The Causes of the Divergent Development of Banking Regulation in the U.S., Canada, and Spain

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The Causes of the Divergent Development of Banking Regulation in the U.S., Canada, and Spain

A dissertation presented

by

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to

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for the degree of

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in the subject of

Sociology

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Abstract

Why did different countries create different systems of banking regulation in the years leading up to the recent global financial crisis, despite adhering to the same transnational regulatory agreement, the 1988 Basel Capital Accord? Using over 5000 pages of archival material and in-depth interviews with regulators and industry participants, I answer this question by tracing the historical development of banking regulation (1780-2007) across three countries that were all parties to the Basel Capital Accord: the U.S., Canada, and Spain. The conventional wisdom is that banking regulation either follows universal principles of efficiency or reflects the power and interests of the regulated industry. I offer a very different explanation: that regulators from different countries adopted different policies because they subscribed to fundamentally different conceptions of economic order, which can be traced back many decades in each country.
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CHAPTER 1: INTRODUCTION

We live in an increasingly global world. Over the past four decades, the world has witnessed a dramatic intensification in international trade, a marked increase in the mobility of capital, and the rapid and widespread circulation of new ideas and new technology. The rise of this new transnational economy has been accompanied by the rise of transnational regulation and governance (Djelic and Sahlin-Andersson 2006). The participation of national public authorities in global regulatory bodies has tripled in recent decades (Cassese 2004), and transgovernmental and international nongovernmental organizations have increasingly taken over the governance of economic life in areas where states used to dominate (Djelic and Sahlin-Andersson 2006; Boli and Thomas 1999). The turn to transnational regulatory governance is evident in multiple policy domains, including the regulation of labor and work (Kolben 2011), environmental protection (Vogel 1997), and the regulation of trade and financial flows (St. Clair 2006; Djelic and Sahlin-Andersson 2006). International regulatory convergence and transgovernmental regulation are indisputably central features of the modern age.

At the same time, it is equally evident that states continue to matter in the regulatory policymaking process. In nearly every domain of economic activity, national regulators still enjoy some freedom to direct some elements of policy. The result is that even as regulation grows increasingly similar around the world, national regulatory systems continue to develop differently in different countries. To the extent that differences in national regulatory regimes have consequences that we care about - and I will argue that they do - it is important to uncover the mechanisms that drive the development and reproduction of these differences.
In this dissertation, I contribute to existing understandings of how national regulatory regimes develop in the modern age by examining the divergent development of banking regulation in the period leading up to the global financial crisis of 2007-2009. During this period, banking regulators from the world’s major financial capitals continued to make different policy choices in critical areas, even as they adhered to the terms of the same transnational regulatory agreement (the 1988 Basel Capital Accord). Many of the policy differences that developed during this period had major consequences for bank outcomes when the crisis hit. In countries where regulators had encouraged banks to develop conservative buffers against losses (in the form of reserves or capital) and to restrict their reliance on complex and opaque financial instruments that played such a crucial role in the crisis, banks tended to perform better (Admati 2014; Admati and Hellwig 2013; Downe 2010; Courtney and Nivola 2009). Conversely, in countries where regulation had favored risk-taking, as when regulators promoted reliance on complex risk-transfer mechanisms, allowed banks to operate with high leverage ratios, or discouraged banks from erring on the side of conservatism when setting aside reserves or capital, banks tended to perform worse (Admati 2014; Acharya et al. 2013; Financial Crisis Inquiry Commission 2011).

My goal is to explain why regulators from different countries made the different policy choices they did during a period of international regulatory convergence. To this end, I draw from over 5000 pages of archival material and in-depth interviews with banking regulators and other industry participants to examine the evolution of banking regulation across three countries that were all parties to the Basel Capital Accord: the United States, Canada, and Spain. In the process, I call attention to an overlooked driver of regulatory policy development. The received wisdom is that differences in regulatory regimes stem from differences in the economic
conditions regulators face or from differences in the power of the industries they regulate. I offer a very different explanation. I argue that national banking regulators adopt different policies because they approach their tasks through fundamentally different frames of regulatory order, which give the state and the market more or less of a role in promoting safety and prosperity (see Table 1.1). I show that the dominance of the frame of competition in the U.S., the frame of public protection in Canada, and the frame of centralized coordination and direction in Spain encouraged different regulatory priorities. The different goals of national banking regulators ultimately produced different policy choices in the post-Basel era (1988-2007).

Table 1.1. Frames of Regulatory Order and Perceived Sources of Safety and Prosperity

<table>
<thead>
<tr>
<th>United States (frame of competition)</th>
<th>Safety</th>
<th>Prosperity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Market</td>
<td>Market</td>
</tr>
<tr>
<td>Canada (frame of public protection)</td>
<td>State</td>
<td>Market</td>
</tr>
<tr>
<td>Spain (frame of centralized coordination)</td>
<td>State</td>
<td>State</td>
</tr>
</tbody>
</table>

To explain how these frames of regulatory order developed, I begin my investigation at the origins of modern banking in each country, and trace the historical evolution of banking regulation through the onset of the recent global financial crisis. I focus on policymaking in five distinct periods: the 19th century, after the banking crises of the 1920s and 1930s, during the deregulatory period of the 1960s and 1970s, after the banking crises of the 1980s, and in the post-Basel era (1988-2007). Comparing the evolution of national regulatory regimes over the course of two centuries reveals an interesting pattern. Regulatory policies changed dramatically within countries over time, but at the same time, regulatory regimes remained persistently different across countries. Existing accounts of regulatory policy development struggle to explain the simultaneous persistence of differences across countries and the dramatic changes within them. Accounts that highlight economic or political drivers may be able to explain why policies
often change dramatically within countries, but they cannot explain why national policymakers consistently return to different types of solutions even when they face similar economic and political conditions. Accounts that highlight structural or cultural drivers suffer from the opposite problem. They may be able to explain why policies consistently differ across countries, but they struggle to account for how old policy regimes fall apart and get replaced by new ones. In this dissertation, I demonstrate that only a revised institutional account, which focuses on the effects of multiple meanings within institutions, can effectively explain both of these trends.

REGULATORY CONVERGENCE IN BANKING

The Basel Capital Accord had its origins in the economic difficulties of the 1970s, as mounting inflation and the loosening of global capital restrictions ushered in a new era of competition and volatility in banking (Davis 2009; Moss 2009; Krippner 2011). The financial crises of this period put national policymakers and banking regulators under tremendous pressure. They angered voters and threatened market confidence, which suggested a need for regulatory reform. But at the same time, national policymakers also recognized they could not unilaterally impose stricter standards without putting domestic banks at a disadvantage (Singer 2004).

A group of central bankers from the G-10 countries responded to this dilemma by forming the Standing Committee on Banking Regulation and Supervisory Practices, otherwise known as the “Basel Committee” due to its location at the Bank for International Settlements (BIS) in Basel, Switzerland. After a decade of deliberation, the Basel Committee published the Basel Capital Accord,¹ a new international regulatory agreement, in 1988. The purpose of this agreement was to enhance the safety and stability of the global financial system by establishing

¹ In 1989, the provisions of the Basel Capital Accord were extended to several non-G10 European Union (EU) countries, including Denmark, Greece, Ireland, Portugal, and Spain.
common international standards for bank capital adequacy. Banks are highly leveraged institutions, a characteristic that makes them both highly profitable and highly fragile.\(^2\) To keep unexpected costs from driving them into ruin, banks keep a pool of funds on hand (capital) that serves as a buffer against losses, absorbing costs before they can hit depositors or other creditors.\(^3\) The architects of the Basel Capital Accord sought to ensure that banks around the world held adequate capital by establishing common capital adequacy standards that were tied to the riskiness of a bank’s activities. Banks were required to hold at least 8% in regulatory capital against their risk-weighted assets.\(^4\) The introduction of these new, common international rules was regarded as a “landmark in financial regulation” (Kapstein 1989; Simmons 2001), as it represented the first time that the banking regulators from all of the world’s major financial capitals had agreed to enforce a common set of regulatory requirements.

Unquestionably, the passage of the Basel Capital Accord did promote international convergence in banking regulation. This transnational agreement produced real and lasting effects for bank behavior, and in many countries, its implementation dramatically changed the way that banking regulation was done (Quillin 2008). At the same time, it is equally clear that the trend towards regulatory convergence in banking regulation has been incomplete. After the passage of the Basel Capital Accord, regulators from different countries continued to develop different policies in critical areas, with implications for how banks experienced the recent global financial crisis. The terms of the Basel Capital Accord, like the terms of most voluntary

\(^2\) This funding structure magnifies the consequences of small missteps and leaves banks unusually vulnerable to insolvency in the face of sudden losses.

\(^3\) In technical terms, bank capital consists of the funds available to shareholders after all of a bank’s assets are liquidated and all of its liabilities paid off.

\(^4\) Assets were divided into four different “buckets,” each of which carried a risk weight of 0, 20, 50, or 100 percent.
transnational regulatory agreements, were broad and flexible. This feature allowed national policymakers to retain considerable discretion over policymaking, even as they adhered to the terms of the new international standards (Quillin 2008; Kapstein 1989). National banking regulators retained the ability to define critical concepts and relationships in different ways; to establish different regulatory standards for behaviors that had nothing to do with capital adequacy, but still affected bank stability and solvency; and to choose whether or not to extend the Basel standards to other types of financial institutions beyond commercial banks. My goal is to explain why national regulators used their local discretion under the Basel Accord to adopt the different policies they did.

To this end, I examine the evolution of banking regulation in the U.S., Canada, and Spain. These three countries were selected from the pool of fifteen Basel Committee member countries because they provide the broadest range of observations on the outcome to be explained, policy divergence. Table 1.2 summarizes the patterns of regulatory policymaking in each country during the post-Basel era, focusing on overall trends and specific policies in three critical areas. I briefly describe these overall trends below, but leave the detailed discussion of the specific policy choices for Chapter 6.

5 “Divergence” is a relative term. Accordingly, I began by selecting the United States as the point of divergence, due to this country’s leading position in the global financial system and the importance of the choices made here for regulatory policymaking in other countries. I then selected the country where policymakers used their discretion to adopt regulatory policies that were the most similar to those in the U.S. (Canada) and the country where regulators used their discretion to make policy choices that were the most different from those in the U.S. (Spain).
Table 1.2. Divergent Banking Regulation in the U.S., Canada, and Spain, 1988-2007

<table>
<thead>
<tr>
<th></th>
<th>US Permissive</th>
<th>Canada Less Permissive</th>
<th>Spain Very Strict</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overall</strong></td>
<td>Banks encouraged to pursue innovative activities; not encouraged to build conservative margins for error</td>
<td>Banks encouraged to pursue innovative activities, but also encouraged to build conservative margins for error</td>
<td>Banks blocked from pursuing innovative activities; forced to build conservative margins for error</td>
</tr>
<tr>
<td><strong>Securitization</strong></td>
<td>Strongly committed to promoting bank participation in off-balance-sheet securitization</td>
<td>Pursued harmonization with lax U.S. regulation of securitization, except where safeguards were threatened</td>
<td>Opposed bank involvement with off-balance-sheet securitization</td>
</tr>
<tr>
<td><strong>Loan Loss</strong></td>
<td>Regulators fold to accounting standard setter pressure</td>
<td>Banking regulators spend political capital to keep provisions high</td>
<td>Banking regulators introduce and defend novel provisioning regime</td>
</tr>
<tr>
<td><strong>Provisions</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Financial</strong></td>
<td>Investment banks escape strict prudential regulation</td>
<td>Financial conglomerates regulated</td>
<td>Financial conglomerates regulated</td>
</tr>
<tr>
<td><strong>Conglomerates</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Although the overall pattern of divergent regulatory policymaking across these three countries defies easy description, some general trends do emerge. At the most basic level, banking regulators seek to promote bank stability and solvency by ensuring that banks stay away from excessively risky activities and by ensuring that banks are adequately provisioned against the risks of existing activities. Banking regulators in the U.S., Canada, and Spain in the post-Basel era approached these regulatory objectives in different ways.

**Banking Regulation in the U.S.**

In comparative perspective, American banking regulation in the post-Basel era was highly permissive. The regulators at the Federal Reserve took a comparatively hands-off approach to the regulation of bank activities: they placed relatively few limits on the types of innovative activities banks were allowed to pursue, and even promoted greater reliance on risk
transfer practices like asset securitization and the use of over-the-counter derivatives. On the provisioning side, the American banking regulators sought to ensure that banks estimated their risk exposures and the provisions they held against these exposures in a very precise way. Regulation emphasizing precision in provisioning discouraged American banks from building in conservative margins for error in the form of capital or reserves (Balla and McKenna 2009; Admati and Hellwig 2013). The American banking regulators also sought to prevent the extension of bank-style regulation to other types of financial institutions, like investment banks or other members of the shadow banking sector.

These policies proved disastrous for the stability and solvency of American banks during the crisis (Admati and Hellwig 2013; Acharya et al. 2013; Financial Crisis Inquiry Commission 2011). When the crisis hit, American commercial banks were heavily exposed to troubles in the securitization and derivatives markets, and most banks had comparatively few reserves on hand to absorb these losses when they occurred (Admati and Hellwig 2013; Acharya et al. 2013; Financial Crisis Inquiry Commission 2011). These problems were particularly serious for highly leveraged (but loosely regulated) investment banks and shadow banks.

**Banking Regulation in Canada**

Canadian banking regulation in the post-Basel era was less permissive than banking regulation in the United States; however, the regulatory regimes in both countries shared many common features. The Canadian regulation of bank activities mirrored American regulation in

---

6 See the loan loss provisioning policies described in Chapter 6. As another example of the focus on precision in provisioning in the U.S., consider the American banking regulators’ promotion of an internal-model method of estimating capital requirements. The American banking regulators were at the forefront of promoting a method of calculating capital requirements that relied on a bank’s own internal risk models, which was regarded as a more precise method than the imposed risk-based capital requirements of Basel I. Although the Basel Committee officially adopted this new method in 2004, the revised regulatory standards (Basel II) were not implemented until 2008, after the onset of the global financial crisis.
many respects: e.g. the Canadian banking regulators gave their financial institutions a considerable amount of freedom to engage in innovative risk transfer practices, including securitization and over-the-counter derivatives, and they actively pursued greater regulatory harmonization with the U.S. in multiple areas. However, banking regulators in Canada took a different approach to the regulation of bank provisioning practices. These regulators consistently encouraged banks to establish conservative buffers against losses, taking steps that included adopting a maximum leverage ratio, encouraging banks to establish large loan loss reserves, and informally requiring banks to maintain capital holdings that far exceeded the Basel minima (Leblond 2011: 170; Ratnovski and Huang 2009). These policies helped to preserve the stability and solvency of Canadian banks during the crisis. Although Canadian banks did suffer losses on their securitization and derivatives activities, large Canadian banks held provisions that were adequate to absorb the (comparatively few) losses they experienced on these and other activities.

**Banking Regulation in Spain**

In comparative perspective, Spanish banking regulation in the post-Basel era was strict. In the domain of bank activities, the Spanish banking regulators actively restricted banks from participating in innovative risk transfer practices, especially off-balance-sheet securitization. On the provisioning side, the Spanish regulators encouraged banks to establish conservative capital buffers, and they also developed a unique, forward-looking loan loss provisioning regime that forced banks to set aside more reserves against bad loans during upswings in the credit cycle (Fernández de Lis and Garcia Herrero 2009). The Spanish regulators also prioritized the consolidated supervision and regulation of financial conglomerates (Saurina 2009; Caruana
Although Spanish banks eventually performed poorly during the global financial crisis, there is general agreement that the outcomes would have been much worse had Spanish regulators not imposed such strict prudential standards. There is also evidence that the large loan loss reserves that Spanish banks developed leading up to the crisis enabled these institutions to stay afloat for much longer than other banks that experienced comparable losses (Balla and Rose 2011).

EXPLAINING POLICY DIVERGENCE

Five theoretical frameworks highlight alternative drivers of regulatory policymaking. Economic accounts highlight the economic pressures regulators face as the primary driver of their decision-making (Keeley 1990; Goodman and Pauly 1993; Dollar and Friedan 1990), while political or class-based accounts focus on the preferences and relative power of rival interest groups, especially the regulated industry (Gourevitch and Shinn 2005; Stigler 1971; Johnson and Kwak 2010). Structural (or historical institutional) accounts emphasize how political and regulatory system structures shape the policymaking process (Weir and Skocpol 1985, Pierson 1993, Prasad 2006; Krippner 2011; Immergut 1992), while national culture accounts focus on the effects of “national character traits” or stable, nation-specific norms and values (Hofstede 1981; Inglehart and Carballo 1997; Inglehart and Baker 2000). Institutional (or sociological institutional) accounts emphasize how systems of shared meaning, embodied in material

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7 The major banking crisis in Spain had multiple causes, but one clear cause was the dramatic drop in interest rates that accompanied Spain’s entrance into the Eurozone. When Spain joined the Economic and Monetary Union (EMU) of the European Union, interest rates that had conventionally been at 10 percent suddenly dropped to 2 percent. Unsurprisingly, this inspired a massive lending boom. It is equally clear that many of the causes of the crises in other countries (e.g. off balance sheet exposures returning to bank balance sheets, as in the case of ABCP in the U.S., Canada, and many other European countries) did not factor into the crisis in Spain (Fernandez de Lis and Garcia Herrero 2009). The Spanish non-financial sector was also over-leveraged in comparative perspective (Roxburgh et al. 2010).
structures and practices, shape how national regulators perceive problems and develop solutions (Dobbin 1994; Fourcade 2009).

Economic and political explanations currently dominate the literature on regulatory policy development (Campbell 2002; Schmidt 2008). However, emerging research in sociology and political science has started to challenge the dominance of the economic and political perspectives by offering new accounts that emphasize the roles of state structures and state actors in the policymaking process (e.g. Krippner 2011; Prasad 2012; Busch 2009). But even as the literature has started to incorporate more focus on the effects of state structure, accounts that highlight the *meanings attached* to these structures have remained marginalized or dismissed (Burstein 1991; Steensland 2008; Schmidt 2008).

In what follows, I first explain why conventional economic, political, structural, and cultural accounts of regulatory policymaking offer insufficient explanations. Table 1.3 summarizes the predictions of each conventional account and briefly explains why it falls short. Then, I introduce my own revised institutional explanation, and explain how this theory accounts for the divergent development of banking regulation in the U.S., Canada, and Spain.
Table 1.3. Alternative Explanations for Regulatory Policy Development

<table>
<thead>
<tr>
<th>Alternative Explanation</th>
<th>Prediction for Policy Divergence</th>
<th>Why it Falls Short</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Pressure</td>
<td>Regulators will drop restrictions when banks face more intense competitive pressures</td>
<td>Restrictions became less intense at times and places where the banking system was performing well</td>
</tr>
<tr>
<td>Regulatory Capture</td>
<td>Regulation will be more permissive (bank-friendly) when conditions favor capture</td>
<td>Regulation was less permissive in countries when conditions favor regulatory capture</td>
</tr>
<tr>
<td>Political Party Power</td>
<td>Regulation will be more permissive when governments operate under right-wing control</td>
<td>Very different regulation within two countries operating under right-wing control; changes in political party control did not lead to change in regulatory orientation</td>
</tr>
<tr>
<td>State Structure</td>
<td>Regulation will be more permissive when regulatory agencies are less independent and more fragmented, or when political/regulatory system is more open to neoliberal reforms</td>
<td>Orientation of regulatory policy in each country changed dramatically in the late 1980s, yet structures remained stable</td>
</tr>
<tr>
<td>National Culture</td>
<td>Regulation will be more permissive when national norms and values favor risk-taking</td>
<td>Perspective does not reflect advances in understanding of culture; orientation of regulatory policy changed dramatically, yet national norms and values remained stable</td>
</tr>
</tbody>
</table>

**Economic Pressure**

Scholars that emphasize economic drivers of policymaking have overwhelmingly focused on explaining one trend in regulatory policymaking, international regulatory convergence, to the exclusion of other trends. These accounts conceptualize regulators as driven by universal efficiency imperatives, and suggest that national regulators, in the face of increasing competitive pressures, have no choice but to converge around the same optimal regulatory regime (Goodman and Pauly 1993; Dollar and Friedan 1990). In short, convergence is seen as inevitable in an increasingly global financial system, as national policymakers lose the leeway to retain unique
policies and restrictions that might disadvantage their banks in an international competition (MacKenzie and Lee 1991; Goodman and Pauly 1993; Dollar and Friedan 1990).

For this reason, economic accounts of regulatory policy development (at least as currently conceptualized in the literature) are of limited utility when the goal is to explain ongoing cross-national policy divergence. However, the basic insights of this perspective can be extended to develop predictions for why national regulators might continue to make different policy choices in the modern globalized era. If policymaking is driven by rational responses to common efficiency imperatives, as conventional economic accounts of regulatory policymaking suggest, we might expect to find more permissive (and less distinctive) regulation in countries where bank profit margins are being squeezed most tightly. Figure 1.1 reports over-time trends in the profitability of American, Canadian, and Spanish banks, measured using average return on equity, a common measure of bank profitability. It is clear that the observed trends across countries are not consistent with the predictions of an economic account of regulatory policy development. Patterns of regulatory policymaking do not appear to map on to patterns in the intensity of competitive pressure: banking regulation was more permissive at a time (1990-2007) and in a country (U.S.) in which domestic banks were performing comparatively well.
Figure 1.1. Return on Average Equity Among U.S., Canadian, and Spanish Banks, 1990-2007


Regulatory Capture

Regulatory capture explanations currently dominate the literature on regulatory policy development. These accounts emphasize how the actions of interest groups—especially the regulated industry— influence the types of policies regulators adopt. Carpenter and Moss (2014: 13) define regulatory capture as follows:

*Regulatory capture* is the result or process by which regulation, in law or application, is consistently or repeatedly directed away from the public interest and toward the interests of the regulated industry, by the intent and action of the industry itself.
Regulatory capture arguments come in a variety of forms, but they all share the same basic premise: policymakers are for sale, and regulation is commodity purchased by the business groups most interested and able to buy it (Carpenter and Moss 2014: 9; Posner 2014: 52). Originally, this perspective developed to explain why regulators introduce restraints on competition, like licensing or other barriers to entry (Stigler 1971; Peltzman 1976; Becker 1983). The theory casts regulators as motivated by a narrow range of material interests, and posits that incumbent firms within established industries are often in the best position to serve these interests. The idea is that incumbent firms represent the interest group with the greatest incentive and ability to organize to influence their regulators, especially when compared to consumers (Wilson 1980; Meier 1988; Fishback and Kantor 1998; Peltzman 1976).

Theoretical developments in the regulatory capture literature have far outpaced empirical tests of the predictions of this theory (Carpenter and Moss 2014). Regulatory capture effects are often asserted, but the predictions of this account are rarely systemically tested against the predictions of competing accounts (Carpenter and Moss 2014; see Levine 2012; Johnson and Kwak 2010; Barth et al. 2006). The drivers of variation in regulatory capture have also received relatively little attention in this literature (but see Stigler 1971; Laffont and Tirole 1991). There

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8 Industry influence has been theorized to operate through a variety of mechanisms, including outright bribes; dependence on regulated firms for funding; lobbying legislators, who then put pressure on regulators; and the exchange of high-paid jobs in the regulated industry for industry-friendly regulation (see Schleifer and Vishny 1998; Fellmeth 1970; Edelman 1967).

9 These tendencies not to examine variation in regulatory capture or to test the predictions of regulatory capture theory against the predictions of alternative theories of policy development have long been characteristics of the regulatory capture literature. Part of the problem is that regulatory capture scholars have historically assumed that regulators’ intentions can be read from the outcomes of the policies they adopt, despite the tautological implications of this strategy. As Stigler (1975: 140) explained, “the first purpose of the empirical studies [of regulatory capture] is to identify the purpose of the legislation! The announced goals of the policy are sometimes
is a need to make regulatory capture theory a live perspective, with falsifiable predictions that can be tested against the predictions of alternative theories.

The few studies that do examine variation in regulatory capture tend to rely on one of two empirical strategies. The first is to use correlations between industry characteristics (which serve as a proxy for an industry’s power to influence regulators) and the outcomes of regulatory policymaking as evidence of capture (Stigler 1971). The underlying assumption is that in industries with fewer players, or in industries where resources remain concentrated in fewer hands, incumbent firms are in a better position to organize to influence regulators (Stigler 1971). In industries where barriers to collective action are lower, this theory predicts, regulators are more likely to be captured.

Recently, some regulatory capture theorists have pointed to the correlation between rising consolidation in the American banking industry and permissive banking regulation as evidence for regulatory capture (e.g. Krozner and Strahan 2013; Baker 2012; Johnson and Kwak 2010). It is true that the consolidation and concentration of the American banking system has increased dramatically since the late 1980s, and it is possible that this change in the structure of the industry has placed large U.S. commercial banks in a better position to secure policies that favor their interests (Krozner and Strahan 2013; Baker 2010; Johnson and Kwak 2010). But a quick

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10 Although the regulatory capture perspective originally developed to explain the rise of regulatory restrictions to competition, more recent regulatory scholarship has expanded the theory’s scope to account for deregulation and the rise of permissive regulation (Carpenter and Moss 2014: 20). The same basic idea persists in this new generation of regulatory capture scholarship: that “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit” (Stigler 1971: 3). As Carpenter and Moss (2014: 20) explain, “it would seem easier for firms to coordinate on a single message of deregulation - the benefits of which could plausibly accrue to business across the board, in the form of lower costs, potentially at the
glance at the structure of the American banking system in comparative perspective would seem to contradict the predictions of the regulatory capture account. In comparative perspective, the U.S. banking system is unusually deconcentrated and deconsolidated. As Figure 1.2 shows, even after two decades of growing concentration and consolidation, the American banking system still has three times as many independent banks as the banking systems in Canada or Spain. As Busch (2009: 47) notes, the sheer number and diversity of American financial institutions makes collective action very difficult, as no single association or federation can easily represent the interests of the entire financial industry. Figure 1.3 demonstrates that similar comparative patterns also hold for industry concentration. The five largest American banks controlled a much smaller share of the financial marketplace than the five largest Canadian or Spanish banks throughout the 1990s and 2000s. In summary, cross-national variation in banking industry power (as proxied by the measures most commonly used in the existing regulatory capture literature) fails to explain the cross-national regulatory patterns in the post-Basel era.

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11 Even if one were to equate the power of the American banking industry with the absolute size of individual banks (not a common strategy in this literature), trends in the rise of permissive policymaking would still not correspond with the predictions of regulatory capture theory. In 2005, three of the world’s top twenty largest banks were headquartered in the United States, while only one of the top twenty banks were headquartered in Spain, and zero were headquartered in Canada (Global Finance, October 1, 2005). However, it is unlikely that trends in the absolute size of individual American banks explain the rise of permissive regulatory policymaking in this country, since the increase in the size of American banks did not occur until after the trend towards permissive regulation had begun to take hold. American banking regulators started to embrace permissive regulatory policies in the early 1990s, and continued to embrace these policies in a period (1990-1999) in which American banks were not among the world’s largest banks.
Figure 1.2. Number of Banks Per Capita in U.S., Canada, and Spain, 1994-2009

Source: OECD Banking Statistics
Other regulatory capture scholars have relied on a second empirical strategy. These scholars point to the extent of a “revolving door” between regulatory agencies and the regulated industry as evidence for regulatory capture (e.g. Johnson and Kwak 2010; Levine 2012; Barth et al. 2006). The underlying theory is that regulators are more likely to be captured by the industry when agency personnel are more sympathetic to industry interests, as when they enter the agency from an industry background (Kwak 2014), or when personnel leave regulatory agencies for more lucrative positions in the regulated industry (Johnson and Kwak 2010; Levine 2012; Barth et al. 2006; Lewis 2011). The idea here is that the promise of a job in the regulated industry encourages regulators to develop industry-friendly policies during their tenure at the agency.

We currently lack systematic, over-time data on the career trajectories of banking regulators across different countries, which makes it difficult to assess how the revolving door
varies across time and place. However, I use the limited data that is available to assess whether patterns in the career trajectories of national banking regulators correspond to cross-national patterns in the permissiveness of banking regulation. In each country, I examine the career histories of the ten banking regulators who worked most closely on the regulation of one of the bank activities I consider, asset securitization, in the post-Basel era (1988-2007). The results suggest that the revolving door was no more pronounced in the U.S. than it was in Canada. Eight out of the ten regulators in both the U.S. and Canada either came from positions in the regulated industry or left for positions in the regulated industry. The same was only true for two out of the ten regulators in Spain. At least to the extent that these differences can be measured, it does not appear that differences in the operation of the revolving door explain the variation in banking regulation across these three countries.

In summary, the relative absence of testable claims regarding the predictors of regulatory capture, combined with the lack of cross-national data on regulators’ career trajectories, currently makes it difficult for researchers to decisively confirm (or reject!) regulatory capture accounts of policy development. However, after following the empirical strategies most commonly used in the regulatory capture literature and collecting career history data for a subsample of regulators, I find good reason to suspect that variation in regulatory capture alone does not explain the divergent development of banking regulation. Regulation was no more likely to serve bank interests in the country where commercial banks were in the best position to organize and influence their regulators (Canada). Similarly, the regulatory systems in Canada and the U.S.

12 These individuals were identified by reading regulatory documents from this period and by interviewing regulators in each country in 2013-2014. Using publicly available data (e.g. publicly posted resumes) and data taken from regulators’ LinkedIn profiles, I coded for whether the regulator had ever held a position in the banking or financial industry prior to assuming their regulatory role, and whether they secured a position in the banking or financial industry after leaving their regulatory position.
were marked by a similar frequency of movement of personnel between regulatory agencies and the regulated industry, yet banking regulation in the U.S. was consistently more permissive than banking regulation in Canada.

**Political Party Agenda**

An alternative political explanation attributes the content of regulation to the party composition of government. The premise is that political parties try to please their respective social constituencies by adopting policies that reflect their interests. Prior research finds that right-wing parties are more likely to implement policies that serve the interests of “capital, employers, and the better-off in secure employment,” while left-wing parties seek to serve “the unemployed and others most likely to bear the greatest risks and costs associated with an economic downturn” (Cusack 2001: 95; Hibbs 1977; Schmidt 1996). Extending this perspective to the case of banking regulation, we might expect to find more permissive regulation at times and in places where the government operates under right-wing political control.

Table 1.4 shows trends in political party power in the U.S., Canada, and Spain between 1988 and 2007. The Spanish political system contained three major political parties in the post-Basel era: the Center Democratic Union (center-center-right), the Spanish Socialists (left), and the Popular Party (right). Political control in the U.S. changed hands between the Republican Party (right) and the Democratic Party (left). The Canadian political system contains four major political parties: the Conservatives (right), the New Democratic Party (left), and the Liberals (left), and the Bloc Quebecois (center-left). As Table 1.4. demonstrates, the observed trends in political party control do not support the predictions of this account. The American and Spanish governments both operated under right-wing control between 1997 and 2003, yet banking regulators in each country adopted dramatically different regulatory policies during this period.
Similarly, this account cannot explain why the overall orientation of regulatory policy within each country changed very little between 1988 and 2007, even though political party control over the government changed hands multiple times during this period.

<table>
<thead>
<tr>
<th>Year</th>
<th>USA</th>
<th>Canada</th>
<th>Spain</th>
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<tbody>
<tr>
<td>1989</td>
<td>L</td>
<td>R</td>
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**State and Regulatory System Structure**

Structural accounts emphasize the structure of political or regulatory institutions as a primary driver of regulatory policymaking. Structural arguments come in multiple forms, but these perspectives are united by the understanding that the organizational structure of the state itself matters for policy outcomes. The underlying idea is that the coercive, fiscal, judicial, and administrative capacities of the state give politicians, officials, and regulators more or less control over the policymaking process, which shapes the outcomes of this process (Weir and Skocpol 1985; Immergut 1992; Roe 1994; Steinmo 1993; Prasad 2006). In what follows, I describe the predictions of the three structural accounts that are most directly relevant for the current case of regulatory policymaking.

**Regulatory Agency Independence.** The relative independence of the regulatory agency from the political process is one aspect of state structure that receives considerable attention in the regulatory policy development literature (Quintyn, Ramirez, and Taylor 2007; Gilardi 2005). This perspective implies that the involvement of politicians “contaminates” the development of
technical rules and regulatory standards. A lack of independence is expected to lead regulatory agencies to develop weak and ineffective regulations, since politicians, who are primarily concerned with the competitive performance of the banking system, will seek to block the adoption of regulatory restrictions (Quintyn and Taylor 2002). This account implies that we should expect to find stricter regulation in countries where regulators have more autonomy from the political system, as when the legislature delegates regulatory responsibility to independent agencies rather than government-controlled agencies or a central bank (Quintyn et al. 2007: 9).

However, observed trends in the relative independence of the American, Spanish, and Canadian bank regulatory systems do not correspond to the predictions of this account. Prior research has found that the American regulatory system operates more autonomously from the political system than the Spanish or Canadian regulatory systems (Oliveira et al. 2005; Gilardi 2005; Black and Jacobzone 2009).13 Yet it was the U.S. that developed the most permissive system of banking regulation in the post-Basel era.

**Regulatory and Political Fragmentation.** Another key aspect of state structure to receive considerable attention in the regulatory policy development literature is the relative fragmentation of the regulatory system. Scholars have argued that regulatory fragmentation - the extent to which powers are divided across separate regulatory agencies - affects the extent of competition between regulatory jurisdictions (Dell’Ariccia and Marquez 2001; Weinberg 2002). The logic is that when banks have more opportunities to switch between regulators, they are better able to play regulators off each other. This is expected to generate a competitive “race to the bottom” in the quality of regulation, as separate regulatory bodies fight to keep banks within...

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13 To measure the formal independence of regulatory agencies Gilardi (2005) developed an index that attributes formal independence to five major criteria: status of the agency head; status of the members of the management board; relationship with government and parliament; financial and organizational autonomy; and regulatory competencies.
their separate jurisdictions (Dell’Ariccia and Marquez 2001; Weinberg 2002). At first glance, patterns in the relative fragmentation of the U.S., Canadian, and Spanish regulatory system do appear to explain the cross-national trends in regulatory policymaking. Banking regulation was the most permissive in the United States, the country that had had the most fragmented regulatory system: the U.S. had fifty-four separate banking regulators, four at the federal level and fifty at the state level. Both Canada and Spain each had only one prudential banking regulator, which operated at the federal level.14

However, this account cannot explain how banking regulation evolved across these three countries. Few would dispute that banking regulation was relatively permissive in the U.S., less permissive in Canada, and strict in Spain during the post-Basel era (1988-2007). However, this comparative pattern had looked very different only a few years before. Prior to the late 1980s, the United States actually had one of the world’s most restrictive systems of banking regulation. American policymakers had adopted especially tight restrictions on bank structures and activities after the banking crises of the 1930s, and they continued to cling to these restrictions well into the 1960s and 1970s, long after policymakers in other countries had already started to embrace financial deregulation. Trends in banking regulation before the late 1980s also looked very different in Canada. In the 1920s and 1930s, Canadian policymakers avoided imposing the tight restrictions that prevailed in the U.S., and in the 1960s and 1970s, Canadian policymakers were comparatively quick to dismantle the few restrictions they did adopt. As Table 1.5 reveals, Canada was an international leader in all four of the elements that are traditionally grouped under the heading of “financial deregulation” (e.g. the repeal of interest rate controls, the repeal of bank branching restrictions, the repeal of enforced separation between investment and commercial

14 However, securities activities are regulated at the provincial level in Canada.
banking, and the repeal of limits on thrift activities), while the U.S. was an international laggard in all four areas. Spain fell in between these two extremes.

In short, the comparative trends in banking regulation that prevailed before the late 1980s looked very different from the comparative trends that prevailed after that point. The U.S. eventually made up ground in the early 1990s and outstripped other countries in the extent of regulatory permissiveness, while both Spain and Canada started to adopt additional, more stringent regulatory restrictions in the same period. The eventual result was the cross-national pattern described in Table 1.2.

These trends suggest that any theoretical explanation that seeks to explain the divergent development of banking regulation in the post-Basel era must also be able to account for the (somewhat counterintuitive) trajectories through which these national regulatory regimes came to acquire their distinctive forms. For this reason, I argue that the relative fragmentation of each country’s regulatory system cannot explain the divergent development of banking regulation, since this aspect of state structure remained stable even as the orientation of regulation in each country changed dramatically.
Table 1.5. Patterns of Financial Deregulation in the Major Financial Capitals, 1967-1999

<table>
<thead>
<tr>
<th>Country</th>
<th>Deposit Rates</th>
<th>Branching</th>
<th>Thrift Activities</th>
<th>Securities Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>1967</td>
<td>-</td>
<td>1967</td>
<td>1987</td>
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<tr>
<td>Germany</td>
<td>1967</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>France</td>
<td>1985</td>
<td>1987</td>
<td>1984</td>
<td>1984</td>
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<tr>
<td>UK</td>
<td>1971</td>
<td>-</td>
<td>1986</td>
<td>1986</td>
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</table>

*Note: This date marks the initiation of deposit rate deregulation. These ceilings were gradually phased out in both the U.S. and Spain. Deposit rate ceilings were eliminated in the U.S. in 1986 and in Spain in 1987. I use “-” to indicate cases where deregulation did not occur because the regulatory restriction never existed in the country.

Structural Receptivity to Neoliberalism. Scholars from the “varieties of capitalism” tradition have argued that national policymakers are more inclined to adopt policies that serve pre-existing comparative institutional advantages (Hall and Soskice 2001). The idea is that “[g]overnments should be inclined to support [regulatory] initiatives only when they do not threaten the institutions most crucial to the competitive advantages their firms enjoy” (Hall and Soskice 2001: 52). According to this perspective, policymakers from coordinated market economies should be more prone to avoid regulatory policies that threaten implicit contracts between business associations and public authorities, while policymakers from liberal market economies will avoid regulatory policies that threaten market competition and the freer movement of inputs. Accordingly, we might predict that banking regulators in the U.S., as the paradigmatic liberal market economy, would be more likely to adopt permissive or deregulatory (e.g. market-friendly) policies than the banking regulators in Canada or Spain.

Krippner (2011) has also emphasized the pre-existing neoliberal commitments of American state actors as a driver of financial deregulation in the United States. In the early 1980s, American policymakers landed on a strategy of depoliticizing credit allocation by
“substitut[ing] the rationing mechanism of the market for the heavy hand of the state” (Krippner 2011: 142). Krippner (2011) argues that deregulation as a solution persisted in the U.S. because it “offered an answer to the basic dilemma confronted by neoliberal policymakers who faced contradictory imperatives to regulate the economy while deflecting attention from their active role in guiding economic outcomes” (Krippner 2011: 147). Presumably, pressures to deflect attention from the state’s active role in guiding economic outcomes would be more pronounced in the paradigmatic neoliberal economy of the United States than in coordinated market economies like Spain. Why, then, did the United States take so long to start deregulating restrictions that other countries had already started to dismantle (e.g. Krippner 2011: 147; Hall and Soskice 2001: 58)? Structural accounts have difficulty explaining this outcome.

Accounts that highlight changes in economic thought as drivers of permissive regulatory policymaking face a similar problem (e.g. Moss 2011). Prior research finds American political institutions are comparatively open to the dictates of academic economists (Fourcade 2009); additionally, the economic paradigm that is most closely identified with the rise of neoliberalism and the turn to financial deregulation, the Chicago School of Economics, originated in the U.S. in the early 1960s (Moss 2011). So if American policymakers were so comparatively open to insights from economists pushing neoliberalism and deregulation, why then did they lag behind policymakers in other countries in embracing most aspects of financial deregulation? Once again, the pattern suggests that some other factor must be at play.

In summary, the observed pattern of American resistance to financial deregulation in the 1960s and 1970s presents a serious challenge to accounts that emphasize stable features of political and regulatory structures as the primary drivers of policymaking (e.g. Prasad 2006;
Prasad 2012; Immergut 1992; Pierson 1993; Goldstein and Keohane 1993; Skocpol 1992), without also considering the meanings attached to these structures.

National Culture

An alternative account of regulatory policy development highlights the effects of “national character traits,” or stable norms and values shared by members of a country. This perspective is exemplified by the work of Hofstede (1981, 2001), Inkeles and Smith (1974), and Inglehart and colleagues (Inglehart and Carballo 1997; Inglehart and Baker 2000). These scholars argue that national cultural systems are ordered by the extent to which citizens of the country adhere to different value categories (i.e. traditional versus secular-rational; survival versus self-expressive; power distance; individualism; uncertainty avoidance; masculinity, etc.), which shape the way that individuals within these countries approach new situations and events.

This account suffers from two key problems. First, it advances a deterministic, essentialist version of national culture that does not correspond with recent advances in understandings of what culture is and how it operates to shape behavior. Research in both psychology and sociology finds that culture is better understood as a repertoire or ‘tool kit’ of habits, skills, and styles from which people construct ‘strategies of action’ (Swidler 1986: 23; Prasad 2006: 268-9; Lamont and Thevenot 2000; DiMaggio 1997), rather than as a stable, homogenous, and cohesive system that provides the ultimate values towards which action is oriented. The second problem is that observed trends in the evolution of banking regulation do not correspond to the predictions of this account. Accounts that emphasize stable national “character traits” (e.g. Canadian conservatism and risk aversion; American frontier mentality and individualism) as drivers of policymaking cannot account for the dramatic reversal in regulatory orientation that occurred in each country after the late 1980s. If Canadians were so risk adverse
and conservative, then why were policymakers in this country among the first to embrace many aspects of financial deregulation in the 1960s and 1970s, long before policymakers in the U.S. were ready to do so?

**Institutions and Frames**

If economic pressure, regulatory capture, political party control, state structure, and national culture alone do not sufficiently explain the divergent development of banking regulation, what does? I suggest that only a sociological variant of institutional theory can account for both the forms that national regulatory regimes assumed in the post-Basel era and the somewhat counterintuitive paths through which these forms came to be acquired. Institutional theorists take a social constructionist approach to understanding the emergence and persistence of national regulatory regimes. The idea is that in the course of daily life, actors ascribe meaning to the structures, practices, and patterns that exist around them (Berger and Luckmann 1966; Meyer and Rowan 1977; Dobbin 1994). In interpreting their lived experience in conjunction with others, actors develop theories and principles to explain why existing patterns and arrangements are effective, and apply these principles to the design of new structures and practices. These institutionalized meanings, or “taken for granted descriptions and theoretical analyses that specify cause-effect relationships,” structure the policymaking process by constraining the range of problems policymakers perceive and the solutions they consider (Campbell 2002: 22; Dobbin 1994). This focus on taken-for-grantedness, together with a view of institutions as structuring cognition by shaping the types of problems and solutions actors perceive as possible, are the defining features of a sociological institutional approach to policymaking.

The institutional perspective was originally developed to explain why organizations within fields tend to cluster around similar structures and practices, and was later extended to
explain convergence in structure and policy at the national level (Meyer and Rowan 1977; Meyer et al. 1997). However, some institutional theorists have also applied these insights to explain the production of the opposite trend: the reproduction of persistent differences within national policy regimes (Fourcade 2009; Dobbin 1994). Dobbin (1994) demonstrates that industrial culture came to resemble political culture in the United States, Britain, and France, which influenced how policymakers in each country perceived and responded to problems in the early railway industry. In each country, industrial policy was designed to effect processes that were thought to create order in the political realm. In the U.S., where community self-governance was regarded as the key to order, American policymakers initially introduced policies that delegated control to state and local governments, and later implemented policies that reinforced market mechanisms. In Britain, where the political autonomy of individuals was regarded as the key to order, policymakers initially left railroads to their own devices, and later implemented regulations to promote public safety and prevent mergers. And in France, where central state concertation was regarded as the key to order, policymakers closely supervised the railroad industry and implemented centralized planning and financing.

**Critiques of Institutional Theory**

Institutional accounts of regulatory policymaking are currently marginalized in the comparative policy development literature (Burstein 1991; Steensland 2008; Schmidt 2008). These accounts have been criticized for (1) devoting insufficient attention to interests, agency, and contestation and (2) an inability to explain dramatic policy change. Scholars from a variety of literatures, including field theory (Fligstein and McAdam 2011), political sociology (Clemens and Cook 1999), institutional logics (Lounsbury 2008), and historical institutionalism (Hall and Taylor 1996), have noted that institutional theory fails to pay sufficient attention to power and
conflict. The problem, these critics argue, lies in the emphasis that institutionalists place on constrained cognition or taken-for-grantedness as a driver of policy development. As Hall and Taylor (1996: 21) argue, this focus leads institutionalists to advance a “curiously bloodless” theory of policymaking:

That is to say, [this approach] can miss the extent to which processes of institutional creation or reform entail a clash of power among actors with competing interests…. In some cases, the new institutionalists in sociology seem so focused on macro-level processes that the actors involved in these processes seem to drop from sight and the result begins to look like ‘action without agents.’ In general, the approach as a whole might benefit from more attention to the way in which frames of meaning, scripts and symbols emerge not only from processes of interpretation but also from processes of contention (Hall and Taylor 1996: 21)

In other words, if everyone agrees on the obviousness or naturalness of institutional arrangements, then what is there to fight about? Critics of the institutional perspective have argued that this presumption of consensus flies in the face of what is actually observed in the policymaking arena. Policymaking is almost never conflict-free: the legislative record is filled with examples of contestation between rival interest groups advancing alternative arguments. The evolution of banking regulation was certainly no exception to this general rule: in each country, key policy reforms only passed after considerable debate and conflict.

Critics of the institutional perspective have also noted that institutional theory (as currently conceptualized) struggles to explain dramatic policy change (Campbell 2002; Thelen 2003; Gourevitch and Shinn 2005; Schneiberg 2007; Fligstein and McAdam 2012: 12). It is not entirely surprising that a theoretical perspective developed to explain processes of convergence, or persistence over time, would be less well-suited to explaining radical change. As Schneiberg (2007: 50) notes, “[i]t is hard to explain fundamental change and the rise of new paths using arguments about path dependence and the constraining power of context that were originally crafted to explain stability within—or variation across—fields, systems or nation states.”
However, the fact remains that institutional theory’s inability to explain dramatic change is a serious deficiency when the goal is to explain how national regulatory systems evolve. Banking regulation in 1940 looked almost nothing like banking regulation in 1990 in each of the three countries I consider. If institutional theorists hope to fully explain regulatory policy development, they must able to account for these dramatic changes in policy within countries over time, not just the persistent differences across them.

The Argument

My contribution is to advance a revised version of institutional theory that incorporates a greater role for agency and contestation and allows for dramatic policy change. To develop this theory, I introduce a more precise definition of an institution, which calls attention to how institutions are comprised of multiple, more distinct material and cultural sub-components. I suggest that that when institutions are viewed in this way, we can better understand how institutions operate to produce continuity at one level, and change at another.

Institutions Operate at Multiple Levels

The concept of an institution is currently very broadly defined. Scott (2008: 48) defines institutions as “comprised of regulative, normative, and cultural-cognitive elements that, together with associated activities and resources, provide stability and meaning to social life.” At the most basic level, scholars (at least within sociology) generally agree that institutions consist of models, schemas, or scripts for behavior that become naturalized and taken for granted through repeated use and interaction (Berger and Luckman 1967; DiMaggio and Powell 1991) or legitimated through the endorsement of powerful individuals, organizations, or groups (Meyer and Rowan 1977). Such a broad and inclusive definition of an institution has many advantages. It has encouraged scholars who hail from different disciplinary traditions, and work at different
levels of analysis, to talk with (rather than past) one another (Scott 2008). But at the same time, such a broad and inclusive definition has also come with costs. The imprecision of this definition obscures both heterogeneity and hierarchy within institutions. The point that institutional theory neglects heterogeneity within institutional systems has been made by scholars both within and outside of institutional theory. These scholars have argued that particular or prevailing institutional arrangements often coexist with other arrangements (Orren and Skowronek 1994, 2004; Clemens and Cook 1999; Schneiberg and Clemens 2006: 210; Schneiberg 2007) and that multiple logics are often present within institutional fields (Friedland and Alford 1991; Lounsbury 2007, 2008).

However, the neglect of hierarchy between the elements that institutions contain is a point that has received less attention in the institutional literature. While a few scholars in related fields have called attention to the fact that different types of institutions may operate at different levels of society, these insights have not been integrated, and they have not been incorporated into accounts of policy development. For example, in cultural sociology, Sewell (1992) has argued that distinguishing between deep and surface structures provides new insights into how structures both endure and change. He describes deep and surface structures as follows:

Depth has long been a key metaphor of linguistic and structuralist discourse. To designate a structure as "deep" implies that it lies beneath and generates a certain range of "surface" structures, just as structures underlie and generate practices. In structuralist discourse, deep structures are those schemas that can be shown to underlie ordinary or "surface" structures, in the sense that the surface structures are a set of transformations of the deep structures… Consequently, deep structural schemas are also pervasive, in the sense that they are present in a relatively wide range of institutional spheres, practices, and discourses. They also tend to be relatively unconscious, in the sense that they are taken-for-granted mental assumptions or modes of procedure that actors normally apply without being aware that they are applying them (Sewell 1992: 22).
Distinguishing between deep and surface structures allows Sewell (1992) to account for the simultaneous presence of continuity and change. Taking the case of capitalism as one example, he argues that surface structures can change dramatically without disrupting the underlying deep structure, as when the procedures of capitalism prove “remarkably impervious” to (and at times, are even reinforced by) the failures of particular capitalist enterprises or industries (Sewell 1992: 26).

Organizational theorists Haveman and Rao (1997) also draw distinctions between institutions that operate at different levels of society. In an empirical investigation of the changing structure of the thrift industry, the authors distinguish between general and specific institutions. General institutions refer to “broadly accepted norms, values, and belief systems that constitute the master principles of society, such as truth, equality, and justice,” while specific institutions refer to “particular regulations, norms, and ideas that structure the actions of individuals and groups” (Haveman and Rao 1997: 1613-1614). The authors argue that organizational forms are incarnations of specific institutions, but these forms become legitimized to the extent that they accord with general institutions. As they write, “[t]he effects of general institutions are thus filtered through interactions between the designers of organizational forms and the specific institutions these forms render incarnate” (Haveman and Rao 1997: 1614).

I argue that subdividing institutions into their component parts provides the key to understanding how institutions can simultaneously operate to structure both dramatic policy change and persistent continuity across countries. I distinguish between “institutions,” or broad principles of order and their material manifestations, and “frames,” or more specific theories and schemas and their material manifestations. Institutions contain multiple, distinct frames. My conceptualization of an institution is homologous to the general institutions of Haveman and Rao
(1997) or the deep structures of Sewell (1992), while my conceptualization of a frame corresponds to specific institutions or surface structures.

To understand the distinction between what I call institutions and what I call frames, consider the case of the American state. There is something called “the state” that is a clearly an institution: as Clemens and Cook (1999: 442) note, “[f]or many political scientists and sociologists, the massively reinforced and embedded array of the state exemplifies the concept of institution.” However, it is equally apparent that the institution of “the state” is not just an entity unto itself, but a larger package that encompasses a variety of more specific structures, patterns, arrangements, and associated meanings. The American state is at once characterized by an unusual fragmentation of political power across multiple branches of government, the allocation of political power to state and local governments, a pattern of heavy reliance on civic forms of organization, and a pattern of dependence on market methods of allocation, among other features. These various structures, arrangements, and patterns are all separate things, but they are also linked by the fact that they reflect and embody the same broad principle of order. As Dobbin (1994) argues, the material manifestations of the American political system reflect and embody a broader principle of order: that of community self-governance or local sovereignty. In my account, this broad principle constitutes the “institution.”

Just as the entity that we call the American state is made up of multiple, more specific material structures, arrangements, and patterns, it is also comprised of multiple, more specific cultural elements. I refer to these more specific cultural elements as frames of regulatory order. The key argument of this dissertation is that institutions always encompass multiple, more specific frames, and that fully explaining how policy regimes evolve will require attending to the effects of both concepts. By frames, I mean “principles of organization [that] govern the
subjective meanings we assign to social events” (Goffman, 1974: 11). Frames are lenses through which social actors observe and interpret social life, which call attention to certain aspects of social life and hide or block others (Small, Harding, and Lamont 2010).

To understand how different frames can exist within institutions, consider the fact that related (but separate) meanings attach to the related (but separate) material structures, patterns, and arrangements that make up the American state. For example, the devolution of power to state and local governments is a central feature of the American federalist system of government. I suggest that this pattern of allocating power embodies an understanding of order as produced by local groups retaining control over local affairs, and as destroyed by a remote external authority interfering with local prerogatives. This understanding underlies a particular frame of regulatory order, the *frame of deconcentration*, which calls attention to how systems should be designed to promote local sovereignty (power should devolve to the local level). Alternative features of the American state embody different frames. Both the fragmentation of political power across separate branches of government and the pattern of reliance on market methods of allocation reflect an understanding of order as produced by a multiplicity of independent groups (with distinct interests) checking the ambitions of their rivals. This understanding underlies a different frame of regulatory order, the *frame of competition*, which calls attention to how systems should operate to reinforce and preserve local sovereignty (cultivating competitive rivalry between multiple, distinct interest groups).

In short, these frames call attention to particular factors as problems, and other factors as solutions. In the American case, the *frame of deconcentration* primes regulators to see value in remedies that enhance specialization, fragmentation, local allegiance, or state and local concertation in the banking system, and to see problems in the absence of these conditions. The
frame of competition primes regulators to see value in remedies that enhance the market allocation of punishments and privileges, transparency, or impersonal administrative concertation, and to see problems in the absence of these factors. These frames of regulatory order are not mutually exclusive, and they often overlap in practice (just as the material structures and arrangements of the American state overlap in practice). However, at the same time, they are also distinct elements, which means that they can and often do come into conflict.

Structured Alternatives and Institutional Change

Having established that distinct frames exist within institutions, I now explain how institutions and their associated frames structure regulatory policy development. I start from the observation that at a given point in time, the content of a given regulatory regime\(^\text{15}\) often reflects the dominance of a particular frame of regulatory order over alternative frames. I suggest that regulatory regimes often come to reflect the dominance of particular frames because the specific policies within them are advocated for (and opposed) by actors who use particular arguments to justify their positions. One implication is that the adoption of a particular policy reform over alternatives also embodies the triumph of a particular frame of regulatory order over alternatives.

I argue that attending to the effects of both dominant frames (e.g. frames currently embodied, or more embodied, in the existing regulatory regime) and latent frames (e.g. frames not currently embodied, or less embodied, in the existing regulatory regime) within institutional systems sheds new light on how institutions operate to drive policy development.

I argue that latent frames of regulatory order often serve as rhetorical resources that reform advocates can draw from to advance new explanations and policy solutions, and I suggest that the reactivation of latent frames in the U.S., Canada, and Spain helps to explain why the

\(^{15}\) I define a regulatory regime as a configuration of specific regulatory policies, structures, and patterns.
content of banking regulation shifted so dramatically in each country after the late 1980s. During the 1980s, severe banking crises in each country opened up opportunities for reform, which challenger groups then seized. I show that regulatory regimes changed in each country after reformers successfully promoted new diagnoses of, and solutions to, the problems of the 1980s that departed dramatically from the principles embodied within the former regulatory regime. Attending to the structure of the existing regulatory regime, or even to dominant frame embedded within this regime, does not tell us much about the content of the new regime that will follow. Attending to the presence of latent frames makes this content more interpretable. I find that the new diagnoses and solutions that reform advocates offered in each country were not *sui generis*; instead, they were reinterpretations of very old themes. The new regulatory models that emerged after the late 1980s in each country embodied frames of regulatory order that had *lost* in the 1920s and 1930s, and again in the 1960s and 1970s.

My revised institutional theory borrows heavily from recent institutional scholarship, particularly scholarship on “structured alternatives” within established institutional systems (Streeck and Thelen 2005; Schneiberg 2007). These scholars also call attention to how the models of the past serve as vehicles for dramatic change in established policy regimes. The idea is that heterogeneity within institutions, which often comes in the form of “suppressed historical alternatives,” enables strategic actors to rediscover or activate alternative institutional forms (Moore 1979: 376; Streeck and Thelen 2005; Schneiberg 2007). Policy change occurs as “latent subsidiary ways of action [are] rediscovered, and by switching over actors then promote them to dominance or move them from the periphery of the institutional system to its center” (Streeck and Thelen 2005: 20; Schneiberg 2007).

*Institutionally-Structured Contestation and Policy Development*
However, my account departs from the structured alternatives perspective in a key respect: the extent to which it views “structured alternatives” as being structured themselves. I argue that the broader, national institutional context shapes policy development by structuring the range of frames that national policymakers find most salient and available, which in turn shapes the terms of contestation and points of conflict that characterize reform debates within countries.

Many scholars who espouse variants of the structured alternatives perspective have framed their accounts in opposition to more “evolutionary” institutional accounts, which emphasize how centralized institutional tendencies shape the development of policymaking within countries over a long period of time (e.g. Fligstein and McAdam 2012; Schneiberg 2007; Streeck and Thelen 2005). As one example, Schneiberg (2007) argues that his discovery of heterogeneity within established American economic institutions challenges the common practice of conceptualizing national economic institutions in terms of their central tendencies. As he explained:16

My findings…challenge the common practices of conceptualizing [institutional] paths, path creation, and national capitalisms broadly, in terms of their central institutional tendency or predominant configuration of elements. These practices, expressed most recently by typologies of ‘liberal market’ and ‘coordinated market economies’ (Hall and Soskice 2001), effectively assume institutional homogeneity within national economies. But in so doing, they ignore or bracket variety within national capitalisms, leading us to misspecify their character, at least in the U.S. case…And by ignoring structural variety in capitalism, these typologies and practices limit our ability to explain the conditions and processes of change (Schneiberg 2007: 49).

Like the advocates of the “structured alternatives” perspective, I agree that it is important to acknowledge the presence of structural and cultural variety within institutions: this is why I

16 Schneiberg (2007) finds that an alternative cooperative organizational model persisted alongside the dominant impersonal market organizational model during the American era of corporate consolidation.
feature multiple frames at the heart of my revised institutional theory. But at the same time, it is equally important not to lose sight of the features that have given institutional theory its distinct advantage in explaining persistence and continuity. The central insight of the institutional perspective is that due to differences in history, experience, and prior institutional arrangements, policymakers from different countries are primed to view similar tasks, events, and circumstances through different lenses, which are supplied by alternative cognitive frameworks. My revised institutional theory retains this insight by highlighting how the ranges of problems national policymakers are likely to perceive and solutions they consider are not infinite, but bounded by institutionally-structured cognitive frameworks with deep historical roots.

Tracing the evolution of banking regulation over the course of two centuries, I show that the terms of debate have remained remarkably consistent within countries and persistently different across countries. I suggest that an American commitment to local sovereignty produces debates that center around the need to mitigate the threat presented by concentrated power and the need to preserve market mechanisms of allocation, while a Canadian commitment to individual sovereignty produces debates that center around the need to protect individual rights from infringements by powerful actors and the need to preserve individual freedom of choice. The Spanish commitment to state sovereignty produces debates that center around the need to rationalize and organize through centralized coordination and direction and the need to accommodate the interests of powerful groups within civil society.

Acknowledging that cultural elements remain unevenly distributed across national contexts does not have to mean a return to the determinism and essentialism that has historically plagued “national culture” accounts. Many of the scholars within sociology who think most seriously about culture have devoted considerable attention to the problem of describing
variation in cultural processes across countries without reifying this variation as an essential national character trait. In redefining culture as “repertoires” or “toolkits” in which specific cultural elements are distributed in varying proportions across geographic units, comparative cultural sociologists have discovered a way to describe patterned differences across countries while allowing for indeterminacy and heterogeneity within cultural systems (e.g. Lamont and Thevenot 2000). In what follows, Lamont and Thevenot (2000) explain the advantages of this approach:

One of the advantages of our approach is to downplay the contrast between national and intra-national differences. We take elements of repertoires to be present among geographical units such as nations or regions, but in varying proportions. Concretely, for instance, instead of simply contrasting the importance of the market or civic solidarity in France and the United States, we suggest that cultural repertoires prevailing in the United States make market references more readily available to Americans and enable them to resort to such references in a wide range of situations, whereas the French repertoires make principles of civic solidarity more salient and enable a larger number of French people to resort to them across situations, and often precisely in situations in which Americans would resort to market principles. However, this does not mean that market criteria of evaluation are absent from the French repertoires, but only that they are used in a small number of situations by a smaller number of people…We believe that our approach allows us to avoid the…pitfalls [of making generalizations about national cultural differences] (Lamont and Thevenot 2000: 9-10).

In the same way that recasting culture as repertoires has enabled comparative cultural sociologists to retain key insights about variation in cultural processes across national boundaries, while sidestepping the pitfalls associated with earlier “national culture” approaches, I argue that recasting institutions as packages of multiple, distinct, and at times even contradictory frames permits institutionalists to retain key insights about the cultural/cognitive drivers of persistence and continuity while also incorporating much-needed attention to interests, contestation, and conflict.

*Implications for the Ongoing Development of Regulatory Policy*
My theory, which disaggregates institutions and frames and highlights their separate effects in the policymaking process, enhances our understanding of subsequent developments in banking regulation that have taken place since the global financial crisis. I use regulatory reforms in the United States as an illustrative example. The Dodd-Frank Act of 2010 has introduced a new regulatory regime that departs from the former, pre-crisis regulatory regime in multiple ways. However, I suggest that attending to the effects of frames and institutions highlights overlooked continuities between this new regulatory regime and the American regulatory regimes of the past. Many Dodd-Frank reforms embody tenets of the frame of deconcentration, the frame of regulatory order that fell out of favor in the late 1980s. The new Volcker rule, which restricts American banks from engaging in proprietary trading, provides one example. This legislation reflects a return to a familiar American strategy of facilitating order through fragmenting activities, which is thought to promote greater specialization and independence of interests among financial institutions. As another example, consider the targeted focus on systemically important (read: large) financial institutions that is the defining feature of the post-Dodd-Frank regulatory regime. I suggest that this feature embodies a return to a familiar American villain: concentrated power. In redesigning the entire regulatory system around the principle of mitigating the threats presented by large, systemically important institutions, I suggest that American policymakers are resorting back to a Depression-era regulatory model.

My revised institutional theory not only helps to explain evolution of banking regulations within countries, it also helps to explain the ongoing persistence of regulatory differences across countries. In the years since the global financial crisis of the late 2000s, regulators from the world’s major financial capitals have adopted many similar reforms. Yet, at the same time, there

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17 Though it also retains important similarities with the old regime, which I will discuss in greater detail in the conclusion (Chapter 7).
is considerable evidence that national regulators continue to interpret, implement, and augment these common reforms in different ways, and often in precisely the ways we might expect. Consider, for example, the content of regulatory reforms in Spain compared to the content of regulatory reforms in the United States. Spanish policymakers have not introduced an equivalent to the Volcker rule; at the same time, Spanish policymakers have also granted new powers to the Bank of Spain that the Federal Reserve does not share, like the power to directly intervene to shape bank remuneration and compensation practices, the ability to include cajas (savings banks) within the regulatory perimeter, and the authority to implement a countercyclical loan loss provisioning regime. And although Spain, like all Basel member countries, does designate some of its institutions as systemically important, Spanish policymakers have applied the provisions of its new regulatory regime to all institutions, not just systemically important ones (Financial Stability Board 2011: 9). In short, the commitments embodied within the new Spanish regulatory regime (e.g. a focus on consolidated supervision, the expansion of centralized authority) are predictably different from the commitments embodied within the new American regulatory regime (e.g. a focus on supervising large institutions, a return to fragmentation and specialization).

CHAPTER OUTLINE

The organization of the argument in this dissertation proceeds as follows. In Chapter 2, I introduce the institutions that shaped the evolution of regulatory policy in each country and their associated frames of regulatory order. In each country, these institutions and frames developed as domestic political philosophers read meaning into structures, patterns, and arrangements that had emerged for historically identifiable reasons. I explain how policymakers applied these principles to the design of new political structures and arrangements in the eighteenth century, and later, to
the design of bank chartering and regulatory policies in the nineteenth century. In each country, I show that policymakers adopted policies that led the structure of the banking system to resemble the structure of the political system. American policymakers, seeking to reinforce and preserve community self-governance, adopted regulatory and chartering policies that kept banks fragmented, competitive, and locally-oriented. Canadian policymakers, seeking to reinforce and preserve individual autonomy, adopted regulatory and chartering policies that restricted state interference with private economic activity, promoted self-regulation, and led to consolidation within the banking system. Spanish policymakers, seeking to preserve and reinforce state concertation of civil society, adopted regulatory and chartering policies that promoted the centralization of power within the banking system and accommodation of powerful private interests in exchange for services rendered to the state. These early chartering and regulatory policies had important implications for the structure of each country’s banking system leading into the 1920s.

In Chapter 3, I explain how the reform debates that followed the banking crises of the 1920s and 1930s brought two cherished frames into conflict in each country. In each country, the arguments offered by supporters and opponents of particular reforms tended to draw from one of two alternative frames of regulatory order. I argue that both the frames employed, and the outcomes of the debates, had important implications for how banking regulation would evolve moving forward. I show that American policymakers taking rival positions offered arguments that drew from either the frame of deconcentration or the frame of competition. The reforms that eventually passed in the U.S. had been advocated for in deconcentration terms (and opposed in competition terms), with the result that the regulatory regime that prevailed after the 1930s embodied the triumph of the frame of deconcentration over the frame of competition. Canadian
policymakers taking rival positions offered arguments that drew from either the frame of private autonomy or the frame of public protection. The few reforms that actually passed in Canada had been advocated for in public protection terms, but the overwhelming trend was actually the absence of reform. Canadian policymakers consistently rejected the majority of proposed reforms, which had been advocated for in public protection terms and opposed in private autonomy terms. The result was that the regulatory regime that prevailed in Canada after the 1920s embodied the triumph of the frame of private autonomy over the frame of public protection. Spanish policymakers taking rival positions offered arguments that drew from either the frame of centralized coordination and direction or the frame of balancing interests. The reforms that passed in Spain had been advocated for in both centralized coordination and direction and balancing interest terms, but opposed in centralized coordination and direction terms. The result was that Spanish regulatory regime after the 1920s embodied the dominance of the frame of balancing interests over the frame of centralized coordination and direction.

In Chapter 4, I explain how the frames that dominated the American, Canadian, and Spanish bank regulatory systems after the 1930s - deconcentration, private autonomy, and balancing interests, respectively - structured the pace and pattern of financial deregulation in the 1960s and 1970s. I argue that these frames shaped the hurdles that deregulation advocates had to overcome to successfully promote their causes. Focusing on the case of the repeal of interest rate controls, I show that deregulation was relatively slow and contentious in the U.S. because the advocates of deregulation in this country found it hard to argue that this initiative would not threaten the fragmentation and specialization of the banking system, key preconditions for order under the frame of deconcentration. By contrast, I show that deregulation was both quick and comparatively comprehensive in Canada because the advocates of deregulation found it easier to
justify this initiative as a complement to private autonomy. Deregulation only caught on in Spain after dismal economic conditions allowed the advocates of deregulation to successfully reframe this initiative as a method to facilitate greater state control over the banking system. Although policymakers in all three countries would eventually deregulate the banking system, I argue that the salience of particular frames of regulatory order shaped how this process progressed by establishing the taboos that advocates of deregulation had to navigate to promote their cause.

In Chapter 5, I explain the dramatic changes in the orientation of banking regulation that took place in the late 1980s in all three countries. After this point, American policymakers turned away from regulatory policies that kept banks small, local, fragmented, and specialized in favor of new policies that removed the brakes from market competition. Canadian policymakers abandoned their historical reliance on self-regulation in favor of assigning substantial powers to a strong prudential regulatory authority. Spanish policymakers reconsidered their brief experiment with financial liberalization and adopted new regulations to substantially increase the Bank of Spain’s authority to guide, oversee, and direct bank activities. I argue that these changes came about after a series of devastating banking crises opened up opportunities for reform, which challenger groups then seized. Reform advocates in each country drew from the latent frames that had lost in the 1920s and 1930s, and again in the 1960s and 1970s, to develop new explanations for, and solutions to, the disorder of this period. American reformers returned to the frame of competition; Canadian reformers returned to the frame of public protection; and Spanish reformers returned to the frame of centralized coordination and direction.

