

From pragmatism to dogmatism. EU governance, entrenched policy paradigms and the financial crisis

Abstract

Contemporary analyses commonly attribute the global financial crisis to faulty regulation. What have been the roots of these deficient rules, particularly in Europe, where rapid spill-over from US mortgage markets took policymakers and observers by surprise? This article focuses on the ascendancy of regulatory liberalism as the paradigm guiding EU regulation. This paradigm has dominated regulatory thinking for decades, but it has been implemented throughout Europe only since the mid-1990s.

This shift in policy, so this article's core argument, can be traced to the way in which political institutions have filtered the ideas underlying policy. Drawing on three case studies this article shows that EU reforms in financial governance have pushed policy from pragmatism, under which it was adapted to political contingencies, to dogmatism, which adapts policy to the intellectual exigencies of prevailing, rigid policy paradigms. Inadvertently, governance reforms have created an epistemic community in European finance in which 'professional' rule-setters systematically ignored persistent criticisms of a policy firmly grounded in regulatory liberalism. The institutionalized ambition to craft 'intellectually sound' policy – rather than policy that simply 'works' – has generated rules that persistently ignored the self-reflexivity of financial markets and thereby contributed to the depth of the current crisis.

Revised version September 2009, currently under submission.

Daniel Mügge

Amsterdam School for Social science Research
Universiteit van Amsterdam
Kloveniersburgwal 48
1012 CX Amsterdam
The Netherlands
d.k.muegge@uva.nl

INTRODUCTION

The financial crisis that since the summer of 2007 has rippled outwards from US mortgage markets to trigger a global economic downturn has called into question the functioning of global financial markets (Morris 2008: 55) and the rules governing them. But while faulty regulation for everything from accounting via credit ratings to banking supervision contributed to the meltdown, the identification of deficient rules is only the starting point of an analysis of the current crisis and its causes. For what explains the emergence of these rules in the first place? This is the core question this article pursues.

Understanding the emergence of faulty rules is particularly pertinent and intriguing in the European case. EU regulation has changed immensely since the 1990s, with rule-diversity between countries giving way to continent-wide harmonization (Mügge 2006). Only in the mid-1990s did most EU member states begin promoting the capital markets and innovation in the financial sector that ultimately made the whole continent vulnerable to a crisis spilling over from the United States. These rule changes can in part be traced to financial sector lobbying: large European banks in the 1990s identified cross-border capital markets as a key source of future profitability and pushed for rule changes allowing their involvement. But while policy suited the financial industry in some cases, it contravened its interests in others. And while policymakers were undoubtedly influenced by the firms they regulated, they were not their handmaidens.

An alternative approach – whose line of reasoning this article follows – focuses on the policy paradigm underlying financial governance. But what Gamble (2009: 153f) has called ‘regulatory liberalism’ has dominated regulatory thinking in finance for more than two decades. Its intellectual hegemony is thus insufficient to account for the EU reforms in question, which have been much more recent. For particular ideas to dominate thinking in a policy domain is not enough to ensure their implementation. So what, then, explains the ascendancy of regulatory liberalism in EU financial market policy?

To answer this question, this article points to political institutions as filters of ideas and introduces a distinction between two modes of policymaking – pragmatism and dogmatism. The key differences between the two are the value policymakers attach to the intellectual coherence of policy and the extent of their isolation from other stakeholders. Pragmatic policymaking is characterized by relatively low intellectual coherence, ad hoc bargains, quick fixes and a focus on ultimate policy outcomes. In contrast, dogmatic

policymaking is based on deliberation among members of an epistemic community and is theory-based.

Both modes are ideal-types; real arrangements lie between the two poles. Yet institutional reforms in European financial governance since the second half of the 1990s have furthered dogmatic policymaking by handing authority to experts, often in supranational or international bodies, and by disembedding and depoliticizing policy. The result has been a relatively stringent implementation of regulatory liberalism over the past decade, even though it had been the dominant paradigm for much longer. With hindsight, the weight this paradigm acquired in policymaking proved fatal, ignoring as it did the self-reflexivity of financial markets.

After introducing the concepts of pragmatism and dogmatism in policymaking, this article lays out its theoretical argument tracing the influence of policy paradigms on policy output to the design of political institutions. It then demonstrates this argument in three policy domains that have been central in the current crisis: the ascendancy of International Accounting Standards, the non-regulation of credit rating agencies, and regulators' complacency in the face of ballooning credit derivatives markets.

PRAGMATIC AND DOGMATIC MODES OF POLICYMAKING

Over the past decade the role of ideas has acquired increasing prominence in the International Political Economy literature (McNamara 1998, Blyth 2002, Abdelal, *et al.* forthcoming). This scholarship has shown how ideas are instruments of powerful agents and how at the same time they constrain these agents' actions and preference formation. The prevalence of particular ideas in policymaking circles helps explain why certain routes are chosen at particular junctures; the resulting 'battle of ideas' can be understood as a struggle between different 'discourse coalitions' (Hajer 1995).

While building on this work, this article draws attention to a different dimension along which the ideas underlying policymaking vary: the relative strength that ideas exert over policy at different points in time, even when the prevailing policy paradigm does not exhibit major variation. If we consider ideas(-systems) that have influenced economic policymaking in the past – monetarism, the Washington Consensus, demand management, etc. – we find immense variation in the stringency with which they were implemented. In some places and times, though policy was based on a particular set of ideas, policymakers were quite willing to depart from the prescriptions that would seem to spring from them, be it to serve their own interests, to deal with new situations as they arose, or to manage interdependencies between different policy fields. In other instances,

policy was derived from an underlying theory in a much more disciplined manner and the prescriptions emanating from it were implemented relatively unfiltered.

