2016

Explaining Variations in Bailout Policies: A Review of Cornelia Woll's the Power of Inaction

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Recommended Citation

Barnes, Kelsey M. and Wilmarth, Arthur E., Explaining Variations in Bailout Policies: A Review of Cornelia Woll's the Power of Inaction (May 6, 2016). Accounting, Economics & Law - A Convivium, 6(1), pp. 5-30, 2016, DOI: 10.1515/ael-2015-0012 ; GWU Law School Public Law Research Paper No. 2016-24; GWU Legal Studies Research Paper No. 2016-24. Available at SSRN: http://ssrn.com/abstract=2776668

DE GRUYTER Account. Econ. Law 2016; 6(1): 5–30

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Explaining Variations in Bailout Policies: A Review of Cornelia Woll's The Power of Inaction

DOI 10.1515/ael-2015-0012

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1 Introduction

In *The Power of Inaction: Bank Bailouts in Comparison*, Professor Cornelia Woll asks a question of fundamental importance: "What was the nature of power finance wielded over the fate of the economy and the crisis management in 2008, which affected the lives of so many?"[1] To measure the effective power that the financial industry wielded during the crisis, Woll compares the terms of bailout packages that governments adopted in six countries in the aftermath of the 2008 financial crisis. She contends that financial institutions were more likely to receive larger amounts of public support, and to make minimal contributions to rescue plans, in nations where the financial industry's influence satisfied three important factors.

The first two factors relate to the effective political power of the financial industry. Thus, Woll finds that the terms of public bailouts were most advantageous to the financial industry in nations where the industry held the highest levels of structural power and productive power. The third factor is whether the financial industry had the ability to adopt a position of "collective inaction" and, therefore, to reject government calls for industry contributions to help resolve the financial crisis.[2]

The first two factors in Woll's analysis – structural and productive power – have been widely studied and documented in popular and academic literature. Structural power arises from the economy's dependence on the financial industry for its health and strength.[3] Productive power is created when the financial industry exploits its structural influence to promote public policies that favor the industry.[4]

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1 Cornelia Woll, *The Power of Inaction: Bank Bailouts in Comparison* 3–4 (2014).
2 *Id.* at 4–7.
3 *Id.* at 46–50.
4 *Id.* at 50–56.

The third prong of Woll's thesis – the power of "collective inaction" – is a new concept that distinguishes Woll's analysis of financial power from previous studies. Woll persuasively argues that the financial industry's ability to engage in collective inaction was a crucial factor that forced governments to adopt bailout measures that favored the financial sector.[5] Collective inaction occurred when the financial industry refused to act collectively and did not make significant contributions toward the cost of rescuing troubled financial institutions. By successfully pursuing a strategy of collective inaction, the financial industry forced the government to use public funds to pay for rescuing failing banks.[6] Conversely, in countries where the banking sector felt obliged to cooperate with the government and contribute to rescue programs, governments were able to engage in "intervention that did not weigh heavily on the public budget."[7]

Woll illustrates the power of collective inaction in three comparative case studies. Each of Woll's case studies considers a pair of countries in which the financial sector had similar characteristics and wielded similar levels of structural and productive power. Woll compares the United States and the United Kingdom (two liberal, market-based economies), France and Germany (two examples of bank-based economies with large universal banks), and Ireland and Denmark (two small, open economies).[8] Despite similar economies and financial sectors, the government responses within each set of paired countries were quite different. In some countries, government agencies felt obliged to rescue the financial sector by committing vast amounts of public funds. Other governments emerged as successful crisis managers and were able to force the financial industry to make significant contributions toward the costs of rescue programs. In some countries, the financial industry was obliged to comply with onerous new regulations and experienced the crisis as "the end of an era, which effectively ended the world they had once known."[9] In other countries, the financial sector experienced the crisis as an "unpleasant, yet short-lived" crisis, which did not "change their fundamental advantages."[10]

Woll demonstrates that an important distinguishing factor in each of her paired case studies was the financial sector's ability or inability to refuse to cooperate with the government in financing bailouts. Financial institutions were most powerful in those countries where they succeeded in avoiding a collective response and forced national policymakers to rescue banks with public funds.

5 *Id*. at 6.
6 *Id*. at 7.
7 *Id*. at 138.
8 However, unlike Ireland, Denmark is not part of EMU.
9 Woll, *supra* note 1, at 60.
10 *Id*.

In order to prevent bailouts that rely primarily on public resources during the next crisis, Woll warns that policymakers must understand the conditions under which the financial industry can successfully avoid an obligation to act collectively. In that regard, she argues that a crucial factor in determining whether the financial industry can refuse to act collectively is whether the largest financial institutions are relatively strong and therefore do not need to call on the government for public support. As indicated below, we agree that the health of leading financial institutions is a relevant consideration. However, we believe that Professor Woll has understated the central importance of the financial industry's political clout in defining the industry's ability to resist appeals for collective rescue programs. As discussed below, her case studies strongly indicate that the financial industry's power of collective inaction is likely to be greatest when the industry as a whole wields a very high level of political influence.

2 Structural power: How the economy's dependence on the financial sector increases the financial industry's influence

Woll borrows Michael Barnett's and Raymond Duvall's definition of power as "the production, in and through social relations, of effects on actors that shape their capacity to control their fate."[11] During the last financial crisis, the financial industry attempted to use its structural power to secure government bailout programs that favored the industry by drawing primarily on public funds rather than industry contributions. Thus, the first key component of finance power is the structural power that financial institutions derive from their specific role in the economy, including the degree to which the economy's overall performance depends on the financial industry.[12]

Analysis of the structural dynamic between the leading business sectors and the state has a longstanding tradition in academic studies. As scholars have shown, business sectors that play leading roles in a capitalist economy wield structural power because the government desires to achieve economic growth

11 Michael Barnett & Raymond Duvall, *Power in International Politics*, 59 Int'l Org. 39, 45 (2005).
12 Woll, *supra* note 1, at 46–50; *see also* Pepper D. Culpepper & Raphael Reinke, *Structural Power and Bank Bailouts in the United Kingdom and the United States*, 42 Politics & Society 427, 431, 441 (2014), *available at* http://www.carloalberto.org/assets/events/Pepper-30oct2014.pdf (describing "structural power" as a power that "flows from the economic position of the firm in an economy," which provides "a resource on which banks draw deliberately in bargaining with the government").