In Chapter 6, I explain how the frames of regulatory order that reemerged to dominance after the late 1980s shaped the divergent development of banking regulation in the post-Basel era (1988-2007). In this chapter, I shift away from a focus on legislative policies in favor of a focus
on regulatory policies set by the Federal Reserve (U.S.), the Office of the Superintendent of
Financial Institutions (OSFI), or the Bank of Spain (Spain). I argue that frames that dominated in
each country shaped the overarching goals of banking regulation, which ultimately influenced
the policy choices of national banking regulators. In the U.S., the dominance of the *frame of
competition* led to a regulatory focus on enhancing market discipline, which encouraged the
American banking regulators to promote bank participation in the securitization process and to
discourage conservative provisioning practices. The influence of the *frame of public protection*
in Canada led to a focus on striking the right balance between prudential and competitive
considerations, which encouraged the banking regulators in this country to both grant free rein to
banks engaging in innovative activities and promote conservative provisioning practices. In
Spain, the dominance of the *frame of centralized coordination and direction* led to a focus on
combatting the natural excesses of unsupervised banks, which encouraged the Spanish banking
regulators to place tight restrictions on innovative activities and promote conservative
provisioning practices.
CHAPTER 2:
THE INSTITUTIONAL ROOTS OF BANKING REGULATION

Why do regulatory systems in different countries assume distinctive forms? This chapter examines the roots of the institutionalized models of regulation that have structured the evolution of bank regulatory regimes in the U.S., Canada, and Spain for over two centuries. Following prior research, I argue that policymakers derived these principles of financial and economic order from existing principles of political order (Dobbin 1994). In the course of daily life, domestic policymakers read meaning into existing structures and circumstances that had emerged for historically identifiable reasons, and applied the perceived lessons learned to design of new structures and institutions.

In the U.S., political and regulatory institutions embodied the principle of *local sovereignty*. This principle implied that the general interest would be best served by local communities determining local affairs in active competition with rival local groups. In Canada, political and regulatory institutions embodied the principle of *individual sovereignty*. This principle implied that the general interest would be best served when elite individuals, vested with inviolable rights, freely pursued their interests in the absence of external interference. In Spain, political and regulatory institutions embodied the principle of *state sovereignty*. This principle implied that the general interest would be best served when a powerful, centralized authority, with the support of powerful groups within civil society, took charge of organizing, coordinating, and directing private activity.

The major argument of this dissertation is that these different principles of order carried forward to shape the historical evolution of regulatory regimes in the U.S., Canada, and Spain, and ultimately led to the different regulatory systems that prevailed in the post-Basel era (1988-2007). I suggest that these broad principles of order - *local sovereignty, individual sovereignty,*
state sovereignty - encompassed multiple, more specific frames of regulatory order. These frames served as cultural resources that interest groups could draw from to diagnose the causes of, and promote solutions to, disorder in the banking sector. Frames are lenses through which social actors observe and interpret social life, which call attention to certain aspects of social life and hide or block others (Small, Harding, and Lamont 2010). They are “principles of organization [that] govern the subjective meanings we assign to social events” (Goffman, 1974: 11). I suggest that in each country, the evolution of bank regulatory policy was structured by iteration between two specific frames of regulatory order, which called attention to different aspects of the system through which order was believed to emerge. One frame called attention to the structure that enabled order, while another frame called attention to the mechanism that produced order in this structure.

The primary goal of the present chapter is to introduce these different frames of regulatory order. In Table 2.1, I outline the broad principles of economic and political order in each country, and the frames of regulatory order associated with these principles. In the U.S., policymakers sought to create political and regulatory institutions that preserved the sovereignty of the local community. They believed that order could only emerge in systems with a deconcentrated structure: e.g. in a system where power was divided among many independent groups with distinct interests, and where power to direct local affairs remained in local hands. They also believed that order would naturally emerge in such a system as competing groups kept the ambitions of their rivals in check. In Canada, policymakers sought to create political and regulatory institutions that preserved the sovereignty of the elite individual. They believed that order could only emerge in systems where individual rights were protected from encroachments by the state or other powerful private actors. They also believed that order would naturally
emerge in this system as individuals freely pursuing their own interests maximized general welfare in the aggregate. In Spain, policymakers sought to create political and regulatory institutions that preserved the sovereignty of the centralized state. They believed that order could only emerge in systems in which a powerful, centralized authority took charge of organizing, coordinating, and directing private activity to achieve the general good. They also believed that the state’s capacity to serve its order-producing function depended on its ability to effectively accommodate and harmonize the particularistic interests of powerful groups within civil society.

Table 2.1. Principles of Order and Associated Frames of Regulatory Order

<table>
<thead>
<tr>
<th></th>
<th>Principle</th>
<th>Structure</th>
<th>Mechanism</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>Local Sovereignty</td>
<td>Deconcentration</td>
<td>Competition</td>
</tr>
<tr>
<td>Canada</td>
<td>Individual Sovereignty</td>
<td>Public Protection</td>
<td>Private Autonomy</td>
</tr>
<tr>
<td>Spain</td>
<td>State Sovereignty</td>
<td>Centralized Direction and Control</td>
<td>Balancing Interests</td>
</tr>
</tbody>
</table>

This chapter is organized as follows. Taking each country’s case in turn, I begin by explaining how domestic political philosophers read meaning into structures and arrangements that had emerged for historically identifiable reasons, and applied the lessons learned in the course of experience to the design of new political institutions in the eighteenth century. Then, I explain how the same principles shaped critical episodes in regulatory policymaking in the nineteenth century, focusing on bank chartering and regulatory policies in each country (see Table 2.2). I conclude by describing how the policies of this period shaped the structure of the banking system in each country leading into the 1920s.
Table 2.2. Patterns in Banking Regulation in the U.S., Canada, and Spain, 1780 – 1920

<table>
<thead>
<tr>
<th></th>
<th>Chartering authority</th>
<th>Barriers to Entry</th>
<th>State financing</th>
<th>Structure/Activities</th>
<th>Supervision</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>Local</td>
<td>Decentralized</td>
<td>Very low</td>
<td>Banks finance local government directly at first; banks later forced to hold federal and state debt (govt. bonds)</td>
<td>Heavy branching restrictions; low capital reserves; State regulatory commissions; later federal regulatory commissions</td>
</tr>
<tr>
<td>CANADA</td>
<td>Individual</td>
<td>Centralized</td>
<td>High</td>
<td>Banks did not finance the state</td>
<td>High capital reserves; few activity restrictions; Self-regulation</td>
</tr>
<tr>
<td>SPAIN</td>
<td>State</td>
<td>Centralized</td>
<td>High (but fluctuate with political party power and state needs)</td>
<td>Banks finance central government directly at first; later by holding public debt.</td>
<td>Restrictions fluctuated with state needs; Government representative at heads of major banks</td>
</tr>
</tbody>
</table>

THE UNITED STATES: LOCAL SOVEREIGNTY

After the colonies secured their independence, the authors of the American Constitution were faced with the difficult task of designing political institutions that would unite a collection of fragmented individual states with a long history of discord and distrust, while also avoiding the abuses suffered under British rule. In approaching this task, I suggest that early American policymakers ascribed meaning to existing structures and arrangements that had developed for identifiable historical reasons. Local institutions, which had developed out of necessity due to a haphazard British administrative system, were recast as the keys to order and prosperity by domestic political philosophers like James Madison and Thomas Jefferson. The theory was that order had emerged organically, in the absence of any centralized external authority, as local institutions promoted local interests in competition with many other local groups. I suggest that this logic formed the basis of the principle of local sovereignty: the understanding that political
and economic order emerges in systems that preserve and respect the rights and authority of local communities. In what follows, I introduce the frame of regulatory order that called attention to the system structure that was believed to reinforce local sovereignty (the *frame of deconcentration*) and the frame of regulatory order that called attention to the mechanism that produced order in such a system (the *frame of competition*). I describe each frame in turn.

**Frame of Deconcentration**

The American colonies had developed as distinct, rivalrous communities during the sixteenth and seventeenth centuries. During this period, the preoccupied British government had largely left the colonies to their own devices. In the absence of coordinated administration from above, these autonomous local communities started to band together to develop the institutions they needed to promote local welfare and protect against external threats (Kaufman 2009: 50-79). I suggest that these local institutions, which arose for identifiable historical reasons, acquired additional value and meaning in the course of everyday life. The inhabitants of the thirteen colonies came associate their home-grown institutions with order and prosperity, and by the end of the eighteenth century, they were fighting for the right to maintain them (Kaufman 2009: 92; 98-128; Hammond 1957).

In the American political system, all powers not explicitly allocated to the federal government devolve to the states. The authors of the Constitution only granted authority to the federal government in areas that were clearly unsuitable for local control, e.g. the military, foreign policy, interstate commerce, the mail, and the currency. I argue that this division of political power between national and regional levels of government reflects an particularly American understanding of the factors that contribute to and destroy political order. Drawing from past experience, American policymakers assumed that order would emerge most readily
when local communities retained control over local affairs. Early American policymakers believed that local institutions were more likely to acquire the consent of the governed, and that local coordination and administration were more likely to be effective. These understandings are evident in the following excerpt from one of the Federalist papers (Federalist 17), composed by founding father Alexander Hamilton:

> It is a known fact in human nature, that its affections are commonly weak in proportion to the distance or diffusiveness of the object. Upon the same principle that a man is more attached to his family than to his neighborhood, to his neighborhood than to the community at large, the people of each State would be apt to feel a stronger bias towards their local governments than towards the government of the Union; unless the force of that principle should be destroyed by a much better administration of the latter. This strong propensity of the human heart would find powerful auxiliaries in the objects of State regulation (Hamilton, Federalist 17).

In short, early American policymakers believed that a system characterized by deconcentrated political power, in which power was fragmented and divided across many local institutions serving local interests and directing local affairs, was the system that was best equipped to accommodate human nature and achieve the general good.

**Frame of Competition**

For the inhabitants of the thirteen American colonies in the seventeenth and eighteenth centuries, cross-colony competitive rivalry and jurisdictional battles were also central features of life (Kaufman 2009: 60). The British government had granted colonial charters in a haphazard way, and the uncertainty and overlapping nature of legal claims resulted in constant struggle over territorial and jurisdictional boundaries (Kaufman 2009: 56-79). I suggest that early American policymakers ascribed positive meaning to this long history of infighting and mutual suspicion between colonies. They saw that order had emerged organically in this system: despite the absence of centralized legal administration, no single colony had come to dominate the others. In
pursuing their distinctive local interests, colonial institutions had also operated to keep the ambitions of their neighbors in check (Kaufman 2009).

I argue that this understanding of order as maintained through a process of competitive rivalry also informed the way that early American policymakers approached the design of American political institutions. In the United States, political power is unusually fragmented across the executive, legislative, and judicial branches of government. Power within the legislature is also divided into different branches (e.g. the House of Representatives and the Senate). As James Madison explains in *Federalist* 51, this enforced separation of political power was intended to prevent any single branch of government from dominating or abusing the rest:

> It is not possible to give to each department an equal power of self-defense. In republican government, the legislative authority necessarily predominates. The remedy for this inconveniency is to divide the legislature into different branches; and to render them, by different modes of election and different principles of action, as little connected with each other as the nature of their common functions and their common dependence on the society will admit.

But how did this fragmented system promote order? The answer was competitive rivalry. This theory had two parts. First, for order to emerge, the system had to include a sufficient number of independent groups pursuing distinct interests. Otherwise, a majority might form that would threaten the balance of power between distinct groups within the system, and by extension, threaten their ability to keep each other in check. As Madison explained in *Federalist* 10:

> [This method of combating majority rule through the separation of powers] will be exemplified in the federal republic of the United States. Whilst all authority in it will be derived from and dependent on the society, the society itself will be broken into so many parts, interests, and classes of citizens, that the rights of individuals, or of the minority, will be in little danger from interested combinations of the majority. The degree of security...will depend on the number of interests...In the extended republic of the United States, and among the great variety of interests, parties, and sects which it embraces, a coalition of a majority of the whole society could seldom take place on any other principles than those of justice and the general good.
Second, for order to emerge in this fragmented system, these independent groups had to interact with each other. The theory was that in a system with a sufficient number of independent groups, each group, in pursuing its own distinct ambitions, would check the ambitions of others. The fact that each independent group faced rivals pursuing their own interests was framed as the mechanism that facilitated order in a fragmented, specialized, and decentralized political system. This understanding is evident in the justification Madison provided for the separation and division of political powers in American government in *Federalist 51*:

To what expedient, then, shall we finally resort, for maintaining in practice the necessary partition of power among the several departments, as laid down in the Constitution? The only answer that can be given is, that as all these exterior provisions are found to be inadequate, the defect must be supplied, by so contriving the interior structure of the government as that its several constituent parts may, by their mutual relations, be the means of keeping each other in their proper places… This policy of supplying, by opposite and rival interests, the defect of better motives, might be traced through the whole system of human affairs, private as well as public. We see it particularly displayed in all the subordinate distributions of power, where the constant aim is to divide and arrange the several offices in such a manner as that each may be a check on the other -- that the private interest of every individual may be a sentinel over the public rights.

In short, by fragmenting and separating political power across multiple branches of government, the architects of the Constitution sought to establish conditions that would allow order to emerge organically within the American political system. The theory was that if local groups could effectively keep each other in check through competitive rivalry, there would be no need for a tyrannical and ineffective external authority, removed from local needs, to step in and coordinate activity within the system.

**Regulation Embodies Local Sovereignty**

In what follows, I explain how commitments to deconcentrated power and preservation of competitive rivalry also structured the evolution of American chartering and regulatory policies in the nineteenth century. I focus on bank chartering policies. Before continuing with
this line of argument, I must first explain what bank chartering entailed and what this act meant to policymakers in the nineteenth century. The practice of chartering banks began with the chartering of the Bank of England in 1694, which ushered in a new era in banking. Previously, banking had been left entirely in private hands, or was organized as a wholly state-owned operation. Chartering presented a third way to govern and organize the banking system. Instead of owning banks directly, the state could grant special privileges in the form of a charter to a privately-owned institution in exchange for a public service. This was a method of redirecting private initiative to serve public ends.

The first bank charter was granted to the Bank of England to solve a dilemma for English policymakers, not to promote economic growth. This institution was chartered to finance the war effort at a time when the Crown had no other funding sources available. However, it soon became clear that this model of chartered banking had generated other positive externalities. As the Bank of England grew in stability and power, this model of bank chartering began to diffuse to other countries.

Many countries had adopted some form of chartered banking by the start of the nineteenth century, including the U.S., Canada, and Spain. All three countries had entertained proposals for bank charters by the start of the century, and chartered banks came to dominate each country’s financial system by the end of the century. Furthermore, chartered banks in each country were expected to somehow serve the public interest in exchange for special state-granted privileges. However, the similarities ended here. Over the course of the nineteenth century, American, Canadian, and Spanish policymakers developed distinctly different answers to the following questions: where should the authority to charter banks be located, and how freely should charters should be granted? What did chartered banks owe the state in exchange for their
privileges, and should the state continue to receive financing from chartered banks even after the charter had been granted? What restrictions, if any, should the government place on the structures and activities of chartered banks? In what follows, I explain how the *frame of deconcentration* and the *frame of competition* shaped the way that American policymakers came to answer these questions.

**American Policymakers Resist Federal Chartering (1780 - 1836)**

Freedom to charter corporations was a privilege that the individual American states had fought for during the Revolutionary War, and they were quick to exercise and guard this privilege after the war ended (Kaufman 2009: 69). I suggest that this association between chartering and local sovereignty left American policymakers primed to detect hazards in any federal control over bank chartering. These conditions help to explain why the first chartered bank in the U.S., the Bank of North America, voluntarily gave up its federal charter in favor of a charter from the Pennsylvania state assembly.

In 1781, the Bank of North America received a thirty-year charter in exchange for helping to finance the Revolutionary war effort. Although the bank was headquartered in Pennsylvania, its charter granted it the privilege to operate in a number of other states (including Massachusetts, New York, Rhode Island, and Connecticut) – but crucially, this privilege was only valid for the duration of the war (Hammond 1957: 51). At this point, early American policymakers had not yet settled the question of whether the federal government had the authority to grant charters at all. In 1782, the directors of the Bank of North America responded to this legal uncertainly by also seeking a state charter from the Pennsylvania assembly, which was granted in April 1782. As historian Bray Hammond (1957) explains, the bank’s directors’
were motivated to seek this state charter because they feared for the legality of their federal charter:

That Congress had not the power [to charter banks] was maintained by several of its own members and particularly by James Madison, its foremost legal authority. The bank’s directors being themselves in doubt, barely a month passed before they sought a charter from the Pennsylvania Assembly (Hammond 1957: 51).

At this point, the Bank of North American accepted the state charter as the authority under which its operations were to be conducted (Hammond 1957: 51). I suggest that the experience of the very first chartered bank in the U.S. set into motion a pattern that would be continually repeated in the years to come. Even before the ratification of the Constitution, charters offered by the federal government were understood to rest on shaky ground, whereas charters offered by the local governments of individual states (which did not violate the principle of deconcentrated power) were understood to be much less controversial.

In 1791, the year in which Alexander Hamilton first introduced his bill to incorporate a new national bank, the first Bank of the United States, a model of state-chartered banking was already well-established in the United States (Hammond 1957). Hamilton’s proposed bank, which was modeled on the Bank of England, introduced a different model. The bank would receive a federal charter in exchange for providing the nation with a stable and uniform currency and by acting as a depository and fiscal agent for the federal government (Federal Reserve Bank of Philadelphia 2009; Hammond 1957: 115, 128). The bank would be headquartered in Philadelphia, though it would have the authority to set up branch offices in different parts of the country. The first Bank of the United States would not replace the state-chartered banks, but it would compete with them.

This federally-chartered bank was highly controversial. Its advocates argued that a large and powerful federal bank could help the United States jumpstart the commerce and industry that
had collapsed during the war, repay the new country’s war debt, and check inflation (Federal Reserve Bank of Philadelphia 2009). Its opponents, drawing from the frame of deconcentration, argued that a federally-chartered institution violated the authority and autonomy of the individual states. The arguments of the advocates of the First Bank of the United States succeeded over the objections of its opponents, and the bank was granted a federal charter in 1791.

 Debates over the renewal of the First Bank’s charter began in 1809. I argue that the American preoccupation with deconcentration structured the form that these debates took. The arguments of the bank’s myriad opponents, which included the state banks, some state governments, some merchants, and hardline agrarians who hated all banks, drew from the frame of deconcentration. These opponents argued that the First Bank represented a tyrannical and ineffective concentration of power in federal hands, and threatened the sovereignty of the individual states. Accordingly, they argued, this institution needed to be destroyed (Hammond 1957). The bank’s opponents eventually triumphed over its supporters: after ten days of debate in the Senate, the bill to renew the charter of the Bank of the United States was defeated on February 20th, 1811 by a vote of 18 to 17, and the bank was ordered to liquidate immediately (Hammond 1957: 210).

 Plans for a Second Bank of the United States began almost immediately after the destruction of the first one. On April 10, 1816, President Madison signed a bill incorporating the Second Bank of the United States, which was much like the first in both form and function (Hammond 1957: 251). The Second Bank initially faced little opposition; however, its fortunes began to decline after Andrew Jackson became president in 1829. Jackson and his cabinet opposed the Second Bank for both material and ideological reasons, and began to form plans for its destruction soon after Jackson took office (Hammond 1957). The Second Bank’s charter was
not up for renewal until 1836; however, awareness of what the Jacksonians were planning prompted the friends of the Second Bank to push for an earlier vote on the charter’s renewal, in 1830. At the time, most American legislators were not opposed the bank, and Congress voted to extend its charter for an additional twenty years (Hammond 1957). However, Jackson made his crusade against the Bank a critical issue in the 1832 election, and upon his reelection, he vetoed the renewal of this charter, effectively destroying the Second Bank of the United States.

The way that Jackson framed his objections to the Second Bank is instructive. The language of the veto echoed the familiar deconcentration arguments that had played such a prominent role in the destruction of the First Bank of the United States. Jackson argued that a federally-chartered bank operating branch offices in multiple states promoted disorder by infringing on the rights of individual states to oversee their own affairs (Jackson, May 10, 1832). But Jackson’s arguments also added something new. In his veto, he offered a different objection to extending the charter of the Second Bank that pulled from key tenets of the frame of competition. Jackson suggested that the real problem was that the charter conveyed an exclusive privilege to the bank’s current shareholders (Jackson, May 10, 1832). The idea was that the charter was abhorrent because this privilege was not open to all comers: as Jackson put it, “this act does not permit competition in the purchase of this monopoly” (Jackson, May 10, 1832). Jackson elaborated on this argument by describing the problems that were believed to emerge from this non-competitive arrangement:

Every monopoly and all exclusive privileges are granted at the expense of the public, which ought to receive a fair equivalent…It is due to [the American people], therefore, if their Government sell monopolies and exclusive privileges, that they should at least exact for them as much as they are worth in open market…But this act does not permit competition in the purchase of this monopoly. It seems to be predicated on the erroneous idea that the present stockholders have a prescriptive right not only to the favor but to the bounty of Government…For their benefit does this act exclude the whole American people from
competition in the purchase of this monopoly and dispose of it for many millions less than it is worth. This seems the less excusable because some of our citizens not now stockholders petitioned that the door of competition might be opened, and offered to take a charter on terms much more favorable to the Government and country.

I suggest that this argument was a restatement of the basic principle enshrined in the frame of competition. Competitive rivalry was believed to promote order in at least two ways: first, by giving local groups the necessary incentive to check the ambitions of other local groups, and second, by preventing a centralized external authority from intervening in the system. American policymakers, drawing from historical experience, believed that tyranny and ineffectiveness could only result when an external, centralized authority interfered with the natural process of local institutions serving local interests. In part, the perceived problem was that a system of allocation directed by a powerful centralized authority wasn’t impartial. The competitive mechanism, on the other hand, allowed for the impartial allocation of powers, privileges, and punishments.

In short, the major problem with the existing bank chartering regime as defined by Jackson was not state interference with private economic activity per se (as the problem was defined in Canada). The problem was that the state had not allocated these privileges in a free and impartial fashion, which had produced wasteful, unfair, and suboptimal outcomes. This is a fine distinction, but an important one. As Jackson explained:

There are no necessary evils in government. Its evils exist only in its abuses. If it would confine itself to equal protection, and, as Heaven does its rains, shower its favors alike on the high and the low, the rich and the poor, it would be an unqualified blessing. In the act before me there seems to be a wide and unnecessary departure from these just principles (Jackson, May 10, 1832).

By 1832, a clear pattern had emerged within the American bank regulatory system. The salient issue had become the exclusivity of the corporate privilege, rather than the existence of the
corporate privilege itself. Like Canadian and Spanish policymakers, American policymakers in this period regarded bank charters as an example of government intervention with private economic activity. However, unlike Canadian policymakers, who regarded this form of government intervention as a problematic violation of private autonomy, or Spanish policymakers, who saw it as a positive tool that would help to facilitate centralized coordination and direction, American policymakers supported government intervention only when it took a particular local form. In short, American policymakers wanted a banking system that looked like their political system: power should devolve to local institutions and allocation should be determined by competition rather than by fiat.

American Policymakers Embrace Free Banking (1837 - 1864)

Following the veto of the recharter of the Second Bank of the United States, all decisions about bank chartering devolved to the individual states, and the authority to charter banks remained exclusively in state hands in the U.S. until the passage of the National Bank Act in 1864. During the state banking era of 1837-1864, policymakers in the individual states increasingly gravitated towards adopting one of two regulatory models: a free banking system or a banking system dominated by a single state-owned bank with branch offices (Hammond 1957). The coexistence of these two dominant models – which appear very different and somewhat contradictory from a modern perspective – becomes more understandable when they are viewed through the lenses of American frames of regulatory order.

The free banking model originated in New York in the early 1820s, and eventually spread to eighteen states by the start of the 1860s. I suggest that the content of this model reflected key tenets of the frame of competition. Early advocates of free banking argued that state banking systems suffered from the same problem Jackson had perceived in the federal banking system:
any system that artificially restricted the number of charters granted, or made the grant of a charter subject to legislative approval, increased opportunities for order-destroying favoritism and corruption (Hammond 1957; Federal Reserve 1937). The problem was not that state governments were granting powers and privileges to private institutions: it was that the grant of these powers and privileges was exclusive, and closed to competition. The free banking model developed as a response to these perceived problems. It reflected the principle that groups should be able to freely compete for state-sponsored powers and privileges. By opening the chartering privilege to any group or person who met basic capital requirements, and agreed to adhere to regulatory restrictions, the free banking model transformed chartering into an administrative, rather than a legislative, act. In exchange for the privilege to issue bank notes, free banks were required to purchase state bonds and deposit these bonds with an administrative agency. These banks were also required to operate as unit banks, or as independent institutions without branch offices.

*The Form of the National Bank Act (1864)*

Power to charter banks returned to the federal hands during the Civil War. As the costs of financing the war mounted, Congress once again looked to chartered banks to provide an additional source of revenue. The National Currency Act of 1863 and the National Bank Act of 1864 offered national charters to all applicants who could meet minimal capital standards, pass muster with the system’s administrative officer (the Comptroller of the Currency), and who were willing to purchase and deposit U.S. Treasury bonds as security for a new national currency (Office of the Comptroller of the Currency 2011). This legislation also addressed the lack of a uniform national currency: national banks were allowed to issue federal banknotes backed by government bonds, which had the same value everywhere in the country.
The financial needs of the federal government likely explain why Congress adopted a national bank chartering regime, and a change in the balance of political power between the states and the federal government likely explains why the federal government was ultimately successful in imposing its will. However, the way that federal policymakers chose to exercise this restored authority embodied the principle of deconcentrated power. The National Bank Act of 1864 essentially introduced free banking at the federal level. When the architects of the national banking system set out to design this system, they clearly had the mistakes of their predecessors (in the First and Second Banks of the United States) in mind. As the first Comptroller of the Currency, Hugh McCulloch, explains, American policymakers recognized that a national banking system built on the free banking model was *politically legitimate* in ways that a monolithic federal branch bank was not:

The national system of banking has been devised with a wisdom that reflects the highest credit upon its author, to furnish the people of the United States a national bank note circulation without the agency of a national bank. It is not to be a mammoth corporation with power…to control the business and politics of the country. *It can have no concentrated political power*…It will concentrated in the hands of no *privileged persons a monopoly of banking*. It simply authorizes, under suitable and necessary restrictions, a number of persons, not less than five, in any of the States or territories of the Union, to engage in the business of banking, while it prevents them from issuing a single dollar to circulate as money which is not secured by the stocks and resources of the government. It is, therefore, in my judgment, (and as far as calculation is regarded,) not only a perfectly safe system of banking, but it is one that is *eminently adapted to the nature of our political institutions* (Proceedings of the American Bankers Association, 1876, p. 31, quoted in Chapman and Westerfield 1942: 62).

The decision to implement free banking at the national level had important implications for the structure of the American banking system. One consequence was that both state- and federally-chartered unit banks proliferated. Under both national and state legislation, free banks were not permitted to establish branch offices. The authors of the National Bank Act expected the new national banking system to drive the state banking systems out of existence. In 1865, the federal
government sought to speed this process along by imposing a 10% excise tax on state bank notes. Many state banks accepted defeat, and exchanged their state charters for national charters. However, other state banks retained their charters and reformed as deposit banks that did not issue notes.

Branches Become Controversial (1887-1927)

With the National Bank Act of 1864, American federal policymakers finally landed on a method of chartering banks at the national level that was politically stable. After this point, the terms of the debates over bank chartering policies shifted away from the question of whether the federal government should charter banks at all, and towards the question of whether national banks should be permitted to establish branch offices. The battle over branching policies began in earnest in the 1890s. The National Bank Act and the Civil War had nearly destroyed the state banking system in the 1860s; however, the state banks had staged a comeback, and grew in size and number in the 1880s and 1890s. One reason for the rapid growth of state banks was the need for banking services in small rural communities. National banks at the time could not be organized with less than $50,000 capital, a requirement that was out of reach for many small agricultural communities (Federal Reserve 1937: 71). State-chartered banks did not face the same capital requirements, and they had moved to exploit this rural need.

As state-chartered banks began to control a larger share of the banking system, friends of the national banks began to fear for the survival of these institutions. They responded to these changing competitive conditions by introducing new legislation that allowed national banks to establish branch offices. These actors, which included academic economists, banking regulators, members of the administration, and Democrats and Republicans that supported the gold standard, couched their pro-branching arguments in terms that resonated with the frame of competition.
The problem, they argued, was that artificial, non-impartial, and overly conservative restrictions (which included restrictions on national bank branching) were hampering the development of the banking system. To resolve this problem, benefit local communities, and restore competitive equity across regions, national banks needed to be allowed to branch. This logic is evident in the pro-branching arguments offered by Secretary of the Treasury J.G. Carlisle in an 1895 report:

One of the most serious objections heretofore urged against the national banking system as it now exists has been that…it has not furnished the necessary banking facilities to the small centers of local trade…It must be evident, therefore, that any system which will promote such a distribution of the loanable capital of the country as will make it easily accessible, upon reasonable terms, to the producers and purchasers of those products, must be highly beneficial to both, and I am satisfied that, under present conditions, the only successful attempt that can be made to secure these benefits is so to amend the law as to permit national banking associations to establish branches for the transaction of all kinds of business now authorized…[this] would materially aid in relieving the stringency, which, notwithstanding the abundance of currency in the financial centers, is sometimes severely felt in particular localities (Report of the Secretary of the Treasury, 1895, p. LXXXIII-LXXXIV; quoted in Federal Reserve 1937: 74).

But the opponents of national bank branching would eventually beat the supporters of national bank branching at their own game. National branch banking opponents offered arguments that were couched in line with another cherished American principle of order: deconcentration. In the following excerpt from the Proceedings of the American Bankers’ Association, the opponents of national bank branching argued that this reform would destroy order by interfering with the deconcentrated and fragmented structure of the banking system:

[W]e have the greatest banking system that the world has ever known. Thank heaven this great system has been built up under the American theory as distinguished from the monarchial theory - by protecting the opportunities of the small institution, by protecting the right to exist and the right to grow of fifteen thousand differentiated banking units as distinguished from a great central bank protected by government and ramifying out in its commercial influence by branches which prevented the proper development of the country through small institutions fit to cope with the conditions of their localities, built up as we have built up the great American nation - not from the top down, but from the bottom up - by protecting the rights of the individual, by fostering the great American
principle embodied in the American Constitution that the greatest national good comes from the protection of the rights and opportunities of the smallest and weakest as well as the greatest, built up until now in banking, as in commerce, we are coming to be the great and dominant power in the business of the world (Proceedings of the American Bankers’ Association, 1902, p. 121; quoted in Federal Reserve 1937: 88-89).

By 1903, branching was a dead letter issue.\(^\text{18}\) Faced with a choice between allowing national banks to branch and permitting them to lower their capital requirements to better compete with the state-chartered banks for rural business, American policymakers chose the latter option (Federal Reserve 1937). In short, American policymakers were willing to sacrifice some bank stability to maintain the deconcentrated and geographically fragmented structure of the banking system. This form of accommodation would become a familiar pattern in the years to come.

**Summary and Implications: Local Sovereignty and Banking Regulation**

Due in part to differences in history and institutions, members of different national communities are not equally likely to draw on the same cultural tools to construct and assess the world around them (Lamont and Thevenot 2000). I have suggested that the experience of life in the thirteen fragmented colonies that would become the United States was conducive to the development of two frames of regulatory order: the *frame of deconcentration* (power divided, and accruing to local units) and the *frame of competition* (preserving order through rivalry). I suggest that early American policymakers read meaning into structures and patterns that had developed for historically identifiable reasons, and applied the same underlying principles to the design of bank chartering policies in the nineteenth century.

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\(^{18}\) The branching issue returned to the policy agenda in the mid-1910s, in response to changes in the branch structure of state-chartered banks. The arguments for and against branching reform were remarkably similar. Opponents argued that national bank branching would lead to the concentration of financial power in few hands, and threatened local control. Supporters offered the same efficiency-based arguments as before.
I argue that fears of concentrated power explain why American policymakers saw dangers in the presence of a large, federal bank with branch offices in multiple states. These perceived dangers played a large role in the destruction of the First and Second Banks of the United States. A desire to fragment economic power, and to leave the allocation of powers and privileges to the competitive process rather than the whims of legislators, helps to explain why American policymakers embraced an alternative chartering regime that made chartering an administrative act and open to all. American policymakers embraced this free banking model at the state level starting in the 1820s, and at the federal level in the 1860s. The same commitments also help to explain why bank branching was so controversial in this country: American policymakers were primed to see problems in banks establishing offices in more than one location, which was thought to disrupt the local allegiances (and local control) of local institutions.

In short, American policymakers wanted financial institutions that looked like their political institutions: small, plentiful, independent, and locally-oriented. The regulatory policy choices of the nineteenth century that were undertaken in service of this goal shaped the form that the American banking system assumed in the early twentieth century. In 1920, the American banking system was characterized by an unusually large number of independent banks: over 30,000 separate institutions (Calomiris 2000). Banks were chartered by the individual states or the federal government, and the vast majority of banks operated as independent, self-contained unit banks with no branch offices. In comparative perspective, American banks also had low capital holdings, and this, combined with a lack of diversification in their lending portfolios (most of these unit banks were limited to lending within a single local community) left them
highly vulnerable to regional shocks and economic downturns. In summary, the American banking system in the 1920s was a banking system primed for crisis.

**CANADA: INDIVIDUAL SOVEREIGNTY**

The Canadian provinces had a different relationship with their British colonial overlord. Canada was a French colony before it switched to British control in 1760, and its institutional structure bore a distinctly French stamp (Kaufman 2009: 50-55). Canada-as-New-France was run as a military bureaucracy, under the centralized control of a royal governor. Under this administrative system, colonists did not face the same pressures to develop their own homegrown, local institutions to address unmet local needs. Kaufman (2009) argues that this aspect of Canada’s historical development helps to explain why the Canadian colonies were less frustrated with their lack of autonomy from the British Crown, and consequently, why they chose not to rebel alongside the thirteen colonies to the south. One implication of these circumstances was that Canadian policymakers faced an entirely different organizing task than the authors of the American constitution. Instead of bringing together a fractured collective of independent states to form an entirely new country, early Canadian policymakers were seeking to organize activity in a colonial outpost of the British Empire.

In approaching this task, I suggest that the architects of early Canadian political institutions ascribed meaning to structures and arrangements that had developed for historically identifiable reasons. Early Canadians pulled from established British principles of order to explain why British political institutions, which restricted the power of the executive and vested considerable power in the hands of the legislature, represented the keys to order and prosperity. The theory was that order had emerged because of these peculiarly non-interventionist state traditions. Beyond creating and enforcing a rule of law that protected the basic individual rights
of the British public, the weak Crown had done very little to interfere with the political or economic activity of private citizens. Contemporary political philosophers ascribed meaning to these conditions, which had emerged for identifiable historical reasons. I suggest that this logic of order as produced through non-interference in the context of a strong rule of law formed the basis of the principle of individual sovereignty. This principle implied that order emerged in systems in which the rights and autonomy of elite individuals were respected and preserved. In what follows, I introduce the frame of regulatory order highlighting the system structure that was believed to reinforce individual sovereignty (the frame of public protection) and the frame of that highlighted the mechanism believed to produce order in such a system (the frame of private autonomy). I describe each frame in turn.

The Frame of Private Autonomy

The principles of order at the foundation of Canadian political institutions can’t be understood without first understanding the principles at the foundation of British political institutions. As an island kingdom that faced relatively few external threats, England never developed the strong, centralized military that presaged the development of a strong, centralized state in other countries on the European continent (Dobbin 1994). In the absence of a strong centralized state, a decentralized form of feudalism came to characterize early England. In this form of feudalism, wealthy landowners retained considerable control over their landholdings. The Crown was further weakened by the signing of the Magna Carta in 1215, which, among other restrictions, prevented the king from levying taxes without the consent of his royal council. This Parliamentary council, comprised of a handful powerful and wealthy landholders, expanded over time to include a broader range of representatives.
The Glorious Revolution of 1688 further increased the power of Parliament over the Crown. After a union of English parliamentarians and the Dutch stadtholder William of Orange successfully overthrew King James II, the victors were faced with the task of designing political institutions that would restore order to a fractured British polity. To do so, they drew from lessons learned in the course of historical experience, using pre-existing principles of political order to construct new political institutions. These policymakers further strengthened the power of Parliament over the Crown, and created a Bill of Rights that affirmed a number of constitutional principles. These policy choices embodied and reflected an understanding of order as arising organically from elite individuals pursuing their own prerogatives, without fear of external inference by a greedy Crown. After this point, royal authority was weakened, and Parliament, as the institution that aggregated the collective will of these elite individuals, received nearly unlimited power.

In the Westminster parliamentary system of Great Britain, powers are concentrated in the legislative branch of government, which consists of an elected lower house and an appointed upper house comprised of wealthy landowners. The executive branch of government derives its legitimacy from and is held accountable to the legislative branch. The head of government is a member of the legislature (the Prime Minister), while the sovereign serves as head of state, with narrowly circumscribed and primarily ceremonial powers. Following the Constitutional Act of 1791, the provinces of Upper and Lower Canada developed political institutions that were modeled on the Westminster Parliamentary model. The Constitutional Act of 1791 divided the British province of Quebec into two separate provinces. The western half became Upper Canada, and received English law and political institutions, while the eastern half became Lower Canada,
and retained French civil law and land policies. Representative governments based on the Westminster parliamentary model were established in both provinces.

The Frame of Public Protection

The isolated nature of the English kingdom had an additional consequence. In the absence of a strong external threat, the biggest threats that landholders encountered came from each other. I suggest that this historical experience left powerful landholders in England particularly attuned to guarding against potential encroachments from their peers. Contemporary British political philosophers like John Locke read meaning into these circumstances and articulated principles to explain why a participatory parliamentary system that developed to maintain political harmony among rival agricultural elites was also key to the maintenance of order and prosperity. In *Two Treatises On Government*, Locke offered a particular vision of human nature:

To properly understand political power and trace its origins, we must consider the state that all people are in naturally. That is a state of perfect freedom of acting and disposing of their own possessions and persons as they think fit within the bounds of the law of nature. People in this state do not have to ask permission to act or depend on the will of others to arrange matters on their behalf. The natural state is also one of equality in which all power and jurisdiction is reciprocal and no one has more than another. It is evident that all human beings – as creatures belonging to the same species and rank and born indiscriminately with all the same natural advantages and faculties – are equal amongst themselves. They have no relationship of subordination or subjection unless God (the lord and master of them all) had clearly set one person above another and conferred on him an undoubted right to dominion and sovereignty (Locke 2009: 70).

In systems where individuals retained their inherent equality and autonomy, Locke argued, the rights of any single individual were inherently insecure. Accordingly, the safeguard of these individual rights represented the key function of the government, and formed the basis of its legitimacy. As he explained:
If man in the state of nature be so free, as has been said; if he be absolute lord of his own person and possessions, equal to the greatest, and subject to no body, why will he part with his freedom? Why will he give up this empire, and subject himself to the dominion and control of any other power? To which it is obvious to answer, that though in the state of nature he hath such a right, yet the enjoyment of it is very uncertain, and constantly exposed to the invasion of others: for all being kings as much as he, every man his equal, and the greater part no strict observers of equity and justice, the enjoyment of the property he has in this state is very unsafe, very unsecure. This makes him willing to quit a condition, which, however free, is full of fears and continual dangers: and it is not without reason, that he seeks out, and is willing to join in society with others, who are already united, or have a mind to unite, for the mutual preservation of their lives, liberties and estates, which I call by the general name, property (Locke 2009: 123)

The idea was that without collective protection against those seeking to harm or enslave them, people would have no security in their rights and would live in fear. A strong set of rules that protected individual rights from encroachments by other powerful actors (inside or outside the state) was regarded as a necessary precondition for order to emerge in a system characterized by the free pursuit of self-interest, and the absence of a powerful external authority. This desire for protection explained why citizens freely chose to enter into civil or political society: to be part of a larger system that would establish rules that would preserve their lives and property.

The principle of the protection of individual rights was embodied in the political institutions that developed in the aftermath of the Glorious Revolution of 1686. I argue that English history, replete with conflict between rival agricultural elites in a system characterized by a weak Crown, left English policymakers particularly predisposed to ensure that the political institutions of this era would enumerate and protect individual rights. I suggest that this commitment to protecting rights helps to explain why, when the Convention Parliament invited William and Mary to become the joint sovereigns of England in February 1689, they also presented them with a Declaration of Rights. After William and Mary succeeded in obtaining the crown, Parliament passed a Bill of Rights in December of the same year that restated this
declaration in statutory form. The Bill of Rights outlined the basic civil rights of individual English citizens, which included protection from cruel and unusual punishment and the right for Protestants to bear arms. It also circumscribed the power of the monarch and detailed the rights of Parliament. In short, English policymakers saw a problem in the fact that the free actions of one individual could infringe on the rights of another. Accordingly, private actors should be left alone as much as possible, but the state had both the right and the duty to step in and enforce the rules when individual rights were threatened.

**Regulatory Institutions Preserve Individual Sovereignty**

I argue that the same underlying principles that structured the design of British - and by extension, Canadian - political institutions in the eighteenth century also shaped Canadian bank chartering policies in the nineteenth century. In what follows, I explain how commitments to preserving private autonomy and protecting individual rights shaped the evolution of Canadian regulatory institutions by structuring the types of problems policymakers perceived and the range of solutions they considered.

**Canada Resists Chartering Banks (1782 - 1822)**

Efforts to establish banks began almost simultaneously in the three colonies of Upper Canada, Lower Canada, and Nova Scotia (Shearer et al. 1984: 292). Until the early nineteenth century, Canadian merchants performed most of the essential functions of banking, except for the regular issuance of bank notes (Shortt 1986: 56; Easterbrook and Aitkin 1956: 448). However, as exchange with the U.S. increased after the Revolutionary War, this absence of a sufficient circulating medium in the Canadian colonies became an increasingly pressing problem. Canadian importers were forced to pay cash for American produce, which caused specie (metallic money) to drain out of the provinces and into the border states (Shearer et al. 1984: 292).
293). The result was frequent economic disruptions. By the early 1800s, the lack of a sufficient circulating medium had become a serious constraint to commerce (Shortt 1986: 57).

In 1822, the assemblies of Upper and Lower Canada granted charters to two banks, the Bank of Montreal (Lower Canada) and the Bank of Upper Canada (Upper Canada). Advocates of chartered banking in Canada (who were mostly merchants) argued that these banks would provide a valuable public service by providing a circulating medium that would help to foster commerce and would put an end to the outflow of specie from the Canadian colonies (Breckenridge 1911; Shortt 1986: 84-88). The creation of this circulating medium was also expected to have the added benefit of cutting down on the circulation of American bank notes in the Canadian colonies.

In the Canadian provinces, the authority to charter banks was shared between the provincial assemblies and the Home Government (British Parliament), with the Home Government having the final say. At the time, the Home Government was wary of extending charters to any but the most upstanding groups or individuals. I suggest that this wariness was the product of hard-won experience with chartered entities in eighteenth century. In the 1720s, the speculative mania surrounding the South Sea Company, a British joint-stock (chartered) company, led to the formation of a stock market bubble that ruined many British investors. Later in the eighteenth century, the American colonies (which were chartered entities themselves) rebelled, an event that would have further increased British prejudice against chartering.

I suggest that the salience of the frame of private autonomy within the British context helps to explain why eighteenth century British policymakers were primed to see the injudicious extension of a charter as a cause of disorder. Chartering is a form of government interference with private economic activity. It bestows additional powers and privileges on economic actors
that they would have not receive in the course of ordinary economic activity. I suggest that when viewed through the lens of the *frame of private autonomy*, which calls attention to the hazards of allowing the state to interfere with private economic activity, chartering would appear problematic. Accordingly, British (and Canadian) policymakers came to see chartering as an act should only occur under the most exceptional of circumstances.

I suggest that this experience with, and the framing of, chartering in both the British and Canadian contexts helps to explain why the assemblies of the Canadian provinces, and the British Home Government, were much slower to grant charters to banks than the legislatures of the American states, and also why they granted fewer charters to groups and individuals overall. By the time the Bank of Montreal received its charter from the assembly of Lower Canada, American policymakers had already destroyed the First Bank of the United States and had created the Second Bank. And even after Canadian policymakers offered the first charters to banks in the early 1820s, they extended this privilege to very few institutions. As the demand for banking accommodation increased throughout the 1820s and 1830s, policymakers in both Upper and Lower Canada refused to charter any additional banks (beyond the Bank of Montreal and the Bank of Upper Canada) until 1832, preferring to increase the capital subscriptions of existing banks instead (Breckenridge 1911: 16). I argue that the differential speed and extent of chartering in the U.S. versus Canada reflected key differences in the meanings that policymakers in each country attached to this practice. In the victorious American colonies, local communities had revolted in part to gain control over the chartering privilege (Kaufman 2009). Accordingly, this privilege did not acquire the same stigma in the U.S. that it did in Britain or Canada, where past experiences with chartering had been very different. It is evident that the delayed embrace of bank chartering in Canada was not the result of inadequate public interest in the chartering
privilege: merchants in Upper and Lower Canada had attempted to charter banks in 1782, 1808, 1810, but all of these attempts had failed (Shortt 1986).

Thus the real question is why policymakers within the Home Government changed their minds in the early 1820s and agreed to allow charters to be extended to the Bank of Montreal and the Bank of Upper Canada. Evidence suggests that these British policymakers finally caved and allowed for the establishment of two chartered banks because they were highly concerned about the increasing circulation of American bank notes in the Canadian provinces, and believed that the establishment of chartered banks would help put an end to these circumstances (Letter from Lieutenant-Governor Sir Peregrine Maitland, May 7, 1819, quoted in Shortt 1986: 91). Canadian and British policymakers of this period perceived the rising economic power of the United States as a serious threat to order. These concerns echoed Canadian and British fears of rising U.S. political power, which were somewhat well-founded. The U.S. army had invaded Quebec during the Revolutionary War, and Upper Canada during the War of 1812. The Tory policymakers of this period framed both forms of U.S. encroachment - political and economic - as infringing on the rights of Canadian individuals to follow a distinctly Canadian (at the time, British) way of life. Accordingly, these policymakers saw the “invasion” that the increasing circulation of American bank notes represented as a serious violation of the frame of public protection.

The first Canadian bank charters were directly modeled on the charter of the First Bank of the United States (Shortt 1896: 78). One key difference between the First Bank’s charter and the charter of the Bank of Montreal was that the Canadian charter did not allow the government to own shares in the bank. The Bank of Montreal was wholly private: the provincial government did not own any of its shares, whereas the American federal government had owned 20 percent
of the shares of the First Bank. I suggest that this also reflected a desire among Canadian policymakers to ensure that private activity remained separate from public action.

*Experiments with Alternative Chartering and Regulatory Models (1835 - 1860)*

Canadian policymakers proposed and experimented with alternative models of chartering banks between 1835 and 1860; however, these proposals and experiments largely failed. I suggest that the way that these failed proposals and reform attempts unfolded illustrates how the Canadian principles of *private autonomy* and *public protection* operated to shape the evolution of Canadian banking regulation.

In February 1841, the colonies of Upper and Lower Canada united to form the Province of Canada. The Governor General of the new united province, Lord Sydenham, sought to undertake an ambitious public works program (Shortt 1908: 326). To help finance this program, and to improve operations within the Canadian banking system, Sydenham sought to restructure the banking system by removing the issue privilege (e.g. the ability to issue bank notes that served as legal currency) from the hands of the chartered banks and by establishing a new provincial bank of issue.

Sydenham subscribed to an understanding of regulatory order that would later be embodied in Sir Robert Peel’s Bank Act in England. The central feature of this understanding was that “the government should resume and retain the exclusive right to issue paper money payable on demand” (Shortt 1908: 327). In Sydenham’s scheme, the provincial bank would create government notes that the chartered banks would issue in exchange for bullion or approved securities. In addition to serving as a source of government finance, the proposed bank of issue was also expected to improve economic functioning by providing a better circulating medium that would not shrink in bad times (Easterbrook and Aitkin 1956: 456). The way that
Syndenham justified this proposal is illustrative. As he saw it, the creation of a provincial bank of issue would restore a privilege that properly belonged to the government (and the Canadian public), but had been extended to private actors in exchange for services rendered, back to state hands:

A very considerable amount of the capital required might be raised, without any charge whatever for interest, by the assumption by the province of the issue of paper payable on demand, which is now enjoyed by private banks or individuals, without their being subjected to any charge whatever in return for the power thus granted to them by the state (Syndenham, quoted in Shortt 1908: 327).

However, the opponents of a provincial bank of issue did not see things the same way. To these opponents, the proposed bank represented a serious violation of the principle of private autonomy. The chartered banks argued that the creation of a provincial bank of issue would violate their freedom to pursue activities (e.g. issuing bank notes) that they deemed appropriate and would reduce “their ability to render essential services to their customers” (Easterbrook and Aitkin 1956: 456). Other Canadian policymakers drew from the same frame to argue that the creation of a provincial bank would promote disorder by increasing the power of the executive against the legislative assembly (Shortt 1986; Breckenridge 1911). As Canadian historian R.M. Breckenridge explains, the opponents of the provincial bank of issue were concerned that the bank might become a political engine:

A provincial bank in which both individuals and government held shares and to which should be granted an exclusive right to issue paper for circulation, while it was allowed to make discounts and to take deposits like other banks, was believed to be too monopolistic in its tendencies and fraught with grave political dangers (Breckenridge 1911: 46).

In the end, the House of Commons rejected proposals for provincial banks of issue in 1835, 1841, and again in the 1860s (Shortt 1908: 330). In 1841, many members of the Liberal party accepted the general principles embodied in Lord Syndenham’s plan; however, the majority of
Canadian policymakers did not agree. I suggest that the proposals for a provincial bank of issue repeatedly failed in Canada because Canadian policymakers, drawing from the *frame of private autonomy*, were primed to see hazards in the comingling of economic and political activity. These policymakers already had an uneasy relationship with the state granting powers and privileges to private institutions through charters; establishing an economic arm of the state (what the provincial bank of issue represented to many of its opponents) was simply going too far.

While policymakers in Canada repeatedly rejected the creation of a provincial bank of issue, they did experiment with an alternative model of chartering and regulation in the 1850s and 1860s. In 1850, Canadian policymakers passed legislation adopting an American-style free banking model, which allowed bank charters to be issued by executive (rather than legislative) decision, lowered bank capital requirements, introduced American-style restrictions on bank branching, and tied note issuance to the amount of government debt held by the bank.

Populist reformers started to push for free banking in Canada in the early 1840s. Like American free banking proponents, the Canadian free banking proponents argued that that this regulatory model would promote order by wresting control over the banking system out of the hands of large, concentrated chartered banks. They suggested that this new regulatory model would also enable the reformed banking system to answer the need for more banking capital in the province (Easterbrook and Aitkin 1956: 454). By contrast, the opponents of the free banking model argued that this regulatory system would promote disorder by encouraging destructive competition and by allowing the wrong sort of institution to enter the banking system (Easterbrook and Aitkin 1956: 453-4). Breckenridge (1911) describes the concerns of these free banking opponents:
The adoption of a general banking law, under which anyone complying with the statutory restrictions might enter the business, was condemned by the experiences with such measures in the United States, by the multiplication of small local banks to which it led, and by the excessive issues, as well as the weakness and deficient responsibility shown by such banks in times of stress (Breckenridge 1911: 46-47).

In 1850, the proponents of free banking overcame the objections of their opponents and established a free banking regime in Canada. However, the free banking model that was actually implemented failed to obtain widespread acceptance (Shearer et al. 1984: 297). In the U.S., the states that adopted a free banking model also eliminated the option for banks to obtain legislative charters at the same time. However, the Canadian free banking model did not remove the option for banks to obtain legislative charters, and evidence suggests that legislative charters still held considerable appeal for banks in Canada (Shearer et al. 1984: 297). In the end, only six banks were established under the Free Banking Act. Two of these banks quickly failed, and the rest of the free banks converted to legislative charters by the early 1860s (Shearer et al. 1984: 298). From this point onward, the distinctive form of the Canadian banking system, in which bank charters were highly restricted and bestowed at the discretion of legislators, was set.

I suggest that free banking failed in Canada because this model of bank chartering and regulation - which delegated chartering authority to an executive agency and subjected banks to greater government oversight and regulation - did not resonate as closely with existing Canadian principles of order as the previous chartering and regulatory model, which emphasized legislative chartering and hands-off self-regulation. The majority of Canadian policymakers, like the majority of American policymakers, wanted a banking system that looked like the existing political system in this country.

*Confederation and the First Bank Act (1867 - 1880)*
On July 1, 1867, the British colonies of Canada, Nova Scotia, and New Brunswick were federally united into one Dominion of Canada, which was separated into four provinces (Quebec, Ontario, Nova Scotia, and New Brunswick). The act of Confederation assigned responsibility for the regulation of currency and banking to the federal government, which issued the first Canadian Bank Act in 1871. This legislation largely codified and reinforced the principles that had been set out in the first Canadian bank charters (Shearer et al. 1984: 300). It confirmed the existing bank chartering regime, in which charters were granted by legislative fiat and subject to review and renewal every ten years. The structure of the bank charters granted also indicated that public security remained a paramount concern for Canadian policymakers, and trumped concerns about freedom of entry. Groups that hoped to establish a Canadian bank faced a significant hurdle in a minimal capital requirement of $500,000, which was framed as a safeguard for noteholders. By contrast, in this period, a federally-chartered bank in the U.S. could be established in a small town with capital of only $50,000, and a state-chartered bank for even less than that (Shearer et al. 1984: 300). Bank shareholders were also subject to double liability, which was framed as promoting the security of the public (Shearer et al. 1984: 301). At the same time, Canadian chartered banks continued to face few restrictions on their structures or activities. Banks were restricted from mortgage lending and from dealing in real estate, but could participate in a range of other commercial activities. They faced no restrictions on branching: Canadian chartered banks were free to open branch offices at any place or places in the Dominion.

Bank control over note issue remained a controversial issue during this period. In 1868, the Minister of Finance introduced resolutions into the Parliament to restructure banking and monetary policy on the model of the U.S. National Bank Act of 1864. These resolutions sought
to restrict banks from issuing bank notes on the security of their general credit, in favor of allowing banks to issue government notes on the security of government bonds deposited with the Minister of Finance (Shearer et al. 1984: 300). The plan also called for the creation of small local banks, with small capital requirements, to achieve the “diffusion of banking interests in different localities” (Shearer et al. 1984: 300). However, Canadian policymakers decisively rejected these proposals, citing the violation of private autonomy that a government monopoly over paper money or government-bond secured bank notes entailed. Instead, in the 1870 Dominion Notes Act, Canadian policymakers settled on a compromise. This legislation preserved the rights of banks to issue notes on their own security, but restricted these notes to denominations of $4 or greater. The government was given a monopoly over small-denomination notes ($1 and $2). Canadian chartered banks would not lose the privilege to issue their own notes until well into the twentieth century.

In short, the dominant pattern in the Canadian bank chartering and regulatory system was to make it difficult for groups to obtain a charter (through the use of high capital requirements, and by making charters subject to legislative approval and renewal), but leaving these private groups to their own devices once they cleared this initial bar. The Canadian regulatory system that was affirmed in the 1871 Bank Act relied on private or self-regulation. Subsequent revisions to the Bank Act in 1880 and 1890 continued in the same vein (Shearer et al. 1984: 301). In 1881, Canadian policymakers explicitly rejected government inspection. In 1892, the banking industry established a self-regulatory group, the Canadian Bankers’ Association (CBA), and this group was given the authority to establish regulatory clearinghouses for banks, to handle the suspensions of failed banks, and to manage the redemption of bank notes (Easterbrook and Aitkin 1956: 467). Similarly, Canadian policymakers also relied on the banking industry to
regulate the currency. Unlike the American system, in which bank note issuance was tied to bank holdings of government bonds, the Canadian regulation of bank note issuance depended on a Circulation Redemption Fund to which each bank contributed 5 percent of its total circulation. This measure made banks mutually responsible for each other’s note circulation, without linking control over circulation to the state.

Summary and Implications: Individual Sovereignty and Banking Regulation

Canada had a different experience under British rule. Unlike the American colonies, the Canadian provinces retained traditional British political institutions, including the Westminster Parliamentary system and a strong legal framework that protected individual rights. I suggest that Canadian policymakers read meaning into these circumstances, and came to regard the principles of political order that these institutions embodied - private autonomy and public protection - as critical preconditions of economic and regulatory order. Canada’s preservation of traditional British principles of order (and associated political institutions) placed the American and Canadian political and regulatory systems on fundamentally different paths at a very early period.\(^{19}\) Bagehot (1873: 175) summarized the key distinction between the Canadian/British and American political institutions as follows: “the English Constitution, in a word, is framed on the principle of choosing a single sovereign authority and making it good; the American, on the principle of having many sovereign authorities, and hoping that their multitudes may atone for their inferiority.” I suggest that these different principles of regulatory order also explain why American and Canadian policymakers took such different approaches to bank chartering and

\(^{19}\) Of course, Canadian political institutions and British political institutions were not identical. For much of its history, Canada remained a colonial holding of England, rather than a sovereign power in its own right. The sovereignty of the Canadian provincial assemblies was therefore subsumed to that of British parliament and its colonial policies. From the start, Canada also gave greater autonomy to regional and ethnic subunits, and Canadian political institutions also incorporated more federalist principles than British political institutions.
regulation throughout the nineteenth century, which led each country to develop banking systems with very different structures at the start of the twentieth century.

In comparative perspective, Canadian policymakers were late to charter banks. I suggest that this delayed embrace of bank chartering in Canada, and the considerable hurdles that Canadian policymakers required potential charter-holders to surmount, reflect the imprint of the frame of private autonomy and the frame of public protection. The frame of private autonomy highlighted the dangers associated with state interference with private economic activity, and chartering was, in a very obvious way, a form of state interference. It followed that the Canadian public needed to be protected from this potential danger, at first by issuing no charters at all, and later by ensuring that only the most qualified groups and individuals could obtain a charter. To this end, Canadian policymakers established high capital requirements, and later, double liability for shareholders. However, once a charter was granted, banks faced comparatively few restrictions on their activities and also played a comparatively small role in financing the state: I suggest that this enforced division between the state and private institutions also reflects the frame of private autonomy. The same commitment to keeping the state out of private economic activity also helps to explain (1) why multiple proposals to establish a provincial bank of issue failed, and (2) why a Canadian experiment with a free banking model of chartering and regulation was so short-lived, and (3) why the banking industry was largely responsible for regulating its members.

The regulatory policy choices Canadian policymakers undertook in the nineteenth century shaped the form that the Canadian banking system assumed in the early twentieth century. In 1920, the Canadian banking system was dominated by a handful of large, powerful chartered banks with branch offices that extended country-wide (Calomiris 2000; Shearer et al.)
Canadian chartered banks controlled over 75 percent of total financial system assets (Shearer et al. 1984: 308). Bank activities were regulated by self-regulatory bodies like the CBA.

**SPAIN: STATE SOVEREIGNTY**

Unlike the U.S. and Canada, the basic structure of political institutions remained in flux in Spain for most of the eighteenth and nineteenth centuries. Spain had experienced a period of relative peace and prosperity during the early reign of the Bourbon monarchy (1700-1803). However, the country experienced nearly constant upheaval in the period between 1803 and 1874, as political power constantly shifted between liberal and absolutist forces. During this period, state structures were unstable. However, the turmoil of this period was followed by a fifty-year stretch of relative calm known as the restauración, which lasted from 1874 through 1921.

I argue that the architects of the restauración political regime ascribed meaning to structures and arrangements that had developed for identifiable historical reasons, and applied the lessons learned to the creation of new political and regulatory institutions. The policymakers of the restauración era developed theories to explain why coordination and direction from the centralized state, which had originally been created to reinforce the absolute power of the Bourbon monarchs, represented the key to order and prosperity. However, these policymakers also believed that the state could only maintain its control if it secured sufficient buy-in from powerful private groups within civil society.

I suggest that this logic formed the basis of the principle of state sovereignty: the understanding that order emerged in systems in which a powerful centralized authority, seeking to execute initiatives that would benefit the entire society, was able to achieve its will. In what follows, I introduce the frame of regulatory order that called attention to the system structure that
was believed to reinforce state sovereignty (the *frame of centralized coordination and direction*) and the frame of regulatory order that called attention to the mechanism that produced order in such a system (the *frame of balancing interests*). I describe each frame in turn.

Frame of Centralized Direction and Control

The arrival of the Bourbon dynasty in Spain has long been regarded as a turning point in Spanish history (Eissa-Barroso and Varela 2013). The boundaries of modern Spain had been established when Isabella of Castile, the heir to the largest of the Spanish kingdoms, married Ferdinand of Aragon, the heir to the next-largest kingdom in 1469. In 1512, they annexed the Kingdom of Navarre. However, Isabella and Ferdinand ruled these kingdoms as separate entities, and generally respected the institutions, laws, and autonomy of the regional kingdoms across Spain. However, when a Bourbon monarch, Felipe V, ascended to the Spanish throne in 1715 after a thirteen year war of succession, he introduced a different model of governance. Felipe V was a grandson of Louis XIV of France, and he shared his grandfather’s vision of a unified and centralized nation-state. He sought to rule Spain as a single, united polity.

He began his reign by instituting a series of French-style political reforms that were designed to bring the distinct regions of Spain under centralized state control, a model that continued to be promoted by his successors. These reforms were most fully realized under his son Carlos III (1759-1788), who successfully introduced a modern administrative organization—the intendant system, of French origin - to the Spanish political system. The intendants, who had executive, judicial, and military power, improved local administration and linked it directly with the crown rather than with the viceroy (Lynch 1989). Carlos III and his intendants also broke with tradition by undertaking series of ambitious, centrally-coordinated domestic reforms that included large infrastructure projects and the modernization of agriculture and education. Carlos
III’s intent was to make himself more absolute: all of these reforms were intended to display “[t]he glory of the monarchy and its concern for a strong, enlightened kingdom” (Payne 1973: 364). However, these initiatives had generated general prosperity as well. During this period, Spain experienced the “reinvorgation of its government, the strengthening of its military power, and the growth of a transatlantic commerce that filled the state’s financial coffers” and began to recover its position as a leading power in Europe (McFarlane 2013: 181).

I suggest that Spanish policymakers read meaning into these circumstances and applied the lessons learned to the development of new political institutions. During the restauración era, initiatives that had been undertaken to demonstrate Carlos III’s glory and absolute power were reinterpreted as structures that were necessary to promote safety, prosperity, and general welfare. The principle was that order could only emerge when a powerful, external authority organized, coordinated, and redirected the particularistic interests of private actors to better serve the general good. In direct contrast to the American principle of local sovereignty, the Spanish principle of state sovereignty framed the fragmentation of power as a problem to be solved, rather than a structure to be cultivated and reinforced. The idea was that the free pursuit of local group interests disrupted order, by allowing particularistic interests to dominate and block the state from serving its rationalizing function. Pablo de Olavide, a Spanish politician, lawyer, and key enlightenment thinker, drew from this logic to explain how the fragmentation of the eighteenth century Spanish state had produced a lack of progress in this country:

[The eighteenth century Spanish state is] [a] body composed of other and smaller bodies, separated and in opposition to one another, which oppress and despise each other and are in a continuous state of war. Each province, each religious house, each profession is separated from the rest of the nation and concentrated in itself…Modern Spain can be considered as a…monstrous Republic of little republics which confront each other because the particular interest of each is in contradiction with the general interest (quoted in Shubert 2003: 169).
Spanish policymakers believed that history had shown that what was needed was a centralized authority who could take charge of, and rationalize, this anarchic state of affairs. This authority would have the power, and the interest, to overcome the particularistic squabbling of interest groups and promote the general good.

In 1808, Spain rose in popular rebellion against French occupation. The Spanish resistance established the Constitution of Cadiz, which declared Spain to be a constitutional monarchy with sovereignty emanating from the people. The war ended in 1814 with a Spanish victory and the restoration of a Bourbon monarch (Fernando VII) to the throne. However, “liberation from French occupation did not mean national liberation or liberty, but the return of absolutism” (Humelbaek 2015: 9). Fernando VII reasserted his absolute power and annulled the Constitution, pleasing the more conservative elements within Spanish civil society but alienating the more liberal elements. For the next six decades, liberal and absolutist forces would engage in a constant struggle for political power and control. When either side came into power, they sought to reform political and economic institutions to serve their goals and interests. However, neither side was able to hold on to power for long, and the period between 1814 and 1874 was one of constant upheaval and instability.

On December 29, 1874, a coup d’etat by Arsenio Martínez-Campos y Antón, a Spanish military officer, brought an end to the First Spanish Republic and restored the Bourbon monarchy under Alfonso XII. The restoration of a Bourbon monarch marked the onset of a period of relative calm and prosperity known as the restauración. I argue that the architects of the political institutions of the restauración era applied the perceived lessons learned during the reign of Carlos III to the design of new political institutions. Above all, the policymakers of the restauración sought to enhance order and stability by restoring the centralized system structure,
coordinated and directed by a powerful external authority, that they regarded as necessary for order to emerge. This goal manifested in a series of reforms designed to reduce fragmentation in political life. The first set of reforms sought to restore the centralized government’s control over local affairs by reallocating power from regional communities to the centralized government through initiatives that included appointing new mayors to villages where incumbents were of doubtful loyalty to the new regime; assigning the right to make all local and provincial appointments to the Crown; and taking the evaluation and assessment of property out of local hands (Kern 1974: 30; 38; Esdaile 2000: 146).

The theory behind these initiatives was that order could only be restored by reducing unnecessary and harmful fragmentation in the Spanish political system. Echoing Pablo de Olavide, Francisco Romero Robledo, a key member of the restauración leadership who served as the Minister of Public Administration between 1874-7, 1879-1881, and 1884-1885, argued that this consolidation of power into centralized state hands would restore order by putting an end to the feuds between fragmented groups pursuing different interests that were believed to have torn Spain apart. As Kern (1974: 37) explains:

Romero…believed in a unitary philosophy at all costs. As he explained it, the cabinet incorporated all levels of the government into the central administration in order to end the “corrosive political feuds disruptive to local society. What we believe in is a re-assertion of the individual’s influence only where it is best able to exert a beneficial effect upon the neighborhood, the town, or the province” (Speech of Francisco Romero Robledo, March 11, 1876)

The architects of the restauración also sought to restore order by placing limits on, or consolidating, political opposition that might block the success of coordinated state initiatives. Antonio Cánovas del Castillo, one of the central political figures associated with the restauración regime, argued that “opposition [could be] tolerated only so long as it did not disturb ‘works of such social importance that no disagreement can be tolerated’ (Cánovas,
Cánovas sought to make the Spanish political system easier to manage by consolidating and reorganizing competing interests within this system. As he argued:

“representation is fatal to the interest of the state, but no official party can be a mosaic of opinion, capable of representing all responsible political thought. What is necessary is nuclei of authority, placed throughout the nation and embodied in parties of opposite tendency” (Canovas, Problemas Contemporaneos, vol. 3, p. 11; quoted in Kern 1974: 31).

As the following discussion will explain in greater detail, not everyone included in the restauración regime agreed with this centralization project. However, even dissenters to the centralization agenda still drew from the frame of centralized coordination and direction to develop their arguments.  