In ideal-typical terms, the stringency with which ideas are implemented varies between what I call pragmatism and dogmatism. Using the literal definition of the Oxford Dictionary, an approach to policy is pragmatic when it is ‘dealing with things in a way that is based on practical rather than theoretical considerations’.¹ Pragmatic policymaking has several core features: it is oriented primarily towards specific political outcomes (be it financial stability, full employment, low inflation or simply gaining political support) and uses ad hoc political interventions to reach these goals, even if they are at odds with the ‘official’ paradigm. Policymaking in this mode follows the logic of bargaining (cf. Risse 2000): policy represents the degree to which different stakeholders manage to insert their preferences. Note that pragmatic policymaking is neither desirable nor undesirable per se; it can reflect commendable sensitivity to the limits of theory-driven policy as much as short-term opportunism (for example ahead of elections).

Dogmatic policymaking, in contrast, is based on dogma – ‘a principle or set of principles laid down by an authority as incontrovertible’² – which forms the intellectual foundation of policy paradigms (Hall 1993). Policy here emanates from an argument, according to inter-subjectively shared rules among members of a policy community regarding appropriate solutions to policy problems emerging from a shared policy paradigm. Policymaking in this mode follows the logic of appropriateness, with the important caveat that for dogmatic policymaking to emerge, the members of the policy community must also be members of an epistemic community (discussed below).

In a nutshell, then, pragmatic policymaking aims to produce policy that ‘works’ and which generates specific outputs, whereas dogmatic policymaking is primarily concerned with the coherence of the intellectual underpinnings and thus the ‘theoretical soundness’ of policy. Needless to say, both are ideal-types; all policymaking is underpinned by causal beliefs just as no policymaking is completely indifferent to outcomes and practical constraints. Nevertheless, we can identify clear variation along this axis, and this article argues that such variation has played a crucial role in generating the policies that have enabled the contemporary financial crisis.

¹ Concise Oxford English Dictionary (10th ed.), Oxford: Oxford University Press, 2002, p.1123.

² Concise Oxford English Dictionary (10th ed.), Oxford: Oxford University Press, 2002, p.422.

Institutions, ideas, and epistemic communities

The study of ideas in political economy has often been linked to the rise of institutionalism in political science (March and Olsen 1984, Skocpol 1985). Indeed, some scholars have treated ideas themselves as institutions, leading Schmidt (2006) for example to add a fourth, ‘discursive’ institutionalism to the three variants identified by Hall and Taylor (1996). For the sake of clarity, when speaking of institutions this article will refer exclusively to political institutions in a narrow sense (‘the administrative, legislative and regulatory rules that guide the adjudication of conflict’, Ikenberry 1988: 226f) and distinguish them from the individual or collective causal beliefs and norms that guide behaviour that are denoted here as ‘ideas’ (for a similar distinction, see Campbell 1998, Lieberman 2002).

Scholars have long recognized that a core effect – and possibly function – of political institutions is to filter ideas that contend for implementation into policy. Institutions do this by regulating access to policymaking among proponents of different ideas and by shaping deliberation among members of the policy community (e.g. Niemann 2004). In this way, political institutions have been part of the repertoire of factors explaining, for example, the shift towards neo-liberal policymaking from the late 1970s or the breakdown of Bretton Woods (Campbell 1998, Blyth 2002, Best 2005). This article argues that institutions also help explain *to what degree* ideas are implemented, and thus whether policymaking is best characterized as pragmatic (low intellectual coherence, driven by ad hoc bargains and fixes) or dogmatic (high intellectual coherence, driven by ideas).

One central approach to the study of ideas in policy – in international politics in particular – has focused on epistemic communities (Adler 1991, Adler and Haas 1992). In international negotiations, for example, it matters whether parties at the table share common normative and causal beliefs, yardsticks for evaluating each others’ arguments, and understandings of their own mandate and mission (Haas 1992: 4). Under conditions of high uncertainty, for example due to high inter-state interdependence or issue complexity, interactions within the ‘networks of knowledge-based experts’ (Ibid.: 2) that constitute epistemic communities can play a central role in defining national interests and hence the outcomes of international negotiations.

The power of epistemic communities to shape policy need not flow from conscious institutional design or delegation of power. Institutionalist scholarship has shown how once created, institutions can have effects that go beyond the intentions of

their creators (Steinmo, *et al.* 1992, Pierson 2000a, 2000b); institutions can thus become explanatory factors of politics in their own right. Institutional reforms guided by very different intentions may promote or obstruct the formation and empowerment of epistemic communities and thus the relative importance of pragmatic or dogmatic policymaking. In this way, the argument presented here is not in tension with interest-based accounts of regulatory reform in finance (e.g. Sobel 1994, Mügge 2006). When actors such as financial firms push for institutional change, they are clearly guided by their perceived interests. But the end result of a struggle between different factions may still satisfy none of them individually. More importantly, corporate actors may themselves only have a vague idea of what their interests are; they therefore at least partially rely on the ideas-systems generated by policymakers (Woll 2008). Such was the case in the current crisis: financial firms clearly nudged policy towards excessively lenient standards and bred complacency among public actors. This is not to say that the institutions created since the early 1990s are reducible to corporate interests, or that they have not had effects which must be understood independently of the forces that generated them.

