

**Dealer Bank Influence and the International Political Economy of Over-the-Counter
Derivatives Regulation:
The Introduction of Mandatory Margin Requirements for Non-Centrally Cleared
Derivatives after the Global Financial Crisis of 2008**

by

Irene Spagna

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Examining Committee Membership

The following served on the Examining Committee for this thesis. The decision of the Examining Committee is by majority vote.

External Examiner	Eleni TSINGOU Associate Professor
Supervisor	Eric HELLEINER Professor
Internal Member	Bessma MOMANI Professor
Internal Member	Derek HALL Associate Professor
Internal-external Member	Olaf WEBER Professor

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Abstract

Prior to the global financial crisis of 2008, large dealer banks exercised strong influence over the regulation of OTC (over-the-counter) derivatives in the United States and the European Union. Has there been any change in their influence over policy outcomes in the regulation of OTC derivatives in these two jurisdictions since the global financial crisis of 2008? If so, why? If not, why not? This thesis addresses these questions by analyzing the post-crisis introduction of mandatory margin requirements for non-centrally cleared derivatives.

It argues that this regulatory innovation reveals a significant decrease in dealer bank influence. Shifting from a position of dominance before the crisis, the dealer banks' influence over this regulatory reform process was significantly reduced.

To explain this change, the thesis argues that the influence of dealer bank preferences over regulatory outcomes in this sector is moderated by a number of variables. Based on a survey of literature in international political economy (IPE), it identifies six moderators whose effect individually and jointly shapes the degree of bank influence over policy outcomes: business unity, public issue salience, policy-makers' ideational outlook, the state of the transnational policy community, inter-state power relations, and the domestic institutional environment. Prior to the crisis, all six moderators individually and jointly operated to the banks' advantage. The crisis, however, caused an exogenous shock to the system, resulting in a fundamental reconfiguration, and corresponding reduction in influence.

Theoretically, this dissertation speaks to the literature analyzing private financial sector influence over financial regulation. Specifically, it contributes to the literature that conceives of 'influence over policy outcomes' as a moderated condition by exploring the role of the six variables in moderating the influence of dealer bank preferences over regulatory outcomes in this sector. Empirically, it provides the first detailed analysis of some important elements of the margin reform, which, despite the enormous significance of derivatives to the global economy, has received little scholarly attention. The margin reform represents a sea change in terms of the governance of the uncleared market, but it has not been accompanied by broader change reaching beyond the efforts of addressing 'systemic risk'.

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List of abbreviations

ABA	American Bankers Association
ACLI	American Council of Life Insurers
AFG	French Asset Management Association (Association Française de la Gestion financière)
AFME	Association for Financial Markets in Europe
AfR	Americans for Financial Reform
AIMA	Alternative Investment Management Association
APA	Administrative Procedures Act
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
BBVA	Banco Bilbao Vizcaya Argentaria
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
Bn	Billion
BVI	German Investment Funds Association (Bundesverband Investment and Asset Management e.V.)
CAD	Canadian Dollar
CaISTRS	California State Teachers' Retirement System
CCP	Central counterparty
CDO	Collateralized debt obligation
CDS	Credit default swap
CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
CGFS	Committee on the Global Financial System
CHF	Swiss Franc
CIP	Covered Interest Parity
CME	Chicago Mercantile Exchange (& Chicago Board of Trade)
CMU	Capital Markets Union
CNY	Chinese Yuan
CPSS	Committee on Payments and Market Infrastructures
CPMI	Committee on Payments and Market Infrastructures
CRMPG	Counterparty Risk Management Policy Group
CSA	Credit Support Annex
CSE	Covered Swap Entity
DC	Determination Committee
DCO	Derivatives Clearing Organization
Dems	Democrats
Dodd-Frank	Dodd–Frank Wall Street Reform and Consumer Protection Act
DTCC	Depository Trust & Clearing Corporation
EBA	European Banking Authority
ECB	European Central Bank
ECON	Committee on Economic and Monetary Affairs of the European

	Parliament
EFAMA	European Fund and Asset Management Association
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
EMP	Member of the European Parliament
ERISA	Employee Retirement Income Security Act
ESAs	European Supervisory Authorities (European Securities and Markets Authority, European Banking Authority, European Insurance and Occupational Pensions Authority)
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EUR	Euro
FCA	Financial Conduct Authority
FCM	Futures Commission Merchant
Fed	Board of Governors of the Federal Reserve
FINRA	Financial Industry Regulatory Authority
FMU	Financial Market Utility
FSA	Financial Services Authority
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSOC	Financial Stability Oversight Council
FX	Foreign Exchange
GOP	Grand Old Party
GPE	Global Political Economy
GSE	Government-sponsored enterprise
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standard
ICE	Intercontinental Exchange
ICI	Investment Company Institute
IMCA	International Capital Market Association
IFRS	International Financial Reporting Standards
IM	Initial margin
IMA	Investment Management Association
IMF	International Monetary Fund
IIF	Institute of International Finance
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
JPY	Japanese Yen
LCH	London Clearing House
LEI	Legal Entity Identifier
Libor	London InterBank Offered Rate
LIFFE	London Financial Futures Exchange
LSOC	Legally Segregated Operationally Commingled (client assets)

LTCM	Long-Term Capital Management
MEP	Member of the European Parliament
MFA	Managed Funds Association
MPR	Macro-prudential regulation
MSP	Major Swap Participant
NDF	Non-deliverable forward
NFC+	Non-financial corporation(s) beyond the EU clearing threshold
NFC-	Non-financial corporation(s) below the EU clearing threshold
NFC	Non-financial corporation (irrespective of its position vis-à-vis the threshold)
OTC	Over-the-counter
PR	Prudential Regulator
PVP	Payment-versus-payment
Q	(Annual) Quarter
RBS	Royal Bank of Scotland
RTS	Regulatory Technical Standards
SCA	Securities clearing agency
SD	Swap Dealer
SEC	Securities and Exchange Commission
SEK	Swedish Krona
SGD	Singapore Dollar
SIFMA	Securities Industry and Financial Markets Association
SIFMA AMG	SIFMA's Asset Management Group
SIMM	Standardized Initial Margin Model
SMEs	Small and Medium Enterprises
SOMO	Centre for Research on Multinational Corporations
STS securitisations	Simple, transparent and standardised securitisations
TBTF	Too-Big-To-Fail
TRIA	Terrorism Risk Insurance Act
Tn	Trillion
TGC	Transgovernmental community
TPC	Transnational policy community
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
US	United States
USD	US Dollar
US GAAP	US Generally Accepted Accounting Principles
UTI	Unique Trade Identifier
VaR	Value-at-Risk
VM	Variation margin
WGMR	Working Group on Margin Requirements

CHAPTER I - Introduction

1. The argument and overview of the study

During the years leading up to the global financial crisis of 2008, the preferences of large dealer banks exercised strong influence over the regulation of over-the-counter (OTC) derivatives in the United States (US) and the European Union (EU). Has there been any change in their influence over policy outcomes in the regulation of OTC derivatives in these two jurisdictions since the global financial crisis of 2008? If so, why? If not, why not? This thesis addresses these questions, focusing on the post-crisis introduction of mandatory margin requirements for non-centrally cleared derivatives. I argue that this regulatory change reveals a significant decrease in dealer bank influence. Shifting from a position of dominance before the crisis, the dealer banks' influence over this regulatory reform process has been more limited. In many specific episodes surrounding the introduction of mandatory margin requirements for non-centrally cleared derivatives, their preferences did not align with the regulatory outcome; that is, they experienced a direct 'loss'. In other cases, there was closer alignment, but their influence over those outcomes was either non-existent – that is, they benefited from 'congruence', but had no influence – or only limited and indirect.

To explain this change, I argue that the influence of dealer bank preferences over regulatory outcomes in this sector is moderated by a number of variables. Drawing on literature in international political economy (IPE), I identify six moderators whose effect individually and jointly shapes the degree of bank influence over policy outcomes. The six conditions are business unity, public issue salience, policy-makers' ideational outlook, the state of the transnational policy community, inter-state power relations, and the domestic institutional environment. I argue we should study not only the *individual* effect of each moderator on the level of dealer bank influence, as most of the currently existing research does, but also their joint, interactive, and dynamic effects. By 'dynamic' effects, I mean that the particular effect of a moderator on its own can sometimes have little impact on the level of dealer bank influence, but that in other cases, it can set in motion a domino effect, changing the effect of other moderators, with the joint effect leading to a particular level of influence. Such an integrative approach appears particularly promising for cases in which the needle of the influence barometer fluctuates along the spectrum over the course of the policy process, before settling on its final level once the final policy outcome has been produced.

The results of this study reveal that prior to the crisis, all of the six moderators individually and jointly operated to the banks' advantage. The crisis, however, caused an exogenous shock to the system, resulting in a fundamental reconfiguration. Every moderator at times

had a detrimental effect on the banks' respective level of influence. Depending on the specific constellation of the moderators, this resulted in (limited) indirect influence, congruence, or loss. There was not a single case in which the banks returned to the pinnacle of pre-crisis influence. The empirical evidence suggests that there is no 'super moderator' allowing us to predict *ex ante* which level of dealer bank influence will prevail, suggesting that dealer bank influence cannot be reduced to one particular condition.

At the same time, the cross-case analysis reveals that three moderators behaved in a very interesting way in that their effect was positive in those cases in which the banks exercised influence, whereas their effect was negative when the dealers experienced a loss. The moderators in question are policy-makers' ideational outlook, the state of the transnational policy community, and the domestic institutional environment. Often considered only as a 'second' thought by the literature which tends to privilege instrumental and structural power variables, these conditions appear to be of particular relevance to dealer bank influence and their relevance should be further explored.

This thesis makes several contributions to the existing academic literature. First, it makes a theoretical contribution to the literature analyzing private financial sector influence over financial regulation. While the dissertation cannot provide a definite answer the classical question of 'what causes bank influence?' I propose to study dealer bank influence in a particular way that might improve our understanding of the concept. Specifically, I contribute to the literature that conceives of 'influence over policy outcomes' as a moderated condition by exploring the role of the six variables in moderating the influence of dealer bank preferences over regulatory outcomes in this sector. Overall, the analysis suggests that the relationship between dealer bank influence and policy-making is much more complex than simplistic notions of 'regulatory capture' tend to assume. Given that the post-crisis period was punctuated by important, unequivocal losses for the banks, I conclude that scholars interested in understanding post-crisis financial regulation should widen their analytical lens beyond interest group-based analyses to also consider other approaches, including those related to the variables identified as moderators in this thesis.

Second, the dissertation makes several empirical contributions. Most importantly, it provides the first detailed analysis of some important elements of the margin reform, which, despite the enormous significance of derivatives to the global economy, has received little scholarly attention. In addition, it responds to calls from the literature to examine how the pre-crisis role of the banks as central figures in the policy-making process has evolved after the crisis, and the impact this has had on the public-private relationship in the global political economy of finance. I argue that because of the reconfiguration of the moderator constellation that used to provide ample opportunity for dealer bank influence, the banks have lost their central position in the policy-making process and have failed to restore their pre-crisis levels of dominance, resulting in a move of the weight in the public-private partnership towards the public side.

Finally, this thesis also speaks to the wider literature on the extent to which the 2008 crisis has led to 'change'. While President Obama set the bar very high in 2009 by announcing the beginning of 'a new era of economic engagement',¹ most observers are sceptical of the extent to which more far-reaching change has been achieved. Contributing to this debate, I argue that the margin reform has resulted in a sea change in the ways in which the uncleared market is governed, but that policy-makers did not use the momentum this change provided them in order to engage in a debate about how the governance of the OTC derivatives market could be aligned with the broader 'global public interest' defined not exclusively from a 'systemic risk' perspective. However, I show that recent announcements by the Republican-led CFTC, in conjunction with the current discussions on Brexit might lead to a reversal of the change that has been achieved.

The dissertation is organized as follows: Section 2 of this chapter provides some background information on 'derivatives', 'margin', and 'central clearing'. It also discusses the centrality of the dealer banks in the uncleared market, and covers the ways in which the under-collateralization of the uncleared market prior to 2008 contributed to the global financial crisis. Section 3 situates the thesis within existing IPE literature, both theoretical and empirical.

Chapter II develops the analytical framework of the thesis. I first explain the theoretical framework. (II-2). I begin by discussing the difficulties of identifying interest group influence (II-2.1). Next, I address the ways in which dealer banks can articulate their preferences. This thesis focuses on two methods of articulation: the provision of information and the projection of structural and structuring power (II-2.2). In the following section, I introduce the six conditions I have identified in the IPE literature as moderators of interest group influence. I discuss the individual effect of each condition as explained and tested by the literature (II-2.3). Section II-3 presents the individual cases of the thesis which correspond to different aspects of pre and post-crisis regulatory outcomes. While I focus on the pre-crisis deregulation of the OTC market as one case, the other cases cover selected aspects of the post-crisis margin rules. Section II-4 covers the methodological approach of the study. Section II-5 addresses the limitations of the thesis, an important one of which pertains to the comparatively weaker data basis for the EU cases.

Chapter III explores dealer bank influence over pre-crisis deregulation. In chapter IV, I discuss several aspects that transcend the discussion of the individual post-crisis margin rules. These include the initial persistence of the deregulation consensus in 2008 (IV-2), the exponential rise of public issue salience (IV-3), the emergence of the ideational clearing/margining consensus (IV-4), and the marginalization of the banks during the policy-making process (IV-5). I subsequently discuss the individual margin cases. Chapter V covers the mandatory use of initial margin (IM) over which the banks failed to exercise influence, having to accept their first major loss. Chapter VI covers some specific design elements of

¹ Obama (2009:2)

the IM mandate including the 2-way exchange requirement, the segregation requirement, and the rehypothecation ban, each of which equally resulted in a loss for the banks.

Chapter VII focuses on the treatment of non-financial end-users, which was the only case in which the banks successfully exercised influence, even though it was only indirect, and more limited in the EU than the US. Chapter VIII addresses the IM and variation margin (VM) rules for foreign exchange (FX) swaps and FX forwards. While the banks probably benefited from congruence regarding the lack of an IM collateralization requirement, they also lost the VM case. Each case study chapter begins, where necessary, with some background information to introduce the specific rule element(s). I then cover the preferences of dealer banks as well as those of other interest groups, followed by policy-makers' responses, and the ways in which the moderators affected the particular level of influence. In each case, I first provide a brief overview of the policy-making process, before describing it through the lens of the analytical model. The reader will notice the significant length of the end-user case which provides for the longest most encompassing case study chapter. The reason is that, compared to the other rule elements, this part of the framework kept policy-makers on their toes for many years, with the policy-process taking many turns, particularly in the US.

Chapter IX concludes. Section IX-1 pulls the individual results together in light of the overall argument and discusses the theoretical implications of the findings. Section IX-2 covers the empirical contributions, with section IX-3 focusing more specifically on the extent to which the margin reform has led to broader change in the post-crisis derivatives markets.

2. Background: Derivatives, margin, the dealer banks, and central clearing

2.1 Derivatives and the centrality of dealer banks

Derivatives represent a form of financial contract whose value is derived from the price of an underlying asset, such as a security, an index, a currency, an interest rate, or, in principle, any other market variable, including the weather.² Entered into for the purpose of speculation (meaning the investor intends to earn a profit from the difference between the price of the derivative and the underlying asset, which often involves a directional bet) or with the aim of hedging (through which the investor intends to protect herself against adverse changes of the underlying asset through the offsetting effect of the derivative),³

² Waldman (1994:1026f.)

³ Chui (2012:4)

they ‘transfer the consequence of a price change’ for the investor.⁴ In practice, the line between hedging and speculation often blurs.

Derivatives embody a kind of debt in that they ‘involve a promise to make some payment or to deliver some financial asset in the future’.⁵ The obligations differ in function of the type of derivative in question. The most common forms include forwards, futures, options, and swaps. Through a forward, an investor enters the obligation to buy or sell a particular asset for a pre-specified price determined when the contract is signed. A futures contract is based on the same idea, the only difference being that the contract is standardized and traded on an exchange. An option is more flexible in that it conveys the option to buy or sell the underlying asset, without any formal obligation to actually do so. Options can also be traded on an exchange. Swaps involve a two-way exchange of cash flows, based on the assets the two counterparties own, at specific dates defined in the contract.⁶

Derivatives can be traded on an exchange, or over-the-counter (OTC). Leo Melamed, chairman of the Chicago Mercantile Exchange (CME) in 2009 explained that ‘OTC derivatives and exchange traded financial futures are galaxies different’.⁷ OTC and exchange-traded derivatives do indeed differ across several dimensions. For example, the terms of contract (such as size) of exchange-traded contracts are standardized, whereas they are bespoke for OTC trades, although up until the crisis, many counterparties also traded a portion of their standardized deals OTC, given the ease of conducting business in a deregulated environment. Exchange-traded contracts also have a relatively short maturity (i.e. the time until the instrument ceases to exist is short). It rarely exceeds several months, whereas the maturity of OTC contracts can be many years, if not decades. Short maturities also explain why the liquidity of exchange-traded contracts is high, while it can be limited for OTC contracts, given their high level of bespoke nature and long maturity. As well, the volume of exchange-traded derivatives is usually comparatively small in relation to the overall market size, meaning an individual trade would rarely make the market ‘move’. By contrast, OTC trades can be of relatively large size, with a bid or an offer potentially having a significant effect on the direction in which the market moves. Finally, the credit risk (i.e. the risk that the counterparty fails to make a contractually stipulated payment) pertaining to exchange-traded contracts is assumed by a central counterparty (CCP) that interposes itself between buyer and seller, whereas it rests at the bilateral level for OTC contract.⁸

While derivatives have been known since 2000 BC,⁹ most of their modern-day use dates back to the end of the Bretton Woods regime. Susan Strange has described the rise of the uncleared market as the result of a ‘coincidence of escalating growth and escalating risk’, with firms and investors relying on OTC derivatives to respond to the increasing risks

⁴ Turbeville (2013)

⁵ Murphy (2013:9), see also Awrey (2018:11)

⁶ Valiante (2010:2), Coleman (2004:274ff.), Culp and Mackay (1994:39)

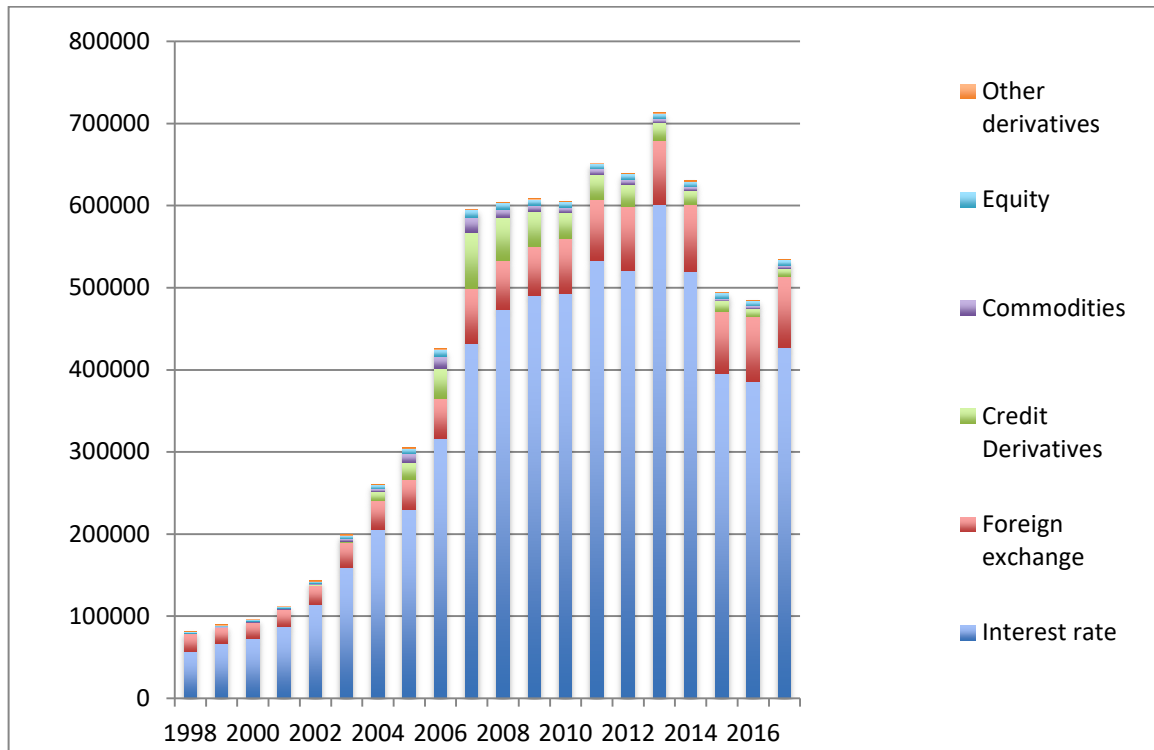
⁷ Melamed (2009:257)

⁸ These points are drawn from Gregory (2014:16) and Persaud (2013:236)

⁹ Hou (1997:175)

associated with accelerating trade and production from the 1970s onwards.¹⁰ With economic globalization taking off in the early 1990s, derivatives soon followed. By the mid-1990s, the OTC market had outgrown the exchange-traded market, given the greater flexibility OTC deals offered vis-à-vis exchange-traded ones. Post-crisis, the exchange-traded market remains at a fraction of the OTC market.¹¹ Figure 1 illustrates the market value of the OTC market broken down across various types of contracts and two different metrics.

Figure 1: The market value of OTC derivatives



Source: Author, based on BIS derivatives statistics ('OTC derivatives outstanding', USD bn). Notional volumes represent the total asset value of the respective underlying positions.

As figure 1 illustrates, the largest segment of the OTC market is captured by interest rate derivatives, followed by FX and credit derivatives. The market grew spectacularly up until the global financial crisis of 2008, when the notional volume of outstanding trades was USD 684tn. After the crisis, growth continued, but at a slower pace. In recent years, market volume has decreased. There are several explanations. Some of them relate to investors' specific perception of market risk, for example with respect to interest rates, the strength of key currencies etc. Others are informed by the post-crisis regulatory agenda. For example, with the advent of mandatory central clearing, the requirements for which began to be phased-in in 2013 (US) and 2014 (EU), market actors had an interest in pursuing portfolio compression. This means 'tearing up' trades that cancel each other out in order to avoid any

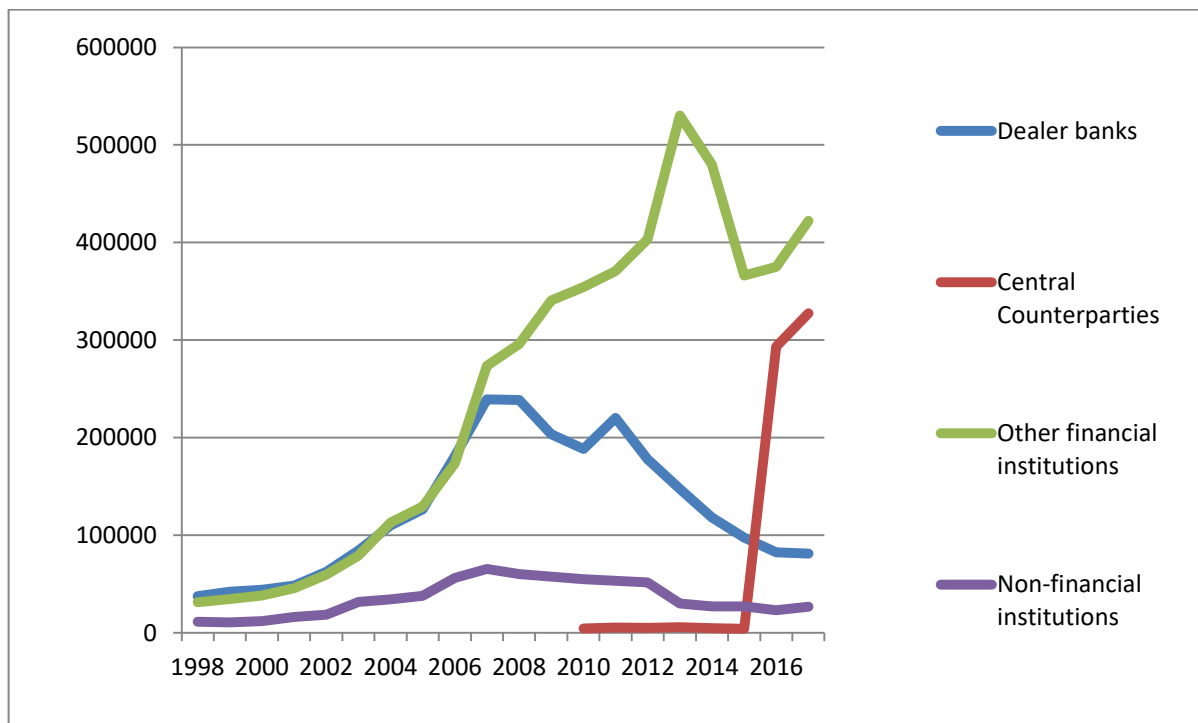
¹⁰ Strange (1998:30f.)

¹¹ See the BIS' 'exchange-traded derivatives statistics', available at <https://www.bis.org/statistics/extderiv.htm>, as of 18 August 2018.

double-counting under the new rules. Compression was particularly pronounced with respect to interest rate derivatives.¹² Reduced volumes, therefore, do not necessarily reflect reduced risk to the economy.

Figure 2 provides an overview of the OTC market in function of counterparty type.

Figure 2: The OTC derivatives market by counterparty type



Source: Author, based on BIS derivatives statistics ('OTC derivatives outstanding'); notional volumes in USD bn.

Up until the 2008 crisis, the dealer banks used to be among the most active group of market participants.¹³ As market makers, the dealers quote bids and offers for their clients. In addition, they often trade in the market for their own account. The dealer market tends to be very concentrated, with a handful of firms (see figure 3 below) capturing the bulk of its share. In terms of terminology, I use the expressions '(large) dealer bank' and '(large) bank' synonymously with 'the industry'.

On the other side of the trade can be found the 'buy-side'. Key actors of the buy-side are 'other financial institutions' including hedge funds, investment funds, insurance firms, smaller non-dealer banks, and institutional investors. In addition, there are 'non-financial institutions'. They capture a rather small share, even though over 90% of globally active non-financial firms are part of this segment.¹⁴ The entities referred to as 'other financial

¹² Schrimpf (2015:24f.)

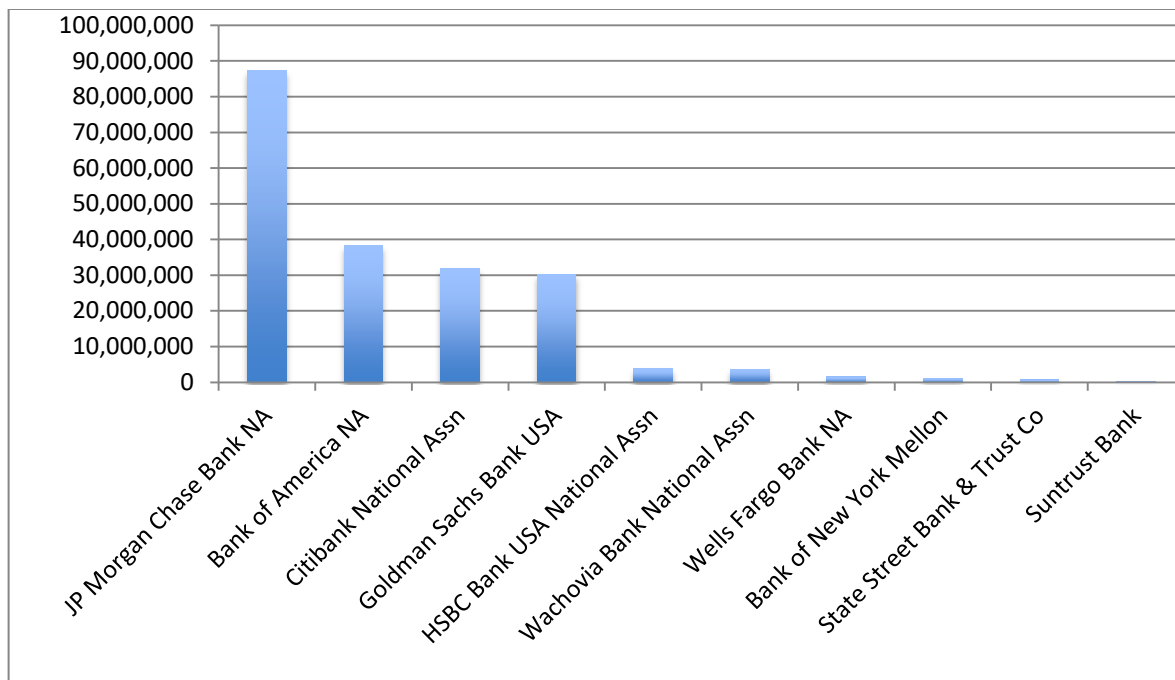
¹³ The information in this section is taken from Spagna (2018:30ff.).

¹⁴ Litan (2010:13) referencing ISDA data

institutions’ are also known as financial end-users. In this thesis, the term ‘end-user’ is reserved for ‘non-financial institutions’, unless otherwise specified. When speaking about the ‘buy-side’, I refer to ‘other financial institutions’.

In the US, the top 25 dealer banks covered 99% of the annual market volume over the period 1998-2008.¹⁵ Within the group of the top 25, the market was even further concentrated. The top 14 dealers accounted for 95%,¹⁶ and within the top 14, the field was again heavily tilted towards the top 4. Figure 3 illustrates this by breaking down the notional amount of derivative contracts held by the top 10 US dealers for the year 2008. While the precise numbers varied from year to year in the lead-up to the crisis, the pattern of concentration towards the top was a consistent feature of the market.

Figure 3: The leading US dealer banks in 2008



Source: Author based on OCC (2009a:22 of the pdf, table 1, USD mn). Notional amount of derivative contracts, top commercial banks and trust companies in derivatives, as defined by the OCC, December 2008.

In Europe, the key dealer banks up until the crisis included Deutsche Bank, Barclays, UBS, HSBC, BNP Paribas, Royal Bank of Scotland, and Credit Suisse.¹⁷

The uncleared business represents a central pillar of the dealer banks’ revenue. Estimates suggest that in the late 1990s, OTC derivatives accounted for up to 40% of the banks’ profits.¹⁸ In 2009, the top 5 dealers in the US earned USD 52.83bn in revenue from trading

¹⁵ See OCC (1999-2009 table 1 of each report)

¹⁶ See Geithner (2014:103)

¹⁷ Singh (2010:114), Valiante (2010:6)

¹⁸ Estimate by Brooksley Born quoted in McLean/Nocera (2010:225).

derivatives and cash securities (Goldman Sachs: USD 19.8bn; Bank of America: USD 10.64bn; JPMorgan: USD 9.34bn; Citigroup: USD 6.84bn; and Morgan Stanley: USD 6.21bn).¹⁹ Pointing in a similar direction, *The New York Times* in 2010 reported that the OTC derivatives business tended to be by far the banks' most lucrative source of income.²⁰ Financial analyst Christopher Whalen even stated that without this income, 'the largest banks cannot survive'.²¹ The banks' reliance on the income earned in this market segment explains their interest in pushing for deregulation and keeping intrusive public intervention at bay, both before and after the crisis.

The dealers are organized through ISDA, the International Swaps and Derivatives Association which serves as the industry's peak business association. Its origins date back to the 1980s, when a group of large banks decided it was necessary to streamline the process of negotiating contracts.²² In 1985, they founded the International Swap Dealers Association (ISDA's predecessor), the aim being to facilitate this work and to 'organize before any problems arise'.²³ Over time, ISDA became what Partnoy calls the 'most powerful and effective lobbying force in the recent history of financial markets'.²⁴ While it comprises over 800 members from nearly 60 countries,²⁵ the dealer banks have traditionally exercised a commanding influence over its decision-making process.²⁶ In the years leading up to the crisis, only one of ISDA's 19 board members was a non-dealer bank official (representing oil giant BP).²⁷

In recent years, the dealer banks have lost market share, not only because of their deleveraging efforts following the crisis, but also because of the rise of central clearing. The rise of central clearing, however, has not been even across all types of derivatives. As table 1 reveals, it has been most pronounced with respect to interest rate and credit derivatives which, compared to other contract types, are more amenable to standardization.

¹⁹ Katz/Schmidt (2010). The numbers cover the first 9 months of 2009.

²⁰ Story (2010)

²¹ Whalen quoted in Tett/van Duyn (2009)

²² Coleman (2004:288)

²³ Jonathan Berg of Bankers Trust, one of ISDA's founding members, quoted in Partnoy (2009:45).

²⁴ Partnoy (2009:45)

²⁵ Collard (2015:883)

²⁶ Gelpern (2009:65f.)

²⁷ Wood (2018)

Table 1: Ratio of OTC derivatives submitted to CCPs

	2010	2011	2012	2013	2014	2015	2016	2017
Foreign exchange							2.23	2.41
Interest rate							74.50	75.05
Equity							0.92	0.19
Credit Derivatives	14.1	18.2	18.6	25.6	28.4	33.1	43.33	54.39
Other derivatives							11.12	29.56

Source: Author, based on BIS derivatives statistics ('OTC derivatives outstanding'); percentages of notional volumes.

2.2 The key mechanics of central clearing

Central clearing means that the counterparties do not face each other directly, as in the uncleared market, but that a CCP interposes itself between them. The CCP 'novates' each trade through counterparty substitution. It thereby becomes the seller to every buyer and the buyer to every seller, and thus the 'central' counterparty to all trades.²⁸ This structure allows the CCP to conduct 'multilateral netting', i.e. the cancellation (offset) of opposite and therefore redundant trades, which brings down notional exposure and enhances market liquidity.²⁹

The most important benefit of central clearing is that counterparties are not directly opposed to each other anymore. All their contracts are with the CCP, which itself keeps a flat book, i.e. it does not take a position in the market itself.³⁰ The effects of counterparty default can thus be reduced, which decreases uncertainty, stabilizes the market and prevents fire sales, in case one counterparty experiences financial difficulties.³¹ By being counterparty to every trade, CCPs also make risks more easily identifiable and facilitate the gathering of trade information, which improves market transparency and allows for better risk management.³² CCPs lower interconnectedness among counterparties, which stops the dominos from falling, if one of them defaults.³³ Overall, central clearing provides for a much more lucid and less complex market structure, compared to the impenetrable network of transactions characteristic of the universe of uncleared derivatives.³⁴

²⁸ Peery (2012:102ff.)

²⁹ Cecchetti/Schoenholtz (2016), Gregory (2014:29)

³⁰ Lubben (2015:136), Podolyako (2010)

³¹ Duffie (2010:14), Helleiner (2011a:136)

³² Gregory (2014:28), Bryceson (2011:1), Cecchetti/Schoenholtz (2016), Glass (2009:S86), Helleiner (2014b:78f.)

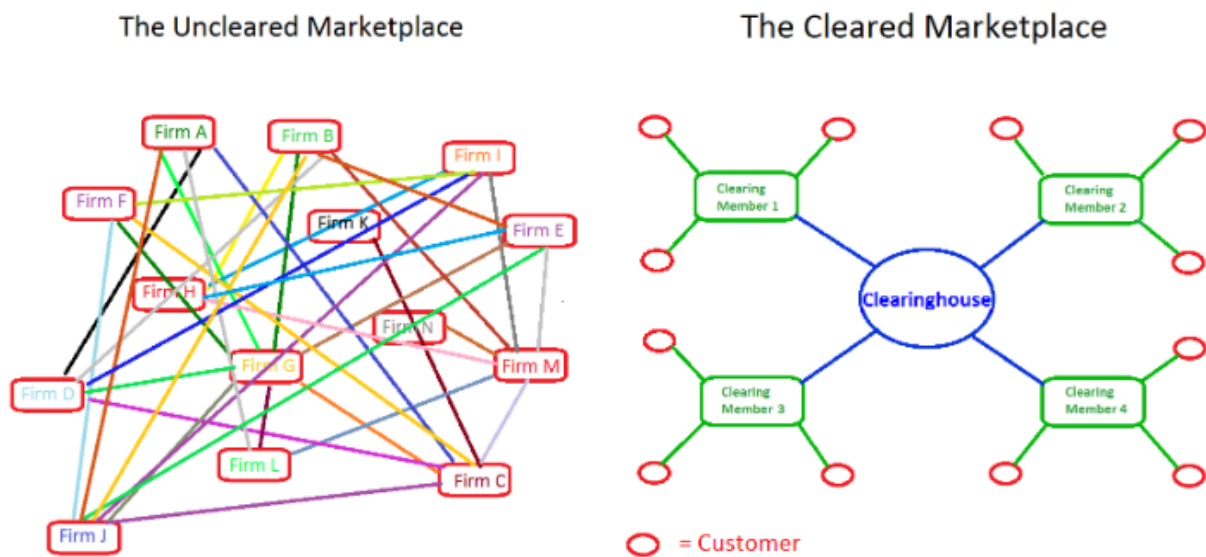
³³ Gregory (2014:28)

³⁴ Cecchetti/Schoenholtz (2016)

The principle of ‘clearing’ dates back to the 18th century Dojima rice market of Osaka, Japan. In the US, the Chicago Board of Trade instituted clearing with margin requirements in 1865. In 1882, a form of clearing including collateral requirements was introduced with the establishment of the Caisse de Liquidation des Affaires en Marchandises in Le Havre, France.³⁵

Figure 4 offers a stylized comparison between the modern-day uncleared and the cleared markets

Figure 4: The uncleared versus the cleared market for derivatives



Source: CFTC (No Year.a: 8)

As reflected by the right-hand side depiction of figure 4, CCPs operate on a ‘principal-to-principal’ basis, meaning that the immediate buyers and sellers of contracts are both ‘clearing members’ which have to meet certain financial, operational, and risk management standards. In addition, clearing members have customers of their own whose trades in terms of payment obligations they must guarantee.³⁶

One of the key features of modern-day central clearing is margining.³⁷ Margin is collateral provided by counterparties. A ‘good faith deposit of money to assure performance’,³⁸ it

³⁵ Norman (2011:ch.4, 5), Steigerwald (2014:17ff.), Gregory (2014:13)

³⁶ Gregory (2014:208f.)

³⁷ Wellink (2010:133)

³⁸ Markham (1991:63)

reduces credit exposure, and counterparty risk.³⁹ Margin is similar to capital in that both concepts lock in funds that otherwise would be available for investment or other purposes. The key difference becomes apparent once the counterparty defaults. Margin is ‘defaulter-pay-oriented’, meaning the surviving counterparty uses the collateral the failing counterparty had provided. This feature renders margin ‘attractive from an economic perspective as ‘the polluter pays’’.⁴⁰ By contrast, capital is ‘survivor-pay-oriented’, i.e. the surviving counterparty uses the assets it has set aside for itself in order to address potential losses.⁴¹

There are two types of margin, variation margin (VM) and initial margin (IM), which respectively account for current and potential future exposure. VM is calculated on a daily basis in response to changes of market prices whose ‘variation’ it accounts for. Positions are marked-to-market, and counterparties must post collateral for a position that has decreased in value in order to make up for the loss (even if is not realized). For this reason, VM is also known as ‘maintenance’ margin. Valuations are conducted several times per day, and intra-day margin calls have started to become more and more common.⁴² The counterparty whose contract is ‘out of the money’, i.e. whose position is marked with a negative value has to post the necessary funds without delay, sometimes within two hours.⁴³ If a counterparty is ‘in the money’, it receives VM. If the clearinghouse does not receive the required VM in time (a situation known as a ‘credit event’), it can promptly liquidate the position(s) in question, thus minimizing its losses.⁴⁴

IM needs to be posted to the CCP at the onset of the contract (hence the term ‘initial’ margin) in order to take account of potential future exposure and residual risk.⁴⁵ It is calculated using risk-based models informed by historical data, as well as other parameters.⁴⁶ IM provides extra protection in terms of a safety cushion the CCP can draw upon in case one of its members defaults and therefore cannot post any VM anymore.⁴⁷ During the time between the clearing member’s default and the close-out of its portfolio, known as the margin period of risk, the CCP holds a directional bet.⁴⁸ It uses the IM in order to provide for the orderly liquidation of that member’s portfolio. The CCP can transfer the portfolio in question to another clearing member. It can also conduct a centralized auction process, potentially enhanced through further netting, which reduces the value of the overall position in need of replacement.⁴⁹ While VM is usually limited to cash, IM can also

³⁹ Gregory (2014:75)

⁴⁰ Wellink (2010:133)

⁴¹ *ibid.*, also BCBS-IOSCO (2012:2)

⁴² Gregory (2014:150)

⁴³ Murphy et al. (2016:2)

⁴⁴ Markham (1991:64f.). In case of a profit, the customer receives the corresponding amount of VM in her account.

⁴⁵ Chander/Costa (2010:10)

⁴⁶ Murphy et al. (2016:2), Gregory (2015)

⁴⁷ Duffie et al. (2010:7), Rosenberg (2010:142), Gregory (2014:86)

⁴⁸ Gregory (2014:152)

⁴⁹ Gregory (2014:6,30f., 140f., 152)

take the form of other assets including, for example, high-quality sovereign bonds, gold, equity indices, and money market or mutual funds.⁵⁰

It is important to not confuse central clearing with exchange trading, which refers only to the venue of execution. Exchange trading involves centralized execution through a board of trade mechanism. Most exchanges provide central clearing services, but central clearing is also possible without exchange trading, i.e. it can be pursued OTC.⁵¹ Prior to the crisis, however, central clearing was rather uncommon for those derivatives that were not traded on exchanges.

2.3 The under-collateralization of the OTC derivatives market and the global financial crisis of 2008

The global financial crisis of 2008 did not have a single cause. A 2017 survey conducted among 'leading' American and European academic economists and cited by the Bank of England⁵² revealed the following ranking of contributing factors, as depicted in figure 5.

⁵⁰ Gregory (2014:137)

⁵¹ Economist (2010)

⁵² Aikman et al. (2018)

Figure 5: Causes of the global financial crisis of 2008

Figure 1: The 2008 financial crisis did not have a single cause



Source: Chicago Booth Initiative on Global Markets (igmchicago.org). Survey of academic economists in the United States and Europe, conducted in 2017. Answers are weighted by respondents' stated confidence. On the European panel, 37 of 49 panelists responded. On the US panel, 37 of 42 panelists responded.

Source: Aikman et al. (2018:5)

Other professions might rank (some of) these factors differently, but the overall relevance of 'inadequate regulation', listed as the number one reason in the survey, would most likely remain unquestioned.

While OTC derivatives were certainly not the sole cause of the crisis, some of this 'inadequate regulation' extended to the bespoke market. Among other weaknesses, there were no specific legal collateralization requirements, given the deregulated nature of the market. IM and VM existed in the uncleared market, where they performed a very similar function as in the cleared marketplace,⁵³ but counterparties were free to negotiate collateralization as they pleased.

There is no precise data on the extent to which margin was used pre-2008, given that the sector was 'the most private of markets'.⁵⁴ Estimates, however, suggest that at the height of the crisis, the market was vastly undercollateralized. Regarding VM, the five largest US and EU dealer banks alone were burdened with USD 500bn and USD 600bn of undercollateralized risk respectively in 2007/2008.⁵⁵ Regarding IM, the total volume of

⁵³ IM for uncleared derivatives was also known as the 'Independent Amount'.

⁵⁴ Riles (2008:608), see also Strange (1998:32).

⁵⁵ Singh (No Year:7)

collateral in the market in 2013 was about EUR 100bn, equalling 0.03% of gross notional exposure.⁵⁶

Indeed, the use of IM was 'quite rare'.⁵⁷ Dealers usually did not post IM to their clients, the justification being their high creditworthiness, as well as the fact that they were already subject to capital requirements.⁵⁸ In general, inter-dealer trades were also not collateralized with IM.⁵⁹ The buy-side was sometimes required to post IM.⁶⁰ Given the perceived riskiness of their business, hedge funds, in particular, often had to collateralize their trades.⁶¹ Decisions on IM were usually based on a credit analysis, but those results could be overshadowed by 'market power and economics of trade between the two parties'.⁶²

VM was used somewhat more frequently, although the dealers usually did not post it to their clients either.⁶³ End-users were generally exempt from all margin requirements, with OTC derivatives being considered part of the overall business, and in particular credit relationship with their banks.⁶⁴

Counterparties clarified their collateralization obligations when negotiating the details of the Credit Support Annex (CSA) of the Master Agreement.⁶⁵ The Master Agreement is a contractual framework developed by ISDA, in which the counterparties define their rights and obligations.⁶⁶ Prior to 2008, two common elements of CSAs were exposure thresholds beyond which and credit ratings below which counterparties needed to post (additional) collateral.⁶⁷ If counterparties agreed to use VM, the idea was for it to be exchanged on a daily basis.⁶⁸ In practice, however, the exchange often occurred much more infrequently, such as on a monthly basis, and the overall collateralization process often tended to be a secondary concern to many market actors.⁶⁹

Against this background, it might not be surprising that the dealer banks routinely did not 'segregate' the IM they received (meaning they did not keep it aside from their proprietary

⁵⁶ BCBS-IOSCO (2013a:26)

⁵⁷ Gregory (2014:87)

⁵⁸ Chander/Costa (2010:11)

⁵⁹ IMF (2010:95)

⁶⁰ Chander/Costa (2010:11)

⁶¹ Gregory (2014:87), Committee on the Global Financial System (2010:5)

⁶² Chander/Costa (2010:13)

⁶³ ISDA and SIFMA (2011:36)

⁶⁴ Gregory (2014:85)

⁶⁵ Gelpern (2009:64ff.)

⁶⁶ Biggins/Scott (2012: 324ff.)

⁶⁷ Duffie (2011:27), Committee on the Global Financial System (2010:5). A downgrade to below A2 (Moody's) or A (Standard & Poor's) was often defined as a credit trigger (Duffie 2010:12).

⁶⁸ Duffie (2010:7), Gregory (2014:77)

⁶⁹ BNY Mellon official referenced in Dale (2010)

assets), and often ‘rehypothecated’ it (meaning they used it to finance their own investments).⁷⁰

A particular type of OTC derivatives, credit default swaps (CDS), played a prominent role during the crisis. A CDS represents ‘a privately negotiated contract where one party (the “protection seller”), in exchange for a fee, agrees to compensate another party (the “protection buyer”) if a specified "credit event" (such as bankruptcy or failure to pay) occurs with respect to a company (the "reference entity") or debt obligation (the "reference obligation")’.⁷¹

While CDS offer a broad range of applicability, they were frequently used as a form of protection against the default of mortgage-backed securities (MBS), the market for which had massively expanded following the deregulation of lending standards.⁷² MBS were often bundled and sliced up in function of the riskiness of the underlying mortgages. The top, ‘senior’ tranche was usually the largest slice, containing the relatively safest mortgages. The expected default rate of these mortgages was ‘only’ 20%, which was informed by the assumption that defaults were uncorrelated.⁷³ As a consequence of this optimistic assessment, the senior tranche was usually given a triple-A rating by credit rating agencies. The middle slice, known as the ‘mezzanine’ tranche, contained those mortgages with relatively elevated risk, while the ‘equity’ tranche was reserved for the relatively riskiest mortgages, which were often drawn from the ‘subprime’ market. The slicing and dicing was repeated in the construction process of collateralized debt obligations (CDOs), which were bonds backed by MBS. There were even third-order derivatives, known as ‘CDOs-Squared’.⁷⁴

As a result of the continuous slicing and dicing, it was often unknown which particular mortgages were part of which slice. In fact, it was perfectly possible for a senior CDO-Squared tranche to contain MBS equity tranches. Nonetheless, the senior tranches of CDOs and CDOs-Squared were usually also rated triple-A. A top rating was usually a precondition for institutional investors to buy these products, given the strict limits set by their statutes.⁷⁵ Banks, in turn, relied on these products as collateralization for their short-term funding.⁷⁶

Investors bought CDS in order to protect themselves against the risk of a default of their MBS/CDO/CDO-Squared tranche(s).⁷⁷ The possibility to acquire ‘naked’ CDS (without holding the underlying asset) allowed market actors to take out bets on other investors’

⁷⁰ Gregory (2014:80), Atkins et al. (2012)

⁷¹ Sjostrum (2009:947f.)

⁷² Hull (2012:184ff.)

⁷³ Golub (2015:662)

⁷⁴ *ibid.*, Blinder (2013:74ff.)

⁷⁵ Blinder (2013:74ff.), Golub et al. (2015:660ff.), Morgan (2010:30), Spagna (2018:45)

⁷⁶ FSA (2009a:16)

⁷⁷ *ibid.*

portfolios.⁷⁸ CDS were also used in connection with other reference portfolios composed, for example, of loans or corporate bonds.

The lack of *mandatory* collateralization requirements often kept the price of these products down, which further fuelled the market. Indeed, the appropriate collateralization of many of these deals, particularly those related to the mortgage market, was often not considered a pressing need. In the autumn of 2007, AIG's CEO Martin Sullivan, for example, said 'the probability that it [i.e. the firm's derivative portfolio] will sustain an economic loss is close to zero'.⁷⁹ Individual corporate officials who warned against the mounting levels of risk and exposure their respective firms had accumulated in the years leading up to the crisis were usually sidelined.⁸⁰

When the real estate bubble burst, the MBSs/CDOs/CDOs-Squared lost value, and the secondary concern regarding collateralization suddenly turned into a crucial, primary one. The loss in value catapulted many counterparties beyond the exposure thresholds in their CSAs, which led to (additional) margin calls, with further calls being made because of rating downgrades. Financial institutions soon began experiencing serious difficulty. The first ones were a number of hedge funds that collapsed in the late spring/early summer of 2007, followed by Northern Rock in the UK, which in the autumn of 2007 experienced a bank run. Next was Bear Stearns which in the spring of 2008 was bought by JP Morgan on the basis of a public financial purchase facilitation programme. In September 2008, the government-sponsored mortgage lending agencies, Fannie Mae and Freddie Mac, were placed into conservatorship (where they remain to this day).⁸¹ The most prominent case was, of course, Lehman Brothers. In the immediate days preceding its default, it was USD 20bn in debt vis-à-vis JP Morgan. As a consequence, JP Morgan froze USD 17bn of the Lehman assets it held, and called for an additional USD 5bn of collateral.⁸²

The US government's decision to let Lehman fail fully catapulted the financial markets into turmoil. It soon turned out that the vast majority of CDS in the market had been sold by AIG. Taking advantage of its triple-A rating, AIG had accumulated an exposure of USD 500bn through the sale of CDS.⁸³ Its overall derivatives portfolio had a total (notional) value of USD 2.7tn,⁸⁴ while its total equity at the height of the crisis was no more than USD 100bn.⁸⁵ In July 2007, i.e. a couple of months prior to AIG CEO Sullivan's confident remark about the safety of CDS, the firm had received a USD 1.8bn collateral call from Goldman Sachs. AIG disputed it for months, with Sullivan insisting he only became aware of the situation, and his firm's overall exposure, much later. By September 2008, Goldman Sachs' margin call had

⁷⁸ White (2016)

⁷⁹ Sullivan quoted in O'Harrow/Dennis (2008).

⁸⁰ See for example Pulliam et al. (2008).

⁸¹ Helleiner (2011b:69)

⁸² Roe (2011:553)

⁸³ Crosman (2018)

⁸⁴ IAIS (2011:39)

⁸⁵ Roe (2011:550)

grown nearly six-fold, reaching a level of USD 9bn.⁸⁶ On 15 September 2008 AIG was downgraded by Moody's and S&P. This led to additional margin calls in the range of USD 20bn, in line with the arrangements the firm had agreed to in its CSAs. AIG was bailed out the following day.⁸⁷ In addition, the US Treasury Department and the Federal Reserve implemented a series of large-scale public support measures, including record low interest rates, as well as vast amounts of liquidity injections through which they hoped to stabilize the crumbling financial markets.

With many CDOs having been entered on a cross-border basis,⁸⁸ the crisis soon spilled into other jurisdictions, and into other sectors of the financial markets. Further compounding factors were the lack of transparency about counterparties' exposure (with top management of some counterparties often not fully aware even of their own exposure⁸⁹) and the high level of financial interconnectedness the use of derivatives had fostered across all asset classes. As a result, the crisis extended to almost every part of the financial sector. Investors responded with fire sales, which led to the freezing of asset markets.⁹⁰ Given the decreased availability of credit, the crisis spilled over into the trade and production sectors, which, in turn, had repercussions on commodity markets and remittances. The crisis soon became global in scope.⁹¹

3. Situating the research within the literature

This study situates itself at the nexus of three overlapping bodies of IPE literature: the literature on derivatives, the literature on interest group influence over post-crisis financial regulation, and the broader literature discussing changes to the politics of financial regulation after 2008.

3.1 The IPE literature on derivatives

Empirically, the thesis contributes to the IPE literature on derivatives by providing the first detailed study of the development of the new margin rules for uncleared derivatives. Despite the relevance of the derivatives sector to the global economy, these products have attracted scant scholarly interest, particularly when compared to the banking sector.⁹² This

⁸⁶ Awrey (2018:44ff.), Clark, A. (2010)

⁸⁷ Sjostrom (2009a:962f.)

⁸⁸ Alloway (2009)

⁸⁹ Dash/Creswell (2008)

⁹⁰ Blau et al. (2013:3009)

⁹¹ Helleiner (2011b:69)

⁹² Helleiner et al. (2018:2)

section provides a first overview of the existing literature that will be expanded upon in the discussion of the theoretical framework.

Recent research has approached the study of the IPE of pre-2008 derivatives from different angles, applying various theoretical or disciplinary lenses. Oldani has explored the implications of derivatives for monetary theory, monetary policy, and fiscal policy.⁹³ Lagna has examined the derivatives-related financialization of the Italian state.⁹⁴ Robertson has analyzed the global dominance of the community of derivatives practitioners trained in French schools and banks which are renowned for the quality of their education in this particular area.⁹⁵ Spagna has covered the pre-crisis rise in importance of derivatives, which at the height of the crisis had become the world's largest market.⁹⁶ Bryan and Rafferty, as well as LiPuma and Lee have approached the dominance of OTC derivatives markets from a structuralist perspective.⁹⁷ Riles has offered several ethnographically informed accounts on derivatives trading.⁹⁸

Post-crisis derivatives regulation has also received some attention: Helleiner and Mügge have each presented bird's eye-view accounts of the broad contours and the significance of the reform developments after 2008.⁹⁹ Pagliari has used the lens of public issue salience to trace the legislative debate on the post-crisis rules for derivatives in the US and the EU.¹⁰⁰ Clapp and Helleiner have focused on the US Congress' debate on agricultural derivatives.¹⁰¹ The cross-border dimension of the new rules has also attracted some scholarly interest. Pagliari and Gravelle, as well as Knaack have studied this aspect for the rules on central clearing and trade reporting.¹⁰² Lockwood has focused on CCPs, demonstrating that CCPs' valuation methods remain heavily informed by VaR.¹⁰³ Helleiner et al. have published a collection of essays on post-crisis derivatives reform which, among other developments, notes trends towards growing regulatory fragmentation across jurisdictions.¹⁰⁴

However, there are few accounts on the *precise content* of the new rules and the *process* of their generation. Helleiner, for example, has highlighted the need for 'more detailed analyses of the content of [post-crisis] regulatory initiatives [...]'.¹⁰⁵ Along similar lines,

⁹³ Oldani (2008)

⁹⁴ Lagna (2016)

⁹⁵ Robertson (2014)

⁹⁶ Spagna (2018)

⁹⁷ Bryan/Rafferty (2006), LiPuma/Lee (2004)

⁹⁸ Riles (2000, 2008, 2010, 2011)

⁹⁹ Helleiner (2011a, 2014a, 2014b), Mügge (2014a)

¹⁰⁰ Pagliari (2013b). His research also covers hedge funds and credit rating agencies.

¹⁰¹ Clapp/Helleiner (2012)

¹⁰² E.g. Gravelle/Pagliari (2018), Knaack (2018,2015)

¹⁰³ Lockwood (2018)

¹⁰⁴ Helleiner et al. (2018:11), see also Helleiner/Pagliari (2011). This trend is also noted in a joint report published by the Atlantic Council, TheCityUK, and Thomson Reuters (see Atlantic Council et al. 2013:29ff.).

¹⁰⁵ Helleiner (2014b:70)

Posner has called upon scholars to develop ‘[a] better grasp of how rules are made [...]’.¹⁰⁶ In order to address this gap, Helleiner has already taken some steps by tracing the debate on position limits in the US and the EU. In a similar vein, Pagliari has examined some of the rules pertaining to clearing house membership and the *de minimis* threshold beyond which financial entities have to register as swap dealers with the CFTC.¹⁰⁷ Newman and Posner have analyzed the relevance of international soft law for the alignment of post-crisis policy-making in banking and central clearing regulation.¹⁰⁸

Margin requirements for uncleared derivatives, however, have barely attracted attention from the IPE community to this date. The recent collection of essays edited by Helleiner et al., which provides an overview of post-crisis derivatives regulation and to which several of the authors listed above have contributed, mentions the concept a few times, but does not expand on it.¹⁰⁹ Neither do Newman and Posner who briefly touch on the topic in their comparison of post-crisis banking and central clearing regulation.¹¹⁰ Pagliari and Young have examined the end-user carve-out from the clearing requirement under Dodd-Frank, but their contribution studies *exemptions* from the rules, rather than the rules themselves.¹¹¹

The gap in research on margin is particularly significant for at least three reasons: First, the derivatives market is of great significance to the global financial system. At the height of the crisis, it was the ‘world’s largest market’.¹¹² As we have seen, the lack of appropriate collateralization of derivatives is considered one of the reasons for the global financial crisis of 2008. Second, observers have emphasized the significance of the margin reform, describing it as ‘one of the bedrocks of global regulatory efforts to curb risk in the market [...]’¹¹³ and as a ‘part of the law [which] is among the most controversial’.¹¹⁴ Third, the reform represents one of the most important cases of post-crisis intervention in that it reaches beyond mere attempts at increasing transparency by imposing direct costs on market participants, particularly the dealer banks.

The thesis begins to address this lacuna. It focuses on the actual content of some of the margin rules, as well as the process of their generation by applying the analytical lens of ‘dealer bank influence’ over the respective policy outcomes.

¹⁰⁶ Posner (2018:55)

¹⁰⁷ Helleiner (2018), Pagliari (2018)

¹⁰⁸ Newman/Posner (2018)

¹⁰⁹ Helleiner et al. (2018), see in particular the chapters by Posner (2018) and Li (2018).

¹¹⁰ Newman/Posner (2018:chapter 6)

¹¹¹ Pagliari/Young (2014, 2013)

¹¹² Helleiner et al. (2018), Spagna (2018)

¹¹³ Brush/Weber (2017)

¹¹⁴ Peery (2012:164, his quote refers to the margin and capital reforms)

3.2 The literature on interest group influence over post-crisis financial regulation

The post-2008 literature on interest group influence over financial regulation can be grouped into two categories. One focuses on the theoretical conceptualization of ‘influence’, the other on the empirical question concerning changes to the role of private financial groups in the policy-making process.

3.2.1 Theoretical literature

Theoretically, this study contributes to the growing literature on the role of private interest groups in financial regulation before and after 2008 which conceives of ‘influence’ as a moderated condition. Recent scholarship has noted that ‘numerous authors have debated how different resources, institutions and structural features of contemporary economies enable financial industry groups to influence the regulations to which they are subject’.¹¹⁵ Most of these studies, however, focus on the *individual* effect of these variables, rather than attempting the development of a more integrative approach.

A recent example of this literature is the work of James and Quaglia who explore the question why the banks have not been more successful in preventing, or at least attenuating Brexit. They identify three inhibitors, including ‘political statecraft’ (i.e. the May government’s decision to pursue a ‘hard line’ in light of electoral and internal party concerns), ‘institutional structures’ (i.e. the reorganization of decision-making authority regarding Brexit, which removed the banks’ traditional interlocutors from the drivers’ seat), and ‘business organization’ (i.e. the failure of the banks to mobilize wider corporate support against Brexit).¹¹⁶ A conceptually similar study has been presented by Bell and Hindmoor who argue that banks’ structural power in the UK over the design of capital rules before and after the crisis was shaped by three factors, i.e. policy-makers’ ideational interpretation of the banks’ threats of using the exit, the extent to which institutional arrangements fostered ‘state capacity’ to act, and the level of ‘politicization’ of banking reform.¹¹⁷ Young has examined the ways in which private financial groups have changed their advocacy strategies after 2008 in response to two factors, i.e. ‘increased issue salience and a strained policy network’.¹¹⁸ His analysis of pre-crisis private sector influence over the formation of several policies under Basel II already revealed that interest group influence was sometimes fostered by the receptiveness of the financial policy network for the banks’ arguments, but often restrained by business conflict.¹¹⁹

¹¹⁵ Pagliari/Young (2014:576)

¹¹⁶ James/Quaglia (2018)

¹¹⁷ Bell/Hindmoor (2017), for a similar study see Bell/Hindmoor (2015).

¹¹⁸ Young (2013b:460)

¹¹⁹ Young (2012)

I argue that, in addition to studying the *individual* effect of these moderators in isolation from each other, we should embrace a more *integrative* approach examining their joint, interactive and dynamic effects. In particular, I suggest that a specific focus on what is termed ‘institutions and structural features’¹²⁰ in the quote at the beginning of this section can provide valuable insights improving our understanding of a concept as difficult to capture as ‘influence’.

Drawing on the wider IPE literature, I propose a theoretical framework in which the strength of dealer bank influence is understood as being shaped by a collection of six conditions moderating the relationship between their policy preferences and reform outcomes. These variables are: business unity, public issue salience, policy-makers’ ideational outlook, the state of the transnational policy community, inter-state power relations, and the domestic institutional environment. Conceptually, these six factors could be subsumed under the three ‘dynamics’ Helleiner et al. have identified with respect to post-crisis derivatives regulation: transnational, domestic, inter-state.¹²¹ The state of the transnational policy community corresponds to Helleiner et al.’s ‘transnational dynamic’, while business unity, salience, and the domestic institutional environment align with the ‘domestic dynamic’. Inter-state power is consistent with their ‘inter-state’ dynamic. Business unity could also be counted towards the ‘transnational’ level, if we were interested in transnational policy-making, which is not the primary focus of this thesis. Policy-makers’ ideational outlook spans both the ‘domestic’ and the ‘transnational’ categories.

3.2.2 Empirical literature

Scholars writing about post-crisis reform have called upon their colleagues to examine the evolution of ‘private actors, particularly financial firms, as key players in the policymaking process’.¹²² Young noted that the question of ‘how these groups adapt to and contribute to the process of financial regulatory change is not well understood’.¹²³ More generally, he asked whether ‘financial industry influence [is] less consistent than in the past’.¹²⁴ Along similar lines, Pagliari posed the question ‘Who Governs Finance?’ after the crisis, and invited further research on changes regarding ‘how the responsibility to regulate and oversee financial markets is divided between public regulatory agencies and private market actors’.¹²⁵ Helleiner, in turn, has encouraged scholars to examine ‘the changing public-private relationship in the global political economy’.¹²⁶

¹²⁰ Pagliari/Young (2014:576). The terms themselves are not precisely defined in the article.

¹²¹ Helleiner et al. (2018:22)

¹²² Mosley/Singer (2009:425)

¹²³ Young (2013b:460)

¹²⁴ Young (2013a:700)

¹²⁵ Pagliari (2012a:45)

¹²⁶ Helleiner (2014b:70)

Against this background, the verdict of the empirical literature having addressed these questions can be aligned along a spectrum. Several observers have identified a loss of financial sector dominance, but there are also sceptical voices pointing to its potential resurgence, if not continuing dominance. Johnson argues that even the worst crisis since the Great Depression has failed to effectively curtail the banks' influence. He concludes that '[b]ig banks, it seems, have only gained political strength since the crisis began'.¹²⁷ Kirshner's assessment of the situation also points to continuous dominance. He speaks of 'stasis', which he attributes to the persisting 'power of the financial community and its enmeshment with political elites'. In his view, 'the Wall Street-Washington axis endures'.¹²⁸ In a similar way, Chalmers identifies a return to "'business as usual", with the lobbying efforts of banks effectively taking the teeth out of the new regulation'.¹²⁹ Litan's conclusion is of particular relevance to this research, since he considers the perseverance of dealer bank influence as one of 'the main impediments to meaningful reform'.¹³⁰

A number of commentators have also pointed to 'regulatory capture'¹³¹ as a contributing factor to the crisis, and a persistent feature in its aftermath. The term is informed by an understanding according to which 'particularistic interests hijack[] public policy'.¹³² The former Governor of the Bank of England, Mervyn King, for example, considered regulatory capture 'one of the major problems leading up to the crisis'.¹³³ The Warwick Commission on International Financial Reform, an expert body charged with providing recommendations on how to enhance global financial stability concluded that '[r]egulatory capture substantially contributed to the regulatory failure'.¹³⁴ According to Baker, 'regulatory capture was [...] a principal political cause of the financial crisis of 2007-2009', and he finds that 'it has not been confronted directly or explicitly in current reform efforts'.¹³⁵ Weng insists that the banks have captured the process leading to the adoption of Basel III.¹³⁶ Along similar lines, Lall argues that the transition from Basel II to Basel III is a 'history of [...] failure after failure', as a result of capture.¹³⁷

In the middle of the spectrum we might locate a number of scholars who have pointed to the banks' increased reliance on the corporate sector to assist them in fending off public regulatory intervention, which we might interpret as a sign that, by themselves, the banks are often unable to halt reform. Keller, for example, notes the success of the bank/end-user

¹²⁷ Johnson (2009)

¹²⁸ Kirshner (2014:101)

¹²⁹ Chalmers (2017:108)

¹³⁰ Litan (2010:3)

¹³¹ For analytical explorations of the concept, which can be traced back to Stigler (1971), see for example Mattli/Woods (2009) and the contributions in Pagliari (2012b).

¹³² Stellinga/Mügge (2017:415)

¹³³ King quoted in Masters (2011).

¹³⁴ Warwick Commission on International Financial Reform (2009:28), see also SOMO (2016).

¹³⁵ Baker (2010:663)

¹³⁶ Weng (2015)

¹³⁷ Lall (2012:632). The overall assessment about the post-crisis situation is also shared by Underhill (2015:483) and Chalmers (2017). For Basel II, see also Underhill/Zhang (2008:546) and Helleiner/Porter (2009:14ff.)

coalition in watering down post-crisis capital requirements in the EU.¹³⁸ Kastner illustrates the coalition's success in weakening the EU Commission's proposal of a financial transaction tax.¹³⁹ As already mentioned, Pagliari and Young have examined the battle of the dealer/end-user coalition in favour of exemptions for non-financial firms from post-crisis derivatives rules.¹⁴⁰ Helleiner argues that the banks now find themselves 'under the heavy shadow of the state',¹⁴¹ but that this has not entirely curtailed their ability to derail financial reform. He illustrates this with his research on the banks' success at derailing the CFTC's position limits rule by taking the agency to court over its interpretation of Dodd-Frank that had informed the proposed rule.¹⁴² Still in the middle of the spectrum, we might also situate Tsingou who concludes that the transnational policy community in banking regulation is 'under stress but not broken',¹⁴³ and that financial groups still serve as regulators' point of reference for the development of new rules.¹⁴⁴

Towards the other end of the spectrum, we might locate several authors who have identified even stronger signs of reduced dominance. Analyzing post-crisis banking regulation and derivatives regulation more generally, Young finds that private financial groups have lost their ability to kill regulatory proposals at the pre-agenda stages, and that they can no longer veto those proposals that do make it onto the agenda. Regarding the initial policy formulation stage, he notes banks' '*Relatively Passive Acceptance*' of the general parameters of the new rules and '*Selective Involvement*' in the design of specific details. By contrast, he identifies an increased focus on the implementation stage, with the industry trying, often successfully, to '*Seek to Delay Implementation*'.¹⁴⁵ Pagliari notes that the banks have often been held back by conflict with other financial sector groups, an example being the size of the capital threshold determining clearinghouse membership.¹⁴⁶ Porter points to the billions to trillions of USD the banks will have to raise in additional capital under Basel III, as well as to the stronger rules governing the work of CRAs. He concludes that '[w]hile there are a great many ways in which private financial actors have sought, often successfully, to block or reverse reform, these have not been enough to restore the levels of power [...] that private sector actors enjoyed before the crisis'.¹⁴⁷ Along similar lines, Posner observes that 'governments are withdrawing support for self-regulation by market participants, taking more direct control over financial governance [...]'.¹⁴⁸ In a similar way, Germain suggests the role of private financial interest groups will cede to some

¹³⁸ Keller (2016)

¹³⁹ Kastner (2017)

¹⁴⁰ Pagliari/Young (2014, 2013)

¹⁴¹ Helleiner (2011:148)

¹⁴² Helleiner (2018:207). The SEC's proxy access rule regarding the nomination and election of public corporation directors experienced a similar fate (see Coffee (2012:352ff.)).

¹⁴³ Tsingou (2010:22)

¹⁴⁴ Tsingou (2010)

¹⁴⁵ Young (2013b:474, table 4, emphases in the original), see also Young (2014b).

¹⁴⁶ Pagliari (2018:156f.)

¹⁴⁷ Porter (2014b:136)

¹⁴⁸ Posner (2015:197)

extent, while the state's 'centrality within the globalized structure of financial governance will grow'.¹⁴⁹

This study's results on dealer bank influence over selected elements of the margin reform suggest a position towards the side of the spectrum indicating reduced dominance. In fact, the only reason we would not opt for a position closer to that end is the fact that the banks exercised (indirect) influence in the end-user case, relying on the heavy support of the corporate sector they helped to mobilize. The other cases, however, suggest that the margin reform has led to anything but 'stasis'¹⁵⁰ or a return to 'business as usual'.¹⁵¹ While the banks also tried to delay the implementation of the margin reform (an aspect I do not cover in this thesis), they vehemently opposed any reform proposal that would have marked an end to the pre-crisis deregulation status quo. However, despite their fierce resistance, they lost in all but one case, in which they probably benefited from congruence (besides their indirect influence over the treatment of end-user deals).

Although not at the height of or immediately after the crisis, policy-makers eventually performed a 180-degree turn away from self-regulation, thereby increasing the footprint of the state, and pulling the weight in the public-private relationship towards the public side, away from the private sector. The reason, I argue, is that the moderator constellation which had allowed the banks to exercise tremendous influence prior to the crisis fundamentally changed to their disadvantage after 2008. Increased business conflict, as identified by Pagliari, was only one of several changes to the pre-crisis configuration.

Analytically, the results can be interpreted as an encouragement for scholars interested in post-crisis financial regulation to not only focus on the analysis of interest group influence, but to adopt a mixed research strategy drawing, in particular, on the insights of constructivism, transgovernmental approaches, as well as domestic institutionalist analyses.

3.3 The wider literature on change in post-crisis financial governance

This study also contributes to the growing body of literature focusing on the extent to which there has been broader change to the politics of international financial regulation following the worst crisis since the Great Depression. The topic is considered '[o]ne of the central questions confronting political economy over the last decade',¹⁵² with 'change' having become 'the catchword in the international regulatory debate'.¹⁵³ In a 2009 speech, President Obama set the bar very high by promising 'a new era of economic engagement'

¹⁴⁹ Germain (2016a:177)

¹⁵⁰ Kirshner (2014:101)

¹⁵¹ Chalmers (2017:108)

¹⁵² Young/Yagci (2018:1)

¹⁵³ Moschella/Tsingou (2013a:1)

and that there would be no ‘return to the status quo’.¹⁵⁴ Some scholars had equally high expectations. In 2009, Mügge summarized the widespread belief that ‘neo-liberal capitalism itself [was] at a crossroads’.¹⁵⁵ One year later, Nesvetailova and Palan, argued that ‘the neoliberal project is most probably dead and buried [...]’.¹⁵⁶

Others were less optimistic, warning that the *potential* for rapid change was limited. Morgan and Drezner, for instance, observed that policy-makers’ successful stabilization efforts in terms of pulling the global economy away from the brink of utter collapse had in fact pulverized any chance for lasting long-term change. They therefore predicted that policy-makers finding themselves back in their comfort zones would fail at implementing significant reforms.¹⁵⁷ Helleiner adopted a nuanced position. As with some of his colleagues, he identified ‘a legitimacy crisis for the neo-liberal globalized financial regime’.¹⁵⁸ However, at the same time, he cautioned that change should be considered a long-term process, observing that even episodes of monumental transformation, such as the establishment of the Bretton Woods System after the Second World War were the result of ‘a longer “critical juncture” dating back to the Great Depression’.¹⁵⁹ In his view, fundamental change might therefore require more time than some of his peers suggested.

Warning about a more specific challenge, Singer identified the institutional fragmentation of the US as one of the key stumbling blocks for fundamental change.¹⁶⁰ Indeed, already 15 years prior to the crisis, then former FDIC chair William Seidman had argued that ‘[y]ou have three totally independent agencies in the business. There is no power on earth that can make them agree – not the President, not the Pope, not anybody. The only power that can make them agree is the Congress of the United States by changing the structure so that the present setup does not continue’.¹⁶¹ By 2008, little had changed. Seidman’s statement had referred to the Fed, the FDIC, and the OCC, but, in addition, there were also the CFTC, the SEC, and the Office of Thrift Supervision (not to forget the countless state-level regulators). Over the years, there had been many attempts at consolidating these entities, but all of them failed. Post-crisis, policy-makers eliminated the Office of Thrift Supervision. They also debated merging the SEC and the CFTC, as well as elevating the role of the Fed to that of a ‘super-regulator’. However, these plans were soon dropped, given the political cost the merger would have incurred, and the criticism of the Fed’s perceived mismanagement of the crisis.

¹⁵⁴ Obama (2009:2,5)

¹⁵⁵ Mügge (2009:514)

¹⁵⁶ Nesvetailova/Palan (2010:797)

¹⁵⁷ Morgan (2010a:39f.), Drezner (2012)

¹⁵⁸ Helleiner (2010:627)

¹⁵⁹ Helleiner (2016c:767 of the pdf)

¹⁶⁰ Singer (2010, 2009), see also Busch (2009:54), Cunningham/Zaring (2009:50).

¹⁶¹ Seidman quoted in Lavelle (2013:85)

Given that the entities of one single bank holding company can potentially be subject to regulation by all of the surviving agencies listed above,¹⁶² sweeping reform would require inter-agency consensus, which Singer considered unlikely. With the US being held back by regulatory fragmentation, he was also sceptical about the country's ability to provide global leadership, without which the chances of lasting change would be minimal.¹⁶³ In a similar vein, Coffee warned that without global leadership, 'the first and reflexive response of many regulatory agencies after a crash is simply to move the deck chairs around in a sufficiently noisy fashion to show that they are on the job'.¹⁶⁴

Focusing specifically on derivatives, some observers added that the product characteristics of these instruments made change in terms of enhanced regulation unlikely. Already prior to the crisis, structuralist authors, such as Bryan and Rafferty had considered substantial change a 'near impossibility', not only because '[d]erivatives are too elusive to be easily regulated', but also because doing so would mean 'to confront the [...] nature of capitalism itself'.¹⁶⁵ Along similar lines, LiPuma and Lee had argued that derivatives regulation would be futile, given the transnational and opaque nature of the market.¹⁶⁶ Some regulators echoed similar concerns. For example, the outgoing CFTC chair, Walt Lukken, in 2008 told the US Congress that '[t]he dispersed and non-standardized nature of many OTC instruments makes finding a regulatory solution a challenging task'.¹⁶⁷

Regarding the *relevance* of the change that actually did occur over the last 10 years, scholars' verdicts tend to fluctuate between disappointment and (modest) approval. Moschella and Tsingou have put forward a pessimistic assessment. Rather than 'rapid and revolutionary', change in their view has been 'small and incremental', often amounting to no more than 'symbolic', 'marginal adjustments'.¹⁶⁸ Limited to 'policy instruments and settings', reforms 'at the level of policy goals have been quite rare, if not altogether absent'.¹⁶⁹ Along similar lines, Fioretos identifies efforts in '[r]etrofitting' rather than fundamental reformulations of financial governance',¹⁷⁰ although he acknowledges 'intense' reform activity which has led to 'a more robust regulatory regime of financial market regulation [...]'.¹⁷¹

Several authors have studied the results of *specific* reform efforts. Focusing on Basel III, Porter appears cautiously optimistic, arguing that if Basel III had been the standard prior to the crisis, banks' liquidity levels would have been much more solid.¹⁷² While not entirely

¹⁶² See Lavelle (2013:144)

¹⁶³ Singer (2010, 2009)

¹⁶⁴ Coffee (2012:368)

¹⁶⁵ Bryan/Rafferty (2006:197,16,214)

¹⁶⁶ LiPuma/Lee (2004:94)

¹⁶⁷ Lukken quoted in US House Agriculture Committee (2008b:9).

¹⁶⁸ Moschella/Tsingou (2013a:2, 2013b:193, 197), see also Wigan (2010), Singer (2009:26).

¹⁶⁹ Moschella/Tsingou (2013b:196f.)

¹⁷⁰ Fioretos (2016:68,91)

¹⁷¹ Fioretos (2016:69)

¹⁷² Porter (2011:182)

satisfied with the change achieved to this date, he points out that the reform ‘significantly increases the accountability of private financial actors for their risk management activities, imposing significant costs on them’.¹⁷³

Others harbour some reservations about the significance of the changes deriving from Basel III. Bell and Hindmoor have collected a series of sceptical assessments, ranging from the ‘mouse that did not roar’, and a reform that ‘falls far short of its creator’s aims’, to an outcome that ‘on its own will not prevent another crisis’.¹⁷⁴ Moschella and Tsingou point to the fact that the banks are still allowed to calculate their capital requirements themselves, and that a strong regulatory framework for SIFIs is still missing, as is a viable cross-border insolvency regime for failing banks.¹⁷⁵ Regarding change in the accounting sector, Botzem speaks of a mix of ‘avoidance of confrontation, reframing of criticism and carefully renewing organizational leadership’, that in his view has caused minimal interference with self-regulation.¹⁷⁶ Brummer draws attention to the limited progress with regard to preventing excesses in executive compensation.¹⁷⁷ Kastner and Kalaitzake discuss the lack of progress with regard to the development of a financial transaction tax.¹⁷⁸

Directing our attention to the ideational level, Baker has analyzed the rise of macroprudentialism, but cautions that the concept ‘remains an issue of dispute across the G20’,¹⁷⁹ and that there is a lack of ‘[m]ore ambitious blue prints and guiding rationales’.¹⁸⁰ Adopting a broader ideational perspective, Helleiner observes that while post-crisis reformers are certainly interested in protecting the wider society from future shocks, their conceptualization of the ‘global public interest’ is much narrower, focused on the ‘public’ in a ‘prudential sense’, rather than informed by a broader political vision, similar to the one that dominated after World War II.¹⁸¹ His book-length reflection on the significance of the broader strokes of post-crisis financial reform leads him to conclude that we are witnessing a ‘status quo crisis’, rather than an era of ‘transformative’ change.¹⁸²

With regard to the derivatives market, Omarova’s assessment of Dodd-Frank suggests that it ‘falls short of radically reshaping the structure or operation of derivatives markets’.¹⁸³ Focusing specifically on the elevation of CCPs to one of the main pillars of post-crisis derivatives market governance, Lockwood highlights that they remain private, profit-oriented businesses relying on risk-management techniques very similar to those that had

¹⁷³ Porter (2014b:133)

¹⁷⁴ The Financial Times’ Martin Wolf, IPE scholar Ranjit Lall, and the Governor of the Bank of England, Mervyn King quoted in Bell/Hindmoor (2017:108).

¹⁷⁵ Moschella/Tsingou (2013a:2), see also Kirshner (2014:133).

¹⁷⁶ Botzem (2013:150,165), see also Porter (2014c:12), Stellinga/Mügge (2017)

¹⁷⁷ Brummer (2012:254)

¹⁷⁸ Kastner (2017), Kalaitzake (2017)

¹⁷⁹ Baker/Carey (2014:101)

¹⁸⁰ Baker (2018:295)

¹⁸¹ Helleiner (2014b:87f.)

¹⁸² Helleiner (2014c:2)

¹⁸³ Omarova (2013:99)

failed during the crisis.¹⁸⁴ Regarding trade reporting, it has recently become clear that a loophole in Dodd-Frank allows the banks to keep deals from certain offshore entities undisclosed.¹⁸⁵ In addition, the information on those trades that do get reported can often not be properly used, given policy-makers' coordination failure in terms of developing an integrated system of trade identification codes.¹⁸⁶ As a result, not even the basic transparency-enhancing reforms of the post-crisis framework have been an unconditional success. This is also the overall conclusion of Helleiner et al.'s book-length assessment of the post-crisis framework of derivatives regulation more generally. The editors suggest that the ambitious initiatives policy-makers promised to implement have often been affected by 'Delays and Inconsistences', and, probably more significantly, by 'Conflict and Fragmentation', which has limited their overall effectiveness.¹⁸⁷

The empirical evidence on the margin case calls for a nuanced conclusion. On the one hand, the reform has resulted in a 'seismic shift'¹⁸⁸ in the governance of the uncleared market. While a number of exceptions apply, there is now a firm legal collateralization requirement. Trades need to be supported with margin. Collateral posted as IM has to be segregated and must not be rehypothecated. The margin rule for uncleared trades has also led to the shift of about 60% of the bespoke market to CCPs, even though, as we saw in table 1, this migration has been largely limited to interest rate and credit derivatives. Studied from a narrow angle, the margin reform has thus resulted in a veritable sea change that is anything but 'symbolic' or 'incremental'. It has also demonstrated that a reform of the derivatives markets is in fact possible, against the predictions of structuralist observers and other skeptics.

Yet, once we broaden the analytical angle, the significance of this 'sea change' begins to pale. As we will see, policy-makers imported the collateralization requirement from the cleared market, where it had already existed for numerous years prior to the crisis. Some authors, such as Baker and Hall argue that initial reform efforts often tend to be anchored within the existing environment.¹⁸⁹ Policy-makers, however, did not take advantage of the momentum the margin reform provided, in order to explore more far-reaching opportunities for change. This lack of more substantial reform efforts indirectly confirms the assessment of those observers deploring the lack of more transformative change. Indeed, beyond a focus on 'systemic risk', there has been little debate about the 'global public interest' regarding the governance of the OTC derivatives market more generally.

In addition, while CCPs have welcomed the new trades and are operating with high degrees of efficiency, central clearing has led to the emergence of new risks, many of which policy-makers had initially not expected, when the G20 adopted the clearing and margining

¹⁸⁴ Lockwood (2018)

¹⁸⁵ Flitter (2018)

¹⁸⁶ Knaack (2018)

¹⁸⁷ Helleiner et al. (2018:8,11; caps in the original)

¹⁸⁸ Risk.net (2013)

¹⁸⁹ Baker (2013), Hall (1989)

mandates. Moreover, while the transition of trades from the uncleared to the cleared marketplace has led to a decline in the overall volume of the bespoke market, it has not reduced the centrality of the dealers, most of which have now also become globally systemically important banks. Indeed, the large banks continue to dominate the uncleared market as dealers, and, in addition, represent central pillars of the cleared market, given their role as clearing members of CCPs. In other words, there has been fundamental change in terms of the re-regulation of the uncleared market and the relative lack of bank influence over the corresponding policy process. However, the dealer banks remain pivotal actors in the cleared and uncleared market, and there has been little substantial debate about the broader public interest in post-crisis reform.

Finally, recent announcements by CFTC chair Giancarlo regarding the need for 'reforming the reform', as well as the UK's plans to engage in deregulation following Brexit, might result in a reversal of some of the requirements that have been adopted, which would further limit the change that has been achieved.

The next chapter develops the analytical approach of the thesis.

CHAPTER II – The analytical approach

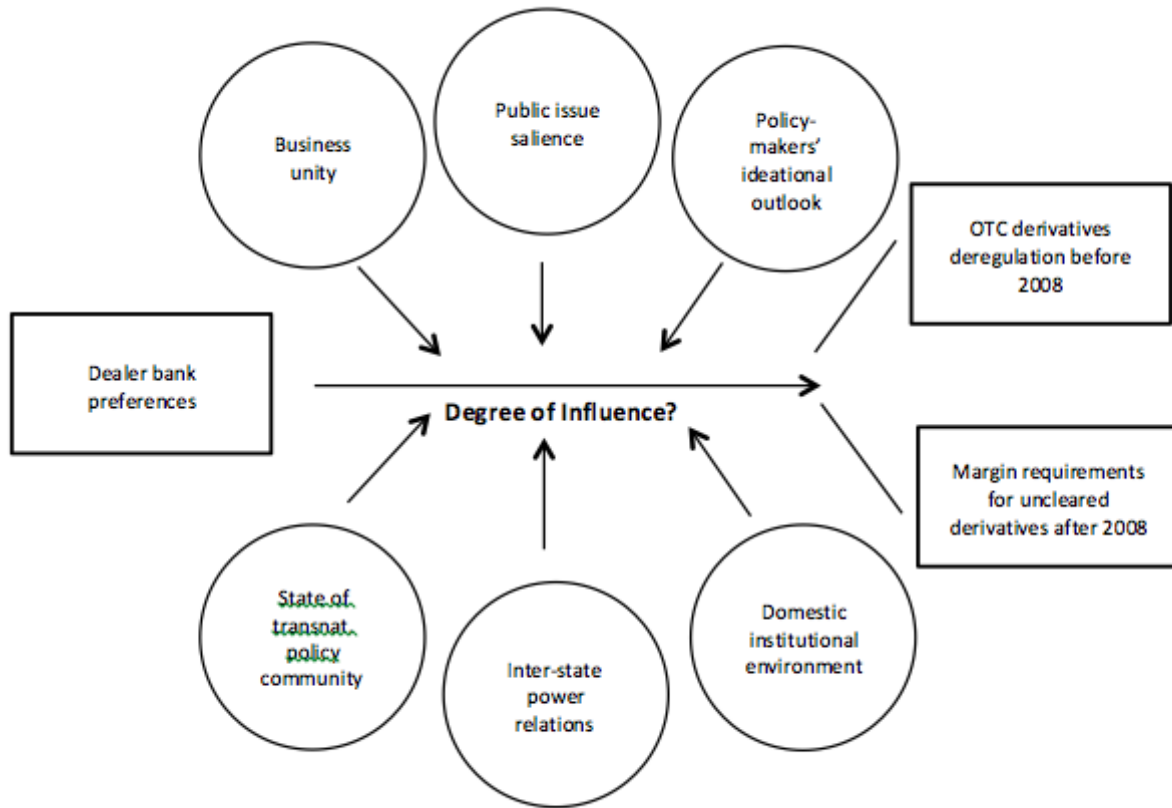
1. Overview of the chapter

This chapter presents the analytical approach of the thesis. Section 2 discusses the theoretical framework. In section 2.1, I explain different ways in which the banks can articulate their preferences. This study focuses on two vectors: the provision of information to policy-makers and the use of structural and structuring power. Section 2.2 addresses some of the challenges associated with studying interest group influence. In section 2.3, I develop my argument of conceptualizing interest group influence as a moderated variable. I suggest that the level of dealer bank influence is conditional upon the strength of six different moderators: the level of business unity, the level of public issue salience, the nature of policy-makers' ideational outlook, the state of the transnational policy community, the nature of inter-state power relations, and the domestic institutional environment. In section 2.4, I introduce the cases of derivatives deregulation prior to 2008, and mandatory margin requirements for uncleared derivatives after the crisis. Section 3 describes the methodological approach of the study. Section 4 addresses the limitations of the thesis.

2. The theoretical framework

Figure 6 illustrates the theoretical framework of the study which will be developed in this chapter.

Figure 6: The theoretical framework



Source: Author

As shown in figure 6, by conceptualizing influence as a moderated variable, this thesis is interested in understanding how the degree of influence of dealer bank preferences over policy outcomes is shaped by a number of conditions.

2.1 Challenges associated with identifying interest group influence

Identifying 'influence' can be a challenging endeavour, given that the concept is a latent variable that cannot be observed directly. As Lowery emphasizes, 'interpreting, much less measuring political power or influence is difficult'.¹⁹⁰

Existing literature has highlighted several challenges. First, we should not derive the presence of 'influence' from 'post-hoc correlations'.¹⁹¹ Specifically, rather than automatically interpreting the (full) overlap of interest group preferences with the contours

¹⁹⁰ Lowery (2013:8)

¹⁹¹ Hacker/Pierson (2002:285)

of policy outcomes as evidence of ‘influence’, we should look for ‘causation’, which means finding evidence that a given policy outcome is the result of interest group activism.¹⁹² A second difficulty is related to the risk of being ‘tempted to take policy outcomes as proof of intentions and, from there, to impute the influence or control of the eventual beneficiaries.’¹⁹³ Essentially, this is the risk of conflating by-products of a policy outcome with policy-makers’ core intention, and inferring the presence of influence from the overlap of these by-products with interest groups’ preferences.

A third pitfall consists of overlooking the possibility that interest groups might actually exercise considerable influence ‘behind the veil’, by ensuring that only palatable proposals make it onto policy-maker’s agenda.¹⁹⁴ When exercising this form of influence, interest groups rely on what is commonly understood as the ‘second face of power’, which in the words of Bachrach and Baratz, who have popularized the term, is related to ‘the dynamics of *nondecision-making*’.¹⁹⁵ Lowery warns that in such cases, the researcher might systematically underestimate interest group influence, because ‘[t]here will be no actual decisions to observe’.¹⁹⁶ In many cases, the situation is less clear-cut, i.e. interest groups might not be able to completely keep an issue off the agenda, but they might succeed in having policy-makers put a less ‘harmful’ version of the originally planned proposal on it. Of course, interest groups might sometimes also be interested in the opposite, i.e. they might try to lobby policy-makers to make room for a particular issue on their busy agenda.¹⁹⁷

I differentiate between three levels of influence, ‘causal influence’, ‘congruence’ (in the sense of ‘happy coincidence’), and ‘loss’. Causal influence means that we can trace an outcome back to interest group activism which ‘successfully engender[ed] changes in regulatory policy content that cannot be attributed to other factors’.¹⁹⁸ Congruence, by contrast, indicates that interest groups were pleased with a regulatory outcome, but that it was not the result of their causal influence. As Büthe puts it, ‘[w]e should therefore not simply assume that the effects of private regulations explain why they were provided’.¹⁹⁹ Rather, we need to uncover the precise causes that led to the adoption of a particular policy. Congruence and loss both indicate a lack of influence, the main difference being that in case of a loss, the policy outcome clashes with interest groups’ preferences.

¹⁹² Hacker/Pierson (2002:285), for a very similar discussion, see Dür (2008b). Some studies acknowledge this challenge by labelling their dependent variable ‘success’, which allows for the possibility that ‘luck’, rather than ‘influence’ lead to a desired outcome. This applies particularly to quantitative large-N studies. Examples can be found in (Dür et al. (2015), Klüver (2013) McKay (2012), Young/Spagna (2017). The implicit assumption is usually that over a large sample, errors cancel each other out, which, of course, implies that the error is random, rather than systematic.

¹⁹³ Hacker/Pierson (2002:285)

¹⁹⁴ Lowery (2013:9)

¹⁹⁵ Bachrach/Baratz (1962: 952, emphasis in the original). There is also a ‘first’ face of power which is related to the more classical question of who wins and who loses in a given situation (see Dahl 1961).

¹⁹⁶ Lowery (2013:8)

¹⁹⁷ Baumgartner et al. (2009:214)

¹⁹⁸ Young (2012:671)

¹⁹⁹ Büthe (2010:6)

2.2 Preference articulation and mechanisms of influence

There are several ways through which interest groups can articulate their preferences and attempt to exercise influence. This study focuses on two key mechanisms: the provision of information (sometimes considered a form of ‘instrumental power’²⁰⁰) and the reliance on structural and structuring power. While the provision of information allows interest groups to articulate their preferences through words, the exercise of structural power involves articulation through (the threat of) action in terms of firms leveraging a credible threat to exit the jurisdiction through disinvestment. Structuring power can bridge both categories in terms of interest groups strategically providing information to policy-makers abroad so as to design their exit options from the domestic market. These mechanisms are not mutually exclusive. As we will see, the banks often used them in a complementary fashion, in particular prior to 2008.

2.2.1 The provision of information

The literature suggests that policy-makers acting in an environment marked by uncertainty often rely on interest group input in search of information about the perceived effectiveness and potential consequences of a given policy proposal. Resource constraints preventing them from generating the required information themselves often intensify this need, particularly if the policy to be decided on is technically complex.²⁰¹ In many cases, policy-makers are also legally obliged to organize consultations to provide an opportunity for democratic participation in public decision-making, which frequently also results in the submission of information.²⁰²

Hall and Deardorff conceive of interest groups as a ‘service bureau’ policy-makers can turn to for information in order to evaluate their policy proposals.²⁰³ The provision of information can therefore act as a channel of influence.²⁰⁴ Chalmers argues that ‘[t]echnical policy-relevant information is the currency of influence for global financial governance’.²⁰⁵ Information can be transmitted through written comments, through meetings, or other forms of exchange. It can be directed to legislators and/or regulators, both at the (supra-)national or transnational level.

²⁰⁰ See for example Fuchs (2005:774)

²⁰¹ Bernhagen et al. (2015), Austen-Smith (1993), Chalmers (2011), Bouwen (2004), James (2017), Bernhagen/Bräuninger (2005), Yackee (2005)

²⁰² The Administrative Procedure Act lays out the details for the US. Details for the EU can be found in the Treaty of Lisbon.

²⁰³ Hall/Deardorff (2006:72)

²⁰⁴ Klüver (2012:491f.)

²⁰⁵ Chalmers (2017:111f.), see also De Bruycker (2015:599f.).

Dür introduces important qualification by noting that influence through information provision might in fact be dependent on several conditions. One is interest groups' expertise on the issue in question. Another is policy-makers' dependence on the particular information, which itself can be conditional on the complexity of the issue, and the availability of alternative sources of information, either from other submissions or from in-house analysis. A third is the utility policy-makers associate with the submitted information in terms of promoting their overall goals of office-seeking and/or policy-seeking.²⁰⁶ Young, for example, emphasizes the possibility that policy-makers might value the provision of information, without necessarily acting upon it.²⁰⁷

'Information' and 'preferences' can overlap to a large extent, but they can be differentiated by conceiving of 'preferences' as statements as to how a certain policy should be designed, and of 'information' as articulated reasons supporting these statements. Of course, preferences can also be voiced without the submission of additional information.

