Political Economy of Financial Regulation (with Shikhar Singla and Vikrant Vig)

Abstract

In this paper, we study the decision making of financial regulators in international standard setting. Since the introduction of the Basel Accord, regulators negotiate harmonized rules that most economies around the world incorporate into their national law. We construct a unique dataset containing the positions of banks and regulators regarding the most important issues of Basel II and III. The probability of a regulator opposing a specific initiative increases by 31% if the respective national champion opposes the new rule. Smaller banks do not have such an impact on regulators' stand. Interestingly, regulator rally for its national champions mostly when the issue being discussed differentially affects banks from different countries. The documented behavior of the regulator has important consequences on which type of rules get implemented. We observe a substantial watering down in 11 out of the 30 most important issues negotiated in the Basel II/III frameworks. Issues that asymmetrically impact national champions from different countries have a high probability to end up being watered down. Our findings are consistent with a regulatory capture hypothesis as well as regulators interest to ensure financial stability by supporting their national champions. Irrespective of the underlying motives of regulators' decision making, our evidence questions the efficiency of the existing process of international standard setting.