Political Economy of Financial Regulation

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Motivation

- Increased interdependencies across countries have led to calls for greater harmonization of regulations
  - Financial regulation, climate agreements, international tax treaty
- The process of harmonization follows complex negotiations between national regulators conducted behind closed doors
- Objective of the negotiations: globally consistent standards that maximize welfare
  - BCBS's mandate *"is to strengthen the regulation, supervision and practices of banks worldwide to enhance financial stability."*
  - Regulators are supposed to *"promote the interests of global financial stability and not solely national interests."*
- However, interest of regulators often contradicts
  - Maintain stability through regulatory stringency
  - Promote the competitiveness of domestic economies

Motivation

"I believe [output floors] to be a reasonable approach, because it keeps in check the complexity that is inherent in today's risk-based regulations."

- Andreas Dombret, 29th Oct 2015

"From a German perspective, there are two essential areas of action for the negotiations at the end of November. First, preservation of internal credit risk models, ... and second, not *introducing an output floor."*

- Andreas Dombret, 16th Nov 2016

- What made Andreas Dombret (executive board member of Deutsche Bundesbank) change his mind?
  - This paper investigates the process through which harmonization of financial regulation is achieved.
  - Understanding of these issues is important to gauge the efficacy of harmonized regulatory reforms.

What We Do

- Focus on the negotiation of regulators in rule-making process of the Basel Committee on Banking Supervision (BCBS)
  - Negotiations are behind closed doors
  - Leaked voting records provide us with a unique opportunity to examine this question
- Focus on two research questions:
  - How do national regulators form their positions?
  - What are the consequences on the resultant regulations?

How Do We Answer the Question

1. Construct novel dataset on different positions taken by stakeholders in BCBS negotiation process
   - Collect list of important regulatory issues during Basel II and III negotiations
   - Code positions of regulator regarding these issues as well as collect their speeches during this process
   - Code positions of banks (national champions (NC) and smaller banks regarding these issues)
2. Investigate what drives positions of national regulators
   - Empirical analysis of regulators' positions
   - Investigate regulators' speeches around the consultative documents
3. Analyze consequences of the behavior of national regulators for international standard-setting
   - How far does the behavior of regulators impact what kind of rules get implemented

Summary of Findings

- National regulators' positions are correlated with positions of their large banks
  - Probability of opposing a regulatory issue is 30% higher if the NC opposes it
  - Regulators rally for their NC particularly when the proposed rule disproportionately affects them
- Textual analysis of regulator's speeches
  - Time-series of positions of regulators
  - Same regulator's position changes after the consultative document is issued
- Mechanism
  - Smaller banks do not have such an influence even when their collective share is high
  - The effect is stronger for regulators with prior connections to large banks
- NCs positions tend to impact what kind of rules become an international standard
  - 11 out of 30 Basel initiatives get watered down
  - Initiatives with differential impact on NCs are more likely to be diluted

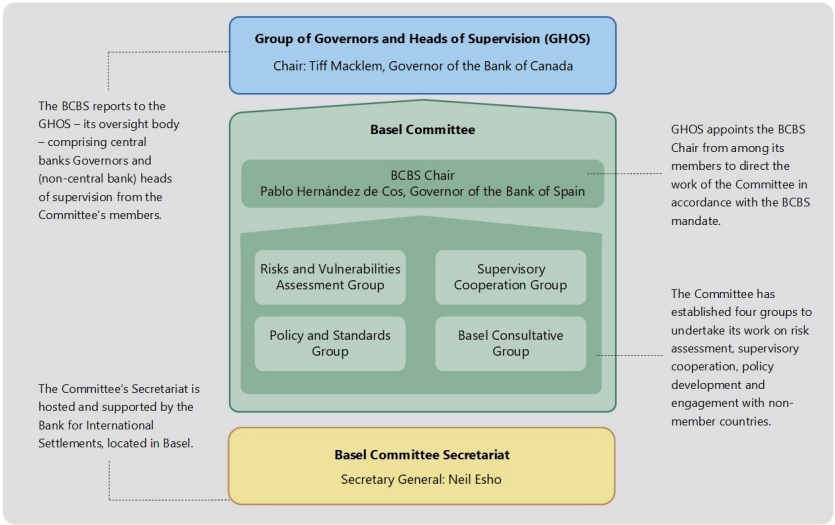
Outline

1. **Institutional background**
2. Data and coding of variables
3. Empirical analysis
    1. Determinants of regulators' positions
    2. Time-series evidence on regulators' positions
    3. Potential Mechanism
    4. Consequences on regulatory initiatives getting passed
4. Conclusion

