
Capital Rules: The Domestic Politics of International Regulatory Harmonization

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Abstract In the past fifteen years, financial regulators from the developed world have attempted to create international regulatory standards in a variety of financial issue areas. Their negotiations are notable for the stark variation in the preferences of regulators toward international regulatory harmonization. Certain regulators actively resist any attempts at regulatory harmonization, while others are vocal in their advocacy for an international agreement. When will regulators seek to harmonize their rules with their foreign counterparts? I propose a principal-agent framework for analyzing regulator behavior that views international harmonization as a means of satisfying domestic political pressures. The framework predicts that regulators are more likely to seek international regulatory harmonization when confidence in the stability of financial institutions is declining, and when competitive pressures are increasing from foreign firms facing less stringent regulations. I explore the consistency of the framework with two important cases in the history of international financial regulation: the negotiations among bank regulators leading up to the 1988 Basel Accord on bank capital adequacy, and the negotiations among securities regulators over capital adequacy for securities firms between 1988 and 1992.

The globalization of capital markets has drawn increasing attention to the prudential regulation of banks and securities firms. In an era of high capital mobility in the industrialized countries, market volatility and competitive pressures place great strains on financial regulators. Shocks such as the less-developed countries (LDC) debt crisis and the 1987 stock market crash can lead to a crisis of confidence in a country's regulatory environment. However, if regulators respond unilaterally with strict and costly regulations, they may put their financial sectors at a competitive disadvantage with foreign rivals. Faced with this "regulator's dilemma," financial

I thank Gabe Aguilera, David Bach, Ethan Bueno de Mesquita, Dan Carpenter, Bill Clark, Mark Copelovitch, Jeff Frieden, Dan Gingerich, Dan Ho, Devesh Kapur, Joseph N. R. Sanberg, Ross Schaap, Allan Stam, Matt Stephenson, two anonymous reviewers, and the editors of *IO* for helpful comments, discussions, and feedback. I am also indebted to the thirty current and former regulators and financial industry executives who participated in interviews to advance this project. Finally, I thank the Weatherhead Center for International Affairs and the Center for European Studies for research funding.

regulators from the industrialized countries have initiated a range of efforts to harmonize their prudential regulations—that is, to negotiate internationally accepted minimum requirements for the stability of financial institutions.¹ The variation in regulator behavior in these negotiations is striking: certain regulators are adamant in pushing for an international standard, while others remain aloof or actively resist the creation of an international agreement.

The political science literature has offered few studies of the circumstances under which financial regulators will demand international standards. Existing studies of the 1988 Basel Capital Accord—the most prominent example of international regulatory harmonization—either assume that regulators have the lofty goal of mitigating global systemic risk, or neglect the importance of regulators as agents in the negotiation process.² By treating the Basel Accord as an isolated case, these studies miss an important opportunity to offer a more general model of the politics of international regulatory harmonization. A recent study by Simmons examines the processes of regulatory harmonization in four financial issue areas but uses a country's "incentives to emulate" as an independent variable rather than specifying systemically what those incentives are and how they vary.³ As regulators gain prominence as international actors in the current era of globalization, it is imperative that scholars of international relations learn more about their patterns of cooperation. This article contributes to the literature by explaining the circumstances under which financial regulators will seek to harmonize with their foreign counterparts—or, in other words, to explain precisely what the incentives are that lead a regulator to press for harmonization.

I propose an analytical framework that captures the competing domestic pressures on regulators, and the role of international regulatory harmonization in addressing these pressures. The framework assumes a principal-agent relationship between a legislature and a regulator.⁴ The legislature, as the principal, delegates the responsibility for setting and implementing financial regulations to a regulatory agency and imposes boundaries on that agency's policymaking through the threat of legislative intervention. The legislature maximizes a combination of campaign contributions and aggregate welfare, whereas the regulator is only concerned with maintaining its decision-making autonomy. Furthermore, the regulator is limited to a single policy tool of regulatory stringency, unlike the legislature, which has a range of policy options at its disposal. The regulator chooses a degree of regulatory stringency that falls within its "win-set"—the range of policy choices

1. On the regulator's dilemma, see Kapstein 1989. Financial regulators use the terms *harmonize* and *harmonization* to refer to the purposive efforts by regulators to agree on a common set of regulations for a given issue area. I differentiate harmonization from the process of regulatory convergence that arises organically through market pressures or emulation. In this article, *international regulatory harmonization* implies an agreement between regulators—that is, the purposive creation of an international regulatory standard.

2. See Kapstein 1989; and Oatley and Nabors 1998.

3. Simmons 2001.

4. See Weingast 1984; and Ferejohn and Shipan 1990.

that do not result in legislative intervention. Exogenous shocks to international competitiveness or voter confidence in financial stability can decrease the size of the win-set and make intervention more likely. In such circumstances, the regulator has incentives to seek international regulatory harmonization as a means of increasing the size of its win-set and safeguarding its autonomy. In short, the regulator's domestic political environment prompts an international solution.

I explore the consistency of the framework with two important cases in the history of financial regulation: the 1988 Basel Accord, which established a minimum capital standard for internationally active banks in the Group of Ten (G-10) industrialized countries; and the negotiations over capital adequacy for securities firms, which took place under the auspices of the International Organization of Securities Commissions (IOSCO) from 1988 until 1992. The Basel Accord is familiar to scholars of international political economy as the one of the most prominent examples of international regulatory harmonization. However, the IOSCO effort—which ended without an agreement—represents a “negative” case and has therefore been overlooked in academic circles, despite its obvious parallels to the Basel negotiations.⁵ More important for this study is that the cases reveal significant variation in regulators' desires for an international standard. In the Basel negotiations, the U.S. Federal Reserve was one of the primary proponents of an international capital adequacy standard, whereas the U.S. Securities and Exchange Commission (SEC) was vocal in its resistance of a similar standard for securities firms. Regulators in the United Kingdom (U.K.) advocated for international standards in both cases, whereas Japanese regulators were resistant in both.

This article proceeds as follows. First, I review two existing studies of the Basel Accord and use elements of both to develop an improved framework for analyzing international regulatory harmonization. I then provide an overview of the importance of capital adequacy regulations in a globalized world, including a brief overview of the Basel Accord and a more lengthy account of the IOSCO negotiations. I follow with a critique of the existing literature in light of the two cases and demonstrate that the new “confidence-competitiveness” framework provides a more compelling explanation of demands for international regulatory harmonization. I conclude with a reevaluation of the current literature on regulatory harmonization and a brief typology to guide future research.

Explaining International Regulatory Harmonization

In the past twenty years, there have been several attempts by regulators to harmonize financial regulations, from establishing capital adequacy standards to pay-

5. While academics may overlook the case, regulators and industry executives are quick to mention the IOSCO negotiations as a striking counterexample to the Basel Accord. Author's interviews with current and former Basel Committee members, 18–20 June 2002, Basel, Switzerland.

ments system requirements to supervisory standards.⁶ These negotiations are notable not for the convergence of views among the participants, but rather for the wide variation in the preferences of regulators toward the creation of an international standard. While certain regulators are strong proponents of an international standard, others are adamantly opposed. How can one explain the varying preferences of regulators toward international regulatory harmonization?

The political science literature on financial regulatory harmonization has focused almost exclusively on the Basel Accord, an agreement that established an international capital adequacy standard for commercial banks. Kapstein argues that the accord was created as a result of regulators' consensual knowledge of the systemic risks of undercapitalized banks. As banks' capital levels declined throughout the 1970s and 1980s, they became more vulnerable to losses from loan defaults and exogenous shocks. Kapstein's argument, which has become conventional wisdom among economists and political scientists, is that the adoption of minimum capital standards by the G-10 countries provided the global public good of financial stability and thus was in regulators' collective interests.⁷ When applied beyond the specific case of Basel, this argument implies that harmonization will occur whenever an international regulatory standard is needed to address systemic problems, including financial instability.⁸

In a recent paper, Oatley and Nabors challenge this functionalist logic by arguing that the Basel Accord is an example of *redistributive cooperation*: "the creation of an international institution that intentionally reduces at least one other government's welfare compared to the status quo."⁹ They argue that the U.S. Congress legislated tough capital adequacy requirements domestically in 1983 and directed U.S. regulators to impose these regulations onto foreign competitors—especially the Japanese—through an international agreement. More generally, Oatley and Nabors argue that politicians drive the international regulatory process: electoral incentives lead legislators to shift the costs of their policies onto foreign countries. International regulatory harmonization, then, represents the particular interests of one country's politicians, rather than a jointly provided public good. Oatley and Nabors imply that regulators themselves are important only in that they carry out the directives of the legislature.

The framework presented here synthesizes elements of both of these arguments but offers a more compelling and analytically useful explanation of regulator preferences. Similarly to Kapstein, I incorporate regulators as important actors in international regulatory harmonization. In the past fifteen years, regulators have become important actors on the world stage, creating new possibilities for international cooperation. Regulators have considerable discretion in coordinating with their for-

6. See Dobson and Hufbauer 2001; and Kapur 2000.

7. See, for example, Mishkin 2001; Herring and Litan 1995; and Porter 1993. On the Basel Accord and global public goods, see Reinicke 1998.

8. See Keohane 1984.

9. Oatley and Nabors 1998, 36.

eign counterparts. Unlike many other types of international agreements, regulatory agreements are usually not ratified by legislatures, nor are they legally binding on signatories. Nevertheless, these agreements are far from inconsequential: market forces and pressure from international organizations help to ensure compliance with global regulatory standards.¹⁰ Any model of international regulatory harmonization must therefore include regulators as key actors. However, I also incorporate Oatley and Nabors's focus on legislatures and domestic politics more generally. The behavior of regulators is constrained by the preferences of elected officials. A complete analysis of regulatory harmonization therefore requires an integrative approach that accounts for the incentives of both regulators and legislatures.