**Frame of Balancing Interests**

Although the centralized administrative structure of the Spanish and French political systems reflected a similar understanding of order as contingent on the presence of a central power that would direct self-interested actors towards collective goals, these political systems differed in an important way. The ancien régime in France had successfully accomplished the “patient destruction of autonomous sources of power,” but this effort had been less successful in Spain, where regional aristocrats retained considerably more economic and political power (Hoffman 1963; Payne 1973). In attempting to introduce a new system of centralized administration to Spain, Felipe V encountered serious opposition from the regional aristocrats who were already in power. To secure their support, he largely left the many economic and

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20 Liberal opposition may have resisted reliance on oligarchic interests, but Sagasta (Liberal opposition leader) and Canovas jointly issued a proclamation on November 11, 1878 that stressed the loyalty of both parties to the Restoration. “Liberals and Liberal-Conservatives alike agreed on the subordination of local government, strong administration, and the cooperation of business and government” (Kern 1974: 41).
social privileges of this group intact. As Payne (1973: 375) explains, “Felipe V was not opposed to nobility, but he demanded an aristocratic elite obedient to royal authority.” In exchange for ceding positions within the government to royally-appointed ministers, the regional aristocracy were able to retain their economic and social powers, including their control of large untilled estates and the system of legally unalterable succession in the inheritance of landed property (Lynch 1989).

This initial accommodation between the King and the aristocracy set into motion a pattern that would be continually repeated in Spain, with the state bestowing economic privileges on powerful private actors in exchange for their political allegiance. I argue that the Spanish policymakers of the restauración era read meaning into this historical experience and applied the lessons learned to design of new institutions. The understanding was that the state’s authority, and thus its ability to effectively direct the particularistic interests of rival groups towards collective goals, was contingent on the extent to which the state could secure sufficient buy-in from powerful groups within civil society, and especially regional aristocrats.

During the nineteenth century, Spain witnessed the rise of new powerful interest groups, as proponents of liberalism emerged to challenge the proponents of absolutism in the Church, the nobility, and the Army (Casanova and Andrés 2014). The experience of 1808-1873 had demonstrated that existing political institutions would fail to last long if the state did not take steps to accommodate and harmonize the often competing interests of both of these groups. The architects of the restauración regime faced a serious dilemma: historical experience had demonstrated that Spanish leaders could not afford to ignore liberal demands for representative government, but at the same time, the state could not effectively rule without securing the
support of traditionally powerful groups who opposed widespread political representation.

Casanova and Andrés (2014: 23) explain the circumstances these policymakers confronted:

[Spain] was a centralized state that aimed to be enduring, following the French model, but wasn’t capable of reaching all corners of the country…The Spanish state had to contend with the opposition of the Catholic Church to any secularizing measure that diminished its privileges, with the Army’s constant interference in civil life, and with an oligarchic and influence-peddling system that was supposed to reforms of the democratic nature, with a highly limited potential for social penetration because of the continuity of local powers that acted with a fair amount of autonomy

I suggest that the policymakers of the restauración era responded to this dilemma by applying the familiar principle of balancing interests. The recent bloody history between liberal and absolutist forces had shown that allowing competing interest groups to battle it out without the state serving as an effective negotiator was a situation that could only lead to anarchy.

Accordingly, the policymakers of this era came to believe that the state’s ability to facilitate order would not just require planning and executing projects from above, as the frame of centralized coordination and direction suggested - it would also require the state to allocate powers and privileges in ways that would minimize conflict between interest groups.

The emphasis on accommodating and balancing competing interests was embodied in multiple political institutions of this era. Perhaps the most obvious example was the Pacto del Pardo, a formal power-sharing agreement in which the political leaders of both the Liberal party (Práxedes Sagasta) and the Liberal-Conservative party (Antonio Cánovas del Castillo) agreed to a system of alternating governments (known as the gobierno de turno pacífico) where each party took turns assuming political leadership. This institution reflected the underlying understanding that ensuring the continuity of the existing political establishment required ensuring that all powerful groups had a vested stake in the state’s survival. As Esdaile (2000: 144) explains, this concern was at the forefront of the minds of the leaders of the restauración regime:
For Antonio Canovas del Castillo, one consideration was paramount. Revolution having at all costs to be contained, such ruptures in the governing classes as those at 1840, 1854 and 1868 could simply no longer be permitted. What was required, in short, was a new political system that, by allowing rival factions within the establishment fair turns at the trough, would dissuade them from summoning one ambitious general or another to elbow their opponents out of the way (Esdaile 2000: 144).

While the Pacto del Pardo reflected a perceived need to harmonize and balance the competing interests of multiple groups, the remainder of the restauración-era political institutions reflected a perceived need to accommodate the interests of a single, very powerful group: the landed elite. The restauración regime under both Liberal-Conservative and Liberal leadership gave considerable powers and privileges to men of wealth, in the both the political assemblies and in local government (Kern 1974: 32; 33). I suggest that the allocation of these privileges to the landed elite reflected, once again, an understanding that long-term stability and order would depend on the state securing buy-in from groups in civil society with the power to block its rule.

While the granting of privileges to powerful groups was extremely common in Spain, it was also controversial. However, the critics of the political institutions and bargains of the restauración regime also offered arguments that drew from the frame of centralized coordination and direction. They argued that any system that awarded the majority of privileges to established oligarchic interests could only produce disorder, because this system would reflect the particularistic interests of this group, instead of the general interests of society as a whole. In other words, these policymakers were concerned that adding to the accumulated advantages of existing powerful groups would advance the power of these groups at the expense of the state’s power to effectively coordinate and direct activity (Kern 1974).

The critics of the restauración regime argued for deconcentrating power, stripping it from the centralized legislature and placing it in the hands of the regional subunits. However,
their motives for advancing this solution differed from those of the American advocates of deconcentrated political power. Spanish critics opposed the centralized institutions of the restauración “not because [these centralized institutions] denied the individual or the local group’s right to self governance, but rather because [these institutions] represented a small minority of social interests” (Kern 1974: 89). The point was that Spanish reformers saw regional government as a tool to break the stranglehold powerful groups held on (otherwise orderly) centralized political institutions; by contrast, American policymakers saw local control as the default option, and centralized power as inherently wrong.21

**Regulatory Institutions Preserve State Sovereignty**

I argue that the same underlying principles that structured the evolution of Spanish political institutions also structured the design of Spanish bank chartering and regulatory policies. In what follows, I explain how commitments to *centralized coordination and direction* and *balancing interests* shaped the evolution of Spanish policy in the nineteenth century, with major implications for the structure of the Spanish banking system in the twentieth century.

**Bank Chartering in Spain: Solving the Problem of State Financing**

In the 1780s, Spain entered into a war against England, which interrupted trade between Spain and its colonies and placed serious constraints upon the Crown’s finances (Tortella and Garcia Ruiz 2013: 14). The administration responded by issuing Treasury bills (*vales reales*) that

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21 That Spanish reformers understood the problem to be the need to keep particularistic interests at bay, rather than the need to restore local affairs to local control, is evident in the types of alternative policy solutions they advanced. For example, one “solution to this problem consisted of a rebalancing of power to favor a neutral class, or an oligarchy in the public interest. The oligopoly would formulate and apply reforms. The power of the Cortes would be replaced by a great leader with nearly despotic powers to initiate these reforms and represent a Spain with honor. After decades of misrule, no other alternatives existed; cacique-like methods had to be used to destroy caciquismo” (Kern 1974: 90). Dictatorship was clearly not consistent with the principles of private autonomy or deconcentrated power that prevailed in Canada and the U.S.
were backed by a loan from a syndicate of Spanish, French, and Dutch financiers whose representative in Madrid was the French financier Francois Carrabus. In 1782, Carrabus submitted a plan for a bank that would be charged with accomplishing three government-related functions in exchange for a charter that would permit the bank to enter any business that the Crown considered conducive to economic development. This proposed bank, the *Banco Nacional de San Carlos*, would manage the redemption of the *vales*, make foreign remittances for the Crown, and act as a supply contractor for the armed forces (Tortella 1977: 37). Carlos III agreed to charter the bank in June 1792 (Tortella and Garcia Ruiz 2013: 15).

I suggest that both the design and function of the first chartered bank in Spain embodied key tenets of the *frame of balancing interests*. The chartering privilege itself represented a form of privilege and patronage that enabled the state to accommodate the interests of powerful private actors, and to induce these actors to serve the interests of the centralized state (which were regarded as equivalent to the general good). In this case, a private group received an exclusive privilege in exchange for serving a range of public functions - especially state financing. The timing of the creation of the first chartered bank in Spain is instructive, as it corresponded directly with the financial exigencies of the state. There had been frequent schemes for publicly owned or chartered banks in Spain from the 1740s onward; however, as Tortella (1977: 36) argues, it was not until the needs of the Crown became truly pressing due to the war that one of these projects was finally put into practice.

In the 1790s, the relationship between the *Banco San Carlos* and the Spanish government fell apart over the issue of provisioning the army and navy. The costs of provisioning turned out to be higher than expected, and the government refused to pay the bank’s invoices (Tortella and Garcia Ruiz 2013: 20). At the 1790 shareholder’s meeting, the bank and the government
mutually agreed to suspend the provisioning contract, and the bank was reorganized (Tortella and Garcia Ruiz 2013: 21). However, the period between 1793 and 1808 was marked by nearly constant warfare, and the state once again looked to the bank as a source of finance for the nearly bankrupt Treasury. The massive amounts of state debt in the bank’s portfolio eventually paralyzed the institution, leaving it unable to meet the state’s growing financing needs by extending new loans (Tortella and Garcia Ruiz 2013: 23-5).

In 1829, the Spanish state transformed the insolvent Banco de San Carlos into the Banco de San Fernando, a new bank of issue and discount. This reformed bank operated extremely prudently for the first four years of its existence, as part of an effort to shake off the bad reputation it had acquired due to its connection with the failed Banco de San Carlos. However, with the outbreak of civil war in 1833, the bank was pressured into withdrawing credit from the private sector in favor of lending to the government (Tortella and Garcia Ruiz 2013: 27). The Banco de San Fernando suffered a similar fate to the Banco de San Carlos: by the time that the war ended in 1840, the Treasury was in dire straits, but the Banco de San Fernando, with a massive portfolio of state debt, was no longer able to lend to the state and finance its deficits. This was a serious problem.

By this point, Spanish policymakers had come to rely on loans from a chartered bank to preserve political harmony at a time when liberal and absolutist forces were continually at each other’s throats. Loans from a chartered bank lending were framed as crucial tools that allowed the state to balance the competing interests of rival groups within civil society (Pérez 1997). This alternative source of state financing allowed Spanish policymakers to avoid reforming the tax system, a move that would either anger the aristocracy or place an even heavier burden on an already highly taxed industrial sector and peasantry (Pérez 1997). The early history of the
Spanish banking system was marked by a distinctive pattern: reforms invariably occurred when chartered banks were unable to serve the state’s financing needs.

This framing of chartered bank lending as a tool that facilitated the state’s ability to maintain the right balance of interests through extending credit to the state helps to explain why Spanish policymakers moved to create two new banks of issue, the Banco de Isabel II and the Banco de Barcelona, in 1844. At this point, the state could no longer rely on the Banco de San Fernando as a reliable source of financing, and policymakers sought to create new institutions to help fill this need (Tortella and Garcia Ruiz 2013: 38). Spain wasn’t unique in using chartered banking as a source of state financing, but it was unique in the extent to which these early reforms of bank chartering and regulatory policies depended almost entirely on the financial condition of the Treasury (and the chartered banks’ abilities to finance the state’s debt).

Bank Chartering Regimes Change with the Political Winds (1844-1874)

After 1849, bank chartering in Spain became highly politicized. In 1848, the reigning absolutist government passed a new banking law that forbade the creation of new banks of issue. The absolutist policymakers of this period sought to combat the spread of liberalism and laissez faire, which appeared to them as forms of excessive fragmentation that would promote disorder by disrupting entrenched (and as they saw it, natural) bastions of economic, political, and social power in Spain (Tortilla and Garcia Ruiz 2013: 44).

In 1854, progressive policymakers toppled the existing absolutist Moderado government, and introduced a series of reforms (Tortilla and Garcia Ruiz 2013: 48). One of these reforms restructured the bank chartering regime that the previous absolutist government had put into place. At the time, many Spanish policymakers desired greater fiduciary circulation, and sought to create a bank of issue to accomplish this goal. However, the two groups of reformers that
sought banks of issue that took different forms. The *Banco de San Fernando* and its supporters sought the monopoly of issue for this institution, and the ability to increase the bank’s capital subscription and to open branches in the provinces (Tortella and Garcia Ruiz 2013: 50). However, a different group of provincial businessmen and left-wing politicians sought to create more independent institutions, and believed that more competition would be healthy and desirable (Tortella and Garcia Ruiz 2013: 50). The new twin banking laws that passed in 1856 reflected a compromise between these two groups. This legislation changed the name of the *Banco de San Fernando* to the Bank of Spain, and gave this institution a privileged (though not monopolistic) position in the Spanish banking system. It did not give the Bank of Spain the monopoly of issue, and it also created twenty additional independent banks of issue. However, it also restricted more than one issuing institution from operating in each town, whether the institution be an unofficial bank or a branch of the Bank of Spain (Tortella and Garcia Ruiz 2013: 50). The legislation also introduced a new chartering and regulatory regime that was loosely modeled on the free banking regime of the U.S. However, in Spain, the “free” banks of issue were also strictly regulated and enjoyed local emitting monopolies (Tortella and Garcia Ruiz 2013: 58).

After the revolution of 1868, a liberal coalition rose to power and established a bank chartering and regulatory regime that represented a more intense version of the pattern the progressives had established. This group of reformers believed that economic liberalism was necessary to achieve economic growth, and admired the American/British model of chartered banking (Tortella and Garcia Ruiz 2013: 69). In 1868, the liberal reformers passed a new freedom of incorporation act that was much closer to the U.S. and Canadian free banking acts than the previous Spanish legislation. This legislation established free general incorporation for
all financial institutions, effectively making bank chartering an administrative, rather than legislative, act. It also explicitly declared that “the companies established after the publication of this law will not be subjected to the inspection or vigilance of the government” (Tortella and Garcia Ruiz 2013: 70). However, the state reserved the right to appoint the governors of the Bank of Spain and another powerful private bank, the Banco de Barcelona. As Tortella and Garcia Ruiz (2013: 69) explain, this decision was motivated by the government’s need to preserve key financing relationships:

> these exceptions [to the rule of unregulated banks of issue] show how revolutionaries had to compromise their principles when questions of finance were involved. As neither the Bank of Spain nor the Banco de Barcelona played the role of central bank, the reason for the government wanting to reserve some control over them was their size and the fact that they operated in Spain’s two largest cities; **they could hence render considerable services to the government.**

*The Bank of Spain’s Monopoly of Issue Restored (1874)*

The experiment with free banking in Spain would be even more short lived than the experiment with free banking in Canada. Once again, the state’s pressing fiscal needs inspired reform. In the 1870s, the Spanish state once again faced intractable fiscal problems, which brought an end to the liberal experiment in the banking sector. After attempting other solutions, the new liberal Minister of Finance, José Echegaray, negotiated a massive loan to the government from the Bank of Spain in 1874. This loan came with a heavy price. In exchange for financing the Treasury, the Bank of Spain received the monopoly of bank note issue. It was clear to all parties that granting this powerful private actor this monopoly power violated longstanding liberal principles; however, the liberal policymakers of this period felt that they had no other choice, given the state’s financial needs and the need to avoid disrupting the existing balance of interests through tax reform (Tortella and Garcia Ruiz 2013: 73-75).
After granting the Bank of Spain the monopoly of issue, the Banking Law of 1874 also gave existing chartered commercial banks the opportunity to convert into branches of the Bank of Spain, and most of these existing institutions seized this opportunity. After this point, the size, geographic spread, and power of the Bank of Spain increased dramatically (Tortella and Garcia Ruiz 2013). I suggest that this particular compromise embodied the longstanding Spanish commitment to achieving the balance of interests that made order possible. In this case, the state’s ability to rule (or operate) depended on its ability to accommodate the interests of the powerful private group that controlled the resources the state needed.

However, the Bank of Spain’s monopoly privileges continued to remain controversial whenever they came up for renewal, as they did in 1891, 1907, and 1921 (Tortella and Garcia Ruiz 2013: 98). I suggest that this issue was so controversial in Spain because it brought two cherished principles, centralized coordination and direction and balancing interests, into tension. The advocates of preserving the Bank of Spain’s monopoly of issue drew from the frame of centralized coordination and direction to argue that placing the control over currency issue in the hands of a single strong, independent private institution facilitated order by promoting easier coordination and rationalization of this important function (Tortella and Garcia Ruiz 2013: 99). Opponents drew from the frame of balancing interests to argue that this arrangement disrupted order by allowing the particularistic interests of a powerful private institution (the Bank of Spain) to dominate over the interests of society as a whole (Tortella and Garcia Ruiz 2013: 99). The idea was that the Bank of Spain was simply trying to fill its own coffers, rather than serve the needs of agriculture and industry (Tortella and Garcia Ruiz 2013: 99). These opponents also argued that the Bank of Spain, as the institution was currently structured, did not do enough to
pay the state back for the privileges it had received, and argued that this institution should allow greater state participation in its profits (Paret 1921).

As part of an effort to break the stalemate between advocates and opponents of the Bank of Spain’s monopoly of note issue, Spanish policymakers in the 1870s searched for a third solution that would accommodate the interests of both of these groups. The solution they developed was for the state to step in and fill needs that the private banking sector was not then addressing by creating new, state-owned banks that would primarily extend long-term credit to industry (Pérez 1997). In short, Spanish policymakers established new institutions designed to harmonize the competing interests of rival interest group by better serving the needs of agriculture and industry without upsetting the status quo in the commercial banking sector.

**Private Banks Finance the Deficit in Exchange for Powers and Privileges (1917)**

In the period of prosperity that extended between 1898 and 1914, Spain granted charters to fifty new banks (Tortella and Garcia Ruiz 2013: 92). The majority of these banks were established in Madrid and the Basque country. The Basque banks established in this period engaged in “mixed banking,” undertaking both industrial and commercial banking activities (Tortella and Garcia Ruiz 2013: 92).

In 1900, the liberal-conservative minister Raimundo Fernández Villaverde introduced a successful stabilization plan that included a substantial reduction in the volume of public debt (Tortella and Garcia Ruiz 2013: 90). As part of the debt reduction effort, Villaverde placed limits on the permitted banknote circulation by the Bank of Spain (Tortella and Garcia Ruiz 2013: 97). These limits persisted until 1909, when deficits returned after an increase in military expenditures to manage the conflict in Spanish Morocco. Faced with these mounting deficits, Spanish policymakers once again resorted to the banking system for relief. However, in the
recently expanded Spanish banking system, relief assumed a different form. In 1917, Spanish policymakers replaced the direct monetization of the public debt by the Bank of Spain with a new mechanism: the indirect monetization of the public debt by the other chartered commercial banks, a tool known as the *pignoración automática*. The government appealed to the Bank of Spain to accept public debt bonds as collateral from the other chartered commercial banks at low interest rates and with favorable tax treatment (Tortella and García Ruiz 2013: 97). The final policy allowed the other commercial banks to automatically obtain credit from the Bank of Spain for up to 90 percent of the public debt that they subscribed (Pérez 1997: 48). This arrangement was very agreeable to these commercial banks: “this made purchasing public bonds very convenient: the [bonds] guaranteed an acceptable rate of interest and were quite liquid, as they could be pawned at the Bank of Spain at any moment for interest rates that were ordinarily below the bonds’ yield” (Tortella and García Ruiz 2013: 97).

Once again, Spanish policymakers moved to restore order by striking a bargain with powerful actors within the private sector. In this case, in exchange for state financing, the state accommodated the interests of an emergent commercial banking sector by establishing a bank-friendly debt financing regime. The only difference between this pattern of accommodation and the patterns of the past was that the membership of the powerful private group the state was accommodating had expanded.

**Summary and Implications: State Sovereignty and Banking Regulation**

I suggest that the experience of life in Spain during the period of early Bourbon rule supported the development of two frames of regulatory order: the *frame of centralized coordination and direction* (power centralized within a powerful external authority, who coordinated and redirected particularistic interests) and the *frame of balancing interests*
(preserving order by accommodating and harmonizing the interests of powerful groups within civil society). Early Spanish policymakers read meaning into structures and arrangements that had developed in the course of historical experience, and applied the same underlying principles to the development of banking regulation throughout the nineteenth century.

I argue that a commitment to preserving centralized state power, and the reliance on a patronage system to keep order intact, helps to explain why Spanish policymakers moved to charter a bank in the first place: the bank’s primary purpose was to help finance a bankrupt Treasury in the midst of war, and in exchange, it received powers and privileges. The aid that the bank would provide to commerce, industry, agriculture, and public works was a secondary concern (Tortella and Garcia Ruiz 2013: 16-17). This initial episode of bank chartering in Spain established a pattern whereby reforms of the banking system varied with the state’s financial needs. Throughout the turbulent first three quarters of the nineteenth century, chartering and regulatory practices changed with the political party in power, as policymakers sought to redesign the banking system to better accommodate the interests of the groups that controlled the political system. The restoration of the monopoly of issue to the Bank of Spain in 1874 also reflected the imprint of the frame of balancing interests. Although the granting of monopoly power violated liberal ideals, this accommodation was regarded as necessary for the state to continue to rule. The same principle was also reflected in expanded private banking system that developed in the late nineteenth and early twentieth centuries.

In short, Spanish policymakers wanted a banking system that looked like their political system: centralized and ready to accommodate and harmonize the interests of powerful private groups. The regulatory policy choices of the nineteenth century that were undertaken in service of this goal shaped the form that the Spanish banking system took in the early twentieth century.
In 1920, the Spanish banking system was dominated by a handful of large banks that directly financed the Treasury in exchange for state-granted credit on easy terms. The Bank of Spain operated as a monolithic institution at the center of this system: in addition to serving the financing needs of the government alongside the other chartered banks, it also dominated the commercial banking sector. This system was also highly inflationary, as it gave cheap access to credit to commercial banks in exchange for financing the public debt (Tortella and Palafox 1984: 88). Pérez (1997) argues that the practice of underwriting industrial promotion through inflationary public finance represented the “original sin” that would come to shape the relationship between Spanish banks and industry for years to come. Since Spanish commercial banks had access to a highly liquid and virtually riskless source of funding, they had little incentive to develop competitive, long-term industrial investment strategies (Pérez 1997).
CHAPTER 3: NATIONAL RESPONSES TO THE BANKING CRISSES OF THE 1920s & 1930s

The end of World War I in the U.S., Canada, and Spain was followed by a major economic recession, which had adverse implications for the health of each country’s banking system. Economic downturns often lead to trouble in the financial sector, as nervous bankers anticipating lean times curtail lending to business, and the decline in credit provision tends to amplify and extend the decline in the real economy. This familiar pattern played out in most Western countries, including the U.S., Canada, and Spain, during the 1920s and 1930s. Each of these countries experienced at least one banking crisis during this period. In the U.S., a series of regional banking crises followed the 1929 stock market collapse, eventually culminating in widespread bank suspensions and the failure of over a third of American banks in the early 1930s. In Canada, a chartered bank with over 70 branches failed in the early 1920s, an event that prompted widespread public concern. Additionally, while no Canadian bank failed during the Great Depression, many did suffer heavy losses, which alarmed policymakers and the public. In Spain, a banking crisis in Catalonia in the early 1920s ended with the failure of the venerable Bank of Barcelona.

After each crisis, policymakers implemented reforms that were intended to prevent these events from happening again. However, the policy remedies adopted in the U.S., Canada, and Spain looked very different. American policymakers responded with extensive reforms to promote deconcentration in the banking system, by maintaining the system’s geographic fragmentation and increasing its functional specialization. By contrast, Canadian policymakers adopted very few reforms, and the few reforms adopted were designed to protect the rights of weaker economic actors while simultaneously avoiding undue state interference. Spanish policymakers responded with reforms that enhanced the ability of the Bank of Spain to
coordinate and direct activity in the Spanish banking system, but also increased the power and privileges of other private Spanish banks.

The primary goal of this chapter is to explain why the American, Canadian, and Spanish policy responses to the banking crises of the 1920s and 1930s took the different forms that they did. I argue that these reforms cannot be fully explained without accounting for what domestic policymakers believed to be true about the causes of economic order and disorder. I find that the same nation-specific frames of order that structured the development of American, Canadian, and Spanish banking regulation in the nineteenth century carried forward to shape each country’s responses to the crises of the 1920s and 1930s. As American, Canadian, and Spain policymakers attempted to explain what had caused the banking crises, they turned to familiar villains: in the U.S., this was the effect of concentrated and centralized power; in Canada, the effect of state interference with private activity; and in Spain, the effect of excessive fragmentation, foreign interference, and uncoordinated anarchy.

These definitions of the problem to be solved shaped the types of solutions policymakers considered and debated. I show that in course of the reform debates that followed the crisis in each country, different frames of regulatory order came into conflict, as proponents and opponents of particular reforms offered arguments that drew from different elements of the same overarching principle. In the U.S., arguments that drew from the frame of deconcentration faced off against arguments that drew from the frame of competition. In Canada, arguments that drew from the frame of private autonomy were pitted against arguments that drew from the frame of public protection. And in Spain, arguments that drew from the frame of balancing interests battled against arguments that drew from the frame of centralized coordination and direction.
This chapter is organized as follows. Taking the American, Canadian, and Spanish cases in turn, I then explain how the dominant principle of order in each country structured the way that domestic policymakers understood the causes of the banking crises, and how the multiple frames that these broad principles encompassed shaped the terms of debate over policy reform. I use information collected from legislative transcripts, newspaper articles, and secondary sources to reconstruct the explanations offered and arguments advanced in each country. I conclude by demonstrating that in each country, arguments framed in line with one frame of regulatory order triumphed over arguments framed in line with an alternative frame of regulatory order.

CRISIS AND POLICY DEBATE IN THE UNITED STATES

In the United States, the economic downturn of 1920-1921 hit agricultural areas particularly hard, with devastating consequences for the small, undiversified, rural banks that served these areas (Fischer 1968: 199). Country banks were faced with the combined challenges of “dwindling deposits, an increased demand for funds, inability to obtain repayment of existing borrowings, and a decline in value in the security for past loans” (Fischer 1968: 200). Small, rural unit banks, with undiversified local lending portfolios, began to fail in increasing numbers over the course of the 1920s. These bank failures were followed by the collapse of the American stock market on October 29, 1929. The turmoil in securities markets quickly spilled over into the real economy, spurring another economic recession and producing a series of regional banking panics. After a decade of losses, many rural unit banks were already skating on the edge, and with the onset of this new recession, many of these banks began to fail.

In a system dominated by thousands of independent unit banks, it was difficult to economic actors to clear and settle payments. American banks had responded to these conditions by organizing into correspondent networks in which larger regional banks took responsibility for
the payment obligations of many small community banks. In exchange, the small community bank deposited the majority of their deposit funds with their regional correspondent. Many of these small community banks began to experience liquidity problems in the turbulent climate of the early 1930s, and responded by calling on funds deposited with regional correspondent banks. However, these regional correspondent banks had many of their own funds deposited with the large, money-center banks, and often lacked sufficient liquid assets to respond to the rising demands from so many community banks. And when local banks did not receive funds from their regional correspondent bank in time, depositors often engaged in a run on the bank, propelling further panic.

In November 1930, these and other problems culminated in the failure of the Bank of Tennessee in Nashville, a principle correspondent for depository institutions in Tennessee and surrounding states. The failure of this large regional correspondent bank magnified the difficulty in the banking system and triggered a chain reaction of over 100 additional bank failures (Richardson 2007: 3). Similar patterns of contagious bank failures repeated in other states, and gradually encompassed larger and larger banks. By 1932, many states had declared state-wide bank suspensions that were often followed by widespread bank failures. On March 6, 1933, President Roosevelt undertook the unprecedented step of declaring a national bank holiday. All told, nearly a third of the entire American banking system disappeared during this period.

The Crisis as a Failure of Local Sovereignty

As American policymakers searched for an explanation to account for the near-destruction of the banking system, they returned to a familiar villain: the destructive effects of concentrated power. Operating under a worldview that emphasized unfettered competition between fragmented local groups serving local interests as the key to an orderly and effective
polity and economy, I find that American policymakers entered the 1930s predisposed to see a problem in the nation’s deposit funds concentrated in a few large, money-center banks. This concentration of deposit funds was believed to have perpetuated the crisis by diverting local funds away from their proper location and purpose and by giving the large money-center banks a degree of financial power that was easily abused.

Although other explanations for the crisis were offered in the U.S., the explanation that emphasized the destructive effects of concentrated power as the root cause was the one that prevailed. Alternative explanations emphasized the incentive-distorting influence of the Federal Reserve System and the inherent instability of a unit banking system comprised of thousands of small, branchless, geographically fragmented banks with low capital holdings (e.g., *Congressional Record*, May 10 1932: 9892). However, both of these alternative accounts were controversial and heavily contested. Not every American policymaker believed that the effects of concentrated power was the primary cause of the Depression-era banking crises. However, this was clearly the explanation that inspired the most consensus: virtually all American policymakers agreed that concentrated financial power was at least one cause of the Depression-era banking crises.

In short, all four of the major policy reforms debated in the immediate post-crisis period sought to address the same basic, agreed-upon problem - concentrated power - and they were all oriented toward the goal of deconcentrating power in the financial system. The specifics of the reform proposals would be heavily debated, but American policymakers generally agreed on the basic principle that restoring order would require stopping the flow of deposit funds to large metropolitan banks, and returning these funds to the hands of local banks and local communities.
As A.P. Fierson, Vice President of East Tennessee National Bank, put it, what America needed was:

[A] distribution, a decentralization of depositing the wealth of this nation, [which] it should stay in the local communities where it originated and not all be sent away to some large city, to some great bank, where it can be used, and will be used, for other banks’ profit (To Provide Guaranty Fund for Depositors in Banks, March 14, 1932).

Reform Debates Pit Deconcentration Against Competition

In 1932, Senator Carter Glass (D-VA) introduced a bill to reform the banking system that was designed “to provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes” (Banking Act of 1933). The final bill, which would become the Banking Act of 1933, was co-sponsored by Rep. Henry Steagall (D-AL) in the House. It introduced three major reforms that would have lasting implications for the structure of the American banking system: the enforced separation of investment and commercial banking; the imposition of a maximum limit on the interest rates banks could offer their depositors (Regulation Q); and the creation of a federal deposit insurance system. After protracted debate, the final bill passed the Senate in February 1932 and the House in May 1933, and was signed into law by President Roosevelt on June 16, 1933.

Both supporters and opponents of particular reforms offered arguments that reflected the principle of local sovereignty. However, competing arguments drew from different frames of regulatory order encompassed by this broad principle. Arguments framed in deconcentration terms were pitted against arguments framed in competition terms. The frame of deconcentration calls attention to the system structure that produces order: order can only emerge in systems characterized by multiple, fragmented, and independent groups pursuing distinct local interests.
The *frame of competition* calls attention to the mechanism through which order is produced: order can only emerge through competitive rivalry between groups, as the pursuit of distinct local interest also keeps the abuses of any single group in check.

In the reform debates of the early 1930s, American policymakers were forced to negotiate a difficult tradeoff between preserving the deconcentrated structure that was thought to make order possible and the competitive mechanism through which order was believed to be produced within such systems. In what follows, I explain how this conflict manifested in debates over four key reforms: the enforced separation of investment and commercial banking; the imposition of deposit rate ceilings; the creation of a federal deposit insurance system; and branching reform.

*Separation of Investment and Commercial Banking*

American reform advocates, drawing from the frame of deconcentration, argued that restoring order to the banking system would require greater fragmentation of bank activities. They sought to prevent the same financial institution from engaging in both investment and commercial banking. They argued that the combination of these activities within financial institutions had promoted disorder by increasing the concentration of resources in the hands of the large money-center banks and by distorting the proper allegiance of American banks. A key tenet of the *frame of deconcentration* is that disorder can be expected to emerge when any single interest group becomes too large and powerful, a condition that would not allow other groups to adequately check its abuses. For this reason, it was important to ensure that power was sufficiently fragmented across many diverse groups. The proponents of the enforced separation of investment and commercial banking drew from this frame to argue that this initiative would remedy the breakdown of order in the banking system by restoring the type of system structure that kept order intact. They argued that the problem was that the interests of financial institutions
- who constituted the relevant “groups” in this context - were not sufficiently diverse and independent. The result, they argued, had been the dangerous concentration of financial resources in the hands of large, money-center banks. As the following testimony suggests, reform advocates believed that bank participation in securities activity was the magnet that had encouraged these banks to draw deposits away from local communities and into metropolitan centers:

> If banks had not been in the investment business, they would not have tended to drain so rapidly money from the small towns into the cities for speculative purposes (Congressional Record, May 22, 1933: 3956).

One solution to this problem, reform advocates argued, was to block the mechanism through which the large, money-center banks had come to accumulate their inordinate financial power, by preventing these banks from using local deposits to finance their speculative securities activities.

The frame of deconcentration also implied that order emerges from local institutions pursuing local group interests. Reform proponents offered a second line of argument in favor of the enforced separation of investment and commercial banking that highlighted threats to the local allegiance of the diverse groups that comprised the banking system. Groups maintaining distinct interests, or “[unique] will of [one’s] own,” provided these groups with the requisite interests or “personal motives to resist encroachments of the others” (Federalist 51). Thus these distinct interests were regarded as a necessary precondition for order. I argue that this left American reform advocates primed to see problems in the case of a single institution engaging in multiple types of financial activities. The combination of distinct activities inside of a single bank, reform proponents argued, had disrupted order by dividing the bank’s allegiance. The logic is evident in the testimony of Rep. Kopplemann before the House of Representatives:
The unholy alliance between the brokerage office and the bank must be broken… This has grave dangers. It violates the fundamental principle of the lawyers’ code of ethics – that of undivided allegiance. In banking as elsewhere, no man can serve two masters… (*Congressional Record*, May 22, 1933, 3907).

Reform advocates argued that that this divided allegiance had produced a range of negative effects. It had caused banks to lose sight of what they properly owed their depositors and local communities, and had steered banks away from serving local interests. Proponents of the enforced separation of investment and commercial banking argued that banks attempting to serve too many masters had thrown the entire financial system out of whack:

Had banks confined their activities to commercial banking they would not have been tempted to load the country down with securities at inflated prices. They would not so lavishly have extended credit for speculative uses. They would not have used their coercive powers over correspondents nor their persuasive power over depositors to cause them to buy on faith. Had private banks and investment houses – which are the logical medium for long-term financing – not had this competition they would have handled legitimate issues on their merits and the market would have been conditioned by credit policies consistent with sound commercial banking (*Congressional Record*, May 22, 1933: 3954).

The solution, reform proponents argued, was to break this divided allegiance by forcing investment and commercial banks to operate as separate, distinct units (*Congressional Record*, May 22, 1933: 3954).

This enforced specialization represented a familiar solution to a familiar problem. In separating investment and commercial banking, American policymakers applied the same method they had used to guard against majority rule in the polity to the problem of excessive concentration in the banking system: fragmenting the branches of government and the financial system by specialized function. Following argument offered in favor of this remedy mirrors the language of checks and balances that Madison used to justify the choice to fragment the structure of the American political system:
By divorcing long-term financing from short-term financing the conditions affecting each will serve as a check upon the other, and the exaggerated results of the intimate association between the two will be avoided. From this we may expect sounder credit policies from our commercial banks and an investment business more accurately responsible to the needs of industry (Congressional Record, May 22, 1933: 3955).

Opponents of this reform, which included most of the banking industry, some academics, and the Chamber of Commerce, offered arguments that drew from the frame of competition. They argued that the separation of investment and commercial banking would not only fail to address the disorder that had emerged in the banking system, it would produce disorder by interfering with a bank’s freedom to determine own financial activities, without external interference (Congressional Record, May 22, 1933: 3954). The implication was that the state interfering with financial institution choices would block the natural competitive process that produced order in the absence of any powerful external authority.

Regulation Q (Deposit Rate Ceilings)

Advocates of a second policy remedy sought to place maximum limits on the interest rates that banks could offer on time, savings, and demand deposits. Proponents of capping deposit interest rates, like the proponents of separating investment and commercial banking, offered arguments in support of this reform that drew from the frame of deconcentration. They argued that this initiative would restore order to the banking system by stemming the flow of deposits away from local banks. One of the reasons that deposit funds had concentrated in the money-center banks, they argued, was because these banks had many more funds at their disposal, which enabled them to offer interest rates on deposits that smaller, local community banks could not match. A. P. Fierson described the problem succinctly:

The metropolitan banks in turn pay interest on their daily deposits because they have such huge sums sent in; whereas the country bank cannot compete with them, because the country bank cannot afford to pay interest on demand deposit
subject to check, and therefore cannot compete with that great city banks (To Provide Guaranty Fund for Depositors in Banks, March 14, 1932: 59).

Having diagnosed the crisis as the result of excessive concentration, proponents of this reform argued that the key to preventing a return of the crisis was to break the vicious cycle whereby concentration begat further concentration. Capping deposit rates, reform proponents argued, would restore order by removing the competitive advantage that large banks enjoyed in the market for deposits. Removing this source of advantage would prevent financial resources from concentrating in the large money-center banks, and restore these resources to the communities from which they had originated (where they properly belonged).

A second argument in favor of capping deposit rates also drew from the frame of deconcentration. Competition over time deposits had grown increasingly fierce over the course of the 1920s, and many of the small banks that failed had held a high ratio of time to demand deposits. Both Senator Glass and Representative Steagall argued this “ruinous competition” between local banks over deposit funds had produced the kind of excessive risk-taking that led to bank failure. Both also sought to give “the Federal Reserve Board authority which it does not now possess…to put a stop to the competition between banks in payment of interest, which frequently induces banks to pay excessive interest and has many times over again brought banks into serious trouble” (Congressional Record 77, Part 4, May 19, 1933: 3729). In this case, the mechanism that was believed to promote order in the American polity and economy, unfettered competitive rivalry, was also believed to have facilitated disorder by threatening the survival of the independent local bank, the building block of an orderly and prosperous banking system.

Faced with a tradeoff between preserving the mechanism that allowed order to arise in the absence of external intervention, and preserving the system structure that that makes order possible, American policymakers opted for the middle ground. Placing a maximum limit on the
interest rates that banks could offer depositors would certainly constrain competition in the market for deposits, but it would not fundamentally disrupt the competitive process itself. No bank could exceed the maximum interest rate, which would prevent the kind of “ruinous competition” that threatened community bank survival, yet all banks were still free to compete on deposit rates up until they reached this maximum limit. I argue that a provision placing limits on the interest rates that banks could offer depositors faced very little opposition during in the Depression-era policy debates because it did not seriously disrupt the competitive process itself. Its inclusion in the final Banking Act of 1933 represented another triumph for the frame of deconcentration over the frame of competition.

Deposit Insurance

The provision of the Banking Act of 1933 that created a federal deposit insurance system was highly controversial, and the debate over this policy remedy stalled the passage of reform legislation for almost three years. Deposit insurance was not a new initiative, but it was a politically contentious one (Flood 1991; Calomiris 2000: 164-211). Between 1866 and 1931, 150 deposit insurance bills had been brought before Congress, yet none of them had passed (Calomiris 2000: 173). I argue that this reform was particularly contentious because it brought one cherished frame of regulatory order – competition – into the sharpest conflict with another cherished frame of regulatory order - deconcentration. Separating investment and commercial banking and capping interest rates on deposits placed some limits on competition in the banking system, but they did not disrupt the market mechanism itself. Deposit insurance did.

The proposed deposit insurance system was intended to protect an insured bank’s depositors from losses if the bank became unable to pay debts when due. In this system, all
national- and state-chartered banks would be required to pay into a general deposit insurance fund, which would be organized and overseen by a government-sponsored corporation, the Federal Deposit Insurance Corporation (FDIC). The size of each bank’s contribution into the fund would be proportionate to its holdings of insured deposits, not its risk of failure: large banks, which held more deposits, would also contribute more. Deposit insurance was thus opposed by most of the large money center banks, who did not want to subsidize failures among small unit banks, where failures most often occurred, and was supported by most unit banks, who sought greater protection against instability at a lower cost than under state deposit insurance regimes (Calomiris 2000).

The opponents of deposit insurance drew from the frame of competition to argue that this initiative would promote disorder by fundamentally distorting the mechanism through which order emerged in the fragmented and locally oriented American economy. This initiative, they argued, effectively subsidized risk-taking by removing the penalties for bank failure. This reduction in the costs of failure was thought to encourage bad banks to continue operating long after they should have closed their doors. These wayward banks would then breed further disorder, dragging the good banks down with them and disrupting order within the entire system.

A spokesman from the American Bankers’ Association explains the mechanism through which deposit insurance was expected to keep risky banks afloat, while economist E.W. Kemmerer explains how these circumstances would lead to greater bank risk-taking at the aggregate level:

A bank which does not earn a fair average rate of return over a period of years not only is unable to build up reserves against bad times, but, in order to improve profits, is under constant temptation to take risks which in the end are likely to lead

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22 Initially, insurance coverage was limited to banks who were members of the Federal Reserve system. This membership requirement was dropped by 1939 (FDIC 1997: 36).
to failure. The tendency of [deposit insurance] will be to nurture these unprofitable units and keep them going temporarily in the knowledge that upon failure the losses can be shifted to other banks (Association of Reserve City Bankers 1933: 19-20, quoted in Flood 1991: 61).

For it is to be remembered that the weak banks get the same insurance as the strong ones, and, unlike the situation in other kinds of insurance, the bad risk pays no more for its insurance than the good one. This means competition among banks in slackness in the granting of loans. The bank with the loose credit policy gets the business and the bank with the careful, cautious credit policy loses it. The slack banker dances and the conservative banker pays the fiddler. If the conservative banker protests, the slack one invites him to go to a warmer climate. Soon all are dancing and the fiddler, if paid at all, must collect from the depositors or from the taxpayers (E.W. Kemmerer, speaking to the Savings Bank Association of Massachusetts on September 14, 1933, quoted in Flood 1991: 60).

Deposit insurance was also thought to disrupt order by reducing the incentive for depositors to check risky bank behavior. In a system in which the self-interest of one group limited other groups’ abilities to abuse the system, an initiative that reduced the incentive of any one group to monitor the activities of others was regarded as especially problematic. This concern about insured depositors losing interest in disciplining banks, and the threat this held for order, is evident in the following anti-deposit insurance arguments from Mr. William S. Elliot, Vice President of the Georgia Banker’s Association, before the House Committee on Banking and Currency:

I feel that one indirect result of this legislation will be the stimulation of a laxity on the part of the officials who run the banks knowing that their depositors, whom they have to look into the face every day on the street, can not lose anything by their mismanagement of the banks, and also to stimulate a laxity of intelligent effort on the part of the depositors in selecting a banking institution and supporting it and making a success of it, based upon the character and capacity of the men who are running it. I think it will develop a laxity in the business world. They will say: ‘We will depend on the Government's guarantee’ (To Provide a Guaranty Fund for Depositors in Banks: 180).

To counter the arguments of deposit insurance opponents, the advocates of deposit insurance employed three rhetorical strategies. Like Canadian advocates of deposit insurance,
they offered a moral argument: American depositors were entitled to some form of protection against bank mismanagement. They also explicitly rejected the claim that deposit insurance would fundamentally disrupt the competitive process in the way that its opponents suggested. They argued that because deposit insurance only covers losses to depositors, instead of all costs of bank failure, a bank’s managers and shareholders would still have sufficient skin in the game to avoid taking outsize risks. They also argued that the tendency for insured institutions to take outsize risks would be further restrained by the interest rate limits imposed by Regulation Q. However, most importantly, American deposit insurance proponents drew from the frame of deconcentration to offer positive arguments in favor of deposit insurance, and negative arguments against an alternative policy remedy described below, branching reform. These advocates argued that deposit insurance would shore up the stability of the unit banking system. Keeping the unit banking system strong and stable would stall the flow of funds toward metropolitan banks, thereby preventing a return to the centralization and concentration that were believed to have caused the crisis. Testifying before the House Committee on Banking and Currency, A. P. Fierson outlines this theorized mechanism:

If we had a bill, if we had a law that would guarantee deposits in banks and some reasonable degree, the money that is now daily flowing into the great metropolitan centers of the country, would remain in towns where it originates, where it could be loaned in a banking way for the development of industry and commerce and agriculture of the communities…sad to relate, on account of the breakdown of the public confidence throughout the nation in the banking structure, business houses, businessmen are now sending their money out of town into the great metropolitan centers (To Provide Guaranty Fund for Depositors in Banks, March 14, 1932: 59).

In the end, after a long and contentious debate, the Banking Act of 1933 included a provision establishing a federal deposit insurance system. The inclusion of this provision represented another triumph of the frame of deconcentration over the frame of competition.
Branching Reform: Failure on Deconcentration Grounds

Deposit insurance was also framed an alternative to a different policy remedy: the elimination of restrictions on bank branching. Proponents of branching reform sought to restore order to the American banking system by removing restrictions on the ability of national banks to establish offices in multiple locations. Drawing from the frame of competition, these reform proponents argued that branching reform, unlike deposit insurance, would naturally correct the inherent instability of the unit banking system without distorting the competitive process. The benefits of allowing banks to expand and branch included the diversification of bank assets and funding sources, which would improve their ability to weather a range of economic conditions, as well as the ability to easily shift funds from strong and stable locations to troubled areas. They argued that this method of restoring stability to the banking system was preferable to deposit insurance, since it harnessed the competitive mechanism that produced order, rather than disrupting it. This logic is evident in the following argument from one supporter of branching reform:

Deposit guaranty is undoubtedly a guarantee of reckless banking, it is usually followed by increasing bank failures, and this in turn accelerates the depletion of the guaranty fund and its ultimate bankruptcy. Safety for the depositor can be best achieved through a unified branch banking system under competent bankers, strict examination and supervision, limitations as to interest rates and dividends until large surpluses are created, and responsibility placed where it belongs – on the officers and directors of the individual banks. A guaranty fund does not supplement but defeats this purpose (*Congressional Record*, May 22, 1933: 3961).

The opponents of branching reform returned to familiar tropes associated with the frame of deconcentration. They argued that an expansion of branch banking, with federal bank offices crossing state lines, would only bring the banking system closer to the consolidated and centralized
structure that had played such a central role in causing the crisis. This logic is evident in the following critique of branch banking systems offered by an opponent of this reform:

I say to you that the Senate…has adopted a policy up to this time that the way to cure this condition to create a further monopoly of credit by branch banking, although credit monopoly is the very thing which has brought us to the condition that we are now in (Congressional Record, January 18, 1933: 2036).

Removing restrictions on national bank branching, these opponents argued, would threaten the autonomy of the local community, violating a key tenet of the frame of deconcentration:

The Glass bill in its present form gives national banks the right to establish branches in any State regardless of the State laws…this is not merely a matter of banking. This is a matter which involves our whole social and economic system…Mr. Speaker, give me the control of the credit of a community and I will control every activity in it, it makes no difference what it is; and this attempt to monopolize the credit of our country means, among other things, that the metropolitan centers will control the legislatures of the states (Mr. Goldsborough, Congressional Record, May 22, 1933: 2036).

Branching reform was not included in the Banking Act of 1933, which represented another triumph of the frame of deconcentration over the frame of competition.

Why did deposit insurance succeed as a method of restoring stability to the banking system, while branching reform failed? I suggest that American policymakers wanted an economic system that embodied the same principles that underlay their political system. Consolidated banks, with branch offices that spread across geographic areas, did not fit that vision. In short, bank branches had been defined as threats to local sovereignty long ago, and advocates of branching reform were hard pressed to counter this stigma.

**Summary: United States**

In the United States, the principle of local sovereignty shaped the types of problems perceived and the range of solutions considered in the policy debates that followed the banking crises of the early 1930s. This principle shaped the way policymakers diagnosed the causes of
these crises, directing attention toward the problem of concentrated power and away from alternative diagnoses. It also defined the range of solutions that American policymakers debated and considered. All of the major proposed remedies sought to restore order by addressing the homogeneity of interests or the concentration of power in the banking system (separation of investment and commercial banking, deposit rate ceilings, deposit insurance) or by promoting freer competition (branching reform). proposed solutions were oriented toward the same basic goal of fragmenting large bank power and empowering community banks.

Arguments that drew from different elements of the principle of local sovereignty faced-off during the reform debates of the 1930s. In the course of these debates, American policymakers were forced to choose between preserving the structure that was expected to produce order and prosperity – a multiplicity of fragmented, independent groups, each oriented toward serving distinct local interests – and preserving the mechanism that produced order – unfettered competitive rivalry between equivalent groups. Examining each proposed major reform in turn, I demonstrated that arguments that drew from the frame of deconcentration consistently triumphed over arguments that drew from the frame of competition (see Table 3.1). The reforms that were eventually adopted had been advocated for in deconcentration terms, and had been opposed in competition terms. The converse was also true: the reforms that failed had been advocated for in competition terms, and had been opposed in deconcentration terms. In Chapters 4-6, I explain how the terms of this the debate, and the resolution of this conflict, informed the subsequent development of American banking regulation in the twentieth and twenty-first centuries.
Table 3.1. Frames of Regulatory Order Mobilized in Debates in U.S., Canada, and Spain, 1920s-1930s

<table>
<thead>
<tr>
<th>Reforms Debated</th>
<th>For</th>
<th>Against</th>
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<tbody>
<tr>
<td><strong>United States (1933)</strong></td>
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<tr>
<td>Separation of Investment and Commercial Banking</td>
<td><strong>Deconcentration</strong></td>
<td>Competition</td>
</tr>
<tr>
<td>Interest Rate Ceilings</td>
<td><strong>Deconcentration</strong></td>
<td>Competition</td>
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<tr>
<td>Branching Reform</td>
<td>Deconcentration</td>
<td><strong>Deconcentration</strong></td>
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<td></td>
<td>Competition</td>
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<tr>
<td>Deposit Insurance</td>
<td><strong>Deconcentration</strong></td>
<td>Competition</td>
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<tr>
<td><strong>Canada (1924)</strong></td>
<td></td>
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<tr>
<td>Central Bank</td>
<td>Public Protection</td>
<td><strong>Private Autonomy</strong></td>
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<tr>
<td>Inspector of Banks</td>
<td><strong>Public Protection</strong></td>
<td>Private Autonomy</td>
</tr>
<tr>
<td>Deposit Insurance</td>
<td>Public Protection</td>
<td><strong>Private Autonomy</strong></td>
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<tr>
<td>Inspector of Trust Companies</td>
<td>Public Protection</td>
<td><strong>Private Autonomy</strong></td>
</tr>
<tr>
<td>National Currency</td>
<td>Public Protection</td>
<td><strong>Private Autonomy</strong></td>
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<tr>
<td><strong>Spain (1921)</strong></td>
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<tr>
<td>Bank of Spain as Central Bank</td>
<td><strong>Centralized Coordination and Direction</strong></td>
<td>Balancing Interests (right) Centralized Coordination and Direction (left)</td>
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<tr>
<td>Special Rediscount Rate</td>
<td><strong>Balancing Interests</strong></td>
<td>Centralized Coordination and Direction</td>
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<td>Consejo Superior Bancario</td>
<td>Balancing Interests</td>
<td>Centralized Coordination and Direction</td>
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<td>Centralized Coordination and Direction</td>
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CRISIS AND POLICY DEBATE IN CANADA

In August 1923, the Home Bank, the third smallest of the seventeen chartered Canadian banks, collapsed. At the time, the bank operated more than 70 branches across Canada, and its failure rattled policymakers and the public. Chartered banks had failed in Canada before, but never with such large losses to depositors. As a result of the Home Bank’s collapse, more than 60,000 depositors across the country lost their life savings (Plummer 2013). By contrast, no Canadian bank failed during the Depression, although many did suffer heavy losses, and all Canadian banks curtailed their lending. I focus the analysis on the reform debates that followed the Home Bank crisis, rather than those that followed the Depression-era banking crisis, because Canadian policymakers appeared to regard the Home Bank crisis as more salient, as measured by the length and intensity of the debates in each episode.

The Canadian government had been aware of problems at the Home Bank for some time. In 1916, and again in 1918, the bank’s directors from its western division had alerted the Minister of Finance that the bank had large outstanding non-performing loans, yet was continuing to pay dividends out of uncollected interest (Murphy 1993). However, the Finance Minister, operating in a political environment that eschewed government interference in the regulation and supervision of banks, responded by calling on the bank’s private auditor to conduct internal investigations. The bank passed these private audits, and continued to operate until the onset of the postwar economic recession increased its costs, revealing its inherent instability.

Diagnosing the Crisis: Mismanagement and State Inaction

As policymakers searched for an account to explain the collapse of a major chartered bank, they returned to a familiar villain: state interference with the free execution of private
Operating under a worldview that emphasized the unfettered pursuit of private initiative and the preservation of private individual rights as keys to economic order, I suggest that Canadian policymakers entered the early 1920s predisposed to blame undue state interference and the inadequate safeguard of public rights for the disorder that had emerged in the banking system.

Policymakers across political lines agreed that mismanagement by the Home Bank’s directors, which was believed to encourage over-expansion, injudicious banking, and inappropriate insider lending, represented the most proximate cause of the crisis (Hansard, House of Commons, April 9, 1924: 1199; Murphy 1993). Ten citizens were eventually arrested in connection with the bank’s collapse, including the bank’s president, vice president, five of its directors, and its accountant, and most of these actors were convicted of fraud. However, the prevailing diagnosis for the Home Bank crisis moved beyond these individual-level factors to encompass both the actions and the inaction of the state. As policymakers searched for a diagnosis to explain what had gone wrong in the wake of the Home Bank collapse, they returned to an issue that had always inspired unease and tension: bank chartering.

Chapter 2 described the contention that had long surrounded the issue of bank chartering in Canada. When viewed through the lens of individual sovereignty, the state granting special privileges to private institutions was easily framed as unfair and distortionary interference with natural private economic activity. Operating under a worldview in which order emerges organically when individuals freely pursue their own self-interest, I suggest that Canadian policymakers were primed to regard any form of state interference with suspicion.

Canadian policymakers largely agreed that in granting the Home Bank a charter, the state had sown the seeds of the disorder to come. Progressive policymakers advanced an extreme form
of this argument: they argued that the state’s grant of special privileges to the Home Bank had directly pushed the bank’s directors into malfeasance. The idea was that privileges easily obtained through the political process, rather than earned naturally in the course of free market competition, were more easily abused. This logic is evident in the arguments of Mr. MacLean, a Progressive member of Parliament, in favor of banking reform:

You will find that a lot of those banks went into business because of the temptation of being allowed to issue their own notes and put them in circulation, and in many cases they lent money to their friends. That is probably what wrecked the Home Bank and many other banks in this country - the unfortunate power that was given them to issue bank notes up to the extent of their capital. Anything that is easy to get is easily parted with, and there was not that care in the administration of the banks that there would have been if permission to issue banknotes had not been allowed in the Bank Act (Hansard, House of Commons, July 2, 1924: 3929).

Not all Canadian policymakers went so far as to argue that the state had directly caused the crisis by chartering the Home Bank. Members of the reigning Liberal party and the official Conservative opposition were more temperate in their critiques of the state’s role in perpetuating the crisis. The Senate was also less reform-minded than the House. However, virtually every Canadian policymaker agreed that state shared at least partial responsibility for the Home Bank’s abuse of unsuspecting depositors. The state was culpable for these abuses, policymakers argued, because it had failed to restrain the monster it created. In granting the bank a charter, the state had effectively given the bank its blessing. The implication was that the state had a duty to step in to restrain charterholders from infringing on the rights of other participants in the banking system, and that it had failed to do so. This logic is evident in the arguments from Senator Pardee, a liberal member of the Senate:

[When any government takes a corporation under its aegis and grants it a charter to do business, and that charter advertises to the world that the corporation will receive deposits and make payments on them, the idea
prevails that it will carry on business in a reputable way; and when that implied promise, or implied contract, has been entirely shattered, has been blown to the four winds of heaven, then it is quite time that somebody should step in …and see that such safeguards are imposed on these institutions as shall prevent a recurrence of what has happened (Hansard, Senate, March 4, 1924: 8-9).

In short, the prevailing diagnosis for the Home Bank crisis in Canada included two distinct components that aligned with key tenets of individual sovereignty. First, the state, by chartering the bank and interfering with private economic activity, bore at least some responsibility for the crisis, since it had given the bank the privileges that were then abused. Second, the state also had a duty to protect the rights of weaker economic actors from infringements by more powerful economic actors, and had failed to institute an adequate rule of law that would preserve the rights of depositors. In short, the explanation for the Home Bank crisis that prevailed in Canada implicated both the actions (charter-granting) and the inaction (poor protection of public rights) of the Canadian state.

**Debates Over Policy Remedies: The Triumph of Private Autonomy**

All of the major policy reforms debated in Canada were oriented toward achieving two basic objectives: forcing the state to take a more active role in protecting the rights of vulnerable depositors, while simultaneously avoiding new forms of state interference with private economic activity. In the Canadian reform debates of the 1920s and 1930s, one cherished principle, *private autonomy* faced off against another cherished principle, *public protection*. As explained in Chapter 2, the *frame of public protection* calls attention to the structure that promotes order: a system characterized by clearly defined and protected individual rights. The frame of *private autonomy* calls attention to the mechanism through which order is produced: many individuals freely pursuing their self-interest, in the absence of interference from the state or other powerful private actors.
In debating key regulatory reforms after the Home Bank crisis, Canadian policymakers were forced to make difficult tradeoffs. Many of the proposed reforms brought these two frames into conflict. To protect the rights of weaker individuals like bank depositors from the abuses of chartered banks, the state needed to step in to enforce better “rules of the game”. But at the same time, giving the state a larger role in regulating and supervising the banking system also represented a threat to the autonomy of the private actors who operated within this system. Thus, Canadian policymakers were forced to choose between two problematic alternatives: the state interfering with the progress of private economic activity or powerful private actors trampling the rights of weaker actors in the absence of an adequate regulatory framework. In what follows, I explain how this conflict played out in debates over five proposed policy reforms after the Home Bank crisis: the creation of a government office of bank inspection; the creation of a central bank; the establishment of a deposit insurance system; a switch to a national currency; and the creation of a government office of trust company inspection.

**Government Inspector of Banks: A Minor Triumph for Public Protection**

In the three decades leading up to the Home Bank failure, the Progressive Party had continually pushed for the government to take on a larger role in overseeing chartered banks. These reform attempts were consistently denied. Each time, Progressive calls for a government inspector of banks went unheeded because members of the dominant Conservative and Liberal parties were reluctant to permit the state to interfere with the chartered banks, who were seen as private economic actors. The concerns of these reform-opposed policymakers embodied key tenets of the *frame of private autonomy*, which calls attention to the hazards of state interference with private economic activity.
The creation of a government inspector of banks had been a longstanding pet policy issue for Progressive policymakers. However, opponents of a government bank inspectorate had consistently argued that externally (government) imposed regulation could never trump the existing system of self-regulation, which reflected the free activity of private actors. For this reason, these reform opponents argued that government bank inspection would not only be ineffective and costly - it would also result in harm. This understanding is evident in Minister of Finance William Fielding’s objections to a 1923 proposal to create a government inspector of banks:

At every revision of the bank act a question of paramount importance has been raised concerning government inspection. Every minister of finance who has preceded me has…reached the conclusion that it was not wise to adopt a system of government inspection…With our widespread system of branch banks any adequate system inspection would call for a small army of officials; it would involve large expenditure, and my own impression is, that in the end you would have no better guarantee of the soundness of a bank, after government inspection, than you have under the present system…I do not believe government inspection will give you any greater real protection that you now have, but it would, I think, give a false security, it would create the impression in the minds of the people that the government were guaranteeing the transactions of the bank...Embarrassment and trouble…would follow (Hansard, House of Commons, March 20, 1923: 1310-1311).

However, with the failure of the Home Bank, the Liberal government abandoned its earlier objections to government bank inspection. Minister Fielding responded to the Home Bank collapse by resurrecting the same proposal he had rejected only a few months earlier. The new proponents of creating an office of government inspection offered arguments that drew from frame of public protection: they suggested that the rights of vulnerable depositors were in need of greater state protection, especially because the state had implicitly endorsed the Home Bank in granted the institution a charter. This extraordinary action, they argued, had led unwitting depositors to assume that Parliament would ensure that the bank was behaving prudently and
living up to high standards. Accordingly, the majority of Canadian policymakers came to agree that Parliament owed something more to depositors. Mr. Hocken, a Conservative member of Parliament, draws from this frame to explain why the majority of Canadian policymakers agreed that Parliament had a duty to reimburse the Home Bank’s depositors for their losses:

I want to suggest...that the [government] should indemnify all those who held savings deposits in that bank. I differentiate the savings account from the open and business account. Savings accounts are held by widows and by poor men who save ten dollars at a time; sometimes they are trust funds. They were put in there in the belief that when Parliament chartered that bank it was going to take some precautions to protect those deposits...I for one would be willing to support any measures that would give to these widows and poor men – mechanics, laborers, and servant girls – the money that they deposited there in good faith, depending on the government for their protection (Hansard, House of Commons, March 10, 1924: 183).

The same line of argument was used to support the creation of a government office of bank inspection. Even most members of the Conservative party, who resisted all other reform efforts, agreed that the Home Bank crisis had revealed a need for the state to do more to safeguard the public’s right to a safe and stable banking system. The following quote from Mr. Meighen, a Conservative MP, is representative of the general sentiment among these policymakers:

I have no question mark in my mind at all as to the wisdom of government inspection so long as its efforts are directed toward reasonably safeguarding the public of Canada (Hansard, House of Commons, June 11, 1924: 3045).

The answer, the proponents of this reform initiative argued, was to establish a government office that would be charged with implementing regulations that would prevent chartered banks from violating depositor rights to the safeguarding of their funds by carefully scrutinizing whether banks were adhering to established standards. This logic is reflected in the arguments of Mr. Shaw, a Member of Parliament who identified as Independent:

It is unnecessary for me to remind the house that Parliament is charged with the responsibility of furnishing adequate credit facilities to the people of Canada...Parliament saw fit to delegate this duty to certain quasi-public
corporations, subject to certain rules and regulations...Under the terms of the Bank Act the banks have been given many special and important privileges. The providing of credit to the nation has been exploited – and I do not use that word in any improper sense - by the banks for the purpose of making private profit; the banks are entitled to that privilege under the act as it now stands. We have provided by the act that from month to month, semi-annually and also annually, the bank shall make reports to the Finance department, but that department have been of little value so far is **checking up or making any careful scrutiny of these returns is concerned**. I do not think that anyone, not even the Minister of Finance, will dispute that statement (*Hansard*, House of Commons, July 2, 1924: 3921).

The proposal to create an Office of the Inspector General of Banks with limited regulatory and supervisory powers passed both the House of Commons and the Senate virtually unopposed in July 1924, which represented a triumph of the **frame of public protection over the frame of private autonomy**. However, it is important to note that even with the new bank inspectorate, the Canadian banking system remained heavily dependent on private (and self) regulation. The new Inspector General was granted few independent powers: the official was limited to reporting problems observed in the banking system to Parliament, which retained the authority to sanction or close wayward banks. The Canadian regulatory system also remained heavily reliant on external audits conducted by private firms. The self-regulatory character of the Canadian banking system is particularly pronounced in contrast to the American regulatory and supervisory system.

*Failed Reform Proposals: The Triumph of Private Autonomy*

Progressive reform advocates may have won the battle over government bank inspection, but they largely lost the war. Progressive policymakers proposed four additional major policy reforms immediately after the Home Bank crisis; however, motions to refer these policy reforms to discussion by a committee were repeatedly denied, which effectively killed them. The majority of Canadian policymakers appeared to agree that creating a new bank inspectorate was
going quite far enough. The additional reforms included the establishment of a Canadian central bank, modeled on the U.S. Federal Reserve System; the creation of a federal deposit insurance system; a switch to a national currency and the end of private bank note issuance; and the creation of a government inspector for trust companies. Proponents of all four reforms offered arguments framed in public protection terms. They argued that a central bank would “protect the rights of the public against anybody who may seek to encroach on them hereafter” by increasing the security of deposits and augmenting the stability of the system (Hansard, House of Commons, July 2, 1924: 3927; 3932, 3935; 3955); deposit insurance would perform a similar role; government inspection of trust companies was needed to protect the rights of shareholders and small creditors (Hansard, House of Commons, June 11, 1924: 3047); and a national paper currency would restore control over credit back to the hands of the public, to which it properly belonged by right (Hansard, July 2, 1924: 3932, 3957). In short, all four reforms were framed as initiatives that would restore order by protecting the rights of smaller and weaker individuals (depositors, borrowers) from infringement by large and powerful economic actors (chartered banks).

Why did a government office of bank inspection succeed, while the rest of these proposed remedies failed? I suggest that the government office of bank inspection represented less of a violation of the frame of private autonomy than any of the other proposed reforms, which may explain its comparative success. Liberal and Conservative policymakers were particularly concerned that both the creation of a central bank (as a powerful, separate administrative body) and the creation of a national currency would either make the banking system an engine of the state or expose this system to ineffective political interference (e.g. Hansard, House of Commons, July 2, 1924: 3923). For many Canadian policymakers, including
Thomas Vien, a member of Parliament from the Conservative party, these reforms represented a serious violation of core Canadian principles:

There are in this house and in the country today a certain number of people who find everything wrong with our banking system, and who would like to reformat, not by the ordinary course of evolution, but by drastic measures which would be in effect an actual revolution of the system. This frame of mind is understandable...the Home Bank failed. Hon. Gentlemen say that if we had a Federal Reserve board for a Federal Reserve Bank such difficulties as these would not occur. I say, Sir, it is a mistake. It is an error of principle; it is the wrong way of reasoning (Hansard, House of Commons, July 1, 1924: 3917):

For similar reasons, most Canadian policymakers opposed the creation of a federal deposit insurance system. The concern was that deposit insurance would threaten the mechanism that produced order in the Canadian banking system: the invisible hand. Deposit insurance threatens the principle of private autonomy, as it forces good banks to bear the cost of bad banks failing. It also changes the self-interest of the public, and prevents them from caring about the health of the bank:

The mutual guarantee of deposits has proven unworkable in the United States [state deposit insurance systems] and is basically unsound as it means that the conservative and properly operated bank would be called upon to bear the losses through mismanagement, fraud, and otherwise incurred by competitors over whom it has no control. The final outcome would only be a disaster as the public would not be called upon to discriminate between sound institutions, with whom their funds would be safe, and the others (Canada Department of Finance 1924, quoted in Carr, Mathewson, and Quigley 1995).

The arguments of deposit insurance opponents in Canada echoed the arguments of deposit insurance opponents in the U.S. However, while the debate over deposit insurance was framed as a choice between the preservation of deconcentrated financial system and the free operation of the competitive mechanism in the U.S., it was framed as a choice between the preservation of the autonomy of private economic actors and the preservation of the depositor’s right to safeguarded funds in Canada.
The same conflict between the *frame of public protection* and the *frame of private autonomy* also structured the content of the policy debates that followed the banking crises of the Great Depression. Although no Canadian bank failed during the Depression, many did suffer heavy losses, and all banks curtailed their lending, an event that hit Western farmers particularly hard. Like American policymakers, Canadian policymakers after the banking crises of the 1930s also faced strong populist demands for banking reform. However, once again, the Canadian response was characterized by a lack of response. The one major change was the creation of a central bank in 1935. However, Canadian policymakers gave this institution a minimal role to play in the economy and left it structured as a private institution until 1938. During the same period, Canadian policymakers also rejected a number of additional reforms, including the nationalization of the banking system, that had been advanced by advocates who offered arguments that drew from the *frame of public protection*. Similarly, reform opponents after the Depression, like reform opponents after the Home Bank crisis, offered arguments that drew from the *frame of private autonomy*. The arguments offered by Minister of Finance Ilsley, which touch upon nearly every taboo possible under the *frame of private autonomy*, are generally representative:

If we do not want a socialist state, we do not want a socialized commercial banking system to *deaden the initiative of our system of free enterprise*. We do not want this government or any other government to have a *monopoly* of the business of lending for commercial purposes nor even of the business of keeping the people’s banking accounts. The relation between banker and borrower, and between banker and depositor is a private, confidential relationship. A large proportion of our citizens would *not want any government*, even one which they support, to *intervene* in this confidential relationship or to be privy to it. But a far more important point is the undesirability of having the credit of each of us and of every business throughout the country *assessed by civil servants working under political control* for a *government banking monopoly*, rather than by bank managers interested not in the political or other views of the borrower but solely in his ability and trustworthiness as a debtor (*Hansard*, House of Commons, May 2, 1944: 2546).