Institutional background - About the BCBS

- Primary global standard setter for international financial regulation
- Membership stands at 28 member countries
- Countries are represented by the central bank and by any authority with formal responsibility for banking supervision
- Located at the BIS in Basel and meets four times a year
- Working groups are comprised of members and experts from member agencies
- Group of Central Bank Governors and Heads of Supervision (GHOS) is the oversight body of the BCBS and approver of its major decisions
- No formal supranational authority

Institutional background - Organizational of BCBS



Institutional background - Regulation framing process at the BCBS

- **Step 1:** Agenda is set by the G20 or FSB
- **Step 2:** Working groups of Basel committee work out a proposal:
  - Exact impact is not clear
- **Step 3:** Basel Committee publishes consultative document:
  - Regulators learn about positions of international banks
- **Step 4:** National regulators negotiate on the final regulation:
  - Regulation needs to be unanimously decided by the committee
  - Outcome of the final regulation becomes international standard

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Coding banks' positions

Code	Position	Examples
Strong Opposition	banks have a problem with central parts of the regulatory standard and do not want the regulation to go through	1. We will be in a position to express out strong concern 2. We urge the Committee to withdraw a proposal which it believes has no basis in fact 3. The consequences will be dramatic
Weak Opposition	banks have problem with certain rules within the regulatory measure	1. We do not agree with some aspects of the proposed framework 2. The treatment of risk associated with asset securitizations is too conservative. 3. We consider that the proposed TLAC Holdings definition is far too broad
Neutral	bank did not choose to comment or was in favor of the regulation	

Data - position of regulators

- Negotiation process is highly secretive
- Main source for regulator's positions:
  - Leaked positions to regulatory website risk.net
- Additional sources for regulator's positions:
  - Speeches made by central bankers
  - Official parliamentary documents from Germany (protocols from meetings of the Finanzauschuss)
  - Fed officials' testimonies
  - Minutes of meetings for Bank of England and Financial Conduct Authority
  - Roman Goldbach's coding for US and Germany of Basel II issues
  - Newspaper articles - text mined from Factiva and LexisNexis

Basics of the data

Total issues	30
Issues in Basel III	22
Countries coded for Basel III	DE, EU, FR, GB, JP, US
Issues in Basel II	8
Countries coded for Basel II	DE, FR, GB, JP, US
Issue-NCs or Issue-Regulator observations	172
Opposition from NCs	119
Strong opposition from NCs	42
Opposition from Regulators	36
Opposition from smaller banks	99
Strong opposition from smaller banks	12
Issues that had differential impact on NCs	8
Watered down issues	11

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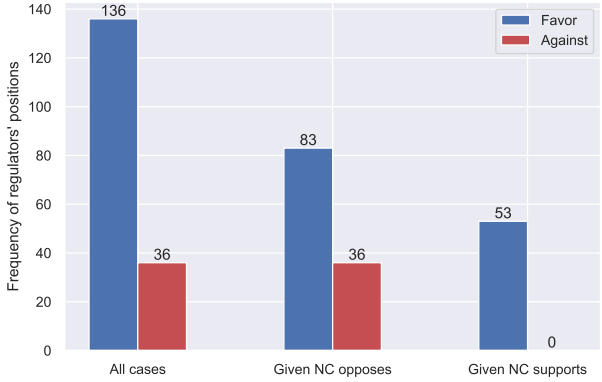
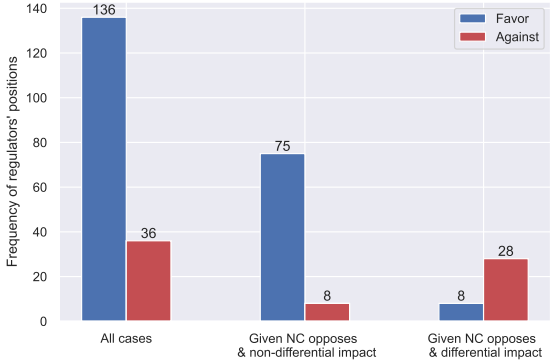
Regulator moves with the NC?