Analytical Framework

Legislators and financial regulators are engaged in a principal-agent relationship.¹¹ Legislators, as the principals, delegate the responsibility for setting and implementing financial regulations to regulatory agencies. Regulators make frequent modifications to the regulatory environment for firms—such as altering prudential supervisory protocols, tightening capital adequacy rules, and changing reporting requirements—but rarely do these changes arise because of observable pressure from elected officials. However, if a regulator enacts a policy that runs counter to the interests of elected leaders, the legislature can intervene and change the policy.

Political intervention is the bane of a regulator's existence.¹² When politicians attempt directly to influence regulatory policy—for example, by holding hearings and publicly criticizing the decisions of regulators, or by legislating new regulations—they threaten the agency's autonomy and prestige. Intervention may also affect regulators' future job prospects, especially for an agency head who is forced to resign. The prospect of intervention by legislators therefore creates *ex ante* constraints on regulators' discretion, which ensures that the principals can maintain some control over the agent. Regulators will use all strategies at their disposal to minimize the possibility of intervention.

I begin by assuming that the legislature maximizes a combination of aggregate welfare and campaign contributions, in accordance with standard political economy models of politics.¹³ This means that the legislature responds to the demands of financial firms (the primary source of campaign contributions), but also that it

10. On market pressures, see Kapstein 1994; on compliance with the Basel Accord, see Ho 2002.

11. Weingast 1984.

12. This corresponds to the notion in the principal-agent literature that there are costs to the agent when its policy is overturned. See Ferejohn and Shipan 1990.

13. Grossman and Helpman 2001.

seeks to enact policies that are beneficial for voters as a whole. In an open economy, firms are interested in profits, and they seek to maximize their competitiveness with foreign rivals. Voters, on the other hand, demand financial stability—or what the financial press often calls “confidence”—which arises when banks and securities firms are resistant to collapse and insolvency. The legislature can influence competitiveness through industrial policy (for example, tariffs, subsidies, barriers to entry), regulatory policy, and other legislative options. Likewise, the legislature can influence confidence by creating new regulatory agencies or oversight boards, altering existing agencies, or legislating new prudential restrictions for firms. Consider, for example, the creation of the Public Company Accounting Oversight Board (PCAOB) in the wake of the Enron and WorldCom financial scandals.¹⁴ Congress created the PCAOB to increase confidence in U.S. companies after the scandals galvanized the attention of voters toward accounting lapses and corporate malfeasance.

Note that confidence and competitiveness do not move in lockstep. Policies that improve one variable often have negative consequences for the other variable. For example, new legislation that allows financial institutions to engage in high-risk activities may improve competitiveness at the expense of confidence. Also, the legislature must take into account the effects of legislation on other welfare considerations, such as aggregate economic growth and productivity.

The legislature delegates the responsibility for setting and implementing prudential regulations to the regulatory agency. I further assume that the legislature incurs a cost for intervening in regulatory policymaking. This cost can be seen as the time and resources needed to monitor and criticize a regulator’s policy, the opportunity cost of not working on other legislative issues, or the resources needed to draft and implement new legislation.

To minimize the possibility of legislative intervention, the regulator must take into account the legislature’s preferences. Unlike the legislator, the regulator only has one tool at its disposal: regulatory stringency. Regulations that are too lax (for example, low minimum capital levels for financial institutions) will ultimately contribute to faltering firms and a crisis of confidence among voters, triggering a swift intervention by elected officials. On the other hand, in an open economy with competitive financial markets, regulations that are too strict will put domestic firms at a competitive disadvantage with foreign firms. Regulators therefore face a trade-off between confidence and competitiveness. As Walter notes,

In going about their business, regulators continuously face the possibility that “inadequate” regulation will result in costly failures, on the one hand, and on the other hand the possibility that “overregulation” will create opportunity

14. The PCAOB emerged from the Sarbanes-Oxley Act of 2002, U.S. Public Law 107-204; 30 July 2002.

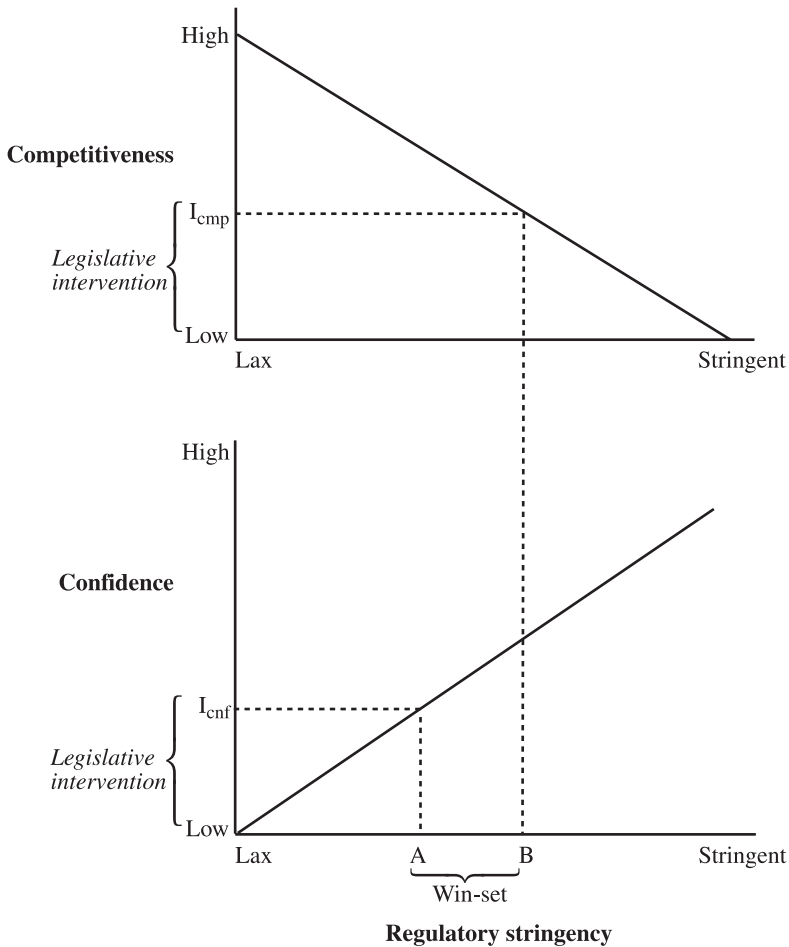


FIGURE 1. *The regulator's win-set*

costs in the form of financial efficiencies not achieved, or in the relocation of firms and financial transactions to other regulatory regimes.¹⁵

The threat of political intervention creates a limited zone of acceptance—or what could be called a “win-set”—for regulatory policy.¹⁶ I depict the win-set in Figure 1. The two graphs show the effects of regulatory stringency on competi-

15. Walter 2002, 18.

16. On the “zone of acceptance” for bureaucracies, see Meier 1985; on win-sets, see Putnam 1988. Moe 1987 offers a similar argument about constraints on bureaucracies.

tiveness and confidence, respectively. The horizontal axis on both graphs represents the regulator's range of policy choices, with lax regulations on the left side and stringent regulations on the right side. For simplicity, I depict each relationship as linear: as regulations become more stringent, competitiveness declines (top graph) and confidence increases (bottom graph). Each graph contains an intervention threshold for the legislature, labeled I_{cmp} for competitiveness (top graph) and I_{cnf} for confidence (bottom graph). When levels of either confidence or competitiveness fall below these thresholds, the legislature's utility for intervening will outweigh the cost. To avoid intervention, the regulator must maintain confidence and competitiveness above these thresholds.

In Figure 1, the legislature's intervention thresholds correspond to regulatory policy choices on the horizontal axis. To maintain a level of competitiveness above I_{cmp} , the regulator must enact a policy that is no more stringent than point B, as indicated by the vertical dotted line. Regulations more stringent than B will lead to a loss of market share to foreign firms and will trigger political intervention on behalf of the domestic financial sector. Similarly, to maintain confidence above I_{cnf} , the regulator must enact a policy that is no more lax than point A. Regulations to the left of this point will lead to a crisis of confidence in the financial system and will trigger political intervention on behalf of voters. The space to the right of A and to the left of B represents the regulator's win-set, because policies that fall between these thresholds will not trigger political intervention.

It is critical for the framework that a win-set generally exists (that is, that A is to the left of B). Of course, if there were no win-set, then there would be no delegation from the legislature to the regulator. When a win-set exists, regulators can generally make small changes in regulation without significant consequence—and indeed, regulators frequently modify existing regulations without much fanfare. However, a substantial loosening of regulations will eventually lead to widespread financial instability, whereas a substantial tightening of regulations will eventually lead to a sizeable loss of market share for domestic firms. The range of policies within these extremes constitutes the win-set.