Analysis will reveal that, while the industry's information was highly valued prior to the crisis, this was much less the case afterwards. Policy-makers tended to listen, but often challenged the utility of the submitted information and only rarely acted upon it.

2.2.2 The projection of structural and structuring power

Unlike the provision of information as a form of instrumental power, structural power tends to operate in a more subtle way.²⁰⁸ The core of the 'structural power' argument can be traced back to Lindblom's observation of governments' dependence on private businesses serving as a motor of economic growth through their control of resources deemed crucial for investment and production. This dependence allows firms to try exercise influence by threatening democratically elected policy-makers to 'exit' their jurisdiction through disinvestment, if they do not heed their preferences.²⁰⁹ Policy-makers have been known to adjust their proposals already in anticipation of the potential invocation of this threat by financial firms, which points to a particularly important dimension of structural power, i.e. its potential effectiveness without any explicit expression.²¹⁰

Since Lindblom's key publication on the topic in 1977, the concept has been frequently critiqued, extended, and refined.²¹¹ However, the overall focus on the exit threat has

²⁰⁶ Dür (2008a:1214)

²⁰⁷ See the discussion in Young (2012,2013a).

²⁰⁸ Hacker/Pierson (2002), Woll (2016), Culpepper/Reinke (2014), James/Quaglia (2018)

²⁰⁹ Lindblom (1977)

²¹⁰ Culpepper/Reinke (2014:429)

²¹¹ See for example Vogel (1989), Hacker/Pierson (2002), Culpepper/Reinke (2014), Bell/Hindmoor (2017), Bell (2012).

remained a constant element of this strand of research. This thesis adopts this perspective and conceives of structural power as dealer banks' power to exit. Banks are often considered particularly privileged in this regard.²¹² First they provide credit, which is widely perceived as the 'infrastructure of the infrastructure'.²¹³ Second, the mobile nature of their business affords them the 'ability to defy national regulators because of the internationalization of their markets'.²¹⁴ The OTC derivatives business is particularly mobile. In the words of LiPuma and Lee, 'OTC markets have no location and hence no address, contractual parties can be anywhere in the universe, and more specifically, the address of the computer site from which the trade was initiated may bear no relation to the location of the institution or agent initiating the trade'.²¹⁵

The credibility and thus effectiveness of the threat depends to a large extent on businesses' availability of an attractive market for relocation. Culpepper and Reinke's research on the forced recapitalization of banks at the height of the crisis provides some good illustration of this point.²¹⁶ The study shows that the US and UK governments both shared a preference for ensuring their respective interventions would be as profitable as possible for their own taxpayers. However, because of variations in the extent to which their banks relied on the domestic market as a principal depository base, the outcome of their interventions was uneven. The forced recapitalization of the American banks was relatively successful, because no bank had a significant alternative depository base outside the US. This resulted in highly diminished levels of structural power, which in turn enabled the US administration to include not only the struggling financial institutions in the programme, but also the healthier ones, and therefore to structure the capital infusions such that they yielded an overall profit for the American taxpayer. By contrast, the relatively healthiest bank in the UK at the time, HSBC, was not dependent on its home market to the same extent as its domestic competitors. Given important income from Asia, it could also sustain its losses in the US. This situation afforded it tremendous structural power and the ability to boycott the UK government's intervention. In the end, the only banks covered by the UK programme were the comparatively weak ones, and the overall outcome from the UK taxpayer's perspective was relatively disappointing.

Recent research has pointed to a more active role interest groups can adopt in designing exit options themselves. Farrell and Newman have coined the term 'structuring power' to denote 'the ways in which actors can shape exit options through cross-national action', which in turn can impact their 'bargaining power'.²¹⁷ For the purpose of this research, structuring power is understood as 'shaping the rules of other jurisdictions'.²¹⁸ This means that interest groups lobby policy-makers abroad to have foreign rules modified, such as to

²¹² See for example Bell/Hindmoor (2017:104f.).

²¹³ Cerny (1994)

²¹⁴ Culpepper/Reinke (2014:428)

²¹⁵ LiPuma/Lee (2004:94)

²¹⁶ Culpepper/Reinke (2014). The overall topic has also been analyzed by Woll (2016).

²¹⁷ Farrell/Newman (2015:529,532; emphases in the original)

²¹⁸ Farrell/Newman (2015:534; emphasis in the original)

ensure their compatibility with the rules under which they already operate in their domestic context. The aim is to facilitate the seamless relocation of their business, and thus to enhance the credibility of the exit threat.²¹⁹

Analysis will reveal that in the pre-crisis period, the US and the UK derivatives market acted as attractive relocation destinations for banks from the respective other side of the Atlantic. The industry effectively exercised both structural power and structuring power, particularly in the US. The dealers frequently prevented intrusive intervention by threatening to relocate the uncleared business to the City of London, where deregulation had already occurred in one sweeping move through the Big Bang in the 1980s. In addition, ISDA successfully lobbied many foreign governments to adjust their domestic legal framework in order to ensure the enforceability of key provisions of the Master Agreement. This form of structuring power then endowed the banks with additional structural power at home, as it enhanced the credibility of their exit threat.

Post-crisis, the dealer banks, specifically in the US which acted as the first mover on the regulatory scene, initially appeared optimistic about their ability to kill the margin proposal by relying on their structural power. However, this hope turned out premature. We will see that the banks still vehemently fought the rules, but that threats of exit were widely absent, given the strong public ideational consensus in favour of reining in the market that policy-makers had adopted on both sides of the Atlantic. Subsequently, the banks were so completely absorbed by the task of preventing public intrusion that they also did not exercise any substantial structuring power anymore.

Beyond the provision of information and the exercise of structural/structuring power, we could also think of other methods of articulation and mechanisms of influence which are not included in this study. One such mechanism would be financial donations. Lobby money facilitates access to sympathetic policy-makers.²²⁰ While campaign contributions are limited to elected policy-makers, they also have the potential to exercise an indirect effect on the decision-making of unelected regulators. Gordon and Hafner argue that contributions to legislators can be interpreted as a signal to regulators reflecting interest groups' willingness to 'flex their muscles' in terms of their 'intention to fight agency decisions through subsequent action in the political arena'.²²¹ However, this variable would be difficult to use for the present study. Most importantly, data for the EU has only recently been made available and does not cover the entire duration of the EMIR-related decision-making process, nor the pre-crisis period. This is not to say that campaign contributions were not relevant, particularly after 2008. Specifically, we will see that the banks made important expenditures with respect to the end-user treatment in the US. More generally, media

²¹⁹ Note that in Farrell and Newman's framework, the exercise of structuring power is not limited to interest groups. Public actors can equally rely on this strategy. The authors also suggest a second form of structuring power, i.e. the '*shaping of jurisdictional reach*' of domestic rules, such that they also apply extraterritorially (Farrell/Newman 2015:534; emphasis in the original).

²²⁰ McKay (2012:909)

²²¹ Gordon/Hafner (2005:245)

reports suggest that the financial sector in the US at certain times spent up to USD 1mn per day in its effort to try to shape Dodd-Frank.²²² However, given the lack of sufficient data, this variable remains outside the scope of this analysis, the only exception being the US end-user case study.

Another vector is the ‘revolving door’ through which many corporate and public officials shift between the private and public sector at different points in their careers, and which is often hypothesized to have a beneficial impact on interest group influence. I will address this factor further, when discussing the ‘state of the transnational policy community’ moderator. I will cover its relevance for the pre-crisis period, but it will not figure prominently for the post-crisis period, the reason being data limits regarding the identities of the public officials involved in the margin policy-making process, both at the private and public sector level. The most famous post-crisis example, which defies the often-purported positive effect of the revolving door on interest group influence, is CFTC chair Gary Gensler whose role will be discussed at great length in the end-user case.

2.3 Dealer bank influence as a moderated variable

Following the classical definition by Baron and Kenny, a moderator is a ‘variable that affects the direction and/or strength of the relation between an independent or predictor variable and a dependent or criterion variable’.²²³ It is important to note that such a variable can also act as a predictor. This means that the six conditions can also have a direct effect on the policy outcome.²²⁴ Given the dissertation’s primary focus on explaining dealer bank influence over policy outcomes, rather than explaining the policy outcomes themselves, figure 6 does not depict this relationship.

Drawing on the IPE literature, I identify six variables which I argue shape the strength of dealer bank influence over policy outcomes. These variables are: business unity, public issue salience, policy-makers’ ideational outlook, the state of the transnational community, inter-state power relations, and the domestic institutional environment. For each moderator, I differentiate between three effects, positive, negative, and neutral. I use the terms ‘moderator’ and ‘factor’ interchangeably, even though they denote different concepts in

²²² Connor (2010), see also Harper (2010). An even higher estimate of USD 1.4mn per day is reported in Scheiber (2010b).

²²³ Baron/Kenny (1986:1174)

²²⁴ Note that a ‘moderator’ differs from a ‘mediator’, even though in the social sciences it might at times be difficult to differentiate between the two. Baron and Kenny (1986:1176) explain that for a mediator to be present, the following conditions must apply: ‘(a) variations in levels of the independent variable significantly account for variations in the presumed mediator (i.e., Path *a*), (b) variations in the mediator significantly account for variations in the dependent variable (i.e., Path *b*), and (c) when Paths *a* and *b* are controlled, a previously significant relation between the independent and dependent variables [i.e., Path *a*] is no longer significant, with the strongest demonstration of mediation occurring when Path *c* is zero’.

classical statistical terminology.²²⁵ The following sections cover the expected *individual* effect of each moderator, as discussed in IPE theory.

2.3.1 Business unity

The first moderator of influence is the degree of business unity in the sector affected by a given regulation. It has an impact on the degree with which the interest groups targeted by a particular regulation can speak with one voice when submitting their preferences. Rooted within neo-pluralist approaches, this variable takes issue with an implicit assumption underlying the ‘structural power of business’ hypothesis, i.e. the assumption that business acts as a unitary actor. Questioning the ubiquitous validity of this assumption, these approaches draw attention to the distributive effects that many policies incur. The fact that interest groups often display ‘competing interests and values’ therefore moves to the centre of the analysis.²²⁶ A high degree of business unity allows interest groups to submit a clear message to policy-makers, which should foster influence. By contrast, low degrees of unity, which can manifest through ‘counter-active’ lobbying by dissenting groups, should dilute the message, and therefore reduce influence.²²⁷

James and Quaglia argue that ‘[w]here the effectiveness of business organization is limited by heterogeneous preferences and weak coordination, policy-makers have reason to doubt the veracity of [the key mobilizing actors]’.²²⁸ Along similar lines, Dür and De Bièvre emphasize that preference heterogeneity encourages policy-makers to stick to ‘their preferred policies’.²²⁹ By contrast, preference homogeneity has the potential to propel interest group influence.²³⁰ Preference homogeneity often goes hand in hand with the presence of alliances of groups sharing the same position on a given issue. Following Pagliari and Young, acting through coalitions can ‘leverage’ interest group influence in several respects. First, it allows interest groups to join forces with respect to both monetary and non-monetary resources, such as information, reputation, and expertise.²³¹ Second, different coalition members often enjoy access to policy-makers through different channels, which allows the coalition to launch multi-pronged campaigns in its attempts to exercise influence over a specific policy outcome.²³² Third, coalitions can function as a ‘signalling device’ in terms of displaying the extent to which an advocacy position enjoys wider approval and perceived legitimacy.²³³ Alliances need not necessarily always be organized in

²²⁵ The term ‘factor’ is also used by James/Quaglia (2018:1).

²²⁶ Cerny (2010:4), see also Falkner (2008:25).

²²⁷ See Nelson/Yackee (2012:339), Heaney (2004:258), Lavelle (2014:121), Austen-Smith/Wright (1994), Bernhagen (2007:124), Yackee (2009:213f., 2005:107), Morgan (2008:658)

²²⁸ James/Quaglia (2018:11)

²²⁹ Dür/De Bièvre (2007:6)

²³⁰ Pagliari/Young (2014)

²³¹ See also Nelson/Yackee (2012:340).

²³² Empirical evidence for this conjecture has been found by Beyers/Braun (2014) and Carpenter et al. (1998).

²³³ Pagliari/Young (2014:585f.)

the sense of 'formal' coalitions. Rather, consensus can also be displayed in form of groups lining up on the same 'side' of an issue, without explicit coordination or a common organizational framework.²³⁴

James and Quaglia's empirical research shows that one of the key reasons why the banks in the UK were not successful in preventing Brexit was preference heterogeneity within the banking sector itself. On the one hand, the big investment banks favoured Remain which would have allowed them continued access to the EU's common market. On the other hand, many small retail banks lobbied against the big banks, given their fear of being boycotted by their non-corporate clients many of whom had subscribed to the arguments of the Leave camp.²³⁵ Pagliari and Young have studied the importance of business conflict with respect to the development of Basel II. Their research suggests that preference heterogeneity between banks and insurance firms on the treatment of residential mortgages under Basel II eventually led the BCBS to strengthen the related requirements. In the area of derivatives regulation, Pagliari has analyzed preference heterogeneity regarding CCP membership and capital requirements for CCPs, as designed by the CFTC. In both cases, the CFTC 'took advantage of the policy space created by the conflict between different key stakeholders and decided not to deviate from their original proposal'.²³⁶

The analysis in this dissertation will reveal that prior to the crisis, the dealer banks enjoyed maximum business unity. Not only did ISDA act as spearhead for the industry, it effectively monopolized the entire advocacy arena, together with the banks. No other private sector groups mobilized on a regular basis. As a result, the message sent by the large banks was crystal clear, which strengthened their influence. ISDA also fostered unity through its management of the market's main contractual infrastructure in form of the Master Agreement, which serves as a boilerplate contract providing the backbone of the vast majority of all trades.²³⁷

After the crisis, however, the lobbying scene became more populated and diverse. The dealer banks maintained their pre-crisis unity, but they lost their exclusive position of speaking for the market. For the first time ever, the banks' clients (i.e. the buy-side and the end-users) raised their voice over the regulation of derivatives. Several authors have also noted the increased importance of NGOs in the post-crisis derivatives debate,²³⁸ but in the margin case they did not play a prominent role that changed the course of the policy process. By contrast, the buy-side actors made a decisive entry into the political arena. They agreed with the banks in disputing the need for regulatory intervention. Yet, beyond their opposition to intrusive rules, they turned out largely unable to reach wider consensus on how the new rules should actually be designed. The buy-side's associations, in particular, were often held back by the large extent of preference heterogeneity among their

²³⁴ Baumgartner et al. (2009), see also Bernhagen et al. (2015:572).

²³⁵ James/Quaglia (2018:8f.)

²³⁶ Pagliari/Young (2014a:592ff.), Pagliari (2018:158)

²³⁷ Spagna (2018:41)

²³⁸ See for example Clapp/Helleiner (2012), Helleiner/Thistlethwaite (2013).

members. Unlike deregulation, re-regulation has more immediate distributive effects. Individual buy-side firms often interpreted the cost-benefit effects of the new rules very differently, which complicated the development of common positions. An important exception was SIFMA, the Securities Industry Financial Markets Association. Technically, it represents not only the banks that are active in the securities markets, but also buy-side firms, such as insurance firms and asset managers. However, the association appears to have been dominated by the dealer banks which exercised commanding influence in the drafting of most of its submissions. The association's buy-side members often operated through SIFMA's Asset Management Group. Given their bad reputation after the crisis, many banks did not lobby by themselves, but preferred to act under the umbrella of ISDA or SIFMA. Overall, the lack of business unity between the industry and the buy-side stymied the potential for dealer banks influence.

By contrast, the importance of the emergence of the end-user community cannot be overestimated. To a large extent mobilized by the banks for their untarnished reputation and their credibility with policy-makers, non-financial firms became dealers' strongest allies in arguing for an end-user exemption from the rules. To the IPE literature, this phenomenon is not entirely new. As already mentioned, Pagliari and Young have discussed parts of the end-user case with respect to the clearing requirement.²³⁹ Other studies have shown that the banks relied on a similar mobilization strategy in order to soften other post-crisis rules including capital requirements, and the plans for a financial transaction tax in Europe.²⁴⁰ The end-user case represents the only case in which the dealers exercised influence, although their influence was indirect and stronger in the US (where end-users are entirely exempt), than in the EU (where a clearing threshold applies).

2.3.2 Public issue salience

Public issue salience refers to 'the relative importance or significance that an actor ascribes to a given issue on the political agenda. [...] It is a measure of the attention actors devote to the issue in question and of the issue's overall prominence in the minds of decision-makers'.²⁴¹ In the political arena, the desire of elected policy-makers to maintain their popularity and remain in office or to ensure a smooth transition for their successors will lead them to adopt policies reflecting the preferences of their electorate.²⁴² Regulators, in turn, are equally receptive to the public's preferences. According to Singer, they are highly receptive to elected policy-makers' preferences as they strive to maintain their autonomy and prevent intervention in their work,²⁴³ which means they also respond to public issue

²³⁹ Pagliari/Young (2014)

²⁴⁰ Pagliari/Young (2014), Keller (2016), Kastner (2017)

²⁴¹ Oppermann/de Vries (2011:3), see also Kollman (1998:9), Soroka (2003:29f.), Wlezién (2005:556ff.).

²⁴² Soroka/Wlezién (2005), Knecht/Weatherford (2006), Oppermann/Viehrig (2009), Pagliari (2013b:94), Wlezién (2004), Woll (2013:559)

²⁴³ Singer (2007:115)

salience. In case of high issue salience, they will take measures reflecting those preferences, in order to let legislators know that ‘the issue has been “taken care of”’.²⁴⁴ Regulators’ main concern in this context is to avoid political interference in their activities, which might result in increased oversight or budget cuts.²⁴⁵ Culpepper has coined the term ‘quiet politics’ to characterize situations of low public issue salience, which he argues provides a fertile environment for interest group influence to take hold. In these situations, ‘managerial groups, which both understand the issues and care about them a great deal, [...] wield disproportionate political influence’.²⁴⁶ If public issue salience is low, voters pay little attention, which means that policy-makers are likely to be more receptive to the narrow preferences of special interest groups.²⁴⁷ By contrast, Culpepper emphasizes that ‘business power goes down as political salience goes up’.²⁴⁸ If public issue salience is high, politics becomes ‘noisy’ and the voters’ preferences will supersede those voiced by private interest groups.²⁴⁹ The distinction between policy-makers and regulators is tricky with regard to the EU, where the EU Commission is a member of WGMR (BCBS-IOSCO’s Working Group on Margin Requirements), but was also closely involved in the legislative discussions.

Pagliari has shown that ‘low salience’ was the ‘default state’²⁵⁰ under which financial regulation in general, and derivatives regulation in particular took place prior to 2008. Three mutually related factors anchored this default state. First, the high level of complexity of the subject matter meant that financial regulation was widely considered ‘esoteric’,²⁵¹ best left to the judgement of experts. Porter, for example, has noted that ‘there is very little that would not require a significant degree of background technical knowledge to understand. [...] The technical character of the [regulatory] institutions’ work is the key factor explaining the lack of political bargaining’.²⁵² Along similar lines, Kapstein has argued that ‘one of the great ‘successes’ of financial supervisors over the past thirty years [since the foundation of the BCBS] has been to depoliticize the systemic risk environment and to transform crisis management into a technocratic exercise [...]’.²⁵³

Second, the complex subject matter caused significant information asymmetries between financial institutions and other societal stakeholders, which made it difficult for anybody but the dealer banks to effectively mobilize.²⁵⁴ High technical complexity also increased policy-makers’ dependence on outside information to form a judgement on what policies to adopt

²⁴⁴ Pagliari (2013b:106)

²⁴⁵ Pagliari (2013b:95 following Gormley (1986)), see also Singer (2007).

²⁴⁶ Culpepper (2011:8)

²⁴⁷ Woll (2013)

²⁴⁸ Culpepper (2011:177)

²⁴⁹ Culpepper (2011:xvi, 145ff.)

²⁵⁰ Pagliari (2013b:101)

²⁵¹ Moran (1984:5); Moran originally used the term in relation to the UK monetary and financial system of the early 1970s.

²⁵² Porter (2003:536)

²⁵³ Kapstein quoted in Goodhart (2009).

²⁵⁴ Olson (1965)

and how to design them.²⁵⁵ This leads to a third factor, which was policy-makers' focus on the issues that voters care about in order to secure re-election.²⁵⁶ With the exception of unemployment, inflation, tax, and questions concerning homeownership (in US policy-making), monetary and financial policy debates were usually of subordinate importance to the average voter.²⁵⁷ Prior to 2008, policy-makers, therefore, had few incentives to educate themselves on derivatives.²⁵⁸ They often also feared revealing their lack of understanding vis-à-vis the bankers whom they often revered for their wealth and reputation.²⁵⁹ Low issue salience thus opened the door for dealer bank preferences to prevail before 2008.

It is important to highlight that in the pre-crisis period, there were several derivatives-related scandals that put the spotlight on derivatives. The effect, however, was short-lived, probably because the tangible effects on the lives of the vast majority of voters remained limited. After a short period of heated debate, Down's 'issue attention cycle'²⁶⁰ set in, causing most policy-makers and the wider public to quickly lose interest in the issue.²⁶¹ Several individuals from both the public and private sector kept warning of a looming crisis, but their comments failed to raise issue salience to a level where policy-makers would have felt compelled to intervene in the market, a move which would have also been in conflict with the ideational consensus at the time.

The severity of the global financial crisis, however, turned derivatives regulation into a 'high salience' issue. Large-scale bailouts and other financial rescue packages financed with taxpayers' money, as well as the widespread recession and unemployment directly affecting people's daily lives, put immense pressure on policy-makers to become directly involved in financial regulation.²⁶² The relevance of high salience after 2008 has been illustrated by several recent studies. Woll has described the effect of high issue salience on hedge fund regulation, as has Pagliari, who, in addition to hedge funds, has also examined post-crisis regulation of CRAs and derivatives regulation.²⁶³ Helleiner has shown how the politicization of commodity price volatility at the height of the crisis encouraged policy-makers to mandate the imposition of position limits for commodity derivatives.²⁶⁴ Regarding the uncleared market, the *Financial Times* noted that after the crisis, "credit derivatives" almost became a household phrase'.²⁶⁵

²⁵⁵ Pagliari (2013b:110f.)

²⁵⁶ Wlezien (1995, 2005)

²⁵⁷ Pagliari (2013b: 97), Lavelle (2013:106)

²⁵⁸ Culpepper (2011:145)

²⁵⁹ Lavelle (2013:106)

²⁶⁰ Downs (1972)

²⁶¹ An exception unrelated to OTC derivatives is the US Congress' support for the establishment of Basel I, given public pressure in favour of stricter financial regulation following the tax-payer funded bailout of several banks that had incurred severe losses during the Latin American debt crisis (see Oatley/Nabors 1998).

²⁶² Pagliari (2013b)

²⁶³ Woll (2013), Pagliari (2013b)

²⁶⁴ Helleiner (2018)

²⁶⁵ van Duyn (2008)

While ‘credit derivatives’ indeed became a negatively connoted catchword, most voters did not suddenly become experts in the field, nor did most policy-makers. However, in line with Wlezien’s idea of policy-makers engaging in a ‘thermostatic analysis of public opinion’,²⁶⁶ they quickly and accurately sensed the need for more public intervention and expressed it accordingly. The analysis in this dissertation will reveal that banks’ previously impeccable reputation became ‘radioactive’.²⁶⁷ In the words of the *Financial Times*’ Gillian Tett, ‘the word “ISDA” has become distinctly toxic in Washington and Brussels’ political circles’.²⁶⁸

Following the disastrous consequences of the crisis, public issue salience skyrocketed, which greatly limited the banks’ ability to influence the design of post-crisis rule making. Political analyst Robert Kaiser notes that ‘[b]ankers were among the most unpopular people in the society’ and ‘lost most of their political influence as a result of the crash’.²⁶⁹ In this heated climate, most banks avoided publicly lobbying legislators, hoping instead that the regulators who tend to be several steps removed from the public limelight would be more receptive to their demands, which, however, they were usually not.

Beyond pressure exercised by the electorate, we can identify two additional sources of public issue salience. Indeed, while public attention by voters can keep corporate influence at bay, business groups are not always completely helpless at this stage. Rather, they can try to manipulate the level of public issue salience themselves, meaning that salience can be (or become) an endogenous feature of the policy-making process itself.²⁷⁰ If well crafted, this strategy can help them to be part of the game again, even if only in an indirect, though not necessarily less effective fashion. Keller argues that interest groups can enhance their chances of influence by adopting ‘a framing strategy that resonates positively with the broader public’ on the basis of ‘claims of why a certain policy is desirable, unfair or why a certain claim is legitimate’.²⁷¹ Manipulating public issue salience can thus help the dealers to increase their influence. In the margin case, the banks could not directly implement this strategy themselves, given their tarnished reputation. However, they mobilized the end-users to take over this part. The non-financial firms beat the drum for an exemption by claiming that subjecting them to margin requirements would equal punishing the victims of the crisis, and that the financial cost of being obliged to post collateral would hurt the wider economy (‘one dollar of margin is one dollar less to invest’).²⁷² This support by the end-users community in terms of creating what we could call ‘friendly’ issue salience was of quintessential importance for the banks, and it is the only case in which they were able to

²⁶⁶ Wlezien (1995)

²⁶⁷ Enrich (2011)

²⁶⁸ Tett (2010)

²⁶⁹ Kaiser (2013:162f.,376)

²⁷⁰ Dür (2008a:1218), Dür/De Bièvre (2007a:7), Dür/Mateo (2014)

²⁷¹ Both quotes taken from Keller (2016:6), see also Kastner (2017).

²⁷² In a broader sense, one could consider these threats as an example of the exercise of structural power. However, this thesis limits the concept to the power of exit.

successfully exercise influence.²⁷³ Further, as we will see, policy-makers can also raise public issue salience themselves, by launching a public awareness campaign. This was the case of CFTC chair Gary Gensler who increased the prominence of the end-user question in the US. Forcefully arguing for a tight regulatory framework, he turned the issue into one of the most contested aspects of Dodd-Frank.

Overall, prior to 2008, low public issue salience helped propel dealer banks' influence, whereas after the crisis high public issue salience kept it at bay, with the exception of the end-user case, where creating, countering and dominating public issue salience was key for the end-users to succeed in securing a full carve-out in the US and wide-reaching privileges in the EU.

2.3.3 Policy-makers' ideational outlook

Policy-makers' ideational outlook is a relevant condition in that shared ideas and causal beliefs inform their interpretations of and interactions with their political, social, and economic environment.²⁷⁴ Compatibility between interest group preferences and policy-makers' ideational outlook provides a fertile environment for influence to take hold. However, if there is a clash between those two outlooks, the chance of influence decreases. In line with Weber who compared the role of ideas to 'switchmen' deciding which 'tracks' courses of action should follow,²⁷⁵ Goldstein and Keohane argue that 'ideas influence policy when the principled or causal beliefs they embody provide road maps that increase actors' clarity about goals or end means relationships [...]'.²⁷⁶ Kirshner goes one step further by insisting that 'the power of ideas does more than just shape the possible. It defines the feasible'.²⁷⁷

For the purpose of this study, the focus rests on policy-makers' perspectives on the ways in which they believe financial markets operate and the implications this has for their stance on (de-)regulation. These perspectives frame policy-makers' interpretation of interest groups' preferences and the weight that should be attributed to them, which in turn has an impact on the extent to which their influence can take hold.²⁷⁸ While the thesis touches on the question of how policy-makers acquire new ideas,²⁷⁹ it is primarily interested in

²⁷³ A similar term has been used by Thesen et al. (2017) who study the different electoral effects of 'issue-friendly' media agendas for government versus opposition parties.

²⁷⁴ Wendt (1999), Blyth (2002), Abdelal et al. (2010a), Widmaier et al. (2007). A discussion of recent developments in constructivism can be found in Bertucci et al. (2018).

²⁷⁵ Weber (1958:280)

²⁷⁶ Goldstein/Keohane (1993:3)

²⁷⁷ Kirshner (2003:12)

²⁷⁸ See Baker (2013:36f.)

²⁷⁹ For a discussion of a number of theoretical approaches analyzing this process, see for example Abdelal et al. (2010c).

understanding how a given policy-makers' ideational outlook promotes or constrains interest group influence.

Prior to 2008, the 'deregulation consensus' provided ample leverage for the banks to exercise influence, as it was preconditioned on the idea of 'laissez-faire' in terms of policy-makers delegating decision-making authority to the banks themselves. The banks were thought to be sophisticated entities knowing best what was good for them and for the economy. Self-regulation by the industry was therefore considered sufficient to address any potential problems arising in the market. This intellectual climate widely opened the door for the dealers' preferences to prevail.

To a large extent, the banks' influence was derived from the widespread confidence in efficient and self-regulating markets. In the words of Simon Johnson, the 'financial industry gained political power by amassing a kind of cultural capital – a belief system'.²⁸⁰ The basis of this belief system was derived from a series of assumptions including the idea that the future represents the 'statistical shadow of [the] past', as suggested by Samuelson's 'ergodic axiom',²⁸¹ that markets are characterized by perfect information, as postulated in the classical general equilibrium model,²⁸² that investors always take rational decisions, as implied by the ideal of the 'homo oeconomicus', and that decision-making takes place in a world of calculable risk, rather than unpredictable uncertainty.²⁸³ The conclusion of Eugene Fama (widely considered the 'father of modern finance'²⁸⁴) in a 1970 article that 'the efficient markets model stands up well' soon became accepted as sacrosanct, even though it came with several reservations.²⁸⁵ As a consequence of this intellectual outlook, public intervention was widely considered unnecessary, if not even harmful to the exercise of market discipline.

Competitive deregulation in terms of a race towards being the jurisdiction that best implemented this ideational consensus therefore became policy-makers' guideline. In a similar way to which Helleiner has described financial liberalization towards the end of the Bretton Woods period, states followed the old "'mercantilist" strategy to maximize [their] own benefits from the open system at other states' expense'.²⁸⁶ Looking back after the

²⁸⁰ Johnson (2009)

²⁸¹ See Davidson (2010:252)

²⁸² See Arrow/Debreu (1954)

²⁸³ Nelson/Katzenstein (2014)

²⁸⁴ See Prof. Fama's website: <https://www.chicagobooth.edu/faculty/directory/f/eugene-f-fama> , accessed 1 December 2017.

²⁸⁵ Fama (1970:383). Fama actually differentiated between three versions of the 'efficient market hypothesis', a weak, a semi-strong, and a strong one. His empirical evidence showed support for the first two forms. Regarding the third form, he cautioned that insider trading could have a harmful effect on market efficiency and that exchange traders might dispose of better information than average investors. Beyond these groups, he found no evidence for any actor being able to outperform the market. Fama also called for the development of 'models of market equilibrium under uncertainty' (p. 416). However, the nuances of his conclusions were often ignored.

²⁸⁶ Helleiner (1994:196f.); Helleiner builds on reference of 'mercantilism' as understood by John Plender.

crisis, the SEC's chair, Mary Schapiro admitted that 'everybody a few years ago got caught up in the idea that the markets are self-correcting and self-disciplined, and that the people in Wall Street will do a better job protecting the financial system than regulators would'.²⁸⁷ In sum, the deregulation consensus propelled the banks' influence prior to 2008.

Post-crisis, however, policy-makers adopted a new ideational outlook. In line with the constructivist assumption that crises can challenge existing ideational outlooks,²⁸⁸ policy-makers began advocating the return of a more visible hand and an emphasis on 'market-shaping', rather than 'market-making'.²⁸⁹ Foot and Walter emphasize that 'the rising prominence of the third norm of self-regulation suffered a serious setback in US regulatory and political circles as it did elsewhere'.²⁹⁰ Along similar lines, Pagliari and Young argue that '[t]his shift in the ideational landscape has [...] reduced the capacity of financial firms to rely on claims regarding the superiority of market-based solutions in order to oppose more stringent forms of regulation'.²⁹¹

Specifically, policy-makers on both sides of the Atlantic started believing that public intervention was required, that the uncleared business needed to transition to CCPs as much as possible, and that those trades that remained in the bilateral marketplace needed to be margined. This new ideational consensus was at odds with what the industry believed, i.e. that market-based solutions remained the best solution to the crisis. Policy-makers' new ideational consensus clashed with the banks' preferences, which largely reduced their influence over the new rules. At the same time, however, it is not entirely clear to what extent policy-makers' new ideational outlook was in fact the result of an 'ideational' change, rather than a response to increased public issue salience.²⁹² Indeed, we will see that the initial public response to the crisis did not represent a clear break with the market-based paradigm, as policy-makers first delegated the immediate post-crisis response to the industry itself, and only began tightening the reins once this approach turned out insufficient in light of growing public pressure for more intervention. Constructivist scholarship is aware of the problem of isolating the specific factors that cause change, given that 'new ideas interact with existing institutional settings'.²⁹³

Once policy-makers' realized that self-regulation was inadequate, they embraced the idea of public intervention informed by a strong consensus in favour of the central clearing of uncleared derivatives. While they initially believed that the vast majority of uncleared trades would move to CCPs, it soon turned out that a significant portion of deals were insufficiently standardized for CCPs, meaning they would remain in the riskier bilateral space. These trades therefore required a separate regulatory treatment. Mandatory margin

²⁸⁷ Schapiro quoted in Wyatt (2010)

²⁸⁸ Widmaier (2004:437), Blyth (2002:chapter 2), Baker (2013), Abdelal et al. (2010b:232)

²⁸⁹ E.g. Quaglia (2011), Helleiner/Pagliari (2010:89)

²⁹⁰ Foot/Walter (2010:245)

²⁹¹ Pagliari/Young (2013:128)

²⁹² See for example Pagliari (2013b:86ff.), Helleiner/Pagliari (2010:87), more generally Mügge (2014b:319).

²⁹³ Baker (2013:36)

requirements became the solution of choice, as their imposition allowed transferring one of the key characteristics of central clearing (i.e. compulsory collateralization) to the bilateral market. Policy-makers associated two key benefits with the imposition of margin requirements. First, the new rules would account for the higher degree of systemic risk emanating from uncleared, as compared to cleared trades. Second, they would incentivize the transition to CCPs, thereby ensuring that the uncleared marketplace would only be used for trades unsuitable for central clearing.

While the thesis does not explore the clearing rules themselves, it emphasizes that the ideational consensus on clearing and margining needs to be studied in conjunction, as the margin rules represent a derivative of the clearing mandate. Analysis will reveal that the industry supported the clearing consensus, as long as the use of CCPs was not mandatory. However, it largely rejected the margin consensus. With the banks' preferences and policy-makers ideational outlook no longer coinciding, as had been the case prior to 2008, the banks lost much of their influence.

The last paragraph might lead some readers to believe that policy-makers' decisions were guided more by functionalism (and public issue salience), rather than any ideational inspiration. While we should not exclude the presence of any functional logic, it is important to note that clearing and margining are, in fact, part of a broader ideational shift from microprudential to macroprudential regulation. Macroprudentialism is a multi-faceted concept which privileges a top-down regulatory approach focusing on the stability of the financial system as a whole, rather than just the health of individual institutions (as had been the case prior to the crisis). The networked character of financial markets and the systemic components of risk are some of the key concerns guiding policy-makers in the development of new rules.²⁹⁴ Macroprudentialism differentiates itself from the efficient market hypothesis in at least four respects:²⁹⁵ First, it places the analytical focus on the 'fallacy of composition', meaning that the safety of the financial system cannot be simply deduced from the safety of its component parts. Second, it takes account of 'endogeneity', meaning that crises are not simply considered the result of an 'exogenous' shock'. Third it is informed by the notion of 'procyclicality', meaning that market actors' behaviour reinforces the business cycle, given that they tend to underestimate financial risk during times of boom, while they overestimate it when the economy cools down. Fourth, it encourages awareness of 'complexity', meaning that financial risk operates at a cross-sector basis.

Specifically, as Stefan Ingves, governor of central bank of Sweden (Sveriges Riksbank) and chairman of the BCBS noted in 2013, the margin rules 'can also have broader macroprudential benefits, by reducing the financial system's vulnerability to potentially destabilising procyclicality and limiting the build-up of uncollateralised exposures within the

²⁹⁴ For more details see Borio (2009a,2009b,2011), Baker (2013), more generally Persaud (2009,2010), Haldane/May (2011).

²⁹⁵ See Baker (2018:301ff.).

financial system'.²⁹⁶ Policy-makers viewed margin requirements as a macroprudential tool allowing them to account for the higher systemic risk emanating from uncleared trades, and to promote central clearing, which limits interconnectedness. I will refer to this consensus as the 'margining/clearing consensus'.

Overall, while the pre-crisis ideational consensus provided leverage for bank influence, the new ideational outlook obstructed their influence after 2008.

2.3.4 The state of the transnational policy community

The literature has employed the term 'policy community' in different contexts, but a commonality across all approaches has been the focus on 'the key features of interdependent actors from public and private sectors forming a group with clearly-defined boundaries'.²⁹⁷ The term 'transnational policy community' has been coined by Tsingou to denote the close ties between policy-makers and banks that characterized public-private collaboration in banking regulation during most of the pre-crisis period.²⁹⁸

The origins of the transnational policy community can be traced back to the 1960s when public officials began to form a transnational regime under the umbrella of the BIS, first to monitor the expansion of the Euromarkets (which were frequently affected by high degrees of volatility) and subsequently also to overcome collective action problems over the regulation of financial markets. The policy community has since interacted through various settings, such as the BCBS, and consulted with interest groups on the best course of action.²⁹⁹ Over time, numerous other bodies and groups have been established, and they have often closely interacted with private financial sector officials.

The interactions among the members of the transnational community are similar to those characterizing 'epistemic communities' which can be understood as 'network[s] of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area'.³⁰⁰ Their members are united by several key elements, including 'a shared set of normative and principled beliefs', 'shared causal beliefs', 'shared notions of validity', and 'a common policy enterprise'.³⁰¹ In addition, they often share a common elite professional background, which informs their credibility vis-à-vis each other, as well as vis-à-vis those policy-makers that

²⁹⁶ Ingves (2013:25), see also Haldane (2011:2). The connection between MPR and derivatives reform was drawn more loosely in the US.

²⁹⁷ Thatcher (1998:391)

²⁹⁸ Tsingou (2010:22f, 2006, 2015)

²⁹⁹ Porter (2011:178), Helleiner (1994:198)

³⁰⁰ Haas (1992:3)

³⁰¹ *ibid.*

remain outside of the community.³⁰² This close collaboration, of course, also helps to anchor the dominating 'ideational outlook'.³⁰³ In such an environment, policy-making does not rely on threats and open pressure. Rather, it tends to be informed by learning, persuasion, and an emphasis on 'best practices'.³⁰⁴ According to Djelic and Quack, 'the additional value of the community dimension for understanding transnational governance arrangements lies in their potential to align the cognitive and normative orientations of their members over time'.³⁰⁵ In a similar way, Young argues that within the transnational policy community, '[p]rivate sector norms and preferences [...] make their way into financial regulatory policymaking through a slow-moving and diffuse social process'.³⁰⁶

Newman and Posner equally highlight the consensus-fostering attributes associated with policy-making at the transnational level, arguing that '[s]oft law proposals, by providing new policy ideas, force the engagement of competing regulatory factions'.³⁰⁷ They continue elaborating that 'transnational policy proposals become political facts that undermine a blocking faction's defense of the status quo [...]'.³⁰⁸ As an additional element they emphasize the legitimacy-enhancing effects of soft law at the domestic level in terms of providing a justification for regulators' alignment of national standards with international frameworks.³⁰⁹

If interest groups form an integral part of the transnational policy community, their chances of exercising influence are higher than if they are relegated to the margin, or not represented at all. The relevance of being part of such a community has been confirmed by Bernhagen et al. who conclude from a statistical analysis that interest groups that provide information while being part of a policy community tend to be more successful in shaping policy outcomes than those groups that only submit information, but are not well-integrated.³¹⁰ By contrast, they show that 'the ability to offer relevant information may be ineffective, if a group faces hostile political decision-makers'.³¹¹ More generally, the literature has found that interest groups prefer lobbying 'friendly' policy-makers who support their cause, rather than 'foes' who tend to view it more critically.³¹² As Chalmers argues, '[t]he goal of lobbying is, on balance, not to change the minds of those who do not agree with you, but rather to subsidize the work of those who already do'.³¹³

³⁰² Chwiero (2007, 2015), Levine (2012)

³⁰³ See Fioretos (2016:73)

³⁰⁴ Helleiner/Porter (2009:15), Slaughter (2004:51ff.)

³⁰⁵ Djelic/Quack (2010:397)

³⁰⁶ Young (2014a:315)

³⁰⁷ Newman/Posner (2018:29)

³⁰⁸ *ibid.*

³⁰⁹ Newman/Posner (2018:24ff.)

³¹⁰ Bernhagen et al. (2015)

³¹¹ Bernhagen et al. (2015:571)

³¹² E.g. Marshall (2010), Hall/Deardorff (2006)

³¹³ Chalmers (2011:474)

We will see that prior to the crisis, the banks enjoyed a privileged, central position within the transnational policy community, which facilitated their exercise of influence. One key reason was again related to the high complexity of derivative products, which already tended to keep issue salience low. As a consequence, the transnational policy community was largely undisturbed from the haggling of messy day-to-day policy-making in other areas.³¹⁴ Helleiner and Porter emphasize that the ‘elite, and highly technical character of regulatory networks provide[d] privileged access points for business’,³¹⁵ particularly for financial industry representatives who often ‘share[] a common background, expertise, and worldview’³¹⁶ as the regulators. Along similar lines, Lall argues that it is the ‘issue-specific characteristics of global finance – in particular, its highly technical and complex nature’ that bestow on the large banks a privileged position within the ‘technical elite network’.³¹⁷ The close-knit transnational community became even more interwoven by the embrace of the deregulatory ideational consensus, as well as the regular use of the revolving door connecting private and public office.³¹⁸ The result was a form of ‘elite interlacement’³¹⁹ where ‘the public/private demarcation [became] obsolete’.³²⁰

Within the confines of the transnational policy community, policy-makers formed a *transgovernmental* community, but prior to the crisis, the borders between those two communities blended seamlessly. Except for occasional interference by the CFTC, regulators and dealer banks were in full agreement over the deregulation consensus. Representing a nexus of its own, the transnational policy community thus developed into an elite ‘club’,³²¹ largely impenetrable to any ‘outside’ member, even for those from the broader financial sector itself.³²²

After the crisis, however, the ‘demarcation line’ between the public and private members of the transnational community came into sharp relief. Tsingou shows that in banking regulation, the transnational ‘policy community is under stress but not broken’.³²³ Change has occurred, but it has remained limited. Indeed, she identifies a remarkable degree of ‘resilience’, in the sense that, despite all reform efforts and some sharp rhetoric employed by regulators, ‘the special role of the financial sector is, if anything reinforced’ and the expertise of its representatives ‘ha[s] not been fully discredited’.³²⁴

³¹⁴ Claessens et al. (2008:319)

³¹⁵ Helleiner/Porter (2009:20)

³¹⁶ Helleiner et al. (2018:15), see also Claessens et al. (2008:314).

³¹⁷ Lall (2015:126)

³¹⁸ On the revolving door, see for example Braun/Raddatz (2009), Igan/Mishra (2011), Blanes-i-Vidal et al. (2012), Blau et al. (2013), Cornaggia et al. (2016), Young/Spagna (2017).

³¹⁹ The term is taken from Brösamle (2013:223).

³²⁰ Tsingou (2010:23), see also Lavelle (2013:130).

³²¹ Tsingou (2015)

³²² Lall (2009, 2015)

³²³ Tsingou (2010:22, 2015:245)

³²⁴ Both quotes taken from Tsingou (2010:22).

We will see that in the margin case, the transnational policy community was more than just 'under stress'. The analysis will reveal that it was in fact severely shaken. The dealer banks were still part of the community, but they were pushed to its margin. By contrast, it was the transgovernmental community that now dominated. United by the new ideational consensus, and subsequently institutionalized in form of WGMR, the transgovernmental community retained most, if not all the constituting elements that had marked the overarching transnational policy community including the exchange of ideas, learning and persuasion, which greatly facilitated the development of the margin rules.

The post-crisis literature has confirmed the relevance of well-functioning transnational regulatory networks for the emergence of the new regulatory regime. Helleiner et al., for example, argue that '[t]he speed with which the G20 agenda was developed can be attributed at least in part to the density of transgovernmental networks of financial officials with expertise in this area'.³²⁵ In another publication, Helleiner has noted that '[b]oth consensus formation and the development of specific new international regulatory standards for OTC derivatives were greatly facilitated by the density of transgovernmental networks among technocratic officials'.³²⁶

During the development of the margin rules, regulators took notice of the dealer banks' advice, but followed it only in rare cases. Moreover, the tone of their conversations with the banks became significantly more adversarial than before 2008. This was probably also related to changes to two other factors that previously had indirectly nourished the community, i.e. the emergence of a new ideational consensus, which the banks for the most part did not share, and the high degree of public issue salience, which massively reduced the previously "'Olympian" distance'³²⁷ from ordinary day-to-day policy-making in national arenas. As a consequence, the banks lost their privileged position within the community, which led to a significant decrease of their influence over the new rules.

More generally, this assessment does not only apply to post-crisis derivatives regulation, but financial market governance more broadly. For example, in 2011, Robert Jenkins of the Bank of England's Financial Policy Committee publicly condemned the bank's attempts at weakening post-crisis financial reform as 'intellectually dishonest and potentially damaging', and threatened that further recalcitrance on their part might only strengthen regulators' resolution to rein in the market. 'A profession which should stand for integrity and prudence', he added, 'now supports a lobbying strategy that exploits misunderstanding and fear'. He recommended that rather than complain about the cost of post-crisis reform, the banks should reduce risk and lower cost by cutting bonuses.³²⁸

³²⁵ Helleiner et al. (2018:16)

³²⁶ Helleiner (2014a:137), see also Helleiner (2011a:148).

³²⁷ Claessens et al. (2008:319)

³²⁸ Jenkins quoted in Masters/Goff (2011).

Helleiner has equally noted that ‘the relationship between top regulators and the dealer banks has been less cosy and more confrontational than before the crisis’.³²⁹ Qualitative case study evidence collected by Young regarding the reform of capital requirements for banks also points in this direction. He references interview evidence characterising the post-crisis relationship between the banks and regulators, the content of which could be drawn directly from the margin case. For instance, his interviewees report that ‘there was a significant drop in communication between financial industry associations and regulatory bodies at both the national and transnational levels. [...] groups had to ‘muscle in’ to meetings’ and that overall, ‘engagements with regulators ‘stiffened’ considerably.’³³⁰ Moreover, banks tended to learn about new proposals or changes to existing ones ‘at a much later stage than they had in the past’.³³¹ He also notes that the information commenters often submit in response to consultations had previously been eagerly awaited by the regulators, even though they did not always act upon it in the way the banks hoped for, but that ‘this kind of equilibrium has changed’. In contrast to pre-crisis discussions, regulators often responded ‘with disinterest and scorn’.³³² The relevance of these statements becomes even clearer when linked to his other results including the fact that private financial interest groups have been largely unable to influence the content of a variety of transnational policies under Basel III.³³³

Overall, prior to 2008, interest groups’ privileged status as respected members of the transnational policy community allowed them to exercise significant influence. After the crisis, however, they lost their central position, which went hand-in-hand with a loss of influence. At the same time, a tight-knit transgovernmental community emerged whose actions often diametrically contradicted the banks’ preferences.

2.3.5 The nature of inter-state power relations

The effect of the nature of inter-state power relations depends less on which kind(s) of power are exercised than whether its exercise leads to results whose contours are aligned with the banks’ preferences.

While governance through the transnational/transgovernmental policy community emphasizes the importance of the exchange of ideas and information, the embrace of ‘best practices’, and an emphasis on persuasion, this does not mean that ‘power’ is entirely absent. Kahler and Lake observe that while networks are characterized by ‘the absence of a

³²⁹ Helleiner (2014a:138)

³³⁰ Young (2013b:463f.)

³³¹ Young (2013b:463)

³³² Young (2013b:466, referring to Young (2012))

³³³ See Young (2014b).

third-party arbiter for dispute resolution’, they can also contain ‘elements of hierarchy’.³³⁴ Inter-state power therefore matters, particularly when there is a lack of (ideational) consensus among the transgovernmental policy community. Interest groups cannot directly affect inter-state power relations. However, as Newman and Posner have argued, studying this variable is particularly important in order to avoid confusing ‘congruence’ with ‘influence’, which might apply in cases where policy outcomes are the result of policy-makers being driven by power-related considerations, rather than by interest group pressure.³³⁵

At the most basic level, power can be considered ‘the production, in and through social relations, of effects on actors that shape their capacity to control their fate’.³³⁶ It is a multi-faceted concept that manifests in numerous forms and can therefore also be parameterized in different ways. While the different forms of power often overlap in the empirical world, which can make it difficult to isolate them from each other, they represent analytically distinctive concepts. This study focuses on three different kinds of inter-state power, ‘power through market size’, ‘power as regulatory capacity’, and ‘power as structural power’.

Post-crisis derivatives research has often focused on a fourth variation of power, i.e. power through the extraterritorial application of domestic law. This form of power played an important role in much of post-crisis derivatives regulation, given that Dodd-Frank and EMIR (the European Market Infrastructure Regulation) granted the CFTC and ESMA (the European Securities and Markets Authority) significant extraterritorial authority to pursue the cross-border extension of the domestic framework, the objective being to prevent a race to the bottom.³³⁷ Several studies have examined the extraterritorial application of domestic rules regarding clearing, trade reporting, and trade venues.³³⁸ In the margin case, however, the cross-border aspect of the rules was discussed separately from the cases explored in this study, and extraterritorial aspects appear not to have had any significant impact on the policy-process. The analysis of the case studies themselves will therefore not cover this variation of power. The implications of its lack of relevance, however, will be discussed in the conclusion.

Power through market size

The exercise of ‘power through market size’ is related to the assumption that policy-makers’ influence over regulatory outcomes is a function of the relative size of their domestic market for a given product or service.³³⁹ A policy-maker overseeing a relatively larger market than his foreign colleague can threaten to prevent market access to foreign

³³⁴ Kahler/Lake (2009:268,271). In network analysis, the power of the various members is usually inferred from their position and connections to other members of the network (Kahler 2009:20f.).

³³⁵ See Newman/Posner (2016:124)

³³⁶ Barnett/Duvall (2005:45)

³³⁷ Knaack (2015:1226ff.), Helleiner et al. (2018:18f.), Helleiner (2018)

³³⁸ Quaglia (2017), Gravelle/Pagliari (2018:87), Pagliari (2013a), McKinstry (2013)

³³⁹ Drezner (2007:34)

businesses from that other jurisdiction, which endows her with the power to shape regulatory outcomes, or even veto them. In line with Realist thinking, Drezner argues that '[m]arkets have a gravitational effect on producers – the larger the economy, the stronger the pull for producers to secure and exploit market access'.³⁴⁰ Simmons observes that the financial power of the largest jurisdictions in terms of the size, depth, and liquidity of their markets allows them to export their preferred regulatory arrangements to other countries.³⁴¹ Following this line of reasoning, a number of studies have traced the adoption of Basel I to threats by the US (and the UK) to close their markets to foreign banks.³⁴² In a similar way, Bach and Newman's analysis of the diffusion of insider trading laws reveals that close ties with the SEC represent a more powerful predictor of other jurisdictions adopting such laws, than membership within IOSCO.³⁴³ These empirical results, of course, also hint at the presence of 'structuring' power operating in the background, but backed up, supported, and sustained with power through market size.

Power as regulatory capacity

The analysis of the exercise of 'power as regulatory capacity' departs from the importance of market size, but adds 'that a sizeable internal market must be coupled with potent regulatory institutions to yield power over global governance'.³⁴⁴ For Büthe and Mattli, it is the 'effective representation of domestic interest that confer[s] the critical advantage in these regulatory processes'.³⁴⁵ Bach and Newman, in turn, conclude that '[r]egulatory capacity is the mechanism linking market size to power in international market regulation'.³⁴⁶ Much of scholarly analysis has focused on the recent growth in regulatory capacity of the EU, and the implications of this development for the EU's power over international regulatory policy formation. Indeed, initially, the EU suffered from fragmented regulatory policy-making located at the national level and split across (sub-)sectoral lines. This often forced Europe to succumb to the preferences of the US.

For example, in the 1990s, European policy-makers tried to convince the SEC of a mutual recognition regime for accounting standards, but did not succeed. One of the key reasons was that EU decision-making in the accounting sector was not centralized at the supranational level, but located at the national level, with the UK, Germany, and France often competing against each other, rather than aligning their preferences in a cohesive manner. As a consequence of this fragmented internal institutional set-up, European policy-makers were unable to exercise leverage in accounting-related discussions with the SEC, which, in turn, feared that any equivalence decision of accounting standards might have

³⁴⁰ Drezner (2005:843)

³⁴¹ Simmons (2001)

³⁴² Kapstein (1992,1994), Oatley/Nabors (1998), Simmons (2001), Singer (2007)

³⁴³ Bach/Newman (2010b)

³⁴⁴ Bach/Newman (2007:827)

³⁴⁵ Büthe/Mattli (2011:12f.)

³⁴⁶ Bach/Newman (2010a:671)

negative repercussions for the competitiveness of US stock markets.³⁴⁷ More generally, Newman and Posner have noted that US policy-makers were not always necessarily in complete consensus regarding the direction a certain policy should take, but that in most cases, there was ‘a regulatory actor that was able to steer the transnational rule-setting process despite the sometimes unsettled nature of the issues at home’.³⁴⁸

However, as of the late 1990s, the EU began elevating its ‘power as regulatory capacity’ through political and institutional reforms leading to the growing centralization of financial policy-making authority at the supranational level.³⁴⁹ The kick-start was the EU Commission’s adoption of the Financial Services Action Plan in 1999, which involved a large bundle of regulatory measures to promote the European integration of national financial services industries. At the institutional level, Alexandre de Lamfalussy, a former advisor to the BIS and founding president of the European Monetary Institute (the predecessor of the ECB), in 2001 provided recommendations on further strengthening the architecture of European financial services regulation.³⁵⁰

Inspired by his recommendations, the EU developed the ‘Lamfalussy architecture’ which structured the financial policy-making process on the basis of the co-decision procedure of the EU institutions (i.e. Commission, Parliament, and Council) and the work of three European supervisory committees, one each for the securities, banking, and insurance/pension fund sector. The responsibilities of the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS), and the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) involved providing technical advice to the Commission, issuing joint standards, recommendations, and guidelines, as well as monitoring member states’ implementation efforts. Since the Lamfalussy committees lacked legal personality and direct formal enforcement powers,³⁵¹ this architecture did not result in the complete centralization of financial policy-making at the supranational level.³⁵² Nonetheless, the new political and institutional framework raised the EU’s confidence sufficiently for it to claim the status of ‘global standard setter’.³⁵³ Feeling emboldened, it began to strike back against unilateral US decision-making. This frequently caused US negotiators to voice ‘surprise and consternation that the EU and its member state supervisors would presume to ‘pass judgement’ on U.S. rules and supervision’.³⁵⁴ However, as opposed to the area of capital account liberalization, where the EU promoted the idea of a ‘managed’ form of globalization,³⁵⁵ it limited its newly gained

³⁴⁷ Posner (2009), Büthe/Mattli (2011)

³⁴⁸ Newman/Posner (2016a:134, also 143)

³⁴⁹ See Posner (2009a, 2007, 2010a), Deeg/Posner (2016), Posner/Véron (2010). The process was often incremental, with policy-makers drawing on previous ideas, groups, and procedures, rather than designing a radically new approach (see Quaglia 2008a, 2010), Mügge (2010), Deeg/Posner (2016).

³⁵⁰ Lamfalussy Report (2001)

³⁵¹ Ferran (2012:116ff.)

³⁵² Posner (2009)

³⁵³ EU Commission (2007:7)

³⁵⁴ Drawn from a quote obtained by Posner (2009:673) in an interview from a US official.

³⁵⁵ Abdelal/Meunier (2010)

leverage in financial market regulation to foster the competitiveness of its own markets, rather than advocating a distinct approach.³⁵⁶ In the words of Posner and Véron, it exercised ‘power without purpose’,³⁵⁷ which did not lead to any restraint of bank influence. This also applied to the area of OTC derivatives regulation.

After 2008, there were clear signs suggesting the EU intended to move beyond the exercise of shared regulatory authority with the US. Indeed, in 2009, the EU Commission emphasized that ‘Europe should play an instrumental role in shaping a global regulatory regime’ and that a ‘EU framework could serve as a reference for global regulation’.³⁵⁸ The EU secured the institutional capacity necessary for charting this new course by upgrading the Lamfalussy committees to independent supervisory authorities with enhanced powers.³⁵⁹ The new European Supervisory Authorities (ESAs), the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA) which became operational in January 2011 took over all responsibilities of their predecessors, but were also given legal personality.³⁶⁰

Reflecting on the effect of these institutional developments on post-crisis regulation, Helleiner and Pagliari have concluded that ‘analysts focusing on inter-state power relations would be right to identify the growing capacity of the European Union to act collectively, both unilaterally and at the international level, as [a] significant development [...]’.³⁶¹ First corroborating evidence can be found in the EU Commission’s refusal to provide market access to US financial institutions on the basis of simple mutual recognition of the underlying regulatory framework, which would have been the standard approach before the crisis. For example, non-European dealers operating in the EU were obliged to clear derivatives through CCPs located in and authorized by the EU. In addition, the EU no longer allowed US regulators to act as the sole supervisors of American credit rating agencies in Europe, but insisted on the establishment of local subsidiaries to be placed under its supervision.³⁶²

Power as structural power

³⁵⁶ Posner/Véron (2010), Newman/Posner (2018:64f.). This is not to say that there was no intra-European disagreement. Rather, it was the result of the ‘market-making’ coalition composed of mostly Northern countries prevailing over the Southern member states which traditionally embraced more of a ‘market-shaping’ perspective (Posner/Véron (2010) using terminology introduced by Quaglia (2008b)). In areas other than finance, such as health, food safety, and environment, the EU insisted on more far-reaching regulatory changes (see for example Vogel (2012) and Pollack/Shaffer (2009)).

³⁵⁷ Posner/Véron (2010)

³⁵⁸ EU Commission quoted in Quaglia (2012:525).

³⁵⁹ See the report of the De Larosière Group (2009:chapter 3).

³⁶⁰ Ferran (2012:134ff.)

³⁶¹ Helleiner/Pagliari (2010:90)

³⁶² Pagliari (2013a), the EU’s growing power as power through regulatory capacity might also be understood as a form of ‘power-as-autonomy’ as discussed by Cohen (2006:32).

The third form of power considered by this study is 'power as structural power'. The term was first introduced by Cohen who differentiates between 'process power' and 'structure power'. Process power denotes an actor's 'ability to extract advantage within the existing interaction situation', whereas structure power allows her to 'favorably modify[] the interaction situation'.³⁶³ The term was subsequently popularized by Strange who defined it as 'the power to shape and determine the structures of the global political economy within which other states, their political institutions, their economic enterprises, and (not least) their scientists and other professional people have to operate'; it is 'the power to decide how things shall be done'.³⁶⁴ In contrast to 'relational power', which operates through the (threat of) application of direct pressure, the effects of structural power are therefore often subtle.³⁶⁵ The analysis of structural power through Strange's analytical lens is further complicated by the fact that its effect can sometimes also be unintentional, the result of 'non-decisions', and/or a consequence of a structurally powerful actor simply 'being there'.³⁶⁶

Kirshner has proposed a slightly different variation of 'structural power' that is certainly not incompatible with the approaches of Cohen and Strange, but places a somewhat different emphasis. His conceptualization is inspired by Hirschman's³⁶⁷ insights on the effects of asymmetric trade relations. Kirshner applies these insights to currency relations, with a particular focus on the pre-eminent position of the USD, which provides the link to this study. Drawing on Hirschman, he argues that being engaged in a free trade agreement with a large state has an impact on how a small state perceives its own interests, in the sense that over time, there will be an alignment of interests of the two trade partners, without any direct pressure being exercised by the larger on the smaller economy.³⁶⁸ Following Hirschman, this observation leads him to conclude that, in the resolution of currency-related questions, 'the US gains because participation in a dollar-based international monetary order [...] shapes the perceived self-interests of states [...]'.³⁶⁹ '[T]he special role of the dollar, simply by serving as the axis around which monetary affairs are organized, has provided the United States with [...] structural power. Choices, frameworks, and relations are implicitly shaped by the dollar's international role, and, as with the pattern of international trade, generate incentives that subtly influence the way actors go about calculating what is in their best political interest'.³⁷⁰ As Kirshner's example shows, 'power as structural power' is not far removed from 'power as market size', and in the empirical world the lines might blur at certain times. However, one of the key differences is that the exercise of 'structural power' does not involve the voicing of any explicit threats, as policy-

³⁶³ Cohen (1977:56)

³⁶⁴ Strange (1994[1988]: 24f.)

³⁶⁵ Strange (1996:26)

³⁶⁶ *ibid.*

³⁶⁷ Hirschman (1980[1945])

³⁶⁸ Kirshner (2005:8)

³⁶⁹ Kirshner (2008:425)

³⁷⁰ Kirshner (2014:16)

makers in the 'smaller' economy conclude by themselves that it is in their own best interest to act in a certain way.³⁷¹

This dissertation will reveal that, in the pre-crisis period, 'power through market size' allowed the US to veto global regulatory efforts it did not agree with. Once the EU had strengthened and centralized its institutional financial decision-making architecture, it used its 'power as regulatory capacity', but not in order to challenge the deregulation course. 'Power as structural power' might have mattered in the sense that both the US and the UK felt that, with the respective other side of the Atlantic offering an attractive marketplace, it was in their own interest to respond to deregulation abroad with further deregulation at home in order to prevent the melting away of their respective market share. Prior to 2008, power in its various manifestations therefore reinforced the ability of the dealer banks to exercise influence.

In the post-crisis period, there was often no need for the exercise of power, given policy-maker's strong embrace of the clearing/margining consensus and the presence of WGMR to foster agreement. However, it was probably not completely absent. Power was most likely exercised in two cases, by the EU in the two-way IM mandate case, and by the US in the FX case. In the two-way IM mandate case, the EU appears to have exercised power vis-à-vis the US Prudential Regulators, which would have preferred a one-way mandate, by relying on power through market size and power through regulatory capacity. However, besides power, the Prudential Regulators' membership in the transgovernmental community of WGMR might have equally played a role. In the FX case, it seems that US structural power might have mattered, in that the EU's reliance on the USD probably made it adopt an exemption from IM for certain FX products, against its own preferences and despite the fact that it held both 'power as market size' (with London being the leading market for these products) and 'power as regulatory capacity'. However, it was the US that supplied the traded good, i.e. the currency, and the EU's dependence on it endowed it with structural power to push through its preferred policy outcome.

2.3.6 The domestic institutional environment

As with inter-state power, the effect of the domestic institutional environment on dealer bank influence depends less on the institutions themselves, than on the way in which domestic institutional arrangements play out over the course of the policy-making process. Specifically, I concentrate on two dimensions, regulatory fragmentation and the domestic national institutional set-up, each of which can provide an opening for industry preferences to shine through. The focus of this thesis rests primarily on regulatory fragmentation. Sometimes fragmentation opens a window of opportunity for the banks if it moves the

³⁷¹ As Kirshner notes, his understanding of 'structural power' is not dissimilar to 'soft power' as understood by Nye, i.e. 'getting others to want what you want them to want' (Kirshner 2008:425).

policy process closer to their preferences. At other times, it can put into question progress that the banks thought had already been achieved on their way towards achieving influence. When speaking about the ‘domestic institutional environment’ with respect to the EU, I refer to the supranational, rather than the member state level (unless specified otherwise). In the next section, I will first briefly speak about the terms ‘institutionalism’ and ‘institutions’, before discussing each of the two dimensions listed above.

The literature differentiates between various forms of institutionalisms and their effects on policy outcomes. Among the most common forms are rational choice, sociological, and historical institutionalism.³⁷² They vary in function of how they position themselves on the micro-macro axis and the material-cognitive axis (i.e. interests vs. ideas), although there can also be some overlap.³⁷³ The rationalist approach supports an understanding according to which self-interested, utility-maximizing individuals choose institutions on the basis of mostly fixed, exogenous preferences, the aim being to facilitate coordination that is considered necessary to create or maintain equilibrium.³⁷⁴ The historical approach, in contrast, emphasizes the temporal dimension and ‘see[s] institutions as the legacy of concrete historical processes’.³⁷⁵ The sociological version, in turn, studies institutions through the lens of cognition and the impact of collectively held norms and shared understandings.³⁷⁶

I follow Moschella and Tsingou who loosely align their edited volume on post-crisis incremental change in financial regulation with the historical approach by adopting a perspective which in their own words is ‘more practical than theoretical’.³⁷⁷ This approach is also in line with Helleiner and Pagliari’s invitation to scholars to pay closer attention to the impact of ‘distinct domestic foundations of policies toward international financial regulation’.³⁷⁸

There are several other studies in the IPE of finance literature which have followed a similar approach, both with regard to the impact of domestic institutions on international regulation and vice versa. Walter, for example, has studied how the influence of domestic institutions in several East Asian jurisdictions has led to ‘mock’, rather than ‘substantive’ compliance with the requirements of Basel I. The key reasons for ‘cosmetic’ compliance include the prevalence of bank-based financial systems, where banks closely cooperate with mostly family-owned businesses, as well as other ‘institutional’ features of the more interventionist, ‘developmental’ state.³⁷⁹

³⁷² Fioretos (2011), Thelen (1999)

³⁷³ Fioretos et al. (2016:21,31 of the pdf)

³⁷⁴ Fioretos et al. (2016:22 of the pdf)

³⁷⁵ Thelen (1999:382)

³⁷⁶ Thelen/Conran (2016:77f. of the pdf)

³⁷⁷ Moschella/Tsingou (2013a:6)

³⁷⁸ Helleiner/Pagliari (2011:181)

³⁷⁹ Walter (2008). Similar arguments can be found in Chey (2014).

For the developed countries, Lütz has studied the effect of financial globalization on financial policy convergence. While she finds significant policy convergence regarding the *content* of banking rules, this does not apply to the *institutional set-up* of domestic financial regulation. She argues that the domestic institutional context ‘provid[es] actors with restrictions and opportunity structures’, as a result of which she observes ‘convergence within national diversity’.³⁸⁰ Focusing on the bottom-up direction, Mattli and Büthe argue that domestic ‘institutional complementarities’ in terms of the extent to which domestic stakeholders coordinate amongst each other, and the degree to which the representation of interests is organized hierarchically determine who can act as a first mover when international standardization is negotiated, and who has to assume the role of a follower, having to accept international rules less in line with their domestic institutional context.³⁸¹

For the post-crisis period, James and Quaglia have shown that the UK banks’ structural power to prevent/attenuate Brexit was limited by the ‘reconfiguration of institutional structures within government’.³⁸² Indeed, Prime Minister Theresa May closed the traditional communication channels of the industry with policy-makers by shifting responsibility for the Brexit negotiations to the newly established Department for Exiting the European Union and the Department for International Trade, at the expense of the Treasury which used to be the traditional interlocutor through which the banks had traditionally channelled their influence.³⁸³

One of the key weaknesses associated with historical institutionalism as an analytical approach, whether followed narrowly, or more loosely, as in this thesis, is its struggle to offer ‘forward-looking explanation[s]’.³⁸⁴ This means that it is difficult to develop predictive hypotheses of the specific impact of institutions *ex ante*. As well, one might argue that it is often problematic to delimit precisely what exactly should be considered an ‘institution’, and what aspect(s) of domestic arrangements should be explored. Moschella and Tsingou note that the spectrum of possibilities is rather wide. Indeed, it can range from ‘formal institutions and rules’, ‘regimes’, and ‘supervisory practices’ to ‘policy practices and strategies of actors’.³⁸⁵ They themselves consider ‘institutions’ as ‘the result of political struggles and temporal processes that crystallise interests as well as routines and habits’.³⁸⁶ This dissertation leans on their definition, but remains aware that this approach does not fully mitigate either of the two weaknesses.

Regarding regulatory fragmentation, the US is considered a notorious case, as already mentioned in chapter I-3.3 with respect to the likelihood of meaningful post-crisis change. Singer, for instance, notes that the US regulatory agencies often tend to be in conflict with

³⁸⁰ Lütz (2004:170,169). A similar study has been published by Busch (2009).

³⁸¹ Mattli/Büthe (2003)

³⁸² James/Quaglia (2018:2)

³⁸³ James/Quaglia (2018:7f.)

³⁸⁴ Drezner (2010:795)

³⁸⁵ Moschella/Tsingou (2013a:19)

³⁸⁶ *ibid.*

each other about the precise contours of financial regulation.³⁸⁷ Indeed, the American financial regulatory bodies were formed over a long period of time, and they are equipped with different mandates in order to respond to different kinds of risk.³⁸⁸ The overall set-up is also reflective of traditional US scepticism vis-à-vis any attempt at concentrating power.³⁸⁹ However, as a result, there is often disagreement among the authorities as to which course of regulatory reform should be pursued. From a domestic institutionalist perspective, one might also associate an element of ‘path dependence’³⁹⁰ with this factor, in that policy-makers’ present-day decision-making follows a path-dependent trajectory. This particular aspect, however, will not be at the centre of the analysis.

Overall, the analysis will reveal that prior to 2008, the domestic institutional structure on both sides of the Atlantic provided a benign environment for dealer bank influence to take hold. With the exception of the CFTC, which periodically attempted to regulate the uncleared market, there was cross-institutional consensus on deregulation, the effect of which was reinforced over time by positive feedback effects.

For the post-crisis period, however, the picture is more complex. On the one hand, the shock of the crisis was intense enough to rally support for a fundamental re-calibration of the financial system through the imposition of margin requirements. On the other, agreeing on the precise ways in which to design the content and contours of post-crisis regulation often turned out more challenging than agreeing to simply not intrude in the market. In several cases in the US, regulatory fragmentation in terms of the differing mandates of the regulatory authorities, as well as historical legacies of jurisdictional battles started shining through. This sometimes provided an opening for industry preferences to be reflected in the policy outcome, even though this was probably not a result of causal influence. For the EU cases, regulatory fragmentation was less relevant, with the partial exemption of the end-user case. In the pre-crisis period, the main centre of regulatory activity was in London, where decision-making was centralized, first at the level of the Securities and Investment Board, and subsequently the FSA (Financial Services Authority). When the EU introduced consolidated supervision, it was again less a question of a regulatory intrusion. For the post-crisis period, there is no publicly available evidence suggesting that the ESAs did not all pull in the same direction.

The second factor relates more narrowly to ‘national’ institutions, with a particular focus on the EU. Scharpf, for instance, points to the different effects of unitary vs. federal, parliamentary vs. presidential, and two-party vs. multi-party systems on political decision-making.³⁹¹ While the US is a truly federal system, the EU is a system *sui generis*: ‘Less than a

³⁸⁷ Singer (2009:27). See also Moschella/Tsingou (2013a:16) and FDIC chair Sheila Bair’s memoir (2012:268ff.). Fioretos (2011:385f.) generalizes the argument for regulatory systems beyond the US.

³⁸⁸ Lavelle (2013:114,144). A historical overview can be found in Busch (2009:33ff.).

³⁸⁹ Coleman (2004:283)

³⁹⁰ See for example Pierson (2000).

³⁹¹ Scharpf (1997:22)

federation. More than a regime'.³⁹² This thesis is less interested in categorizing the precise political system of the EU. The moderator also does not capture the augmentation of the supranational character of the EU, which we already discussed in relation to 'the nature of inter-state power relations'. Rather, it focuses on the practical consequences related to this consolidation in light of the fact that the EU with its 28 member states has federal features, but is not a state. Post-crisis, the institutional consolidation of the EU meant that EMIR and the ESAs' rules applied directly at the member-state level as a regulation. However, the rules sometimes also had to interact with other domestic institutions that differed across member states, or had not yet been institutionalized at the EU level. Again, this sometimes opened a window of opportunity for the banks, but without the overall effect necessarily being causally related to dealer bank influence.

The thesis does not reflect on the impact of different 'varieties of capitalism',³⁹³ which are sometimes also associated with the domestic 'institutional context'.³⁹⁴ The 'varieties of capitalism' approach invites the researcher to differentiate between two kinds of capitalist economies located at either end of a continuous spectrum. On the one end, we find liberal market economies (such as the UK and the US) that are traditionally dependent on financial intermediation through capital markets, as opposed to coordinated market economies, such as Germany, which rely on bank credit-based financial intermediation.³⁹⁵

The key reason for the omission is a practical one, related to the lack of sufficient data on the individual preferences of EU member states, particularly for the post-crisis period (see also the discussion on the limitations of this study in section 5 of this chapter). At the same time, the repercussions of the omission for the overall research appear limited. As we will see, in the pre-crisis period, both the US and the EU favoured 'market-friendly regulation', i.e. different varieties of capitalism seem to have played a relatively minor role.³⁹⁶ It is also not entirely clear to what extent this theoretical lens could help us better understand the post-crisis regulatory response. The use of uncleared derivatives is not *a priori* limited to, or concentrated within any specific sector of the economy, although precise data about the exact distribution is scarce.

Given that the uncleared derivatives business is typically intermediated by the dealer banks, the classical working hypothesis would be to expect that liberal market economies favour stronger regulation of the derivatives industry, given their relatively lower reliance on bank-based credit intermediation, as compared to co-ordinated market economies.³⁹⁷ However,

³⁹² Wallace (1983)

³⁹³ Hall/Soskice (2001)

³⁹⁴ Fioretos et al. (2016)

³⁹⁵ The two countries are usually considered to be located on either end of the spectrum, with other economies situated in between. The two types of economies are considered to differ across several other dimensions of their national economic models including industrial relations, wage negotiations between trade unions and employers, and systems of corporate governance (Hardie et al. 2013:693).

³⁹⁶ See Howarth/Quaglia (2016:26).

³⁹⁷ See for example the discussion in James/Quaglia (2017:3f.).

as we will see, the earliest and strongest calls for stronger OTC derivatives regulation emanated from the US, and the limited data available to me suggests that not only the EU as a whole, but also some key actors in the UK supported a strong regulatory response. This suggests a rather uniform preference of public officials for regulatory intervention across different ‘varieties of capitalism’. We will also see that private sector responses did not display any pattern that might easily be reconciled with the varieties of capitalism logic. For these reasons, Pagliari equally dismissed the relevance of this factor in his research on the effect of public issue salience of derivatives regulation on the post-crisis response in the US and the EU.³⁹⁸ We might further add that derivatives are also available through non-bank broker dealers, which renders differentiating between bank/non-bank-based financial systems more challenging.³⁹⁹

Summarizing the *individual* effects of these moderators, as discussed in existing accounts in the IPE literature, we can expect the dealer banks to exercise high levels of influence, if

- 1) they can secure high levels of business unity,
- 2) the public issue salience of the policy in question is low, or if the banks succeed in raising the public issue salience of their preferred version of a policy (‘friendly’ issue salience),
- 3) policy-makers embrace an ideational consensus that encourages delegating decision-making power to the banks themselves or that is otherwise in line with their preferences,
- 4) the banks occupy a central position within the transnational policy community,
- 5) inter-state power relations (understood as power as market size, power as regulatory capacity, and/or power as structural power) play out in a way that does not clash with their preferences, and
- 6) domestic institutional arrangements (in terms of regulatory fragmentation and the domestic ‘institutional’ set-up) play out in a way that does not clash with their preferences.

My overall argument, however, is that we can begin capturing the essence of dealer bank influence only, if we combine these theoretical explanations and focus on the interrelationships of the moderators, rather than just their individual effects. The literature on the banks’ ability to rely on the end-users to create ‘friendly’ issue salience already goes

³⁹⁸ Pagliari (2013b:64ff.)

³⁹⁹ The thesis largely excludes the broker-dealer segment (see also section 3 of this chapter discussing the case selection).

in this direction, as it implicitly connects ‘business unity’ with ‘issue salience’.⁴⁰⁰ Moreover, some of the publications I have discussed in this chapter touch on the joint relevance of moderators in the narrative exposition of their case studies. Examples include James and Quaglia’s research on the UK banks’ lost battle to prevent Brexit, or Bell and Hindmoor’s analysis of banks’ structural power over capital regulation in the UK.⁴⁰¹

I suggest going beyond these efforts in favour of explicitly conceptualizing these connections between the moderators in the analytical framework. In other words, I argue that it is not just the individual presence of certain moderators, but their particular combination and interaction that leads to a particular level of dealer bank influence. Each of the theoretical explanations discussed above contributes important insight, but, on its own, each one is insufficient to equip us with a grounded understanding of dealer bank influence. In particular, I propose to focus on the dynamic effect that can sometimes exist among the moderators. For example, in some cases, the effect of one moderator can have little impact on dealer bank influence, whereas in other cases, it can produce cascading reactions by encouraging the effect of other moderators to change, with the joint effect resulting in a particular level of influence. Such an approach appears particularly promising for those cases where the needle on the barometer of dealer bank influence changes during the policy process, before settling on a final category, once the outcome has been produced. Overall, my argument suggests that a particular level of influence is more than just the result of the individual effects of each single moderator.

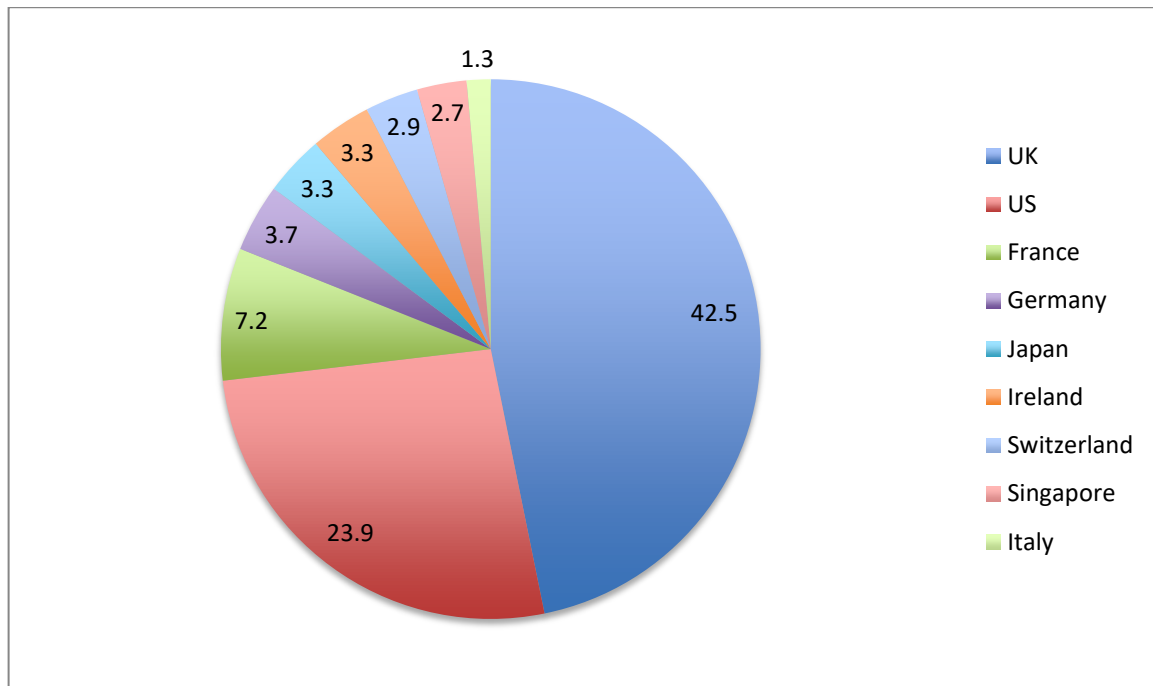
3. The cases: Derivatives deregulation prior to 2008 and the introduction of mandatory margin requirements after the global financial crisis in the US and the EU

This thesis focuses on dealer bank influence over derivatives deregulation prior to 2008 and the introduction of mandatory margin rules for non-centrally cleared derivatives after the crisis. In terms of jurisdictions, it is limited to two cases, the US and the EU, which have the largest markets for uncleared derivatives, respectively accounting for 24% and 58% of the global market in 2007. Figure 7 provides a breakdown of global market share. In the thesis, I use the terms ‘EU’ and ‘Europe’ interchangeably.

⁴⁰⁰ See for example Keller (2016) and Kastner (2017).

⁴⁰¹ James/Quaglia (2018), Bell/Hindmoor (2017)

Figure 7: The global market for OTC derivatives



Source: Author, based on IFSL Research (2007:2, table 1 informed by BIS data). Percentages, average daily turnover for 2007.

Given that prior to 2008, there was no specific margin rule, nor was the introduction of mandatory collateralization requirements seriously discussed, I concentrate on policy-makers' broader decisions over keeping the market deregulated and/or deregulating it further. I treat the pre-crisis period as one case, although, as we will see, there were several important decisions that served as markers on the deregulation path. The period of observation covers the time between the early 1970s and 2008. Considering the lack of existence of, or substantial debate about, a specific margin rule, one might ask whether the pre-crisis case would not better be considered as 'background', rather than a 'case'. However, in light of the thesis' interest in understanding *change* in dealer bank influence over policy outcomes in the regulation of OTC derivatives, as well as the corresponding changes to the moderator configuration, I treat the pre-crisis period as a full 'case'.

I use the term 'deregulation' with a certain amount of qualification. Most importantly, for the purpose of this research, 'deregulation' does not equal 'lack of regulation'. Indeed, while some commenters tend to refer to the pre-crisis OTC derivatives market as 'an unregulated and dysfunctional private casino', allowing the large banks to bet money 'in a regulatory void',⁴⁰² this observation is not entirely accurate. Carruthers, for example, emphasizes that '[t]he OTC market was not anarchic'.⁴⁰³ As we will see, there was in fact a

⁴⁰² Both quotes are taken from Wigan (2009:158). Rauterberg and Verstein (2013:15) equally reference the wide-spread application of this '[d]ominant [n]arrative'.

⁴⁰³ Carruthers (2013:396)

significant amount of public intervention. However, this intervention was undertaken with the aim of unleashing ‘the forces of competition and innovation, as opposed to regulatory restrictions’.⁴⁰⁴ Deregulation is qualitatively ‘different’ from much of the intrusive regulation that occurred post-crisis, but it is not equivalent to the presence of a ‘regulatory void’. Of course, these pre-crisis initiatives were also complemented with the explicit suppression of regulation, for example through the adoption of the Commodity Futures Modernization Act of 2000. However, even such suppression of regulation required legislation to ensure that ‘deregulation’ could take hold. In addition, policy-makers supported self-regulation by the industry which established numerous bodies and initiatives for this purpose. Against this wider background, Harvey has concluded that ‘the “unregulated” image of the market was legally constructed’ through a series of regulatory decisions.⁴⁰⁵ For the purpose of this study, I therefore conceive of ‘deregulation’ as market-friendly regulation intended to remove restraints considered detrimental for market expansion. My approach is certainly not entirely novel. In his analysis of the emergence of the competition state following the intensification of economic globalization as of the 1990s, Cerny has noted a trend towards ‘the actual expansion of *de facto* state intervention and regulation in the name of competitiveness and marketization’.⁴⁰⁶ A similar train of thought has been developed by Vogel who argues that deregulation often leads to ‘freer markets and *more* rules’.⁴⁰⁷ I follow these lines of reasoning and apply them to the pre-crisis period.

Post-crisis regulation differs from ‘deregulation’. The margin rules are specifically designed to improve collateralization. Unlike before the crisis, regulation was therefore not premised anymore on the sole aim of minimizing the cost of doing business. As we will see, the main purpose policy-makers saw in the margin rules was two-fold: accounting for the systemic risk emanating from uncleared trades, and incentivizing their transition to the cleared marketplace. This means that the rules put a corset around the uncleared market, whereas they are designed to promote the growth of the cleared one. The margin requirements themselves are based on a detailed and complex rulebook covering almost every dimension of the collateralization process. I have selected seven specific requirements. Overall, this results in 8 cases for each of the US and the EU, or 16 cases in total:

- (1) Pre-crisis deregulation
- (2) The mandatory use of initial margin (IM)
- (3) The two-way IM requirement meaning that IM needs to be collected *and* posted by the dealers, rather than just collected, which would result in a one-way requirement

⁴⁰⁴ The terminology is borrowed from Underhill (1997:21)

⁴⁰⁵ Harvey (2013:345, also 344)

⁴⁰⁶ Cerny (2007:251, emphasis in the original)

⁴⁰⁷ Vogel (1996:3, emphasis in the original)

- (4) The segregation requirement, meaning IM has to be kept separately from proprietary assets
- (5) The prohibition of rehypothecation, meaning IM must not be recycled by the receiving counterparty for its own purpose
- (6) The exemption of commercial end-users from the margin rules
- (7) The exemption of FX swaps and FX forwards from IM, but
- (8) not from variation margin (VM)

For the post-crisis period, the period of observation reaches from 2008 to the autumn of 2017, when the bulk of the decision-making process on the margin rule was completed. The conclusion will reflect on more recent developments.

Regarding the margin rule, I exclude all aspects pertaining to the calculation of the specific amounts of collateral that need to be posted, the amount of time counterparties have available to make payments after execution, as well as the kinds of assets deemed eligible for this purpose. The thesis also leaves aside all questions concerning the cross-border applicability of the rules, as well as the treatment of inter-affiliate swaps, which is often a closely related question. The cases I retain represent the building blocks of the new rules on which the excluded aspects build. These building blocks were also the parts of the rules that were completed first, whereas the decision-making process on some of the calculation requirements is still on-going to this date.

At the regulatory level, the EU margin rules were developed jointly by the ESAs, while regulatory responsibility in the US was spread across several agencies. I concentrate on the rules developed by the CFTC (which has jurisdiction over most derivatives under Dodd-Frank) and the joint group of the Prudential Regulators (PRs). There are five PRs: the Federal Reserve, the OCC, the FDIC, the Farm Credit Administration (FCA), and the Federal Housing Finance Agency (FHFA). However, the agenda was driven by the first three of the group which were also the only PRs represented in BCBS-IOSCO's Working Group on Margin Requirements. I therefore exclude the FCA and FHFA. While the Fed, OCC, and FDIC act as the US banking regulators, the CFTC is in charge of non-bank entities.⁴⁰⁸

I also leave aside the SEC which has jurisdiction over brokers/broker-dealers. Following the Securities Exchange Act of 1934, a 'broker' is any person that buys and sells securities for other parties, but is not a bank. Similar to a dealer bank, a broker-dealer is a broker that also trades for its own firm, often with another broker-dealer. Many banks own brokerage firms as separately regulated business units or subsidiaries. As a consequence, the list of the largest broker-dealers is very similar to that of the largest dealer banks. While the agency

⁴⁰⁸ Details can be found in CFTC (2011b:23733) and PRs (2011:27566, footnote 4).

published a first draft proposal in 2012,⁴⁰⁹ it did not add a final rule, or a second proposal during the period of observation. By contrast, the rule-making process pertaining to the cases I do examine was completed by the other agencies during that time. The lack of a final SEC rule might invite us to classify it as a successful example of influence by the broker-dealers in terms of pushing regulation off the agenda. At the current stage, however, the case leaves too many question and data gaps to allow us to substantiate this conclusion. Given the lack of final SEC margin rules, security-based swaps in the bespoke US market, including single-name CDS, are currently not subject to any mandatory margin rules.⁴¹⁰ The thesis does not address this issue any further.

The EU was represented in WGMR through the ESAs and the EU Commission. This makes it difficult to differentiate between the legislative and regulatory level for the EU, given that the Commission is involved in both. Unlike in the US, where final rules by the agencies were in fact final, the ESAs final draft regulatory standards also needed to be approved by the EU Commission, as well as the Parliament and the Council. Comparing the US and the EU can therefore be challenging at times. Bach and Newman note that in these situations, ‘we can [still] compare processes that – while distinct – can be treated as analytical equivalents, provided the comparison is appropriately contextualized’.⁴¹¹

4. Methodological approach

Aiming to avoid the pitfalls associated with identifying influence, as explored at the beginning of this chapter, I employ the method of process tracing. In the words of George and Bennett, ‘the process tracing method attempts to identify the intervening causal process – the causal chain and causal mechanism – between an independent variable (or variables) and the outcome of the dependent variable’.⁴¹² More generally, ‘this procedure is intended to investigate and explain the decision process by which various initial conditions are translated into outcomes’.⁴¹³

I used this method to study the extent to which dealer bank preferences translated into influence across the individual cases. Specifically, I examined the publicly available official documents associated with the policy process surrounding the development of the margin rules. These included draft/final legislation/rules, the comment letters submitted by interest

⁴⁰⁹ SEC (2012)

⁴¹⁰ Note that the SEC re-opened the comment period on its 2012 proposal including the request for feedback on additional questions on 11 October 2018 (see SEC 2018).

⁴¹¹ Newman/Bach (2004:389, on the basis of insights developed by Locke/Thelen 1998)

⁴¹² George/Bennett (2004:206)

⁴¹³ George/McKeown (1985:35). More recent discussions of process tracing can be found in a special issue of *New Political Economy* (see for example Trampusch/Palier (2016)) and the volumes by Bennett/Checkel (2015) and Beach/Pedersen (2013).

groups, transcripts of hearings, official policy reports, published statements, speeches, etc. I complemented this research by studying the financial press coverage of the margin rules. Of particular relevance was *Risk.net*, a financial news website with a dedicated focus on regulation and the derivatives markets, and *FX Week*, a magazine covering developments in the FX markets. In addition, I pursued an extensive keyword search in order to identify further information on the policy process.

One might ask whether the strategy of relying on policy-makers' and interest groups' own statements is in fact the best way to identify their true preferences, even though it is widely adopted by scholars in the field.⁴¹⁴ Indeed, the literature warns of the bias that might be introduced into the research by uncritically adopting this approach. Lowery, for instance, explains that neither interest groups nor policy-makers 'take positions in a vacuum. Rather, they plausibly take positions on issues in anticipation of reactions from other actors'.⁴¹⁵ Specifically, there is the risk of interest groups and policy-makers both publicly adopting more 'extreme' positions than they actually espouse, particularly at the initial stage of the consultation process, so as to create some manoeuvring room for future negotiations.

Associations have an additional motivation for potentially 'over-stating' their preferences. Young and Pagliari note that the comments submitted by associations 'leave a record which demonstrates to their members that they are actively working for a given advocacy cause'.⁴¹⁶ An association's leadership might therefore have an incentive to be seen as particularly vocal and active in communicating its members' preferences to policy-makers, which might encourage it to advocate exaggerated views. Of course, this presupposes that its members actually do share a common position on the issue(s) in question to begin with, which, as we will see, is not always the case.⁴¹⁷ One might add that associations, as well as individual firms, also write with a third audience in mind, i.e. their members' individual clients, to whom they might equally want to demonstrate commitment. Again, this could provide an incentive for overstating preferences.

Disregarding this overall risk might have important repercussions for identifying interest group influence. If interest groups and/or policy-makers voice overstated preferences, and interest groups fail to achieve full victory, the final outcome might still overlap (perhaps even perfectly) with their 'true' position. The researcher, however, would wrongly underestimate their influence. The same applies to comparing policy-makers initial statements with the final policy outcome. The process tracing analysis, therefore, has to be conducted carefully.

⁴¹⁴ See for example Yackee/Yackee (2006), Klüver (2012), Chalmers (2017), Young (2012), Pagliari/Young (2014, 2013), Young/Pagliari (2017a), Préfontaine et al. (2010), Nelson/Yackee (2012), Yackee (2005), Young/Spagna (2017).

⁴¹⁵ Lowery (2013:6)

⁴¹⁶ Young/Pagliari (2017:7)

⁴¹⁷ Smith (2000:42), for example, notes that the members of the US Chamber of Commerce are often divided to an extent that the association itself cannot forcefully engage in the respective political debate.

In order to gain a better background understanding of the policy process, I complemented the detailed document analysis with anonymous research interviews. In total, I conducted 104 anonymous conversations with experts. All interviews took place in person or over the phone and were semi-structured. I provided thematic anchors, but allowed for flexibility for the respondents to elaborate on points of interest. In order to protect all interviewees' identities (a consistently voiced concern given the recent nature of the margin reform), and because the interviews were used only to gain background understanding to support my detailed document analysis, I do not provide any information from these interviews or about the interviewees at any point in the thesis.

Overall, the data basis for the US cases is superior, compared to those for the EU. For example, the official documentation of many sessions of the EU Parliament is often succinct, and does not reach beyond the publication of a list of agenda topics in bullet point form. In some cases, a link to a video recording of a session might be provided, but in practice, the content is often not accessible, or of suboptimal quality, or provides only partial coverage. The reports and studies prepared by the Parliament are usually very detailed, and in many cases one can consult the different versions leading to the final version. However, there is often little contextual information, which can complicate analysis of the documents. The official documentation of EU Council meetings is usually also not very detailed, given that the wording tends to be the result of careful negotiations by member state representatives who are used to meeting behind closed doors. The reports of the Commission, by contrast, tend to provide both detail and context. However, they represent only one segment, although a very important one, of the EU's decision-making on the margin rules. By contrast, the US Government Publishing Office provides verbatim coverage of Congressional hearings, and thus a much richer source of information.

At the regulatory level, the ESAs' coverage of the rule-making process is by definition of a technical nature, but considerably more so, when compared to their American peers. Indeed, the US regulatory agencies often publish detailed minutes of their meetings from which important details about the decision-making process can be inferred. In addition, there is a rich archive of speeches, which serves a similar purpose. Regarding the text of the regulatory rules themselves, the American Procedures Act stipulates that the comments submitted by interested parties need to be reviewed, which often results in more detailed contextual explanations of why a particular agency (or group of agencies) adopted a certain policy.⁴¹⁸ The ESAs also carefully considered the comments submitted in response to their own proposals. For instance, they published a lengthy 'feedback table' with additional data going beyond the information provided in the final draft regulatory standards.⁴¹⁹ However, from a researcher's perspective, the US documents provide more contextual richness. With very few exceptions, there was also very little detailed, publicly available information on the individual EU member states' preferences regarding the margin rules.

