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Widen the market, narrow the competition : the emergence of supranational governance in EU capital markets

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CHAPTER 4: NEGOTIATING THE SINGLE MARKET: INTERESTS AND INSTITUTIONS AROUND 1990

Bargaining over the single market for investment services was a protracted and acrimonious affair (Brown 1997). The Commission tabled its first proposal for the Investment Services Directive (ISD) late in 1988; it was finally adopted in May 1993. The second important directive for investment services—the Capital Adequacy Directive (CAD)—was likewise finalized at the turn of 1992/93. At times, negotiations effectively broke down (Waters 1991b). Compared to other financial market sectors such as insurance and banking, the ISD did less than had been hoped to create a single, unified market (Steil 1993, 1998). The result was no accident: it reflected the underlying constellation of competitive interests in Europe at the time. The protectionist impulses of national governments—and of the financial industries that their positions reflected—were too strong and irreconcilable.

The story of the negotiations and this ‘first round’ of European financial market integration has been well told (Steil 1993, Brown 1997, Leyshon and Thrift 1997, Story and Walter 1997, Underhill 1997). The aim of this chapter is therefore not to rehearse it once more, but to put it into theoretical perspective. Its core question is deceptively simple: why did efforts to establish a single European market in investment services fail to live up to official ambitions? In the context of this thesis, the answer to this question forms the backdrop against which the renewed—and this time more successful—integration efforts since the late 1990s are evaluated. Taken on its own, however, the failure presents a puzzle. It cannot simply have been governments’ hesitancy to cede ‘sovereignty’ to a supranational body. In the same year that the ISD was adopted, European governments signed the treaty of Maastricht that would lead most of them to relinquish their national currencies before the end of the decade. Also, the Second Banking Coordinating Directive, the ISD’s sibling for credit markets, took less than a year to elicit agreement from European governments and was formally adopted at the end of 1989. What

made investment services different?

The competition politics approach of this thesis reveals the divergent regulatory preferences of national financial market incumbents in the central EU member states as the core obstacle to effective agreement. Negotiations largely depended on agreement between Germany, France and the UK. Their positions represented the spectrum of opinion at the negotiating table; the nine smaller EU members rallied around them in varying constellations. So agreement among the big three was needed to adopt legislative proposals. Smaller countries could always be brought on board by giving them extra time to 'adjust' to the agreed measures. This is precisely what happened with the ISD.

Recognizing the difficulty of agreeing on a single set of harmonized standards, the Commission had chosen mutual recognition as the way forward for the single market project, including financial services (Moravcsik 1998: 354f, Egan 2001). Combined with a single passport and home country control, mutual recognition should unleash regulatory competition and thus further convergence. The theoretical attraction of the approach did not prevent disillusion once it was put into practice. The regulatory competition the regime unleashed was a double-edged sword: governments did compete, and used regulation to do it. But they used regulation not only to attract mobile business, but also to give their own financial players a competitive edge. Regulation turned out to be a tool for protectionism as much as for liberalization.

This chapter details this argument in two steps. The first places the negotiations in historical perspective and situates financial markets in the single market project. Integration efforts in banking proper left their imprint on capital market negotiations as they tilted the 'playing field' strongly in favour of universal banks. The second part analyses the negotiations around the ISD and the CAD and the competition politics that dominated them, and it locates these politics in global efforts to craft common rules, for example through the International Organization of Securities Commissions. In spite of their limits, the market-opening the European directives eventually entailed sowed the seeds of a further transnationalization of the

financial industry and thus a shift in large banks' preferences in favour of EU rules that would go far beyond the original agreements. In structuration terms, the regulatory structures that European public and private actors negotiated in the early 1990s were to inspire new agency half a decade later. In this way, the ISD triggered market changes that would make its own overhaul look all but inevitable less than a decade later. Those developments are left for the remaining chapters of the thesis, however.

Financial services in the Single Market project

Financial services occupy an awkward position in the single market project. Measured against the salience of financial matters in the 1990s, they were conspicuously peripheral to the project when it got underway around 1985. Whereas large European industrial firms played an important role in re-launching the internal market—just how important continues to be debated (Sandholtz and Zysman 1989, Cowles 1995, Moravcsik 1998: 355ff, van Apeldoorn 2002)—financial firms were hardly visible. There is little evidence that they were a driving force behind integration.

Once the single market programme was underway, financial firms' interest in it remained subdued (de Jonquieres 1988, 1993). Only a small group of international banks took it seriously; among the most prominent were Barclays, ING and Deutsche Bank (Interview 160306.b). The City of London was digesting the effects of the Big Bang and the Financial Services Act. The Euromarkets were so far removed from any regulatory oversight that significant intervention by any public authority, European or otherwise, seemed unlikely. For securities markets, the wake up call came once the Second Banking Coordination Directive enshrined pan-European access for universal banks in 1989 (Interview 030406). 'Europe' had left its first imprint on the competitive landscape. From the perspective of firms in the City, negotiations around the CAD and the ISD had to recalibrate the balance between bank and non-bank players. The consequences of 2BCD for securities markets provided incentives to stay at the bargaining table; without them, negotiations may well have broken down.