The Role of International Regulatory Harmonization

The applicability of this framework to international harmonization can be seen when exogenous shocks are taken into account. Because it is impossible to ascertain the precise location of the win-set, I focus instead on changes in its size. When a win-set exists, regulators can use their discretion to set regulatory policy within the threshold points. However, exogenous shocks to confidence or competitiveness can shift the thresholds toward each other, reducing the size of the win-set or eliminating it altogether. For example, in the event of a high-profile failure of one or more financial institutions, voters will have less confidence in the efficacy of existing regulations to ensure the stability of domestic firms. The U.S. savings and loan (S&L) crisis in the late 1980s is representative: as S&Ls throughout the country began to fail, voters became aware that the existing regulatory environment

was insufficient to ensure the stability of their neighborhood thrifts. Voters were not well informed of the specifics of thrift supervision, but the series of S&L insolvencies led to implicit demands for more stringent regulations to shore up stability. More generally, shocks to confidence occur when there are innovations and structural changes in financial markets, resulting in increased risk for financial institutions. In the S&L example, one of the most salient changes was an increase in interest rates, which created tremendous pressure on S&Ls to find higher-yielding assets. As shown in Figure 2, an exogenous shock to confidence shifts the confidence line downward (to the bold dotted line), indicating that more stringent regulations are required to maintain any prior level of stability. As a result, A shifts to the right (to A'), indicating the legislature's implicit demands for more stringent

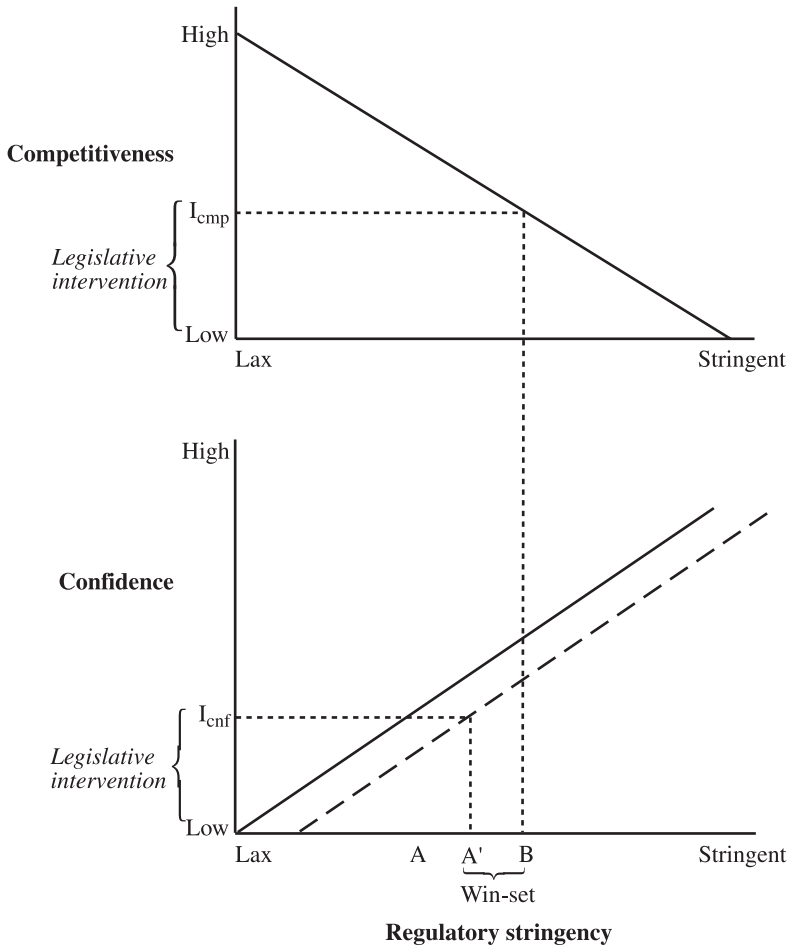


FIGURE 2. Shock to confidence

regulations to maintain confidence at its existing level. Note that the legislature's preferences over confidence do not change, but the exogenous shock alters the regulatory policy needed to maintain that degree of confidence.

On the other hand, an exogenous shock to competitiveness would occur if domestic firms incurred a loss of market share to foreign firms with less stringent regulations. As an example, consider the rise of the Eurocurrency markets in the 1960s, largely as a result of the congressionally mandated interest equalization tax and Regulation Q interest rate ceilings in the United States.¹⁷ These policies pushed dollars out of U.S. banks and into banks in London and elsewhere in Europe, where regulations were not nearly as strict.¹⁸ An exogenous shock to competitiveness, such as the rise of the Euromarkets, shifts the competitiveness line downward for the adversely affected domestic financial sector, as shown in Figure 3. This shift implies that less stringent regulations are required to maintain the prior level of competitiveness. After the shock, the regulator must choose a policy to the left of B' to avoid legislative intervention.

When the size of the win-set decreases, the probability of political intervention increases. If an exogenous shock is powerful enough—or if there are simultaneous shocks to voter confidence and firm competitiveness—then the thresholds can cross each other such that no win-set exists for regulators, as shown in Figure 4. Given that there are no policies both to the right of A' and to the left of B' , there is no win-set for regulators. Unless the regulator can shift one or both of the threshold points, then it is impossible to meet the minimum requirements of the legislature.

The absence of a win-set necessarily implies that the legislature will intervene. But it also raises the question, how and why would the government intervene if it is impossible to satisfy both groups? The answer is that the win-set applies to regulators, not legislatures. The framework posits that regulators can only employ regulatory stringency to affect voter confidence and firm competitiveness. A legislature, however, has other options at its disposal. For example, the legislature can enact trade barriers, subsidies, and tax breaks to bolster firm competitiveness, or repeal costly legislation, such as the Regulatory Q interest rate ceilings or restrictions on bank lending. These options are not available to regulators. Likewise, it can reverse a downward spiral in voter confidence through a highly publicized change in the structure of the regulatory agency. For example, the legislature can create a new regulatory body with oversight and enforcement powers, such as the PCAOB. In more extreme cases, the legislature can abolish an agency entirely and create a new one in its place. Such was the case in the aftermath of the S&L crisis, when Congress dismantled the existing S&L regulator—the Federal Home Loan

17. See Eichengreen and Kenen 1994; and Frieden 1987.

18. Reinicke 1995. The outflow of dollars was not entirely detrimental to U.S. firm competitiveness, because some of these funds landed in foreign branches of U.S. banks.

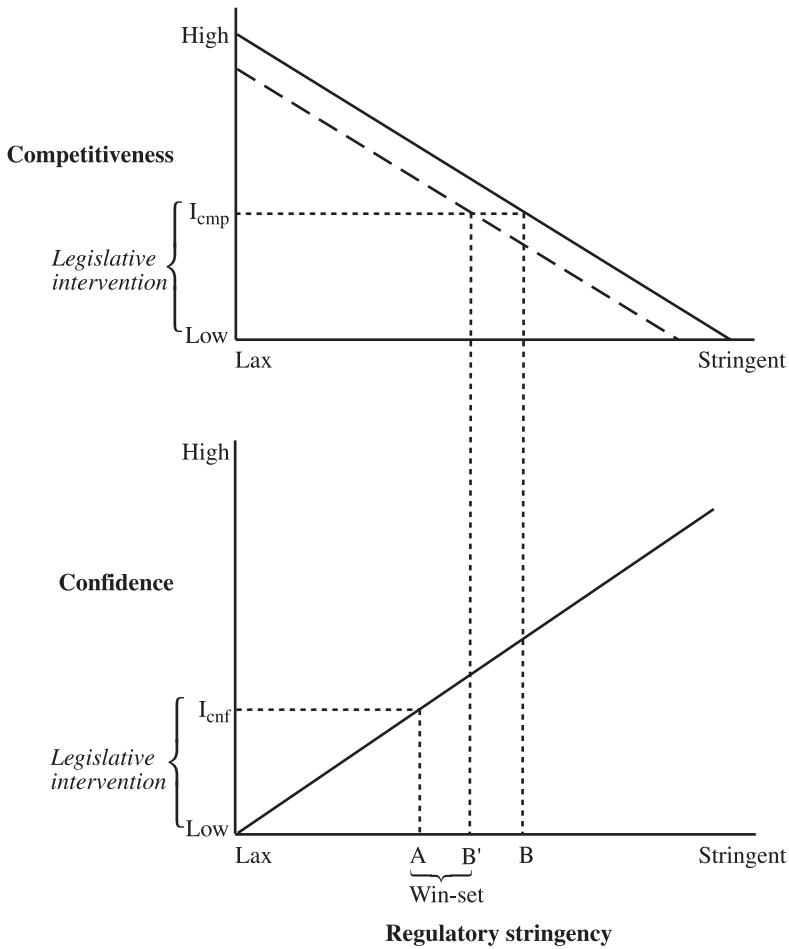


FIGURE 3. Shock to competitiveness

Bank Board (FHLBB)—and created the Office of Thrift Supervision.¹⁹ It was certainly possible for Congress to institute substantive regulatory changes within the existing FHLBB, but the creation of the OTS constituted a signal to the public of a new, more prudent regulatory environment.²⁰

Figure 4 indicates that regulators are powerless to protect their authority unless they can effect a shift in the threshold points. Such a shift can be achieved through

19. The congressional restructuring of S&L regulation is contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), U.S. Public Law 101-73.

20. On the S&L crisis, see Kane 1989; and Mayer 1990.

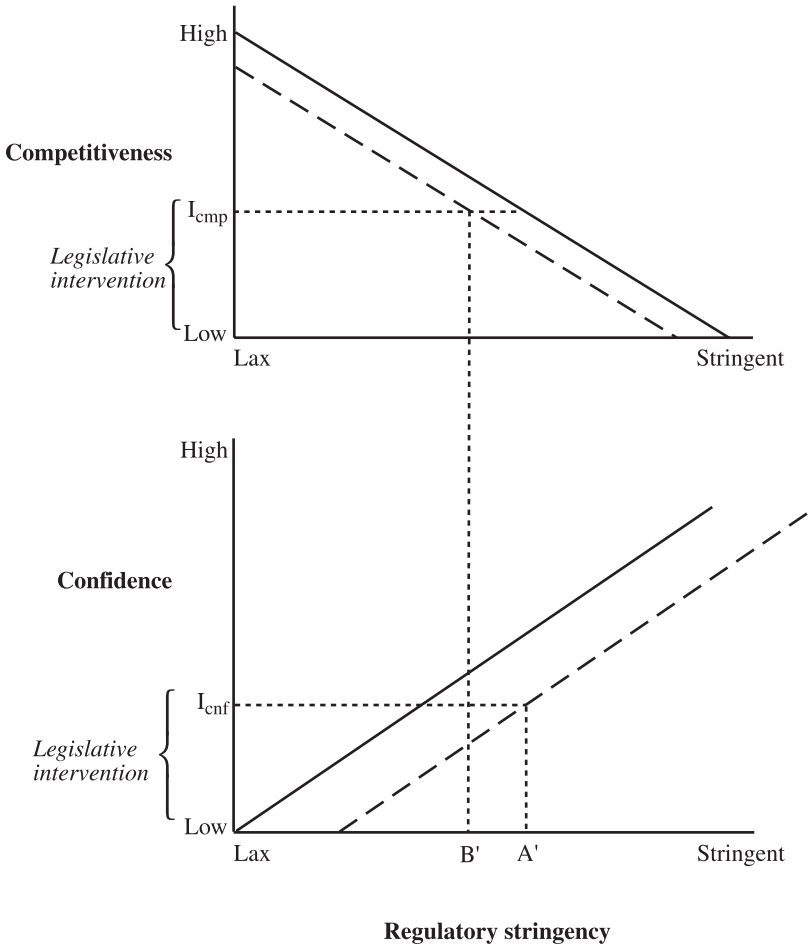


FIGURE 4. *No win-set after exogenous shocks*

international regulatory harmonization. Smoothing over differences in regulation affects the competitiveness of firms, either positively or negatively depending on the stringency of regulations before international harmonization. This is important in cases where domestic firms are losing market share to foreign firms in less stringent regulatory environments. It is also important when declining voter confidence requires the enactment of more stringent regulations that would put domestic firms at a competitive disadvantage with foreign rivals. If international regulatory harmonization is possible at the more stringent level, then the regulator can bolster confidence without harming domestic competitiveness. More generally, I argue that a regulator is more likely to seek international regulatory harmonization when its win-set is shrinking because of exogenous shocks. An inability to fend off domestic political pressures leads the regulator to seek an international solution.