⁴¹⁸ See Lavelle (2014:119ff.).

⁴¹⁹ See ESAs (2016b).

5. Limitations of the study

This study is affected by a number of important limitations. First, regarding the pre-crisis chapter, the reader will notice its principal focus on deregulation by the US. This imbalance is informed by the fact that the UK liberalized through one big step in the adoption of the Big Bang legislation in 1986, while deregulation in the US was a multi-step and multi-year process. The EU appeared on the scene rather late, meaning it will not be covered in great detail either. Tsingou confirms that the pre-crisis deregulation was ‘predominantly US-centred’,⁴²⁰ which might justify the imbalance. Second, regarding the post-crisis chapters, my power-related arguments suffer from the weakness that there is often not sufficiently robust evidence to clear all doubts about the potential validity of alternative, competing explanations. The third weakness pertains to the post-crisis chapters more generally. It concerns the fact that the empirical evidence tends to be weaker for the EU than the US cases. This ‘evidence differential’ is to a large extent informed by the challenges which arose during the research process and which were already discussed in section II-4.

This limitation has important implications. Most significantly, the thesis says little about the ways in which the preferences of the *individual* EU member states contributed to the shaping of the EU’s positions. Ideally, we would be interested in a more detailed exploration of the ways in which the UK in particular, but also Germany, and France (which host the largest national continental EU markets) contributed to each of the outcomes discussed in this study. For the same reason, the policy process leading to the emergence of the G20 consensus and the establishment of WGMR will also not be discussed in detail. While the focus of the dissertation rests on dealer bank influence, rather than that of the EU’s member states, we might feel more confident about our conclusions regarding industry influence, if we knew more about the preferences of UK, German, and French policy-makers. Given a lack of data, the study also remains silent on the preferences of the individual ESAs, whereas this aspect of the policy-making process will be explored in detail for the US cases.

Other limitations apply more evenly to the US and EU cases. Indeed, as a fourth limitation, the reader might identify an imbalance regarding the thoroughness with which the thesis explores the various mechanisms through which the industry tried to exercise influence, particularly with respect to the post-crisis period. Specifically, the thesis says little about the exact mechanisms through which the banks might have tried to exercise influence through the provision of information. For example, I often do not differentiate between direct lobbying of legislators vs. regulators, and whether this lobbying took place at the domestic or the transnational level. For the EU case, the lack of detailed transcripts of discussions held in the EU Parliament and EU Council further complicated the task of identifying these

⁴²⁰ Tsingou (2015:243)

mechanisms. In a similar vein, differentiating between the domestic and transnational level proved difficult, because interest groups often submitted (nearly) identical letters to their domestic regulators as well as WGMR, and/or often cc'd policy-makers from the other side of the Atlantic as well. This complicated the accurate tracing of the way in which dealer bank influence might have been exercised in this form. There is one important exception. The end-user case was almost exclusively discussed at the domestic level, both in the US and the EU, whereas it did not rank high on WGMR's agenda. Moreover, in terms of sequencing, the US was already much more advanced when the EU began its official deliberations. This allows me to provide a much richer picture of the mechanisms through which influence was exercised, whereas the analysis in this respect is coarser with respect to the other cases.

Fifth, while the thesis covers a total of 7 post-crisis cases (or 14 if counted at the jurisdictional level), important areas of the margin rules remain outside its scope. As already indicated in section 3 of this chapter, the thesis disregards all issues pertaining to eligible forms of collateral for both IM and VM, the calculation of the numerical amounts of IM that need to be posted, including the definition of the IM thresholds that apply, and the time period within which it has to be posted to the counterparty. We cannot exclude that the industry gained back some of its influence over the discussion of these issues. For example, seemingly small details regarding calculation requirements might have a tremendous effect on the actual amounts of collateral that need to be posted. The industry could have lost with respect to the broad strokes of the margin rules discussed by the thesis, but it could still have exercised some influence, potentially even significant influence, over the finer lines of the calculation of the amounts that need to be posted. Overall, this would still signal a relative loss of influence compared to the pre-crisis period, but the argument would need to be made in a more nuanced fashion. Without further research, we cannot provide a definite answer to this question. Overall, given this series of limitations, we should be extremely careful with respect to generalizing the results derived from the individual case studies. More generally, the analysis might over- or underestimate the relevance and importance of some nuances. The complexity of the margin rules, the multi-level and multi-agency character of the decision-making process, as well as the overall challenges associated with identifying influence make these risks appear particularly pertinent. The conclusions of this research should therefore be interpreted cautiously.

6. Conclusion

This chapter has discussed the analytical framework of the study. The theoretical model I suggest concerns how the influence of dealer bank preferences, articulated through the provision of information and the projection of structural/structuring power is moderated by a number of variables, and how the particular level of influence depends on the individual, joint, and dynamic effect of these moderators. The moderators are business unity, public

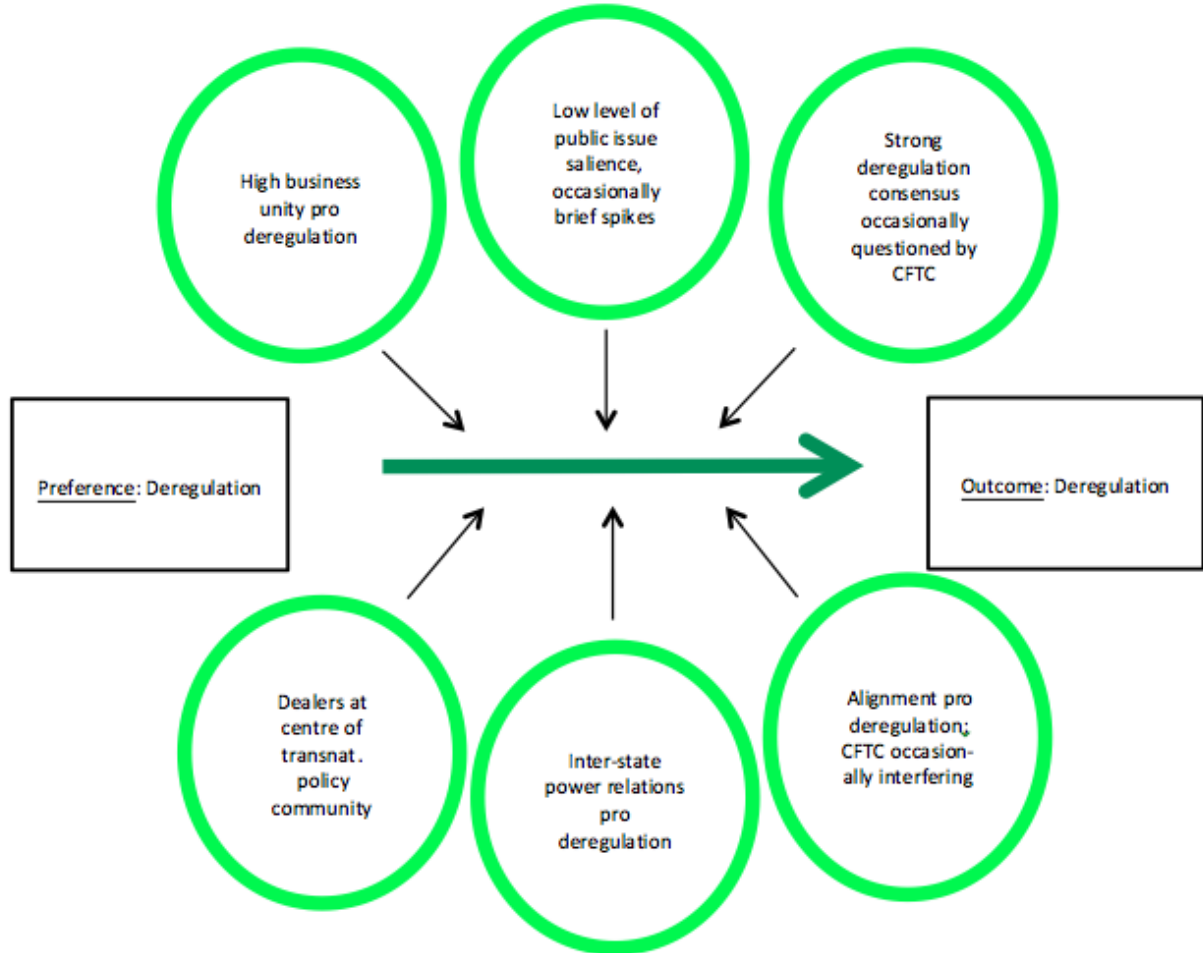
issue salience, policy-makers' ideational outlook, the state of the transnational policy community, inter-state power relations, and the domestic institutional environment. The case studies to which I apply this model include derivatives deregulation prior to 2008 and selected aspects of the mandatory margin requirements developed after the crisis. The thesis relies on detailed empirical work. Nonetheless, it is affected by several analytical and empirical limitations, meaning its conclusions should be interpreted cautiously.

CHAPTER III - Dealer banks' high influence over the deregulation of OTC derivatives markets prior to 2008

1. Overview of the chapter

This chapter suggests that in the pre-crisis period, the industry exercised strong influence over the deregulation of OTC derivatives markets. The dealer banks benefited from a highly advantageous constellation of factors that individually and jointly allowed them to exercise influence over policy-makers' promotion of the deregulation of OTC derivatives. Each of the moderators identified in the framework worked to the industry's advantage, but many of them also fed into one another, which reinforced the overall, positive effect on the strength of dealer bank influence. As well, given the complexity of the derivatives business, policy-makers were dependent on the information the banks provided them. In addition, the industry successfully exercised (or threatened to exercise) both structural and structuring power. Figure 8 illustrates the pre-crisis case graphically.

Figure 8: The pre-crisis deregulation cases in the US and the EU



Source: Author

A green sphere indicates that the respective moderator had a positive individual effect on the relationship between dealer bank preferences and policy outcome. By contrast, a red stop sign would signal the opposite. The continuous, thick, green arrow represents the high level of dealer bank influence. This kind of figure cannot capture a case in all of its facets, but it can anchor the analysis by visualizing some important elements.

The next sections explore the ways in which the six moderators individually and jointly fostered dealer bank influence. Section 2 focuses on the ideational outlook which, based on the ‘efficient market hypothesis’, encouraged competitive deregulation. Section 3 shows that there was maximum business unity, with ISDA acting as the central voice of the market and serving as the monopoly provider of its contractual infrastructure, which placed it in a position from which it could exercise structural/structuring power.

Section 4 discusses the low degree of public issue salience of derivatives regulation, which was only briefly disrupted by occasional derivatives-related scandals. This section also

reveals the extent to which the banks and policy-makers shaped a close-knit transnational policy community. Their privileged position within the transnational policy community allowed the banks to fend off public intervention in favour of private self-regulation when issue salience temporarily rose following some corporate scandals in the early 1990s. Section 5 reveals that transatlantic power relations among policy-makers promoted, rather than constrained derivatives market deregulation.

2. The ideational deregulation consensus

The ideational outlook of the pre-crisis era was premised on the efficient market hypothesis which encouraged competitive deregulation, and thus opened the door for dealer bank preferences to prevail. Three innovations were particularly relevant. The first was the Black-Scholes equation published by Fisher Black and Myron Scholes in 1973.⁴²¹ The formula is premised on an options pricing model, the use of which provides information as to how to perfectly hedge a given option. This created the widely-shared impression that 'risk' had lost its unpredictable character, having become a manageable statistic instead. Many market participants embraced the formula without critically questioning it, in the belief that it would consistently provide accurate predictions of market prices. In fact, however, it was the widespread use of the formula itself that provided for this result. A textbook case of 'performativity',⁴²² the formula's popularity allowed for the 'remake [of] observable reality in [its] own image',⁴²³ i.e. market events following the course predicted by the formula were not a sign of its mathematical prowess or ingenuity, but a testament to its wide-spread use.

The second innovation was the development of the VaR (Value at Risk) methodology introduced by JP Morgan in the 1980s, which soon become heralded as a form of sophisticated risk management. VaR allowed market participants to quantify the risk of an investment in terms of the extent and occurrence ratio of losses to be expected over a given time period. VaR, however, suffered from several limitations including: First, short time frames of observation usually not exceeding one year; second, the idea that the Gaussian probability distribution could be fitted to most, if not any price movement data, without the need to account for rare, but disastrous 'black swan' events; third, the failure to include additional safeguards to protect against built-in procyclicality which would force firms to deleverage once a certain risk limit was broken. Rather, the formula was inspired by the assumption that 'irreducible uncertainty could be transformed into manageable risk'.⁴²⁴ Most policy-makers did not worry about these and other limitations associated with

⁴²¹ Black/Scholes (1973)

⁴²² MacKenzie (2006)

⁴²³ Mügge (2009:522)

⁴²⁴ Nelson/Katzenstein (2014:379), Taleb (2007), Lockwood (2015)

perfectly rational decision-making. Indeed, regulators endorsed VaR as an approved method for the industry to calculate risk and required capital levels in the Basel II Accord.⁴²⁵

The third development concerned the invention of the CDS. Originally developed by Bankers Trust in 1991, but first produced at a higher volume by JP Morgan, CDS fostered the belief that risk could be outsourced to the institution(s) most prepared and capable of sustaining it.⁴²⁶ The Fed subsequently permitted banks that relied on CDS as a risk management device to reduce their capital requirements.⁴²⁷

One of the strongest defenders of the market-based approach was Fed Chair Alan Greenspan who believed that 'markets are an expression of the deepest truths about human nature and ..., as a result, they will ultimately be correct'.⁴²⁸ He also insisted that the use of hedging through derivatives had invariably minimized risk, as it was now borne by the counterparties most able and willing to assume it.⁴²⁹ In his view, '[c]oncentrations of risk are more readily identified, and when such concentrations exceed the risk appetites of intermediaries, derivatives and other credit and interest rate risk instruments can be employed to transfer the underlying risk to other entities. As a result, not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient'.⁴³⁰ Regarding the use of margin requirements, a member of the Federal Reserve Bank of Chicago confidently stated that '[d]erivatives market participants can and do simply decline to deal with counterparties who are considered to be not creditworthy and unable to post sufficient collateral'.⁴³¹

In the UK, the free-market philosophy was equally dominant. Looking back, the FSA in 2009 explained that 'the predominant assumption was that increased complexity had been matched by the evolution of mathematically sophisticated and effective techniques for measuring and managing the resulting risks.'⁴³² '[T]he predominant assumption behind financial market regulation – in the US, the UK and increasingly across the world – has been that financial markets are capable of being both efficient and rational, and that a key goal of financial market regulation is to remove the impediments which might produce inefficient and illiquid markets'.⁴³³ The conclusion was clear: '[W]holesale market customers are by definition sophisticated and do not need protection'.⁴³⁴ Along these lines, the governor of

⁴²⁵ Nelson/Katzenstein (2014:378)

⁴²⁶ Tett (2009:46ff.)

⁴²⁷ Levine (2010:5)

⁴²⁸ Greenspan quoted in Ramo (1999), see also Greenspan quoted in Goodman (2008).

⁴²⁹ Sanders and Greenspan quoted in Goodman (2008).

⁴³⁰ Greenspan (2004), see also Greenspan quoted in Kirshner (2014:89).

⁴³¹ Bliss (2004:44)

⁴³² FSA (2009a:22)

⁴³³ FSA (2009a:39)

⁴³⁴ FSA (2009a:108)

the Bank of England, Robin Leigh-Pemberton in 1984 declared that the work of regulators should be informed by ‘reliance on market forces as [much as] we can defend politically’.⁴³⁵

Overall, the risks of deregulation appeared minimal and manageable, which ignited a competitive race among policy-makers in terms of each jurisdiction striving to attract as much of the uncleared business as possible in order to promote economic activity and growth. The deregulation consensus paired with the desire to win this race made policy-makers very receptive both to threats of the industry moving the uncleared business overseas, but also to information on how an ‘exit’ could be prevented and/or how additional business could be attracted.

3. Maximum business unity with ISDA acting as the uncontested voice of the market

The key private sector actor in the pre-crisis period, beyond the individual banks themselves, was ISDA as the industry’s peak business association. It spoke as the central voice of the market, having successfully ‘turned competitors into collaborators’ since its formation in 1985.⁴³⁶ Neither the buy-side, nor the end-users participated in the debate to any significant extent. With business unity thus being undisturbed by conflict, the industry could send a clear signal about its preferences. Indeed, in the years of the pre-crisis period, ISDA in the eyes of some observers ‘traveled an amazing course’.⁴³⁷ In the words of leading financial analyst, Frank Partnoy, it was widely considered ‘to be the most powerful and effective lobbying force in the recent history of financial markets’.⁴³⁸

Of crucial importance was the establishment and widespread use of ISDA’s ‘Master Agreement’. First published in 1987 and later updated in 2002, the Master Agreement emerged from the Code of Standard Wording, Assumptions and Provision for Swaps (known as the ‘Swaps Code’) published in 1985.⁴³⁹ Representing a ‘technical system’ through which counterparties ‘identify themselves as part of a common enterprise’,⁴⁴⁰ it structures the backbone of nearly all uncleared trades by providing key definitions and a catalogue of provisions from which the counterparties can chose to tailor the bilateral contract according to their preferences.⁴⁴¹ By managing the market’s key contractual infrastructure, ISDA further consolidated its monopoly position as the market’s leading voice.

⁴³⁵ Leigh-Pemberton quoted in Oren/Blyth (2018:11).

⁴³⁶ Flanagan (2001:17 of the word doc)

⁴³⁷ *ibid.*

⁴³⁸ Partnoy (2009:45)

⁴³⁹ Gelpern (2009:64)

⁴⁴⁰ Porter (2014a:112)

⁴⁴¹ Gelpern (2009:64)

The highly mobile character of the OTC derivatives business already by itself made structural power in terms of the 'exit' threat a relatively easy-to-pursue strategy for the banks. However, ISDA also actively shaped its exit options by employing structuring power. Specifically, it successfully lobbied foreign jurisdictions to adjust their national legislative frameworks in such a way as to ensure the enforceability of the key provisions enshrined in the Master Agreement. Of crucial interest to ISDA was to secure 'safe harbour' status for OTC deals and to receive exemptions from gambling legislation as well as 'automatic stay' provisions under the respective bankruptcy code.⁴⁴² The idea was to prevent uncleared deals from being prosecuted as purely 'speculative investments' and to guarantee that in case of a credit event, the surviving counterparty could 'jump' the creditor queue and directly engage in close-out netting without interference by a local bankruptcy judge.⁴⁴³ ISDA defines 'close-out netting' as 'a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable [amount]'.⁴⁴⁴

In order to facilitate and coordinate the necessary reforms, ISDA developed a 'Model Netting Act' on the basis of which it provided detailed information to policy-makers, instructing them precisely how their respective legal frameworks needed to be changed in order to provide the desired legal certainty.⁴⁴⁵ The logic of competitive deregulation, and the wish to ensure the domestic market remained part of 'the game' encouraged policy-makers in many jurisdictions to implement the changes ISDA asked for without much hesitation.⁴⁴⁶ In Ireland, for example, the minister in charge made the following statement: 'I understand that it was the understanding to move ahead more quickly than many of our *competitors*. [...] a number of major players in the North American market have signalled their interest in Dublin...'.⁴⁴⁷ In Japan, ISDA provided 'substantial assistance' to policy-makers and the 'final draft [of the Netting Law] draws upon the logic of ISDA's Model Netting Act'.⁴⁴⁸

In 1994, the BCBS gave banks permission to include the close-out netting methodology in their capital requirements calculation for countries that had guaranteed the legal enforceability of the measure.⁴⁴⁹ By 2010, around 40 jurisdictions had adopted the required changes, including the EU which adopted two related directives in 1996 and 2002.⁴⁵⁰ ISDA's principal argument justifying these efforts was inspired by the dominating ideational outlook of the time, meaning that business unity and the ideational consensus fed off each other. The association insisted that close-out netting improved market efficiency and that it

⁴⁴² Biggins/Scott (2012:327)

⁴⁴³ See Biggins/ Scott (2012:327f.), Riles (2008:611), Behof (1993:25), Gelper (2009:65f.)

⁴⁴⁴ Mengle (2010:2)

⁴⁴⁵ Biggins/Scott (2012:328), Gelper (2009:60f.)

⁴⁴⁶ See Bliss (2007:138)

⁴⁴⁷ Biggins/Scott (2012:330, emphasis in the original)

⁴⁴⁸ Riles (2000:30)

⁴⁴⁹ BCBS (1994)

⁴⁵⁰ Newman/Bach (2014:442)

reduced systemic risk, as uncontrolled chain reactions following a credit event would be prevented.⁴⁵¹ More generally, the use of the Master Agreement was widely considered to provide for ‘a reduction in transactions costs, lower legal fees, less legal risk, and reduced default risk’.⁴⁵²

While these benefits facilitated trading across multiple jurisdictions, they of course also eased the relocation of business to other countries, meaning this form of structuring power also reinforced the structural power of the industry. In fact, as the ‘master’ behind the Master Agreement, ISDA came close to assuming itself the role of a regulator. For example, in 1998, when Long-Term Credit Bank, one of the largest Japanese banks, risked failing, policy-makers first turned to ISDA in order to determine whether the bank’s nationalization would be considered a ‘credit event’ under the Master Agreement. A contract volume of USD 450bn was at risk. The Japanese authorities proceeded with their bailout plan only after ISDA had published a document resembling a ‘no action letter’ (normally considered the prerogative of public regulatory agencies), reassuring policy-makers that the nationalization would not cause an uncontrollable chain reaction.⁴⁵³

4. Predominantly low public issue salience, a largely supportive domestic institutional environment, and the banks’ central position within the transnational policy community

The UK deregulated the market in one large leap in the form of the Financial Services Act of 1986, as a response to the problems associated with Keynesianism, including stagflation, unemployment, and low economic growth.⁴⁵⁴ The ‘Big Bang’ guaranteed the legal enforceability of uncleared derivatives, regardless of the extent to which they were deemed ‘speculative’.⁴⁵⁵ This set the standard to be reached for the US, whose principal legislative reference for the governance of derivatives markets was the Commodity Exchange Act of 1936 adopted after the damage caused by speculation during the Great Depression.⁴⁵⁶

In 1974, Congress had passed an amendment stipulating ‘that futures and options contracts on virtually all commodities, including financial instruments, be traded on a regulated exchange [...]’.⁴⁵⁷ It also established the CFTC, and charged it with regulating and supervising

⁴⁵¹ See Biggins/Scott (2012:328).

⁴⁵² Flanagan (2001:9 of the word doc)

⁴⁵³ Gelpern (2009:60f.)

⁴⁵⁴ Oren/Blyth (2018)

⁴⁵⁵ Biggins/Scott (2012:318)

⁴⁵⁶ Greenberger (2010b:3f.)

⁴⁵⁷ Financial Crisis Inquiry Commission (2011:46)

commodity futures, after the SEC had refused to assume jurisdiction over the market.⁴⁵⁸ Note, however, that the SEC had jurisdiction over broker-dealers and their use of derivatives.

For most of the pre-crisis period, public issue salience was low. With the average ('median') voter showing little interest in derivatives regulation, policy-makers tended to fully listen to the industry. In addition, the banks did not shy away from using (or threatening to use) their structural power of exiting the market to ensure policy-makers remained attentive to their demands. Several derivatives-related scandals in the 1990s risked causing an end to this form of 'quiet politics',⁴⁵⁹ which had provided important leverage for the banks' influence. However, public attention quickly faded away, one reason being that the crisis did not spill over into most voters' private lives. The domestic institutional environment was widely supportive of deregulation, the only exception being the CFTC which occasionally attempted to secure jurisdiction over the uncleared market. However, acting in unison with the regulators through the transnational policy community, the banks always convinced Congress that they had the situation under control and that enhanced self-regulation would render public intervention unnecessary.

Following the UK's Big Bang, the dealer banks' concerns grew that uncleared deals would become subject to the exchange-trading requirement, and thus part of the CFTC's jurisdiction. This would have rendered the market much less profitable, given higher levels of transparency and the tight corset of rules applying to exchange-traded derivatives.⁴⁶⁰ There was also growing concern that trades remaining outside the exchange-traded market could potentially be considered legally unenforceable.⁴⁶¹ In 1987, these fears materialized, when the CFTC voiced the idea of treating uncleared derivatives, in particular commodity derivatives, as futures. It also began examining the portfolio of Chase Manhattan and indicated that bespoke trades might be unenforceable under the CEA.

The dealer banks responded by flexing their structural power muscle and exiting the US.⁴⁶² According to one observer, '[t]he domestic commodity swap business ceased to exist as all deals moved overseas [...].'⁴⁶³ As a result, Congress quickly made the CFTC drop the idea, with the aim being for business to return to the US market. In 1989, the agency published the 'Swap Policy Statement' according to which most derivatives were excluded from regulation, on the condition that they were bespoke (and thus unsuitable for trading on an exchange) and exclusively marketed to 'sophisticated' investors.⁴⁶⁴ As a consequence, the domestic commodity swaps market soon recovered.⁴⁶⁵

⁴⁵⁸ Benson (1991:1175)

⁴⁵⁹ Culpepper (2011)

⁴⁶⁰ Financial Crisis Inquiry Commission (2011:46)

⁴⁶¹ Rosenberg (2010:146)

⁴⁶² Romano (1996:55)

⁴⁶³ Tormey (1997:2360)

⁴⁶⁴ Funk/Hirschman (2014:688f.), Jones Day (2001)

⁴⁶⁵ Tormey (1997:2360)

However, in 1990, the CFTC's decision, later upheld in court, to classify Brent oil forward contracts as futures once again caused the industry to question the agency's reliability.⁴⁶⁶ The banks therefore lobbied Congress to put an end to the uncertainty the CFTC kept causing. Responding to this pressure, Congress in 1992 passed the Futures Trading Practices Act which provided the CFTC with the legal authority to grant exemptions from regulation.⁴⁶⁷ On this basis, the agency in 1993 adopted 'Exemptions for certain Contracts Involving Energy Products'. As a consequence of this rule, public oversight was reduced, particularly over certain energy trades. The CFTC justified this decision by citing the need to 'enhance[] the global competitive position of U.S. businesses'.⁴⁶⁸ None of these decisions attracted wider public attention.

Low issue salience, however, risked coming to an end in the early 1990s, when a series of derivatives-related scandals directed public attention to the uncleared business. In 1991, Gibson Greetings, the US's second largest greeting card producer found itself in a loss spiral caused by its unsuitable use of derivatives, with the situation being aggravated by the fact that its dealer bank, Bankers Trust, had misled it on several accounts. The corporation eventually accumulated a loss of USD 27.5mn, i.e. about 10 times the limit it had set.⁴⁶⁹ In 1993, German corporation Metallgesellschaft lost 1.37 billion USD through misapplied OTC oil trades taken out for hedging purposes by its US subsidiary.⁴⁷⁰ The problems continued in 1994, when the Fed unexpectedly increased interest rates by 25 basis points from 3 to 3.25%, and eventually to 6.8% by the end of the year. This placed many firms with interest rate swaps in their portfolios in serious difficulties. Among the most prominent victims were Procter&Gamble and Orange County. The consumer goods manufacturer had turned to Bankers' Trust for help to improve its cost management. However, the interest rate swaps it purchased were only favourable to the firm as long as interest rates were falling, a fact it had not fully understood. After the interest rate hike, it found itself confronted with a pre-tax loss of USD 157mn.⁴⁷¹ Orange County suffered an even worse fate, having to file for bankruptcy. As part of its overall investment strategy, it had bought inverse floaters which are debt securities whose coupon varies inversely with respect to the prevailing interest rate. This means they provided income for the county as long as interest rates were stable or decreasing.⁴⁷² However, when interest rates suddenly rose, 'the inverse' occurred, resulting in an overall loss of USD 2bn.⁴⁷³

Congress was alarmed by this development. Representative Jim Leach (R-IA) compared the OTC derivatives market to a 'pyramidal house of cards'. His colleague Byron Dorgan (D-ND)

⁴⁶⁶ Leon (1994:339f.)

⁴⁶⁷ Leon (1994:341)

⁴⁶⁸ CFTC (1993:11 of the pdf)

⁴⁶⁹ Tsingou (2006:179)

⁴⁷⁰ Hu (1995:989), Markham (2014:266, fn. 16), Zelenko (2017:83ff.)

⁴⁷¹ Tett (2009:36)

⁴⁷² Veronesi (2011:61ff.)

⁴⁷³ Tett (2009:36)

approvingly quoted a *Fortune* article which placed the blame on the doorstep of the dealer banks: 'The threat is not from foreign competition, or government deficits or regulation. It is from Wall Street, and a new form of sophisticated financial bingo called derivatives... [D]erivatives could swamp our economy in a sea of red ink A single default... could ignite a chain reaction that runs rampant through the financial markets. Inevitably, that would put deposit insurance funds, and the taxpayers behind it, at risk'.⁴⁷⁴ Responding to high issue salience, Congress discussed several bills that would have reined in the uncleared market. The Derivatives Safety and Soundness Act of 1994 and the Derivatives Supervision Act of 1994 would have imposed capital, disclosure, and accounting rules.⁴⁷⁵ The Derivatives Limitations Act of 1994 in turn would have adopted an even more aggressive approach by prohibiting proprietary trading by federally insured depository institutions.⁴⁷⁶

The industry, however, did not remain inactive. Already prior to these scandals, it had established the G30, a transnational expert body composed of (former) representatives from the private and public sector, think tanks, as well as academia, which together formed the nucleus of the transnational policy community.⁴⁷⁷ The objective was to keep regulatory intrusion at bay. In 1993, the G30 published a report produced under the guidance of former Fed governor Paul Volcker who chaired the group and provided it with an authoritative aura, given his towering reputation acquired during his tenure at the Fed when he had managed to rein in rampant inflation in the 1970s.

The dealers made several commitments including the promotion of expertise on the part of dealer bank officials, the development of a suitable operational infrastructure to manage trade flows, and the sharing of qualitative information on the business with regulators.⁴⁷⁸ The report insisted that through the use of derivatives 'systemic risks are not appreciably aggravated, and supervisory concerns can be addressed within present regulatory structures and approaches'.⁴⁷⁹

The G30 report was widely endorsed by regulators including the Fed, OCC, FDIC, CFTC, BCBS and IOSCO, each of which was satisfied with the commitments the industry had made. The Fed, for instance, recommended that bank's '[s]enior management should evaluate regularly the procedures in place to manage risk to ensure that those procedures are appropriate and sound'.⁴⁸⁰ The OCC tasked banks with the responsibility of ensuring that the derivatives business was conducted in line with firms' 'overall risk management philosophy' and 'business strategies'.⁴⁸¹ The CFTC stated that 'no fundamental changes in

⁴⁷⁴ See Krawiec (1997:1, footnote*).

⁴⁷⁵ Culp/Mackay (1994:42f.)

⁴⁷⁶ Culp/Mackay (1994:43)

⁴⁷⁷ Tsingou (2006:175)

⁴⁷⁸ Tsingou (2003:10f.)

⁴⁷⁹ G30 (1993:6 of the pdf)

⁴⁸⁰ Board of Governors of the Federal Reserve System (1993:2)

⁴⁸¹ OCC (1993:5)

regulatory structure appear to be needed⁴⁸² and the SEC's chair Arthur Levitt advocated that securities firms' efforts to address legal problems should remain entirely 'voluntary'.⁴⁸³ At the transnational level, BCBS and IOSCO joined the choir praising self-regulation. The BCBS relied on the report when publishing its 'guidelines [that] bring together practices used by major international banks'. Underlining the voluntary character of the approach and clarifying that it did not mean to impose regulation by any means, the committee added that '[w]hile no bank may follow the framework precisely, it could provide guidance to all banks'.⁴⁸⁴ IOSCO, in turn, saw no need to issue 'normative standards'.⁴⁸⁵

The banks occupied a central position within the transnational policy community and formed a nearly inseparable symbiosis with policy-makers. For BIS General Manager Sir Andrew Crockett, the close-knit community espoused 'Masonic' elements. In his eyes, the groups' activities demonstrated to public and private sector members alike that 'their interests are not different'.⁴⁸⁶ In the words of John Heimann, former Comptroller of the Currency and at the time a senior official with Merrill Lynch, the G30 enjoyed 'credibility because of member prestige'.⁴⁸⁷ Several regulators from the SEC argued that the 'G30 would not have come up with recommendations that were not good and sound'.⁴⁸⁸

The G30's report also served as a key piece of information when Congress deliberated public intervention in 1994. Indeed, a copy of the report was listed as the first supporting piece of information in a compilation of documents House members had at their disposal when pondering their decision.⁴⁸⁹

During the public hearings, ISDA insisted that public intervention 'would interfere with the management of banks and their affiliates in a rapidly evolving and competitive activity.' Rather, 'industry participants should be allowed to continue their voluntary cooperation with regulators'.⁴⁹⁰ The ABA (American Bankers Association) told Congress, the proposed legislation 'would seem to accomplish nothing that the regulatory authorities [...] are not already doing'. It warned policy-makers not to underestimate the effects 'such legislation may have on the financial marketplace'.⁴⁹¹ Bank of America emphasized that '[e]veryone is concerned that an attempt at legislation could cause significant dislocations in the way the market operates'. To ensure policy-makers understood the message referencing the

⁴⁸² CFTC quoted in Tsingou (2003:14).

⁴⁸³ Levitt quoted in Faerman et al. (2001:374).

⁴⁸⁴ Both quotes taken from BCBS (1994:1).

⁴⁸⁵ See IOSCO (1994:6).

⁴⁸⁶ Crockett quoted in Tsingou (2015:237f.).

⁴⁸⁷ Heimann quoted in Tsingou (2015:238).

⁴⁸⁸ Evidence provided by members of the SEC interviewed by Tsingou (2015:238).

⁴⁸⁹ Tsingou (2003:16)

⁴⁹⁰ Both quotes by Mark Brickell of ISDA cited in US House Banking, Finance, and Urban Affairs Committee (1994).

⁴⁹¹ Both quotes by John Ward Logan of ABA cited in US House Banking, Finance, and Urban Affairs Committee (1994).

industry's structural power, it added that the OTC market 'is one of the only truly global product markets, which can move at the drop of a pin'.⁴⁹²

Congress understood. Representative Leach and his colleagues dropped their inflammatory rhetoric against derivatives. Rather, Leach acknowledged that "[w]e've seen that when you have uneven regulation, money flows to the least regulated [jurisdiction]," [...] "The only way to have even regulation is to have legislation".⁴⁹³ The administration also did not favour intervention. Treasury Secretary Lloyd Bentsen said it was necessary 'to be careful about interfering in markets in too heavy-handed a way'.⁴⁹⁴ The regulators once again seconded the industry. The OCC, for example, stated that regulation was not 'necessary' and that it would act promptly if it 'f[ou]nd current measures to be inadequate'.⁴⁹⁵ The FDIC declared that Congress did not have to worry since 'there are both regulatory and market safeguards that help to prevent a derivatives induced default at a large institution'.⁴⁹⁶ Greenspan believed the Fed was 'ahead of the curve on this issue as best one can get'.⁴⁹⁷ His support, in particular, was considered of tremendous importance.⁴⁹⁸ Indeed, a senior banker told the press (probably only half-jokingly) that the industry actually did not even have to lobby Congress, "'since we have Alan Greenspan [...] doing that'".⁴⁹⁹ Through their close cooperation as part of the transnational policy community, the regulators and the banks succeeded in convincing Congress not to adopt any of the bills. It certainly also helped that the direct repercussions the corporate scandals had on individual voters' lives appeared limited. The public's attention, and therefore policy-makers' interest in the issue, soon moved to other topics, thus allowing 'quiet politics'⁵⁰⁰ to take over the reigns again.

Note that, despite the industry's success at preventing legislation, not everybody was convinced that deregulation was actually as risk-free and unproblematic as the transnational policy community, with the banks at its centre, had tried to make policy-makers believe. For example, in 1992, Gerald Corrigan, president of the New York Fed, told the dealer banks that "'you had all better take a very, very hard look at off-balance sheet activities'",⁵⁰¹ where much of the derivatives-related exposure began piling up. One year later, Brian Quinn, Executive Director at the Bank of England commented on the G30 report, emphasizing that its overall conclusion suggesting that derivatives did not add any risk 'strikes [him] as somewhat complacent'. He warned that '[i]f the demand for this new

⁴⁹² Both quotes by Lewis Teel taken from Peltz (1994:67).

⁴⁹³ Leach quoted in Peltz (1994:68).

⁴⁹⁴ Bentsen quoted in Tett (2009:39).

⁴⁹⁵ Comptroller of the Currency John Lujan quoted in US House Banking, Finance, and Urban Affairs Committee (1994).

⁴⁹⁶ Acting FDIC chair, Andrew C. Hove quoted in US House Banking, Finance, and Urban Affairs Committee (1994).

⁴⁹⁷ Greenspan quoted in US House Banking, Finance, and Urban Affairs Committee (1994).

⁴⁹⁸ Tsingou (2003:17)

⁴⁹⁹ Senior banker quoted in Tett (2010). The quote refers to the pre-crisis situation more generally.

⁵⁰⁰ Culpepper (2011)

⁵⁰¹ Corrigan quoted in Lee (1992).

source of profit should expand more quickly than the supply of people capable of doing the business, there can only be trouble ahead'.⁵⁰²

One year later, the United States General Accounting Office published a report whose conclusions anticipated much of the 2008 crisis. It highlighted that '[b]ecause the same relatively few major OTC derivatives dealers now account for a large portion of trading in a number of markets, the abrupt failure or withdrawal from trading of one of these dealers could undermine stability in several markets simultaneously, which could lead to a chain of market withdrawals, possible firm failures, and a systemic crisis. The federal government would not necessarily intervene just to keep a major OTC derivatives dealer from failing, but to avert a crisis, the Federal Reserve may be required to serve as lender of last resort to any major US OTC derivatives dealer, whether regulated or unregulated. [...] The interrelationships among OTC derivatives dealers and markets worldwide increase the likelihood that a crisis involving derivatives will be global'.⁵⁰³

However, with issue salience having reached low levels again and the ideational deregulation consensus remaining largely unchallenged, the warnings did not have any significant effect. Also, they were never voiced in a coordinated fashion, and thus did not reach a level that could have disrupted low issue salience. The technical complexity of the derivatives business (which even Greenspan after the crisis admitted he had not fully understood in all its elements⁵⁰⁴) further complicated raising long-term interest in regulation.⁵⁰⁵ The dominant mantra thus remained that 'what was good for Wall Street was good for America'.⁵⁰⁶

Under the leadership of Corrigan, who in the meantime had moved through the revolving door from the New York Fed to Goldman Sachs, and following a suggestion by SEC chair Levitt, the industry in 1994 established the Derivatives Policy Group as another vehicle of the transnational policy community. In 1995, the Group formed the Framework for Voluntary Oversight through which the banks once again promised to enhance risk management, to provide the regulators with confidential reports on credit risk exposure, and to prepare and implement guidelines for the adequate management of counterparty relationships.⁵⁰⁷ Corrigan emphasized that the industry was very serious about adhering to this form of self-regulation. In his words, the Group's promises were 'commitments', rather than 'recommendations or proposals'.⁵⁰⁸

⁵⁰² Quinn (1993:536,537)

⁵⁰³ US General Accounting Office (1994:12f.). In the same year, the IMF (1994:25) also voiced a similar warning.

⁵⁰⁴ Greenspan quoted in Hirsh (2010:180).

⁵⁰⁵ Lavelle (2013:252)

⁵⁰⁶ Johnson/Kwak (2010:24 of the pdf)

⁵⁰⁷ Derivatives Policy Group (1995), Faerman et al. (2001:375)

⁵⁰⁸ Faerman et al. (2001:375)

It took another shock with a corresponding increase of public issue salience to reanimate the discussion about the need for regulation. The crisis in question occurred in 1998 with the failure of Long Term Capital Management (LTCM), a hedge fund with rock star status, which, for several years, had provided double-digit returns to its investors.⁵⁰⁹ Relying to a large extent on the Black-Scholes formula and having Scholes himself as a board member, LTCM had invested in a ruble-denominated security known as the GKO (signifying the Russian initials of the product) on which the Russian government had promised a 40% return. To hedge this investment, the fund had bought forward contracts on the ruble. In theory, this should have provided for a flat book, with losses on the GKO being recovered through the forward. However, once the Russian government defaulted on its debt and prohibited its banks from meeting their requirements under FX contracts, LTCM saw itself confronted with exposure levels spiralling out of control.⁵¹⁰ The ensuing chain reaction swept through the financial markets, causing a serial break of VaR limits, which in turn risked provoking a fire sale. In order to prevent the worst, a group of banks joined forces and bought what was left from the firm that had lost 90% of its capital (~USD 4.6bn).⁵¹¹

Once again alarmed, the US Congress charged the President's Working Group on Financial Markets with drafting a report on LTCM's debacle. The report noted that '[t]he near collapse of Long-Term Capital Management [...] highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system'.⁵¹² However, in line with the ideational outlook of the time, a second report concluded that '[t]he sophisticated counterparties that use OTC derivatives simply do not require the same protections under the CEA as those required by retail investors'.⁵¹³

One of the few regulators not convinced of returning to 'business as usual' was CFTC chair Brooksley Born. In 1998, she published a concept release intended to take stock of the state of the OTC market, and to derive conclusions about the potential need for regulation. The text itself was carefully worded, insisting that '[t]he Commission has no preconceived result in mind. The Commission is open both to evidence in support of broadening its exemptions and to evidence indicating a need for additional safeguards'.⁵¹⁴ However, Born's public comments on the concept release made it clear that the agency was in fact pushing for regulation.⁵¹⁵ In one of her 1999 speeches she summarized this ambition in one sentence: 'These issues [i.e. the issues the CFTC felt the uncleared market was negatively affected by] include lack of transparency, excessive leverage, insufficient prudential controls, and the need for greater coordination and cooperation among international regulators'.⁵¹⁶ Among

⁵⁰⁹ Allington et al. (2012:559)

⁵¹⁰ Blyth (2003:250)

⁵¹¹ Greenberger (2010b:7f.)

⁵¹² President's Working Group on Financial Markets (1999a:7)

⁵¹³ President's Working Group on Financial Markets (1999b:16)

⁵¹⁴ CFTC (1998)

⁵¹⁵ Stout (1999:705f.)

⁵¹⁶ Born (1999b); for similar remarks see Born (1999a).

other measures, Born also considered imposing mandatory margin requirements on uncleared derivatives.⁵¹⁷

Her move did not go unnoticed.⁵¹⁸ US Treasury Secretary Robert Rubin (another Goldman Sachs veteran), Fed governor Greenspan, and SEC chair Levitt immediately responded with a joint statement intended to undermine the CFTC's authority: 'We seriously question the scope of the CFTC's jurisdiction in this area, and we are very concerned about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives'.⁵¹⁹ In addition, they convinced Congress to issue a temporal ban on any derivatives-related regulation for a period long enough to ensure Born could not interfere anymore until the end of her mandate.⁵²⁰

The policy discussions on Capitol Hill regarding the need for public intervention followed the same pattern as in the early 1990s. The banks insisted they had the situation under control. They also pointed to their commitment to further self-regulation. Indeed, in 1999, the Counterparty Risk Management Group (CRMPG), another private sector body, once again co-led by Corrigan, published a report on the lessons of LTCM's failure. It suggested the banks improve their trade documentation and pursue informal exchanges with regulators.⁵²¹ However, the report also insisted that its conclusions were 'recommendations', rather than 'static or "one size fits all"' commitments. Above all, it clarified that '[i]t would be a mistake to attempt to codify risk management practices in that fashion'.⁵²² ISDA warned Congress that the "... recent actions and statements of the CFTC culminating in its Concept Release concerning privately-negotiated swaps have undercut and imperilled the legal certainty that has until now existed for swaps through in large measure, the foresight and efforts of Congress. Moreover, the CFTC has sent a chill through this business by raising the specter that it may seek to impose new restrictions on privately-negotiated swap transactions'.⁵²³ A dealer bank alliance composed of Citigroup, Chase Manhattan, Credit Suisse, Goldman Sachs, Merrill Lynch and Morgan Stanley reminded legislators of the banks' structural power of using the exit by voicing the barely concealed threat that a 'yes' in favour of the bill would "'prevent the flight of our domestic financial derivatives business abroad"'.⁵²⁴

The threat was once again effective. Senator Richard Lugar (R-IN) showed himself impressed after 'an electronic demonstration' the industry had organized on Capitol Hill during which a bank official 'transacted a trade right in front of [policy-makers] on his computer on a

⁵¹⁷ Born (1998)

⁵¹⁸ Born quoted in McLean/Nocera (2010:225).

⁵¹⁹ US Treasury Department (1998)

⁵²⁰ Scheer (2010:105)

⁵²¹ CRMPG (1999:9f., 37)

⁵²² CPMPG (1999:2)

⁵²³ ISDA quoted in Carruthers (2013:395).

⁵²⁴ Dealer bank alliance quoted in Chander/Costa (2010:22f.).

European market ...'.⁵²⁵ This demonstration did not mean that policy-makers actually fully understood what they had just seen on the screen. Senator Trent Lott (R-Miss.) a few years later made the following statement which revealed to extent to which policy-makers had to rely on the information the industry provided them with. He said that 'I hope we won't do a test here to ask Senators to define what a derivative is. In fact, we have been checking Webster's, trying to make sure we understand the definition of derivative. After having read the definition, I don't think it clears up anything'.⁵²⁶ Indeed, prior to 2008, many policy-makers were often hugely impressed by bankers' (personal) financial success, to the extent that they believed that the industry's business decisions could not be anything but smart and correct, and that it was Congress' duty to provide the banks with the best conditions to expand their market share.⁵²⁷

In the hearing during which the live demonstration of the trade took place, Senator Phil Gramm (R-TX) pointed out that '[w]e have competition from all over the world that would very much like to see this goose that lays the golden egg, these financial markets, roosting in their coop. They are trying to do things to attract it'.⁵²⁸

Rather than imposing constraints on uncleared derivatives, Congress decided to deregulate the market once and forever through the adoption of the Commodity Futures Modernization Act of 2000 which codified the previously temporal prohibition of the CFTC to regulate the uncleared market. While a crucial decision, the public barely took notice of it, since the media were largely pre-occupied with the Supreme Court's vote on the winner of the presidential elections (Al Gore vs. George W. Bush).⁵²⁹ Even within Congress, the bill did not attract much attention, having been added at the last minute as a rider to an 11,000-page omnibus appropriations conference report and put up for vote only a few days before the Christmas break.⁵³⁰

US firms were determined to ensure the OTC business would remain free from any further intrusion. By the mid-2000s, the New York Fed's president and CEO, Timothy Geithner, started being concerned about the growing operational infrastructure problems of the market. Indeed, the dealers suffered from backlogs of trade confirmation caused by the widespread reliance on handwritten notes and faxed orders, rather than electronic trade processing. Moreover, they often novated (i.e. re-assigned) trades to a new counterparty without informing the other one, which caused further confusion. Geithner convinced the banks to optimize their back-office activities, which resulted in a drop of the backlog of unconfirmed CDS by 92% and a tripling of electronic trade processing of equity derivatives to 94% by 2008.⁵³¹ However, in a volume published after the crisis, he stated he was realistic

⁵²⁵ Lugar quoted in Chander/Costa (2010:22).

⁵²⁶ Lott quoted in US Congress (2002:3401).

⁵²⁷ See for example Johnson/Kwak (2010), also Lavelle (2013:106).

⁵²⁸ Gramm quoted in Chander/Costa (2010:22).

⁵²⁹ Labaton (2009:28)

⁵³⁰ Blumenthal (2009)

⁵³¹ Geithner (2014:103)

enough not 'to overstate the importance of these reforms. [...] Large banks and nonbanks had a mutual interest in upgrading their derivatives infrastructure, so we managed to persuade them to upgrade it. But we couldn't persuade enough of them to reduce their leverage or manage their risks more carefully, because they didn't think that was in their interest'.⁵³²

Overall, with the exception of the CFTC, which occasionally attempted to intervene in the uncleared market, the US domestic institutional environment was benign for the banks to exercise influence. From a domestic institutional point of view, securing the success of deregulation was largely unproblematic, particularly if it meant for regulators to simply not get involved with counterparties' decision-making rationales. Policy-makers realized they could keep the US' market share stable or growing only if they continued on the deregulation path. The industry's past success in terms of securing market growth also provided positive feedback effects, which increased the weight of its voice and influence. As well, the deregulation consensus had acquired a strong institutional presence in the other regulatory agencies, which kept the CFTC in check and helped 'guide' Congress' actions.

Around the turn of the millennium, the UK equally assured the market that the deregulated status of uncleared derivatives would not be touched upon. In the 1990s, policy-makers and financial firms had begun noticing the shift from traditional 'relationship banking' to 'transaction banking', where clients' main criterion for the choice of their bank was the price of the transaction, rather than their past relationship with an individual firm. In their view, the US banks appeared to be clearly winning the race.⁵³³ In order to retain the business, policy-makers therefore decided to reinforce the deregulated status of uncleared derivatives through the Financial Services and Market Act of 2000 which explicitly exempted bespoke trades between sophisticated counterparties from regulation.⁵³⁴

Institutionally, the domestic environment provided an equally fertile environment for the banks to influence policy outcomes. The regulatory authorities which could have constrained the market, first the Securities and Investment Board and later the FSA both subscribed to a 'noninterventionist approach', which over the years became deeply engrained in both authorities' institutional identity.⁵³⁵ Regulators' expectations vis-à-vis the banks were detailed in The London Code of Conduct.⁵³⁶ Its leitmotif '[was] that the wholesale markets are for professionals, and participants are expected to look after their own interests. Core principles will generally assume that their counterparties, whether or not also professionals, have the capability to make independent decisions; all principals should assess for themselves the risks of dealing in the wholesale markets'.⁵³⁷

⁵³² Geithner (2014:104)

⁵³³ Singer (2007:81)

⁵³⁴ Awrey (2010:46)

⁵³⁵ *ibid.*

⁵³⁶ Coleman (2004:283)

⁵³⁷ James (2013:147)

Predominantly low levels of issue salience, a benign domestic institutional environment, and the banks' privileged position within the transnational policy community thus individually and jointly provided the ground for deregulation to take hold, persist, and continue.

5. Inter-state power relations fostering the deregulation trend

The nature of transatlantic inter-state power relations further supported the strength of this factor constellation. During extended periods of the pre-crisis period, inter-state power between public policy-makers did not play any major explicit role. One might argue, though, that structural power kept lurking in the background of competitive deregulation, in the sense that policy-makers felt it was in their own interest to pursue this course of action to prevent the respective other side of the Atlantic from siphoning away market share. However, there were also two episodes where power was more clearly at play. The outcome, however, never constrained the banks and their successful exercise of influence.

In the first case, the UK was concerned that its deeply rooted regulatory structure based on the consolidated supervision of financial institutions might disadvantage its banks vis-à-vis their US competitors. Consolidated supervision means that prudential supervision was exercised over financial groups across all organizational levels including the holding company as well as its divisions and subsidiaries. It also meant that no part was exempt from capital requirements.⁵³⁸ The SEC, by contrast, did not impose regulation on its broker-dealers on a consolidated basis. In addition, most of the US derivatives business used to be channelled through unregulated holding institutions, which did not have to post capital, and therefore frequently succeeded in outcompeting their UK peers.⁵³⁹ Indeed, US shops, above all Goldman Sachs and Morgan Stanley, dominated the list of the securities firms most appreciated by UK clients in London.⁵⁴⁰

To resolve the predicament, the UK brought up the issue within IOSCO,⁵⁴¹ hoping for the development of an international capital adequacy standard for securities firms, similar to the one the BCBS had succeeded in establishing for the banks a few years earlier.⁵⁴² From the SEC's point of view, however, this would have equalled intrusive regulation of the uncleared business. The failure of US investment bank Drexel Burnham Lambert in 1990 following irregularities in its junk bond business increased the UK's hope that the SEC would support a global arrangement.⁵⁴³

⁵³⁸ The information for this paragraph is drawn from Singer (2010:98).

⁵³⁹ Singer (2007:81f.)

⁵⁴⁰ Singer (2007:80)

⁵⁴¹ The regulatory body in charge was the Securities and Investments Board.

⁵⁴² Singer (2007:82f.), see Oatley/Nabors (1998) on the establishment of Basel I.

⁵⁴³ Singer (2007:85f.)

The agency, however, refused taking this step, claiming that increasing the transparency of holding companies through more detailed reporting requirements was sufficient. This course of action, of course, fully reflected the deregulation consensus. It meant little interference with securities firms' derivatives business, which was fully in line with the industry's preferences. Congress was equally satisfied with this solution and did not demand any further action.⁵⁴⁴ The SEC therefore vetoed any IOSCO-led solution. According to a 1992 IOSCO report, it considered 'that prudential consolidation does not provide any discernible advantages. [...] [It] creates unnecessarily high expectations and therefore risk along with unnecessary costs'.⁵⁴⁵

What put the SEC in the position to torpedo international regulation was its dominant market share. Singer argues that '[d]ata on the derivatives business of firms in the late 1980s and early 1990s are notoriously difficult to find, and the patchy data that do exist [...] are generally not helpful as indicators of international market share'.⁵⁴⁶ Nonetheless, to policy-makers, results such as those of the survey referenced above were sufficient to indicate the US's leading position in the market. With the American investment banks arguably controlling the bulk of the uncleared business, an international agreement against US preferences was not viable. The EU at that time did not play any major role at the international level.

The topic of consolidated supervision, however, only temporarily disappeared from policy-makers' agenda. Following its steps towards institutional consolidation, the EU picked it up again a decade later in the early 2000s. This time, the SEC found itself in a situation where the other side of the Atlantic disposed of both market power and power through regulatory capacity. This combination paralyzed its own veto power, and the US had to align itself with Europe's preferences. Indeed, following a series of market-integration reforms,⁵⁴⁷ the EU adopted the Financial Conglomerates Directive of 2002 which stipulated that all non-EU financial conglomerates with operations in Europe were to become subject to consolidated supervision. The content of the directive, however, 'was more an accident of history than an indicator of a willingness to manage globalization',⁵⁴⁸ i.e. policy-makers did not intend to abandon the deregulatory paradigm. Rather, its objective was to promote financial integration within the EU and to streamline the regulation of European universal banks.⁵⁴⁹ The directive had EU-wide application, i.e. it covered the entire European market, including the City in London, which provided EU policy-makers with a lever during their transatlantic negotiations with the SEC. It required foreign jurisdictions to successfully complete an equivalence determination in order for their firms to continue enjoying access to the European market. The non-attribution of the equivalence label would have had serious consequences. For example, it would have resulted in foreign conglomerates being

⁵⁴⁴ Singer (2007:86)

⁵⁴⁵ IOSCO (1992:15)

⁵⁴⁶ Singer (2007:80f.)

⁵⁴⁷ See Posner (2009).

⁵⁴⁸ Posner/Véron (2010:404)

⁵⁴⁹ Posner/Véron (2010:404ff.)

supervised directly by the EU, which would have entailed the financially burdensome ‘ring-fencing’ of their assets, as well as other costs.⁵⁵⁰

Again, we lack the necessary data to comprehensively evaluate the situation from a market share perspective. The BIS, however, has collected some data on national shares for interest rate and FX derivatives. This data suggests that for interest rate derivatives, the EU in 2004 accounted for 69% of global market volume (the global share of the UK being 42%), with the US trailing behind with 24%. Regarding the FX sector, the ranking was similar, with the EU leading with 49% (the global share of the UK being 32%) and the US market accounting for no more than 19%.⁵⁵¹ The threat of the US losing access to the EU market, therefore, appears to have been meaningful. Without rapid action, the US securities firms under SEC supervision would have no longer had the opportunity to conduct business in Europe. Further confirmation underlining the seriousness of the EU’s threat and thus the effectiveness of its power as market share *cum* regulatory influence can be found in the response by US financial firms which immediately started pushing for the adoption of the regulatory changes necessary for obtaining a positive equivalence decision by the EU. As Maxfield notes, ‘[a]ny foot-dragging by US authorities would [have] put US firms’ European operations at a competitive disadvantage against European firms operating in Europe’.⁵⁵²

The SEC complied, and in 2004 established the Consolidated Supervised Entities programme which brought securities firms’ entire corporate structure under consolidated supervision. While of voluntary nature, all of the five large broker-dealers (i.e. Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley) eagerly participated.⁵⁵³ Despite this regulatory activity, it is important to stress that neither the SEC’s programme, nor the EU’s directive restrained firms’ uncleared business.⁵⁵⁴ While the SEC obliged the firms in the programme to keep a minimum capital base of USD 1bn and to inform the agency if the base decreased to less than USD 5bn,⁵⁵⁵ it provided for immediate compensation by allowing them to significantly increase their leverage ratio (i.e. the ratio of debt to equity). Transatlantic power relations among policy-makers therefore did not constrain the dealers’ pre-crisis influence either.

6. Conclusion

⁵⁵⁰ Maxfield (2011:8f.)

⁵⁵¹ Authors’ calculation by other based on BIS derivatives statistics (table D12.2 – Turnover of OTC interest rate derivatives, by country, and table D11.2 -Turnover of OTC foreign exchange instruments, by country). IR and FX are the only asset classes for which this kind of data is available.

⁵⁵² Maxfield (2011:9)

⁵⁵³ Satow (2008)

⁵⁵⁴ Bhatia (2011:14)

⁵⁵⁵ Maxfield (2011:9)

This chapter has analyzed dealer banks' dominant influence over the deregulation of OTC derivatives prior to 2008. The banks, whose preference was to keep intrusive regulation at bay, benefited from a unique factor constellation. Each of the six moderators identified in the analytical framework served as an open floodgate providing leverage for their influence to take hold. First, the industry benefited from maximum business unity, with conflict being virtually absent. This allowed ISDA and the banks to send an undiluted message about their preferences. Through the Master Agreement, ISDA also served as the monopoly provider of the market's contractual infrastructure. Its success in having key jurisdictions adjust their legal framework such as to ensure compatibility with the contractual arrangements contained in the Master Agreement, allowed the banks to exercise structuring power in terms of shaping its exit options. This, in turn, endowed the industry with further structural power, and it frequently threatened to move the highly mobile uncleared business across the Atlantic to the City of London, if policy-makers did not heed bankers' demands. Second, the dominance of the efficient market hypothesis made the risks of deregulation appear minimal, animating policy-makers to enter a race of competitive deregulation in terms of each jurisdiction striving to attract as much market share as possible. Third, the banks also benefited from the fact that public issue salience was generally low, and that warnings against the risks of deregulation never succeeded in mobilizing a critical audience. Following sudden spikes of issue salience, the industry's central position within the transnational policy community allowed for a joint bank-regulator effort to tame the risk of public intervention, keep the CFTC in check at the domestic institutional level, and to subsequently enshrine the unregulated status of OTC derivatives through the adoption of corresponding legislation. The high complexity of derivatives also meant that policy-makers willingly relied on the information the banks supplied them with. The nature of inter-state power relations between policy-makers never challenged the deregulation course, and in the case of the SEC even further promoted it. The domestic institutional environment was also benign for dealer bank influence to take hold. In the US, the CFTC several times tried to regulate the market, but was reined in by the other agencies which had all largely embraced the deregulation course as part of their institutional identity.

The high level of bank influence was not only promoted by the individual effects of the moderators, but also by their joint interaction. The absence of business conflict fostered the banks' position within the transnational policy community whose members subscribed to the deregulation consensus, which consolidated support for deregulation among most members at the domestic institutional level, which again fed back into the ideational deregulation consensus. The dominance of this consensus also ensured that inter-state power plays never had a market-constraining effect. Predominantly low levels of public issue salience provided further stability to this configuration. Occasional spikes of issue salience and the attempts by the CFTC to rein in the market could not shake this constellation, and therefore did not lower dealer banks' level of influence.

CHAPTER IV – Over-arching changes to the post-crisis factor constellation

1. Overview of the chapter

Before proceeding with the analysis of dealer bank influence over the development of the post-crisis margin rules, this chapter explains the post-crisis context within which the development of the new requirements took place. It covers several changes that transcend the analysis of the individual rules. Discussing these aspects separately upfront is advantageous, as it facilitates our understanding of the debate on the individual rule elements covered in the subsequent chapters. Specifically, this chapter focuses on three of the moderators in the overall post-crisis configuration, i.e. high public issue salience, the ideational clearing/margining consensus, and the dealers' loss of their privileged position within the transnational policy community. It will be limited to overarching commonalities, while the individual case study chapters will provide further evidence and case-specific nuance. The other moderators, i.e. business unity, inter-state power relations, and the domestic institutional environment remain outside this part of the analysis.

Section 2 shows that policy-makers' immediate response to the crisis was not to drop the deregulation consensus, but to privilege continued self-regulation by the industry. The banks did not oppose central clearing and margining per se, but expected them to be industry-led initiatives, without any intrusion by policy-makers. The dealers were initially fully convinced they would be able to continue exercising dominant influence over the design of the post-crisis derivatives governance arrangements. However, their progress towards addressing the problems in the market was limited, and, this time, they faced a backlash.

Section 3 reveals that the unprecedented public intervention required to stabilize the economy after the crisis made the public issue salience of derivatives regulation skyrocket. As a consequence, policy-makers deemed continued reliance on self-regulation untenable. Instead, they advocated public intervention and an end to competitive deregulation.

Section 4 explores the new ideational consensus that emerged in response to policy-makers' determination to turn their backs to the deregulation of the uncleared market. The main pillar of the new consensus was the promotion of central clearing, given that centrally cleared derivatives had fared much better during the crisis than many bespoke ones. Section 4.1 examines the clearing consensus which was informed by several ideas: First, the idea that CCPs would reduce interconnectedness, second, the fact that they had successfully weathered the crisis, third, the reassurance by CCP officials that they were willing to take over the new business and that regulators had experience in overseeing

these entities, and fourth, that the overall idea allowed policy-makers to show strength and determination during times of crisis. Section 4.2 reveals that policy-makers soon had to realize that a substantial fraction of the bespoke market would be unsuitable for central clearing, which required identifying a different regulatory solution for uncleared products. They settled on mandatory collateralization, so as to import a key feature of the cleared into the uncleared market. The new ideational consensus was two-fold: Policy-makers believed that mandatory margin requirements for non-centrally cleared derivatives would account for the higher systemic risk emanating from bespoke trades and that they would encourage investors to shift suitable trades to CCPs. Section 4.3 shows that the US immediately acted upon the new consensus, taking on the role of a first-mover in the development of the margin rules. Europe, however, soon began lagging behind. From the point of view of the US, some skeptical EU voices questioning the utility of margin requirements cast doubt on Europe's willingness to follow through with the reform. This raised the spectre of the return of competitive deregulation. Following strong encouragement by the US, policy-makers therefore decided to establish an international working group through BCBS-IOSCO (known as the Working Group on Margin Requirements (WGMR)), which solidified the ideational post-crisis consensus and committed itself to the development of a harmonized set of global rules.

Section 5 discusses evidence of the deteriorating relationship between regulators and the industry within the transnational policy community that was characteristic of the rollout of the margin requirements more generally, but without being tied to a particular rule element. It indicates that the banks found themselves expelled from the centre of the community, relegated to its margin.

2. The initial persistence of the deregulation consensus: Self-regulation by the industry as the first public response to the crisis

As the 2008 crisis began to unfold, policy-makers did not immediately abandon the deregulation consensus that had dominated in the pre-crisis period. In April 2008, the Financial Stability Forum limited itself to recommending that '[m]arket participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound'.⁵⁵⁶ The communiqué of the G20 summit in Washington, D.C. of November 2008 did not deviate from the deregulation consensus either. For example, the declaration recommended that '[r]egulators should [...] encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management. [...] Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large

⁵⁵⁶ FSF (2008)

counterparty risk positions across products and geographies'.⁵⁵⁷ Regarding the OTC market, the G20 charged regulators with the task of 'speed[ing] efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions [...], expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes'.⁵⁵⁸ Fed chair Ben Bernanke clearly approved of emphasizing firms' self-regulatory efforts. 'Correcting these weaknesses', he observed 'is, first and foremost, the responsibility of the firms' managements and they have powerful incentives to do so'.⁵⁵⁹

The industry immediately began developing plans, strategies, and commitments to address the problems revealed by the crisis. The Counterparty Risk Management Policy Group (CRMPG), a group composed of senior officials from the largest US and EU dealer banks whose aim was to promote strong corporate risk management strategies, decided on a series of recommendations including the improved management of valuation disputes as well as more sophisticated trade confirmation and collateral management processes.⁵⁶⁰ In addition, it discussed the advantages of central clearing. 'A central counterparty', it argued, 'helps address many of the deficiencies of the current market foundation'. The group therefore suggested 'that the industry move with deliberate speed toward the creation of one or more such counterparties [...]'.⁵⁶¹ The dealer banks did indeed associate some key advantages with central clearing:⁵⁶² For example, some of them expected that the increased standardization of trades through central clearing might lower their operational costs. Others were optimistic that central clearing might turn into a new business line they would be able to control. There was also a strategic component in that the industry hoped that its embrace of central clearing would prevent policy-makers from adopting even more far-reaching reforms, such as the mandatory trading of contracts on exchanges.

However, from the banks' point of view, it was imperative that these initiatives were industry-led and would 'not compromise the integrity or robustness of the [uncleared] marketplace', as the CRMPG put it.⁵⁶³ This clarification left no doubt that the industry was unwilling to give up the deregulated status of bilateral trades. Rather, it argued that reforms had to be conducted 'in a manner that preserves the ability of firms to execute and maintain bespoke transactions which serve legitimate economic interests'.⁵⁶⁴ The dealer banks were therefore not prepared to lose any influence over the development of the contours of the post-crisis derivatives market. In line with the industry's previous commitments, CRMPG declared it 'firmly believes that these recommendations are more than just aspirational in nature. Rather, they are concrete goals that, if implemented by

⁵⁵⁷ G20 (2008:8)

⁵⁵⁸ G20 (2008:8)

⁵⁵⁹ Bernanke (2008)

⁵⁶⁰ CRMPG (2008:33,88,104,112f.)

⁵⁶¹ CRMPG (2008:104)

⁵⁶² See Helleiner (2014a:139).

⁵⁶³ CRMPG (2008:104)

⁵⁶⁴ CRMPG (2008:113, emphasis in the original)

major market participants, will substantially enhance the credit market's resilience to stress events and conditions, including the failure of one or more major counterparties'.⁵⁶⁵

Following these initial promises, the large dealers, known as the G15,⁵⁶⁶ pledged that each of them would centrally clear at least 95% of new eligible credit derivative trades and 90% of new eligible interest rate derivatives as of the end of 2009.⁵⁶⁷ In 2009, the banks renewed these promises, declaring that '[t]he industry commits to broaden the set of OTC derivatives for clearing, taking into account risk, liquidity, default management and other factors. The industry also commits to elevated targets for clearing dealer-to-dealer swaps and to work with clearinghouses to accelerate the growth of clearing for transactions between dealers and buy-side market participants'.⁵⁶⁸ The dealers also committed themselves to 'proactively inform' the relevant authorities',⁵⁶⁹ in case the successful completion of these projects were to be threatened by unexpected delays. Regarding the margining of trades that would remain uncleared, the banks pledged to 'enhance bilateral collateralization arrangements to ensure robust risk management'.⁵⁷⁰ In Europe, the Derivatives Working Group comprising industry representatives and public sector officials from (supra-)national authorities worked on similar market-based solutions to those being developed in the US.⁵⁷¹

3. High public issue salience of derivatives regulation and policy-makers' embrace of a market-shaping philosophy

Up until this point, the policy process looked very similar to the pre-crisis era, with the banks in the driver's seat. The industry's effective progress towards meaningful self-regulation was limited, falling short of the expectations it had created, which also did not differ significantly from the pre-crisis period. For example, by the end of 2009, no more than a third, rather than the promised 90% of eligible interest rate contracts were centrally cleared, and, in the eyes of the regulators, there were few indications of far-reaching improvements to counterparty risk management.⁵⁷² In Europe, the industry's progress

⁵⁶⁵ CRMPG (2008:104)

⁵⁶⁶ The G15 comprised Bank of America-Merrill Lynch, Barclays Capital, BNP Paribas, Citigroup, Commerzbank AG, Credit Suisse, Deutsche Bank AG, Goldman Sachs & Co, HSBC Group, International Swaps and Derivatives Association, Inc., JP Morgan Chase, Morgan Stanley, The Royal Bank of Scotland, Société Générale, UBS AG, Wachovia Bank, N.A.

⁵⁶⁷ Duffie et al. (2010:13, table 2). 'Eligible' trades means trades for which a central clearing infrastructure exists.

⁵⁶⁸ ISDA (2010b)

⁵⁶⁹ AllianceBernstein et al. (2010:10)

⁵⁷⁰ AllianceBernstein et al. (2010:2)

⁵⁷¹ Pagliari (2013b:161)

⁵⁷² See for example Duffie et al. (2010:12).

towards clearing was even further limited, given policy-makers' insistence on central clearing activities being located inside the EU, rather than in the US.⁵⁷³

What was different this time was the persistently high public issue salience attributed to derivatives regulation and financial regulation in the US and Europe more generally.⁵⁷⁴ The dramatic consequences of the crisis which quickly turned into the worst recession since the Great Depression in terms of record unemployment and wide-spread foreclosures meant public attention would not vanish as quickly as during earlier episodes of distressed derivatives markets.⁵⁷⁵ In addition, unprecedented public intervention in form of the large-scale bail-out of AIG, the Treasury's purchase of illiquid assets through the USD 700bn Troubled Asset Relief Programme - both funded with tax-payer money of which financial firms decided to use a portion to pay for bonuses while the average voter was suffering -, as well as various other broad-based Fed-administered lending facilities comprising an additional several hundreds of billions of USD kept the American public on its toes.⁵⁷⁶ Another factor capturing public attention was the high volatility of commodity prices that had resulted in steep price increases, which were widely attributed to speculation by financial investors.⁵⁷⁷ As a consequence, the industry found itself confronted with an unprecedented degree of outrage and antagonism, particularly in the US Congress, where policy-makers' statements across the aisle were garnished with an unheard degree of hostile metaphoricity. As a result, a broad coalition of policy-makers advocated dispensing with self-regulation and pursuing public intervention in the OTC derivatives market.

The chair of the House Agriculture Committee, Collin Peterson (D-MN) argued 'I trust these guys about as far as I could throw them',⁵⁷⁸ and Brad Miller (D-North Carolina) specified he considered them 'an agent of destruction for the gross domestic product and of impoverishment for the middle class'.⁵⁷⁹ One of the representatives of New York, Democratic Congressman Joseph Crowley, demanded 'ending the era of Cowboy Capitalism' and his colleague Carolyn McCarthy (D-New York) decried the 'irresponsibility, arrogance, and hypocrisy' of the financial sector.⁵⁸⁰

Congressman Jeb Hensarling (R-Texas) condemned compensation being financed with bailout money as 'the outrage of the week', but insisted that 'the greater outrage ought to be taxpayer money used to sustain counterparties to make them whole, counterparties who

⁵⁷³ Grant/Tait (2009), Price (2009)

⁵⁷⁴ See Pagliari (2013b)

⁵⁷⁵ Estimates suggest that the crisis imposed a cost USD 50.000-120.000 per US household (Luttrell et al. 2013: 1)

⁵⁷⁶ Estimates suggest that US banks used USD 18.4bn out of the USD 700bn for compensation purposes (Moore 2009:89). An overview of the stabilization measures is provided in US Treasury Department (2012a).

⁵⁷⁷ See for example Clapp/Helleiner (2012). Pirrong (2010) provides an account questioning the link between speculation and food price volatility.

⁵⁷⁸ Peterson quoted in Chung et al. (2009).

⁵⁷⁹ Miller quoted in US House Financial Services Committee (2010:27).

⁵⁸⁰ Crowley quoted in US House Financial Services Committee (2008a:23) and McCarthy quoted in House Financial Services Committee (2009b:134).

undertook a risk versus taxpayers who did not take the risk'.⁵⁸¹ Republican presidential primaries candidate of 2008, Mike Huckabee, in turn, deplored that Congress had 'ask[ed] taxpayers to suck up the staggering results of the hubris, greed, and arrogance of those who sought to make a quick buck by throwing the dice'.⁵⁸² Andre Carson (D-IN) weighed in, demanding that '[t]ax subsidized corporate welfare must end. It is unbecoming, unjust, and unpatriotic. [...] The greed of Wall Street that flourished under these deregulation policies have [*sic*] now brought our economy to her knees'.⁵⁸³

Speaking about CDS, Barney Frank (D-Mass.), chair of the House Financial Services Committee, argued that bankers 'were issuing life insurance on vampires. They didn't think they needed any money because vampires don't die. And then when the vampires died, they didn't have any money'.⁵⁸⁴ Unsatisfied with the statement by ISDA's CEO, Robert Pickel, that his organization did not perform any self-regulatory functions and therefore did not take any action against AIG writing CDS for half the world, Brad Sherman (D-California), summarized ISDA's mission with the words that 'if the devil wants to join your organization, the only question is, does his dues check clear'.⁵⁸⁵ He demanded decisive action, refuting the classical answer of "Well, this is just a private market decision." Tell that to the taxpayers who have bailed out AIG. [...] Let us not be told that the present system is fine as long as the taxpayers write the check'.⁵⁸⁶ During a radio show in his home state, Senator Charles Grassley (R-Iowa) even went as far as to suggest that the AIG leadership 'follow the Japanese example and come before the American people and take that deep bow and say, I'm sorry, and then either do one of two things: resign or go commit suicide'. He went on to specify that 'in the case of the Japanese, they usually commit suicide before they make any apology'.⁵⁸⁷ A comment Goldman Sachs CEO, Lloyd Blankfein, made in an interview according to which he was 'doing God's work' was unsuitable to calm down policy-makers' outrage.⁵⁸⁸

Summing up the public mood, Barney Frank and Senator Chris Dodd (D-CT, chair of the Senate Banking Committee), whose names would become associated with the Dodd-Frank Act argued that time was ripe for public intervention. In a meeting with bankers, Frank said '[t]here's going to be a bill, and either you're going to have to get on the bus or be run over by it',⁵⁸⁹ language that very much contrasted with policy-makers' pre-crisis rhetoric aimed at letting the industry drive the bus itself. In a 2012 article entitled 'Why Dodd-Frank is necessary', Dodd reflected on his work on the bill as representing 'a long overdue

⁵⁸¹ Hensarling quoted in US House Financial Services Committee (2009b:13).

⁵⁸² Huckabee quoted in Easton (2008).

⁵⁸³ Carson quoted in US House Financial Services Committee (2008a:15f.).

⁵⁸⁴ Frank quoted in US House Financial Services Committee (2008b:81).

⁵⁸⁵ Sherman quoted in US House Financial Services Committee (2009d:28); see also Sherman quoted in US House Financial Services Committee (2009e:63).

⁵⁸⁶ Sherman quoted in US House Financial Services Committee (2009d:10).

⁵⁸⁷ Grassley quoted in Nichols (2009).

⁵⁸⁸ Blankfein quoted in Phillips (2009).

⁵⁸⁹ Frank quoted in Kaiser (2013:527).

regulatory overhaul [...] that fundamentally changed the way the financial sector operates'.⁵⁹⁰

Regulators voiced their support. CFTC chair Gary Gensler stated 'I support the concept of regulating derivatives because they helped cause the problem'.⁵⁹¹ FDIC chair Sheila Bair stated '[t]he Industry Needs Regulation to Prevent Excesses'.⁵⁹² Fed Governor Daniel Tarullo supported 'regulatory reorientation',⁵⁹³ and Fed chair Ben Bernanke, in a reversal of his initial position, called for 'changes to the financial rules of the game', urging 'Congress to close regulatory gaps'.⁵⁹⁴ Further impetus for ending self-regulation was provided by the team of the 'Three Marketeers', Greenspan, Summers, and Rubin who had wholeheartedly embraced derivatives deregulation in the 1990s, a decision they now publicly distanced themselves from. Most famously, Alan Greenspan acknowledged being 'in a state of shocked disbelief' and feeling 'distressed' by the 'flaw' he had identified in his prior regulatory philosophy. 'The whole intellectual edifice [...] collapsed', he declared.⁵⁹⁵ In a similar way, Larry Summers, now President Obama's chief economist, presented himself as 'reeducated' by the crisis, admitting to not having had 'perfect foresight' when deregulating derivatives.⁵⁹⁶ Robert Rubin, in turn, had already insisted prior to the crisis having always been aware of the fact that derivatives 'could pose problems', particularly 'when the system is stressed', but that back in the 1990s his concerns had not been listened to.⁵⁹⁷ More generally, CFTC chair Bair declared the end of competitive deregulation. 'Pursuing financial institution competitiveness as a policy goal in a way that compromises safety-and-soundness, [...] will ultimately harm both our financial institutions and our economy'.⁵⁹⁸

The only group of policy-makers less convinced of the need for public intervention, and therefore more inclined towards continued self-regulation, were the Republicans. They were as outraged as the Democrats about the misuse of bailout money for compensation purposes, but they doubted that derivatives were the culprits of the crisis. '[L]ook[ing] at all the root causes of our economic turmoil', Hensarling declared, had not made him feel 'quite convinced [...] that the derivatives market is among them'.⁵⁹⁹ His colleague, Congressman Scott Garrett (R-NJ), shared similar convictions, warning not to extrapolate from AIG. In his view, reforms should not be undertaken solely informed 'by the fact that one high profile financial institution, AIG, made a bad investment decision'.⁶⁰⁰ Referring to the industry's commitments, he observed that '[t]he private sector has made significant progress in a

⁵⁹⁰ Dodd (2012)

⁵⁹¹ Gensler quoted in US Senate Banking Committee (2010:180).

⁵⁹² Bair (2011a, with capital letters in the original)

⁵⁹³ Tarullo (2009)

⁵⁹⁴ Bernanke (2009a and 2009b)

⁵⁹⁵ Greenspan quoted in Andrews (2008).

⁵⁹⁶ Summers quoted in Hirsh (2009b).

⁵⁹⁷ Rubin (2004:287)

⁵⁹⁸ Bair quoted in US House Financial Services Committee (2011b:62).

⁵⁹⁹ Hensarling quoted in US House Financial Services Committee (2009e:7).

⁶⁰⁰ Garrett quoted in US House Financial Services Committee (2009d:3).

relatively short period of time [...], and I think we should look at this further'.⁶⁰¹ In a similar vein, Congressman Spencer Bachus (R-Alabama) applauded the industry's pledges, considering them 'efforts to remind us that market-based solutions are capable of generating the information that investors and companies need to make informed decisions'.⁶⁰² However, the Republicans' scepticism did not change the course of the debate.

Compared to the US, the political system of the EU is marked by a complex combination of inter-governmentalism and supranational centralization, which is often perceived as several steps removed from the average citizen. Also, the European Parliament does not publish minutes of its sessions to the same extent and with the same degree of detail as the US Congress, and the deliberations of the EU institutions figure much less prominently in the news. The tone of the political debate in Europe was therefore less dramatic.⁶⁰³ Moreover, the crisis was initially widely associated with problems having originated in the US, rather than in Europe, even though financial institutions from the EU, such as some German *Landesbanken* had avidly invested in MBS-related products.⁶⁰⁴ Nonetheless, derivatives regulation was still a highly salient issue.

European Commissioner for Internal Market and Services, Charlie McCreevy, argued that '[w]hen the crisis started, neither the market nor supervisors knew who was bearing what risk in the economy. But now, it has become obvious: It's the taxpayer'.⁶⁰⁵ His successor Michel Barnier who believed the lack of regulation had turned the OTC derivatives market into a 'Wild West territory'⁶⁰⁶ called for a 'new deal between financial regulation and society'.⁶⁰⁷ Regarding the role derivatives had played in the crisis, Christian Noyer, governor of the Banque de France, argued it was 'crystal clear that [...] financial innovation based on credit derivatives was at the heart of the financial crisis'.⁶⁰⁸ Pointing to the repercussions of the crisis, his counterpart at the Bank of England, governor Mark Carney agreed that 'over the counter (OTC) derivatives markets were a path for contagion rather than a source of strength'.⁶⁰⁹

The EU Parliament equally noted that 'OTC derivatives have helped to make large market participants mutually dependent even when they are regulated entities',⁶¹⁰ thus questioning

⁶⁰¹ Garrett quoted in US House Financial Services Committee (2009d:4).

⁶⁰² Bachus quoted in US House Financial Services Committee (2009d:6). Note that on a personal level, Bachus was not opposed to central clearing, saying 'I personally believe that most derivatives, if they are not too highly customized, should be placed in a clearinghouse situation. It helps you identify risk and define risk' (see US House Financial Services Committee (2009d:5)).

⁶⁰³ For a similar finding, see Pagliari (2013b:125)

⁶⁰⁴ Schwartz (2016:88f.)

⁶⁰⁵ McCreevy (2009)

⁶⁰⁶ Barnier quoted in O'Donnell (2010).

⁶⁰⁷ Barnier (2010), see also Barnier (2011,2012b).

⁶⁰⁸ Noyer (2010:1)

⁶⁰⁹ Carney (2013:12)

⁶¹⁰ EU Parliament (2010a:2)

one of the industry's pre-crisis arguments according to which derivatives regulation was unnecessary given that deals were exclusively made by counterparties that were sophisticated and already heavily regulated themselves. The EU Commission, in turn, criticized the structure of the OTC derivatives market, observing that 'the private nature of contracting with limited public information, the complex web of mutual dependence, the difficulties of understanding the nature and level of risks – increases uncertainty in times of market stress and accordingly poses risks to financial stability'.⁶¹¹ Making a similar argument, the EU Council concluded that 'such characteristics increase uncertainty in times of market stress and accordingly, pose risks to financial stability'.⁶¹²

OTC derivatives were not only criticized for their role in the failures of Lehman Brothers and AIG, but also for their contribution to the Greek sovereign debt crisis.⁶¹³ Banks's reputation in the EU received a severe hit once it became clear that Goldman Sachs had assisted the Greek government to swap its debt into the future, while at the same time purchasing CDS to protect itself against a potential Greek default.⁶¹⁴ Against this background, the heads of state/ government from France, Germany, Greece, and Luxembourg urged EU Commission President Barroso to study 'the role and impact of speculative practices in connection with CDS trading in the government bonds of European countries', and the EU parliament also pushed for encompassing reform in this area.⁶¹⁵ The European Parliament's vice-president, Arlene McCarthy, called on the Commission to take measures 'to stop banks assisting European governments in hiding public debt'.⁶¹⁶ The banks were dealt another blow when the EU Commission opened judicial procedures against several financial institutions suspected of having formed cartels in order to manipulate the London and Euro Inter Bank Offered Rates, LIBOR and EURIBOR.⁶¹⁷ While derivatives had impacted each of these events and developments in different ways and to varying extents, the 'd-word' acquired a bad taste.

As in the US, putting an end deregulation, thus, ranked high on policy-makers' agenda. French President Sarkozy stated that '[s]elf-regulation as a way of solving all problems is finished. Laissez-faire is finished'.⁶¹⁸ Lord Adair Turner, the head of the UK's FSA, admitted to the 'intellectual failure'⁶¹⁹ of the pre-crisis system and called upon his regulator colleagues to 'not treat it as a given that direct product regulation is by definition inappropriate'.⁶²⁰ Joaquin Almunia, EU Commissioner for Competition, argued '[t]he age of deregulation has produced a financial sector which has grown too large and too complex for

⁶¹¹ EU Commission (2009a:5)

⁶¹² EU Council (2011:3)

⁶¹³ See Helleiner (2014c:113f.).

⁶¹⁴ Carney (2010)

⁶¹⁵ Pagliari (2013b:168)

⁶¹⁶ McCarthy quoted in Moya (2010).

⁶¹⁷ EU Commission (2011), Croucher (2013)

⁶¹⁸ Sarkozy quoted in Quaglia (2012:529).

⁶¹⁹ Turner quoted in Quaglia (2012:528).

⁶²⁰ FSA (2009a:110)

comfort; which serves its own interests a whole lot better than the interest of the rest of us; and which poses a serious threat to the stability of our economies'.⁶²¹ Along similar lines, Barnier demanded 'a paradigm shift away from the traditional view that derivatives are financial instruments for professional use and thus require only light-handed regulation'.⁶²² The EU Council emphasized '[t]he financial crisis has clearly demonstrated the weaknesses of the current regulatory framework'⁶²³ and that '[i]ncentives to promote the use of CCPs have not proven to be sufficient [...]'.⁶²⁴ It therefore approved a move 'from so-called "light-handed regulation" to a more ambitious and comprehensive regulatory policy'.⁶²⁵ The UK FSA and HM Treasury, as well as the EU Commission each also provided a list of more technical reasons they believed made self-regulation inadequate for solving the problems in the market for uncleared derivatives.⁶²⁶

4. The emergence of the clearing and margining consensus

4.1 The transatlantic consensus on the clearing mandate

Building on their earlier efforts of encouraging the industry to move trades to CCPs, policy-makers quickly settled on central clearing as the overarching objective of the new regulatory system. The empirical evidence reveals four inter-related reasons that made the clearing idea appear as the ideal candidate.

First, policy-makers pointed to the suitability of the clearing mechanism for reducing interconnectedness. Geithner highlighted that '[c]learing has the attribute that no longer would the financial system be so interconnected. Individual firms, rather than having exposures to each other, would have the clearinghouse that has to have the discipline of daily mark-to-market and daily posting of collateral.'⁶²⁷ The other US regulators agreed. CFTC chair Gensler stated that '[b]y mandating the use of central clearinghouses, institutions would become much less interconnected, mitigating risk and increasing transparency'.⁶²⁸ FDIC chair Bair pointed out that 'concentrations of derivatives exposures among certain dealers helped catalyze systemic breakdown' and therefore wished to see standardized derivatives to be traded 'through a regulated, centralized counterparty

⁶²¹ Almunia (2012)

⁶²² Barnier quoted in Quaglia (2012:528f.).

⁶²³ EU Council (2009a:5)

⁶²⁴ EU Council (2011:6)

⁶²⁵ EU Council (2009b)

⁶²⁶ These lists can be found in FSA and HM Treasury (2009:16f) and EU Commission (2009b:14ff. of the pdf).

⁶²⁷ Geithner quoted in US Senate Agriculture Committee (2009a:8, see also 2009c:15,27).

⁶²⁸ Gensler quoted in US Congress (2010b:31) with reference to his Senate Banking committee testimony of 22 September 2009.

system'.⁶²⁹ The Fed insisted that 'CCPs offer an important tool for managing counterparty credit risk, and thus they can reduce risk to market participants and to the financial system'.⁶³⁰

European policy-makers joined the chorus. For Jean-Pierre Jouyet, president of the French Autorité des Marchés Financiers, 'CCPs are the fire-doors' breaking up the high degree of financial interconnectedness among market actors that 'shut automatically' in case of an institution's failure.⁶³¹ The UK FSA and HM Treasury considered central clearing 'a key step in mitigating this risk. A CCP can impose consistent and robust risk management practices as well as act as a circuit breaker to the default of a member'.⁶³² At the Bank of England, Andrew Haldane viewed central clearing as a solution to the crisis as CCPs' 'hub-and-spokes' structure serves as a shock absorber, breaking the loss cascade that would normally ensue in the uncleared world, following a large counterparty's default.⁶³³

The EU Commission declared that it is '[...] robust margining procedures and other risk management controls that render the CCP the most creditworthy counterparty. Margins are effective, initial margins are always calculated irrespectively of the counterparty of the trade, future replacement cost is duly taken into account and exposures are generally fully collateralised on a daily basis'.⁶³⁴ The EU Council equally approved of central clearing, calling the margin system 'the primary line of defence for a CCP'.⁶³⁵ The EU Parliament, in turn, commissioned an academic expert study on the basis of which it '[b]ack[ed] the call for the compulsory introduction of CCP clearing'.⁶³⁶

Second, policy-makers and regulators noted that CCPs had proven their resilience and reliability during the 2008 crisis.⁶³⁷ For example, LCH.Clearnet, which had held USD 9tn of Lehman's cleared interest swaps, wound down the portfolio with minimal disruption, auctioning off the positions within less than a month of the bankruptcy without imposing any losses on other counterparties.⁶³⁸ This process crucially hinged on the USD 2bn of IM Lehman had posted with the clearing house.⁶³⁹ By contrast, untangling Lehman's uncleared

⁶²⁹ Bair (2009a), see also Bair (2010b).

⁶³⁰ Patricia White of the Fed quoted in US Senate Banking Committee (2009e:56).

⁶³¹ Jouyet (2010:2), see also Banque de France governor Noyer (2010:3).

⁶³² FSA and HM Treasury (2009:11)

⁶³³ Haldane (2011:4)

⁶³⁴ EU Commission (2009b:17 of the pdf)

⁶³⁵ EU Council (2010a:13; see also 2010b:4,7ff.)

⁶³⁶ EU Parliament (2010a:4), for the expert study see EU Parliament (2009).

⁶³⁷ Note that problems have not been unknown in the history of CCPs. Failures, such as those of the Caisse de Liquidation in Paris of 1974, the Kuala Lumpur Commodities Clearing House of 1983, clearing member Volume Investors of Comex Clearing Association in 1985, and the Hong Kong Futures Exchange of 1987 did occur. However, the size and repercussions of these failures were limited and contained (see Tucker (2013:180), Compass Lexecon (2013:20)).

⁶³⁸ Global Custodian (2008)

⁶³⁹ Gregory (2014:42f.) The Hong Kong Securities Clearing Company had to use some of its members' default fund contributions to close out the Lehman portfolio, but did not have to escalate the process to another level of the waterfall (Gregory 2014:42f.) The default fund acts as an additional layer of safety. It is a hierarchically

business turned out a hugely difficult process that took years and resulted in much more substantial losses.⁶⁴⁰ Indeed, 10 years after the crisis, the insolvency proceedings have still not been completed.⁶⁴¹

The CFTC observed that CCPs had ‘met all their financial obligations without the infusion of any capital from the Federal government. This was not the case in the world of uncleared swaps’.⁶⁴² The Fed noted that ‘[t]he collateral Lehman Brothers had posted covered all losses on its positions, and thus the clearinghouse did not have to use any of its other financial resources’.⁶⁴³ Gensler also pointed out that, if AIG had been subject to the ‘harsh discipline’ of the margining regime imposed by CCPs, its problems would have been identified much earlier and could thus have been contained at a less critical stage.⁶⁴⁴ More generally, he observed that ‘[t]hroughout this entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses continued to be cleared and settled’,⁶⁴⁵ with Comptroller of the Currency, John Dugan and FDIC chair Bair, making very similar statements.⁶⁴⁶

In Europe, Haldane attributed the attractiveness of the clearing model to its successful performance during the crisis: ‘Experience during the crisis means we now know why [to pursue it]’.⁶⁴⁷ In a similar way, the EU Commission observed that ‘CCPs have proven to be resilient even under stressed market conditions as the one we are facing today and showed their ability to ensure normal market functioning in case of failure of a major market player [...]’.⁶⁴⁸

Third, the existence of fully operational CCPs that could take on uncleared derivatives and that regulators had experience in supervising rendered the clearing solution even more attractive. In the US, the CFTC and SEC could draw on decades of experience in regulating and supervising derivatives clearing agencies and securities clearing agencies respectively.⁶⁴⁹ Gensler’s immediate predecessor Walt Lukken who left the CFTC in 2008 emphasized that ‘[c]learinghouses have been functioning for many years as a means for

organized multi-level pool of money, known as the waterfall, which provides further liquidity to the CCP (see for example Gregory (2014:38, 141f.).

⁶⁴⁰ In 2017, i.e. nine years after the crisis, discussions on potential settlements were still ongoing (see for example Randles 2017).

⁶⁴¹ Carter (2018)

⁶⁴² Commissioner Dunn quoted in CFTC (2011a:9), see also Ananda Radhakrishnan of the CFTC quoted in US House Agriculture Committee (2008b:136).

⁶⁴³ Patrick Parkinson of the Fed quoted in US House Agriculture Committee (2008b:76).

⁶⁴⁴ See Gensler quoted in US Senate Banking Committee (2009e:19).

⁶⁴⁵ Gensler quoted in US Congress (2010b:31) with reference to his Senate Banking committee testimony of 22 September 2009.

⁶⁴⁶ Dugan and Bair quoted in US Senate Banking Committee (2009b:187,209).

⁶⁴⁷ Haldane (2009:29)

⁶⁴⁸ EU Commission (2009b:17 of the pdf)

⁶⁴⁹ Lubben (2015:141)

mitigating the risks associated with exchange-traded financial products'.⁶⁵⁰ The Fed observed that the markets were already beginning to transition the OTC business to CCPs, which would facilitate the process of rolling out the new model for OTC derivatives: 'Market participants have already established several CCPs to provide clearing services for some OTC interest rate, energy, and credit derivative contracts. Regulators both in the United States and abroad are seeking to speed the development of new CCPs and to broaden the product line of existing CCPs'.⁶⁵¹

In Europe, the UK FSA noted '[t]here are currently six potential providers of CCP services which have announced their intention to launch CDS clearing'.⁶⁵² The EU Commission also commented favourably, emphasizing that clearing was 'the most immediate way of addressing the limitations' the crisis had revealed and 'the most effective way of reducing credit risk [that] is broadly feasible in all market segments'.⁶⁵³ Table 2 provides an overview of the largest CCPs operational in 2010.

Table 2: Central clearing market structure in 2010

Table 3.1. Currently Operational Over-the-Counter Derivative Central Counterparties

Platform (Domicile)	Contract Type				
	Interest rate swap	Credit default swap	Foreign exchange	Equities	Other ¹
CME Clearing (U.S.)		✓			✓
BM&FBovespa (Brazil)	✓		✓		✓
Eurex Clearing AG (Germany)	✓	✓		✓	✓
Euronext/LIFFE BClear (U.K.)				✓	✓
KCE Clear Canada (Canada)					✓
KCE Clear Europe (U.K.)		✓			✓
KCE Trust (U.S.)		✓			
LCH.Clearnet (U.K.)	✓				✓
LCH.Clearnet.SA (France)		✓			
IDCG International Derivatives Clearinghouse (U.S.)	✓				
NASDAQ OMX Stockholm AB (Sweden)					✓
NOS Clearing (Norway)					✓
SGX AsiaClear (Singapore)					✓

Source: IMF staff.