and is therefore inclined to agree to demands made by those business sectors.[13] In a country with a large financial sector, the financial industry is likely to enjoy a high degree of structural power. The dependence of the economy on financial intermediaries for investment and credit, combined with the threat that large financial institutions may shift their operations outside of a country if its policies are unfavorable, will provide the financial industry with significant influence over other sectors of the economy and the government.[14]

The particular relationships among banks, other providers of financial services, business firms, and the government are important in defining the nature of structural power.[15] In bank-based economies, governments depend primarily on the ability of banks to provide credit to the real economy. In market-based economies, governments depend on both banks and the capital markets to promote economic growth and, therefore, are primarily concerned with maintaining financial market stability. This distinction implies that governments in market-based systems will focus on the welfare of the largest financial institutions whose failure would be likely to undermine financial stability.[16]

The size, scope and power of "too big to fail" banks have increased as financial products and markets have become more complex and as the financial sector has grown larger in many developed economies. Even so, as indicated above, the relationship between the financial sector and the state is likely to differ based on the particular type of financial system that is found in each country. Governments in bank-based economies will be strongly inclined to rescue banks in order to save the economy, while governments in market-based economies will be likely to save the most important banking or nonbanking financial institutions in order to stabilize their financial markets.[17]

A second factor that determines the structural power of the financial industry is the size of its activities in relation to the economy of a country.[18] In small

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13 Fred Block, *The Ruling Class Does Not Rule*, 7 Socialist Revolution 6, 6–28 (1977); Charles E. Lindblom, *The Market as Prison*, 44 J. Pol. 323 (1982).

14 Block, *supra* not 13; Philip G. Cerny, *Globalization and the Erosion of Democracy*, 36 European J. Pol. Res., no. 1, 1999, at 26; Adam Przeworski & Michael Wallerstein, *Structural Dependence of the State on Capital*, 82 Am. Pol. Sci. Rev. 11, 11–29 (1988).

15 Woll, *supra* note 1, at 49.

16 Emiliano Grossman & Cornelia Woll, *Saving the Banks: The Political Economy of Bailouts* (Jan. 2012), at 4, *available at* http://cps.sagepub.com/content/47/4/574.

17 Woll, *supra* note 1, at 49.

18 David Howarth & Lucia Quaglia, *The Comparative Political Economy of Basel III in Europe* (University of Edinburgh School of Law Research Paper No. 2015/19, Europa Working Paper No. 2015/03, 2015), at 10, *available at* http://papers.ssrn.com/abstract=2630555 (listing the relative importance of bank credit to national financial systems as an important factor in determining regulator's preferences in implementing Basel III); Woll, *supra* note 1, at 50.

countries with large banking industries, such as Ireland and Denmark, governments will place a very high priority on avoiding serious potential harm to the financial sector.[19] The growth of structural power can also be seen in larger countries with highly developed financial markets, such as the United States. The size, economic significance, and political influence of America's financial sector have expanded enormously over the past thirty years, a phenomenon that some analysts have described as the "financialization" of the U.S. economy.[20] Between 1978 and 2007, the U.S. financial sector grew from 3.5% to 5.9% of the economy, measured by its contribution to gross domestic product (GDP).[21]

The structural power of the financial industry can be high in both bank-based and market-based economies, as shown in Woll's case studies. Wall Street and the City of London are the two most important global financial centers, and the United States and the United Kingdom have highly developed capital markets that are actively supported by government policy. Finance has increasingly assumed a central role within both nations' economic growth strategies.[22] In terms of the financial industry's structural power, France and Germany are also quite similar, with a strong tradition of bank-based finance but with a growing role for capital market activities. Because the largest French and German banks are universal banks, they wield a high degree of power and influence due to their combination of banking and capital markets services. The increasing reliance of the French and German economies on their financial sectors, and the desire of both governments to create major financial centers in continental Europe, have enhanced the structural power of the financial industry in both France and Germany.[23]

The structural power of finance was also very high in both Ireland and Denmark, because both countries experienced a rapid expansion of their financial industries relative to the size of their economies during the period leading up to the financial crisis. Both governments encouraged financial innovation

19 Woll, *supra* note 1, at 50.

20 Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* 6 (2013); Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 59 (2010); *see also* Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street*, 81 U. Cin. L. Rev 1283, 1406–07 (2013), *available at* http://ssrn.com/abstract=2327872 (stating that the "far-reaching deregulation of the U.S. financial services industry after 1980 and the resulting proliferation of new financial activities and products promoted rapid growth in the industry's size, profitability and compensation.").

21 Bureau of Economic Analysis (2015, October 29). *Gross Domestic Product, Expanded Detail,* Table 1.5.5, available at http://www.bea.gov/national/nipaweb/SelectTable.asp.

22 Woll, *supra* note 1, at 83–85.

23 *Id.* at 113–15.

and gave top priority to further development of the financial sector.[24] Despite all these similarities, the six nations approached bailouts very differently. Woll therefore concludes that it is not sufficient to understand the structural power that the financial industry wields in a particular country. We must also understand how the financial industry uses its structural power to secure favorable public policies. This leads her to a consideration of productive power.

3 Productive power: How the financial industry exploits its privileged position within the economy to secure favorable treatment

The theory of productive power also has a strong academic pedigree. First developed by Foucault through his analysis of political authority,[25] the concept of productive power explains how citizens decide to accept the political framework through which they are governed.[26] After showing that the financial sector holds a privileged position within many developed countries, Woll turns the theory of productive power away from its initial focus on citizens to study how governments themselves are influenced through social relations between government officials and industry representatives.[27] She emphasizes the importance of closely intertwined networks linking public officials and executives from the financial sector. She further explains how those networks can produce and maintain not just a "light touch" approach toward regulating finance,[28] but also a general positive *ideology* that promotes the welfare of finance.[29] Woll contends – correctly, in our view – that this regulatory mindset in favor of finance and light-touch regulation is a product of (i) shared social experiences between government officials and