Consider the threshold points in Figure 4. Ideally, the regulator wishes to increase the stringency of regulations to point A' without harming domestic competitiveness. If the regulator can successfully push for international regulatory harmonization at this more stringent level, then the competitive effects of the more stringent regulations will be minimized. In other words, the competitiveness line will shift upward—indicating a change in foreign regulations that has competitive implications for domestic firms—and B' will correspondingly shift to the right and create a viable win-set for regulatory policy.

This analytical framework yields observable implications about demands for international regulatory harmonization. First, I expect international regulatory harmonization to be initiated most often by regulators themselves, not by legislatures. This is an important implication of the principal-agent framework and stands in contrast to scholars who argue that elected officials are the only relevant actors in the creation of international standards. The regulator seeks an international standard in response to an increased probability of legislative intervention, which in turn is generated by changes in voter confidence and financial competitiveness. While the threat of legislative intervention creates constraints on the regulator, the legislature itself does not dictate the regulator's strategy. The legislature may in fact express opposition to an international agreement, as shown in the Basel case below, or remain largely aloof, as in the IOSCO case.

Second, a regulator is more likely to seek international regulatory harmonization when less stringently regulated foreign firms are capturing market share from domestic firms. The regulator could enact lax standards in line with the foreign competitor, but such a policy choice would result in decreased stability, which shrinks the win-set and increases the probability of legislative intervention. International regulatory harmonization in this instance addresses the competitive distortions caused by the difference between foreign and domestic regulations without contributing to a decline in voter confidence. Regulators facing a loss of market share are likely to push for an international standard based on their more stringent domestic regulations. On the other hand, when domestic firms are dominant and face minimal competition from foreign firms, then the domestic regulator will be unlikely to press for harmonization.

Third, regulators are more likely to seek international regulatory harmonization when confidence in the stability of financial institutions is declining. It is assumed in the model that the only tool for regulators to bolster confidence is regulatory stringency. Because the enactment of stricter regulations affects the competitive position of domestic firms, regulators can push for international regulatory harmonization to mitigate the competitive effects of increased stringency. Simultaneous exogenous shocks to confidence and competitiveness (as shown in Figure 4) have the effect of shrinking the regulator's win-set more sharply than a single shock to just one of these variables. Thus, when dual exogenous shocks occur, regulators are especially likely to push for international regulatory harmonization. Confidence and competitiveness are therefore additive in their influence on regulators' decisions.

The framework presented above is not designed to capture all of the nuances of regulatory policymaking in the industrialized world. Rather, it is designed to be broadly applicable to any political environment in which the regulator is granted authority by a popularly elected body. Certain regulators are more insulated from political pressures than others, and not all regulators have the same scope or mandate. These sources of variation are deliberately overlooked by the model in exchange for a more general account of regulatory politics in an international context.

Finally, the framework is designed to explain why regulators demand international harmonization, not how they achieve it. Understanding preferences is the first step in a more theoretically complete analysis of the circumstances under which regulators will create international standards. Once one understands who wants what and why, one is in a much better position to explain harmonization outcomes using variables such as market power and international institutions.²¹ In the cases that follow, the final outcomes—harmonization for banking, no harmonization for securities—are not particularly puzzling once one understands the preferences of the key participants in the negotiations.

Case Studies: Capital Adequacy for Banks and Securities Firms

Banks and securities firms are in the business of taking risks. Banks lend money directly to businesses, governments, and individuals, thereby incurring *credit risk*: the risk that borrowers will fail to repay their loans. Securities firms underwrite new issues of marketable securities, serve as market-makers in the secondary markets, and often engage in their own speculative trading. In these activities, firms assume *market risk* for as long as it takes them to sell any securities in their inventories.²² The willingness of firms to assume these risks allows for the transfer of surplus capital from savers to borrowers—the essence of global capital markets.

Capital itself is critical for both banks and securities firms, as it provides a cushion against losses that result from borrower default or changes in asset prices. Capital also provides incentives for bank managers to lend prudently, as the capital of the firm—and not just customers' deposits and other government-insured

21. Kapstein 1989 and Oatley and Nabors 1998 are in agreement on the importance of market power in explaining the emergence of a multilateral agreement for bank capital adequacy. On the role of international institutions in the process of harmonization, see Simmons 2001.

22. As an example, consider a securities firm that agrees to underwrite an offering of stock by fictitious ABC Corporation. In a so-called *firm commitment*, the securities firm purchases all of the stock from ABC for resale to the public. The profit from this transaction consists of the difference between the price paid to ABC and the price charged to the public. The securities firm faces market risk from the time it takes possession of the ABC stock until it is sold to the public, which could be anywhere from a couple of days to several weeks. If the market value of ABC's stock were to plummet during this period, the securities firm could incur a substantial loss.

liabilities—is at risk.²³ Both types of firms view capital reserves as necessary for their prosperity and stability. However, in the event of severe adverse conditions, regulators view capital quite differently for banks and securities firms.²⁴ For banks, the regulator's goal is to enable the bank to weather adversity and thereby protect depositors' funds and public confidence in the banking system. Capital levels should be sufficient to absorb losses and enable the bank to continue as a going concern.²⁵ For securities firms, capital regulations are designed to allow a firm to wind down its operations in an orderly manner in the event of severe market losses. This would include selling off marketable securities, repaying any outstanding obligations, and shutting down operations with sufficient warning to the market.²⁶ Note that capital requirements are designed to prevent insolvency and default for both banks and securities firms; however, in the event of severe trouble, banks should stay standing whereas securities firms should wind down.

Initially, capital adequacy was a purely domestic issue. Regulators feared the possibility of contagion—where the collapse of a financial institution could lead to similar collapses and a widespread crisis of confidence in the financial system—but this fear did not extend to other countries until banking and securities markets began a rapid process of internationalization in the 1970s and 1980s. In 1974, the failure of Bankhaus Herstatt, a medium-sized German commercial bank involved in the foreign exchange markets, led to a temporary halt in the international payments system. Stock markets began to show similar interdependence beginning in the 1980s, culminating in the worldwide stock market crash in 1987. This evidence of “systemic risk” gave regulators incentives to communicate with their foreign counterparts through international committees and organizations. Groups such as the Basel Committee and the IOSCO enabled regulators from different countries to share “best practices,” discuss different regulatory approaches, and sometimes create international regulatory standards.

The Basel Case

The events leading up to the Basel Accord have been thoroughly documented,²⁷ so only a brief summary is provided here. Soon after the Herstatt fiasco, central bankers from the G-10 industrialized countries formed the Standing Committee on Banking Regulations and Supervisory Practices, now known as the “Basel Committee” because of its home at the Bank for International Settlements in Basel, Switzerland. The purpose of the committee was to provide a forum for bank reg-

23. I thank the editors of IO for this point.

24. See Haberman 1987; and Walker 1992.

25. Dale 1996.

26. In the United States, the SEC's net capital rule (SEC Rule 15c3-1) stipulates that a broker-dealer should have the capacity to wind down its operations and protect its customers within one month. See Haberman 1987.

27. See Kapstein 1989, 1991, 1994; Reinicke 1995, 1998; and Braithwaite and Drahos 2000.

ulators from the industrialized world to share ideas and best practices, and to address the issue of systemic risk in international banking markets. In the early 1980s, the Basel Committee began to investigate the wide-scale deterioration of capital levels in internationally active banks. The LDC debt crisis of 1982 served as a wake-up call to regulators about the dangers of low capital levels, as banks in New York, London, and Tokyo struggled with substantial losses on their lending portfolios. The committee began work on a set of guidelines for capital adequacy, but progress was slow. Central bankers could not decide on a proper definition of “capital,” let alone agree on an appropriate minimum level that banks should hold. Also, Japanese banks were operating with substantially less capital than Western banks, which allowed them to offer more favorable pricing than their competitors. French banks also had relatively low capital levels and resisted any movement toward stricter regulations. There may have been a superficial consensus that bank capital levels were a systemic problem, but French and especially Japanese regulators were resistant to creating an international standard that would prove enormously costly to their respective banking markets.

In 1987, in a move that surprised the Basel Committee, the Bank of England and the U.S. Federal Reserve signed a bilateral agreement on capital adequacy. This Anglo-American agreement established a “risk-weighted” standard in which capital requirements would increase with the degree of risk of a bank’s loan portfolio. It was clear from the beginning that the agreement was not intended to last in isolation; rather, it was a strategy to force the Basel Committee into a multilateral agreement favorable to U.S. and U.K. regulators.²⁸ Implicit in this Anglo-American “zone of cooperation” was the threat of excluding noncompliant countries’ banks from British and American markets.²⁹ As Kapstein notes, “The tacit threat of preventing foreign banks from expanding operations or establishing new ones within that zone was apparently credible enough to move discussions to the multilateral level.”³⁰ After several months of negotiations to smooth over the differences between the U.S./U.K. coalition and the rest of the G-10, the Basel Committee published the Basel Accord in late 1987. The accord immediately superseded the Anglo-American agreement, and established a global standard for minimum capital levels.