¹Other includes commodities, energy, freight, and macroeconomic (e.g., inflation) indicators.

Source: IMF (2010:94)

Crucially, not only the regulators and some of the large banks favoured the clearing solution, but the CCPs themselves were also eager to take on the new business. LCH.Clearnet emphasized that 'CCPs across the world performed in an exemplary fashion at the height of the financial crisis in 2008, providing safe harbours at a time of extreme

⁶⁵⁰ Lukken quoted in US House Agriculture Committee (2008b:6).

⁶⁵¹ Patricia White of the Fed quoted in US Senate Banking Committee (2009e:56).

⁶⁵² FSA (2009b:176)

⁶⁵³ EU Commission (2009b:16,4)

uncertainty'.⁶⁵⁴ CME observed that '[o]ur clearinghouse has a proven ability to scale operations to meet the demands of new markets and of unexpected volatility'.⁶⁵⁵ The firm signalled it was ready 'to help alleviate the risks to the economy' emanating from the entire OTC market.⁶⁵⁶ Referring specifically to CDS, Eurex voiced its optimism that clearing 'will bring significant benefits to the OTC market [...]'.⁶⁵⁷ ICE communicated to policy-makers that 'we could be ready to begin that process by year's end. We don't need a significant lead time'.⁶⁵⁸

Fourth, the speed with which policy-makers thought they could implement the clearing solution must not be underestimated. Indeed, high issue salience acted as a further incentive for policy-makers' quick and solid embrace of the clearing solution. According to this interpretation, the height of the crisis, with every regulatory agency being under intense public scrutiny, was not the time to experiment with any new form of financial infrastructure. CCPs were ready, had weathered the crisis well, and allowed regulators to demonstrate leadership and strength at times when high levels of public attention called for decisive action. Given the complexity of the topic, many legislators struggled to fully understand the concepts of derivatives and clearing. Early in the process, Barney Frank, for example, confessed his inability to recognize a derivative even 'if it hit [him] on the face'.⁶⁵⁹ Senator Mike Crapo (R-ID) asked: 'What exactly are we talking about there when we talk about establishing a clearing counterparty or a clearing system?'.⁶⁶⁰ However, despite the complexity of the concept, it was clear that policy-makers demanded a decisive response to the crisis. Collin Peterson's (D-MN) call for rapid action was representative, when he urged regulators to give him a 'sense of how quick we can get this clearing mechanism established'.⁶⁶¹

Building on the clearing consensus and acting on their expectation of a fully operational clearing infrastructure being quickly available, the G20 at their Pittsburgh summit of 2009 formalized the objective of having all standardized derivatives centrally-cleared 'by end-2012 at the latest'.⁶⁶² For trades remaining in the uncleared marketplace, higher capital requirements were decided.⁶⁶³

⁶⁵⁴ LCH.Clearnet chair Aigrain (2013:155)

⁶⁵⁵ Kim Taylor of CME quoted in US House Agriculture Committee (2008b:54).

⁶⁵⁶ CME chair and CEO Terrence Duffy quoted in US Senate Agriculture Committee (2008:40).

⁶⁵⁷ Thomas Book of Eurex quoted in US House Agriculture Committee (2008b:170).

⁶⁵⁸ Jonathan Short of ICE quoted in US House Agriculture Committee (2008b:174).

⁶⁵⁹ Frank quoted in Zubrod (2014). Following a steep learning curve, he would later joke having learned more 'than [he] ever wanted to know' (see Protes 2011).

⁶⁶⁰ Crapo quoted in US Senate Agriculture Committee (2008:51).

⁶⁶¹ Peterson quoted in US House Agriculture Committee (2008b:2).

⁶⁶² G20 (2009a)

⁶⁶³ *ibid.*

4.2 The transatlantic agreement on the need for margining uncleared derivatives

Policy-makers initially expected that 90% or even more of the OTC market would transition to CCPs. Sheila Bair, for example, at one point spoke of ‘limited circumstances’ under which OTC deals would remain uncleared.⁶⁶⁴ However, policy-makers overestimated the share of OTC deals fitting the profile for central clearing.

There were three main challenges. First, central clearing requires a minimum level of fungibility in terms of trades sharing very similar, ideally identical, characteristics. For example, multilateral netting can only be performed efficiently if trades are similar enough to each other to cancel each other out.⁶⁶⁵ Moreover, the calculation of margin requirements hinges on the liquidity of the trade in question, meaning there must be a sufficiently high number of buyers and sellers whose transactions can provide the required data.⁶⁶⁶ Given that CCPs (re-)calculate VM on a daily basis, the underlying computations need to be relatively easy to perform. The central clearing of sparsely traded bespoke contracts is, therefore, operationally and conceptually difficult (and thus also unprofitable). In times of crisis, the central clearing of unsuitable contracts can actually enhance risk and incur losses for the CCP, if the clearing house is unable to find new counterparties willing to quickly purchase the unwound trades and/or provide similar ones for replacement purposes.⁶⁶⁷ Research by the FSB reinforced these concerns by showing that many bespoke trades were tailored to an extent that their valuation might take several days, which rendered them unsuitable for central clearing.⁶⁶⁸ As we saw in table 1, central clearing has been most significant with respect to interest rate and credit derivatives which tend to display a relatively high level of standardization, whereas other contract types have largely remained in the uncleared marketplace.

A second, closely related problem was that standardization turned out to be not as easily achievable, as policy-makers initially expected. Indeed, many trades are intentionally tailor-made to provide for optimal hedging, which can be beneficial from an accounting perspective. The rules of the International Accounting Standards Board and the US Financial Accounting Standards Board both stipulate that in order for hedge accounting benefits to prevail, the hedge must be ‘highly effective’, meaning the derivative and the underlying risk must co-evolve in a highly correlated manner. For example, according to IAS 39, the hedge must offset fair-value gains and losses on the hedged item within a band of 80-125%. Similar rules apply under US GAAP. The lack of hedge accounting treatment introduces volatility to a firm’s profit and loss accounting which, in turn, can result in enhanced capital

⁶⁶⁴ Bair (2010a)

⁶⁶⁵ Gregory (2014:19)

⁶⁶⁶ Gregory (2014:32,132)

⁶⁶⁷ Duffie et al. (2010:7f.), Duffie (2011:65f.)

⁶⁶⁸ FSB (2010:19)

costs.⁶⁶⁹ Initially, many policy-makers appeared to believe the hedge accounting corridor was large enough for standardization and central clearing to occur, but this optimism soon vanished.

A third concern emerged once policy-makers realized market actors' widespread tendency 'to exploit loopholes in regulations'.⁶⁷⁰ For example, one specialist observed that 'good lawyers can make any derivative customized in about 10 minutes if it will enable the issuer to escape additional regulatory cost'.⁶⁷¹ This realization about the potential ease with which market actors might engage in regulatory avoidance further lowered the initial optimism regarding the uptake of central clearing.

Policy-makers therefore had to correct their initial expectations about the extent of central clearing downwards. In practice, this process did not work as smoothly as it might appear from reading these paragraphs. Rather, it was a slow process of learning that already began in 2009. Regarding updated estimates about the ratio of cleared derivatives, the UK FSA in 2009 expected that half the market of CDS could remain uncleared.⁶⁷² In a similar spirit, the IMF in 2010 estimated that one third of CDS, one quarter of interest rate derivatives, and two thirds of the other asset classes would remain uncleared.⁶⁷³ The EU Commission simply observed that 'not all OTC derivatives are suitable for CCP-clearing'.⁶⁷⁴ In the US, Geithner was not yet willing to give up hope, and declared that the Administration was planning to 'propose a broad definition of 'standardised' OTC derivatives that will be capable of evolving with the markets [...]'.⁶⁷⁵ However, it was obvious that this would be a challenging endeavour. In fact, the term 'standardized' has never been clearly defined in either jurisdiction. Rather, both the US and the EU legal provisions stipulate precise product categories for which central clearing has become mandatory.⁶⁷⁶ The Fed in later years expected a clearing ratio of no more than 60%,⁶⁷⁷ which is very close to the ratio reached in 2018 (see table 1).

The likelihood of a significant fraction of OTC deals remaining uncleared meant a regulatory solution for this market segment had to be found. The consensus quickly settled on margin requirements which represent one of the key defining parameters of settlement via central clearing. Already in 2009, policy-makers had discussed a potential margin mandate. The FSF had recommended that '[a]uthorities should review enforcing minimum initial margins and

⁶⁶⁹ FSB (2010:20, with more detail provided in footnotes 26 and 27). A detailed explanation of hedge accounting can be found in PWC (2005), with recent updates available in PWC (2016).

⁶⁷⁰ FSB (2010:20)

⁶⁷¹ John C. Coffee Jr., Adolf A. Berle Professor at the Columbia University Law School quoted in US Senate Banking Committee (2009f:232).

⁶⁷² FSA (2009a:83)

⁶⁷³ IMF (2010:101, footnotes 1 and 3 of table 3.2). See also the interpretation of BCBS and IOSCO (2012:2).

⁶⁷⁴ EU Commission (2010b:32)

⁶⁷⁵ Geithner quoted in Madigan (2009e).

⁶⁷⁶ For an overview see Hogan Lovells (2017:10f.) and Legal Information Institute (2016).

⁶⁷⁷ Board of Governors of the Federal Reserve System (2014:25)

haircuts for OTC derivatives and securities financing transactions'.⁶⁷⁸ Later in the same year, the G20's Pittsburgh Working Group had called upon policy-makers to 'enhance incentives needed for the use of central counterparties' and had identified margin requirements as a viable 'aspect' for 'making regulatory regimes more effective',⁶⁷⁹ but the final communiqué did not include an explicit reference to margin for uncleared derivatives. In both cases, the initial optimism about the applicability of the clearing solution had relegated the need of margining uncleared trades into the background.

However, once it became clear that central clearing would not cover the entire market, there appeared to be shared consensus on moving forward with the margining mandate. Most importantly, margin requirements would allow policy-makers to import a key element of central clearing into the uncleared market. In Europe, Noyer in 2010 noted that '[a] consensus among policy makers and beyond has [...] emerged to try and *force* a change in the OTC derivatives market to make it adopt as much as possible the technical features and infrastructures of organised markets.'⁶⁸⁰ In the UK, both the UK's FSA and Treasury already voiced support for subjecting uncleared derivatives to margin requirements one year earlier in 2009. They commented that '[t]he near-collapse of AIG is an example where commercial decisions regarding these bilateral arrangements resulted in incomplete mitigation of the counterparty risk. It is therefore essential that steps are taken to ensure that these types of transactions are adequately risk managed'.⁶⁸¹ At the supranational level, the De Larosière report of 2009 equally recommended 'to take a wide look at the functioning of derivative markets', advising that for OTC derivatives 'the development of appropriate risk-mitigation techniques [...] could go a long way towards restoring trust in the functioning of these markets'.⁶⁸² The European Parliament in 2010 argued that 'derivative markets require a comprehensive collateralisation policy encompassing both central and bilateral clearing arrangements'.⁶⁸³ One year prior to that report, the European Council had already advocated 'proper collateralisation for bilateral clearing' and the Commission had considered it essential to 'strengthen bilateral collateral management'.⁶⁸⁴

Across the Atlantic, Gensler in 2009 observed that '[c]ustomized derivatives are by their nature less standard, less liquid and less transparent. Therefore, I believe that higher capital and margin requirements for customized products are justified'.⁶⁸⁵ Bernanke considered margin 'an appropriate cost of protecting against counterparty risk'⁶⁸⁶ and Tarullo stressed the importance of margin, in particular IM, pointing to the 'checks and balances initial margins would have placed on AIG's positions'. '[S]trong capital standards alone are not

⁶⁷⁸ FSF (2009:24)

⁶⁷⁹ Both quotes taken from G20 (2009b).

⁶⁸⁰ Noyer (2010:1, emphasis added)

⁶⁸¹ FSA and HM Treasury (2009:16)

⁶⁸² Both quotes taken from De Larosière Group (2009:25).

⁶⁸³ EU Parliament (2010a:3). Bespoke OTC derivatives are sometimes referred to as 'bilaterally' cleared.

⁶⁸⁴ EU Council (2009b:28), EU Commission (2009b:4, see also 2010a:19,15)

⁶⁸⁵ Gensler quoted in US House Agriculture Committee (2009b:160).

⁶⁸⁶ Quote by Bernanke dating back to 2009 cited in US Congress (2010b:31).

enough to contain systemic risk'.⁶⁸⁷ As the agency in charge of managing the resolution of failing insured depository institutions, the FDIC also welcomed margin requirements as a safety-enhancing feature that would make it possible 'to significantly raise the cost of being too big or interconnected' and 'to reduce the opacity in the OTC market'.⁶⁸⁸ In line with the other agencies, FDIC chair Bair also pointed out that initial margin would have restrained AIG's appetite to write CDOs and its clients to blindly trust the firm: 'The exchange of initial margin would have placed some check on AIG's ability to present itself as a guarantor of an impossibly large volume of subprime collateralized debt obligations (CDOs) and would have discouraged institutions from relying unquestioningly on the AIG guarantee'.⁶⁸⁹

By comparison, the OCC was probably the least ambitious regulator. In 2009, a spokesperson for the agency insisted '[t]he system has always worked on derivatives', and one year later, Comptroller of the Currency Dugan still warned of 'swing[ing] the regulatory pendulum too far too fast'.⁶⁹⁰ Nonetheless he appeared supportive of margin requirements, making the same argument about AIG as the other regulators: 'These margin requirements would likely have limited the volume of trades that AIG could have done, or forced them to exit the transactions prior to the losses becoming so significant that they threatened the firm's solvency'.⁶⁹¹

Most members of the US Congress who were supportive of encompassing reform rarely evoked the technical aspects of margin requirements for uncleared derivatives directly, but those who did also supported the concept. For Frank and Petersen, capital and margin requirements were essential for 'creat[ing] a strong incentive for dealers and users of derivatives to trade them on an exchange or electronic trading platform or have them cleared whenever possible. Significantly higher capital and margin charges will apply to non-standardized transactions that are not exchange-traded or centrally-cleared'.⁶⁹² Congressman Brad Sherman (D-California) emphasized that 'there ought to be reserves',⁶⁹³ and Gregory Meeks (D-New York) stated the reform of margin requirements 'brings the focus back to systemic risk by addressing issues of leverage and safety and soundness'.⁶⁹⁴ In the Senate, Gaylord Conrad (D-North Dakota) referred to AIG by saying that 'we have got an absolute obligation to make sure that can't happen again, and I don't know how you do that without some margin requirement'.⁶⁹⁵ Chris Dodd also insisted that '[m]ore collateral in the system, through margin requirements, will help protect taxpayers and the economy from bailing out companies'.⁶⁹⁶

⁶⁸⁷ Tarullo quoted in US Senate Banking Committee (2009b:253) and Tarullo (2011).

⁶⁸⁸ Bair (2009b, 2010a)

⁶⁸⁹ Bair (2011b)

⁶⁹⁰ Kevin M. Mukri quoted in Nasiripour (2009), Dugan (2010).

⁶⁹¹ Dugan quoted in US Senate Banking Committee (2009b:187).

⁶⁹² Frank/Peterson (2009:1f.)

⁶⁹³ Sherman quoted in US House Financial Services Committee (2009d:10).

⁶⁹⁴ Meeks quoted in US House Financial Services Committee (2009e:26).

⁶⁹⁵ Conrad quoted in US Senate Agriculture Committee (2009b:22).

⁶⁹⁶ Dodd as cited in US Congress (2010b:31).

Speaking for the Administration, US Treasury Secretary Geithner in 2009 declared that ‘[t]he shock absorbers that are critical to preserving the stability of the financial system—capital, margin, and liquidity cushions in particular—were inadequate to withstand the force of the global recession, and they left the system too weak to withstand the failure of major financial institutions’.⁶⁹⁷ He perceived of margin requirements as an indispensable tool for encouraging counterparties to standardize their trades, promote the shift to CCPs, and prevent regulatory arbitrage. In his words, margin requirements ‘create incentives for market participants to use centralized clearing and standardized contracts so that they do not needlessly externalize risks to the financial system by avoiding central clearing’.⁶⁹⁸

4.3 The US as the ‘first mover’, doubts about the EU, and policy-makers’ definite embrace of margin requirements

The US Administration’s confidence in margin requirements was so profound that it firmly committed to them, even before the EU (or any other jurisdiction) had formally embraced the idea. Rahm Emanuel, president Obama’s chief of staff, pushed Barney Frank to move quickly, hoping that Obama would be able to present a strong response to the crisis at his first G20 summit in London 2009.⁶⁹⁹ US leadership in leaving the crisis behind was of paramount importance to Obama. He explained that ‘[w]e will act boldly to lift the American economy out of crisis and reform our regulatory structure, and these actions will be strengthened by complementary action abroad. Through our example, the United States can promote a global recovery and build confidence around the world; together with the other members of the G-20 we can forge a secure recovery, and future crises can be averted’.⁷⁰⁰ Along similar lines, Geithner declared the failure of laissez-faire regulation, pointing out that ‘[t]he United Kingdom’s experiment in a strategy of ‘light touch’ regulation to attract business to London away from New York and Frankfurt ended tragically’.⁷⁰¹ Without dwelling on the past deregulatory efforts of his own country, he praised the US as the jurisdiction with ‘the highest standards for disclosure and investor protection, [...], the strongest protections for depositors and against money laundering [...]. We did not lower our sights to match the more limited ambitions of others. We knew we would be more vulnerable if we did’.⁷⁰²

Inspired by this track record, he soon explained the US’s ambition to ‘propose regulations for the Over-the-Counter (OTC) derivatives market that go beyond G-20 [Pittsburgh] commitments’.⁷⁰³ The US Treasury’s under secretary for International Affairs, Lael Brainard,

⁶⁹⁷ Geithner quoted in US House Agriculture and Financial Services Committees (2009:12, see also 14).

⁶⁹⁸ Geithner (2011), See also Geithner (2009a, 2009b, and US Treasury 2009:48).

⁶⁹⁹ Kaiser (2013:159f.)

⁷⁰⁰ Obama (2009:4)

⁷⁰¹ Geithner (2011)

⁷⁰² Geithner (2011)

⁷⁰³ US Treasury (2009:81)

insisted that strong action by the US would act like a magnet, meaning that '[b]y moving first and leading from a position of strength, we are elevating the world's standards to ours'.⁷⁰⁴ To Geithner, leading from a position of strength represented 'an enviable position', most importantly because he believed that 'all [jurisdictions] know that if anybody tries to compete by lowering those standards, it would be adverse to their interests'.⁷⁰⁵ Margin requirements for uncleared derivatives became a key component of this agenda and formed part of the Dodd-Frank discussions from the first draft onwards. US policy-makers perceived strong regulation as potentially competitiveness-enhancing. At the same time, however, they were aware that acting as the first mover could also hurt the competitiveness of their domestic firms. Geithner, therefore, declared the need 'to work with authorities abroad to promote implementation of complementary measures in other jurisdictions, so that achievement of our objectives is not undermined by the movement of derivatives activity to jurisdictions without adequate regulatory safeguards'.⁷⁰⁶ His objective was to 'encourag[e] a race to the top, a race to higher standards',⁷⁰⁷ and he explained the US was working hard in order 'to encourage [the EU and Asia] to adopt equally robust standards [...]'.⁷⁰⁸

However, questions were soon raised about the EU's seriousness in following up on the adoption of the new margin rules. Despite all the support key European policy-makers/institutions had voiced in favour of this project, there was initially little evidence of concrete steps taken in this direction. US policy-makers' concerns can be grouped in two categories, one related to the EU's institutional complexities, the other to the extent of its regulatory ambitions regarding margin. Regarding the first category, the US was aware that the comparatively low speed of EU policy-making was informed by Europe's complex decision-making procedures characterized by an intricate combination of supranational and inter-governmental elements.⁷⁰⁹ However, beyond these well-known complexities, the EU's new regulatory architecture posed some additional problems. Indeed, when the US passed the Dodd-Frank Act in 2010, the EU's ESAs were not even yet operational.⁷¹⁰ One year later, when the ESAs had eventually resumed their work, there was still major uncertainty about the distribution of key responsibilities at the supranational level. For example, ESMA and the Council disputed which body was in charge of determining the clearing eligibility of trades. The eventual outcome was a typical case of EU policy-making, resulting in a complex compromise of shared responsibility between ESMA, the Council, Parliament, and the Commission.⁷¹¹ Achieving this compromise, however, cost time and cast some doubt on the EU's ability to act.

⁷⁰⁴ Brainard quoted in US House Financial Services Committee (2011b:13) see for a very similar comment US Senate Banking Committee (2012a:38).

⁷⁰⁵ Geithner (2009c)

⁷⁰⁶ Geithner (2009b:2f.), see also Brainard quoted in US House Financial Services Committee (2011b:94).

⁷⁰⁷ Geithner quoted in US House Financial Services Committee (2009c:8).

⁷⁰⁸ Brainard quoted in US House Financial Services Committee (2011b:94).

⁷⁰⁹ Helleiner (2014a:141)

⁷¹⁰ Grant (2010)

⁷¹¹ Khaliq (2011a)

US policy-makers were also worried about the strength of the new EU rules. As discussed in the previous section, there had been much support for margin requirements in the EU, but upon closer analysis, these comments often appeared overshadowed by more sceptical voices. For example, in 2009 EU Commissioner Charlie McCreevy argued that bilateral swaps needed to be ‘tightened and made more secure’, but cautioned that ‘[t]he route to get there has still to be worked out’.⁷¹² He was also unsure how to best enhance central clearing in the market: ‘The question is how to do this: Should we provide incentives, for example through regulatory capital, or should we mandate the use of CCPs?’, he asked.⁷¹³ In its first consultation on ‘Possible initiatives to enhance the resilience of OTC Derivatives Markets’, the EU Commission discussed various options including improvements to collateralization, but provided a wide spectrum of possible solutions ranging from ‘self-regulatory initiatives’ to ‘appropriate legislative instruments’.⁷¹⁴ The next consultation document on ‘Derivatives and Market Infrastructures’ published one year later did insist on the ‘timely and accurate exchange of collateral and appropriate and proportionate holding of capital’ for uncleared derivatives.⁷¹⁵ Reflecting on the state of the development of derivatives rules in Europe and the US, the EU Commission in 2010 therefore identified ‘no significant risks of regulatory arbitrage’, but immediately cautioned that it would be ‘very difficult to predict’ if this were to remain the case after the adoption of the required legislation and technical standards.⁷¹⁶

Adding to these concerns, it had become evident that at least some policy-makers in the EU doubted the need to impose both, capital *and* margin requirements on uncleared trades. In 2009, McCreevy made it sound as if margin requirements were an optional approach, saying that ‘[o]ne approach might be stricter collateral requirements. We could also think about raising the regulatory capital cost for bilaterally-cleared derivatives’.⁷¹⁷ The tension kept brewing for several years. In 2011, a press article summarized a statement by ‘[a] source close to the rule-making process’ according to which ‘the capital versus margin debate is a live one, and it is not clear how close the two sets of rules [i.e. the US and EU ones] will be’.⁷¹⁸ Another anonymous European regulator agreed on the need for VM, the imposition of which he considered a must, but cautioned that ‘with initial margin the question is more open [...] Coming up with sensible regulation is tricky’.⁷¹⁹ The article concluded that ‘[t]he lack of enthusiasm from foreign regulators means sparks are beginning to fly in the US’.⁷²⁰

⁷¹² McCreevy (2009:2)

⁷¹³ *ibid.*

⁷¹⁴ EU Commission (2009e:11)

⁷¹⁵ EU Commission (2010c:6)

⁷¹⁶ EU Commission (2010b:56f.)

⁷¹⁷ McCreevy (2009a:3)

⁷¹⁸ Cameron (2011b)

⁷¹⁹ Anonymous regulator quoted in Cameron (2011b).

⁷²⁰ Cameron (2011b)

In light of the EU's apparent hesitation to act, the US realized it found itself in a vulnerable position. Congress had adopted mandatory margin requirements through Dodd-Frank in 2010, followed by a first round of proposals by the CFTC and Prudential Regulators in 2011, while the EU was still acting indecisively. The Republicans were already fretting that 'there is no indication' of other jurisdictions following along, warning that '[t]he rules are unenforceable globally'.⁷²¹ The Democrats were also starting to feel uncomfortable. Barney Frank cautioned that '[t]here is a danger that various financial institutions in each country will lobby to the point where there is an overall reduction'.⁷²² Congressman David Scott (D-Georgia) also considered it 'unlikely that foreign jurisdictions will adopt similar laws as that within the Dodd-Frank law, since the issue was not addressed as part of the G-20 accords'.⁷²³

Given the absence of the 'race to higher standards' Geithner had hoped for back in 2009, he identified margin requirements as an area involving 'remaining work towards alignment' and recognized 'the need to develop a global margin standard'.⁷²⁴ He warned that the failure to establish a global regime would undermine the objective of promoting central clearing, as the derivatives business would shift to the least regulated market, the result of which would be 'a recipe for another crisis'.⁷²⁵ Fed Governor Tarullo emphasized that '[s]uch an agreement would increase the stability of the financial system by reducing the likelihood of a race to the bottom in jurisdictions that do not implement equivalent standards'.⁷²⁶ Using Helleiner's terminology, we can say that policy-makers realized that whereas the 'benefit' of deregulation could be 'consumed' through unilateral liberalization, the expected benefit of regulation required collective action to prevent 'free-riding' by those trying to attract business through unilateral deviation.⁷²⁷

In Europe, the supporters of a margin mandate shared Tarullo's perspective. Edouard Vieillefond, Deputy General Secretary of the French Autorité des Marchés Financiers, in 2011 remarked that the EU and the US were in consensus about 90% of the new derivatives regulations and applauded the US whose proposals he considered 'a move in the right direction in that they create cost differential between uncleared and cleared derivatives'.⁷²⁸ However, at the same time, he warned that if the two jurisdictions '[...] don't have the same [...] rules for margining and capital including the same capital and collateral requirements for uncleared bilateral derivatives, it won't be manageable'.⁷²⁹ The EU Commission concurred, stating that '[t]he importance of an internationally coordinated approach cannot

⁷²¹ Both citations are drawn from Cameron (2011b): The first quote cites a letter by Spencer Bachus (R-Alabama) to Geithner, the second quote is by Congressman Darrell Issa (R-Ca.).

⁷²² Frank quoted in US House Financial Services Committee (2011b:3).

⁷²³ Scott quoted in US House Financial Services Committee (2011b:8).

⁷²⁴ Geithner (2011)

⁷²⁵ *ibid.*

⁷²⁶ Tarullo quoted in US House Financial Services Committee (2011b:197).

⁷²⁷ The language in this sentence is borrowed from Helleiner (1994:18,196ff.).

⁷²⁸ Vieillefond quoted in Cameron (2011b).

⁷²⁹ Vieillefond quoted in Braithwaite et al. (2011).

be overstated. Given the global nature of the OTC derivatives market, the lack of internationally coordinated action would only lead to regulatory arbitrage'.⁷³⁰

Policy-makers therefore decided to formally elevate the role of margin requirements by making it a priority for the G20. At their Cannes summit in November 2011, the leaders decided to expand the remit of the Pittsburgh reforms by including mandatory margin requirements among the key requirements for global OTC derivatives reform: 'We call on the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commission (IOSCO) together with other relevant organizations to develop for consultation standards on margining for non-centrally cleared OTC derivatives by June 2012 [...]'.⁷³¹ As with prior global regulatory standards, the aim was to pursue stability-enhancing reform, while keeping incentives for competitive deregulation at bay.⁷³² The work of WGMR soon dissipated any doubts about Europe's determination to pursue the margin mandate. The group provided two justifications for IM, a 'macroprudential' one in terms of the '[r]eduction of systemic risk', and a market-shaping one in terms of the '[p]romotion of central clearing'.⁷³³ The clearing/margining consensus would subsequently act as the ideational bedrock for the development of the specific collateralization requirements.

5. Relegated to the margin: The loss of the banks' privileged position within the transnational policy community

As the individual case studies will show in more detail, the interactions between private sector groups and regulators became rather confrontational after the crisis. For example, Theo Lubke, senior vice president and head of the financial infrastructure department of the New York Fed told ISDA that '[i]t is simply unacceptable in today's environment that the design and structure of the OTC derivatives market can be controlled by a handful of large dealers.' 'There is opacity in the OTC market that doesn't have commensurate public policy benefits. This is not something that can continue'.⁷³⁴ CFTC chairman Gary Gensler made it very clear that the time for the dealer banks to enjoy a privileged position within the transnational policy community had come to an end. 'Right now', he said, 'we have a dealer-dominated world, and that nearly drove us off a cliff'.⁷³⁵

There were clear signs pointing towards an estrangement between the public and private sector representatives of the transnational policy community. For example, it appears that

⁷³⁰ EU Commission (2010b:8), see also Barnier (2012a).

⁷³¹ G20 (2011)

⁷³² See Singer (2007:3) and Kapstein (1994:106) for accounts on the relevance of these objectives for international financial reform more generally.

⁷³³ BCBS-IOSCO (2012:2, 2013a:2, 2013b:2)

⁷³⁴ Lubke quoted in Glass (2009:S98).

⁷³⁵ Gensler quoted in van Duyn (2010c).

at least some previously well-connected lobbyists often had to rely on specialized news outlets or regulators' websites to remain up to date on the margin rule. Moreover, while regulators seemed to appreciate the fact of being supplied with information, they often did not show any reaction after an industry-moderated presentation, whereas prior to 2008, a subsequent exchange of views had been the norm. As a consequence, lobbyists frequently felt left 'high and dry', having to wait for the next draft proposal or final rule to see which course the requirements were taking. Moreover, regulators often appeared to resent the attitude some interest group representatives tended to display. In particular, the efforts by some commenters to 'educate' public officials on why public intervention was misapplied often did not fall on fertile ground. More generally, an anonymous banker quoted in *The New York Times* expressed his frustration about the deterioration of the industry's overall relations with the regulatory community by saying that '[w]e're on the outside, knocking on the window and saying, 'Hey, listen to us just a little bit'.⁷³⁶

At least some regulators also seemed split regarding the utility of maintaining close relations with the industry, which, compared to the pre-crisis period, was a rather big novum.⁷³⁷ On the one hand, many regulators still felt the need to communicate with a variety of constituents who were knowledgeable about the market and could supply information. On the other hand, there appear to have been others who began viewing close interactions rather critically. Their justification seemed to be that there was a need for more transparency, and that such relationships risked privileging those parties who could afford travel and meetings, which in turn might enable them to exercise more influence over the rules, compared to their peers who lacked the resources to engage in this form of interaction. Further research would be needed to substantiate the extent to which these concerns were representative of the wider regulatory community involved in the development of the margin rules.

In sum, there were clear signs pointing towards the alienation of the transgovernmental community from the banks.

6. Conclusion

The purpose of this chapter was to discuss some key features of the post-crisis regulatory context which transcended the decision-making process of the individual rules. These features are related to three of the moderators: public issue salience of derivatives regulation, the post-crisis ideational consensus, and the state of the transnational policy community.

⁷³⁶ Appelbaum/Lichtblau (2010)

⁷³⁷ See for example Tsingou (2010).

Policy-makers initially intended to continue embracing the deregulation consensus with a focus on industry self-regulation. However, the dealer banks' lack of substantial progress on this front, combined with the dramatic consequences of the crisis, caused the public issue salience of derivatives regulation to shoot to and remain at stratospheric levels. On both sides of the Atlantic, derivatives became a 'red flag' to policy-makers who decried the reckless actions of the banks and demanded decisive action. Policy-makers subsequently abandoned the deregulation consensus and decided to rein in the OTC derivatives market.

The ideational consensus centred on channelling uncleared trades through CCPs which had successfully withstood the crisis and were eager to take on the new business. Policy-makers believed central clearing would decrease the high degree of interconnectedness that had served as an incendiary mechanism during the crisis. However, it soon turned out that insufficient levels of standardization would cause a significant proportion of bilateral trades to remain in the uncleared marketplace. Policy-makers therefore chose to import margin requirements which represent a key element of central clearing into the uncleared market, the idea being that collateralization would address the higher systemic risk inherent in bespoke trades, and that it would incentivize investors to move suitable trades to CCPs. The US immediately acted on the new consensus, taking on the role of first-mover. The EU, however, lagged behind. Moreover, several comments by EU policy-makers questioning the need for IM created the impression of a growing risk that the post-crisis ideational consensus could falter. Policy-makers therefore decided it was necessary to promote the development of globally harmonized rules, and established WGMR to serve as a focal point for this purpose.

The chapter also discussed case-study over-arching evidence regarding the estrangement between the members of the transnational policy community, with regulators displaying a more reserved attitude towards the dealer banks than had been the case prior to the crisis.

Overall, three of the moderators that prior to the crisis had fostered dealer bank influence, i.e. public issue salience, policy-makers' ideational outlook, and the state of the transnational policy community, had flipped.

CHAPTER V - Making the use of IM mandatory

1. Overview of the chapter

This chapter analyzes the first of the post-crisis case studies: the imposition of the mandatory use of IM, a policy the banks vehemently opposed. It argues that in both the US and the EU, the dealer banks lost the battle against the introduction of IM as a regulatory principle. Section 2 shows that they opposed the compulsory use of IM because it would reduce the profitability of the uncleared business. In the early stages, the industry was confident that the margin mandate might in fact die in Congress. Alternatively, in case it were to survive against all odds, the banks believed that chances were high that Europe would not follow along. This would leave the US isolated internationally, in which case the banks were convinced their threat to exit the market would finish off the idea. In either case, there would be a return to business as usual, meaning that deregulation with a focus on industry-led self-regulation would prevail.

However, with the formation of WGMR, it became clear that margin requirements would not simply disappear from policy-makers' agenda. The industry responded with a radical advocacy campaign against margin requirements. The banks submitted information seeking to refute claims that OTC derivatives had been negatively implicated in the crisis. They also insisted that they were already protecting themselves sufficiently against any risk in the market. Specifically, the dealers argued that if any public intervention were to be envisioned at all, policy-makers should limit themselves to mandating the use of VM which, according to the industry, was already a business standard. The banks also warned against the steep macroeconomic costs of a mandatory IM regime.

The industry received support from the buy-side which equally objected to the mandatory use of IM, the main arguments being that its use of bilateral derivatives was 'safe', and that imposing IM would only increase the financial burden for their customers. Preference homogeneity between the sell- and the buy-side thus allowed the industry to submit a clear signal to policy-makers about its objection to the IM mandate.

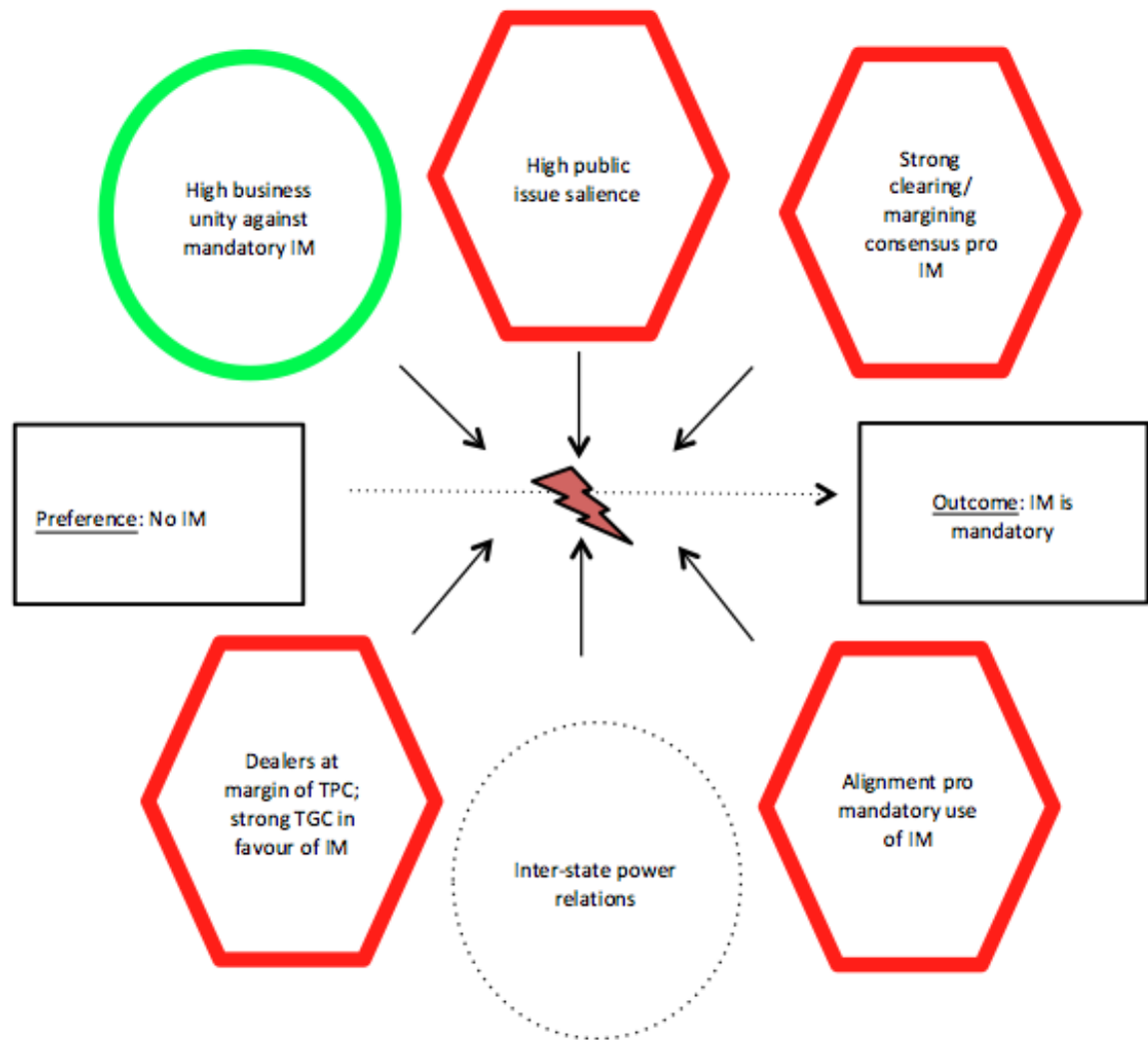
Section 3 reveals that the dealers lost the battle against the mandatory use of IM, with regulators on both sides of the Atlantic pushing ahead, against the banks' preferences. Boosted by the high degree of public issue salience of derivatives regulation, policy-makers dismissed most of the information they received from the market. Regarding the sell-side, they were sceptical about the collateralization levels the industry claimed had already been achieved. In addition, they did not consider the financial burden associated with the new rules as unbearable as the banks claimed. Regarding the buy-side, policy-makers warned that the use of bilateral derivatives by these entities was actually not as 'safe' as they insisted. Overall, the transnational policy community of the pre-crisis period had

disintegrated into a strong transgovernmental community composed of regulators from both sides of the Atlantic who were committed to the idea of making the mandatory use of IM a reality, on the one hand, and the industry which found itself pushed to the sidelines, on the other.

Applying the theoretical framework, we can say that the shock of the crisis and the huge public outcry it caused disrupted the stability of the pre-crisis configuration in which dealer bank influence had been dominant. High issue salience led to the adoption of a new ideational consensus which was shared at the domestic institutional, as well as the transgovernmental level. The new ideational consensus also led to a reformation of the transnational policy community in terms of the dealer banks being pushed to its margin. With the ideational consensus being shared on both sides of the Atlantic, there was no need for policy-makers to invoke inter-state power. The result was a loss for the banks, which could not prevent the adoption of the IM mandate, despite high levels of business unity.

Figure 9 summarizes the constellation of this case. The dotted contours of the power moderator indicate that it was neutral. The barely visible dotted arrow line, superimposed by the red lightning bolt, indicates the lack of dealer bank influence.

Figure 9: The mandatory use of IM cases in the US and the EU



Source: Author

2. Dealer bank opposition to IM supported by the buy-side

The industry strongly opposed the mandatory use of IM. The margin rules risked turning a previously highly profitable segment into a dime business. As already mentioned, in the first nine months of 2009 alone, Goldman Sachs, Bank of America, JP Morgan, Citi, and Morgan Stanley had earned USD 53bn from their derivatives business.⁷³⁸ According to a Standard & Poor's estimate, the overall package of post-crisis derivatives regulation risked shaving off

⁷³⁸ Katz/Schmidt (2010)

an annual USD 4-4.5bn from dealers' revenue.⁷³⁹ JP Morgan alone anticipated an overall loss of USD 2bn.⁷⁴⁰ *The Financial Times* reported that '[a]s the dominant players, the largest banks should be the losers'.⁷⁴¹ Testifying in front of Congress, former ISDA representative Mark Brickell spoke about policy-makers 'shooting doves with an 8-gauge'.⁷⁴²

Indeed, the stakes for the industry were enormous. First, the mandatory use of IM would enhance transparency, as a consequence of which clients might find it easier to identify which fraction of the cost of a deal was related to collateralization and which represented profit for the banks. This level of transparency, some of the banks feared, might incentivize clients to use standardized trades and move to CCPs, where higher levels of transparency and lower cost tend to prevail. Second, and relatedly, if trades were to move to CCPs that guarantee their performance, the dealers would no longer be able to point to their own 'investment grade' status in order to justify the hefty price tags informed by the promise that they would assume performance under all conditions.⁷⁴³ Along these lines, hedge fund manager Michael Masters told the US Congress that with the rise of CCPs, the banks will 'lose oligopoly pricing power because any two counterparties can trade, regardless of their respective credit ratings'.⁷⁴⁴

Initially, ISDA and the large banks may have believed that despite all the promises and announcements policy-makers had made, the margin idea would probably never see the light of the day. Similarly, at least some bank officials may have felt that the complexities of shepherding any policy project through Congress, not to speak of the difficulties of global coordination would likely derail the project sooner, rather than later. The sceptical voices emanating from the EU about the need to introduce both capital *and* margin requirements (referenced in section IV-4.3) might have only further reinforced this perspective. The statement of an anonymous US dealer bank lawyer to the press that he 'very much doubt[s]' 'our regulators somehow find a way to get other jurisdictions to follow our rules'⁷⁴⁵ can be considered representative of this conviction. According to the industry's reasoning, the lack of a global rule would leave the US isolated internationally, thus allowing the banks to finish off the proposal at the national level by making the 'exit' threat. There was also the hope that public issue salience would cede again, and with it policy-makers' urge to implement the margin mandate. In Europe, a similar perspective appeared to prevail. A few banks seemed to believe that explicit threats on their part might not even be required, and that the discussion would quickly revert to the usual conversation about enhancing private sector solutions, meaning that the OTC market would essentially remain deregulated.

⁷³⁹ Mackenzie/Alloway (2012)

⁷⁴⁰ van Duyn (2010b)

⁷⁴¹ Braithwaite et al. (2013)

⁷⁴² Brickell quoted in US House Agriculture Committee (2009a:201).

⁷⁴³ Reuters (2009a)

⁷⁴⁴ Masters quoted in US Senate Agriculture Committee (2009a:109).

⁷⁴⁵ Anonymous general counsel of a dealer bank quoted in Cameron (2011b).

The formation of the WGMR, the international working group on margin requirements established by BCBS and IOSCO, destroyed these hopes. When it became clear that the ideational consensus was strong enough for the project to become a reality on both sides of the Atlantic, the banks lost the ability to make the exit argument with any degree of credibility. The key reason was that with the exception of Japan and the partial exception of Singapore, the derivatives market outside the US and the EU (plus Switzerland) was not well enough developed at the time to allow for a quick shift of the business to other jurisdictions. This means that unlike HSBC and Deutsche Bank in the forced capital injections case briefly discussed in section II-2.2.2, the large dealer banks lacked a realistic target to relocate their OTC business. From that moment, threats of relocation were not a dominant component of their advocacy strategy anymore. Once ISDA and the dealer banks realized that this time would be different and that there was a real risk of them not getting away with the promise of self-regulation, they began fighting tooth and nail on both sides of the Atlantic to prevent the adoption of the IM mandate.

The information ISDA and the sell-side submitted to policy-makers formed part of two main arguments. The first one involved denying that OTC derivatives had had any harmful effect during the crisis. The industry also praised the status quo, insisting that the use of VM and the application of capital requirements, as well as other forms of risk-mitigation already provided enough protection against current and potential future exposure. The second argument consisted in submitting estimates about the dramatic consequences a binding IM mandate would have for the global economy.

Indeed, in 2009, the City of London co-authored a report arguing that '[t]here is very little evidence to suggest that these [i.e. CDS] contributed in any significant way to the crisis'.⁷⁴⁶ This sentiment was widely shared among the industry. Frédéric Oudéa, chair and CEO of Société Générale claimed that derivatives had been largely unrelated to the crisis of AIG. He insisted that concerns about a default of AIG potentially dragging down the entire economy had been largely exaggerated and unwarranted. '[S]uch contagion fears may have been unfounded, due to the relatively manageable derivatives exposure of individual counterparties to AIG'.⁷⁴⁷ The European Banking Federation concluded 'that OTC derivatives markets have been quite resilient, have remained open and functioned efficiently throughout the financial crisis'.⁷⁴⁸ ISDA attributed the perceived superb functioning of the derivatives market to the widespread use of its Master Agreement, concluding that the existing 'infrastructure works extremely well'.⁷⁴⁹

In ISDA's view, banks were taking their responsibilities in the trading of OTC derivatives extremely seriously. For example, the association emphasized that dealers 'are in the business of taking credit risk, which is weighed carefully against the probability of default,

⁷⁴⁶ City of London and Bourse Consult (2009:2)

⁷⁴⁷ Oudéa (2012:228f.)

⁷⁴⁸ European Banking Federation (2009:3)

⁷⁴⁹ Pickel quoted in US House Agriculture Committee (2009a:157).

the size of potential losses relative to capital, and consideration of any loss mitigation that may exist'.⁷⁵⁰ Self-regulation should therefore prevail. Morgan Stanley wrote 'the decision to require margin and the details of how it is handled should be left to an individual negotiation [...]'.⁷⁵¹ JP Morgan agreed, saying that firms should be trusted to take collateralization decisions on their own, 'as part of their overall risk management process'.⁷⁵² Building on this praise of the status quo, the industry argued that OTC deals were already well collateralized thanks to the consistent use of VM to protect against current exposure. ISDA referenced the results of its own margin surveys suggesting that in 2010, 83% of respondents had bilateral collateral agreements in place (up from 65% in 2009 and 63% in 2008), with the remainder being unilaterally collateralized.⁷⁵³ Deutsche Bank equally insisted that 'the vast majority of exposures between financial firms are already collateralized on a bi-lateral basis'.⁷⁵⁴ The European Banking Federation emphasized that 'collateralisation is such a key interest for banks that uncollateralised transactions are infrequent'.⁷⁵⁵ To the French Banking Federation, appropriate collateralization and tracking credit exposure represented 'the top priorities of the financial industry', meaning 'there is no need for additional legislative instruments'.⁷⁵⁶ To BNP Paribas, appropriate collateralization was 'at the forefront of institutional thinking generally',⁷⁵⁷ and to the German Banking Industry Committee it was 'a core interest of all institutions'.⁷⁵⁸

ISDA suggested that regulators limit themselves to making the consistent exchange of VM a legal requirement, without adding any further requirements.⁷⁵⁹ The association claimed this move would have minimal disruptive effects, given that 'the infrastructure for VM collections is currently in place'.⁷⁶⁰ Barclays provided a corroborating statement, saying that 'institutions collect 'variation' margin on a regular basis in line with any increase or decrease in exposure [...]'.⁷⁶¹ JP Morgan '[did] not believe that beyond the introduction of CCPs for standardised contracts, there are systemic changes that can be made in improving the coverage of collateralised credit exposures'.⁷⁶²

Regarding potential future exposure, the banks believed that capital requirements provided sufficient protection. ISDA explained that '[r]equiring both IM and increased capital for the same swaps will result in duplicative and unnecessary costs'.⁷⁶³ It continued claiming that

⁷⁵⁰ ISDA (2010c:7)

⁷⁵¹ James Hill of Morgan Stanley quoted in US House Financial Services Committee (2009e:51).

⁷⁵² JP Morgan (2009:3), see also Barclays (2012b:3), Lloyds Banking Group (2012:1).

⁷⁵³ ISDA (2011b:12; 2009:2)

⁷⁵⁴ Jon Eilbeck of Deutsche Bank in Deutsche Bank (2010:1).

⁷⁵⁵ European Banking Federation (2009:7)

⁷⁵⁶ French Banking Federation (2009:7,8), see also European Association of Public Banks (2009:7).

⁷⁵⁷ BNP Paribas (2009:4)

⁷⁵⁸ German Banking Industry Committee (2009:11)

⁷⁵⁹ ISDA (2013:7)

⁷⁶⁰ *ibid.*

⁷⁶¹ Barclays (2009:8)

⁷⁶² JP Morgan (2009:2)

⁷⁶³ ISDA (2013:7), see also ISDA and Financial Services Industry (2012:8).

putting aside capital for this purpose ‘has proved to be an effective risk mitigant’.⁷⁶⁴ UBS commented that ‘capital requirements [...], rather than IM, is what avoids systemic risk’.⁷⁶⁵ SIFMA concurred that ‘[c]apital requirements already differentiate the perceived differences in risk presented by centrally-cleared versus non-centrally cleared derivatives’ and that the use of IM would result in a massive form of ‘overcollateralization’.⁷⁶⁶ Barclays, Société Générale, Intesa San Paolo were of the same view.⁷⁶⁷

Second, the industry warned that the mandatory use of IM would hurt the global economy. ISDA claimed that IM would ‘ha[ve] the potential to significantly strain the liquidity and financial resources of the posting party’.⁷⁶⁸ It presented numerous estimates according to which the aggregate cost of the new rules would range from USD 1-30tn, depending on the precise design of the new regime.⁷⁶⁹ It warned policy-makers of the ‘irreparable damage to the OTC derivatives business because of the dramatic increase in the cost of providing such products’, the effect of which ‘would be tantamount to reducing the monetary base available to the economy’.⁷⁷⁰ Morgan Stanley explained that the funding for IM would be ‘coming off banks’ balance sheets that would ordinarily be deployed into the economy for lending [...]’.⁷⁷¹ The German Banking Industry Committee issued a similar warning.⁷⁷²

The buy-side equally rejected the imposition of IM. While not part of a formal alliance with the banks, buy-side firms advanced very similar arguments. In their public advocacy, asset managers, insurance firms, and pension funds relied on a two-pronged strategy. Above all, they claimed they were ‘safe’ entities because existing legal requirements already precluded any form of potentially dangerous use of uncleared derivatives. The mandatory use of IM would therefore unnecessarily increase the financial burden of their clients.

The buy-side firms’ first argument against the imposition of IM was that their use of derivatives was ‘safe’. The American Council of Life Insurers (ACLI), for instance, argued that ‘life insurers [...] pose minimal risk to the financial markets – their trades are risk reducing in nature and almost fully collateralized’.⁷⁷³ MetLife advanced the identical argument.⁷⁷⁴ ACLI, Nationwide Mutual Insurance Company, and the Association of British Insurers also emphasized they were prohibited from using derivatives for any purpose other than hedging.⁷⁷⁵ The Association of British Insurers claimed that because of their solid business

⁷⁶⁴ ISDA (2012:5)

⁷⁶⁵ UBS (2012:3)

⁷⁶⁶ SIFMA (2012:9)

⁷⁶⁷ Barclays (2009:8), Société Générale (2009:7), Intesa San Paolo (2009:7)

⁷⁶⁸ Stephen O’Connor of ISDA quoted in US House Agriculture Committee (2013b:25).

⁷⁶⁹ Becker et al. (2013), ISDA/SIFMA (2011:4), also ISDA (2012:2)

⁷⁷⁰ ISDA (2012:7)

⁷⁷¹ Steve O’Connor of Morgan Stanley quoted in CFTC (2010:52).

⁷⁷² German Banking Industry Committee (2012:6)

⁷⁷³ ACLI (2011:2)

⁷⁷⁴ MetLife (2011:4f.)

⁷⁷⁵ ACLI (2014:4), MetLife (2011:4), Nationwide Mutual Insurance Company (2011:1f.), Association of British Insurers (2012b:2)

model and prudent use of derivatives, ‘pension and insurance funds [...] are extremely unlikely to default’.⁷⁷⁶ Pension funds concurred. Associations including SIFMA AMG, the Committee on Investment of Employee Benefit Assets, the American Benefits Council, and the California State Teachers’ Retirement System (CalSTRS) pointed to the ‘comprehensive regulatory regime’⁷⁷⁷ which required firms to pursue ‘prudence and diversification requirements, professional management standards, transparency requirements, and limits on leverage’.⁷⁷⁸ Pension funds, in particular, claimed they were ‘exactly the type of counterparties whose swap activity does *not* increase systemic risk’.⁷⁷⁹ European pension funds argued along similar lines, insisting they ‘do not have the potential to create systemic risk’⁷⁸⁰, because of their status as ‘not-for-profit’ businesses, because their statutes precluded the use of derivatives for speculation, and because they did not employ leverage.⁷⁸¹

Asset managers adopted the same line of reasoning. For the US, the Investment Company Institute (ICI), pointed to federal securities law, whose ‘oversight prevents excessive speculation and contributes to the stability of funds, ensuring that they do not contribute to systemic risk’.⁷⁸² In Europe, investment funds, such as the members of the European Fund and Asset Management Association (EFAMA), the German Investment Fund Association (BVI), its Italian counterpart, Assogestioni, and its French sister association AFG (French Asset Management Association) insisted that the EU’s UCITS (Undertakings for Collective Investment in Transferable Securities) Directive served a similar purpose, for example by limiting leverage and by forcing funds to hold enough resources to meet all derivatives-related obligations.⁷⁸³ Speaking for both pension funds and asset managers, the European Fund and Asset Management Association (EFAMA) argued that any residual risk was fully under control, ‘given that we already operate a daily [VM] process’.⁷⁸⁴

Second, the buy-side firms warned of the increased cost of a binding IM mandate for their respective clients. Insurance firms such as ACLI, Nationwide Mutual Insurance Group, and the German Insurance Association pointed to ‘the potential increase in product costs to the consumers who rely on insurers for their financial security’.⁷⁸⁵ Insurance Europe told

⁷⁷⁶ Association of British Insurers (2012:3)

⁷⁷⁷ SIFMA AMG (Asset Management Group) (2012:15)

⁷⁷⁸ Committee on Investment of Employee Benefit Assets and American Benefits Council (2011:7; the other associations were the Committee on Investment of Employee Benefit Assets, PensionsEurope, the European Association of Paritarian Institutions, National Coordinating Committee for Multiemployer Plans, and Pension Investment Association of Canada), also CalSTRS (2011:5ff.)

⁷⁷⁹ American Benefits Council et al. (2012:6, emphasis in the original)

⁷⁸⁰ Federation of Dutch Pension Funds (2012:3)

⁷⁸¹ PGGM (2014:1f.), also PensionsEurope (2014:4,10)

⁷⁸² ICI (2011b:3)

⁷⁸³ EFAMA (2012:3f.), BVI (2012:3ff.), Assogestioni (2012a:2), AFG (2012:1f.), see also Amundi (2012:1ff.), Union Investment (2012:2ff.; 2014:4ff.), Mirova (2014:2ff.), Natixis Asset Management (2014:2)

⁷⁸⁴ EFAMA (2012:16)

⁷⁸⁵ ACLI (2011:14), see also Nationwide Mutual Insurance Company (2011:2), German Insurance Association (2012:3).

regulators the imposition of IM would be ‘distinctly disadvantageous’ to its clients.⁷⁸⁶ Pension funds, in turn, informed regulators that the victims of a binding IM mandate would be ‘the pensioners and many millions EU citizens [*sic*] saving for their retirement’, as the extra cost would ‘mak[e] it more expensive for pension schemes arrangements to insulate themselves from risk’.⁷⁸⁷ CalSTRS estimated the financial burden for policy-holders to be ‘significant’⁷⁸⁸ and the European Federation for Retirement Provision emphasized the ‘disastrous impact’ IM could have, including ‘less hedging and hence increasing risks in the system’, even more so as pension funds lacked netting opportunities, ‘given the large one-sided exposure’ of their portfolios.⁷⁸⁹ PensionsEurope announced that the mandatory use of IM would not only harm policy holders, but also the wider economy, as pension funds would have less resources available to invest and thus ‘contribute to the long-term financing of the European economy’.⁷⁹⁰

Investment funds, such as BlackRock, equally warned that the costs of IM would be borne by the clients, because of ‘capital being locked away that would otherwise be available for investment [...]’.⁷⁹¹ To SIFMA’s AMG, IM would ‘make swaps unnecessarily costly’.⁷⁹² PIMCO developed this thought further, explaining that ‘[h]igher transaction costs will, in turn, lead to lower returns for the end users that continue to use non-cleared swaps [...]’.⁷⁹³ Hedge funds also opposed a mandatory margin regime. Prior to the crisis, most of them had already been contractually required to post margin, but the largest ones had sometimes been in a position to make the banks/brokers compete for their business by lowering the cost.⁷⁹⁴ Despite their name, the hedge funds could not claim using derivatives exclusively for the purpose of ‘hedging’, but they joined the other buy-side actors in warning about the costs of a mandatory IM requirement. The Managed Funds Association (MFA) argued that ‘this mandate will directly affect the cost to buy-side firms when entering into uncleared swaps’.⁷⁹⁵ Along similar lines, the Alternative Investment Management Association (AIMA) rejected the formal imposition of IM as ‘largely unnecessary’ as ‘the cost of capital would ultimately be passed on to the client [...]’.⁷⁹⁶ AIMA also pointed out that the ‘[t]wo-way exchange of variation margin is today considered best practice in the industry’.⁷⁹⁷ MFA made the same claim.⁷⁹⁸ Union Investment went as far to insist that the G20 at their Cannes

⁷⁸⁶ Insurance Europe (2012:1)

⁷⁸⁷ Federation of Dutch Pension Funds (2012:4), see also American Benefits Council et al. (2012:6f.).

⁷⁸⁸ CalSTRS (2011:7)

⁷⁸⁹ European Federation for Retirement Provision (2012:15,4), see also National Association of Pension Funds (2012:3), American Benefits Council et al. (2012:8f.).

⁷⁹⁰ PensionsEurope (2014:4)

⁷⁹¹ BlackRock (2012:2)

⁷⁹² SIFMA AMG (2011:3)

⁷⁹³ PIMCO (2011:4)

⁷⁹⁴ See Bernanke (2006:2).

⁷⁹⁵ MFA (2011:3), see also MFA (2012b:4).

⁷⁹⁶ AIMA (2012:3)

⁷⁹⁷ AIMA (2011a:3)

⁷⁹⁸ MFA (2012b:6)

summit had, in fact, not mandated the use of IM, meaning that there was no need for policy-makers to heed in that direction.⁷⁹⁹

After having voiced their enthusiastic support for reform at the start of the policy-making process, CCPs and exchange houses were rather silent during most of the remaining debate. The mandatory use of IM would cause the OTC market to become ineffective, with CCPs ideally placed to provide a solution.⁸⁰⁰ In Europe, the London Stock Exchange and LCH.Clearnet, for example, preferred not to comment on how collateralization of bilateral credit exposures could be enhanced.⁸⁰¹ An exception was Germany's EUREX which considered mandatory IM 'the best way forward to protect against counterparty default [...]'.⁸⁰²

The only voices outside the public sector unequivocally supportive of binding IM requirements were the NGOs. Americans for Financial Reform (AfR), for example, attributed the bulk of the crisis to 'the overly leveraged, undercapitalized, under collateralized [*sic*] and opaque nature of unregulated swaps transactions among dealers and their counterparties [...] and urged regulators to adopt strong requirements.'⁸⁰³ Public Citizen perceived strict rules as the only effective means against 'reckless derivatives speculation'.⁸⁰⁴ In Europe, trade unions, such as the European Trade Union Confederation, the Deutsche Gewerkschaftsbund, and SOMO (the Centre for Research on Multinational Corporations in the Netherlands) made similar arguments.⁸⁰⁵

3. A loss for the industry: Regulators pushing ahead

Despite the high degree of business unity displayed among private interest groups, the dealer banks lost the battle against the mandatory use of IM which became a requirement under the rules of the CFTC, the PRs, and the ESAs.⁸⁰⁶ As we already saw in section IV-4, there was strong ideational consensus in favour of margining, with legislators and regulators on both sides of the Atlantic supporting the measure.

High levels of public issue salience facilitated the adoption of the IM mandate. Both Dodd-Frank and EMIR made the use of IM and VM mandatory, without providing any blanket

⁷⁹⁹ Union Investment (2014:5)

⁸⁰⁰ See Helleiner (2014b:79).

⁸⁰¹ London Stock Exchange (2009:5), LCH.Clearnet (2009)

⁸⁰² Eurex Clearing (2012:4)

⁸⁰³ AfR (Americans for Financial Reform) (2011a:2)

⁸⁰⁴ Public Citizen (2014:2), see also Better Markets (2011:1ff.).

⁸⁰⁵ European Trade Union Confederation (2010), Deutscher Gewerkschaftsbund (2010), SOMO (2010), see also Bundesarbeitskammer (2009) and Weltwirtschaft-Ökologie-und-Entwicklung (2010).

⁸⁰⁶ CFTC (2015:638ff.), Prudential Regulators (2015:74863ff.), ESAs (2016a:6)

exemptions for the buy-side.⁸⁰⁷ Given their tarnished reputation, the banks barely spoke up during the legislative process, particularly in the US. We therefore need to look to the regulators in order to get an impression of how the information the banks and the buy-side submitted was interpreted.

Regulators on both side of the Atlantic were not impressed by market actors' arguments against IM. With the harsh wind of public issue salience blowing against everybody who voiced concerns against regulation, and reinvigorated by the ideational clearing and margining consensus, they felt little restraint to dissect commenters' claims one after the other. Regarding the level of already existing collateralization, they did not doubt that VM was used, but they were sceptical about its scope of application. Nout Wellink, president of the Dutch central bank and Ingves' predecessor as BCBS chair summarized this scepticism, saying that despite various claims to the contrary, 'it is unclear to what extent positions are covered by collateral'.⁸⁰⁸

Regulators also discarded the industry's idea of using capital requirements as an alternative for mitigating against potential future exposure. WGMR explained that margin was "'targeted" and dynamic' in the sense of being adjusted to individual portfolios, whereas capital had to cover firms' activities 'collectively', meaning it might 'be more easily depleted at a time of stress'.⁸⁰⁹ The CFTC may have been particularly vocal against the exclusive focus on a 'capital requirements' solution, not just for the reasons elaborated by WGMR, but also given the fragmentation of the US regulatory system, as a result of which it would bear the responsibility for market stability, but without having a say over the design of the capital rules themselves that have traditionally been part of the PRs' (and SEC's) jurisdiction.

The banks' 'cost' argument also did not withstand regulators' scrutiny, particularly since the regulators decided to introduce IM thresholds. Given its technical nature, this specific aspect of the rules never attracted the spotlight of public issue salience, but it allowed the regulators to tailor the new requirements to the largest and potentially most interconnected, and thus the riskiest entities. The values were USD 8bn of material swaps exposure (i.e. in order to be covered, entities needed to have an average daily aggregate notional exposure of uncleared swaps of a minimum of USD 8bn) and USD 50mn of aggregate credit exposure. IM did not have to be exchanged below these thresholds.⁸¹⁰ Taking these thresholds into account, the regulators' own estimates suggested a liquidity need towards the lower end of ISDA's projections.⁸¹¹ The OCC, for example, approximated the cost of IM to USD 2.05tn.⁸¹² BCBS-IOSCO conducted a Quantitative Impact Study

⁸⁰⁷ See Section 731 of Dodd-Frank, Article 11 of EMIR.

⁸⁰⁸ Wellink (2010:133)

⁸⁰⁹ BCBS-IOSCO (2012:2f.)

⁸¹⁰ See for example Latham & Watkins (2017:3).

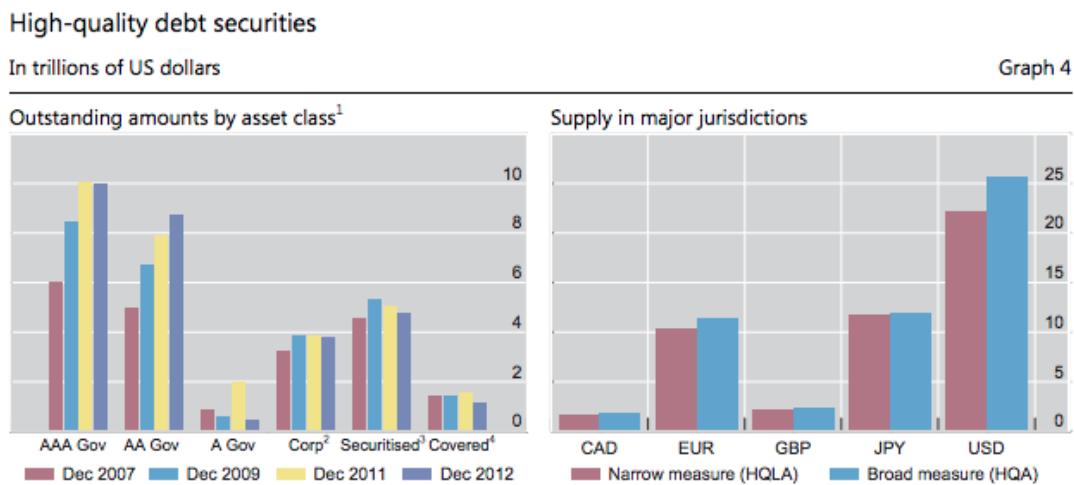
⁸¹¹ Board of Governors of the Federal Reserve (2015:18), Bank of England quoted in Clark (2013d), PRs (2014:57382)

⁸¹² OCC (2011:6)

revealing a liquidity need of Euro 0.7-1.7tn⁸¹³. For Europe, the Dutch central bank expected the cost to be USD 608bn,⁸¹⁴ whereas the ESAs projected a range of Euro 116-420bn.⁸¹⁵

Unlike the majority of market actors, regulators did not consider this burden to be unbearable. The Committee on the Global Financial System housed at the BIS studied the liquidity needs caused by post-crisis rules more generally. It concluded ‘there is no evidence or expectation of any lasting or widespread scarcity of such assets in global financial markets’.⁸¹⁶ Figure 10 illustrates the Committee’s findings across a range of different types of collateral assets (left-hand panel) and a breakdown for different national jurisdictions (right-hand panel).

Figure 10: Supply of high-quality assets



¹ Outstanding amounts with maturity greater than one year. ² Global corporate bonds rated single-A or higher. ³ US securitised bonds. ⁴ Global covered bonds.

Sources: Barclays; national data.

Source: Committee on the Global Financial System (2013:21). The right-hand panel does not include commercial bank and central bank balances.

Along similar lines, the Bank of England equally did not identify any ‘need to panic about excessive and difficult-to-meet collateral requirements’. It highlighted ‘that there is a lot of high-quality collateral available and the amount of it is not numerically decreasing, but actually increasing’.⁸¹⁷ Among other factors, this comment referred to central banks’

⁸¹³ BCBS-IOSCO (2013a:26)

⁸¹⁴ Levels/Capel (2012:41)

⁸¹⁵ ESAs (2014:79)

⁸¹⁶ Committee on the Global Financial System (2013:iii). The committee’s mandate is ‘to identify and assess potential sources of stress in global financial markets, to further the understanding of the structural underpinnings of financial markets, and to promote improvements to the functioning and stability of these markets’ (see the committee’s website at <https://www.bis.org/cgfs/>, accessed on 18 April 2018). See also Joint Forum (2015:10).

⁸¹⁷ Both quotes by Edwin Schooling Latter, head of the payments and infrastructure division at the BoE, as cited in Clark (2013d).

growing balance sheets and the related cash infusions into the financial markets. Figure 11 provides an overview of central banks' growing balance sheets in function of domestic GDP.

Figure 11: Central banks' growing balance sheets

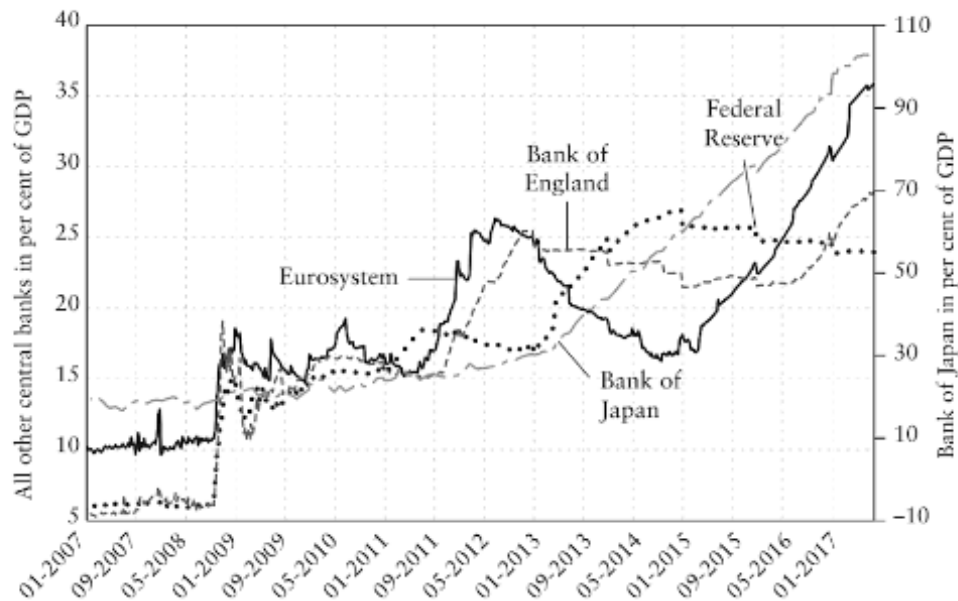


Figure 18.6 Balance-sheet sizes of major central banks

Note: Balance-sheet size is measured as total assets in per cent of domestic GDP.

Sources: Bank of England, Bank of Japan, ECB, Federal Reserve Board and ECB calculations.

Source: Hartmann (2018:312)

Both graphs display the availability of sufficient funds to finance counterparties' collateral needs, as perceived by the regulatory community. The BIS also conducted a macroeconomic analysis which contradicted the sell-side's claim about the negative macroeconomic effects of a binding IM mandate. The study revealed that the overall package of post-crisis OTC derivatives reforms would boost, rather than constrain, expected GDP by an annual 0.09-0.13%.⁸¹⁸

The regulators also pointed out that, compared to the costs of the financial meltdown to which derivatives had contributed, the predicted liquidity need was not out of proportion. Gary Gensler, for instance, argued that the crisis had shown 'how "expensive" derivatives markets can be without sufficient regulation' and that the new rules were necessary 'precisely because the current system cost taxpayers very heavily'.⁸¹⁹ A Fed study revealed

⁸¹⁸ BIS (2013:2)

⁸¹⁹ Gensler (2010), see also Massad (2015).

that the output loss the crisis had imposed on the US alone ranged from USD 6 to 14tn, or USD 50.000 to 120.000 per household.⁸²⁰ Regulators also interpreted the cost of the crisis as a reflection of market participants' previous failure to adequately manage the counterparty risk associated with OTC trades. Stephen Cecchetti of the BIS observed that '[i]n the past, some parties seem to have simply ignored the credit component [inherent in OTC trades]'.⁸²¹ The ESAs backed this argument, declaring that the idea of 'establishing robust risk management' was a key purpose of the rules.⁸²² A US regulator commenting anonymously to the press said '[t]here is going to be more liquidity tied up, but you might even find some regulators who would say there was a little too much liquidity sloshing around prior to the crisis'.⁸²³

More generally, and in line with the post-crisis ideational consensus, regulators emphasized that counterparties should consider the liquidity cost as a stimulus to move their trades to CCPs where they would benefit from multilateral netting, which would bring down the cost. Speaking on behalf of WGMR, the governor of the Bank of England, Mark Carney, explained that '[w]e needed to provide the economic incentives between central clearing and bilateral trades'.⁸²⁴ Along similar lines, US deputy Treasury secretary Neal Wollin confirmed that financial incentives were necessary in order 'to speed up the process of standardization'.⁸²⁵

Regarding the scope of coverage, regulators in both the US and EU insisted that the new rules had to be applied consistently across all types of firms (with the exception of commercial end-users, a case discussed separately in chapter VII of the thesis). Regulators felt an encompassing mandate was required, if only to prevent regulatory evasion by the sell-side. Many of them also appeared unconvinced that 'hedging' was as riskless as the buy-side had claimed. Indeed, hedging requires perfectly aligned interest between both counterparties, which does not always apply in real-life situations, meaning that almost by definition, it introduces a speculative element into the larger picture.

In addition, the regulators disputed the claims that asset managers, insurance firms, and pension funds were 'safe' entities that could be exempt from the rules. For example, the PRs observed that these firms 'by the nature and scope of their financial activities present a higher level of risk of default and are integral to the financial system, and thus, pose greater risk to the safety and soundness of their [...] counterparties and the stability of the financial system'.⁸²⁶ The PRs shared this interpretation, insisting that the scope of the rules extend to these firms '[b]ecause financial counterparties are more likely to default during a period of

⁸²⁰ Luttrell et al. (2013:1)

⁸²¹ Cecchetti (2013:5)

⁸²² ESAs (2016a:65)

⁸²³ Anonymous US regulator quoted in Whittall (2010).

⁸²⁴ Carney quoted in Masters/Stafford (2013).

⁸²⁵ Wollin quoted in van Duyn (2010a).

⁸²⁶ CFTC (2015:682)

financial stress, they pose greater systemic risk [...].⁸²⁷ The ESAs equally decided for the rules to apply to ‘all entities undertaking OTC derivatives transactions’.⁸²⁸

The proposed and final rules often did not engage *directly* with the claims the buy-side firms had made in order to justify special treatments. However, the margin rules were not the only way through which regulators began targeting these firms. Indeed, the post-crisis period saw a major public effort of bringing these entities out of the ‘shadow’. The justification for these endeavours also served as an explanation for including these firms in the margin framework, even though the determination of the margin rules in some cases preceded the output of these broader discussions.

Regulators justified their alertness vis-à-vis the buy-side’s use of derivatives on the grounds of the growing similarity between the activities of these firms and the tasks traditionally performed by banks, and the resulting rise of interconnectedness which could provoke uncontrollable chain reactions at times of individual and/or collective distress. Regarding insurance firms, Fed governor Tarullo noted that their liabilities were traditionally related to specific occasions, such as death or property destruction, meaning these firms were less susceptible to runs than banks. However, he observed that recent trends had created important vulnerabilities. For example, the closing of accounts had become easier than in the past, often not requiring the occurrence of any ‘special occasion’ anymore. Moreover, he pointed to insurance firms’ growing engagement in traditional banking activities, such as securities lending, repo,⁸²⁹ and OTC derivatives that ‘can create a balance sheet with much tighter connections to the rest of the financial system and greater liquidity risk in times of financial market distress’.⁸³⁰ AIG was considered the typical example of an insurance firm having embraced these trends.

The US Office of Financial Research (OFR) (created by Dodd-Frank to support the equally newly established Financial Stability Oversight Council (FSOC) that was charged with identifying and responding to systemic risk⁸³¹) identified further vulnerabilities. It observed that insurance firms ‘could pose systemic risk’, given their exposure to low interest rates and equity market volatility. It concluded that ‘[t]he impact of shocks through these channels could be substantial’.⁸³² FSOC therefore designated the largest insurance firms including AIG, MetLife, and Prudential as SIFIs, imposing upon them enhanced capital and liquidity requirements, as well as the obligation to prepare plans for an orderly

⁸²⁷ PR (2011:27575; also 2015:74843)

⁸²⁸ ESAs (2015:66)

⁸²⁹ A repo is a repurchase agreement entailing short-term borrowing by dealers. The dealer sells securities (e.g. government or other debt securities) to a buyer and re-purchases them at a higher price at a pre-specified date (often overnight), or on demand (see Euroclear 2009:5ff.).

⁸³⁰ Tarullo (2015b, also 2015a)

⁸³¹ Madison et al. (2018)

⁸³² OFR (2016:58)

dissolution.⁸³³ The FSB shared similar concerns. In 2013, it collaborated with the International Association of Insurance Supervisors to create a list of G-SIFI insurers ‘whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity’.⁸³⁴ Similar to the US insurers identified by FSOC, these firms were subject to ‘recovery and resolution planning requirements; enhanced group-wide supervision; and higher loss absorbency requirements’.⁸³⁵

Regarding pension funds, the Joint Forum noticed that the growing longevity of policyholders had often encouraged riskier business practices. For example, many pension funds had started using longevity swaps. These are derivative contracts through which pension funds transfer the risk of a policy-holder exceeding her statistical life expectancy to an insurer or a bank which in turn is compensated for taking on that risk in form of regular payments.⁸³⁶ The Joint Forum concluded that this market had not yet reached levels warranting ‘systemic concerns’, but that its ‘massive potential size and the growing interest from investment banks in mobilising this risk make it important to ensure that these markets are safe, both on a prudential and a systemic level’.⁸³⁷ The FSB, in turn, cited pension funds’ use of derivatives to hedge against longevity among other sources of risk as key factors contributing to leverage and financial interconnectedness.⁸³⁸

With respect to asset managers, OFR identified a number of factors feeding into systemic risk including firms’ desire to reach for yield, herding behaviour encouraged by competitive pressures, the use of leverage, and the potential for large and sudden redemption by investors.⁸³⁹ It identified close similarities between asset managers and banks: ‘For example, asset managers may create funds that can be close substitutes for the money-like liabilities created by banks; they engage in various forms of liquidity transformation, primarily, but not exclusively, through collective investment vehicles; and they provide liquidity to clients and to financial markets’.⁸⁴⁰ IOSCO issued similar warnings, committing itself to investigate asset managers’ ‘liquidity management, leverage, operational risks and securities lending’.⁸⁴¹ The FSB highlighted similar factors ‘as potential structural sources of

⁸³³ Harris/Chiglinsky (2016). At the stage of writing (i.e. spring 2018), Prudential is the only insurance firm left on that list, following AIG’s contraction in size and MetLife’s successful lawsuit overruling its designation (Basak/Chiglinsky 2017). For responses critical of FSOC’s work, see for example Wallison (2014) Wimberly (2014-2015), and Harrington (2016).

⁸³⁴ IAIS (2013:3). The inaugural list of 2013 included the American firms already singled out by FSOC, in addition to Allianz, Assicurazioni Generali, Aviva, Axa, and Ping An Insurance (FSB 2013b:4).

⁸³⁵ FSB (2013a)

⁸³⁶ Allen&Overly (2013)

⁸³⁷ Joint Forum (2013:2)

⁸³⁸ FSB (2016:40)

⁸³⁹ OFR (2013:9ff.)

⁸⁴⁰ OFR (2013:1)

⁸⁴¹ Natasha Cazenave deputy head of the policy and international affairs department at France’s financial markets authority and head of IOSCO’s committee five on investment management quoted in Alexander (2016).

vulnerability associated with asset management activities'.⁸⁴² Taken together, these considerations reinforced regulators' determination to not grant any carve-outs. WGMR recommended imposing mandatory IM without any blanket exemptions.⁸⁴³ At the domestic level, the CFTC, the PRs, and the ESAs, each followed this course and equally did not provide any sector-based carve-out.⁸⁴⁴

4. Conclusion

This chapter has argued that the dealer banks failed to exercise influence over the introduction of IM as a requirement, a policy to which they strongly objected. Initially, the industry had hoped that the IM idea would either not survive in Congress, or not be adopted in Europe, which would leave the US internationally isolated. As a consequence, American policy-makers would become vulnerable to the projection of structural power, allowing the industry to kill the idea by threatening to relocate the business overseas.

Once it was clear that Europe was fully on board and that WGMR would be working on international standards, the industry led a fierce lobbying campaign against IM. It claimed that OTC derivatives had barely caused any damage during the crisis, that reliance on VM and capital requirements represented a sufficient risk-mitigation strategy, and that the overall macroeconomic cost of the IM mandate would be unjustifiably high. The industry benefited from high business unity as the buy-side equally opposed the IM mandate. Insurance firms, pension funds, and investment firms insisted their use of bilateral derivatives was completely safe and that the compulsory use of IM would impose additional costs on their clients.

The regulators, however, refuted the validity of each of these claims. As a result, the industry found itself pushed to the sidelines of the transnational policy community that turned into a tight-knit transgovernmental community of regulators defending the IM mandate. Policy-makers were also united by their strong embrace of the margining consensus, as well as the high public issue salience of derivatives regulation, which engraved the need for IM within their institutional identity. Policy-makers' broad agreement on the IM mandate, once WGMR was established, meant that transatlantic power relations probably did not play any major explicit role.

⁸⁴² FSB (2015d:1)

⁸⁴³ See principle 2 in BCBS-IOSCO (2012:4, 2013a:4, 2013b:4).

⁸⁴⁴ Note that in the EU, pension funds have enjoyed for a temporal exemption from central clearing given their difficulties in posting cash. Originally thought of as an arrangement allowing CCPs to develop solutions for pension funds to also post non-cash collateral, there are signs indicating that the temporal exemption might become permanent (ESMA 2018a).

Overall, the banks lost the IM battle because the large-scale consequences of the crisis and the huge public outcry it caused catapulted public issue salience to a record high. This in turn boosted the adoption of a new ideational consensus which was shared at the domestic institutional level and led to a re-organization of the transnational policy community where the dealer banks were pushed to the margin. With the ideational consensus shared by both the US and the EU, there was no need for policy-makers to invoke inter-state power. High levels of business unity were insufficient to turn the tide.

CHAPTER VI - The design of the IM mandate: The two-way mandate, mandatory segregation, and the prohibition of rehypothecation

1. Overview of the chapter

This chapter analyzes the design of the IM mandate, focusing on three key requirements: that the banks need to collect *and post* IM, that collateral needs to be segregated from proprietary assets, and that it must not be re-invested by the transferee for her own purpose. The chapter argues that the banks lost all three battles.

Section 2 discusses the introduction of 2-way IM. The public issue salience of 1-vs 2-way IM itself was comparatively low, both in the US, and the EU. The main conundrum was whether the banks should not only collect IM, but also post it to their clients. Section 2.1 shows that the dealer banks vehemently opposed the idea of having to post themselves to their customers. The information they submitted to policy-makers centred on the claim that two-way IM was highly costly and uneconomical. However, unlike in the 'mandatory use of IM' case, the banks did not enjoy the full support of the buy-side which was split on the idea. Depending on whether buy-side firms believed that the additional cost of receiving collateral from the banks (which would of course be priced into the deal) was worth the additional protection against counterparty risk or not, they supported or rejected the idea.

Section 2.2 reveals that the question of whether IM should be posted 1- or 2-way initially also split the transgovernmental community which disagreed over how the ideational consensus and its macroprudential component should be interpreted. The conflict originated in the US. It centred on the regulatory treatment of transactions with the dealers' clients, given that trades between the banks themselves were already covered by the post-only mandate. Dodd-Frank delegated the question to the regulators. Its resolution pitched the CFTC against the PRs, meaning there were frictions at the domestic institutional level. While both (sets) of agencies agreed that IM was a must, the way in which to apply it set them apart. At the root of the conflict was the decentralized nature of the US regulatory landscape. Each side drew on their respective institutional mandate to offer a different explanation of how IM was supposed to reduce systemic risk. As a market regulator, the CFTC favoured a 2-way arrangement protecting both counterparties, whereas the PRs, as prudential regulators, decided to focus primarily on the health of the individual banks, and thus one side of the transaction only. Unlike the CFTC, they preferred a 1-way approach, arguing that it was unjustifiable to have assets flowing from the regulated banking sector to hedge funds, in particular, which were often domiciled in jurisdictions exercising light-touch regulation or no regulation at all. At first, the PRs prevailed, with the CFTC officially aligning its position, but the conflict kept brewing in the background.

In Europe, by contrast, there was comparatively little ideational or institutional friction. Both the ESAs and the EU Commission envisioned a 2-way approach, insisting that it was the only way in which the risk of the uncleared market could be addressed.

At the transgovernmental level, the conflict was eventually resolved in favour of the EU (and the CFTC). What led to the PRs changing their mind was probably a combination of two factors. The first one might have been related to learning/socialization effects through their membership within the transgovernmental community. The second one might have been derived from the EU's power through market size and power through regulatory capacity. The transgovernmental solution also brought the US domestic institutional environment and ideational outlook in alignment for a 2-way mandate. Both jurisdictions subsequently adopted the 2-way mandate.

Figures 12 and 13 illustrate the moderator constellation of the 2-way IM case in the US and the EU. A super imposition of two shapes means the moderator changed its effect over the course of the policy-making process, with the thicker line reflecting the final effect.

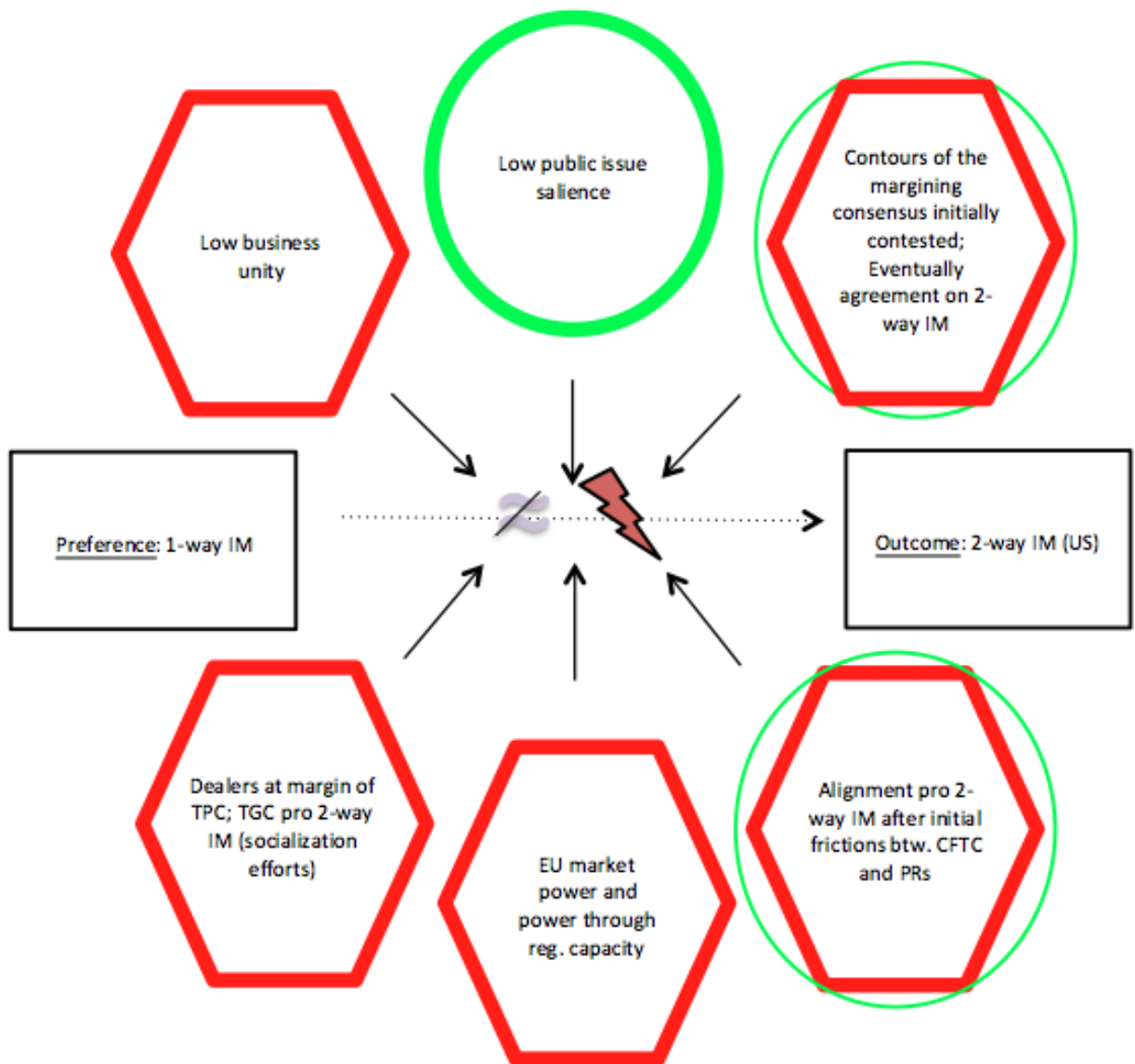
The banks on both sides of the Atlantic did not like the idea of IM, but if there had to be IM, their preference was for it to be one-way, meaning they wanted to only collect it from their clients, rather than having to post IM to them themselves. They lost in both jurisdictions.

In the US, the needle of the influence barometer swung from 'congruence' to 'loss' over the course of the policy-making process. Figure 12 reflects this in form of the crossed-out light-shaded double-wave symbol, with the double-wave itself representing congruence. Initially, there was conflict about the contours of the ideational consensus. The CFTC and the PRs disagreed about whether there should be 1-way or 2-way IM, given regulatory fragmentation and differing mandates. At first, the PRs prevailed with their preference for 1-way IM, which turned the effect of the ideational and domestic institutional moderators to positive, as seen from the banks' perspective. If the PRs had also prevailed at the transgovernmental level, this would have led to congruence for the dealers.

However, the resolution of both the brewing conflict between the CFTC and the PRs, as well as the disagreement between the PRs and the ESAs in favour of 2-way IM, be it through socialization efforts and/or EU market power cum power through regulatory capacity, turned the sign of the domestic ideational consensus against the banks. At the domestic institutional level, it brought the CFTC and the PRs in alignment in favour of a 2-way exchange. The new agreement also meant that the transgovernmental and inter-state power moderators were now equally turned against the banks. In combination with low business unity, bank influence was constrained under this new equilibrium, and low levels of issue salience alone were insufficient to increase it. The overall result was a significant loss for the dealers.

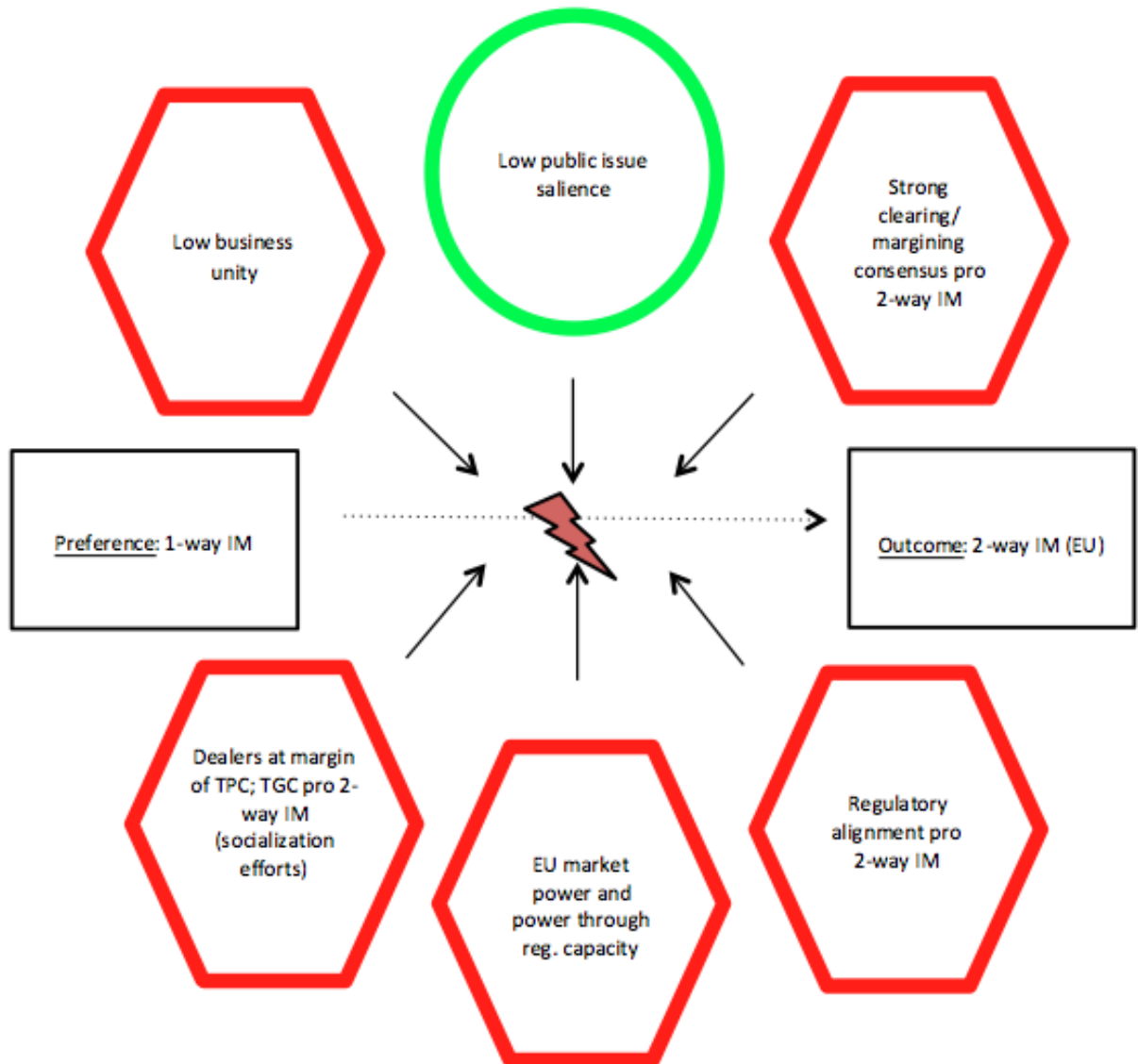
In the EU, the constellation leading to a loss for the banks originated from the stable ideational consensus in favour of 2-way IM, which was not weakened by any challenges at the domestic institutional level. As a consequence, both the ideational outlook and the domestic institutional environment moderators were turned against the banks. With WGMR eventually in favour of a 2-way solution, probably because of EU power as market power and regulatory capacity and/or broader socialization efforts by like-minded policy-makers, the transgovernmental and inter-state power moderators equally operated against the dealers. In addition, the banks also suffered from a lack of business unity. Again, in this environment, low issue salience alone was insufficient for them to exercise influence.

