

Political Economy of Financial Regulation

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 - ▶ Regulators are appointed by politicians to serve public interest
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- Focus on negotiation of regulators in rule-making process of the Basel Committee on Banking Supervision (BCBS)
- Focus on two research questions:
 - ▶ How do national regulators form their positions?
 - ▶ Why do some rules go through and some get diluted/discarded?

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- Research in financial economics focuses on impact assessment of regulation; no research on rule-making process

Roadmap

- 1 Construct novel dataset on different positions taken by stakeholders in BCBS negotiation process
 - ▶ Define 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
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- ③ Analyze consequences of the behavior of national regulators for international standard setting
 - ▶ In how far does the behavior of regulators impact what kind of rules get implemented

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- NCs positions tend to impact what kind of rules become an international standard
 - ▶ 11 out of 30 Basel initiatives get significantly watered down
 - ▶ Initiatives with differential impact on NCs are more likely to be diluted

Outline

- 1 Introduction
- 2 Institutional background
- 3 Data and coding of variables
- 4 Empirical analysis
 - 1 Determinants of regulators' positions
 - 2 Time-series evidence on regulators' positions
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- No formal supranational authority

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 - ▶ 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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- Last thread in this process is national discretion and options

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- We bucket banks into national champions and smaller banks
- Larger banks reply individually and smaller banks reply as a part of a bankers association

Coding banks' positions

Code	Position	Examples
-2	banks have a problem with central parts of the regulatory standard and do not want the regulation to go through	<ol style="list-style-type: none">1. We will be in a position to express out strong concern2. We urge the Committee to withdraw a proposal which it believes has no basis in fact3. The consequences will be dramatic
-1	banks have problem with certain rules within the regulatory measure	<ol style="list-style-type: none">1. We do not agree with some aspects of the proposed framework2. The treatment of risk associated with asset securitizations is too conservative.3. We consider that the proposed TLAC Holdings definition is far too broad
0	bank did not choose to comment or was in favor of the regulation	

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- Additional sources for regulator's positions:
 - ▶ Speeches made by central bankers
 - ▶ Official parliamentary documents from Germany (protocols from meetings of the Finanzausschuss)
 - ▶ Fed officials' testimonies
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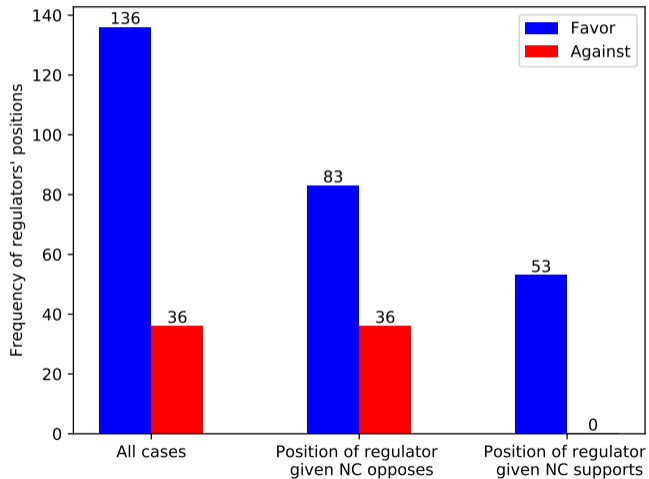
Basics of the data

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 (-1)	119
Strong opposition from NCs (-2)	42
Opposition from Regulators	36
Opposition from smaller banks (-1)	99
Strong opposition from smaller banks (-2)	12
Issues that had differential impact on NCs	8
Watered down issues	11

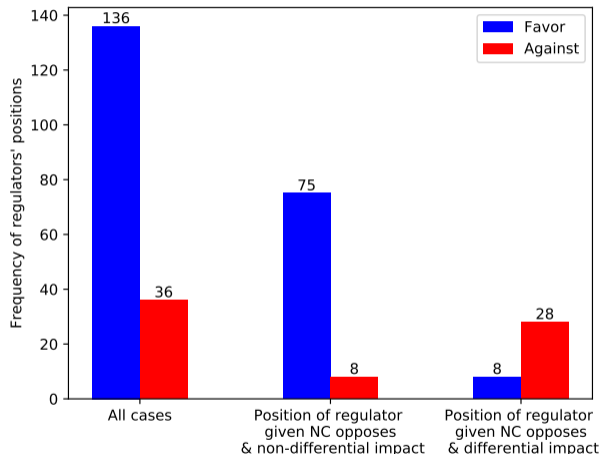
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Regulator moves with the NC?