We can discern variation along two dimensions that may empower epistemic communities and thus the influence of their belief systems. First, and most obviously, conscious ‘depoliticization’ of a domain in the name of finding optimal policy justifies the relative isolation of experts from day-to-day political pressure. The extremes of the continuum are full democratic control at one end and complete technocracy by non-majoritarian expert institutions at the other. In the latter case, isolation of policymaking from public debate and democratic scrutiny facilitates the entrenchment of particular policy paradigms. In more advanced forms, such technocratic governance also becomes isolated from academic criticism as technocrats themselves assume the role of providing the intellectual underpinnings of the policy they make; Marcussen (2005) has argued this point convincingly for the scientization of monetary policy within contemporary central banks. In addition, technocratic governance – by virtue of its pretence to objectivity – is less sensitive to potential contradictions within policy and its inherent tensions. To justify itself, technocratic governance has to uphold its belief in being ‘right’, reducing the scope for pragmatic policy which may simply ‘work’ but be intellectually unsound.

Note that such depoliticization can be used strategically to institutionalize particular visions of policy in the interests of a specific constituency, as much as it can flow from a genuine belief in the perfectibility of national economic performance through optimal market-enhancing government policy. Nevertheless, the end result is an

isolation of experts who face less pressure to bargain and hence have more room for deliberation (within the confines of the dominant policy paradigm). One of the most prominent examples of such depoliticization has been the independence of the European Central Bank (e.g. Jabko 2003, Jones 2003: 59ff).

Second, the delegation of policymaking to supranational or international bodies has often enhanced the importance of specific epistemic communities, and by removing deliberation from societal and parliamentary checks, contributed to the depoliticization of issues. The commonly noted shift of policymaking to arenas beyond the nation-state (for finance, see e.g. Cerny 2005) can have similar effects as technocratization: if successful, it fosters an epistemic community that henceforth constitutes the global vanguard in thinking about particular policy problems (cf. Kapstein 1992). Where policy paradigms may previously have varied across national policy communities, their merger in one transnational epistemic community reduces intellectual challenges from without. Intellectual socialization is displaced into transgovernmental networks (for finance, see Baker forthcoming), which again become more impermeable to outside criticism.

In the economic domain, the delegation of policymaking to supranational bodies has been accompanied by a disembedding of policy from national ‘varieties of capitalism’ where policies across domains were coordinated to exploit institutional complementarities (Hall and Soskice 2001) or to engineer specific policy outcomes in order to satisfy compromises between societal stakeholders (Jayasuriya 2001). For finance, this point has been convincingly argued by Best (2003). Supranational delegation of authority thus means that policy is less adapted to its context (socio-economic bargains, interactions with other policy fields, etc.), giving greater scope for epistemic communities to devise policy that can be considered theoretically sound in its own right.

Pragmatism versus dogmatism in finance

What is the significance of the above exposé on modes of policymaking for financial markets? Dogmatic economic policymaking need not be limited to some form of neo-liberal policy, but can be applied within different policy paradigms. Economic history is full of episodes in which strong ideas were implemented only half-heartedly – whether concerning flat taxes, Keynes’ idea of ‘fair’ burden-sharing between surplus and deficit countries in the post-WWII economic order, or more or less stringent versions of top-down economic planning. One idea that was implemented relatively unfiltered, and with catastrophic consequences, was the virtue of a restored gold standard after World War I.

As Ahamed (2009) argues, the institutionalized scope that leading central bankers enjoyed to implement their stubborn faith was crucial.

That said, global financial governance over the past two decades has been dominated by a paradigm that, following Gamble (2009: 153f), one might call regulatory liberalism, promoted by actors Armijo (2001: 384f) has referred to as ‘transparency advocates’. Regulatory liberalism argues that the ostensible virtues of markets – optimal allocation of resources, promotion of efficiency through competition, tendency towards equilibrium – can be harnessed to the public benefit through market-enhancing public regulation. Such regulation is not an alternative to markets for allocating resources, but enables markets to unleash their full potential. Note that this stance differs from market fundamentalism, which is much more skeptical about the merits of such market-enhancing intervention (Gamble 2009: 143ff, cf. Armijo 2001: 381ff). Regulatory liberalism can thus be seen as the regulatory arm of the neoclassical synthesis that came to replace Keynesianism as the paradigm guiding macroeconomic policymaking in the 1970s (Best 2005: 87ff).

In recent times, then, the difference between pragmatic and dogmatic financial governance lies in how stringently the core assumptions guiding regulatory liberalism have been implemented. Three assumptions of this paradigm have been crucial: given an appropriate regulatory environment, (1) financial markets can generate an optimal allocation of capital and hence maximize aggregate welfare, (2) these markets tend towards equilibrium, and (3) at least in principle, private incentives and the public interest can be aligned. The first two assumptions are indebted to advances in finance theory since the 1950s (MacKenzie 2006: 69ff, cf. Hudson 2005: 75f) as well as to faith in calculability (Mitchell 2002: 80ff) and computational methods based on technological advances (de Goede 2001). As Best (2003: 379) has argued, the financial reforms that followed the Asian financial crisis in 1997/98 ‘re-embedded’ a financial market order built on universal trust in these assumptions.