This was surprising as the failure to create a functioning single market in investment

services came at a time when governments were anything but timid in their integration efforts. The watered down ISD was adopted by the Council in the same year European governments agreed on the Treaty of Maastricht. In areas where agreement could be reached on substance, the intergovernmental nature of EU decision-making formed no obstacle to the adoption of new legal measures. The outcome in investment services could therefore not be attributed to disadvantageous decision-making structures. In other areas, notably the launching of the single market programme itself, the Commission had played an important role as a policy entrepreneur. Yet when it came to securities markets, the Commission was sidelined. The institutional makeup of the EU was not responsible for the limited success in securities markets integration. Its roots lay in competitive issues unique to the sector.

The role of finance in the launch of the single market project

Before the 1980s, the EU had achieved little financial market integration (Nicoll 1993). The First Banking Coordination Directive, adopted in 1977, granted EU financial institutions the right to open branches throughout the Union (Story and Walter 1997: 14).¹² But due to the differences between national financial regimes, it provided banks with few incentives to Europeanize. The directive's effects on the industry were minimal.

In banking as well as insurance, most EU members were reluctant to comply with what market opening legislation required. Representing frustrated insurance firms, the British Commissioner Tugendhat initiated legal proceedings at the European Court of Justice against a number of continental EU members for their non-compliance in 1983 (Young and Wallace 2000). That same year, the Commission developed plans for a single market in financial services as part of a larger package. They had little immediate effect.

The real push for financial market integration came with the White Paper on the completion of the internal market, tabled by the Commission two weeks before the Milan

¹² Council Directive 77/780/EEC

Council in June 1985 (European Commission 1985a). Financial services played a minor role in the White Paper compared to many industrial sectors. This was even more the case for securities markets than for banking and insurance. For the 1987-1992 period, the White Paper suggested only one legislative project in the field: a directive concerning investment advisors (European Commission 1985b)—a field that turned out to be peripheral to the push for integrating capital markets over the next two decades (Fisher 1988). The selling point of the single market vision was the building of a coherent economic space for the production and consumption of goods. Financial services mattered primarily insofar as they were conducive to this project.

Most scholars of the single market project agree that giving large corporations the space to organize their operations on a pan-European basis was central to the 1992 endeavour. Disagreement centres on the relative importance of different groups of actors: Sandholtz and Zysman have emphasized the ‘entrepreneurial’ role of the Commission, and how it could suddenly sell a long-time favourite—the single market—as the solution to Europe’s economic problems, particularly rising unemployment (Sandholtz and Zysman 1989, cf. Young and Wallace 2000: 91f). The Commission proposed pan-European industrial restructuring in key sectors as an answer to the industrial rise of Japan. It was aided by a ‘transnational industry coalition [that] perceived the need for European-level action and supported the Commission’s efforts’ (Sandholtz and Zysman 1989: 96, Dinan 1999: 111ff).

Cowles has focused even more narrowly on support from industry, particularly through the European Roundtable of Industrialists (ERT, see Cowles 1995). In her reading,

business leaders from the ERT largely were responsible for relaunching and *setting the agenda* of the single market programme in the early 1980s. (Cowles 1995: 503, emphasis in original)

The evidence presented by Cowles and van Apeldoorn shows how the single market idea was ‘alive’ within corporate circles before 1985. Again, both identify ‘competitive threats’ from

American and particularly Japanese producers as key factors (van Apeldoorn 2002: 123f).

In a nutshell, top European corporations wanted to exploit the economies of scale a single market would offer. In doing so, they pushed for the same kind of market re-organizing that this thesis argues happened in securities markets a decade later (see also Fligstein and Mara-Drita 1996).

Departing from a perspective at pains to emphasize ‘national preferences’ in European integration, Moravcsik’s argument on the 1992 project and the Single European Act also stresses the (perceived) imperatives emanating from the restructuring of the global economy:

[N]ational preferences primarily reflected economic interests, and in particular increasing global and regional trade and investment, which exacerbated concerns about international competitiveness. (Moravcsik 1998: 318)

In his subsequent analysis of these ‘national preferences’, the core factor is domestic industry support in the face of common ‘competitive threats’ and perceived transnational opportunities. Thus, regardless of their differences, scholars agree that industry support for the project was crucial—whether it made itself felt domestically, in transnational policy coalitions or as the avant-garde of a transnational capitalist class.

To some degree, financial market integration was subordinated to market integration in the interests of big industry. As Moravcsik found, ‘deregulation in financial services [was] not initially the central part of Cockfield’s White Paper’ (Moravcsik 1998: 336). In transnational as well as domestic political contexts, banks and especially securities houses were not overly enthusiastic. Indeed, one of the earliest integration efforts in wholesale investment services came from the ERT when it set up the European Venture Capital Association to fund pan-European industrial projects in 1984 (Cowles 1995: 508).

In setting the *general* agenda—including integration of European financial services and particularly investment banking—well-established national policy communities for financial services played minor roles. It was only when work on individual directives began that they reasserted themselves. In this sense, the ignition of the integration process in finance came from

outside the political space whose inner dynamics were later to determine its direction. Because this external impulse did not fall on particularly fruitful ground within the inner circles of financial market politics, integration remained incomplete.

More efficiency in European finance?