The IOSCO Case

Several studies were published in the 1980s that validated what regulators and investors already knew: equity prices in the major markets—including the United

28. Author’s interviews with senior Bank of England officials, 24–25 June 2002, London. See also Kapstein 1989.

29. Kapstein 1989, 340.

30. *Ibid.*, 344.

States, Europe, and Japan—were becoming increasingly correlated.³¹ A sudden plunge in equity prices in one exchange would often reverberate quickly throughout other exchanges, regardless of market fundamentals. A prime example was the stock market crash of 1987, which was centered in New York but spread quickly to other markets throughout the world. This interdependence highlighted the potentially deleterious consequences of the collapse of a major securities firm. If a firm in London, for example, were to go bankrupt, the firm's outstanding transactions with broker-dealers in other countries would go unrealized. If these firms were not sufficiently capitalized, they could default or collapse, creating an ever larger circle of bankruptcies worldwide.³² An influential OECD publication in 1991 stated the problem more starkly:

The extreme systemic threat arising from a collapse of securities prices is that default by one or more large securities dealers will lead to further defaults and that the failures will extend into the core of the banking system and cause a breakdown in the flow of payments in settlement of financial transactions throughout the world.³³

Fortunately the stock market crash of 1987 did not lead to such a dire outcome, but the event served as a jarring lesson for regulators about the potential dangers of interdependent markets. The crash was responsible for spurring a number of research reports on “systemic risk” in securities markets.³⁴ Regulators were also growing more aware of the risks involved in securities firms' investment strategies, from currency trading and futures to interest rate swaps and complex derivatives.³⁵

The late 1980s marked the emergence of the IOSCO as an important forum for securities regulators. In 1986, IOSCO created a “Technical Committee,” consisting of regulators from the developed countries, to guide the work of its members.³⁶ It also increased its membership to include most of the world's major stock exchanges.³⁷ In 1987, the Technical Committee created a working group to study the issue of capital adequacy for securities firms, and included regulators from the United States, France, Japan, and the U.K.³⁸ In 1989, the group issued its first report, which was then approved by the full Technical Committee for presentation at IOSCO's annual meeting. The report concluded that a common framework was

31. See OECD 1991; and Rhee 1992.

32. See Hewitt 1992; and Tobin 1991.

33. OECD 1991, 15.

34. For a comprehensive list of reports stemming from the 1987 stock market crash, see Tobin 1991, 282–83.

35. OECD 1991.

36. In 1988 these countries were the United States, United Kingdom, Japan, West Germany, France, Australia, Canada, Hong Kong, Italy, the Netherlands, Sweden, and Switzerland.

37. By the end of 1989, IOSCO had forty-eight members. Tobin 1991, 315.

38. IOSCO 1989.

needed regarding the capital requirements of securities firms, and should contain the following elements:³⁹

1. Liquidity and solvency should be covered by a standard that provides for a firm to have sufficient liquid assets to meet its obligations given the risks a firm faces.
2. Marking of marketable securities and commodities positions to market is necessary to prevent firms from storing up losses and also to give a true picture of a firm's position.
3. Risk-based requirements should cover all the risks to a firm and, in particular, should contain:
 - i. A base requirement reflecting the scale of a firm's activities to capture nonmeasurable risks.
 - ii. Position risk requirements (for both on- and off-balance sheet items) reflecting the price volatility of individual securities with provisions for concentrated positions and allowances for risk reduction measures such as hedging.
 - iii. Settlement risk requirements reflecting the risk of nonperformance in a timely manner.

The bottom line was that firms should hold enough capital to exceed the sum of these risk-based requirements.

The 1989 IOSCO report was merely a set of guidelines that set the agenda for further negotiations. The group had yet to decide how to measure capital, let alone what the specific minimum level of capital should be for securities firms. Another obstacle was the relationship between the proposed IOSCO standard and the Basel Accord. Because an increasing number of banks were involved in securities activities, the competitive implications of any new regulations were of critical importance. In the three years after the 1989 report was published, the IOSCO Technical Committee and the Basel Committee exchanged a number of issue papers in an attempt to arrive at a consensus view of the appropriate capital requirements for any firm conducting securities business. At a meeting in late January 1992, negotiators tentatively agreed that securities firms would be required to hold capital equivalent to four percent of their gross holdings plus eight percent of their net holdings, after netting out long against short positions.⁴⁰ At the conclusion of the meeting, the U.K.'s Securities and Investments Board (SIB)—the most vocal advo-

39. Ibid.

40. *Economist*, 31 October 1992, 76. See also Steil 1994. A "long position" means that a firm has ownership of a security, whereas a "short position" means that a firm has "sold short" a security by delivering borrowed shares to the purchaser, but has yet to cover its position by buying the shares in the market. Firms (and individuals) often take short positions to protect the profits in their long positions.

cate of a capital standard—was optimistic that a formal IOSCO agreement would be forthcoming at the October annual meeting.⁴¹

The Technical Committee had scheduled one final meeting in July 1992 before the annual meeting, with the intent of drafting a preliminary agreement. However, as it became clear that an agreement was actually feasible, U.S. regulators surprised the other participants by opposing the creation of a capital standard.⁴² A particularly contentious issue was the extent to which a securities firm should be able to reduce its capital requirement through hedging.⁴³ The SIB backed a plan that would allow a firm to carry 2 percent of the sum of its long and short positions, assuming the firm had a perfectly hedged book as defined in the proposal.⁴⁴ This plan was substantially lower than the SEC's existing standard of 15 percent. Richard Breeden, Chairman of the SEC, said that under the SIB's proposed rules, a major U.S. securities firm would have failed after the October 1987 crash, and refused to endorse a standard that he called "dangerously low."⁴⁵ He also argued that IOSCO should be a "clearing house of ideas" and not a rule maker.⁴⁶ The IOSCO annual meeting therefore produced no agreement, and the Technical Committee went back to the drawing board to see if a consensus could still be created. However, despite the SIB's protests, it was clear that no further progress would be made on the issue, and IOSCO officially abandoned the effort to harmonize capital adequacy regulations.⁴⁷

Analysis

Under what conditions will regulators seek to create global financial standards? The Basel and IOSCO cases described above present a puzzle. In both cases, bank and securities regulators came together to discuss capital adequacy regulations for their respective industries. Negotiations occurred at roughly the same time under similar market conditions. But ultimately the negotiations unfolded in different ways, with varying coalitions advocating or resisting harmonization. How can one explain this variation, and what do these cases say about the larger phenomenon of international regulatory harmonization? I begin by critiquing the current literature on the Basel Accord, which for convenience I divide into "systemic risk" and

41. Author's interview with former SIB official, 27 June 2001, London.

42. *International Securities Regulation Report*, 28 July 1992, 1.

43. *Ibid.*, 7–8.

44. *Financial Times*, 28 October 1992, 30.

45. *Economist*, 31 October 1992, 76. In early 1992, the SEC requested that the Federal Reserve Bank of New York run a simulation of the 1987 stock market crash, assuming that U.S. firms were capitalized at the SIB's proposed level. The study found that the crash would have led to the collapse of one of the largest securities firms in the country. Author's interview with former senior SEC official, 7 May 2002, New York.

46. *Financial Times*, 28 October 1992, 30.

47. *Financial Times*, 11 February 1993, 29.

“redistributive” arguments. After showing that these explanations cannot satisfactorily explain the variation in the two cases, I advance a new argument based on the confidence-competitiveness framework that is more successful in explaining the variation.

Systemic Risk

Kapstein argues that the Basel Accord was created as a result of international “consensual knowledge” of the systemic risks of bank lending, combined with the leadership of the United States and the U.K.⁴⁸ In establishing the importance of consensual knowledge, he points to the failure of the Franklin National Bank and Bankhaus Herstatt as the impetus for the creation of the Basel Committee. He argues that these prominent firm failures, along with the LDC debt crisis in 1982, led to a consensus among regulators of the risks of global capital markets. This consensus was echoed in a number of publications by international financial organizations, including the OECD’s influential publication *The Internationalisation of Banking*.⁴⁹

Kapstein acknowledges that consensual knowledge of systemic risk was necessary but not sufficient to bring about an international agreement. When it became clear that the Basel Committee was reaching a stalemate, the United States and the U.K. announced a bilateral agreement on capital adequacy in 1987 to jumpstart the Basel negotiations. He implies that all of the G-10 countries were eager to create a global standard, but it took a show of market power to move the negotiations along. This view is in fact common among scholars who have studied the Basel Accord.⁵⁰

The main challenge to Kapstein’s argument is that it cannot explain the dynamics of the Basel negotiations. It is crucial to remember that capital adequacy regulations are costly, as they affect banks’ profit margins. Assuming that regulators are rational, there are tremendous incentives for countries to free ride and let other countries assume the costs of global financial stability. As the primary explanatory variable, systemic risk cannot explain why U.S. and U.K. regulators exerted significant energy to bring about an agreement, while Japanese regulators (with seven of the ten largest banks at the time⁵¹) remained on the sidelines and resisted an increase in capital standards.

Systemic risk is also an unhelpful variable in the IOSCO case. Note that the IOSCO capital adequacy story unfolds almost in parallel to the Basel story. The debt crisis galvanized the attention of bank regulators just as the 1987 stock market crash galvanized the attention of securities regulators, and academic publications noted the international interdependence of markets in each case. Securities

48. Kapstein 1989.

49. Pecchioli 1983.

50. See Mishkin 2001; Herring and Litan 1995; and Porter 1993.

51. Kane 1988, 371.

regulators all agreed about the systemic risks of international securities markets, but the IOSCO negotiations revealed stark differences in regulator preferences toward harmonization.⁵² During the negotiations, U.S. regulators realized that their capital standard for broker-dealers was more stringent than virtually anywhere else. Yet rather than use their market power to push through an IOSCO standard at existing U.S. stringency levels, U.S. regulators ultimately pulled out of the negotiations and ensured the defeat of a global standard.