Why is dogmatic regulatory liberalism problematic – so problematic that it has contributed significantly to the contemporary crisis? In a nutshell, its fault lies in its disregard for the reflexivity of financial markets, a feature that loomed large in Keynes’ case for government intervention (Sapir 2000: 244, Best 2004: 387f, cf. Soros 2008: 51ff). Investment decisions require second-guessing other actors’ future expectations. Markets can display periods of calm, for example when market participants use similar models to (try to) transform uncertainty into knowable risk (Abdelal, *et al.* forthcoming: 15ff). At

the same time, this use of shared models may feed a self-defeating over-optimism in markets that ultimately triggers crises (Minsky 2008 [1986]). Financial markets are thus not only prone to instability per se (Mandelbrot and Hudson 2004); the belief in their self-correcting nature exacerbates crises by feeding prolonged upswings.

This article argues that it not only matters whether the dominant financial market paradigm acknowledges such reflexivity or not, as for example Best (2004) and Soros (2008) point out. It also matters *to what degree* policy deriving from such a paradigm is implemented. Even when non-reflexive paradigms are the wisdom of the day, pragmatic policymaking will mean that policy practice will always be ‘messy’. Politicians will tailor policy to please specific constituencies and apply quick fixes if outcomes fail to impress. The paradigm is never implemented in full; its potentially destructive effects are mitigated, if not (unconsciously) avoided.

Again, this is not to suggest that pragmatic policymaking is inherently ‘better’ than its dogmatic variant. The self-serving, ‘pragmatic’ behavior of policymakers has often been responsible for disastrous economic and financial policies; hyperinflation as a result of fiscal irresponsibility is only one of many examples here. Nevertheless, if the dominant paradigm ignores a central feature of financial markets – their self-reflexivity – then a relatively unbridled implementation of that paradigm, facilitated by specific policymaking institutions, is bound to spell trouble. It is in this way that the institutional reforms in EU financial governance over the past two decades have contributed to the crisis that started in the summer of 2007.

INSTITUTIONAL CHANGES AND DOGMATISM IN EU FINANCIAL GOVERNANCE

The following three sections substantiate this argument empirically. Institutional reforms in the governance of accounting standards, credit rating agencies, and banking and derivatives shifted decision-making from the national to the supranational/international level, removing it from democratic control and broad contestation. These shifts, in turn, furthered the dogmatic application of regulatory liberalism. These sections will demonstrate this claim by focusing on the composition, origin and homogeneity of the policy community in question, the mechanisms of its insulation, the prevailing paradigm, the sources of (largely disregarded) criticisms and the relevance of regulatory liberalism to the crisis. Table 1 provides an overview of the three cases along these dimensions.

Table 1: Overview of cases

	<i>Accounting</i>	<i>CRAs</i>	<i>Banking and derivatives</i>
<i>Composition of policy community</i>	Accounting professionals from the Big Four firms assembled in International Accounting Standards Board (IASB)	Regulators assembled in Committee of European Securities Regulators (CESR) and in International Organization of Securities Commissions (IOSCO)	Central bankers assembled in Basle Committee for Banking Supervision (BC)
<i>Origin of epistemic community</i>	EU delegation of policymaking to fend off US dominance	For EU: delegation of authority to CESR as part of capital market integration	Consolidation of epistemic community set up in late 1980s to govern regulatory externalities
<i>Source of group homogeneity</i>	Common professional background	Convergence of regulatory thinking inside EU and across Atlantic	Further strengthening of epistemic community since establishment of BC in late 1980s
<i>Specific ideas that unite community</i>	Support for fair value accounting; market values proper guides to asset values	Market for ratings can generate reliable information; principle-agent problems and reflexivity not an issue; private incentives (of CRAs) and public interest can be aligned	Risk is quantifiable; appropriate micro-management of risk can ensure systemic stability; private incentives (of banks) and public interest can be aligned
<i>Mechanisms that insulate community from criticism</i>	Independence of the (private) IASB	Authority of CESR in EU policymaking, global coordination by regulators, not politicians	Authority and relative independence of central bankers, primacy of international/ supranational coordination over national policy autonomy
<i>Source of criticisms</i>	Academics, policymakers in other fields, financial industry	Academics, politicians	Academics, financial industry
<i>Relevance to crisis</i>	Exacerbation of pro-cyclicality and volatility in bank earnings	Support of excess credit supply and fostering of complacency through over-optimistic ratings	Unregulated and intransparent derivatives concentrated unquantifiable risk on bank balance sheets; bank-internal risk management failed

Accounting standards

Historically, accounting standards have varied considerably even within Europe (Nobes and Parker 2000). Attempts by accounting professionals to harmonize them in the 1970s and 1980s led nowhere, as did efforts led by the European Commission. After all, there was no overriding imperative to craft a single rule set. Accounting standards had co-evolved with the national economies in which they were employed, providing strong disincentives to change nationally idiosyncratic rule sets. German accounting rules for example encouraged the build-up of ‘hidden’ corporate reserves which facilitated the kind of corporate long-termism that has long been hailed as one of the strengths of the

German variety of capitalism. Accounting rules were embedded in national varieties of capitalism and the political compromises these entailed; they were, in short, pragmatic.

When in the early 1990s US Generally Accepted Accounting Principles were gaining ground worldwide due to the strength of US capital markets, the EU embarked on a new strategy towards harmonized accounting standards (European Commission 1995). Lest EU authorities be marginalized in global standards setting, the Commission threw its weight behind the International Accounting Standards (IAS) project, an effectively private initiative of dedicated accounting professionals (Dewing and Russell 2004). The European Commission's attempts in 2000 to convince the US to accept IAS as global standards failed. Nevertheless, two years later EU member states had decided that from 2005 onwards, the standards drawn up by the International Accounting Standards Board (IASB, see Donnelly 2007) would be mandatory for all listed companies in Europe. In effect, EU member states delegated standards setting to a private professional body whose members could work relatively isolated from political and societal pressures.