24 *Id.* at 140–43.
25 *See generally* Mitchell Dean, *Governmentality: Power and Rule in Modern Society* (1999); Michel Foucault, *Power/Knowledge: Selected Interviews and Other Writings* 1972–1977 (Colin Gordon eds., 1980); Nikolas Rose, *Powers of Freedom: Reframing Political Thought* (1999).
26 Michel Foucault, *Security, Territory, Population: Lectures at the Collège de France 1977–1978* (Michel Senellart eds., Graham Burchell trans., 2004).
27 Woll, *supra* note 1, at 51.
28 *Id.* at 50–56.
29 *Id.*; *see also* Johnson & Kwak, *supra* note 20, at 89, 104; Blinder, *supra* note 20, at 56; Jagdish Bhagwati, *The Capital Myth: The Difference Between Trade in Widgets and Trade in Dollars*, Foreign Affairs, May-June 1998, at 7–12 (describing how the ideology of free markets in the United States "lulled many economists and policymakers into complacency about the pitfalls that certain markets inherently pose," while revolving doors placed representatives of Wall Street into influential positions in Washington).

financial representatives, (ii) biases resulting from regulatory officials' belief in the presumptively superior expertise of financial industry insiders, and (iii) the fragmentation in many countries of financial regulation among multiple agencies, resulting in competing regulatory approaches and an opportunity for financial institutions to engage in regulatory arbitrage.[30]

3.1 Shared social and professional experiences between policymakers and industry insiders promote regulatory capture

Financial industry representatives in each of the six countries studied by Woll built close social networks with government officials in order to persuade regulators to adopt policies that were consistent with the industry's preferences. For example, according to Simon Johnson and James Kwak, the financial industry in the United States built an elite network between Wall Street and Washington and used the resulting "cultural capital"[31] to promote a "mindset" that "what was good for Wall Street was good for America."[32] The term "regulatory capture"[33] does not necessarily imply that financial regulators are corrupt in the sense of accepting bribes, or that their actions are consciously motivated by selfish personal interests. Instead, regulatory capture typically occurs when regulators share the worldview and the preferences of the industry they supervise, and when regulators believe that they are acting in the public interest by supporting the industry.[34]

One of the authors of this review (Wilmarth) has similarly attributed much of the financial sector's political clout to the extensive professional and social contacts that take place between senior government officials and top executives in the financial industry. Financial regulators identify with the views and experiences of industry leaders because both groups have similar educational and professional backgrounds and engage in policy discussions in numerous venues.[35] Likewise, Andrew Baker concludes that "cognitive capture" results

30 Woll, *supra* note 1, at 50–56.
31 Johnson & Kwak, *supra* note 20, at 90.
32 Johnson & Kwak, *supra* note 20, at 10; *see also* Jacob S. Hacker & Paul Pierson, *Winner-Take-All Politics: How Washington Made the Rich Richer – and Turned Its Back on the Middle Class* 221–30, 247–50 (2011).
33 Johnson & Kwak, *supra* note 20, at 93.
34 *Id.* at 93.
35 Wilmarth, *supra* note 20, at 1417–18; *see also* Cristie L. Ford, *Macro- and Micro-Level Effects on Responsive Financial Regulation*, 44 U.B.C. L. Rev. 589, 614–15 (2011).

from similar training and a shared belief in the same policy goals, all of which contribute significantly to the financial industry's influence.[36]

Johnson, Kwak, and Wilmarth argue that the "revolving door" encourages regulatory capture by promoting a continuous interchange of senior personnel between elite government posts and executive positions within large financial institutions and their professional service providers.[37] Woll emphasizes that the most important impact of the revolving door is the production of "worldviews, meanings, and interpretations that develop from shared experiences," so that government policymakers sincerely believe that they are serving the greater good by adopting policies favored by the financial industry.[38]

3.2 The highly technical nature of modern finance and the insulation of policymaking from public accountability encourage regulators to adopt pro-industry views

Woll also cites the "technicality" of finance and the relative insulation of financial regulatory policy from public accountability as contributing factors to the productive power of the financial industry.[39] In specialized, relatively obscure areas where the general public has little knowledge or interest, policymakers are likely to feel most comfortable in basing their decisions on private discussions with industry representatives.[40] Michael Moran has referred to this phenomenon as the "wink-and-nod" method of governance, in his analysis of financial regulation in the United Kingdom.[41] Similarly, Pepper Culpepper has argued that business influence is much greater in "quiet politics," where issues are negotiated in secret without much public attention.[42]

The highly technical and complex nature of "innovative" financial products has encouraged the belief that regulators should give great deference to industry expertise when regulatory policies are developed. Anat Admati and Martin Hellwig argue that financial industry representatives deliberately use the "mystique" of

36 Andrew Baker, *Restraining Regulatory Capture? Anglo-America, Crisis Politics, and Trajectories of Change in Global Financial Governance*, 86 Int'l Aff. 647, 647–63 (2010).

37 Johnson & Kwak, *supra* note 20, at 92–104; Wilmarth at 1407–17.

38 Woll, *supra* note 1, at 51.

39 Ford, *supra* note 35, at 614–15 (stating that regulators "operate within a relatively narrow, insulated and expertise-based" field of work that they share with "sophisticated repeat players" in the financial industry); Woll, *supra* note 1, at 52–53.

40 Woll, *supra* note 1, at 52.

41 Michael Moran, *The Politics of Banking: The Strange Case of Competition and Credit Control* (1984).

42 Pepper Culpepper, *Quiet Politics and Business Power: Corporate Control in Europe and Japan* (2011).

modern finance to promote light-touch regulatory approaches. "Anyone who questions the mystique and the claims that are made is at risk of being declared incompetent to participate in the discussion," they argue. "The specialists' façade of competence and confidence is too intimidating. Even people who know better fail to speak up."[43] Similarly, Wilmarth observes that the perceived "socioeconomic and intellectual superiority of Wall Street insiders provide further inducements for regulators to accept the financial industry's viewpoints."[44]

3.3 Fragmentation of financial regulation leads to regulatory arbitrage

The fragmentation of financial regulation frequently creates regulatory competition among government agencies that supervise different types of financial products, such as those generated by retail, commercial, and investment banking services. The evolution of different regulatory arrangements for various types of financial institutions can create fragmented and overlapping networks. In addition, financial institutions can increase their leverage over policymaking if they are allowed to choose their regulators for different activities. Thus, regulatory fragmentation and competition can lead to regulatory arbitrage that weakens governmental control.[45]

Wilmarth points to regulatory arbitrage in the 1990s and 2000s as a source of financial sector influence in the United States. He states that the industry "actively promoted" regulatory competition and "pushed agencies to adopt policies that would please their existing constituents and attract new ones." The resulting regulatory arbitrage "undermined the ability and willingness of regulators to apply rigorous supervisory policies."[46] A similar regulatory competition for large financial institutions took place on an international level, especially between New York and London, with each financial center (and

43 Anat Admati & Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It* 2 (2013); *accord* Johnson & Kwak, *supra* note 20, at 109 ("people who didn't subscribe to [the advantages of financial innovation] could be written off as ignoramuses who failed to understand the elegance of modern finance.").

