

Financial Regulation in Europe: Divergent Institutional Responses in the Ages of Globalization and an Untidy Compromise

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The financial origins of the recent world economic crisis have focused attention intensely on the role of financial regulation in advanced industrialized countries. In both the United States and the EU—which witnessed the largest public bail-outs of financial institutions—the crisis has raised serious questions about the adequacy of existing regulatory arrangements and prompted institutional reforms intended to forestall similar future disasters. In Europe, the EU Commission led the effort to raise regulatory authority over financial institutions to the EU level so as to match the now centralized “lender of last resort” function of the European Central Bank (ECB). Yet the effort to create any such authority at the EU level has faced important obstacles. One of these has come from the resistance of member states to cede their regulatory powers over financial institutions. Yet a different, less often recognized obstacle is financial regulatory reform involving the fundamental differences in the national regulatory models that co-exist across the EU.

As we have argued elsewhere recently (Perez and Westrup, 2010), differences in national regulatory models are not simply the result of long-running institutional legacies. They are the product of divergent choices made by EU governments as they responded to the last wave of regulatory challenges in the financial arena during the 1990s and early 2000s. In this period, some member states organized their regulatory authority into a single, unitary institution separate from their national central banks, while others divided such authority among multiple regulators leaving banking in the hands of their central banks. This divergence in national institutional models is an important constraint on efforts by EU authorities to create an effective EU-wide framework of financial supervision and regulation.

The sub-prime crisis in the United States revealed risk-linkages among financial institutions that cut across both the Atlantic and the world. It quickly became clear that those risk-linkages extended across the EU, for the exposure of institutions under UK and German regulatory authority was also found to expose institutions in other member states. The widespread failure of financial regulators throughout the member states to appreciate these new risk-linkages among their financial sectors led to calls from some experts for

a strong, pan-European financial “super-regulator” that would have authority over institutions operating across EU member states, and which could provide leadership and gauge the level of systemic risk in the EU.

A report commissioned by the EU Commission from a small group of experts headed by Jacques de Larosière explicitly set aside this option, however, in favor of an alternative, two-layer model. In this alternative model, a “European Systemic Risk Council (ESRC)” under the leadership of the ECB would oversee systemic or “macro” financial risks, while so called “micro risk”—that attached to individual institutions—was to be left to three new EU supervisory agencies for banking, insurance, and securities markets that would set binding standards and supervise colleges of national regulators tasked with monitoring financial institutions operating across more than one EU state.¹ As for the European System of Financial Supervisors (ESFS), the report went on, it “should be neutral with respect to national supervisory structures...[because] national supervisory structures have been chosen for a variety of reasons and it would be impractical to try to harmonise them...” (p. 44).

By the time final agreement was reached among the member states in September of 2010, the Larosière model was further altered, principally (but not exclusively) to accommodate Britain—not a member of the ECB. The binding nature of decisions by the three new EU “micro regulators” was limited to “emergency situations” and a “fiscal safeguard” was further introduced, preventing the EU authorities from allocating fiscal responsibility when public funds would be required to address the financial risks posed by a cross-border institution. In addition, the ECB’s chairing of the new ESRC was limited to the first five years after its

1 The High Level group on Financial Supervision in the EU Chaired by Jacques de Larosière, Brussels 25 february 2009. Available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

inception (*Financial Times*, September 3, 5 and 7, 2010).

This new EU regulatory arrangement, which will come into effect at the start of 2011, thus provides improved mechanisms for information sharing and the harmonization of technical rules across countries. Yet, it also constitutes what many experts see as a highly untidy and potentially ineffective regulatory response

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that may miss the main lessons revealed by the crisis—namely, that a lack of clear coordination and leadership among national regulators and macro-economic authorities can be disastrous.² The outcome of the EU’s reform initiative was predictable, however, not only because

the creation of a pan-European super-regulator would have required a large shift of regulatory powers to the EU level, but also because the regulatory philosophy behind it conflicted with arrangements existing in many EU member states. The Larosière report acknowledged as much in rejecting the notion that the ECB should be given regulatory authority over financial institutions. “Giving a micro-prudential role to the ECB would be extremely complex,” it argued, “because in the case of a crisis the ECB would have to deal with a multiplicity of Member States Treasuries and supervisors.” Moreover, conferring micro-prudential duties on the ECB would be particularly difficult given the fact that a number of ECB/ESCB members have no experience or established competence in such financial supervision (Larosière Group report, p. 43). Indeed, as the following table illustrates, the regulatory structures adopted in Europe in the period following the initiation of single European market in financial services in 1992 varied substantially along two dimensions: 1) whether or not the regulation of different types of financial activities (commercial and investment banking, securities markets, and insurance) was unified under a single regulator, and 2) what role the central bank