The broad aims of the 1992 project [in financial markets] were fairly straightforward: they were to boost the effectiveness and efficiency of European economic activity through the easing of barriers to market processes. (Leyshon and Thrift 1997: 95)

With the benefit of hindsight, the picture was more complicated. In particular, Leyshon and Thrift do not adequately differentiate between the integration of the market for financial *instruments* (including currencies) and the market for financial *services*. In practice, most financial instruments are difficult to obtain without an ancillary financial service (for example brokerage) so the difference may seem irrelevant. But the distinction becomes important in assessing alleged policy goals. Whereas policymakers profess to be concerned with optimizing markets so that financial *instruments* are priced ‘correctly’, financial institutions are much more interested in the prices of the *services* they sell. The two objectives can be at odds. Take, for example, stock markets: the ‘efficient’ pricing of shares might warrant concentration of their trading in one exchange whereas the efficient pricing of trading services would warrant competition between different exchanges. So what does ‘more efficiency’ in financial markets refer to—the instruments or the services? This under-appreciated distinction continues to haunt financial services integration by allowing actors to call for outright contradictory policies in the name of increased efficiency. What is clear is that as the baton was passed to members of established policy communities, concern over the price of *services* came to overshadow concerns over the efficient allocation of capital and the pricing of financial *instruments*.

Most of the studies that tried to quantify the single market’s economic benefits in the second half of the 1980s were ambiguous on this point (Tsoukalis 1997: 68ff), combining ‘static effects’—largely one-off ‘welfare increases’ through price cuts resulting from trade

openness—with ‘dynamic’ ones (Egan 2001: 46ff). In the long run, the second category was supposed to be much more important: the increased efficiency of production that was to result from the restructuring of European industry, the exploitation of economies of scale, and lower X-inefficiencies thanks to higher ‘competitive pressures’.

It was in these dynamic effects of integration that financial services gained prominence within official accounts of the single market. For example, the so-called Cecchini Report (Cecchini 1988)¹³ estimated that the economic benefits from the financial services sector could be up to a third of the total benefits from the single market project as cheaper capital would benefit all sectors (Leyshon and Thrift 1997: 83). Other studies tried to estimate price decreases from heightened competition. The widely quoted Price Waterhouse study, for example, calculated that integration would save consumers between 0.3 and 1 per cent of EU GDP on spending on financial services (see also *The Economist* 1988). Some observers shared this optimistic vision while others remained sceptical (Grilli 1989, N. Walter 1989), wondering how the spoils would be distributed—something about which most studies had little to say (Tsoukalis 1997: 71).¹⁴

In any case, while integration enthusiasts trumpeted the economic gains to be derived from financial market integration, they failed to impress all of the parties negotiating the single market for investment services. Once discussion turned to details and core policy communities became involved, overall ‘integration logics’ receded to the background—never mind the abstract ‘Costs of Non-Europe’. As the following sections will show, considerations over the competitiveness of national financial industries trumped all other issues. But before we turn to the negotiations, we need to understand the broader ‘legislative environment’ in which they took place.

¹³ Strictly speaking, the Cecchini report was a privately written study. Having been commissioned by the European Commission and arguing its case, it became closely associated with the latter. Other important publications also focused on these dynamic effects, e.g. *The Costs of Non-Europe*.

¹⁴ As it turned out, the sceptics were right; hardly any of the projected gains materialized. See Gardner et al. 2001.

Edging towards a single securities market—capital movements and other prerequisites

Once the Council endorsed the single market project in June 1985 and member states, in a radical departure, ratified the Single European Act in early 1986, the European political apparatus started to digest the roughly 300 legislative measures the 1985 White Paper had suggested. Out of the legislative flurry that ensued, two measures are particularly relevant for understanding securities markets politics: the directive that liberalized capital movements and the Second Banking Coordinating Directive (2BCD).¹⁵

The Capital Movements Directive showed that governments were in principle willing to move towards a European financial area. This excludes general obstinacy as an explanation for the modest achievements. The directive was to abolish limits to capital flows and was agreed by the Council in June 1988.¹⁶ Member states were given a mere two years to comply, while some poorer ones plus France and Italy were treated more leniently (Story and Walter 1997: 20). Considering how capital mobility could interfere with national economic policy, the most remarkable aspect of this directive was that it was adopted at all.¹⁷ Surely, if governments could agree on something so fundamental that conflicted with ‘economic sovereignty’, more mundane questions of cross-border services provision should not pose insurmountable obstacles? The directive on the free movement of capital showed just how far governments in principle were willing to go. As the second half of this chapter shows, however, the conflicting competitive interests of national market incumbents blocked any far-reaching agreement.

The 2BCD, concluded in 1989 after less than two years of negotiations, had serious implications for competition in investment services.¹⁸ The 2BCD applied to credit institutions the

¹⁵ Two other directives were concluded in the field of securities—the Insider Trading Directive and the Prospectus Directive. The latter is inconsequential for our case; the former is more interesting. German recalcitrance (which had lasted for years) was broken when the banks started to fear the reputational damage Frankfurt might suffer from continued embarrassing discussions. Because it does not directly bear on the ISD and CAD negotiations, we will come back to it in our discussion of national policy change in chapter six. See McCahery 1997, Lütz 2003b: 139f.

¹⁶ Council Directive 88/361/EEC.

¹⁷ Some countries, notably Germany, the UK and the Benelux countries, already had a fairly permissive regime for cross-border capital flows. But even for them, abandoning national discretion on the matter was a novel departure. Cf. Williamson and Mahar 1998.