44 Wilmarth, *supra* note 20, at 1420; *see also* Johnson & Kwak, *supra* note 20, at 92–94 ("[A]s the world of finance became more complicated and more central to the economy, the federal government became more dependent on people with modern financial expertise – which meant people from the big banks and from their most cutting-edge businesses.").

45 Woll, *supra* note 1, at 56.

46 Wilmarth, *supra* note 20, at 1390; *see also* Johnson & Kwak, *supra* note 20, at 96 (noting that the desire for larger regulatory fees among U.S. banking agencies created incentives for a "race to the bottom," in which agencies attracted "customers" by offering lax regulatory enforcement).

their respective national governments) pressuring their regulators to adopt industry-friendly, light-touch policies.[47]

3.4 Political contributions and lobbying increase the financial industry's influence

Woll acknowledges the long line of academic studies focusing on financial institutions and their interactions with governments through lobbying activities.[48] However, she criticizes as superficial the assumption that political decisions are a direct outcome of lobbying resources: "[h]ow these resources are used and when they matter seems to depend on other features that go beyond the pure contacts between the industry and public authorities."[49]

It is true that we cannot point solely to lobbying resources as the source of all financial sector influence. However, lobbying activities, together with political contributions, appear to contribute significantly to the financial industry's political clout. As Wilmarth has pointed out, (1) the financial sector in the United States has spent huge sums on political contributions and lobbying, (2) the financial sector's political clout increased as commercial banks joined forces with securities firms and insurance companies to create a unified industry perspective, and (3) the industry received excellent returns from the political investments it made during the period leading up to the financial crisis. Between 1994 and 2007, "the financial industry achieved a series of landmark legislative victories and also defeated numerous bills that tried to impose tighter constraints on subprime and Alt-A mortgage lending."[50]

An International Monetary Fund (IMF) staff study concluded that lobbying by the financial industry between 1999 and 2006 significantly improved the likelihood of passage for bills favored by the industry and also increased the probability of defeat for bills opposed by the industry.[51] Another study by Benjamin Blau and others found that politically influential banks received significantly larger amounts of TARP assistance, compared with banks that

47 Admati & Hellwig, *supra* note 43, at 9–10, 96, 192–95, 199; Darius Wojcik, *The Dark Side of NY-LON: Financial Centres and the Global Financial Crisis* (University of Oxford Employment, Work and Finance Working Paper No. 11–12, July 20, 2011), at 7, *available at* http://ssrn.com/abstract=1890644; Wilmarth, *supra* note 20, at 1393–98.
48 Woll, *supra* note 1, at 4.
49 *Id.* at 6.
50 Wilmarth, *supra* note 20, at 1359–64.
51 Deniz Igan & Prachi Mishra, *Three's Company: Wall Street, Capitol Hill, and K Street* 4, 15–18 (IMF Working Paper, June 2011), *available at* http://ssrn.com/abstract=1915164.

were not actively involved in politics. For every dollar that financial institutions spent on lobbying during the five years prior to TARP, the same firms received about $500 of additional TARP support.[52] Johnson and Kwak also point to the 1990s and 2000s as a period of rapidly increasing political contributions and lobbying by the financial sector that led to major changes in laws and regulations that favored the industry.[53] Thus, there appears to be a strong connection between the industry's deployment of political contributions and lobbying resources and the industry's productive power – i.e., its success in achieving favorable policy outcomes.

3.5 Woll's case studies demonstrate the importance of productive power

Woll concludes that the financial industry wielded a high degree of productive power in the United States, the United Kingdom and Ireland, where the regulatory approach "enshrines a low level of constraint, high risk-taking, and fragility of financial institutions as a positive contribution to the economy."[54] High productive power in all three nations can be seen in the adoption of light-touch financial regulatory regimes as well as close relationships among financial, political and regulatory elites.[55]

Woll contends that the financial sector's productive power was less pervasive in Denmark and Germany and least significant in France.[56] France and

52 Benjamin M. Blau, Tyler J. Brough, & Diana W. Thomas, *Corporate Lobbying, Political Connections, and the 2008 Troubled Asset Relief Program* 4, 22 (Sept. 30, 2011), *available at* http://ssrn.com/abstract=1878653.
53 Johnson & Kwak, *supra* note 20, at 90–92 (reporting that campaign contributions from the financial sector, including finance, insurance, and real estate, quadrupled from $61 million in 1990 to $260 million in 2006, while contributions from the securities and investment industry sextupled from $12 million to $72 million over the same span of time); *see also* Wilmarth, *supra* note 20, at 1363 (Between 1990 and 2012, the financial sector spent more than $3.3 billion on political campaigns and $5.3 billion on lobbying between 1998 and 2012 and ranked third among all industry sectors in lobbying outlays. The financial industry accounted for 15% of lobbying expenditures by all industry sectors between 1999 and 2006).
54 Woll, *supra* note 1, at 56; *see also* Johnson & Kwak, *supra* note 20, at 93 ("[A]s banking insiders gain power and influence in Washington, the positions they held – that complex financial products, free financial markets, and large, sophisticated financial institutions were good for America – became orthodoxy in the United States.").
55 Woll, *supra* note 1, at 83–85.
56 *Id.* at 56.