2 See for instance “De Larosière report fails to tackle main issues,” *Euractiv* April 6, 2009, pp. 231-32.

THE STRUCTURE OF FINANCIAL SUPERVISION IN SOME KEY EU ECONOMIES IN 2007

COUNTRY	SINGLE REGULATOR	TWIN REGULATORS	THREE SEPARATE	REGULATORY ROLE OF CENTRAL BANK
UNITED KINGDOM	X			systemic risk*
GERMANY	X			secondary to BaFin
FRANCE			X	banking supervision
ITALY			X	oversees banking and part of the bond market
SPAIN			X	banking supervision
NETHERLANDS		X		banking and systemic risk
BELGIUM	X			banking and systemic risk
SWEDEN	X			secondary
GREECE			X	banking supervision
IRELAND	X			central bank is overarching regulator
PORTUGAL			X	banking regulation

SOURCE: AUTHOR'S ELABORATION BASED ON WYMEERSCH (2007).

*IN 2010 THE NEW CONSERVATIVE GOVERNMENT IN THE U.K. PUT THE FSA UNDER THE AUTHORITY OF THE BANK OF ENGLAND, TURNING THE CENTRAL BANK INTO THE SINGLE REGULATOR.

was given in the post-1992 regulatory framework.

To understand the paradox of divergent institutional responses in an age of globalization and financial liberalization, we must pay attention to the role of political elites, and particularly, to their domestic political motivations in establishing and shaping regulatory reforms in Europe. Admittedly, pressure from sectoral actors and efforts to boost the role of one financial capital or another played a role in the decisions of governments during the last decades. Yet, politically sensitive developments—such as the shift of risk for old age income maintenance from public

to private pensions—also heightened the interest of elected officials in financial market regulation and may offer a better explanation for some of the main lines of divergence in their institutional choices.

Divergent regulatory choices in the pre-crisis period

The decades leading up to the financial crisis precipitated by the collapse of the U.S. subprime mortgage market were ones of intense reform in the institutions of financial regulation across Europe. In the 1970s and 1980s, reform efforts had focused on the

deregulation of credit (principally in those countries where postwar regulatory practices were seen to hinder monetary policy operations by central banks) and on boosting capital markets as a less inflationary form of corporate finance. But in the 1990s and early 2000s, governments across Europe became concerned principally with matters of prudential regulation and with the goal of better public supervision of newly deregulated financial activities. Up until the 1980s, the norm across Europe had been one of self-regulation in the banking sector and among licensed stock brokers.³ Yet from that decade on, governments from Spain, France, and Italy to Germany and the UK, began to create new independent agencies and government offices or, in some cases, strengthen the powers of inspection and sanction of existing state bodies.

This was the general trend. However, the institutional structure of supervision on which governments settled varied substantially across Europe. In many countries, the supervisory powers of the central bank over the banking system were strengthened in the 1990s and new securities regulators were created (or, as in Italy and France, existing regulators were newly empowered).⁴ The most dramatic change, however, took place in the UK, where the Labour government in 1997 created a new single regulatory authority for the financial sector—the Financial Services Authority (FSA)—and in Germany, where the Red/Green coalition government of Gerhard Schröder similarly concentrated powers under a new agency—

³ To offer some examples, in Britain neither the Treasury nor the Bank of England had any formal legislative powers to supervise banks until the Banking Act of 1979. And although the German government created a banking supervisor, the Bundesaufsichtsamt für das Kreditwesen, in 1961, that institutions established rules only through close consultation with the large banks (Busch, 2000, and Coleman, 1996). Securities markets were also characterized by the absence of public supervision, or at least powers of sanction. In Britain, it was not until 1986 that the Securities and Investment Board (SIB) - an institution Moran (1991) characterized as a mesocorporatist body with responsibility shared between state and market actors - was created. Neither Spain nor Germany had independent securities regulators until 1989 and 1994 respectively. And in France and Italy, existing regulators (the Commission des Opérations de Bourse (COB) and the Commissione Nazionale per le Società e la Borsa (Consob)) did not have the power to enforce sanctions until 1989 and 1998 respectively.

⁴ The insurance sector was covered through the creation of separate insurance regulators.

the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) early in 2002 (Westrup, 2007, ch. 4). In both countries, the new regulators were given responsibility for all three segments of finance (banks, securities markets, and insurance), although the FSA was organized in a more integrated manner while the BaFin was created as an umbrella agency to oversee existing securities and insurance regulators (the BAWe and BaV (Bundesaufsichtsamt für das Versicherungswesen) as well as the existing prudential regulator for the banking system (BaKred). In both countries, the introduction of the new super-regulator implied a sharp reduction in the regulatory role of the national central bank, whose powers were largely reduced to carrying out bank inspections (although the Bank of England, as Britain's monetary authority, naturally retained responsibility for systemic risk).