A functionalist theory also cannot explain the behavior of regulators during the IOSCO negotiations. The leader in the push for harmonized capital standards was the U.K.'s SIB. This is especially curious because broker-dealers in London faced less stringent capital requirements than in the United States. Rather than boost capital requirements to U.S. levels, the SIB wanted to harmonize at or near its existing capital levels. U.S. regulators deemed these levels to be insufficient to prevent against insolvency, and they were concerned that the SIB's proposed standard—albeit a minimum requirement—would put downward pressure on U.S. and European capital levels.⁵³ If systemic risk fuels regulator interest in global standards, it is difficult to understand the SIB's demands to validate a capital standard deemed “dangerously low” by the world's largest securities market.⁵⁴

Redistributive Cooperation

In a recent paper, Oatley and Nabors challenge Kapstein's functionalist logic by arguing that the Basel Accord was an example of “redistributive cooperation.”⁵⁵ In 1983, the developed world looked to the International Monetary Fund (IMF) to bail out large Western banks that were failing because of the LDC debt crisis—an effort that would require a substantial increase in IMF resources. The United States agreed to increase its IMF quota by \$8.4 billion, subject to the approval of a wary Congress. With a recession in full swing, voters became indignant at the prospect of using taxpayer dollars to coddle a handful of multinational banks.⁵⁶ At the same time, the banks were struggling with wide-scale default from Latin America and a rising competitive threat from less-regulated Japanese banks. Oatley and Nabors argue that from the perspective of Congress, a reasonable compromise was to move ahead with the IMF quota increase, but to force banks to take responsibility for

52. Some scholars have argued that the risk of contagious collapse is unique to banks, and that the rationale for regulating the capital levels of securities firms is not clear. Dale, for example, argues that a securities firm in trouble can simply liquidate its holdings at market value without disrupting other firms. Dale 1996; see also Herring and Litan 1995. While there is debate about the systemic risks of securities markets within academia, securities regulators—the key actors in this case—agreed that capital adequacy for securities firms was a global concern. See IOSCO 1989.

53. Author's interview with former senior SEC official, 7 May 2002, New York.

54. Steil 1994.

55. Oatley and Nabors 1998.

56. It should be noted that an IMF quota increase does not require additional government spending or taxes. This fact is overlooked in the Oatley and Nabors analysis.

their imprudent lending behavior by enacting stricter regulations. Such a move, however, would entail imposing a competitive disadvantage on the domestic banking sector, potentially hastening the rise of Japanese banks.

To address the competing pressures from voters and banks, Congress embedded the IMF quota increase in the International Lending Supervision Act (ILSA) of 1983. The ILSA dictated that U.S. regulators should increase domestic capital adequacy standards and seek to coordinate prudential standards on an international level. Oatley and Nabors argue that the ILSA satisfied voters by forcing banks to raise new capital and assume at least part of the responsibility for their aggressive lending behavior. At the same time, they argue that the mandate to seek an international agreement assuaged banks' concerns about the loss of market share that could result if they faced stricter regulations than their foreign counterparts, especially the Japanese. Oatley and Nabors contend that ultimately it was the exercise of U.S. market power—as evidenced by the initial Anglo-American agreement—that led inexorably to the Basel Accord.

While the importance of market power in the creation of the Basel Accord is beyond question, a sole emphasis on congressional directives yields an incomplete story. It is important to note that there is a five-year gap between the passage of the ILSA in 1983 and the creation of the Basel Accord in 1988, and that U.S. regulators unilaterally increased domestic capital standards a second time during this period.⁵⁷ Congressional sentiment in the years leading up to the accord was inconsistent. Throughout the negotiations over ILSA, Congress was adamantly in favor of new capital adequacy regulations for U.S. banks, reflecting voters' desire to make the banks take responsibility for their lending behavior during the debt crisis. However, as the Basel Accord was being finalized in late 1987, Congress began to vocalize its concerns about the competitive ramifications to U.S. banks, and to speak out against the Basel Accord. For example, U.S. Representatives Charles Schumer (D-N.Y.) and Norman Shumway (R-Calif.) circulated a memo to the House Banking Committee that questioned the competitive implications of the Basel agreement.⁵⁸ Schumer stated, "I am concerned that unanticipated and unnecessary effects of the regulations may seriously jeopardize the international competitiveness of American banks."⁵⁹ The irony is unmistakable: in 1983 the House Banking Committee mandated higher domestic capital adequacy standards and an international regulatory agreement through the ILSA, but five years later that same committee began holding hearings on the competitive implications of the Basel Accord.⁶⁰ Legislative pressures were clearly salient in influencing regulator behavior, but a principal-agent framework is required for a full explanation of the preferences of U.S. regulators during the Basel negotiations.

57. Capital standards were raised in 1984–85. FDIC 1997. See also Reinicke 1995.

58. U.S. House of Representatives 1988.

59. *Ibid.*

60. Reinicke 1995.

A sole focus on elected officials is similarly unhelpful in the IOSCO case. In the securities markets there was no sudden regulatory change—akin to the putative voter-mandated increase in capital adequacy standards in the United States in 1983—that would prompt a regulator to shift the costs of stringent regulations onto foreign competitors through international regulatory harmonization. In fact, during the 1980s and early 1990s, securities capital adequacy regulations were quite stable throughout Europe and the United States. Moreover, politicians in Europe were focused on creating a Capital Adequacy Directive (CAD) that would promulgate a single capital adequacy standard for all financial institutions in the European Union, including banks and securities firms. During the early 1990s, most observers expected that the formula in the Basel Accord would ultimately find its way into the CAD, leaving no room for a separate standard for securities activity.⁶¹ European politicians, then, were not involved in initiating the IOSCO negotiations, nor did they play a significant role as the negotiations progressed.

Nevertheless, the Oatley and Nabors framework, with its emphasis on redistributive politics, draws attention to the competitive element behind the IOSCO negotiations. In Europe, regulators calculated capital requirements on a *consolidated* basis—that is, capital had to cover the risks associated with all divisions and subsidiaries of the firm. In the United States, capital requirements only applied to registered “broker-dealers”; parent or holding companies were not regulated. This lack of regulatory oversight gave U.S. firms a competitive advantage over European firms in the growing derivatives market.⁶² I address the importance of these competitive pressures in the following section.

The Confidence-Competitiveness Framework

The confidence-competitiveness framework assumes that regulators choose policies that safeguard their decision making from direct political intervention. This leads regulators to strike a balance between the competitiveness of regulated firms and voter confidence in the stability of financial institutions. Regulators are therefore more likely to seek international regulatory harmonization when confidence is declining, or when less-regulated foreign firms are infringing on the market share of domestic firms. As I discuss below, this framework provides a compelling explanation of regulator demands in the Basel and IOSCO cases.

61. Author's interviews with former senior official of the SIB and financial industry executives, 25–27 June 2002, London.

62. Author's interviews with former senior official of the SIB and senior financial industry executive, 25–27 June 2002, London.

Basel: Dual Shocks for the United States and the United Kingdom

Both the United States and the U.K. faced a rising competitive threat from Japanese banks during the 1980s. Table 1 shows the total assets of the ten largest banks in the world for 1974, 1984, and 1994, indicating the tremendous growth of Japanese banks at the expense of U.S. and British firms. By 1986, Citicorp fell from its symbolically important perch as the largest bank in the world to the sixth largest, behind five Japanese banks.⁶³ More importantly, U.S. and U.K. markets were home to a growing proportion of Japanese bank assets. The lending activity of Japan's overseas branches exploded throughout the 1980s. As shown in Table 2, Japanese branches in the United States experienced a 315 percent increase in total assets between 1981 and 1988, while the figure for Japanese branches in the U.K. was 232 percent.⁶⁴ By 1988, more than 38 percent of the assets of Japanese banks were held in overseas branches, mostly in the United States and the U.K.⁶⁵ In 1985, Japanese international lending outpaced U.S. lending for the first time ever.⁶⁶ The United States and the U.K. therefore each experienced an exogenous shock to competitiveness in the mid-1980s, as shown in Figure 3.

It is beyond the scope of this article to address the specific reasons for the growing strength of the Japanese banking sector. However, it is clear that if Japanese banks were to hold the same level of capital as their competitors in the United States and U.K., their competitive advantage would be severely cut.⁶⁷ In 1986, Citicorp and Barclays (U.K.) had capital-to-asset ratios of 4.73 and 4.71, respectively, while Japan's Dai-Ichi Kangyo, Sumitomo, and Fuji had ratios of 2.38, 2.89, and 2.95.⁶⁸ Gerald Corrigan, head of the New York Federal Reserve during the Basel negotiations, stated bluntly: "The single item on which I place the greatest emphasis relates to . . . the goal of moving Japanese bank capital standards into closer alignment with emerging international standards."⁶⁹

Exogenous shocks to confidence were also salient in the Basel case. In 1982, the LDC debt crisis exposed the imprudent lending behavior of a number of U.S. and British multinational banks. By the end of 1981, the exposure of U.S. banks to Latin America amounted to nearly 100 percent of capital.⁷⁰ When Mexico and other countries in Latin America defaulted on their loans, U.S. and British banks were threatened with insolvency. An increase in IMF resources helped to stem the crisis in the short term, but it was clear that market confidence was badly shaken.

63. Kapstein 1989.

64. Terrell, Dohner, and Lowrey 1990.

65. Ibid.

66. *Financial Times*, 31 January 1986, 24.

67. Kapur 2000. It was estimated that individual Japanese banks would have to raise \$20 to \$30 billion by 1992 to meet the new requirements. *Washington Post*, 13 July 1998, F1.