¹⁸ Council Directive 89/646/EEC.

mutual recognition approach that had become central to constructing the single market (cf. Egan 2001: 109ff). From the envisaged implementation date, 1993, a banking licence issued by an EU member state would function as an EU-wide ‘single passport’. It would allow financial institutions to carry out functions they performed at home throughout the EU. In negotiations, Germany had pressed particularly hard to make sure that the capital market business would be included in its purview (Interview 030406). In effect, the resulting directive gave German and French universal banks the right to engage in just about everything except insurance on a pan-European scale (Underhill 1997). For investment business, the 2BCD had shifted the terms of competition among specialist securities houses and universal banks decidedly in favour of the latter.

From the perspective of our framework, trouble-free agreement on pan-European market access for banking business proper would be surprising. Were there no competitive concerns for the firms involved? There were, but they had already been addressed. To begin with, effective European competition in retail financial services had never been particularly likely for numerous reasons: customer loyalty, the role of publicly owned financial institutions such as savings banks and cooperatives, the need to build up new branch networks, cultural differences, etc. (and it did not materialize up to this day, see European Commission 2007b). In terms of potential for pan-European competition, this left wholesale banking.

One central cost factor—and hence competitive issue—revolved around the reserves that banks had to set aside. Just as negotiations on the 2BCD began, central bankers reached international agreement on this question in the Basle Committee on Banking Supervision (BCBS) (Wood 2005). The Capital Accord, as it became known, defined both minimum standards for how much capital banks needed to set aside and how this capital would be calculated. EU negotiators only had to transcribe these provisions into European law in the Own Funds

Directive and the Solvency Ratio Directive.¹⁹ Compared to securities, banking proved an easy nut to crack: the core competitive issues had already been solved through other means (wholesale banking) or were unlikely to arise in the first place (retail banking).

The 2BCD gave continental universal banks free access to European securities markets (Underhill 1997: 111). Because it only applied to credit institutions, this right did not extend to the securities houses and investment banks that dominated the City's markets, both British and American. British negotiators had consciously detached the regulation of securities houses from banking negotiations in order to keep a tight grip on the former (Interview 230306.b). In hindsight, they miscalculated (Nicoll 1993). Separating banking (where continental member states were strong) from securities markets (where London was the undisputed leader in Europe) backfired. Once continental universal banks had secured pan-European access to securities markets, they had little to lose in later negotiations on investment services (Interview 020506). To be sure, calibrating the competitive balance between banks and non-banks within securities markets was only one of the two issues that came to dominate negotiations. But this competitive 'overhang' from banking sector legislation helps account for both the negotiations' difficulties and the British determination to reach a deal. The deal took another four years to reach.

Negotiating an European market in investment services

When negotiations began in 1989, the UK securities industry was busy digesting the impact of the Big Bang and the Financial Services Act. That said, it is too easy to let the changes overshadow the continuities. While ownership structures, business models and regulatory structures had indeed changed (Moran 1991, Augar 2000), the international importance and future ambitions of the City remained (Bindemann 1999). In the late 1980s, the City looked as if it was simply getting better at what it had been doing for almost four decades—attracting securities business from abroad (Burn 1999). The SEAQ International trading system was but its latest success.

¹⁹ Council Directive 89/299/EEC (own funds) and Council Directive 89/647/EEC (solvency ratio).

The previous chapter argued that while the institutional and policy links between public actors and the financial services industry were relatively weak in the UK, the government was committed to the City as a place of financial service provision. In this respect the government was more concerned with the ‘attractiveness’ of the City as a place to do business than was the case in either France or Germany.

In pushing for the interests of the City’s financial services industry, two core constituencies eventually rallied behind the British government: American (i.e. non-bank and non-EU) investment banks and smaller, (still) independent securities houses that had traditionally been the core of the City’s industry. Continental European banks, in contrast, tended to form alliances with their home governments—regardless of the fact that they had become important City players in their own right. The ‘national’ divisions running through the industry thus prevailed, and were clearly reflected in the intergovernmental character of the negotiations.

In France, impending EU negotiations intersected with a pro-active domestic reform programme; strategic considerations were thus central in the French government’s approach. In contrast, the Thatcher government had championed deregulating European services markets for years, not least to allow the ‘competitive’ British services industry to make headway on the continent. At the same time, it had little use for ‘positive integration’, actively using ‘Europe’ to achieve specific policy goals. Deregulation was part of the Thatcher government’s *programme* but it—as well as European financial market policy as a whole—was not embedded in a government *strategy*. France was different: European integration was perceived as allowing both market restructuring and continued public control. The French reforms had anticipated European integration, seen for example in steps towards loosening capital controls and restructuring the brokerage industry. French goals in the negotiations reflected reformers’ ambitions: anchoring the universal banking model in Europe (achieved with the 2BCD), preserving the competitive position of French financial institutions (still state-dominated at the time) and consolidating the position of Paris as a financial centre. This last point united the

preferences of French financial institutions—their fate, it was perceived, was tied to that of Paris—and those of policymakers who wanted to keep as much financial market activity as possible under the public eye.