**Summary:** Canada
In Canada, the principle of individual sovereignty shaped the types of problems perceived and the range of solutions considered in the policy debates that followed the banking crises of the early 1920s and early 1930s. This principle shaped the way that Canadian policymakers diagnosed the causes of these crises, by directing attention toward the effects of state interference in the economy and away from alternative explanations. It also defined the range of policy solutions to the crises that policymakers considered: all of the proposed reforms were oriented toward the same basic goal of protecting the rights of weaker economic actors from infringements by more powerful economic actors.

But the debates over policy reforms following the Home Bank crisis also brought different elements of the principle of individual autonomy into conflict. Canadian policymakers were forced to choose between preserving the system characteristic that served as critical precondition for order – the preservation of individual rights – and preserving the mechanism that produced order within this system – the private pursuit of self-interest, unrestrained by interference from the state. I demonstrated that arguments that drew from the frame of private autonomy largely triumphed over arguments that drew from the frame of public protection (see Table 3.1). While the few reforms adopted in Canada were advocated for in public protection terms, the dominant trend in Canada was to reject reform. The majority of Canadian reform proposals were defeated, and they were opposed by arguments that drew from the frame of private autonomy. In Chapters 4-6, I explain how both the terms of these debates, and the way this conflict was resolved, informed subsequent developments in Canadian banking regulation in the twentieth and twenty-first centuries.

CRISIS AND POLICY DEBATE IN SPAIN
Spain, like the U.S. and Canada, experienced an economic recession in the immediate post-war years that led to problems in the banking system. Banks in the region of Catalonia were hit particularly hard. In the early 1920s, the Catalan banking system experienced a liquidity crisis, which eventually resulted in the collapse of the venerable Bank of Barcelona. The Bank of Spain was aware of problems at the Bank of Barcelona, and initially extended liquidity support to keep the bank afloat. However, after realizing the extent of the Bank of Barcelona’s problems, which suggested that the problem was one of insolvency rather than liquidity, the Bank of Spain withdrew its support. The insolvent Bank of Barcelona closed its doors in January 1921.

**Diagnosing the Crisis: Fragmentation and Absence of Centralized Leadership**

As Spanish policymakers searched for a cause to explain the crisis, they returned to a familiar villain: the absence of centralized coordination and direction in the banking system. Operating under a worldview that emphasized state sovereignty as the key to order, Spanish policymakers were particularly attuned to the potential evils of entities with particularistic interests facilitating financial activity without direction from the top. The disorganized and excessively fragmented structure of the Spanish banking system was diagnosed as the primary cause of the Catalan banking crisis and the collapse of the Bank of Barcelona. Both this diagnosis, and remedies to address this perceived problem, were heavily promoted by the charismatic Minister of Finance, the Catalan politician Francesc Cambó. Drawing from the principle of state sovereignty, Cambó argued that the crisis had emerged because the Spanish banking system suffered from three major deficiencies: excessive fragmentation, which made this system difficult to coordinate and direct; the unwelcome presence of foreign banks, who had increased ruinous competition; and the absence of a strong, centralized industry leader, who could better coordinate and direct activity within the system.
Cambó argued that the fragmented structure of the Spanish banking system had perpetuated the crisis through two mechanisms. First, this fragmentation made it difficult for an external authority to coordinate and direct bank activity. In line with key tenets of the *frame of centralized coordination and direction*, Spanish policymakers were primed to see hazards in banks pursuing their own self-interest in the absence of a strong external authority. As Cambó explains, a key cause of the crisis was believed to be that the Spanish banking system in the post-WWI era had “operated in a spirit of exaggerated individualism, one could even say almost anarchic” (*El País*, 29 December 1981). Policymakers also agreed that this fragmentation had promoted ruinous competition within the Spanish banking system. As Cambó argued, the intensity of competition had generated negative consequences for the system as a whole:

The most prudent banks, the most serene banks, they are encouraged, inevitably, to follow the path that has been marked by the boldest or the most thoughtless, and they must conform themselves to pursuing the types of activities that these [bold and thoughtless] banks have invited them to, because, if they don’t, not only will they not prevent the more general and widespread damage that these types of activities occasion, but this general damage will be accompanied by the specific harm of [the prudent bank] being significantly handicapped in its client relationships (Cambó, quoted in *El País*, 29 December 1981).

Spanish policymakers believed that this ruinous competition was exacerbated by the presence of foreign banks. Cambó argued that the unchecked presence of foreign banks in the Spanish banking industry represented a major threat to the autonomy of the Spanish state, and by extension, to the Spanish people. Finally, Cambó also argued that the Bank of Spain, as the dominant player in the Spanish financial system, was partially responsible for crisis, as it had failed to step up to the plate by providing aid to the Bank of Barcelona when help from this powerful institution was desperately needed. Drawing from the *frame of centralized coordination and direction*, Cambó suggested that the Bank of Spain’s inaction was only a symptom of a
larger problem. The banking system lacked a strong leader that would use its power and authority to promote the general interest, rather than putting its own particularistic interests first.

Debates Over Policy Remedies

To resolve the crisis and prevent its return, Cambó argued that reform was needed. In the reform debates that followed the Catalan banking crisis, both supporters and opponents of particular policy initiatives offered arguments that drew from the principle of state sovereignty. However, in these debates, one cherished frame of regulatory order, *centralized coordination and direction*, faced off against another cherished frame: *balancing interests*. Spanish policymakers were forced to choose between two problematic alternatives: powerful private actors blocking the state’s ability to rationalize and redirect activity within the banking system, or the same powerful actors exiting the coalition that kept the state’s power and economic and political order intact.

In what follows, I explain how this conflict structured debates over policy reforms leaning up to the Banking Law of 1921. These reforms included restructuring the Bank of Spain’s role within the banking system and creating a new regulatory organization to oversee the banking system and establishing a special financing relationship between domestic banks and the Bank of Spain.

*The Bank of Spain as a Central Bank: Imposing Centralized Coordination*

Cambó introduced a draft law in 1921 that aimed at comprehensively reorganizing the Spanish banking system and the Bank of Spain’s role within it. The law had two major objectives: to force the Bank of Spain to take a more active leadership role in coordinating and directing activity in the banking system, and to rationalize and reorganize the remainder of the private banks. In advocating for the need to reform the Bank of Spain’s role in the banking
system, Cambó offered arguments that pulled from key tenets of the frame of *centralized coordination and direction*. As Spanish historian Gomez Ochoa (1991) explains: “[Cambó] aimed to introduce noticeable changes in the economic conception of the state during the Restoration…he strove to **strengthen and update the state apparatus**, adapting it to historical reality and making it a instrument to foment economic development” (translated from Spanish, Gomez Ochoa 1991).

Having diagnosed the crisis as the result of excessive fragmentation and unchecked competition, Cambó argued that the Spanish banking system needed a leader who would step in to rationalize activity and direct it towards a more productive course. What the banking system needed was a strong leader. As the dominant player in the Spanish banking system, with both a privileged financing relationship, the monopoly of issue, and a dominant position in the commercial banking sector, the Bank of Spain was the obvious candidate to assume this position. To rationalize the banking system, Cambó argued, the Bank of Spain would need to transition away from its dominant position within the commercial banking industry and assume a new role as a true central bank or banker’s bank:

> The Bank of Spain, due to the services it has provided to the country and the economic position that has been reached, does not have the structure the country needs…In [an appropriately structured] credit system, the [bank note] issuing bank must operate as a rearguard, leaving the private banks for the leading role, or the economic boldness (translated from Spanish, Cambó quoted in *La Vanguardia*, October 7, 1921).

To further expand the centralized coordination and direction of the banking system, Cambó also sought to enhance the state’s role in overseeing private banking activity. The draft law also proposed to impose government representatives on the boards of both the Bank of Spain and the other private Spanish banks (Gomez Ochoa 1991).
Cambó’s proposed reforms were extremely unpopular with members of all of the major political parties. Few Spanish policymakers disagreed with his diagnosis of the causes of the Catalan banking crisis, but they argued that his proposed remedies would cause more harm than good. Both the center-right political establishment and the far right and left objected to Cambó’s reform of the Bank of Spain, albeit for different reasons. The center-right argued that the reform disrupted order by breaking the implicit compact between the state and powerful groups within Spanish society. In exchange for political allegiance and extensive financing, the state had granted economic and social privileges to these powerful private actors. With the new law, it looked like the state now wanted to take these privileges away. The other bastions of traditional privilege within Spanish civil society did not like the precedent that this set, and resisted any attempt to limit the bank’s privileges. As Gomez Ochoa (1991) wrote:

[The political establishment] came out in defense of oligarchical interests linked to Banco de España, noting their distaste for the subordination of the Bank to the decisions of the state and the needs of private banking…[e]xpressed in other terms, [the law was a problem because it] was willing to put in question some of the privileges enjoyed by an institution that constituted one of the essential socioeconomic forums to the restorationists (Gomez Ochoa 1991).

From the perspective of the political establishment and the far right, a reform that attacked any of the Bank of Spain’s existing privileges, including its ability to dominate commercial banking sector, was tantamount to breaking the contract between the state and civil society that kept order intact. For similar reasons, the same group of actors vehemently objected to the appointment of government representatives to the board of the Bank of Spain.

By contrast, critics of the reform of the Bank of Spain on the left offered different arguments, which drew from the frame of *centralized coordination and direction*. Left-leaning policymakers in Spain had long objected to the Bank of Spain’s monopoly as the sole bank of issue (Tortella and Garcia Ruiz 2013). This extreme concentration of power in private hands was
thought to block the state from effectively serving the public’s interest. Instead, the particularistic interests of this powerful private actor dominated. In other words, they objected to Cambó’s proposed reforms because they believed that the Bank of Spain, as a dominant and privileged private institution, owed the state much more in light of the privileges it had been granted (Paret 1921; Tortella and García Ruiz 2013). The Bank of Spain wasn’t doing enough to help Spain, so it shouldn’t be granted new powers.

In the end, the Cortes passed a considerably stripped down version of Cambó’s original reform proposal. The fact that any reform passed at all has surprised many historians, given the intensity of the opposition (Gomez Ochoa 1991). The Banking Law of 1921 did put an end to the Bank of Spain’s presence in the commercial banking sector, forced the Bank to act as a liquidity provider and lender of last resort, and placed boundaries on its lending to the Treasury. However, the final law dropped the provision increasing the government’s presence on the Bank’s board of directors, a nod to the interests of the far right and center-right (Gomez Ochoa 1991: 263).

*The Consejo Superior Bancario and Privileged Financing for Private Banks*

In addition to forcing the Bank of Spain to adopt a more public-minded role in the banking system, Cambó also sought to restructure the private banking system. To do so, he proposed two additional initiatives: the creation of new regulatory organization, the *Consejo Superior Bancario* (CSB), which was given the responsibility to monitor and oversee the activities of the private banks, and the establishment of a privileged financing relationship between domestic private banks and the Bank of Spain. Foreign banks would not receive this privilege, and would be excluded from operating retail branches in Spain.

The proponents of the creation of the CSB argued that this organization would restore order by enabling the banks within this system to better fend off foreign invaders and by
introducing new rules and regulations that would enhance the safety and stability of the system.

These new regulations were framed as a remedy for the excessive individualism and competition that was believed to have brought the banking system down. This understanding is evident in Cambó’s speech before the Cortes, summarized by Spanish economic historians Martin-Acena, Pons, and Betran (2009):

In his parliamentary speech, Cambó expressed his conviction that, due to their “special nature”, banks and credit companies should be subject to some form of control. The Finance minister told members of Parliament that "the banking industry (...) by its nature cannot be an absolute free industry". Coordination and regulation were needed to avoid excessive competition and individualism, and to defend both the public interest and the stability of the financial structure...Lack of restraint and imprudent behavior such as excessive risk-taking by individual banks could endanger the functioning of the whole financial structure and undermine the soundness of the banking system. Hence, a prudential regulation policy was needed to ensure the well functioning and stability of the banking system” (Martin-Acena et al. 2009: 138).

Cambó offered similar arguments in favor of excluding foreign banks from Spain. The idea was that the exclusion of these banks would cut down on excessive competition. This argument reflected a key tenet of the frame of centralized coordination and direction. To achieve order in the banking system, Cambó suggested that an external authority would need to impose order from above, through regulation. Order would also require consolidating the banking system. In a speech before the Cortes in 1921, Cambó explains this logic:

Then [opponents of reform] spoke of the enormous sacrifices imposed on the state...we talked about the constitution of the Consejo Superior Bancario, its unconstitutional power... stronger than the Parliament and the King. [Opponents argued that this organization] would hand out Spanish territory and tear apart the country, [Spain] would be converted into Manchuria and Mongolia, to satisfy certain appetites. But as I understand it, the Mongolian’s embarrassment was serving as a pasture for the appetites of the foreigners that did business with them, instead of being organized by national forces, and it seems to me that if the Mongolians could advise Spain with regard to Spain’s financial situation, they would be calling attention to the instances of weakness, not yet disappeared, in our private banking system, whose weakness has allowed foreign banks to invade this country...[we need to] strengthen Spanish banking, to create a
proprietary Spanish banking organization that can shield our economy from excessive predominant infiltration of foreign banks (Francesc Cambó: Discursos Parlimentaris 1991: 738).

Cambó also used this logic to argue for the establishment of a privileged financing relationship (rediscount rate) between domestic private banks and the Bank of Spain. The idea was that giving domestic banks (but not foreign banks) a preferential rate would promote order by consolidating economic power within the domestic banking system, which would place foreign invaders at a disadvantage.

Cambó also argued that the same initiative would induce the private banks to accede to this new regulatory regime. To get buy-in from the established banks, the state had to give these institutions something in return. Just as the state under Ferdinand IV had been forced to grant privileges to the aristocracy to secure their acquiescence to his rule, Cambó argued that the state needed to grant powers and privileges to Spanish banks to secure their support for reform:

This bonus scheme is granted to the private banks as a quid pro quo, that is, as a submission to restoring order to the banking system…Recall the drawbacks of the terrible banking competition, in which the most conservative institutions were pummeled by the most bold, and the desire of these banks to be reinforced by a system that operates more prudently. In other countries the banking order arises spontaneously, but in Spain order in the banking system has to be imposed. With this system, an aristocracy of banks will arise, composed of those banks that have submitted to the imposed order. In this system, the Bank of Spain will carry out all inspections, and will take care of auditing the private banks (La Vanguardia, 27 October 1921: 13).

Opponents of the CSB and the preferential financing rate offered arguments that drew from the frame of centralized coordination and direction. On the one hand, many of the reform opponents took issue with the degree of power that the new reforms gave to existing banks. Although the CSB would be nominally controlled by the state, it primarily consisted of representatives from Spain’s six largest private banks. The extent of private control over this regulatory institution was believed to threaten the state’s centralized power in the banking
system. This understanding is evident in the way that Cambó described the arguments of the opponents of the CSB:

Mr. Riu said: ‘It’s like, in approving the project, Parliament and Government are alienating their own power to regulate private banking, because it delimits the field of intervention and would concede to this to the body that dominates the private banks.’ I must say that this was never my thinking, I think the project saves the prerogatives not only of Parliament but of Government (Francesc Cambó: Discursos Parlamentaris 1991: 752).

The idea was that the CSB, in allowing banks to run themselves, was placing the satisfaction of the particularistic interests of these institutions over the general good. This understanding is evident in the writings of critics like journalist Luis Olariaga, who argued in an editorial in La Vanguardia, a Liberal Catalan newspaper, that this represented no kind of reform at all:

[In the proposed law], regulation of private banking is delegated to a Superior Banking Council, in which the public power will not be represented and the representatives of banks will be in the majority - that is, the banks will be permitted to run themselves. In the United States, banks are regulated by statute, and the regulatory, inspection, and correction functions...are performed by banking institutions that are regulated by a Federal Council, represented directly and exclusively by the state, whose members "will not enjoy representation or employment in any bank while performing the job and for two years afterward." Not that we are enthused by such legal arrangements in Spain - where we can not forget the words of the English specialist Harvey Withers: ‘the good banking system isn’t made with good laws, but with good bankers” – nor do we believe that it would be simple to effectuate that kind of precept in our country; but “restoring order” is the title of the bill before us, and is, according to Minister of Finance, its main justification, so it is no wonder that this element is missed. Because if not [to restore order], for what reason have we sacrificed other parts of the project that are of vital interest to the national economy and the state? (Olariaga 1921: 3, translated from Spanish).

Both the creation of the CSB and the privileged financing relationship between private banks and the state were included in the final version of the Banking Law of 1921, representing a triumph of the frame of balancing interests over the frame of centralized coordination and direction.

Summary: Spain
In Spain, the principle of state sovereignty shaped the types of problems perceived and the range of solutions considered in the policy debates that followed the banking crises of the early 1920s. This principle shaped the way policymakers diagnosed the causes of these crises, by directing attention toward the fragmented structure of the banking system and the absence of centralized leadership, and away from alternative explanations. It also defined the range of policy solutions Spanish policymakers considered: all of these solutions were oriented toward rationalizing and strengthening the domestic banking system through consolidation and centralized oversight.

However, the debates over policy reforms that followed the Catalan banking crisis brought different elements of the principle of state sovereignty into conflict. Spanish policymakers were forced to choose between preserving the mechanism that produced order within this system - a powerful, centralized external authority – and preserving the structure that allowed the state to effectively serve its facilitating function: the system of privilege and patronage that allowed the state to secure sufficient buy-in from powerful groups. Examining each reform effort in turn, I show that arguments that drew from the frame of balancing interests narrowly triumphed over arguments that drew from the frame of centralized coordination and direction (see Table 3.1). Both the terms of this the debate, and the ways that the conflict was resolved, would inform the subsequent development of Spanish banking regulation in the twentieth and twenty-first centuries.
CHAPTER 4: FINANCIAL DEREGULATION IN THE U.S., CANADA, AND SPAIN

After two decades of postwar prosperity, American, Canadian, and Spanish policymakers began to confront serious economic problems in the 1960s and 1970s. In all three countries, rising inflation led to problems in the financial system. Policymakers in each country had previously placed restrictions on the interest rates that banks could offer depositors or charge to borrowers. These interest rate controls led to different types of problems in different types of financial systems, but they generally caused headaches for policymakers and regulators everywhere. In the market-based financial systems of the U.S. and Canada, these interest rate controls led to disintermediation, or the outflow of financial resources outside of the banking sector into alternative types of financial institutions or investments. However, in the 1960s and 1970s, general interest rates climbed to levels that American and Canadian banks, constrained by statutory restrictions on the interest rates they could offer savers, could not match. The result was that American and Canadian savers increasingly withdrew their funds from banks, and deposited them with financial institutions that faced fewer constraints. In the bank-based financial system of Spain, the interest rate controls frustrated the ambitions of monetary policymakers. These rate restrictions prevented these policymakers from developing tools (e.g. a working money market) that would allow them to inject liquidity into the banking system in a discretionary and systematic way (Pérez 1997; Lukauskas 1997).

By the end of the 1980s, policymakers in all three countries had responded to these problems by eliminating all interest rate controls on bank lending and deposits. However, each country took a very different path to the deregulation of interest rate controls. Canadian policymakers deregulated interest rate controls relatively early, in 1967, soon after inflation
began to cause problems in this country (Slater 1968; Freedman 1998). American policymakers took the opposite approach. In 1966, they extended deposit rate ceilings to a new class of financial institutions, and took an additional fourteen years (until 1980) to deregulate interest rate controls for any type of financial institution. American policymakers did not eliminate all interest rate controls for banks and thrifts until 1986. The Spanish approach to deregulating interest rate controls fell between these two extremes. Spanish policymakers started to deregulate much earlier than American policymakers (in 1974); however, the deregulation proceeded slowly in this country. Spanish policymakers did not repeal all interest rate controls for banks and thrifts until 1987 (Pérez 1997; Tortella and García Ruiz 2013; Lukauskas 1997). While this chapter focuses exclusively on explaining the comparative pattern in the deregulation of one particular restriction, interest rate controls, a similar comparative pattern also characterized the deregulation of other restrictions, including limitations on bank branching, the enforced separation of investment and commercial banking, and limits on permissible activities for banks and other types of financial institutions (see Table 4.1).

**Table 4.1. Patterns of Financial Deregulation in Major Financial Capitals, 1967-1999**

<table>
<thead>
<tr>
<th>Country</th>
<th>Remove Interest Rate Controls</th>
<th>Expand Thrift Activities</th>
<th>Eliminate Branch Restrictions</th>
<th>Combine Invest/Commercial Banking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>1967</td>
<td>1967</td>
<td>-</td>
<td>1987</td>
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<tr>
<td>Germany</td>
<td>1967</td>
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<tr>
<td>UK</td>
<td>1971</td>
<td>1986</td>
<td>-</td>
<td>1986</td>
</tr>
</tbody>
</table>

*Note: This date marks the initiation of interest rate control deregulation. These ceilings were gradually phased out in both the U.S. and Spain. Interest rate controls were eliminated in the U.S. in 1986 and in Spain in 1987. I use “-” to indicate cases where deregulation did not occur because the regulatory restriction never existed in the country.
In this chapter, I explain how the frames of regulatory order embodied in the American, Canadian, and Spanish regulatory systems that emerged after the 1920s and 1930s carried forward to shape financial deregulation in the 1960s and 1970s. In the previous chapter (Chapter 3), I explained how the regulatory system that emerged in each country after the banking crises of the 1920s and 1930s reflected the triumph of one frame of regulatory order over an alternative frame. In the U.S., the regulatory system embodied the frame of deconcentration; in Canada, the frame of private autonomy; and in Spain, the frame of balancing interests. In the current chapter, I suggest that the “winning” frame in each country structured the pace and pattern of financial deregulation by shaping the size of the hurdle that the proponents of deregulation had to overcome. I argue that deregulation started earlier and proceeded more quickly in countries where pro-deregulation arguments resonated with the frame of regulatory order that the existing regulatory system embodied.

In what follows, I argue that the arguments of Canadian deregulation proponents drew from key tenets of the frame of private autonomy, the frame embodied within the existing Canadian regulatory system. This correspondence between the arguments of deregulation proponents and the dominant frame of regulatory order in Canada helps to explain why Canadian policymakers were relatively receptive to the deregulation of interest rate controls as a solution to the economic difficulties of the 1960s, and consequently, why these controls were repealed relatively early and quickly in this country. By contrast, American deregulation proponents offered arguments that drew from the frame of competition, the frame that had lost in the reform debates of the 1930s. The lack of correspondence between the arguments of deregulation proponents and the frame of regulatory order that the U.S. regulatory system embodied (the frame of deconcentration) helps to explain why American policymakers were less receptive to
the deregulation of interest rate controls as a solution to the economic difficulties of the 1960s. The arguments of Spanish deregulation proponents drew from both the *frame of balancing interests* and the *frame of centralized coordination and direction*. Initially, Spanish policymakers rejected the arguments of pro-deregulation reformers, who framed interest rate controls as structures that blocked state control over monetary policy, in favor of the arguments of a group of pro-intervention reformers, who framed interest rate controls as tools that facilitated state control over activity in the banking system. Spanish policymakers became more receptive to the arguments proffered by the advocates of financial deregulation after the interventionist credit regulation framework that the latter group promoted appeared to fail. To understand the relatively early adoption and delayed pace of financial liberalization in Spain, it is important to note how deregulation advocates framed interest rate controls (as structures that distorted order by giving powerful private banks tools to resist the state’s reform agenda), and to attend to how this framing resonated with the *frame of balancing interests* embodied within the existing Spanish regulatory system.

**THE SLOW DEREGERULATION OF INTEREST RATE CEILINGS IN THE U.S.**

In Chapter 3, I explained how American policymakers debated, and eventually adopted, placed limits on the maximum interest rates American banks could offer depositors as part of the Banking Act of 1933. This mechanism, also known as Regulation Q, also served as a mechanism that kept credit expansion and inflation in check (Krippner 2011: 62). When general interest rates exceeded the Regulation Q ceiling (e.g. the maximum interest rate that banks were allowed to offer on deposits), savers recognized that they could achieve better returns elsewhere, and responded by withdrawing their funds from banks. Banks, lacking the funds to finance new loans, responded by withdrawing credit, especially to consumers. Although this very blunt credit
regulation tool caused some consternation among borrowers, this system worked more or less effectively in the period between 1933 and the early 1960s (Krippner 2011: 62).

In 1959, inflation spiked in the United States (see Figure 4.1). Concerned about the potential for disintermediation and the effects of a credit crunch on the real economy, regulators at the Federal Reserve responded by raising the Regulation Q ceiling four times between 1959 and 1966 (Krippner 2011: 65). This initiative achieved its intended purpose of attenuating the flow of savings out of commercial banks. However, it also had an unintended consequence: it increased the flow of savings out of a different type of American financial institution, the thrift. Thrifts, also known as savings banks or a savings and loan associations, operate similarly to banks in that they take in deposits and issue loans. The main difference between thrifts and banks is that thrifts lend primarily to consumers (especially in the form of mortgages), while banks have historically lent primarily to businesses.
By the time that inflationary pressures intensified in the mid-1960s, American banks and thrifts were already embroiled in heavy competition for a dwindling pool of consumer savings (Krippner 2011). The intensifying competition between these institutions concerned American policymakers, who believed that this situation was fueling inflationary dynamics. The idea was that banks and thrifts, in an effort to outbid each other for savings, were raising rates on deposits (Interest Rates and Mortgage Credit 1966). They also believed that activity on one side of the balance sheet (deposits) was affecting activity on the other side (loans): as banks and thrifts increased the interest rates they offered on deposits, they inevitably increased the interest rates they charged on loans, especially mortgage loans. The cost of credit began to increase substantially, angering borrowers and consumer groups (for a detailed discussion, see Krippner 2011: 64-68; Prasad 2012).
American Policymakers Extend Deposit Rate Ceilings to Thrifts

In 1966, following another sharp increase in inflation, American policymakers moved to extend deposit rate ceilings, which had previously only applied to banks, to thrifts as well. Thrifts had historically been free to offer market interest rates on passbook savings accounts, but after 1966, they were constrained to offering rates that were only slightly higher than those offered by commercial banks. This slight difference in permissible interest rates that could be charged by thrifts vs. banks was termed the Regulation Q differential. I argue that the relative salience of the frame underlying the structure of the American bank regulatory system after the Great Depression, the frame of deconcentration, explains why American policymakers chose to expand interest rate controls to this new group of financial institutions, rather than dismantling these rate controls altogether (the Canadian approach).

In the U.S., rate ceilings on deposits were tightly linked to the preservation of the deconcentrated structure of the American financial system. During the reform debates of the 1930s, advocates of the Regulation Q rate ceilings had framed these structures as tools that would ensure the continued survival and independence of local community banks by cutting down on destructive and excessive rate competition between banks. They had also framed these structures as safeguards that would prevent risk-seeking banks from abusing the federal deposit insurance system. I argue that the tight coupling between the Regulation Q interest rate controls and the preservation of this deconcentrated structure helps to explain why American policymakers did not seriously consider eliminating these controls until after 1966. In other words, the federal banking regulators and the vast majority of American policymakers supported the expansion of the Regulation Q deposit rate ceiling to thrifts because this structure was part of
the foundation of the regulatory framework that was believed to keep the deconcentrated structure of the American financial system intact.

The comments of Undersecretary of the Treasury Joseph Barr during a 1966 hearing on the question of reforming interest rate controls illustrate the connection that American policymakers perceived between restraining competition over deposit interest rates and preserving the deconcentrated structure of the banking system. Responding to a question from committee Chairman Robertson, Barr acknowledges that interest rate controls restricted the free operation of market mechanisms, but he contends that preserving these controls was justified because of the vital role they played in ameliorating threats to the stability of the deconcentrated and fragmented American financial system:

[An interest rate] is a commodity that does fluctuate with supply and demand pressures. The Congress reached a decision in the 1930’s, however, that unbridled competition in a situation where we have 14,000 banks and 7,000 thrift institutions in the United States was not in the best interests of the country. The Congress came to this conclusion after reviewing the experiences of the Depression, and they gave to the Federal Reserve Board and the FDIC the authority to set a ceiling on the amounts that banks could pay. We are here recommending today that that authority be broadened and extended to the other half of the mortgage market (Interest Rates and Mortgage Credit, August 4, 1966: 8).

In short, Barr and his fellow reform proponents, which included the federal banking regulators, drew an analogy between the perceived problems that American policymakers confronted during the Depression (excessive competition over deposit rates, which had required policymakers to impose deposit rate ceilings) and the problems they confronted in the mid-1960s. These reform proponents argued that the problem was that banks and thrifts were currently engaged in unproductive and excessive competition over deposit rates, which threatened the stability, independence, and survival of both industries (Interest Rates and Mortgage Credit 1966). Accordingly, one obvious solution was for policymakers in the 1960s to do as the Depression-era
policymakers had done: expand deposit rate ceilings to prevent this undesirable behavior. This understanding of both cause and solution is also evident in the arguments Barr offered in favor of expanding deposit rate ceilings to thrifts:

[T]he record of July, the month just passed, indicated to us that if we are to have any effective ceiling on what we consider to be potential excessive rate competition, you cannot put a ceiling on one-half of the savings in the United States, those in commercial banks, and leave the ceiling off of the other half of the savings in the United States, those in the thrift institutions, the savings and loan associations and the mutual savings banks. We are convinced, as I say, that the record of July indicates strongly that, if you are going to have any effective restraint on excessive rate competition, you are going to have to cover the whole area, thrift institutions, as well as commercial banks (Interest Rates and Mortgage Credit, August 4, 1966).

It is clear that American policymakers in both the House and the Senate found this line of argument convincing. In 1966, legislation extending deposit rate ceilings to thrifts passed easily and with minimal debate (Gilbert 1986). The expansion of deposit rate ceilings to thrifts received tepid support from American commercial banks; however, it was heavily opposed by the American thrift industry (Interest Rates and Mortgage Credit 1966: 102). Thrifts were accustomed to offering market rates on consumer deposits, and they feared (correctly) that the imposition of rate controls could only lead to the further outflow of savings outside of thrifts (Interest Rates and Mortgage Credit 1966: 102).

It is important to note that when American policymakers and regulators were initially confronted with evidence of inflation-induced problems in the financial system, they did not see the repeal of interest rate controls as a valid solution. At the time, American policymakers saw no problem with the state intervening to impose restrictions that would ensure that banks and thrifts remained healthy, independent, separate, and fragmented institutions. The American commitment to the frame of deconcentration helps to explain why most policymakers and regulators sought to tweak (rather than dismantle) the system of interest rate controls that had
started to cause havoc in the financial system. By contrast, the majority of Canadian policymakers in this period (drawing from the frame of private autonomy) viewed these interest rate controls differently, regarding them as a form of inappropriate and discriminatory state interference with private economic activity. I suggest that these differences in prevailing American and Canadian perceptions of interest rate controls helps to explain why American policymakers chose to extend these deposit rate ceilings to new financial institutions in 1966, while Canadian policymakers chose to repeal these controls entirely in 1967.

**Retaining Rate Ceilings Despite Regulatory/Administrative Opposition**

By 1973, the American federal banking regulators and the Nixon administration had changed their minds about deposit rate ceilings. After a spike in inflation in the early 1970s caused another serious episode of disintermediation for both American commercial banks and thrifts, the policymakers deduced that the expansion of rate ceilings to thrifts had not sufficiently addressed the problems in the American financial system. The banking regulators at the Federal Reserve began to argue that ongoing disintermediation presented a serious threat to the safety and solvency of all deposit-taking institutions. On July 5th, 1973, the Federal Reserve responded to the most recent episode of disintermediation by permitting commercial banks to offer a time deposit without an interest rate ceiling: these deposits were known as “wild card” certificates (*The Credit Crunch and Reform of Financial Institutions* September 10, 1973: 316-7). The introduction of the wild card certificates did promote a return of savings to banks - but they also produced a massive outflow of funds from thrifts. These circumstances led the Federal Reserve to withdraw these certificates less than four months later, and Congress called multiple hearings to discuss the issue.
By this point, the administration and the federal banking regulators were extremely frustrated. It was clear that extending deposit rate ceilings to thrifts had not produced the expected benefits, as William E. Simon, Deputy Secretary of the Treasury, explained before the Senate Subcommittee on Financial Institutions:

Interest ceilings on savings accounts have failed to achieve their objectives. Contrary to expectations, they did not protect the liquidity of thrift institutions by preventing an outflow of funds during periods of tight money, nor did they produce funds for the mortgage market (Financial Structure and Regulation, November 6, 1973: 25).

Having exhausted the option of expanding Regulation Q, the administration and the federal banking regulators saw no alternative but to get rid of these interest rate controls altogether. At this point, they began to publicly support the gradual elimination of deposit rate ceilings for both banks and thrifts, as part of a larger plan to restructure the American financial system (The Credit Crunch and Reform of Financial Institutions, September 10, 1973; Financial Structure and Reform, November 6, 1973).

However, by 1973, the thrifts had changed their minds on deposit rate ceilings too. Although the thrift industry had initially opposed the extension of the Regulation Q framework to thrifts, the industry had since come to see the small differential they enjoyed under Regulation Q as necessary for their continued survival. The wild card episode had only solidified their position on this issue, by giving the thrifts a preview of what would happen in a world without deposit rate ceilings. Thrifts did not like what they had seen (The Credit Crunch and Reform of Financial Institutions, September 10, 1973: 58-59). Testifying in hearings before Congress, representatives of the thrift industry mobilized familiar deconcentration arguments in support of their new position on maintaining deposit rate ceilings (and the Regulation Q differential). Now,
it was the thrift industry’s turn to draw analogies to the competitive rate wars that had caused so much destruction during the Great Depression:

There are a number of economists, government officials and businessmen who feel the only reason for savings deposit rate controls is to protect thrift institutions. They have forgotten that uncontrolled rate competition and savings rate wars can threaten our entire financial fabric. The experience of the past two months, with deposit rates partially unbridled, should prove the fallacy of such thinking. While Congress recognized the need for deposit interest rate controls and on June 30, 1973 passed a law to accomplish this end, the Federal Reserve saw fit to virtually negate this law on July 5 (The Credit Crunch and Reform of Financial Institutions, September 10, 1973: 60).

It became clear that the 1966 extension of the deposit rate ceiling to thrifts, a policy shift that had gone largely unremarked and unchallenged at the time, had powerful political and institutional implications. The extension of Regulation Q to thrifts had changed the political landscape by giving the powerful American housing industry a vested interest in preserving these rate ceilings and the thrift differential. The homebuilding industry received almost half of its financing from thrifts, and its representatives believed that the differential was necessary to keep these institutions intact and lending (Housing and Financial Reform, December 11, 1974). For similar reasons, organized labor also supported the preservation of Regulation Q and the thrift differential.

I suggest that this new connection between the preservation of interest rate ceilings and the preservation of specialization and diversity within the American financial system (e.g. by ensuring that thrifts continued to operate as healthy, independent institutions) helps to explain why American policymakers continued to retain interest rate controls even after these controls were no longer supported by the federal banking regulators or the administration. In extending deposit rate ceilings to thrifts, American policymakers had created yet another linkage between interest rate controls and the preservation of a deconcentrated financial system.
Many American policymakers in this period were concerned about the prospect of the financial system turning into a “one bank” financial system, in which all financial institutions shared a similar structure. Operating within a regulatory system that embodied the frame of deconcentration left American policymakers primed to see problems in a lack of diversity in financial institution structure and function. These concerns about the repeal of interest rate controls leading to the creation of a “one-bank” system are evident in the following questions Senator Hathaway (D-ME) posed to a representative of a presidential commission appointed to study the structure and regulation of the nation’s financial institutions:

Did the Commission give any thought to greater diversity, to getting away from the trend toward a one-bank system and making suggestions for greater diversity so that we in turn would have greater competition, so that we would have more ways in which both the borrower and the depositor would have greater choices? (The Credit Crunch and Reform of Financial Institutions, September 10, 1973).

**Pro-Deregulation Arguments Draw from a Less Convincing Frame**

The American proponents of deregulating interest rate controls offered two types of arguments in support of their position. One group of deregulation proponents attempted to argue against key tenets of the frame of deconcentration by denying that the rise of more powerful, consolidated financial institutions would threaten the fragmented and specialized structure of the financial system. The following arguments from Deputy Secretary of the Treasury William Simon are generally representative:

Specialty boutiques can compete against large department stores…[i]s the banking system different? Of course not. There will always be a demand for the small and personal or specialized bank or savings and loan association. Homogenization of the U.S. banking system will not occur, just like it has not occurred in any other U.S. industry (Financial Structure and Reform, November 6, 1973).

A second group of deregulation proponents offered pro-reform arguments that drew from the frame of competition. In his testimony before Congress, FDIC Chairman Wille acknowledged
that greater deposit rate competition might threaten the survival of thrifts as independent institutions (in clear violation of the frame of deconcentration), but the advantage was that the same rate competition would restore order by reinforcing the competitive mechanism through which order was believed to emerge:

Moreover, while greater deposit rate competition could have a significant impact on the earnings of banks or thrift institutions, I do not feel that the public is well served by the present policy which insulates banks and thrift institutions from competition to the degree that high earnings are assured even for institutions with questionable management quality (Financial Structure and Reform, November 6, 1973: 39).

Banking regulators at the Federal Reserve also offered arguments in favor of the liberalization of interest rate controls that drew from the frame of competition. The idea was that the rate controls had disrupted order by disturbing the natural process of bank and thrift adjustment (e.g. the destruction, through competition, of unfit and unprofitable institutions) to a changing market environment:

Along with the liberalization of thrift institution asset powers, the Board strongly endorses the gradual elimination of deposit interest rate controls. We believe that such controls are anticompetitive, inequitable to small savers, and can be disruptive to financial and housing markets. By restricting competition among commercial banks and thrifts, deposit rate ceilings have retarded the adjustment of many of these institutions to a changing market environment (Regulation Q and Related Measures Federal Reserve Board of Governors: 831).

In the end, the arguments of deregulation opponents, framed in deconcentration terms, initially triumphed over the arguments of deregulation proponents, framed in public protection terms. The repeal of interest rate ceilings continually returned to the legislative agenda over the next seven years, as problems in both the banking and thrift industries continued to mount, but the institutional and political dynamics outlined above limited the success of the calls for reform. This stalemate between the supporters and opponents of deregulation was only broken in 1980, after a series of legal battles that effectively forced the hands of American policymakers in this
area (see Krippner 2011: 80-81). In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), which established schedule for the gradual phase-out of deposit rate ceilings for both banks and thrifts. All deposit rate ceilings were finally eliminated in 1986.

Summary: United States

In short, I argue that the deregulation of interest rate controls proceeded more slowly in the U.S. than in Canada or Spain because the American proponents of deregulation found it harder to offer arguments that resonated with the frame of regulatory order that was embodied in the existing American regulatory system after 1933: the frame of deconcentration. In short, it was hard for American proponents of deregulating deposit rate controls to argue that this reform wouldn’t result in a more concentrated and less specialized financial system, whatever its benefits. American deregulation proponents faced the same difficulty in arguing for other reform proposals during this period, e.g. the expansion of permissible thrift activities, the elimination of bank branching restrictions, or the end of enforced separation between investment and commercial banking. I argue that this explains why American policymakers initially chose to extend interest rate controls to both banks and thrifts, rather than getting rid of these controls altogether, and why the reform of interest rate controls took so long in this country. In 1966, interest rate controls were framed as restrictions that preserved the deconcentrated structure of the American financial system, and repealing these controls was not seen as a serious option. By 1973, the federal banking regulators and monetary policymakers had become disenchanted with the Regulation Q interest rate controls and sought to repeal them. However, by this point, the damage had already been done. In extending interest rate controls to thrifts, American policymakers had linked the preservation of this structure to the preservation of the
fragmentation and specialization of independent institutions within the financial system. This connection helps to explain why American policymakers were so hesitant to repeal interest rate controls throughout the 1970s, even as these rate controls repeatedly caused serious headaches for both policymakers and banking regulators.

**RAPID DEREGULATION OF INTEREST RATE CEILINGS IN CANADA**

While Canadian policymakers never followed American policymakers in imposing a ceiling on deposit rates, they did cap interest rates on bank loans. The rate cap was adopted in the 1940s, as part of an effort to keep credit affordable during the dramatic Canadian economic expansion of the post-war years (Puri 2012: 162). Canadian banks were limited to charging an interest rate on loans that was no higher than six percent. The Canadian rate ceilings generated Regulation Q-like effects, because limiting returns on bank loans also effectively limited the rates that banks could their offer depositors. However, this was not the intended objective of this policy.

Starting in the late 1950s and early 1960s, the interest rate ceiling for chartered banks began to have serious effects for competitive dynamics within the Canadian financial system. This period was marked by the emergence and growth of a new type of financial institution: the near bank. These near banks, which included credit unions, *caisses populaires*, mortgage loan companies, and trust companies, began to compete effectively with the chartered banks in multiple areas, including savings deposits and term deposits of Canadian households and firms, as well as some lending businesses, particularly mortgages and personal loans (Shearer, Chant, 2012).

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23 Canadian chartered banks could charge no more than a 6 percent interest rate on loans. Banks in the U.S. also faced similar caps on lending interest rates, but these restrictions (“usury laws”) varied by state.

24 Canadian policymakers also imposed relatively high reserve requirements (8 percent) on both time and demand deposits, which generated similar effects (MacDonald 1978: 33).
The rise of the near banks helps to explain why the share of Canadian deposits controlled by chartered banks slipped from 87 percent in 1947 to 74 percent in 1960 (MacDonald 1978: 64).

The rapid rise of the near banks was due to a combination of rising inflation and the differential regulation of the two types of financial institutions (Shearer et al. 1984: 352). Canada experienced a sharp increase in inflation in the late 1950s, as well as a rapid influx of foreign capital that made it difficult for policymakers to maintain the balance of payments in a floating exchange rate system. Each time that general interest rates exceeded six percent, the Canadian chartered banks found themselves unable to profitably lend to businesses or consumers in many markets, including mortgage markets (MacDonald 1978: 63). These circumstances eventually culminated in the wholesale abandonment of the mortgage market by the chartered Canadian banks by 1962 (MacDonald 1978: 63). From the banks’ perspective, the real problem was that their losses had been the near banks’ gains. Almost all of the near banks operated under provincial regulation, while the chartered banks were governed by federal regulation. The provincial regulatory restrictions were generally far less stringent than the federal regulations (Shearer et al. 1984: 352). The chartered banks particularly resented the fact that the near banks were not subject to the six percent interest rate ceiling, and were therefore free to lend to businesses and consumers even when market interest rates were high (MacDonald 1978).

**The Porter Commission Advocates Repealing Interest Rate Controls**

In October 1961, Parliament (at the bequest of the Minister of Finance) responded to the difficulties in the banking sector by creating the Royal Commission on Banking and Finance, informally as the *Porter Commission*. The commission was asked to examine, evaluate, and make recommendations for improving the structure and methods of operation of the Canadian
financial system. One of the top items on the agenda was to determine the appropriate nature and scope of competition between chartered banks and near banks (Shearer et al. 1984: 352). Other key agenda items included determining how to achieve a more effective implementation of monetary policy and enhancing the overall strength of the Canadian financial system (MacDonald 1978: 57, 64; Shearer et al. 1984: 352).

To understand why the Porter Commission was so determined to shore up the strength of the Canadian financial system during this period, it is important to understand the economic context Canadian policymakers faced, and what this context meant to them. In 1962, an American bank acquired a Canadian bank for the first time, an event that many Canadian policymakers found deeply disturbing (Azzi 1999). This acquisition reignited longstanding fears about American economic encroachment. Preserving the autonomy of the Canadian financial system in the face of foreign encroachment, Canadian policymakers believed, would require equipping this system with sufficient defenses to fend off foreign invaders. In a world where financial markets were becoming increasingly global, policymakers recognized that Canadian banks had to be strong enough to make it on their own. In short, there was general agreement that the Canadian financial system needed to be strengthened in the face of growing international competition. However, policymakers did not agree on which strategy to pursue in order to accomplish this goal (Shearer et al. 1984: 352). Rival interest groups advanced different solutions. I focus on the debates that surrounded one of these proposed solutions: the elimination of interest rate controls on chartered bank lending.

By the early 1960s, the Canadian chartered banks had come to seriously resent the six percent interest rate cap on bank lending. In its submission to the Porter Commission, the Canadian Bankers’ Association (CBA) offered arguments in favor of the repeal of this interest
rate control that drew from the *frame of private autonomy*. The CBA argued that the interest rate ceiling was both ineffective and unfair: it represented a form of active government discrimination against chartered banks (CBA, Submission to Royal Commission, 88-89; MacDonald 1978: 63-64). As MacDonald (1974: 60) explains:

> The banks’ main points for removal of the ceiling centered around the notion that banks were unfairly competed against by other financial institutions. The banks charged that the ceiling prevented them from making loans on which higher rates of interest ought to be charged to cover costs and risks (MacDonald 1978: 60).

I suggest that this line of argument corresponded directly with key tenets of the *frame of private autonomy*, the frame of regulatory order that the existing Canadian regulatory system embodied. Policymakers operating within this regulatory framework were primed to see “unfair competition” as a major problem in need of remedy. To understand this, consider the principles that underlie the *frame of private autonomy*. This regulatory model calls attention to state interference with private economic activity as the key source of disorder. From this perspective, state interventions are bad enough on their own, but they become even worse when they disrupt the natural balance of power among private economic actors. In previous Canadian reform debates, this logic had been wielded to highlight the hazards of the state providing private actors with privileges: in the current debate, the same logic was used to highlight the hazards of the state restricting private economic activity. To restore order to the Canadian financial system, the advocates of repealing the interest rate ceiling argued, the state needed to restore the freedoms to banks that it had unfairly taken away. The subtext to this argument was that in placing limits on certain types of private institutions (banks), but not others (near banks), the state had disrupted the process through which order emerged, by artificially elevating one group of economic actors above another.
I argue that the salience of the *frame of private autonomy* within the existing Canadian regulatory system helps to explain why the Porter Commission largely bought this line of argument. In early 1964, Commission issued a report of its findings, which included the recommendation to repeal the interest rate ceiling for chartered banks. In support of these recommendations, the Porter Commission cited the need to remove discriminatory regulatory distortions, restore monetary control, and the desire to strengthen the Canadian banking system in preparation for increased international competition (*Report of the Royal Commission on Banking and Finance* 1964). The members of the commission agreed with the banks that the six percent ceiling had distorted the flow of funds within the financial system, and conceded that “greater freedom to move rates with the tide would undoubtedly contribute to smoother and more equitable changes in credit conditions and remove the artificial incentive for borrowers to call on bank credit” (*Report of the Royal Commission on Banking and Finance* 1964: 136; MacDonald 1978: 66). Additionally, they agreed that the interest rate ceiling, which applied only to chartered banks, represented a form of unfair (and state-sponsored) discrimination against banks, and as such, should be eliminated (*Report of the Royal Commission on Banking and Finance* 1964: 357).

This concern about discrimination in regulation is evident in the conclusion to the Porter Commission report, in which the Commission outlined its goals for the Canadian framework of banking law:

> “Finally, the framework of banking law should provide a fair and acceptable pattern of regulation which **does not discriminate** among those doing an essentially similar business” (Canadian *Royal Commission on Banking and Finance* 1964: 357).

**Anti-Deregulation Arguments Draw from a Less Convincing Frame**

In 1964, the Porter Commission recommended repealing the interest rate ceiling on chartered bank lending in 1964. However, this ceiling was not actually dismantled until the 1967
revision to the *Bank Act*. What explains this three year delay? Although the repeal of the interest rate ceiling had many supporters, including monetary policymakers and the chartered banks, it also had many serious opponents (MacDonald 1978). Many members of the Liberal minority government, including Minister of Finance Walter Gordon, opposed the repeal of the interest rate ceiling, and this conflict stalled the passage of the 1965 revisions to the *Bank Act*, the legislation governing the Canadian banking system that automatically expired every ten years, for over two years (MacDonald 1978: 68).

The opponents of repealing the interest rate ceiling offered arguments that drew from the *frame of public protection*. They argued that restrictions on bank lending should be maintained for two reasons. First, because they protected vulnerable consumers from exploitation by the chartered banks (e.g. Caouette, *Hansard*, July 7, 1966: 7325; Thompson, *Hansard*, July 7, 1966: 7329). The idea was that the rate ceiling was the only thing preventing powerful banks from charging exorbitantly high interest rates to smaller and weaker consumers and firms, and to protect these vulnerable actors, some form of a cap on chartered bank lending rates was necessary. Second, deregulation opponents argued that the same restriction would permit the continued survival of near banks in the Canadian financial system. These opponents rejected the argument that removing the interest rate ceiling would enhance the level of competition in the financial system. Instead, they believed that this reform would have the opposite effect. Gordon argued that “the very size of the [chartered] banks, let alone their possibilities for expansion under less restrictive regulations would not permit a free competitive system to develop” (MacDonald 1978: 68). The rate ceiling, these deregulation opponents argued, was needed to preserve the rights of the near banks, and to prevent the chartered banks from driving them into extinction (Smith 1973: 235).
Thus, in arguing against the repeal of interest rate ceilings, this group of deregulation opponents returned to familiar Canadian tropes. The underlying idea was that chartered banks, which had been granted enormous powers and privileges by the state, could never fairly compete with financial institutions that not received the same privileges. If there was discrimination in banking legislation, it was in discrimination that worked in favor of the chartered banks: the charter itself, as always, was the problem. The interest rate ceiling was there as a public safeguard, as part of the legal framework that kept these artificial, powerful institutions from entirely consuming the Canadian financial system (MacDonald 1978: 68). “Free” competition in the financial system, the opponents of the interest rate ceiling repeal argued, would be an unfair fight, and the state needed to protect the rights of consumers and near banks by maintaining existing statutory restrictions (MacDonald 1978: 71).

The 1967 Bank Act: Canadian Policymakers Repeal Interest Rate Ceilings

The 1965 version of the Bank Act had died on the order paper as Canada moved toward an election in the fall of that year (MacDonald 1978: 69). This legislation, presented by Minister of Finance Gordon, had stalled due to conflict between Gordon and financial community regarding the absence of a provision that would dismantle interest rate ceilings for chartered banks (MacDonald 1978: 68). After the Liberals returned to a minority position following the election, Minister Gordon resigned (MacDonald 1978: 69). Gordon’s resignation paved the way for the advocates of repealing interest rate controls to finally achieve their objectives in 1967. Gordon was replaced as Minister of Finance by Mitchell Sharp, another Liberal MP who was more open to compromise with the financial industry (MacDonald 1978; Azzi 1999). In July 1966, Sharp introduced revisions to the Bank Act in July 1966 that were virtually identical to Gordon’s earlier proposed revisions, save one crucial difference: the new reform package
removed the 6 percent interest rate ceiling on chartered bank lending (Azzi 1999: 152).

Supported by a wide coalition of Liberal and Conservative policymakers, Sharp’s revisions to the *Bank Act* passed the House and the Senate in March 1967, over vocal opposition from the NDP, Social Credit, and several western Conservative M.P.s. (*Bank Act* 1967; MacDonald 1978: 74).

**Summary: Canada**

In short, I argue that the deregulation of interest rate controls proceeded more quickly in Canada than in the U.S. and Spain because Canadian proponents of deregulation were able to offer arguments that resonated with the frame embodied in the existing Canadian regulatory system: the *frame of private autonomy*. The main proponents of deregulating interest rate controls, the chartered banks and monetary policymakers, argued that inflation had promoted disorder in the Canadian financial system because the state had imposed artificial restrictions on bank autonomy (statutory caps on lending interest rates) that also discriminated against one group of private economic actors. Canadian policymakers were primed to see problems in the state interfering with private economic activity through allocating powers, privileges, or restrictions, and I argue that this explains why they moved to eliminate these interest rate controls in 1967, soon after inflation began to disrupt competitive dynamics within the Canadian financial system.

**SPAIN CHANGES COURSE IN THE DEREGULATION OF INTEREST RATE CEILINGS**

The Banking Law of 1921 authorized the *Consejo Superior Bancario* to establish deposit rate ceilings for chartered banks, and Spanish policymakers introduced additional controls on lending rates in 1927, when they authorized the CSB to set minimum interest rates for loans.
Scholars of this period generally agree that these interest rate controls had a transparent purpose: to enrich the existing banking cartel (Lukauskas 1997: 84; Pérez 1997).

After the nationalist forces overcame the republican forces in the Spanish Civil War of 1936-1939, General Francisco Franco rose to power. He established an authoritarian regime that would persist through 1975. The Franco regime initially continued the regulatory trends that its predecessors had established. While the regime transferred the authority to establish deposit rates from the CSB to the Ministry of Finance, they kept these deposit rate ceilings and minimum loan interest rates intact (Lukauskas 1997: 84). The Franco regime’s policy with regard to the banking sector had a clear goal: to reward the powerful banking cartel for supporting Franco’s bid for power, and to ensure its continued allegiance (Lukauskas 1997: 84; Pérez 1997: 60; Pons Brias 2002: 56). In short, interest rate controls from the moment that they were first established in Spain were tied to the preservation of the right balance of interests: e.g. in exchange for acquiescence to a new regulatory regime and some expansion of the state’s jurisdiction over the banking sector, powerful private Spanish banks received compensatory economic privileges.

**Banking Law of 1962: Rate Controls Facilitate State Control**

Rising inflation became a serious problem in Spain long before it became a serious problem in the U.S. and Canada. In 1957, the Spanish Minister of Labor mandated two dramatic wage increases that led to a sharp increase in credit demand from business (Pérez 1997: 63). Banks responded by dramatically expanding their lending to business, setting inflationary dynamics into play. To finance this dramatic expansion in lending, Spanish banks traded in their massive portfolios of public debt for credit at the Bank of Spain (Pérez 1997: 63). The result was that in their zeal to lend to the credit-hungry industrial sector, Spanish banks drained the Spanish Treasury. To try to halt the expansion of credit, policymakers took a restrictive fiscal stance and
sharply reduced the issuance of public debt between 1957 and 1958; however, the damage had been done. The banks’ existing portfolios of public debt were simply too large, and the state could not prevent the banks from cashing in. By June 1959, the problem had become critical: net reserves at the Bank of Spain had turned negative (Pérez 1997).

Spanish policymakers agreed that the events of the economic crisis of 1957-1959 could not be repeated. Monetary policymakers needed to get a better handle on credit expansion, and there was general consensus that restoring control would require the state to wrest power over credit expansion away from the powerful banking cartel. The question was how to reassert this control. One group of reformers, a group of technocrats closely associated with the Catholic lay organization Opus Dei, sought to address this problem by introducing a system of French-style credit planning to Spain, with the goal of increasing the state’s jurisdiction over credit allocation (Pérez 1997: 77). A second group of reformers, which primarily consisted of economists housed within the Bank of Spain, sought to restore order by liberalizing restrictions on bank activities and barriers to entry in the Spanish financial system. Rather than expanding the state’s jurisdiction over credit provision, the goal was to restore the state’s control over credit expansion by eroding the bases of entrenched power that these reformers saw as hindering the achievement of monetary policy objectives (Lukauskas 1997: 88; 97).

Spanish policymakers initially chose the first model of reform over the second. The content of the Banking Law of 1962 demonstrates that Spanish policymakers initially chose an interventionist credit regulation framework, modeled on the credit regulation framework of postwar France, over an alternative framework with financial liberalization as the centerpiece (see Pérez 1997: 66-76). The Banking Law of 1962 introduced four major reforms: it nationalized the Bank of Spain; imposed a regime of enforced banking specialization; established
three new public regulators; and increased the state’s role in directing credit allocation (Pérez 1997: 67-68; Pons Brias 2002: 59-60).

Interest rate controls played a crucial role in this new interventionist framework of credit allocation. These controls acted as the levers that allowed the state to execute its objectives: to control credit allocation, the architects of this framework established two conduits of privileged financing, which allowed the state to direct credit towards specific users and industries (Pérez 1997: 68). The first conduit channeled credit through state-created “official credit institutions”, while the second relied on special rediscount lines, which allowed commercial banks to rediscount credit extended to borrowers in sectors that had been handpicked as priority areas (Pérez 1997: 68, 71). However, the effectiveness of these initiatives depended on policymakers maintaining a controlled interest rate environment (Pérez 1997: 73). Accordingly, the architects of this framework initially framed interest rate controls as tools that promoted order by facilitating the state’s ability to achieve its objectives, which included the centralized coordination and direction of selective credit allocation.

Preserving these deposit rate ceilings and interest rate floors on loans had an additional benefit: the powerful “Big Seven” Spanish banks saw these restrictions as in their interest. As Lukauskas (1997: 141) explains, these banks supported the preservation of interest rate controls, since these controls tended to lock in each bank’s current share of total deposits. The Big Seven banks had superior resources and visibility, which allowed them to fare better in the non-price competition that took the place of price competition for deposits in a system governed by interest rate controls. For all of their rhetoric about reasserting state control over the activities of private banks, the architects of the interventionist regulatory framework were well aware that they would not succeed unless they maintained the support of the powerful private banks (Pérez 1997: 76).
By confining their intervention to areas and initiatives that did not directly threaten the economic privileges of the existing bank cartel (including the interest rate controls that preserved the cartel’s high profits and power), the architects of the new credit regulation framework were able to maintain banks’ continued support while achieving their own objectives. In short, the structure of the interventionist credit regulation framework also continued to embody the frame of balancing interests: in exchange for acceding to the new regulatory regime, banks were allowed to keep the economic powers and privileges that they most valued (Pérez 1997: 76-77).

I suggest that this interventionist credit regulation framework initially prevailed in Spain over other, alternative models of regulation (which included financial deregulation) because it was the model that corresponded most closely with the frame of regulatory order that the existing Spanish regulatory system embodied. Spanish policymakers in the 1920s had introduced reforms to restore order to the banking system by enhancing centralized control over banking activity, while simultaneously accommodating bank interests by allocating additional economic privileges to banks. An interventionist credit regulation framework, which extended state control over banking activity while preserving the economic privileges banks most valued, was a more familiar regulatory model than the other proposed alternatives. To justify the imposition of this new interventionist regime, advocates drew from familiar frame: they argued that this framework would restore order by placing control over credit expansion in the hands of a centralized authority, instead of allowing credit expansion to be dictated by the whims of the capricious private banking system (Pérez 1997: 67; Pons Brias 2002: 59-60). I argue that the resonance between these arguments and the frame embodied in the existing Spanish regulatory system helps to explain why Spanish policymakers elected to impose this interventionist framework over alternative reform options, like the deregulation of the financial system. The arguments offered
by the advocates of financial deregulation, who argued that restoring order to the banking system would require dismantling state-imposed restrictions (that reinforced the power of the private banking cartel), were less resonant with the existing frame of regulatory order, and were therefore less convincing.

**The Reforms of the Early 1970s: Rate Controls Block State Control**

However, the interventionist credit regulation framework was short-lived in Spain. Although this framework originally appeared to be a success, cracks began appear by the mid-1960s. In 1967, Spain experienced a sharp decline in economic growth after eight years of economic prosperity and stability (Pérez 1997: 87). Industrial production ground to a halt and short-term capital outflows increased sharply, and devaluations of the peseta in 1967 and 1968 failed to restore the external balance (Pérez 1997: 89). In a repeat of the events of 1957-1959, the Spanish banking cartel responded to the rising demand for credit by dramatically expanding their lending to business. This led to another sharp deterioration of the current account in 1969. The Franco dictatorship also experienced its “sole great politico-economic scandal” during this period (Tortella and Jimenez 1986: 188; quoted in Pérez 1997: 90). In 1969, Spain’s largest export firm, MATESA, defaulted. This event generated massive losses and led to a further deterioration in the solvency of the Spanish Treasury. MATESA had been the recipient of more than half of the credit granted by the Banco de Crédito Industrial, one of the state-owned official credit institutes (Pérez 1997: 90). Combined with the poor economic performance of this period, the failure of MATESA represented the death blow for the interventionist credit regulation framework that had been introduced with the Banking Law of 1962.

The decline of the planning bureaucracy that had retained a tight hold on financial policymaking in Spain since the late 1950s allowed for the rise of a different group of reformers,
affiliated with the Bank of Spain and the Ministry of Finance (Pérez 1997: 91). This was the same pro-deregulation group that had failed to convince Spanish policymakers to adopt financial liberalization in the late 1950s. Seizing the moment, these reformers argued that they held the keys to resolving the economic crisis of the late 1960s. Like the promoters of the interventionist credit regulation framework, their goal was to restore the state’s ability to coordinate and direct activity in the financial system. However, they sought to do so by liberalizing restrictions on financial activity, instead of introducing new restrictions. Anderson (1970:140) explains how the Spanish advocates of financial deregulation framed their initiatives:

In fact, [these reformers argued that] liberalization was designed to restore centralized control over economic policy. Over the years, definitive control had slipped from the hands of the central authorities. There were problems of public sector coordination, and critical branches of private enterprise could pretty well dictate public policy as it affected their own concerns. Despite the word *liberalization*, what the Opus Dei ministers were promising Franco was not a restoration of economic liberty but of **economic order**, a prime value of the authoritarian regime, and of the **centralization of authority**, a historical Spanish political propensity. Direct controls no longer guaranteed responsiveness to central authority. But monetary and fiscal instruments, manipulated from above, could produce a regimented and predictable response throughout the system…Control and management were the essence of their economic philosophy (Anderson 1970: 140).

The liberalization of interest rate controls was policy priority number one for this group of reformers. They argued that the Spanish state (specifically, the administrators of monetary policy) lacked the ability to sufficiently direct and coordinate activity in the financial system because the powerful private banks were standing in their way (Pérez 1997; Lukauskas 1997). The main problem, they argued, was that Spanish policymakers did not have access to a true money market that could be used to control the level of liquidity in the financial system in a routine and discretionary fashion (Pérez 1997: 94). They could not create this money market because in a closed banking system with controlled interest rates, banks easily made substantial
profits. As Pérez (1997: 103-104) explains, these circumstances made banks complacent, and prevented a money market from emerging: “given the lack of price competition in the sector, the banks felt very little compulsion to maximize their operating margins by creating a money market for their cash surpluses.”

Thus, interest rate controls, which had previously been framed as tools that facilitated centralized coordination and direction, were reframed by deregulation advocates as blocking to the state’s ability to effectively direct and control the economy. The idea was that these controls reinforced the entrenched power of the big Seven Spanish banks, the institutions who were preventing monetary policymakers from moving forward with their reform agenda. To understand how financial deregulation unfolded in Spain, it important to understand both how these deregulation advocates framed interest rate controls (as blocks to state control, rather than the tools that enabled it), and the point at which this reframing effort became successful (after the economic difficulties of the late 1960s).

**Reformers Chip Away at Interest Rate Controls but Preserve Balance of Interests**

In the summer of 1969, the Bank of Spain finally succeeded in pushing through a reform package that linked all interest rates to the central bank’s rediscount rate and introduced a ceiling on the interest rates banks could offer on loans, rather than a floor. This reform successfully brought about a reduction in credit expansion that helped to restore Spain’s external balance. However, even with the new reform, the Bank of Spain continued to struggle to keep credit expansion (and by extension, inflation and the balance of payments) under control (Pérez 1997: 93). Serious problems returned to the Spanish banking system after the oil shock crisis of 1973. Once again, the administrators of monetary policy within the Bank of Spain found themselves unable to inject or withdraw liquidity into the banking system in a systematic and discretionary
way, and once again, they blamed the absence of price competition in the banking sector (Pérez 1997: 103). Although these policymakers repeatedly tried other solutions, they continued to run up against the same basic problem.

In 1974, Spanish policymakers responded to these conditions by taking the first steps towards dismantling interest controls. They passed a reform package that liberalized rates on bank loans and deposits with terms of more than two years. The main advocates of this reform were located within the Ministry of Economics, the Ministry of Finance, and the Bank of Spain. The reform was opposed by the Treasury, who argued that the removal of deposit rate ceilings would increase the cost of issuing new public debt (137). The reform divided the banking system. The Big Seven banks that made up the Spanish banking cartel vehemently opposed the removal of all interest rate controls (Lukauskas 1997: 141). Spanish banks saw the presence of a rigid framework of interest rate controls, which ensured their ability to maintain a pricing cartel, as their major protection from competition from international financial markets, and they were not eager to lose this protection (Pérez 1997: 102). However, some smaller and less established banks supported the removal of these rate ceilings because they believed that they would be able to gain larger market shares in a deregulated market. Other small banks opposed their removal because they preferred the guaranteed profit margins these ceilings provided (Lukauskas 1997: 141).

I argue that the perceived need to secure buy-in for reform efforts from powerful groups (like the Big Seven banks) in Spain shaped the way that the proponents of deregulation approached financial liberalization in Spain. Interest rate controls, as the restriction that Spanish banks sought to maintain above all else, were dismantled very slowly in Spain, especially in comparison to other deregulatory reforms. Spanish financial deregulation proceeded in a very
peculiar pattern (Pérez 1997; Lukauskas 1997). Pérez (1997: 95) explains that early steps towards deregulation liberalized the price of credit without making it subject to competition - to the great benefit of the banking cartel. As Pérez (1997: 105) explained:

The particular pattern of deregulation instituted in the mid-1970s made little economic sense. Yet it served to compensate the banks for the loss of cheap liquidity, and more important, got them implicitly to buy into the reform agenda. From the reformers’ standpoint, this early stage of the reform process was therefore not fruitless because it sowed the seeds that would eventually strengthen the more reformist elements among the bankers.

In short, this pattern of deregulation made very little economic sense - but it did help secure bank buy-in for the reform agenda (Pérez 1997: 104-105). In 1972, reformers secured the deregulation of the commission banks charged on their lending activities, and in 1974, the deregulation of restrictions on bank branching. It was only after these two initiatives passed, to the very great benefit of the Big Seven Spanish banks, that these banks were ready to accept any deregulation of interest rate controls. I suggest that the commitment to maintaining the right balance of interests while pursuing simultaneously pursuing reforms to promote greater centralized coordination and direction helps to explain the course financial deregulation took in Spain.

Reformers within the Bank of Spain recognized that they would need to approach the liberalization of the financial system in a way that was sensitive to bank interests: otherwise, the powerful bank cartel would rebel and crush their reform agenda (Pérez 1997: 104).

1977 Interest Rate Deregulation: Balancing Interests

In 1977, the Ministry of Economics introduced a new reform package that would liberalize all deposit and loan interest rates with maturities of one year or longer. Franco had died in 1975, and Spain was in the midst of its transition to democracy. These events placed the pro-deregulation reformers in a stronger political position to impose their agenda on the banks, as there was now a risk that other political actors (who would be less friendly to bank interests)
would gain control over the reform process (Pérez 1997: 116-120). The banks and their regulators now had an even stronger incentive to work together.