Regulator moves with the NC when there is a differential impact



Differential impact is defined as when at least one NC is neutral (0) to the reform and at least one NC strongly opposes it (-2)

NC driving the regulators

Probability of support by regulator $_{ij} = \alpha_i + \alpha_j + \text{Position of NC}_{ij} + \epsilon_{ij}$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of the NC	0.284*** (0.075)	0.303*** (0.065)	0.355*** (0.098)	0.452*** (0.059)	0.071 (0.054)	0.078 (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

Probability of a regulator opposing the regulation increases by 30% if its NC opposes the regulation by -1.

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Position of the NC	0.308*** (0.064)	0.310*** (0.066)	0.355*** (0.099)	0.439*** (0.059)	0.025 (0.036)	0.038 (0.063)
Position of Small Banks	-0.133** (0.060)	-0.018 (0.058)	-0.031 (0.076)	0.050 (0.037)	0.081* (0.044)	0.066 (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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- Tone is measured as $(\text{positive words} - \text{negative words}) / \text{total words}$

Topic Covered in Speeches - Example



(a) Topic Related to Bank, regulation and supervision

Textual analysis - setup

- Shocks:
 - ▶ Consultative document of differential impact reform introduced by Basel and NC champion strongly opposes it
- Dummy is 1 for 8 quarters after the shock and 0 otherwise
- Different countries get impacted at different times: Dif-in-Dif setup

Speech examples - before and after

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- **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”*

NC driving the regulators

$$\text{FavourofRegulation}_{i(j)t} = \beta_1 \text{NC Support}_{jt} + \beta_i + \beta_t + \epsilon_{it}$$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of National Champions	0.055** (0.022)	0.064** (0.029)	0.029** (0.011)	0.028** (0.012)	0.015 (0.015)	0.015 (0.016)
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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Position of Small Banks	0.014 (0.025)	0.027 (0.030)	-0.014 (0.047)	-0.039 (0.057)	0.000 (0.025)	0.033 (0.034)
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 - ▶ By following its national champion
 - ▶ Even in case of differential impact regulations
- Self-interest/regulatory capture hypothesis - revolving doors or political pressures
- Barth et al. (2012) suggest a behavioral explanation responsible for regulators supporting banks from their home country

Cross Sectional Difference in Voting

$$\text{Probability of opposition by regulator}_{ij} = \alpha_i + \text{Position of NC}_{ij} + \epsilon_{ij}$$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of NCs × High NC Share	0.277*** (0.085)	0.327*** (0.067)	0.410*** (0.047)	0.515*** (0.068)	0.074 (0.064)	0.098 (0.068)
Position of NCs × Low NC Share	0.296*** (0.081)	0.348*** (0.074)	0.463*** (0.043)	0.429*** (0.068)	0.216* (0.113)	0.168 (0.121)
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Issue Fixed Effects	No	Yes	No	Yes	No	Yes
Adj.-R ²	0.280	0.759	0.826	0.902	0.131	0.640
Obs.	150	150	30	30	120	120

- Effects are identical even NC has a lower share

Cross Sectional Difference in Tone of Speech

$$\text{Probability of opposition by regulator}_{ij} = \alpha_i + \text{Position of NC}_{ij} + \epsilon_{ij}$$

	All		Differential Impact		No Differential Impact	
	(1)	(2)	(3)	(4)	(5)	(6)
Position of NCs × High NC Share	0.043** (0.021)	0.057** (0.027)	0.026** (0.012)	0.025* (0.013)	-0.002 (0.024)	0.003 (0.026)
Position of NCs × Low NC Share	0.061** (0.025)	0.076** (0.035)	0.055*** (0.021)	0.054** (0.022)	0.013 (0.016)	0.013 (0.017)
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	0.0402	0.0398	0.0406	0.0401	0.0371	0.0371
Obs.	1439	1439	1439	1439	1439	1439

- Effects are identical even NC has a lower share

Outline

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

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- 11 issues out of a total of 30 issues had some sort of dilution.

Watering down of regulation

	Watering Down	
	(1)	(2)
Ratio of opposing NC	1.076* (0.532)	0.538 (0.499)
Ratio of opposing NC * differential impact		2.531*** (0.488)
R-squared	0.0747	0.541
Obs.	30	30

- Mean of opposing national champions for all issues is 69.3%
- Average watering down of 0.75 ($0.693 * 1.076$, column 1)
- Issues which had a differential impact on NCs had extra dilution of 1.75 ($0.693 * 2.53$) compared to a issue which did not have a differential impact (column 2).

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- Subset of regulations that create an unequal impact on NCs of players with negotiation power get diluted
- It goes against the basic premise of supranational regulatory design - race to the bottom
- Important implications for countries with low or no negotiation power