Handing power over accounting standards to an independent, unaccountable body immediately triggered questions over the legitimacy of the new rules (Mattli and Büthe 2005). Perry and Nölke (2005) have shown that numerous experts in the IASB had present or past ties to the Big Four accounting firms. With its members sharing similar views on accounting from the outset, the IASB constituted a tightly knit epistemic community of professionals. International Accounting Standards were more than just a harmonization or convergence project; they were also an attempt by accounting experts to tackle many of the intellectual ambiguities that had dogged accounting for centuries.

The underlying problem in accounting already frustrated Ricardo and Marx (Blaug 1996: 90ff, 217ff, cf. Nitzan and Bichler 2009): do commodities and capital have objective value? If the question is answered in the negative, all accounting regimes rest on thin intellectual ice (Tinker 1980). What is recorded in corporate books is then, if not arbitrary, a product of academic whim. Because of its intractable problems, economists had largely abandoned value theory by the late 20th century after intense interest in the subject in the 1960s and 1970s. But the fundamental problem that there is no objective – and hence ‘correct’ – way of measuring capital has never ceased to dog controversies over accounting standards.

The accounting debate of the past two decades has focused on two alternatives for recording capital values in corporate books: historic cost accounting (HCA) and fair

value accounting (FVA). The former values assets by their original cost to the firm; later changes in market valuation of, for example, real estate never show up on the books. The firm's stock market valuation can therefore deviate considerably from its book value, which becomes a poor indicator of what it is worth (Barlev and Haddad 2003).

The FVA regime addresses this shortcoming by trying to value corporate assets and liabilities at their current market price, effectively 'looking up' going rates for similar assets and liabilities as they change hands in the market place. In line with regulatory liberalism, this approach – intellectually more coherent as a guide to 'what goes on' in a company than HCA – relies on market actors as the discoverers of value. But as one recent commentator found,

[a]t a conceptual level, fair value accounting is a plus [..]. But concepts are one thing and implementation another. (Penman 2007: 42)

Two problems recur: first, assets and liabilities that cannot be 'marked-to-market' due to the lack of liquidity in similar items are valued through informed guesswork. Precision evaporates. While this is hardly a problem for bakeries and barbershops, problems accrue for firms with large holdings of financial securities, particularly complex and illiquid over-the-counter derivatives. If securities are held for trading or are up for sale, International Accounting Standards require them to be marked-to-market even when markets are illiquid. What sounds good in theory becomes practical guesswork in spite of quantitative models summoned to fill the gap.

Second, if market valuations (even where they exist) do not reflect underlying objective 'value', neither do corporate statements. Prices of everything from tulip bulbs to OTC derivatives can be very volatile (Kindleberger 1978, Mandelbrot and Hudson 2004). Long swings in both valuation and volatility not only make the market prices of securities an unsound basis for assessing the 'underlying value' of a corporation (Rayman 2006), they also pose insurmountable problems for banks' internal risk assessment procedures and computer-assisted modelling of prices for illiquid assets. As the weight of the financial sector in advanced economies has grown steadily over the past decades (for the US, see Krippner 2005), the proper valuation of derivatives has ceased to be an issue of interest only to accountants. Through the financial firms that hold them, derivatives now permeate entire economies.

FVA has been identified as a crucial link in the sequence of events that first made the crisis possible and then exacerbated it (e.g. Ricol 2008: 50ff, Wallison 2008). The

most common criticism of IAS is that they have strong pro-cyclical effects when FVA is applied to securities because mark-to-market accounting ignores the self-reflexivity of such valuations. Marking to market securities in a falling market generates immediate losses for firms, potentially triggering fire-sales and further market declines at the worst possible moment. Pro-cyclicality had previously worked in the opposite direction to inflate the credit bubble: value increases in securities, including derivatives, were immediately recognized as profits, something that had long been forbidden for example in Germany to avoid the excessive growth of paper profits (Gebhardt 2000: 348). Just as FVA exaggerated the ‘bad news’ of market declines, it flattered companies in good times and helped sustain an originate-and-distribute model (Alexander, *et al.* 2007: 20ff) whose strength on paper belied its shaky foundations. Financial markets could only fall so spectacularly because they had previously climbed so high; FVA helped markets attain peaks that without it would never have been reached.

To be sure, reservations over FVA had been voiced before the crisis. A report of ECB staffers found that FVA could potentially threaten financial stability (Enria, *et al.* 2004). Leading regulators (Jopson 2005) criticized the IASB’s excessive focus on technicalities, while financial firms (Parker and Pretzlik 2004) feared that a stringent application of FVA to derivatives would exacerbate volatility of their profits. Yet the IASB remained reluctant to dilute the coherence of its approach and accepted minor revisions only after a standoff with the European Commission. Even after the crisis exposed the shortcomings of the contemporary regime, the IASB has remained unyielding in its defence of the intellectual soundness of its approach (Hughes 2008). EU governance reforms in accounting had ended up in the hands of professionals whose approach to policy was, in a word, dogmatic.