Figure 12: The two-way IM case in the US



Source: Author

Figure 13: The two-way IM case in the EU



Source: Author

Section 3 discusses segregation. It begins with a background section providing further information on different forms of segregation. Section 3.2 reveals that once again there was a lack of business unity. The dealer banks preferred to keep the question of segregation outside the perimeter of formal regulation, insisting on total optionality. The preferences of the sell-side, however, were scattered, with some groups favouring optionality and others opposing any firm segregation requirement. There were also some supporters of relatively strict segregation requirements. Business unity was therefore low.

At the legislative level, there was little debate about the contours of segregation, with Dodd-Frank granting counterparties the right to request segregation, and EMIR stating only

that some form of segregation had to take place. Public issue salience, therefore, was comparatively low again, with legislators delegating most of the detailed work on these issues to the regulators. Regulators fully embraced the ideational clearing/margining consensus, insisting that segregation had to apply and that it had to be informed by stricter rules than those governing the cleared marketplace. There were also no challenges from a domestic institutionalist point of view, with the CFTC and PRs both preferring tight rules.

However, while the US regulators followed through with the adoption of third-party segregation with a custodian at the domestic level, the ESAs were forced to compromise, most likely because of domestic institutional constraints, including the lack of a EU-wide insolvency regime, as well as an insufficiently high number of custodian banks to cover each member state. The ESAs' rules thus stipulated segregation, but left it to the counterparties to decide on the desired strength of the segregation arrangement. This outcome was closer to the dealer banks' preferences than in the US, but it still represented a loss, as segregation cannot be negotiated away anymore under the new rules.

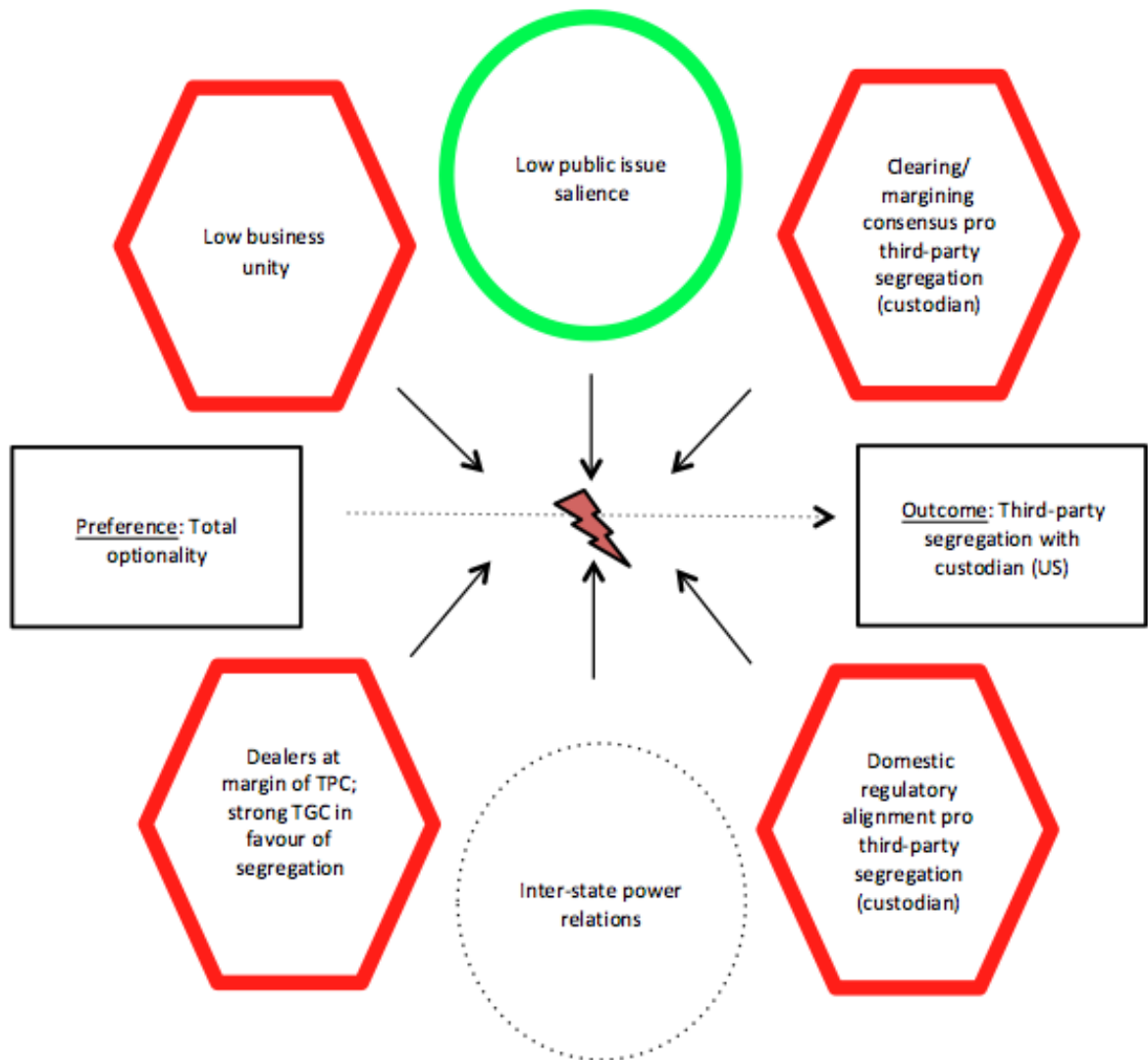
WGMR, in principle, equally supported strong segregation, but in light of the EU institutional challenges, it appears to have adopted more flexible wording. Given the broad consensus in favour of segregation, the relevance of inter-state power relations faded away.

Figures 14 and 15 illustrate the constellation of the segregation case in the US and the EU.

The banks requested total optionality in both the US and the EU, but lost in either case, even though the EU adopted a somewhat more flexible regime than the US. In the US, policy-makers' ideational outlook called for the strictest form of segregation with a third-party custodian. This ideational consensus was fully shared at the domestic institutional environment and also by WGMR at the transgovernmental level (even though it was stricter than the group's minimum recommendations). This means that the ideational, domestic institutional, and transgovernmental moderators all operated against the banks. Again, low business unity further constrained the dealers, and low issue salience alone was insufficient to elevate their level of influence. Given transatlantic public agreement on the need for segregation, inter-state power relations appear not to have been at the forefront of this case.

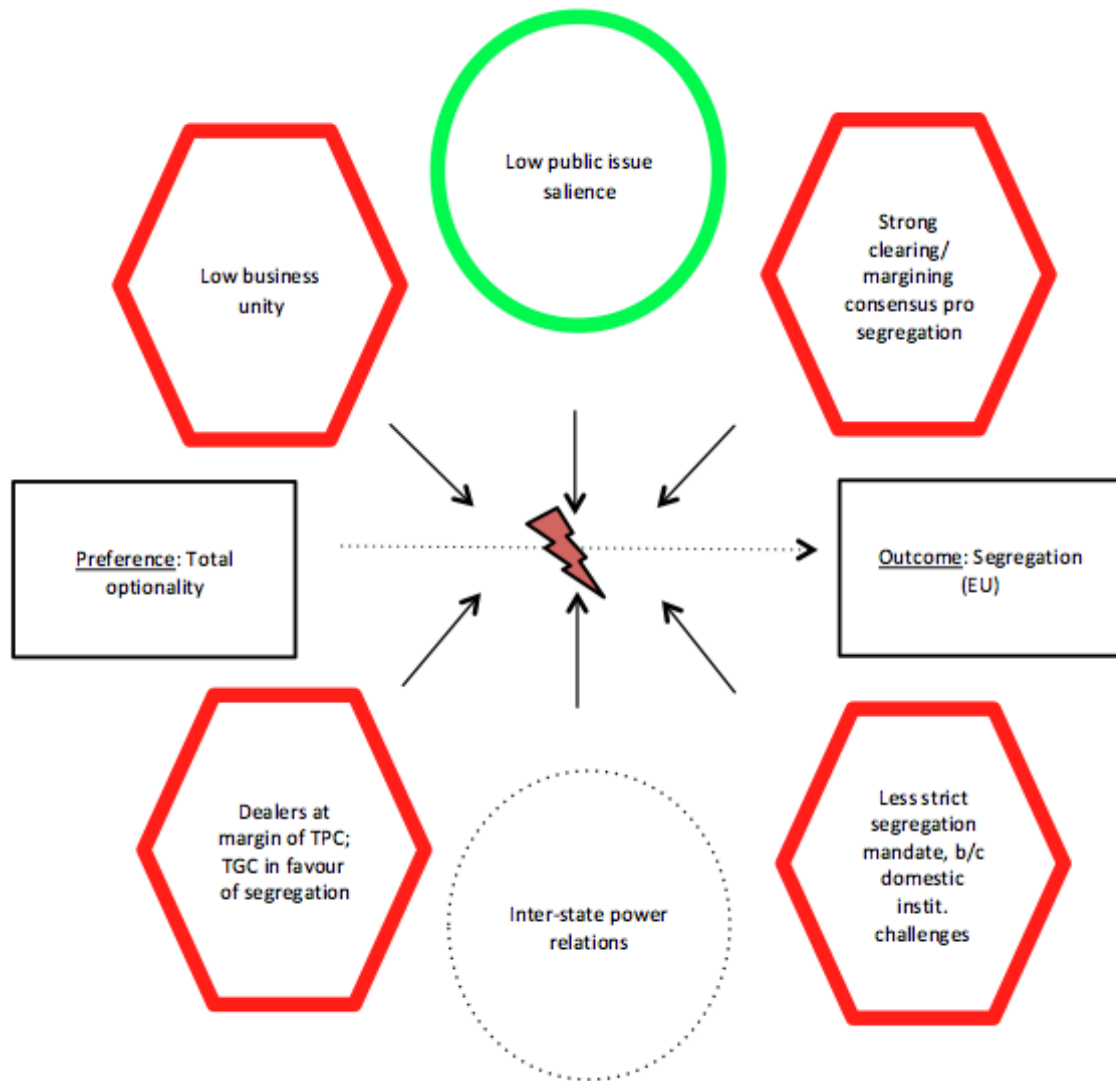
In the EU, the configuration looked very similar, i.e. the ideational outlook, domestic institutional environment, and transgovernmental moderators were oriented in favour of a strong segregation approach, and thus against the banks. However, the EU stopped short of adopting third-party segregation with a custodian, most likely because of domestic institutional challenges associated with the lack of a pan-European insolvency framework and the insufficient number of banks that could have served as custodians across individual member states. As a consequence, it opted for a less strict segregation solution, while still remaining within the remits of WGMR (to whose recommendation it had contributed). The banks were further constrained by a lack of business unity. As in the US, low levels of issue salience alone were insufficient for them to exercise effective, causal influence.

Figure 14: The segregation case in the US



Source: Author

Figure 15: The segregation case in the EU



Source: Author

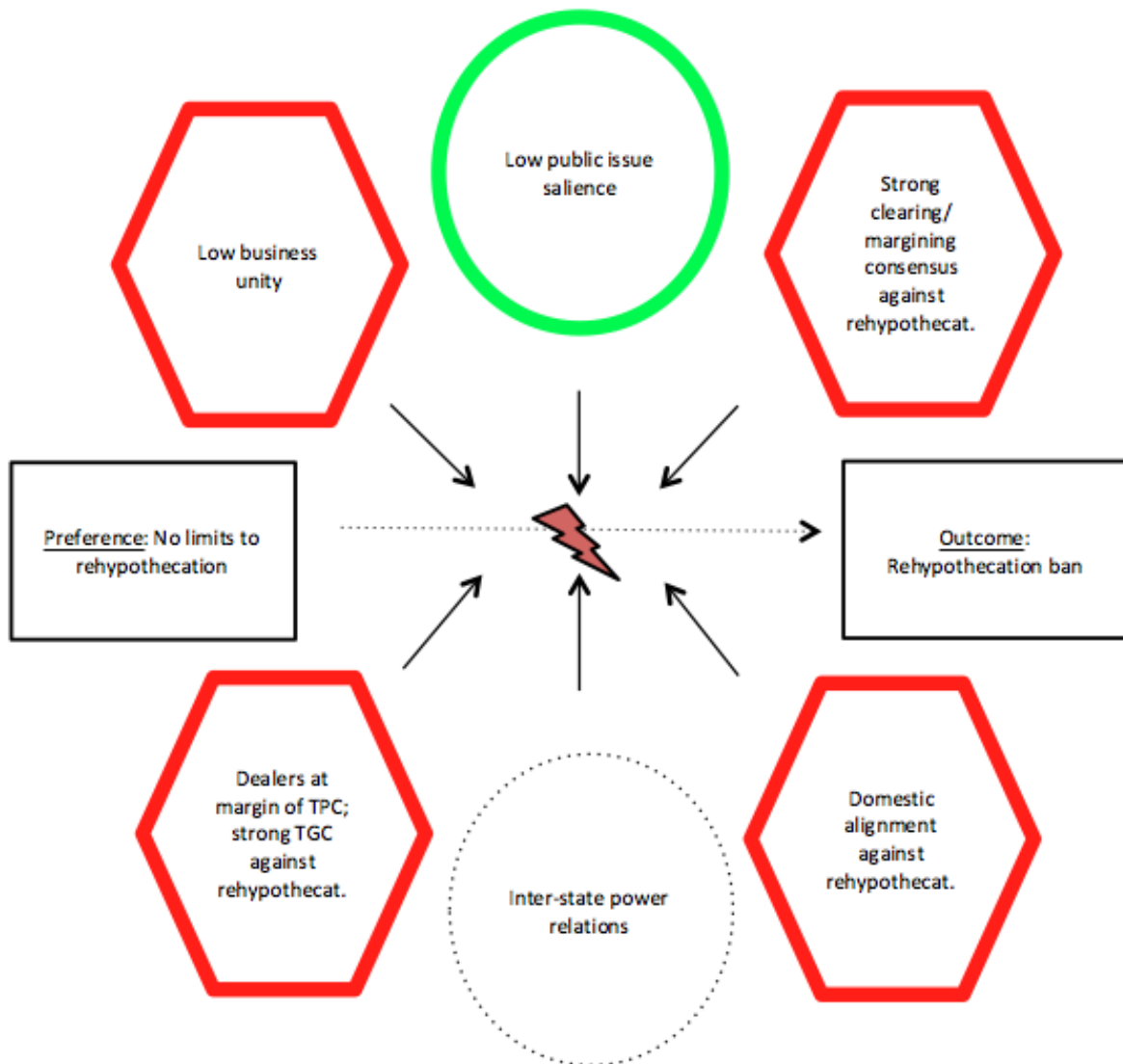
Section 4 turns to rehypothecation. I first introduce the concept in section 4.1. Section 4.2 reveals that the dealers also opposed a ban on rehypothecation, arguing it would cause a huge liquidity drain. As in the previous cases, business unity was low, with several buy-side actors engaging in counter-active lobbying. The buy-side’s preferences ranged from a prohibition of rehypothecation, to leaving the question to the counterparties, to support for the banks’ position. In a similar way to the segregation case, the key factor determining buy-side firms’ stance on the issue was their interpretation of the costs versus the benefits a rehypothecation ban would incur.

Section 4.3 discusses regulators' decision to ignore the pleas of the banks and to largely prohibit rehypothecation. The question was not intensely debated at the parliamentary level, meaning public issue salience was comparatively low again. Regulators in both jurisdictions fully embraced the ideational clearing/margining consensus, insisting that without a rehypothecation ban, the protection derived from segregation would be meaningless. Again, there were no challenges from a domestic institutionalist point of view. As in the segregation case, the broad-based consensus of the transgovernmental community and its embrace of the ideational consensus meant that inter-state power relations did not feature prominently. At the domestic level, the cohesiveness of the institutional environment in both jurisdictions further constrained bank influence.

Figure 16 illustrates the constellation of the US and the EU case.

The factor constellation keeping dealer bank influence at bay was the same as in the segregation case, and it was equally strong and stable in both jurisdictions. The ideational consensus, which pointed against rehypothecation, was shared at the domestic institutional and transgovernmental levels, meaning all three moderators operated against the banks' preferences. In addition, low levels of business unity equally mitigated against the banks. Again, low issue salience alone was insufficient to create an opening for the banks. The inter-state power dimension was probably not of any major relevance to this case, given policy-makers' shared consensus on the required outcome.

Figure 16: The rehypothecation cases in the US and the EU



Source: Author

Across all cases, the dealers had to learn the hard way that they had lost their privileged role within the transnational policy community, which had morphed into a tight transgovernmental community with regulators not wavering in their support for regulation. The information the banks provided was noted, but had little impact on policy-makers' choice. Exit threats by the banks were not a dominant feature of either case.

2. Two-way IM

2.1 Dealer banks' opposition to 2-way IM and the lack of consensus among the buy-side

Realizing the extent of regulators' determination, market actors somewhat stomached the idea that the banks had to collect collateral (in the sense of a one-way mandate). The focus of the debate now turned to the question of whether the dealers should also be obliged to post assets themselves (equivalent to a two-way mandate). The banks absolutely rejected the idea as a matter of principle. In fact, they appeared even more opposed to a 2-way mandate than to the introduction of IM as a binding regulatory principle. From the dealers' point of view, IM only mattered in a highly unlikely once-in-a-lifetime 'end-game situation'. A two-way mandate, they argued, would unnecessarily double the amounts of collateral stored away, which would drain the economy and incentivize the central clearing of unsuitable trades.

ISDA considered the bilateral exchange of IM 'extremely inefficient as it assumes that both parties to every contract must be protected against each other's default simultaneously'.⁸⁴⁵ Along similar lines, SIFMA claimed that 'both parties cannot each simultaneously default while owing the other money'.⁸⁴⁶ More generally, ISDA observed that a 2-way exchange 'is not an effective tool to accomplish the stated goals of the G20 leaders and BCBS/IOSCO', given its 'excessive cost to market liquidity and stability'.⁸⁴⁷ SIFMA equally predicted a binding 2-way regime would 'have a potentially significant destabilizing impact on the financial system and the real economy'.⁸⁴⁸ It also warned that IM in general, and 2-way IM in particular 'is not necessary to promote central clearing'.⁸⁴⁹ To the contrary, it would result in 'uneconomic decision-making' and might encourage counterparties to shift unsuitable trades to CCPs, which would raise, rather than decrease risk. The association also claimed that the analogy of 2-way IM applying in the centrally-cleared market was logically inconsistent, as the clearing house itself did not post any IM.⁸⁵⁰ The German Banking Industry Committee commented 'we see no practical need to make collection/posting of IM mandatory', citing 'serious concerns because of liquidity burdens for counterparties'.⁸⁵¹ The European Banking Federation advanced the same argument.⁸⁵² Barclays rejected a 2-way regime on the grounds that it would be 'overly burdensome and fail to strike the correct balance between financial stability versus market efficiency and economic expansion'.⁸⁵³ Goldman Sachs warned that a posting requirement for the dealers would 'lead[] to

⁸⁴⁵ ISDA (2012:5)

⁸⁴⁶ SIFMA (2012:9)

⁸⁴⁷ ISDA (2012:9)

⁸⁴⁸ SIFMA (2012:6)

⁸⁴⁹ SIFMA (2012:10)

⁸⁵⁰ *ibid.*

⁸⁵¹ German Banking Industry Committee (2012:3)

⁸⁵² European Banking Federation (2012:4)

⁸⁵³ Barclays (2012:1), see also ING Bank (2012:1)

additional risks for the posting firm, thereby arguably increasing the overall risk in the system'.⁸⁵⁴ Deutsche Bank advanced a similar argument.⁸⁵⁵

The buy-side, by contrast, was split, with commenters' positions ranging from support to outright rejection of a 2-way mandate, depending on whether the entity in question emphasized the benefits or the costs of receiving collateral from its banks. The benefits included perceived risk-reduction, while the costs resulted from the banks pricing the expense of posting collateral to their clients into the contracts. Several buy-side commenters felt that if IM could not be prevented, it should at least apply two-way, so as not to disproportionately disadvantage the banks' customers.⁸⁵⁶ These buy-side actors argued that from a risk perspective, two-way margin was superior to a one-side application, given the mutual protection it allowed for. Second, they emphasized that it would level the playing field, particularly for small clients who would otherwise lack the leverage to negotiate a 2-way arrangement. Their third and fourth arguments maintained that a two-way mandate would mirror the way VM was used in the market, and that it would prevent the dealers from using bilateral swaps to circumvent the requirement to post margin in the centrally cleared marketplace.

First, adopting a risk-based perspective, CalSTRS declared that a one-way regime would leave bank clients unprotected from a dealer bank failure, which 'will adversely affect the U.S. financial system'.⁸⁵⁷ ACLI argued that two-way margin 'enhances the safety and soundness of [the client] [...], thereby enhancing the stability of the financial system as a whole'.⁸⁵⁸ MetLife recalled that the '[u]nchecked accumulation of exposures was a contributing factor to the financial crisis'.⁸⁵⁹ ICI pointed out that '[t]he collection of two-way margin helps to protect the individual counterparties to a swap transaction as well as the swaps and other derivatives markets more broadly'. It therefore considered a two-way mandate 'the most effective risk reduction tool to protect against residual counterparty credit risk' and 'an essential component of [...] reducing systemic risk'.⁸⁶⁰ Fidelity emphasized that a one-way system would enable the dealer to trade derivatives without ensuring appropriate collateralization, 'thereby presenting potentially significantly more risk to its counterparties'.⁸⁶¹ In a similar way, asset manager Insight Investment shared its conviction that a 2-way regime would 'ensure robust and prudent risk management' on the part of the dealers.⁸⁶² EFAMA insisted that a 2-way regime 'avoids shifting the risk to the [client] only'.⁸⁶³ Building on these claims, PIMCO indicated that in many cases buy-side

⁸⁵⁴ Goldman Sachs (2012:3)

⁸⁵⁵ Deutsche Bank (2012:3)

⁸⁵⁶ See for example Union Investment (2012:4).

⁸⁵⁷ CalSTRS (2011:9)

⁸⁵⁸ ACLI (2011:9)

⁸⁵⁹ MetLife (2011:8)

⁸⁶⁰ First quote from ICI (2011b:6), second and third ones from ICI (2014:5).

⁸⁶¹ Fidelity (2011:3)

⁸⁶² Insight Investment (2012:3), see also Axa Investment Managers (2012:1).

⁸⁶³ EFAMA (2012:3)

entities were ‘more stable and secure’ than the banks, so that it would only be logical if the dealers were obliged to post margin as well.⁸⁶⁴ The American Benefits Council and other pension fund associations equally insisted that because of their superior risk management practices, ‘[p]ension plans pose significantly less counterparty risk to dealers than dealers do to pension plans’. A two-way mandate, they continued, would therefore be the only logical solution, unless pension plans were exempt from the rules to begin with.⁸⁶⁵

A second argument raised by several buy-side actors centred on the claim that a 2-way regime would increase their influence in the collateralization negotiations with their banks. ACLI, for example, was worried that if the decision were left to the counterparties, only the largest clients would be able to secure a two-way arrangement with their banks. It warned that ‘[t]his result could require smaller market participants to accept uncollateralized exposure to their [...] counterparties as a cost of mitigating business risks for which no cleared swap is available’.⁸⁶⁶ Nationwide Mutual Insurance Company urged the regulators to avoid a scenario where clients would find themselves ‘in an unbalanced position during negotiation of credit support arrangements’.⁸⁶⁷ To the American Benefits Council as well other pension fund associations it was essential that smaller counterparties would be able to conduct a ‘reciprocal’ relationship with their banks.⁸⁶⁸

Third, several buy-side firms justified a 2-way mandate on the grounds that it would mirror the way in which VM was traditionally handled. ACLI, for example, argued the design of the IM mandate should mirror the ‘customary practice’ of maintaining two-way VM relations.⁸⁶⁹ MetLife said ‘[t]he mutual posting requirement preserves the market practice typically observed’ with respect to VM.⁸⁷⁰ For CalSTRS, a one-way exchange would conflict with the ‘quite common and very well accepted practice in the market that collateral arrangements in ISDA Master Agreements or other swap documentation apply bilaterally’.⁸⁷¹

Finally, several buy-side entities insisted that a two-way exchange forcing the banks to post, rather than just collect, would prevent them from using bilateral swaps to evade the margin payments they would be subject to in the centrally-cleared market. MetLife therefore recommended regulators avoid any ‘discrepancy’ between the treatment of centrally-cleared and bilateral derivatives.⁸⁷² Along similar lines, ICI insisted banks’ instincts in terms of the ‘avoidance of posting of initial margin’ had to be addressed by a two-way mandate.⁸⁷³

⁸⁶⁴ PIMCO (2011:7)

⁸⁶⁵ American Benefits Council et al. (2012:8), see also Committee on Investment of Employee Benefit Assets/American Benefits Council (2011:13).

⁸⁶⁶ ACLI (2011:9)

⁸⁶⁷ Nationwide Mutual Insurance (2011:4)

⁸⁶⁸ American Benefits Council et al. (2015:11)

⁸⁶⁹ ACLI (2011:9)

⁸⁷⁰ MetLife (2011:8)

⁸⁷¹ CalSTRS (2011:8)

⁸⁷² MetLife (2011:8)

⁸⁷³ ICI (2014:5)

Fidelity warned of ‘a perverse incentive for [dealers] to increase uncleared trading activity’, in case the banks were relieved from the posting requirement.⁸⁷⁴

However, not every buy-side firm subscribed to that logic. Several buy-siders remained attached to their outright rejection of IM, as discussed in chapter V-2. The Association of British Insurers, for instance, questioned whether a 2-way mandate was ‘appropriate’, given that it did not account for the unique characteristics which in the association’s view rendered insurance firms and pension funds particularly safe.⁸⁷⁵ BVI, representing the German investment fund and asset management industry, advanced similar arguments, topped with the observation that an exchange of collateral had in fact not been requested by the G20.⁸⁷⁶ Hedge fund association AIMA also vehemently opposed a 2-way mandate, claiming that receiving collateral from the bank would ‘not outweigh the costs’ of having this practice factored into the price of the trade.⁸⁷⁷

Between these two extremes, there was a group of buy-side actors who adopted a middle-ground position. AXA, for example, insisted that if IM were to be introduced, it should be 2-way, but that insurance firms, given their perceived safety, should be compensated in the form of reduced capital requirements.⁸⁷⁸ There were also several associations whose members comprised both supporters and skeptics who could not decide on a common position. As a consequence, their submissions recommended leaving the decision to the counterparties themselves. SIFMA’s AMG, for example, cautioned that the risk of a dealer default ‘could cause ripple effects throughout the financial system’, but instead of supporting a two-way regime, the association proposed that regulators should allow bank clients ‘to elect whether to collect initial margin’.⁸⁷⁹ MFA’s members were also not united, with the association’s comments dancing around the issue. On the one hand, the submission acknowledged the need for rules that ‘appropriately reflect and address the risks to the financial system’. On the other, it warned that a 2-way mandate ‘could reduce liquidity and adversely impact market participants’ ability to properly hedge their portfolios’.⁸⁸⁰ The association of the French-based investment management industry, AFG, equally proposed that in light of the costs associated with a 2-way exchange, regulators ‘should permit counterparties to choose not to exchange IM’.⁸⁸¹

2.2 A loss for the industry: Policy-makers embracing 2-way IM

⁸⁷⁴ Fidelity (2011:4)

⁸⁷⁵ Association of British Insurers (2012:2)

⁸⁷⁶ BVI (2012:4)

⁸⁷⁷ AIMA (2011b:3)

⁸⁷⁸ Axa (2012:1)

⁸⁷⁹ SIFMA AMG (2011:3)

⁸⁸⁰ MFA (2012b:15)

⁸⁸¹ AFG (2012:3)

The conflict regarding the need for 2-way IM was replicated within the regulatory community. While the US regulators had concurred on making IM compulsory for all types of entities, they fundamentally disagreed on the need for a two-way regime, given their differing institutional mandates. Frictions caused by regulatory fragmentation thus marked the US domestic institutional environment. The US regulators' disagreement was eventually resolved within WGMR, when it became clear that Europe was moving full speed ahead with the two-way mandate.

The conflict between the US regulators emerged because Dodd-Frank stipulated that the rules apply to 'Swap Dealers [SDs] and Major Swap Participants [MSPs] that are banks', and 'Swap Dealers and Major Swap Participants that are not banks',⁸⁸² i.e. to the largest players in the market, but left it to the regulators to decide how the new requirements would precisely affect the counterparties of these entities. Indeed, the Act only stipulates that

To offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared, the [margin rules] shall

- (i) help ensure the safety and soundness of the swap dealer or major swap participant; and
- (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.⁸⁸³

Both the PRs and the CFTC agreed that the large players should collect IM from their clients. However, there was disagreement as to whether the banks should also post to their customers in return for collecting collateral from them. The agreement on 'collect' meant that there was a *de facto* two-way mandate for the large players which both had to 'collect' from each other. This limited the discussion to whether the dealers should have to post to non-banks. The CFTC supported this requirement, while the PRs rejected it.

Both the CFTC and PRs were determined to limit systemic risk, but their different institutional outlooks resulted in them focusing on the particular portion of systemic risk most relevant to the exercise of their respective mandates. The PRs traditionally focus on the health of the *individual* institution, although there has been a recent emphasis on the 'macroprudential' dimension, particularly as far as the Fed is concerned. Indeed, the latest version of the Fed's key publication on its 'Purposes & Functions' explains that it '**promotes the safety and soundness of individual financial institutions** and monitors their impact on

⁸⁸² See section 731 of Dodd-Frank. The precise definitions of those terms are complex (see CFTC (No Year.b) and Willkie Farr & Gallagher (2012)). For the purpose of this thesis it is sufficient to recall that the SD category captures all of the large dealer banks. The threshold value for SD-registration is USD 8bn of annual notional exposure. The MSP category is based on a series of non-numerical considerations. It was designed to prevent regulatory arbitrage in terms of the large banks re-structuring themselves, such that they would not qualify as dealers anymore.

⁸⁸³ See 7 U.S. Code §6s - Registration and regulation of swap dealers and major swap participants.

the financial system as a whole'.⁸⁸⁴ The FDIC's mission is also institution-specific in terms of 'Insuring deposits', 'Examining and supervising financial institutions for safety and soundness and consumer protection', 'Making large and complex financial institutions resolvable', and 'Managing receiverships'.⁸⁸⁵ The same applies to the OCC which is expected '[t]o ensure that national banks and federal savings associations operate in a safe and sound manner, [...]'.⁸⁸⁶

With their key focus directed to the safety and soundness of the *individual* institution, the PRs' first proposal, published before the establishment of WGMR, suggested a one-way IM regime.⁸⁸⁷ The PRs believed their proposal was 'consistent with the statutory requirement that these rules help ensure the safety and soundness of the covered swap entity and be appropriate for the risk to the financial system associated with non-cleared swaps [...] held by covered swap entities'.⁸⁸⁸ For the PRs, a 'covered swap entity' (CSE) denotes a prudentially regulated entity engaging in uncleared trades, whereas for the CFTC, it signifies a SD or MSP for whom there is no prudential regulator.⁸⁸⁹

The PRs' rejection of a two-way mandate may have been informed by their focus on banks' 'safety and soundness', which they likely saw at risk if collateral were to flow to non-bank entities, in particular hedge funds, over which they had no jurisdiction. Indeed, in the US, hedge funds have to register with the SEC and CFTC, rather than the PRs, and some of them might be domiciled in the Cayman Islands or other lightly regulated, or even unregulated, tax havens. Already prior to the crisis, in 2006, Bernanke had voiced 'concerns about counterparty risk management'⁸⁹⁰ in this particular sector, although at that time, he considered it primarily a case for enhanced transparency and market discipline, rather than public intervention. After 2008, the Fed and the OCC appeared to believe that macroprudential stability was best served by strengthening banking institutions, which, from their point of view, might have collided with collateral flowing out of their vaults to these entities over which they had little oversight. The FDIC, in turn, had never left any doubt that its 'first duty as receiver, is to protect insured depositors and the insurance fund'.⁸⁹¹ Having funds flowing out of the banks risked being equally at odds with this commitment.

By contrast, the CFTC's mandate 'is to foster open, transparent, competitive, and financially sound markets. By working to avoid systemic risk, the Commission aims to protect market

⁸⁸⁴ Board of Governors of the Federal Reserve System (2016:1; emphasis in the original)

⁸⁸⁵ See the FDIC's website at <https://www.fdic.gov/about/strategic/strategic/mission.html>, accessed 10 May 2018.

⁸⁸⁶ See the OCC's website at <https://careers.occ.gov/about/mission-and-values/index-mission-values.html>, accessed 10 May 2018.

⁸⁸⁷ PRs (2011:27567)

⁸⁸⁸ PRs (2011:27567). Note that the (proposed) rules of all regulators introduced minimum standards, i.e. counterparties were free to negotiate tougher requirements.

⁸⁸⁹ PRs (2011:27566), CFTC (2011b:23734)

⁸⁹⁰ Bernanke (2006:2)

⁸⁹¹ See for example Bair (2008).

users and their funds, consumers, and the public [...].⁸⁹² Compared to the PRs, the CFTC places relatively greater emphasis on strengthening *market-wide* stability. This mission suggests a stronger preference for a two-way mandate, even more so given that the CFTC's core focus has traditionally been the futures world centred around CCPs, where both of the original counterparties to a trade have to post VM and IM. Indeed, as the CFTC declared itself, 'in designing the proposed margin rules for uncleared swaps, the Commission has built upon the sound practices for risk management employed by central counterparties for decades'.⁸⁹³ The agency was therefore rather unsatisfied with the PRs' proposal. CFTC Commissioner Scott O'Malia publicly stated he was 'struck by the fact that prudential regulators are hiding behind the safety and soundness language in the Act to draft rules that prohibit bank swap dealers from posting margin to their counterparties. To be clear, this is a one-way posting of margin'.⁸⁹⁴ He was concerned that the market would interpret this move as a sign 'that regulated banks are too big to fail', and that a one-way mandate 'institutionalizes purchasing and negotiating power on one side of the commercial transaction [i.e. on the banks' side]'.⁸⁹⁵

As a comment by CFTC chair Timothy Massad (Gensler's successor) illustrates, the agency rejected the sell-side's logic that it was unnecessary to protect against the highly unlikely scenario of both counterparties defaulting, insisting that it was unknown *ex ante* which one of them would fail. Indeed, in his words, '[s]ome will characterize this [i.e. a two-way mandate] as expensive insurance, as both parties must post initial margin as protection against potential future loss, even though in default, only one would actually recover against the margin. But we need only remember the costs of the crisis to our economy to recognize that this is, on the contrary, quite sensible'.⁸⁹⁶ The cooperation by the CFTC and the PRs appears to have been further complicated by the differing professional background of regulatory officials. While the PRs tend to be dominated by (financial) economists, CFTC recruits are often lawyers, meaning the authorities' intellectual approach to regulation sometimes differs.

However, in the end, the CFTC's first proposal equally contained a one-way mandate.⁸⁹⁷ As the smallest regulator of the group, the CFTC appears to have conceded to the PRs, even more so given Dodd-Frank's stipulation that the regulators coordinate their work and strive for maximum similarity between their rules.⁸⁹⁸ In its first proposal, the CFTC thus emphasized that its 'approach is consistent with what the prudential regulators are proposing in their margin rules'.⁸⁹⁹ At the same time, the agency did not miss the

⁸⁹² See the CFTC's website at <https://www.cftc.gov/About/MissionResponsibilities/index.htm>, accessed 10 May 2018.

⁸⁹³ CFTC (2011b:23733)

⁸⁹⁴ O'Malia quoted in CFTC (2011a:17).

⁸⁹⁵ O'Malia quoted in CFTC (2011a:17f.).

⁸⁹⁶ Massad (2015)

⁸⁹⁷ CFTC (2011b:23735ff.)

⁸⁹⁸ See CFTC (2011b:23733).

⁸⁹⁹ CFTC (2011b:23736)

opportunity to subtly clarify its true preference for a two-way mandate. First, the proposal's opening pages emphasized that '[w]ell-designed margin systems protect both parties to a trade as well as the overall financial system'.⁹⁰⁰ Second, it explicitly asked interest groups whether 'requiring a CSE to post initial margin to non-SD/MSP counterparties [would] reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)'.⁹⁰¹

With the European Commission being a member of WGMR,⁹⁰² it soon became clear that Europe favoured a two-way mandate, and that unlike Dodd-Frank, EMIR would be much more detailed, providing a long list of clearly specified 'financial counterparties'. In a discussion paper published prior to the adoption of the final version of EMIR, the ESAs emphasized that a 2-way arrangement would result in uncleared derivatives being cheaper to trade bilaterally than through CCPs. It cautioned that this 'could act as a disincentive to migrate towards central clearing and therefore could be viewed to be contrary to the objectives of the Regulation'. The paper also warned of adverse incentives for banks 'to arbitrage the requirements'.⁹⁰³

Unlike in the US, the EU domestic institutional environment did not show any open cracks. Article 11(3) of the final version of EMIR subsequently codified the 2-way approach. The definition of 'financial counterparty' as detailed in Article 2(8) comprised investment firms, credit institutions, insurance/assurance/reinsurance undertakings, UCITS funds, institutions for occupational retirement provision, and alternative investment funds. The EU authorities appeared to believe that IM could best deliver its full potential if both counterparties had to post collateral, in a similar way to CCPs, where the two original parties to a trade equally have to post IM to the clearing house

To the PRs, this came as a shock. With the EU initially far behind the US in the development of the margin rules, they had begun the international discussions in the firm conviction that as first-movers they would be able to provide the blueprint for the international framework, in line with Geithner's expectation of the US as the leading jurisdiction which would 'bring the world with [it]'.⁹⁰⁴ In the 2-way IM case, however, the EU brought the PRs with it. Indeed, the disagreement was eventually solved in favour of the EU (and the CFTC). There seem to have been two vectors of conflict resolution. The first one might have been related to the PRs' membership within the epistemic community formed by WGMR. The PRs appear to have begun reconsidering their position as a result of the arguments advanced by the supporters of a 2-way approach. Indeed, these arguments seem to have contributed towards invalidating the PRs' concerns about the hedge fund industry, by highlighting that the crisis had not in fact originated within this particular sector, but rather inside the US

⁹⁰⁰ CFTC (2011b:23733)

⁹⁰¹ CFTC (2011b:23740, emphasis in the original)

⁹⁰² See BCBS-IOSCO (2012:7 of the pdf) for a list of the group's members. The EU Commission was the only group member directly involved in the legislative process.

⁹⁰³ Both quotes taken from ESAs (2012:10).

⁹⁰⁴ Geithner (2011)

banking sector itself. From this perspective, a 2-way exchange of collateral was considered to constrain bank leverage and therefore also to promote the stability of the banks themselves. The PRs seem to have eventually subscribed to this logic, following a series of exchange and discussion of the issue. This points to the importance of WGMR as a focal point displaying the key characteristics of an epistemic community, bound together by shared experiences, learning, and socialization. Being part of this community most likely helped to overcome differences rooted in diverging institutional legacies. This interpretation would also confirm the consensus-fostering and legitimacy-enhancing attributes Newman and Posner have associated with ‘[s]oft law proposals [which] by providing new policy ideas, force the engagement of competing regulatory factions’.⁹⁰⁵

On the other hand, the PRs might have also responded to the EU’s resolution to stay its course, and its power to do so. With EMIR and the ESAs’ rules going to apply directly at the member state level, given the EU’s enhanced institutional consolidation following the crisis, the EU enjoyed power as regulatory influence. Moreover, it hosted the world’s largest uncleared market located in the City of London, i.e. in addition to power as regulatory influence, it also had power through market size. Table 3 below provides some quantitative illustration of domestic market size for the IR and FX markets for which the best data is available.

Table 3: Breakdown of global market share of IR and FX derivatives

	<i>IR</i>		<i>FX</i>	
	2010	2013	2010	2013
US	24%	23%	17%	19%
EU	63%	65%	50%	53%
UK	47%	50%	37%	41%

Source: Author, based on BIS derivatives statistics (table D12.2 – Turnover of OTC interest rate derivatives, by country, and table D11.2 -Turnover of OTC foreign exchange instruments, by country; ‘Net-gross’ basis, daily averages).

In the end, the PRs gave up their resistance to a two-way mandate and WGMR equally recommended this solution in both its consultation papers, as well as its final framework. Specifically, regulators decided to have counterparties exchange gross IM, i.e. the amounts due could not be netted down.⁹⁰⁶ Back in the US, the PRs justified their U-turn as a ‘refinement’ of their original approach, developed in light of the ‘2013 international framework’.⁹⁰⁷ Their second proposal argued that ‘[w]hile the Agencies believe that imposing requirements with respect to the minimum amount of initial and variation margin to be collected is a critical aspect of offsetting the greater risk to the covered swap entity and the financial system arising from the covered swap entity’s non-cleared swap exposure, the Agencies also believe that requiring a covered swap entity to post margin to other

⁹⁰⁵ Newman/Posner (2018:29)

⁹⁰⁶ See Requirement 2 in BCBS-IOSCO (2012:4; 2013a:4; 2013b:4).

⁹⁰⁷ PRs (2014:57354).

financial entities could forestall a build-up of potentially destabilizing exposures in the financial system'.⁹⁰⁸ Both the PRs' second proposal and final rule contained the two-way mandate.⁹⁰⁹ The CFTC also officially shifted to a two-way regime.⁹¹⁰ In Europe, the ESAs never left any doubt they would impose a two-way mandate. The final draft RTS clearly stipulated that in order 'to prevent the build-up of uncollateralised exposures within the system', counterparties 'will also be required to exchange two-way initial margin to cover the potential future exposure resulting from a counterparty default'.⁹¹¹

The outcome in both jurisdictions ran counter the dealers' preferences, indicating that they lost the battle. Over the course of the debate, regulators selectively referenced the information they had received from commenters on the issue in order to support their own position, but the comment letters themselves do not appear to have changed the tide.

3. Segregation

3.1 Background: Different forms of segregation

The idea of segregation is to separate the margin counterparties receive from their trading partner from their own assets, so as to ensure the trading partners' collateral is not lost in case they were to default. Segregation is particularly relevant for IM which acts as a performance bond, whereas VM represents collateral owed as a result of mark-to-market changes. Prior to 2008, segregation was only rarely applied.⁹¹² An exception pertained to investment funds subject to the SEC's Investment Company Act of 1940 that prescribes strict segregation rules regarding the management of customer funds.⁹¹³ In Europe, UCITS are also subject to certain safekeeping duties.⁹¹⁴ The banks, as a general rule, did not segregate the collateral they received, since keeping it on their own books allowed them to earn additional income, for example through interest rate payments. Sometimes, the clients would be compensated for this through specific provisions in the CSA. As a downside, however, they were exposed to the risk of losses at times of default. The Lehman debacle clearly illustrated this risk, when clients found out their collateral (if they had posted assets in the first place) had evaporated, or had become entangled with the banks' own assets, thus requiring a lengthy and expensive 'unscrambling' exercise. The result of this exercise

⁹⁰⁸ PRs (2014:57354)

⁹⁰⁹ PRs (2014:57354; 2015:74843f.)

⁹¹⁰ CFTC (2014:59907f.; 2015:649)

⁹¹¹ ESAs (2016a:6). For the respective formulations in the proposed draft RTS, see ESAs (2014:7; 2015:5).

⁹¹² Gregory (2014:90)

⁹¹³ Markham (2013:104ff.), Watterson (2014)

⁹¹⁴ The details have recently been clarified by ESMA (2017). In 2018, the EU Commission adopted two draft regulations providing further guidance (see for example Jaminon (2018)).

was unknown *ex ante* and often turned out disappointing *ex post*. After the crisis, segregation therefore ranked high on the agenda, particularly once regulators had decided on a gross 2-way exchange of IM without any netting.

Segregation can take several forms, with each arrangement representing a different cost-benefit profile.⁹¹⁵ Under *omnibus segregation*, the receiving counterparty parks all assets it receives as IM collectively in one account that does not hold any of its proprietary assets. This means that IM is not commingled with its own assets, but is also not stored separately for each client, meaning *all* assets in the account can potentially be drawn upon to respond to the financial obligations of a particular client. This approach is cost-efficient, as only one account is needed. However, for the posting counterparty, it entails the risk of losses arising from the default of other counterparties that its trading partner does business with. *Individual segregation* addresses this limitation of omnibus segregation by specifying a separate account for each of the banks' counterparties. Of course, the more elaborate account structure and the additional protection associated with individual segregation increase operational cost. A compromise between omnibus and individual segregation is the *LSOC* (legally segregated, operationally commingled) protection scheme in which all pledged collateral can be held in one account, but must be clearly attributed to the original pledger in the pledgee's books and records. However, even individual segregation and LSOC do not entirely exclude any potential misuse of the funds by the pledgee, or problems of recuperating assets in case the receiving counterparty fails. *Third-party segregation* can provide a solution to this problem. This arrangement involves parking the collateral with a neutral agent who is distinct from both the posting and receiving counterparty. Within third-party segregation, a variety of different arrangements are possible. However, regardless of its precise design, this structure has its price, which further increases the cost of the deal. Third-party segregation is often provided by special banks known as custodian banks that also offer similar services for other kinds of financial transactions. The custodian business is very concentrated, given the need of scale to ensure profitability. Among the largest custodian banks are State Street, BNY Mellon, JP Morgan, and Northern Trust. Note that some of these banks, most importantly JP Morgan, also act as dealer banks themselves. While third-party segregation can, in principle, also be pursued through entities other than custodian banks, this thesis refers to the two approaches interchangeably.

3.2 Dealer banks' opposition to firm segregation requirements and the lack of consensus among the buy-side

Once again, the industry opposed the imposition of any strict segregation requirements, arguing that the regulators should not interfere with counterparties' choices. The only

⁹¹⁵ The information on the different forms of segregation is drawn from Gregory (2014:220ff.) and Osborn (2013).

exception was the custodian banks that favoured a regulatory solution through which their business model would become part of a compulsory requirement.

ISDA rejected public intervention, clarifying that ‘the margin rules should permit [...] flexible segregation arrangements, so long as they sufficiently mitigate counterparty risk’. It also believed that counterparties were able to judge the suitability of those arrangements themselves.⁹¹⁶ SIMFA emphasized that regulators should not place unnecessary ‘limitations on the scope of permissible segregation arrangements’.⁹¹⁷ It also warned against any segregation approach that would ‘give rise to punitive costs’.⁹¹⁸ Along similar lines, the Financial Services Roundtable stated that policy-makers should not restrain counterparties in ‘whether and where’ to segregate posted assets.⁹¹⁹ Equally advocating optionality, the Association of Financial Markets in Europe (AFME) recommended regulators should not interfere with segregation beyond ensuring the availability of the ‘relevant operation processes and procedures to enable this [i.e. segregation] to take place’, if so desired by the counterparties.⁹²⁰ The German Banking Industry Committee and the European Banking Federation voiced similar opinions, recommending that clients should be allowed to take the decision themselves, ‘depending on their specific needs and risk profile’.⁹²¹ The French Banking Federation, in turn, insisted that the segregation requirements needed to be ‘feasible’.⁹²² Deutsche Bank alerted the regulators to the perceived risks of pressing counterparties into a tight corset of segregation rules, which ‘may lead to segregation taking place against the interests of the client (for example where operational costs outweigh the benefits’.⁹²³ In a joint submission, ISDA and SIFMA equally pointed to the costs of mandatory segregation which ‘would be burdensome’.⁹²⁴ The dealers were particularly opposed to third-party segregation, given the cost of maintaining third-party accounts and their perception that custodian banks lacked the sophistication to handle high volumes of segregated assets. Along those lines, ISDA, for instance, warned that ‘because there are limited numbers of large custodians, requiring use of non-affiliates may cause issues with total custodial capacity’.⁹²⁵ UBS, in turn, informed policy-makers that third-party segregation would disproportionately concentrate risk within a few entities acting as custodians.⁹²⁶

The custodian banks themselves did not see any reason why third-party segregation should not become the gold standard, and considered themselves perfectly capable of managing

⁹¹⁶ ISDA (2014:29, see also 2013:18), the same argument is made in ISDA and Financial Services Industry (2012:4).

⁹¹⁷ SIFMA (2014:27)

⁹¹⁸ SIFMA (2014:28)

⁹¹⁹ Financial Services Roundtable (2011:4)

⁹²⁰ AFME (2014:7), see also ABA (2014:11)

⁹²¹ European Banking Federation (2012:13), see also German Banking Industry Committee (2012:9).

⁹²² French Banking Federation (2015:5)

⁹²³ Deutsche Bank (2014:9)

⁹²⁴ ISDA/SIFMA (2011:22)

⁹²⁵ ISDA (2014:29)

⁹²⁶ UBS (2012:15f.)

increased volumes of assets. The submission by State Street, BNY Mellon, and Northern Trust identified third-party segregation as an ideal approach to protecting client assets, because it ‘provides high levels of protection for each counterparty to a swap’.⁹²⁷ They also claimed that this approach was ‘consistent with existing banking practices’,⁹²⁸ with State Street emphasizing in a separate letter that requiring third-party segregation with an independent custodian would mean responding to a market-led trend in terms of this arrangement being ‘increasingly requested by parties posting collateral, even in the absence of a regulatory mandate’.⁹²⁹ Precise data on this trend is difficult to identify.

The buy-side’s preferences were scattered across the entire spectrum of options. A close analysis of their written submissions suggests that most associations favoured optionality, probably as a result of their members’ inability to reach consensus on a common position. Some firms appeared to believe segregation was too expensive to pursue. By contrast, others may have thought they brought enough business to the table in order to exercise leverage over the banks and make them pay at least part of the additional cost of segregation. Others again seemed to believe segregation did not provide any tangible benefits in terms of enhanced risk protection and could therefore be left aside.

MFA’s members, for instance, welcomed the additional protection granted by segregation, but appeared to lack consensus on which precise arrangement should be required, most likely because of the differing cost profiles related to the individual forms of segregation. The association therefore called upon the regulators to ‘provide optionality for CSE customers’.⁹³⁰ AIMA’s views on the issue appeared to evolve. One submission advocated letting counterparties decide ‘where and how assets are held’.⁹³¹ Another one contained a plea ‘to segregate funds and collateral posted as initial margin with an independent third party custodian’.⁹³² A third one suggested letting the posting party decide on whether it preferred segregation at the level of the trading partner or through a custodian.⁹³³ EFAMA’s members may have equally shared divergent preferences. The association’s submission kept dancing around the issue, without providing any clear recommendation to the regulators. The comment letter concluded that ‘EFAMA members believe that whatever the solution is, there will always remain a risk’.⁹³⁴ EIOPA’s Occupational Pensions Stakeholder Group and Insurance and Reinsurance Stakeholder Group, asset manager Insight Investment, and IMA (representing the UK’s Investment Management Industry) also insisted on giving carte blanche to banks’ clients.⁹³⁵

⁹²⁷ BNY Mellon et al. (2011a:2)

⁹²⁸ State Street et al. (2014:4)

⁹²⁹ State Street (2014:6)

⁹³⁰ MFA (2014b:16; see also 2011:15, 2014a:15)

⁹³¹ AIMA (2012:8)

⁹³² AIMA (2011b:4, see also 2013:1f.)

⁹³³ AIMA (2014:4)

⁹³⁴ EFAMA (2012:12)

⁹³⁵ EIOPA OPSG and IRSG (2014:12), Insight Investment (2012:11), IMA (2012:13)

Other associations narrowed down their members' preferences more specifically. The Federation of Dutch Pension Funds for example, asked regulators to let their members choose between segregation at the level of the counterparty or with a third-party custodian.⁹³⁶ The Association of British Insurers, in turn, advocated a choice between individual and omnibus segregation.⁹³⁷ To some groups, such as ACLI, MetLife, and SIFMA's Asset Management Group, optionality was equally of paramount importance. These groups also insisted on regulators explicitly protecting clients' right to ask for third-party segregation. This request was motivated by the desire to ensure that, if a member favoured a segregation arrangement, it would not find itself in a situation where its pledged funds were 'used simply as a source of liquidity for the CSEs'.⁹³⁸

A number of groups advocated a more specific regulatory outcome. Indeed, several commenters strongly embraced third party segregation. For ICI, for instance, using a custodian was key to the 'Safeguarding of Two-Way Margin Collateral'.⁹³⁹ Pension fund manager Cardano, the European Federation for Retirement Provision, the French Asset Management Association (AFG), asset manager BlackRock, and insurance firm AXA advanced very similar arguments.⁹⁴⁰ PIMCO equally advocated third-party segregation, asking the regulators to develop specific provisions 'to ensure that a covered swap entity does not unduly delay the establishment of tri-party custodial agreements'.⁹⁴¹ Insurance Europe, too, supported the compulsory use of an independent custodian. However, it was concerned about the additional cost this form of protection would incur, and therefore requested additional regulatory intervention in order to 'ensure that these charges are not so excessive that the cost of this protection becomes prohibitive'.⁹⁴²

On the other hand, there were also groups which rejected any regulatory intervention on the issue. The German Investment Association (BVI), for instance, warned that granting the right to have IM segregated could risk operationally overwhelming the receiving counterparty. It 'could create operational shortcomings and could lead to the situation that the collecting counterparty is not capable to handle the numerous individual accounts for investment funds'.⁹⁴³

3.3 A loss for the industry: Policy-makers embracing (third-party) segregation

Policy-makers were not impressed with the information the dealers submitted in favour of letting counterparties decide for themselves on the level of protection they desired. Indeed,

⁹³⁶ Federation of Dutch Pension Funds (2012:13)

⁹³⁷ Association of British Insurers (2012:8)

⁹³⁸ ACLI (2011:12), see also SIFMA AMG (2012:27f.), MetLife (2011:11f.).

⁹³⁹ ICI (2011b:8, caps in the original)

⁹⁴⁰ Cardano (2012:10), European Federation for Retirement Provision (2012:11), AFG (2012:9), BlackRock (2012:2), AXA (2012:1); see also Amundi (2012:5).

⁹⁴¹ PIMCO (2011:9)

⁹⁴² Insurance Europe (2012:2)

⁹⁴³ BVI (2014:4)

they appeared to believe that the crisis had shown the result of leaving the choice to counterparties. Given the complexity of the issue, segregation was not much discussed at the parliamentary level, particularly in the US. Section 724 of Dodd-Frank stipulated that '[a] swap dealer or major swap participant shall be required to notify the counterparty of the swap dealer or major swap participant at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty'. Article 11(3) of EMIR went a step further by imposing the principle of segregation in terms of specifying that 'counterparties shall have risk-management procedures that require the timely, accurate and appropriately *segregated* exchange of collateral' (emphasis added). Both jurisdictions, however, left the definition of the precise contours of the segregation rules to the regulators.

In the US, both the CFTC and the PRs embraced compulsory third-party segregation and made it a regulatory requirement. The disagreement about one- vs. two-way margin did not extend to this part of the rule-making process, meaning the domestic institutional environment was comparatively free of frictions. Regardless of whether margin was to be collected only, or collected and posted, regulators agreed that it had to be safeguarded. The rules stipulate that the custodian must not be affiliated with any of the counterparties (i.e. a dealer such as JP Morgan cannot rely on its own custodian division to hold client assets). In addition, the custodian must be part of the same insolvency regime as the CSE, such as to guarantee and speed up the release of assets, when deemed necessary.⁹⁴⁴ There seemed to be strong consensus among the US regulators that margin had to be available when needed, which they believed could be best ensured if it was stored outside the entity potentially facing difficulty.⁹⁴⁵ Another reason justifying the viability of third-party segregation appears to have been the fact that no custodian bank had ever failed, although it was clear that the rise in volume of assets might lead to a concentration of risk.

The US collateral segregation rules for uncleared derivatives were also stricter than those for cleared ones, thus accounting for the perceived higher level of risk regulators associated with bilateral trades, and providing an incentive for market actors to transition to CCPs. Indeed, CCPs' segregation requirements are limited to LSOC, which represents a less burdensome arrangement.⁹⁴⁶ While some regulators might have preferred a stricter CCP segregation requirement, the US bankruptcy law made this difficult to achieve, given a provision stipulating the 'loss-sharing among customers of a [clearing member], meaning all client assets have to be pooled, including those held in individual segregated accounts'.⁹⁴⁷

In the EU, the regulatory decision-making process was more complicated. The ESAs' rules specify that

⁹⁴⁴ CFTC (2011b:23739; 2014:59914; 2015:670f.), PRs (2011:27578, 27589f.; 2014:57373; 2015:74875)

⁹⁴⁵ E.g. PRs (2015:74875)

⁹⁴⁶ CFTC (2012)

⁹⁴⁷ Sourbes (2014)

Collateral collected as initial margin shall be segregated in either or both of the following ways:

- (a) on the books and records of a third party holder or custodian;
 - (b) via other legally binding arrangements;
- so that the initial margin is protected from the default or insolvency of the collecting counterparty.

Collateral collected as initial margin shall meet all the following requirements:

- (a) where collateral is a proprietary asset of the collecting counterparty, it shall be segregated from the other proprietary assets of the collecting counterparty;
- (b) where collateral is not proprietary asset of the collecting counterparty, it shall be segregated from the proprietary assets of the posting counterparty;
- (c) it shall be segregated from the proprietary assets of the third-party holder or custodian.⁹⁴⁸

The ESAs's rules thus stipulate that segregation needs to take place (meaning counterparties cannot negotiate it away), but there is some optionality regarding the precise contours of the arrangement. In addition, cash needs to be deposited with an independent third party holder or a custodian bank (neither of which must be part of either counterparty's organization), or with a central bank.⁹⁴⁹ This special provision is related to the fact that cash cannot be properly segregated. Indeed, if held on the balance sheet of the transferee, it represents a liability, but cannot be easily separated from her own (or other counterparties') assets, which is problematic at times of default.

There is little publicly available material explaining the ESA's precise decision-making rationale. At least some officials might in theory have preferred a stricter segregation approach. However, there appear to have been two factors that may have caused the authorities to settle for a more flexible solution. The first one relates to the fact that the EU counts as one jurisdiction with respect to the margin rules, but not with regard to insolvency proceedings which remain anchored at the national level. This means that while the EU's institutional consolidation allows counterparties to engage in uncleared derivative trades across member-state borders under one common set of rules, market actors will find themselves confronted to distinct national regimes in case of a default.

In 2016, AFME, in a different regulatory context, compiled a list of some of the key 'areas in which European national insolvency laws and practices vary, both substantively and procedurally, and in which stakeholders can expect varying results depending on the applicable jurisdiction:

- the opening of insolvency proceedings;
- applicable insolvency triggers/tests;
- the interpretation and application of insolvency rules and regulations;

⁹⁴⁸ ESAs (2016a:50f.; building on 2015:48; 2014:42; 2012:16)

⁹⁴⁹ ESAs (2016a:51)

- the length of and process for a general stay of creditor rights;
- management of insolvency proceedings;
- ranking of creditors;
- the role and level of participation of creditors in insolvency proceedings;
- filing and verification of claims;
- responsibility for proposing and approving reorganisation plans;
- annulment of transactions entered into prior to insolvency proceedings;
- liability of directors, shareholders and management; and
- the availability of post-petition financing (i.e. financing provided to an enterprise operating under court-supervised protection after it has already entered into insolvency or similar proceedings)⁹⁵⁰.

A report by the EU Parliament published several years earlier had derived similar conclusions.⁹⁵¹ In 2000, the EU passed a regulation on insolvency proceedings, with updates added in 2015. More recently, it also adopted a Recommendation, but the currently existing pan-European framework is limited to procedural matters, such as assisting firms in identifying the regime applying to their particular case.⁹⁵² As a consequence, at least some regulators appear to have been concerned that third-party segregation might, in fact, provide little additional protection in a worst-case scenario involving counterparties located in different member states. The legal situation in the EU is very complex, and further examination is needed in order to derive a full picture of the situation.

One might ask why, in light of this challenge, the regulators did not impose third-party segregation for trades conducted by counterparties located in the same member state. This leads us to the second potential institutional challenge. Several of the EU's 28 member states, particularly the smaller ones, lacked a sufficiently high number of banks that could serve as independent custodians. In light of the insolvency regime challenge, the custodian would ideally be domiciled within the same jurisdiction as the two counterparties to the trade. While the CFTC and PRs could afford this requirement, given the depth of the US financial market and the availability of a federal insolvency regime applying across all member states, the ESAs' hands were tied. It appears likely that the presence of these two domestic institutional challenges may have caused the ESAs to adopt a more relaxed approach. They mandated segregation, but on the basis of a broad range of acceptable arrangements, allowing customers to opt for a higher degree of protection, if they so desired. It could also be that for similar reasons, the segregation rules for bilateral deals are not significantly stronger than those for cleared trades. Indeed, the segregation rules for

⁹⁵⁰ AFME (2016:9)

⁹⁵¹ EU Parliament (2010b)

⁹⁵² AFME (2016:10)

Since the publication of the final rules, the EU has begun work on harmonizing parts of the various insolvency regime through a draft directive proposed by the Commission in 2016, but progress so far has been modest (Comte 2017).

CCPs require the client to be given a choice between omnibus and individual segregation, rather than imposing third-party segregation.⁹⁵³

WGMR's discussion on segregation was probably much less heated than the debate on 2-way IM. Regulators broadly shared the conviction that strong segregation requirements were indispensable, but that domestic institutional challenges could not be easily overcome. BCBS-IOSCO therefore limited itself to recommending that 'collected collateral must be segregated from the initial margin collector's proprietary assets' and that clients had to be given the right to ask for individual segregation. In addition, the final framework called upon jurisdictions to ensure their specific rules were compatible with their respective legal frameworks, in order 'to ensure that collateral can be sufficiently protected in the event of bankruptcy'.⁹⁵⁴

4. Rehypothecation

4.1 Background: The concept of rehypothecation

Prior to the crisis, the rehypothecation of customer assets by dealer banks was widespread, to the point of being considered a 'practice [that] oils the wheels of finance'.⁹⁵⁵ At the same time, the concept was often not well understood, even among frequent users of derivatives, some of whom then experienced a rude awakening during the crisis.⁹⁵⁶ Rehypothecation entails the 'onward pledging' of collateral by a derivatives counterparty, usually the dealer, to a third party vis-à-vis whom it has another financial obligation. In practice, rehypothecation often moves beyond the mere re-pledging of assets, resulting in the re-use of said assets. Re-use involves the full transfer of ownership rights, as exemplified by a re-sale of the collateral posted by the client.⁹⁵⁷ The transferor is usually compensated for agreeing to rehypothecation, for example through lower fees. This thesis employs the term 'rehypothecation' to capture all the different facets of collateral re-cycling, thus applying a 'loose' definition.⁹⁵⁸

ISDA estimates that pre-crisis, the dealer banks used to rehypothecate around 70% of the collateral they received.⁹⁵⁹ Back then, IMF research suggests, the average length of the

⁹⁵³ Sourbes (2014)

⁹⁵⁴ Both quotes taken from BCBS-IOSCO (2013b:19f.).

⁹⁵⁵ Atkins et al. (2012)

⁹⁵⁶ Parker/McGarry (2009:18f.)

⁹⁵⁷ Singh (2011:9).

⁹⁵⁸ *ibid.* There are also differences depending on whether the deal in question is governed by English or New York Law. More details on the technical background can be found in Gregory (2014:80ff.).

⁹⁵⁹ ISDA estimate quoted in Levels/Capel (2012:39).

rehypothecation 'chain' was roughly three links, i.e. the collateral provided by a given counterparty was re-cycled three times. After 2008, the chain length dropped to around 2.4 links, one key reason being increased investor awareness.⁹⁶⁰

The problems that can arise from rehypothecation are particularly intense with regard to IM. VM is exchanged frequently in function of mark-to-market changes, and therefore requires collateral to be easily available, which tends to discourage rehypothecation. By contrast, IM is only posted once at the inception of the transaction to serve as a buffer at times of counterparty default. This provides dealers with an incentive to recycle it, even more so given the long maturities of many uncleared deals. Once the 2008 crisis erupted, many investors learned this the hard way (particularly in the case of Lehman) when they realized that an important fraction of their assets was not available anymore.⁹⁶¹

4.2 Dealer banks' opposition to a rehypothecation ban and the lack of consensus on the buy-side

Already infuriated about the two-way mandate in form of the exchange of gross IM and the segregation requirement, the banks completely rejected any public intervention regarding rehypothecation. ING Bank, for example, declared rehypothecation was 'at the heart of the banking business model'⁹⁶² and an anonymous dealer banker told the press it 'would be ludicrous if we didn't have the ability to rehypothecate'.⁹⁶³ Another bank official furiously commented that '[w]e might as well just shut down the US financial system and go home'.⁹⁶⁴ DACSI (the Dutch Advisory Committee Securities Industry), the peak business association of the Dutch derivatives and securities industry, insisted rehypothecation had to remain legal. Any other solution 'would be an impediment for parties in the chain (forcing them to make money "dead"), and would be incompatible with the conventional approach of the banking industry'.⁹⁶⁵

The dealers' main argument in favour of maintaining rehypothecation related to the liquidity drain any form of restriction would incur. ISDA warned that limiting rehypothecation would be 'likely to lead to an extensive liquidity and collateral shock with unintended consequences for the global economy. [...] The combined effect would be analogous to a "quantitative tightening" but one of gargantuan proportions'.⁹⁶⁶ UBS, the European Association of Public Banks, and the French Banking Federation predicted higher prices for customers and liquidity shortages.⁹⁶⁷ Credit Suisse believed the banks had the

⁹⁶⁰ Singh (2011:16)

⁹⁶¹ Parker/McGarry (2009:18f.), ICMA (2016), Deryugina (2009:257)

⁹⁶² ING Bank (2014:5)

⁹⁶³ Anonymous dealer banker quoted in Cameron (2011a).

⁹⁶⁴ *ibid.*

⁹⁶⁵ DACSI (2014:6)

⁹⁶⁶ ISDA (2012:7)

⁹⁶⁷ UBS (2012:17), European Association of Public Banks (2012:4), French Banking Federation (2014:7)

risks related to rehypothecation fully under control, arguing that restricting rehypothecation would ‘arbitrarily restrict liquidity when the risk of rehypothecation can be fully addressed’.⁹⁶⁸ Spanish bank BBVA defended rehypothecation as purely beneficial from the clients’ point of view, given that it ‘tries to obtain the best profitability for them’.⁹⁶⁹ Summing up the industry’s position, the German Banking Industry Committee maintained ‘there cannot be any restrictions’.⁹⁷⁰

The buy-side was less united, given firms’ differing interpretations of the costs and benefits a prohibition of rehypothecation would incur. A ban would increase the cost of the deal, given enhanced collateral protection, while allowing for asset re-use would lower the cost. Several firms favoured an outright prohibition, or at least strict limits to rehypothecation. Vanguard, for instance, wrote it ‘strongly prefers the overall prohibition on *[sic]* the rehypothecation of initial margin’ as allowing it would be ‘contrary to the intention of margin’.⁹⁷¹ The American Benefits Council and other pension fund associations pointed out that a prohibition would not only mitigate systemic risk and enhance investor protection, it would also assist ‘regulators in overseeing the liquidation of a dealer because collateral can be identified faster and with greater certainty in a dealer bankruptcy’.⁹⁷² The Federation of Dutch Pension Funds considered rehypothecation ‘inappropriate’, emphasizing that ‘IM functions as a buffer and must be available when a counterparty defaults’.⁹⁷³ ICI also made it very clear it favoured a regulatory outcome under which IM ‘may not be rehypothecated, repledged, reused or otherwise transferred’.⁹⁷⁴

On the other end of the spectrum, i.e. in close proximity to the banks, were several buy-side entities that emphasized the OTC markets’ dependence on rehypothecation. Submitting identical comments, Insurance Europe and the Association of British Insurers indicated that restricting rehypothecation ‘could leave the market effectively grid-locked’⁹⁷⁵ by making insurance contracts more expensive and therefore less profitable. AXA and Natixis Asset Management insisted that rehypothecation was indispensable for maintaining the market’s liquidity.⁹⁷⁶ Insight Investment warned that restraining rehypothecation would risk rendering the OTC market ‘unviable’.⁹⁷⁷

The majority of commenters, however, positioned themselves between those two extremes, recommending leaving the decision to the counterparties themselves. Several associations once again had to accommodate a split membership.⁹⁷⁸ This also applied to

⁹⁶⁸ Credit Suisse (2014:8)

⁹⁶⁹ BBVA (2012:4)

⁹⁷⁰ German Banking Industry Committee (2014:15)

⁹⁷¹ Vanguard (2014:12,13)

⁹⁷² American Benefits Council et al. (2012:11)

⁹⁷³ Federation of the Dutch Pension Funds (2012:6)

⁹⁷⁴ ICI (2014:17)

⁹⁷⁵ Association of British Insurers (2012:8), Insurance Europe (2012:2)

⁹⁷⁶ AXA (2012:2), Natixis Asset Management (2014:9)

⁹⁷⁷ Insight Investment (2012:12)

⁹⁷⁸ E.g. European Federation for Retirement Provision (2012:12) and PensionsEurope (2014:24).

some larger funds which were often composed of specialist companies acting independently from each other, but remaining affiliated with the main firm. EIOPA's Occupational Pensions Stakeholder Group and Insurance and Reinsurance Stakeholder Group urged regulators to be 'pragmatic' in delegating the decision to the counterparties.⁹⁷⁹ The UK, French, and German investment associations IMA, AFG, and BVI each communicated their preference for bilateral solutions negotiated by the trading partners.⁹⁸⁰ The European Fund and Asset Management Association as well as individual asset managers Amundi and Mirova each highlighted that 'derivatives are traded between professionals' who were aware of the risks involved in rehypothecation and should therefore not be restricted in their decision whether to grant this right or not.⁹⁸¹ The members of the large hedge funds associations were also not united on this question. Some members of AIMA appeared to harbour doubts about the virtues of rehypothecation, given that the association recommended rehypothecation should 'only be permitted where specifically authorised by the customer'.⁹⁸² MFA, in turn, simply advised against 'restricting the choices of the counterparties'.⁹⁸³

4.3 A loss for the banks: Transatlantic public consensus on banning the rehypothecation of IM

From the beginning, regulators shared the conviction that rehypothecation of IM had to be prohibited, since the idea of segregation would otherwise risk being led *ad absurdum*.⁹⁸⁴ BIS economic advisor, Stephen Cecchetti, summarized the transatlantic consensus by observing that 'the result will be financial institutions that are safer, more transparent, more liquid and less interconnected than was the case before'.⁹⁸⁵

The level of public issue salience was similar as in the segregation case, i.e. there was comparatively little debate about the question at the legislative level, particularly in the US. Regulators in both jurisdictions justified the prohibition of rehypothecation along nearly identical lines across all their releases, which reflected a domestic institutional environment without cracks. Justifying the prohibition, the CFTC argued the rules had to be 'designed to prevent the same asset from being passed around as margin for multiple positions',⁹⁸⁶ which would risk leading to a situation where payment problems affecting one link of the chain might have 'cascading' effects,⁹⁸⁷ both for psychological reasons and due to delays in the recovery of posted assets. The PRs also prohibited rehypothecation, saying that '[i]f

⁹⁷⁹ EIOPA OPSG and IRSG (2014:12)

⁹⁸⁰ IMA (2012:14), AFG (2014:16), BVI (2014:9)

⁹⁸¹ EFAMA (2014:13f.), Amundi (2014:7f.), Mirova (2014:8f.)

⁹⁸² AIMA (2012:9)

⁹⁸³ MFA (2012a:14)

⁹⁸⁴ This prohibition did not extend to VM.

⁹⁸⁵ Cecchetti quoted in Atkins et al. (2012).

⁹⁸⁶ CFTC (2011b:23739)

⁹⁸⁷ CFTC (2014:59923, also 2015d:687f.)

swap entities exchange similar amounts of initial margin and these funds are available for general use and rehypothecation by the swap entities, then the net effect is as if little initial margin was exchanged'.⁹⁸⁸

To WGMR, two-way IM equally required a prohibition of rehypothecation: 'Although a firm has received initial margin as collateral, the firm also now bears the risk of additional loss on the initial margin that it has provided to the counterparty if the counterparty defaults, which may offset some or all of the benefits of initial margin received. The risk would be exacerbated if the counterparty re-hypothecates or re-uses the provided margin, which could result in third parties having legal or beneficial title over the margin, or a merging or pooling of the margin with assets belonging to the others as a result of which the firm's claim to the margin becomes entangled in legal complications, thus delaying or even denying the return of re-hypothecated/re-used assets in the event that the counterparty defaults'.⁹⁸⁹

In Europe, the EU Commission observed that 'rehypothecation works well until a bankruptcy occurs'.⁹⁹⁰ In line with WGMR's interpretation, the ESAs further elaborated on this argument, explaining that rehypothecation 'would create new risks due to claims of third parties over the assets in the event of a default'.⁹⁹¹ Because of the legal and operational challenges involved in making IM available when needed, they noted that keeping the practice of rehypothecation legal 'would be contradictory to the concept of the IM'.⁹⁹²

Both the US and the EU authorities may have also perceived a rehypothecation ban as consistent with promoting central clearing. Indeed, post-crisis, US CCPs are prohibited from placing a lien on customer collateral, i.e. the CCP cannot use client assets to meet unrelated financial obligations of its own.⁹⁹³ However, US CCPs and clearing members can re-invest cleared swap customer assets in high-liquidity, low-risk assets, such as US government bonds and commercial paper, subject to restrictions.⁹⁹⁴ In a similar way, EMIR stipulates that conditional upon clearing member consent, the CCP can re-invest assets, but 'only in cash or in highly liquid financial instruments with minimal market and credit risk'.⁹⁹⁵

For the regulators, it followed that the rules for the uncleared market had to be stricter, although the final outcome does not take this logic to its extreme which would entail a

⁹⁸⁸ PRs (2011:27579, see also 2014:57373f., 2015:74845)

⁹⁸⁹ BCBS-IOSCO (2012:24f., 2013a:17f., 2013b:18). Note that WGMR in fact allowed for one-time rehypothecation under very restrictive conditions, following pressure by the SEC. The ESAs and the other US regulators did not support this carve-out, and did not translate it into their domestic framework.

⁹⁹⁰ EU Commission (2013:119)

⁹⁹¹ ESAs (2016a:27)

⁹⁹² ESAs (2016b:74, 2014:20)

⁹⁹³ Nazareth (2012)

⁹⁹⁴ *ibid.*

⁹⁹⁵ Article 47(1) of EMIR

requirement for the collecting party in the uncleared market to leave the assets completely untouched (at the cost of overall liquidity in the system). The rules of the CFTC, the PRs, and the ESAs each ban the rehypothecation of assets posted as IM. Reinvestment is possible, particularly with respect to cash, but subject to tight restrictions.⁹⁹⁶ As in the segregation case, the special treatment of cash is informed by its problematic role in case the entity holding it defaults.⁹⁹⁷

Overall, both the US and the EU policy outcomes represented another loss for the banks.

5. Conclusion

This chapter has argued that the banks failed to exercise influence over the adoption of the 2-way IM mandate, the segregation regime, and the rehypothecation ban, each a requirement they vehemently opposed. It also showed that policy-makers did not act on the information the banks submitted, and that the industry found itself at the margin of the transnational policy community. There were also no attempts by the banks to project structural power in terms of threats of exit. Business unity was low across all cases. While the dealer banks were united in their opposition to policy-makers' proposals, the buy-side's preferences on each of the three issues varied greatly, including multiple incidents of counter-active lobbying. As a result, interest groups sent a messy signal to the regulators.

Regarding 2-way IM in the US, the needle of the influence barometer at first pointed to congruence, given that at the domestic institutional level and with respect to the ideational outlook, the PRs initially prevailed in the conflict with the CFTC with their preference for one-way IM. However, the banks lost the battle because EU market power *cum* power through regulatory capacity, most likely in combination with socialization efforts projected on the PRs by the other members of WGMR, turned the sign of the transgovernmental and inter-state power moderators against them. The transgovernmental outcome also provided a solution to the domestic dispute about the contours of the ideational consensus in favour of a 2-way exchange, meaning that the ideational moderator and the domestic institutional environment moderator were now also operating against the banks. The lack of business unity further constrained the banks. The dealers benefited from low issue salience, but given the overall factor constellation, they were unable to exploit it in their favour in terms of preventing the adoption of the 2-way mandate.

In the EU, the banks' lack of influence was the result of policy-makers' shared ideational consensus in favour of 2-way IM, which was not constrained by any challenges at the

⁹⁹⁶ For details, see PRs (2015:74845), CFTC (2015:671), ESAs (2016a:51,2016b:75). An overview of the different forms of eligible collateral can be found in Latham & Watkins (2017:4).

⁹⁹⁷ For more information on the challenges associated with cash, see for example Association of Global Custodians (2015:2).

domestic institutional level. As a consequence, both moderators were turned against the banks from the start. The fact that EU power probably contributed to the adoption of a 2-way solution within WGMR, maybe in combination with socialization efforts, then also turned the transgovernmental and inter-state power moderators against the dealers. Low business unity further restricted the banks. In this constellation, low issue salience pointing in their favour was insufficient for them to exercise any influence.

Regarding segregation in the US, the early embrace of third-party segregation with a custodian by both the CFTC and the PRs turned the ideational outlook and domestic institutional environment moderators against the banks. Given that strong segregation was also supported by WGMR, the transgovernmental moderator equally operated against them. As in the 2-way IM case, the dealers were also constrained by a lack of business unity. Low issue salience alone was again insufficient for them to exercise influence. In light of the broad transatlantic agreement in favour of segregation, inter-state power relations were probably not invoked.

In the EU case, the factor constellation was the same. The ideational consensus pointed towards the need for segregation, and WGMR supported this principle. Business unity was again low. This means that, as in the US, the moderators indicating the effect of the ideational outlook, domestic institutional environment, transnational community, and business unity were flashing red. However, the EU's segregation requirements did not go as far as those in the US, most likely because of challenges at the domestic institutional level in terms of the lack of a EU-wide insolvency regime and the insufficient number of banks that could serve as custodians across all member states. Nonetheless, segregation is required and cannot be negotiated away, meaning the outcome still represents a loss for the dealers. Inter-state power was probably not at the forefront of this case. The banks benefited from low issue salience, but given the overall factor constellation, the positive signal of this moderator alone was once again insufficient for them to exercise any causal influence.

The rehypothecation case was another lost battle for the banks where they exercised no influence over the outcome. The feedback mechanism limiting dealer bank influence was the same as in the segregation case, without any shocks to it in either jurisdiction. The ideational consensus stipulated that for the IM mandate to be viable, collateral must not be re-used, which clashed with the principle of rehypothecation. The consensus was supported at the domestic institutional and transnational levels, with all three moderators having a detrimental effect on bank influence. Low business unity added a fourth moderator that operated against the banks. Again, low issue salience alone was insufficient for the dealers to exercise any influence.

Comparing the pre-crisis deregulation case with the post-crises cases discussed so far allows us to identify a commonality across all cases. The banks were able to exercise influence when the effect of three moderators was working in their favour: policy-makers' ideational outlook, the state of the transnational policy community, and the domestic institutional

environment. However, they lost when these moderators were turned against them. We will return to this result in the conclusion of the thesis.

CHAPTER VII - The Treatment of Commercial End-Users

1. Overview of the chapter

This chapter discusses the treatment of commercial end-user trades under the margin rules. The end-user case was the only one in which the banks successfully exercised influence, even though only in an indirect way, by forming a coalition with the corporate sector which did most of the lobbying on their behalf. The banks (and end-users) were more influential in the US where trades with non-financial firms are completely exempt. In the EU, by contrast, the bank/end-user coalition failed to secure a full exemption, meaning dealer bank influence was less strong. The two cases unfolded primarily at the domestic level, with transatlantic power relations not playing a dominant role.

Section 2 covers the US case. Section 2.1 reveals that initially, the end-user question did not rank high on the political agenda, with policy-makers and regulators believing that the end-user business did not represent a major source of systemic risk. Instead, the idea at first was to delegate the issue to the regulators, and to allow them to pursue exemptions where they saw fit. At this time, public issue salience was low, and there was an implicit consensus that the ideational clearing/margining consensus would not apply to non-financial firms.

It was CFTC chair Gary Gensler who radically changed this equilibrium by launching a public issue salience-raising campaign and forcefully discussing the risks of leaving the end-user business outside the regulatory umbrella. The PRs, by contrast, showed little interest in the issue, meaning that at the domestic institutional level, the effects of regulatory fragmentation became visible. Section 2.2 discusses the response Gensler's campaign provoked. Section 2.2.1 shows that it alarmed the dealer banks which did not want to lose this profitable source of income. Given their tarnished reputation, they could not publicly lobby for an end-user carve-out themselves. For this reason, they mobilized the end-user community which drew upon a critical resource the banks lacked: their credibility with policy-makers. Together, they launched a counter attack, redirecting the focus of public issue salience towards the risks of not excluding the end-user business from the new rules. Section 2.2.2 suggests that, in addition to their alliance with the end-users, the banks also built a second coalition with the New Democrats for whom the end-user carve-out became a central part of the political agenda. Section 2.2.3 examines the end-users' own campaign on Capitol Hill in which they vociferously refuted Gensler's claims.

Section 2.3 covers Congress' response to the two campaigns. As a consequence of Gensler's campaign and the counter-campaigns organized by the bank/end-user alliance as well as the bank/New Democrat alliance, the public issue salience of the end-user question reached

increasingly high levels. Indeed, the treatment of non-financial firms was among the most debated topics of the derivatives-related provisions of the Dodd-Frank legislation. The Democratic Party was split regarding the need to apply the ideational clearing/margining consensus to the end-users. As sections 2.3.1 and 2.3.2 illustrate, several progressive Democrats, the Democratic Party leadership, and the Treasury fell in line behind Gensler. The House bill, however, did not tighten the language on the end-user treatment, most likely because Barney Frank needed the votes of the New Democrats on some of the other Dodd-Frank-related policies. The House bill also contained a clearing exemption through which Frank hoped he could appease the end-users (which he could not). The Senate bill similarly contained the clearing exemption, but it, too, lacked any stricter language regarding margin for end-user deals. While most of the Democratic Party's progressive Senators favoured Gensler's approach, the Democratic chair of the Agriculture Committee, Blanche Lincoln, sided with the end-users.

The final version of Dodd-Frank then surprisingly lacked any precise wording on the margin treatment of end-user deals. Senators Dodd and Lincoln drafted a letter intended to clarify the situation, but which in fact only complicated it further. The proponents of a carve-out claimed it confirmed the exemption under Dodd-Frank. The skeptics, however, insisted that, while the Act did not impose margin requirements, it did not prohibit the regulators from approving a system where the banks themselves could ask for margin (or include its equivalent cost in the price of the deal). From their perspective, the Dodd-Lincoln letter was fully compatible with this interpretation.

Section 3.4 discusses the policy-process leading to the final adoption of the waiver. Section 3.4.1 shows that because of the ambiguous legal context, the CFTC believed it lacked the authority to impose margin rules on the end-users. However, it still felt reinvigorated enough by the situation to ask the banks to calculate hypothetical margin amounts and to determine thresholds below which the end-users would be free to not post any collateral. The PRs, by contrast, were of the view that Dodd-Frank did not give them the authority to implement a complete waiver. Largely unsatisfied that neither of the proposed rules granted a full carve-out, the bank/end-user coalition intensified its advocacy campaign on Capitol Hill in order to secure a legally codified exemption. The public issue salience of the topic, thus, remained at a maximum. The Republican victory in the 2010 House mid-term elections subsequently pitched the progressive Democrats against the GOP. Having made the repeal of Dodd-Frank their rallying cry, the Republicans made the codification of the end-user waiver one of their top priorities. Section 3.4.2 explains that, while the House soon adopted the required legislative changes, the Senate Democrats resisted the waiver over several years, before finally accepting it as part of the reauthorization of the Terrorism Risk Insurance Act (TRIA), a piece of legislation considered a 'must-pass' bill they felt they could not block.

Compared to the US case, the policy process in the EU was much less complex. Section 3.1 shows that, as in the US, there was a bank/end-user campaign which advocated a full carve-out on similar grounds. However, the alliance operated much more in the open than its

American counterpart, taking advantage of the fact that in the early stages, many EU policy-makers interpreted the 2008 crisis very much as a 'US problem', meaning EU banks' reputation was not as tarnished.

Section 3.2 argues that the level of public issue salience of the end-user question was relatively higher from the beginning, given Europe's tradition of providing special treatments for their SMEs under its financial rules, which facilitated the work of the bank/end-user coalition. Policy-makers also largely agreed that the coverage of the ideational consensus should extend only to the larger end-user firms. Some members of the EU Parliament initially advocated the adoption of a complete waiver. The majority of policy-makers, however, favoured a threshold approach exempting only the smaller entities, and this was also the solution eventually implemented through EMIR. The bank/end-user coalition was therefore not fully successful, in that the margin rules cover the largest corporate firms.

Section 3.3 studies ESMA's post-EMIR attempts at further tightening the threshold approach. ESMA's activism had two effects. First, it questioned the contours of the ideational consensus. Second, it introduced frictions at the domestic institutional level, since ESMA's preferences clashed with those of the Commission which had to approve its work. ESMA's plans failed, to a large extent because of the end-users' continuing efforts at keeping public issue salience high. The ideational consensus and the institutional context thus returned to their earlier post-crisis levels.

At the transnational level, WGMR took little interest in the end-user question. The vast majority of its members did not believe that the ideational consensus should extend to most end-users, given that trades with non-financial firms 'are viewed as posing little or no systemic risk'.⁹⁹⁸ Its final framework recommended covering only systemically-important non-financial firms.⁹⁹⁹

Figures 17 and 18 depict the configuration of the end-user case in the US and the EU. The banks' preference in both cases was a full exemption for all end-user trades. In the US, the needle of the influence barometer initially pointed towards a loss, but the dealers succeeded in pushing it to the (limited indirect) 'influence' category. Figure 17 illustrates this through the crossed out lightning bolt.

Gensler's campaign raised the level of public issue salience against an exemption. It also conditioned the ideational outlook of the Treasury and parts of the Democratic Party against it. In addition, it introduced friction at the domestic institutional level, given that the CFTC clarified its intention to bring the end-user business under the regulatory umbrella, whereas the PRs showed little interest in the issue. All three moderators were therefore

⁹⁹⁸ BCBS-IOSCO (2013a:7)

⁹⁹⁹ *ibid.*

initially turned against the banks, meaning the needle of the influence barometer pointed to a loss.

In the end, however, the dealers were able to secure a victory. Because of the bank/end-user coalition, business unity was high. The coalition's advocacy successfully countered Gensler's campaign by raising the issue salience of the perceived need for an exemption, which eventually superseded the effects of his efforts. The bank/end-user campaign also raised the support of the New Democrats and other members of the Democratic Party, which put the ideational consensus under pressure. The missing language in Dodd-Frank, however, represented a setback for the banks, as it allowed the CFTC to propose rules that fell short of granting a full-scale exemption. The bank/end-user coalition responded by multiplying its efforts to keep 'friendly' issue salience at an all-time high. With the Republican victory in the 2010 elections, the coalition's efforts to turn the signal of the ideational consensus to their advantage experienced a significant boost, which eventually led to the exemption of end-user trades through the reauthorization of TRIA. This then also shifted the domestic institutional environment to the banks' advantage, as it tied the hands of the CFTC. The dealers also benefited from the fact that WGMR showed little interest in the issue. The end-user exemption is thus the result of bank influence. However, because most of the dealers could not act directly in the open, being forced instead to rely on the end-users as their intermediary, their influence was only indirect.

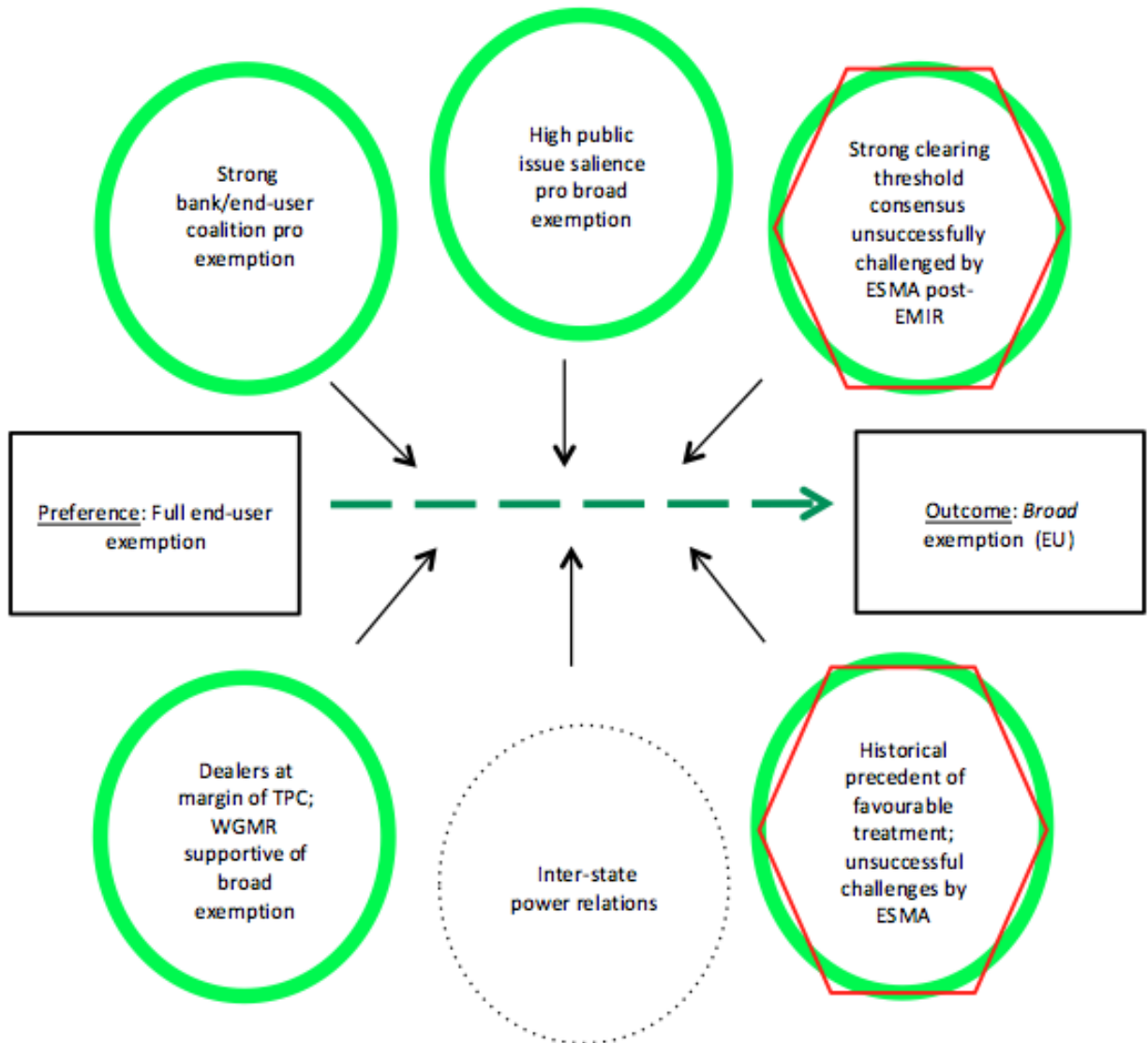
In the EU, the policy process was less complex and more favourable to the banks from the beginning. As in the US, the dealers mobilized the end-users, ensuring high business unity. However, the hurdles the coalition had to overcome were smaller, given the EU's historical precedent of shielding SMEs from potentially harmful effects associated with bank-related financial regulation. The domestic institutional moderator therefore operated in favour of the banks. This almost automatically translated into higher issue salience in favour of some kind of preferential treatment for end-user deals, and an ideational outlook conducive towards some form of carve-out. The banks also benefited from a positive signal of the transgovernmental moderator, given that WGMR approved of exempting all but the largest corporate entities. The bank/end-users' campaign focused on sustaining the momentum towards an exemption. After the adoption of the clearing threshold through EMIR, the campaign maintained the level of issue salience and ensured ESMA's recommendations on further tightening the rules would not fall on fertile ground. However, given that the final outcome, at least at this stage, does not include a full carve-out, the banks' indirect influence was only limited. The arrow in figure 18 is therefore thinner than in figure 17. Because the end-user question was largely considered a domestic issue, the inter-state power dimension was of comparatively little relevance in either case.

Figure 17: The end-user case in the US



Source: Author

Figure 18: The end-user case in the EU



Source: Author

2. The US case

2.1 CFTC chair Gary Gensler raising the issue salience of the end-user question

The 'end-user' component of the reform efforts initially ranked low on the priority list of policy-makers, both the US Congress and the Administration. In fact, back at the time, many staffers who had been involved in earlier discussions about derivatives regulation were not

even familiar with the term ‘end-user’.¹⁰⁰⁰ With the importance of the end-user business for systemic risk being considered minor, the Administration at first intended to delegate the topic to the regulators. Its Draft Legislation for Financial Regulatory Reform published in September 2009 provided for a ‘permissive’ exemption, granting regulatory authorities the discretion to pursue exemptions where they saw fit:

Regulators may, but are not required to, impose margin requirements with respect to swaps in which one of the counterparties is—
“(i) neither a swap dealer, major swap participant, security-based swap dealer nor a major security-based swap participant;
“(ii) using the swap as part of an effective hedge under generally accepted accounting principles; and
(iii) predominantly engaged in activities that are not financial in nature [...].¹⁰⁰¹

Neither Frank’s ‘Over-the-Counter Derivatives Market Act of 2009’ nor Dodd’s ‘Restoring Financial Stability Act of 2009’ questioned these exclusions,¹⁰⁰² the main difference being that Frank’s version excluded transactions used to hedge ‘commercial risk’ (which allows for a wide interpretation of ‘hedging’), whereas Dodd’s approach followed the Administration by exempting only ‘effective hedges’ (which limited exemptions to those respecting the restrictions of hedge accounting rules).