Germany both have "market-shaping"[57] approaches to financial regulation; however, France's regulatory framework was relatively stricter and more centralized.[58] Denmark had a particularly stringent regulatory structure with several crisis-related policy instruments that were adopted following the Scandinavian financial crisis of the early 1990s.[59]

Woll's cases studies demonstrate that productive power is not simply the result of elite social networks that link government officials with industry insiders. For example, the French banking system has been referred to as a "cartel-like structure"[60] and an "informal consortium,"[61] due to the highly concentrated nature of the French banking industry as well as common education and work experiences shared by heads of French banks and government officials. Even so, Woll considers the financial sector of France to wield the least amount of productive power because France has a long tradition of government intervention (e.g., state ownership of banks was common until the 1990s) and the government has maintained strong oversight of the principal activities of the financial industry.[62] The French experience suggests that tight business-government relations could be less effective in manipulating governmental policies if proper regulatory restraints are established and enforced.

Overall, Woll's case studies demonstrate that the resources of the financial industry and the links that industry insiders maintain with policymakers are substantial everywhere. However, productive power is not sufficient by itself to explain the variations in bailout policies that existed among the six countries included in Woll's case studies. Those significant differences in bailout policies caused Woll to examine how financial industry insiders and government officials actually dealt with each other during the 2008 financial crisis. After studying

57 Lucia Quaglia, *The 'Old' and 'New' Politics of Financial Services Regulation in the European Union*, 17 New Pol. Econ. 515, 518–22 (2012), *available at* http://dx.doi.org/10.1080/13563467.2012.622360 (comparing a "market-shaping" approach to financial regulation, which prioritizes financial stability and consumer protection through rule-based regulation, to a "market-making" approach, which emphasizes the objectives of competition and market efficiency through light-touch regulation and private sector governance).

58 Woll, *supra* note 1, at 115.

59 Grossman & Woll, *supra* note 16, at 11.

60 Woll, *supra* note 1, at 126.

61 Nicolas Jabko & Elsa Massoc, *French Capitalism under Stress: How Nicolas Sarkozy Rescued the Banks*, 19 Rev. Int'l Pol. Econ. 562, 562–85 (2012).

62 Woll, *supra* note 1, at 112–15; *see also* Quaglia, *supra* note 57, at 520–22 (stating that France led the "market-shaping coalition" in the EU, which was characterized by "prescriptive, rule-based regulation" and a "strong steering action from the public authorities").

those interactions, Woll focused her attention on the power of collective inaction displayed by the financial industry in four out of her six case studies.[63]

4 The power of inaction: Forcing the government to pick up the pieces

The third element of Woll's thesis, and the most innovative, analyzes the conditions under which the financial industry will or will not act collectively to save itself in times of crisis. During the financial crisis, governments everywhere tried to encourage collective participation by the financial sector in support of official rescue programs. In four of the six countries studied by Woll, the financial industry refused to participate in rescue programs and forced the government to use public funds to prevent the collapse of the financial system.[64] Collective inaction was the preferred strategy for the financial industry because that strategy shielded financial institutions from the need to contribute their own funds to support government rescue programs. However, collective inaction was a successful strategy only in those countries where the financial industry had sufficient strength to withstand the government's pressure.[65]

4.1 When is collective inaction possible?

Woll derives her theory of collective inaction from Mancur Olson's *Logic of Collective Action*, which seeks to understand the conditions under which collective action will or will not occur. Olson demonstrates that small groups have an advantage over large groups when it comes to organizing collective action. In larger groups, even if everyone has an interest in supporting the public good, self-interested individuals will decline to participate if their support cannot be enforced, because they can free ride on efforts made by others. In contrast, the incentive to free ride is weakened in small groups, where the lack of participation of individual members can be monitored and sanctioned.[66]

63 *Id.* at 61.
64 *Id.* at 170.
65 *See* Karl Deutsch, *The Nerves of Government: Models of Political Communication and Control* 111 (1963) (defining power in a similar manner as "the ability not to learn" from one's mistakes and to continue operating as usual, "insensitive to the present," while forcing other people to adapt to changed circumstances).
66 Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (1965).

The same type of conflict exists during banking crises. All banks recognize financial stability as a public good, but helping to rescue failing competitors will impose costs that banks prefer to avoid. When the failure of a financial institution could impair the stability of the entire industry, banks will evaluate whether their only realistic choice is to contribute to a collective rescue, or whether they could be successful in forcing the government to pay for the bailout with public funds. If financial institutions believe that the government has adequate resources for the bailout and will not allow a systemically important institution to fail, and if institutions also believe that they will not incur serious sanctions for refusing to help, they will adopt a strategy of collective inaction and "free ride" on a bailout financed entirely by public funds.[67] Woll examines the circumstances under which the financial industry can be reasonably confident that the government will allow the industry to decline to cooperate.

In Woll's view, the likelihood of collective inaction within the financial sector depends on relationships between the various types of financial institutions that make up the industry as well as their individual motivations for participating in a joint rescue program. She believes that the structural power and productive power of the financial sectors are important factors, but she views them as "only enabling conditions."[68] She contends that the pivotal factor is the health of leading financial institutions: "If the most significant ones or a significant portion of a country's financial industry has no need for government support, individually, this is likely to lead to collective inaction."[69] Healthy institutions can refuse to cooperate because their survival is not dependent on government support: "They may agree on the benefits of a rescue scheme, in general, but can afford to gamble with the government in the hope that the government will pay for the bailout rather than the industry."[70]

However, Woll's emphasis on the health of leading financial institutions, as the most important factor supporting a strategy of collective inaction, does not fully answer some key questions. Why do strong leading financial institutions conclude that they have a choice not to help in saving failing

67 Woll, *supra* note 1, at 58–59.

68 *Id.* at 172.

69 *Id.*; *see also* Culpepper & Reinke, *supra* note 12, at 440–41, 445–47 (claiming that leading financial institutions in the United Kingdom and Germany shaped bailout packages in favor of the industry by choosing not to participate in government rescue programs).