Governance a la Lamfalussy and rating agencies

Credit rating agencies (CRAs) have come under severe attack in the wake of the financial crisis. CRAs have been accused of generating a false sense of security among holders of complex credit derivatives whose value was potentially highly volatile (Hunt 2009) and of spotting troubles far too late – in the summer of 2007 the biggest CRAs downgraded more than 1,150 securities in less than 10 days (Ricol 2008: 55). Little doubt remains that CRAs in Europe will be subjected to some form of regulation; in November 2008 the European Commission tabled a proposal to this effect (European Commission 2008). With hindsight, giving credit rating agencies such a crucial role in global financial markets and leaving them unregulated was a poor decision. Here as well, reforms in European

financial governance facilitated a regulatory approach that in its reliance on and lenience towards CRAs exacerbated the crisis.

The crucial governance reform for credit rating agencies was the installation of the Committee of European Securities Regulators (CESR) as part of the so-called Lamfalussy process in EU capital market governance (Gottwald 2006, Mügge 2006, de Visscher, *et al.* 2007), introduced after EU member states had endorsed a list of 43 legislative measures deemed necessary to complete financial market integration (European Commission 1999). In the face of rapid market transformation, so the argument went, the traditional co-decision procedure was too cumbersome for legislation to stay abreast of market developments (Committee of Wise Men 2001).

Even though CESR is not particularly powerful on paper, since its inception in 2001 it has assumed a central role in European capital market regulation. CESR brings together national securities regulators and advises the European Commission on implementing measures – the technical ‘details’ in European legislation that the Commission is mandated to fill in. As part of its increasingly tight integration in global regulatory circles, CESR holds its own dialogue with the Commodities and Futures Trading Commission, the US derivatives regulator (Commodities and Futures Trading Commission 2005).

As the role of regulators and experts grew at the expense of politicians and national parliaments, so did the importance of ‘sound’ regulatory ideas in financial market policy. Compare this to the situation in the early 1990s when regulation across Europe varied immensely (see the country cases in Underhill 1997b) as it sought to fine-tune the functioning of markets to national compromises and varieties of capitalism (Story and Walter 1997). Back then, rule-setting in many countries was often left to financial firms (Lütz 2002: 59ff); unsurprisingly, they aimed to promote their own interests rather than implement sound regulatory paradigms. Early attempts to agree on pan-European rules were thus little more than hard-nosed bargaining by national governments to defend their banks’ interests (Underhill 1997a). The result was a pragmatic mode of regulation – both domestically and internationally – that was a far cry from the ambition of regulators less than a decade later to develop best practices and search for rule-sets ideally suited to support market functioning. We can see, however, that the continued importance of industry interests in policymaking has done little to dampen the shift in regulators’ approach to their task.

The criticisms rating agencies have sustained in the wake of the current crisis mirror earlier debates triggered by the failures of Enron in the US and Parmalat in Europe – both cases in which CRAs were accused of failing to spot problems in time. Following these scandals, European politicians demanded regulatory oversight for rating agencies and asked CESR to study the matter and report by April 2005 (Batchelor 2004). Yet before EU institutions ever heard back, CESR’s members in December 2004 agreed in the International Organization of Securities Commissions (IOSCO), the global securities regulators’ club, that there would be little scrutiny for rating agencies (International Organization of Securities Commissions 2004). Instead, CRAs only had to sign up to a voluntary ‘code of conduct’ without regulatory teeth or hard rules. In its later advice to the Commission, CESR simply reiterated the position it had taken in IOSCO (Buck 2005). While this decision disappointed national governments, leading banks saw themselves confirmed in their vociferous opposition to CRA regulation (cf. *The Banker* 2004). The relative isolation from other political forces in which CESR made its decision helped reproduce a business model of the agencies that, with hindsight, proved fatal.

The decision of CESR members dovetailed with academic, market-based arguments in favour of regulatory liberalism and against CRA regulation. These held that rating agencies feared for their reputations and would do their utmost to provide high-quality ratings (e.g. Schwarcz 2002). Critics commonly pointed to principal-agent problems and the protected status of rating agencies (their de facto exclusive licensing by the SEC) as potential sources of suboptimal performance (Partnoy 1999, Hill 2004); they further lambasted the industry model in which the firms that issued the securities – and not the users of the ratings, the investors – paid the rating fees. Yet such arguments failed to penetrate the epistemic community that had come to dominate CRA governance in Europe.

The most fundamental problem, however, was the reflexivity – and hence indeterminacy – built into ratings of creditworthiness. Although corporate ratings took account of macro-economic factors such as the business cycle, they retained a strong bias in favour of micro-economic thinking, thereby ignoring more systemic understandings of the financial system. In the case of credit derivatives, on which criticisms of CRAs now focus, the creditworthiness of debtors relied on the steady increase of credit available in the system as a whole, which by fuelling consumption and price hikes staved off individual bankruptcies. The extension of credit by each particular creditor depended in turn on each individual borrower’s creditworthiness. The result, as has often been noted,

was an overexpansion of credit that fed off itself until it reached a tipping point in the summer of 2007 (Soros 2008).

Such systemic considerations played a minor role in the rating process, which relied largely on historical data – of which there was little as complex credit derivatives were a recent invention. Yet the idea that enough information and transparency coupled with sophisticated computer models could help perfect market functioning continued to rein supreme in regulatory circles. A report the European Commission requested from the European Securities Markets Expert group in 2008 admitted that the scientific pretences of ratings, particularly in structured finance, were with hindsight unrealistic:

Models should play a part in the rating decision, but not the only part and a balance should be struck between the model and qualitative assumptions in the decision process. (European Securities Markets Experts Group 2008: 12)

In the face of persistent criticism, the belief among policymakers in the viability of the standard CRA model was remarkably long-lived. Again, such dogmatic policymaking was buttressed by policymakers' relative isolation and the premium they placed on intellectually coherent approaches to policy. That the lessons that could have been learnt from the Enron and Parmalat debacles were never translated into actual policy was a direct consequence of the way in which EU financial governance had been reformed.