The PRs did not display great interest in the question either, considering the systemic risk associated with the end-user business to be comparatively low. The only proponent of strong rules was Gary Gensler. A former partner at Goldman Sachs who had followed the well-trodden path from the bank to the US Treasury, where he had helped push through the Commodity Futures Modernization Act of 2000, Gensler became one of the most dedicated, if not *the* most dedicated reformer,¹⁰⁰³ who would later be remembered for his unique ‘aggressiveness’¹⁰⁰⁴ in seeking change. Changing from Saul to Paul, Gensler used his confirmation hearing to do penance for his prior deregulatory efforts by confessing ‘that all of us – all of us that were involved at the time, and certainly myself, should have done more to protect the American public through aggressive regulation, comprehensive regulation’.¹⁰⁰⁵ He ruled out ever returning to Wall Street for future employment, which, in his own words, felt ‘very liberating’.¹⁰⁰⁶ In his view, neglecting the regulation of the end-user business would provide the banks with a giant loophole and allow Wall Street to

¹⁰⁰⁰ Scheiber (2012:348)

¹⁰⁰¹ US Congress (2009b:219 of the pdf)

¹⁰⁰² See US Congress (2009a:61) for Barney Frank’s discussion draft and US Congress (2009c:543f.) for Chris Dodd’s version.

¹⁰⁰³ Katz/Schmidt (2010)

¹⁰⁰⁴ SEC chair Mary Schapiro characterizing Gensler in Protesch (2014).

¹⁰⁰⁵ Gensler quoted in Hirsh (2010:282).

¹⁰⁰⁶ Gensler quoted in Starkman (2010).

maintain an important aspect of the pre-2008 deregulation status quo that had contributed to the crisis.¹⁰⁰⁷

Once he realized that his concerns were not fully listened to by the Administration or on Capitol Hill, he shifted his strategy from traditional discussions behind closed doors to raising the public issue salience of the need to regulate the end-user business. For a regulator, this move was nearly unheard of. In the words of Noam Scheiber, '[i]n the normal order of the bureaucratic universe, this would have been the end of the discussion. The obscure regulator, having noted his objections, would have fallen in line behind the Treasury secretary. [...] But Gensler had little interest in the normal order of things.'¹⁰⁰⁸ Rather, '[i]t was now clear that Gensler was playing a different game: not a backroom negotiating game, but an outside political game. He was appealing over the heads of bureaucrats and congressmen and making a run at public opinion'.¹⁰⁰⁹ The core of Gensler's strategy involved raising public attention by testifying in front of Congressional committees, speaking to industry groups and ensuring he was quoted in the press.¹⁰¹⁰

Unlike his colleagues from the PRs who saw no need to bring the end-users under the regulatory tent, it was unequivocally clear to Gensler that the ideational consensus had to apply to the end-user business as well. His position consisted of three major points. The first one was the objective of preventing regulatory evasion in terms of the financial industry shifting its deals to the end-user community. Gensler urged Congress to 'ensure that customized derivatives are not used solely as a means to avoid the clearing requirement'.¹⁰¹¹ He therefore considered it necessary to implement encompassing reform, 'to cover the entire market and that means corporates, small municipalities and non-profits that use these markets to hedge'.¹⁰¹²

Gensler's second argument pertained to the macroprudential dimension of the margining consensus. He observed that the end-users had a tendency to underestimate the systemic risk to which their transactions with the dealer banks contributed. Posting and receiving margin would protect them against the elevated systemic risk of customized derivatives, as well as against the effects of the potential failure of one of their banks. He warned that '[e]ven though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system'.¹⁰¹³ 'If we can bring more transactions in, we further lower the risk of the financial sector'.¹⁰¹⁴ '[W]e have to protect the American public'.¹⁰¹⁵ Gensler emphasized that the failure of a highly interconnected

¹⁰⁰⁷ See Hirsh (2009c).

¹⁰⁰⁸ Scheiber (2012:349f.)

¹⁰⁰⁹ Scheiber (2012:351f.)

¹⁰¹⁰ Scheiber (2012:352-354)

¹⁰¹¹ Gensler quoted in US Senate Agriculture Committee (2009a:89).

¹⁰¹² Gensler quoted in Clark (2009).

¹⁰¹³ Gensler quoted in US Congress (2010b:33) based on his Congressional testimony of 18 November 2009.

¹⁰¹⁴ Gensler quoted in Kranish/Wirzbicki (2009).

¹⁰¹⁵ Gensler quoted in US Senate Agriculture Committee (2009a:15).

dealer bank could bring down all its end-user customers with it, unless they had taken precautionary measures by margining their transactions. He explained: ‘These banks also have other lines of business that can generate financial risks, such as lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Given the interconnectedness of these banks, one bank’s failure can have profound effects on every one of its customers or counterparties’.¹⁰¹⁶

Gensler’s third argument concerned the price of OTC transactions. Describing the OTC derivatives market ‘as a dark ocean’,¹⁰¹⁷ he claimed that the end-users would highly benefit from regulation, not only in an abstract sense in terms of being exposed to less systemic risk and reduced (social) cost in times of crisis, but also much more directly in a very tangible way through reduced trading costs derived from greater price transparency. He argued that the end-users were actually already paying for margin as part of the price of the deal. He explained that the banks themselves did not keep the risk of an end-user trade unhedged on their books, but that they took out hedges themselves, with the cost being passed on to the client. However, given the lack of transparency of the OTC marketplace, Gensler insisted, the end-users were unaware of the precise composition of the price of the trade. Improved transparency through imposed regulation would result in increased competition among dealers, and thus better prices for the end-users. In his words, ‘[i]f currently they are not posting any margin or taking it out, it is already priced into the contract. It might be opaque, but it is priced into the contract’.¹⁰¹⁸ The reforms would therefore ‘benefit every small utility company, every small user of derivatives to have greater transparency. The only party that would naturally be opposed is Wall Street because they right now have the information advantage [...]’.¹⁰¹⁹ As a model for his reform plans, Gensler referred to the futures and securities markets where bid/ask spreads are readily available, which ensures that the informational advantage tends to reside with the public in form of the buyer, rather than the seller. ‘It is only the Wall Street banks that benefit from such an exemption, not the end-users or the public’.¹⁰²⁰

2.2 The counter initiative: The banks ...

Gensler’s campaign elicited strong resistance on Wall Street. Alarmed by his dedication and eagerness to push for deep, encompassing reform, the banks feared losing yet another profitable source of income, after they were already at risk of losing the battle on the IM front. For this reason, their overall objective became ensuring a Congressional end-user carve-out. However, in light of the high public issue salience of derivatives regulation and their own reputation as the *bête noire* of the country, most of the banks avoided raising the

¹⁰¹⁶ Gensler (2009b)

¹⁰¹⁷ *ibid.*

¹⁰¹⁸ Gensler quoted in US House Agriculture Committee (2009b:195), see also Gensler in US Senate Agriculture Committee (2009b:10). The point is also made by Litan (2010).

¹⁰¹⁹ Gensler quoted in US House Financial Services Committee (2009e:22f).

¹⁰²⁰ Gensler (2009b)

idea in public. The few representatives of the financial industry that publicly testified on the issue decided to frame their arguments by pointing out the macroeconomic benefits they associated with an end-user exemption, without drawing attention to the fact that such an outcome would also largely benefit themselves. ISDA's CEO Robert Pickel, for example, stressed that OTC derivatives were quintessential to the thriving of the American economy. Encouraging Congress 'to understand that the benefits of the OTC derivatives business are significant for the American economy and American companies', he emphasized that 'OTC derivatives exist to serve the risk management and investment needs of end-users such as the businesses that are the backbone of our economy and the investors that provide funds to those businesses. The development of OTC derivatives has followed the development of the American economy'.¹⁰²¹

One of the few, if not the only dealer banks to openly testify on the end-user question was JP Morgan. In contrast to its competitors, it had weathered the financial crisis relatively well, and unlike most of his CEO colleagues, Jamie Dimon continued to enjoy considerable bipartisan respect on Capitol Hill.¹⁰²² The firm warned of the employment effect that bringing the end-user business under the legislative umbrella would have. It 'hurts the company and its employees'.¹⁰²³ Regulating the trades of non-financial firms 'would limit their ability to manage the risks they incur in operating their business and have negative financial consequences for them via increased collateral and margin posting. These unintended repercussions have the potential to harm an economic recovery'.¹⁰²⁴ In addition, JP Morgan advanced 'the moving business overseas argument',¹⁰²⁵ which in the past had been so successful in fending off regulation. JP Morgan concluded that there was no need to change the status quo: 'The current method by which end-users negotiate and execute OTC derivatives is suitable for them [...] and does not harm the financial system'.¹⁰²⁶

2.2.1 ... mobilizing the end-users ...

Given their damaged reputation, the banks needed others to advocate the waiver, and to advocate it forcefully by using a framing strategy that would point out the dire economic consequences a regime without exemptions would cause. The end-users' were an obvious, natural ally, given their credibility with policy-makers. In public, the banks consistently denied having formed this alliance, and so did most of the end-users.¹⁰²⁷ The larger end-

¹⁰²¹ Pickel quoted in US Senate Banking Committee (2009f:16,130).

¹⁰²² Dimon's star began to sink after the bank's trading loss associated with the 'London whale' scandal in 2012 (see for example Hurtado 2016).

¹⁰²³ Mark Lenczowski of JP Morgan quoted in US Senate Agriculture Committee (2009a:97).

¹⁰²⁴ Don Thompson of JP Morgan quoted in US House Financial Services Committee (2009d:190).

¹⁰²⁵ Don Thompson of JP Morgan quoted in US House Financial Services Committee (2009d:39). Note that Thompson tried taming the argument by adding that it 'is not one I am as focused on', (*ibid.*), but the threat was clear nonetheless.

¹⁰²⁶ Blythe Masters of JP Morgan quoted in US Senate Agriculture Committee (2009c:99).

¹⁰²⁷ See for example Grim (2010).

users, such as Cargill (which in light of the size of its derivatives portfolio had to register as a swap dealer with the CFTC¹⁰²⁸) certainly did not need the banks to raise their attention. As well, the size of their portfolios combined with their credit rating sometimes enabled them to make the banks compete for their business, resulting in lower fees. Based on these considerations, it would be an oversimplification to reduce the bank/end-user connection to a 'master-puppet' relationship. However, the importance of the banks must not be underestimated, and there is strong evidence contradicting the denials of their close cooperation with the end-users.

The press has quoted several knowledgeable individuals confirming the benefits the banks saw in having the end-user community lobby policy-makers on their behalf. In addition, some end-user representatives have corroborated the banks' activism in this regard, and several members of the US Congress equally voiced their concerns about the end-users having been directed to Capitol Hill to advocate on behalf of Wall Street. The media reports include an article describing how JP Morgan lobbyist Kate Childress, a former Democratic staff member of the Senate Banking Committee, 'urged the other big banks to contact the chief financial officers of their corporate clients and warn that their derivatives could disappear or become prohibitively expensive unless they appealed to Congress'.¹⁰²⁹ A Congressional staffer provided further evidence, citing a conversation with a corporation in which one participant referred to Jamie Dimon as being highly active in 'imploing all of our clients to start calling Congress, get their lobbyists involved'.¹⁰³⁰ Another anonymous staffer spoke of 'an orchestrated, well-funded effort by the banks to manipulate our legislation and leave no fingerprints'.¹⁰³¹

The press has also cited a banking lobbyist who acknowledged that '[e]nd users are very important because they have the most credibility',¹⁰³² which highlighted the obvious quality the banks were lacking in the eyes of most policy-makers. In addition, a 'derivatives industry lawyer' was quoted as saying that the end-user activism 'is going to be pretty critical. [...] [I]t would be naïve to think companies have not been talking to their bankers about how the business is going to be affected going forward'.¹⁰³³ Another anonymous banker confirms: 'We've really had to work to alert our clients', 'Many customers didn't understand that they were being lumped together with the AIGs and monoline insurers of this world and they're only now seeing the risks'.¹⁰³⁴

Most corporations vehemently dismissed the idea of having been mobilized by the banks. However, there were also some exceptions. Sean Cota, the president of Cota & Cota, a small petroleum product company explained the situation as follows: 'We had a consensus

¹⁰²⁸ Miedema (2013)

¹⁰²⁹ Scheiber (2010b)

¹⁰³⁰ Anonymous congressional staffer quoted in Scheiber (2012:348).

¹⁰³¹ Anonymous congressional staffer quoted in Hirsh (2009a).

¹⁰³² Anonymous bank lobbyist quoted in Stone (2009), see also Kaiser (2013:909f.).

¹⁰³³ Anonymous lawyer quoted in Scheiber (2010a).

¹⁰³⁴ Anonymous banker quoted in Hughes (2009b).

amongst everybody that this [i.e. the margin requirements] was all a great thing until ISDA, the International Swaps and Derivatives Association, with the big players and the money in the over-the-counter market, said ‘You’ve got to figure out who your biggest accounts are and start telling them that it’s going to get really expensive to do these hedging programs for you folks [...]. So you need to make sure that financial reform doesn’t happen’.¹⁰³⁵ Jim Collura of the New England Fuel Institute, a regional trade and business association representing the home heating fuels industry, confirmed the scale and intensity with which the banks pursued their efforts. In his words, the end-users were ‘getting hammered constantly with ‘You’re going to be put out of business; you’re not going to be able to hedge; you’re not going to be competitive anymore’’.¹⁰³⁶

Several Congressional policy-makers shared this impression. Collin Peterson (D-M), chair of the House Agriculture Committee, reported ‘that some of the big financial players have sent a bunch of these end-users around to talk to you [i.e. his colleagues on the House Agriculture Committee] about this. [...] a lot of this stuff that has been ginned up around here has been by those guys that are on the other side of this. When this goes on a clearinghouse or exchange or is made transparent, their margins are going to narrow’.¹⁰³⁷ Chris Dodd concurred, confirming his impression that ‘the end users have been basically used by the major investment banks’.¹⁰³⁸

2.2.2 ... and the New Democrats

Despite their tarnished reputation, the banks still succeeded in winning support on Capitol Hill, particularly among the New Democrats Coalition, a segment of the House Democratic Caucus that, inspired by Bill Clinton’s Third Way was ‘committed to pro-economic growth, pro-innovation, and fiscally responsible policies’.¹⁰³⁹ The New Democrats’ positions on various policies were also informed by the fact that many of their districts traditionally voted Republican, which often led to tight electoral races.¹⁰⁴⁰ After the crisis, the financial industry provided massive financial support to the New Democrat candidates¹⁰⁴¹ in order to put them in a position where they could advance their ‘pro-growth’ and ‘common sense’ policies.¹⁰⁴²

¹⁰³⁵ Sean Cota of Cota & Cota quoted in Grim (2010).

¹⁰³⁶ Jim Collura of the New England Fuel Institute quoted in Grim (2010).

¹⁰³⁷ Peterson quoted in US House Agriculture Committee (2009b:199), for a similar quote by Peterson see Madigan (2009c).

¹⁰³⁸ Dodd quoted in Grim (2010).

¹⁰³⁹ See the New Democrats’ website at <https://newdemocratcoalition-himes.house.gov/>, accessed on 22 February 2018.

¹⁰⁴⁰ Kaiser (2013:358)

¹⁰⁴¹ Jones/Stern (2010), Vekshin/Kopecki (2009)

¹⁰⁴² The language is taken from the NewDemPAC at <http://www.newdempac.com/>, accessed on 22 March 2018.

The end-user carve-out became a central part of the New Democrats' political agenda. Steve Bartlett, President and CEO of the Financial Services Roundtable considered them '[his] favorite group in Congress in the sense of doing the right things for the country'.¹⁰⁴³ Reflecting this sentiment, the New Democrats chair, Congressman Ron Kind (D-WI), at one point reassured his audience at a meeting with lobbyists of the Chamber of Commerce and the big dealer banks that he and his colleagues were 'working hard with you to get the policy [i.e. reform under Dodd-Frank] right'.¹⁰⁴⁴ ISDA's CEO, Robert Pickel, confirmed the importance of the New Democrats' support on the end-user question, crediting them with 'hav[ing] played a central role here both in terms of interacting with the end-users but also being able to take that concern to Chairman [Barney] Frank'.¹⁰⁴⁵

2.2.3 The end-user campaign

The end-user community raised the issue salience of the need for a carve-out by a multiple of what the banks would have been able to achieve by themselves. Two groups were particularly influential. Most active was the 'Coalition for Derivative End Users', a group established by the US Chamber of Commerce, the Business Roundtable, and the National Association of Manufacturers which comprised firms and associations from all sectors of the economy.¹⁰⁴⁶ It coordinated the bulk of the end-users' efforts on Capitol Hill, but also advocated in its own name, particularly at the later stages of the legislative debate, once Dodd-Frank had already been signed into law. Several sources claim the banks contributed towards the formation and funding of the group,¹⁰⁴⁷ but the Coalition has denied having received any such support.¹⁰⁴⁸

There was also a second group led by the National Gas Supply Association (NGSA) which mobilized groups from the agricultural sector, such as the National Corn Growers Association.¹⁰⁴⁹ In addition, several firms decided to lobby in a stand-alone capacity in order to convey their message in as unfiltered a way as possible. Again, this highlights that, despite the importance of the banks, there was no mono-directional trajectory leading to the end-users' mobilization.

The end-users campaigned in favour of both an exemption from central clearing as well as a carve-out from the collateralization requirements for uncleared trades (both IM and VM). Most of their arguments applied to both dimensions, given the similar role played by margin

¹⁰⁴³ Bartlett quoted in Jones/Stern (2010).

¹⁰⁴⁴ Kind quoted in Jones/Stern (2010).

¹⁰⁴⁵ Pickel quoted in Bloomberg (2009).

¹⁰⁴⁶ Dennis (2009)

¹⁰⁴⁷ See for example Scheiber (2009, 2010b), Connor (2010).

¹⁰⁴⁸ See for example the denials reported in Hirsh (2009a) and Grim (2010).

¹⁰⁴⁹ See CEO Update (2014:4).

in either market. The thesis, however, focuses on their arguments regarding the margin waiver.

The end-users particularly resisted the second and third of Gensler's claims, i.e. his interpretation that the imposition of margin requirements would make the end-users contribute towards financial stability and lower systemic risk, and that it would save them money by improving transparency. In their view, Gensler had his arguments upside down. By using OTC derivatives, they were not contributing to systemic risk, but rather reducing it. Moreover, they claimed that given their financial strength, most of them did not actually have to post or pay for any margin. Any mandatory collateralization requirements would therefore not provide them with any savings, but would in fact cost them millions, if not billions of dollars, with drastic consequences for the already battered economy in terms of more job losses, higher costs for consumers, and foregone growth.

Detaching their business practices from those traditionally pursued by the banks, the Industrial Energy Consumers of America, the National Rural Electric Cooperatives Association, and Deere & Company, in separate statements, emphasized that their firms were 'not a broker or dealer',¹⁰⁵⁰ that their 'volumes are too small to manipulate the market',¹⁰⁵¹ and that they did 'not use derivatives as speculative investments, nor to bet on the ebbs and flows of different sectors of the economy'.¹⁰⁵² Cargill insisted that OTC derivatives' sole and only purpose involved allowing the end-user community 'to affordably and efficiently hedge their flour, heating oil, and chicken risks'.¹⁰⁵³ The firm therefore advised against regulation for 'OTC products that have not created systemic risk',¹⁰⁵⁴ and called upon Congress to show 'some recognition that the bakery hedge, for example, did not cause systemic risks for the financial system'.¹⁰⁵⁵

Regarding systemic risk, the end-users argued that not only had they not contributed towards its increase prior to the crisis, their prudent use of OTC derivatives for hedging purposes had actually reduced it. Chatham Financial forcefully made this point, declaring that '[t]he business end-users who use derivatives to hedge do not create systemic risk; rather they use derivatives to reduce their business risk, which in turn reduces systemic risk'.¹⁰⁵⁶ This argument was related to the principle of hedge accounting (already discussed in section IV-4.1 above), which the end-users argued provided for balance-sheet stability.¹⁰⁵⁷ They also emphasized that given their excellent credit ratings, most firms were

¹⁰⁵⁰ Glenn English of the National Rural Electric Cooperatives Association quoted in US House Agriculture Committee (2009b:10).

¹⁰⁵¹ Industrial Energy Consumers of America's Paul N. Cirio quoted in US House Agriculture Committee (2009a:197).

¹⁰⁵² Steven H. Holmes of Deere & Company quoted in US House Financial Services Committee (2009e:141).

¹⁰⁵³ Jon Hixson of Cargill quoted in US House Financial Services Committee (2009e:43).

¹⁰⁵⁴ David Dines of Cargill quoted in US Senate Agriculture Committee (2009a:38).

¹⁰⁵⁵ Jon Hixson, of Cargill quoted in US House Financial Services Committee (2009e:44).

¹⁰⁵⁶ David Hall of Chatham Financial quoted in US House Financial Services Committee (2009e:49).

¹⁰⁵⁷ See for example David Dines of Cargill quoted in US Senate Agriculture Committee (2009a:73) and Independent Petroleum Association of America quoted in US House Agriculture Committee (2009b:201).

in fact not posting any margin, and therefore also not paying for it. For example, Delta Airlines declared: 'We do not have to post initial margin'.¹⁰⁵⁸ Building on these arguments, the National Gas Supply Association urged Congress to abstain from reforms whose only purpose would consist in forcing end-users to channel 'capital to Wall Street'.¹⁰⁵⁹ Along similar lines, the American Public Gas Association concluded that margin requirements for end-users would in fact be equal to 'punishing the victim' of the crisis.¹⁰⁶⁰

Regarding Gensler's third claim, the end-users fundamentally rejected the idea of the banks in any way taking advantage of them through the pricing mechanism of OTC derivatives. In fact, many corporations considered themselves more than capable enough to request quotes, compare prices, and identify the best seller. Cargill, for example, insisted that 'financially strong food companies, industrial, commercials, and producers should have the flexibility to negotiate credit terms. [...] This system works very well'.¹⁰⁶¹ While the end-user community was very concerned about the liquidity drain a compulsory IM requirement would imply, it was the repercussions of VM that worried them most, given that VM has to be posted regularly in function of the development of market prices. The National Association of Corporate Treasurers warned that firms risked insolvency in case they weren't able to raise VM: 'If a corporate treasury is called to meet margin requirements and it doesn't, then it's in default. So we would have to hold credit to meet that potential margin call'.¹⁰⁶² Deere & Company also feared 'a liquidity event for firms that aren't able to access the capital markets and raise the margin'.¹⁰⁶³ 3M concluded that 'robust margin requirements would create substantial incremental liquidity and administrative burdens for commercial users, resulting in higher financing and operational costs'.¹⁰⁶⁴ The end-users therefore argued that they preferred paying fees, rather than importing this kind of volatility through the requirement of having to post VM.

The end-user community expected massive financial losses from a mandatory margin mandate, warning of the devastating effects this would have in 'the midst of a liquidity crisis',¹⁰⁶⁵ '[a]t a time when the U.S. economy needs more free-floating capital'.¹⁰⁶⁶ The

¹⁰⁵⁸ Richard Hirst of Delta Air Lines quoted in US House Agriculture Committee (2009b:39). See also David Schryver of the American Public Gas Association quoted in US House Agriculture Committee (2009b:13), Jeff Billings of the Municipal Gas Authority of Georgia on behalf of the American Public Gas Association quoted in US Senate Agriculture Committee (2009b:36), Paul N. Cirio of the Industrial Energy Consumers of America quoted in US House Agriculture Committee (2009a:197).

¹⁰⁵⁹ Natural Gas Supply Association and National Corn Growers Association (2010:2)

¹⁰⁶⁰ David Schryver of the American Public Gas Association, quoted in US House Agriculture Committee (2009b:28).

¹⁰⁶¹ William M. Hale of Cargill and the Grain and Oilseed Supply Chain North America and David Dines of Cargill quoted in US House Agriculture Committee (2009a:186).

¹⁰⁶² Thomas Deas of the National Association of Corporate Treasurers quoted in Hintze (2011a).

¹⁰⁶³ Steven H. Holmes of Deere & Company quoted in US House Financial Services Committee (2009e:60).

¹⁰⁶⁴ Timothy Murphy of 3M, quoted in US House Financial Services Committee (2009d:173), see also Murphy quoted in US House Agriculture Committee (2009b:151).

¹⁰⁶⁵ Letter by the Business Roundtable, the Grocery Manufacturers Association, the National Association of Manufacturers, and the US Chamber of Commerce as in US House Agriculture and Financial Services Committees (2009:59).

National Association of Corporate Treasurers, for instance, observed that in order to verify the legitimacy of margin calls, businesses would ‘have to replicate the same systems banks use’.¹⁰⁶⁷ The end-users provided staggering cost estimates, reaching from millions to billions of USD. At the firm level, Delta Airlines calculated ‘that it would cost us about \$300 million annually in liquidity’,¹⁰⁶⁸ and MillerCoors judged that the ‘proposal would tie up well over \$100 million a quarter’.¹⁰⁶⁹ Ford, the National Rural Electric Cooperatives Association and the American Public Gas Association put forward similar numbers.¹⁰⁷⁰ The Business Roundtable commissioned a study which concluded that ‘[a] 3% margin requirements, assuming no exemptions, would result in aggregate collateral of \$33.1 billion for non-financial, publicly traded BRT [Business Roundtable] companies. On average, this would be equal to \$269 million per firm [...] Extending the analysis to the S&P 500 companies, this note estimates that a 3% margin requirement on OTC derivatives could be expected to reduce capital spending by \$5 to \$6 billion per year’.¹⁰⁷¹ The Natural Gas Supply Association and the National Corn Growers Association identified an even larger funding gap that would cause ‘a staggering potential \$900 billion economic drain’.¹⁰⁷² The entire economy would feel the consequences in terms of higher prices for customers, and corporations shifting production, and job losses. In the words of 3M, ‘[t]his could result in slower job creation, lower capital expenditures, less R&D and/or higher costs to consumers’, thereby ‘discouraging hedging, and diverting scarce capital that could otherwise be used in further growing American businesses’.¹⁰⁷³

Ford, in turn, urged Congress to take into account that its own estimate of ‘a half-a-billion dollars of margin could be a very significant new product from the standpoint of our ability to stay competitive, not only domestically, but against foreign competition’.¹⁰⁷⁴ The American Public Gas Association, the National Rural Electric Cooperatives Association, MillerCoors, and the Independent Petroleum Association of America, among others, made similar statements.¹⁰⁷⁵ The Business Roundtable’s study projected ‘a loss of 100,000 to 120,000 jobs’,¹⁰⁷⁶ and the National Association of Corporate Treasurers predicted a mass exit of businesses, threatening Congress that if hedging ‘would no longer be economic, unfortunately the U.S.-based manufacturer might have to consider moving its production overseas to match its costs with its revenues’.¹⁰⁷⁷

¹⁰⁶⁶ Chesapeake (2009:140)

¹⁰⁶⁷ Thomas Deas of the National Association of Corporate Treasurers, quoted in Hintze (2011b).

¹⁰⁶⁸ Richard Hirst of Delta Air Lines quoted in US House Agriculture Committee (2009b:39).

¹⁰⁶⁹ Richard Crawford of MillerCoors, quoted in Fitzgerald (2010).

¹⁰⁷⁰ See US Senate Agriculture Committee (2009b:40), US House Financial Services Committee (2009e:62).

¹⁰⁷¹ Keybridge Research (2010:2).

¹⁰⁷² Natural Gas Supply Association and National Corn Growers Association (2010a:1 and footnote 2 of p.2 for an explanation of the methodology used to derive the estimate).

¹⁰⁷³ Timothy Murphy of 3M quoted in US House Financial Services Committees (2009d:173f.), see also Murphy quoted in US House Agriculture Committee (2009b:151).

¹⁰⁷⁴ Neil M. Schloss of Ford Motor Company, quoted in US Senate Agriculture Committee (2009b:40).

¹⁰⁷⁵ See for example US House Agriculture Committee (2009b:28,202), Fitzgerald (2010:2).

¹⁰⁷⁶ Keybridge Research (2010:2)

¹⁰⁷⁷ Thomas Deas of the National Association of Corporate Treasurers quoted in Kelly (2013).

2.3 Policy-makers' response to the two campaigns: Conflict in the Democratic Party and on Capitol Hill

2.3.1 Resistance against an end-user margin exemption among the Treasury and influential, often progressive Democrats

Many observers were surprised by Gensler's ability to conjure his political magic. Following his campaign, the Treasury and several progressive Democrats began making comments reflective of his advocacy, pulling many of the more moderate Democrats with them. Their statements appeared largely unimpressed with, if not sceptical of the information the end-users had advanced. Noam Scheiber argues that Gensler's strategy had been highly effective, mainly because of his unique ability 'of looking at himself through the eyes of an ordinary voter',¹⁰⁷⁸ which turned out 'uniquely effective at shaming public officials'.¹⁰⁷⁹ Scheiber also quotes a bank lobbyist according to whom Gensler's activism turned the CFTC 'into the most powerful agency in the federal government'.¹⁰⁸⁰

While Gensler's influence was certainly crucial, it is important to pause for a moment and acknowledge that beyond his activism, there were also other factors at play that increased the salience of the end-user question. For example, estimates suggested that the vague wording of Frank's draft legislation would have risked opening a gigantic loophole, potentially covering up to 80% of the OTC derivatives market, given its wide interpretation of 'hedging'.¹⁰⁸¹ In addition, one of Dodd's closest advisors, Julie Chon, began to learn about the perceived need to rein in derivatives through conversations with the BIS as well as other experts who advocated a tough response to the crisis. Inspired by these exchanges, she began guiding her boss in that direction.¹⁰⁸² Also, Senator Cantwell, among other left-leaning Democrats, 'made derivatives a personal interest' which she and her colleagues were not willing to give up easily.¹⁰⁸³

Nonetheless, Gensler's influence must not be underestimated. Not only did he firmly place the issue on the political agenda, but most of the subsequent debate, in one way or another, also centred on the arguments he had made on the issue. Regarding regulatory arbitrage (Gensler's first point), Barney Frank soon began reconsidering the discretionary language of his bill. The CFTC chair's campaign had inspired two particularly influential articles - one in the Boston Globe, the most important newspaper of Massachusetts (Barney

¹⁰⁷⁸ Scheiber (2012:345)

¹⁰⁷⁹ Scheiber (2012:353)

¹⁰⁸⁰ Bank lobbyist quoted in Scheiber (2009).

¹⁰⁸¹ Scheiber (2009), also Katz/Schmidt (2010).

¹⁰⁸² Kaiser (2013:913ff.)

¹⁰⁸³ Kaiser (2013:929ff.), Scheiber (2010c)

Frank's home state), and another in Newsweek, a weekly magazine with nationwide coverage - both of which caused furor in Washington, D.C.¹⁰⁸⁴ The first article accused Frank, who had previously been widely considered a 'hero to the left'¹⁰⁸⁵ for his past accomplishments in terms of progressive policy-making in favour of consumer and gay rights,¹⁰⁸⁶ of having sold the soul of the reform. The article cited an observer as saying 'he [i.e. Frank] has cut out the limbs and we're left with the torso'.¹⁰⁸⁷

In the second article, Michael Greenberger, a former senior official with the CFTC who had become an advocate on behalf of Americans for Financial Reform attacked Frank upfront: 'I don't think he [i.e. Frank] ever fully understood the legislation'.¹⁰⁸⁸ These articles incensed Frank, causing him to shift his position. In a letter to Gensler, he declared it was necessary to avoid a situation where 'clever financial firms will somehow scheme to get themselves under an exception to which they are not entitled'.¹⁰⁸⁹ In the upper chamber, Senator Tom Harkin (D-Iowa) also promoted comprehensive reform, warning that otherwise '[t]hese mathematical geniuses who create these things can find a way to turn anything into a customized swap. [...] You'd get a loophole big enough to drive a truck through. It could be worth trillions and trillions of swaps'.¹⁰⁹⁰ The Treasury, in turn, also started pushing for 'protections against evasion',¹⁰⁹¹ indicating that it would 'oppose all attempts to create loopholes or carve-outs that undermine the basic goals of transparency and comprehensive oversight'.¹⁰⁹²

Regarding the need for corporations to margin trades in order to contribute towards financial stability (Gensler's second point), Treasury Secretary Geithner declared that 'those products come with a lot of risk [...] And, therefore, it is important that there be [...] a comprehensive framework of oversight and authority over those instruments, as well'.¹⁰⁹³ Congressman Bill Foster (D-Illinois) equally argued 'you need to have that sort of margin requirement for both the customized and the non-customized things if you intend to use margining as the way of preventing future AIGs'.¹⁰⁹⁴ Chris Dodd, in turn, insisted that, '[t]here are trillions of dollars in play that would raise risks again'.¹⁰⁹⁵ He went on to explain that '[t]he problem of under-collateralization is especially apparent in bank transactions with non-financial firms and regulators should address this problem through the new

¹⁰⁸⁴ See Kranish/Wirzbicki (2009) in the Boston Globe, and Hirsh (2009a) in Newsweek.

¹⁰⁸⁵ Hirsh (2009a)

¹⁰⁸⁶ Hirsh (2009a), Bloomberg (2009)

¹⁰⁸⁷ John Taylor of the National Community Reinvestment Coalition quoted in Kranish/Wirzbicki (2009).

¹⁰⁸⁸ Greenberger quoted in Hirsh (2009a).

¹⁰⁸⁹ Frank (2009:1) in a letter to Gary Gensler and Mary Schapiro.

¹⁰⁹⁰ Harkin quoted in Morgenson/van Natta Jr. (2009), see also Harkin quoted in US Senate Agriculture Committee (2009c:14).

¹⁰⁹¹ Geithner quoted in US Senate Agriculture Committee (2009c:5).

¹⁰⁹² Deputy Secretary of the Treasury Neal Wolin quoted in Paletta (2010b), see also Geithner in US House Agriculture and Financial Services Committees (2009:10,13).

¹⁰⁹³ Geithner quoted in US House Agriculture and Financial Services Committees (2009:17).

¹⁰⁹⁴ Foster quoted in US House Financial Services Committee (2009d:46).

¹⁰⁹⁵ Dodd quoted in Paletta (2010a).

margin requirements for uncleared derivatives [...]’.¹⁰⁹⁶ Senators Diane Feinstein (D-CA), Maria Cantwell (D-WA), Byron Dorgan (D-N.D), and their Republican counterpart from Maine, Olympia Snowe (one of the few Republican supporters of a comprehensive approach), shared Dodd’s perspective, arguing that ‘an exemption would be a mistake. [...] The collapse or default of any major swaps dealing Wall Street bank would create a systemic failure [...]’.¹⁰⁹⁷

Finally, regarding the costs borne by the end-user community (Gensler’s third argument), the Treasury expected ‘greater price competition among dealers and improved prices for end users of derivatives’.¹⁰⁹⁸ Geithner warned of giving in to the rhetoric employed by the end-users: ‘Opponents have tried to convince the American people that these reforms will hurt Main Street [...]. Those arguments won’t work because they aren’t true’.¹⁰⁹⁹ In the Senate, Jon Tester equally rejected the claim that the end-users would actually ‘have to put money up front’.¹¹⁰⁰ Along similar lines, Feinstein and her colleagues stated that ‘[t]here is no free lunch. “End-users” currently pay significant fees to swap dealing Wall Street banks, but not margin payments. These fees serve as the major profit center in the derivative business’. Embracing Gensler’s position and opposing the estimates submitted by the end-users, they identified major cost savings for the end-user community ‘because trades, fees and derivative products would be transparent, [and] competition would likely reduce the costs to end users’.¹¹⁰¹

In the House, Collin Peterson equally voiced his scepticism, emphasizing that a mandatory requirement ‘is actually going to cost the big guys money and actually save the little guys money. [...] we are going to get an outcome that is going to benefit these little guys’. Most significantly, he also strongly dismissed the ‘exit’ argument the end-users had made. In his own words, ‘[...] this old saw that everybody is going to go to Europe if we get too tough, well, what we heard over there was the reason they didn’t regulate is they were told that if they got too tough, everybody is going to go to the U.S., and it was the same people that were telling both sides. So I mean this has been going on, and it is part of why we got into this trouble in the first place’.¹¹⁰²

2.3.2 The push for an exemption by the New Democrats as well as some leading Democratic Senators, and the missing language in Dodd-Frank

The Democratic Party, however, was not fully united by the idea of imposing mandatory margin requirements on end-user trades. In contrast to their progressive colleagues, the

¹⁰⁹⁶ US Congress (2010b:33)

¹⁰⁹⁷ Feinstein et al. (2010:1f.), see also Madigan (2010).

¹⁰⁹⁸ Geithner (2009d)

¹⁰⁹⁹ Geithner quoted in Hamburger (2010).

¹¹⁰⁰ Tester quoted in Grim (2010).

¹¹⁰¹ Both quotes taken from Feinstein et al. (2010:2).

¹¹⁰² Both quotes by Peterson as cited in US House Agriculture Committee (2009b:195).

New Democrats became strong supporters of the end-users' cause. Underscoring the importance of derivatives to the end-user community, they insisted that '[w]hether they are being used by a rural electric cooperative looking to hedge against spikes in energy inputs, an airline protecting itself from rising fuel costs, or a community bank guarding against interest rate fluctuations for loans, derivatives play an important role in reducing risk in our commercial sector, and keeping prices stable and low for consumers'.¹¹⁰³ At the individual level, congressmen Gregory Meeks (D-Florida) and Michael McMahon (D-NY) made strong statements in favour of an exemption: Meeks pushed his party 'to be reasonable and responsible' by exempting the 'end-users who pose no systemic risk and who do the right thing by hedging business risks they don't control'. Otherwise, 'this may lead to smaller firms doing more riskier things'.¹¹⁰⁴ McMahon, in turn, reminded his party of the responsibility to 'be sure that any new regulation is smart and rational regulation. We need to target any new rules to directly address the potential for systemic risk without needless imposing of regulations that could have unintended effects. Because derivatives are financial instruments that help all of us, they help keep our energy costs low and stable. They help insurance companies keep premiums low. They help companies complete construction projects on time and under budget. And despite the negative press and lack of understanding of the derivatives market, for the most part, the derivatives market works. We cannot throw the baby out with the bath water. We must work to protect the end-users, good American businesses that are just trying to manage their cash flows and hedge against uncertain risks beyond their control in a cost-effective manner'.¹¹⁰⁵ The New Democrats also intervened with the Administration in order to try and make them shift their position. Summarizing a meeting of several New Democrats with Geithner, Congressman James Himes (D-CT) confirmed: 'We got into the weeds on the derivatives bill'.¹¹⁰⁶

At the time, the New Democrats themselves did not occupy any influential positions that would have allowed them to directly influence legislation, but the size of their group accounting for 68 of the 256 Democratic seats in the House meant that the party's leadership could not ignore them, even more so considering that the Democrats overall majority consisted of no more than 38 seats, and that the Republicans almost unanimously opposed the Dodd-Frank reform efforts.¹¹⁰⁷ While Barney Frank had intended to 'sharpen' his bill following Gensler's campaign,¹¹⁰⁸ the ultimate House bill pointed in the opposite direction. The Wall Street Reform and Consumer Protection Act of 2009 introduced a clearing exemption for end-user transactions, while keeping the language regarding the 'permissive' exemption intact.¹¹⁰⁹ Frank initially seemed to believe he could navigate a course allowing him to simultaneously placate the end-users by relieving them from the

¹¹⁰³ New Democrat Coalition (2010:2)

¹¹⁰⁴ Meeks quoted in US House Financial Services Committee (2009e:26) and US House Agriculture and Financial Services Committees (2009:35)

¹¹⁰⁵ McMahon quoted in US House Financial Services Committee (2009e:6f.).

¹¹⁰⁶ Himes quoted in Bloomberg (2009).

¹¹⁰⁷ Bloomberg (2009)

¹¹⁰⁸ Jones/Stern (2010) quoting Frank, also Kaiser (2013:712).

¹¹⁰⁹ See US Congress (2009d:603f.,634ff.).

clearing requirement, while also responding to Gensler's campaign by introducing firm requirements for trades remaining in the bilateral, and thus riskier, marketplace. However, in the end, the discretionary margin language survived, probably as the result of a horse trade through which Frank secured the New Democrats' approval of the Consumer Financial Protection Agency.¹¹¹⁰ This new agency represented one of the other highly contested provisions of Dodd-Frank. Over time, it had become a cause close to the heart of the Democratic leadership.¹¹¹¹ According to this interpretation, the desire to conserve the establishment of the new agency in the bill might have trumped concerns over strengthening the language of the end-user margin requirements.

In the Senate, Dodd's staff initially considered the House bill too weak.¹¹¹² However, the final version of the Senate bill, S.3217 – Restoring American Financial Stability Act of 2010, hardly differed. It equally contained the clearing exemption and retained the discretionary language regarding margining.¹¹¹³ The main reason for leaving it untouched appears to have been resistance against burdensome end-user rules by the chair of the Senate Agriculture committee, Blanche Lincoln (D-AK). '[V]ery sympathetic' to the end users' cause, Lincoln had taken on board their arguments early in the process, citing her awareness of 'the importance of cash flow and working capital to businesses' and the need for the new rules to 'be surgical'.¹¹¹⁴ Up for re-election during the critical stage of debate on Dodd-Frank, she faced strong competition, first for her nomination as the Democratic candidate, and then from her Republican challenger,¹¹¹⁵ which strengthened her resolution to be tough on the banks, but reject any policies that could potentially be interpreted as detrimental to employment, investment, and growth in her home state.¹¹¹⁶

In addition to these immediate re-election concerns, Lincoln also appeared eager to work with her Republican colleagues to continue the bipartisan spirit that traditionally distinguishes the Agriculture Committee from most other committees, given its overall preoccupation with defending public support for farmers against various attempts by other committees to appropriate those funds differently. For this reason, she seemed more willing to listen to the concerns the Republicans harboured against burdensome rules, at the cost of alienating herself from the rest of Democratic Party's leadership.¹¹¹⁷ The Treasury tried to intervene, but ultimately could not convince her to change her

¹¹¹⁰ Support for the need Frank attributed to pleasing the New Democrats is provided by Scheiber (2009) and Vekshin/Kopecki (2009).

¹¹¹¹ Kaiser (2013)

¹¹¹² See for example Kaiser (2013:919).

¹¹¹³ See US Congress (2010a:532, 571ff.).

¹¹¹⁴ Lincoln quoted in Reuters (2010b) (first and third quote) and US Senate Agriculture Committee (2009b:2).

¹¹¹⁵ Catanese (2010)

¹¹¹⁶ See also Risk (2015), Cameron (2010b). Lincoln famously demonstrated her resolution to reign in the banks by developing the 'push-out' provision which forced banks to push out certain swaps into separate affiliates so that they would no longer be part of the business of FDIC-insured entities (see Cameron (2010b), Quinlivan (2014), Clarke et al. (2014), and Risk (2015)).

¹¹¹⁷ The overall reasoning of these accounts is confirmed by Kaiser (2013:920ff.).

position.¹¹¹⁸ Lincoln wrote a letter to her colleagues Feinstein, Cantwell, Dorgan, and Snowe who had resisted an end user exemption, arguing that '[c]ommercial entities, as opposed to financial firms, have strong arguments regarding regulatory costs and their impact on keeping jobs in the United States'. Her letter also emphasized the need to 'ensur[e] that tough regulations on Wall Street don't cost us jobs on Main Street.'¹¹¹⁹ Opposition to bringing the end users under the legislative umbrella was also voiced by Senator Debbie Stabenow (D-Michigan) who called upon her colleagues not to unnecessarily burden the end-users, as 'the ability to provide financial certainty to companies' balance sheets is absolutely critical for them and for us in terms of jobs and so on'.¹¹²⁰

Most of the Republicans in both chambers firmly embraced the end-users' point of view and showed themselves utterly convinced by the information they had received. The GOP's opposition added to the high degree of public issue salience surrounding the end-user question. For Senator Richard Lugar (R-Indiana), the end user argument that 'this might affect job production, that we are going to have margin instead of jobs, [...] makes it a very acute political problem'.¹¹²¹ His colleagues Saxby Chambliss (R-Georgia) Jim Bunning (R-Ky), and David Vitter (R-La), joined by their Democratic colleague from Colorado, Michael Bennet approvingly cited the cost estimate submitted by the Natural Gas Supply Association and the National Corn Growers Association, claiming that the reform 'would force companies to set aside \$900 billion in capital that would otherwise be used to build factories, hire workers, and fund research and development.'¹¹²² In the House, Congressmen Frank D. Lucas (R-Oklahoma) and Bill Cassidy (R-Louisiana) warned of 'overreach'¹¹²³ and 'pass[ing] on higher costs to consumers from entities which are really not out there to disrupt the market [...]'.¹¹²⁴ Their statements were representative of the Republican position on the issue.

The final version of the Dodd-Frank Act, as reported by the joint (House and Senate) Conference Committee on 29 June 2010 and signed into law by President Barack Obama on 21 July 2010 then came as a surprise. As expected, it contained the clearing exemption, but any mention of margin requirements for end-users had disappeared, i.e. the collateralization of end-user trades was neither imposed nor excluded. As to the reasons for this omission, there are several competing hypotheses. The press has cited an anonymous Congressional staffer who simply considered it the result of 'an oversight' related to the fact that the conference committee deliberated the final version of the bill until long after midnight.¹¹²⁵ Alternatively, other observers have argued the margin exemption was considered redundant. According to this second interpretation, the regulators were

¹¹¹⁸ See the detailed account of events provided by Kaiser (2013:924ff.) and in Risk (2015).

¹¹¹⁹ Both quotes taken from Lincoln (2010:2).

¹¹²⁰ Stabenow quoted in US Senate Agriculture Committee (2009b:12).

¹¹²¹ Lugar quoted in US Senate Agriculture Committee (2009c:24).

¹¹²² See US Congress (2010b:240).

¹¹²³ Lucas quoted in US House Agriculture and Financial Services Committees Hearings (2009:4).

¹¹²⁴ Cassidy quoted in US House Agriculture and Financial Services Committees Hearing (2009:44).

¹¹²⁵ Anonymous congressional staffer quoted in Cameron (2010c).

supposed to know of the implied existence of an end-user waiver in the Act and to act accordingly, even more so given the clearing exemption. For example, a letter drafted by Dodd and Lincoln shortly after the adoption of the Act (later known as the Dodd-Lincoln letter) explicitly confirmed that ‘a number of provisions were deleted by the Conference Committee to avoid redundancy and to streamline the regulatory framework’.¹¹²⁶ A third hypothesis implies the opposite. It postulates that in line with Gensler’s campaign, one or several critics of a carve-out intentionally dropped the language in order to ensure the end-users were covered by the margin rules. *The Wall Street Journal*, for example, reports that it was Frank who deleted the respective passages, with his ‘gambit’ initially going unnoticed.¹¹²⁷

A consistently shared interpretation suggests the work on Title VII began past 12.30am, with a constant stream of pages and proposed changes coming in, to the extent that few individuals, if any, might be in a position to accurately reconstruct the entire timeline of events. Around 6am, the missing language began to raise broader attention, but there was no time to immediately discuss the issue on site. The G20 summit in Toronto during which the Administration intended to demonstrate strong US leadership was imminent, and any delay in enacting Dodd-Frank might have been interpreted as a sign of US weakness. A few days after the conference, Senator Chambliss offered an amendment to get the exemption back into the text, but with the exception of the Republicans and Senator Lincoln, all Democrats voted against it, and the Democratic House leadership subsequently refused to re-open the debate on the issue.¹¹²⁸ Dodd, in turn, suggested rectifying the situation through future legislation, if need were to arise.¹¹²⁹

Against this background, the Dodd-Lincoln letter ‘seeks to provide some additional background on legislative intent’.¹¹³⁰ The proponents of an end-user exemption would go on to cite it as evidence supporting their cause, which eventually contributed to the myth of Dodd-Frank actually containing a margin waiver for non-financial firms. For example, in 2011, Senators Debbie Stabenow and Tim Johnson (D-SD) together with Congressman Frank Lucas sent a letter to the Treasury and the regulators in which they expressed ‘support for the comments expressed in the [...] letter from former Senators Christopher Dodd and Blanche Lincoln’, calling on regulators to ‘exempt end-users from margin requirements’.¹¹³¹

However, there is reason to believe that the Dodd-Lincoln letter was in fact worded much more ambiguously than its proponents implied. On the one hand, it clearly stated that ‘[t]he legislation does not authorize the regulators to *impose* margin on end-users’ and that ‘[j]ust

¹¹²⁶ Dodd/Lincoln (2010:167)

¹¹²⁷ Wall Street Journal (2010)

¹¹²⁸ Indiviglio (2010)

¹¹²⁹ Cameron (2010a)

¹¹³⁰ Dodd/Lincoln (2010:167)

¹¹³¹ Both quotes taken from Stabenow et al. (2011:1). Stabenow and Lucas had become the new chairmen of the Senate and House Agriculture committees respectively. Several Senators from both parties under the leadership of Mike Johanns (R-Neb.) sent a similar letter (see Johanns et al. 2011).

as Congress has heard the end-user community, regulators must carefully take into consideration the impact of regulation and capital and margin on these entities'. However, on the other, it also emphasized that '[i]n cases where a Swap Dealer enters into an uncleared swap with an end-user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction'.¹¹³² As a result, the letter did actually *not* prohibit the regulators from approving a system in which the dealers, without being formally required to do so, would either explicitly request, or implicitly include margin requirements for end-user trades, i.e. it did not speak against a continuation of the status quo.

Barney Frank indirectly backed this interpretation by saying that '[w]e do differentiate between end users and others. The marginal [*sic*] requirements are not on end users. They are only on the financial [*sic*] and major swap participants. And they are permissive. They are not mandatory, and they are going to be done, I think, with an appropriate touch'.¹¹³³ Collin Peterson made a similar comment, following the same line of reasoning: 'Nowhere in this section do we give regulators any authority to *impose* capital and margin requirements on end users'. 'What is going on here is that the Wall Street firms want to get out of the margin requirements, and they are playing on the fears of the end-users in order to obtain an exemption for themselves'.¹¹³⁴

2.4 The end-user exemption 2.0: Getting the carve-out formalized and winning the end-user debate

2.4.1 Public issue salience reaching new heights

With both the CFTC and the PRs proposing rules that lacked a definite end-user exemption, it was clear that the debate would continue. The CFTC suggested that banks and end-users 'would be free to set initial margin and variation margin requirements in their discretion and any thresholds agreed upon by the parties would be permitted'.¹¹³⁵ It also asked banks to calculate hypothetical margin amounts for OTC trades with their end-user clients.¹¹³⁶ In a similar way, the PRs' first proposal stated that as long as end-users' exposure remained beneath the threshold decided by their banks, no margin would need to be posted. The PRs justified this approach as being 'consistent with current market practices with respect to nonfinancial end users, in which derivatives dealers view the question of whether and to what extent to require margin from their counterparties as a credit decision'.¹¹³⁷ The CFTC

¹¹³² Dodd/Lincoln (2010:167 emphasis added,168,167)

¹¹³³ Frank quoted in US Congress (2010c).

¹¹³⁴ Peterson quoted in Reuters (2010a, emphasis in the first quoted added).

¹¹³⁵ CFTC (2011b:23736)

¹¹³⁶ CFTC (2011b:23737)

¹¹³⁷ PRs (2011:27569f.)

felt it did not have the authority to explicitly impose margin requirements on the end-users, but tried using its manoeuvring room as much as possible. In contrast, the Fed believed it lacked the authority to not introduce any requirement, and therefore proposed as little as possible. The second proposals of the agencies did not differ substantially from the first ones.¹¹³⁸

The end-users adamantly rejected this approach, interpreting the lack of an exemption as synonymous with the imposition of margin requirements, which they claimed was in conflict with the Dodd-Lincoln letter and the overall spirit of Dodd-Frank. For example, Boeing, Caterpillar, Daimler, John Deere, Ford, American Honda, Hyundai, Nissan, Toyota, and Volvo in a joint submission referred to the letter as explaining that Dodd-Frank 'did not extend that authority to imposing margin requirements on commercial endusers. The Congressional intent is clear on this point'.¹¹³⁹ The Coalition for Derivatives End Users equally claimed that the letter 'states unequivocally that [regulators do] not have the authority to create this type of regime'.¹¹⁴⁰ ISDA joined the choir, arguing that 'Senators Lincoln and Dodd specifically addressed Congressional intent regarding the treatment of end-users [...]'.¹¹⁴¹ The National Grain and Feed Association's submission summed up the end-users' demand that the regulators 'state clearly and definitely that all non-financial end-users are exempt'.¹¹⁴²

The end-users appeared to fear that once the dust of the debate on Dodd-Frank would settle, the regulators, in particular Gary Gensler at the CFTC, would sharpen the rules by imposing mandatory margin requirements, essentially turning the 'hypothetical' margin calculations into 'real' ones. Indeed, as noted by an observer, the CFTC rules 'raised a ruckus among derivatives end users, which see the language as a back-door attempt to impose margin requirements on them [...]'.¹¹⁴³ CFTC commissioner Scott O'Malia (who after the end of his tenure at the agency would continue his career as CEO of ISDA) in turn poured oil on the fire by insisting that the PRs' rules 'will require that end-users pay initial and variation margin to banks'.¹¹⁴⁴ The end-users worried that one-day, the PRs could invoke their supervisory authority to oblige the banks to tighten their margining practices vis-à-vis their end-user clients, a situation that the National Association of Corporate Treasurers characterized as 'having the sword of Damocles hanging over you'.¹¹⁴⁵ JP Morgan confirmed the end-users' fears by claiming that 'the draft rules raise the specter of margin requirements applying to the hedging activities of thousands of Main Street companies'.¹¹⁴⁶

¹¹³⁸ CFTC (2014:59906f.), PRs (2014:57538)

¹¹³⁹ Boeing et al. (2011:5)

¹¹⁴⁰ Coalition for Derivatives End Users (2011:39)

¹¹⁴¹ ISDA/SIFMA (2011:7)

¹¹⁴² National Grain and Feed Association (2011:2)

¹¹⁴³ Hintze (2012)

¹¹⁴⁴ O'Malia (2011)

¹¹⁴⁵ Thomas Deas of the National Association of Corporate Treasurers, quoted in McGrane (2011), for a similar statement see Luke Zubrod of Chatham Financial, quoted in Hintze (2011c).

¹¹⁴⁶ Barry Zubrow of JP Morgan quoted in US House Financial Services Committee (2011b:237).

The end-users' ultimate objective therefore consisted of securing an explicit *prohibition* of margin requirements for their businesses through a legally codified carve-out. Their activism propelled the issue salience of the margining exemption to new heights. Representatives from the Coalition for Derivatives End Users, the National Council of Farmer Cooperatives, American Public Power Association, the National Rural Electric Cooperatives Association, and the National Association of Corporate Treasurers, among others, continued to forcefully plead their cause on Capitol Hill, using the same arguments they had advanced prior to the passage of Dodd-Frank.¹¹⁴⁷ NGOs and individual scholars whose voices, compared to the end-users, had so far been more in the background of the public debate, now also began making more forceful arguments. In particular, they criticized the end-users' estimates of the macroeconomic costs of mandatory margin requirements as dramatically exaggerated and based on the inaccurate assumption that the non-margining of OTC deals did not incur any extra cost.¹¹⁴⁸ Some of these critics also argued that in order to protect their businesses, the end-users should take out 'classical' loans, rather than functionally equivalent derivatives that were up to 10 times as lucrative for the banks.¹¹⁴⁹ However, the end-user community swiftly and effectively countered these claims, relying on the same canon of arguments they had been making since the beginning of the debate.¹¹⁵⁰

Called to testify to Congress, Gensler used slightly more conciliatory language than earlier in the process,¹¹⁵¹ but defended the manoeuvring room Dodd-Frank had provided the CFTC. He argued that the agency had 'the authority *not to impose*' end-user margin requirements, while the PRs de facto had the possibility to do so under supervisory guidance. Under the proposed rules, he explained, '[d]ealers would have the same authorities they would have today to do that [i.e. request margin] by individual negotiation, depending upon end users' balance sheet [...]'.¹¹⁵² In line with the end-users' position, the House Agriculture Committee's new Republican chair, Frank Lucas, interpreted Gensler's approach in the

¹¹⁴⁷ See for example Coalition for Derivative End Users in US House Financial Services Committee (2011a:52, 310f.,370; 2012:44f.,176f.), National Council of Farmer Cooperatives in US House Agriculture Committee (2011a:38; 2012:78f.), separate statements by American Public Power Association, Electric Power Supply Association, and National Rural Electric Cooperatives Association in US House Agriculture Committee (2011b:161ff.,194; 2011e:30f.), National Association of Corporate Treasurers in US House Agriculture Committee (2011d:48,104f.) US Senate Banking Committee (2011b:27,53; 2011c:113f.), and US House Financial Services Committee (2014:15f.,31,45,92ff.), Honeywell International in House Agriculture Committee (2013a:110) and US Senate Agriculture Committee (2014:38f.), and American Petroleum Institute in US Senate Agriculture Committee (2014:180).

¹¹⁴⁸ See for example Americans for Financial Reform quoted in US House Agriculture Committee (2013a:97), Sorkin (2011), Greenberger quoted in US Senate Agriculture Committee (2011a:31), Parsons quoted in US House Financial Services Committee (2012:53f.,145ff.) and Mello/Parsons (2013).

¹¹⁴⁹ See Turbeville (2013).

¹¹⁵⁰ See in particular Chatham (2011).

¹¹⁵¹ See Gensler quoted in US House Financial Services Committee (2011a:13f.), also Gensler quoted in Senate Banking Committee (2011a:62) and his statement in US House Agriculture Committee (2011a:32).

¹¹⁵² Both quotes taken from Gensler cited in US House Agriculture Committee (2011a:36; emphasis in first quote added).

sense that ‘yes, you [i.e. Gensler] believe the Commission could in the future under the rule’ proceed to imposing end-user margining rules.¹¹⁵³

The PRs, which in the early stages of the legislative process had kept a rather low profile on the end-user question, decided to employ appeasing language, with Fed Chair Ben Bernanke explaining ‘that nonfinancial end users benefit and that the economy benefits from the use of derivatives’.¹¹⁵⁴ Along similar lines, Tarullo emphasized the ‘relatively low systemic risk posed by most end users’.¹¹⁵⁵ Tarullo also confirmed that the lack of an explicit exemption in Dodd-Frank had obliged the PRs to introduce margin rules for corporate firms in some form, and that they had done so in the least intrusive way through the ‘thresholds’ approach. Dodd-Frank ‘applies broadly and there is obviously no exception provided for any class of counterparties’, he explained.¹¹⁵⁶ The Fed itself felt ‘very comfortable with [its] proposal’,¹¹⁵⁷ arguing that no legislative change was needed. Tarullo, however, confirmed the end-users’ fears by informing Congress that the Fed ‘ha[d] a general safety and soundness authority, and when we see things that are being done in an unsafe or unsound fashion, we can seek a change in that’, although he was quick to add that with respect to the end-user question, he did not see any need to proceed in that direction.¹¹⁵⁸

2.4.2 Getting the end-user exemption codified

While the regulators themselves felt satisfied with their approach, the Republicans began pushing for legislation accommodating the end-users’ wish to prohibit margin requirements. At this point, the public issue salience surrounding the end-user question reached new heights. The end-users kept hammering Congress, and the topic became one of the flagship initiatives, if not the point of the spear of Republican activism directed at repealing Dodd-Frank.¹¹⁵⁹ While the GOP had been in a minority position before 2010 and thus unable to block Dodd-Frank, it regained the majority in the House in the 2010 mid-term elections, missing the Senate majority by only a few seats. Exemplary of its criticism were the statements by Frank Lucas who insisted that the proposed margin rules were ‘clearly inconsistent with Congressional intent’,¹¹⁶⁰ by Scott Garrett who worried that they

¹¹⁵³ Lucas quoted in US House Agriculture Committee (2011e:26).

¹¹⁵⁴ Bernanke quoted in US Senate Banking Committee (2012b:10).

¹¹⁵⁵ Tarullo quoted in US House Financial Services Committee (2011a:13, also 328), see also his statement in US Senate Banking Committee (2011d:113f.), and Michael S. Gibson, director of the Fed’s Division of Banking Supervision and Regulation quoted in US Senate Agriculture Committee (2011b:6f.,13).

¹¹⁵⁶ Tarullo quoted in US House Financial Services Committee (2011a:14). For a very similar statement by Bernanke, see Reuters (2012).

¹¹⁵⁷ Bernanke quoted in US Senate Banking Committee (2012b:10) and Tarullo quoted in US Senate Banking Committee (2013:23).

¹¹⁵⁸ Tarullo quoted in US Senate Banking Committee (2013:23).

¹¹⁵⁹ For a broader overview see Pagliari (2018:141f.).

¹¹⁶⁰ Lucas quoted in US House Agriculture Committee (2011a:2), see also his statement in US House Agriculture Committee (2013a:1f.).

were ‘harming the functioning of a mature market’,¹¹⁶¹ and by Jeb Hensarling who claimed that ‘[t]hanks to the “end user” margin requirements imposed by Dodd-Frank, Main Street businesses and farmers across America face higher costs in managing their risk and producing their products, costs which are passed through to their customers and felt directly by every American at the kitchen table’.¹¹⁶²

In line with their overall rejection of Dodd-Frank which they felt originated from ‘a false premise that somehow deregulation or lack of regulation led us into the crisis’,¹¹⁶³ the Republicans believed the text should not be considered as ‘chiseled in stone; nobody brought it down to us from Mount Sinai’.¹¹⁶⁴ They therefore began pursuing what Frank characterized as ‘a death through a thousand cuts’ approach.¹¹⁶⁵ Indeed, the House Republicans launched a barrage of bills (more than two dozen in 2011 alone) all of which aimed at revoking key provisions of the Act.¹¹⁶⁶ The Business Risk Mitigation and Price Stabilization of 2011 (H.R. 2682), which passed the House on 26 March 2012, after having been first introduced on 28 July 2011, explicitly exempted end-users from margin requirements.¹¹⁶⁷ It passed the House again as H.R. 634 in 2013, both times with the support of the New Democrats, as well as other House Democrats who may have felt they could no longer defy the end-users’ pressure any more.

In the Senate, Republican sentiment was similar. Saxby Chambliss, for example, rejected Dodd-Frank as ‘overly burdensome’ and ‘a law that potentially regulates American businesses as if they were all large risky financial institutions’.¹¹⁶⁸ Thad Cochran (R-Miss.) felt the need to ‘ensure that the proposed regulations will not hinder the country’s desperate need for economic growth and job creation’.¹¹⁶⁹ The Senate Democrats, however, kept the door shut for several years, resisting any debate on a potential softening of the rules. Particularly vocal was Elizabeth Warren (D-Mass., first elected in 2012) who fought tooth and nail against any attempt at weakening Dodd-Frank whose passage she considered a modern-day example of ‘David can beat Goliath’.¹¹⁷⁰ The Administration equally refused to support any bill that would provide an explicit end-user exception, with Geithner declaring that ‘[w]e can’t allow loopholes, gaps, and weaknesses to take hold and undermine the fundamental strength of our reforms’.¹¹⁷¹

¹¹⁶¹ Garrett quoted in US House Financial Services Committee (2011c:2).

¹¹⁶² Hensarling (2014)

¹¹⁶³ Hensarling quoted in US House Financial Services Committee (2014:1).

¹¹⁶⁴ Hensarling (2015)

¹¹⁶⁵ Frank quoted in Rivlin (2011).

¹¹⁶⁶ See Baram (2011).

¹¹⁶⁷ See US House Financial Services Committee (2011d).

¹¹⁶⁸ Chambliss quoted in US Senate Agriculture Committee (2014:50 and 2011a:47; emphasis in the second quote in the original).

¹¹⁶⁹ Cochran quoted in US Senate Agriculture Committee (2011a:51).

¹¹⁷⁰ Warren quoted in Crowe (2015).

¹¹⁷¹ Geithner (2011)

Yet after several years, with the memories of the crisis beginning to fade away, the consensus among the Senate Democrats against breaking up Dodd-Frank weakened, and the Republican attempts to exempt the end-users attracted more and more Democratic support.¹¹⁷² However, final legislation providing full end-user relief from the margin requirements did not pass the Senate before being attached to a ‘must pass’ bill, i.e. a bill of such high relevance to the Democrats that it could not be held back over political struggles. The bill in question was the Renewal of the Terrorism Risk Insurance Act (known as TRIA) signed into law by President Obama on 12 January 2015.¹¹⁷³ TRIA, originally enacted following 9/11 to provide federal support to insurance firms selling terrorism protection, had expired at the end of 2014, meaning large parts of the economy including the construction and transportation sectors faced the cancellation of their insurance plans at the beginning of 2015.¹¹⁷⁴ The Republicans had shown only lukewarm support, if not outright resistance, towards extending this kind of federal intervention,¹¹⁷⁵ but to many Democrats it turned out an important provision. Chuck Schumer, the Democratic senior Senator from New York, who was among the strongest supporters of the bill, eventually struck a deal with Representative Jeb Hensarling, and the Democrats secured the reauthorization in exchange for agreeing to the end-user exemption.¹¹⁷⁶ Warren offered an amendment to strip the end-user provision from the renewal of TRIA, but failed to mobilize the necessary votes.¹¹⁷⁷ With the passage of the reauthorization of TRIA, the commercial end-users became explicitly and unequivocally exempt from the rules.

3. The EU case

3.1 The bank/end-users alliance

Compared to the US case, the banks in Europe exercised considerably less restraint in voicing their open support for an end-user exemption, even during public testimonies. In a 2010 hearing, for example, a Deutsche Bank official said: ‘OTC Derivatives provide

¹¹⁷² The Republican attempt included S. 947 - A bill to provide end user exemptions from certain provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934, and for other purposes (introduced in 2011, see <https://www.congress.gov/bill/112th-congress/senate-bill/947>), S. 3480 - A bill to provide end user exemptions from certain provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934 (introduced in 2012, see <https://www.congress.gov/bill/112th-congress/senate-bill/3480>) and S.888 - A bill to provide end user exemptions from certain provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934 (introduced in 2013, see <https://www.congress.gov/bill/113th-congress/senate-bill/888> ; all links accessed 20 January 2018.).

¹¹⁷³ See Title III – Business Risk Mitigation and Price Stabilization (US Congress 2015).

¹¹⁷⁴ Weisman (2015)

¹¹⁷⁵ See Mimms/House (2014).

¹¹⁷⁶ Sistrunk (2015)

¹¹⁷⁷ Vinik (2015)

corporations with efficient risk transfer mechanisms to protect their downside, and give them a sound financial footing from which to invest and grow. [...] Non-financial corporations do not generally post collateral at all on their OTC trades today and any requirement to force them to clear their trades, or exchange collateral on a bilateral basis, would be a major issue for them. It would also provide an incentive to not hedge their risks, leaving them more vulnerable to market volatility and potentially increasing risk in the real economy'.¹¹⁷⁸ At the early stages of the policy-making process, the crisis was still widely interpreted as a problem caused by American, rather than EU banks. European banks were therefore subject to less intense levels of public scrutiny, at least initially, which afforded them with more manoeuvring room during the consultation process. Some of the end-users may have believed the intensity of bank lobbying could in fact risk undermining corporate firms' credibility with policy-makers.

Despite the progress the American end-users had achieved, commenters in Europe rarely publicly referenced the US solution as a model for the EU, since both financial and non-financial businesses felt that EU policy-makers would not appreciate an invitation to draw inspiration from the very country whose failure to properly monitor its financial system had precipitated the crisis. The uncertainty surrounding the missing language in Dodd-Frank further decreased the attractiveness of such an approach. Nevertheless, at the conceptual level, the bank/end-user-coalition advanced nearly identical arguments, i.e. that end-user deals had not caused the crisis because they did not contribute to systemic risk, and that any collateralization requirements would represent an immense liquidity drain hurting the broader European economy.

Regarding the first claim, German energy giant RWE insisted that the 'activities of energy trading firms in the financial markets have neither in the past created any systemic risk nor is there any reason to believe that they will in future'.¹¹⁷⁹ The European Federation of Energy Traders in turn blamed the crisis on 'bubbles in the real estate and financial markets as well as highly complex securities', all of which it considered far removed from end-users' day-to-day business.¹¹⁸⁰ Siemens explained the source of all problems 'originates from the financial sector'.¹¹⁸¹ Along similar lines, the Federation of German Industries (Bund Deutscher Industrie) wrote that '[i]ndustrial companies do not use derivatives for speculative reasons, but for reasons of risk reduction in combination with an existing or planned underlying operative transaction'.¹¹⁸² The submissions of many other end-user firms contained a similar message.¹¹⁸³ 'It follows therefore', the European Association of

¹¹⁷⁸ Jon Eilbeck of Deutsche Bank, see Eilbeck (2010).

¹¹⁷⁹ RWE (2010:2)

¹¹⁸⁰ European Federation of Energy Traders (2010:2)

¹¹⁸¹ Siemens (2009:2)

¹¹⁸² BDI (2010:2)

¹¹⁸³ E.g. Verbund Austrian Power Trading (2010:2f.), E.ON (2010:2ff.), Association of Corporate Treasurers in Belgium (2010:3ff.), Association of Corporate Treasurers (2009:4ff.), Shell (2010:7ff.), Deutsche Telekom (2009:1ff.), German Association of Energy and Water Industries (2010:4ff.), Deutsche Post-DHL (2009:2ff.), Statoil (2010:2ff.).

Corporate Treasurers concluded, ‘that the non-financial sector should so far as possible not be exposed to the adverse consequences summarised above from an initiative that is appropriate for the financial sector only’.¹¹⁸⁴

The banks sustained this perspective. Société Générale declared that end-user margin ‘will not make the financial system stronger and/or safer’¹¹⁸⁵ and HSBC considered it ‘unlikely’ that corporate end-users would ever ‘cause systemic risk’.¹¹⁸⁶ Deutsche Bank argued that regulatory intervention ‘makes sense for systemically risky financial institutions’ only.¹¹⁸⁷ Similarly, ISDA co-authored a letter with the Association of Financial Markets in Europe (AFME) and the British Bankers Association in which it maintained that ‘increased margin and operational requirements would be too burdensome and the reduction in systemic risk is insufficient to justify the imposition of these costs on the economy as a whole’.¹¹⁸⁸

Sanofi pointed to the negative repercussions a mandatory margin regime would have for the credit rating of end-user firms, given that some rating agencies would likely count collateral towards gross debt, rather than cash reserves.¹¹⁸⁹ The Association of European Airlines branded mandatory ‘collateralization [...] a risk accelerator. Harmless and limited counterparty risk is replaced by dangerous and unlimited liquidity risk’.¹¹⁹⁰ Siemens alerted EU policy-makers to the risk that ‘[t]he demand for additional cash to meet a margin call could be a crucial event triggering collapse of the company’.¹¹⁹¹ Lufthansa claimed that on these grounds ‘[i]t is good that one third of overall credit exposures remain uncollateralized. It should be even more’.¹¹⁹² BASF predicted the required operational updates necessary to manage margin requirements ‘would cause unreasonably high costs’.¹¹⁹³ Warning that firms would be left with the choice between a rock and a hard place, Rolls Royce argued firms would either discontinue their hedging strategies or spend precious resources on the collateralization of their trades. Either option would ‘impair economic growth’ and ‘hamper investment in R&D’.¹¹⁹⁴ Energy provider E.ON put it in very simple terms: ‘More cash has to be allocated for [margin] at the expense of investments in the real energy business’.¹¹⁹⁵ EDF Energy added that ‘[t]hese costs will ultimately be passed on to other firms and consumers’.¹¹⁹⁶ German market leaders E.ON, Siemens, and MAN submitted estimates of the aggregate cost of mandatory margin requirements for their firms of EUR 10bn, 4bn, and

¹¹⁸⁴ European Association of Corporate Treasurers (2009:2)

¹¹⁸⁵ Société Générale (2010:5)

¹¹⁸⁶ HSBC (2010:1), see also French Banking Federation/Association Française des Marchés Financiers (2010:5).

¹¹⁸⁷ Jon Eilbeck of Deutsche Bank in Eilbeck (2010:1).

¹¹⁸⁸ ISDA et al. (2010:7)

¹¹⁸⁹ Sanofi (2012:2), see also European Association of Corporate Treasurers (2010:3).

¹¹⁹⁰ Association of European Airlines (2010:2)

¹¹⁹¹ Siemens (2009:5), see also BDI (2009:2).

¹¹⁹² Lufthansa (2009:7)

¹¹⁹³ BASF (2009:2), see also NationalGrid (2009:2), Deutsche Post-DHL (2009:3), Linde (2009:2), Association of Italian Corporate Treasurers (2010:2).

¹¹⁹⁴ Rolls Royce (2010:2), see also Daimler (2009:3).

¹¹⁹⁵ E.ON (2012:3)

¹¹⁹⁶ EDF (2012:3), see also Scottish and Southern Energy (2010:2) and BP (2010:2f.).

2bn respectively.¹¹⁹⁷ Along similar lines, the European Association of Corporate Treasurers reported warnings of some firms that the ‘cash needs could reach 100% and more of their market capitalization’.¹¹⁹⁸

The banks again reinforced these claims. The German Banking Association, for instance, communicated to policy-makers the ‘growing concerns amongst German treasurers in the non-financial sector’ about mandatory collateralization requirements which ‘would impair their ability to hedge their risk position effectively and at existing cost levels’.¹¹⁹⁹ Similarly, ISDA and the European Banking Federation in separate submissions warned of ‘the liquidity squeeze’ and ‘working capital issues’ end-users would face.¹²⁰⁰ Santander pointed to the ‘detrimental effect on their daily cashflow’.¹²⁰¹ Banks from various member states including Barclays, BNP Paribas, Société Générale, and Intesa San Paolo also observed that end-users lacked the infrastructure necessary to manage margin requirements.¹²⁰² The European Banking Federation concluded that ‘[t]aking away the possibility from clients to hedge their risk in a cost efficient way could stifle innovation and economic growth’.¹²⁰³

3.2 Policy-makers’ consensus on a ‘clearing threshold’

Compared to the US, the end-user question ranked high on the EU institutions’ agenda early on, resulting in elevated public issue salience which the end-users further increased and sustained. There was no individual policy-maker equivalent to Gary Gensler to catapult the need for regulation into prominence. The ESAs, however, in particular ESMA, appear to have harboured strong concerns about a broad-based carve-out. After the adoption of EMIR, ESMA openly discussed these concerns, but pre-EMIR, and compared to the CFTC, it did not play as prominent a role in the public discussion. For most of the time, the political debate also lacked the ‘all-or-nothing’ dimension that had marked the discussions in the US. Rather, it was characterized by the EU’s tradition of insisting on shielding commercial businesses, in particular SMEs, from the potentially harmful effects increased capital requirements could have on their access to credit. This tradition can be traced back to the design of Basel II in the early 2000s, when Europe, in particular Germany, had pushed through carve-outs for banks providing capital to the *Mittelstand*.¹²⁰⁴ From an early moment, this tradition set the end-user case on a path towards some form of an exemption.

Early on, EU policy-makers discussed the burdensome effect of mandatory clearing/margin requirements for the end-user community. Governor of the Banque de France, Christian

¹¹⁹⁷ Grant/Tait (2010)

¹¹⁹⁸ European Association of Corporate Treasurers (2010:3), see also Bayer (2009:5).

¹¹⁹⁹ German Banking Industry Committee (2009:17)

¹²⁰⁰ ISDA and Financial Services Industry (2012:4), European Banking Federation (2009:7).

¹²⁰¹ Santander (2009:2), see also JP Morgan Chase (2010:2).

¹²⁰² Barclays (2009:7), BNP Paribas (2010:5), Société Générale (2009:6), Intesa San Paolo (2009:7)

¹²⁰³ European Banking Federation (2009:13), see also European Association of Public Banks (2009:10).

¹²⁰⁴ See Pagliari/Young (2014:590f.). This legacy has also permeated the discussions on Basel III (see for example EU Commission (2016b)).

Noyer, for example, explicitly recognized that ‘this [new rule] would trigger additional liquidity needs that they cannot afford’, and that the end-users might be affected by a ‘lack of operational capabilities’. However, he also observed that non-financial institutions were not all alike, with larger firms usually more involved in the financial markets than smaller ones. He therefore considered a ‘one-size-fits-all’ approach as ‘certainly not appropriate for all corporations active in OTC markets’.¹²⁰⁵ The UK authorities employed nearly identical language. The FSA and HM Treasury, for example, openly acknowledged that margin requirements ‘would increase costs and introduce an unpredictable liquidity burden’ and that some corporations might lack the necessary ‘levels of financial and operational resource to dedicate to this function’.¹²⁰⁶ However, rather than advocating a full carve-out, they equally concluded that the requirements should be ‘proportionate’.¹²⁰⁷ The German and Italian authorities also supported this nuanced approach.¹²⁰⁸ Policy-makers, thus, shared the belief that the ideational clearing/margining consensus should extend to parts of the end-user community.

On the basis of this agreement, the EU Commission decided on pursuing a threshold approach, not in the sense of a ‘permissive’ threshold up to the discretion of the banks or the regulators, as had initially been considered by the US Congress, but rather by formally imposing a mandatory ‘clearing threshold’ beyond which counterparties would have to either centrally clear trades if they were part of the list of transactions to be cleared, or post collateral, if they were not.¹²⁰⁹ The threshold was to be designed such as to cover only large players ‘that are particularly active in the OTC derivatives market and if this is not a direct consequence of their commercial activity’.¹²¹⁰ This means transactions undertaken purely for hedging purposes were to be excluded from any clearing/margining requirement.

There were two key reasons as to why the EU Commission did not give the end-users complete ‘carte blanche’ for *all* their trades. As in the US, the first one was to prevent regulatory arbitrage. The deputy director general of the EU Commission’s internal market and services unit, David Wright, spoke about the need to find ‘a balance’: ‘We can’t design a system where the cost is so high that it takes out derivatives that can be used to hedge. On the other hand, if we have a system with loopholes, the system could be gamed’.¹²¹¹ For the EU Commission, the clearing threshold allowed for such a balanced approach. In its view, it represented ‘a sensible system that reflects the economic and financial hedging needs of

¹²⁰⁵ Noyer (2010:3)

¹²⁰⁶ FSA and HM Treasury (2009:13,17)

¹²⁰⁷ HM Treasury and FSA (2010)

¹²⁰⁸ German Federal Ministry of Finance et al. (2010:3), Italy’s Ministry of Economy and Finance (2010:3)

¹²⁰⁹ The ‘clearing’ threshold thus also doubles as the ‘margining’ threshold, although the latter term is not commonly used.

¹²¹⁰ EU Commission (2010a:7)

¹²¹¹ Wright quoted in Financial Times (2009). Wright would soon move on to become chair of IOSCO where he helped coordinate the work of WGMR.

corporate end-users', while at the same time providing for 'a reduction of risk in the financial system that does not tolerate regulatory arbitrage'.¹²¹²

Second, the EU Commission believed the riskiness of a trade was a function of its size, rather than the type of entity undertaking it. Against the claims the end-users had voiced, it was convinced that certain end-users traded positions large enough for them to contribute to systemic risk. The Commission appeared particularly worried about the trades undertaken by the large commodity firms which it believed were often not purely hedge-motivated. Indeed, it insisted that large corporations can 'be a risk to their counterparties and possibly to the system as whole should they default'.¹²¹³ The Commission was confident that the costs of the threshold approach were reasonable. From its perspective, the macroeconomic effects of the crisis in terms of foregone growth had clearly demonstrated that corporations had a keen interest in enhancing the stability of the derivatives market. As the Commission put it, '[a]ddressing the root causes for the financial crisis in order to provide a more stable financial foundation for the real economy is therefore a vital interest for us all, non-financial institutions included'.¹²¹⁴

In contrast to the US, where many supporters of comprehensive margin reform insisted the new rules would decrease the cost of derivatives for end-users, the EU Commission believed the price for end-user trades prior to the crisis had actually been too low and needed to be adjusted upwards. Patrick Pearson, head of the Commission's financial infrastructure unit, observed that '[a] number of derivatives exposures were underpriced in the past, and corporates benefited from underpriced risk through lower fees passed on by the dealers'.¹²¹⁵ The press also cited an anonymous source from the Commission which further specified this argument by explaining that '[c]orporates actually enjoyed underpriced risk in the past, but once the new legislation kicks in it will mean they will have to pay the proper price, which is higher than what they're used to. They might not like that, but you can't have taxpayers subsidise their derivatives business'.¹²¹⁶ The Commission decided that the size of the threshold should be determined by ESMA on the basis of a thorough information gathering exercise.¹²¹⁷ The EU Council was in broad agreement with the Commission, arguing that 'consideration should be given to the purpose for which [a] non-financial counterparty uses OTC derivatives'.¹²¹⁸

The banks and end-users found their strongest allies in the European Parliament where several MEPs from the UK and Germany would have preferred a much more aggressive approach than the one the Commission charted. The Economic and Monetary Affairs

¹²¹² Both quotes taken from EU Commission (2010c:5).

¹²¹³ EU Commission (2009d:5)

¹²¹⁴ *ibid.*

¹²¹⁵ Pearson quoted in Clark J. (2010).

¹²¹⁶ Anonymous member of the EU Commission's financial market infrastructure unit quoted in Madigan (2009d). See also EU Commission (2009c:3 and 2009d:4).

¹²¹⁷ See Clark/Cameron (2010)

¹²¹⁸ EU Council (2010a:8)

Committee (ECON) seemed concerned about delegating the design of the threshold to ESMA, for fear the result would disproportionately restrain the end-user community.¹²¹⁹ Swinburne introduced an amendment that would have restricted ESMA's manoeuvring room by stipulating that the clearing threshold should apply only in case end-users' non-hedge-related positions surpassed the clearing threshold for more than 90 consecutive days.¹²²⁰ Bowles proposed another amendment, stipulating that the threshold to be defined by ESMA would only apply '**at the time the position is taken**', meaning that non-hedge related trades causing a firm to cross the threshold at a later point of their lifecycle would be *de facto* exempt.¹²²¹ In yet another amendment, she suggested that a non-financial entity would be exempt, in case it could demonstrate '**that it is not projected to exceed the threshold on a regular basis**'.¹²²² MEP Markus Ferber (elected from Germany) went even further by introducing an amendment that would have limited the applicability of the clearing threshold to financial entities. This would have provided non-financial firms with a blanket exemption, as they enjoyed in the US.¹²²³

The EU Parliament as a whole stressed the need for the new rules to reflect 'the specificities of small and medium enterprises',¹²²⁴ but without supporting any of these far-reaching amendments discussed in the ECON committee. Particularly vocal about the need to cover *all* end-user deals were the Greens who in their own words 'want the clearing obligation to cover non-financials as every derivative done by a non-financial usually has a financial counterparty. Exempting such derivatives for the non-financials therefore also exempts them from clearing by financials, thus weakening the impact of EMIR'.¹²²⁵ There were two factors which made a larger group of MEPs reaching beyond the Greens reject the idea of a carve-out. A key moment occurred in 2009, when the media reported that Porsche had earned six times more on the stock market than through its traditional core business of selling cars.¹²²⁶ While this was a special case related to the firm's attempt to take over its much larger competitor Volkswagen (which eventually failed, resulting in the reverse move), it confirmed the skeptics' position that certain end-users seemed to behave like hedge funds.

The final outcome in the Parliament was a classic compromise, according to which the rolling average of end-users' portfolios of non-hedge-related trades would have to cross the threshold for 50 business days in order for the clearing threshold to apply.¹²²⁷ The inter-institutional 'trilogue' between Parliament, Council, and Commission then led to a reduction

¹²¹⁹ For more information, see Stafford/Barker (2013), Herbert Smith Freehills (2013), and EU Parliament (2013).

¹²²⁰ EU Parliament (2011c:43, amendment 474)

¹²²¹ EU Parliament (2011c:44, amendment 476; emphasis in the original)

¹²²² EU Parliament (2011c:59, amendment 503; emphasis in the original)

¹²²³ EU Parliament (2011b:117, amendment 311)

¹²²⁴ EU Parliament (2010a:2)

¹²²⁵ Giegold (2011:1)

¹²²⁶ See Hughes, E. (2009).

¹²²⁷ EU Parliament (2011a:29)

of this number to 30 business days,¹²²⁸ a result likely due to pressure by the Commission for a more conservative approach. The bank/end-user alliance was thus successful in maintaining the momentum in favour of the threshold approach, but it failed to achieve a full carve-out for all end-user deals.

In September 2012, ESMA published the numerical values of the threshold, which were EUR 1bn for credit and equity derivatives respectively, and EUR 3bn each for interest rate, FX, commodity, and all other derivatives.¹²²⁹ ESMA specified that a non-financial entity whose aggregate portion of trades not concluded for hedging purposes crossed one of these thresholds had to margin/clear its entire portfolio, i.e. not just the excess ratio or the asset class in question.¹²³⁰ Such an entity would be referred to as a NFC+, as compared to a NFC- designating a corporate firm below the threshold. ESMA also provided information on what characteristics trades needed to reflect in order to be classified as ‘objectively’ risk-reducing, including those of the ‘hedging’ definition as understood by IFRS, or, alternatively those of ‘proxy hedging’ or ‘portfolio hedging’ in order to take account of cases where direct hedging was not possible.¹²³¹

3.3 Further accommodations for the end-users post-EMIR

With EMIR stipulating a review of the entire Regulation by August 2015, in particular the systemic effect of NFCs’ use of derivatives and the impact of the new rules on their business,¹²³² the debate barely ever stopped, even though this deadline preceded the actual implementation of the requirements themselves. As in the US, public issue salience thus remained high.

ESMA’s report recommended extending the coverage of the ideational clearing/margining consensus to a larger fraction of the end-user community. Specifically, it encouraged the EU Commission to reinforce the threshold approach by tightening the ‘hedging’ concept. The recommendation was informed by three observations ESMA had made. First, an empirical analysis led it conclude that the aggregate portfolio of trades undertaken by large NFCs- combining both hedge-related and unrelated trades was in fact often larger than that of NFCs+. ESMA interpreted this result as indicative of many NFCs- being de facto NFCs+, without having made the required notification.¹²³³ Second, ESMA was worried that the broad definition of ‘hedging’ had resulted in the ‘inconsistent application’ of this concept across firms.¹²³⁴ Third, it noted that a large fraction of NFCs- had reported *all* their trades as

¹²²⁸ EU Council (2012:37), see Article 10 of EMIR.

¹²²⁹ ESMA (2012:18)

¹²³⁰ ESMA (2012:20)

¹²³¹ ESMA (2012:72)

¹²³² See Article 85(1) of EMIR.

¹²³³ ESMA (2015:12,11). Note that ESMA also identified a significant fraction of counterparties which had categorized themselves as NFC+ even though the size of their positions did not approach the clearing threshold.

¹²³⁴ ESMA (2015:32)

hedge-related, which it interpreted as evidence suggesting that many NFCs- were actually overwhelmed by the task of accurately categorizing their trades.¹²³⁵ Overall, ESMA questioned the suitability of the ‘hedging’ concept for determining the size of the various thresholds, arguing ‘that the share of hedging versus non-hedging of positions may not be the most relevant criteria to assess the systemic relevance of NFCs’.¹²³⁶ It recommended that the EU Commission keep the asset-class based thresholds, but reformulate the calculation instructions, such as to require NFCs to add together all their trades per asset class *regardless* of their relevance for ‘hedging’ purposes. ESMA concluded that such a reformed approach would be suitable for ‘capturing the most systemically important NFCs’ and removing all ambiguities related to the nature of ‘hedging’, while at the same time relieving the smaller NFCs from the ‘hedge’ classification effort.¹²³⁷

The report led to consternation among the end-user community. The European Association of Corporate Treasurers went on to invalidate ESMA’s report point by point. First, it argued that the systemic importance of NFCs was minor compared to financial institutions, given that NFCs were diversified across various sectors, which meant that both business and bankruptcy risks were less correlated across firms. Second, it insisted that portfolio size was a poor indicator of systemic importance, ‘as often large companies have sizeable portfolios due to the scale of their business activities, not due to speculative actions’.¹²³⁸ Third, the Association considered it ‘perfectly logical’¹²³⁹ that many NFCs- had classified the totality of their trades as hedge-oriented, given that in its view, corporate firms used derivatives primarily for commercial risk-mitigation, rather than speculation. Fourth, regarding the classification problems ESMA had identified, it blamed EMIR’s difficult reporting regime, rather than a lack of corporate capacity.¹²⁴⁰ As a result, it rejected any changes to the threshold methodology. A group of German and other European end-user associations submitted a nearly identical letter to the EU Commission in which they qualified ESMA’s position as ‘plainly wrong’, insisting that ‘the retention of the hedging exemption is of utmost importance’.¹²⁴¹ Their submission equally identified the reporting regime as the main problem, explaining that in many cases trade repositories had not accurately registered or saved the information provided by end-user firms.¹²⁴² The associations concluded that except for trade reporting ‘only smaller changes to EMIR are necessary’, such as the automatic attribution of the ‘NFC- label’ to small end-users with insignificant uncleared portfolios.¹²⁴³

¹²³⁵ ESMA (2015:23f.)

¹²³⁶ ESMA (2015:14)

¹²³⁷ ESMA (2015:32)

¹²³⁸ European Association of Corporate Treasurers (2015:3)

¹²³⁹ European Association of Corporate Treasurers (2015:4)

¹²⁴⁰ European Association of Corporate Treasurers (2015:2)

¹²⁴¹ BDI et al. (2015:5,4). The associations were Bundesverband der Deutschen Industrie (BDI), Bundesverband Großhandel, Außenhandel, Dienstleistungen (BGA), Deutsches Aktieninstitut, Deutscher Industrie- und Handelskammertag (DIHK), European Federation of Energy Traders (EFET) and Verband Deutscher Treasurer (VDT).

¹²⁴² BDI et al. (2015:8)

¹²⁴³ BDI et al. (2015:7)

The end-users attributed ESMA's intransigence in part to the unbalanced composition of its Securities and Markets Stakeholder Group, a consultative body that had been formed in 2013. Indeed, after two unsuccessful applications for membership, the European Association of Corporate Treasurers submitted a formal complaint to the European Ombudsman, challenging ESMA's position that *'even if non-financial companies also have a legitimate interest in the work of ESMA there is however no explicit legal obligation to include such stakeholders. To be selected, interested parties do not only have to apply but they should also be considered better placed than other candidates'*.¹²⁴⁴ The complaint was later withdrawn and a representative of the association was appointed as a member of the group.¹²⁴⁵

The EU Commission was much more sympathetic towards the end-users' concerns and suggested adjusting the ideational consensus in order for it to better suit the needs of smaller firms. Acknowledging the challenges with regard to trade reporting, the Commission recommended 'streamlining' the respective requirements for end-users.¹²⁴⁶ Most importantly, it contradicted ESMA's view by characterizing 'hedging' as 'a relevant factor when considering the systemic relevance of NFCs because hedging entities are generally not highly leveraged and hold underlying offsetting positions to their OTC derivatives contracts'.¹²⁴⁷ Its proposal for an amendment of EMIR published in May 2017, suggested lowering, rather than increasing the end-users' burden, for example by providing for a simplified reporting regime for NFCs. Regarding the clearing thresholds, the Commission proposed keeping the original approach of exempting only hedge-related transactions. However, NFCs would no longer have to study the size of their non-hedging oriented uncleared derivatives portfolio on a continuous basis, but only for a period of three months (March, April, and May) per year. Moreover, a threshold breach would no longer oblige them to clear/margin all trades, but only those of the asset class for which the breach had occurred and which fell under the clearing/margining requirement.¹²⁴⁸

Overall, without the constant hammering by the bank/end-user coalition, it would have been much easier for ESMA to have its reservations heard, both early in the process and after the adoption of EMIR.

4. Conclusion

This chapter has argued that the end-user case was the only one in which the banks exercised influence. However, compared to the pre-crisis deregulation case, they did so only indirectly, and their influence in securing a (partial) carve-out was larger in the US than the

¹²⁴⁴ European Association of Corporate Treasurers (2014b:1f., emphasis in the original)

¹²⁴⁵ ESMA (2016)

¹²⁴⁶ EU Commission (2016a:7)

¹²⁴⁷ EU Commission (2016a:4)

¹²⁴⁸ EU Commission (2017:13f.)

EU. Bank influence was indirect, rather than direct, given that the dealers had to lobby through the end-users as their coalition partner. In light of their damaged reputation after the crisis, the dealers lacked the strength and credibility to directly engage policy-makers themselves.

Interestingly, in the US, the banks exercised indirect influence in spite of the high levels of 'hostile' issue salience initially pointing against them. In the pre-crisis period, high issue salience had always come with the risk of regulatory intrusion, but this time, the banks turned the situation to their advantage. Indeed, in the US, the banks succeeded in turning the tide from what appeared to be a loss to a victory, even if only in form of indirect influence. The moderator constellation was initially configured against the banks. Gensler's campaign had turned both the public issue salience and the contours of the ideational consensus as perceived by the Congressional Democrats and the Treasury against an exemption. His advocacy for an encompassing set of rules also introduced friction at the domestic institutional level, given that, unlike the CFTC, the PRs showed little interest in the end-user question.

The factor constellation enabling the banks to exercise indirect influence was premised on the high degree of business unity the banks were able to achieve by mobilizing the end-users. The bank/end-user coalition, in turn, succeeded in changing the signal of the public issue salience moderator to the dealers' advantage. The coalition also secured the support of the New Democrats and other members of the Democratic Party, as a result of which the sign of the ideational outlook on Capitol Hill equally began to turn. The missing end-user exemption in Dodd-Frank dealt the banks with a temporal setback, as it reinvigorated the CFTC. The bank/end-user coalition, however, responded by turning up the volume of their campaign exponentially. In conjunction with the Republican victory in the 2010 elections, the campaign eventually succeeded in completely shifting the signal of the ideational outlook to the banks' advantage. The exemption was eventually implemented through the renewal of TRIA. With an unambiguous carve-out now formally adopted, this also turned the sign of the domestic institutional moderator, as it tied the hands of the CFTC. The banks also benefited from the fact that at the transnational level, the end-user debate did not attract much attention, with WGMR directing comparatively little attention to the issue and approving of a broad-based exemption. As a primarily domestic topic, the end-user question did not raise any inter-state power-related concerns. In sum, the final exemption was the product of bank influence, but since the dealers themselves had to leave most of the talking to the end-users, their influence was indirect, rather than direct.