Regulator moves with the NC when there is a differential impact



NC driving the regulators

$$Y_{cj} = \delta NCSupport_{cj} + \beta_c + \beta_j + \epsilon_{cj}$$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of the NC	0.284***	0.303***	0.355***	0.452***	0.071	0.078
	(0.075)	(0.065)	(0.098)	(0.059)	(0.054)	(0.083)
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Issue Fixed Effects	No	Yes	No	Yes	No	Yes
Adj.-R^2	0.287	0.755	0.482	0.859	0.0625	0.536
Obs.	172	172	46	46	126	126

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NC driving the regulators

$$Y_{cj} = \delta_1 NCSupport_{cj} + \delta_2 SmallSupport_{cj} + \beta_c + \beta_j + \epsilon_{cj}$$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of the NC	0.308***	0.310***	0.355***	0.439***	0.025	0.038
	(0.064)	(0.066)	(0.099)	(0.059)	(0.036)	(0.063)
Position of Small Banks	-0.133**	-0.018	-0.031	0.050	0.081*	0.066
	(0.060)	(0.058)	(0.076)	(0.037)	(0.044)	(0.051)
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Issue Fixed Effects	No	Yes	No	Yes	No	Yes
Adj.-R^2	0.339	0.755	0.485	0.861	0.0875	0.544
Obs.	172	172	46	46	126	126

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Textual analysis - data and methodology

- Speeches and interviews made by regulators of DE, FR, GB, JP, US, EU from 2009 till 2016 (Basel III)
- Speeches provide time-series of positions
- Identify parts of speeches that are about regulation using Latent Dirichlet Allocation model
- Get tone of the speech - sentiment analysis (Loughran and McDonald (2011))
- Tone is measured as (positive words - negative words)/total words