Banking regulation and derivatives

In contrast to accounting and credit ratings, the governance institutions in banking regulation have remained relatively stable over the past two decades. Throughout this period, rules for capital adequacy were devised in the Basle Committee for Banking Supervision (BC). All EU member states with major financial markets are represented in the BC; only four of the 13 countries represented in the BC are not EU members. Agreements struck in the BC have therefore constituted de facto EU rules: the 1988 Basle Accord was translated into the 1989 Second Banking Coordinating Directive (Wood 2005: 95) while the revised Basle II Accord of 2004 informed the Capital Requirements Directive (CRD), adopted in 2006 and implemented over the following years.

Since the 1980s, the BC has evolved from an international negotiation and coordination arena (Nabors and Oatley 1998) into a tightly integrated body – the epicentre of banking regulation – within which the logic of bargaining has given

considerable ground to reasoning and deliberation (Tarullo 2008: 99f). As Blom (2009: 3) argues, the epistemic community that was nascent in the early 1990s has since attained much greater coherence (cf. Marcussen 2005), allowing it to agree on a much more detailed accord than the rough ‘command-and-control’ standard that was Basle I. Conversely, banking regulation witnessed a disembedding from national contexts similar to what the previous section described for capital markets. Banking rules were previously attuned to, for example, the peculiarities of German cross-shareholdings or French top-down credit management (Story and Walter 1997: 162ff). They have now been largely harmonized through Basle II, the CRD, and the implementation of the EU Financial Services Action Plan, while supranational bodies and international forums have become the primary arenas for crafting new rules.

The shift from pragmatism to dogmatism has been clearly visible in banking regulation, and particularly in the Basle II Accord. Basle II did not significantly contribute to the crisis (High-Level Group on Financial Supervision in the EU 2009: 15ff); at the time of writing, its implementation is still under way. Nevertheless, given that capital charges for banks are a key pillar of financial regulation, the stringent application of regulatory liberalism in the Basle II Accord is key evidence of the broad-based shift in policymaking that this article seeks to demonstrate.

Of more direct consequence for the crisis was the BC’s inaction and complacency in the face of ballooning credit derivative markets in the early 2000s. Rather than heeding warnings from practitioners and academics (discussed below), the committee stuck to its liberal emphasis on the benefits of market transparency. In 1999, the BC together with IOSCO issued non-binding recommendations to financial institutions regarding derivatives disclosure, believing that enhanced market discipline would further the prudent and beneficial use of derivatives (Basle Committee on Banking Supervision & Technical Committee of the International Organization of Securities Commissions 1999). A report on banks’ disclosure practices in 2003 found, however, that disclosure of credit derivatives and credit risk modelling was the lowest of the twelve categories surveyed (in both categories, only a third of surveyed institutions disclosed information, Basle Committee on Banking Supervision 2003). Apparently, banks had reasons for secrecy.

That same year, the Financial Stability Forum asked the BC together with IOSCO and the International Association of Insurance Supervisors, collectively known as the Joint Forum, to establish how well credit risk transfer through securitization and credit derivatives was functioning, and particularly whether credit derivatives were achieving a

‘clean transfer of risk’, whether market participants understood the risks involved, and whether ‘undue concentrations of risk’ were developing. Under BC leadership, the Joint Forum reported in 2005 that there was little to worry about (The Joint Forum 2005). It found that credit derivatives had ‘a relatively good record’ in achieving ‘a clean transfer of risk’ (Ibid.: 2) and that ‘[m]arket participants seem to be largely aware of the risks associated with credit derivatives activity [...]’ (Ibid.: 3). It also had ‘not found evidence of “hidden concentrations” of credit risk’ (Ibid.: 4).

How were these conclusions reached? The Joint Forum had surveyed financial institutions, asking banks how well the market was functioning. The approach revealed two key aspects of the forum’s thinking: first, in its view public and private interests were aligned, meaning that if banks were unconcerned (or at least professed to be so), public officials had no reason for alarm. Second, banks’ judgment of market developments, for example of risk concentration, could be trusted due to their own incentives and capacity to manage exposures.

Both assumptions – indebted to regulatory liberalism and invalidated by the recent crisis – stood central in the overhaul of the Basle capital accord. Even if national representatives have continued to pay heed to their national financial industries’ insistence on a ‘level playing field’ (Tarullo 2008: 113ff), the committee’s work has become a rigorous intellectual project. The core mission was to rectify incoherencies in Basle I in which capital charges did not correspond to risks posed by individual borrowers and, so the argument went, decreased market efficiency.

Basle II’s approach to this problem is ingenious: it uses banks’ own risk assessments as the basis for calculating regulatory capital (Basle Committee on Banking Supervision 2004). Large international banks use models that far surpass those of supervisory authorities in sophistication; banks also possess information that in principle should allow them to reach much more fine-grained risk assessments than outsiders. Most importantly, the whole approach capitalizes on banks’ incentives to understand the risks to which they are exposed (cf. Power 2005). In this way, Basle II aligns the perspectives of banks and regulators; all that was left to do was for supervisors to assess the banks’ models.