In Europe, the banks did not find themselves in as much an uphill battle as in the US. There were two starting points for the feedback mechanism leading to (limited) indirect bank influence. As in the US, the dealers mobilized the end-users, thus ensuring high business unity. At the domestic institutional level, the historical legacy of granting special treatment to SMEs under bank capital rules provided further momentum to the coalition's campaign, as it raised the issue salience of the question and oriented the ideational outlook towards some form of exemption. As in the US, the banks also benefited from WGMR's benign

interpretation of a broad exemption. The bank/end-user alliance secured this equilibrium, and defended it against ESMA's attempts to stack the domestic institutional environment against the banks and change the contours of the ideational outlook by bringing a larger proportion of the end-user community under the regulatory umbrella. Inter-state power again was not at the forefront. However, given the lack of a complete end-user carve-out, the banks' indirect influence in the EU was less complete than in the US.

Again, as in the pre-crisis deregulation case, (indirect) dealer bank influence emerged under a factor constellation that included positive effects emanating from the three moderators associated with policy-makers' ideational outlook, the state of the transnational policy community, and the domestic institutional environment. Chapter IX will further expand on this finding.

CHAPTER VIII - The Treatment of FX swaps and FX forwards

1. Overview of the chapter

This chapter discusses the treatment of FX swaps and FX forwards. While the US and the EU both implemented an exemption from IM, but not from VM, the dynamics of the policy process on either side of the Atlantic were very different.

Before we begin with the detailed case analysis, section 2 provides some background information on the FX market. Section 3 covers the US case. Section 3.1 illustrates the efforts of the US Treasury to carve out FX swaps and FX forwards from Dodd-Frank on the grounds that it considered this segment of the OTC derivatives market to be 'different' from the other types of bespoke trades. Its campaign attracted Congress' attention, which increased the public issue salience of the question, even though it did not reach the same level as the end-user question. The progressive Democrats and their Party leadership, together with the CFTC which hoped to secure jurisdiction over those products, objected to the Treasury's suggestion, insisting that the consensus be left intact, and that an exemption would only represent another loophole in favour of the banks. The Treasury, however, prevailed. While Dodd-Frank did not directly provide for an exemption of FX swaps and FX forwards from the definition of 'swap', it allowed the Treasury to prepare a determination justifying that these products should in fact be exempt, which would also relieve them from the margin requirements associated with it. The Treasury complied and exempted them under the Determination, at a time when public attention had already turned to other questions.

Section 3.2 reveals the high level of business unity among the banks and the buy-side in favour of an exemption of FX swaps and FX forwards from both IM and VM. The information the banks submitted stated that these products were 'safe', given stable payment obligations known *ex ante*, short maturities corresponding with deep market liquidity, and high degrees of market transparency. The only remaining risk, commenters claimed, was settlement risk, which in their view was already sufficiently mitigated by the CLS Bank, a specialized financial institution providing settlement services for FX transactions (see section 2). The critics of an exemption, including exchange houses, NGOs, the Senate Homeland Security and Governmental Affairs Committee, as well as individual observers, submitted evidence trying to invalidate each of these claims.

Section 3.3 argues that while the exemption from IM reflects the preferences of the banks, it was probably a case of congruence, rather than influence. The banks most likely saw their

preferred option adopted for another reason: a (historically informed) turf war at the domestic institutional level, with the Treasury aiming to ensure that the CFTC would not obtain jurisdiction over the FX market. The intended beneficiary was the Fed which has an important stake in the market, first, because of the relevance of these products for its monetary policy, and second, because of the leading role it plays in the governance of international payments systems. The domestic decision in the US was taken before the establishment of WGMR.

Section 3.4 provides further evidence indicating that the Treasury did indeed sacrifice, rather than simply dismiss the ideational margining consensus in favour of the banks. In fact, the Fed actually appeared highly concerned about the risks in the FX market. However, as the domestic exemption had rendered the adoption of a formal IM mandate impossible, the Treasury needed to prevent WGMR from recommending such a requirement. From a competition point of view, stronger requirements abroad would have likely benefited the US, but they would have probably also further increased systemic risk in the domestic banking system, which the Fed appeared keen to avoid. In order to introduce some level of oversight, while keeping the exemption formally intact, the Fed operated through BCBS-CPSS's Working Group on Foreign Exchange Settlement Risk which recommended the use of VM for FX trades. With the support of the US, WGMR imported this guideline and made it a recommendation under its own framework. Against the preferences of the banks, and even though issue salience was low, the Fed subsequently imposed the use of VM through supervisory guidance.

The US portion of the chapter concludes with some reflections on why the Treasury might have opted for this complicated strategy, rather than asking Congress directly to grant the Fed exclusive jurisdiction in the first place. One likely reason is the high degree of public issue salience the Fed's perceived mismanagement of the crisis had created on Capitol Hill. The banks' preferences do not appear prominently in this overall equation, suggesting that with regard to IM, they probably did not exercise causal influence. Supervisory guidance on the use of VM also did not overlap with their preferences.

Section 4 discusses the EU case. In section 4.1, we will see that there was business unity regarding the need for an exemption from IM. The use of VM was not extensively discussed in market actors' written submissions. Business consensus on the need for a carve-out was not unanimous, but it would be too much to speak of business conflict. Section 4.2 reveals that the public issue salience of the question was high in the EU, just as it had been in the US. With the exception of some MEPs, the majority of policy-makers refused a blanket carve-out for FX. The EU's decision to adopt a VM requirement for these products was therefore accompanied by comparatively little debate. The transnational discussion on IM was controversial, given the EU's insistence on IM, and WGMR was split. In the end, however, the US prevailed, and the EU pursued an exemption from IM. Section 4.3 focuses on Europe's decision to forego the IM requirement. It discusses several hypotheses why the EU might have taken this decision, suggesting that it was probably US structural power that

made the EU drop its IM plans and sacrifice the ideational consensus *pro* IM, given its banks' dependence on the USD.

Figures 19 to 22 provide graphical illustrations of the IM and VM cases for FX swaps and FX forwards in the US and the EU. The two purple waves indicate congruence. The crossed-out lightning bolts shows that the banks initially faced the possibility of a loss regarding IM in either jurisdiction, but that the needle on the influence barometer eventually shifted away from this category.

The banks on both sides of the Atlantic opposed any form of mandatory IM or VM requirement. In the IM for FX swaps and FX forwards case in the US, the banks most likely benefited from congruence, after the needle of the influence barometer had initially hovered over the 'loss' category. Indeed, at first, the dealers found themselves confronted with a factor constellation in which high issue salience and the CFTC's as well as the Democrats' ideational outlook on the issue were turned against an exemption. The Treasury probably equally subscribed to this consensus, although we can only indirectly infer this from the VM case.

The domestic institutional moderator at this stage equally operated against the banks, since the CFTC attempted to achieve jurisdiction over the market, with the firm intention of imposing strict margin requirements on those trades. What changed the tide was the turf war between the CFTC and the Fed/Treasury. In order to prevent the CFTC from gaining jurisdiction, the Treasury most likely sacrificed the ideational consensus and pushed the US Congress to exempt FX swaps and FX forwards from the definition of 'swap' under Dodd-Frank. The subsequent adoption of the exemption from IM through the Treasury Determination turned the domestic institutional environment moderator to the banks' advantage. As well, when the Treasury adopted the Determination, public attention had already turned to other questions, meaning issue salience was comparatively low again. The banks themselves benefited from business unity in favour of the Determination, but their own lobbying appears to have had little direct causal influence over the decision. Given that the Determination was adopted before WGMR was officially established, the transnational moderator most likely did not play a major role. Finally, with the EU far behind in the policy process, inter-state power-related questions were not at the forefront of this case.

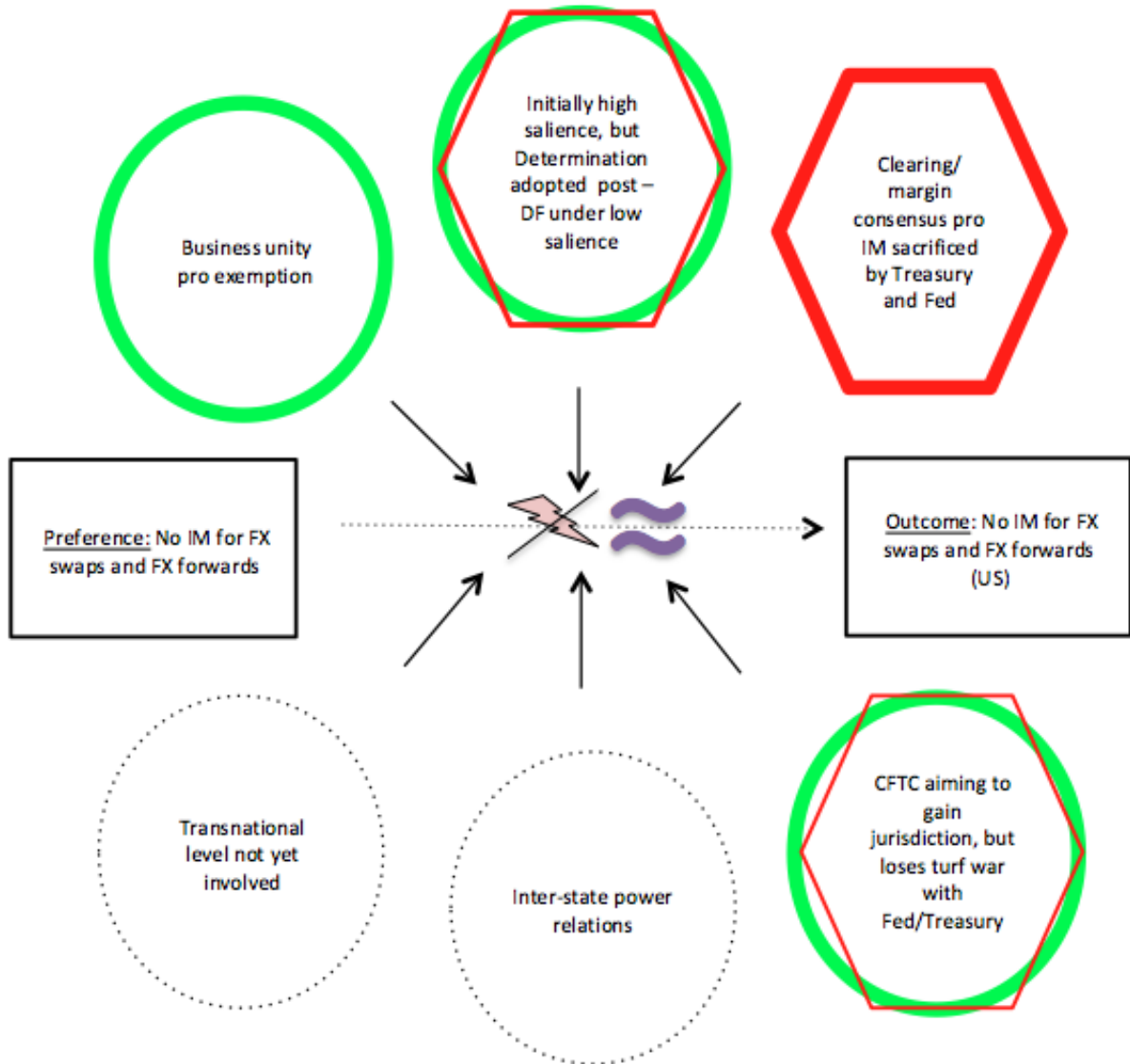
In the EU, the banks probably also benefited from congruence, with the needle at first equally hovering over the 'loss' category. Indeed, as in the US, the factor constellation initially appeared set against the banks, with the same moderators flashing red. The ideational outlook called for FX swaps and FX forwards to be covered by IM. There were no stumbling blocs at the domestic institutional level challenging this assessment. In addition, the public issue salience of the question was high. The EU's strong preference for an IM mandate put WGMR under stress, given US opposition to an IM requirement. What turned the tide in favour of an exemption, and thus congruence for the banks, was most likely structural power exercised by the US through Europe's dependence on the USD. WGMR subsequently recommended an exemption from IM. The EU followed this recommendation,

in spite of the prevalence of high issue salience against an exemption. As in the US, the fact that the banks preferred the exemption and could point to business unity in their favour was most likely insufficient for the dealers to exercise any causal influence over the decision.

While the banks probably benefited from congruence regarding IM, they registered another loss with respect to VM. In the US, the ideational post-crisis consensus implied that FX swaps and FX forwards needed to be collateralized, if not with IM, then at least with VM. The consensus was equally embraced by BCBS-CPSS and WGMR at the transgovernmental level. At the domestic institutional level, Dodd-Frank and the Treasury Determination had removed any stumbling blocs by ensuring the CFTC would not gain jurisdiction over this segment of the FX market. The ideational, transgovernmental, and domestic institutional environment moderators were thus all turned against the banks. The dealers benefited from business unity and low issue salience, but these two factors were insufficient for them to exercise any influence. As a result, the banks had to accept yet another loss. Inter-state power most likely had receded to the background again.

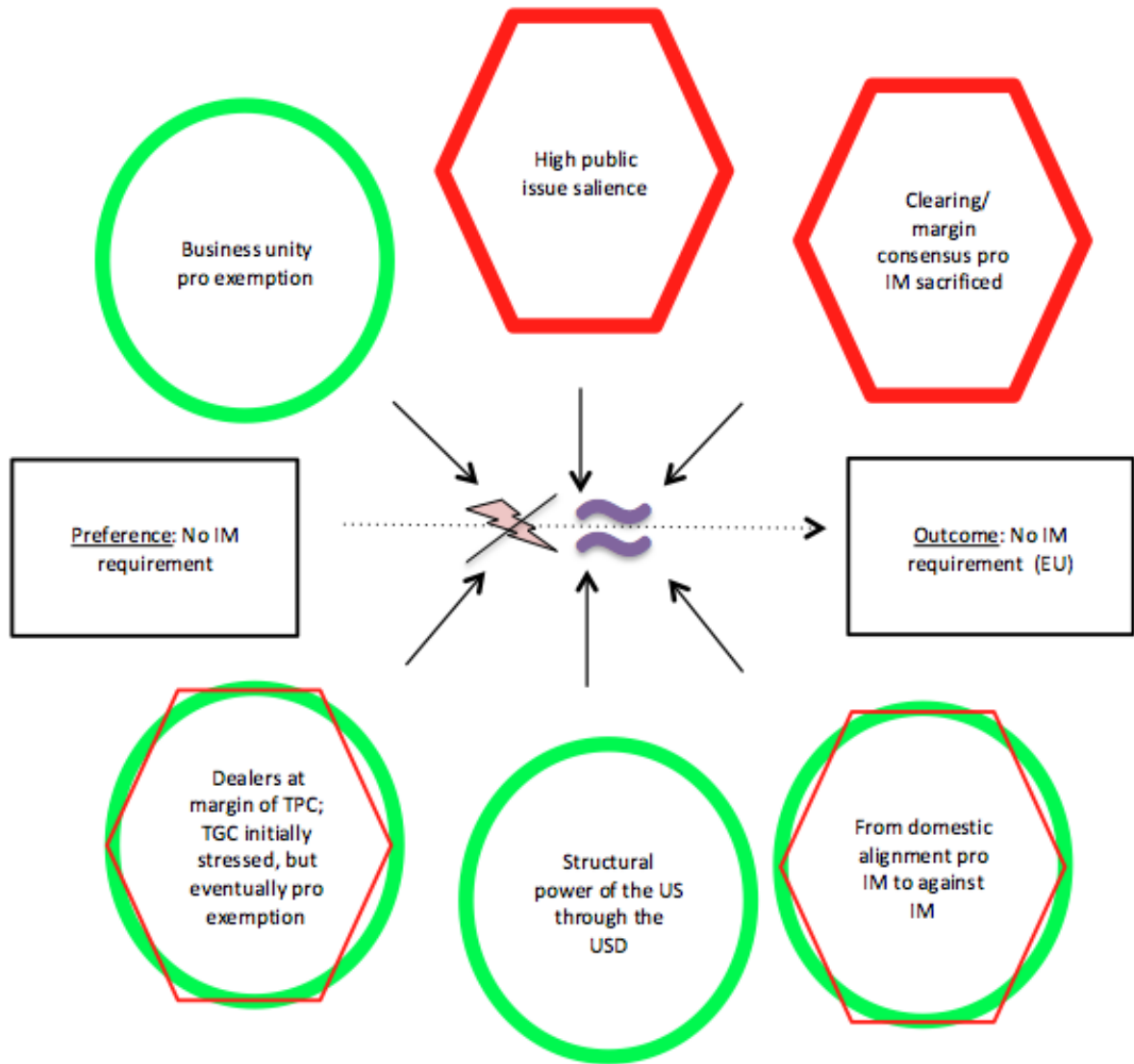
In the EU, the factor constellation keeping bank influence at bay was the same as in the US, the only exception being high issue salience which further constrained it.

Figure 19: The IM exemption for FX swaps and FX forwards in the US



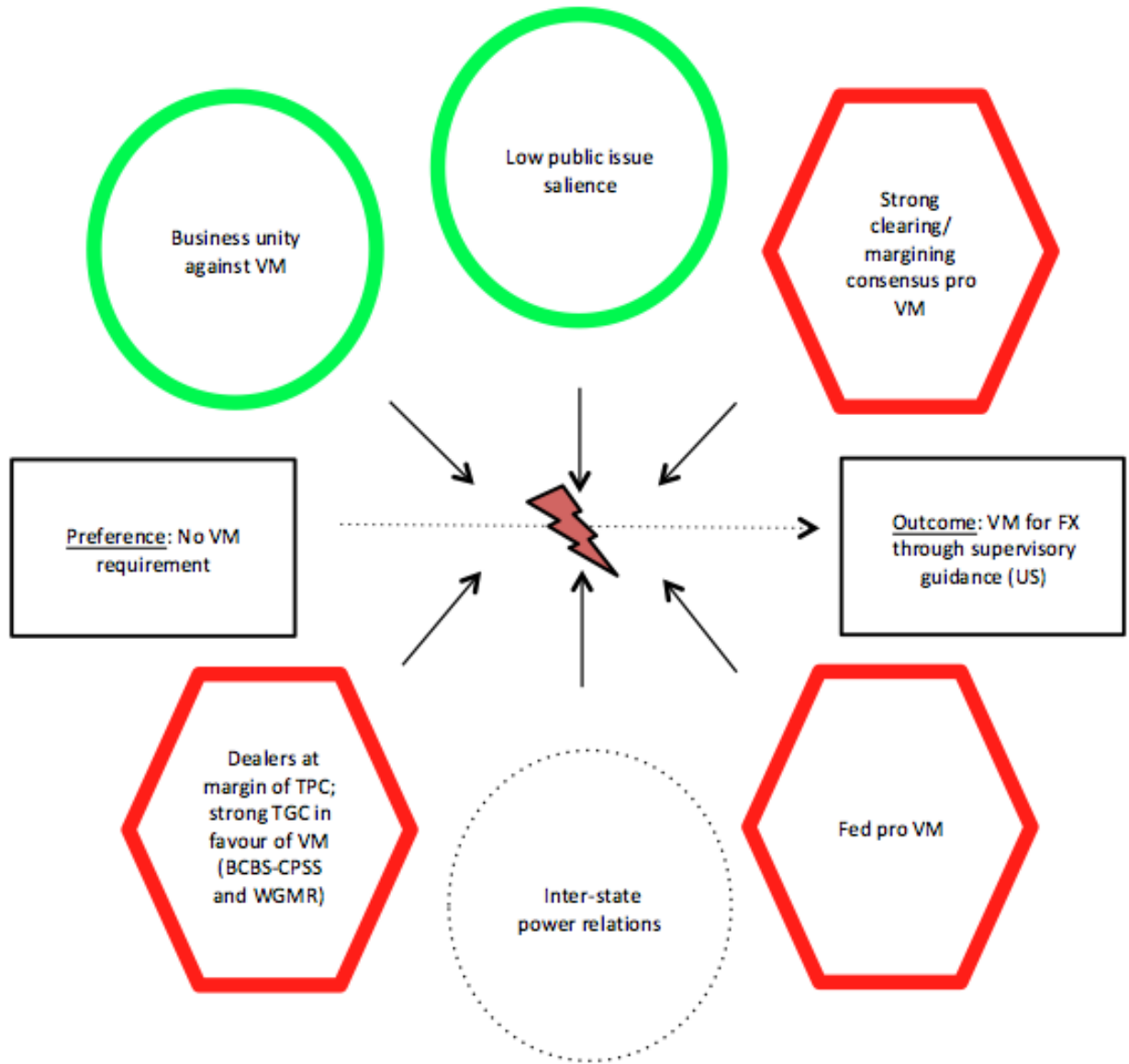
Source: Author

Figure 20: The IM exemption for FX swaps and FX forwards in the EU



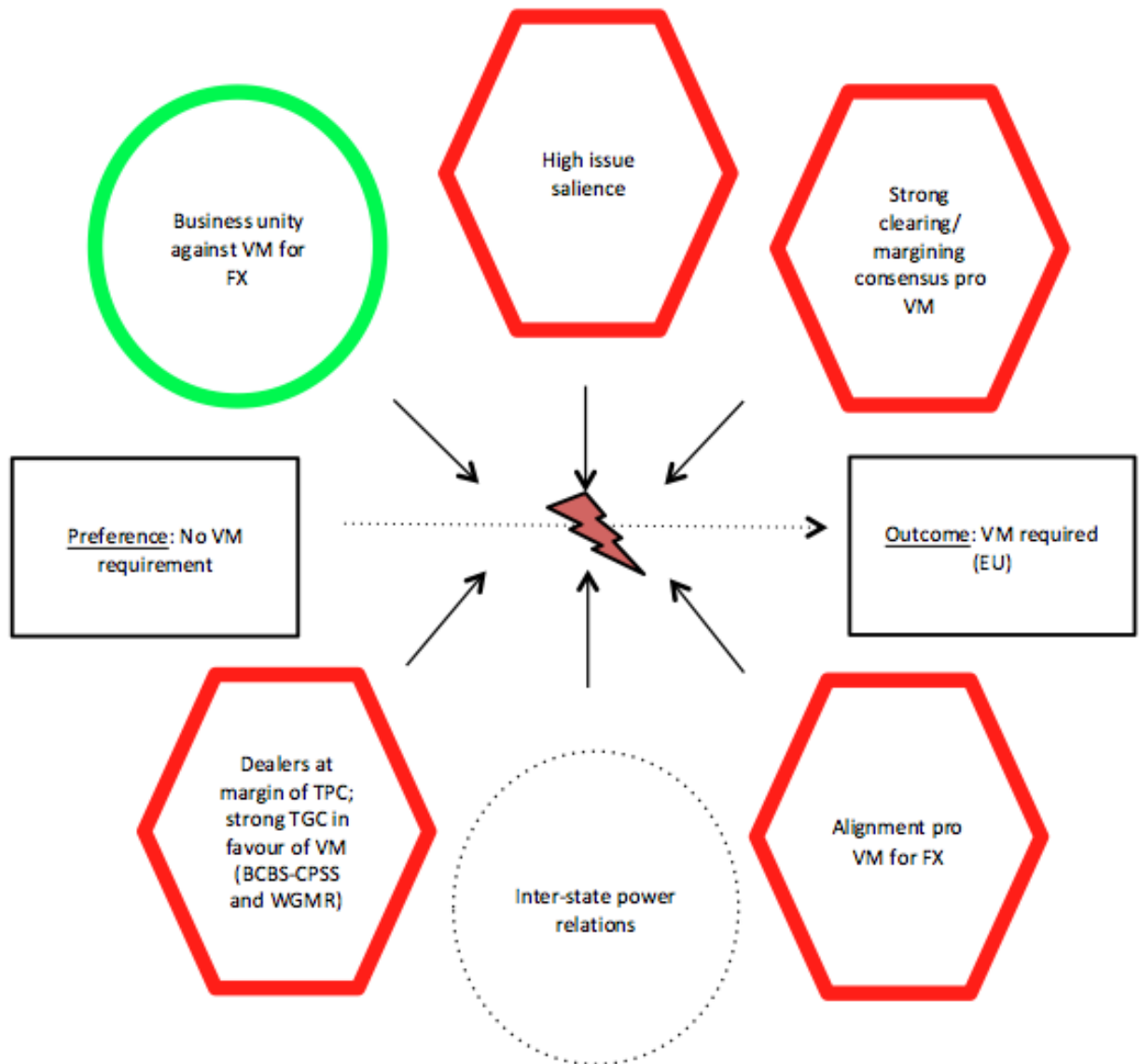
Source: Author

Figure 21: Supervisory guidance on VM for FX swaps and FX forwards in the US



Source: Author

Figure 22: The mandatory use of VM for FX swaps and FX forwards in the EU



Source: Author

2. Background: Different types of bilateral FX trades and the role of the CLS Bank as the first line of defence against settlement risk

FX spot trades involve the purchase of a currency against the sale of another for immediate delivery 'on the spot'. The maturity of spot trades is short, usually less than two days.¹²⁴⁹ Spot trades are generally not considered to be derivatives. Once the maturity of a spot trade extends beyond two days, it becomes a derivative and is called an FX forward. This product allows the investor to buy or sell foreign currency at a pre-specified price on a future date.¹²⁵⁰ An FX swap, in turn, involves two parties simultaneously borrowing and lending currency from/to each other. Repayment is locked in at the FX forward rate valid at the time the deal is struck. The FX swap can therefore be considered a combination of spot and forward.¹²⁵¹ The purpose of a currency swap is to exchange principal and interest for two different currencies, with maturity usually not being reached for several years.¹²⁵² An FX option grants the right (without imposing any obligation) to convert currency A into currency B at a pre-specified date at a pre-determined rate.¹²⁵³ Non-deliverable forwards (NDFs), in turn, allow for the trading of movements in less easily available currencies issued, for example, by countries having put in place capital controls. They are cash-settled in USD, with the exchange of cash flow being calculated as the difference between the exchange rate of the day when the deal is concluded and the day it reaches maturity.¹²⁵⁴

Most of the public regulatory debate focused on the treatment of FX swaps and FX forwards. Two characteristics distinguish these product types from other FX contracts, their short maturities and physical settlement. As figure 23 illustrates, most FX swaps and FX forwards reach maturity within a year or less, and the bulk of FX swaps (panel A) actually mature within 7 days or less. By contrast, many other uncleared trades have maturities stretching several years, if not decades.

Figure 23: Maturities of FX swaps and FX forwards

¹²⁴⁹ For USD-CAD trades settlement is one Toronto business day (see for example Canadian Foreign Exchange Committee (2010:3)).

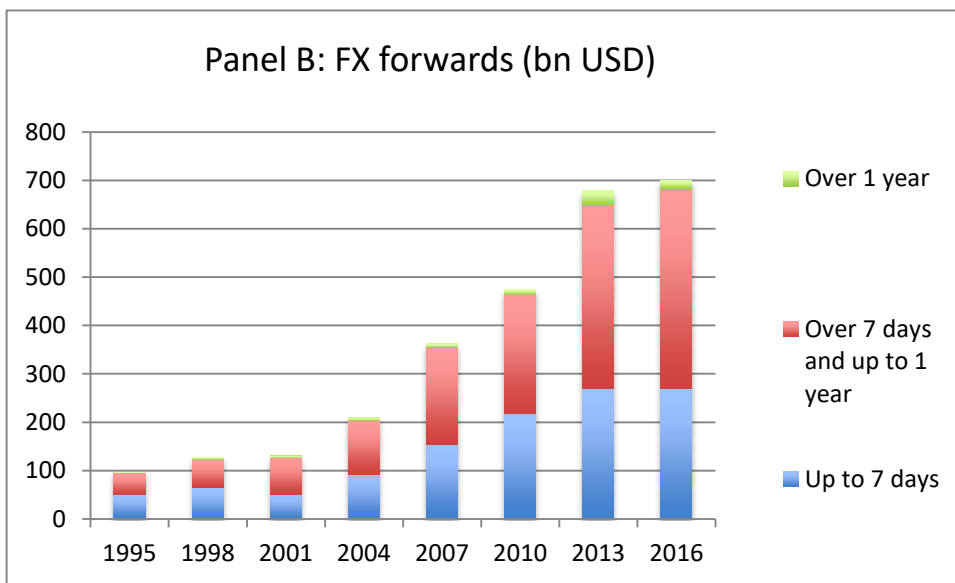
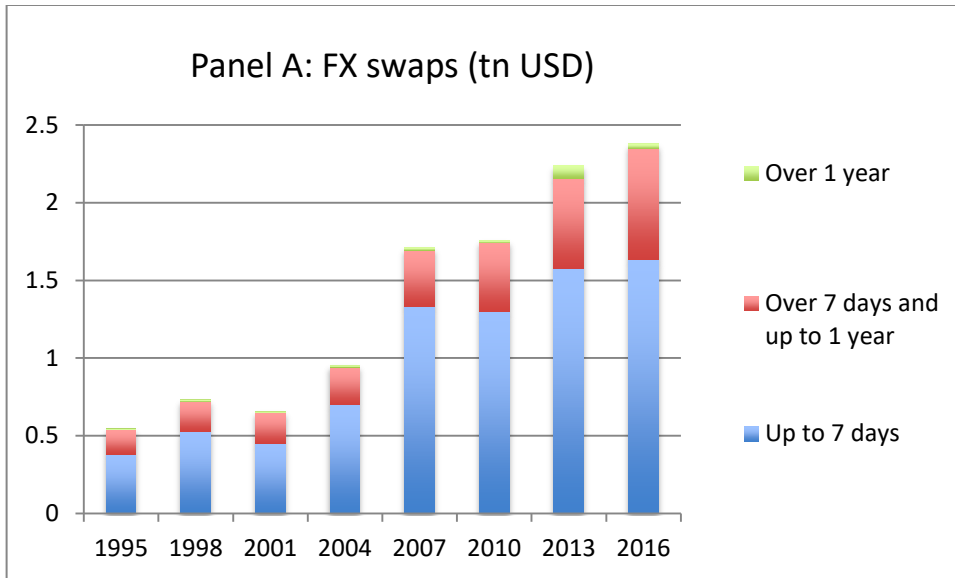
¹²⁵⁰ See for example Tormey (1997:2316).

¹²⁵¹ BIS (2008)

¹²⁵² Baba et al. (2008:82)

¹²⁵³ James et al. (2015:4)

¹²⁵⁴ Abdel-Qader (2017)



Source: BIS Triennial Survey of foreign exchange and OTC derivatives trading (Table D11.4: Foreign exchange turnover by instrument, counterparty and maturity)

Physical settlement means that the underlying currency is exchanged. One of the main risks of physically-settled FX derivatives is therefore settlement risk, which is the risk of a counterparty handing over the agreed amount of currency, without receiving in exchange the contractually stipulated amount of currency from its trading partner. The reasons can vary, from struggles with technical problems to financial distress/insolvency.¹²⁵⁵ The period of exposure stretches from the moment the payment instruction cannot be revoked anymore until the moment the funds have been received. On average, it lasts beyond 24

¹²⁵⁵ CPSS (2008:6)

hours.¹²⁵⁶ Revoking the payment instruction might be necessary in case it turns out erroneous, or if the issuing counterparty learns that its trade partner has become insolvent. This part of the risk management process is further complicated by time zone differences and legal problems concerning the question under which precise conditions cancellations are possible.¹²⁵⁷

One of the most prominent cases of financial disaster in this segment of the derivatives market is the collapse of Germany's Bankhaus Herstatt in June 1974. Indeed, Herstatt filed for bankruptcy after having received millions of Deutsch Mark from US banks, but before making the promised USD payments in return. The related risk of losing principal is therefore often called 'Herstatt' risk.¹²⁵⁸ The decades following this debacle were punctuated by several other insolvencies including the failures of Drexel Burnham Lambert in the US in 1990 and Bank of Credit and Commerce International (BCCI) in the UK one year later.¹²⁵⁹ As a response, the CLS (Continuous Linked Settlement) Bank was established. Since its inception in 1999, it has acted as a major pillar of the international payments systems. The CLS Bank provides the 'link' between the two legs of an FX transaction that is missing in case banks rely on traditional correspondent banking. It operates a 'payment-versus-payment' (PVP) system ensuring that one payment does not occur without the other.¹²⁶⁰ Otherwise, payments are refunded to the party that made the pay-in.¹²⁶¹ Each settlement member (together more than 60 financial institutions worldwide¹²⁶²) holds an account with one subaccount per currency through which payments are made.¹²⁶³ CLS simultaneously settles the two legs of a trade by adjusting the respective subaccounts of the two counterparties, provided sufficient funds available. In order to protect its clients against Herstatt risk, CLS pursues various risk management controls before proceeding to settlement.¹²⁶⁴ In addition, it applies multilateral netting techniques, thereby freeing up significant amounts of liquidity, up to 96% according to its website.¹²⁶⁵ CLS also maintains loss-sharing arrangements with its members and contingency plans for liquidity provision with large banks, in case one or several counterparties break their limits of negative balances.¹²⁶⁶ While some of CLS's operational procedures make it appear similar to a CCP, it is important to understand that it is in fact not a central counterparty. It settles the payment instructions associated with trades, but without providing for counterparty

¹²⁵⁶ Kos/Levich (2016:6f.) quoting BIS data published in 2008.

¹²⁵⁷ Lindley (2008:55)

¹²⁵⁸ Levich (2012:10f.)

¹²⁵⁹ CPSS (1996:6f.)

¹²⁶⁰ Lindley (2008:57)

¹²⁶¹ Kos/Levich (2016:14)

¹²⁶² See the CLS Bank website <https://www.cls-group.com/products/settlement/clssettlement/membership/>, accessed 14 May 2018.

¹²⁶³ Miller (2002:17ff.)

¹²⁶⁴ Galati (2002:63), CPSS (2008:79f.)

¹²⁶⁵ See the CLS Bank website at <https://www.cls-group.com/products/settlement/>, accessed 15 May 2018.

¹²⁶⁶ The value of the missing payments might increase in case of negative intra-day exchange rate developments, which could result in a situation where CLS owes money to one or several of its members, but either lacks the funds or does not have access to them in the correct currency (see Galati (2002:63)).

substitution, i.e. it does not become counterparty to these trades.¹²⁶⁷ Headquartered in New York City, CLS settles a daily volume of USD 5tn of payment instructions across 18 currencies, with a focus on spots, forwards, and swaps.¹²⁶⁸

3. The US case

3.1 The US Treasury's push for an exemption of FX swaps and FX forwards

From a very early stage, the US Treasury urged Congress to provide an exemption for physically settled FX swaps and FX forwards from the definition of 'swap', which would have otherwise become part of the CFTC's jurisdiction. The Treasury's publicly voiced arguments for the exemption at this stage of the process remained somewhat cryptic, much to the dissatisfaction of the Congressional leadership. Geithner emphasized that '[t]he FX markets are different. They are not really derivative in a sense and they don't present the same sort of risk'. To support this claim, he pointed to the CLS Bank and its 'elaborate framework' to address settlement risk. Concluding that '[t]hese markets actually work quite well',¹²⁶⁹ he opposed any form of regulation going beyond business conduct and reporting standards.¹²⁷⁰

Compared to the end-user debate, the FX question attracted less attention among policy-makers. First, the end-users pushed for encompassing relief covering all asset classes, meaning they did not single out FX derivatives. Second, given their tarnished reputation, the banks did not dare address the topic in public. Geithner's initiative, however, led to a significant increase in public issue salience on Capitol Hill.

Several influential Democrats of the US Congress vehemently rejected an exemption. Their arguments resembled those made during the end-user debate. First, they insisted that there should not be any gaping loopholes in the reform. Dave Smith, chief economist of the House Financial Services Committee, summarized the House Democrats' view by saying '[w]e want to promote as much transparency as possible'.¹²⁷¹ The Senate Democrats argued along similar lines. Blanche Lincoln explained that 'we have seen sharp operators in derivative markets use just this kind of loophole to get around Federal regulation'.¹²⁷² An outraged Maria Cantwell commented as follows: 'I can't believe the first decision the administration would make to carry out Dodd-Frank would be an anti-transparency decision. The idea that

¹²⁶⁷ See CPSS (2008:78, footnote 66 and footnote 31 on p.24)

¹²⁶⁸ See the CLS Bank website at <https://www.cls-group.com/products/settlement/>, accessed 15 May 2018.

¹²⁶⁹ All quotes by Geithner taken from Reuters (2009b), see also Geithner quoted in US Senate Agriculture Committee (2009c:7).

¹²⁷⁰ Clark (2011)

¹²⁷¹ Smith quoted in Nasiripour/Grim (2010).

¹²⁷² Lincoln quoted in US Senate Agriculture Committee (2009c:7).

the foreign-exchange markets are not at risk is preposterous – we now know that they required multitrillion-dollar bailouts. Anytime you have a lack of transparency, there is potential for abuse'.¹²⁷³ She concluded that 'current law with its loopholes would actually be better than these loopholes, which are just going to continue to promulgate the problem'.¹²⁷⁴ Gary Gensler who tried to claim these products for the CFTC's jurisdiction also voiced concerns about regulatory evasion. In his words, FX trades 'could be broken down into their component parts and then restructured to resemble a series of foreign exchange forwards or a foreign exchange swap to come within the scope of these foreign exchange exclusions and thereby avoid regulation'.¹²⁷⁵

Second, the Democrats insisted that an exemption would represent a Wall Street subsidy to the banks whose reckless behaviour had caused the crisis in the first place. The Senate Banking Committee's chief economist, Rob Johnson, for example, characterized the proposed exemption as a 'form of Wall Street protectionism' and therefore inadequate to 'address the fault lines that OTC derivatives represent'.¹²⁷⁶ Using similar arguments, Bernie Sanders (I-VT) branded a potential carve-out 'an absolute disaster'.¹²⁷⁷ Against this background, Barney Frank promised to leave no room for an exemption.¹²⁷⁸ In the Senate, Chris Dodd considered closing the loophole a 'legitimate issue'.¹²⁷⁹

The Treasury, however, prevailed. While the Act did not provide for a blanket exemption, it specified the following:

Foreign exchange swaps and foreign exchange forwards shall be considered swaps [...] unless the Secretary [of the Treasury] makes a written determination [...] that either foreign exchange swaps or foreign exchange forwards or both –

- (I) should be not be regulated as swaps under this Act; and
- (II) are not structured to evade the Dodd-Frank Wall Street Reform and Consumer Protection Act [...] ¹²⁸⁰

The arrangement was considered a face-saving solution, particularly for the group of Democrats who had strongly opposed an exemption.¹²⁸¹ Note that any potential carve-out did not extend to business conduct and reporting standards.

¹²⁷³ Cantwell quoted in Kuttner (2011).

¹²⁷⁴ Cantwell quoted in Linkins (2010), for similar quotes see Cantwell cited in Newsmax Finance (2010).

¹²⁷⁵ Gensler (2009a:p.2 of the analysis)

¹²⁷⁶ Johnson quoted in Linkins (2010).

¹²⁷⁷ Sanders quoted in Kuttner (2011).

¹²⁷⁸ Frank quoted in Madigan (2009b).

¹²⁷⁹ Dodd referenced in Nasiripour/Grim (2010).

¹²⁸⁰ Section 1a(47)(E) of the CEA.).

¹²⁸¹ See Nasiripour/Ross (2012).

3.2 Lobbying under the banner of business unity: The banks and the buy-side pushing for an exemption

Interest groups' responses to the Treasury's public consultation on the determination revealed that the market widely supported an exemption, with the banks and the buy-side acting in unison and sending compatible signals. The only dissenting voices came from the exchanges that spoke through a joint submission of the World Federation of Exchanges and International Options Market Association. NGOs and the Senate Homeland Security and Governmental Affairs Committee also drafted skeptical submissions.

Building on ISDA's claim that 'the FX market has withstood many market disruptions' over the last decades and had also weathered the 2008 crisis extremely well,¹²⁸² the proponents of an exemption advised that FX swaps and FX forwards were safe products and that regulatory intrusion would risk disrupting a well-functioning market. Regarding product safety, they pointed to three key characteristics, which, from their point of view, differentiated those products from most other kinds of OTC derivatives: Stable payment obligations the size of which is known *ex ante*, short maturities which provide for deep market liquidity, and transparency, given widespread execution through electronic trading platforms. To the American Bankers Association (ABA), the Institute of International Finance (IIF),¹²⁸³ and the Financial Services Roundtable, '[t]hese unique features result in a substantively different, and substantially reduced, risk profile compared to other swaps and derivatives'.¹²⁸⁴ ICI argued that these are 'all features that mitigate risk and help ensure stability'.¹²⁸⁵ ISDA concurred, stating that '[t]he FX market is transparent and efficient'.¹²⁸⁶ Several other market actors advanced similar arguments.¹²⁸⁷

Settlement risk was the only type of risk market participants considered relevant. Indeed, according to a joint submission by SIFMA, AFME (Association of Financial Markets in Europe), and ASIFMA (Asia Securities Industry and Financial Markets Association), it 'dwarfs all other risks in the FX market'.¹²⁸⁸ The Foreign Exchange Committee whose members included ISDA alongside a number of individual large banks, believed it was 'the predominant risk'.¹²⁸⁹ Most private sector respondents believed this form of risk was already well addressed, if not entirely eradicated through counterparties' use of the CLS

¹²⁸² ISDA (2010a:2), see also microfinance provider MFX (2010:3).

¹²⁸³ The IIF acts as a forum representing banks and buy-side institutions.

¹²⁸⁴ ABA et al. (2011:2)

¹²⁸⁵ ICI (2011a:2)

¹²⁸⁶ ISDA (2010a:4)

¹²⁸⁷ SIFMA et al. (2010a:2ff.), BlackRock (2011:2), FXall (2010:2f.), Foreign Exchange Committee (2010:3ff.). The end users which at that point had not yet secured an encompassing exemption also voiced these points (see for example Coalition for Derivatives End Users (2010:5ff.)).

¹²⁸⁸ SIFMA et al. (2010a:3)

¹²⁸⁹ Foreign Exchange Committee (2010:3)

Bank. SIFMA, AFME, and ASIFMA, for instance, maintained that ‘CLS Bank’s settlement system today eliminates virtually *all* settlement risk to CLS Bank participants’.¹²⁹⁰

The supporters of an exemption also directed attention to the fact that the banks as the most active market participants were already sufficiently regulated themselves, with ISDA highlighting the importance of ‘consolidated supervision by the relevant banking regulator’.¹²⁹¹ The proponents of a carve-out therefore saw no reason for the Treasury not to pursue the exemption. BlackRock highlighted that ‘the FX market has already attained, under its current regulatory structure, the goals Dodd-Frank seeks to achieve for other OTC derivative markets’.¹²⁹² Along similar lines, the ABA, IIF, and the Financial Services Roundtable commented that ‘the presence of statutory carve-out language in Dodd-Frank is a recognition that the FX Swaps and FX Forwards markets already reflect Dodd-Frank’s primary goals for reform: greater transparency, effective risk management, and financial stability’.¹²⁹³

In contrast, the critics of an exemption emphasized that from their view, FX swaps and FX forwards were by far not as safe as the banks and some of their clients tried to make everybody believe, and that an exemption would only provide yet another loophole for Wall Street. The skeptics contended that the FX market had in fact experienced high levels of volatility during the crisis. Table 4 derived from sources cited in their submissions provides an overview of volatility in the FX market from the fall of 2007 to the autumn of 2008.¹²⁹⁴ It documents a drastic increase in the number of transactions (left column), which was driven by counterparties’ desire to quickly pass on risk. In addition, it indicates the presence of large average bid-offer spreads (middle column), as well as their increased volatility (right column).¹²⁹⁵

¹²⁹⁰ SIFMA et al. (2010a:4, emphasis in the original, see also p.13f.), see also ABA et al. (2011:3, in particular footnote 15), Foreign Exchange Committee (2010:4), and FXall (2010:3).

¹²⁹¹ ISDA (2010a:6)

¹²⁹² BlackRock (2011:2)

¹²⁹³ ABA et al. (2011:4)

¹²⁹⁴ See AfR (2010:3, footnote 11; 2011b:6, footnote 19).

¹²⁹⁵ Similar data was submitted by the World Federation of Exchanges and International Options Markets Association (2011:6).

Table 4: Increased volatility of the FX markets at the height of the crisis

Table 2

The Increase in FX Transactions and Spreads on Electronic Crossing Networks: Pre-crisis to Post-crisis

The table shows the percentage change from the Sept-Oct 2007 period to the Sept-Oct 2008 period in a) the number of transactions in each currency pair, b) the average bid-offer spread, and c) the volatility of the spread as collected from the EBS and Reuters electronic brokerage systems. Source: RBS.

	% increase in total transactions	% increase in avg bid-offer spread	% increase in volatility of avg bid-offer spread
EURUSD	92%	60%	336%
USDJPY	58%	60%	158%
GBPUSD	28%	293%	5500%
AUDUSD	81%	127%	1212%
USDMXN	36%	467%	715%
USDZAR	75%	135%	412%

Source: Melvin/Taylor (2009:29)

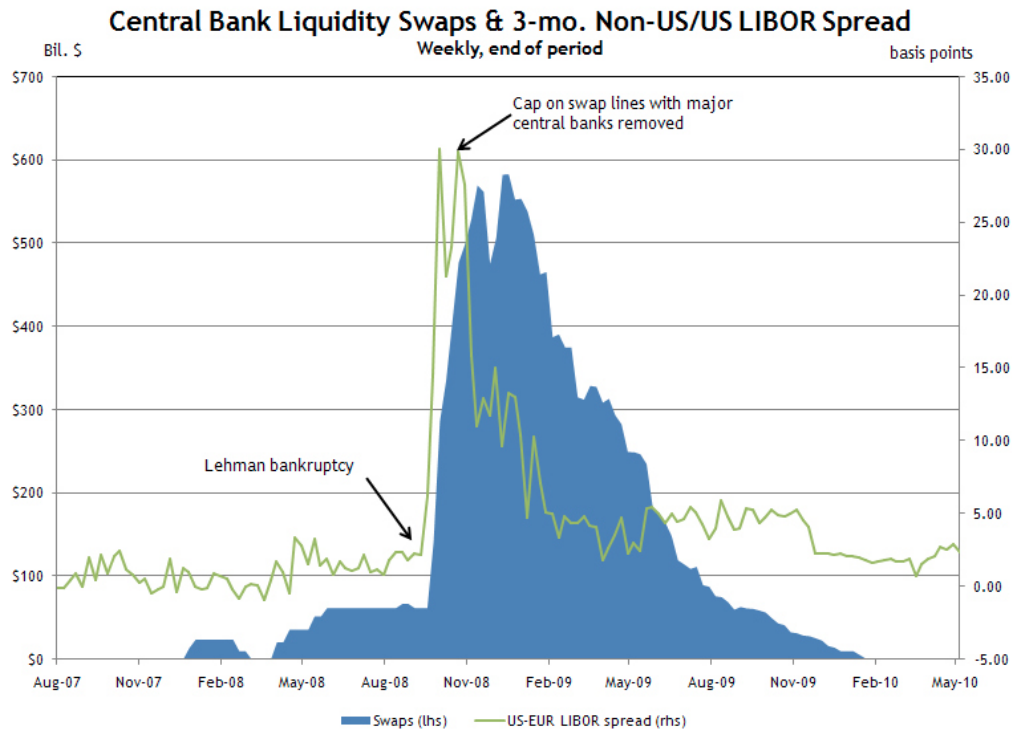
Better Markets explained that the effects of the crisis in this market had only been alleviated following the Fed’s arrangement of currency swap lines with foreign central banks of an unprecedented size.¹²⁹⁶ These central bank currency swaps functioned in the same way as currency swaps traded by private actors. Specifically, they allowed the Fed’s central bank counterparties to inject liquidity into their domestic economies, which eventually calmed the markets.¹²⁹⁷ Figure 24 illustrates this relationship, plotting the Fed’s central bank swaps and the 3-month non-US/US LIBOR spread as an indicator of market stability.¹²⁹⁸

¹²⁹⁶ Better Markets (2011:21ff.). Better Markets is a non-profit organization fighting for tighter financial reform.

¹²⁹⁷ The Fed itself did not use the funds it received through the swaps (Helleiner 2016b:96).

¹²⁹⁸ The LIBOR (London Interbank Offered Rate) represents a benchmark rate denoting at which interest rates a group of leading international banks are willing to lend short-term to each other. The rate provides the basis for calculating interest rates for a variety of loans at the global level.

Figure 24: The market-stabilizing effect of the Fed's central bank swap lines



Source: Federal Reserve Board/Bloomberg

Source: Federal Reserve Bank of Atlanta (2010)

Americans for Financial Reform (AfR) argued that this kind of intervention would have been unnecessary, '[h]ad the FX markets been better regulated'.¹²⁹⁹ It also cited a publication by the BIS according to which the use of CLS was not nearly as universal as market actors had claimed, with '\$1.2 trillion of FX obligations [...] still subject to settlement risk as a result of the use of traditional correspondent banking arrangements [...]'.¹³⁰⁰ In the same vein, Better Markets wrote that less than half of all transactions were channelled through electronic platforms, which made it conclude that the industry's claims about full market transparency were 'unfounded'.¹³⁰¹ The World Federation of Exchanges and the International Options Market Association went on to explain that not only was settlement risk not fully addressed, given that not every trade was channelled through the CLS Bank, but that the Bank itself did not mitigate counterparty credit risk.¹³⁰² Better Markets added that neither did stable payment obligations, nor short maturities, nor the mere availability of CSAs.¹³⁰³

¹²⁹⁹ AfR (2010:3)

¹³⁰⁰ AfR (2011b:13) quoting CPSS (2008:13).

¹³⁰¹ Better Markets (2011:13)

¹³⁰² World Federation of Exchanges and International Options Market Association (2011:3ff.), also AfR (2011b:12).

¹³⁰³ Better Markets (2011:14,9)

The critics of an exemption also believed that providing regulatory relief for FX swaps and FX forwards would open a giant loophole for the industry. The Senate Homeland Security Committee, for instance, observed that the industry itself had already provided sufficient evidence for the accuracy of this view in light of its past actions. Specifically, the committee pointed to the actions of Goldman Sachs which in the early 2000s had assisted the Greek government in disguising the level of its debt through the perceived misuse of sophisticated FX derivatives. The committee explained that the discovery of this (entirely legal) manoeuvre had contributed to the start of the sovereign debt crisis. The fact that a number of other entities ranging from the government of Italy to energy giant Enron had previously applied similar strategies only reinforced its conviction that ‘foreign exchange swaps and foreign exchange forwards should not be exempted from regulation’.¹³⁰⁴ For the critics, any carve-out would act as the ‘starting gun for the financial wizards on Wall Street to let their creative juices flow and figure out how many products they can cram through the loophole’.¹³⁰⁵

3.3 The seemingly perfect reflection of the banks’ arguments in the Treasury Determination: A case of congruence for the banks

The Treasury Determination provided the exemption for FX swaps and FX forwards¹³⁰⁶ that Geithner had sought from the beginning.¹³⁰⁷ The document was published shortly after the presidential elections of 2011, at a moment when the level of issue salience was low enough for the solution to attract comparatively little public attention.¹³⁰⁸ Referring again to the ‘qualitatively different’¹³⁰⁹ nature of these products, the Determination repeated the industry’s arguments. Indeed, in order to explain away the need for regulation, it listed the same product characteristics market actors had discussed as risk-reducing and concluded that these ‘distinctive structural characteristics [...] merit different regulatory treatment’.¹³¹⁰ For example, the Determination pointed out that market ‘participants know their own and their counterparties’ payment obligations and the full extent of their exposures at settlement through the life of the contract’.¹³¹¹ In addition, it highlighted the ‘much shorter maturities’, which, in its view, resulted in ‘significantly lower levels of counterparty credit

¹³⁰⁴ US Senate Homeland Committee (2010:5). The NGOs also advanced these arguments (see for example AFR (2011b:15), Better Markets (2011:12), and Greenberger (2010a:6)).

¹³⁰⁵ Dennis Kelleher of Better Markets quoted in Braithwaite (2011), see also Better Markets (2011:11), AFR (2011b:13f.), US Senate Homeland Committee (2010:1f.).

¹³⁰⁶ Given the design of cross-currency swaps, the exemption automatically extended to the portion involving the fixed, physically-settled exchange of principal of these trades (Latham&Watkins 2017:16, endnote 9).

¹³⁰⁷ The final Determination was preceded by a proposal (see US Treasury Department 2011), which at the time was considered and eventually turned out ‘to be the final word on the issue’ (Braithwaite 2011). For this reason, the analysis only references the final version.

¹³⁰⁸ Nasiripour/Ross (2012)

¹³⁰⁹ US Treasury Department (2012b:69696)

¹³¹⁰ *ibid.*

¹³¹¹ US Treasury Department (2012b:69697)

risk'.¹³¹² Finally, the Determination cited statistics suggesting that 41% of FX swaps and 72% of FX forwards were already channelled through electronic trading platforms, which made it conclude that stricter regulation 'would be unlikely to improve price transparency significantly'.¹³¹³ In line with the industry, the Treasury observed that this unique set of product characteristics 'contributes to a risk profile that is largely concentrated on settlement risk'.¹³¹⁴ Equally in line with the majority of commenters, the Determination insisted that this source of risk was already 'largely address[ed]', given the 'extensive' use of PVP arrangements and CLS's settlement of 68% of the market.¹³¹⁵

Regarding the concern about regulatory evasion, the Treasury reassured the skeptics that the carve-out from the definition of 'swap' did not provide any relief from Dodd-Frank's trade reporting and business conduct standards.¹³¹⁶ In addition, it emphasized that any attempt to use the exemption as a loophole would not only be 'illegal',¹³¹⁷ but also further complicated given 'operational challenges and transaction costs'.¹³¹⁸

Finally, the Determination dismissed reservations against an exemption by reinforcing the industry's observation that the banks as the most active FX market actors 'are subject to prudential supervision, including comprehensive risk-management oversight'.¹³¹⁹ The Treasury did not expand on the role of the Fed's currency swaps or the general performance of the FX market during the crisis, the only exception being a brief reference to the market as 'one of the few parts of the financial market that remained liquid throughout the financial crisis'.¹³²⁰

At first sight, the Treasury's justification of the exemption appears as a glorious victory for market actors, above all ISDA and the large banks. Some observers have indeed taken that line. One media article, for example, cited statistical data from the OCC according to which the dealers had derived more than a third of their revenues for Q1-3 of 2010 from the FX segment. The article implicitly suggests that the exemption had to be interpreted as the result of successful bank lobbying and that the Treasury simply intended to protect the banks' profitability.¹³²¹ The 'profitability' argument implies that the Treasury's 'no harm' argument, discussed earlier in this chapter, mainly involved doing 'no harm' to the banks' balance sheets.

¹³¹² *ibid.*

¹³¹³ *ibid.*

¹³¹⁴ *ibid.*

¹³¹⁵ US Treasury Department (2012b:69698)

¹³¹⁶ US Treasury Department (2012b:69699)

¹³¹⁷ Mary J. Miller, Assistant Secretary of the Treasury for Financial Markets, quoted in Braithwaite (2011).

¹³¹⁸ US Treasury Department (2012b:69702)

¹³¹⁹ US Treasury Department (2012b:69701)

¹³²⁰ *ibid.*

¹³²¹ Kuttner (2011), see also Greene/Potiha (2013:357).

However, there is reason to believe that this was probably not the Treasury's *primary* motivation. Indeed, if it had been the Treasury's driving concern, we would need to ask why it pushed for encompassing regulation across all other asset classes in the first place. Derivatives in general (i.e. not only FX swaps and FX forwards) used to be among the most lucrative parts of dealers' business. The 'profitability' argument also does not explain why the Treasury did not ask for an outright exemption of *all* FX derivatives, rather than insisting on a special treatment for these two product types. While we cannot exclude that the Treasury at some point might have requested a broader carve-out behind closed doors, we know that its main focus rested on these particular product types.

The most likely alternative explanation for the exemption seems to be the Treasury's intention to keep these products outside the CFTC's jurisdiction to which they would have otherwise automatically been subject. Why would the Treasury disapprove of the CFTC having jurisdiction over FX swaps and FX forwards, while it supported having the bulk of the other derivative products regulated by the very same agency? Why were these product types considered 'different'? A derivatives lawyer of Jones Day has been quoted in the press as saying that '[w]hat it comes down to is an issue of regulatory turf. [...] It might not be an issue that forex is a fundamentally different product to other OTC contracts, but a political move rather than anything else'.¹³²²

Against this background, we might need to interpret the Determination as a tactical solution intended to limit the CFTC's reach. Indeed, the 'political move' of outmanoeuvring the agency might have been informed by at least two reasons related to turf, both of which concerned the Fed's special role in this segment of the FX market. The first one related to its conduct of monetary policy, the second one to its dominant role in the governance of international payments systems.¹³²³

The first reason concerns the relevance of FX swaps and FX forwards to the Fed's monetary policy, in particular the foreign currency segment of its Open Market Operations. The Fed's use of FX swaps and FX forwards is part of its cable transfers, which 'encompasses purchases and sales through standalone spot or forward transactions and through foreign exchange swap transactions'.¹³²⁴ Back in 1961, the Fed's general counsel, Howard Hackley, wrote a memo which 'argued that various sections of the [Federal Reserve] Act - when considered together - authorized the Federal Reserve System to hold foreign exchange, to intervene in both the spot and forward markets, and to engage in swap transactions with foreign central banks and with the US Treasury'.¹³²⁵ The 'Hackley Memo' is still relevant today, with eminent economist Allan Meltzer arguing that it 'remains as the legal basis of the Federal Reserve's holding of foreign exchange by purchase or 'warehousing', i.e. a loan to the Treasury secured by foreign currency'.¹³²⁶ While warehousing has gone slightly out of

¹³²² Joel Laub of Jones Day quoted in Madigan (2009a).

¹³²³ These two reasons are also referenced in SIFMA et al. (2010a) and ISDA (2010a).

¹³²⁴ Federal Open Market Committee (2018:1)

¹³²⁵ Bordo et al. (2015:140)

¹³²⁶ Meltzer (2009:350, footnote 138)

fashion, given the political concerns such a loan might fuel with regard to the Fed's independence,¹³²⁷ this chapter has already discussed the Fed's swap lines with other central banks as a fundamentally important stabilizing element at the height of the crisis. Indeed, the Fed acted as the *de facto* international lender-of-last-resort to the central banks of Australia, Brazil, Canada, Denmark, England, the EU, Japan, Korea, Mexico, New Zealand, Norway, Singapore, Sweden, and Switzerland.¹³²⁸ In his memoir, Ben Bernanke describes the swap lines as 'crucial in containing global contagion'.¹³²⁹ Preventing the CFTC from interfering with these vital aspects of the Fed's Open Market Operations could thus have been one of the reasons for the exemption.

The second reason might relate to the Treasury's intention of shielding the governance of the international payments systems, a central pillar of which is the CLS Bank, from the influence of the CFTC. Already in the 1970s, when the US Congress amended the Commodity Exchange Act of 1936 to create the CFTC (i.e. at a time when the CLS Bank did not yet exist), the Treasury drafted an amendment, known as the Treasury Amendment, which clarified that the new agency should limit its oversight to FX futures traded on organized exchanges. In a letter to the Senate Agriculture and Forestry Committee, the Treasury further detailed its motivation. While the letter was clearly informed by the rising deregulation consensus, it equally reflected the desire to prevent the CFTC from interfering with the work of the Fed (and the OCC):

*Virtually all futures trading in foreign currencies in the United States is carried out through an informal network of banks and dealers. This dealer market, which consists primarily of the large banks, has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements. The participants in this market are sophisticated and informed institutions, unlike the participants on organized exchanges, which, in some cases, include individuals and small traders who may need to be protected by some form of governmental regulation. Where the need for regulation of transactions on other than organized exchanges does exist, this should be done through strengthening existing regulatory responsibilities now lodged in the Comptroller of the Currency and the Federal Reserve. These agencies are currently taking action to achieve closer supervision of the trading risks involved in these activities. The Commodity Futures Trading Commission would clearly not have the expertise to regulate a complex banking function and would confuse an already highly regulated business sector.*¹³³⁰

The US Congress approved the Amendment in 1974.¹³³¹ After more than two decades of legal battle over the precise interpretation of the text during which the CFTC tried to extend

¹³²⁷ Humpage (2017:1). The Fed nonetheless keeps its authorization to pursue warehousing up-to-date (see Federal Open Market Committee (2018:2)).

¹³²⁸ Helleiner (2016a:2), Board of Governors of the Federal Reserve System (No Year).

¹³²⁹ Bernanke (2015:410)

¹³³⁰ US Treasury quoted in Harvey (2013:346, emphasis in the original).

¹³³¹ US General Accounting Office (1997:23)

its jurisdiction, the Supreme Court upheld the core of the Treasury Amendment in 1997.¹³³² Justice Antonin Scalia made the following comment corroborating the view that one of the Treasury's main intentions was to prevent the CFTC from expanding its jurisdiction:

[I]f Treasury were that confident [that the CFTC would not interfere with the efficiency of the interbank market], they would never have introduced the Treasury Amendment[.] If they were content to rely upon the good offices of the ... Commodity Futures Trading Commission, they wouldn't have introduced the amendment at all. They would have just said we'll cut our deal with the Commission. We know they're reasonable people.¹³³³

The importance of the Fed's leadership to the governance of the international payments systems can also be derived from various reports published by a number of groups composed of central bank representatives acting under the umbrella of the BIS. For example, the 1990 report of the Committee on Interbank Netting Schemes highlighted that '[i]nterbank payment and settlement arrangements provide the basic mechanism for the exchange of monetary value among financial institutions and, as such, are fundamental components of each country's banking and monetary system'.¹³³⁴ In a similar way, a 1996 report by CPSS (the Committee on Payments and Market Infrastructures) argues that '[s]ecure and well-functioning payments systems are necessary for the attainment of central banks' monetary, macroprudential, supervisory and other policy objectives. [...] It is therefore appropriate that central banks should be concerned that the settlement arrangements in the foreign exchange markets should be structured so as to minimise systemic risk (the risk that the failure of one market participant to meet its required FX settlement or other obligations when due may cause significant liquidity or credit problems for other participants, and so may threaten the stability of the financial markets)'.¹³³⁵

In light of this assessment, it is probably not surprising that the CLS Bank is regulated by a group of central banks through the 'CLS Oversight Committee [which is] organized and administered by the Federal Reserve'.¹³³⁶ The CLS Bank maintains accounts at the participating central banks in which it receives settlement members' payments and through which it adjusts their respective sub-accounts. While central banks do not issue money for this purpose, CPSS notes that 'all payments to and from CLS are made through the issuing central bank, so central bank money retains a necessary role, pivotal but not central, in the settlement of foreign exchange transactions in CLS'.¹³³⁷ The exemption of FX swaps and FX forwards which together represent the bulk of trades settled by CLS might therefore also be understood as a move to protect the privileged relationship between the Fed (as well as other central banks) and the CLS Bank.

¹³³² See Tormey (1997).

¹³³³ Scalia quoted in Tormey (1997:2365), with all modifications to the quote made in the article itself.

¹³³⁴ Committee on Interbank Netting Schemes (1990:14)

¹³³⁵ CPSS (1996:4f.)

¹³³⁶ CLS Bank (2011:6)

¹³³⁷ CPSS (2003:3)

If the CFTC had gained jurisdiction over FX swaps and FX forwards, it would most likely have imposed a clearing mandate. This means a CFTC-regulated CCP would have had to cooperate with the CLS Bank, an outcome the Fed might have intended to avoid. Indeed, the central clearing of FX trades had already been explored 30 years earlier, but central banks had dismissed the idea because of turf. In its 1989 report, the Group of Experts on Payment Systems (representing the central banks of the G10 countries) identified as particularly problematic ‘the overlapping jurisdiction of domestic supervisory authorities. [...] [C]learing houses are likely to have characteristics that are similar to clearing corporations for organised securities and futures exchanges. Thus, in countries where the authority to supervise banking, securities and futures activities is divided between two, or more, official bodies, jurisdictional questions may arise’.¹³³⁸

After the crisis, central banks once again considered the idea of central clearing for FX trades. However, the Committee on the Global Financial System and the Markets Committee¹³³⁹ housed at the BIS ultimately rejected it, referencing the risk that ‘any migration to a CCP model for a significant part of the FX market will have implications for the CLS business model’.¹³⁴⁰ Shielding FX swaps and FX forwards from the CFTC might have also been an additional reason (beyond the deregulation consensus and concerns pertaining to competitiveness) why Greenspan, Summers, and Rubin shut down Brooksley Born’s attempts of regulating OTC derivatives in the late 1990s.

3.4 Discarding IM, but imposing VM through supervisory guidance

An additional reason casting doubt on the ‘profitability’ argument is the New York Fed’s decision, taken in cooperation with other central banks, to pursue supervisory guidance over banks’ adequate use of VM in their FX derivatives business. While the Determination attempted to downplay the risks of the market, Geithner was in fact acutely aware of them. Under his leadership as chair of the New York Fed, CPSS had discussed the results of a survey on financial institutions’ management of FX settlement obligations that had identified major weaknesses.¹³⁴¹ For example, while it found that 55% of the total transaction volume was channelled through CLS, it concluded that the fraction of trades still depending on ‘traditional correspondent banking remain[s] significant’.¹³⁴² In addition, it reported that the total settlement exposure of some institutions surpassed their capital by a

¹³³⁸ Group of Experts on Payment Systems (1989:8)

¹³³⁹ The Markets Committee focuses on ‘assessing current events as well as longer-term structural trends that may have implications for financial market functioning and central bank operations’ (see the Committee’s website at <https://www.bis.org/about/factmktc.htm>, accessed on 20 August 2018).

¹³⁴⁰ Committee on the Global Financial System and Markets Committee (2010:13)

¹³⁴¹ The survey covered 109 institutions located in the jurisdictions of 27 central banks (15 currency areas) whose trades represented 80% of the FX market (CPSS 2008:4).

¹³⁴² CPSS (2008:6)

factor of 3-6.¹³⁴³ Most worryingly, the survey revealed that the risks of FX trades were often not well understood by market actors. No more than a third of the institutions questioned were equipped with appropriate control mechanisms to check their exposures, and this fraction often did not include the institutions managing the largest exposures in function of capital.¹³⁴⁴

This might have presented the Fed with a dilemma. There was a perceived need for improved collateralization, but the Treasury Determination had made it impossible to impose formal requirements. Against this background, the preferred strategy was to enhance the use of VM through supervisory guidance by the New York Fed under its safety and soundness mandate, a solution which did not require new legislation and was compatible with existing one. The overall approach of the US thus involved pursuing an exemption from IM, but introducing VM through supervisory guidance. Most of this reasoning took place away from the public spotlight, meaning it did not attract or raise public issue salience.

At the transnational level, this approach required several steps to be taken. First, WGMR had to be pushed to adopt a similar exemption for FX swaps and FX forwards from IM. From a purely competition-oriented perspective, the US might have probably benefited if banks in foreign jurisdictions had been required to post IM for FX swaps and FX forwards, while its own banks were exempt and thus in a position to lower cost and attract new business. However, this move would have likely further increased systemic risk in the American banking system. Most importantly, it would have openly contradicted the US's overall desire to achieve a regulatory race to the top, which might have negatively affected its credibility. Further research would be required to uncover the precise decision-making rationale in this context.

WGMR contemplated an exemption in its early discussions. Its first consultation paper cited 'the particular market and structural features of those instruments',¹³⁴⁵ i.e. the characteristics the Treasury Determination had considered risk-reducing. However, there were tensions among the group, reflected by a passage in the consultation paper according to which it was 'unclear whether these characteristics fully offset the need for margin requirements'.¹³⁴⁶ The European members, in particular, rejected an exemption from IM (see section 4 of this chapter).¹³⁴⁷ In the end, however, the US prevailed and WGMR adopted the desired exemption.¹³⁴⁸

¹³⁴³ CPSS (2008:9)

¹³⁴⁴ CPSS (2008:12). Similar conclusions were drawn by CPSS' sister committee, the Committee of the Global Financial System (2010b).

¹³⁴⁵ BCBS-IOSCO (2012:7)

¹³⁴⁶ *ibid*, see also Clark (2013b).

¹³⁴⁷ See for example Noyes (2014).

¹³⁴⁸ See BCBS-IOSCO (2013b:6f.).

Second, the use of VM had to be promoted. The Fed decided to take advantage of BCBS-CPSS's Working Group on Foreign Exchange Settlement Risk which was chaired by its representative Jean-Marie Davis of the New York Fed. Davis identified the 'sharpen[ing] of the discussion of replacement cost risk and holding of variation margin' as one of the group's key tasks.¹³⁴⁹ In February 2013, the group published a package of seven guidelines, recommending a series of measures for banks to tackle FX risk, in line with the concerns discussed by the CPSS survey. The third guideline recommended the use of VM:¹³⁵⁰

A bank should use legally enforceable collateral arrangements and should have an explicit policy on margin, eligible collateral and haircuts to reduce replacement cost risk. A bank should exchange (ie both receive and deliver) the full amount of variation margin necessary to fully collateralise the mark-to-market exposure on physically settled FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities. [...]¹³⁵¹

Davis strongly affirmed the importance of the use of VM for banks' FX risk management: 'This is an important piece of supervisory guidance and I expect there to be a lot of important development in the industry in response to it'. Emphasizing that 'the industry will have some work to do in making sure they have all the CSAs they need', she announced that '[w]e will monitor the progress of implementation of the guidance and we want to see an improvement in the industry's ability to identify, measure and monitor the duration of the risks, and then take steps to eliminate or mitigate the risk'.¹³⁵²

WGMR subsequently imported this guideline on the use of VM into its own framework. This manoeuvre worked rather smoothly, given the strong support for regulation of the FX swaps and FX forwards business by many of the group's European members. The WGMR framework recommended that '[i]n developing variation margin standards for physically settled FX forwards and swaps, national supervisors should consider the recommendations in the BCBS supervisory guidance'.¹³⁵³ The US Fed did so through the adoption of corresponding supervisory guidance.¹³⁵⁴

One might ask why the Treasury did not simply ask Congress to grant the Fed jurisdiction over FX derivatives in the first place, rather than strategizing the rather cumbersome manoeuvre of pushing for a domestic and then global exemption first, only for guidance to be subsequently issued both at the international level and domestic level. Publicly available material on this question is scarce, but it appears that public issue salience might have rendered it unwise for the Treasury to make this move. Indeed, the Fed faced strong

¹³⁴⁹ Davis quoted in Clark (2013c).

¹³⁵⁰ The supervisory guidance comprises 7 guidelines targeting banks' governance arrangements, capital needs, as well as protections against principal risk, liquidity risk, operational risk, and legal risk.

¹³⁵¹ BCBS (2013:15)

¹³⁵² All quotes by Jeanmarie Davis as cited in Clark (2013c).

¹³⁵³ BCBS-IOSCO (2013b:6)

¹³⁵⁴ See Board of Governors of Federal Reserve (2013:2).

domestic criticism for having failed to prevent the crisis, and its perceived mismanagement of the crisis itself only reinforced Congress' anger. For example, Congress' antagonism had already torpedoed the Treasury's original plan to turn the Fed into a systemic risk regulator for the entire US financial system,¹³⁵⁵ with the job going to FSOC instead.

House Agriculture committee chair Collin Peterson spoke for many of his colleagues who believed the Fed had been asleep at the wheel, when he approvingly cited a press article in which the Fed was criticized as having been 'supposed to supervise the lending of many of the banks now in trouble, and yet seemingly they did nothing.' Referring to the systemic risk regulator debate, Peterson went on to quote from the article which asked 'why, when they didn't do the job they were supposed to be doing, one would give them even more responsibility'.¹³⁵⁶ In the Senate, Chris Dodd pointed out that '[f]rom its failure to protect consumers, to regulate mortgage lending, to effectively oversee bank holding companies, the instances in which the Fed has failed to execute its existing authority are numerous.¹³⁵⁷ Citing an American scholar and former Fed official, he concluded that '[g]iving the Fed more responsibility at this point [...] is like a parent giving his son a bigger faster car after he crashed the family station wagon'.¹³⁵⁸

Jim Bunning criticized the secrecy surrounding the Fed's emergency lending decisions, arguing that 'the American people have a right to know where that money is going'.¹³⁵⁹ Regarding the lack of funds flowing to domestic businesses, he attacked the Fed for having 'put the printing presses into over-drive to [...] hand out cheap money to [its] masters on Wall Street, which they used to rake in record profits while ordinary Americans and small businesses cannot even get loans for their everyday needs'. In a public hearing, he told Bernanke he considered this failure sufficient 'to send you [i.e. Bernanke] back to Princeton'.¹³⁶⁰ At one point, the Fed's chair nomination for a second term seemed at serious risk in the Senate.¹³⁶¹

The Fed's swap lines, in particular, were widely considered a back-door bailout of foreign banks, to the detriment of the American taxpayer. Bernie Sanders, for example, furiously expressed his disapproval of this policy, saying that '[i]t is incomprehensible to me that while creditworthy small businesses in Vermont and throughout the country could not receive affordable loans, the Federal Reserve was providing tens of billions of dollars in credit to a bank [i.e. Arab Banking Corp] that is substantially owned by the Central Bank of

¹³⁵⁵ Hopkins (2009)

¹³⁵⁶ Peterson quoting an article by Lynn Turner, former chief economist of the SEC as cited in US House Agriculture Committee (2008b:136).

¹³⁵⁷ Dodd quoted in US Senate Banking Committee (2009b:2).

¹³⁵⁸ Dodd quoted in US Senate Banking Committee (2009c:10) as citing Mark Williams, professor of finance and economics at Boston University and former Fed examiner.

¹³⁵⁹ Bunning quoted in US Senate Banking Committee (2009a:16).

¹³⁶⁰ Bunning quoted in US Senate Banking Committee (2009d:26,25). Bernanke had been a professor at Princeton before becoming Fed chair.

¹³⁶¹ Scheiber (2010b)

Libya'.¹³⁶² Congress' anger went so far as to result in an audit of the Fed's emergency lending system and the statutory limitation of its emergency lending powers during future crises.¹³⁶³ In addition, several bills calling for a full audit of the Fed's entire range of activities, including its monetary policy, were introduced, although ultimately none of it was ever enacted.¹³⁶⁴

Under these circumstances, asking for the exclusive jurisdiction over FX derivatives could have turned out problematic for the Fed, as it might have reinvigorated Congress' appetite for limiting the central bank's powers even further. Against this background, the Treasury's request for an exemption of FX swaps and FX forwards provided an elegant alternative, as it directed Congressional attention away from the Fed. The final solution kept the Fed's influence over these two important product categories intact, shielding its conduct of monetary policy and the governance of payments systems from any outside interference. Dealer bank influence does not appear to have played a significant role in this case.

4. The EU case

4.1 The banks' push against regulation support by the buy-side

In Europe, interest groups from both the sell-and buy-side unanimously opposed IM for FX swaps and FX forwards. VM was also widely rejected, although there were one or two cracks in the consensus. NGOs rarely participated in the public debate, and, as in the US, the end-users had already asked for an encompassing exemption for all product categories.¹³⁶⁵

The banks' submitted information centred on two arguments in support of regulatory relief. First, as in the US, they believed that these products were 'different' compared to other types of OTC derivatives. The London Foreign Exchange Joint Standing Committee, housed at the Bank of England and composed of the largest market participants, pointed to numerous safety-enhancing features of the market including '[t]he deep and liquid nature of the market and high level of transparency, together with the risk mitigating structures already in place and a well established code of conduct between participants'.¹³⁶⁶ It also observed that many counterparties 'are themselves regulated entities'.¹³⁶⁷ GFMA (the Global Financial Markets Association representing AFME, SIFMA, and ASIFMA) applauded

¹³⁶² Sanders quoted in Hardie/Maxfield (2016:607).

¹³⁶³ Greenstein (2011), Lynch (2013)

¹³⁶⁴ See for example Paul (2009).

¹³⁶⁵ See for example European Association of Corporate Treasurers (2014a:3), Austrian Federal Economic Chamber (2014:3), and Argus Media (2010:2).

¹³⁶⁶ Foreign Exchange Joint Standing Committee (2009:2), see also RBS (2010:2).

¹³⁶⁷ Foreign Exchange Joint Standing Committee (2009:6)

the work of the CLS Bank, arguing that ‘prudent supervision, practice guidelines and capital implications’ were already in place to address all pertinent forms of risks.¹³⁶⁸ Bank of America-Merrill Lynch mentioned the widespread reliance of market actors on electronic trading and collateralization through the use of CSAs.¹³⁶⁹ From ISDA’s point of view, the overall safety of the market allowed for only one logical conclusion, i.e. ‘that such trades should attract lower regulatory capital and margin requirements, if any at all, than other uncleared trades to reflect this lower level of risk’.¹³⁷⁰ UBS simply explained to policy-makers that ‘common sense must be applied’ in the rule drafting.¹³⁷¹

Second, the dealers highlighted the competitive repercussions for EU firms, in case Europe were to divert from the course of the US. Warning of ‘unnecessary differences’, ISDA maintained ‘that a level international playing field is required to promote competition and prevent the distortions in trade which result from differing regulatory regimes’.¹³⁷² GFMA wrote ‘it is essential that the smooth functioning of the FX market not be disrupted’.¹³⁷³ The recommendation of the German Banking Industry Committee read that the ESAs should ‘align the European framework more closely with that of other regulatory frameworks, in particular the USA [...] and thus help to avoid the significant competitive advantages’ any other decision would imply.¹³⁷⁴ Along similar lines, the French Banking Federation insisted that ‘[i]nternational consistency is needed to avoid what could be a major disruption of competition for banks submitted to EMIR and their clients’.¹³⁷⁵ Exit threats were not a dominant part of the banks’ publicly available communications.

The buy-side advanced very similar arguments. Commenters questioned the virtues of public intervention, given ‘that many of the benefits the regulation seeks to address have been sufficiently mitigated by market practice without the cost implications’,¹³⁷⁶ in particular the mitigation of settlement risk through the CLS Bank, short maturities and stable payment obligations.¹³⁷⁷ Numerous buy-side actors also pointed to the need for regulatory consistency with the US Treasury Determination.¹³⁷⁸ SIFMA’s Asset Management Group, for instance, asked for complete relief from both IM and VM, claiming that any other regulatory approach, in particular the imposition of VM by the ESAs, would result in ‘conflicting requirements’ with the US margin rules, which ‘could lead to regulatory

¹³⁶⁸ GFMA (2014:3), see also State Street (2014:2, 2010a:2f.), HSBC (2010:1).

¹³⁶⁹ Bank of America-Merrill Lynch (2010:2)

¹³⁷⁰ ISDA and Financial Services Industry (2012:2)

¹³⁷¹ UBS (2010:3)

¹³⁷² ISDA and Financial Services Industry (2012:2)

¹³⁷³ GFMA (2014:3)

¹³⁷⁴ German Banking Industry Committee (2014:21)

¹³⁷⁵ French Banking Federation (2014:2)

¹³⁷⁶ Record Currency Management (2014:7)

¹³⁷⁷ Record Currency Management (2014:1f), see also Adrian Lee & Partners (2014:2).

¹³⁷⁸ See for example Record Currency Management (2014:1), see also Millennium Global (2015:2), Russell Investment (2015:2f.), The Investment Association (2015:14). More generally also BVI (2014:1) and Assogestioni (2014:1).

arbitrage'.¹³⁷⁹ EIOPA's Occupational Pensions Stakeholder Group and Insurance and Reinsurance Stakeholder Group explicitly backed the sell-side's position, arguing that 'the banks recommend that physically-settled FX forwards and swaps should be exempted from any regime which requires the exchange, collection or posting, of initial margin between transacting parties on a mandatory basis'.¹³⁸⁰

Regarding the use of VM, ISDA was crystal clear in its rejection of any formal requirement, arguing that supervisory guidance as applied in the US was less strict than formal rules: '[C]ompliance with supervisory guidance is not identical to compliance with margin rules; supervisory guidance does not have the same level of detail, it may apply only to banks, and may be interpreted in different ways for different countries. As a result, there is a significant difference for ISDA members between implementing margin rules and implementing supervisory guidance'.¹³⁸¹ Deutsche Bank pointed to '[t]he potential competitive distortion' mandatory EU rules would introduce,¹³⁸² given that entities exclusively regulated by the CFTC were not subject to the New York Fed's supervisory guidance, while the ESAs' rules would apply across all types of firms.

On the buy-side, VM requirements found support among the members of EIOPA's Pensions Stakeholder Group and Insurance and Reinsurance Stakeholder Group which suggested that a '[v]ariation margin requirement for these products should be required as a result of supervisory guidance or national regulation'.¹³⁸³ The vast majority of buy-side firms, however, rejected VM. Asset manager Adrian Lee & Partners, for example, requested the ESAs to show 'consistency' with Dodd-Frank and the Treasury Determination. It warned of the competitive implications of the mandatory prescription of VM, which 'would only result in putting EU financial institutions at a competitive disadvantage'.¹³⁸⁴ Millennium Global equally argued that a VM mandate 'is at odds with international standards. [...] This would put EU banks at a competitive disadvantage'.¹³⁸⁵

4.2 EU policy-makers imposing VM and harbouring strong reservations against an exemption from IM

As already mentioned in the analysis of the US case, EU policy-makers harboured important reservations against carving out these products, and, initially, they did not see any reason for deviating from the overall ideational consensus. For the EU Commission, there were three main concerns. First was the risk of regulatory arbitrage, with Michel Barnier drawing

¹³⁷⁹ SIFMA AMG (2015:4,9)

¹³⁸⁰ EIOPA OPSG and IRSG (2014:13)

¹³⁸¹ ISDA (2016:8)

¹³⁸² Deutsche Bank (2015:3). State Street (2014:2) also opposed the imposition of a formal VM mandate.

¹³⁸³ EIOPA OPSG and IRSG (2014:14)

¹³⁸⁴ Adrian Lee & Partners (2015:1,2)

¹³⁸⁵ Millennium Global (2015:2)

attention to 'the possibility of transactions being re-categorised in order to benefit from such an exemption'.¹³⁸⁶ Along similar lines, another EU Commission official emphasized that '[i]t makes little sense to go down an asset-specific, single path. We must target all derivatives'.¹³⁸⁷ Second, the Commission pointed out that counterparty credit and settlement risk were still relevant.¹³⁸⁸ In the words of Patrick Pearson, head of the Commission's financial infrastructure unit, '[m]ost risk in FX is settlement risk. Is it really true that CLS took care of that?'¹³⁸⁹ Indeed, Germany's KfW-Bank, a government-owned development bank, had made a Euro 300mn payment outside of CLS to Lehman Brothers on the very day of the bank's bankruptcy, without obtaining a single dollar of the amount it should have received in return for its payment.¹³⁹⁰ Third, Pearson referred to statistics showing a dramatic increase of FX volatility during the crisis, which made him question the impression created by some interest groups that the FX segment had weathered the crisis well.¹³⁹¹

The EU Parliament largely supported the Commission's views. A few MEPs led by the UK representatives Sharon Bowles and Kay Swinburne pushed for an exemption. Both policy-makers contended that the CLS system was sufficient to address the main risks of the market.¹³⁹² Swinburne whose 'personal preference would be to take FX out of the clearing obligation altogether' hoped that the Treasury Determination would make her position 'gain more traction'.¹³⁹³ Her ideal approach would have been 'to address this directly in the regulation'.¹³⁹⁴ Bowles equally maintained that '[i]nternational consensus with the US is quite important, which is why you shouldn't be rigid where you don't need to be rigid. You don't want to find your EU legislation has left you high and dry'. Unlike Swinburne, she preferred a more nuanced approach, in case the US would reconsider its position: '[W]e didn't want to explicitly say 'exempt FX' in case the US changes its mind; we'd then be stuck with it in our primary legislation', she explained.¹³⁹⁵

Bowles and Swinburne, however, faced strong opposition from their continental European colleagues who advocated a more independent European approach. German MEP Markus Ferber, for instance, questioned that FX was 'different', noting that 'there was no-one able to explain to me why there should be a totally different approach for FX markets in comparison to other markets. Of course I've learnt what the US did [...] - they will not include FX swaps in the Dodd-Frank regime. But that is the US approach. For the moment I don't see any need to have another approach for FX at the European level. The Parliament's

¹³⁸⁶ Barnier (2013)

¹³⁸⁷ Mattias Levin of the EU Commission quoted in Grant (2009).

¹³⁸⁸ Barnier (2013)

¹³⁸⁹ Pearson referenced in Khalique (2011b).

¹³⁹⁰ Hughes (2009a), Melvin/Taylor (2009:14)

¹³⁹¹ Pearson referenced in Khalique (2011b).

¹³⁹² See Khalique (2011c, 2011e, 2011f)

¹³⁹³ Swinburne quoted in Khalique (2011c,2011d).

¹³⁹⁴ Swinburne quoted in Khalique (2011d).

¹³⁹⁵ All quotes by Bowles as cited in Khalique (2011f).

position is very clear: FX is included in the rules'. 'If you add all the financial centres in the EU together, we have the largest financial market. I don't follow that we have to adopt only Dodd-Frank and then everything is clear. No, Europe is different'.¹³⁹⁶ The Green Party in the Parliament equally insisted that '[t]he US Treasury is not a European legislator and the European Parliament should assess the issue independently'.¹³⁹⁷ Given this high level of resistance, pushing through an exemption turned out impossible. Swinburne conceded that '[w]ithin Parliament, we have never discussed an outright exemption for FX'. 'A few of us suggested it but had absolutely no traction among the majority of the Parliament members'.¹³⁹⁸

The ESAs probably shared most, if not all the concerns voiced by the Commission and the Parliament. As a result, WGMR's discussions of the FX question became contentious, with the transgovernmental community showing signs of cracks. An anonymous member of the group told the press that 'there has been disagreement and we don't currently have consensus'.¹³⁹⁹ While VM for FX products was largely uncontested, the debate on the need for IM took place over an extended period of time, with both sides digging in their heels. In the end, however, the US prevailed, and, as already mentioned in the previous section, WGMR exempted FX swaps and FX forwards from IM.

The ESAs followed the same path as the US, sacrificing the ideational consensus. Support for the idea that the ESAs probably 'sacrificed' the consensus, rather than simply amending on the basis of an ideational re-orientation, is provided by their comments on the issue. Indeed, in the first draft proposal, they clearly stated that '[t]here appears to be a risk involved in these transactions'.¹⁴⁰⁰ The second consultation equally noted that 'the physical settlement characteristics do not minimise the counterparty risk against unforeseen events such as counterparty default. [..] An initial margin requirement for non-centrally cleared physically settled foreign exchange swaps and forwards is expected to minimise the risk associated with counterparty default'.¹⁴⁰¹

Regarding VM, the ESAs' (final) draft RTS stipulate that despite the exemption from IM, 'the counterparties are still expected to post and collect the variation margin associated with these contracts'.¹⁴⁰² ISDA tried to intervene with the EU Commission to have it veto the ESAs' plan of adopting a VM requirement, but to no avail.¹⁴⁰³ While market actors praised the decision on IM, they interpreted the VM requirement as 'a shock to the system'.¹⁴⁰⁴

¹³⁹⁶ Ferber quoted in Alys (2012).

¹³⁹⁷ Canfin quoted in Khalique (2011d).

¹³⁹⁸ Swinburne quoted in Khalique (2011b).

¹³⁹⁹ Anonymous member of WGMR quoted in Clark et al. (2013).

¹⁴⁰⁰ ESAs (2014:7)

¹⁴⁰¹ ESAs (2015:65f.)

¹⁴⁰² ESAs (2014:7; almost identical in 2015:8; 2016a:13)

¹⁴⁰³ ISDA (2016:7)

¹⁴⁰⁴ James Binny of State Street in London quoted in Chatterjee (2017).

4.3 The EU decision against IM: A case of congruence for the banks

Given that the EU institutions appeared to care deeply about the perceived risks of FX trades, with some MEPs, such as Ferber, even willing to flex the EU's 'market power' muscles, one might wonder why Europe gave in to the US' pressure for an exemption from IM for FX swaps and FX forwards, after having stood its ground regarding the universal two-way exchange of IM. This leads us to the question of why FX, again, was considered 'different', and why the EU sacrificed the ideational consensus on the issue.

We can think of several hypotheses. At first glance, one might attribute Europe's decision to successful bank lobbying, particularly given the fact that, unlike in the 2-way IM debate, there was unanimous consensus among market actors in favour of an IM exemption. We cannot entirely discard this option. However, given that the EU representatives in WGMR kept resisting an exemption as long as possible, and that the Parliament equally rejected a carve-out, this interpretation appears unlikely.

A second interpretation might focus on the role of the CFTC. In the 2-way IM case, the CFTC supported the European position for a collect *and* post mandate. This undermined the PRs' call for a collect-only regime and resulted in the US lacking a consistent approach, which the EU could exploit by pushing for a universal 2-way exchange alongside the CFTC. In the FX case, however, the agency's hands were tied because of the Treasury Determination, meaning the European regulators lacked a crucial ally.

We can also think of a third potential interpretation. When drafting the RTS, the ESAs made a comment emphasizing the need for globally harmonized rules: '[T]o maintain international consistency, entities subject to the RTS may agree not to collect initial margin'.¹⁴⁰⁵ The emphasis on 'international consistency' in the regulation of the highly integrated global FX market might be considered an indicator of a 'functionalist' logic being at play.¹⁴⁰⁶ However, margin for FX swaps and FX forwards appears to be much more than just a technical issue which, if left unresolved, would cause elevated transaction costs, inefficiencies, and externalities, thus requiring international coordination. An example of such an issue and its (to this date rather unsuccessful) resolution would be the adoption of a common system of legal entity identifiers (LEIs) and unique trade identifiers (UTIs) required for the efficient operation of post-crisis derivatives trade reporting.¹⁴⁰⁷ In this case, coordination was necessary to develop a common language for all counterparties. Policy-makers were also unlikely to be constrained by the design of the rules themselves. Some of them harboured confidentiality concerns regarding the requirement to share relevant data,¹⁴⁰⁸ but this responsibility evenly applied to all members of the system.

¹⁴⁰⁵ ESAs (2014:7; 2015:8; 2016a:13)

¹⁴⁰⁶ For a full development of the theoretical arguments undergirding an important strand of functionalism, see for example Keohane (1984) and Martin/Simmons (1998).

¹⁴⁰⁷ See Knaack (2018).

¹⁴⁰⁸ See FSB (2018).

Margin for FX swaps and FX forwards, however, appears to be different. The consistent application of IM, or the granting of an exception would certainly reduce transaction costs, inefficiencies, and externalities. However, the outcome could have lasting uneven effects (either enabling or constraining) in terms of the particular risks and costs associated with the chosen approach, both at the level of the individual entity and the respective jurisdiction in which it operates. Indeed, the effects would probably reach beyond those associated with classical functionalist solutions, such as the agreement on a particular width of railroad tracks, where most of the cost is concentrated at the early stages of the implementation phase for those jurisdictions having to adjust their systems to the commonly agreed solution. More generally, focusing on the desire of achieving 'international consistency' does little to help us in understanding who has to concede to whose definition of 'consistency'. If the EU had prevailed with its original preference in favour of an IM requirement, European policy-makers could have probably made the exact same 'consistency' argument in justifying the adoption of a comprehensive IM mandate.

This leads us to a fourth possible interpretation: competitiveness concerns. The ESAs note that imposing IM 'would give the EU a comparative disadvantage vis-à-vis other players', given the 'additional costs for the industry, which may in turn downsize the market'.¹⁴⁰⁹ In the UK, the FSA equally highlighted that charting a regulatory course out of sync with the US would disadvantage the City whose competitiveness as a premier financial centre would suffer. As a consequence, the FSA insisted on the need 'to avoid potentially creating the arbitrage issues that might arise from the discrepancies between two such large markets'.¹⁴¹⁰ There is thus some important support for this hypothesis.

However, we might ask how this fourth interpretation fits together with the imposition of the VM mandate. As we saw, US supervisory guidance on the use of VM is limited to entities under oversight by the Fed, whereas firms falling under the CFTC's jurisdiction are not directly affected. Indeed, the EU was the only major jurisdiction to adopt a formal VM requirement. Because the ESAs issued joint rules for all types of financial entities, their VM requirements also covered a much broader range of firms than those subject to the Fed's supervisory guidance. If competitiveness had been the EU's *sole* decision-making criterion, we might have expected it to forego the VM requirement altogether, or to significantly curtail its scope.

An explanation allowing us to retain competitiveness as a central decision-making criterion, but to embed it within a richer theoretical context is the idea that the EU sacrificed the consensus because of its fundamental dependence on the USD, and that the US prevailed at the international level, given its structural power informed by precisely this dependence. On the one hand, Europe enjoyed power as regulatory capacity, given the elevation of the ESAs to regulatory agencies and the EU-wide scope of EMIR. Moreover, it also had power as market size by hosting the largest market for FX transactions in the City of London. London

¹⁴⁰⁹ ESAs (2015:66; 2016a:68)

¹⁴¹⁰ Alexander Justham of the FSA quoted in Khaliq (2011g), more generally Marsh (2009).

owes much of its pre-eminent status to the City’s geographical time zone location allowing for local trading sessions to overlap with those in Asia (London morning) and New York (London afternoon). As already mentioned in the two-way IM chapter, the EU in 2010 accounted for 50% of the global FX market, with the UK covering 37%, while the US was trailing behind with a share of no more than 18%. In 2013, the respective figures were 53% (EU), 41% (UK), and 19% (US).¹⁴¹¹ While these data cover the FX market in its entirety, the breakdown for the FX *swap* market yields similar results. In 2010, for example, the average daily volume of FX swaps traded in the US was USD 220bn, which is less than a third of the 775bn traded in the UK over the same period. For 2013, the figures were USD 237bn (US) and USD 1127bn (UK) respectively.¹⁴¹²

However, while the US did not host the leading marketplace, it supplied the most traded good - the USD - and thus the currency European banks fundamentally depended on. Indeed, for historical reasons, the USD is (still) the world’s ‘top currency’ which Strange ‘defined as the currency of the state that has world economic leadership, the currency of the predominant state in the international economy’.¹⁴¹³ She argues that the dollar has acquired this dominant role as a result of the decades during which the US occupied the leading position in the areas of global production, knowledge, security, and finance.¹⁴¹⁴

Table 5 reflects the dominance of the USD with regard to the currency distribution in the OTC FX market.