Examples of Topic Covered in Speeches - Regulation

(a) Topic Related to Bank, regulation and supervision

(b) Topic related financial market, regulation

Examples of Topic Covered in Speeches - Other

(a) Topic Related to Monetray Policy, price, inflation

(b) Topic related production, inflation, growth

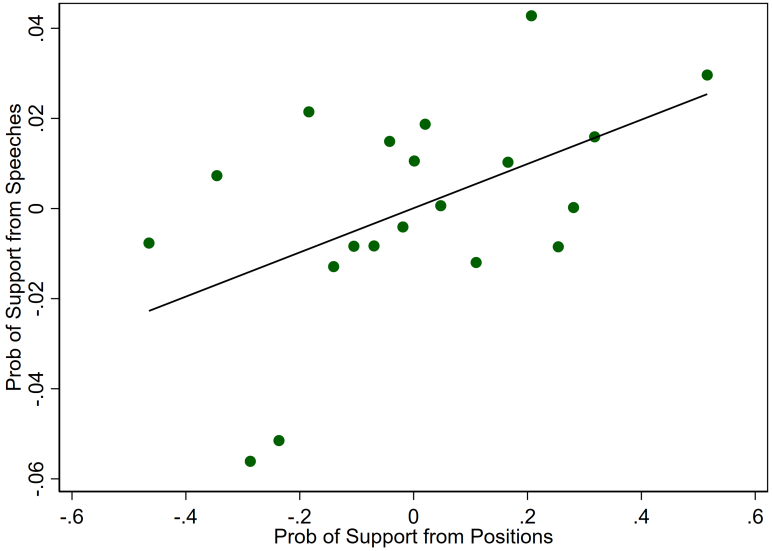
Speech examples - before and after

- **Andreas Dombret, (before the consultative document)**: *"I fully agree with the leverage ratio's overall intention to deliver transparent and credible ratio, complementing the risk-based capital requirements"*
- **Andreas Dombret, (after the consultative document)**: *"Yet a leverage ratio would also create the wrong incentives If banks had to hold the same percentage of capital against all assets, any institution wanting to maximise its profits would probably invest in high-risk assets, as they produce particularly high returns"*
- **Andrew Bailey, (before the consultative document)**: *"The post-crisis adjustment of the capital adequacy standard is a welcome and necessary correction ... I do not however accept the view that raising capital standards damages lending. Analysis by the BIS indicates that in the post-crisis period banks with higher capital ratios have experienced higher asset and loan growth"*
- **Andrew Bailey, (after the consultative document)**: *"it is sometimes said that the banking system still needs markedly more capital , and that a focus on other issues is a distraction from tackling a system that is still over-leveraged. The second, closely-related, point is that we should focus much more exclusively on non-risk based measures of capital requirements. I don't agree with either of these positions, and nor would I say do most supervisors I know"*

Correlation of positions and speeches

	Speech in Support of Regulation)	
	(1)	(2)
Position in support of Regulation	0.045***	0.047**
	(0.017)	(0.018)
Year-Quarter	Yes	Yes
Control	No	Yes
Speaker	Yes	Yes
Obs.	1439	1439

Correlation of positions and speeches



NC driving the regulators

$$Y_{i(j)t} = \beta_1 NC\ Support_{jt} + \beta_i + \beta_t + \epsilon_{it}$$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of National Champions	0.025**	0.029**	0.026**	0.025**	0.006	0.005
	(0.010)	(0.013)	(0.010)	(0.011)	(0.006)	(0.006)
Year-Quarter	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Control	No	Yes	No	Yes	No	Yes
Adj.-R^2	0.0409	0.0405	0.0404	0.0399	0.0379	0.0378
Obs.	1439	1439	1439	1439	1439	1439

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Speaker	Yes	Yes	Yes	Yes	Yes	Yes
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Year-Quarter	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Control	No	Yes	No	Yes	No	Yes
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NC driving the regulators

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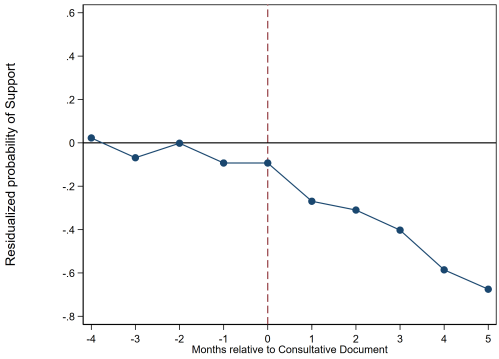
	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of National Champions	0.026**	0.028**	0.027**	0.027**	0.004	0.008
	(0.010)	(0.014)	(0.011)	(0.012)	(0.008)	(0.010)
Position of Small Banks	0.008	0.016	-0.004	-0.007	-0.019	-0.078
	(0.014)	(0.018)	(0.006)	(0.007)	(0.025)	(0.052)
Year-Quarter	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Control	No	Yes	No	Yes	No	Yes
Adj.-R^2	0.0409	0.0405	0.0404	0.0399	0.0379	0.0378
Obs.	1439	1439	1439	1439	1439	1439

Falsification Test

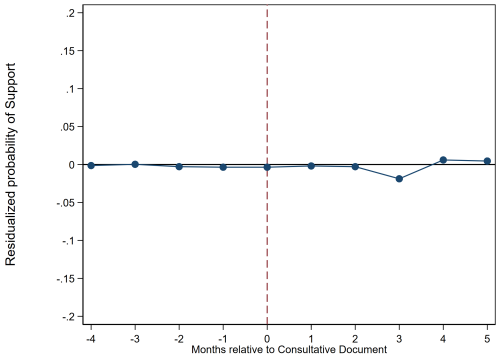
$$Y_{i(j)t} = \beta_1 NC\ Support_{jt} + \beta_i + \beta_t + \epsilon_{it}$$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of National Champions	0.001	0.001	0.001	0.002	-0.002	-0.002
	(0.002)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Year-Quarter	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Control	No	Yes	No	Yes	No	Yes
Adj.-R^2	0.0409	0.0405	0.0404	0.0399	0.0379	0.0378
Obs.	1439	1439	1439	1439	1439	1439