Unlike the token interest rate deregulation of 1974 (few banks offered loans or solicited deposits with terms greater than two years, so this had been essentially an empty reform), the interest rate reform of 1977 presented a more serious threat to the margins of the Big Seven Spanish banks. Once again, the reform was supported by the Bank of Spain and the Ministry of Finance, who argued that interest rate liberalization was necessary because market-determined interest rates would allow for the implementation of more effective monetary policy: these policymakers sought to “create a financial environment in which economic actors would be malleable to [central bank] interventions, [and] market-determined interest rates were a key requirement for the attainment of this goal” (Pérez 1997: 125; Lukauskas 1997: 124). This proposed reform was strongly opposed by most of the banking sector, business, and many state officials, including the Minister of Industry and the Ministers of Public Works and Agriculture (Lukauskas 1997: 149; El Pais May 15, 1977). The Big Seven banks were particularly adverse to paying higher interest rates on deposits (Pérez 1997: 125).

Once again, the final reform outcome reflected a compromise between the interests of the state and those of a powerful private group. The reform package of July 1977 centered on the main objectives of the reformers’ agenda (giving greater technical control over the banking system’s liquid assets to the monetary authority and dismantling the institutional structure that had given other state actors a say in financial policy), but did so in a way that preserved bank interests as much as possible (Pérez 1997: 124). As Pérez (1997: 124) explains, these reformers still sought to reach a compact with banks over the manner in which deregulatory reforms were carried out:
If the bankers were willing to adopt a democratic demeanor and to endorse the principle of liberalization, their support was based on the premise that liberalization would be carried out in a way that protected their interests. The second task for the reformers was therefore to reach a compact with the banks over the manner in which reform was carried out. The deregulation process have been molded so as to make it acceptable to the banks even before the transition [to democracy]. If the reformers were now in a stronger political position to impose some of their agenda on the bankers, their desire for the bankers’ support meant that reform would nonetheless continue to be driven by the search for mutual accommodation (Pérez 1997: 124).

I suggest that this dual commitment to achieving superior *centralized coordination and direction* over banking activity and preserving the correct *balance of interests* among powerful groups within civil society informed the way that Spanish policymakers approached the deregulation of interest rate controls. In introducing the 1977 reform package, the Ministry of Economics had also expressed an intention to remove all controls on interest rates by the summer of 1978 (Lukauskas 1997: 149). However, in the end, the Minister of Economics eventually caved to strong bank pressure to slow down these reforms. The final 1977 reform package only deregulated rates on credit and deposits with terms of more than one year; rates on shorter-term deposits and credits would only be gradually liberalized in following years (Pérez 1997: 125; see *El Pais*, May 15, 1977). United opposition from banks, business, and their representatives in the state was sufficiently strong to stall the further deregulation of interest rates until 1981.

**Summary: Spain**

In short, I argue that the deregulation of interest rate controls in Spain started relatively early, but also proceeded relatively slowly, because Spanish proponents of deregulation initially found it difficult to offer arguments that resonated as closely with the *frames of regulatory order* that were embodied in the existing Spanish regulatory system: the frames of *centralized coordination and direction and balancing interests*. This helps to explain why Spanish policymakers initially supported an alternative regulatory regime (an interventionist credit
regulation framework) that was a closer fit with established Spanish principles: it followed a familiar Spanish pattern of restoring order through extending state control over banking activity while simultaneously preserving the economic privileges banks most valued. It was only after this regulatory regime began to generate negative effects (in the late 1960s) that Spanish policymakers were ready to consider alternative reform models, including financial deregulation. It is important to note that the Spanish proponents of deregulating interest rate controls offered pro-deregulation arguments that also corresponded with the frames of regulatory order that the existing Spanish regulatory system embodied. These reformers reframed interest rate controls as structures that blocked effective centralized coordination and direction by reinforcing the power of the established banking cartel, which prevented the administrators of monetary policy from developing effective policy tools. However, these reformers were also smart enough to pursue their financial liberalization agenda in a way that avoided infringing on the economic privileges of the Big Seven banks (which were reinforced by interest rate controls) as much as possible. These events help to explain both when Spanish policymakers turned to financial deregulation (in the early 1970s, after the previous interventionist reform effort had failed) and why the deregulation of interest rate controls in particular progressed so slowly in this country.

CONCLUSION

By 1966, policymakers in the U.S., Canada, and Spain had each adopted some form of interest rate controls for banks; by 1987, all of these countries had dismantled these rate controls. However, the deregulation of interest rate controls proceeded differently each country: while Canadian policymakers moved to dismantle these restrictions soon after inflation began to rise in this country (in 1967), American policymakers took an additional fourteen years to deregulate these rate controls (in 1980), and only did so after extending these controls to a new types of
financial institution in 1966. Spanish policymakers started dismantling interest rate controls after
Canada, but before the U.S (in 1974). However, they were the last country to completely
eliminate these restrictions (in 1987), and generally went about deregulating the financial system
in a way that favored bank interests.

In this chapter, I explained how the frame of regulatory order embodied within each
country’s regulatory system shaped each country’s path to financial deregulation. In the U.S.,
this was the frame of deconcentration; in Canada, the frame of private autonomy; and in Spain,
the frame of balancing interests. I argue that the extent to which deregulation proponents were
able to offer arguments that resonated with this prevailing frame of regulatory order in each
country structured the pace and pattern of financial deregulation.

I suggest that the deregulation of interest rate controls occurred much earlier in Canada
because it was easier for Canadian proponents of deregulation to frame their arguments in ways
that corresponded with the prevailing frame of regulatory order in this country. Deregulation
proponents in Canada argued that when the state discriminated against one group of economic
actors in favor of another, disorder was bound to result; furthermore, the solution to this
competitive inequity was not to extend the scope of state interference, as American policymakers
had done, but to ensure that all economic actors had the same freedoms by removing the source
of state interference that had caused the problem. Similarly, I suggest that it was particularly
difficult for the American proponents of deregulation to offer arguments that corresponded with
the frame of deconcentration. These proponents argued that deregulation would ameliorate
distortions and enhance competition within the financial system; however, they were hard-
pressed to argue that it would not challenge the deconcentrated structure of the financial system.
This conflict between the frames offered by deregulation proponents and the frame embodied
within the American regulatory system helps to explain why the deregulation of interest rate controls was so much slower, and so much more controversial, in the U.S. Finally, I suggest that the Spanish deregulation of interest rate controls only began after Spanish reform advocates successfully reframed these controls as blocks to centralized coordination and direction. Furthermore, I suggest that Spanish financial deregulation proceeded in a slow and piecemeal fashion because the reformers within the Bank of Spain were careful not to disrupt the balance of interests that kept order intact.
CHAPTER 5:
THE CRISES OF THE 1980s AND NEW FRAMES OF REGULATORY ORDER

Most of the world’s major financial capitals experienced a series of devastating banking crises during the turbulent decade of the 1980s. In this chapter, I explain how American, Canadian, and Spanish policymakers responded to these crises. American policymakers moved away from regulatory policies that kept banks fragmented and specialized, and moved towards policies that sought to increase market competition in the financial system. Canada, previously a bastion of self-regulation and an early adopter of deregulation, embraced a substantially greater role for the government in supervising and regulating banks. Spanish policymakers abandoned policies to reduce oligopolistic power in the banking sector, and moved towards policies that enhanced regulators’ ability to oversee and direct activity in the financial system.

My aim in this chapter is to answer two interrelated questions. What accounts for this dramatic shift in regulatory orientation in each country? And what are the implications for understanding the role of institutions in shaping the evolution of regulatory policymaking? I show that the banking crises of the 1980s opened up opportunities for reform advocates to promote new regulatory models that departed dramatically from past practice in each country. I argue that the seemingly radical breaks in regulatory orientation that followed were actually institutionally structured. I suggest that reform advocates in each country drew from familiar, but alternative, frames of regulatory order to explain the failure of the pre-crisis regulatory system and to develop remedies to address these perceived problems. Specifically, I argue that in each country, reformers pulled from the frame that had fallen out of favor after the policy debates of the 1920s and 1930s to diagnose and explain the problems of the 1980s: the frame of competition.
in the U.S., the *frame of public protection* in Canada, and the *frame of centralized coordination and direction* in Spain.

The banking crises of the 1980s in all three countries shared common features. American, Canadian, and Spanish policymakers agreed that the root cause of these crises was imprudent bank lending during an economic boom. However, these policymakers arrived at fundamentally different understandings of why banks had engaged in this excessive risk-taking (see Table 5.1). I argue that these different understandings were the product of differences in the availability and salience of particular frames of regulatory order within each country. American reform advocates, drawing from the *frame of competition*, were primed to see government initiatives that had interfered with the competitive mechanism as the primary reason why banks and thrifts had taken excessive risks, and they promoted remedies designed to enhance the role of the market in disciplining the behavior of financial institutions. Canadian reform advocates, drawing from the *frame of public protection*, argued that banks had taken excessive risks because financial liberalization had allowed more unskilled and imprudent bank managers to enter the financial system, breaking the “gentlemen’s agreement” that kept order intact in a self-regulated system, and promoted remedies to better protect the public’s right to a safe and stable financial system through proactive prudential regulation. Spanish reform advocates, drawing from the *frame of centralized coordination and direction*, argued that excessive bank risk-taking was a natural response to heightened competitive pressures, and promoted remedies that were designed to strengthen regulatory power and oversight through consolidation and centralization.

The result was that by 1991, policymakers in each country passed new legislation that actively departed from key tenets of the frame of regulatory order that had shaped each country’s approach to regulation for over five decades. This pre-crisis regulatory system reflected the
frame of deconcentration in the U.S., the frame of private autonomy in Canada, and the frame of balancing interests in Spain. In Chapter 6, I explain how this move away from these old regulatory models, and the embrace of new models embodying a different frame, shaped the divergent development of banking regulation in the period leading up to the recent global financial crisis.

Table 5.1. Diagnoses for the Banking Crises of the 1980s in the U.S., Canada, and Spain

<table>
<thead>
<tr>
<th>Why banks take excessive risks</th>
<th>United States</th>
<th>Canada</th>
<th>Spain</th>
</tr>
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<tbody>
<tr>
<td>Banks face adverse incentives (moral hazard) due to presence of government “safety net”</td>
<td>Banks take excessive risks when managed by less prudent and experienced managers</td>
<td>Banks naturally take excessive risks (and hide these risks) when faced with economic pressures</td>
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<table>
<thead>
<tr>
<th>Why regulators failed to stop adverse bank behavior</th>
<th>United States</th>
<th>Canada</th>
<th>Spain</th>
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</thead>
<tbody>
<tr>
<td>Regulators are biased, inherently fallible, and identify too much with the regulated industry</td>
<td>Regulators lacked sufficient personnel and powers, and had no power to intervene quickly</td>
<td>Regulators had insufficient knowledge of bank activities (and power to redirect them)</td>
<td></td>
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</tbody>
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<table>
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<tr>
<th>How liberalization went wrong</th>
<th>United States</th>
<th>Canada</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market discipline was not intact when policymakers liberalized the financial system</td>
<td>Liberalization brought new types of actors into previously closed financial system; regulatory system did not adjust to this compositional change</td>
<td>Liberalization allowed unqualified entrants into the banking system and increased economic pressures that established institutions faced</td>
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UNITED STATES: THE CRIOSES OF THE 1980s AND LEGISLATIVE REFORM

The 1980s were hard years for American banks and thrifts. Over 1600 federally-insured banks failed or received FDIC financial assistance between 1980 and 1994, far more than in any other period since the advent of federal deposit insurance (FDIC 1997: 3). The American thrift industry fared even worse: between 1986 and 1995, over a third of thrifts had to be rescued by the federal deposit insurance system, at an eventual cost of $132 billion to the American taxpayer (Curry and Shibut 2000; FDIC 1997: 187). Trouble in both of industries had originated in the
high interest rate environment of the 1970s. As discussed in Chapter 4, the preservation of deposit rate ceilings (Regulation Q) in an inflationary environment had led to extensive disintermediation in both the banking and the thrift industries. While disintermediation was a major problem for commercial banks, it was even more problematic for thrifts, due to the structure of their assets. Thrift assets primarily consisted of long-term, fixed rate mortgages. This asset structure proved deadly in the face of extended inflation. As inflation spiked and persisted into the 1980s, the rates of return on thrifts’ long-term assets fell far below the current costs of borrowing, and these institutions struggled to make up the difference. By the early 1980s, American policymakers were well aware that the problems in the thrift industry had become severe. Net thrift income fell from $781 million in 1980 to negative $4.6 billion and $4.1 billion in 1981 and 1982 (FDIC 1997: 168, Table 4.1).

Congress responded to the declining profitability of the thrift industry with two laws in the early 1980s. The 1980 Deposit Institutions Deregulation and Monetary Control Act (DIDMCA) revoked the Federal Reserve’s power to set interest rate ceilings for time and savings deposits for banks and thrifts, reduced net worth requirements for thrifts, and allowed federally chartered thrifts to made acquisition, development, and construction loans (FDIC 1997: 175-6). As an additional step to alleviate disintermediation, DIDMCA also increased federal deposit insurance coverage to $100,000 per account, up from $40,000 (FDIC 1997: 176). The 1982 Garn-St. Germain Depository Institutions Act further broadened the range of acceptable thrift activities to include lending in new consumer markets and to commercial real estate ventures. During this period, American policymakers and the federal thrift regulatory agency also allowed thrifts to adopt more permissive accounting standards, which masked their poor financial condition. The general hope was that expanded powers for thrifts – combined with a little
forbearance in accounting - would allow these institutions to weather the storm until macroeconomic conditions improved (FDIC 1997: 173). To compete with relaxed regulation at the federal level, the regulators of state-chartered thrifts also reduced their regulatory standards (FDIC 1997: 177).

The thrift industry underwent dramatic change in response to the changing legal and regulatory environment. The industry’s share of assets and deposits grew dramatically between 1982 and 1985 (FDIC 1997: 178). Entrepreneurs, recognizing an investment opportunity, rushed to acquire or charter new S&Ls. Thrifts rapidly shifted away from home mortgage lending into new activities, particularly commercial real estate lending (FDIC 1997: 179-180). This growth was particularly strong in particular regions of the country, especially in the Sunbelt states and in states with energy-related economies (FDIC 1997: 182). The federal thrift regulator realized what was happening by 1984, and took steps to curtail excessive lending, but the rapid expansion resulted in predictable consequences. Unsound lending by banks and thrifts, especially in unfamiliar real estate markets (FDIC 1997; Seidman 1996). By 1984, 687 federally insured thrifts were insolvent on the basis of tangible net worth, representing 22 percent of the industry and 37 percent of industry assets (White 1991: 144). By 1987, this situation had become untenable. FSLIC didn’t have enough money. Forced a federal bailout of the thrift industry.

Trouble was also present in the commercial banking industry during this period, although losses were less severe than in the thrift industry. A series of severe regional and sectorial recessions hit banks in a number of banking markets (especially commercial real estate lending), producing regional banking crises (FDIC 1997). By 1991, the losses associated with these regional bank failures had grown so severe that they threatened to wipe out the reserves of the FDIC.
Diagnosing the Crisis: Insufficient Market Discipline

By the time that the situation in the thrift and banking industries became critical, the new Bush administration, Congress, and the federal banking regulators had already come to a collective understanding of the root cause of these crises. Thrifts and banks had failed in record numbers, these actors believed, because government interventions in the banking system had blocked the mechanism of market competition that kept order intact.

Depression-era legislated consumer protections in the banking system - especially deposit insurance - were cast as the primary villains (Financial Institutions Reform, Recovery, and Enforcement Act of 1989, House, March 16, 1989: 6). American policymakers argued that the presence of these government-created protections had changed the incentive structure in the banking system in ways that encouraged excessive risk-taking. The idea was that bank executives, knowing that the government would absorb the costs of failure, faced strong incentives to take on additional risk. Making matters worse, the same incentive system also left bank shareholders and creditors with little incentive to curtail this risky bank behavior. Why should these market participants discipline bank behavior, the logic went, when the government (as the entity picking up the tab for bank failures) was already doing the regulatory and supervisory job for them? In short, American policymakers in the late 1980s came to see government regulation and market regulation as substitutes, and came to understand the banking crises of the 1980s as products of a regulatory system that had done too much to emphasize the former source of regulation at the expense of the latter.

Concerns about the potential incentive-distorting effects of deposit insurance had been around as long as deposit insurance itself. During the reform debates that preceded the Banking Act of 1933, proponents of deposit insurance did not deny that deposit insurance would
encourage banks to take excessive risks. However, they argued that other initiatives included in the same legislation, like the Regulation Q deposit rate ceilings, would mitigate these risk-enhancing effects (see Chapter 3). When the deregulatory reforms of the early 1980s dismantled many of these initiatives, these old concerns about deposit insurance returned to the legislative agenda (e.g. Financial Institutions Restructuring and Services Act of 1981, October 27, 1981). Concerns about the moral hazard associated with government interventions further intensified after the 1984 failure and bailout of Continental Illinois Bank (e.g. Financial Condition of the Bank and Thrift Industries October 2, 1985). By 1985, representatives from large and powerful banks were actively appealing to the threats these initiatives posed to market discipline as they argued against particular regulatory reforms. As Thomas F. Huertas, a Vice President at Citibank, argued before the Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance of the House of Representatives:

“[These new risk-based capital requirements]…can only dilute and distort market discipline, for they weaken the incentive of market participants to monitor and discipline banks independently. Society can either rely on the market or on the regulator to discipline banks, and the safer choice for depositors, for the FDIC and for the banking system as a whole is, in our view, to allow the market to discipline banks” (Huertas, Financial Condition of the Bank and Thrift Industries, October 2, 1985).

However, not everyone shared this perspective. The American banking regulators argued that past experience indicated that regulators and supervisors still had an important role to play in ensuring that the banking system remained safe and stable. As Fed Chairman Paul Volker noted in 1985, market discipline alone could not replace regulation:

[O]ur financial history demonstrates unambiguously the dangers of relying on market discipline alone. Prior to the 1930s, market discipline did not prevent bank failures or systematically discourage excessive risk-taking—until after periodic crises had occurred, at great expense to the economy generally (Deposit Insurance Reform 1985: 1264).
However, by the late 1980s, virtually all of the major players in the American bank regulatory system - policymakers, regulators, academics, and banks and thrifts themselves - agreed that the banking and thrift crises had been either caused or exacerbated by moral hazard and a lack of market discipline in the American financial system (*Financial Institutions Reform, Recovery, and Enforcement Act of 1989, House, March 16, 1989*: 6). The diagnosis of the crisis offered by Al Williams, the Chairman of the Credit Union National Association, was generally representative:

"Moral hazard" is a term used to define one of the inherent problems of a federal deposit insurance system. The problem arises when an entrepreneur can buy a federally insured financial institution with an amount of capital that is but a tiny fraction of the total assets of the institution. The owner can then attract deposits at low, risk-free interest rates--because of deposit insurance--and acquire much riskier and higher yielding assets. If all goes well, the owner gets a phenomenal return on the capital invested. If all does not go so well, the federal deposit insurance system is left to pick up the pieces. All the owner loses is his capital--small relative to total assets. This theory of moral hazard goes a long way toward explaining the problems of Texas thrifts over the past several years. Note that moral hazard does not refer to fraud. It simply implies that the costs of legal risk taking are not borne by the risk taker. This leads to excessive risk taking (Al Williams, Chairman of Credit Union National Association, *Financial Institutions Reform, Recovery, and Enforcement Act*, March 16, 1989: 296).

Similarly, a task force sponsored by the American Banker’s Association found that:

De facto 100 percent deposit insurance has encouraged thrift managers to take excessive risks. Depositors and other creditors of depository institutions have no incentive to force discipline on officers and directors of the institutions when their interests are fully protected. This has led some managers, many of whom are running insolvent or nearly insolvent thrifts, to take inappropriate and excessive risks knowing that the down-side exposure would fall on the FSLIC [thrift deposit insurance fund]. It is important that these abuses of the deposit insurance system be corrected (*Financial Institutions Reform, Recovery, and Enforcement Act of 1989, House, March 22, 1989*: 397. *Findings of the ABA’s FSLIC Task Force*).

It is not surprising that industry lobbying groups blamed government initiatives like deposit insurance for the bank behavior that had produced the crises of the 1980s - after all, this line of argument shifted the blame away from their members. However, it is somewhat more surprising
that the American banking and thrift regulators also offered similar accounts to explain these crises. The testimony of William Seidman, the Chairman of the FDIC, clearly suggests that the American banking regulators also regarded moral hazard as a major driver of excessive bank and thrift risk-taking:

The current debate [over deposit insurance reform] appears to focus on the moral hazard caused by a Federal safety net. The hazard is described as follows: to the extent that bank creditors are protected by a deposit insurance system, their incentive is to seek the highest return without concern for the condition of the financial institution. Without market penalties for assuming more risks, the incentive for bank management is to take greater risk. The fact that a moral hazard exists is clear (Testimony of FDIC Chairman William Seidman, February 21, 1990, Deposit Insurance Reform: 5).

In short, there was general agreement that the primary reason for the mess in the banking and thrift industries was the fact that government initiatives had distorted bank incentives in ways that favored excessive risk-taking, and had discouraged bank shareholders and creditors from intervening to stop this behavior.

However, the problem was not just that the incentive system for banks and market participants had been distorted. From the perspective of most American policymakers, the problem was also that the (government-designed) regulatory framework in the banking system represented an inherently poor substitute for market discipline. The argument was that unlike unbiased market mechanisms, regulators were inherently fallible, and prone to bias and partiality. This was thought to explain why thrift regulators had avoided stepping in to stop adverse thrift behavior until the problems in this industry had become unmanageable. American policymakers and even the American banking regulators agreed that this regulatory inaction (or regulatory forebearance) on the part of thrift industry regulators had exacerbated the crisis by allowing insolvent institutions to continue operating, instead of shutting them down.

The perceived problem of regulatory forbearance was cast as a major issue to be resolved
in the reform debates of the late 1980s and early 1990s. As Congressman Jim Leach argued before Committee on Banking, Housing, and Public Affairs:

Mr. Chairman, the time has come for Congress to cease mincing words about thrift problems. The dilemma we are confronted with is of our own making. Too loose laws have led to too loose regulation which in turn has led to too loose banking practices…Multi-billion dollar obligations have been made by politicians refusing to stand up to special interest concerns and made larger by regulators preferring to buy time rather than spread ill winds through an industry strewn with ill will (Statement of Congressman Jim Leach before the Committee on Banking, Housing, and Public Affairs, July 7, 1988, Condition of the Federal Deposit Insurance Funds: 163).

In this way, the American understanding of why the pre-crisis regulatory system had failed departed from the Canadian and Spanish understandings. Policymakers in all three countries believed that the banking and thrift regulators had fallen down on the job. However, while Canadian policymakers argued that the regulatory failure was the product of inadequate regulatory power, and Spanish policymakers argued that it was the product of inadequate regulatory knowledge and authority. American policymakers argued that it was the result of regulators’ inadequate will to act. This understanding had important implications for the content of the reform debates to come. If regulators were inherently prone to look the other way when the institutions they oversaw ran into problems, as American policymakers believed that they were, then giving regulators new powers or access to more information would not resolve the underlying problem that had led to the failure of the regulatory system.

In short, during the reform debates of the 1980s, American policymakers, regulators, academics, and industry participants settled on the same basic understanding of what had caused the banking crises of this period. The issue was that deregulatory reforms had taken place in a system where proper market incentives, which should have allowed order to emerge organically in such a system, had been distorted by prior government interference (Oversight Hearings on
the Condition of the Banking System, October 5, 1989, Kaufman, 14). Compounding the problem, the government regulation that had been imposed in the place of market regulation of bank behavior was seen as an inherently inferior substitute.

Legislative Reforms Embody the Frame of Competition

American policymakers passed two major legislative reforms in the aftermath of the banking crises of the 1980s to address the perceived causes of these crises. In August 1989, President George H.W. Bush signed the first reform, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) into law. Although this law was primarily intended to clean up the mess in the S&L industry, it also introduced important changes in thrift and commercial bank regulation.25 FIRREA sought to restore order to the American financial system by increasing capital requirements for thrifts, reducing regulator discretion, and by initiating an in-depth investigation of the federal deposit insurance system. Most of its provisions enjoyed near-unanimous support from all of the members of the financial industry, including banks, credit unions, savings institutions, and bank holding companies (Financial Institutions Reform, Recovery, and Enforcement Act of 1989, House, March 16, 1989: 18; 1-2; 16-18; 26).

The primary justification for increasing the capital requirements for thrifts was that higher capital holdings were necessary to correct for the distorted incentive structure within the financial system, and by extension, to protect the solvency of the deposit insurance system (Deposit Insurance Issues and Depositor Discipline, October 3, 1990: 29). This provision was notable in the extent to which it broke with tradition. Over the past decade, American policymakers and regulators had consistently reduced capital requirements for banks and thrifts.

25 The law is best remembered for allocating $150 billion in taxpayer funds to resolve insolvent institutions and for establishing the Resolution Trust Corporation to facilitate this formidable task.
As explained in Chapter 4, the goal in reducing the stringency of the regulation that governed thrifts was to maintain the specialized character of the American financial system (e.g. with banks and thrifts operating as independent and distinct types of institutions). In a context where rising interest rates threatened to put an end to thrifts altogether, preserving thrift independence had required policymakers and regulators to reduce capital and solvency standards for these institutions. In seeking to increase capital requirements for thrifts, American reform proponents were breaking with past practice, with the goal of restoring the appropriate corrective mechanism to the financial system - even if this restoration would threaten the survival of thrifts as separate institutions. As Senator Kennedy explained, reform advocates believed that restoring order to the financial system would require a break away from well-intentioned (but harmful) attempts to lower the regulatory bar for struggling institutions:

One of the principal reasons that the thrift industry is in such a mess is the capital standards and their laxity. Misplaced sympathy for the thrifts has led the Federal Government to relax capital and regulatory standards, and the resulting system has been abused by high-flying investors. In a sense, we have been killing the thrifts with kindness. [This why] [t]he Bush plan [for the reform of thrift regulation] moves in the direction of tougher capital requirements (Financial Institutions Reform, Recovery, and Enforcement Act of 1989, March 16, 1989: 174).

It is worth noting that in the same period in which legislators were increasing capital requirements for thrifts with FIRREA, the American banking regulators were also adopting a new method of calculating capital requirements. In 1988, the Federal Reserve signed on as a party to the Basel Capital Accord, and agreed to enforce a uniform set of capital guidelines based on the riskiness of a bank’s asset portfolio. In a Federal Reserve Bank of Richmond research publication, Kuprianov and Mengle (1989) framed these risk-sensitive capital requirements as a corrective to the distorted incentive structure that was believed to have produced the banking crises of the 1980s. As the authors explain, these capital requirements addressed the problem of
excessive bank risk-taking by changing the incentive structure banks faced:

While one may argue with specifics of the proposal [that introduced risk-based capital requirements], it clearly marks an advance over previous regulation of banks for at least three reasons. First, it places implicit costs on certain risky activities. This makes banks internalize some of the costs of taking on added risk while at the same time allowing banks more flexibility than under direct regulation (Kuprianov and Mengle 1989).

Accordingly, the federal banking regulators believed that “higher capital requirements should go a long way toward inducing market-like behavior in banks” (Greenspan, Deposit Insurance Issues and Depositor Discipline, October 3, 1990: 14; Seidman: 65).

However, most American reform advocates regarded the increase in bank and thrift capital requirements as a temporary fix for a more pernicious problem. Temporarily increasing capital requirements, they argued, would not solve the underlying problem of regulators hesitating to crack down on struggling institutions. To resolve this perceived problem, reform proponents sought to both lower the extent of regulatory discretion and to enhance the level of market discipline in the American financial system (Financial Institutions Reform, Recovery, and Enforcement Act of 1989, House, March 22, 1989: 397. Findings of the ABA’s FSLIC Task Force). As Senator Schumer explains, limiting regulatory discretion was expected to promote order by addressing regulators’ natural tendency towards inaction when faced with struggling institutions:

One of the problems I think we face is having too much flexibility in the law with regulators…Five years from now, when this crisis is distant history and we're involved in some other crisis…we could be finding ourselves, unless we write some restrictions [on regulatory discretion] in the law, back in the drink again. I, for one, having lived through this hellish nightmare of what's happened here, don't want to just leave things to the discretion of the regulators. That's one of the problems that we got into before (Schumer, Financial Institutions Reform, Recovery, and Enforcement Act of 1989, March 16, 1989: 47).

Multiple FIRREA provisions sought to reduce the level of regulatory discretion in the financial
system. Regulators were required to follow new codified procedures and to better document their actions (Malloy 1989). The thrift regulators (the Federal Home Loan Banking Board) was dissolved and reconstituted as the Office of Thrift Supervision, and the thrift deposit insurance system was placed under the control of the FDIC. These new statutory restrictions on regulatory discretion followed directly from an understanding of regulators as fundamentally incapable of keeping risky banks in line.

FIRREA also initiated the attack on the program that American policymakers regarded as the root cause of distorted incentives in the financial system: the federal deposit insurance system. The Act required the federal financial regulators, in conjunction with the Secretary of the Treasury, to undertake a study of the bank and thrift deposit insurance systems and to advance suggestions for reform. This move was widely supported by the banking industry, the administration, and the federal banking regulators, as the following testimony from Federal Reserve Chairman Alan Greenspan implies:

The Federal Reserve Board attaches considerable importance to the provision of the proposed legislation that calls for the Secretary of the Treasury, in conjunction with the Federal financial regulators, to undertake a study of the Nation's deposit insurance system. There are major areas of concern about the system, focusing on its apparent bias toward excessive risk-taking, its tendency in the direction of differential treatment of small and large institutions, and the unintended expansion of insurance coverage through such techniques as brokering deposits that have been disaggregated into $100,000 segments (Financial Institutions Reform, Recovery, and Enforcement Act of 1989, March 16, 1989: 152).

In the end, the content of FIRREA reflected a triumph of the frame of competition over the frame of deconcentration. With this legislation, American policymakers had started to break away from a traditional emphasis on reinforcing the fragmentation and specialization of the banking system in exchange for an emphasis on restoring order by removing barriers to the free operation of market mechanisms.
The situation in the American banking system continued to deteriorate after FIRREA was enacted. At the time, there was widespread concern that the banking industry would follow the thrift industry into collapse, and that the FDIC (like the insolvent FSLIC) would require a large injection of taxpayer funding. Congress responded quickly, passing the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in November 1991. FDICIA was a major reform that dramatically altered the structure and function of the bank regulatory system. Its provisions were governed by three key objectives: to increase the overall level of capital in the banking industry, to reform the function of the bank regulatory and supervisory system, and to reform the federal deposit insurance system (Deposit Insurance Issues and Depositor Discipline, October 3, 1990). In service of these objectives, the Act introduced a number of initiatives to make regulation more risk-sensitive, mitigate the effects of moral hazard, and curtail the discretion of the banking and thrift regulators.

The overarching goal of FDICIA was to further reform the bank and thrift deposit insurance systems. Having diagnosed risk insensitivity as the problem, reform advocates (including the majority of policymakers and the federal banking regulators) sought to enhance the risk sensitivity of the deposit insurance system. As FDIC Chairman Seidman explained, the goal of this reform was to reintroduce market discipline into the financial system:

The deposit insurance system should be designed to ensure that the industry -- both the institutions and their customers -- bears the appropriate costs. The deposit insurance system should not result in a subsidy to the banking industry, particularly a subsidy that eliminates the penalties the marketplace imposes on reckless conduct (Deposit Insurance Issues and Depositor Discipline, October 3, 1990: 65).

26 “This time last year, the committee began work on the Financial Institutions Reform, Recovery and Enforcement Act. This act brought the committee face to face with serious deficiencies in the deposit insurance system. However, the legislation was conducted in the emergency room, so to speak. It is now time for the committee to begin the practice of preventive medicine” (Chairman Henry B. Gonzalez, Deposit Insurance Reform, February 21, 1990: 1).
Deposit insurance was established some 55 years ago and today we believe that it is at a watershed period. It was created as a reaction to severe problems the banking industry and its depositors faced during the Depression. However, the role and nature of deposit insurance as conceived in the 1930's has changed dramatically as the structure of the banking system has evolved. Recent experience with deposit insurance in both the banking and thrift industries indicates that substantial improvements need to be made to the system to meet current conditions. Improvements to the system are necessary in order to contain potential insurance losses and define the scope of the Federal safety net. **Better supervision and market discipline are required to achieve this result** (Condition of the Federal Deposit Insurance Funds, July 7, 1988: 109).

FDICIA reduced the scope of deposit insurance by limiting insurance on brokered deposits, linking the premia banks pay on FDIC insurance to their financial strength, and creating a risk-based deposit insurance assessment scheme. The express goal of all of these initiatives was to reduce the incentive for banks to take on excessive risks, and to increase the incentives for shareholders and creditors to more closely monitor bank risk-taking (*Deposit Insurance Issues and Depositor Discipline*, October 3, 1990: 67).

FDICIA also dramatically reduced the discretion of the American banking regulators by imposing new statutory requirements for when and how regulators should resolve problems at troubled banks. The “prompt corrective action” provision required the federal banking regulators to apply progressively more severe penalties in response to declining capital at insured depository institutions. In short, if bank capital fell below the cut-point specified by legislation, the regulator was obligated to take specific supervisory actions, which were outlined in statute. The “least cost resolution” provision also restricted FDIC discretion by requiring the deposit insurer to choose the bank failure-resolution method that would minimize the cost to taxpayers. Finally, FDICIA also required banks to switch to preparing regulatory statements in accordance with generally accepted accounting principles (GAAP), rather than regulatory accounting principles (RAP). This action further reduced regulator discretion by taking control over bank
accounting entirely out of regulatory hands. As with FIRREA, all three of these initiatives were intended to minimize the effects of “regulatory forbearance” that was believed to have contributed to the bank and thrift crises (Deposit Insurance Issues and Depositor Discipline, October 3, 1990: 92).

Summary: United States

I argue that the American legislative reforms of the late 1980s and early 1990s embodied a return to the frame of competition and signaled the beginning of a decline in the dominance of the frame of deconcentration. Having diagnosed the primary cause of the crisis as the presence of government initiatives that blocked market mechanism and promoted moral hazard, American policymakers adopted reforms that were intended to supply what they believed the financial system was missing. FIRREA and FDICIA sought to reduce the discretion of the banking and thrift regulators, to increase capital requirements for regulated institutions, and to increase the risk-sensitivity of the deposit insurance, regulatory, and supervisory systems, all in the name of enhancing the role of market discipline in the financial system. At the same time, these reforms also represented a move away from model of enforced specialization and fragmentation that had dominated American financial regulatory policy for over five decades. In addition to increasing capital requirements for banks and thrifts, FIRREA and FDICIA also permitted bank holding companies to directly purchase and own thrift institutions for the first time, and it also consolidated the deposit insurance systems for the banking and thrift industries.

THE CRISES OF THE 1980s AND LEGISLATIVE CHANGE IN CANADA

The banking and thrift crises that took place during the 1980s in Canada were comparatively mild. A number of thrifts failed in the early-to-mid 1980s, with minimal cost to the system. However, the losses were nowhere close to the losses associated with the thrift crisis
in the United States, and this event did not inspire serious reform. The collapse of two Canadian banks in the mid-1980s was a more politically salient event. In 1985, the Canadian government closed and liquidated the assets of two small, regional banks in the western province of Alberta. These banks, the Canadian Commercial Bank (CCB) and Northland Bank, were the first Canadian chartered banks to fail in over 60 years. These failures alarmed policymakers and the public, and Parliament devoted considerable resources to explaining what had gone wrong. Policymakers immediately called legislative hearings and initiated a large-scale government investigation.

The two failed banks had many characteristics in common. Both had been in operation for a relatively short time, and both had engaged in unsound lending during the economic boom of the late 1970s. Both lent excessively to firms in volatile sectors, like real estate, construction, and energy. The CCB also purchased a minority interest in an American bank that later proved to be unsound. In March 1985, CCB asked the federal government for assistance, and the Government of Canada, the Government of Alberta, and six chartered banks arranged a $55 million bailout package. However, the initial bailout proved insufficient. CCB had not accurately assessed its losses, and the government was forced to advance another $0.3 billion to the failing bank before it eventually shuttered its doors in late September. On the same day that CCB was allowed to fail, Northland Bank was placed under a curator. The March collapse of CCB collapse had shaken money markets - and Northland was seen as the same sort of bank. Northland soon ceased operations and was eventually liquidated.

**Diagnosing the Crisis: New Entrants and Bank Mismanagement**

Canadian policymakers from all political camps agreed that poor strategic choices on the part of executives who had managed the failed banks explained the banking crisis of the 1980s.
The accounts of the crisis offered by Mike Cassidy and Dan Heap, both Members of Parliament from the New Democratic Party, are generally representative:

We had the very unfortunate collapse of two western banks a couple of years ago, apparently caused by unwise lending practices, unwise in the sense that they made bad loans because they thought they would get high interest, and their investors invested because of high interest (Dan Heap, *Hansard*, House of Commons, May 29, 1987: 6543).

It became clear that financial difficulty was frequently related to severe errors on the part of managers, to excessive risk-taking, to self-dealing, to conflict of interest, and to the mismatching of assets and liabilities (Mike Cassidy, *Hansard*, House of Commons, May 4, 1987: 5672).

In short, it was clear to all that the managers of failed banks had displayed poor judgment, and that bank shareholders had abetted (or at least failed to restrain) this behavior. The question was why managers and investors had behaved so imprudently. In Canada, the explanation that prevailed was that the financial liberalization of the preceding two decades had allowed a new type of manager to enter the financial system (*Hansard, House of Commons*, May 4, 1987). In the 1960s and 1970s, Canadian policymakers had relaxed barriers to entry in banking system as part of an effort to introduce more beneficial competition into this system. But in doing so, the advocates of reform argued, policymakers had also introduced new risks into the system. In Chapters 3 and 4, I explained how Canadian policymakers came to believe that order would emerge organically as chartered banks (owned and controlled by qualified, stable, and self-supporting groups and individuals) freely pursued their interests in an environment governed by informal regulation that the banks themselves had created. The problem, reform advocates argued, was that in granting bank charters more freely, Canadian policymakers had weakened the mechanism through which self-regulation produced order (*Hansard, House of Commons*, May 4, 1987). The idea was that in expanding the banking privilege to additional groups, policymakers had unwittingly facilitated the replacement of the “gentleman manager” of the past by the less
prudent and experienced “fast boys” of the present. This compositional shift in the Canadian banking system was believed to have induced excessive bank risk-taking among many of the newly-created institutions (*Hansard*, House of Commons, May 4, 1987: 5671; 5676).

However, as Simon de Jong, a Member of Parliament from the NDP, explained, the problem was not that opening up the Canadian banking system to new entrants had promoted greater risk-taking - the real problem was that the Canadian regulatory framework had not kept pace with these important changes:

> [T]he regulatory agencies were indeed woefully inadequate in dealing with the crisis. You see, our regulators sort of assumed that our banks were controlled by a group of Methodist managers. It wasn’t the fear of the government or the regulators which forced them to be honorable gentleman in banking, but the fear of God. If they tried to play hanky-panky with the books and other people’s deposits, they would answer to God on the day of judgment. We are now living in a new era. The smart boys on the street do not have the fear of God in them…It was really the fast boys who brought about the collapse of a fair number of our financial institutions…(*Hansard*, House of Commons, May 4, 1987: 5696-7).

In short, the Canadian understanding of why banks had taken excessive risks differed from the American and Spanish understanding in that where American policymakers blamed excessive bank risk-taking on an incentive system that disrupted market mechanisms, and Spanish policymakers saw this behavior as a natural (but undesirable) response to mounting competitive pressures, Canadian policymakers blamed a compositional shift within the banking system, and a lack of regulatory adjustment to this new reality. An examination of the reform debates leading up to the passage of the *OSFI Act* and the 1987 revisions to the Canadian *Bank Act* reveals that this diagnosis was shared by Canadian policymakers across political lines (e.g. *Hansard*, House of Commons, May 4, 1987: 5671-5672). Mike Cassidy’s complaints represent the prevailing sentiment:

> We have had a surfeit of public policy studies of regulation of financial institutions…[a]ll these reports concluded…that there was a major systemic
weakness in the government’s ability to spot and identify problems in unhealthy institutions and, further, to do something about those problems once they began to be identified (Hansard, House of Commons, May 4, 1987: 5672).

In diagnosing the insufficiency of the legal and regulatory framework that protected the rights of weaker individuals in a newly liberalized market as the primary cause of the banking crisis of the 1980s, Canadian reform advocates pulled from key tenets of the frame of public protection. Operating in a context in which the existing system of regulation embodied the frame of private autonomy, I suggest that reformers in Canada were primed to search for the causes of the failure of this system in the inadequate preservation of individual rights. The underlying idea was that regulators had a duty to protect the rights of the Canadian public from encroachments (especially by state-sponsored institutions!), but had failed to do so.

**Legislative Reforms Embody the Frame of Public Protection**

In 1987, Canadian policymakers introduced two major reform packages to address and remedy these perceived regulatory failures. The purpose of Bill C-42, the first reform, was to realign the structure of the regulatory, supervisory, and deposit insurance systems. Bill C-42 combined two existing regulatory agencies, the Office of the Inspector General of Banks and the Department of Insurance, to create a new agency, the Office of the Supervision of the Financial Institutions (OSFI), and gave the reformed agency substantially greater powers and authority. As the arguments of members of parliament Bill Attewell (NDP) and Mike Cassidy suggest, reform proponents framed the creation of this agency as a response to the changing character of the banking system that had weakened the “gentlemen’s code” that had served as the foundation of an effective self-regulatory system:

The reform in Bill C-42 is a consequence of… the concerns I and many other have been raising about institutional solvency and about the fact that the standard of behavior for people involved in the financial services industry is changing to the point where we can no longer trust the unwritten gentleman’s code that ensured
Recent events would indicate that the traditional gentleman’s approach to financial supervision is no longer appropriate in an environment of increased risks, frequent and significant economic shifts, and intense competition. A more assertive supervisory approach is required, together with the requisite enforcement powers to get the job done. The traditional reactive mode of supervision must give way to a proactive mode. (Attewell, *Hansard*, House of Commons, May 4, 1987: 5676).

Reform advocates argued that if Canadian policymakers hoped to restore order to the banking system by protecting the public from financial institution abuses, the government would need to take a more proactive role in supervising and regulating banks (*Hansard*, House of Commons, May 4, 1987: 5668). The vast majority of Canadian policymakers believed that the existing bank regulatory agency, the Office of the Inspector General of Banks, was understaffed, underfunded, and lacked sufficient power to intervene in the banking system (*Hansard*, House of Commons, May 4, 1987: 5675; 5668; *Hansard*, House of Commons, May 29, 1987: 6542; 6547). The solution, reform advocates argued, was to create a strong, centralized regulatory and supervisory authority - a prudential regulatory agency with teeth. This initiative clearly represented a departure from past practice in Canadian banking regulation. For centuries, policymakers had resisted the imposition of external regulation, favoring industry self-regulation instead. Thus, in creating OSFI, Canadian policymakers were clearly shifting to an alternative regulatory model.

The second reform package, Bill C-56, combined two seemingly unrelated initiatives. Like Bill C-42, Bill C-56 sought to strengthen prudential regulation by giving new powers to the prudential regulatory agency, like the authority to issue cease-and-desist orders and to revalue bank assets secured by real estate (*Hansard*, House of Commons, May 29, 1987: 6547; *Hansard*, House of Commons, June 30, 1987: 7832). But at the same time, Bill C-56 also gave banks new powers. It removed limits on investment and ownership of securities firms by Canadian financial
institutions and gave Canadian banks the power to underwrite corporate securities. At first glance, these two reforms may seem at odds. As Cassidy noted during the second reading of Bill C-56, it seemed that “[t]he government has come up with a legislative compromise in which it is trying to both deregulate and re-regulate the system” (Hansard, House of Commons, May 4, 1987: 5671). To understand the seemingly paradoxical content of Bill C-56, it is important to attend to the lenses through which Canadian policymakers viewed the challenges they confronted.

Minister of Finance Hockin describes the “considerable challenge” that policymakers saw themselves as confronting in this period:

During the last 2 ½ years the federal government was faced with a formidable challenge. It had the responsibility of formulating a policy which would, first and foremost, protect the public interest and the safety of depositors. Second, we wanted to introduce a policy which would allow our Canadian financial institutions to compete in a rapidly changing global environment...objectives were to protect the system and the depositors while making it a modern, global system (Hansard, House of Commons, May 4, 1987: 5666).

Canadian policymakers were in a bind. They had diagnosed insufficient protection of the public’s right to a safe and stable banking system as the root cause of the crisis, and had recently strengthened prudential regulation to address this perceived problem. At the same time, they had not abandoned their desire to preserve private autonomy. Canadian policymakers, drawing from the frame of private autonomy, continued to believe that banks freely choosing their own activities and structures was the mechanism that produced a profitable and internationally competitive banking system. In short, they believed that safety and prosperity derived from fundamentally different sources.

As explained in Chapter 4, preserving Canadian control over the domestic financial system was an important goal for Canadian policymakers, and in the 1960s and 1970s, they came believe that accomplishing this goal would require Canada to maintain strong financial
institutions that could defend their own interests in international competition. The desire to maintain and promote a strong and internationally competitive Canadian financial system was very clearly the rationale behind the provision giving banks the power to own and invest in securities firms. The policy allowed foreign institutions to own Canadian securities dealer as of June 1988; however, Canadian financial institutions would get a head start (Hansard, House of Commons, May 29, 1987: 6550). As Minister of Finance Hockin explained:

The power for federal institutions to own securities dealers, as well as the constraints on the initial participation by non-resident owned institutions, are being introduced to this afternoon to ensure a strong and viable Canadian presence in the strategic securities industry as it is increasingly opened to international competition. We recognize that they must be part of the international market, but we want to give them an important head start (Hansard, House of Commons, May 29, 1987: 6548).

Stricter regulation was not only seen as the key to public protection, it was also regarded as a quid pro quo for these new powers. Increasing bank powers may have made these institutions more intentionally competitive, but this also increased the chance that these powerful institutions would abuse others. For this reason, Canadian policymakers sought to accompany this process of ongoing financial liberalization with a strong prudential framework that would keep banks in line without forcing regulators or policymakers to intervene too heavily in their selection of activities. As Ms. Nicholson, a member of parliament from the Liberal party, explained, the goal was to strike the right balance between public-protecting restrictions and bank-strengthening freedoms:

The government’s goal of greater integration of services can lead both to greater competitiveness and to greater concentration. It is very important to ensure that appropriate balance is struck. Greater integration also brings with it greater potential for abuse and conflict of interest, and that’s a greater need for consistent and vigilant regulation (Hansard, House of Commons, May 29, 1985: 6551).

In Chapter 6, I explain how this commitment to striking the right balance between these competing considerations would become the defining characteristic of the Canadian financial
regulatory system moving forward.

**Summary: Canada**

The Canadian reforms of the late 1980s reflected a return to the frame of public protection, and a move away from the exclusive commitment to preserving private autonomy. Having diagnosed the primary cause of the crisis as a weak supervisory and regulatory system that had not adjusted to changes in the composition of the financial system, Canadian policymakers adopted reforms that established a new prudential regulatory agency and gave this agency new powers to protect the rights of vulnerable creditors, policyholders, and depositors. At the same time, Canadian policymakers continued to expanded the range of permissible bank activities. The goal was to strike the right balance between the structure that promoted safety and stability in the banking system (a regulatory framework that protected individual rights) and the mechanism that produced prosperity and maintained the autonomy of this system (the free choice of structures and activities by private banks).

**THE CRISSES OF THE 1980s AND LEGISLATIVE CHANGE IN SPAIN**

The Spanish banking system suffered a major banking and financial crisis between 1977 and 1985. The 1973 oil price shock and the break-up of the Bretton Woods system disrupted the stable economic environment that had existed in Western Europe since the end of the Second World War. After a decade of rapid growth, the Spanish economy began to stagnate in the mid-1970s, while inflation skyrocketed. During the same period, Spanish policymakers had taken steps towards financial liberalization. The relaxation of barriers to entry, deposit rate controls, and investment coefficients led to increased competition in the banking sector (Martín-Aceña et al. 2010). New credit institutions were created, and existing financial institutions expanded into new business areas. Credit to financial and non-financial corporations expanded dramatically.
In the adverse economic conditions of the mid-to-late 1970s, industrial firms started to struggle. As these firms struggled to repay loans, the cost of credit increased. Debt reached unsustainable levels, and major industrial firms began to fail. The crisis in the banking system broke in two waves. The first wave began in February 1978 with the insolvency of two small regional banks, the Banco de Navarra and Banco Cantábrico. The crisis was initially limited to the failures of the smaller banks that had been created during liberalization efforts of the 1970s. None of these banks survived the crisis as independent institutions. All told, 90 percent of the banks that were involved in the crisis had been established between 1973–78 (Caruana 2009: 35). The second wave of the crisis began in the early 1980s, and affected larger banks with heavy exposures to failing industrial firms, especially those in traditionally volatile industries.

In 1983, the Ministry of Finance elected to nationalize 18 banks that formed the massive RUMASA banking group (Lukauskas 1992: 378). Over 70 percent of the credit granted by seventeen affiliated banks went to finance the operations of the 600 industrial and commercial firms in the group. By the end, the crisis had become widespread. 52 of the 110 banks that were active in the Spanish banking system in 1977 experienced solvency problems. Resolving the crisis was costly: the gross fiscal cost of the rescue operation represented 5 percent of GDP (Martín-Aceña et al. 2010: 38).

**Diagnosing the Crisis: Heightened Competition**

Policymakers across political lines agreed that one major cause of the Spanish banking crisis of 1977-1985 had been the “disorderly expansion” of the banking system that had followed the financial liberalization efforts of the early 1970s (Tortella and García Ruiz 2013). These policymakers may have disagreed on the desirability of continuing to liberalize the financial system moving forward, but even the strongest advocates of financial deregulation (located in the
Bank of Spain and the Ministry of Finance) did not contest that the liberalization process to date had been mismanaged, and had proceeded too quickly. The idea was that financial liberalization had encouraged an explosion in small and medium-sized banks, which had disrupted order by allowing new, excessively risky, and unprofessional actors to enter the financial system. As Minister of Finance Miguel Boyer Salvador, a member of the left-leaning Partido Socialista Obrero Español (PSOE), explained:

[A] set of circumstances have been instrumental [in causing the banking crisis]...related to the rupture of the banking status quo in 1972, which led to the creation of new banks whose authorization in some cases should not have occurred given their speculative orientation and lack of professionalism, and which, in any case, reached the crisis stage insufficiently established and not in adequate financial condition (Diario de Sesiones Del Congreso de Los Diputados, February 18, 1983).

As further evidence that this diagnosis of the causes of the crisis was shared by policymakers across political lines, consider the comments of Boyer’s political rival, Abel Matutues y Juan, a member of the right-leaning Partido Popular:

I find [Minister Boyer’s] analysis regarding the negative effects, that, in addition to leading to the crisis, led to the breakdown of the banking status quo, to be correct. Here, the problem...was not that more banks were needed, but more and better bankers. Therefore, I seriously doubt whether new banks, which as a result of auctions go into the hands of the State, or the birth of credit unions, will increase the professionalization of the sector. I fear that, however, the effects are very different and contradictory (Diario de Sesiones Del Congreso de Los Diputados, February 18, 1983).

However, it was not only small banks that had failed during the crisis. A number of established banks that had lent heavily to industrial firms in volatile industries also collapsed, with wide-ranging implications. These banks had lent heavily their industrial affiliates during the credit boom of the 1970s, and suffered major losses when these industrial firms failed. In a retrospective analysis of the causes and responses to the banking crisis of 1977-1985, former
Bank of Spain Governor Jaime Caruana explained how this concentrated lending to industrial affiliates left banks exposed to extensive credit risk:

In the Spanish case, the most significant factor [in promoting the crisis] was credit risk. [Banks] failed because their losses on doubtful and unrecoverable assets exceeded their capital, in some cases two or three times over. Credit risk was aggravated by the concentration of the risk of the loan portfolio in the group to which the institution itself belonged (Caruana 2009: 36).

To explain these bank failures, Spanish policymakers blamed the liberalization of the financial system once again. The idea was that financial liberalization of the 1970s had introduced heightened competitive pressures into the banking system, which had encouraged these banks to take excessive risks, as a columnist from the center-right newspaper *El Pais* explains:

Until the last decade, banking has followed that picture framed by Cambó in 1921. However, recently, banks have been forced to accept decisive changes that have introduced a greater degree of freedom and competition in the financial market. Banks have thus lost much of their corporate character and have been forced to face increasing foreign and domestic competition, a phenomenon unknown since 1921 - and, coinciding with the current economic crisis, this has caused remuneration on deposits and the narrowing of operating margins to rise to reckless levels, problems which have also been exacerbated by the concentration of risk in...banking (*El Pais* 1981).

Heightened competitive pressures, then, had caused even established banks to take excessive risks. Making matters worse, finished policy makers also believe that the same competitive pressures had encouraged banks to hide their risk exposures away from the watchful eyes of regulators. As Caruana explained:

In a weak accounting and supervisory environment, as existed in Spain in the 1970s, bankers in trouble have a tremendous capacity to conceal losses. In particular, they did not recognize bad assets and avoided provisioning for them...This was fully known only when examiners came into the banks to make a full assessment of the situation (Caruana 2009: 40).

Martin-Acena, Pons, and Bertran (2009) echo the same general understanding in their description of the causes of the crisis. These scholars suggest that key regulatory actors viewed
the inadequacy of the existing regulatory framework, which did not allow for sufficient regulatory awareness of or oversight over bank risk-taking:

The authorities (Ministry of Finance and Bank of Spain) realized that the previous framework was flawed in many respects. The regulations in place at the time of the banking crisis were inadequate and insufficient. The financial statements provided by banks did not permit [regulators] to evaluate the real risks of the institutions. Accounting procedures were obsolete. Moreover, the inspection capacity of the Bank of Spain was limited, and the sanctions that could be imposed on banks’ administrators for wrong doings were of dubious efficacy (Martin-Acena, Pons, and Bertran 2009).

In short, reform advocates in Spain offered a diagnosis for the banking crisis of the 1980s that drew from the frame of centralized coordination and direction. Spanish policymakers believed that the pre-crisis regulatory system had failed because it had not given an external authority sufficient awareness or control over bank activity in a newly competitive environment. In a departure from the perspective of the American policymakers, who saw excessive risk-taking as the unnatural result of a distorted incentive system and inadequate market discipline, or Canadian policymakers, who attributed it to the changing composition of financial professionals, Spanish policymakers saw excessive risk-taking as a natural response to heightened economic pressure.

**Legislative Reforms Embody the Frame of Centralized Coordination and Direction**

In 1988, Spanish policymakers passed a major reform of the banking system, entitled the “Discipline and Intervention of Credit Institutions Law” (Law 26/1988). In keeping with the prevailing diagnosis of the banking crisis, this reform sought, above all, to enhance regulators’ ability to oversee, coordinate activity, and redirect undesirable activity in the banking system. If the problem was that heightened competitive pressures had induced banks to take inappropriate risks that threatened the general interest, then it followed that one solution was for a powerful external authority to actively combat this unfortunate, but natural, bank response. Although Spanish policymakers disagreed on which portion of the state should have the authority to lead
the reform effort, there was near-unanimous agreement on the broad strokes of what this reform effort should involve (Diario de Sesiones Del Congreso de Los Diputados, April 21, 1988). Policymakers agreed that restoring order to the banking system would require better regulatory awareness of problems within the banking system and the power to fix these problems once spotted. This commitment is evident in the arguments that Minister of Finance Solchaga Catalán offered in favor of Law 26/1988 when it was introduced before the Cortes:

It beyond doubt that credit institutions, by their peculiar position in the economic system and due to the breadth and heterogeneity of the public to which they relate, should be subject to a system of administrative supervision of special intensity to ensure [that regulators have] the fullest information on their development and activities and to prevent practices or operations that increase their liquidity or solvency risk. The effectiveness of this regime depends on the existence of sufficient enforcement powers in the hands of the supervisory authorities, to ensure proper implementation (Diario de Sesiones Del Congreso de Los Diputados, April 21, 1988: 6420-1).

To restructure the regulatory system in a way that would achieve these goals, Spanish policymakers applied a familiar solution to a familiar problem. They consolidated and centralized regulatory authority within a single powerful institution: in this case, the Bank of Spain. Law 26/1988 enhanced the Bank of Spain’s scope of oversight, introducing a common set of regulatory standards for all financial institutions and giving the Bank of Spain the authority to regulate supervise these institutions, and granted this regulatory agency new powers. As Minister of Finance Catalán explained, the intention in consolidating regulation for all Spanish credit institutions, and centralizing the regulatory control of these institutions within the Bank of Spain, was to rationalize the banking system and make it easier to govern. Once again, excessive fragmentation and heterogeneity were problems to be solved through centralized coordination and direction:

Current legislation is also insufficient and unsatisfactory due to its absolute heterogeneity and dispersion. This heterogeneity is not reasonable once one takes
into account the basic unity of nature and activity of the various categories of 
credit institutions: dispersion ultimately leads the principle of legal certainty to 
suffer…The problems posed by the situation just described…are not merely 
academic; in fact, we have experienced these problems dramatically in the not so 
distant past, with the banking crisis. This bill therefore seeks…first of all, to 
overcome the shortcomings of current legislation in the areas mentioned (Diario 
de Sesiones Del Congreso de Los Diputados, April 21, 1988: 6438).

The centralization and consolidation of regulatory authority within the Bank of Spain was also 
expected to solve another problem: regulators’ insufficient awareness of problems in the banking 
system. Spanish policymakers believed that regulators had failed to notice the mounting 
problems in the banking system because banks in trouble have a tendency to bury risk exposures 
inside of their subsidiaries, away from the attention of the supervisory authority (Caruana 2009). 
The newly powerful and centralized Bank of Spain was expected to resolve the problem of 
inadequate regulatory oversight in a newly competitive financial system by implementing a 
consolidated bank supervision program. Law 26/1988 required banks to submit consolidated 
financial statements to the Bank of Spain, and examiners were charged by assessing and 
evaluating the risk exposures of the entire banking group as a whole. The idea was that this 
centralized and consolidated approach would allow regulators to obtain better information on the 
entire range of a bank’s risk exposures at a given moment. Sufficient awareness of these 
exposures was regarded as crucial precondition of order: to effectively coordinate and direct 
bank risk-taking, regulators first had to be aware of what they were dealing with. This 
consolidated approach represented a key pillar of Spanish banking regulation in the period after 
the passage of Law 26/1988:

In terms of the lessons that marked the way supervision has been done at the Bank 
of Spain since [the crisis]…[o]ne is the need for comprehensive, consolidated 
supervision. It is more than emphasis; it is almost an obsession. Examiners 
analyze the banking group, the whole group, interpreting regulation very strictly 
to encompass as much as possible. The lesson from the crisis was that it is 
sometimes a subsidiary of a subsidiary that ruins a bank (Caruana 2009: 39).
A similar rationale (of enhancing transparency to improve regulatory efficacy) explains why the Bank of Spain also received the authority to set bank accounting standards. As the preamble of Law 26/1988 makes clear, the goal was to make risk exposure more transparent:

The Law consolidates and generalizes the provisions under which financial authorities have been empowered to issue minimum capital requirements for credit institutions, to determine their accounting statements and to impose minimum provisions in their standard contracts for the sake of ensuring transparency of the credit institutions and protecting the interests of their clientele (Law 26/1988: 1).

Centralizing regulatory authority within the Bank of Spain was also expected to improve capacity for the effective coordination of all types of financial activity. The preamble to Law 26/1988 outlines this connection:

[P]owers to register, monitor and inspect all credit institutions, as well as mutual guaranty companies, are concentrated in Banco de España. This concentration is justified, first, by the similarity of activities and the problems of these entities, which need coordinated treatment (Law 26/1988: 3).

Finally, the centralization of regulatory authority was also expected to enhance the Spanish regulatory system by improving the speed of regulatory response. Sr. Munoz Garcia, a member of the PSOE, citing the work of Spanish economist Alvaro Cuervo García, argued in the reform debates that preceded the adoption of Law 26/1988:

Professor Alvaro Cuervo…says in his latest book on the banking crisis that it wouldn’t be possible to have had an effective system of control from the central bank to prevent the banking crisis, not simply because the central bank lacked sufficient high-quality information, but also because of limits on [the central bank’s powers to] sanction [banks]. He says that our disciplinary system, which corresponds to an administrative legal system, is marked by slowness and rigidity that conflicts with the dynamics of situations [regulators] have to confront, which require agility, etc. These types of issues are what this law comes to put into order, because in the financial system, extreme agility is required, because there are situations that within hours become fully impaired (Diario de Sesiones del Congreso de los Diputados, May 11, 1988: 9631).
Law 26/1988 also gave the Bank of Spain new powers and authority to intervene to curtail undesirable bank behavior. Having established that the competitive environment had changed in ways that favored excessive bank risk-taking, reform advocates argued that repairing the system would require financial regulators to take a more proactive role to restrain this order-destroying behavior. The Bank of Spain used its new powers to crack down on risky activity in the banking system, by introduce limits on concentrated lending and other unacceptable banking practices and by establishing new (and very conservative) loan-loss provisioning and capital standards (Lukauskas 1992: 403; Law 26/1988).

The provisions of Law 26/1988 that enhanced the power and authority of the Bank of Spain did inspire some controversy. In the debates that preceded the passage of this reform, some opponents drew from the frame of centralized coordination and direction to argue that granting additional powers to a separate regulatory agency would destroy order by usurping the state’s authority to effectively direct economic policy (Diario de Sesiones Del Congreso De Los Diputados, April 21, 1988). Other opponents drew from the frame of balancing interests to protest that the centralized consolidation of regulatory power would infringe on the authority of the newly created autonomous communities (Diario de Sesiones Del Congreso De Los Diputados, April 21, 1988). But in the end, neither group of reform opponents seriously questioned the underlying diagnosis of the crisis as a failure of regulatory oversight and intervention in a newly competitive environment, nor the basic premise of the reform designed to address it. Virtually all Spanish policymakers agreed that restoring order to the banking system would require a stronger, proactive regulatory authority to more effectively coordinate and direct activity within the financial system (see for example the comments of Sr. Olabarría Muñoz,
Diario de Sesiones Del Congreso De Los Diputados, April 21, 1988: 6421). They simply disagreed on where this regulatory authority should be housed within the state.

Summary: Spain

The Spanish legislative reforms of the late 1980s embodied key tenets of the frame of centralized coordination and direction. Having diagnosed the primary cause of the crisis as insufficiently controlled (but natural) bank responses to mounting competitive pressures, Spanish policymakers adopted reforms designed to restore order by consolidating and centralizing regulatory and supervisory power within a single external authority. This consolidation and centralization was believed to make it easier for public-minded experts to obtain a clearer picture of activity within the entire system, and to proactively intervene to restrain undesirable bank behavior. Greater knowledge and greater power were both expected to enhance the regulator’s ability to effectively coordinate and direct activity within the system. To ensure that the banking system adequately served the general interest, an external authority had to take the lead.

CONCLUSION

In the 1980s, the US, Canada, and Spain experienced serious banking crises that shared common features. Policymakers in each country agreed on fundamental points: (1) these crises were ultimately the product of banks engaging in imprudent lending during an economic boom; (2) regulators had somehow failed to prevent this adverse bank behavior; (3) the recent liberalization of the banking sector had exacerbated the crisis because it had not been accompanied by necessary adjustments in regulation or supervision. However, they held different understandings about the why banks had taken excessive risks, why regulators had failed to stop this behavior; and why the regulatory system had failed in a newly liberalized environment. I argue that these different understandings reflected fundamentally different frames.
of regulatory order in each country.

To explain the crisis, American reform advocates drew from the frame of competition. Viewed through this lens, it appeared that banks had taken excessive risks because the presence of government policies had subsidized the costs of risk-taking. Regulators had failed to stop this behavior because they were biased and fallible, unlike the impartial market. Canadian reform advocates drew from the frame of public protection. Viewed through this lens, it appeared that banks had taken excessive risks because the composition of bank managers had changed to include less prudent and experienced individuals. Regulators had failed to stop banks from taking excessive risks because they lacked sufficient power to intervene and curtail undesirable bank behavior. Spanish reform advocates drew from the frame of centralized coordination and direction. Viewed through this lens, it appeared that banks had taken excessive risks because this was a bank natural response to heightened economic pressure. Regulators had failed to stop this behavior largely because they had lacked sufficient awareness of what banks were doing.

These different diagnoses of the causes of the crises shaped the content of the legislative reforms that followed. With FIRREA and FDICIA, American policymakers adopted new policies that sought to enhance the level of market discipline in the banking system through limits to regulatory discretion, risk-sensitive regulation, and larger capital requirements. With the OSFI Act and the 1987 revisions to the Bank Act, Canadian policymakers sought to strike the right balance between prosperity and safety, and did so by expanding bank powers while simultaneously establishing stricter prudential safeguards and creating a more powerful regulatory agency. With Law 26/1988, Spanish policymakers adopted new policies that sought to enhance regulatory oversight and coordination through consolidating and centralizing the regulatory and supervisory system and by enhancing the transparency of financial reporting.
I devoted a chapter to the reforms of the late 1980s and early 1990s for two reasons. First, this episode will prove important for future policymaking: as Chapter 6 will reveal, the frames of regulatory order that these reforms embodied also structured the divergent development of banking regulation in the post-Basel era. Second, these reforms also represented a radical break from past regulatory practice in each country, a circumstance that makes them theoretically interesting. American, Canadian, and Spanish policymakers didn’t just embrace new regulatory models in the late 1980s and early 1990s: they also explicitly moved away from old ones. These reforms broke with key tenets of the frames of regulatory order that had characterized regulatory policymaking in each country for almost 50 years: the promotion of specialization and fragmentation in the U.S., the preservation of self-regulation and private autonomy in Canada, and the reallocation of powers and privileges to harmonize interests and secure buy-in in Spain.27

I argue that the content of this radical break can only be fully explained by attending to the multiple meanings embedded within national institutions. I show that reform advocates in each country pulled from frames that had “lost” in the reform debates of the 1920s and 1930s, and yet again during the deregulation debates of the 1960s and 1970s, to explain and propose remedies for the problems of the 1980s. In short, the range of options that policymakers attended to was constrained by the availability and salience of particular alternative regulatory models. As a result of past experience, American policymakers were primed to see problems in blocks to market competition. Similarly, Canadian policymakers were primed to see problems in failures of the rule of law that protected the rights of weaker individuals, while Spanish policymakers were primed to see problems in fragmentation and unguided competition.

27 These models weren’t entirely abandoned with the reforms, but there was some movement away from them, they became second-order priorities, and their days were numbered moving forward (e.g. branching restrictions, restraints on investment/commercial banking in the U.S.).
CHAPTER 6:
THE DIVERGENT DEVELOPMENT OF BANKING REGULATION IN THE POST-
BASEL ERA

The 1988 Basel Capital Accord sought to increase the stability and soundness of the
global financial system by ensuring that banks around the world held adequate capital. Banks are
highly leveraged institutions, a characteristic that makes them very profitable, but also very
fragile. This funding structure magnifies the consequences of small missteps and leaves banks
unusually vulnerable to insolvency in the face of sudden losses. To keep unexpected costs from
driving them into ruin, banks keep a pool of funds on hand, known as bank capital, that acts as a
buffer against losses, absorbing them before they can hit the bank’s depositors or other
creditors. The Basel Accord emerged as a response to the banking crises that took place in most
of the world’s major financial capitals during the volatile 1970s and 1980s, which angered voters
and threatened market confidence. The crises suggested a need for reform, but at the same time,
domestic financial policymakers recognized they could not unilaterally impose stricter standards
without putting their banks at a competitive disadvantage in a cutthroat global marketplace
(Singer 2004). The banking regulators from the world’s major financial capitals responded by
creating the Basel Committee, an international regulatory forum, which introduced the Basel
Capital Accord as a solution to this problem.