70 Woll, *supra* note 1, at 172.

competitors and maintaining the stability of the entire economy? Why do they not fear the potential adverse effects of refusing to cooperate in government rescue plans, including the possibility of reprisals by government agencies? These questions lead us back to a consideration of the industry's political clout (productive power). In our view, major financial institutions do not need to fear the consequences of refusing to cooperate in countries where (1) there has been a consistent public policy in favor of the financial sector, or at least its most significant members, (2) the government has the necessary resources to prevent the collapse of the financial system (i.e., the financial system is not "too big to save"), and (3) the largest institutions can therefore be reasonably confident that the government will use public funds to save systemically important banks and will not punish other large banks who refuse to help. A consistent pattern of favorable regulation, as demonstrated by Johnson, Kwak, Adam Levitin,[71] and Wilmarth, typically is produced by political contributions, lobbying activities, close industry-government relations, and regulatory arbitrage. Woll's thesis sheds important light on the reasons why leading financial institutions would prefer a strategy of collective inaction, and why those financial institutions might be willing to adopt that strategy despite its potential risks. However, we believe that Woll does not give sufficient attention to the crucial interaction between the (i) cost-avoiding preferences of "too big to fail" institutions and (ii) their ability to wield political influence that can shield them from tighter governmental supervision and meaningful public sanctions.[72]

In sum, the authors of this review agree with Woll's thesis to the extent that the power of collective inaction is a very significant phenomenon that helps to explain why some countries adopted bailout policies that were highly favorable to the financial industry while other countries did not. However we have reservations about Woll's thesis to the extent that she assigns less importance to the financial industry's political clout as a factor that determined whether the financial industry was successful in adopting a strategy of collective inaction. To explore this area of disagreement, we turn to Woll's six case studies to evaluate the relative importance of political clout and the health of leading financial institutions as factors that determined whether the financial industry successfully adopted a strategy of collective inaction.

71 Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 Harv. L. Rev. 1991, 2037–49 (2014).
72 Johnson & Kwak, *supra* note 20, at 90–92, 120–44; Wilmarth, *supra* note 20, at 1288–95.

4.2 Where and why did collective inaction occur?

4.2.1 The United States and the United Kingdom

The financial industries of the United States and the United Kingdom enjoyed comparable structural and productive power, in large part because those nations had long traditions of following market-oriented policies and had established the two most important global financial centers. In both countries, the financial industry refused to contribute to collective plans to rescue failing financial institutions, despite the efforts of both governments. The unsuccessful attempt by the U.S. Treasury and the Federal Reserve to organize a collective rescue of Lehman Brothers was a notable example of the government's failure to promote collective action by systemically important institutions.[73] Collective inaction by the largest U.S. and U.K. financial institutions forced both governments to fund costly bailouts, an outcome that supports Woll's thesis. However, it is important to examine the reasons why the financial industries in both nations were successful in refusing to act collectively.

Woll focuses on the health of leading banks in both countries. She argues that, in the United States, strong banks like JPMorgan Chase and Wells Fargo were able to adopt a strategy of collective inaction because they did not need government support. Similarly, in the United Kingdom, three major banks with large international operations – HSBC, Barclays, and Standard Chartered – adopted a similar strategy of collective inaction.[74] However, questions remain as to why the stronger U.S. and U.K. banks felt they could take the risk of allowing other large financial institutions to fail. The answer appears to lie partly in the banks' confidence that the government could and would intervene with public funds, and partly in the industry's formidable productive power. In other words, the strongest big banks were convinced that (1) the U.S. and U.K. governments would rescue their weaker peers, allowing them to reap the indirect benefits of government bailouts without paying the costs, and (2) they would not incur any serious sanctions for their uncooperative behavior, in view of their privileged positions as major sources of economic power and political influence.

Woll points out that there were significant differences between the government bailouts that followed collective inaction in the United Kingdom and the United States. When U.K. officials realized that the strongest banks would not

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73 Woll, *supra* note 1, at 94–107.

74 Woll, *supra* note 1, at 171–72; *see also* Culpepper & Reinke, *supra* note 12, at 438–41, 447 (arguing that HSBC had significant operations abroad and could credibly threaten to move its headquarters outside the United Kingdom if the government intervened too strongly).

voluntarily contribute to a collective rescue program, the government adopted a bailout scheme that contained much more onerous terms than those offered to banks in the United States.[75] In our view, this important difference in bailout terms resulted from two factors related to political power that went beyond considerations of institutional health. First, the U.K. financial industry retained substantially less political clout after the bailouts compared to the U.S. financial sector because the U.K. bailouts were substantially larger in relation to the size of the U.K. economy. As a result, public anger against big banks in the United Kingdom was significantly more intense than it was in the United States. In the aftermath of the bailouts, public outrage greatly diminished the City of London's traditional influence over public policy in the United Kingdom, while Wall Street was considerably more successful in obstructing financial reform efforts.[76]

Second, although both countries had a history of light-touch regulation with repeated concessions to financial institutions, the political influence of the financial sector in the United States was particularly strong due to the sector's massive campaign contributions and lobbying expenditures, as well as the rapidly spinning revolving door.[77] For both reasons, we believe that the largest U.S. banks had a significantly greater capacity to resist unfavorable government policies and, therefore, had less reason to fear a government backlash when they did not join government rescue programs. As Woll points out, the U.S. financial industry was correct in believing that it could forgo collective action without incurring severe government sanctions. Compared to the United Kingdom, the United States financial sector effectively received a "free bailout."[78]

The foregoing comparison indicates that the most important source of the financial industry's ability to adopt a strategy of collective inaction is its political clout (productive power). Although the health of leading banks, such as JPMorgan Chase, Wells Fargo, Barclays, HSBC, and Standard Chartered, certainly played a role in supporting the collective inaction of the two financial

75 Woll, *supra* note 1, at 102–03.

76 Compare Kevin Crowley & Ambereen Choudhury, *Made-in-London Scandals Risk City Reputation as Money Center*, Bloomberg (July 6, 2012); and Kevin Crowley & Ambereen Choudhury, *London Shrinks Faster Than Any Financial Center as Banks Come Under Attack*, Bloomberg (Jan. 17, 2012); with Wilmarth, supra note 20, at 1296–1328.

77 Levitin, *supra* note 71, at 1237–49; Wilmarth, supra note 20, at 1363–1446; Gautami Mukunda, *The Price of Wall Street's Power*, Harv. Bus. Rev. 70, 72–73 (June 2014). For a skeptical response to claims that U.S. financial regulatory policies indicate a high degree of capture by the financial industry, see Philip Wallach, *What Is Regulatory Capture?*, *The New Rambler: An Online Review of Books* (2015), *available at* http://newramblerreview.com/book-reviews/political-science/what-is-regulatory-capture.

78 Woll, *supra* note 1, at 172–75.

sectors, the financial health factor cannot fully explain why U.S. banks were more successful than their U.K. peers in avoiding bailouts with onerous terms.