Event Plot



(a) Event



(b) Falsification Test

Consultative Documents as Events

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Oppose × Post	-0.050*	-0.049	-0.093***	-0.102***	-0.020	-0.003
	(0.026)	(0.034)	(0.032)	(0.034)	(0.038)	(0.049)
Country ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
Event-Month ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Speaker ×Issue	No	Yes	No	Yes	No	Yes
R^2	0.145	0.246	0.189	0.230	0.141	0.252
Obs.	3638	3458	748	719	2888	2739

Consultative Documents as Events

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Oppose × Post	-0.050*	-0.049	-0.093***	-0.102***	-0.020	-0.003
	(0.026)	(0.034)	(0.032)	(0.034)	(0.038)	(0.049)
Country ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
Event-Month ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
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R^2	0.145	0.246	0.189	0.230	0.141	0.252
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	(1)	(2)	(3)	(4)	(5)	(6)
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	(0.026)	(0.034)	(0.032)	(0.034)	(0.038)	(0.049)
Country ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
Event-Month ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Speaker ×Issue	No	Yes	No	Yes	No	Yes
R^2	0.145	0.246	0.189	0.230	0.141	0.252
Obs.	3638	3458	748	719	2888	2739

Consultative Documents as Events - Falsification

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Oppose × Post	-0.000	0.001	0.002	0.003	0.001	-0.000
	(0.001)	(0.001)	(0.002)	(0.003)	(0.002)	(0.000)
Country ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
Event-Month ×Issue	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Speaker ×Issue	No	Yes	No	Yes	No	Yes
R^2	0.224	0.356	0.522	0.524	0.182	0.314
Obs.	3884	3709	798	771	3084	2938

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Possible explanations of regulator's behaviour

1. Regulators care about domestic financial stability
   - National champion is more important to financial stability than the smaller banks
   - If the regulators care about national stability, their view would vary with the relative importance of the smaller banks.
2. There could be regulatory entrenchment by the national champions
   - Self-interest/regulatory capture hypothesis
   - The effect stronger for existing connections

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Cross Sectional Tests - Positions

	All		Asymmetric Impact		No Asymmetric Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
	Panel A: Positions of Central Bankers					
Position of NCs × low SB Share	0.300***	0.265***	0.255*	0.442***	0.011	0.023
	(0.077)	(0.058)	(0.134)	(0.054)	(0.039)	(0.057)
Position of NCs × high SB share	0.310***	0.255***	0.394**	0.622***	0.058	0.053
	(0.062)	(0.057)	(0.129)	(0.097)	(0.048)	(0.061)
Position of small × low SB Share	-0.072	0.078	0.049	0.073	0.110*	0.079
	(0.072)	(0.054)	(0.065)	(0.137)	(0.056)	(0.062)
Position of small × high SB share	-0.175**	0.017	-0.150	0.039	0.076	0.067
	(0.069)	(0.051)	(0.127)	(0.095)	(0.061)	(0.050)
R-squared	0.286	0.738	0.428	0.883	0.102	0.548
Obs.	172	172	46	46	126	126
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Issue Fixed effecs	No	Yes	No	Yes	No	Yes

Cross Sectional Tests - Speeches

	All		Asymmetric Impact		No Asymmetric Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
	Panel B: Tone of Speech					
Position of NCs × low SB share	0.030**	0.031**	0.018	0.018	0.010	0.005
	(0.013)	(0.016)	(0.011)	(0.012)	(0.007)	(0.008)
Position of NCs × high SB share	0.021	0.021	0.044**	0.043**	0.001	-0.004
	(0.029)	(0.030)	(0.018)	(0.020)	(0.015)	(0.016)
Position of small × low SB share	0.005	0.017	-0.009	-0.019	-0.010	0.004
	(0.035)	(0.034)	(0.020)	(0.023)	(0.012)	(0.015)
Position of small × high SB share	0.013	0.021	0.010	0.003	0.016	0.021
	(0.027)	(0.028)	(0.018)	(0.021)	(0.019)	(0.019)
Year-Quarter	Yes	Yes	Yes	Yes	Yes	Yes
Control	No	Yes	No	Yes	No	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Adj.-R^2	0.0391	0.0389	0.0400	0.0397	0.0365	0.0366
Obs.	1439	1439	1439	1439	1439	1439