The elegance of the solution is striking. Henceforth, supervisors would no longer work ‘against’ the banks by reining them in, but would work with them by taking a perspective on risk that, through the use of bank models, overlapped with theirs. That only a small subset of banks would be able to fully use this so-called internal ratings-

based approach did little to lessen its appeal; given the immense concentration in global wholesale finance (Group of Ten 2001), it would still cover a large chunk of global banking.

The increasing detachment of the policy community in charge of banking regulation from the wider political and academic world – coupled with its faith in intellectually attractive theory – contributed to complacency regarding banks’ ballooning use of derivatives. The confidence with which policymakers generally condoned their widespread use belied the underlying intellectual challenges that derivatives still pose. In policymaking circles, credit derivatives – the villains of many crisis accounts – were commonly seen as enhancing market efficiency and hence a boon for global finance (European Central Bank 2004). Regulatory and supervisory challenges were painted as identifiable and manageable (cf. Tsingou 2003) while commonsensical criticisms of derivatives failed to feed into policy. Warren Buffet’s (2003: 13ff) stern warning about derivatives as ‘time bombs’ and their scope for abuse seems prophetic with hindsight.

In the ivory tower that banking regulation had become, such arguments carried little weight. Only in a 2008 update to the above-mentioned Joint Forum report did the forum’s members identify serious concerns surrounding credit derivatives: their complexity, the role of rating agencies, the reliability of valuation and risk modelling, market liquidity, and operational, legal, and reputation risk (The Joint Forum 2008: 24ff). While critics of credit derivatives – both practitioners such as Buffett and academics (e.g. Partnoy and Skeel 2006) – had long warned about these problems, their arguments failed to impress the Basle-centred epistemic community until the crisis erupted. The trust in the perfectibility of markets, if only transparency and incentives were set right, was impregnable.

Instead, policymakers stuck to ‘hyper-rational management’ (Power 2005: 595). That this belief system – and not only one or another maladapted rule – was to blame came to the fore in the study commissioned by the European Parliament in 2007 when the troubles in global finance were just beginning:

A persistent theme of this Report is the intellectual failure of the philosophy of financial regulation that has dominated official thinking over the past two decades, and is embodied in Basle 2 and the [Capital Requirements Directive]. (Alexander, *et al.* 2007: 57)

Banking regulation had been disembedded from national policymaking; it had moved from the realm of pragmatic policymaking – one that focused on ‘what works’ – towards one based on dogma.

Conclusion

With the industrialized world deeply in the throes of recession – and much of the developing world on the brink of it – a consensus has emerged among observers of all economic persuasions that faulty financial regulation has played a key role in the current crisis. Correct as this assessment undoubtedly is, it still begs the question who, or what, has been responsible for a regulatory regime capable of wreaking havoc not only on global finance, but indeed on the global economy.

Much commentary points to special interests. As long as the party lasted, banks – and bankers themselves – could earn fortunes with the originate-and-distribute business model that swamped the financial system in complex credit derivatives and generated wholly unrealistic real estate prices on both sides of the Atlantic. While an interest-based account of financial governance can explain important regulatory flaws, it also leaves important gaps. In spite of banks’ clear influence on policy, regulators have been more than just handmaidens of the industry; if anything, financial regulation had become more professional – even if not better – over the past two decades.

But this professionalization, this article has argued, has turned out to be a bane rather than a boon. Financial market governance in Europe was overhauled over the past 15 years with an emphasis on supranational, technocratic policymaking. Regulation, it was thought, should be less politicized and based on sound theory. The messy regulatory patchwork that still characterized Europe in the early 1990s was thus replaced with an ambitious regulatory project that sought to put financial market governance on a firm footing.

These institutional changes had the opposite effect of what had (officially) been intended. They empowered epistemic communities rooted in regulatory liberalism to exert much greater influence over financial rules than had previously been the case. This liberalism ignored the reflexivity of financial markets and instead put its faith in the perfectibility of these markets through increased transparency and appropriate incentive structures. As institutional reforms increasingly isolated the epistemic communities in charge of policy, their members were desensitized to criticisms of rigorous regulatory liberalism emanating from academia as well as the financial industry itself. In this way, the dogmatic mode of policymaking fostered by the institutional reforms aggravated the

crisis through the promotion of a fundamentally unsound vision of finance (Soros 2008, Minsky 2008 [1986]).

What does this argument imply for future reform? If past arrangements institutionalized the self-confidence of regulators who believed that quasi-scientific regulation was possible, future arrangements will have to do its opposite: institutionalize humility and regulatory conservatism. With the benefit of hindsight, policymakers, instead of pursuing grand regulatory designs, would have been well advised to err on the side of caution – whether on derivatives regulation, corporate credit-raters as part of regulatory mechanisms, or accounting standards that mistook market prices for ‘true’ values.

Institutional design, the core focus of this article, also needs to be adapted. Even if it slows policymaking, checks from outside the epistemic communities currently in charge of policy need to be strengthened. National parliaments – which in Europe had been sidelined by institutional reforms – need the power, time, and resources to screen policy critically. At some stage of the policy process, it will be paramount to solicit counter-expertise and to oblige policymakers to address the criticisms contained therein. Given what is at stake, counter-arguments to prevailing wisdom should be taken especially seriously to prevent myopia. Finally, at least for the time being, we should acknowledge that fully theory-driven financial market policy is impossible, both because reality is messy and because most theories ignore how their own application may alter the world they seek to describe (MacKenzie 2006). As long as the inner workings of financial markets remain as much of a mystery as they do today, we should mistrust reform proposals that claim possession of the magic regulatory bullet. That such solutions are not only elusive, but dangerous, is one lesson the crisis has taught us.

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