4.2.2 France and Germany

The banking sectors in France and Germany wielded similar structural power due to both nations' long history of bank-based economies. Traditionally both nations adopted regulatory policies that were more interventionist than those of the United States and the United Kingdom, and both nations offered fewer opportunities for financial innovation. (However, as noted below, the stringency of bank regulation in Germany weakened considerably during the 1990s and 2000s, as German authorities sought to enable their largest banks to compete with U.S. and U.K. banks, and to promote Frankfurt as a rival to New York and London.) Compared with the financial sectors of the United States and the United Kingdom, the financial industry had a lower productive power in continental Europe, particularly in France.[79]

Despite the similarities in structural and productive power between the French and German banking industries, the German bailout placed a much greater strain on the public budget because large commercial banks refused to support a collective rescue program. When sharp divisions between the different segments of the German banking industry blocked collective action, "the government was left with no other options than to pick up the bill if it wanted to avoid a complete collapse of its banking sector and possibly its entire economy."[80] Woll contends that the most important reason for collective inaction by the German banking industry was that Deutsche Bank, the largest commercial (universal) bank, was a healthy institution. Deutsche Bank would have been the most important contributor to a collective rescue program, but Josef Ackerman publicly expressed his opposition to a collective program and also declared that Deutsche Bank did not need government support to withstand the crisis.[81]

In contrast, the French banking industry cooperated with the French government to organize a private-public rescue plan. Woll attributes this collective action to the fact that there were only six important French banks,[82] and all but one of them needed some degree of public assistance. The only French bank that clearly did not need government support was Crédit Mutuel, but that bank was

79 *Id.* at 114–15.
80 *Id.* at 137.
81 *Id.* at 131, 172.
82 *Id.* at 137.

"one of the smallest French financial institutions" and therefore "had no clout in the collective negotiations."[83]

Woll is correct in pointing out that all of the largest French banks needed public support, and they therefore felt obliged to accept collective plans for liquidity provisions and recapitalization by the French government. Even so, BNP Paribas was a comparatively strong bank, and it improved its financial position after closing investment vehicles that had been exposed to the US housing market. Nevertheless, BNP's chairman, Michel Pébéreau, played a central role in designing the French plan.[84]

Why were the leading financial institutions in France willing to work toward a collective solution, while Deutsche Bank refused? In France, as Woll points out, the financial sector exercised less productive power. Pre-crisis regulation was relatively strict in France. By contrast, Germany adopted a more permissive attitude toward the banking industry during the decade leading up to the financial crisis. German officials applied lax accounting rules and allowed German banks to engage in subprime lending and investment activities through special purpose entities, in part because Germany wanted to promote a financial sector and a financial center (Frankfurt) that could compete on equal terms with their U.S. and U.K. counterparts.[85] In addition, Deutsche Bank was by far the largest and most important German bank and had extensive international operations (with only 27% of its income derived from Germany). Like HSBC, but unlike the big French banks, Deutsche Bank had sufficient international standing and enough political clout to refuse to cooperate with the German bank rescue plan.[86] Thus, Deutsche Bank's greater political potency – including its ability to shift operations from Germany to other countries – appears to have been an important factor that may explain why Deutsche Bank (unlike the leading French banks) could afford to play a game of "chicken"[87] with its national government.

4.2.3 Ireland and Denmark

Woll's final pair of case studies addresses two small European countries with "substantial financial development, a homegrown housing market bubble, and a

83 *Id.* at 172; *see also* Culpepper & Reinke, *supra* note 12, at 18–19.
84 Jabko & Massoc, *supra* note 61, at 562–85.
85 Woll, *supra* note 1, at 114, 128.
86 Culpepper & Reinke, *supra* note 12, at 438–41, 445–47.
87 Woll, *supra* note 1, at 3.

great dependence on international wholesale markets for bank funding."[88] In both Ireland and Denmark, the national economy had a high degree of structural dependence on the financial industry due to the very large size of the industry in proportion to GDP. Despite their similar economic settings, Ireland and Denmark adopted bank support schemes that were strikingly different. The Irish government incurred massive government liabilities in supporting its banking sector, and those obligations eventually triggered a sovereign debt crisis. In contrast, the Danish government orchestrated a public-private rescue scheme that was supported by substantial contributions from the financial industry. The Danish plan required the banking sector to contribute collectively by paying substantial fees for guarantees and also by paying into a new fund that would cover losses from bank failures. Denmark's rescue program "effectively ring-fenced the Danish financial industry and protected the public budget."[89]

Woll addresses the question of why Danish banks were willing to act collectively while Irish banks did not. Woll states that "Denmark might have looked like Germany had Danske Bank been in good health. But [Danske Bank] was not, to a point where some speculated that the Danish recapitalization was… just to put into place a bail out for Danske Bank." Thus, unlike Deutsche Bank, the biggest Danish bank needed public help and therefore did not have any incentive to "walk away from the table."[90] At the same time, all three major banks in Ireland – Allied Irish Bank, Bank of Ireland and Anglo Irish – desperately needed help, but they still chose *not* to act collectively. According to Woll's thesis, the very weak condition of all three Irish banks should have caused them to act collectively by joining the Irish government's rescue plan for the banking industry.

Once again, the very different responses of the Danish and Irish banks appear to be directly tied to sharp disparities in their political clout. The Danish government maintained a stricter regulatory scheme and could call upon several policy instruments during the financial crisis. An important reason for the Danish government's strong control over Danish banks was that the "memory of the [Scandinavian] financial crisis of the 1990s was still vivid in the Nordic countries in the 2000s."[91] Bank resolution was an important public concern, and the Danish government established a public guarantee fund in 1994 to provide for unwinding distressed financial institutions and protecting depositors and investors. In 2007, after the European Union (EU) decided that

88 *Id.* at 139.
89 *Id.* at 140.
90 *Id.* at 172.
91 Grossman & Woll, *supra* note 16, at 11.

the Danish public guarantee program violated EU state aid rules, Danish banks collectively established an industry-funded plan (the Private Contingency Association) to handle failures of distressed banks.[92]

In contrast, Ireland's banking industry enjoyed ample productive power. Irish banks expanded rapidly during the decade leading up to the financial crisis and became extremely large compared to the Irish economy. Ireland's bank regulators adopted a lax approach that was similar to the United Kingdom's "principles-based" system with "light touch" oversight, due in part to Ireland's close economic links with the United Kingdom.[93]

Woll acknowledges that the productive power of the financial industry in Demark "appears to be lower than in Ireland.... In Ireland, it was very high."[94] Therefore, it seems likely that the reasons for the willingness of Danish banks to contribute to the Danish government's rescue plan were similar to the reasons why French banks adopted a cooperative response. In both Denmark and France, the banks needed public support and also did not believe that they had enough political influence to resist a collective response.