In its approach to 1992, Germany found itself between France and the UK. German universal banks had embraced the single banking passport that extended to securities markets. For them, this was a major victory. But due to their relatively strong position in the British markets, German banks were reluctant to call for excessive protectionism within the European financial area. In the end, they came down in favour of ‘laissez-faire’ market integration. Nevertheless, the impending negotiations presented an opportunity to push for advantage. Germany saw its banks locked in a battle with smaller British firms over ‘levelling the playing field’, and pushed for higher capital adequacy requirements—for all financial institutions, irrespective of where services were produced or provided. The French dispute with the British, in contrast, focussed on where services would be provided. While competitive struggles were at the root of both disputes, they showed that French banks remained more wedded to their home markets than their German counterparts.

The Capital Adequacy Directive in global perspective

As an observer who was relatively close to the negotiations around the ISD and the CAD, Philip Brown once remarked that ‘any full history [of the negotiations] would require a combination of a CD-ROM and a three-dimensional chessboard’ (Brown 1997: 128). Alas, Brown’s assessment was probably too optimistic. It already seemed a fair appraisal of events in the EU arena. But while EU member states were busy negotiating the provisions for the single market, no less than four other international forums were busy devising rules—the International Organization of Securities Commissions (IOSCO), the so-called Barnes Committee of the Basle Committee for Banking Supervision, the so-called ‘Hexagonal’ talks between the UK, the US and Japan, and a European securities regulators group convening independently of the EU single market talks

(Waters 1990, P. Lee 1992). The resulting mess was reminiscent of more than a dozen actors playing chess on five boards simultaneously, with different rules governing each game.

Though EU negotiations were embedded in global developments, focusing on the competition politics of negotiating capital adequacy provides us with a relatively clear picture. Two arenas can be distinguished: EU and global financial markets. For the first, negotiating common rules was a *sine qua non* for issuing a pan-European ‘passport’ to securities firms. The CAD was to provide the minimum harmonization upon which mutual recognition (in the ISD) would be built. This provided incentives for players expecting to benefit from pan-European market access to keep negotiations alive.

This link between common minimum standards and mutual market access was absent at the global level (in IOSCO and the Barnes Committee). Internationally, negotiating capital adequacy rules is a zero-sum game: as competitive advantage is always relative, some players gain while others lose. With the additional transaction costs it would entail (for negotiating and implementing and monitoring standards), and without mechanisms for coercion, agreement appeared unlikely. In the case of capital adequacy standards for banking (Basle), there was still the ‘public, common good’ of allegedly greater systemic stability through agreement (Kapstein 1992). A competitively neutral regime that had something for everybody through higher system stability thus created a theoretical win-set. Even then, it took some arm-twisting by the US and the UK to force others into agreement (Nabors and Oatley 1998).

In securities markets, the ‘systemic stability’ incentive was considerably smaller. If caught in a falling market with illiquid positions, securities firms might falter and cause disruption. Compared to bank failures, however, the impact would be limited. The 1987 stock market crash had led to the failure of some securities firms, most prominently Tuffier & Associés and Drexel Burnham Lambert. Any wider effects, however, were limited (Bush 1990, Graham 1990). Trying to follow the Basle example in securities was bound to be an uphill struggle; it was surprising that it took IOSCO members four years to conclude that compromise was out of reach. That they

kept negotiating had much to do with the awkward three-level constellation within which capital adequacy was discussed.

The core problem in the negotiations around capital adequacy for securities operations was that firms engaged in them had different business models and hence different regulatory preferences depending on how rules influenced their competitive position. The main divide ran between banks and non-bank securities houses (Waters and Kellaway 1990, Underhill 1997). Firms in the securities business are normally required to maintain capital reserves to cover risks associated with market crashes, company failures, settlement problems, etc. Two questions ensue: how should the capital required for a specific market position be calculated? And what counts as 'capital' in the first place? Only equity, or subordinated debt as well?²⁰ These questions matter to firms because capital is a cost factor and affects their profitability. Capital needs to be serviced, in the simplest instance through the payment of dividends to shareholders. In addition, stringent capital adequacy rules might force companies with stretched reserves to unwind securities positions in an unfavourable market environment to stay within the mandated limits (Filipovic 1997: 184). Such rules would thus act as a deterrent for small firms to assume larger risks, and thereby 'tilt' the playing field against them.

The securities business was conducted under the auspices of two different regulatory regimes. On the one hand, universal banks, for example in Germany, were regulated by banking authorities. The rules for how much capital they needed to put aside to cover the risk from their securities operations was an integral part of the rules governing banks. In addition, most universal banks could use a single pool of capital to cover exposures in both their credit and securities businesses. On the other hand, non-bank securities firms—'pure' brokers and investment banks offering a wider range of services—were covered by rules specifically devised for capital markets. In the UK, the required level for capital cushions was rather low, not least due to firms' small

²⁰ Subordinated debt leaves the creditor with fewer rights to recover the principal in times of distress, allowing the debtor company to use the money to service other liabilities first. In return, subordinated debt generates a higher yield for the creditor.

average size and the sector's history of self-regulation. Securities firms thus tried to influence 'their' governments to push for standards that would skew the terms of competition vis-à-vis the banks in their favour. The banks tried to do exactly the opposite.

The IOSCO negotiations well illustrate this (Filipovic 1997: 141ff). In 1989 its most powerful body, the Technical Committee, which brings together securities regulators from the core global markets, tabled a report on 'Capital Adequacy Standards for Securities Firms' at IOSCO's annual conference in Venice (Waters 1989a). At the eleventh hour, the German delegation withdrew its support for the text, claiming that the deal 'could possibly damage the vital interests of German banks'. The most contentious issue was the treatment of subordinated debt as capital and whether amounts thus recognized should be limited (Filipovic 1997: 183). The Germans—indirectly supported by other countries with universal banks (France and Switzerland in particular)—desired tight ceilings to limit capital-scarce investment firms' ability to 'leverage' their core capital in the short run.

