund manager should be regulated. The maximalists, led by continental regulators, argued that the hedge fund itself should be regulated.[29] In the end, the IOSCO recommendations that emerged were deliberately ambiguous on this issue, which suited the UK's interests.

In the EU negotiations that followed in 2010, UK regulators repeatedly blocked the legislative proposal for AIFMD, resulting in deadlock in the Council. With German support waning, and under the threat of retaliation from the US, the French eventually agreed to back down by amending the more contentious provisions. In July 2010, the FSA brokered a compromise that resolved the third country issue by relaxing the new rules for regulatory equivalence and delaying implementation to 2018. In response to the revisions, industry signalled that the outcome was something that it could "live with". Having failed to resist EU-level harmonisation on competitiveness grounds, UK regulators nonetheless succeeded in watering down the directive in line with industry demands.

[23] Interview with UK negotiator, April 2014.
[24] Interview with UK regulator, February 2014.
[25] Interview with UK regulator, April 2014.
[26] Interview with industry lobbyists, December 2013.
[27] Interview with industry lobbyist, April 2014.
[28] Interview, UK official, December 2013.
[29] Interviews, with IOSCO official, March 2009 and Italian official, June 2010.

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Conclusion

This article started with an empirical puzzle concerning the UK's inconsistent preferences on post-crisis international and EU financial regulation. We argue that when political pressures are high and regulatory institutions are strong, regulators are able to resist powerful economic interests and pursue more stringent regulation aimed at restoring financial stability (as in the case of bank capital requirements). However, when political pressures are absent and regulatory institutions are relatively weak, economic interests wield greater influence in shaping regulation designed to protect their competitiveness (as in the regulation of hedge funds).

The article contributes to the broader literature on lobbying and business power by specifying the conditional nature of the financial industry's influence. In the case of capital markets, UK regulators prioritised competitiveness issues and the trading down of international and EU rules. This is because political pressures for regulatory reform at home was low, and domestic regulatory institutions lacked the capabilities to resist powerful economic interests. In the case of hedge funds, regulators therefore had little choice but to forge a close alliance with industry to leverage its expertise during the international and EU negotiations. In banking regulation, by contrast, regulators were under high political pressure to avoid further bank failures and restore financial stability. Regulatory institutions had been significantly strengthened in terms of both policy-making powers and resources, underpinned by new macroprudential regulatory ideas. This enabled regulators to shun industry lobbying efforts, pursue harmonisation around more stringent bank capital requirements and even push for discretionary powers to permit rules above and beyond international and EU standards.

Although beyond the scope of this article, we conclude by reflecting briefly on what our framework would predict for "mixed" cases: that is, cases of strong political pressure/weak regulatory institutions and weak political pressure/strong regulatory institutions. If political pressure is strong and regulatory institutions are weak, we expect that elected officials would establish new or *ad hoc* institutional structures to overcome the limited capacity of existing regulatory institutions. These new structures would be designed to accumulate knowledge and expertise around a specific regulatory issue, and to develop regulatory reform proposals. An illustration of this would be the UK's banking reform process. In the absence of expertise on bank "structural" reform among regulators, and in response to political pressure for high street banks to be broken up, the government responded by establishing an ICB in July 2010 to gather evidence and make policy recommendations. Although this *ad hoc* institution

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proved highly effective in resisting industry lobbying, the disbanding of the ICB in 2011 paved the way for large banks to exert greater influence over the Treasury. This resulted in the final legislation being significantly weaker than originally intended (James 2017). The framework would also lead us to expect that, in relying on ad hoc institutional structures to develop regulatory proposals, the scope for international harmonisation is likely to be much less. This was indeed the case with bank structural reform, whereby the UK has made little effort to define or shape international or EU-level standards (Quaglia and Spendzharova 2017).