Table 5: Currency breakdown of the OTC FX market

Currency	2001	2004	2007	2010	2013	2016
USD	89.9	88.0	85.6	84.9	87.0	87.6
EUR	37.9	37.4	37.0	39.0	33.4	31.4
JPY	23.5	20.8	17.2	19.0	23.0	21.6
GBP	13.0	16.5	14.9	12.9	11.8	12.8
AUD	4.3	6.0	6.6	7.6	8.6	6.9
CAD	4.5	4.2	4.3	5.3	4.6	5.1
CHF	6.0	6.0	6.8	6.3	5.2	4.8
CNY	0.0	0.1	0.5	0.9	2.2	4.0

Source: Author based on BIS (2016, table 2). The table denotes percentage shares of average daily turnover. The total of all currencies is 200%, rather than 100%, given that the recorded transactions involve two currencies. Only the top 7 currencies are listed, i.e. the mark of 200% is not reached.

¹⁴¹¹ Author’s calculation by other based on BIS derivatives statistics (table D11.2 -Turnover of OTC foreign exchange instruments, by country).

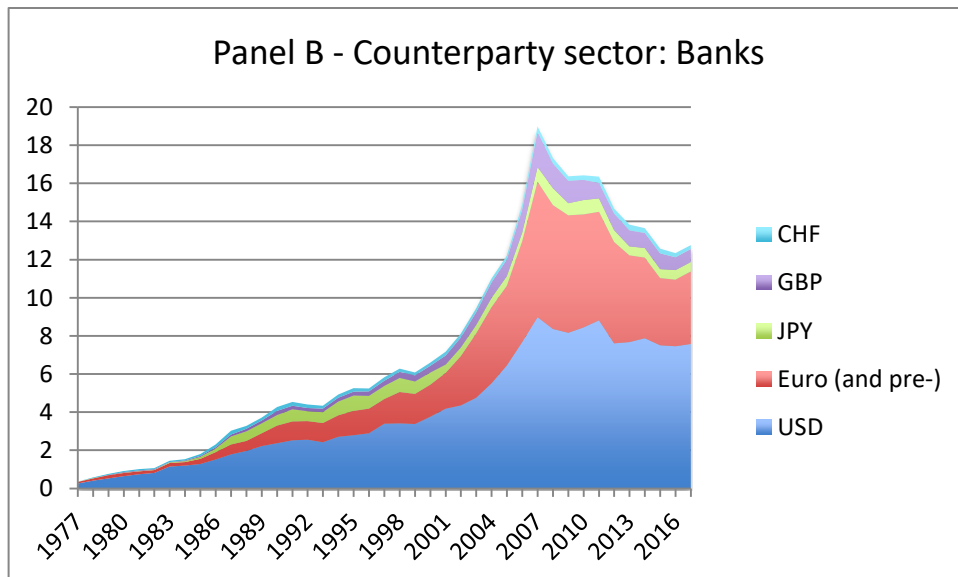
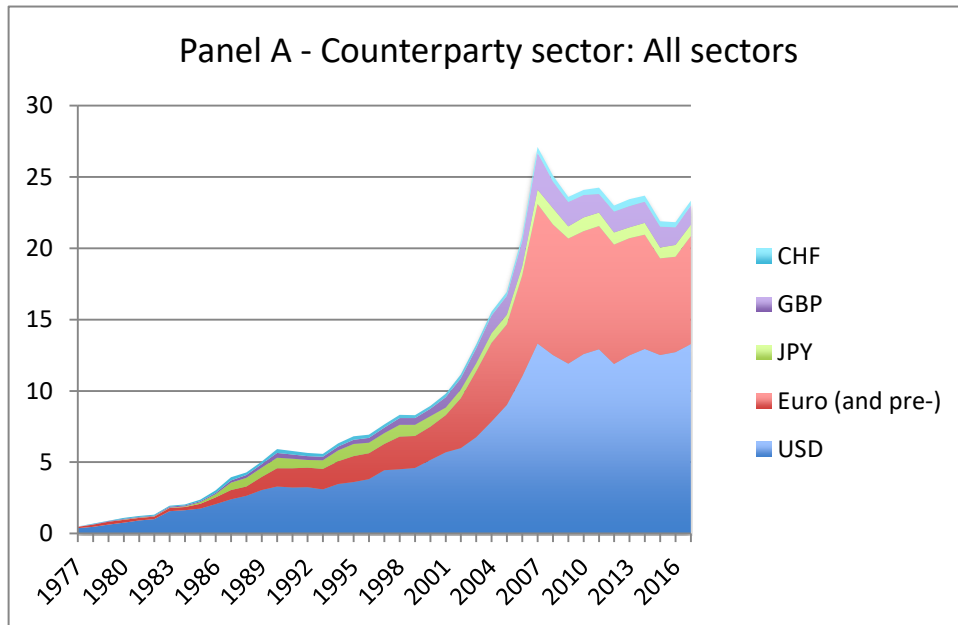
¹⁴¹² The data is taken from the FX volume surveys conducted by the Bank of England’s Foreign Exchange Joint Standing Committee and the New York Fed’s Foreign Exchange Committee.

¹⁴¹³ Strange (1971:221)

¹⁴¹⁴ Strange (1987:565). Since her first publications on the topic, many scholars have made similar arguments building upon her insights (see for example Cohen (1998,2013) and the collection of essays in Germain (2016b)).

Moreover, as shown by figure 25, the USD is also the currency that dominates international cross-border lending. A comparison of panel A and panel B reveals that most of the lending is accounted for by banks.

Figure 25: Currency denomination of cross-border lending



Source: Author based on BIS Locational Banking Statistics (Table A1-S: Summary of locational statistics, by currency, instrument and residence and sector of counterparty; USD tn)

Other BIS data indicates that prior to the crisis, European banks had accumulated large USD-denominated exposures. For example, the USD-share of UK banks' foreign operations at the end of 2007 accounted for 42%. The equivalent ratio for Spain was 36%, 33% for Germany, 31% each for the Netherlands and France, 23% for Belgium, and 10% for Italy.¹⁴¹⁵ The reasons for European banks' appetite for USD-denominated exposures ranged from the growing importance of structured finance and securitization perceived as yielding attractive rates, the rise of 'universal banking' and the related growth of proprietary trading, as well as the expansion of the hedge fund industry to which the banks provided loans through their brokerage arms.¹⁴¹⁶ A second incentive for accumulating USD was related to the dollar's status as the world's 'vehicle currency'. Unlike non-Eurozone European countries that can use the Euro, most countries have to go via the USD in order to exchange their currencies, which represented an attractive business opportunity for Europe's banks.¹⁴¹⁷ To these more specific considerations one might add a broader third factor: the general attractiveness of the US financial markets, unrivalled in their depth and liquidity. Finally, a fourth factor might involve (continental) Europe's traditional reliance on banks rather than securities markets for financial intermediation, a dependence the Commission has recently begun to address by taking first steps towards the development of a capital markets union.¹⁴¹⁸

The high level of USD-denominated exposures made Europe's banks vulnerable, because most of them lacked the necessary funds to finance them internally. The banks therefore had to rely on external dollar liquidity. Besides US money market funds and (emerging market economies') central banks, the FX swaps market represented the most important funding source.¹⁴¹⁹ European banks' vulnerability was elevated not only because of the *level* of their USD exposure, but also because of its *maturity* structure.¹⁴²⁰ Indeed, as is the case for most banks, the maturity of their loans was longer than that of their deposits, while the maturity of their foreign currency funding was shorter than that of their domestic currency funding.¹⁴²¹ The situation for Europe's banks was further compounded by the fact that because of the USD's central role, their US counterparts had only modestly expanded their own foreign claims, i.e. their demand for European currencies was much smaller than vice versa, and their need to hedge international investments was comparatively much less severe.¹⁴²² As a consequence, rolling over debt was a constant urgent need for European banks. Estimates suggest that in mid-2007 Europe's banks required a minimum of USD 1-1.2tn.¹⁴²³

¹⁴¹⁵ McGuire/von Peter (2009:7, table 1)

¹⁴¹⁶ McGuire/von Peter (2009:9)

¹⁴¹⁷ Committee on the Global Financial System and Markets Committee (2010:4)

¹⁴¹⁸ For more information, see EU Commission (2015).

¹⁴¹⁹ See for example Goldberg et al. (2011:5).

¹⁴²⁰ Committee on the Global Financial System and Markets Committee (2010:2)

¹⁴²¹ Allen/Moessner (2010:5), Destais (2014:3)

¹⁴²² See Committee on the Global Financial System and Markets Committee (2010:1f.).

¹⁴²³ McGuire/von Peter (2009:2)

With the intensification of the crisis in 2008, securing access to USD became more and more difficult, and after the traditional sources of USD liquidity had dried up following the failure of Lehman, it became nearly impossible. Indeed, US money market funds began to retreat, given their domestic losses, and (emerging market) central banks pulled back some (or all) of their USD deposits in order to channel them towards their own banking systems. At the same time, the FX swap market risked freezing. US banks that could have provided USD preferred not to, be it in order to hoard them for precautionary reasons, to signal strength to their competitors, and/or to deleverage their own balance sheets.¹⁴²⁴ Investors scrambling to buy dollars as a 'safe haven' asset created additional demand for the currency.¹⁴²⁵ Those banks with offices in the US that could tap the Federal Reserve System transferred USD funds to Europe, but in general these amounts proved insufficient.¹⁴²⁶ The ECB did not have enough USD in its vaults either, meaning that Europe was unable to liberate itself from the USD shortage.

Rather, it was the US Fed which, acting as the international lender-of-last-resort, provided the required liquidity through its swap lines with other central banks.¹⁴²⁷ The ECB was the main recipient drawing on USD 8tn in aggregate, followed by the Bank of England with USD 900bn, and the Swiss National Bank with USD 456bn.¹⁴²⁸ Through the swap lines, the ECB was able to infuse USD liquidity into the European banking system, thereby easing the tension in the market. Ben Bernanke writes in his memoir that ECB President Jean-Claude Trichet tried 'to foster the impression that the swap lines were part of a solution to a U.S. problem, rather than an instance of the Fed helping out Europe'. However, he argues that Europe's fundamental dependence on this kind of support was evident.¹⁴²⁹

The success of the Fed's swap lines and the resilience of the USD during the crisis (as opposed to its demise which some observers had initially expected) further reinforced the dollar's centrality.¹⁴³⁰ The sudden failure of the Euro on its path towards rivalling the greenback, caused by the sovereign debt crisis and the serious limitations of the EU's crisis management, indirectly strengthened the USD even further.¹⁴³¹ The yuan, long considered a potential long-term rival of the dollar turned out to be exactly that: a *potential, long-term* rival. At the height of the crisis, several influential Chinese policy-makers voiced concerns about their country being embedded in a monetary system premised on the USD, but the enormous amount of USD-denominated currency reserves tied their hands with respect to any drastic short-term change.¹⁴³² Indeed, China's decision against any precipitous move

¹⁴²⁴ Mancini-Griffoli/Rinaldo (2011:22ff.), Committee on the Global Financial System and Markets Committee (2010:6ff.), Allen/Moessner (2010:6f.), McGuire/von Peter (2009:16ff.), Borio et al. (2017:47)

¹⁴²⁵ Helleiner (2014c:8)

¹⁴²⁶ McGuire/von Peter (2009:17)

¹⁴²⁷ McDowell (2012)

¹⁴²⁸ All data is taken from Weder di Mauro/Zettelmeyer (2017:8).

¹⁴²⁹ Bernanke (2015:184)

¹⁴³⁰ Helleiner (2016b, 2014c:ch.3)

¹⁴³¹ See Cohen (2015) and Germain/Schwartz (2014).

¹⁴³² See for example Kirshner (2014).

towards full currency convertibility, caused to a great extent precisely by the size of its reserves,¹⁴³³ prevented it from dumping large amounts of USD within a short period of time. As a result, the yuan did not have any negative short-term effects on the dollar's centrality either.¹⁴³⁴

Overall, the USD had therefore lost little, if anything, of its pre-crisis attractiveness. As a consequence, and with the exception of structured finance and securitization whose importance decreased following the US housing crash, the factors causing European banks' appetite for USD-denominated exposures had remained unchanged. In fact, they might have even *grown* in importance, given the US's stronger relative economic performance. With the adoption of stricter rules for US money market funds by the SEC following the crisis,¹⁴³⁵ European banks dependence on the FX swap market might have actually become even more severe. Against this background, a unilateral imposition of IM on FX swaps and FX forwards by the EU would have had severe repercussions for the competitiveness of its banks, as it would have increased their cost of accessing USD even further, and this at a time, when they were already struggling with the effects of the sovereign debt crisis.

This explanation would confirm Kirshner's interpretation of Hirschman's approach according to which 'the US gains because participation in a dollar-based international monetary order [...] shapes the perceived self-interests of states [...]'.¹⁴³⁶ It also appears compatible with the frameworks developed by Strange and Cohen. While the analysis suggests that the American representatives in WGMR certainly had to do more than simply attend and 'be there' in order to make the EU drop its preference for an IM mandate, Europe's reliance on the USD allowed them to exercise 'the power to decide how things shall be done', in Strange's terminology,¹⁴³⁷ and to 'favorably modify[] the interaction situation', in Cohen's parlance.¹⁴³⁸

While policy-makers never explicitly mentioned the relevance of structural power in public, the explanation aligns with some comments by the EU Commission's Patrick Pearson on its effects. For example, at one point he observed that 'you would probably have to wear a pretty big pair of boots to come up with a different decision [than the US]'.¹⁴³⁹ Along similar lines, an unnamed source from the EU Commission commented in the media that '[i]f we are very strict on those instruments, we would simply hurt ourselves'.¹⁴⁴⁰

¹⁴³³ According to Wildau (2014), the total size actually increased from USD 610bn to USD 4tn between 2006 and 2014.

¹⁴³⁴ See for example the collection of essays in Helleiner/Kirshner (2014).

¹⁴³⁵ Pozen (2014)

¹⁴³⁶ Kirshner (2008:425)

¹⁴³⁷ Strange (1994[1988]: 25)

¹⁴³⁸ Cohen (1977:56)

¹⁴³⁹ Pearson quoted in Sifma et al. (2010b:9, appendix B). For a very similar comment by Pearson, see Clark (2012).

¹⁴⁴⁰ EU Commission source quoted in Madigan (2009d).

While we require further empirical evidence to understand the precise impact of and interplay between ‘power’ in its different facets in this case, the analysis appears sufficient to provide an answer to the overall research question of the thesis, in the sense that it appears unlikely that dealer bank influence acted as the primary causal driver of public decision-making in either jurisdiction. The exemption from IM, while congruent with their preferences for keeping the market deregulated, appears to have been taken for different reasons in the US and the EU, but none of them seems to have been directly related to bank lobbying. The dealers also could not prevent the adoption of VM for FX swaps and FX forwards, be it in form supervisory guidance, as in the US, or through the imposition of formal rules, as in Europe.

5. Conclusion

This chapter has argued that the exemption of FX swaps and FX forwards from IM in the US and the EU was in keeping with the banks’ preferences, but that in both cases it was most likely a case of congruence, rather than causal influence. Regarding VM, the dealers lost on both sides of the Atlantic.

In the US, the factor constellation regarding IM initially appeared stacked against the banks. High levels of issue salience, the Democrats’ (plus maybe the Treasury’s) ideational outlook, and the CFTC’s attempts to disturb the domestic institutional environment resulted in an initial configuration in which each of the three moderators at first disadvantaged the banks. What turned the tide in favour of congruence was most likely the turf war between the CFTC and the Fed/Treasury which caused the Treasury to sacrifice the ideational consensus, leading to the exemption of FX swaps and FX forwards through the Treasury Determination on the basis of Dodd-Frank granting this opportunity. This turned the sign of the domestic institutional moderator to the banks’ favour, as it cemented the CFTC’s lack of jurisdiction. After the passage of Dodd-Frank, public attention had moved on to other questions, meaning low levels of issue salience now equally worked in favour of the banks’ preferences. High business unity added to the stability of this equilibrium. The banks themselves, however, seem to have exercised little causal influence over the decision. The transgovernmental and inter-state power moderators at this stage were most likely uninvolved.

In the EU, the same moderators were initially turned against the banks, with the overall factor constellation equally placing them in the direction of a loss. In light of the ideational outlook calling for IM, and this consensus being accompanied by persistently high levels of issue salience, as well as a frictionless domestic institutional environment, a loss for the banks appeared likely. Indeed, at first the EU insisted on WGMR embracing a recommendation in favour of the use of IM. What turned the tide in favour of congruence was most likely US structural power in terms of European banks’ dependence on the USD. It ensured that WGMR eventually decided against the imposition of IM, which then turned the

domestic institutional environment moderator around, leading to the adoption of an exemption by the ESAs, in spite of high issue salience and an opposing ideational outlook. As in the US, the banks benefited from business unity, but their preferences do not appear to have been the causal driver of the policy process.

Regarding VM, the banks lost because of the individual and joint effects of the ideational outlook, the domestic institutional environment, and the transgovernmental community operating against their preferences. At this point, inter-state power had most likely receded into the background again. The only difference between the two jurisdictions appeared to be the level of issue salience which was high in the EU, but low in the US. Under either constellation, high business unity (in conjunction with low salience in the US) was insufficient for the banks to exercise influence and prevent the adoption of the VM mandate in the form of supervisory guidance in the US, and as part of the ESAs' draft regulatory standards in Europe.

As opposed to the cases of influence or loss discussed in the previous chapters, in the IM cases, the individual and joint effect of the three moderators associated with policy-makers' ideational outlook, the state of the transnational community, and the domestic institutional environment pointing in the same direction was absent, most likely because these were examples of congruence. However, we once again identified the effect in the VM cases, where it appears to have contributed to keeping bank influence at bay. The following chapter will further address this finding.

CHAPTER IX - Conclusion

1. Discussion of the results, the argument, and theoretical contributions to the literature

Has there been any change to the influence of dealer bank preferences over policy outcomes in the regulation of OTC derivatives in the US and EU since the global financial crisis of 2008? If so why? If not, why not? Focusing on OTC derivatives deregulation prior to 2008 and the introduction of mandatory margin requirements for non-centrally cleared derivatives after the crisis, I have argued that dealer bank influence has significantly decreased since 2008, having shifted from pre-crisis dominance to a mix of (limited) indirect influence, congruence, and losses thereafter.

Table 6 summarizes the results of the empirical analysis. The table follows the same notation as used for the individual case-related illustrations in the empirical chapters. Green shading indicates a moderator had a positive effect on the level of influence, as seen from the banks' perspective with regard to their preferences (second column from the left). Red stands for a negative effect. A frame in the opposite colour (red for green, green for red) indicates the moderator had its sign turned. Note that the discussion of the results does not always follow the chronological chapter order.

Table 6: Overview of results

Source: Author

Case	Preferences	Moderators						Outcome	Influence
		B. unity	Saliency	Ideas	TGC	Power	Dom. Instit.		
1. Pre-crisis deregulation	Deregulation (US)	High and pro dereg.	Low	Pro dereg.	Pro dereg.	Pro dereg. (US market power; EU market + regulatory power)	Pro dereg.	Deregulation (US)	Influence (US)
	Deregulation (EU)							Deregulation (EU)	Influence (EU)
2. Mandatory use of IM	No IM (US)	High and against IM	High and pro IM	Pro IM	Pro IM	-	Pro IM	Mandatory IM (US)	Loss (US)
	No IM (EU)							Mandatory IM (EU)	Loss (EU)
3. 2-way IM	One-way IM (US)	Low	Low	Pro 2-way IM (US)	Pro 2-way IM	Pro 2-way IM; EU market + reg. power	Pro 2-way IM (US)	Two-way IM (US)	From congruence to loss (US)
	One-way IM (EU)			Pro 2-way IM (EU)	Pro 2-way IM		Pro 2-way IM (EU)	Two-way IM (EU)	Loss (EU)
4. Segregation	Total optionality (US)	Low	Low	Pro third-party segregation with custodian	Pro segregation	-	Pro third-party segregation with custodian (US)	Third party segregation with custodian (US)	Loss (US)
	Total optionality (EU)			Pro segregation			Pro segregation (EU)	Segregation (EU)	Loss (EU)
5. Rehypothecon	No restrictions (US)	Low	Low	Pro ban	Pro ban	-	Pro ban	No rehypothecon (US)	Loss (US)
	No restrictions (EU)							No rehypothecon (EU)	Loss (EU)
6. Treatment of end-user deals	Full exemption (US)	High: Bank/end-user coalition pro exemption	Pro exemption (US)	Pro full exemption (US)	Pro broad exemption	-	Pro full exemption (US)	Full exemption (US)	From loss to indirect influence (US)
	Full exemption (EU)		High and pro broad exemption (EU)	Pro broad exemption (EU)			Pro broad exemption (EU)	Only large entities covered (EU)	Limited indirect influence (EU)
7. IM for FX	No IM (US)	High and against IM	Low (US)	Pro IM	-	-	Pro exemption (US)	No IM for FX (US)	From loss to congruence (US)
	No IM (EU)		High and pro IM (EU)				Pro exemption	Pro exemption (US structural power)	Pro exemption (EU)
8. VM for FX	No requirements (US)	High and against VM	Low (US)	Pro VM	Pro VM	-	Pro VM	Supervisory guidance (US)	Loss (US)
	No requirements (EU)		High and pro VM (EU)					VM rules (EU)	Loss (EU)

As we can infer from the outer right column, there was not a single post-crisis case over which the banks succeeded in exercising direct influence post-2008. The only case in which they projected some influence concerned the treatment of commercial end-users. However, given the dealers' tarnished reputation following the crisis, they were largely forced to act through the end-users as their coalition partner, meaning their influence was only indirect. Moreover, it was limited in the EU, where policy-makers did not adopt a full exemption. The banks probably also benefited from congruence regarding the exemption from FX swaps and FX derivatives from IM, but they most likely did not have any direct causal influence over these outcomes.

Most strikingly, however, the banks had to accept several major defeats in cases over which they lost and failed to exercise influence. The mandatory use of IM, the fact that it has to be exchanged 2-way, the requirement to segregate it (with a third-party custodian in the US), the prohibition to rehypothecate it, and the VM requirement for FX swaps and FX forwards are each in direct contradiction to their preferences. The empirical analysis suggests that the banks did not 'overstate' their 'true' preferences, meaning we can classify these cases as 'losses' with some degree of confidence.

The table also reveals that the needle indicating the level of bank influence sometimes fluctuated over the course of the policy-making process, before settling at its final level. We find this outcome only for some of the post-crisis cases, including the 2-way IM case in the US, the end-user case in the US, as well as the IM for FX swaps and FX forwards cases in both the US and the EU.

Focusing on the final level of influence for the post-crisis cases, with each jurisdiction counting as one case, the overall results yield the following score: 2 cases of (limited) indirect influence, 2 cases of congruence, and 10 cases of loss. This stands in sharp contrast to the pre-crisis period, where the banks exercised constant dominant influence in both the US and the EU, with no regulatory decision being taken against their preferences.

The broader case study evidence also suggests that post-crisis, policy-makers attributed much less importance to the information the banks submitted in order to justify their preferences. As well, the dealers lost their ability to exercise structural/structuring power which they had used to prevent or correct deviations from the deregulation paradigm prior to 2008. Relatedly, the banks lost their central position within the transnational policy community. In fact, in the margin case, the transnational policy community dissolved, with the transgovernmental community emerging in sharp relief.

How can we explain this change?

I suggest conceiving of 'dealer bank influence' as a moderated condition whose expression in terms of causal 'influence', 'congruence' and 'loss' can be explained by six conditions, the level of business unity, the level of public issue salience, policy-makers' ideational outlook, the state of the transnational policy community, the nature of inter-state power relations,

and the domestic institutional environment. In particular, I argue that we should study this system as a dynamic and interactive one in which it is not always just the effect of the individual moderator that determines the particular level of influence, but also their interaction amongst each other. Such an integrative approach appears particularly relevant for developing an understanding of cases in which the needle moves along the 'influence barometer' before settling in its final category at the end of the policy process. In other words, when examining the table, we should not focus only on the individual effect of each moderator across all cases, but also on their interplay in each individual case.

Prior to 2008, the banks benefited from a unique constellation in terms of a positive effect emanating from each of the moderators. There was high business unity, public issue salience of derivatives regulation was usually low, policy-makers' ideational outlook was informed by the 'efficient market' hypothesis, the banks occupied a privileged position in the transnational policy community, inter-state power relations never played out in a way that could have been detrimental to deregulation, and at the domestic institutional level the dealers equally found an environment conducive towards deregulation.

Most importantly, many factors also positively reinforced each other. The absence of business conflict promoted the banks' position within the transnational policy community, whose members subscribed to the efficient market hypothesis, which consolidated support for deregulation at the domestic institutional level, which again fed back into the ideational deregulation consensus. The dominance of this consensus also ensured that inter-state power plays never had a market-constraining effect. Predominantly low levels of public issue salience added further stability to this configuration. In other words, it was not only the *individual* effect of the moderators that strengthened bank influence prior to the crisis, but also their joint and interactive effect. The banks' influence was also supported by their ability to provide information highly valued by policy-makers, and to (threaten to) exercise structural/structuring power, if deemed necessary to keep this equilibrium in place. The stability of this configuration might also be the reason why neither occasional spikes in issue salience, nor occasional attempts by the CFTC to rein in the market could shake it and push the banks' level of influence into a weaker category.

The crisis, however, caused an exogenous shock to this configuration, resulting in a fundamental reconfiguration. Each of the moderators at times had a detrimental effect on the banks' respective level of influence. Depending on the specific moderator constellation, this resulted in (limited) indirect influence, congruence, or loss. There was not a single case in which the banks reached their peak-level of pre-crisis dominance.

The policy-making process on the margin rule began with the mandatory use of IM, a case which turned out a lost battle for the banks in both jurisdictions. The high issue salience of derivatives regulation, caused by the negative repercussions of the worst financial crisis since the Great Depression, led to the adoption of a new ideational outlook in form of the 'clearing/margining' consensus. This consensus which clashed with banks' preferences, was shared by policy-makers both at the domestic institutional and the transgovernmental level,

meaning inter-state power relations were not at the forefront (nor was any of the margin cases openly used as a side show to solve some other inter-state problem). With the exception of 'business unity', which was high, thus exercising a positive effect, as well as 'inter-state power', which was neutral, all moderators were flashing red. It was not just the individual effect of these factors, but also their joint interaction, that produced a fatal constellation in which high business unity against IM alone did not allow the banks to exercise any influence.

In the 2-way IM case in the US, the banks at the beginning appeared to be set for 'congruence', but the needle of influence eventually settled in the 'loss' category. Initially, there was friction at the domestic institutional level, informed by the differing mandates of the CFTC (which preferred a 2-way mandate) and the PRs (which favoured a 1-way approach). With the PRs prevailing at first, this moderator thus exercised a positive effect on the level of bank influence. The same applies to the ideational moderator, given that the PRs also prevailed from an ideational point of view. Public issue salience was low, adding yet another positive effect. In the early stages, the only factor operating to the banks' detriment was the lack of business unity, given the high degree of preference divergence on the buy-side. What changed the tide and pushed the level of influence from 'congruence' to 'loss' was probably a mix of EU market power *cum* power through regulatory capacity, in combination with socialization efforts of the PRs within WGMR, which turned the signs of the transgovernmental level- and inter-state power-related moderators negative. With the EU and US members of WGMR ultimately in agreement about the need for 2-way IM, this also changed the effect of the domestic institutional level moderator from positive to negative. As a consequence, in the end, the only positive effect on influence emanated from public issue salience, which remained low. However, on this basis alone, the banks were unable to exercise effective influence.

There were also other cases which reflected a dynamic interaction of the moderators. In the IM for FX swaps and FX forwards case, the banks were initially set for a loss on both sides of the Atlantic. In the US, the level of issue salience was initially high and the CFTC claimed jurisdiction over this segment of the FX market. The ideational outlook probably also called for covering these products with IM. As a result, all three moderators were operating against the banks. What turned the level of influence from 'loss' to 'congruence' was probably the turf war between the CFTC and the Fed/Treasury at the domestic institutional level, which made the Treasury adopt an exemption. The exemption of these products from the definition of 'swap' under Dodd-Frank ensured the CFTC would not gain jurisdiction, which turned the effect of the domestic institutional moderator from negative to positive. Once the Treasury adopted the Determination, the public issue salience of the question had already returned to lower levels again, as a result of which the signal of this moderator equally changed from negative to positive. The effects of the transgovernmental policy community and inter-state power moderators were probably neutral, given that the US took this decision before the official establishment of WGMR, and at a stage when the EU was far away from any final decision-making. The fact that business unity was high and in

favour of the exemption, and that the banks welcomed a carve-out was probably unrelated to the outcome.

In the EU, the initial factor constellation was the same. The level of public issue salience was high, the ideational outlook called for the use of IM, and the domestic institutional environment was comparatively free of any frictions. This meant that all three moderators operated against the banks. What turned the tide and shifted the level of influence from 'loss' to 'congruence' was probably US structural power exercised through European banks' dependence on the USD, which caused the EU to give in to the US. The effect of the inter-state power moderator was therefore positive. This set in motion a cascading development. Structural power led to the adoption of an exemption by WGMR, thus ensuring an equally positive signal from the transgovernmental policy community moderator. This, in turn, changed the signal of the domestic institutional environment moderator, with the ESAs equally embracing an exemption, in spite of high issue salience and policy-makers' opposing ideational outlook. As in the US, the banks' preference for an exemption and the display of business unity on the question were probably unrelated to the decision.

We find a similar dynamic pattern in the end-user case, particularly in the US, where the dealers succeeded in preventing a loss in favour of achieving '(indirect) influence'. Gary Gensler's campaign initially stacked the field against the banks, conditioning public issue salience, policy-makers' ideational outlook and the domestic institutional environment against them. What turned the tide and pushed the needle on the influence barometer from 'loss' to '(indirect) influence' was the high level of business unity between the banks and the end-users. The bank/end-user coalition launched a major campaign with the aim of creating 'friendly' issue salience, which, over time, changed the overall sign of the issue salience moderator to the banks' advantage. The campaign also raised the support of the New Democrats and other members of the Democratic Party, as a result of which the effect of the ideational outlook began to change to the banks' advantage. The missing language on the treatment of end-user deals in Dodd-Frank caused a temporary setback for the banks, since it boosted Gensler's determination to not let go of the mandatory collateralization of end-user trades. As a response, the end-users reinvigorated their efforts, ringing the salience bell at full alarm regarding the need for a carve-out. With the advent of the Republican majority whose members supported the end-users' preferences, the ideational outlook on Capitol Hill further evolved in the banks' favour. The exemption was therefore only a question of time. It was eventually adopted as an unrelated provision to the renewal of TRIA. With a legal exemption in place, this also turned the domestic institutional moderator to the banks' advantage, as it tied the hands of the CFTC. In addition, the banks benefited from the fact that WGMR did not show much interest in the question, supporting a broad exemption. As a consequence, the transgovernmental community moderator equally flashed green. The end-user question being primarily a domestic issue, inter-state power relations were not invoked, corresponding with a neutral effect of this moderator.

In all the other cases, the process was more straightforward, meaning the banks' level of influence did not fluctuate during the process. In the end-user case in the EU, the bank

exercised (limited) indirect influence. They benefited from the fact that at the domestic institutional level, historical precedent of promoting SMEs had made policy-makers much more receptive towards some form of a carve-out. This, in turn, meant that the ideational outlook and salience moderators were also operating to the advantage of the banks. As in the US, the level of business unity was high. The dealers also formed a bank/end-user coalition whose campaign ensured that ESMA would not disrupt this equilibrium. As in the US, the fact that WGMR approved of a broad exemption and that the end-user question was considered a domestic concern provided further support to the stability of the factor constellation.

The banks lost all the other cases, with the needle never leaving the 'no influence' segment of the spectrum. In the 2-way IM case in the EU, as well as the segregation and rehypothecation cases in both jurisdictions, the ideational outlook called for a strong regulatory response, with this assessment being shared both by the transgovernmental community and at the domestic institutional level. As a result, all three moderators operated against the banks, forming a stable feedback mechanism. The dealers also suffered from the fact that business unity was low across all cases. With low levels of issue salience being the only moderator working in their favour, they turned out unable to exercise any influence.

The VM for FX case evolved in a similar way. On both sides of the Atlantic, the same three moderators operated against the banks' preference for regulatory relief. In the EU, this was complemented with high levels of 'hostile' issue salience. With business unity as the sole moderator operating to their advantage, the banks experienced a major loss. In the US, high levels of business unity were complemented with comparatively low levels of issue salience, but the positive effect of these two moderators alone was insufficient for the banks to prevent a loss. In both cases, the relevance of the inter-state power moderator had ceded into the background again.

The results of this study do not allow us to answer the eternal question of what 'causes' influence, or, more precisely, what moderators or constellation(s) of moderators determine in which category of influence the banks will find themselves at the end of the policy process. The model is not predictive,¹⁴⁴¹ meaning that we cannot specify *ex ante*, which variable(s) will initiate a movement of the needle on the influence barometer, and in which direction.

However, what we can derive from the analysis is that a sole focus on the final, individual effect of each moderator would limit our understanding of dealer bank influence. Each of the theoretical explanations of the individual effect of the moderators contributes important insight, but on their own, each of them is insufficient for us to comprehend the overall level of dealer bank influence. Rather, banks' level of influence appears to be the

¹⁴⁴¹ The model shares this characteristic with other theoretical approaches of the IPE literature, such as the historical institutionalist framework discussed in chapter II-2.3.6.

result of the individual effects of the moderators *plus* particular combinations of moderators and their interaction effects. In other words, the sum is more than the parts.

The table also allows us to make further observations that other scholars might find interesting. First, there appears to be no single 'super' moderator whose expression allows us to predict which level of dealer bank influence will prevail. This means that dealer bank influence cannot be reduced to a single cause. However, with the relatively limited number of six conditions and various combinations thereof, we were able to explain all outcomes, even though we cannot guarantee that we have not missed a critical condition.

Second, in each case over which the banks enjoyed influence, all moderators had a positive effect (or a neutral one in the case of inter-state power). We did not study enough cases to infer that *all* these moderators *always* need to be flashing green (or exercise a neutral effect) in their final constellation in order for influence to occur. However, it appears that configurations associated with 'influence' or 'loss' become more stable, the higher the number of moderators operating in sync.

Third, a comparison of the 'influence' and 'loss' cases suggests that three moderators and their interactions are of particular relevance: policy-makers' ideational outlook, the state of the transnational policy community, and the domestic institutional environment, which together appear to have formed a 'core' across all these cases. Every time the banks were influential, the 'core' and its individual components exercised a positive effect, whereas every time they lost, the 'core' had a negative effect. It is perhaps not surprising that the only cases to which this observation does not apply are the congruence cases, where the core was split, leading to an outcome that pleased the banks, but over which they had exercised little causal influence.

Pre-crisis, banks' use of information and structural/structuring power may have contributed to maintaining the positive effect of the 'core' and its component variables, whereas post-crisis, the dealers lacked the means to disrupt it. However, it appears, difficult to establish initial causation for each case. Nonetheless, the presence of the 'core' and the interaction among its component variables is an interesting observation, worthy of further investigation.

Fourth, the specific configuration of the 'core' factors does not render the other moderators irrelevant. In the post-crisis period, inter-state power appears to have been particularly relevant for cases marked by transatlantic preference divergence of policy-makers as a result of challenges at the domestic institutional level. From a 'bank influence' perspective, there is no clear tendency in which direction the 'inter-state power' moderator operates. In the 2-way IM case in the US, it pushed the needle from the 'congruence' to the 'loss' category, whereas it shifted it from 'loss' to 'congruence' in both IM for FX swaps and FX forwards cases. Whenever the US and the EU were already in agreement about the desired policy outcome, this moderator was not of any explicit relevance to banks' influence.

Business unity was less meaningful to the pre-crisis cases, in that the dealers were the only private sector actors raising their voice. In the post-crisis period, however, business unity between the banks and non-financial firms was crucial. Indeed, in the end-user case, it was the key ingredient causing the needle to shift from 'loss' to 'influence', particularly in the US. However, banks' success on this front in terms of exercising (limited) indirect influence over the outcome also meant that they subsequently lacked their most valuable coalition partner, given policy-makers' embrace of (partial) regulatory relief for end-user trades.

The evidence also indicates that banks' attempts to use high levels of business unity with the buy-side in order to block reform never resulted in influence. We don't have a case where they agreed on a 'constructive', alternative reform proposal, given the preference divergence on the buy-side and the banks' constant obstruction against reform. It would be worthwhile studying the factor constellation and corresponding level of influence that would have emerged from the banks forming a strong coalition with the buy-side and submitting such proposals.

Finally, public issue salience was a particularly interesting moderator. As theoretically expected, the dealer banks were influential in the pre-crisis period, when issue salience was low, while they lacked influence post-crisis, when public attention reached high and 'hostile' levels. The banks' attempts at manufacturing 'friendly' issue salience in the end-user case were crowned with success, paving the way for a full exemption in the US, and ensuring the policy-process stayed 'on track' in the EU. Importantly, however, the banks never succeeded in exercising influence, even when public issue salience was low. This, again, highlights the need to study the joint and interactive effect of the moderators. With the exception of the IM for FX swaps and FX forwards case in the US, where the carve-out stretched two steps across the adoption of Dodd-Frank and the Treasury Determination, low levels of issue salience in the post-crisis period always coincided with the presence of the 'core' variables flashing red. This would suggest that as long as policy-makers share a common ideational consensus on a given policy, with this agreement being sustained at the transgovernmental and domestic institutional levels, the banks have a hard time disrupting the equilibrium in the event they oppose it, even under conditions of low issue salience.

What are the implications for research on private financial interest group influence over the design of post-crisis rules?

Studying dealer bank influence over policy outcomes in financial regulation as a moderated condition appears promising. I have identified a range of six variables that individually and in their various combinations promote our understanding of the change of dealer bank influence from pre-crisis derivatives deregulation to the development of some important elements of the margin rule as a crucial post-crisis case of re-regulation. Specifically, I have proposed that we should not study only the 'individual' effect of the moderators, but also examine their joint, dynamic, and interactive effect. These (dynamic) interactions have so far received little attention in the literature, but the results suggest that such an integrative approach might be promising for future research. In particular, we should direct more

attention to the ‘tipping points’ at which moderators turn their sign, thereby often initiating a cascade of effects over the course of which other moderators change their signal. When do these tipping points occur? How many moderators need to change before the banks enter into a new category of influence?

Out of the six variables I have suggested to study, three appear to be of particular relevance for banks’ degree of influence: policy-makers’ ideational outlook, the state of the transnational policy community, and the domestic institutional environment. Dealer bank influence appears more likely if these three moderators are in alignment, with the banks’ preferences, but also amongst each other.

This thesis has taken only an initial step towards understanding and conceptualizing dealer bank influence as a moderated condition. More conceptual work would be necessary in order to put this approach on a more solid analytical footing. For example, how would one respond to studies not confirming the theoretically expected *individual* effect of a particular moderator? While the framework developed in this thesis provides an explanation as to why such inconclusive results based on individual effects may be possible, it would be important to critically examine the relevance of such findings for the broader validity of the approach.

Conceptually, we might also have to apply more nuance to specifying the role of the different methods of preference articulation the banks have at their disposal. In the empirical cases, the banks moved from a situation where their information was highly sought after and where they could freely project structural/structuring power, to almost the opposite scenario. This left us with little granularity to further develop the model in this direction.

Another observation we made was that the border between ‘methods of articulation’ and ‘moderators’ sometimes blurs. For example, the revolving door can be considered a vector of preference articulation, but, prior to the crisis, it also sustained the vitality of the transnational policy community. Relatedly, the banks’ post-crisis mobilization of the end-users for the creation of ‘friendly’ issue salience could also be considered an indirect form of ‘preference articulation’. While these issues did not constrain us in answering the overall research question undergirding this thesis, a more refined version of the framework would have to address these issues.

The sceptical reader might suggest that the generalizability of the results could be contingent on the cases to which the framework was applied. Indeed, we witnessed a reversal from complete deregulation to strong, even if not full re-regulation. While such radical changes have also occurred in other areas of post-crisis reform (two important examples being the regulation of hedge funds and credit rating agencies¹⁴⁴²), the more common ‘routine’ case involves a smaller shift along the regulatory spectrum in favour of

¹⁴⁴² Pagliari (2013b)

'more' or 'less' intervention. Applying the framework to a number of such 'routine' cases would therefore be important. Bank capital regulation might offer such an opportunity.

At the conceptual level, it might also be worthwhile examining the utility of modifying the basic design of the framework in order to apply it to questions other than interest group influence over policy outcomes. For example, we might be interested in developing a better understanding of the ways in which policy-makers' embraced the ideational post-crisis consensus. In this case, policy-makers' ideational outlook would become the dependent variable. Alternatively, we might focus on the post-crisis development of US-EU inter-state power relations. In either case, the other variables - including dealer bank influence, or private sector influence more generally - would have to be re-arranged in function of the precise research question. If considered useful, this level of flexibility would add to the model's intellectual purchase and theoretical versatility.

At the empirical level, the next steps would involve testing how the framework, including the results pertaining to the 'core', travel to the other parts of the margin rule which we did not study. In particular, it would be interesting to see if the dealer banks were able to recoup some of their lost influence during the negotiation of the precise calculation requirements (see also the discussion in chapter II-5). In addition, we could apply the model to the later stages of the policy cycle, when market actors began implementing the new requirements, or when policy-makers started evaluating the reform's overall performance.

Another promising research strategy would consist in adding more cases at the jurisdictional level. This thesis has focused on the largest markets for uncleared derivatives, i.e. the EU and the US. However, the commitment to develop post-crisis derivatives rules was made at the level of the G20, and thus by many more jurisdictions. Since the 2008-crisis, the Asian derivatives markets, in particular, have started gaining in importance.¹⁴⁴³ Examining the implementation of the G20 agreements in Asia could yield valuable lessons for IPE scholarship. Japan hosts the largest and most developed market in the area. At the same time, Singapore and Hong Kong are aiming to increase the respective shares of their own markets.¹⁴⁴⁴ A comparative analysis of the reform process in Asia and the US/the EU could also help us derive relevant conclusions.

Moving beyond the framework as such, the results suggest that scholars interested in bank influence over post-crisis financial regulation should spend more time analyzing the relevance of the 'core' variables. While this would of course not mean dismissing the other factors, scholars might find it useful to pursue a mixed approach combining insights specifically from constructivism, transnational approaches, and domestic institutional analyses. The variables related with these literatures sometimes tend to be considered only as a 'second thought' by the interest group literature which often tends to place particular emphasis on 'instrumental' and 'structural' power variables, or to consider policy-makers

¹⁴⁴³ Li (2018)

¹⁴⁴⁴ *ibid.*

‘as mere vectors of competing interests’.¹⁴⁴⁵ Balancing both aspects might further enrich our understanding of the notoriously difficult-to-capture notion of ‘interest group influence’.

More generally, the results indicate that an uncritical focus on the idea of ‘regulatory capture’ is misleading. In the margin case, business unity alone was never sufficient for influence to prevail, even if it occurred in conjunction with low issue salience. The results of this thesis contribute to a growing literature calling for a more nuanced approach to the study of interest group influence. For example, at the most basic level, Carpenter and Moss highlight the empirical challenges of ‘proving’ capture, given the difficulties in precisely defining the ‘public interest’ a particular policy should serve. In their words, ‘policy analysts are often quick to see capture whenever an interest group appears to benefit from regulation, or even when there is merely *motive* for capture’.¹⁴⁴⁶ Carpenter also warns of uncritically subscribing to the idea that public policies favouring a particular industry necessarily collide with the public interest as perceived by policy-makers themselves.¹⁴⁴⁷ The pre-crisis case, when most policy-makers on both sides of the Atlantic genuinely believed in the virtues of full-scale deregulation as beneficial for the wider economy illustrates this point.

Approaching the ‘regulatory capture’ concept from a different angle, Stellinga and Mügge, observe that a closer look at ‘the controversies and debates that occur[] in the policy process’ often reveals that ‘[p]olicy problems may show a much greater resistance to effective solutions than we often assume’,¹⁴⁴⁸ which can constrain the adoption of ‘optimal’ policies, creating the impression that private interest groups drove the decision-making process. The exemption of FX swaps and FX forwards from IM might have been such an example.

Finally, Young argues that ‘if we really want to acquire a substantive understanding of private sector influence in global financial governance, it is not sufficient to only examine instances when private sector groups appear to get what they want’.¹⁴⁴⁹ His empirical research shows that financial groups’ success in influencing policy outcomes during the development of Basel II was often paired with considerable losses. The results of the margin case point in a similar direction. More generally, the evidence indicates that the level of dealer bank influence is conditional on an array of six conditions, as well as their interaction, of which three appear particularly important. Even in the pre-crisis period, when dealer bank influence was dominant, deregulation was not simply the result of the banks asking for

¹⁴⁴⁵ Stellinga/Mügge (2017:416). Their conceptualization focuses on regulators, while I widen it to include policy-makers more generally.

¹⁴⁴⁶ Carpenter/Moss (2014:20, emphasis in the original). The ‘common interest’ and its relation to ‘capture’ are also at the centre of an analysis by Mattli/Woods (2009).

¹⁴⁴⁷ Carpenter (2014)

¹⁴⁴⁸ Stellinga/Mügge (2017:415)

¹⁴⁴⁹ Young (2012:683)

it and policy-makers acting upon that request, but of a much more complex inter-play of a number of different factors.

One particular risk of elevating the relevance of these factors during the research process is that it could lead us from one extreme, where we see ‘capture’ everywhere, to another one where we fail to identify ‘influence’ anywhere. One strategy to avoid this trap could be paying particular attention to the dynamic nature of the interactions of the moderators. In the end-user case, for instance, this analytical perspective helped us identify the role of banks’ (indirect) influence over the eventual carve-out, particularly in the US, thus preventing us from classifying this example as an outcome unrelated to dealer bank lobbying.

What are the implications of this study for the wider literature on post-crisis financial derivatives regulation?

Most importantly, the margin case suggests that an exclusive focus on dealer banks and their preferences is limiting, if we aim to develop a better understanding of particular outcomes of post-crisis financial derivatives regulation. This thesis has suggested that the level of dealer bank influence is conditional upon an array of six conditions and their inter-play. Post-2008, the expression of these conditions and their interaction changed. Scholars interested in post-crisis derivatives regulation should focus not exclusively on interest group approaches, but widen the analytical lens so as to elevate the relevance of these other conditions. As Helleiner has noted, understanding the complexity of post-crisis financial reforms requires ‘a more contingent, conjunctural, and nuanced understanding of the politics of global regulation’.¹⁴⁵⁰ Indeed, it is the particular inter-play of all these variables that allows us to comprehend why post-crisis derivatives regulation (at least with respect to the margin case) was in fact possible, against the predictions of some structuralist observers as well as other skeptics.

2. Empirical contributions

Beyond the theoretical contributions discussed in the last section, the dissertation also makes several empirical contributions.

First, it contributes to the IPE literature on derivatives. Despite a number of recent publications exploring selected aspects of post-crisis derivatives regulation,¹⁴⁵¹ this area still represents relatively uncharted territory for IPE scholarship. The thesis provides the first

¹⁴⁵⁰ Helleiner (2011a:148)

¹⁴⁵¹ See for example Pagliari (2018), Lockwood (2018), Knaack (2018), Helleiner (2018), Pagliari/Young (2014, 2013).

detailed analysis of some key elements of the reform leading to the introduction of mandatory margin requirements for uncleared derivatives. The study is also among the first that does not only focus on the content of new rules, but also traces the policy process of their adoption. In adopting this perspective, it responds to calls by other scholars to provide ‘more detailed analyses of the content of [post-crisis] regulatory initiatives’¹⁴⁵² and develop ‘[a] better grasp of how rules are made’.¹⁴⁵³

Second, the thesis contributes to the literature on interest group influence over post-crisis financial regulation. The empirical results shed light on the role of private financial interest groups over post-crisis reform, an ambition encouraged by a number of scholars inviting us to study the evolution ‘of private actors, particularly financial firms, as key players in the policymaking process’,¹⁴⁵⁴ the process of ‘how these groups adapt to and contribute to the process of financial regulatory change’,¹⁴⁵⁵ and to examine whether ‘financial industry influence [is] less consistent than in the past’.¹⁴⁵⁶

The evidence suggests that the dealer banks lost their privileged role in the policymaking process leading to the adoption of the margin reform. While they had exercised commanding influence over the pre-crisis deregulation of derivatives, the global financial crisis and the reconfiguration of the factors which I suggest moderate bank influence led to an evaporation of large parts of this influence. Rather than shaping the policy-making process and contributing to the design of the specific requirements, the dealers mostly attempted to obstruct any change of the status quo, usually to no avail. While they had not lost a single of the pre-crisis battles, they were forced to swallow several major defeats post-2008, and where they did exercise influence after the crisis, they did so indirectly and sometimes with only limited success. Other policy outcomes that align with their preferences were probably the result of congruence, rather than causal influence.

Post-2008, the significantly reduced level of ISDA’s influence appears particularly striking. Indeed, with respect to the margin rule, the association clearly lost its pre-crisis position as the ‘most powerful and effective lobbying force in the recent history of financial markets’.¹⁴⁵⁷ Indeed, ISDA’s tremendous pre-crisis success may have boosted its confidence to an extent that it believed it could weather the 2008 crisis and simply block change, as it had so frequently succeeded in the past. This would also explain the often rather confrontational, ‘all-or-nothing’ advocacy style it decided to adopt. One should also keep in mind that ISDA is not, and has never been, a Self-Regulatory Organization, such as FINRA (the Financial Industry Regulatory Authority) which develops and enforces rules for brokerage firms and exchanges. Given its pre-crisis success in ensuring the deregulation of financial markets, as well its confidence in maintaining the status quo in the immediate

¹⁴⁵² Helleiner (2014b:70)

¹⁴⁵³ Posner (2018:55)

¹⁴⁵⁴ Mosley/Singer (2009:425)

¹⁴⁵⁵ Young (2013b:460)

¹⁴⁵⁶ Young (2013a:700)

¹⁴⁵⁷ Partnoy (2009:45)

aftermath of the crisis, ISDA probably did not see the need for a wider discussion about owning that space, and once the political climate had turned against the banks, the window of opportunity for policy-makers to support such a move had closed.

In addition, ISDA frequently struggled to unite the banks' preferences with those of the buy-side, except for when it came to obstructing change. The quest for business unity was certainly not facilitated by the fragmentation of preferences on the buy-side, as well its peak business associations. However, there also appears to have been a perception that ISDA probably did not do enough to reach out to buy-side actors to identify areas in which a pro-active collaborative advocacy approach could have been possible.

Regarding the location of the empirical results on the spectrum of change in private financial interest group influence after 2008, the case study evidence suggests a position towards the end that identifies reduced financial sector dominance. We should not choose the far end of the spectrum, given the dealers' success at exercising (limited) indirect influence over the end-user case. The end-user case also corroborates a number of post-crisis empirical studies suggesting that financial group influence is often indirect, exercised through the advocacy of a coalition partner.¹⁴⁵⁸

Unlike broader analysis of post-crisis banking and derivatives regulation more generally suggests, the dealers in this particular case did not 'passively accept'¹⁴⁵⁹ the new margin rules. To the contrary, they actively fought tooth and nail against every proposal that would have resulted in a reversal of the pre-crisis status quo of deregulation. Yet in most cases, they were unsuccessful, and where they saw their preferences adopted by policy-makers, they were probably lucky in terms of benefiting from congruence, the only (partial) exception being the end-user case. One reason, (though, as we saw, far from the only one) was the growing trend towards intra-financial sector conflict that Pagliari has already identified with respect to other aspects of post-crisis derivatives regulation.¹⁴⁶⁰ The empirical evidence also confirms Porter's observation about banks having been unsuccessful in their attempts 'to restore the levels of power [...] that private sector actors enjoyed before the crisis'.¹⁴⁶¹ Overall, the margin reform which has brought an end to self-regulation has, to this date, led to anything but 'stasis',¹⁴⁶² or a return to 'business as usual'.¹⁴⁶³ Taken together, the results provide a clear answer to the question of how the 'public-private relationship' has evolved after the crisis.¹⁴⁶⁴ The balance has shifted towards the public side, after it had long resided on the private one.¹⁴⁶⁵

¹⁴⁵⁸ Pagliari/Young (2014), Kastner (2017), Keller (2016)

¹⁴⁵⁹ See Young (2013b:474).

¹⁴⁶⁰ Pagliari (2018:156ff.)

¹⁴⁶¹ Porter (2014b:136)

¹⁴⁶² Kirshner (2014:101)

¹⁴⁶³ Chalmers (2017:108)

¹⁴⁶⁴ Helleiner (2014b:70), see also Pagliari (2012a:45).

¹⁴⁶⁵ Note that this factor alone should not be interpreted as a normative assessment of the reform.

The analysis of the margin rule also allows us to make some broader observations which contribute to the literature on post-crisis financial regulation more generally. First, unlike some skeptics had initially expected, challenges at the domestic institutional level, such as regulatory fragmentation in the US, did not derail the (trans)national decision-making process, nor did they lead to significant fragmentation.¹⁴⁶⁶ One of the key reasons for this outcome appears to have been the strength of the ideational consensus, in combination with the role of WGMR to serve as a focal point for policy-makers to coordinate their reforms.

Newman and Posner have conducted a comparative analysis studying the degree of alignment of US and EU post-crisis banking and derivatives regulation, particularly central clearing. They find that, while in banking ‘politicized bilateralism characterized by mutual threats of retaliatory action has been the exception’, it has been much more frequent with regards to CCPs, the result being ‘outcomes based on relative power as opposed to technocratic rationales’.¹⁴⁶⁷ The key difference they identify between these two cases is the presence or absence of an established international forum enabling policy-makers to develop international soft law, understood ‘as a set of written, advisory prescriptions’¹⁴⁶⁸ that carry legitimacy at the national level and are adopted, ideally, before the launch of the domestic policy-making process.¹⁴⁶⁹ Over the course of their analysis, they reveal that while the BCBS served as the focal point for post-crisis banking regulation, central clearing lacked such a forum. As a consequence, policy-makers drafted their own clearing rules independently from each other at the domestic level, which often led to fragmentation and conflict about the cross-border applicability of these requirements.

For example, one of the most contested aspects of the clearing rules, which resulted in a long-lasting public blame game and significantly delayed transatlantic equivalence determinations, concerned the minimum length of the ‘liquidation period’ IM collected by CCPs should cover. The CFTC insisted on one day, whereas the EU preferred two days. The dispute persisted for several years, before being eventually resolved in 2016 in favour of the US.¹⁴⁷⁰ After large parts of the CCP rules were already in place in both jurisdictions, CPSS-IOSCO in 2012 published some ‘Principles for Financial Market Infrastructures’.¹⁴⁷¹ However, in spite of the length of the document extending across a total of 188 pages, the principles were ‘principles’, rather than ‘advisory prescriptions’, to use Newman and Posner’s terminology. Moreover, they were frequently not specific enough, and they came too late in

¹⁴⁶⁶ Singer (2010, 2009b), see also Busch (2009:54), Cunningham/Zaring (2009:50).

¹⁴⁶⁷ Newman/Posner (2018:141)

¹⁴⁶⁸ Newman/Posner (2018:15)

¹⁴⁶⁹ Newman/Posner (2018:15ff.)

¹⁴⁷⁰ The information in this paragraph is drawn from Stafford (2015a, 2015b), Madigan (2015), Brunsden/Stafford (2016), and Posner (2018).

¹⁴⁷¹ CPSS-IOSCO (2012)

order to shape the domestic policy process. Also, the group did not enjoy the same extent of immediate legitimacy in domestic policy-making, as is the case for BCBS.¹⁴⁷²

In derivatives trade reporting (not at the focus of Newman and Posner's analysis), policy-makers operated in 'a web without a center', with the FSB equally acting too late and not decisively enough.¹⁴⁷³ The result has been chaos, even though this transparency-enhancing reform 'is arguably the least controversial'.¹⁴⁷⁴

The margin rule has been spared this fate. Newman and Posner briefly hypothesize this thought, but without further developing the idea.¹⁴⁷⁵ As we saw, BCBS-IOSCO's WGMR was established by the US because of uncertainty whether the EU would follow up on its G20 commitment, at a time when the extent of the problems in the realms of clearing and trade reporting could not yet have been gauged. The timing was not ideal, since Dodd-Frank was already adopted, and the CFTC and the PRs had already published a first round of draft rules. While an earlier establishment would have facilitated the decision-making process, it was not yet too late for the adoption of a harmonized global approach, since the EU was not yet advanced in its decision-making process, and the US regulators could re-set their rule-making through a second draft proposal.

Fragmentation, particularly with respect to 1-vs. 2-way IM, could thus be prevented. As well, where disagreements persisted, as in the IM for FX swaps and FX forwards case, a transgovernmental solution could be found (exception from IM, but introduction of VM requirements) before fragmentation and retaliation were to poison the political climate, as they did in the clearing case. With the exception of the (EU) segregation case, and the highly politicized end-user case where the current exemption in the EU is not as all-encompassing as in the US, fragmentation along domestic lines has been mostly averted.

While we have to limit the applicability of this statement to the cases we examined, the fact that the equivalence determinations pertaining to the collateralization of cross-border trades revealed comparatively little contestation, provides further indirect evidence pointing to the relevance of WGMR in preventing fragmentation.¹⁴⁷⁶

However, while the relevance of WGMR, in conjunction with the strong ideational consensus, was of unquestionable importance for achieving harmonization, power considerations were not completely absent. The power-related arguments of the analysis are comparatively less strong, given data constraints and the general difficulties of identifying power in its application. Keeping these challenges in mind, the EU's power through regulatory capacity and power through market power probably represented the

¹⁴⁷² E.g. Newman/Posner (2018:140ff., in particular p.142). There have been several follow-up initiative since then, yielding equally limited success (see for example the comments made in DeFrancesco (2018)).

¹⁴⁷³ Knaack (2018:252)

¹⁴⁷⁴ Knaack (2018:251)

¹⁴⁷⁵ Newman/Posner (2018:128, fn9)

¹⁴⁷⁶ Details on the specifications can be found in Latham&Watkins (2017:12ff.).

‘second leg’ which, in combination with socialization effects, ensured the stability of the PRs’ embrace of the 2-way mandate. The US regulators, in particular the PRs, had initially expected that as first movers, they would provide the blueprint for the global margin rules, with one of the purposes of WGMR being to ensure that the other jurisdictions would follow the American lead. However, the 2-way IM case reveals that the EU has in fact become an independent voice in global financial governance. Shortly after the crisis, Posner predicted ‘a greater willingness on the part of national politicians and EU representatives to use strengthened bargaining positions to export EU models to the international level’.¹⁴⁷⁷ The empirical evidence provides support in favour of this conjecture.

At the same time, the IM for FX swaps and FX forwards case points to the (current) limits of the EU’s inter-state power. While Europe enjoyed both power through regulatory capacity and power as market power, it was not in control of the supply of the key traded good, i.e. the USD. Even more so, not only was the EU not in control of its supply, it was in fact highly dependent on it for its own domestic banking sector. This might have allowed the US to project structural power through the relevance of the USD as the international key currency, and thus to extract a concession from the EU in terms of the exemption of these products from IM. We also saw that in light of the immediate lack of credible contenders, the USD’s centrality is likely to continue.¹⁴⁷⁸

This thesis asked: has there been any change to the influence of dealer bank preferences over policy outcomes in the regulation of OTC derivatives in the US and the EU since the global financial crisis of 2008. If so, why? If not, why not? The analysis up to this point has focused on *change to the influence of dealer banks*. As a final step, we might ask to what extent the margin reform per se signifies *change to the governance of post-crisis derivatives markets more generally*. The following section will discuss this broader question in order to conclude the study.

3. The margin reform and broader change to the governance of post-crisis financial derivatives markets

The empirical evidence underscores the structural overhaul the uncleared market has undergone. Much more than just ‘symbolic’ and ‘marginal’, as some observers have commented with respect to post-crisis financial regulation more generally,¹⁴⁷⁹ the reform has imposed significant costs on market participants and represents a ‘seismic shift’¹⁴⁸⁰ in terms of how the market is governed. The mandatory use of IM, in combination with the

¹⁴⁷⁷ Posner (2010b:108)

¹⁴⁷⁸ See for example Helleiner (2016b).

¹⁴⁷⁹ Moschella/Tsingou (2013b:193, 197), see also Wigan (2010), Singer (2009, 2010).

¹⁴⁸⁰ Risk.net (2013)

requirement to segregate and to not rehypothecate it, represents a sea change, even though some exemptions and limitations apply. This defies the notion that ‘the Dodd-Frank Act falls short of radically reshaping the structure or operation of derivatives markets’.¹⁴⁸¹ It also runs counter to some structuralist observers who had maintained that OTC derivatives reform was ‘a near impossibility’ because of the uncleared market being ‘too elusive to be easily regulated’.¹⁴⁸² In 2017, CFTC chair Massad explicitly confirmed the significance of margin rule by saying that ‘I believe one of our most important accomplishments is that we have built a broader consensus that these reforms make sense.’¹⁴⁸³

As well, analysts consider the increased use of CCPs, which represents a central pillar of the post-crisis ideational consensus, as ‘probably the main accomplishment of the post-2008 reform’.¹⁴⁸⁴ Indeed, more than 60% of the OTC market is now centrally cleared. This is a significant achievement, even though, given limits to standardization and exceptions for certain FX derivatives as well as (some) end-user trades, only two product types - interest rate derivatives and, to a smaller extent, credit derivatives - account for this ratio (see table 1). A survey conducted by BCBS/CPSS/FSB/IOSCO in 2018 revealed that the margin rule is among the top three criteria incentivizing dealers to use CCPs, besides perceptions of counterparty credit risk and the clearing mandate itself.¹⁴⁸⁵

The significance of the extent of this change must not be underestimated. However, once we broaden the angle of our analysis, it becomes clear that a large proportion of this success builds on policy-makers’ ability to draw on margining and central clearing as already existing market practices. Conceptually, these practices had been firmly established within the market for decades, even though in terms of volume, they used to be less widely applied.

From a theoretical perspective, we might argue that it was precisely the previous existence of the clearing model which contributed to the success of the margin reform. Indeed, the literature argues that ideas evolve in an incremental fashion.¹⁴⁸⁶ As Baker observes, ‘new or changing ideas and policy programmes do not appear on a blank canvas but rather interact with existing institutional context’.¹⁴⁸⁷ Clearing and margining were not ‘revolutionary’¹⁴⁸⁸ new concepts. Rather, they preceded the financial crisis and were already well anchored within the market of exchange-traded derivatives. The post-crisis clearing/margining consensus also evolved along the three lines Hall has identified as prerequisites for the successful implementation of new political ideas: their economic, political, and

¹⁴⁸¹ Omarova (2013:99)

¹⁴⁸² Bryan/Rafferty (2006:197,16), see also LiPuma/Lee (2004:94).

¹⁴⁸³ Massad (2017)

¹⁴⁸⁴ Zelenko (2017:20)

¹⁴⁸⁵ BCBS et al. (2018:24)

¹⁴⁸⁶ See for example Helleiner (2010, 2016c).

¹⁴⁸⁷ Baker (2013:36)

¹⁴⁸⁸ The term is adopted from Moschella/Tsingou (2013a:2).

administrative viability.¹⁴⁸⁹ As we saw, the clearing/margining idea appealed to regulators on economic theoretical grounds. Policy-makers embraced it as it allowed them to demonstrate strength and leadership in the immediate aftermath of the crisis (even though the US Republicans never fully subscribed to the idea). The administrative viability in terms of the availability and willingness of CCPs to take over the uncleared business as well as regulators' experience in supervising these entities provided further momentum to the idea.

Policy-makers, however, did not use this momentum to consider more far-reaching changes to the governance of the markets. The justification was often that policy-makers first needed to consolidate the vast array of the new reforms the G20 had adopted, before further change could be contemplated. However, this often meant that the momentum the crisis had provided was not fully exploited.

Placed into a *larger* context, the degree of change the margin reform has provoked therefore remains limited. Most importantly, beyond the immediate confines of the (un-)cleared market, the reform has not been part of, nor has it led to, the definition of more ambitious 'policy goals',¹⁴⁹⁰ or ways to promote the 'global public interest' in more than a predominantly '(macro-)prudential' sense.¹⁴⁹¹ Ten years after the crisis, we can conclude with some confidence that we have not entered the 'new era of economic engagement' Obama had optimistically announced in 2009.¹⁴⁹²

Indeed, the margin reform is reflective of policy-makers' more limited perspective, informed by the belief that financial risk need only be 'better' managed, rather than fundamentally addressed through broader structural reform. It is true that financial risk, particularly systemic risk, cannot easily be dissolved or 'regulate[d] away',¹⁴⁹³ and that a financial system that curtails risk too significantly risks itself becoming highly counterproductive on many levels. However, given the destruction caused by the 2008 crisis, and the multitude of factors that contributed to it (see figure 5 in chapter I-2.3), a broader discussion about finding the right balance to address and manage financial risk would have required a more far-reaching approach. Most importantly, it would have required renegotiating the 'social purpose' of the financial system itself.¹⁴⁹⁴ Ideally, this conversation would involve 'an ongoing interactive process' towards the development of 'a systemic vision, which specifies the purpose, function and contribution of the financial system, in wider economic and social terms, derived from combinations of empirical and normative reasoning, that is communicated publicly and explicitly to build an inter-subjective consensus concerning appropriate economic goals, principles, values and

¹⁴⁸⁹ These are the terms used by Hall (1989:369ff.).

¹⁴⁹⁰ Moschella/Tsingou (2013b:197)

¹⁴⁹¹ Helleiner (2014b:76, 86ff.)

¹⁴⁹² Obama (2009:2, see also 5)

¹⁴⁹³ Tsingou (2010:28)

¹⁴⁹⁴ Baker (2018)

activities'.¹⁴⁹⁵ The debate about the macroprudential dimension of the margin rules barely scratches the surface of such a conversation.¹⁴⁹⁶

Returning to the more immediate consequences of the margin reform, CCPs have taken on the new business and are now successfully operating in the market on both sides of the Atlantic. However, it is important to highlight that central clearing in its current post-crisis form does not contain risk to the extent many policy-makers had initially hoped for, when they embraced the ideational consensus.¹⁴⁹⁷

There is range of challenges associated with the current situation which this thesis can only briefly touch on. First, in order to optimize netting benefits, there should be only one CCP in place to cover the global market in its entirety, or at least one CCP per asset class.¹⁴⁹⁸ Policy-makers, however, quickly abandoned this idea, mainly for political reasons.¹⁴⁹⁹ Second, this also means that the problem of interconnectedness, which had contributed to the crisis, has not been resolved. Indeed, firms have to use several CCPs in order to clear their portfolios.¹⁵⁰⁰ Third, contrary to the initial expectations of some observers, CCPs have not been turned into not-for-profit, user-owned entities,¹⁵⁰¹ or even public utilities, but remain private, profit-oriented businesses.¹⁵⁰² Fourth, at the same time, the recent growth of the cleared market has turned a number of CCPs into systemically important entities which are considered 'the ultimate case of "too big to fail", or, alternatively, 'too big to fail on steroids'.¹⁵⁰³ Fifth, there are increasingly doubts about how well these entities are risk-managed. For example, there have been growing concerns 'about the limitations of [their] risk models as a centerpiece of [their] risk management strategies'.¹⁵⁰⁴

Sixth, the preceding challenges further raise the importance of identifying viable strategies to stress-test CCPs, and to resolve them if they should fail. The latest stress tests in the US (2017) and EU (2018) identified some weaknesses, but the results were broadly optimistic.¹⁵⁰⁵ However, despite ongoing modifications of the underlying methodologies of these tests, analysts have identified several important limitations.¹⁵⁰⁶ More generally, discussions about how to resolve a failing CCP have been keeping policy-makers on their toes for several years. Yet, in spite of intensive debate, analysts conclude that the current

¹⁴⁹⁵ Baker (2018:296, 294)

¹⁴⁹⁶ See again Baker (2018) for a broader discussion on the relevance of the macroprudential paradigm in this context.

¹⁴⁹⁷ For an early warning, see for example Bernanke (2011).

¹⁴⁹⁸ Gregory (2014:143), Duffie et al. (2010:14), Singh (2013:20)

¹⁴⁹⁹ Das (2011)

¹⁵⁰⁰ See BCBS et al. (2017).

¹⁵⁰¹ See for example Bank of England (2010:10).

¹⁵⁰² Helleiner (2014b:79)

¹⁵⁰³ Das (2011), Haldane quoted in Douglas (2012).

¹⁵⁰⁴ The quote is taken from Lockwood (2018:169). Reports about recent manifestations of some of these concerns can be found in Aimone (2018a,2018b) and Woodall (2018).

¹⁵⁰⁵ See ESMA (2018b) and CFTC (2017).

¹⁵⁰⁶ For a detailed analysis, see for example Cox/Steigerwald (2017).

'toolkit is insufficient to avoid the costs of resolution being borne by taxpayers'.¹⁵⁰⁷ Seventh, the Brexit vote has re-opened heated discussions about regulatory jurisdiction. The key question is which (group) of regulators should oversee the UK CCPs, particularly LCH.Clearnet which clears a large proportion of continental European client trades. These debates are not limited to the UK and the EU, but also include the US CFTC which fears that the current equivalence determination that took years to negotiate might be at risk again.¹⁵⁰⁸ The ideational consensus undergirding the margin reform in terms of the incentivization of central clearing has, therefore, not led to a vastly 'safer' market, even though the reasons for this failure are not directly connected to the reform itself.

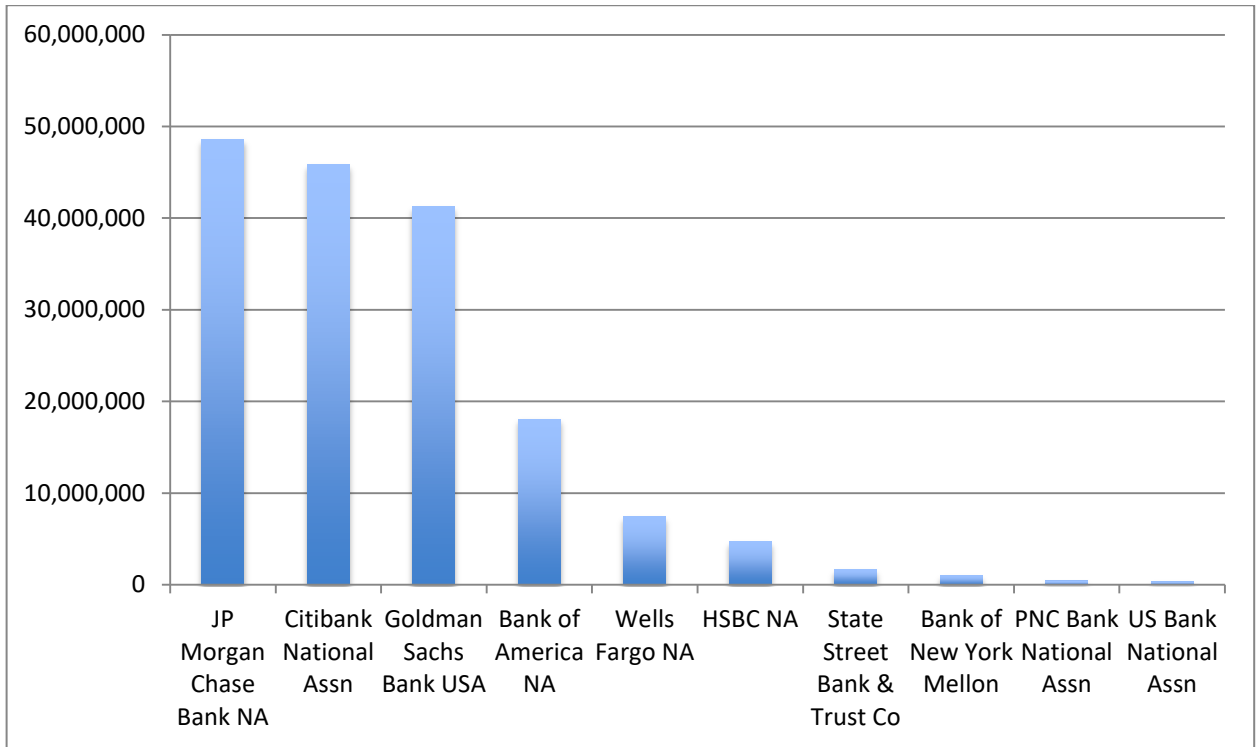
It is also worth returning to the role of the large banks. We saw that the dealers had to accept major defeats during the policy-making process on the regulation of bespoke trades. However, at the same time, they continue to act as the dominant players in both derivative markets, as dealers in the uncleared one, and clearing members in the cleared one. In the uncleared market, the top 4 banks are still the same as in 2008, only in different order of size. As well, in both markets, there is a concentration towards the top players, meaning the banks' centrality has persisted, if not even increased. Currently, this concentration is still less pronounced in the cleared market, but the trend towards growing concentration can be equally identified.¹⁵⁰⁹ Figures 26 and 27 provide quantitative illustrations.

¹⁵⁰⁷ Singh/Turing (2018:2)

¹⁵⁰⁸ Brush/Weber (2018), Jones (2018a), Rubin (2018)

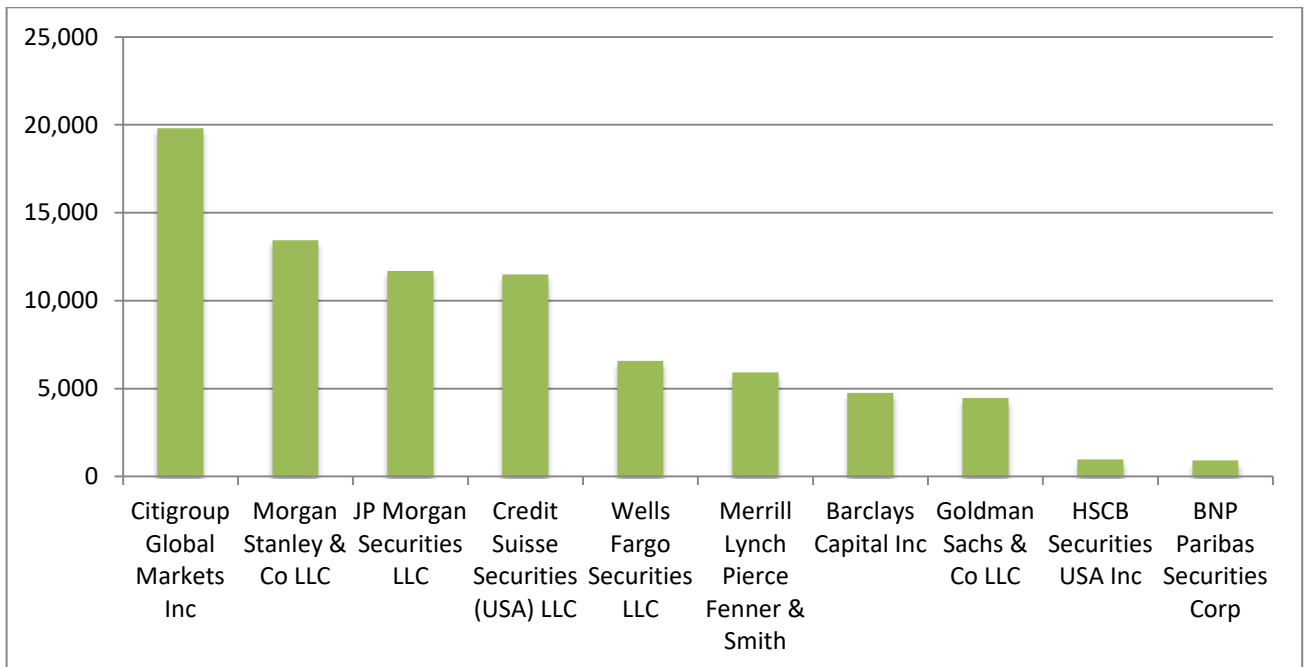
¹⁵⁰⁹ Skarecky (2017)

Figure 26: The leading US dealer banks in 2017



Source: Author based on OCC (2018:37 of the pdf, table 1. Notional amount of derivative contracts, top commercial banks and trust companies in derivatives, as defined by the OCC (December 2017, USD mn)).

Figure 27: The leading US clearing members



Source: Author based on Skarecky (2017). The figure depicts the top 10 US futures commission merchants in function of client funds related to swaps (September 2017, US bn)

Finally, recent trends point to a possible return of the pre-crisis factor constellation, particularly in the US, as a result of which the level of bank influence might be on the rise again.

Indeed, the Republican victory in the 2016 US elections has catapulted the skeptics of the margin reform into the driver's seat. The PRs have so far remained relatively quiet on the topic, although Randal Quarles, Tarullo's successor as the Fed's new vice chair for financial supervision, has clarified that 'everything is up for a fresh look'.¹⁵¹⁰ The CFTC, by contrast, has publicly announced plans for reforming the reform.

CFTC chair Giancarlo, who was confirmed as Massad's successor in August 2017, recently co-authored a White Paper identifying the perceived flaws of the reform. Most importantly, he insists that the two components of the *ideational consensus* that undergird the margin reform – accounting for the systemic risk emanating from uncleared trades and promoting the transition of uncleared trades to CCPs - cannot be reconciled in one reform. '[T]hese two standards for uncleared margin are not compatible from a policy perspective. Margin requirements on uncleared derivatives can either be set to reflect counterparty risk, thus avoiding regulatory arbitrage, or they can be set higher, to discourage uncleared trades and promote clearing'.¹⁵¹¹ While the precise meaning of the statement itself is not fully clarified in the White Paper, the remainder of Giancarlo's comments suggests that he believes the uncritical implementation of the ideational consensus has made the regime too costly and burdensome for some market actors.

Specifically, he argues that the CFTC fundamentally misinterpreted the Dodd-Lincoln letter by insufficiently accounting for its clarification that under Dodd-Frank, the margin rules 'must set the appropriate standards relative to the risks associated with trading ...'.¹⁵¹² The White Paper does not challenge the central pillars of the margin reform pertaining to the use of IM, the segregation mandate, and the prohibition of rehypothecation. However, Giancarlo offers a roadmap for adjusting the contours of the reform. The respective section of the document, which fully resonates with many of the preferences the dealer banks had voiced during the earlier stages of the reform process, is titled 'Uncleared Margin Requirements Should Not be Prescriptive'.¹⁵¹³ This commitment, if further acted upon, might inaugurate the beginning of the return of the banks as policy-makers' trusted interlocutors and providers of information. The *Financial Times* reports that Giancarlo 'won a standing ovation from the derivatives industry when he gave his first speech as chair'.¹⁵¹⁴

The adjustments he envisions include an exemption for 'smaller financial end-users' including pension funds and insurance firms 'for the same reasons that commercial end

¹⁵¹⁰ Quarles quoted in Spicer/Oran (2017).

¹⁵¹¹ Giancarlo/Tuckman (2018:82)

¹⁵¹² Giancarlo/Tuckman (2018:83) quoting from the Dodd-Lincoln letter.

¹⁵¹³ Giancarlo/Tuckman (2018:80)

¹⁵¹⁴ See Shubber (2018).

users are exempt'.¹⁵¹⁵ The White Paper contains no details about the precise threshold that would inform the definition of 'smaller'. Second, he proposes to raise the USD 50mn IM payment threshold and the USD 8bn 'material swap exposure' threshold below which no IM needs to be posted, because they disproportionately affect 'larger entities that have small swap books relative to the size of their businesses'.¹⁵¹⁶ Third, he intends to introduce VM thresholds for end users, given that 'there are many other regulations, like capital and liquidity ratios, to ensure the safety of swap dealers'.¹⁵¹⁷

Giancarlo acknowledges that '[i]t will be challenging for the CFTC to implement these recommendations on its own. While they are all consistent with the requirements of Dodd-Frank, they are not consistent with the rules of other domestic regulators or international standards or guidance'.¹⁵¹⁸ The US Treasury recommends that regulators 'cooperate with non-U.S. jurisdictions that have implemented the BCBS-IOSCO framework',¹⁵¹⁹ but it is unclear to what extent the CFTC would be willing to embrace this approach. For CFTC Commissioner Brian Quintez, 'different jurisdictions must have the flexibility to adopt the approaches that fit best within their existing regulatory frameworks and market structures'.¹⁵²⁰ He insists that this would not ignite 'regulatory arbitrage' or a 'regulatory "race to the bottom"', an insinuation he 'completely reject[s] [as] disingenuous'. To the contrary, from his point of view, '[m]arket participants seek neither the least nor the most regulated marketplaces, but rather marketplaces that have the best balance of sensible, objective, and reliable regulation'.¹⁵²¹

The EU Commission could not disagree more. Commissioner for Economic and Monetary Affairs, Valdis Dombrovskis, has emphasized that '[i]nternational finance needs international regulatory cooperation. Without it, we run the risk of regulatory arbitrage and renewed instability'. 'Lax regulation in one country can create conditions for inadequate regulation and contagion throughout the world'. He has made it clear that '[w]e are sensitive to talk of unpicking financial legislation which applies carefully negotiated international standards and rules'.¹⁵²²

It appears uncertain to what extent any changes to the post-crisis margin rules would be adopted at the transnational level through WGMR. The group was not dissolved after the publication of its final framework, but it has so far remained largely quiet on the current deregulation debate in the US.

¹⁵¹⁵ Giancarlo/Tuckman (2018:vi)

¹⁵¹⁶ Giancarlo/Tuckman (2018:78, see also 79f.)

¹⁵¹⁷ Giancarlo/Tuckman (2018:79)

¹⁵¹⁸ Giancarlo/Tuckman (2018:80)

¹⁵¹⁹ US Treasury Department (2017:130)

¹⁵²⁰ Quintez (2018)

¹⁵²¹ *ibid*, emphasis in the original.

¹⁵²² Dombrovskis quoted in Jones (2017).

While the EU has also chipped away at the rules, its current reforms of the reform have been much less far-reaching than those envisaged by the CFTC. In May 2018, the ESAs published a proposal that would exempt simple, transparent and standardised (STS) securitisations from the requirements to exchange IM and post VM.¹⁵²³ As well, there are plans to relax the VM requirement for FX swaps and FX forwards which would apply to a significantly smaller range of entities. Indeed, in May 2018, a report by the EU Parliament proposed that ‘[i]n order to avoid international regulatory divergence and bearing in mind the particular nature of the trade in such derivatives, the mandatory exchange of variation margins on physically settled foreign exchange forwards and physically settled foreign exchange swap derivatives should only apply to transactions between the most systemic counterparties, namely credit institutions and investment firms’.¹⁵²⁴ At the time of writing, the precise contours of the final solution remain to be determined. It is also not entirely clear whether policy-makers’ primary objective is to simply bring the EU requirement more in line with the US, where supervisory guidance applies only to banks under the Fed’s jurisdiction, and/or whether it is a response to industry pressure. Regarding the end-user business, the report suggests the adoption of two separate clearing thresholds for financial and non-financial firms, ‘[s]ince financial counterparties and non-financial counterparties present different risks’.¹⁵²⁵

Compared to the US, the EU has so far largely maintained its resolution against deregulation. However, it is open whether it would persist past Brexit, when the City of London would no longer be part of the EU market. The major uncertainties surrounding Brexit as well as its precise implications for the City mean that currently we cannot fully discuss this aspect. The FCA’s recent comments on the issue have been less pronounced. For instance, chair Charles Randell has warned of the ‘damaging cycle’ deregulation might initiate.¹⁵²⁶ By contrast, the UK government has already voiced its preference for large-scale deregulation in order to boost the competitiveness of its financial system post-Brexit.¹⁵²⁷ Against this background, it cannot be excluded that the UK would join the US at the *ideational level*.

It remains to be seen how the EU would respond to such a move. On the one hand, competitive deregulation dynamics could equally set in on the continent. On the other hand, the EU could strengthen its resolve, trying to sail against the wind blowing from the US. An exit from Brexit, which is occasionally discussed, could reinforce this trend, as it would leave the EU’s *inter-state power* informed by market size intact. However, if the UK were to leave the EU market as planned, Europe would likely lose this power, unless a special arrangement for the EU-UK financial markets was adopted. Absent such an agreement, Brexit would make standing against the tide more difficult for the EU, unless it were to result in a mass exodus from the City to the continent. In this case, the EU could

¹⁵²³ ESAs (2018)

¹⁵²⁴ EU Parliament (2018:10)

¹⁵²⁵ EU Parliament (2018:8)

¹⁵²⁶ Randell quoted in Jones (2018b).

¹⁵²⁷ See for example Gordon et al. (2017).

respond more forcefully to US deregulatory plans, since its overall market share would probably decrease less significantly. However, if the US were to deregulate alone, bypassing the transnational level, the EU could find itself exposed to market forces that might turn out difficult to resist. Indeed, the dynamics in the US might encourage EU banks to once again (threaten to) exercise structural power in order to try to extract regulatory concessions, even though many firms are still struggling with the wider effects of the triple crisis (financial, debt, and economic). On the other hand, a ‘hard’ Brexit could also lead to serious market disruptions that could prevent the deregulation trend from taking hold, although they would probably result in corresponding shocks to market size.

If the deregulation trend were to gain further strength, *domestic institutional variables* would most likely not stand in its way. As we saw in the pre-crisis chapter, from a domestic institutional point of view, deregulation is often much easier to achieve than regulation.

In addition, the level of *public issue salience* pertaining to the need to regulate the derivatives markets has significantly decreased since 2008, and, without a new, large-scale scandal or crisis, is likely to remain low. The challenges associated with central clearing keep attracting attention, at least among the more informed policy-makers. However, the regulation of the uncleared market appears to no longer be a major concern for the average policy-maker, and even less so for the average voter, of which there is now also a new generation which was less immediately exposed to the effects of the 2008 crisis. Against this background, Bernanke, Geithner, and Paulson in a recent op-ed published by *The New York Times* warn that ‘[f]or those working to keep our financial system resilient, the enemy is forgetting’.¹⁵²⁸

This leaves us with the *business unity* moderator. While the rise of the buy-side as a chorus of new voices should not be underestimated, the empirical evidence of the post-crisis cases highlights that market actors faced few challenges in achieving consensus on the perceived need for keeping regulatory requirements relaxed. This consensus would probably translate to renewed deregulation.

Overall, if these trends were to persist, they could lead to a re-emergence of strong bank influence over a new round of deregulation. They could also result in the more fragmented and decentralized framework that observers had initially expected after the crisis,¹⁵²⁹ and which has already become a reality with respect to several aspects of the cleared market and trade reporting.¹⁵³⁰

In conclusion, the margin reform per se represents a ‘seismic shift’¹⁵³¹ in the ways in which the uncleared market is governed. This ‘shift’ is the result of a reform over which the large

¹⁵²⁸ Bernanke et al. (2018)

¹⁵²⁹ Helleiner/Pagliari (2011)

¹⁵³⁰ Helleiner et al. (2018)

¹⁵³¹ Risk.net (2013)

dealer banks, as the central actors of the uncleared market, exercised limited influence. The post-crisis situation therefore stands in sharp contrast to the pre-crisis period which was characterized by deregulation and a factor constellation which afforded the banks commanding influence. However, if studied in a larger context, it becomes clear that the margin reform has not led to, nor has it been accompanied by more far-reaching change to the governance of the derivatives market, and that the regulatory pendulum might soon begin swinging back.

While we are not witnessing a ‘status quo crisis’,¹⁵³² we have also not entered ‘a ‘constitutive’ phase in the development of a new international financial system’,¹⁵³³ and a return to a ‘status quo crisis’ cannot be excluded.

¹⁵³² Helleiner (2014c)

¹⁵³³ Helleiner (2010a:634)

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Appendix A - Timeline of major events

1974

Congress adopts Treasury Amendment
Establishment of the CFTC

1985

Formation of the International Swaps Dealers Association

1986

Adoption of the Financial Services Act in the UK

1987

Publication of the first version of ISDA's Master Agreement

1989

CFTC publishes 'Swap Policy Statement'

1991

Gibson Greetings derivatives scandal

1992

IOSCO fails to adopt an international accord on capital requirements
for securities firms

1993

CFTC issues 'Exemption for certain Contracts Involving Energy
Products'

Metallgesellschaft derivatives scandal

G30 publishes 'Derivatives: Practices and Principles'

1994

Procter & Gamble and Orange County derivatives scandals

Establishment of the Derivatives Policy Group

1995

Derivatives Policy Group publishes 'Framework for Voluntary Oversight'

1998

Failure of Long Term Capital Management

CFTC issues 'Concept release concerning Over-the-Counter Derivatives Market'

1999

Counterparty Risk Management Group publishes 'Improving Counterparty Risk Management Practices'

2000

US Congress adopts the Commodity Futures Modernization Act

UK adopts the Financial Services and Market Act

2002

EU adopts the Financial Conglomerates Directive

2004

SEC adopts Consolidated Supervised Entities programme

2008

15 September Failure of Lehman Brothers

16 September Bailout of AIG

14-15 November G20 Summit in Washington, D.C.

2009

- 3 July EU Commission publishes first consultation on 'Possible initiatives to enhance the resilience of OTC derivatives markets'
- 22 September US administration publishes 'Draft Legislation for Financial Regulatory Reform'
- 24-25 September G20 Summit in Pittsburgh
- 13 October Barney Frank introduces 'Over-the-Counter Derivatives Market Act of 2009 (H.R. 3795)'
- 10 November, 10th Chris Dodd introduces 'Restoring Financial Stability Act of 2009' (discussion draft)
- 11 December House of Representative passes 'The Wall Street Reform and Consumer Protection Act of 2009' (H.R. 4173)'

2010

- 15 April Chris Dodd introduces 'S.3217 - Restoring American Financial Stability Act of 2010'
- 14 June EU Commissions publishes second consultation on 'Derivatives and Market Infrastructures'
- 21 July President Obama signs the 'Dodd-Frank Act Wall Street Reform and Consumer Protection Act (H.R. 4173)' into law
- 19 October US Treasury publishes notice and request for comment on the 'Determination of Foreign Exchange Swaps and Forwards'

2011

- 1 January EU's ESAs become formally operational
- 17 March Joint BCBS-CPSS 'Working Group on Foreign Exchange Settlement Risk' established
- 11 April Prudential Regulators publish first proposal on 'Margin and Capital Requirements for Covered Swap Entities'

12 April	CFTC publishes first proposal on 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants'
29 April	US Treasury publishes 'Notice of Proposed Determination on Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act'
8 September	CFTC publishes 'Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements Under Section 4s of the CEA'
October	WGMR established
3-4 November	G20 Summit in Cannes

2012

6 March	ESAs publish 'Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories (JC/DP/2012/1)'
4 July	EU Commission adopts 'Regulation No 648/2012 of the European Parliament and Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (European Market Infrastructures Regulation- EMIR)'
31 July	ESRB publishes its report 'Macro-Prudential Stance on the Use of OTC Derivatives by Non-Financial Corporations'
July	WGMR publishes first consultation paper on 'Margin requirements for non-centrally-cleared derivatives'
27 September	ESMA publishes numerical values of the clearing threshold
18 October	SEC publishes proposed rule 'Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers'
16 November	US Treasury publishes 'Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act'

19 December EU Commission adopts 'Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP'

2013

February WGMR publishes second consultation paper on 'Margin requirements for non-centrally cleared derivatives'

15 February BCBS-CPSS publishes 'Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions'

September WGMR publishes final policy framework for 'Margin requirements for non-centrally cleared derivatives'

23 December US Fed implements 'Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions'

2014

14 April ESAs publish first 'Consultation Paper Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012'

3 September Prudential Regulators publish second consultation paper on 'Margin and Capital Requirements for Covered Swap Entities'

23 September CFTC publishes second consultation paper on 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants'

2015

12 January President Obama signs the TRIA Reauthorization Bill (H.R. 26) into Law

March WGMR decides on extended implementation deadlines of Margin requirements for non-centrally cleared derivatives

10 June	ESAs publish 'Second Consultation Paper Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012'
13 August	ESMA publishes 'EMIR Review Report no.1 - Review on the use of OTC derivatives by non-financial counterparties'
21, 22 October	Prudential Regulators publish final rules on 'Margin and Capital Requirements for Covered Swap Entities'
18 December	CFTC publishes final rule on 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants'

2016

8 March	ESAs publish 'Final Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012'
25 April	EU Commission adopts a uniform definition of 'spot contracts' through the COMMISSION DELEGATED REGULATION (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive
9 June	EU Commission informs ESAs of delayed implementation of draft margin RTS
16 August	ISDA publishes VM Protocol for the US
17 November	ISDA publishes EMIR-compliant version of the VM Protocol
23 November	EU Commission published 'Report from the Commission to the European Parliament and the Council under Article 85(1) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories'
1 September	Launch of IM and VM phase-in in the US
4 October	EU Commission adopts final margin RTS through 'COMMISSION DELEGATED REGULATION (EU) 2016/2251 of 4 October 2016

supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty'

2017

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| 1 February | Launch of IM phase-in the EU |
| 1 March | Second final deadline for non-phase 1 US and all EU entities to become VM rule-compliant |
| 4 May | EU Commission publishes 'Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories' |
| 1 September | Ultimate deadline for US and EU entities to become VM rule-compliant |
| 18 December | ESAs publish 'Draft regulatory technical standards on amending Delegated Regulation (EU) 2016/2251 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 with regard to physically settled foreign exchange forwards' |