In contrast, the Irish banks enjoyed significant political clout due to their rapidly expanding importance within the Irish economy as well as their strong alliances with real estate developers, who exerted great influence over the Irish government. Moreover, the Irish government was committed to an "extremely light-touch financial regulatory regime" in order to achieve Ireland's goal of becoming a global center for attracting operations by "offshore" financial institutions.[95] The largest Irish banks apparently felt quite confident that their government would commit public funds for a generous bailout scheme that would not require any contribution from the banks.[96]

92 *Id.*

93 Woll, *supra* note 1, at 141; *see also* James R. Barth, Gerard Caprio Jr. & Ross Levine, *Guardians of Finance: Making Regulators Work for Us* 123–30 (2012); Kenneth P.V. O'Sullivan & Stephen Kinsella, *Financial and regulatory failure: The case of Ireland*, 14 J. Banking Reg. No. 1, at 1, 5–12 (2013).

94 Woll, *supra* note 1, at 143.

95 Gregory Connor, Thomas Flavin & Brian G. O'Kelly, *The US and Irish Credit Crises: Their Distinctive Differences and Common Features* (Mar. 8, 2010), at 14–17, 20–21 *available at* http://ssrn.com/abstract=1566844; *see also* Suzy Hansen, *The Reckoning*, Bloomberg Businessweek 83, 90 (Nov. 22–28, 2010) (explaining that "politicians, developers, regulators, and bankers" in Ireland were "interdependent on each other," and further noting that "Irish banks operated in a culture of deference and uniformity.... Ireland had 10 to 15 major property developers who could drive the market, and everyone wanted to loan money to them.").

96 Connor, *supra* note 95, at 5, 20–21 (stating that "Irish domestic banks were blessed with extremely generous bailout policies by the government," and "[f]or the two largest Irish domestic banks, there was probably some foresight that if their reckless actions during the bubble period led them into trouble, the government would step in and save the institutions").

The confidence of the Irish banks proved to be well-placed. The Irish government issued blanket guarantees that protected depositors and senior bondholders in the Irish banks. The guarantees were so far-reaching that they triggered a sovereign debt crisis. Ireland was ultimately forced to accept a bailout of more than $110 billion from the EU, the European Central Bank (ECB), and the IMF.[97]

During the past three years the Irish economy has gradually recovered from its deep slump, and Irish banks have also revived, thanks in large part to the open-ended bailouts they received. The Irish government placed Anglo-Irish Bank into liquidation and prosecuted several of its senior executives. However, the other leading Irish banks (including the two largest, Allied Irish Bank and Bank of Ireland) survived the crisis after receiving government bailouts.[98] The banks' political allies, large real estate developers, have also returned to prominence as housing construction has resumed.[99] This evidence suggests that the surviving Irish banks may have retained a substantial portion of their productive power despite Ireland's financial crisis.

5 Conclusion

Professor Woll's book argues persuasively that the financial sector's willingness or refusal to act collectively can be a decisive element in shaping bailout terms and also in measuring the power that the financial sector wields over national governments. However, we disagree with her view that the health of leading

97 Dara Doyle & Joe Brennan, *Irish Tell Spain to Imagine Worst in Banking Bailout*, Bloomberg (June 14, 2012) (explaining how Ireland's guarantees for its banks caused a sovereign debt crisis); *UPDATE 3-Ireland opts to exit bailout without back up credit line*, Reuters (Nov. 14, 2013) (discussing Ireland's sovereign debt crisis and its bailout by the EU, ECB, and IMF).

98 Vincent Boland, *Signs the Celtic Tiger is slowly prowling back,* Fin. Times (Sept. 27, 2015); Vincent Boland, *Ex-Anglo Irish chief faces US court as Ireland seeks extradition*, Fin. Times (Oct. 11, 2015); Donal Griffin, *Irish Bankers Vow This Time It's Different After Bust: Mortgages*, Bloomberg (Feb. 28, 2014); *see also* Joe Brennan, *Irish Bank Evicts Pensioner After $155 Billion Losses: Mortgages*, Bloomberg (April 25, 2012) (reporting that the Irish financial crisis resulted in "the nationalization of five of the country's biggest lenders" as well as the government's infusion of 62 billion euros of new capital into six Irish banks); Doyle & Brennan, *supra* note 97 (explaining that the Irish government also helped its banks by establishing the National Asset Management Agency, which paid 32 billion euros to the banks and assumed "74 billion euros of toxic real estate assets").

99 Vincent Boland, *Return of the Irish property developer*, Fin. Times (Nov. 6, 2015); Griffin, *supra* note 98.

financial institutions is the most important factor in determining whether the financial sector can resist a collective rescue plan. While institutional health is certainly a significant factor, we believe that the productive power (political clout) of the financial industry is even more important in affecting the industry's ability to refuse the government's call for collective action. In the United States, United Kingdom, Germany and Ireland, financial institutions avoided contributing to government rescue plans because of the political influence they wielded. In the United States and Ireland, financial institutions received the most generous bailout terms because they possessed the highest levels of political influence among the six national industries analyzed in Professor Woll's book.

We agree with Professor Woll that it is essential to understand the economic and political circumstances that enable financial institutions to adopt a strategy of collective inaction when a financial crisis occurs. However, we believe that Professor Woll's analysis understates the potential threat posed by the political influence of systemically important financial institutions. Financial reform efforts must emphasize the goal of diminishing the financial industry's political influence, because that influence presents the single greatest obstacle to the adoption and implementation of government policies that would serve the public interest rather than the industry's preferences. Reform efforts should seek to reduce the financial industry's political clout by addressing problems created by political contributions, lobbying, the revolving door, and excessively concentrated industry structures.

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