The Basel Accord sought to restrict excessive risk-taking and restore solvency to the
global banking system by holding banks to a common capital adequacy standard, tied to the
riskiness of their activities. Banks from all Basel member countries were required to hold a
minimum of 8% in regulatory capital against their risk-weighted assets. The Accord also
introduced a series of risk-weights (or “capital charges”) for different types of bank assets.

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28 In technical terms, bank capital is defined as the funds left for shareholders after all of a bank’s
assets are liquidated and all of its liabilities paid off.
Riskier assets, like loans to small businesses, carried a 100% capital charge: this meant that banks would need to hold the full $8 in regulatory capital against each $100 of the loans they granted. Less risky assets, like loans to the governments of other OECD countries, carried a lower regulatory capital charge.

This international regulatory agreement was widely touted as an unprecedented step towards international regulatory convergence, as it represented the first time that the banking regulators from the world’s major financial capitals had agreed on a common set of rules (Rausa 2004). There is no question that the Basel Accord had real and lasting effects for bank behavior, or that its introduction reduced the extent of cross-national variation in banking regulation. However, as the events of the global financial crisis made obvious, cross-national differences in banking regulation continued to develop in the post-Basel era. While regulators from all of the Basel member countries complied with the basic terms of this international agreement, these terms, like those of most transnational regulatory agreements, allowed considerable room for local discretion. Banking regulators from different countries defined critical concepts in different ways; they augmented international regulatory standards by imposing requirements that went above the Basel minima; they adopted different regulations for other aspects of bank behavior with implications for bank capital adequacy (like loss provisioning); and they elected to apply the Basel standards to different types of financial institutions. The result was that the effects of the Basel Accord, like those of many other international regulatory regimes, ultimately rested upon decisions that remained squarely under local control.

My goal is to explain why national banking regulators exercised the local discretion that the Basel Accord afforded them in the different ways that they did. To this end, I trace the divergent development of banking regulation across three Basel member countries (the U.S.,
Canada, and Spain), focusing on policy choices in three specific regulatory domains: the regulation of bank participation in the securitization process, the regulation of bank loan loss provisioning practices, and the application of bank-style regulation to financial conglomerates. I selected these regulatory domains for the following reasons: (1) choices in each domain were substantively important, with critical implications for domestic bank outcomes during the crisis; (2) each domain highlights a different mechanism through which national policy can diverge in a world increasingly governed by transnational agreements; and (3) policy choices in each domain are directly comparable across all Basel member countries.

The patterns of divergent regulatory policymaking in the post-Basel era defy easy description, but some general trends do emerge. American banking regulation was comparatively permissive. American policy choices encouraged banks to pursue innovative activities, while building in very little margin for error. Spanish banking regulation was comparatively strict. Spanish banking regulators restricted bank involvement in innovative activities and ensured that banks held high buffers against potential losses. Canadian banking regulation fell in between these two extremes. Canadian policy gave banks substantial freedom to pursue innovative activities, but also required them to maintain high prudential safeguards against the potential for losses. Table 6.1 summarizes the pattern of policy outcomes in all three domains; I describe these patterns in detail below.

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29 Regulators may define underlying concepts in different ways (securitization); they may choose to regulate other behaviors, with implications for outcomes transnational agreements seek to control, in different ways (loan-loss provisioning); and they may apply common regulations to different types of institutions (financial conglomerates).
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<th>US: Competition</th>
<th>Canada: Public Protection</th>
<th>Spain: Centralized Coordination</th>
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<tr>
<td><strong>Securitization</strong></td>
<td>Prudential practice</td>
<td>Benefits and risks</td>
<td>Threat to order</td>
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<tr>
<td><strong>Policy</strong></td>
<td>Strongly committed to promoting bank involvement with securitization</td>
<td>Pursued harmonization, except where it threatened safeguards</td>
<td>Opposed bank involvement with OBS securitization</td>
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<tr>
<td><strong>Loan Loss Provisions</strong></td>
<td>Expendable</td>
<td>Major priority</td>
<td>Unique strict regime</td>
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<td><strong>Policy</strong></td>
<td>Regulators fold to accounting standard setter pressure</td>
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<tr>
<td><strong>Financial Conglomerates</strong></td>
<td>Ring-fence deposit takers</td>
<td>Comprehensive powers, but also comprehensive supervision</td>
<td>Consolidated regulation and supervision</td>
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<tr>
<td><strong>Policy</strong></td>
<td>I-banks escape prudential regulation</td>
<td>Financial conglomerates regulated</td>
<td>Financial conglomerates regulated</td>
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The chapter is organized as follows. I start by introducing the specific pattern of cross-national regulatory policymaking to be explained, and show why alternative theoretical accounts are not sufficient to explain it. Then, I introduce my own explanation for policy divergence, which implies that the same nation-specific frames of regulatory order that emerged in response to the banking crises of the 1980s (see Chapter 5) also shaped how banking regulators understood their missions in the post-Basel era. The bulk of the chapter is devoted to explaining how the correspondence between these regulatory missions and characteristics of the regulated practice shaped policy choices in two critical domains of banking regulation: securitization and loan loss provisioning.

**Regulation of Securitization**

The rise of securitization revolutionized banking by allowing banks, which had historically retained assets like loans and other forms of contractual debt until they matured, to
repackage these assets and sell the associated credit risk to the market. However, retained exposure to the risks of securitized assets served as an important source of losses for many banks worldwide during the recent global financial crisis. The way that national banking regulators chose to regulate bank participation in the securitization process had major implications for the extent to which domestic banks absorbed losses when the massive global asset-backed commercial paper (ABCP) market collapsed in August 2007.

The American, Canadian, and Spanish banking regulators approached the regulation of securitization in different ways. The American banking regulators actively encouraged bank participation in this process, consistently intervening to combat potential threats to securitization markets and leaving many choices about deal structure and capital allocation to the discretion of banks themselves. The Canadian banking regulators placed few limits on bank participation in the securitization process, but required banks to hold conservative buffers against potential losses in exchange for this privilege, and defined critical concepts (e.g. liquidity enhancements) very narrowly. The Spanish banking regulators actively opposed bank participation in the securitization process and imposed strict regulatory requirements that reduced the economic incentive for banks to transfer risk off the balance sheet. One result of these different regulatory regimes was that American banks absorbed the majority of losses when the ABCP market failed; Canadian banks absorbed fewer losses, and Spanish banks suffered no losses at all.

**Regulation of Loan-Loss Provisioning**

To account for the possibility that some loans in a bank’s portfolio will turn out to be bad, banks create a fund, known as the *loan loss reserve*, to absorb loan losses when they occur. American, Canadian, and Spanish regulators approached the regulation of loan-loss provisioning, or the practice of allocating funds to the loan loss reserve, in different ways. Different loan loss
provisioning policies had direct implications for bank capital adequacy. In countries where banks had set aside more funds to protect against potential loan losses (through the loan loss provisioning process), fewer loan losses were left to be absorbed by capital when the economy tanked during the crisis. Over the course of the 1990s and 2000s, the American, Canadian, and Spanish banking regulators all came into conflict with accounting standards-setters, who held different views about the correct way to calculate and report loan-loss provisions. In general, banking regulators want banks to maintain conservative loan loss reserves, while accounting standards-setters seek greater transparency in the provisioning process.

American, Canadian, and Spanish banking regulators chose to regulate bank loan loss provisioning in different ways. The American banking regulators caved in to accounting standards-setters’ demands for greater transparency, acquiescing to policy proposals that had the effect of lowering loan loss reserves at a time when credit risk was increasing. The Canadian banking regulators, by contrast, used every tool at their disposal to ensure that banks maintained conservative loan loss reserves - including permitting banks to violate generally accepted accounting principles (GAAP). The Spanish banking regulators developed a unique (and uniquely conservative) loan-loss provisioning regime, and they actively fought to preserve it when it came under attack in the mid-2000s. The result was that Canadian and Spanish banks were comparatively well provisioned against loan losses on the eve of the crisis; American banks were in a less favorable position.

**Application of Bank-Style Regulation to Financial Conglomerates**

Regulators in the Basel member countries were only technically required to apply the Basel Accord to large, internationally-active banks. However, in practice, most regulators went beyond this baseline standard. American, Canadian, and Spanish policymakers and regulators
varied in the extent to which they applied bank-style regulation to financial conglomerates, financial institutions that engaged in combinations of banking, insurance, and/or securities activities. The American banking regulators only applied the Basel standards to financial conglomerates that owned banks (e.g. Bank of America, Wells Fargo, Wachovia), which initially left standalone investment banks (e.g. Bear Stearns, Merrill Lynch, and Goldman Sachs) free from these regulatory requirements. This changed in 2005, when the Securities and Exchange Commission (SEC) - a market conduct regulator, not a prudential regulator - agreed to provide comprehensive regulation for standalone investment banks.\(^{30}\) By all accounts, the SEC was a shoddy prudential regulator, implementing a highly permissive version of the Basel II standards and doing little to enforce these standards. The Canadian banking regulators applied the Basel standards to all federally regulated financial institutions, which included all financial conglomerates engaged in banking or insurance activities. The Spanish banking regulators not only applied the Basel standards to all financial conglomerates - they were also at the forefront of pushing the EU to ensure that all financial conglomerates operating within its boundaries were subject to comprehensive, Basel-style regulation. The result was that the American investment banks entered the crisis with very high leverage and very little capital, and suffered accordingly when the crisis hit. Financial conglomerates in Canada and Spain entered the crisis in stronger financial positions.

**FRAMES OF REGULATORY ORDER**

I argue that the American, Canadian, and Spanish approaches to banking regulation in the post-Basel era are only fully interpretable in light of the frames of regulatory order that

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\(^{30}\) The passage of new legislation in the EU would have prevented U.S. investment banks from operating in Europe if these banks had not been subjected to some form of consolidated supervision.
structured policymaking in each country. In the U.S., this was the frame of competition; in
Canada, the frame of public protection; and in Spain, the frame of centralized coordination and
direction. Chapter 5 explained how these frames emerged from different diagnoses of the
banking crises of the 1980s, and were embodied in the legislative policy reforms of the late
1980s and early 1990s. I argue that the same frames also structured the policy choices of the
American, Canadian, and Spanish banking regulators in the post-Basel era. In what follows, I
briefly describe the content of each frame, and then explain how it informed the overarching
regulatory mission (and associated policy goals and objectives) of the regulatory agency with the
authority to regulate large, internationally-active commercial banks in each country. This was the
Federal Reserve Board of Governors in the U.S.; the Office for the Supervision of Financial
Institutions (OSFI) in Canada; and the Bank of Spain in Spain.

United States: Frame of Competition

The prevailing diagnosis for the American banking crises of the 1980s was that the pre-
crisis regulatory system had failed by blocking the market, the optimal governor of bank
behavior, from serving its proper disciplinary function. American policymakers believed that the
presence of market distorting policies, especially the presence of the federal bank “safety net” -
or the package of legislated protections for bank customers that included programs and policies
like deposit insurance, the lender of last resort, or access to the federal clearing system - had
caused the crisis by inducing banks to take more risks than they otherwise would have and by
removing the incentive for private market participants to stop this excessively risky behavior.
Compounding the problem, the actors charged with preventing excessive risk-taking in the pre-
crisis regulatory system, government regulators, had failed to intervene to stop this behavior until
it was too late. In Chapter 5, I explained how this diagnosis structured the content of the
American legislative reforms of the early 1990s. To restore order, American policymakers sought to enhance the role of market discipline in the banking system by making regulatory standards more risk-sensitive and by limiting the amount of discretion regulators had to apply these standards.

I argue that the same conceptualization of regulatory order embodied in these reforms also shaped the way that the American banking regulators approached their regulatory tasks in the post-Basel era. The American regulators subscribed to the same understanding of what had caused the banking crises of the 1980s as American policymakers. Federal Reserve Governor Alice Rivlin outlines the prevailing diagnosis:

In the 1930s, Americans learned, expensively, about the hazards of not having a safety net in a crisis that almost wiped out the banking system. In the 1980s, they learned a lot about the hazards of having a safety net, especially about the moral hazard associated with deposit insurance. Deposit insurance, which had seemed so benign and so successful in building confidence and preventing runs on banks, suddenly revealed its downside for all to see. Some insured institutions, mostly thrifts, but also savings banks, and not a few commercial banks, were taking on risks with a "heads I win, tails you lose" attitude--sometimes collecting on high stakes bets but often leaving deposit insurance funds to pick up the pieces. At the same time, some regulators…were compounding the problem--and greatly increasing the ultimate cost of its resolution--by engaging in regulatory "forbearance" when faced with technically insolvent institutions (Rivlin 1996).

In short, the American banking regulators subscribed to a view of bank managers as hyper-strategic actors that were ready and eager to exploit any loophole in government regulation. Government regulators, from this perspective, were fundamentally incapable of effectively restraining these actors. Only the impartial, unbiased operations of the all-seeing market could hope to keep them in line. These basic assumptions help to explain why the American banking regulators in the post-Basel era sought, above all, to enhance the role of market discipline in the banking system. In a world where the problem was defined as the absence of market discipline,
the solution was to restore what was lacking. Federal Reserve Governor Laurence Meyer explains the logic:

I have noted that the safety net dampens the incentive of the market to assess risks in banks. The solution is not to ignore the potential for market discipline, but rather to find ways to enhance its role in banking (Meyer, September 27, 1999).

In what follows, I explain how this overarching regulatory mission to enhance market discipline informed the major policy objectives of the American banking regulators in the post-Basel era. These objectives included: (1) avoiding direct regulatory interventions, (2) designing regulation to mimic market signals, and (3) improving market functioning.

(1) Avoid Direct Regulatory Interventions

Drawing from the perceived lessons learned from the banking crises of the 1980s, the American banking regulators assumed that market discipline and regulatory interventions operated as substitutes. They believed that when government regulators stepped in to direct or control bank behavior, the private market would invariably step out. Federal Reserve Chairman Alan Greenspan explains the mechanism through which this substitution effect was believed to occur:

It is critically important to recognize that no market is ever truly unregulated. The self-interest of market participants generates private market regulation. Thus, the real question is not whether a market should be regulated. Rather, the real question is whether government intervention strengthens or weakens private regulation. If...private market regulation is effective, then government regulation is at best unnecessary. At worst, the introduction of government regulation may actually weaken the effectiveness of regulation if government regulation is itself ineffective or undermines incentives for private market regulation. We must be aware that government regulation unavoidably involves some element of moral hazard--if private market participants believe that government is protecting their interests, their own efforts to protect their interests will diminish to some degree (Greenspan, February 21, 1997).

This assumption helps to explain why the American banking regulators were so eager to avoid introducing new regulatory restrictions in the 1990s and 2000s. Under a worldview in which
market discipline and regulatory interventions were framed as substitutes, and market discipline was assumed to be the inherently superior form of regulation, regulatory interventions represented a serious threat to order, because they were believed to block market discipline. Accordingly, the American banking regulators throughout the post-Basel era sought to avoid any direct interference with bank behavior to the greatest extent possible.

(2) Mimicking Market Signals

However, the American banking regulators did believe that regulatory intervention was warranted under a particular set of conditions. In areas in which market discipline was prevented from operating at full strength, American regulators believed that they had a duty to step in and correct for the weakness of private regulation. The bank safety net was framed as the central villain in this regard. The presence of the safety net in the American banking system was believed to obligate the American banking regulators to intervene to shape bank behavior, because these policies and programs blunted the operation of market forces. But how could banking regulators intervene to redirect bank behavior without introducing new market distortions in the process?

The answer was to design regulation that mimicked market signals as closely as possible. Chairman Greenspan outlines the logic behind this policy objective:

The disconnect between risk-taking by banks and banks' cost of capital, which has been reduced by the presence of the safety net, has made necessary a degree of supervision and regulation that would not be necessary without the existence of the safety net. That is, regulators are compelled to act as a surrogate for market discipline since the market signals that usually accompany excessive risk-taking are substantially muted, and because the prices to banks of government deposit guarantees, or of access to the safety net more generally, do not, and probably cannot, vary sufficiently with risk to mimic market prices. The problems that arise from the retarding of the pressures of market discipline have led us increasingly to understand that the ideal strategy for supervision and regulation is to endeavor to simulate the market responses that would occur if there were no safety net (Greenspan, January 14, 1997).
If market-blocking regulatory interventions represented the root causes of disorder, but followed that banking regulators could minimize the threat their interventions posed to order by ensuring that these interventions mirrored market behavior.

Although this objective to was present throughout the post-Basel era, understandings of what it meant for the design of regulation practice changed over time. In the immediate wake of the banking crises of the 1980s, the American banking regulators believed that forcing banks to hold higher levels of capital was consistent with regulating to mimic market signals. Chairman Greenspan explains the logic:

As a result of the safety net, too many banking organizations, in our judgment, have travelled too far down the road of operating with modest capital levels. It may well be necessary to retrace our steps and begin purposefully to move to capital requirements that would, over time, be more consistent with what the market would require if the safety net were more modest (Greenspan, July 12 1990).

However, the American banking regulators soon came to see capital restrictions as sources of market distortion in their own right. By the mid 1990s, it became clear that banks were changing their behavior in response to the Basel Accord, and often in ways that the American banking regulators regarded as unproductive. Governor Meyer describes the problem these regulators perceived:

After the mid-1990s, this emphasis on high capital requirements as a corrective to moral hazard began to change, as concerns that regulatory capital requirements had market-distorting effects of their own started to mount…our capital rules have been undermined by the state of the art. The one-size-fits-all risk weight for credit risk on commercial loans has induced creative ways to arbitrage whenever regulatory capital exceeds economic capital…The result has been a greater emphasis by banks on unproductive capital arbitrage schemes and bank capital ratios that are significantly less relevant and informative than intended. Indeed, as banks become more adept at internal risk classifications, their incentive to arbitrage economic and regulatory capital can only increase, and regulatory capital will carry less and less meaning (Meyer, January 14, 2000).
After the mid-1990s, capital requirements became reclassified as a market-distorting intervention, instead of a method of mimicking market signals. This reclassification affected the way that the American banking regulators viewed the Basel standards, and drove them to push for reforms to the Basel Accord. The American regulators argued that existing methods of calculating regulatory capital were too inflexible and one-size-fits-all, and furthermore, that this kind of top-down, arbitrary regulation was likely to hurt more than it helped. To remedy the perceived deficiencies in the existing Basel standards, the American banking regulators proposed a new method of calculating regulatory capital that would rely more heavily on a bank’s own internal risk measurements.

The ultimate goal of the American-led reform of the Basel standards was to bridge the gap between regulatory capital and economic capital. Economic capital refers to the amount of capital that banks would hold in a world without the safety net or government regulation. In other words, economic capital reflects the amount of capital the market wanted the bank to hold. In practice, this concept was usually defined as the amount of capital banks were already voluntarily allocating against particular activities. The American banking regulators, chasing market discipline, came to believe that the more closely they could align regulatory capital with economic capital, the better off regulation (and the banking system) would be.

One consequence of this commitment to bridging economic and regulatory capital was that the American banking regulators actively sought impose regulations that were as risk-sensitive, bank-specific, and flexible as possible. The idea was that flexible and risk-sensitive regulations did a better job of mimicking market signals (and patterns of economic capital allocation, which naturally varied from bank to bank) than any one-size-fits-all regulatory restriction. Federal Reserve Governor Susan Phillips explains the logic:
No single or specific technique is best for everyone. Each institution should tailor its risk measurement and management process to its own needs. While adhering to basic principles, each institution must determine for itself the proper incentives and techniques for managing its affairs. No two banks or banking markets are identical in their operations, structure, or historical development. **Permitting a range of compatible responses to similar situations encourages experimentation, innovation, and growth.** Accommodating a certain level of flexibility is necessary for banks, and it is necessary for regulators, too (Phillips Jan 28 1997).

(3) Improve Market Function

The American banking regulators also believed that regulators had a duty to intervene in cases where interventions would enhance the market’s ability to effectively function. For this reason, the interests of bank shareholders carried particular weight in the American system of banking regulation. Shareholders were seen as the guardians of market discipline, as it was their actions that aggregated to form the private capital market. In a context where regulators hoped to compel the market to do most of the governing of bank behavior, it was particularly important to ensure that these shareholders/governors were well-equipped.

To encourage the market to function more effectively, the American banking regulators sought to increase the quality and quantity of information disclosed to bank shareholders. Increasing the transparency of bank financial reporting was a major policy priority. As Chairman Greenspan explains, by providing shareholders with more complete and accurate information, regulators could enhance order by improving market participants’ abilities to discipline bank behavior:

I would like to emphasize the importance of transparency, by which I mean in this context enhanced reporting and public disclosure of financial activities…It is only through adequate disclosure that market discipline can effectively be brought to bear as an important complement to supervisory oversight (Greenspan, November 18, 1996).
One consequence was that the American banking regulators were unusually proactive in supporting the initiatives of accounting standards-setters throughout this period. In most countries, accounting standard setters were charged with regulating to improve market conduct. Banking regulators were charged with regulating to ensure safety and stability. In the American context, where the banking regulators believed that market discipline promoted safety and stability, standard-setters and regulators wanted the same thing: greater transparency in bank financial reporting, which was believed to improve market functioning.

**Frame of Public Protection**

The prevailing diagnosis for the Canadian banking crises of the mid 1980s was that the pre-crisis regulatory system has failed because regulators had not adequately protected the Canadian public - defined as the depositors, creditors, and policyholders of Canadian financial institutions - from the costs of bank misbehavior and mismanagement. Even after the crisis, Canadian policymakers continued believe that most banks were well-managed, and furthermore, that these banks, when left to their own devices, would pursue initiatives that maximized their self-interest (which would serve the interests of the Canadian public as a whole). However, with the Western banking crisis, Canadian policymakers also came to recognize that some minority of banks would be poorly managed and prone to excessive risk-taking. They believed that the pre-crisis regulatory system had failed primarily because regulators had not intervened to stop the distressed Western banks from continuing to lend after it became clear that these banks lacked sufficient funds to cover potential problems. This diagnosis structured the content of the legislative reforms that followed the crisis in Canada. To restore order, Canadian policymakers created a new prudential regulatory agency (the Office for the Supervision of the Financial Institutions) and assigned this new agency considerable powers and discretion.
I argue that the same conception of regulatory order that was embodied in these reforms also shaped the way that the Canadian banking regulators approached their regulatory tasks in the post-Basel era. Like Canadian policymakers, the Canadian banking regulators continued to believe that an effective banking system required regulators to preserve bank autonomy from encroachments by other actors (both foreign and domestic). They regulators continued to regard the unfettered pursuit of self-interest as the wellspring of growth and prosperity, and did not wish to unduly block banks’ abilities to freely pursue their interests. At the same time, they also believed that they had an obligation to protect the Canadian public (and public confidence) from the consequences of excessive bank risk-taking.

Drawing from the frame of public protection, the Canadian banking regulators believed that a stable and effective banking system would require regulators to successfully negotiate this trade-off between preserving the public’s right to a safe and stable banking system and maintaining due regard for banks’ need to freely assume appropriate risks. This dual commitment is reflected in OSFI’s legislated mandate:

[OSFI’s] mandate…recognize[s] that a balance must exist between the role of the supervisor to minimize risks and the role of financial institutions, which must take reasonable risks to meet the demands of the marketplace and to prosper. Thus, the objectives set out in its mandate….clarify that, while OSFI must protect the rights of depositors, policyholders and creditors of financial institutions, OSFI would have regard to the need to allow financial institutions to compete effectively and take reasonable levels of risk (Enhancing the Safety and Soundness of the Canadian Financial System, February 1995, Department of Finance, Canada).

This conceptualization of order, which implied that order derived from regulators maintaining the appropriate balance between the mechanisms promoting growth and stability in the banking system, informed the two major policy objectives of the Canadian banking regulators. These objectives included: (1) ensuring that banks held adequate buffers to protect the public from
potential losses and (2) avoiding regulation that might hinder Canadian banks’ abilities to compete in a global marketplace.

(1) Force Banks to Maintain High Buffers Against Losses

Drawing from the perceived lessons learned from that banking crises of the 1980s, the Canadian banking regulators believed that public confidence in the banking system represented a critical precondition of order. If the public is unsure that they will get their money back, the system as a whole is in danger of breaking down, with disorder as the result. High-quality financial regulation was believed to play an important role in ensuring that public confidence remained intact. OSFI Superintendent Nick Le Pan explains the connection:

Financial regulation is ultimately about maintaining public confidence in a stable financial system, a very important linchpin for a healthy economy. Financial regulation is also about protecting consumers....promoting safety and soundness is about consumer protection in a very fundamental way. We know that any financial sector over history, left to itself, has been susceptible to instability. Financial systems don’t in my view always work according to perfect financial economic models. Various human behaviors matter and can matter a lot. Prudential regulation is designed to be a counterweight to the potential for problems. Consumers want confidence they will get their money back (Le Pan 2002).

This emphasis on regulating to promote public confidence provides one explanation for why the Canadian banking regulators were so eager to ensure that banks retained sufficient prudential safeguards to guard against the potential for problems. Prudential safeguards are defined as high buffers against losses, generally contained in the form of capital holdings or other types of reserves. Regulators’ commitment to avoiding unnecessary restraints on bank autonomy provides an additional explanation. High prudential safeguards, pegged to a bank’s risk-taking, allowed the Canadian banking regulators to achieve both of their cherished objectives at once: high prudential safeguards protected the public (and promoted confidence in the banking system) by ensuring that that banks would have sufficient funds on hand to compensate vulnerable members
of the public if problems arose, and they also preserved the mechanism of efficiency and growth by removing the need for regulators to interfere with a bank’s choice of activities. So long as the public was protected, regulators could allow banks to do as they wished.

In other words, the Canadian banking regulators believed that conservative prudential safeguards allowed regulators to strike the right balance between growth and stability. The result was that Canadian regulators consistently held a firm line when faced with pressures to scale back regulations that might impacted a bank’s capital or reserve funds. This commitment to maintaining high prudential safeguards is evident in the following comments from OSFI Superintendent John Palmer:

And as the last recession recedes from memory, the public debate concerning the financial sector has shifted away from prudential themes such as the protection of the savings of depositors and policyholders toward the challenge posed by technology and globalisation. Policymakers are now wrestling with questions of how to permit our institutions to compete with much larger foreign competitors and unregulated institutions while at the same time ensuring that the rights and needs of consumers are not overlooked. In this environment, some might argue that OSFI is still fighting the last war - working busily to build and strengthen a prudential "Maginot Line" around our institutions, while bigger, stronger, more technologically advanced, and often foreign competitors sweep past our defences and mount their electronic blitzkrieg against our institutions, well beyond OSFI's reach...Let me acknowledge that there may be an element of truth to this observation. We still see building prudential protection as the heart of OSFI's job. The government has given no indication of weakening OSFI's mandate to protect your savings, and we have not suggested this. OSFI has not forgotten about the last recession and those that preceded it (Palmer 2000).

(2) Preserve Bank Autonomy

Protecting the public to preserve the stability of the banking system represented one side of the regulatory balance in Canada; protecting bank autonomy to preserve the drivers of efficiency and growth in the banking system represented the other side. The Canadian banking regulators, still operating under the assumption that growth and efficiency could only emerge
when banks were free to select and pursue the activities of their choice, were wary of introducing restrictions that might hinder this process.

The Canadian commitment to avoiding restraints on bank activities became increasingly pronounced in response to changes in the relative profitability of American and Canadian banks. After two decades of relatively poor performance, profits in the American banking system in the mid-1990s began to surpass those of the Canadian banking system, reigniting familiar concerns about American economic encroachment. One interview respondent described the sentiment that prevailed among the Canadian banking regulators during this period:

[During this period, we thought] Canada was being left behind. Our banks weren’t innovating like the major American banks, like the major money center banks in the UK. And our banks needed to do more of what was going on in the States…There were people here that suggested that our whole financial system was going to be hollowed out…hollowed out and consumed by the U.S. and British banks” (Interview with OSFI Regulator, July 2013, Ottawa).

Canadian banking regulators from the mid-1990s onward believed that a major threat to the autonomy of Canadian financial institutions, in the form of a strong and powerful American banking system, loomed on the horizon. One result was that these regulators were highly attuned to the need to ensure that the Canadian banking system retained a strong competitive position in the global marketplace. Having abandoned the protectionist policies of the 1960s and 1970s, these regulators realized that only a competitive and efficient Canadian banking system would be strong enough to repel the American threat. This desire to maintain a strong international competitive position helps to explain why the Canadian banking regulators in the post-Basel era pursued regulatory harmonization as a major policy objective. If Canadian banks were to maintain their competitive position, and by extension, their autonomy, regulatory restrictions on Canadian bank activities could not be greater in Canada than they were in other countries (especially not the U.S.). As a result, the Canadian banking regulators in the post-Basel era
actively sought to close the gap between Canadian and American banking regulations. OSFI Superintendent John Palmer explains how the objective of preserving of Canadian bank autonomy through regulatory harmonization fit into the larger Canadian regulatory project of maintaining the appropriate balance between growth/autonomy and stability:

The financial sector is key to our current and future economic success. We need a financial sector that offers a competitive array of products and services to Canadians and we need to ensure there is room for competitive, successful Canadian-based financial institutions…While we need to maintain prudential walls around our institutions, those walls can't be higher than those which we see in our major trading partners… OSFI's mandate continues to be the protection of your deposits and insurance policies in federal institutions, but **we're trying to do this in a balanced way** that recognizes international developments and facilitates a competitive financial system (Palmer, June 8, 2000).

OSFI Superintendent Nick Le Pan outlines the implications for regulatory policymaking:

Our regulatory regime must not disadvantage Canadian financial institutions…competitiveness in rule setting may require that we think about adopting the approaches of others and preserving our differences only in the relatively few areas where differences matter to us for policy reasons (Le Pan, May 21, 2002).

**Frame of Centralized Coordination and Direction**

The prevailing diagnosis for the Spanish banking crisis of the 1977-1985 was that the pre-crisis regulatory system had failed by giving banks too much autonomy and discretion to choose inappropriate activities. Lax regulation was believed to have led to an explosion of unstable and risky banks, which were among the first institutions to fail when the crisis hit. Banks had also engaged in inappropriately risky activities, including overly optimistic lending to firms in volatile industries, and had hidden these activities from the sight of regulators by delegating them to subsidiaries. This diagnosis structured the content of the Spanish legislative reforms that followed the crisis, which sought to restore order by improving the extent of regulators’ control and oversight over bank activities.
I argue that the same conception of regulatory order embodied in these reforms also structured the way that the Spanish banking regulators, operating under the frame of centralized coordination and direction, perceived and approached their regulatory tasks in the post-Basel era. These regulators subscribed to a view of bank managers as fundamentally myopic, and prone to superstition and bias. They assumed that order could not emerge naturally in a system comprised of self-serving, shortsighted actors; left to its own devices, the banking system would run itself into the ground. Consequently, they believed that a stable and effective banking system would require greater coordination, stronger leadership, and better oversight from an unbiased authority with the ability to see the big picture. The regulators at the Bank of Spain believed that only they had the appropriate characteristics and motives to effectively direct the banking system. Their technical expertise ensured that they would take a rational and unbiased approach to coordinating bank activity, unlike self-serving bank managers. The Spanish banking regulators also believed that their system-level perspective and desire to integrate the interests of all of the parties involved gave them superior insight into what banks should be doing.

In what follows, I explain how this conceptualization of order, which implied that order derived from regulators actively correcting and redirecting bank behavior to promote growth and stability in the banking system, informed the three major policy objectives of the Spanish banking regulators. These objectives included: (1) regulating and supervising banks on a consolidated basis; (2) combating procyclicality; and (3) promoting Spain’s integration with the rest of Europe.

1) Regulating and Supervising Banks on a Consolidated Basis

Drawing from the perceived lessons learned from the baking crises of the 1980s, the Spanish banking regulators believed that banks, if left to their own devices, would lead
themselves into ruin. Only interventions from expert regulators could prevent this outcome. But to effectively intervene, regulators first had to be aware of what banks were doing. This commitment to ensuring that regulators had sufficient knowledge of the activities banks were engaging in helps to explain why the Spanish banking regulators sought to supervise and regulate banks on a consolidated basis.

In forcing banking groups to offer financial statements that presented a holistic picture of their activities and risks, the Spanish banking regulators sought to avoid a repeat of the events of the 1980s, when banks had hidden risk exposures inside of subsidiaries that has not shown up on the balance sheet. When viewed through the lens of the frame of centralized coordination and direction, which emphasized regulatory interventions and oversight as key to order, these restrictions on bank accounting and reporting practices would promote order by eliminating an important mechanism through which banks could escape the watchful eyes of regulators. Jaime Caruana, the former governor of the Bank of Spain, explains the logic underlying this regulatory commitment:

In terms of the lessons that marked the way supervision has been done at the Bank of Spain since [the crisis]…[o]ne is the need for comprehensive, consolidated supervision. It is more than emphasis; it is almost an obsession. Examiners analyze the banking group, the whole group, interpreting regulation very strictly to encompass as much as possible. The lesson from the crisis was that it is sometimes a subsidiary of a subsidiary that ruins a bank (Caruana 2009: 39).

To prevent these events from happening again, the Spanish banking regulators took pains to ensure that banks would report all of their activities, on a consolidated basis, to their regulators at the Bank of Spain.

(2) **Combating Procyclicality**

The Spanish banking regulators also believed that they had a duty to step in to correct, channel, and redirect the inherently biased and myopic behavior of individual banks. This
commitment to redirecting bank behavior helps to explain why the Spanish banking regulators sought to implement anti-cyclical policies throughout the post-Basel era. Drawing from lessons from the banking crises of the 1980s, the Spanish regulators believed that banks were particularly vulnerable to over-optimism in one of their most important functions: lending to industrial firms. They recognized that banks behavior was highly procyclical, with a tendency to both follow and amplify fluctuations in the real economy. During upswings in the business cycle, banks grew excitable and overly optimistic, and extended credit to industry too freely. Then, during downswings, banks grew overly conservative and restricted credit too much, which only exacerbated the problems in the economy. The Spanish banking regulators believed that this type of procyclical behavior was not productive for the banking system nor for the economy as a whole. This helps to explain why the Spanish banking regulators in the post-Basel era consistently imposed regulations with the explicit objective of combatting procyclicality.

Drawing from the frame of centralized coordination and direction, they assumed that restoring order would require regulators to step in to counteract this natural, yet destructive, bank behavior.

To accomplish this objective, the Spanish banking regulators focused on augmenting the size of the buffers banks held against expected and unexpected losses. By forcing banks to set aside more funds in reserve when times were good, regulators hoped to prevent such dramatic withdrawals of credit when times were bad. For this reason, prudential safeguards (high capital and loss reserves) were regarded as critical policy tools in Spain, as they were in Canada. However, the same prudential tools carried different meanings in each country. In Spain, they were regarded as tools that facilitated regulators’ abilities to correct and redirect fundamentally irrational bank behavior. In Canada, they were regarded as tools that allowed regulators to avoid interfering directly with a bank’s selection of activities.
Promoting Integration with Europe

The Spanish banking regulators held a comparatively broader view about the constituency that banking regulation was designed to serve. The American banking regulators designed banking regulation with an eye to the interests of shareholders; the Canadian banking regulators sought to protect creditors, depositors, and policyholders. The Spanish banking regulators sought to regulate in the interests of broader Spanish society. This commitment is evident in the official mandate of the Bank of Spain, Spain’s prudential banking regulator:

The Banco de España supervises credit institutions in a special way. Firstly, a specific regulation has been created to preserve the correct functioning of financial institutions, to strengthen their capacity to deal with adverse events and to harmonize the interests of all parties involved (banks, savers and investors) with general interests, and secondly, they are closely supervised to ensure compliance with banking rules, and in particular, regulations governing accounting procedures, their solvency, customer protection and market transparency.

The Spanish banking regulators thus believed that they not only had a duty to serve the needs of regulated banks and their users - they also had a duty to integrate these needs with the interests of the other interest groups that composed civil society. This regulatory commitment reflected a central tenet of the frame of centralized coordination and direction: order could only emerge when a centralized authority accommodated and harmonized the interests of all of the parties involved in the name of the public good. This commitment to harmonizing the interests of banks and consumers with general interests meant that the Spanish banking regulators sought to design regulation that would further goals that included, but also extended beyond, the promotion of efficiency and safety in the banking system.

One such goal was the pursuit of greater political and economic integration with the rest of Europe. The Spanish commitment to regional integration in the post-Franco era also bore the imprint of long-standing Spanish principles of order. Spanish policymakers had long believed
that progress and prosperity required greater integration, facilitated by a public-minded centralized authority with the power to direct and channel the interests of different groups towards a common goal. Previously, policymakers had limited their integration efforts to integration within Spain’s national borders. However, after the late 1970s, Spanish policymakers began to embrace the project of integration at the supranational level. Both the right and the left came to believe that political and economic progress would require Spain to join forces with other powerful states in the region. Spain succeeded in joining the European Community in 1986; with this victory secured, Spanish policymakers focused on becoming part of the first wave of countries to adopt the euro in the late 1990s. The commitment to serving the interests of wider Spanish society, and not just the banking system, helps to explain why Spanish banking regulators sought to design regulations that promoted Spain’s economic integration with the rest of Europe, even when some of these initiatives conflicted with other regulatory priorities.

**THE REGULATION OF ASSET SECURITIZATION**

The rise of securitization in the last decades of the 21st century revolutionized the global banking system by transforming credit risk into a tradable commodity. The emergence of this practice allowed banks to transform previously illiquid assets, like loans and other forms of contractual debt, into securities. In this way, securitization fundamentally changed the banking business, by reshaping the relationship between lender and borrower. It also served as a major source of bank losses during the global financial crisis of the late 2000s.

This section traces the divergent development of the regulation of bank participation in the securitization process in the US, Canada, and Spain. I argue that the dominant frame of regulatory order in each country shaped the way that banking regulators conceptualized the relationship between securitization and their overarching regulatory mission. The different ways
in which securitization was framed help to explain why banking regulators from different
countries executed their local discretion to regulate this practice in the different ways that they
did, with critical implications for bank outcomes during the crisis.

The Basel Accord and the Regulation of Securitization

The large, internationally active commercial banks that the Basel Accord regulated
played many roles in the securitization process. Two particularly notable roles included serving
as the asset originator for securitization transactions and providing credit and liquidity support to
securitization programs. A securitization transaction begins when the asset originator (often a
bank) sponsors or creates a securitization conduit, a separate subsidiary company that is designed
to be bankruptcy remote from the sponsoring organization (i.e. It is protected even if the parent
organization goes bankrupt). Conduits are essentially robot companies: their actions are usually
tightly controlled, and generally limited to financing, buying, or selling assets. In a securitization
transaction, the conduit purchases assets from the asset originator, restructures and repackages
these assets, and reissues the associated credit risk in the form of asset-backed securities (ABS)
to investors.

Transferring assets to a bankruptcy remote conduit benefits both ABS investors and
sponsoring banks. This practice benefits investors by protecting their investment in the case of
bankruptcy on the part of the sponsoring bank: if the bank fails, its creditors cannot grab back
assets that have been legally transferred to a conduit. This practice benefits banks by enabling
them to remove securitized assets from their balance sheets. Under the terms of the Basel
Accord, off balance sheet assets carried a lower regulatory capital charge (usually zero percent)
than on balance sheet assets, because off balance sheet assets were believed to pose less risk to
bank. As a result, banks in most countries could achieve savings on regulatory capital by conducting their securitization business through conduits.

In addition to sponsoring securitization conduits, banks also provided credit enhancements and liquidity enhancements to conduits. These techniques were designed to increase investor interest in the ABS securitization programs produced. When a bank provides a credit enhancement to a conduit, it agrees to absorb some portion of the conduit’s losses, should losses occur. Examples of credit enhancements include techniques like overcollateralization, excess spread accounts, or explicit credit guarantees. When a bank provides a liquidity enhancement to a conduit, it agrees to provide short-term loans to cover temporary cash shortfalls. Securitization conduits must pay their investors on a set schedule, and they sometimes lack sufficient cash to make these payments. Bank liquidity support allowed conduits to smooth over these temporary funding difficulties, easing investor concerns. Since liquidity enhancements posed less risk to the bank, they carried a lower regulatory capital charge under the terms of the Basel Accord. Short-term liquidity lines (with a term of one year or less) carried a 0% regulatory capital charge, while credit enhancements carried charges that ranged between 50% and 100%.

Banking regulators in the U.S., Canada, and Spain all basically complied with the securitization-related provisions of the Basel Accord. However, these broad and flexible provisions also left room for local discretion, and the banking regulators in each country exercised their available discretion differently. In what follows, I explain how regulators confronted the same two questions in the post-Basel period: (1) how should they react to a change in accounting standards that affected a bank’s ability to take assets transferred to a conduit off its balance sheet and (2) how should they define and regulate bank provision of liquidity enhancements to conduits?
The American, Canadian, and Spanish banking regulators developed different answers to these questions, which had important implications for bank performance following the 2007 collapse of the asset backed commercial paper (ABCP) market. The collapse of this market is generally regarded as the precipitating event of the global financial crisis of the late 2000s (Krozner and Strahan 2011; Richardson et al. 2011). At the time, ABCP programs represented one of the most popular forms of securitization, at over $1.2 trillion outstanding (Acharya and Schnabl 2010). The seeds of the market’s demise were planted in the summer of 2007, when ABCP investors grew increasingly concerned about the quality of the medium-to-long term assets that backed many ABCP programs. As these concerns mounted, many investors stopped rolling over their ABCP holdings, and this withdrawal of funding by some investors prompted additional withdrawals by others. The eventual result was that ABCP, which was previously regarded as a highly liquid and stable investment, could no longer be traded. The lack of demand for the end product of securitization process left many ABCP conduits with a funding shortfall, which eventually forced them to suspend operations and sell off their assets at fire-sale prices (Williams 2008; Acharya et al. 2013). The associated losses were huge.

The ways in which domestic banking regulators had responded to changing accounting standards and the ways in which they had elected to define and regulate liquidity enhancements to conduits affected the extent to which domestic banks absorbed losses when the global ABCP market collapsed. I briefly describe the choices that banking regulators faced in each of these areas.

Response to Accounting Changes

In the late 1990s and early 2000s, accounting standards setters around the world changed the criteria under which assets transferred elsewhere could qualify as a “true sale,” and be
removed from the balance sheet. The changed standards had important implications for securitization markets, because they required banks to bring many of the assets they had transferred to securitization conduits (specifically, ABCP conduits) back on the balance sheet. Regulators in many countries, including the US and Canada, responded by giving banks “regulatory capital relief” for the assets that had returned to the balance sheet as a result of the changed accounting standards. This meant that for regulatory capital purposes, the banking regulators allowed banks to pretend as if the assets were still off the balance sheet (and consequently, to avoid allocating any capital against these assets). But regulators in other countries, including Spain, made the opposite choice, going above and beyond what the new standards required to make it even more difficult for banks to remove assets transferred to a conduit from their balance sheets. In countries where regulators had given banks regulatory capital relief, the domestic ABCP market (and the corresponding losses) tended to be larger (Acharya et al. 2013; Acharya and Schnabl 2010).

**Definition and Regulation of Liquidity Enhancements**

The feature that separated liquidity enhancements (or “liquidity lines”) from credit enhancements was the permanency of the loans they granted to conduits. Liquidity enhancements provided short-term support - a *temporary* loan that the conduit was expected to quickly repay. Credit enhancements absorbed losses: the support they extended to conduits was not repaid. This difference was the major reason why liquidity enhancements carried a much lower regulatory capital charge than credit enhancements under the terms of the Basel Accord. However, banking regulators in all of the Basel member countries were also attuned to the possibility that a liquidity enhancement could turn into a credit enhancement if the conduit failed, the idea being that a bankrupt conduit cannot repay even a temporary loan. To prevent this
from happening, liquidity providers and conduits drew up contracts specifying the terms under which liquidity support would no longer be extended. Banking regulators from different countries gave their banks different degrees of latitude to define the terms of liquidity enhancements (or at least those that qualified for a zero percent capital charge). In countries where these terms were loosely defined, as they were in the U.S., banks absorbed the majority of conduit losses when the ABCP market collapsed, which quickly swamped the amount of capital they had set aside against this risk exposure. In countries where these terms were strictly defined, as they were in Canada, conduit losses tended to be borne by the ABCP investors instead. And in countries where regulators went beyond the minimum Basel requirements and assigned all liquidity lines a large regulatory capital charge, as they did in Spain, banks hardly suffered any losses at all.

In what follows, I explain how the dominant frames of regulatory order in each country shaped the way that American, Canadian, and Spanish banking regulators exercised their local discretion when responding to changes in accounting standards and defining and regulating liquidity enhancements. I argue that the American banking regulators, operating under the frame of competition, conceptualized securitization as a critical aid to their overarching regulatory mission, which helps to explain the decision to give banks regulatory capital relief in response to changing accounting standards and their lax regulation of liquidity enhancements. The Canadian banking regulators, operating under the frame of public protection, conceptualized securitization as an activity with the potential to both help and hurt their regulatory mission, which helps to explain why they mimicked the American regulatory response to changing accounting standards, but also maintained such a strict definition of liquidity enhancements. The Spanish banking regulators, operating under the frame of centralized coordination and direction, regarded
securitization as a serious threat to their regulatory mission, which helps to explain why they adopted conservative accounting standards and a strict capital treatment of liquidity enhancements.

**UNITED STATES: COMPETITION AND SECURITIZATION**

The American banking regulators embraced and actively encouraged bank participation in the securitization process, consistently fighting against initiatives that threatened to constrain the operation of securitization markets, and they did relatively little to ensure that American banks were adequately protected against losses from their securitization exposures. This generally permissive approach to the regulation of bank participation in securitization process was evident in the way that the American banking regulators responded to a change in accounting standards that would have restored ABCP program assets to bank balance sheets and in the way that they defined and regulated liquidity enhancements to securitization conduits.

I argue that the permissive American approach to the regulation of securitization can only be fully understood after accounting for the influence of the *frame of competition*, which shaped the way that the American banking regulators conceptualized bank participation in the securitization process. The American regulators viewed securitization as a prudential practice (a practice that increased the safety and stability of the banking system) to an extent that was not found in other countries. Bank participation in securitization markets was believed to enhance market discipline through multiple mechanisms: by allowing regulators to avoid intervening in the banking system, by facilitating the transfer of credit risk to unregulated (and therefore better regulated) financial institutions, and by giving banks a tool to correct the effects of market-distorting policies. Accordingly, the American banking regulators viewed this practice as central to their overarching regulatory mission.
Securitization as a Prudential Practice

Banking regulators in many countries believed that bank participation in the securitization process made the banking system more efficient: the American banking regulators were unique in the extent to which they believed that this practice also made the banking system safer. The American banking regulators believed that securitization enhanced market discipline, and by extension, enhanced the safety and stability of the American banking system by: (1) removing the need for regulators to intervene to improve banks’ risk management systems, (2) transferring risk to more appropriate areas of the financial system, and (3) providing a way for banks to actively fight back against market distortions.

Avoid Regulatory Interventions

The American banking regulators believed that securitization enhanced market discipline because one feature of this practice, its role in creating a market for credit risk, was thought to allow banking regulators to avoid imposing market-distorting regulatory restrictions. Buying and selling credit risk through the securitization process gave banks a “natural” or market-driven incentive to improve existing risk measurement systems, which obviated the need for regulators to step in. The logic was that banks risked losing money on securitization transactions unless they had a good understanding of what the risks of the underlying assets were worth. The prospect of losing money, the American banking regulators believed, would encourage banks to improve their existing systems of risk measurement. A better understanding of risk would prevent banks from taking on too much of it: “[b]etter and more quantifiable estimates of risk are tantamount to risk reduction” (Greenspan, October 5, 1996).

The American banking regulators, operating under the assumption that government regulation and private regulation were substitutes, believed that a market-driven incentive to
improve risk measurement and risk management system would do much of their job of promoting safety and soundness for them - and it would do it better than any form of imposed regulation could. Federal Reserve Chairman Alan Greenspan explains the logic:

[W]e must be assured that with rare and circumscribed exceptions we do not substitute supervisory judgments for management decisions. That is the road to moral hazard and inefficient bank management. Fortunately, the same technology and innovation that is driving supervisors to focus on [risk] management processes will, through the development of sophisticated market structures and responses, do much of our job of ensuring safety and soundness. We should be careful not to impede the process (Greenspan, June 13, 1996).

Securitization’s role in facilitating better risk measurement became even more salient in the American context after the late 1990s. At this point, the American banking regulators had started to pursue their new goal of reforming the Basel standards by incorporating banks’ own internal risk models into regulators’ calculations of regulatory capital adequacy. The proposed reform of the Basel standards was predicated on banks already having adequate risk measurement and management systems in place. But in the early 2000s, the American banking regulators came to the realization that risk measurement systems at the largest banks were woefully inadequate (Ferguson, March 4, 2002). This revelation presented a serious dilemma. Banks needed to adopt better risk measurement systems; otherwise, the proposed reform of the Basel standards, which presumed the existence of high-quality internal risk measures, could not be successful. However, if the American banking regulators directly intervened to force banks to improve these systems, they believed that they risked blunting market discipline, which would defeat the purpose of the reform altogether.

Securitization provided a way out of this dilemma. Encouraging banks to participate in the securitization process could give the American banking regulators the outcome they wanted - improvement in bank risk measurement systems - while simultaneously avoiding the outcome
they feared most - destruction of market discipline. The Canadian and Spanish banking regulators also believed that securitization gave banks an incentive to improve their risk measurement systems. However, this feature was less salient in countries in which (regulation-induced) market distortions were not regarded the root cause of disorder in the banking system.

In the American context, encouraging bank participation in securitization markets was one of the only acceptable way that banking regulators could intervene to shape the adequacy of banks’ risk measurement systems. In the Canadian and Spanish contexts, this only represented one option out of many.

*Transfer Risk To Institutions Governed By Market Discipline*

The American banking regulators also believed that securitization enhanced market discipline by drawing credit risk outside the regulated banking system. Under a worldview that framed regulatory interventions and market discipline as substitutes, less regulated financial institutions were believed to be better regulated institutions. Unlike banks, non-bank financial institutions were not covered by the market-distorting safety net, and were subject to fewer regulations in general. As a result, regulators believed, non-bank financial institutions were governed by better market discipline. Accordingly, securitization, which facilitated flow of credit risk outside of regulated banks and towards other financial market players, was seen as enhancing order in the banking system. Greenspan explains the logic:

Some other concerns about the transfer of credit risk outside the banking system seem to be based on questionable assumptions. Some observers believe that credit risks will be managed more effectively by banks because they generally are more heavily regulated than the entities to which they are transferring credit risk. But those unregulated and less heavily regulated entities generally are subject to more-effective market discipline than banks…private regulation generally has proved far better at constraining excessive risk-taking than has government regulation (Greenspan, May 5, 2005).

*Correct and Highlight Regulators’ Mistakes*
Finally, the American banking regulators also believed that securitization enhanced market discipline by giving banks a tool that they could use to both highlight and mitigate the mistakes of regulators. In the American context, “regulatory mistakes” were defined as situations in which regulatory capital had diverged too far from economic capital. Securitization allowed banks to sidestep regulatory capital restrictions by removing assets with high regulatory capital charges from the banks’ balance sheets. This practice was known as “regulatory capital arbitrage” (Kwak 2009). The American banking regulators framed regulatory capital arbitrage in a more favorable light than banking regulators in most of the other Basel member countries. They recognized that regulatory capital arbitrage made their jobs as regulators harder; however, they also believed that poorly designed regulation, and not banks, were to blame. Federal Reserve Governor Laurence Meyer explains the logic:

The point here is not to blame banks for engaging in regulatory capital arbitrage. The fact is that regulatory capital arbitrage is an outgrowth of the considerable resources that banks have devoted to better measuring, pricing and managing risk. And it is also a response to serious shortcomings in our international capital standards (Meyer, September 18, 1998).

Furthermore, the American banking regulators also believed that regulatory capital arbitrage had benefits: this practice both alerted regulators to areas in which economic and regulatory capital had diverged and it gave banks a way to mitigate the effects of poorly designed regulation. In the American context, both features were expected to promote better regulation.

In choosing to securitize their assets, banks are also sending a signal that the regulatory capital charges attached to the assets are currently too high. This signal carried particular weight in the American context, where banking regulators were constantly attuned to the need to avoid imposing market-distorting regulation. Chairman Greenspan explains how securitization, in
facilitating the transfer of credit risk outside of banks, enabled regulators to perform a valuable “market test” of existing restrictions:

Privately regulated markets in effect provide a market test of the net benefits of government regulation. Migration of activity from government-regulated to privately regulated markets sends a signal to government regulators that many transactors believe the costs of regulation exceed the benefits. When such migration occurs, government regulators should consider carefully whether less regulation or different regulation would provide a better cost-benefit tradeoff without compromising public policy objectives (Greenspan, February 21, 1997).

Securitization was also framed as an important prudential practice because it provided the banking system with a “safety value” or “release valve” that mitigated the effects of regulatory mistakes. Securitization gave banks a tool that they could use to sidestep market-distorting regulatory restrictions. As Governor Ferguson explains, the presence of this tool took some of the pressure off of banking regulators to get regulatory capital requirements right (e.g. in line with economic capital) the very first time:

We have tried hard to set risk-based regulatory capital requirements in Basel II below economic capital measures so that regulatory requirements will not affect the allocation of capital within the bank. If we make a mistake and set the regulatory capital requirements too high relative to market-based economic capital, we can read the effect of our error right away in the securitization of the exposure; securitization is a release valve that relieves the pressure of our mistakes (Ferguson, June 17, 2003).

Effects for Policy Choices

The framing of securitization as a critical aid to market discipline helps to explain why the American banking regulators were so committed to combatting potential threats to securitization markets and also why they left many choices about deal structure and capital allocation to banks themselves. In what follows, I explain how these commitments structured critical American policy choices with important implications for American bank performance during the 2007 ABCP crisis.
Response to Accounting Changes

The corporate accounting scandals of the early 2000s inspired serious soul-searching among the accounting standards-setters at the Financial Accounting Standards Board (FASB), the regulator of bank accounting practices in the U.S. In 2003, FASB moved to close an important loophole in existing standards by issuing a new interpretation, FIN 46R, that changed the criteria for when a sponsoring institution could remove assets transferred to a conduit from its balance sheet. The goal was to prevent another Enron by forcing the institutions that sponsored off-balance-sheet vehicles, and continued to control the majority of the risks and rewards of these vehicles, to account for these exposures to their shareholders. This change in accounting standards had major implications for the continued viability of the ABCP market, then one of the largest securitization markets in the U.S. and around the world. The new consolidation criteria that FIN 46R introduced would have required sponsoring banks to consolidate their ABCP program assets. By forcing banks to restore ABCP conduit assets to the balance sheet, FIN 46R would have removed one of the biggest economic incentives for banks to create an ABCP programs (the ability to achieve a reduced regulatory capital charge for securitized assets), which threatened the continued viability of this market.

In the American context, securitization was regarded as not only a source of competitive advantage, as it was in Canada and other countries, but also a vital prudential tool. One consequence of this framing of securitization, I argue, was that the American banking regulators regarded protecting securitization markets (and bank participation in the securitization process) as a top policy priority. This helps to explain why the American banking regulators responded to the change in accounting standards by pulling out all the stops to protect ABCP programs,
eventually adopting a policy that not only contradicted the intent of the accounting standards setters, but was also arguably non-compliant with the terms of the Basel Accord.

In 2004, the American banking regulators responded to the introduction of FIN 46R by issuing a joint policy statement (69 CFR 144, July 28 2004) that gave banks regulatory capital relief for all of the ABCP conduit assets that had returned to their balance sheets as a result of this interpretation. It was not entirely clear whether the grant of regulatory capital relief violated the terms of the Basel Accord: the Basel Accord set regulatory capital charges that were based, at least in part, on where assets in question were located on a bank’s balance sheet located (which was determined by local accounting standards). But the Basel Accord said nothing about accounting standards themselves. Thus the American response to changing accounting standards represented a somewhat gray area of regulation.

Why did the American banking regulators elect to give banks regulatory capital relief for the ABCP conduit assets that returned to the balance sheet as a result of FIN 46R? Attention to the way that the American banking regulators justified this policy change in public documents provides some insight into their motivations. In a Notice of Proposed Rulemaking published in the Federal Register in September 2003, the federal bank regulatory agencies argued that banks should receive regulatory capital relief for their newly consolidated ABCP conduit assets because these consolidated assets posed relatively little risk to the bank:

The agencies believe that the consolidation of ABCP program assets generally would result in risk-based capital requirements that do not appropriately reflect the risks faced by banking organizations involved with the programs. Sponsoring banking organizations generally face limited risk exposure to ABCP programs. This risk usually is confined to the credit enhancements and liquidity facility arrangements that sponsoring banking organizations provide to these programs. In addition, operational controls and structural provisions, along with overcollateralization or other credit enhancements provided by the companies that sell assets into ABCP programs, mitigate the risks to which sponsoring banking organizations are exposed. Because of the limited risks, the agencies adopted an
interim final rule with a request for comment that permitted sponsoring banking organizations, through the end of the first quarter of 2004, to exclude from risk-weighted assets (for purposes of calculating the risk-based capital ratios) ABCP program assets that require consolidation under FIN 46–R (Board of Governors of the Federal Reserve, Notice of Proposed Rulemaking, September 12, 2003).

I suggest that the American banking regulators perceived relatively little risk to banks in this area because the American perception of securitization as a prudential practice called attention to the benefits of this activity and downplayed its risks. Securitization, due to the multiple roles it played in enhancing market discipline in the banking system, was a practice to be protected, rather than blocked.

It is interesting to contrast the actions of the American banking regulators vis-à-vis accounting standards setters in the domain of securitization with their actions in the domain of loan-loss provisioning. In the case of loan-loss provisioning, the American banking regulators refused to intervene to protect conservative loan loss provisioning practices, citing the importance of supporting the initiatives of the accounting standards setters. These initiatives were believed to promote greater transparency (and by extension, better market functioning). The fact that the American banking regulators stepped in with an intervention that contradicted the intent of the standards-setters in the case of securitization regulation provides another indication of this activity’s salience. American banking regulators sought greater transparency in financial reporting, but they could not accept an accounting change that might threatened markets for credit risk transfer.

The same attention to the benefits of securitization, and blindness to the risks, also shaped the way that American banking regulators responded to the revelations of the abuse of securitization conduits by Enron and other wayward corporations in the early 2000s. In the
follow excerpt from a 2003 speech, Federal Reserve Governor Olsen urges market actors not to lose faith in the promises of securitization:

…the [Enron-era] abuses [of securitization] that have received recent attention have obscured their risk-mitigation value. Aggressive interpretations of accounting rules and misuse of structured transactions have cast a shadow over a wide array of financial instruments that have dramatically enhanced the efficiency of financial markets and the availability of funds to all sectors of the economy. Both commercial banks and securities firms have played important roles in structuring, arranging or participating in these transactions, to the economy's great benefit (Olson 2003).

Definition and Regulatory Capital Treatment of Liquidity Lines

I argue that concerns about threatening the critical role that securitization was believed to play in producing order - especially its role in preventing the extension of market-distorting regulatory interventions - left American regulators highly vulnerable to industry arguments for greater discretion to define and allocate capital against the liquidity enhancements they offered ABCP programs. This concern was evident in the way that American banking regulators revised their proposals relating to the regulation of bank liquidity lines in response to industry feedback.

While the American banking regulators believed that the new accounting interpretation that FASB had introduced after the Enron crisis was an overreaction, they largely agreed that the Enron crisis had uncovered a need to address weaknesses in securitization markets. Liquidity lines to ABCP conduits were identified as an area of particular concern. At the time, all short-term liquidity lines carried a zero percent capital charge in the U.S., which was the minimum permitted under the terms of the Basel Accord. However, relationships with ABCP conduits had become an increasingly large portion of business for American banks over the course of the 1990s and 2000s, and the American banking regulators had started to worry about the potential risks associated with this exposure (and the lack of capital held against them).
In the same Joint Notice of Proposed Rulemaking that gave banks regulatory capital relief for their consolidated ABCP programs, the American bank regulatory agencies also attempted to crack down on the definition and capital treatment of bank liquidity lines to ABCP conduits, proposing to increase the regulatory capital charge for short term liquidity lines from 0 percent to 20 percent. They justified this increase in the following terms:

The agencies also are proposing to require banking organizations to hold risk-based capital against liquidity facilities with an original maturity of one year or less that organizations provide to ABCP programs, regardless of whether the organization sponsors the program or must consolidate the program under GAAP. This treatment recognizes that such facilities expose banking organizations to credit risk and is consistent with the industry’s practice of internally allocating economic capital against this risk associated with such facilities (Board of Governors of the Federal Reserve, Notice of Proposed Rulemaking, September 12, 2003).

In other words, the agencies argued that increasing the regulatory capital charge was justified because it would simply codify a pre-existing practice in the banking industry. Banks were allocating capital for this purpose anyway, so the increased capital charge would not distort prevailing market conditions.

Industry participants objected to this proposed increase, framing their objections in a particular way (cf. Smith 2003; American Securitization Forum 2004). Most of the large American commercial banks argued that the proposed increase to a 20 percent capital charge was too high: a 5 to 10 percent capital charge, they argued, would much closer to the amount of economic capital banks were already setting aside to guard against the possibility of unexpected losses from liquidity commitments (Citigroup letter). In other words, against the proposed increase, industry participants used the same line of argument that the agencies had used to support it. This argument was highly persuasive to the American banking regulators, given their objective to more closely unite economic and regulatory capital. This desire to bridge economic
and regulatory capital was the rationale that regulators gave for electing to lower the regulatory capital charge for short-term liquidity lines (to 10 percent) in the final rule:

The application of a 10 percent credit conversion factor would result in an effective capital charge that is more reflective of the amount of economic capital that banking organizations maintain internally for short-term liquidity facilities supporting ABCP.

A proposal for a tighter definition for liquidity lines, also outlined in the same notice of proposed rule making, met a similar fate (Board of Governors of the Federal Reserve, Notice of Proposed Rulemaking, September 12, 2003). The American bank regulatory agencies were concerned by the prospect of liquidity enhancements serving as credit enhancements in practice. If banks extended liquidity support to a conduit with failing assets, the risk was that the distressed conduit, would not be able to repay the bank. In this case, the liquidity enhancement (which was supposed to be a temporary loan) would turn into a credit enhancement (or a permanent loss). The American banking regulators, concerned about this possibility, proposed a stricter definition of the conditions under which conduit assets would be classified as “impaired,” and therefore ineligible for liquidity support. Once again, the American bank regulatory agencies justified this policy change by arguing that it would simply codify a pre-existing industry practice:

In order for a liquidity facility, either short- or long-term, provided to an ABCP program not to be considered a recourse obligation or a direct credit substitute, draws on the facility must meet an asset quality test that precludes funding assets that are 60 days or more past due or in default. Assets that are past due 60 days or more generally are considered ineligible for financing based upon standard industry practice and rating agency guidelines for trade receivables. The funding of assets past due 60 days or more using a liquidity facility exposes the institution to a greater degree of credit risk compared to the purchase of assets of a more current nature. It is the agencies’ view that liquidity facilities that are eligible for the 20 percent or 50 percent conversion factors should not be used to fund assets with the higher degree of credit risk typically associated with seriously delinquent assets (Board of Governors of the Federal Reserve, Notice of Proposed Rulemaking, September 12, 2003).
Once again, industry participants argued against this proposal by appealing to a central tenet of American banking regulation. Industry participants argued that the new proposed asset quality test was too stringent and inflexible. In so many words, they contended that this regulation represented an external imposition, rather than a reflection of existing practice in the banking system. Thus, to avoid introducing distortions into the market, they argued, each individual bank should be allowed develop its own asset quality test. As a representative from Citigroup argued in a letter to the federal bank regulatory agencies, allowing banks to develop their own standards for asset quality was the preferred approach because this approach would “more accurately measure the banking organization’s exposure, and thereby help to achieve the Agencies’ goal of applying greater risk-sensitivity to the assignment of regulatory capital” (Vogel 2003).

This line of argument directly appealed to American banking regulators’ objective of designing regulations that effectively mimicked market behavior, and it appears that the American banking regulators were at least partially convinced by this logic. They would not concede to banks establishing their own asset quality tests; however, they did agree to loosen the proposed cutoff point (from 60 days non-performing to 90 days non-performing) to allow for greater flexibility, citing the need to avoid un-market-like arbitrary constraints:

The agencies believe that it is important to ensure that the primary function of an eligible liquidity facility is to provide liquidity and, accordingly, such a facility should not be used to fund assets with the higher degree of credit risk typically associated with seriously delinquent assets. However, the agencies agree that a limitation of 60 days or more past due might be too constraining for some asset types held in an ABCP program (69 CFR 144, July 28 2004).

Securitization Outcomes
The decision to give banks regulators capital relief for their on-balance-sheet assets had important symbolic effects. Banks and media commentators were aware that American regulators were departing from prior precedent in making this choice, and the decision to adopt a policy that went against the intent of accounting standards-setters and violated the terms of the Basel Accord suggested to market participants that regulators were committed to preserving securitization markets, even when this preservation came at the expense of other regulatory priorities. Acharya and Schnabl (2010) argue that the favorable resolution of this regulatory uncertainty likely spurred the growth of the American ABCP market after 2004 (see Figure 6.1).³¹

³¹ Most American banks ended up responding to FIN 46R by restructuring their ABCP programs to comply with the new consolidation standards and remove conduit assets from the balance sheet. Thus, as far as it concerns bank outcomes during the crisis, the symbolic content of this policy choice (which contributed to large size of this market, which indirectly influenced the size of bank losses) was more important than any direct effects for bank performance.
Figure 6.1. The Rise and Collapse of the American Asset-Backed Commercial Paper Market

Source: Acharya and Schnabl (2010). This figure shows total ABCP outstanding, January 2001 through February 2009. The figure is based on aggregate data from the Federal Reserve Board.
The American definition and regulatory capital treatment of liquidity lines also had important implications for American bank outcomes. The loose terms of American liquidity lines (the relatively long 90 day non-performing period) meant that banks were obligated to provide liquidity support to ABCP conduits with troubled assets, even when it became clear that bank might not recoup this temporary loan. The end result was that American commercial banks absorbed over 97 percent of all ABCP program losses – these were losses that should have accrued to ABCP investors (Acharya et al. 2013: 532). Since these exposures qualified as liquidity enhancements, rather than credit enhancements, American banks had set aside very little capital against them, and the associated losses quickly overwhelmed the limited capital reserves at most major American banks (Acharya et al. 2013).

**CANADA: PUBLIC PROTECTION AND SECURITIZATION**

The Canadian banking regulators took a measured approach to the regulation of bank participation in the securitization process. Like the American banking regulators, they placed few limitations on the types of securitization transactions in which banks could engage. However, in Canada, banks’ relative freedom in this area also came with a price. The Canadian banking regulators consistently took steps to ensure that the depositors, creditors, and policyholders of Canadian banks would be insulated against losses that might result from banks’ exposures to the risks of securitization. This measured approach to securitization was reflected the Canadian response to a change in accounting standards that would have restored ABCP program assets to bank balance sheets and in the way that Canadian regulators defined and regulated liquidity enhancements. The Canadian banking regulators followed the American example in giving banks regulatory capital relief for securitized assets that returned to the balance sheet; however, they took a different approach to the regulation of liquidity enhancements, forcing banks to either
define the terms of liquidity support narrowly or to hold large amounts of capital against
liquidity enhancements.