There are several factors that are identified in the literature to help explain the new focus on prudential standards and state supervision of finance in the early 1990s. With fully functioning money markets, monetary policy had been successfully placed in the hands of central banks, whether or not these had yet received full statutory autonomy. The goal of creating a financial infrastructure that would serve more orthodox monetary practices had thus been achieved. On the other hand, international financial integration was creating a number of new challenges. By the 1990s, the growth of cross-border operations led states to seek agreements on prudential standards (Basel I and II) through the Bank for International Settlement (BIS) and the International Organization of Securities Commissions (IOSCO) (Strange, 1996; Vogel 1998; Held et al., 1999; Simmons, 2001; Pauly, 2002). Another impetus for increased state supervision is said to have come from American institutional investors who are often credited for encouraging higher standards of transparency in corporate governance and financial regulation across Europe (Laurence, 2001; Lütz, 1998, 2004; Moran, 1991). Finally, European directives that followed from the 1992 launching of a single European financial market provided an additional impetus for more formal standards of regulation.

However, because all these factors were

systemic (i.e. would have had similar effects across countries), they do not help us understand why, in their efforts to strengthen public supervision, EU member states would choose such different institutional structures (with governments in some countries opting to create separate regulators for securities and/or insurance while leaving banking under the supervision of the central bank and others choosing to remove banking supervision from the central bank and to create new, unified financial regulators that were directly accountable to national parliaments and governments).

There was, however, another political dynamic at play that strengthened the desire of elected governments to boost financial supervision in the 1990s. Over the 1980s and 1990s, households across much of Europe significantly changed the manner in which they invested their private savings, moving away from secure assets such as bank deposits (still their principal asset in 1980) toward risk assets (including direct holdings of equity and bonds, as well as investments placed in such securities through financial institutions). Between 1980 and 2000, the total proportion of risk assets in household savings rose by substantial percentages (53 to 74 percent in Britain, 33 to 60 percent in Germany, 30 to 61 percent in France, 24 to 75 percent in Italy, and 21 to 64 percent in Spain) (Perez and Westrup, 2010).

This shift in the structure of household savings—the result of earlier policies to ease pressure on national budgets and pension systems such as the privatizations of public utilities and tax incentives to promote private savings and stock ownership—implied a significant rise in the vulnerability of large segments of the electorate to market events. As long as bank deposits dominated household portfolios (as they did until the 1990s), regulation of the financial sector was of interest almost exclusively to technocrats (central bankers and senior civil servants) but not to elected officials. When bank failures occurred, central banks carried out their lender-of-last-resort function, bringing in other domestic banks to assist in rescues if necessary, while the immediate threat to depositors was addressed through deposit insurance schemes. The rise in private pension and securities ownership by the public-at-large, however, changed the scenario. As

regulatory failures now could have dire consequences for large numbers of people, this change in investment habits raised the profile of financial failures in national politics and gave elected officials a far more direct stake in the avoiding regulatory failures. For example, the private pension mis-selling scandal of the 1990s—affecting around seven million people (Banks and Smith, 2000)—and the Barings scandals in the UK were seized upon by the Labour party in its 1997 manifesto, which promised to reform the Conservatives' Financial Services Act.⁵ The 1993 Banesto scandal in Spain, which affected as many as 300,000 small shareholders, set off a political maelstrom (*El Pais*, April, 26, 1994). The 2000-2001 Berlin banking scandal, involving the states regional mortgage bank and costing it billions of euros, contributed directly to the breakdown in the city's grand coalition. And, the Parmalat scandal in Italy, which affected over 85,000 small bondholders, produced a volley of recriminations between the Berlusconi government and the Bank of Italy, with Finance Minister Tremonti calling for the creation of a new, overarching regulatory agency (*Financial Times*, January 24, 2004).⁶

These examples illustrate how matters of financial supervision that had once been the purview of technocrats turned into questions of real electoral relevance. In such a context, we would expect politicians to favor an intensification of supervision. Yet contrary to systemic explanation, such as the influence of American investors or Europeanization, this domestic political dynamic was less likely to produce convergence upon a common institutional model. While voters might blame governments when market failures threaten their life savings, they are less likely to be looking for specific regulatory arrangements than either highly informed foreign investors or international technocrats. Politicians would thus have to have particularly strong motivations to want to create new, unitary regulatory agencies to opt for such an outcome.