68. De Carmoy 1990.

69. Quoted in Kane 1994, 106.

70. James 1996, 352.

TABLE 1. *The ten largest banks in the world (in millions of U.S. dollars)*

| <i>Bank</i> | <i>June 1974 total assets</i> | <i>Bank</i> | <i>June 1984 total assets</i> | <i>Bank</i> | <i>June 1994 total assets</i> |
|----------------------------|-----------------------------------|----------------------------|-----------------------------------|----------------------------|-----------------------------------|
| 1 BankAmerica | \$48,772 | 1 Citicorp | \$125,974 | 1 Fuji Bank | \$538,243 |
| 2 Citicorp | 44,018 | 2 BankAmerica | 115,442 | 2 Dai-Ichi Kangyo Bank | 535,356 |
| 3 Chase Manhattan | 36,790 | 3 Dai-Ichi Kangyo Bank | 110,333 | 3 Sumitomo Bank | 531,835 |
| 4 Banque National de Paris | 30,142 | 4 Fuji Bank | 103,524 | 4 Sanwa Bank | 525,126 |
| 5 Dai-Ichi Kangyo Bank | 28,467 | 5 Sumitomo Bank | 101,147 | 5 Sakura Bank | 523,730 |
| 6 Barclays Bank | 28,304 | 6 Banque National de Paris | 101,019 | 6 Mitsubishi Bank | 487,547 |
| 7 National Westminster | 27,555 | 7 Mitsubishi Bank | 98,062 | 7 Norinchukin Bank | 435,599 |
| 8 Fuji Bank | 24,418 | 8 Barclays Bank | 94,146 | 8 Industrial Bank of Japan | 414,925 |
| 9 Deutsche Bank | 24,389 | 9 Sanwa Bank | 91,257 | 9 Credit Lyonnais | 337,503 |
| 10 Sumitomo Bank | 23,905 | 10 Credit Agricole | 90,211 | 10 Bank of China | 334,752 |

Source: *New York Times*, 29 August 1995, D6.

TABLE 2. *Location of assets of Japanese banks, 1981–88*
(in billions of U.S. dollars)

| <i>Year ending December</i> | <i>Assets in offices in Japan</i> | <i>Assets in foreign branches</i> | | |
|---------------------------------|---------------------------------------|-----------------------------------|-------------|-------------|
| | | <i>Total</i> | <i>U.K.</i> | <i>U.S.</i> |
| 1981 | \$ 791 | \$ 233 | \$134 | \$ 74 |
| 1982 | 811 | 310 | 161 | 97 |
| 1983 | 908 | 350 | 178 | 108 |
| 1984 | 926 | 421 | 194 | 131 |
| 1985 | 1,339 | 600 | 257 | 151 |
| 1986 | 1,927 | 837 | 359 | 208 |
| 1987 | 2,854 | 1,090 | 426 | 252 |
| 1988 | 3,044 | 1,120 | 445 | 307 |
| <i>Percentage increase</i> | | | | |
| 1981–88 | 285% | 381% | 232% | 315% |
| 1984–88 | 229% | 166% | 129% | 134% |

Source: Terrell, Dohner, and Lowrey 1990.

The U.S. Federal Reserve tightened capital requirements in 1983 as part of the International Lending Supervision Act, but a number of developments continued to challenge the confidence in banking markets in the United States and the U.K. In 1984, the tenth largest bank in the United States, Continental Illinois, began to falter after it acquired a large number of risky oil-related credits from Penn Square Bank, which itself failed in 1982.⁷¹ To avert a wide-scale financial crisis, the Federal Reserve stabilized the foreign exchange market and provided a bailout package to the bank. That same year, the U.K. faced a similar crisis when Johnson Matthey Bankers became insolvent after it concentrated its lending to a small number of high-risk firms. The Bank of England had no choice but to provide a rescue package and appoint a new management team for the bank.⁷² Both of these bank failures were embarrassing to regulators and called into question the stability of each country’s banks. Moreover, U.S. bank failures continued into the decade: 468 banks failed between 1985 and 1987, resulting in disbursements from the U.S. Federal Deposit Insurance Corporation of nearly \$13 billion.⁷³ Voter confidence in financial stability was badly shaken in both countries, resulting in the confidence shock depicted in Figure 2. Political intervention seemed close at hand; indeed,

71. Estrella 2001.
72. Ibid.
73. FDIC 1998, 66.

regulators in the U.K. were ignominiously summoned to Parliament to discuss their role in enabling the Johnson Matthey insolvency.⁷⁴

While bank failures were drawing attention to regulators, banks in the United States and the U.K. were devising new financial products that could be kept off their balance sheets, and therefore immune from capital requirements. These “contingent liabilities” were just as risky as conventional loans, but current capital regulations did not apply to them. It was clear to regulators that the decline in market confidence, coupled with banks’ clever avoidance of capital requirements, warranted stricter regulations.⁷⁵

The environment in Japan in the mid-1980s was much different. Japanese banks were not nearly as exposed to LDCs during the debt crisis as were banks in the United States and U.K., and there were no high-profile bank insolvencies throughout the 1980s. The relationship between business and government in Japan was much tighter than in the West, and banks had an implicit guarantee of government support in difficult times, well before insolvency became a possibility; indeed, until recently, no bank in Japan had failed.⁷⁶ The Japanese government’s support of banks implied that exogenous shocks to confidence were rare. This contrasts with the United States and the U.K., in which government financial support of banks was reactive—in the form of public bailouts in the event of confidence-jarring bank failures—rather than preemptive.

With the United States and the U.K. experiencing simultaneous shocks to confidence and competitiveness, regulators in each country shared a strong desire for international regulatory harmonization. In the absence of a change to Japanese regulations, it was becoming increasingly difficult for these regulators to obtain sufficient levels of confidence and competitiveness. More stringent regulations were necessary to bolster stability, but the resulting loss of competitiveness was too great to bear. In order to create a viable win-set for regulatory policy, regulators from the United States and the U.K. were adamant in their support of an international capital adequacy standard, as evidenced by the Anglo-American agreement in 1987.

IOSCO: The U.K. as the Primary Advocate

Throughout the IOSCO negotiations, the U.K.’s SIB was the leading advocate of a global standard for securities firm capital adequacy, while the United States was a vocal opponent. At the heart of the controversy was the issue of consolidated supervision. As mentioned earlier, European regulators imposed capital requirements on securities firms on a consolidated basis, whereas the U.S. SEC imposed requirements only on registered broker-dealers. While the SIB’s requirements were

74. Author’s interview with senior Bank of England official, 26 June 2002, London.

75. Kapstein 1989.

76. Scott and Iwahara 1994.

lower than in the United States, the fact that they were imposed on a consolidated basis was more important in considerations of international competitiveness. Parent companies in the United States could engage in a number of highly lucrative financial activities without concern for the SEC's capital regulations. In particular, U.S. firms were able to offer very competitive pricing on derivatives contracts and other off-balance sheet items, threatening the market share of firms in London.⁷⁷ Capital requirements for broker-dealers, on the other hand, are less important in terms of international competition, in large part because the global market for debt and equity remains relatively fragmented by geographic and regulatory barriers.⁷⁸

The SIB's concern over the competitive implications of consolidated supervision began with the growth of the derivatives market in the 1980s. The Chicago Board of Trade first developed financial futures contracts in 1975, and the United States dominated the market through the mid-1980s.⁷⁹ Other types of derivatives, including stock index futures and interest rate swaps, emerged in 1982.⁸⁰ British firms quickly entered the business of derivatives trading, and a significant futures and swaps market emerged in London by the late 1980s. By the end of 1992, the volume of outstanding derivatives worldwide was approximately \$21 trillion. Firms in other European countries, especially Switzerland, were active in this market, but with the exception of Mitsubishi Bank, the Japanese were not yet major players.⁸¹

By the early 1990s, firms in London were fighting for their share of this lucrative market. Reliable country-specific data on derivatives markets in the early 1990s are notoriously difficult to find, but U.S. firms such as Goldman Sachs and Morgan Stanley were viewed as superior derivative providers compared to British firms such as Morgan Grenfell and Warburg.⁸² British industry executives and regulators are quick to point out that U.S. derivatives providers avoided SEC capital rules by using their holding companies to effect transactions. As a result, these providers could offer more competitive pricing on swaps and futures and maintain a dominant position in the global market.⁸³ Regulators in the U.K. therefore experienced a shock to competitiveness, as shown in Figure 3.

On the other hand, maintaining confidence in securities markets (and securities firms) was a constant constraint on regulators, because instability increased the probability of legislative intervention. The existing capital adequacy regulations in the United States were deemed just right by U.S. regulators, especially after the October 1987 stock market crash. Despite the volatility in U.S. equity prices, one

77. Author's interviews with former senior SIB official and senior financial industry executive, 25 June 2002, London.

78. Walter 1996.

79. Mishkin and Eakins 1998.

80. *Ibid.*

81. Swaps Monitor Publications 1994.

82. *Ibid.*

83. Author's interviews with former SIB official and executive at Goldman Sachs, 26 June 2002, London.

former regulator said that, from the public's perspective, the SEC made it through the crash "with flying colors."⁸⁴ There were no major firm failures,⁸⁵ and no generalized fear that the capital held by securities firms was insufficient to weather the crash. Investors in London, however, were less confident in the stability of their securities firms. The crash occurred in the middle of a £7.25 billion equity offering, the world's largest public offering of stock. On October 15, just four days before "Black Monday," the British government released details of an offer to sell its remaining 31 percent stake in British Petroleum (BP). Merchant bank N.M. Rothschild was the lead manager of the offering, along with a syndicate of sixteen underwriters in London and a small number of firms in North America, Continental Europe, and Japan. When the stock market plunged, underwriters were faced with tremendous losses, estimated at nearly £1 billion.⁸⁶ After intense pressure from investment banks, the British government instructed the Bank of England to repurchase a portion of the shares, but underwriters were nonetheless left with losses totaling some £700 million.⁸⁷ With confidence in British firms in question, the SIB did not have the option of enacting less stringent regulations to counteract the loss of market share to U.S. securities firms.