I argue that the Canadian approach to the regulation of securitization can only be fully
understood after accounting for the influence of the frame of public protection, which shaped the
way that the Canadian banking regulators conceptualized bank participation in the securitization
process. The Canadian regulators viewed securitization as a risky practice that had the potential
to both help and hinder their overarching regulatory mission. Securitization was believed to
enhance order in the banking system by helping Canadian banks maintain their competitive
position (and by extension, their autonomy) in an international marketplace. However, as a
highly complex and relatively untested practice, securitization was also believed to pose risks to
the safety and stability of Canadian banks. To maintain the appropriate balance between these
considerations, the Canadian banking regulators pursued a policy of regulatory harmonization
with the U.S. - except in areas where harmonization would have reduced the size of the capital
buffers Canadian banks held against risk exposures.

Securitization as a Source of Risk and Benefits

Although the Canadian banking regulators agreed with the American banking regulators
that the rise of securitization had improved efficiency and liquidity in the banking system, they
were less sanguine about securitization’s contributions to safety and stability. They recognized
that securitization presented new risks to the banks that engaged in this practice: for example, the
complexity of many securitization transactions made it comparatively difficult for banks to
accurately assess the extent to which they remained exposed to the risks of the transaction. The
regulators at OSFI frequently and publicly warned banks about this potential hazard. The
following comments from OSFI Superintendent Nick Le Pan are generally representative:
A number of these types of [credit risk transfer] transactions are highly complex and it can be very difficult to accurately assess the risk involved. It is not easy for financial institutions to maintain the capacity to make those assessments. I am cautioning institutions to be careful in this area (Le Pan, October 7, 2004).

Drawing from a central tenet of the frame of public protection, the Canadian banking regulators adopted the stance that the Canadian banking system’s increasing exposure to the risks of securitization was acceptable and even desirable - so long as banks held adequate safeguards to insulate the Canadian public from the expected and unexpected losses associated with this activity. As Le Pan explains, the Canadian banking regulators were primarily concerned with ensuring that banks had the ability to withstand surprise losses in this area:

We have seen that risks were materially more diversified than previously, often through the use of risk transfer mechanisms [like securitization], derivatives and reinsurance arrangements. When used improperly these can be used to mislead investors or can pose financial risks to the firms involved. But we don’t want to throw the baby out with the bathwater. Nor do we want to forget that vulnerabilities will always be in part a matter of surprise. So what matters is financial institutions’ contingency capability, financial cushions such as capital and reserves (which are now generally pretty high) and ability to withstand surprises (Le Pan, April 12, 2005).

So long as banks were covered in this respect, the logic went, they were free to pursue whatever innovative activities they wished.

Canadian bank engagement in lucrative and innovative activities became an increasingly salient over the course of the 1990s. The relative competitive position of the Canadian banking system began to slip after the late 1980s. The declining profitability of the Canadian banking system, especially in light of the increasing profitability of the American banking system, reignited old concerns about the threat of American economic encroachment and the corresponding loss of Canadian autonomy. As the global securitization market grew, Canadian banks began to appeal to OSFI for more lenient regulation of this practice. They framed
securitization as a competitive tool that would benefit Canadian banks in global market, and they argued that they would be left behind if regulators did not allow them to partake in these activities. Securitization thus became identified as one of the crucial activities that could help regulators restore the appropriate balance between the competitiveness of the Canadian banking system, which was seen as lacking in the 1990s and 2000s, and its stability. This helps to explain why the Canadian banking regulators were particularly keen to pursue regulatory harmonization with the U.S. in this area. One interview respondent explains how competitive considerations motivated convergence between Canadian and American securitization regulations:

The Canadian regime did come to look like the American regime [with regard to securitization]. I think the broad mentality did shift a bit [after the late 1990s]…There are competitive issues between Canadian institutions and U.S. institutions, particularly…as we were evolving a regime on the capital side there was a much more conscious attempt…to try to make our regime reasonably competitive with the U.S. regime. So I can remember consideration of some very seminal transactions that were also being looked at by the Fed in the whole asset-backed securitization world. And there was a conscious attempt [at OSFI] to say, “Okay, within this sort of kind of [bank] size range we’re okay with that kind of [securitization] structure.” Now, would that be absolutely our preference? Probably not, but I think the recognition of a whole bunch of, sort of, more competitive realities around certain aspects of the capital regime (Interview with Canadian Banking Regulator, Ottawa, July 2013).

In summary, the Canadian banking regulators believed that securitization allowed banks to compete in international markets, but also presented new risks, which would require banks to set aside additional prudential safeguards to hedge against these risks. Seeking a balance between competitiveness and stability in the post-Basel era, the Canadian banking regulators responded to the rise of securitization by giving banks increasingly free rein to take part in innovative securitization transactions, while still maintaining strict standards for capital allocation against their potential risk exposures. Competitive pressures clearly drove changes in Canadian regulation that allowed for the development of new, riskier securitization structures, but these
changes only occurred after Canadian regulators were confident that banks were well provisioned for the increased risk. This dual commitment is evident in the following comments from an interview respondent, who explained why the Canadian regulation of securitization increasingly came to look like the American regulation of securitization:

I think the Basel process [helps to explain it], the fact that we were actively participating in that…I think we had strong links with the American regulators, still do, and assume will continue. I think that’s a major kind of thing and I sense that in a sense the international outlook a bit altered, probably, and a little bit more of the, “Yeah, we need to make sure our regime is reasonably competitive on that side.” Now there were certain aspects that were deliberately not, so we had a higher target capital ratio. We had a lower leverage ratio, de facto. All that sort of kind of stuff. But some of the structural things? Yeah, we were moving closer (Interview with Canadian Banking Regulator, Ottawa, July 2013).

Effects for Policy Choices

The framing of securitization as both a threat and a contributor to order helps to explain why the Canadian banking regulators were so eager to ensure that the Canadian regulation of securitization was competitive with American regulation in this area, and also why Canadian regulators were so determined to avoid policy choices that might lower the size of the buffers banks held against their securitization exposures. In what follows, I explain how these commitments structured critical Canadian policy choices, with important implications for Canadian bank performance during the 2007 ABCP crisis.

Response to Accounting Changes

In 2004, the Canadian accounting standards-setter, the Accounting Standards Board (AcSB), followed FASB’s example, issuing a new accounting interpretation (AcG-15) that was substantially similar to FIN 46R. The Canadian banking regulators, in turn, followed the example of the American banking regulators. OSFI responded by issuing a notice of proposed rulemaking that was nearly identical to the September 2003 notice of proposed rulemaking issued by the
American banking regulators, which gave in giving banks regulatory capital relief for assets that returned to their balance sheets in response to these new guidelines.

Why did the Canadian banking regulators follow the American banking regulators down the path of giving banks regulatory capital relief? It may have been because they, like the American banking regulators and banking regulators from many other countries, believed that ABCP programs posed relatively little risk to the sponsoring bank. Like the American regulators, they justified the decision to give banks regulatory capital relief by citing the limited risk that these programs posed to the bank:

While the accounting treatment has changed, the risks to the bank have not. In particular, risks are limited by operational controls placed on the conduit structures, legal agreements within the transaction, and the selling of positions to third parties. As a result, OSFI will assign a zero per cent risk weight to consolidated third-party assets from ABCP conduits that previously had not been on the institution’s balance sheet or would not be in the absence of AcG-15. This risk-weight applies to conduits that contain only third-party assets (OSFI Draft Guideline B-5).

However, competitive considerations clearly played a major role in shaping this policy choice as well. The Canadian banking regulators did not want regulation that disadvantaged Canadian banks in competition with American banks. The effect of competitive considerations in driving this policy choice is evident in the fact that Canadian regulators did not develop their own, uniquely Canadian response to the introduction of these revised standards: they simply copied the text of the American response almost word-for-word. It is also evident in the fact that Canadian regulators followed the American example in providing regulatory capital relief for consolidated securitized assets, despite the greater willingness of the Canadian accounting standards-setter to work with banking regulators to develop standards that would avoid punishing effects for banks (Hafeman 2002).
Interviews with Canadian regulators also lend support to the claim that Canadian regulation of ABCP programs, including and beyond this specific policy choice, was driven by competitive concerns. One OSFI regulator explained how regulators’ early concerns about the riskiness of particular ABCP transactions were ultimately shelved in recognition of competitive realities:

So, yeah. The Canadian regime [in the regulation of asset securitization] did come to look like being an American regime. I think the broad mentality did shift a bit in the sense that this marketplace is relatively open and it’s relatively close. There are competitive issues between Canadian institutions and U.S. institutions, particularly. So as we were evolving a regime on the capital side there was a much more conscious attempt - and I suspect that the whole Basel process added to this. There was a much more conscious attempt to try to make our regime reasonably competitive with the U.S. regime. So I can remember consideration of some very seminal transactions that were also being looked at by the feds in the whole asset-backed securitization world. And there was a conscious attempt to say, “Okay, within this sort of kind of [bank] size range we’re okay with that kind of structure.” Now, would that be absolutely our preference? Probably not but I think the recognition of a whole bunch of sort of more competitive realities around certain aspects of the capital regime became more important at the timeframe you’re talking about (Interview with Regulator 3, July 2013, Ottawa).

The Canadian banking regulators followed the American banking regulators in giving banks regulatory capital relief for consolidated ABCP assets because they were willing to trade some degree of public protection in exchange for competitive power. It is likely that they did so in this area because granting banks regulatory capital relief for their newly consolidated assets would avoid reducing the prudential safeguards Canadian banks had held against these programs before the accounting standards changed.

Definition and Regulatory Capital Treatment of Liquidity Lines

The liquidity lines that Canadian banks offered to securitization conduits had long represented an area of concern for the Canadian banking regulators. OSFI introduced new guidelines for the accounting and regulatory capital treatment of securitization in 1994 that
included standards for the regulation and capital treatment of liquidity lines. They specified that only “general market disruption” liquidity lines could receive the 0% regulatory capital charge that was afforded to short-term liquidity lines under the minimum terms of the Basel Accord and in most other Basel member countries. All other types of liquidity lines (including other forms of short-term liquidity lines) would carry a full 100% capital charge (OSFI Guideline B-5 1994).

General market disruption liquidity lines strictly limited the conditions under which banks could extend liquidity support: a securitization conduit could only access the liquidity line if trading in the securitization market stopped for reasons that were completely unrelated to the quality of the underlying assets (e.g. the 9/11 attacks, a natural disaster). Most Canadian banks responded to the issuance of Guideline B-5 by exclusively offering general market disruption lines to their ABCP programs (OSFI Backgrounder 2008).

It is clear that Canadian banking regulators in the early 1990s saw the potential for risk in short term liquidity lines to securitization conduits that American banking regulators did not. An OSFI press release highlights the features that Canadian regulators found most concerning:

After the Basel I agreement was struck, securitization started to grow rapidly and OSFI became concerned about increasing risk to the banking sector. OSFI was especially concerned about the fact that no capital was being held for some types of liquidity lines, under which banks would lend to conduits with deteriorating asset quality or buy problem assets from the conduit…OSFI took the position, as it does for all credit risk, that capital was needed to back the risk. This was at a time when other regulators still had no capital charges for liquidity lines under the 1988 Basel 1 Accord. OSFI also took the position that it would only continue to support a zero capital charge if the liquidity line was for pure liquidity purposes (OSFI Backgrounder 2008: 3).

In the Canadian context, since these liquidity lines were believed to pose some risk to the banks that offered them, it was important for regulators to ensure that this source of risk exposure was covered by sufficient capital. Only liquidity support that truly posed no risk to the bank that offered it (e.g. a general market disruption liquidity line) would not require this corresponding
provision to protect safety and soundness. At a time when American regulation was focused on making markets stronger, Canadian regulation was focused on protecting the public by requiring banks to set funds aside to absorb losses, and I argue that these differences in regulatory focus help to explain why Canadian regulators sought to protect banks from what was (at the time) regarded as the remote possibility of demand for ABCP drying up, while the American regulators did not.

The historical development of Canadian regulations for the definition and regulatory capital treatment of liquidity lines helps to explain why Canadian regulators chose to preserve this unique and strict regime even in the face of pressures for convergence. In 2004, when the American banking regulators increased the capital charge for all short-term liquidity lines from 0% (the Basel minimum) to 10%, the Canadian banking regulators followed suit - but with one important exception. Canadian regulators agreed to enforce a 10% regulatory capital charge for all short-term liquidity lines except general market disruption lines. The declared that general market disruption lines would retain a 0% capital charge, which departed from the new American example.

The regulators at OSFI decided to retain a lower capital charge for general market disruption lines because they recognized that Canadian banks might stop offering this form of liquidity support to ABCP conduits if these lines carried the same capital charge as other forms of short-term liquidity support (Interview with OSFI Regulator, July 2013, Ottawa). The Canadian banking regulators did not find this acceptable: they had come to see these strictly defined liquidity lines as a way to avoid banks developing exposure to the risks of securitization through the back door, and they did not want banks to adopt more loosely defined liquidity lines (that still carried a relatively low capital charged). Faced with a compromise between regulatory
convergence and maintaining high buffers against losses in an area they had long seen as important, the regulators at OSFI chose to stand firm, following their mandate to “preserve our differences… where differences matter to us for policy reasons.”

The Canadian choice to retain this liquidity regime is surprising given regulators’ commitment to regulatory harmonization and the intensity of the pressures they faced from important market participants. The major American credit ratings agencies (S&P and Moody’s) opposed general market disruption lines. They argued that this form of liquidity line did not provide sufficient protection to ABCP investors. These credit ratings agencies refused to rate Canadian ABCP after 2004, leaving only one agency, the Canadian Dominion Bond Rating Services, rating these securities. In short, competition concerns lost out to stability concerns in areas that regulators had identified as high-risk, which explains why Canadian regulators retained their distinctive liquidity regime despite the costs. The fact that they did so in the face of potentially serious consequences for the development of the Canadian ABCP indicates how important this was to them.

Securitization Outcomes

As in the American case, the favorable resolution of the uncertainty relating to the regulatory capital treatment of securitized assets that returned to bank balance sheets as a result of changes in accounting standards likely promoted the growth of the Canadian ABCP market during the critical period of 2004 - 2007. The Canadian ABCP market, like the American ABCP market, was large. However, Canadian bank liquidity providers absorbed few losses when the ABCP market collapsed, unlike American bank liquidity providers, due primarily to their extension of general market disruption liquidity lines to the ABCP programs they sponsored. Facing difficulties in the ABCP market in the summer of 2007, many Canadian ABCP conduits
turned to commercial bank liquidity providers to fund their cash shortfalls. However, the bank liquidity providers advised the ABCP programs that a qualifying “market disruption” event had not officially occurred. The terms for providing liquidity under a general market disruption contract had not been met; therefore, Canadian banks refused to support these conduits. As a result, the Canadian ABCP market instantly became insolvent, which generated massive losses for many ABCP investors. However, the Canadian bank providers of liquidity support to ABCP conduits emerged relatively unscathed.

**SPAIN: CENTRALIZED COORDINATION AND SECURITIZATION**

The Spanish banking regulators sought to limit bank participation in the securitization process by placing tight restrictions on a bank’s ability to remove assets from the balance sheet. The strict regulation of securitization in Spain made many securitization programs uneconomic in this country. Like the Canadian regulators, the Spanish banking regulators also required banks to hold sizeable capital buffers against their securitization exposures. This generally strict approach to securitization was reflected in the Spanish response to changing accounting standards and the Spanish definition and regulation of liquidity enhancements. The Spanish banking regulators not only refused to give banks regulatory capital relief for assets that returned to the balance sheet; they also went a step further, adopting the new accounting standards before other European countries and interpreting these standards in a very conservative way. These regulators also went far above the Basel minimum standards by assigning a 100% capital charge to all forms of liquidity enhancements.

I argue that the Spanish approach to the regulation of securitization can only be fully understood after accounting for the influence of the *frame of centralized coordination and direction*, which shaped the way that the Spanish banking regulators conceptualized bank
participation in the securitization process. The Spanish regulators believed that securitization’s role in facilitating risk transfer presented a serious threat to their overarching regulatory mission. Securitization was thought to destroy order in the banking system by allowing banks to shift risk to separate, unregulated entities, which operated away from the watchful eyes of regulators. To maintain their ability to direct and control bank activities, the Spanish banking regulators sought to prevent banks from transferring assets off their balance sheets if the bank retained any exposure to the associated risks. They only made exceptions to this unusually strict regulatory regime if the exception would promote other valued goals, like Spain’s economic integration with the rest of Europe.

**Securitization as a Threat to Order**

One of the defining features of securitization is its role in facilitating a bank’s ability to remove assets from its balance sheet. When viewed through the lens of a perspective that framed consolidated supervision and regulation as vital to order, this feature of securitization was seen as highly problematic. To the Spanish banking regulators, banks transferring securitized assets to conduits, yet continuing to retain some of the risks of these assets, seemed suspiciously similar to the practice of banks hiding risk exposures in separate subsidiaries, which was generally regarded as an important factor in the banking crisis of 1977-1985.

The Spanish banking regulators did not believe that securitization resulted in a true transfer of risk. One industry participant with close ties to regulators at the Bank of Spain explains the logic:

> I remember very well the very beginning of the [securitization] market [in Spain], the person who was responsible of supervision [at the Bank of Spain], he used to say that he didn’t believe in securitization. Because he thought that eventually the banks would be backing the transaction, so there was not, in fact, [a] securitization [with risk transfer]. So, the culture in the Bank of Spain, was always that ‘we don’t believe that this is really a separate thing’…the Bank of Spain said,
“…it’s going to be very difficult [to] prove [to] me that you have sold a sufficient amount of risk...to take these [assets] off [the balance sheet]. So you’re not going to take them off (Interview with securitization industry participant, Madrid, March 2013).

Armed with these doubts about the utility of securitization, and highly attuned to its potential to threaten consolidated supervision and regulation, the Spanish banking regulators actively opposed bank participation in the off balance sheet securitization process.

The Spanish regulators also believed that securitization promoted disorder by facilitating the transfer of credit risk to unregulated entities. Bank of Spain Governor Gonzalo Gil argued:

I pointed out that the transfer of risk outside the banking sector could be an advantage. However, this is not always the case, particularly when these risks are assumed by unregulated entities. This not only implies that the extent of a crisis may be greater, in that imbalances can come about more easily and to a higher degree, but resolving it could also be difficult (Gil 2005).

The Spanish perspective on this feature of securitization could not be more different from the American perspective. While the Spanish banking regulators saw the transfer of risk to unregulated entities as destructive to order, the American banking regulators saw this as a practice that promoted order. I argue that these opposite perspectives reflected fundamentally different conceptualizations of regulatory order. Under a worldview that framed market-distorting policies as the root cause of disorder in the banking system, this transfer of credit risk promoted order by shifting risk to entities subject to better market discipline. But under a worldview that framed unchecked and unmonitored bank behavior as the route of disorder in the banking system, the same transfer of credit risk destroyed order by moving risk away from the watchful eyes of the experts charged with rationalizing the financial system.

This Spanish resistance to securitization was also reflected in policymakers’ comparatively late embrace of this practice. Spanish policymakers did not legalize asset securitization (i.e. the securitization of non-mortgage assets) until the passage of Real Decreto
926 in 1998 - long after most of the other Basel member countries. Once again, the central problem that regulators perceived in bank participation in the securitization process was that fact that securitization involved banks transferring assets to a third party (and taking these assets off the balance sheet, and away from regulatory oversight) while still retaining some exposure to the associated risks. From the perspective of the Spanish banking regulators, off-balance-sheet securitization violated the principle of consolidated supervision and regulation, as it gave banks a tool that they could use to hide their risk exposures from regulators.

Evidence that the perceived problem was not the complexity of securitization transactions, or the fact that these transactions involved the sale of loans to third parties, is found in the fact that Spanish policymakers and regulators had endorsed the on-balance-sheet securitization of mortgages since 1981, which was relatively early in international perspective. These regulators and policymakers actively encouraged banks issuing Participaciones Hipotecaria, covered bonds (a form of on-balance-sheet securitization) that were backed by mortgage collateral. Banks cannot obtain regulatory capital relief for assets transferred to a covered bond, since these securitized assets remain on the sponsoring bank’s balance sheet.

Securitization as a Tool Promoting Regional Integration

If the Spanish banking regulators and Spanish policymakers regarded off-balance-sheet securitization as a major threat to order, why did they allow banks to engage in this practice at all? I argue that a different goal of Spanish banking regulation, the desire to integrate the needs of the banking system with those of society at large, helps to explain why Spanish policymakers finally permitted Spanish banks to engage in asset securitization in 1998, and why the Spanish banking regulators let this decision pass without much objection. At this point, the Euro was on the horizon, and Spain aspired to qualify as one of the founding members of this single currency
(Financial Times, October 15, 1996). To accomplish this objective, Spanish banks would need sufficient collateral to be able to obtain loans from the European Central Bank (ECB). Asset-backed securities represented one important form of collateral that the ECB would accept.

Interviews with Spanish regulators and industry participants indicate that this desire to be in the first wave of countries to adopt the Euro was at the root of Spanish policymakers’ decision to permit limited bank involvement with asset securitization (with the passage of Real Decreto 926/1998). One industry participant explains:

I remember exactly the day when the Bank of Spain called me. It was probably 1998, or I would say before that, 1997, when the Bank of Spain called me. A person that later on was deputy governor, he called me and said, you have to convince the banks to securitize. Why? Because we were going to enter the EU…And we were a country, bankerized [bank-based], not securitized [market-based]. So we didn’t have bonds [asset backed securities], we had banking loans. Typically this country worked with banking loans, not with bonds. And the way in which the euro was going to inherit – the German way of providing liquidity by the Bundesbank – and they were giving ABS as collateral, so we needed collateral. So that’s why the Bank of Spain said, “You have to convince the banks to produce bonds, so that they have the assets to participate in this” (Interview with securitization industry participant, Madrid, March 2013).

Despite their reservations about the threat that bank participation in the securitization process posed to an orderly and ineffective banking system, the Spanish banking regulators chose not to stand in the way of this initiative (Interview with Bank of Spain Regulator, Madrid, March 2013). Their acquiescence to this legislative change implies that Spanish regulators, in addition to Spanish policymakers, were willing to swallow their scruples if the initiative in question helped to promote another valued societal goal: in this case, Spain’s economic integration with the rest of Europe.

Effects for Policy Choices

The framing of securitization as a major threat to expert direction and control in the banking system helps to explain why the Spanish banking regulators were so committed to
limiting bank participation in the securitization process. In what follows, I explain how this commitment (and the banking regulators’ commitment to the pursuit of regional integration) structured critical Spanish policy choices relating to the regulation of securitization, which had important implications for Spanish bank performance during the 2007 ABCP crisis.

Response to Accounting Changes

In Spain, the prudential banking regulator (the Bank of Spain) was also responsible for setting and enforcing bank accounting standards - this structure of accounting oversight was unique in international perspective. The Bank of Spain had complete autonomy to establish accounting standards until 2002, when the European Union voted to adopt International Financial Reporting Standards (IFRS), which were issued by the International Accounting Standards Board (IASB). Firms in all EU member countries (including banks in Spain) were expected to comply with the IFRS standards on or before January 1, 2005.

In 1998, the IASB had issued accounting interpretation SIC 12, which stated that a sponsoring institution must consolidate a conduit if it retained control over the majority of risks or benefits of the conduit. This interpretation was substantially similar to the controversial interpretation of conduit consolidation standards that was found in FIN 46 in the U.S. and AcG-15 in Canada. With the implementation of IFRS on the horizon, European banks and their regulators found themselves in a similar position as the North American banks and their regulators. If regulators did not intervene, European banks would be forced to hold much more capital against the newly consolidated ABCP assets. As a result, banking regulators from many European countries followed the American example, and gave their banks regulatory capital relief for assets that had returned to the balance sheet as a result of SIC 12.
However, the Spanish banking regulators took a different path. The regulators at the Bank of Spain refused to give banks regulatory capital relief for any assets that had returned to their balance sheets. They also use their authority over bank accounting to “goldplate” the new IFRS standards, implementing these standards much earlier than required under EU law and interpreting particular standards (including the conduit consolidation standards outlined in SIC 12) in an unusually conservative way (see Banco de España, Circular 4/2004). The effect was to make it even more difficult - virtually impossible - for Spanish banks to remove assets transferred to conduits from their balance sheets. This was a death sentence for the ABCP market in Spain, which had never really developed to begin with.

I argued that the relationship that Spanish banking regulators perceived between securitization and their overarching regulatory mission (particularly their desire to promote consolidated regulation and supervision and to facilitate Spain’s integration into the wider European community) helps to explain their policy choices in this domain. The Spanish banking regulators chose to goldplate the IFRS consolidation standards for two reasons: because they viewed bank participation in off-balance-sheet securitization as a serious threat to order and because the domestic implementation of the IFRS consolidation standards gave the regulators an opportunity to signal their commitment to the project of regional integration.

Regulators seek to impose rules to restrict undesirable behavior, and in the Spanish context, regulated banks transferring risk to affiliated but separate and unregulated off-balance-sheet entities was viewed as particularly undesirable. It follows that Spanish regulators would try to use the tools at hand to cut down on this type of behavior. Jose Maria Roldan, a former director of regulation at the Bank of Spain, explains the connection:

The Bank of Spain, which acts as financial regulator, has prevented banks from holding any kind of special purpose vehicles off balance sheet. This conservative
stance arose because Spain suffered a big banking crisis in the 1980s when financial groups that had built big industrial empires crashed under the weight of cross-shareholdings and intra-group lending. “We learned early and the hard way,” Mr Roldán said. ‘Since then, we have always looked at risk from a consolidated perspective. Nowadays, this may sound like plain vanilla supervision, but before IFRS [was adopted in Europe in 2005], we were the first regulators to insist on the need to bring special purpose entities within the consolidation perimeter’ (Crawford and Tett 2008).

The Spanish framing of securitization as a threat to order also helps to explain why these regulators viewed the implementation of the IFRS consolidation standards as an opportunity, rather than a threat. I argue that the regulators at the Bank of Spain chose to demonstrate extreme compliance with regional accounting standards in an area where a narrow and conservative interpretation of these standards was already consistent with their general policy objectives (securitization), in the hope that the IASB would forgive their lack of compliance in an area where compliance threatened a major policy objective (loan loss provisions). At the time that Spain regulators issued Circular 4/2004, the IASB and the Bank of Spain had just concluded a battle over an accounting policy related to loan loss provisioning (the “statistical provision”) that the Spanish prudential regulators wanted very much to keep. The IASB originally saw this policy as violating international accounting standards. However, as I will discuss further in the next section, the statistical provision represented the Spanish banking regulators’ primary defense against procyclicality in bank lending, and they were loathe to give it up. After protracted discussions, the IASB grudgingly allowed the Bank of Spain to retain a modified version of its cherished anti-cyclical policy in 2004. Having secured this important victory, the Spanish banking regulators were eager to find a way to demonstrate that their commitment to the IASB’s larger integration project. The regulation of securitization, as an activity that the Spanish banking regulators didn’t even like, presented the ideal site for regulators to demonstrate their strong commitment to compliance with regional standards. This helps to explain why the Spanish
banking regulators chose to implement the IFRS consolidation standards early, and why they interpreted these standards so conservatively.

**Definition and Regulatory Capital Treatment of Liquidity Lines**

Liquidity lines to securitization conduits carried a 100% regulatory capital charge in Spain, which was much higher than the minimum required capital charge under the terms of the Basel Accord. Why did the Spanish banking regulators establish and maintain such a high capital charge for this bank activity? Available evidence, drawn from interview responses and industry publications, implies that regulators assigned a high capital charge to liquidity lines because they believed that these lines represented a form of recourse to the securitized assets *(Interview with Industry Participant, Madrid, March 2013)*. It is not surprising that regulators operating under a worldview that framed risk transfer with recourse as a serious threat to order would assign a hefty regulatory capital charge to an activity that was believed to be dangerous.

**Securitization Outcomes**

The strict Spanish accounting and regulatory standards adopted in 2004 made it extremely difficult - virtually impossible - for a bank to achieve regulatory capital relief for assets it had securitized. The fact that banks were unable to use securitization to engage in regulatory capital arbitrage made many securitization programs, including ABCP programs, uneconomic for banks in Spain. The result was that a domestic ABCP market never developed in Spain. Consequently, Spanish banks suffered few losses when the global ABCP crisis. Spanish banks may have performed poorly during the crisis, but this poor performance was not a product of their securitization exposures.

**THE REGULATION OF LOAN LOSS PROVISIONING**
Banks make money by collecting funds from depositors and using these funds to lend to borrowers or invest in securities. In their role as financial intermediaries, banks are subject to credit risk, or the risk that some borrowers will fail to repay the bank as promised. It is inevitable that some loans in a bank’s portfolio will turn out to be bad. To account for this reality, banks create a fund, known as the loan loss reserve or the allowance for loan and lease losses, which is designed to absorb loan losses when they occur.

The amount placed in the loan loss reserve is supposed to reflect management’s best estimate of the losses inherent in a bank’s portfolio of loans at a given moment in time. Banking regulators have historically preferred banks to err on the side of caution when calculating the loan loss reserve. Bad loans, and reserves that are not adequate to absorb them, have been the primary cause of bank failures worldwide. When loan losses overwhelm the loan loss reserve, they begin to affect a bank’s reported earnings. Banks with highly volatile cash flows are perceived as unstable, and perceptions of instability can instigate a dangerous cycle that ends in bank failure. Banking regulators worldwide learned this lesson the hard way in the 1980s, when emerging debt crisis. Since this time, most bank regulators have encouraged their banks to establish conservative loan loss reserves.

Banks continually assess the adequacy of their loan loss reserves, and build or increase the reserves through making loan loss provisions. To replenish the loan loss reserve after an increase in bad loans, banks typically deduct loan loss provisions from their current earnings, and add these funds to the reserve. Loan loss provisions are considered an expense, and like other expenses, they reduce the bank’s reported income. In short, the loan loss reserve serves a similar function as the bank’s capital reserve: both help to maintain bank stability and solvency in the face of adverse credit events. The main difference is that loan loss reserves are theoretically
intended to absorb expected credit losses, while bank capital is intended to absorb unexpected credit losses. While this distinction makes sense in theory, it proved to be more complicated in practice.

The Basel Accord and Loan Loss Provisions

The stated objective of the Basel Accord was to enhance the safety and stability of the global financial system – and to accomplish this objective, the Basel Committee established a common international floor for bank capital adequacy. Yet even at the time at which the Basel Accord was first developed, its creators recognized that capital was only one piece of the puzzle. As the text of the original Basel Accord indicates, maintaining an adequate reserve against loan losses was also regarded as an important prudential consideration:

It should also be emphasized that capital adequacy as measured by the present framework, though important, is one of a number of factors to be taken into account when assessing the strength of banks…capital ratios, judged in isolation, may provide a misleading guide to relative strength. Much also depends on the quality of a bank's assets and, importantly, the level of provisions a bank may be holding outside its capital against assets of doubtful value. Recognising the close relationship between capital and provisions, the Committee…will seek to promote convergence of policies in this field as in other regulatory matters (Bank for International Settlements 1988: 2).

However, the Basel Committee never achieved this goal of promoting convergence in loan loss provisioning policy. Even today, regulation in this area continues to be determined at the national level.

The way that national banking regulators chose to regulate loan loss provisioning, a policy area that fell outside of the scope of the Basel Accord but still affected bank stability and solvency, had implications for the outcomes of domestic banks during the crisis. Balla and Rose (2011) find that many banks entered the financial crisis of 2007-2009 with low loan loss reserves. As a result, when trouble hit, they had to sharply increase provisions in recognition of
pending losses, which for many banks more than offset earnings and reduced capital. These circumstances compounded existing problems in the banking and financial systems, and led to calls for the reform of loan loss provisioning practices. In March 2009, Ben Bernanke, the chairman of the Board of Governors of the Federal Reserve, publicly called for a review of loan loss provisioning regulation. The Basel Committee also formally encouraged accounting regulatory bodies to adopt a forward-looking loan loss provisioning regime in the revised Basel framework (Basel III) published in 2011.

**Bank Loan Loss Provisioning and Accounting Standards**

The regulation of loan loss provisioning practices was a salient issue for both accounting standards-setters and banking regulators, for reasons I will explain in greater detail below. In Table 6.2, I describe the identities of and allocation of responsibilities between banking regulators and accounting standards-setters in the U.S., Canada, and Spain.
Table 6.2. Distribution of Accounting and Regulatory Authority in the U.S., Canada, and Spain (1988-2007)

<table>
<thead>
<tr>
<th>Type of Activity</th>
<th>Accounting Standards</th>
<th>Securities Market</th>
<th>Banking</th>
<th>Monetary Policy</th>
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Accounting standards-setters and banking regulators generally have different goals. Accounting standards-setters seek to provide an accurate snapshot of a firm’s financial condition at a given point in time. The objective is to achieve transparency, precision, and accuracy in the picture of the firm’s condition they present. Banking regulators generally have a different goal. They seek to ensure that banks remain stable, solvent, and profitable, which includes ensuring that banks can adequately withstand current or future losses. The issue of the regulation of loan loss provisioning brought these goals into conflict in many countries.

The accrual accounting rules under which banks operate require recognition of revenue as it is earned and expenses as they are incurred, regardless of the timing of the actual cash flows. Loan loss provisions were supposed to vary based on current estimates of the losses inherent in a bank’s loan portfolio at a given moment in time. However, estimating inherent losses is a tricky business. There is always going to be a degree of uncertainty surrounding these calculations: this is part of the reason why banks exist.
The accounting categories related to loan loss provisions reflected this reality. In the U.S., Canada, and Spain, loan loss provisions were categorized in one of two categories: general or specific. “General” provisions are set aside to cover losses associated with future uncertain events, for which documentation cannot always be produced. “Specific” provisions are set aside to cover losses associated with certain events (such as past due payments, or other default-like events) for which specific documentation can be produced. The regulation and accounting treatment of general provisions was a contentious issue in all three countries. Across the three countries, accounting standards-setters disagreed with banking regulators on the extent to which these general provisions should be forward looking, and the extent to which regulators should play a role in helping banks estimate the losses inherent in their portfolios. Accounting regulators in the U.S. and Canada, and international accounting standards setters in Spain, offered similar arguments: loan loss provisioning policies that were excessive or forward-looking did not reflect a bank’s true financial position, and should be eliminated.

American, Canadian, and Spanish banking regulators chose to regulate bank loan loss provisioning practices in different ways. The banking regulators at the Federal Reserve gave in to accounting standards-setters’ demands for greater transparency, acquiescing to policy proposals that had the effect of lowering loan loss reserves at a time when credit risk was increasing. The Canadian banking regulators, by contrast, used every tool at their disposal to ensure that banks maintained large loan loss reserves - including permitting banks to violate generally accepted accounting principles. The Spanish banking regulators developed a unique (and uniquely conservative) loan-loss provisioning regime, and they actively fought to preserve it. The result was that Canadian and Spanish banks were comparatively well provisioned against loan losses on the eve of the crisis; American banks were in a less favorable position.
I suggest that the prevailing frame of regulatory order in each country helps to explain this pattern of divergent policymaking. The frame that dominated in each country shaped the extent to which banking regulators viewed loan loss provisioning as central to their overarching regulatory missions, and the dominance of this frame also explains when (and why) regulators acquiesced to pressure from accounting standards-setters. The dominance of the frame of *competition* in the U.S. led regulators at the Federal Reserve to downplay the importance of loan loss provisions, and also to see value in SEC enforcement actions framed as initiatives augmenting market discipline. The dominance of the frame of *public protection* in Canada led regulators at OSFI to place a high value on ensuring that banks maintained conservative prudential safeguards, even when this came at the expense of transparent accounting. The dominance of the frame of *centralized coordination and direction* in Spain helps to explain why regulators developed a unique loan loss provisioning regime that gave the state a major role in bank provisioning practices, and why they fought so hard to keep it, even when integration into the larger European regional community was at stake.

**UNITED STATES: COMPETITION AND LOAN LOSS PROVISIONS**

Encouraging conservative loan loss provisioning practices was not a policy priority in the U.S. in the same way that it was in Canada or Spain. After the SEC started to take enforcement actions against banks accused of setting aside excessive loan loss provisions, the American banking regulators (in comparative perspective) did relatively little to fight back. Regulators at the Federal Reserve even went a step beyond inaction by issuing guidance to American banks that implied that the Federal Reserve agreed with the approach the SEC had taken. This eventually resulted in the introduction of new regulatory standards for loan loss provisioning that
lowered bankers’ discretion in the provisioning process, which had the effect of encouraging American banks to reduce the size of their loan loss reserves during a critical period.

I argue that this lackluster approach to the regulation of loan loss provisioning can only be fully understood after accounting for the influence of the *frame of competition* in the American regulatory system. I suggest that this frame shaped the way that the American banking regulators conceptualized bank provisioning practices. The American banking regulators were less concerned about encouraging banks to hold adequate provisions, because they believed that the market would naturally force banks to establish reserves that fit the risk appetites of investors (and the size of this bank-established reserve would be optimal, because it would be market-driven). Additionally, the regulators at the Federal Reserve did not resist the SEC’s attack on conservative loan loss provisioning practices because the securities regulator had successfully reframed these practices as threats to market discipline. When regulators at the Federal Reserve issued guidance to banks that confirmed the SEC’s approach, these regulators cited the threat to transparency that excessive loan loss provisioning represented, as well as the need to facilitate better market discipline. In a context where enhancing market discipline represented the overarching goal of banking regulation, the redefinition of excessive loan loss provisions as a threat to market discipline represented a powerful argument, and one that induced these regulators to give up one of their traditional regulatory tools.

**The SEC Attacks Loan Loss Provisioning Practices**

In September 1998, SEC chairman Arthur Levitt gave a speech announcing a nine-point plan to combat earnings management among publicly traded firms. Earnings management is the practice of using innovative or aggressive accounting tactics that intentionally mislead stakeholders about the underlying economic performance of the firm. Loan loss provisions are
deducted directly from current earnings; therefore, an increase in provisions causes a decrease in a bank’s reported income. The SEC had grown increasingly concerned that bankers might use loan loss provisions to smooth their reported income, taking overly large provisions when bank earnings were high, and overly small provisions when earnings were low.

The SEC hated the idea that banks might use loan loss provisioning to manage earnings. Earnings management goes against the principles of information disclosure and transparency, and it was thought that this practice might mislead bank shareholders. In 1998, the SEC began to aggressively question the loan loss provisioning practices of publicly traded banks, and a number of large banks received letters from the SEC questioning their policies in this area (Beck and Narayanamoorthy 2012). In the fall of 1998, the SEC announced that it was investigating the loan loss provisioning practices of SunTrust Bank, Inc. At the time, SunTrust was seeking to acquire Crestar Financial Corporation, and had a common-stock registration statement pending before the SEC. However, before the SEC would grant approval of SunTrust’s registration statement, the agency required the bank to reduce and restate its loan loss provisions for the years 1994-1996. The effect of this restatement was to increase SunTrust’s reported earnings by $100 million. These enforcement actions against SunTrust represented a departure from business as usual for the SEC. Ordinarily, investors and regulators are concerned that firms might engage in earnings management practices that artificially increase reported revenues, profits, or earnings per share. SunTrust, on the other hand, was accused of using practices that artificially decreased its reported revenues, profits, and earnings per share. Through its enforcement initiatives, the SEC demonstrated that it was equally concerned with both types of earnings management.

These initiatives were troubling to many of the U.S. federal banking and thrift regulators (e.g. the Federal Reserve, the OCC, the FDIC, and the OTC) and to the banking industry. The
federal banking regulators worried— as it turns out, correctly—that the SEC’s enforcement actions would discourage banks from establishing conservative loan loss reserves. Most of the federal banking regulators were keen to ensure that banks erred on the side of conservatism when it came to loan loss provisioning. The comments of Emory W. Rushton, Senior Deputy Comptroller for Bank Supervision Policy, Office of the Comptroller of the Currency, were indicative of the regulators’ general perspective on this issue:

History has shown us repeatedly that loan losses are awfully hard to forecast before they become obvious, and bad loans have been the primary cause of almost all bank failures. Deficient reserves put an inappropriate burden on bank capital and increase the risk to the Federal Deposit Insurance Fund and, ultimately, the taxpayer. For that reason, it is critical that we closely scrutinize any action that could have the effect of causing banks to lower their reserves (Loan Loss Reserves, June 16, 1999).

For their part, members of the banking industry expressed concern that they would be caught in the middle of a turf battle between the banking regulators, who sought conservative loan loss provisions, and the SEC, who sought greater transparency and precision for loan loss provisioning. In an effort to address the concerns of bankers and ameliorate the regulatory ambiguity, the federal banking agencies persuaded the SEC to issue a joint interagency statement on November 24, 1998 to signal their commitment to working together to develop guidance on loan loss provisioning practices.

However, this initial joint statement did not sufficiently resolve the uncertainty that the SunTrust restatement and the SEC’s letters to other banks had inspired. Subsequent actions by the SEC did not help matters: even after the November 24th statement, the SEC continued to send letters to banking organizations questioning their loan loss reserve disclosure practices. Bankers remained concerned that the SEC would take further action against banks with conservative loan loss reserves (Loan Loss Reserves, June 16, 1999: 250). The federal banking regulators and the
SEC responded to this prevailing sense of uncertainty by sending an additional joint letter to financial institutions on March 10, 1999, which reiterated their commitment to working together to address loan loss provisioning issues. This letter was widely supported by the banking industry, because it suggested that the SEC and the federal banking regulators were finally on the same page (*Loan Loss Reserves*, June 16, 1999: 252).

The federal banking regulators were also pleased. At the time, they saw no problem with current bank loan loss provisioning practices, and did not believe that the practices should be changed. But if the SEC was determined to make loan loss provisioning a policy priority, the federal banking regulators would settle for providing input into the new accounting standard. Laurence H. Meyer, member of the Board of Governors at the Federal Reserve, describes how the federal banking regulators interpreted the intent of the March 10th letter:

> The Federal banking agencies and the SEC issued another joint letter on March 10, 1999, reiterating the agencies' agreement to work together and announcing a number of joint efforts. The joint letter announced new initiatives of the agencies and the accounting profession to develop enhanced guidance on loan loss allowances over a one to two year period. In addition, the agencies stated that they would support and encourage the processes of the accounting standards-setters as they seek to clarify key loan loss allowance accounting issues.

> Most importantly, the letter indicated that the agencies will meet together periodically to discuss important matters that affect bank transparency and will focus on enhancing allowance practices going forward. The spirit of the March 10 joint letter was to put into place a process for resolving issues related to loan loss allowances going forward, and permit the agencies to work together in this process to resolve allowance matters and avoid significant changes in methodology that would encourage a decline in the allowances before this process had run its course (*Loan Loss Reserves*, June 16, 1999: 252).

However, this tentative collaboration between the SEC and the banking regulators only lasted until April 12, 1999, when FASB published a controversial article in *Viewpoints*, the official FASB publication in which staff and board members express views on accounting matters. This article “clarified” the existing interpretation of generally accepted accounting principles (GAAP)
that related to loan loss provisioning. In doing so, it reintroduced the uncertainty and regulatory ambiguity that the federal banking regulators had worked so hard to address.

The controversy over the *Viewpoints* article was less about the content of the article than about what the article represented. On its face, the *Viewpoints* article simply clarified and reiterated FASB’s interpretation of Statement of Financial Accounting Standards No. 5 (FAS 5). This accounting statement had provided GAAP regarding recognition of losses on receivables (including loans) since 1975, and directed firms to calculate loan loss provisions based on loan losses that have already occurred (“incurred losses”), not losses that are expected to occur (“future losses”). The *Viewpoints* article simply reiterated this preexisting principle.

However, the timing and existence of this article concerned the members of the banking industry. Bankers wondered why FASB had chosen this moment to reiterate an accounting principle that bankers already thought they were following. If there was no problem with the way that banks were currently interpreting this standard, then why did the FASB see a need to clarify guidance on this issue? The determination of loan loss provisions is a decision that inherently involves a great deal of managerial judgment – it is as much an art as a science. The timing of the *Viewpoints* article, which followed on the heels of the SEC’s recent enforcement actions, signaled to bank managers that the accounting standards-setters did not believe that these managers were using their discretion wisely.

The executives of large banks responded by restating concerns that the March 10th letter

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32 “We believe that the *Viewpoints* article, by the absence of any exposure for comment or distribution prior to publication, was written in such a way that lent itself to easy misinterpretation. We think the intent of the article was sound, but it could be very easily misinterpreted by many bankers as representing a departure from what is fairly standard industry practice with respect to reserving for expected future losses” (*Loan Loss Reserves*, June 16, 1999: 41).
had supposedly put to rest: “Bankers want to know: is there a problem with the current accounting? Does the SEC view the rules differently from bank regulators and industry? If so, what are the rules?” (Loan Loss Reserves, June 16, 1999: 53). Compounding the problem, FASB had published the Viewpoints article without consulting the federal banking regulators, in violation of the collaborative spirit of the March 10th statement. The SEC’s response only exacerbated this uncertainty. On May 20, 1999, the SEC announced at a public meeting of the FASB’s Emerging Issues Task Force (EITF) that banks should follow guidance in the Viewpoints article when calculating their loan loss provisions. The SEC claimed that the agency was “neutral” regarding whether any banks would need to make adjustments to their current loan loss provisioning practices, but they announced that any banks that had previously misinterpreted GAAP had until the end of the second quarter of 1999 to make appropriate adjustments. The announcement of this formal transition period only amplified concerns that the SEC wanted to see a change in bank behavior.

The SEC’s implicit endorsement of the Viewpoints article provided the final straw for the most of the federal banking regulators. Immediately after the EITF meeting and the SEC’s announcement of the transition period, the OTS, OCC, and the FDIC sent a joint letter to the representatives of the House and Senate Banking Committees. The letter explained that the federal banking regulators were worried that the SEC’s unilateral actions would lead to a decline in loan loss reserves, and requested a formal congressional hearing on the issue. The Chairman of the SEC subsequently made a strong public statement that it was not the SEC's intention to

33 On June 3, 1999, the American Banker reported, "When bank and securities regulators announced a plan in March to promote a 'clearer understanding' of loan loss reserves, bankers were encouraged. An end to months of contradictory signals seemed to be in sight. ... But the cooperative spirit among regulators was short-lived. If anything, the rules on loan loss allowances have grown murkier."
bring about widespread reductions in reserves, but by then it was too late. The hearings were going to happen.

The SEC Frames Loan Loss Provisions as a Threat to Market Discipline

On June 16, 1999, the Financial Institutions and Consumer Credit subcommittee of the Banking and Financial Services Committee of the U.S. House of Representatives heard testimony from the four federal banking regulatory agencies, the SEC, the banking industry, and bank stock analysts on the issue of loan loss provisioning. The hearing opened with testimony from the representatives of the SEC, who sought to defend the agency’s endorsement of the Viewpoints article and its recent enforcement actions. The congressmen had trouble understanding why overly conservative loan loss reserves were problematic, and they criticized the uncooperative actions of the market conduct regulator and accounting standards-setters. Committee members repeatedly asked SEC personnel to justify their decision to engage in enforcement initiatives against banks with conservative loan loss provisions (Loan Loss Reserves, June 16, 1999). The way that the SEC responded was instructive. Harvey Goldschmid, general counsel at the SEC, framed conservative loan loss provisions as a threat to market discipline. This framing is evident in the explanation of the perceived dangers of excessive loan loss provisioning he offered in response to a question from Congressman Ken Bentsen (D-TX):

Mr. BENTSEN: What I don't understand is, why would a public company over-report reserves and deduct from earnings? Why would that be in the interest of a company to decrease earnings in that regard?
Mr. GOLDSCHMID: Let me explain the dangers, and that may explain the reason to you. For some…putting extra reserves, as much as possible in a reserve, sounds like it is [a] good [idea], the more the better for that rainy day. One danger is for shareholders. They will not know the true value of the bank if there are greatly excessive reserves. The shareholder would read the balance sheet - perhaps the most sophisticated analyst might see through [it] - but, the shareholder would read the balance sheet [as] suggesting that the bank is worth much less than it really is. Two, management may have that reserve to begin to feed on when things go bad. Now, that is the most destructive, potential danger in the whole process. If things
begin to go bad, it may be shareholders, market discipline, the market's work here. And even the outside directors, the independent members of the board, may not know things are going wrong. The signals of capitalism that tell the markets and tell the board when things begin to go bad will not be there and the ability to correct early, to change course, to do good things will not be there also (Loan Loss Reserves, June 16, 1999).

Were American banks actually using loan loss provisions to manage earnings? Although it is difficult to know for certain, most of the available evidence suggests that banks were not using loan loss provisions to engage in earnings management (Ahmed et al. 1999). The federal banking regulators, the agencies with the most detailed information about a bank’s loan portfolio and lending behavior, unanimously denied that banks were currently using loan loss provisions to manage earnings (e.g. Spillenkothen 1999). For its part, the SEC provided no information to suggest that banks were engaging in this practice. At the House hearing, agency personnel largely side-stepped the question of whether banks were currently using provisions to manage earnings, arguing instead that it was possible that banks could use provisions for this purpose. From the SEC’s perspective, the potential threat to market discipline was reason enough to justify the agency’s endorsement of the Viewpoints article and its recent enforcement initiatives.

It is worth noting that investors, the supposed beneficiaries of the SEC’s enforcement actions, were not in favor of these actions. As R. Harold Schroeder, a senior equity analyst at Keefe, Bruyette, and Woods, Inc., argued in his testimony before the House, investors were not concerned about banks’ use of loan loss provisions to manipulate earnings, but they were concerned that the SEC’s enforcement actions might threaten the stability of the financial system:

In preparing my testimony, most institutional investors I spoke with sympathized with the SEC's concerns about earnings management and its corrosive effects on the integrity of financial reporting. In fact, when I first read the SEC Chairman's September 1998 speech outlining his concerns on the topic, I too agreed in concept with most of his points. But when it came to bank loan loss reserves
virtually all investors I spoke with were far less supportive. As one investor aptly put it: "there's a direct link between a strong financial system and a strong economy." Adding: "any actions by the SEC that could weaken a bank's resolve to maintain higher reserves would be like putting termites in the foundation."

Investors do not want accounting theory that results in an unwarranted reduction in loan loss reserves; it is not in their best interest. It is my view that, if the SEC's interpretation of current accounting rules is an inhibiting factor to maintaining adequate reserves, then the rules should be changed - not the reserves. Putting aside who may be right on accounting theory, we see no need for dramatic change in the way most banks currently determine reserves or the level of current reserves. Investors are not being misled by current disclosures and they can readily see which banks are conservative versus those that are walking closer to the cliff's edge. In fact investors are very attuned to when banks have used the loan loss reserve to "manage earnings." So, with investors not being misled, it seems unwise to push all banks to the cliff's edge with no room for error.

Maintaining lower reserves is of particular concern given the building market sentiment that credit quality is unlikely to get any better than it is today. Supporting this concern are recent comments made by the President and CEO of the Federal Reserve Bank of New York. In responding to a question about credit quality, he voiced his view that banks don't make bad loans in the middle of a recession - banks make bad loans when the economy is strong. I agree with this view and, therefore, find the timing of the SEC's quest for theoretical purity very puzzling (Loan Loss Reserves, June 16, 1999: 323-324).

The Federal Banking Regulators Fight Back, But the Federal Reserve Caves In

The OTS, OCC, and FDIC argued that banks were not currently over- or under-reserved. Given that the problem that the SEC was seeking to address didn’t exist, they contended that aggressive policy changes for the accounting treatment of loan loss provisions were not warranted. These regulators further argued that the decisions of the SEC and FASB to tackle the issue of excessive loan loss provisioning would generate negative unintended consequences. Banks had indicated to their regulators that they planned to lower their loan loss reserves in response to the recent SEC enforcement actions. Furthermore, while prudential regulators would always prefer banks to err on the side of conservatism when setting loan loss provisions, the timing of the SEC’s enforcement actions were particularly problematic. In 1999, the United States was entering the ninth year of what is a conventionally a seven-year business cycle.
Evidence was starting to mount that credit conditions had declined. Regulators predicted that banks would see heavy loan losses in the very near future; therefore, now was a particularly inappropriate time to engage in activities that might lead banks to reduce their loan loss reserves (Loan Loss Reserves June 16, 1999).

Given the regulators’ frustration with the SEC’s actions and the subcommittee’s support for the banking regulators’ perspective, it is somewhat surprising that the representatives of the federal banking agencies asked for very little at the House hearing. Instead of requesting the power to veto any accounting policies or enforcement initiatives with the potential to threaten prudential considerations, the federal banking regulators simply asked the SEC to recommit to the projects that had been outlined in the March 10th interagency letter. Essentially, the federal banking regulators sought to maintain the previous status quo, in which they provided limited and informal input into the accounting standard-setting process. The objectives of the federal banking regulators are clearly stated in the testimonies of FDIC Chairman Tanoe and OTS Deputy Director Richard M. Riccobono:

Ms. TANOE: So, where does the disagreement lie? The FASB recently published an article in Viewpoints on loan loss reserves. The FDIC is concerned that financial institutions might interpret this article in isolation from other guidance on loan loss reserves, and we are also concerned that institutions might view this guidance as a signal to make unwarranted reductions in their reserves that could threaten bank safety and soundness. It is our view that the Viewpoints article does not address comprehensively many key issues. We have been concerned that the misinterpretation of the Viewpoints article could result in banks having the impression that they are to unnecessarily reduce their reserves in their second quarter financial statements. Given the importance of loan loss reserves to both bank safety and soundness and transparent financial reporting, we at the FDIC remain committed to continuing to work with the SEC and the other agencies on the projects announced in the March 10th Joint Interagency Letter (Loan Loss Reserves June 16, 1999: 36)

Mr. RICCOBONO: Based on information gathered through the working group, the accounting standards-setters, and the industry, the agencies will issue parallel guidance on appropriate methodologies, disclosures, and supporting
documentation for loan loss reserves by March 2000. We urge that all participants respect the integrity of this process so that guidance can be developed based on an open, collegial and informed dialogue. Notwithstanding several intervening actions that may have sent conflicting signals to financial institutions, it is our hope that thrifts will not make fundamental changes to their reserve policies based on unclear guidance about what is and is not GAAP. The reason for formation of the joint interagency working group is for the agencies involved in this debate to share their experiences, and ultimately, to provide consistent guidance to financial institutions about the treatment of loan loss reserves under GAAP. We welcome the opportunity to address these issues with our fellow regulators (Loan Loss Reserves June 16, 1999: 40).

The Federal Reserve did not join the other three federal banking regulators in requesting a formal congressional hearing on the topic of loan loss provisioning. Instead, on May 21, 1999, the Federal Reserve surprised the other banking regulators and the banking industry by issuing guidance that apparently ratified the SEC’s position on loan loss provisioning as reflected in the Viewpoints article. Although the guidance that the Federal Reserve issued explicitly mentioned that banks could legitimately increase their allowances for loan losses under GAAP, it was not interpreted this way by the banking industry: “The Fed’s guidance led bankers and bank regulators to worry that it, albeit indirectly, was encouraging reductions in allowances for loan losses at a point in the business cycle when prudence dictates such reserves should be increasing” (“Washington Furor over Loan Loss Reserves” 1999).

Why did the Federal Reserve essentially validate the Viewpoints article by issuing this guidance, and why did the agency neglect to join the other federal banking regulators in protesting the actions of the FASB and SEC? An excerpt from a speech given by Laurence

34 From the testimony of Gov. Meyer: “This guidance provided helpful background information to assist institutions and their auditors in understanding the SEC announcement and the FASB article in the broader context of other accounting initiatives under way. It also highlighted emerging points of agreement between the SEC and the Federal Reserve on allowance accounting matters. In this regard, the letter encouraged the banking industry to maintain conservative reserving practices consistent with management's best estimates” (Loan Loss Reserves June 16, 1999: 34).
Meyer, the deputy governor of the Federal Reserve, two weeks before the House hearing provides some insight into the agency’s perspective:

Although we disagree with the need for banking organizations to revise previous financial statements, battling the SEC on many of these issues seems not the proper course. They have an obligation to enforce sound reporting and disclosure practices as best they can, and our financial markets have been well served in the process. The U.S. banking industry has its obligations, too, to manage its risks and to tell its story to bank supervisors, the SEC, and the general public. If for no other reason than the fact that banks today are so large and complex and have the potential to present such widespread risk, these largest institutions, in particular, should be held to high performance and compliance standards. As bank supervisors, we should welcome the market’s help to identify and assess banking risks and to minimize the risk of moral hazard (Meyer 1999).

These comments suggest that the Federal Reserve chose to support the SEC on this policy issue because they agreed that that reducing the level of discretion that bank executives held in setting loan loss provisions would lead to enhanced market discipline. In short, I suggest that the Federal Reserve’s overarching goal of promoting greater market discipline in the banking sector left these regulators primed to accept the SEC’s claims.

However, when the Federal Reserve was called before the House subcommittee, Deputy Gov. Meyer backpedaled somewhat on this policy stance. At the hearing, Meyer conceded that the SEC’s endorsement of the Viewpoints article violated the collaborative arrangement between the accounting and banking regulators, but argued that the standard-setting process itself was not problematic. The following exchange between the federal banking regulators and Congressman Vento highlights the Federal Reserve’s perspective on this issue, as well as the lack of agreement between the federal banking regulators on this question:

Mr. VENTO. But the issue is obviously the Federal Accounting Standards Board came forth with this Viewpoints article, and then immediately following that, the Securities and Exchange Commission, SEC, came forth with this guidance. In other words, it suggests that really they had no option but to accept this publicly approved Viewpoints article and implement it because that is part of the process...I think the interpretation I would make is that if I am working with this group over
here and then they are going independently and doing this, it seems to me to compromise the cooperation, at least it seems to me I would be questioning, you know, if I had been co-opted. You apparently don't feel that way.

Mr. MEYER. No, I feel that way completely. Absolutely. The point I would make is we have an excellent process in place. The participants in that have to make their practice conform to that process. I believe that in this case, the combination of the FASB Viewpoints article, but really reinforced by the SEC announcement, was not in fact consistent with that process.

Mr. VENTO. Do we have a two-brain beast here, with one for the tail and one for the head? I don't know. Is that pretty consistent? I don't want to make a point of that. I see people nodding, but for the record you have to say, "Yes." Mr. Rushton.

Mr. RUSHTON (OCC). Yes, sir.

Mr. RICCOBONO (OTS). Yes.

Ms. TANNOUE (FDIC). I affirm that also.

American Loan Loss Provisioning Policy Outcomes

After the House hearing, it appeared that the federal banking regulators had won their first victory in this policy battle, as the transcript from the House hearing suggests that the subcommittee largely sided with the federal banking regulators. On July 12, 1999, the SEC and federal banking regulators issued another joint interagency letter to financial institutions that reinforced their commitment to working together to address the issue of loan loss provisioning. This letter included an additional provision: the SEC agreed to consult with the appropriate banking regulator as part of the process of determining whether to take enforcement actions against excessive loan loss provisions in the future. On July 29, 1999, the Securities subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs heard testimony from Arthur Levitt, Chairman of the SEC, on the topic of the accounting treatment of loan loss reserves. Levitt was the only regulator to testify before this subcommittee: the federal banking regulators were excluded. The record suggests that the primary purpose of this hearing was to chastise the SEC for its lack of collaboration with the banking regulators, and to reconfirm that the SEC would abide by the terms of the July 12th letter going forward. Members of the Senate subcommittee further criticized the SEC and FASB for subverting the GAAP standard-setting
process, arguing that the agencies attempted to change GAAP (a process that requires formally soliciting input from affected stakeholders) by endorsing the *Viewpoints* article that “clarified” existing GAAP. The ongoing deliberations of AICPA’s Allowance for Loan Losses Task Force were expected to address the lack of due process in standard-setting, by providing a formal “forum for resolution of [loan loss provision-related] questions” (*Accounting for Loan Loss Reserves* 1999: 2).

At first glance, it appeared that the OCC, OTS, and the FDIC had gotten what they wanted: the SEC and the banking regulators continued to work together in working groups, and the SEC had been duly chastised by policymakers for overstepping its jurisdiction. However, all was not as it first appeared. It soon became clear that the proceedings were taking longer than expected: e.g. the draft proposal from the joint working groups, originally slated to be released in March 2000, was still not yet ready in July. The SEC and the federal banking regulators did not offer an official statement to explain this delay, but some of them spoke confidentially to the press. One reporter detailed the reasons that at least one federal banking regulator gave for this delay:

Regulators have different explanations for the delay -- none of which they were willing to state on the record. Some say that the guidance is complex, and that they were just "overly optimistic" to think that the research and writing of the proposal could be completed in a year. Others said that the delay stems in large part from disagreements between the banking agencies and the SEC. The bank regulators would prefer that banks be allowed to exercise judgment in setting reserve levels, while the SEC wants reserves to be tied to specific losses (Garver 2000).

It is clear that the issue of accounting for general loan loss provisions was the issue delaying progress. Bankers have particular discretion to set general loan loss provisions (compared to other types of reserves and provisions), and the SEC wanted to close this loophole by eliminating
general provisions. The OCC, OTS, and FDIC disagreed, and argued that these provisions were an important part of their regulatory toolkit.

However, before the SEC/federal banking regulator joint working group could release a draft proposal, the private-sector AICPA task force struck first. In July 2000, AICPA had issued a draft proposal for applying GAAP to loan loss reserves. The proposal would ban banks from setting aside general loan loss reserves: instead, banks would only be allowed to increase loan loss reserves when they could document a specific loss on a particular loan. This proposal to eliminate general loan loss provisions altogether was extreme, and it immediately came under attack from all of the federal banking regulators, including the Federal Reserve. The federal banking regulators eventually persuaded AICPA to allow for some general loan loss provisioning; however, the damage had been done.

The consensus in the financial community was that the introduction of the AICPA proposal made it much more difficult for the federal banking regulators to negotiate a standard that fit with their objectives: as one industry commentator noted, "instead of initiating the debate, banking regulators have been reduced to demanding a meeting with the accounting trade groups in an effort to exert some influence on the plan." Bert Ely, president of Ely & Associates in Alexandria, Va, phrased the point even more strongly: "I can't understand why they are so late on this. This isn't that complicated an issue. Loan-loss reserves have been around as long as banking, and all they had to do was defend well-established standard practices. Their delay created a vacuum that the AICPA has stepped into."

In 2001, the members of the FFIEC issued a joint statement on the accounting treatment of loan loss provisions. The statement confirmed that banks would need to abide by a stricter interpretation of generally accepted accounting principles (GAAP) when calculating loan loss
provisions - especially general loan loss provisions. The new standard required banks to provide more documentation to support the reasonableness of their estimates, including periodic comparison between estimates of the adequacy of the loan loss reserve and the actual loans charged-off (this was bad news for general loan loss reserves, which were often based on bankers’ impressions that were less amenable to quantification and standardized measurement).

As Comptroller of the Currency Dugan (2009) explains, to meet the new standards:

Banks have to document why a loss is probable and reasonably estimable, and the easiest way to do that is to refer to historical loss rates and the bank’s own prior loss experience with the type of asset in question. Unfortunately, using historical loss rates to justify significant provisions becomes more difficult in a prolonged period of benign economic conditions when loss rates decline. Indeed, the longer the benign period, the harder it is to use acceptable documentation based on history and recent experience to justify significant provisioning. When bankers were unable to produce such acceptable historical documentation, auditors began to lean on them either to reduce provisions, or, in some circumstances, to take the extreme step of reducing the loan loss reserve by releasing so-called “negative provisions” that counted as earnings (Dugan 2009).

The FFIEC policy statement suggested that the SEC had largely won the ongoing policy battle over the accounting treatment of the loan loss reserve. The FFIEC statement was issued contemporaneously with a policy statement from the SEC, Staff Accounting Bulletin 102 (SAB 102), and the two statements had virtually identical language. By issuing a policy statement that was consistent with what the SEC had wanted from the beginning, the actions of the FFIEC signaled to banks that the SEC had won.

This change in the bank loan loss provisioning regime had important implications for American bank performance during the crisis of 2007-2009. American banks responded to the SEC’s actions, and the federal banking regulators’ eventual affirmation of the SECs approach, by decreasing their loan loss reserves (Balla and Rose 2011). This had consequences for the stability and solvency of the American banking system as it entered the crisis: as Balla and
McKenna (2009: 405) report, with an alternative policy regime that encouraged (or at least did not discourage) conservative loan loss provisioning practices, “the severe drop in [U.S.] bank income associated with the actual steep rise in loan loss provisioning during the financial crisis of 2007–2009 would have been substantially reduced. With positive net income in its place, banks could have increased their capital through internal means and thus reduced the need for assistance from the U.S. government.”

CANADA: PUBLIC PROTECTION AND LOAN LOSS PROVISIONS

The Canadian banking regulator responded differently to similar conditions. It is clear that ensuring that banks maintained conservative loan loss reserves represented a critical policy priority for OSFI. In the late 1990s, this regulatory agency took the unprecedented step of allowing banks to depart from generally accepted accounting principles (GAAP) in exchange for increasing the size of their loan loss reserves. Even when this decision was criticized by the press, domestic securities regulators, domestic accounting standards-setters, and by regulators and standards-setters in the United States, the Canadian banking regulators held firm. The end result was that Canadian banks retained large loan loss reserves at a time when American banks were reducing their reserves, circumstances that served Canadian banks well during the crisis.

I argue that the Canadian approach to the regulation of loan loss provisioning can only be fully understood after accounting for the influence of the frame of public protection in the Canadian regulatory system. I suggest that this frame shaped the way that the Canadian banking regulators conceptualized bank provisioning practices: as a critical tool that allowed the entire regulatory system to function properly. In a regulatory system where bank autonomy was conditional on banks maintaining sufficiently high prudential safeguards, high reserve and capital holdings were regarded as particularly important. Thus, in the Canadian context, where
striking the right balance between public protection and private autonomy (with a tilt towards the former consideration) was the primary regulatory goal, inducing banks to maintain conservative prudential safeguards was a central policy priority.

**Canadian Banking Regulators Make Loan Loss Provisioning a Priority**

In 1997, the same year that Arthur Levitt announced the SEC’s war on earnings management, the Canadian banking regulators at OSFI announced their new policy priority: encouraging banks to increase their loan loss provisions. Regulators at OSFI were wary about the ongoing credit boom in this period, and encouraged Canadian banks to increase their general provisions in preparation for the inevitable bust, even though troubled loans at the time were way down. In an April 27, 1998 letter from OSFI to all Canadian deposit-taking institutions, Superintendent John Palmer urged these institutions to increase the size of their loan loss reserves by adding to their general loan loss provisions. In a statement that echoed the arguments of the Spanish banking regulators, Palmer attributed this strong suggestion to the need to address “[the] tendency when the economic cycle matures for people to take on additional risk, without understanding what they're taking on because everything looks so good” (Blackwell, The Financial Post, May 15 1998).

There is evidence that Canadian banks were not crazy about this request. In an interview with a reporter from the Financial Post, Palmer noted that while OSFI had not yet met resistance from the banks, “it's fair to say financial institutions are never enthusiastic about doing anything that could impact on earnings, particularly in an environment where there is enormous pressure on them to produce earnings that improve every quarter” (Palmer, Interview with Blackwell, Financial Post, May 15 1998). However, the Canadian banks largely complied with this request,

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35 Ironically, Canadian banking regulators brought the loan loss reserve issue to the attention of the SEC in 1997.
and most increased their general loan loss provisions during this period. OSFI considered these actions to be a step in the right direction, but the banking regulators still remained dissatisfied with the current levels of bank loan loss reserves.