⁵ Labour Party Manifesto, 1997.

⁶ The Bank ultimately only lost its regulatory powers over investment products offered by banks and over bank mergers following the Antonveneta scandal in 2005. Wymeersch, E.. 2007. "The Structure of Financial Supervision in Europe: About Single Peaks, Twin Peaks and Multiple Financial Supervisors." *European Business Organization Law Review*, Vol. 8, pp. 237-306.

As our analysis (Perez and Westrup, 2010) of regulatory changes in five countries (Britain, Germany, France, Spain, and Italy) discusses in greater detail, the construction of new regulatory arrangements in the pre-crisis period involved considerable tensions between different state actors, in particular tension between elected elites and central banks. In both Britain and France, the introduction of new, overarching regulatory agencies with supervisory powers over banking was strongly opposed by the central bank. There are a number of important policy arguments in favor of having a single, unitary regulator for finance (including better risk-assessment of institutions that operate across what are now blurred market segments, and the efficiency gains to be had from moving to a one-stop regulator). At the same time, there are also important arguments against giving such an encompassing regulatory role to central banks which also have the function of serving as lenders of last resort, and in this sense may face a conflict of interest. Moreover, the main argument in favor of granting statutory autonomy to central banks—namely, that elected governments face a problem of time-inconsistency in setting monetary policy—does not extend to the regulatory functions that central banks have traditionally served as the default regulators for the banking system.

In both Britain and France, the introduction of new, overarching regulatory agencies with supervisory powers over banking was strongly opposed by the central bank.

We explain the different choices made by governments across the five largest EU states in terms of two factors: first, the differing level of strength of central banks within national policy-making communities in the 1990s and 2000s, and secondly, the degree of interest on the part of elected elites in placing financial supervision under a more directly politically accountable single regulator. In both the UK and Germany, the introduction of the single, regulatory model formed part of a larger economic project by left-of-center governments. As noted, the creation of the FSA formed part of the Labour Party's 1997 electoral promise and was justified largely in terms of

creating a more accountable supervisory agency that would prevent regulatory failures, such as the private pension mis-selling and Barings scandals. In the case of Germany, the creation of the BaFin was backed by the large banks, but opposed by the Bundesbank and a number of important regional governments. Thus, the decision ultimately came down to Chancellor Schröder and coincided in time with the initiation of a process of pension reform that ultimately shifted the burden of old age income provision significantly from the public pension to private individuals. Noting a cross-national pattern that also extends beyond Europe to other places (such as Japan, for instance), we suggest that where pension reforms have created such a shift, the vulnerability of large segments of the electorate to market events may increase the pressure on governments to seek to re-establish political accountability over financial regulation.

The crisis and its aftermath

As the financial crisis that spread from the U.S. to Europe in 2007 has revealed, none of the national regulatory institutions introduced in Europe during the 1990s and early 2000s proved a match for the contagious risk that new asset backed derivatives and credit default swaps had created for banks and insurance firms across the major OECD economies. Indeed, since the start of the crisis there has been one major change at the national level as the new Conservative-Liberal Democratic coalition that came to office in the UK turned the single regulator model introduced by Labour on its head, placing the Bank of England in control of financial regulation, with the FSA as an agency under its control. The move was justified on the basis that the crisis had demonstrated the need to place responsibility for systemic risk and "micro-risk" under a common authority. Yet, if the FSA had not foreseen the failure at Northern Rock in the UK, neither the central bank

led model of banking supervision maintained in the Netherlands nor the single regulator model introduced in Belgium in 2004 had prevented the collapse of Fortis.

The question of what model is best suited to an environment in which securitization and tranching of asset backed securities have rendered risk opaque can hardly be said to have been settled by the still ongoing financial crisis. Certainly, the issue of systemic risk is back and writ large. This, indeed, was the argument for creating a single regulator at the EU level that would be placed under the leadership of the ECB. For defenders of the notion that systemic risk and the supervision of individual institutions cannot be separated, the failure to arrive at such a solution is thus a primary error.⁷ But

⁷ See for instance the memorandum of René Smits included in "The future of EU financial regulation and supervision," 14th

given the multiplicity of arrangements and regulatory actors across the member states, there was most likely, as the de Larosière Group concluded, little chance of arriving at such an agreement at the EU level. Whether the two-tiered micro- and macro- risk model can offer an improvement over the previously existing model of information-sharing among national regulators will thus likely depend on whether improvements in information-sharing and analysis, and avoidance of regulatory arbitrage, can be significantly reinforced by the three new sectoral European Financial Authorities.

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