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1. Regulators care about domestic financial stability
   - National champion is more important to financial stability than the smaller banks
   - If the regulators care about national stability, their view would vary with the relative importance of the smaller banks.
2. **There could be regulatory entrenchment by the national champions**
   - **Self-interest/regulatory capture hypothesis**
   - **The effect stronger for existing connections**

Personal Experience of Regulators

- We intend to measure links between regulators and large banks
- We hand collect information on the work experience of regulators
- Classify regulators with (significant) prior experience of working in a large bank before joining the central bank.

$$Y_{i(j)t} = \beta_1 NC\ Support_{jt} + \beta_2 NC\ Support_{jt} \times HighExperienceDummy_i + \beta_i + \beta_t + \epsilon_{it}$$

- If regulatory entrenchment then $\beta_2 > 0$

Personal Experience of Regulators

	Dummy (Speech in Support of Regulation)					
	All		Asymmetric Impact		No Asymmetric Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of NCs	0.022*	0.025*	0.016	0.015	0.001	-0.001
	(0.012)	(0.014)	(0.011)	(0.013)	(0.007)	(0.006)
Position of NCs × Experience Dummy	0.011	0.013	0.023**	0.024**	0.011	0.017*
	(0.015)	(0.017)	(0.010)	(0.010)	(0.009)	(0.009)
Year-Quarter	Yes	Yes	Yes	Yes	Yes	Yes
Speaker	Yes	Yes	Yes	Yes	Yes	Yes
Adj.-R^2	0.0312	0.0308	0.0319	0.0313	0.0284	0.0287
Obs.	1425	1425	1425	1425	1425	1425

Outline

1. Institutional background
2. Data and coding of variables
3. **Empirical analysis**
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    2. Time-series evidence on regulators' positions
    3. Potential Mechanism
    4. **Consequences on regulatory initiatives getting passed**
4. Conclusion

Consequences for Harmonized Standards

- We investigate the implication of national regulators' position on the resultant harmonized standard.
- Rule-making process Requires a unanimous voting
  - Any proposed rule will be vetoed till a consensus is reached
- We measure whether the content of the given rule dilutes from the consultative document phase to the final implementation stage.
- We create the following variables:
  1. *Water Down* $= 1$ if either there are some changes, delays or stalling in the proposed rules.
  2. *Delay Dilute* $= 1$ if either delayed or diluted
  3. *Stalled* $= 1$ if the proposed rule is discarded

Probability of Water Down

	Dummy = 1 if Watering Down			Dummy = 1 if Delay or Diluted			Dummy = 1 if Stalled		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Large bank asymmetric impact	0.864***		0.877***	0.330*		0.322*	0.534***		0.555***
	(0.076)		(0.071)	(0.183)		(0.185)	(0.188)		(0.189)
Small bank asymmetric impact		0.154	-0.082		0.135	0.048		0.019	-0.130
		(0.276)	(0.057)		(0.233)	(0.200)		(0.240)	(0.196)
R-squared	0.628	0.0118	0.631	0.184	0.0181	0.186	0.312	0.000239	0.322
Obs.	30	30	30	30	30	30	30	30	30

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Conclusion

- Increased globalization has led to international harmonization of regulatory standards across different sectors
  - Paris Agreement for Environment regulation
  - Capetown treaty in the airline industry
  - BCBS for financial regulation
- Harmonization is done with the idea to reduce negative externalities.
  - Political economic or organizational constraints could reduce the effectiveness
  - Important to understand the underlying process of rule-making
- This paper is an attempt in understanding international rule-making
  - Regulators rather than optimizing global stability follow their NCs
  - Potentially driven by regulatory capture
  - It leads to a race to the bottom - Contradicting the basic premise of supranational regulatory design
- Important implications for countries with low or no negotiation power