The German representatives at the negotiating table, however, were not government regulators in the proper sense, but representatives of the Federation of German Stock Exchanges. The stock exchanges, as pointed out in the previous chapter, were controlled by the large Frankfurt banks. The regulated themselves were thus making foreign regulatory policy, and left little doubt about their own stake in it. German public actors were involved only *post hoc* to back the positions of private actors (Simonian 1989b). The cracks in intergovernmental imagery now become evident: the German government was taking a strong position on the international stage but the underlying conflict was actually a 'private' one. In the event, the German Federation gave in to the report's publication on the condition that further negotiations would follow quickly and that the conference made clear no agreement had been reached (Waters 1989b). The German

finance ministry and the Bundesbank publicly backed their clientele less than a week later, again citing unpalatable competitive implications.²¹

Industry interests were clearly perceptible within the British delegation as well. As Filipovic found,

[t]he [Securities and Futures Authority] maintains close links with its membership, to a degree beyond that of most regulators in other countries. This is especially the case when it come to concrete issues of great salience. For example, commenting on the EC proposal for a Capital Adequacy Directive, the SFA International Capital Committee ... “attached considerable importance to consultation with the membership, and the Chairman of the Committee wrote to all firms on two occasions to inform them of the developments, to highlight issues of concern and to solicit their views”. (Filipovic 1997: 141)²²

The self-regulating members of the SFA, acting as a branch of the SIB, were again sitting more or less directly at the negotiating table. The failure of the 1989 conference was directly attributable to irreconcilable private interests. After the collapse, IOSCO’s technical committee made practically no movement on the issue for three years. As will be seen below, the revival of negotiations in 1992 was short-lived—a prelude to their final breakdown.

Competitive struggles between securities firms and banks equally dominated CAD negotiations in the EU arena. The conflicts were broadly similar, and led to stalled negotiations after 1989. In contrast to IOSCO negotiations, however, the promise of effective market integration gave parties an incentive to keep going. The Investment Services Directive was to provide non-bank securities houses with the pan-European passports that banks had won with the 2BCD. In the words of Sir Leon Brittan, EU Commission Vice President in charge of financial institutions, the CAD was to be ‘the key that [would] unlock the ISD’ (P. Lee 1992).

²¹ Less than two months later, Rolf Breuer, Deutsche Bank board member, publicly deplored the lack of public authorities to represent Germany at forums such as IOSCO. The reason he gave was to better secure ‘German’ (banks’) interests. The call for ‘public intervention’ came from private actors first, for they feared the competitive implications of rule-making where private representative bodies lacked the weight to influence outcomes. Simonian 1989c.

²² The quote within the quote is taken from a SFA report.

The Investment Services Directive

The ISD was to enshrine ‘mutual recognition’ in securities markets regulation and provide securities firms with a single passport (Ashall 1993, Steil 1993: 22ff, Brown 1997, Story and Walter 1997, Underhill 1997, Steil 1998). In theory, the ‘levelling [or rather: calibrating] of the playing field’ through ‘minimum standards’ was to happen through the CAD. But in practice it was not simply a question of one directive building upon the other. Rather, the ISD was used to settle additional competitive issues, of which two stand out: the question of on- and off-exchange securities trading and the application of conduct-of-business-rules (CBRs) by host rather than home authorities.

The German camp had tried to exact a price for the single passport in the form of tough capital requirements for non-bank securities firms. Their strategy reflected specific German market structures: many of the financial institutions advocating regulatory protectionism were already well-established in the City (Deutsche Bank, the most prominent example, had moved its investment banking headquarters there in 1984). The perceived need to ‘update’ Frankfurt to repatriate or retain business was thus balanced by German banks’ stakes in well-established London markets—so long as they would be allowed to operate there under advantageous conditions. The point was not that foreign firms were per se unwelcome in Germany. But the German finance ministry was clearly worried that foreign ‘financial engineers’, as one respondent working for the German government at the time put it, would swamp the domestic industry (Interview 020506).

The French position was less ambiguous. Furthering the interests of French banks almost fully coincided with boosting Paris at the expense of London. At French insistence, a ‘concentration principle’ was inserted into the ISD that basically allowed countries to oblige its residents to trade domestic securities on ‘regulated exchanges’. The aim was to repatriate the trading of French securities from London’s ‘unregulated’ SEAQ International market, where almost a third of it had migrated. Here the French were supported by the ‘Club-Med’—a group

of southern European countries including Italy, Portugal, Belgium, Spain and Greece (*The Banker* 1991). Their motivation was similar to that of France: preventing the exodus of share trading to London.