By contrast, in cases in which political pressure is weak and regulatory institutions are strong, we are more likely to see regulators acting autonomously to tighten regulation domestically, while playing an active role in trading up international and EU-level standards. For example, elected officials in the UK paid relatively little attention to the regulation of over-the-counter derivatives following the crisis. Yet it was regarded as an important priority for regulators in the Bank of England to which responsibility was transferred for the oversight of Central Counter Parties. In response, the Bank was an international pace-setter in defining new standards issued by the IOSCO and the Committee on Payment and Settlement Systems (Quaglia 2014). Unlike bank structural reform, however, regulators were in a much stronger position to resist industry lobbying. In short, while both "mixed" cases produced more stringent rules, regulatory reform proved to be more robust in the face of industry pressure when regulatory institutions were strong.

Our analysis has added significance in light of the UK's decision to withdraw from the EU. Fundamentally, the article challenges pre-crisis narratives about the UK as a champion of financial deregulation, often caricatured as battling to resist the imposition of external (often EU) regulatory burdens on the City of London. On the contrary, we show that UK regulators have often pursued increasingly stringent international and EU standards at odds with the views of the banking industry. This is because standardised rules enable UK regulators to achieve domestic policy objectives, such as restoring stability or boosting competitiveness. This remains important in the context of Brexit. In his evidence to the Treasury Select committee at the House of Commons, the governor of the Bank of England (2017) Mark Carney stated that post-Brexit "We do not want to be a *rule-taker as an authority*. Right now, *we are not a rule-taker*; we come to a consensus within the EU … the rules in the EU are influenced by international standards and by the presence of UK officials in their development. Once we are not there, one would expect increasingly rules with which we do not agree" (*emphasis* added). Post-Brexit, UK regulators are therefore likely to try to increasingly influence international standards to compensate for their loss of influence on EU regulation.

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We anticipate that Brexit will reinforce the tendency of the UK to adopt inconsistent preferences on financial regulation. In banking, UK regulators are likely to maintain strict banking regulation as they prioritise domestic financial stability, in line with their strengthened post-crisis mandate (Pagliari 2017). In his main speech after the UK government invoked article 50 to start the withdrawal from the EU, Bank of England Governor Mark Carney (2017b) argued that hosting the world's leading international financial sector "requires the highest standards of supervision and regulation". Carney signalled that there should be "no bonfire of regulation" as a result of Brexit, and that UK regulators would push for "enhanced equivalence", "mutual recognition" and "intensive supervisory cooperation" at the European and international levels (Carney 2017a, 2017b). Similarly, the head of the FCA, Andrew Bailey, stated that in recognition of the UK's role in underpinning financial markets as an international public good, "we do not intend to create a race-to-the-bottom on deregulation" and that they "continue to be prepared to go further" in regulating financial markets than other jurisdictions (Bailey 2017).

From the perspective of industry, there is little appetite for deregulation in banking. Rather, the "overwhelming majority" of financial firms support maintaining "regulatory coherence with Europe" in order to maximise access to the EU single market, as suggested in several confidential interviews.[30] The Great Repeal Bill is therefore not viewed as a vehicle for regulatory change, but instead as an opportunity to "ensure clarity and continuity wherever possible".[31] Moreover, many expect UK regulators to continue, and even possibly extend, the existing practice of "goldplating" EU legislation, such as on bank capital, so that UK rules are significantly tougher. By contrast, there is greater scope and industry pressure for the UK to pursue less stringent regulation in other financial sectors after Brexit. For example, evidence suggests that insurance firms are "pushing hard" for post-Brexit changes to reduce the regulatory burden of EU legislation, particularly the new Solvency II directive (MS).[32] We would anticipate similar calls from the hedge fund sector, particularly from those firms and individuals that were prominent sponsors of the Leave campaign during the referendum, many of whom view Brexit as an opportunity for "regulatory roll back".[33] In short, we conclude that the impact of Brexit is likely to make the regulatory challenge of managing the British dilemma in finance more, not less, acute.

[30] Interviews, with industry trade association and UK bank, July 2017.
[31] Interviews, with industry trade association and UK bank, July 2017.
[32] Interview, US bank, July 2017.
[33] Interview, UK trade association, July 2017.

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