British regulators therefore found themselves with a shrinking win-set for regulatory policy and political pressures on all sides. Financial institutions in London faced tremendous difficulty in maintaining their share of the derivatives market and were frustrated by the absence of consolidated supervision for U.S. firms. In addition, the declining capital levels of British securities firms indicated an overall drop in international competitiveness. This was borne out by the acquisition of all but one of the major securities houses in London by foreign financial institutions soon after the IOSCO negotiations failed to change the regulatory environment in the United States.⁸⁸ Overseeing the downfall of an industry is a sure way for a regulator to invite legislative intervention.⁸⁹ On the other hand, the stock market crash reminded the SIB that it did not have the luxury of enacting less stringent regulations for providers of derivatives. As the financial press questioned the viability of the SIB and the job prospects of its embattled chairman,⁹⁰ the agency sought an international solution: if the United States adopted consolidated capital rules, then British firms would become more price-competitive as U.S. firms were forced to hold more capital to back up their derivatives trading. The SIB therefore took the lead in promoting international harmonization, even if

84. Author's interview with former senior SEC official, 7 May 2002, New York.

85. Three small, specialized investment firms became insolvent after the crash. *Wall Street Journal*, 21 October 1987, 26.

86. Littlewood 1998.

87. *Ibid.*

88. Acquisitions included Morgan Grenfell by Deutsche Bank, SG Warburg by Swiss Bank Corporation, Kleinwort Benson by Dresdner, and Barings by ING. Shroder was the only major securities firm in London that was not acquired. See Rogers 1999.

89. The SIB ceased operations in 1997 with the creation of the Financial Services Authority.

90. See, for example, *Independent*, 28 January 1990, 4.

that meant that the SEC would lower its capital requirements—or at least validate a lower international standard—for broker-dealers to match the SIB’s regulations.

Consolidated supervision was an implicit component of the IOSCO negotiations. It is difficult to reconcile the SEC’s sole focus on broker-dealers with the spirit of the 1989 IOSCO report, which emphasized such concepts as “a firm’s true position” and an amalgamation of all risks faced by a firm.⁹¹ The SEC itself was pushing for new legislation to force parent companies of U.S. broker-dealers to share financial information with the SEC. SEC Chairman Richard Breeden was a staunch supporter of a bill sponsored by Sen. John Heinz (R-Pa.) and Sen. Christopher Dodd (D-Ct.) that would amend the 1934 Securities Exchange Act by requiring holding companies and affiliated entities of registered broker-dealers to submit periodic financial reports to the SEC.⁹² The bill, called the Market Reform Act, received a push by the failure of securities firm Drexel Burnham Lambert in early 1990. As the Drexel holding company was on the verge of declaring bankruptcy, it began to siphon capital away from its solvent registered broker-dealer, which was regulated by the SEC. The SEC only become aware of this transfer after more than half of the broker-dealer’s capital—some \$400 million—had been depleted, and just eleven days before the Drexel holding company declared bankruptcy.⁹³ As Breeden stated during a Senate Banking Committee hearing, “If there’s a five-alarm fire raging, we think we ought to know about it.”⁹⁴ The bill was eventually passed as the Market Reform Act of 1990, and constituted a significant change in the supervision of holding companies.⁹⁵

Given the growing awareness of the vulnerability of a registered broker-dealer to the unregulated activities of its parent, the SEC had to be wary of a global capital adequacy standard. Requiring information from holding companies is a clear step toward regulating their activities. The SEC had no interest in expanding its capital requirement to include holding companies; indeed, financial firms made their resistance to such a development clearly felt in Congress during the debates over the Market Reform Act.⁹⁶ But in light of Breeden’s push for more information from unregulated affiliates, a global capital adequacy standard—enforced by nearly every other regulator on a consolidated basis—would put the SEC on a clear path toward regulatory supervision of holding companies.⁹⁷ As these developments unfolded, the SEC—eager to defend its own policymaking discretion and the competitiveness of U.S. securities firms—made its preferences known by unceremoniously pulling out of the IOSCO negotiations.

91. IOSCO 1989.

92. U.S. Senate 1990.

93. *Washington Post*, 3 March 1990, C1.

94. U.S. Senate 1990.

95. U.S. Public Law 101-432. Note that the legislation applied only to holding companies of broker-dealers. Bank holding companies were already subject to consolidated supervision in the United States.

96. *Washington Post*, 3 March 1990, C1.

97. Author’s interview with former senior SIB official, 27 June 2002, London. Such pressure is hinted at in Walker 1992.

Conclusion

Efforts to harmonize financial regulations across countries have become a common, although often overlooked, occurrence in the world economy. However, there have been few attempts in the political science literature to explain cross-national variation in preferences toward harmonization. In this article, the principal-agent relationship between legislatures and regulators is critical to understanding why countries demand global financial standards. I argue that regulators' incentives emerge from the possibility of legislative intervention; the legislature's incentives, in turn, derive from the need to choose an optimal trade-off between financial stability and international competitiveness. Regulators must, therefore, use the only tool at their disposal—regulatory policy—to maintain a balance between confidence and competitiveness. In the event of an exogenous shock to confidence or competitiveness, regulatory policy may be ineffective in maintaining this balance unilaterally, in which case regulators have incentives to seek an international regulatory agreement to maintain their autonomy.

The arguments that I present here differ from the existing literature in two main ways. First, I focus on the varying preferences of national regulators in the context of legislative constraints, rather than on systemic concepts such as international market failures and global public goods. I take issue with studies that neglect the principal-agent relationship between the legislature and the regulator, and instead I argue that regulators maintain decision-making discretion within the bounds set by domestic politics. Second, I focus on the trade-off between voter confidence and financial sector competitiveness. Much of the public debate on globalization emphasizes the possibility of “regulatory arbitrage,” where capital will flow to the least regulated areas, thereby inducing a regulatory race to the bottom.⁹⁸ These analyses do not account for the critical role of voter confidence in constraining regulatory policymaking.

My focus throughout this article has been on prudential regulations, which are designed to foster the stability of financial institutions and other enterprises. However, the dual variables of confidence and competitiveness are relevant to a variety of other international harmonization efforts. One example is money laundering, a growing concern among governments, regulators, and financial institutions.⁹⁹ Anti-money laundering regulations require banks and other financial institutions to file currency transaction reports, keep adequate records on the identities of account holders, and monitor suspicious activity. Such requirements can be expensive, especially for smaller banking sectors that are eager for capital inflow. Regulatory laxity can be a significant competitive advantage, as shown by the vibrant banking sector of the tiny island nation of Vanuatu. The members of the Group of 7 (G-7)

98. See Garrett and Mitchell 2001 for a summary of the race-to-the-bottom logic.

99. Money laundering is the processing of the proceeds from criminal activity in an attempt to hide its illegal origins.

industrialized countries, eager to stop money laundering and the predicate criminal activities that fuel it, have led the charge in attacking the market confidence of countries that maintain lax regulations. The G-7's Financial Action Task Force (FATF) conducts periodic regulatory reviews of countries around the world, and publishes the names of countries that do not comply with its "40 recommendations" to fight money laundering. By drawing attention to these countries, the FATF hopes to discourage investment in their markets—that is, effect a downward shift in the competitiveness line in Figure 3—and eventually bring about appropriate regulatory changes.¹⁰⁰

As a final note, the framework presented here, with its emphasis on the industrialized world, highlights an important set of distinctions that should be noted in the literature on harmonization. There are in fact three broad types of international regulatory harmonization. The first, *regulatory convergence*, is the organic process by which countries modify their regulations based on the policies of other countries, especially dominant countries such as the United States, or simply converge on a common set of rules inadvertently.¹⁰¹ A prime example is bank deposit insurance, which is common in many countries but was until recently a U.S. phenomenon.¹⁰² The second type of harmonization, which I label *core harmonization*, is the process emphasized in this article in which a small group of advanced industrialized countries agree, through overt negotiation, to harmonize their regulations. The result of successful core harmonization is an international standard, often with a formal name (for example, the Basel Accord). The creation of an international standard gives rise to the third type of harmonization, *peripheral harmonization*, in which countries outside the core group of industrialized countries choose whether to accede to the standard or to maintain divergent regulations. Third World countries, for example, often tout that they are "Basel-compliant" to increase investor confidence in their banking systems; other countries intentionally diverge from the FATF's anti-money laundering recommendations as a means of attracting capital.

Scholars should be clear about which type of harmonization is under investigation, because each requires a separate analytical approach. Analyses of regulatory convergence might look at epistemic communities, global economic and geopolitical conditions, and other factors that lead regulators and policymakers in multiple countries to adopt similar policies. Economic incentives in emulating a dominant country are also important, especially for countries with open markets. Core harmonization requires an analytical framework rooted in domestic politics—such as the one presented in this article—because the varying preferences of the small number of core countries are critical. Finally, peripheral harmonization focuses

100. For more on the FATF, see Stessens 2000.

101. Simmons and Elkins (forthcoming) use the related term "diffusion" to refer to the international spread of liberal economic policies.

102. Calomiris and White 1994.

one's attention on the coercive power of the core countries through international institutions and economic sanctions, as well as the economic incentives of the peripheral countries themselves in acceding to the international standard.¹⁰³

The Basel Accord provides a useful example of the importance of these types. In the mid-1980s, before the existence of an international standard, there were strong incentives for countries to undercut each other with lax capital requirements, because doing so provided a competitive advantage. However, after the G-10 countries established the Basel Accord in 1988, these incentives largely disappeared, and "Basel-compliance" became an important signal to investors of bank stability. For core harmonization of capital requirements, competitive pressures were a hindrance; but after the G-10 countries harmonized, competitive pressures actually ensured peripheral harmonization.¹⁰⁴

Regulatory harmonization, in its various forms, will continue to be a controversial topic for policymakers and scholars in the years to come. The host of analytical questions that harmonization raises implies that scholars must be sensitive to their choice of analytical framework. In the case of core harmonization, domestic politics and the policy trade-offs of regulators should take center stage in the political science literature.

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103. See the framework offered in Simmons 2001.

104. On worldwide compliance with the Basel Accord, see Ho 2002.

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