Wedded to the 'concentration principle' was another provision aimed at London's markets: the French insistence on 'transparency' in trading. As discussed in the previous chapter, block trading in particular had migrated to London because lower transparency requirements made it easier for dealers to liquidate large swaths of shares without adversely affecting market prices. Unwilling to go down the same road themselves, the French insisted on raising price transparency requirements throughout the EU to thwart SEAQ trading practices. London's financial community, unsurprisingly, was unhappy with the proposals. The British Merchant Banking and Securities Houses Association (BMBA) for example took a very 'liberal' position on the ISD and pressed for 'a flexible approach for information disclosure and publication of trade details on behalf of market-makers' (Filipovic 1997: 129). As with the concentration principle, the German position was closer to that of the British than the French (Waters 1991b, Ashall 1993: 99). This reflected the dominance of the big banks in the German securities business, whereas in France a separate brokerage industry still existed.²³ In addition, German banks were quite active on the SEAQ. In contrast to the French, they faced no opposition at home from a host of smaller financial institutions excluded from the lucrative SEAQ business.

The final major point of contention in the ISD concerned the principle of home country supervision. The idea was straightforward: to facilitate cross-border business operations and to relieve firms of having to report to two (home and host) authorities, home authorities should perform the supervisory function for the financial group as a whole. In combination with the mutual recognition principle, this was to make most dealings with the host authorities unnecessary after initial registration. Fearing the interference of foreign governments with cross-border business, the BMBA early on supported the home country control principle (Hutton

²³ Large institutions are generally better equipped to engage in the relatively risky business on the SEAQ, particularly when large positions that cannot be 'netted' or 'hedged' for regulatory purposes are involved.

1989, Riley 1989). In the name of protecting national investors, the French disagreed. At least retail investors, they argued, needed to be protected by host country rules lest they suffer from excessively loose regulation in financial firms' home countries. With all these conflicting interests, both 1990 and 1991 saw practically no movement in the negotiations.

The bargaining positions of the different parties reflected the interests of the most influential coalitions in their national financial industries. *Euro money*, one of the industry's leading magazines, reached the same conclusion in 1992:

[T]he capital adequacy directive for securities firms is not really about prudent regulation, or level playing fields. It boils down to vested interests trying to skew the regulations to obtain a competitive advantage. (P. Lee 1992: 33)

When the Commission submitted a revised version of the CAD in 1992, it admitted as much when it explained that 'amendments [had been] made to achieve more equality in the treatment of credit institutions and investment firms' (Filipovic 1997: 184). It was an acknowledgement that fine tuning this balance was what the legislative process was all about.

The regulatory protectionism dominating the negotiations was far from erratic or haphazard. In the first instance, it mirrored competition politics—made more virulent by the close ties between private and public actors. Chapter three highlighted the correlation between the embeddedness of financial markets in national economies, the institutionalization of links between public and private actors and relative protectionism in financial market policy. The influence of private-public coalitions on the negotiations merely reinforced pre-existing tendencies.

It was no accident that the French government intervened so vehemently on behalf of its industry. Protectionism and close public-private links were two sides of the same coin—two aspects of what Underhill has called the state-market condominium (Underhill 2001, 2003). The liberal stance of the British government vis-à-vis foreign firms (i.e. the weakness of protectionist impulses) was likewise the flip side of its weak links with the British financial industry. We thus

return to one of the general arguments of this thesis: political institutions cannot be understood independently of the concrete politics they mediate. Over time, they are mutually interdependent.

In the event, EU member states' different regulatory structures and associational institutions made a big difference. Here the contrast between the regulators' club IOSCO and the intergovernmental structure of the EU is telling. In IOSCO, the City industry's interests were represented through the UK SIB, a respected securities markets regulator second in standing only to the SEC and in intense contact with the industry through the remnants of the self-regulatory system (Moran 1991). The informal character of self-regulation in Germany, in contrast, saw German banks fight a rear-guard action in IOSCO. Though sufficient to undermine agreement at the last moment, informal self-regulation made life difficult for the banks, regardless of ex post backing by the Bundesbank and the finance ministry.

Matters worked differently in the EU arena. Here German banks' informal ties with public actors proper (the central bank and the government itself) paid off because their interests were well represented from the start, not least in the negotiation of the 2BCD. In contrast, the self-regulatory structure the British securities industry had developed did little to help it push its regulatory cause, while the industry's comparatively weak ties to the British government, particularly the DTI, weakened its access to EU negotiations.

The embeddedness of financial markets and the importance of national regulatory systems for economic policy also made themselves apparent, though less than the competition politics themselves. As pointed out above, embeddedness affected negotiations through the ties that public actors in coordinated market economies had established with the financial industry. Governments sometimes invoked the 'public interest', for example to justify host authorities' retention of certain regulatory and supervisory rights vis-à-vis foreign firms. But such cases generally referred to 'public goods' like systemic stability or investor protection rather than to a nationally idiosyncratic approach to economic policy.

A European deal shatters global ambitions

Movement returned to the negotiations on capital adequacy for securities firms in early 1992. Surprisingly, the movement was initially within IOSCO rather than the EU (Waters 1992d). IOSCO members met with representatives of the Basle Committee on Banking Supervision to hammer out a deal (Waters 1992c) and reached basic agreement on almost everything, successfully amalgamating the different regulatory ‘philosophies’ that had often been evoked to justify disagreement. Only the all-important numbers remained in dispute: the precise ratio of subordinated debt to equity capital permissible for regulatory purposes and the amount of capital necessary to back up equity and other market risks.