Since 1991, OSFI has held the statutory authority to “override” GAAP, or to allow banks to issue financial reports that depart from GAAP. The agency has rarely used this power to override existing accounting standards, instead preferring to work in conjunction with CICA and the provincial accounting regulators to establish standards that serve the interests of all three constituencies. However, regulators at OSFI took a bold step away from this common practice on the issue of loan loss provisioning. In October 1998, OSFI sent a letter to every Canadian deposit-taking institution encouraging these institutions to increase their loan loss reserves. The letter outlined two pathways that banks could use to achieve this outcome. The first pathway was a conventional method: banks could gradually increase the loan loss reserve through increasing their loan loss provisions over time (and accounting for these provisions in the usual way). However, the second pathway was much more controversial. OSFI indicated that it would also permit banks to take a “one-time adjustment” to the loan loss reserve, which could be deducted from retained earnings instead of current earnings. To understand why this pathway was so controversial, it is important to understand that deducting provisions from retained earnings represents a clear and serious violation of both Canadian and American GAAP. Ordinarily, when a bank increases its loan loss provision, the provision is treated as an expense. This expense is charged to the bank’s current earnings account, which lowers the income reported on a bank’s income statement. By contrast, charging a loan loss provision expense to retained earnings would not affect a bank’s reported income.

The fact that allowing banks to charge their loan loss provision to retained earnings
would materially affect figures reported on a bank’s income statement seriously distressed the regulators in charge of investor protection. This is because investors are known to focus on the income statement (which would not be affected by the charge to retained earnings) when they make investment decisions, rather than the balance sheet (which would be affected by the charge). In short, if a bank deducts loan loss provisions from retained earnings, there is a non-negligible chance that potential investors will be misled about the bank’s true financial condition.

In short, by choosing to exercise its GAAP override power in the case of loan loss provisioning, OSFI sent a clear signal that conservative loan loss reserves were a critical policy priority for the agency, and that depositor protection came above investor protection in their hierarchy of regulatory priorities. The symbolism of this move was not lost on market observers. One anonymous bank analyst interpreted OSFI’s action as suggesting that “all [OSFI] wants is a prudent balance sheet. So to encourage banks to build their general reserves aggressively, OSFI passed them this carrot” (Mathias 1999, Financial Post).

It is clear that OSFI had considered alternative other strategies before taking the extreme step of overriding GAAP. For example, in a series of talks undertaken between 1997 and 1998, OSFI had strongly encouraged CICA (the Canadian accounting standards-setter) to take the lead in reforming existing standards related to loan loss provisioning in ways that would promote more conservative provisioning practices. However, CICA had dragged its heels, and had not changed these standards quickly (Interview with Canadian Banking Regulator, Ottawa, July 2013). At this point, OSFI decided to take action. In a 1998 speech, Palmer explains how OSFI regulators framed the decision to move forward with the GAAP override:

At the end of the day, the decision we make will reflect the balance we strike between the sometimes conflicting concerns of accounting quality and competitive reality. I believe a proper balance can — and will — be struck. The question is whether OSFI will have to strike it, or whether the CICA will take the
lead. We certainly prefer the latter (Palmer, September 28, 1998).

I suggest that this episode in Canadian regulatory policymaking once again affirmed and embodied the principle of balance between *private autonomy* (competitive reality) and *public protection* (accounting quality). When faced with a choice between these competing considerations, OSFI sought to arrive at a solution that would respect both considerations - but in the end, the banking regulators believed that they had a duty to err on the side of *public protection*.

Although the option to circumvent GAAP and deduct loan loss provisions from retained earnings was extended to all Canadian banks, only two banks, Quebec-based National Bank of Canada and Laurentian Bank of Canada, initially elected to take OSFI up on its offer. It is likely that the rest of the Canadian banks would have preferred to do the same. However, four of the “big five” Canadian banks (i.e. Bank of Montreal, Royal Bank of Canada, Toronto-Dominion Bank, and Canadian Imperial Bank of Commerce) were also listed on the New York Stock Exchange, which requires companies to report financial figures using U.S. GAAP. There is no way that banks could deduct loan loss provisions from retained earnings and still be consistent with U.S. GAAP. After all, during this time period, the American accounting standards-setters were considering changing GAAP to eliminate general loan loss provisions altogether! There is no way that they would have allowed NYSE-listed banks to pull an extremely uncommon accounting maneuver to increase general provisions.

**Canadian Accounting and Securities Regulators Respond to the OSFI Override**

CICA was uncomfortable with OSFI’s statutory authority to override GAAP even before OSFI used this power to address the issue of bank loan loss provisioning. In 1997 and 1998 representations to a federal task force on the future of Canada’s financial services sector (the *MacKay* Task Force), CICA requested the elimination of OSFI’s GAAP override powers
(“GAAP Departures Unsettle Investors” 1999). However, to CICA’s disappointment, the MacKay task force elected not to honor this request. It is not surprising then that CICA was seriously troubled by OSFI’s use of its GAAP override powers to permit banks to deduct loan loss provisions from retained earnings. As the following quotation from CICA vice-president Bob Rutherford suggests, accounting regulators were “disquieted” by OSFI’s unilateral actions:

OSFI’s actions are understood to have disquieted the CICA’s standard-setters. "We did have some discussions with OSFI in late 1997 and early 1998," acknowledged CICA vice-president of studies and standards Bob Rutherford. "These discussions focused on which general loan-loss provisions should be determined under GAAP and we expressed concern over some of OSFI's ideas." Rutherford stressed there was no discussion about the possibility of charging extra provisions directly to retained earnings (“GAAP Departures Unsettle Investors” 1999).

For similar reasons, the provincial securities regulators were also not thrilled by OSFI’s decision to override GAAP. However, these regulators appeared to grudgingly accept OSFI’s authority in this area, at least initially. After all, there was little that they could do. Both the 1991 Bank Act and the provincial securities legislation (in all provinces except for British Colombia) gave OSFI the authority to depart from GAAP at the agency’s discretion.36

However, this issue became even more contentious in December 1999, when the Nova Scotia-based financial institution Scotiabank elected to take advantage of the one-time opportunity to deduct loan loss provisions from retained earnings. This action angered CICA and the Ontario Securities Commission (OSC), a key provincial securities regulator, and set off a chain of events that resulted in a public battle and Parliamentary hearings. Why did Scotiabank’s

36 ‘We weren't wild about it,” said Doug Hyndman, BCSC chairman, "but we gave them the exemption order on condition that they provide sufficient disclosure in their annual reports to make it clear to the reader what was going on here . . . and the effect of the departure from GAAP (Mathias 1999) . . . “Bill Hess, chairman of the Alberta Securities Commission, pointed out that the accounting is fully disclosed in the banks' annual reports but agreed that there is ‘still an issue’” (Mathias 1999).
decision to take advantage of OSFI’s GAAP override inspire such vehement protest from CICA and the OSC, when a similar action from the Quebec-based banks had only inspired mild grumbling to the press? One reason was Scotiabank’s size: Scotiabank was the fifth-largest bank in Canada, much larger than the Quebec-based banks, and the bank had also deducted a much larger loan loss provision ($550 million). The difference between Scotiabank’s reported income under GAAP versus that under OSFI’s GAAP override was so extensive that “Scotiabank's performance would have gone from the top of the heap to the bottom” had the bank used conventional GAAP accounting.37

The other reason that Scotiabank’s decision to deduct provisions from retained earnings inspired protest was that this action occurred on the OSC’s turf. Many Canadian companies also cross-list on U.S. stock exchanges, and the primary Canadian securities regulator did not want to jeopardize its important relationships with the NYSE and SEC. At the time of Scotiabank’s unconventional accounting move, the OSC was already worried that it was on thin ice with the U.S. securities regulator. Comments from Eric Reguly, a financial journalist at the Globe and Mail, succinctly summarize the political considerations at play:

Scotiabank's timing could not have been worse, coming as it did when a lot of questions are being asked about the integrity of Canadian accounting. Canada, for example, is about to get booted out of the reciprocity agreement, known as the multijurisdictional disclosure system (MJDS), that has given Canadian companies effortless access to U.S. capital markets since 1991. The system meant that offering prospectuses, once approved by the OSC, would be automatically accepted by the U.S. Securities and Exchange Commission. Although the SEC says it is ejecting Canada from MJDS because it wants to treat Canadian companies like all other foreign issuers, the speculation on Bay Street is that the

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37 “If Scotiabank had done what the other Big Five banks do, its fiscal 1999 profit would have been $1.24-billion instead of $1.55-billion; its share earnings would have been $2.29 instead of $2.93; and its return on equity -- the all-important figure that tells shareholders how effectively their money is being employed -- would be a lowly 12 per cent instead of 15.3 per cent. In other words, using conventional accounting methods, Scotiabank's performance would have gone from the top of the heap to the bottom” (Reguly, The Globe and Mail, December 7, 1999).
SEC was getting fed up with Canada's substandard disclosure, regulatory and accounting standards. Scotiabank was not an MJDS issuer, unlike the other Big Five banks. Nonetheless, its accounting for loan-loss provisions strikes at the heart of Canadian accounting credibility, or lack thereof. What's worse is that Canada's top financial regulator sanctioned the move (Reguly, *The Globe and Mail*, December 7, 1999).

In short, it is clear that from the OSC’s perspective, this episode represented a violation of the principle of *private autonomy*. For the securities regulator, nothing less than the strength, international competitiveness, and autonomy of the entire Canadian economy was at stake. The OSC had been eager to demonstrate to American securities regulators that it was serious about promoting strict and transparent accounting, and the OSFI GAAP override threatened this objective. As Reguly put it, the OSC believed that “Scotiabank's accounting technique, [while] perfectly legal, only reinforces the impression that the Canadian securities market is an international backwater that has a long way to go before it's taken seriously” (Reguly, *The Globe and Mail*, December 7, 1999). For this reason, the OSC was seriously displeased about OSFI’s decision to allow banks to engage in a practice that clearly violated the terms of American and Canadian GAAP. However, although the OSC was angered by OSFI’s decision to exercise its power to override GAAP, the securities regulators could do nothing to prevent this. Scotiabank’s unconventional accounting maneuver was permitted, and the bank was never forced to restate its earnings.

While the provincial securities regulators and accounting standard-setter may have lost the initial battle over the OSFI override, they did not give up their quest to reduce OSFI’s authority over bank accounting standards. In the years that followed, CICA, the OSC, and the Canadian Securities Administrators (CSA) attempted additional attacks on OSFI’s statutory authority to override GAAP. CICA’s attack came first, on March 14, 2001, in the form of testimony before the Canadian Parliament’s Standing Committee on Finance. The committee
was meeting to discuss Bill C-8, which contained an act to establish the Financial Consumer Agency of Canada and amendments to certain acts related to financial institutions. This legislation included a provision that would allow Canadian financial institutions to reorganize as holding companies. CICA was concerned that the OSFI override would be extended to these holding companies as well, not just deposit-taking financial institutions.

The organization sent Tricia O’Malley, chair of the Accounting Standards Board, to testify against the extension of OSFI’s override powers to bank holding companies. In her testimony, O’Malley repeatedly referenced the recent experience with loan loss provisioning to illustrate the dangers involved in permitting banks to diverge from GAAP. The dangers she pointed to reflected key principles of the frame of public protection and the frame of private autonomy. Drawing from familiar themes, Canadian accounting standards-setters and securities regulators cast the OSFI override as both a distortionary and discriminatory form of state interference with private economic activity. As O’Malley argued, OSFI’s GAAP override was believed to have confused and misled unsophisticated investors:

When [the GAAP override] provision was put into the legislation, it was envisioned originally for instances in which, for example, there was some provision in GAAP whose broad application to the financial services industry was going to cause concerns about solvency or stability. The superintendent might say, gee, if we follow this kind of reporting, it's going to create the whole wrong impression about the industry as a whole and perhaps cause a run on the banks and bring the whole system down, so we want the override to ensure the soundness of the system. In fact it has never been used for that. That, I guess, is our concern: that it's been used in a way that in fact makes it more difficult for investors and other security holders in financial institutions to understand what's really going on (Hansard, March 14, 2001).

O’Malley also argued that the override disrupted order by unfairly discriminating between different types of institutions, in this case banks and other firms:

I guess the biggest concern that we have is that this particular override was used in three situations: two banks in one year and one in another. And it's quite clear
from the reaction of the financial press and other investors that they found it very
difficult to try to make investment decisions or comparisons of the performance of
some banks that increased their loan-loss provisions, followed GAAP, and put it
through income, and these other ones that took this other route at the direction of
the Superintendent. And it seems odd, to us anyway, that a provision that our
collective institutional memory says was by and large put into the legislation in
the first place to deal with some concern about a systemic risk—where, for some
reason, following GAAP was not going to be prudential for the entire financial
institution system—is now being used on a selective basis for particular items as
essentially a carrot for good behaviour, if I can put it that way. If you increase
your loan-loss provisions the way we want you to, we'll let you put it to retained
earnings, for example, instead of having to take a charge to your income
statement. So it's a question as to the appropriateness of why it's necessary for
some institutions and not for others. (Hansard, March 14, 2001)

O’Malley’s colleague, Graeme Rutledge, chair of the Financial Institutions Reform Study Group
at CICA, echoed similar concerns in his testimony before the committee:

I think that's very appropriate when we're talking about levelling the playing field
because what really happened as a result of those three banks was that there were
many small investors who just did not understand what was the income, then, of
these particular institutions that availed themselves of this particular
accommodation, as you put it, from the Superintendent [of OSFI]. The press at the
time raised a lot of articles as to how does an investor look at this? And I think
what we're really talking about is levelling that playing field when it comes to
generally accepted accounting principles (Hansard, March 14, 2001).

The attacks on OSFI’s statutory authority to override GAAP from the OSC and the CSA took
similar forms (e.g. OSC Five Year Committee Draft Report, May 29 2002; National Instrument
51-102 Continuous Disclosure Obligations June 2002).

OSFI argued against eliminating the recognition of the GAAP override in Ontario
regulations, and defended its policy choices in speeches, responses to the press, and in formal
letters to the OSC Five-Year Committee. Nicholas Le Pan, then superintendent of OSFI, argued
in August 21, 2002 and August 29, 2002 letters to the committee that the critique of OSFI’s
actions in the draft report was “based on an outdated incomplete understanding of OSFI’s
position” (Letter from Le Pan to OSC Five-Year Review Committee, August 21, 2002). Le Pan
sought to clarify the reasons why OSFI had chosen to use its override powers to address the issue of loan loss provisioning. It was clear from his response that “the case of general allowances is a case in point in which the Office believed that the current accounting for provisions was not producing adequate results,” which, to his mind, justified the unusual use of the override (Letter from Le Pan to OSC Five-Year Review Committee, August 29 2002). As LePan explains, OSFI believed that this unprecedented (and politically expensive) move had been necessary for safety and soundness reasons:

The [OSC] report uses as examples the situation in which [OSFI] used its powers as part of an effort to enhance the loan loss reserves of major banking institutions…The Office engaged in that effort because we believed that it was important for safety and soundness reasons, because we believed that current GAAP did not adequately account for loan losses inherent in portfolios, and after a considerable (but unsuccessful) attempt to get accounting standards setters to reconsider the issue. Subsequent events have shown that our position was correct. It is only now that international accounting standards setters are coming to recognize that the model being used for loan loss accounting has flaws (Letter from Nicholas Le Pan, OSFI Superintendent, to Purdy Crawford, chair of the OSC Five Year Review Committee, August 21, 2002).

**Canadian Loan Loss Provisioning Policy Outcomes**

Canadian Parliament had a number of opportunities to end OSFI’s power to override GAAP. However, in each instance, Parliament elected not to do so. In the end, OSFI’s override powers were extended to cover holding companies as well, not just deposit-taking financial institutions. I suggest that the decision not to strip OSFI of its statutory authority to override GAAP, and later, to expand OSFI’s authority despite the hassles that the loan loss provisioning episode had caused also embodied the Canadian commitment to striking the right balance between public safety and industry competitiveness. Unlike Spanish policymakers, Canadian policymakers did not give the banking regulators the authority to actually set bank accounting standards except in the most extreme cases. However, unlike American policymakers, Canadian
policymakers did give the banking regulators at OSFI the option to override accounting standards if these standards were inconsistent with prudential concerns.

The 1999 OSFI override of the GAAP relating to bank loan loss provisioning practices was an unusual and controversial episode in Canadian bank regulatory policymaking. However, this episode had few direct effects for bank behavior, as the majority of the large Canadian banks could not take OSFI up on the offer to take a one-time deduction from retained earnings, since they were listed on the NYSE. However, these events (and OSFI’s successful protection of its override powers in the 2000s) did carry an important symbolic message. Banks could see that the Canadian banking regulator was very serious about ensuring that banks maintained strong and conservative loan loss reserves. Leading up to the crisis, Canadian banks were very well provisioned for the few losses they would experience (Ratnovski and Huang 2009: see Figure 6.2 and Figure 6.3).
Figure 6.2. Loan Loss Reserves as a Percentage of Non-Performing Assets (2006)

Notes: *The coverage ratio for the United States is the aggregate LLR for all commercial banks as a percentage of the aggregate non-performing loans. It was computed using Call Report data. All other countries’ data come from the International Monetary Fund.

Source: Balla and McKenna (2009)
Figure 6.3. Coverage Ratio for U.S., Canadian, and Spanish Banks, 1999-2008

Note: Data sources include Banco de España Annual Report (Spain); FDIC data for largest banks (USA); Statistics Canada (Canada)
The Spanish banking regulator developed a unique loan loss provisioning regime in the late 1990s. This regime, known as dynamic provisioning, was a forward-looking, countercyclical program. It forced banks to set aside more provisions than they otherwise would have when credit conditions were good, and allowed banks to reduce their provisions when credit conditions were poor. When this program came under attack from international accounting standards-setters, regulators at the Bank of Spain spent valuable political capital to retain it in some form. There is evidence that this conservative provisioning regime helped Spanish banks stay afloat during the crisis for considerably longer than they otherwise would have (Balla and McKenna 2009).

I argue that the Spanish approach to the regulation of loan loss provisioning can only be fully understood after accounting for the influence of the frame of centralized coordination and direction in the Spanish regulatory system. I suggest that this frame shaped the way that the Spanish banking regulators conceptualized bank provisioning practices: as a key underpinning of bank stability and solvency that required active direction and oversight from state experts. The Spanish banking regulators adopted dynamic provisioning as part of an effort to counteract banks’ natural tendency to run themselves into the ground in the absence of strong external oversight. Accordingly, this provisioning regime was very important to the Spanish banking regulators, which helps to explain why they fought so hard (and spent valuable political capital) to keep it even after regional accounting standards-setters turned against this regime.

The Bank of Spain Addresses the Credit Boom with a Countercyclical Policy

In the mid-1990s, Spain’s prospects for becoming one of the first European Union (EU) members of the new single currency appeared dim (Esarey 1998). However, under the center-
right government of José María Aznar, Spain experienced record economic growth in the late 1990s, and when the first wave of EU countries adopted a new single currency (the euro), Spain was among them. But Spain’s entry into the Economic and Monetary Union (EMU) had also come with costs. In the late 1990s, Spain had one of the highest interest rates in the EU, and complying with the terms of the EMU agreement meant that Spanish policymakers would need to drop interest rates dramatically. At the same time, Spain’s entry into the EMU signaled to foreign investors that Spanish investments had become a safer bet, and the investment dollars began to pour in. The result was that by 1999, Spain was experiencing dramatic economic expansion.

Spain’s membership in the EMU pleased regulators at the Bank of Spain, but the rapid credit expansion that had accompanied this shift worried them. The ratio of loan loss provisions to total loans had been declining since 1994, reaching an all-time low in 1999. In a 2000 working paper, one Spanish banking regulator explained why these conditions worried regulators at the Bank of Spain:

Since 1994 the ratio of provisions has continuously decreased reaching an all-time low last year as a result of the economic expansion and the strong decline of problem loans. Loan portfolios have, at the same time, been showing strong rates of growth over the last two or three years. Given the positive (although considerably lagged) relationship between credit growth and problem loans, these developments are worrying. In the downturn, the increase in impaired assets and demanding pro-cyclical loan loss provisions could threaten the profits of the riskiest institutions (Fernández de Lis 2000: 11).

In short, the perceived problem was the procyclicality of bank loan loss provisioning.

“Procyclicality” refers to a characteristic of policies that amplify the natural upswings and downswings of the business cycle. The Spanish banking regulators argued that conventional methods of loan loss provisioning are procyclical because they magnify the effects of credit booms and busts: banks set aside fewer loan loss provisions when the economy is expanding (e.g.
when there are few non-performing loans) and more loan loss provisions when the economy is contracting (e.g. when non-performing loans are increasing). The Spanish banking regulators were worried because they believed that banks had a natural tendency to disregard prudent credit policies during upswings in the business cycle. As the Bank of Spain working paper explained:

[I]t is very difficult to persuade bank managers to follow more prudent credit policies during an economic upturn, especially in a highly competitive environment. Even conservative managers might find market pressure for higher profits very difficult to overcome. This is compounded by the fact that for many countries loan loss provisions are cyclical, increasing during the downturn and reaching their lowest level at the peak. To a large extent, this reflects an inadequate ex post accounting of credit risk…Many credit risk mistakes are made during the expansionary phase of the economic cycle although they only become apparent ex post in the downturn (Fernández de Lis 2000).

This description of the problem to be solved echoed the diagnoses that Spanish policymakers had offered to explain the banking crises of the 1920s and the 1980s. The problem was that heightened competitive pressures were pushing even conservative bank managers into riskier lending practices. Drawing from the frame of centralized coordination and direction, the Spanish banking regulators sought to address this perceived problem by applying a familiar solution.

To preserve the safety and stability of the banking system, the Spanish banking regulators introduced a new loan loss provisioning regime in 1999 that was known as dynamic provisioning. Spanish banks were expected to comply with the new regime by July 1, 2000. The way that Spanish banking regulators described this new regime make it clear that the introduction of this policy was motivated by desire to combat the consequences of procyclicality in credit provision:

All in all, the strong pro-cyclicality of credit in Spain and its negative consequences in several instances explains the Bank of Spain’s decision to introduce statistical provisioning in July 2000. At that time, there was a concern that banks’ loan portfolios continued to expand with very low loan loss provisions – in other words that provisions would not be keeping pace with potential credit losses, which were latent in the new lending (Fernández de Lis and Garcia Herrero 2009: 6).
This new loan loss provisioning regime introduced a new class of loan loss provision, the
*statistical provision*, which complemented the traditional categories of specific provisions and
general provisions. The statistical provision was explicitly intended to budget for latent expected
losses. It weighted a bank’s estimate of specific and general provisions by a factor that varied the
economy’s current place within the credit cycle. The imposition of the statistical provision forced
banks to set aside more provisions than they otherwise would have when credit conditions were
good, and encouraged them to reduce their provisions (and use the money they saved to lend
more freely) when credit conditions were bad. Banks had two options for calculating the
statistical provision: they could calculate based on their own historical loss experience or they
could apply a set of coefficients established by the Bank of Spain.

Regulators at the Bank of Spain used two arguments to justify this alternative accounting
policy. They contended that dynamic provisioning not only increased the safety and solvency of
banks, it also provided a more accurate and precise reflection of a bank’s true economic
condition (Fernández de Lis 2000; *Interview with Spanish Banking Regulators*, Madrid, March
2013). The logic was that loan losses exist from the moment that a bad loan is granted, even if
these losses have not yet materialized. The regulators argued that banks should incorporate an
additional (and expert-determined) buffer against loan losses during economic expansions to
counteract the inherent shortsightedness and temptations of bank managers. The following
excerpt from the Bank of Spain working paper exemplifies this logic:

>[T]here is something wrong in the level of profits shown if the latent credit risk in
the loan portfolio is not properly taken into account. Every loan intrinsically has
an expected (or potential) loss that should be recognised as a cost by means of an
early provision. Otherwise, the picture of the true profitability and solvency of the
bank over time could be distorted. More dangerously, the overvaluation of profits
might lead to an increase in dividends that could undermine the solvency of the
bank... *If the total cost of the loan is not properly recognised and accounted for, bank managers willing to gain market share may be tempted during
economic expansions to underprice loans. More conservative managers will face strong incentives to follow this aggressive pricing behaviour in order to protect market shares. This herding behaviour is very dangerous for the stability of the whole banking system. All these facts and potential or real problems seem to point at the same direction: there is a need for a statistical provision that covers the expected loss inherent to the loan portfolio. This statistical provision should be considered as a cost for the bank and should be taken into account in the pricing of the operation (Fernández de Lis 2000: 11-12).

In short, the Spanish banking regulators, drawing from the frame of centralized coordination and direction, introduced the statistical provision to counteract the natural (but problematic) tendencies of bank managers. These managers could not be left to their own devices, or disorder would be the result. Instead, expert regulators had to take the lead to ensure an optimal outcome.

Spanish Loan Loss Provisioning Policy Outcomes

In a departure from the American or Canadian cases, opposition to this accounting change did not come from domestic securities regulators or accounting standards-setters. The securities and market conduct regulator in Spain, the CMNV, had responsibility for setting accounting policies for all publicly traded firms except for banks in this period. In a relatively uncommon arrangement, the Bank of Spain retained the statutory authority to set all accounting policies for banks: in Spain, GAAP for banks are determined by the prudential regulator.

However, dynamic provisioning did raise some eyebrows internationally, especially after the EU adopted an IASB regulation requiring groups listed on European stock markets, including banks and insurance companies, to prepare consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) in June 2002. The existence of the statistical provision, as originally conceived, represented a clear violation of these standards. As Gebhardt and Novotny-Farkas (2011) explain:

The amendments of IAS 39 during the IASB’s improvement project had the purpose to eliminate or mitigate differences relative to the requirements in US GAAP. SFAS 5 stipulates that a loss should be recognised when based on the
information available prior to issuance of the financial statements it is probable that an asset had been impaired as of the date of the financial statement and only if the loss can be reasonably estimated. SFAS 5.59 further clarifies that **loan loss provisions should not anticipate future events**. After all, this countercyclical provisioning regime does exactly what the SEC was so concerned about: it smoothed banks earnings, by forcing banks to increase their provisions during good times and to reduce them during bad times.

The adoption of IFRS in Spain was implemented by the Ministry of the Economy with the publication of Law 62/2003 on December 30, 2003. One IFRS standard, IAS 39: *Financial Instruments, Recognition and Measurement*, required banks to adopt an incurred-loss method of loan-loss provisioning. Ordinarily, this model would have prevented Spanish banks from engaging in dynamic provisioning.

However, the Spanish banking regulators responded by heavily bargaining with the international accounting standards-setter, and the two parties eventually reached a compromise (*Interviews with Spanish Banking Regulators*, Madrid, March 2013). The Bank of Spain adopted a new loan loss provisioning regime that was nominally an incurred-loss model, but the revised provisioning regime actually operated as a dynamic provisioning model. The only major change was that the new model collapsed the controversial statistical provision under the category of general provisions (Saurina 2009).

**CONCLUSION**

This chapter explains why the American, Canadian, and Spanish banking regulators regulated bank participation in the securitization process and bank loan loss provisioning practices differently in the period leading up to the recent global financial crisis (1988-2007). In the domain of securitization, the analysis zeroes in on two critical areas where national banking regulators encountered nearly identical circumstances, yet adopted different policies: (1) the choice of how much regulatory capital to assign to securitized assets that were brought back onto
a bank’s balance sheet after a change in accounting standards and (2) the definition of and regulatory capital treatment of the liquidity lines banks offered to securitization conduits. Choices in both of these domains had important implications for the extent to which American, Canadian, and Spanish banks bore the associated losses when one of the world’s largest securitization markets, the global asset-backed commercial paper (ABCP) market, collapsed in the summer of 2007. In the domain of loan loss provisioning, the analysis focuses on the content of debates between banking regulators, securities regulators, and accounting standards-setters over the regulation and accounting treatment of general loan loss provisions. Policies in this area had implications for bank stability and solvency on the eve of the financial crisis of 2007-2009.

I argue that conventional accounts of regulatory policymaking, which generally emphasize economic or political factors, cannot fully explain the divergent development of the regulation of securitization or loan loss provisioning across the three countries. Economic accounts frame regulators as powerless to resist the pull of efficiency imperatives, and imply that banking regulation should be more permissive at times and places where domestic banks confront intense competitive pressure. However, these predictions are not borne out in the cases considered here: the regulation of securitization was more permissive, and banks were discouraged from establishing conservative loan loss provisions, in the country with the strongest record of bank profitability in the post-Basel period (the U.S.). Similarly, a regulatory capture account frames regulators as pawns of the industries they regulate, and implies that banking regulation should be more permissive when and where the barriers to collective action within the regulated industry are lower. However, these predictions of this account also fail to explain this case: the regulation of securitization was the most permissive in the country with the highest
barriers to collective action in the banking industry (the U.S.); furthermore, loan loss provisioning practices went against the interests of large commercial banks in all three countries.

I also find that alternative institutional explanations for regulatory policy divergence fail to fully explain the development of banking regulation across these three countries. Institutional accounts that emphasize the effects of different political and regulatory structures, without considering the meanings embedded in these structures, cannot account for the dramatic transformation in the American regulatory regime that occurred in the late 1980s. In a short space of time, the American system of banking regulation transitioned from one of the world’s least permissive regulatory regimes to one of the world’s most permissive regulatory regimes. However, the basic structure of American political or regulatory institutions did not change during this period; accordingly, accounts that emphasize political or regulatory structures as the key drivers of divergent policymaking struggle to explain this pattern.

I contribute by calling attention to a different, overlooked driver of regulatory policymaking: nation-specific frames of regulatory order, which informed the interpretations and agendas of national banking regulators. I argue that the divergent regulation of securitization and loan loss provisioning in the U.S., Canada, and Spain only becomes fully understandable after attending to the frames that dominated in policymaking circles in each countries. These frames, which were structured by the broader institutional environment (see Chapters 2-5), shaped the development of securitization and loan loss provisioning regulations by influencing how regulators conceptualized the relationship between these activities and their overarching regulatory missions.

The American banking regulators subscribed to the frame of competition, which implied that both safety and prosperity originated from the unfettered operation of market processes.
Viewing bank participation in the securitization process through this lens, the American banking regulators framed securitization as *prudential practice*, or as a critical regulatory tool that would improve the safety and stability of the banking system. This framing of securitization as central to their overarching regulatory mission explains why the American regulators consistently bent over backwards to protect bank participation in securitization markets, while doing very little to ensure that banks had set aside sufficient funds to cover the risks of this activity. This helps to explain why the American banking regulators gave their banks such an unusual degree of freedom to set the terms of liquidity enhancements to securitization conduits, and why they aggressively fought back against changes in accounting standards that would have made bank participation in the securitization process more difficult and costly. Viewing loan loss provisioning through this lens, the American banking regulators framed loan loss provisions as secondary priority, and even abandoned the promotion of conservative loan loss provisioning practices after this practice was framed as a violation of market discipline. This helps to explain why the Federal Reserve caved in the face of SEC enforcement actions against banks that had engaged in conservative provisioning practices, which encouraged American banks to reduce their loan loss reserves (McKenna and Rose 2011).

The Canadian banking regulators subscribed to the *frame of public protection*, which offered a view of order as originating from regulators striking the correct balance between protecting the public from the hazards of excessive bank risk-taking and promoting growth and profitability by preserving bank autonomy. Viewing bank participation in the securitization process through this lens, the Canadian regulators framed securitization as an activity with both risks and benefits. The framing of securitization as an activity with the potential to both help and hinder their overarching regulatory mission explains why the Canadian banking regulators took a
more measured approach to the regulation of securitization. This helps to explain why they followed the American banking regulators in fighting back against accounting changes that threatened a bank’s ability to participate in the securitization process, but also why they maintained distinctive regulations regarding the liquidity enhancements banks offered securitization conduits. Viewing loan loss provisioning through this lens, the Canadian banking regulators framed loan loss provisions as a critical safeguard that allowed the entire Canadian regulatory system to work effectively. This helps to explain why Canadian regulators spent valuable political capital and took the unconventional step of overriding GAAP when bank loan loss provisioning practices were at stake in the late 1990s, and why they continued to battle securities regulators and accounting standards-setters about this issue throughout the 2000s.

The Spanish banking regulators subscribed to the frame of centralized coordination and direction, which offered a view of order as originating from interventions by regulators that steered the banking sector towards a more productive, rational, and stable course. Viewing bank participation in the securitization process through this lens, the Spanish regulators framed securitization as a serious threat to order. This framing of securitization as a threat to their overarching regulatory mission explains why the Spanish regulators consistently imposed heavy restrictions that blocked or strictly limited the development of a domestic ABCP market, and also why they responded to a change in accounting standards that would have made bank participation in the securitization process more difficult by “goldplating” these new standards, electing to interpret and implement the standards in an unusually strict and conservative way. It also explains why they imposed such strict regulatory capital requirements on the liquidity enhancements banks offered to securitization conduits. Viewing loan loss provisioning through this lens, the Spanish banking regulators framed loan loss provisions as a critical precondition for
bank stability and solvency that required active direction and oversight from experts. This helps to explain why Spanish regulators spent valuable political capital to keep this regime intact even after international accounting standards-setters initially rejected it.

Policy choices in both of these domains had important implications for bank performance during the crisis. The permissive regulatory treatment of securitization led to heavy losses for the American banks involved in this process during the recent global financial crisis. The American banks that provided liquidity support to securitization conduits absorbed over 97 percent of all conduit losses when the massive American ABCP market collapsed (Acharya et al. 2013). The reduced loan loss reserves of American banks only exacerbated this problem, as banks had fewer reserves on hand to absorb these losses when they occurred. The measured Canadian approach to securitization regulation eventually led to heavy losses for Canadian investors when the Canadian ABCP market collapsed. However, unlike American bank liquidity providers, Canadian bank liquidity providers suffered few losses. Similarly, the strong Canadian commitment to conservative loan loss provisioning helps to explain why Canadian banks were well provisioned against the few loan losses they experienced when the crisis hit. Finally, the strict Spanish approach to the regulation of securitization effectively prevented the Spanish ABCP market from developing. Consequently, Spanish banks suffered few losses when the global ABCP market collapsed (Fernandez de Lis and Garcia Herrero 2009). Spain’s dynamic provisioning regime allowed Spanish banks to weather the events of the crisis (despite high levels of bad loans - see Figure 6.4) for much longer than banks facing similar difficulties in other countries (Balla and McKenna 2009).
Figure 6.4. Bank Non-Performing Loans to Total Gross Loans in the U.S., Canada, and Spain, 2000-2010

Source: IMF Database
CHAPTER 7: CONCLUSION

Why did regulators from different countries develop different systems of banking regulation in the years leading up to the recent global financial crisis, despite adhering to a common transnational regulatory agreement (the 1988 Basel Capital Accord)? In this dissertation, I offer a new theory to explain the divergent development of banking regulation, which departs from much of the conventional wisdom on this subject. The received wisdom is that differences in regulation stem from differences in the economic conditions regulators face or in the power of the industries they regulate. I offer a very different explanation. I argue that banking regulators from different countries adopted different regulatory policies because they viewed their tasks through fundamentally different frames of regulatory order, which can be traced back many decades in each country. By highlighting the ways in which longstanding national institutions continue to structure policymaking, even in the modern globalized and transnational era, I offer an important contribution to a literature that has done much to explain how financial incentives and power dynamics shape the outcomes of regulation, but has largely overlooked the implications of what regulators believe to be true.

THE EVOLUTION OF BANKING REGULATION IN THE U.S., CANADA, AND SPAIN

The argument presented in this dissertation proceeded as follows. In Chapter 2, I introduce the institutions that shaped the evolution of regulatory policy in each country and their associated frames of regulatory order. In each country, these institutions and frames developed as domestic political philosophers read meaning into structures, patterns, and arrangements that had emerged for historically identifiable reasons. I explain how policymakers applied these principles to the design of new political structures and arrangements in the eighteenth century, and later, to the design of bank chartering and regulatory policies in the nineteenth century. In each country, I
show that policymakers adopted policies that led the structure of the banking system to resemble the structure of the political system. American policymakers, seeking to reinforce and preserve community self-governance, adopted regulatory and chartering policies that kept banks fragmented, competitive, and locally-oriented. Canadian policymakers, seeking to reinforce and preserve individual autonomy, adopted regulatory and chartering policies that restricted state interference with private economic activity, promoted self-regulation, and led to consolidation within the banking system. Spanish policymakers, seeking to preserve and reinforce state concertation of civil society, adopted regulatory and chartering policies that promoted the centralization of power within the banking system and accommodation of powerful private interests in exchange for services rendered to the state. These early chartering and regulatory policies had important implications for the structure of each country’s banking system leading into the 1920s.

In Chapter 3, I explain how the reform debates that followed the banking crises of the 1920s and 1930s brought two cherished frames into conflict in each country. In each country, the arguments offered by supporters and opponents of particular reforms tended to draw from one of two alternative frames of regulatory order. I argue that both the frames employed, and the outcomes of the debates, had important implications for how banking regulation would evolve moving forward. I show that American policymakers taking rival positions offered arguments that drew from either the frame of deconcentration or the frame of competition. The reforms that eventually passed in the U.S. had been advocated for in deconcentration terms (and opposed in competition terms), with the result that the regulatory regime that prevailed after the 1930s embodied the triumph of the frame of deconcentration over the frame of competition. Canadian policymakers taking rival positions offered arguments that drew from either the frame of private
autonomy or the frame of public protection. The few reforms that actually passed in Canada had been advocated for in public protection terms, but the overwhelming trend in this country was actually the absence of reform. Canadian policymakers rejected the majority of proposed reforms, which had been advocated for in public protection terms and opposed in private autonomy terms. The result was that the regulatory regime that prevailed in Canada after the 1920s embodied the triumph of the frame of private autonomy over the frame of public protection. Spanish policymakers taking rival positions offered arguments that drew from either the frame of centralized coordination and direction or the frame of balancing interests. The reforms that passed in Spain had been advocated for in both centralized coordination and direction and balancing interest terms, but opposed in centralized coordination and direction terms. The result was that Spanish regulatory regime after the 1920s embodied the dominance of the frame of balancing interests over the frame of centralized coordination and direction.

In Chapter 4, I explain how the frames that dominated the American, Canadian, and Spanish bank regulatory systems after the 1930s - deconcentration, private autonomy, and balancing interests, respectively - structured the pace and pattern of financial deregulation in the 1960s and 1970s. I argue that these frames shaped the hurdles that deregulation advocates had to overcome to successfully promote their causes. Focusing on the case of the repeal of interest rate controls, I show that deregulation was relatively slow and contentious in the U.S. because the advocates of deregulation in this country found it hard to argue that this initiative would not threaten the fragmentation and specialization of the banking system, key preconditions for order under the frame of deconcentration. By contrast, I show that deregulation was both quick and comparatively comprehensive in Canada because the advocates of deregulation found it easier to justify this initiative as a complement to private autonomy. Deregulation only caught on in Spain
after dismal economic conditions allowed the advocates of deregulation to successfully reframe this initiative as a method to facilitate greater state control over the banking system. Although policymakers in all three countries would eventually deregulate the banking system, I argue that the salience of particular frames of regulatory order shaped how this process progressed by establishing the taboos that advocates of deregulation had to navigate to promote their cause.

In Chapter 5, I explain the dramatic changes in the orientation of banking regulation that took place in the late 1980s in all three countries. After this point, American policymakers turned away from regulatory policies that kept banks small, local, fragmented, and specialized in favor of new policies that removed the brakes from market competition. Canadian policymakers abandoned their historical reliance on self-regulation in favor of assigning substantial powers to a strong prudential regulatory authority. Spanish policymakers reconsidered their brief experiment with financial liberalization and adopted new regulations to substantially increase the Bank of Spain’s authority to guide, oversee, and direct bank activities. I argue that these changes came about after a series of devastating banking crises opened up opportunities for reform, which challenger groups then seized. Reform advocates in each country drew from the latent frames that had lost in the 1920s and 1930s, and again in the 1960s and 1970s, to develop new explanations for, and solutions to, the disorder of this period. American reformers returned to the frame of competition; Canadian reformers returned to the frame of public protection; and Spanish reformers returned to the frame of centralized coordination and direction.

In Chapter 6, I explain how the frames of regulatory order that reemerged to dominance after the late 1980s shaped the divergent development of banking regulation in the post-Basel era (1988-2007). In this chapter, I shift away from a focus on legislative policies in favor of a focus on regulatory policies set by the Federal Reserve (U.S.), the Office of the Superintendent of
Financial Institutions (OSFI), or the Bank of Spain (Spain). I argue that frames that dominated in each country shaped the overarching goals of banking regulation, which ultimately influenced the policy choices of national banking regulators. In the U.S., the dominance of the *frame of competition* led to a regulatory focus on enhancing market discipline, which encouraged the American banking regulators to promote bank participation in the securitization process and to discourage conservative provisioning practices. The influence of the *frame of public protection* in Canada led to a focus on striking the right balance between prudential and competitive considerations, which encouraged the banking regulators in this country to both grant free rein to banks engaging in innovative activities and promote conservative provisioning practices. In Spain, the dominance of the *frame of centralized coordination and direction* led to a focus on combatting the natural excesses of unsupervised banks, which encouraged the Spanish banking regulators to place tight restrictions on innovative activities and promote conservative provisioning practices.

**IMPLICATIONS FOR THEORY AND PRACTICE**

The findings of this dissertation have important implications for both theory and practice. Below, I discuss the implications for current debates over (1) convergence and divergence; (2) the drivers of regulatory policy development, with special implications for understandings of path dependence and regulatory capture, (3) theories of institutional change; and (4) the trends in, and consequences of, banking regulation today.

**Convergence and Divergence**

Considerable ink has been spilled over the question of whether the trend towards international convergence or the trend towards ongoing cross-national divergence predominates in modern economic and regulatory systems. This dissertation represents an attempt to channel
this debate towards a more productive course. I start from the observation that both processes - convergence and divergence - are occurring simultaneously. This is possible because the broad and flexible nature of most transnational regulatory agreements, which are designed to secure voluntary compliance from countries with very different arrangements in place, facilitate ongoing divergence. National policymakers still retain considerable discretion to implement, interpret, and augment international standards to fit local conditions. In this way, the trend towards international regulatory convergence has actually produced additional opportunities for cross-national regulatory divergence. More international standards has meant more opportunities for national policymakers to apply and implement these standards in different ways.

Both of these trends (convergence and divergence) are important for understanding how national regulatory regimes in the modern age come to assume the forms they do; however, one trend has received much more scholarly attention than the other. International regulatory convergence represents the newest and most exciting trend, so it makes sense that this would be the trend to attract the most attention in the policy development literature. However, as the events of the recent global financial crisis have revealed, there are also very compelling reasons to redirect our focus towards the causes of cross-national regulatory divergence. The differences in regulation that developed across countries in the post-Basel era had major implications for bank stability and solvency when the crisis hit. For this reason, while I do not dispute that both processes matter very much for the forms national policy regimes take today, I focus on uncovering the drivers of the neglected trend: cross-national regulatory divergence amidst international regulatory convergence.

**Theories of Policy Development**
These findings have important implications for current understandings of regulatory policy development. The literature on this subject is currently dominated by accounts that highlight economic or political drivers of policymaking. By contrast, structural and institutional accounts have received relatively little attention. However, I argue that taking an institutional approach to regulation allows us to explain features of comparative policy development that cannot be explained by more conventional economic or political approaches. I argue that only an institutional account can explain both the remarkable continuity and the dramatic change that we observe over two centuries of regulatory policymaking in the U.S., Canada, and Spain. I show that institutions supply the frames that rival interest groups draw from to advance competing arguments, and find that the return to dominance of three particular frames of regulatory order - competition in the U.S., public protection in Canada, and centralized coordination and direction in Spain - explained the divergent development of banking regulation in the post-Basel era.

Institutional accounts of regulatory policymaking depart most significantly from conventional economic, political, and structural accounts of policymaking by giving serious attention to the cognitive frameworks of banking regulators, or to patterned differences in what national regulators believe to be true about the causes of safety and prosperity. In what follows, I discuss the implications of attending to cultural/cognitive drivers of policymaking for path dependence and regulatory capture theories of regulatory policy development.

Path Dependence

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38 It is important to note that my theory of policy divergence does not require regulators to sincerely believe the principles they espouse. The same theory applies even if regulators do not believe these principles, and are simply mobilizing frames strategically to secure support from the audiences they are appealing to. The point is still that support is more readily secured by particular lines of argument in certain countries than in others.
The literature on path dependence focuses on identifying and explaining the historical junctures that set countries along different developmental paths (Thelen 1999; Pierson 2000; Mahoney 2000). This basic premise is that “casual developments of great import for the character of an ultimate outcome often occur early in the long causal chain that leads to the outcome, perhaps even in the distant past” (Hall 2003: 384). This perspective implies that policy continuity is produced through interactions between existing structures and the material interests of political actors. The idea is that as particular ways of approaching policymaking become institutionalized in legal and administrative structures, these structures tend to generate constituencies that derive benefits from these structures and defend them when they come under attack (Pierson 1993, 1996; Goldstein and Keohane 1993; Skocpol 1992). In this way, policy regimes can continue to persist long after the original motives for adopting the regime have disappeared.

However, I find that trends in the evolution of banking regulation in the U.S., Canada, and Spain challenge path dependence arguments as currently conceptualized. In the late 1980s, the orientation of regulation shifted dramatically in each of the three countries I consider. Old regulatory policies were abandoned, and new policies emerged to take their place. The collapse of these old regulatory regimes would seem to suggest that the constituencies deriving benefits from these regimes were not strong enough to keep them in place. Yet, at the same time, we still see persistent differences across countries in the types of new policies they adopt. What explains this?

I argue that the persistence of these national differences only makes sense after attending to cultural/cognitive drivers of continuity and path dependence. I suggest that latent frames within existing institutions provide the raw cultural material that reform advocates in each
country can then use to diagnose problems and develop solutions. These latent frames are themselves structured by the broader national institutional context: this explains how national institutions can continue to reproduce themselves, even as the specific policies associated with these institutions change dramatically over time.

As evidence that path dependence is often driven by the reactivation of latent frames, rather than constituencies deriving benefits from specific structures or policies, consider the similar arguments offered by two very different interest groups in the United States. I find that large American commercial banks in the 1980s offered arguments to explain and resolve the Savings and Loan crisis that were very similar to the arguments that Andrew Jackson and his followers in the 1830s offered against the recharter of the Second Bank of the United States in the 1830s. Reform advocates in both eras saw a problem in centralized authority, rather than the impartial competitive process, allocating privileges and punishments in the banking system. And in both cases, they sought to fix this problem by reducing the state’s power to allocate rewards and penalties.

*Regulatory Capture*

My revised institutional account also holds important implications for regulatory capture theory. Even today, the vast majority of regulatory capture scholarship continues to assume that we can derive regulators’ intent in adopting a policy from the distributional consequences of the policy (e.g. Levine 2012; Barth et al. 2006). In other words, if regulation happens to generate outcomes that deviate from the public’s interest, it is assumed to be captured. This is a very problematic research strategy. Many other factors, including a lack of information, sincere belief in a particular regulatory strategy, or unforeseen or accidental consequences could produce the exact same outcome (regulation that does not serve the public’s interest) in the absence of
regulatory capture. Accordingly, there is a serious need for scholars of regulatory capture to better conceptualize, and better operationalize, the predictions of this theory.

However, I suggest that the way that regulators and their motives are currently conceptualized in the regulatory capture literature has blocked progress in this regard. Regulators are assumed to be motivated by a narrow range of material interests, like current or future financial rewards. I suggest that by relaxing these assumptions about regulators’ motives, looking beyond financial rewards as the primary driver of their behavior, we can open up a whole new way of thinking about regulatory capture, and especially about how it might vary across time and place. I advocate for a view of regulators as social actors, who are motivated by financial rewards, but also by the desire to secure power and prestige, to find value and meaning in the tasks they perform, and to enact and perform their identities. I suggest that this approach to understanding regulators and their motives, which allows regulators’ interests to vary with the social context, highlights how particular national institutional contexts may increase or decrease regulators’ susceptibility to industry influence.

Finally, I also want to note that the obsession with regulatory capture among American social scientists is itself likely a function of longstanding frames of regulatory order in this country. The salience of the frame of competition in the American context leaves actors within this country primed to see problems in leaving allocation, punishment, and rewards to human decisions, rather than to the outcomes of a competitive struggle. I argue that this helps to explain why there has historically been such a strong distrust towards regulators and their motives in the United States, and it is entirely probable that this (institutionally-rooted) distrust also shapes the types of questions and perspectives American social scientists have chosen to pursue (e.g. Fourcade 2009).
Institutional Change

Institutionalists have become increasingly interested in identifying the drivers of institutional change (Schneiberg 2007; Streeck and Thelen 2005; Clemens and Cook 1999). I contribute to the literature on institutional change by moving the debate back a step, questioning whether dramatic change is happening at the level of the “institution” at all. My revised institutional account implies that changes in regulatory regimes - even dramatic changes - are better conceptualized as occurring at the level of frames. Subdividing institutions into their component parts, and conceptualizing policy change as occurring at the frame level (while the underlying institutions continue to persist), gives institutional theorists the analytic leverage they need to explain simultaneous continuity and change.

This revised perspective on institutional change has implications for current conceptualizations of institutional heterogeneity. One implication is that what the newest generation of institutional scholarship refers to as “multiple orders” may actually be different manifestations of the same underlying order, in ways that existing theory has yet to fully recognize. The structured nature of these multiple orders becomes more apparent when they are viewed in comparative perspective. For example, Schneiberg (2007), focusing on the U.S. case in isolation, finds that in places where the Grangers took a stand against railroads, where trustbusters advocated for deconcentration, and where agrarian movements pushed for alternatives to the corporation, an alternative economic order characterized by the presence of a cooperative organizational form was more likely to emerge alongside the dominant economic order (Schneiberg 2007: 66). However, when viewed in comparative perspective, it becomes evident that these “multiple orders” are structured by a larger, national institutional order. The political struggles over the corporation that Schneiberg (2007) describes all share a distinctly American
character: it is not an accident that the hot button issues in all three debates concerned local control, monopoly power, or state interference with the competitive process. Political struggles over the corporation likely took different forms in Canada and Spain.

**Implications for Regulatory Policymaking Today**

These findings also have implications for how we understand the design of, and current vulnerabilities within, the national regulatory regimes that have developed since the global financial crisis of the late 2000s.

*Causes of Regulation with Adverse Outcomes*

My institutional approach highlights persistent continuities between the regulatory models of the past and the regulatory models of the present that previous research has overlooked. It does so by calling attention to the effects of institutionally-structured latent frames, which serve as resources that groups promoting reform can pull from to develop new diagnoses and solutions. I suggest that awareness of these continuities should change the way we think about the causes of regulation that conflicts with the public’s interests.

In hindsight, there is no question that the content of American banking regulation in the period leading up to the crisis had detrimental consequences for American banks when the crisis hit. The most common explanations for the rise of this permissive regulatory regime highlight factors that have changed relatively recently within the U.S., like shifts in banking industry structure (theorized to produce regulatory capture) or changes in academic economic thought. These explanations are not just offered by academics: American policymakers and the American public subscribe to these explanations as well.

My revised institutional account implies that while these short-term explanations may offer partial or proximate explanations for the rise of permissive regulation in the U.S., the root
cause of the permissive regulatory regime that developed in the U.S. was the distinctive perspective that the American banking regulators brought to their regulatory tasks, which equated government interventions with disorder. The first step to designing effective regulation is to gain a full and correct picture of the causes of past regulatory failures, and the findings of this dissertation clearly demonstrate that the cultural commitments of the American banking regulators represent an overlooked cause of the regulatory failures of the late 2000s. For this reason, I suggest that regulatory reforms that focus on mitigating short-term factors, without attending to deeper, more long-term causes, are doomed to be incomplete.

*Predicting Variation in Implementation*

These findings should also interest international regulators, especially the members of Basel Committee for Banking Supervision. Chapters 5 and 6 demonstrated that the principles embedded in the regulatory reforms of the late 1980s and early 1990s carried forward to shape the divergent implementation of the Basel Capital Accord (Basel I) in the 1990s and 2000s. The idea is that these underlying principles shaped the overarching goals of national banking regulators, and encouraged these actors to make different policy choices in the post-Basel era. For the same reason, I expect to find that the principles embedded in the regulatory reforms of the late 2000s (*deconcentration* in the U.S.; *public protection* in Canada; and *centralized coordination and direction* in Spain) will also carry forward to shape the divergent implementation of the newest version of the Basel Capital Accord (Basel III).

*The Vulnerability of Regulatory Systems*

I suggest that a better understanding of the frames embedded within existing regulatory regimes also allows for a better understanding of where these regimes are most vulnerable to attack. The American case provides an illustrative example. In the introduction, I explained that
many of the reforms undertaken in the Dodd-Frank Act of 2010 (e.g. the Volcker rule, the focus on large and systemically important institutions) embodied key tenets of an old frame of regulatory order, the *frame of deconcentration*. It is also true that other reforms included in the Dodd-Frank Act continue to embody the *frame of competition*. In Table 7.1, I sort Dodd-Frank reforms by the frame of regulatory order they attach to. These reforms can be organized into five categories: those that guard against the hazards presented by systemically important institutions; those that enhance transparency; those that restore specialization; those that promote greater independence of interests; and those that guard against moral hazard.
Some explanation may be needed for readers to understand why policies that guard against the threat of moral hazard reflect the imprint of the *frame of competition*. The answer is that these policies, which seek to mitigate expectations of bank bailouts, rest upon a particular understanding of why the previous regulatory regime failed to prevent the credit crisis, which *draws directly from the frame of competition*. The idea is that the previous regulatory system failed because large American financial institutions lacked a healthy fear of failure. As large American financial institutions observed the bailouts of other large institutions, the theory goes, they started to assume that the government would pick up the tab for their failures. This encouraged them to take risks that they would have avoided otherwise. I suggest that this understanding of the causes of disorder in the banking system has quite a bit in common with the old understanding that developed after the Savings and Loans crisis in the U.S. (see Chapter 6).
In both cases, disorder is theorized to have emerged from government interference with the competitive process that keeps order intact.

I suggest that the salience of the frame of competition in the American context makes it especially hard for American policymakers to accept the market as a villain. When American policymakers search for explanations for disorder, they are likely to look for factors that block the market from serving its proper, order-promoting function, instead of diagnosing ordinary market processes as the source of the problem. American policymakers frequently return to two market-blocking factors in their quest to explain regulatory failures: government interference and concentrated private power. In the period that preceded the credit crisis, the American banking regulators defined the primary threat as government interference. After the crisis, the American banking regulators have redefined the primary threat to include both factors. The new theory is that precisely because banks have become so large and systemically important, the government has no choice but to step in to block the failures of these banks (e.g. engage in bank bailouts) - which in turn distorts the competitive process that keeps order intact. I argue that the continued salience of the frame of competition within the American institutional context makes the regulatory system in this country particularly vulnerable to attacks from interest groups that promote permissive, hands-off regulation (e.g. groups who offer arguments framed in competition terms).

I also predict that the salience of the frame of competition will shape the way that the new regulatory reforms adopted in the Dodd-Frank Act are interpreted and received in the U.S., especially macro-prudential regulations like the new countercyclical capital buffer. American policymakers, like policymakers in the majority of the world’s major financial capitals,

39 Spanish policymakers do not share this compunction. It is much easier for Spanish policymakers to point to natural market processes as problems in need of fixing.
responded to the events of the recent financial crisis by introducing new, macroprudential regulations, including a countercyclical capital buffer (12 CFR Part 217, Appendix A, December 15, 2015). The fact that American policymakers have adopted countercyclical policies at all should come as somewhat of a surprise, given their resistance to policies of this kind in the post-Basel era (see Chapter 6). This resistance had stemmed from the fact that countercyclical policies, which substitute the judgments of state experts for the judgments of market actors, violated a key tenet of the *frame of competition*.

I suggest that a lack of correspondence between the countercyclical capital buffer and the *frame of competition* will make the implementation of this policy relatively contentious in the U.S.; furthermore, I expect that macro-prudential policies will be among the first to attract blame the next time that the American financial system stumbles. There is already evidence that the American policymakers and regulators charged with implementing the new countercyclical capital barrier are concerned about precisely the things we would expect them to be concerned about, given the influence of the *frame of competition*. In the following excerpt from a 2009 GAO report on the subject, the author describes the concerns about countercyclical capital

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40 Macroprudential regulation is aimed at mitigating risk in the financial system as a whole, rather than risk in individual financial institutions. A countercyclical policy aims to counter structural trends, or risks that vary with the financial system’s current position in the business cycle.

41 I suggest that attention to how frames highlight certain policies, or aspects of policies, as being more or less contentious than others also helps to explain why the American banking regulators changed their position on risk-based capital requirements in the 1990s. The American banking regulators adopted strict regulatory capital requirements in the wake of the Savings and Loan crisis, justifying this policy as an aid to market discipline. However, the fact that the opponents of these strict capital requirements found it comparatively easy to draw from the same frame (the *frame of competition*) to successfully redefine these restrictions as *blocks* to market discipline helps to explain why the American banking regulators changed their perspective on these requirements so readily in the late 1990s. The countercyclical capital buffer shares the same vulnerability, and is likely to share the same fate.
buffers that were regarded as most salient by American policymakers. The two major points of concern were that (1) these buffers gave regulators a lot of discretion to adjust minimum capital requirements (a big issue when regulators are regarded as inherently fallible, as they are in the U.S. under the frame of competition) and (2) that these buffers, by design, send signals to banks that directly contradict the signals being sent by market participants (again, a major problem under the frame of competition for obvious reasons). As the author of the GAO report explained:

Regulators have proposed implementing countercyclical buffers…but have acknowledged some challenges in designing and implementing such measures. For example, regulators would need to assess the appropriate balance of discretionary and nondiscretionary measures in achieving adjustment of capital requirements throughout the cycle. One regulatory official told us that regulators face challenges identifying market troughs and, as a result, may find it difficult to adjust minimum capital requirements appropriately throughout the cycle…Furthermore, even if minimum regulatory capital requirements adjust appropriately, some procyclicality in buffers may be unavoidable as institutions respond to market expectations. As an example, an institution might face pressures from credit rating agencies and other market participants to reduce leverage as market strains appear, despite facing a lower minimum regulatory capital requirement (GAO report, The End of Excess (Part One): Reversing Our Addiction to Debt and Leverage, May 6, 2010: 543-544).

This feature does not necessarily mean that policymakers will get rid of these policies entirely. After all, deposit insurance was vulnerable for the exactly the same reasons (it posed a threat to the competitive process), and the U.S. still has a deposit insurance system. But it does help to explain which policies, or aspects of policies, are likely to attract blame or become contentious in particular institutional contexts.

Fixing American Banking Regulation

In the eight years since the credit crisis, the most extreme examples of the pre-crisis “market discipline” rhetoric have largely disappeared from regulatory speeches and legislative debates. This might lead us to believe that the American regulatory system has shifted towards safer ground; however, I suggest that this is not the case. As long as American policymakers and
regulators remain obsessed with cordonning off and tightly regulating institutions that can’t be allowed to fail, and keeping them away from ordinary institutions, the American financial system is going to be vulnerable to experiencing crises in areas where regulation doesn’t extend. Before the credit crisis, this was the unregulated non-bank financial system. In the period leading up to the credit crisis, American policymakers and regulators only included deposit-taking institutions within the bounds of regulation, because they defined the presence of the federal deposit insurance system as the primary threat to order (see Chapters 5 and 6). In short, regulation in this era intentionally separated the institutions who were subject to this perceived market distortion (e.g. deposit-taking institutions) from those that were not (i.e. investment banks or shadow banks).

However, the events of the credit crisis revealed that the failures and abuses of non-bank financial institutions could also hurt the financial system. In the years since the crisis, American policymakers responded to these events by expanding the perimeter of regulation to encompass all large and systemically important institutions, regardless of whether they accept deposits or not. The implication is that the old enemy (deposit insurance) has been replaced by a new enemy (too-big-to-fail status) in the new regulatory regime. But the key point is that this new method of drawing regulatory boundaries is still all about cordonning off institutions who are subject to some form of market distortion from other types of institutions!

The problem with this strategy is that if history has shown us anything, it is that trouble is most likely to emerge in the places where regulators are not currently looking. In the current American regulatory context, this would be among smaller and less interconnected financial institutions. The idea that a crisis might emerge from the actions of local, community-focused financial institutions may be currently unthinkable to many Americans, but there are abundant
historical examples (e.g. the Great Depression) that suggest that a crisis originating here is very possible. Local institutions are just as vulnerable to excess and failure as large and systemically important institutions.
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APPENDIX A: METHODOLOGICAL APPENDIX

The primary goal of the analysis is to assess between competing theories of regulatory policy development. To do so, I employ established historical/comparative methods.

Method

I begin by eliminating causes that are neither necessary nor sufficient for the outcomes, using Mill’s methods of agreement and difference as outlined in Skocpol and Somers (1980). Any hypothesized cause that is not shared by the cases with similar outcomes is not necessary for the outcome’s occurrence; any hypothesized cause that is present in the cases with different outcomes is not sufficient for the outcome’s occurrence. Causal factors that are eliminated by this approach may still be indirect causes of an outcome, or causes that operate in conjunction with other causes; therefore, I continue to consider a cause as potentially relevant until I have explored all of the ways that it might operate in conjunction with other factors.

The bulk of the analysis consists of “systematic process analysis,” a variant of the process-tracing method outlined by Hall (2003). The goal of a process-tracing approach is to identify the causal mechanisms that connect causes and their effects. The relative superiority of a theory is evaluated on the basis of congruence between predicted and observed mechanisms. To assess these mechanisms, I derive a full range of predictions about how events will unfold from the casual theories to be tested. In other words, I generate a large and diverse set of predictions that include the “specific actions expected from various types of actors, statements that reveal their motivation, and the sequences in which actions should occur” (Hall 2003: 394). Whenever possible, I frame each theory so that it yields predictions that could be shown to be false through observation and distinguishable from the predictions of rival theories (Hall 2003).
Case Selection

I intentionally select comparison cases in a manner consistent with my research objectives and strategy (King, Keohane, and Verba 1994: 139). I select the U.S., Canada, and Spain to maximize variation along a range of values of the dependent variable, without regard to the values of the explanatory variables (King, Keohane, and Verba 1994: 141-2). Since my goal is to explain the divergent development of banking regulation in an era of international regulatory convergence, I limit the pool of comparison cases to the fifteen Basel Committee member countries.

Data Sources

I rely on a combination of primary and secondary data sources in each chapter (see Table A1). In Chapter 2, which explains the origins of the frames of regulatory order and how they operated to shape bank chartering and regulatory policies in the nineteenth century, I rely primarily on secondary sources. In Chapters 3-5, I rely on a combination of transcripts from legislative hearings and debates and secondary sources. In Chapter 6, I rely on primary data collected from multiple sources.

In Chapters 3-5, I rely more heavily on data collected from the legislative record in the U.S. and Canada, and more heavily on secondary sources and other forms of primary data in Spain. During the Franco era, many key policy decisions were made at the central executive level, rather than at the legislative level (Lukauskas 1997). There is also reason to suspect that debate over particular policies would be more restrained in the Spanish legislature, with many of the most crucial debates taking place behind closed doors. For this reason, I rely much more heavily on work by other scholars, selected excerpts from policymaker speeches (e.g. Francesc Cambó in the 1920s), and newspaper and magazine articles to analyze Spanish policymaking in
the 1920s and 1930s and the 1960s and 1970s. I rely especially heavily on the work of Pérez (1997) and Lukauskas (1997), who interviewed many of the Spanish policymakers who oversaw the transition to financial deregulation in this country. As much as possible, I seek to triangulate available data from the legislative record in Spain with data collected from these alternative data sources.

In Chapter 6, I use data collected from multiple sources. I rely most heavily on data collected from regulator speeches given across the three countries. In each country, I analyze the entire population of speeches given between 1996 and 2007. I also incorporate data from additional sources into the analysis, including legislative hearings and debates (and especially regulator testimony at these debates), in-depth interviews with banking regulators, internal regulatory agency documents, regulatory agency publications, news and trade magazine articles, the texts of regulations and draft regulations, and correspondence between regulators and the regulated industry (in the form of letters and responses to regulations). I describe all of these data sources in greater detail in Table A1.

I use the interview data to help interpret the archival material, following the strategy outlined by Krippner (2011). Interviews can “verify and provide a context for information contained in historical documents,” and are particularly appropriate if there are gaps and inconsistencies in the historical record (Krippner 2011: 154, Appendix A). Interview questions were designed to identify which groups or institutions served as sources of pressure for regulators, to better understand perceived trade-offs or rationales for particular policy choices, and to assess what regulators knew about the likely outcomes of regulations.

I granted all respondents anonymity. Given the stigma that has attached to regulators since the events of the recent global financial crisis, this seemed to be a prudent choice. Indeed,
at least one regulator in each of the three countries refused to speak with me “on the record,” even after being promised anonymity. For this reason, it is difficult to describe how I sampled respondents within regulatory agencies. The general principle that guided my sampling strategy was to interview (1) regulators who were the most closely involved with day-to-day decisions regarding the specific policies I consider in Chapter 6 (e.g. the regulation of liquidity lines to ABCP conduits; loan loss provisioning) and (2) actors near the top of regulatory agencies, who played a critical role in shaping overall strategy.

I conducted interviews with Spanish banking regulators and industry participants in Madrid over the course of two weeks in March 2013; with Canadian banking regulators, accounting standards-setters, and industry participants in Toronto and Ottawa over the course of two weeks in July 2013; and with American banking regulators and industry participants in Washington D.C. over the course of one week in March 2014.
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<thead>
<tr>
<th>Source</th>
<th>Comments</th>
<th>Chapters Used</th>
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<tr>
<td>Regulator speeches</td>
<td>I analyze every speech given by a banking regulator between 1988 and 2005 that also references at least one of the following topics: bank activities, bank safety or supervision, international financial markets, or domestic economic performance. Speeches given after 1995 in each country are posted online. To obtain earlier speeches, I will travel to archives in each country (see below).</td>
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<tr>
<td>Legislative hearings and debates</td>
<td>I analyze transcripts from legislative debates or hearings, 1988-2005, where at least one of the following conditions is met: (1) a banking regulator is present; or (2) legislators discuss the structure of the regulatory system, financial crisis (domestic or international), the performance of the banking sector, bank safety/soundness, changes in bank activities, or economic competitiveness.</td>
<td>3, 4, 5, 6</td>
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<tr>
<td>Secondary Sources</td>
<td>I analyze the work of historians and other social scientists that covers policymaking in key historical episodes. I also examine the autobiographies of key regulators when available.</td>
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<tr>
<td>Letters to the regulator</td>
<td>I analyze letters from members of the legislature to banking regulators. These letters can be obtained through Freedom of Information Act requests in the U.S. and Canada, and through the BdE archives in Spain.</td>
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<tr>
<td>News and Trade Magazine articles</td>
<td>I use the Factiva and Lexis-Nexis databases to search for relevant articles. Search terms include: “each type of regulation + the name of each banking regulator”; “each type of regulation + industry”; and “name of regulator + banks”.</td>
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<tr>
<td>Regulations and Draft regulations</td>
<td>I analyze regulations and draft regulations published by the FRB, OSFI, and BdE. There are 20 relevant drafts of regulations/final regulations in the U.S.; 15 in Canada; and 10 in Spain.</td>
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<tr>
<td>Responses to requests for comments</td>
<td>The U.S. and Canadian regulatory agencies actively solicit written feedback on proposed regulatory changes from regulated firms and other interest groups. Canada omits the name of each respondent. I have requested these documents from both agencies.</td>
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<tr>
<td>Agency memos, meeting minutes</td>
<td>I request the records from all internal discussions of loan loss provisioning, bank securitization, and the scope of agency oversight, citing the Freedom of Information Act in the U.S. and an equivalent Act in Canada. BdE holds fewer records than FRB or OSFI, but I have requested all available information.</td>
<td>6</td>
</tr>
<tr>
<td>Research publications</td>
<td>I read all research publications from regulatory agency personnel related to securitization, loan loss provisioning, or consolidated supervision.</td>
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<tr>
<td>Interviews with regulators</td>
<td>I interview banking regulators and industry participants (including accounting standards-setters, where relevant) in each of the three countries. I conducted 24 total interviews on the record.</td>
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