On the former, the fault line ran between banking supervisors eager to limit subordinated debt-as-capital and securities market regulators (essentially the SIB and the SEC) who favoured more generous limits. The fault lines for the latter differed: a clear divide opened up between the SEC on one side (backed by the ‘universal bank lobby’, which like the SEC favoured high capital charges) and British and French regulators on the other (P. Lee 1992: 35). Traditionally, the SEC had required firms to hold sufficient capital to withstand firm-level ‘worst case’ scenarios; the British approach, in contrast, was concerned with disruption of the market at large and therefore required less reserves. On both subordinated debt and reserve levels, negotiators once again proved to be advocates of their domestic market incumbents.

While bickering over numbers in IOSCO and the BCBS continued, the EU finally scored a breakthrough. The Commission tabled a revised version of the CAD in May 1992 that fine-tuned the question of subordinated debt-as-capital by introducing a new category: ‘tier three capital’, consisting of short-term subordinated debt that would be treated differently from both equity and long-term subordinated debt (Waters 1992a). The precise numbers were to be decided later by the Council but the new proposal contained a general framework: both securities houses

and banks would have to separate their securities holdings and trading from the rest of their business in a 'trading book' for which the CAD charges would apply.²⁴

IOSCO negotiations now stalled as the potential EU deal gained in clarity. In particular, the SEC grew sceptical as the momentum at the European level excluded it—and the interests it represented—from the discussions (Waters 1992b). When Great Britain acceded to the EU presidency in July 1992, she was determined to end the standstill. UK negotiators managed to rally support for a Common Position on the CAD among all ECOFIN members by November. Agreement on a two per cent capital charge on gross securities holdings—acceptable to EU members—was far below the four per cent that Richard Breeden, SEC chairman, had always advocated. Now that the EU countries had locked themselves in through joint agreement, the SEC effectively withdrew support for the IOSCO-BCBS initiative (Corrigan 1992). The lock-in had decreased the EU's 'win-set' to such an extent that compromise in global negotiations was now impossible (cf. Putnam 1988). Indeed, less than half a year later—tellingly coinciding with the official adoption of the CAD in Brussels—IOSCO's attempts to reach a capital adequacy compromise were formally abandoned (Bacon 1993, Waters 1993).

Once the CAD was agreed, movement accelerated on the ISD as well. In fact, core aspects of the new 'Commission proposal' had been negotiated directly between the French and British delegations (Interview 030406). After the usual last minute bargains, it was finally adopted in May 1993 (for details, see Usher 2000). In the CAD, the problem had boiled down to numbers. Settlement was now reached with an approach where the capital reserves of firms with significant securities operations would consist of two 'building blocks'—two per cent for the gross positions and another eight per cent for the net positions (*Euromoney* 1992). In the case of the ISD, the most sensitive questions lay in definitions. What constituted a 'regulated market' for trading? The agreed definition saw the SEAQ on the edge of inclusion. The question of who

²⁴ This compromise meant that securities houses were to face bank-style capital charges on those parts of their operations that were not part of the trading book itself (for example foreign exchange liabilities and expected future overheads). Again, City firms were irate. See *Euromoney* 1992.

counted as a 'professional investor' was even more delicate. Market participants falling outside this designation would come under the control of host authorities, who were left free to establish rules for firms operating in their jurisdictions; the principle of home country supervision and mutual recognition of home country rules could thus easily be fudged. And with a 'professional' in the field of investment services left undefined, a legal patchwork was poised to persist. While home country supervision was the official rule, "[member] states ensured that the balance tilted in favour of host country supervision" (Story and Walter 1997: 266). McCahery has argued

that the mutual recognition approach to co-operative regulatory control is unlikely to be effective unless member states pursue similar policy interests. (McCahery 1997: 70)

This, however, was not the case.

The implementation date for the ISD was stretched far into the future. January 1996 was the deadline only for those countries that had supported relatively open markets to begin with. France, Spain, Italy and Portugal only agreed to the ISD on the condition that they be granted several more years before they would have to accept 'single passports' (Steil 1993: 23). Writing in 1993, Steil aptly summed up the thrust of the negotiated results:

Not surprisingly [...], several key sections of the ISD are political compromises reflecting the determination of member state governments to protect their domestic industry's competitive position, rather than provisions for ensuring a stable and efficient European financial market. (Steil 1993: 22)

Conclusion

What does all this reveal about European integration and the relationship between market integration and levels of governance? On the surface, negotiation dynamics resembled liberal intergovernmentalist patterns. The success of negotiations depended on national governments, while intergovernmental dissent—despite the Commission's eagerness to see negotiations advance—stalled progress for several years. The prospect of overall welfare gains as identified in

the 1985 White Paper (European Commission 1985a) and the Cecchini Report (Cecchini 1988) did not carry sufficient weight to elicit agreement.

Yet liberal intergovernmentalism tells us little about the underlying social forces at work. Moravcsik's questions predetermine his answers: the focus on intergovernmental politics, not surprisingly, analytically privileges intergovernmental politics. Such analysis, however, misses the underlying conflict. National governments acted as agents. The interesting question concerns their principals. Moravcsik (1997) himself has acknowledged that far from being given, 'national interests' are the outcome of domestic politics. But the image he invokes—of national positions formulated through domestic deliberation—is misleading.

Capital market politics were not a case of top-down consultation (the state aggregating the opinions of its constituencies), nor is it a case of bottom-up public debate. The distance separating the organized interests of the financial industry and the public actors articulating them was less than Moravcsik's imagery suggests. Through more or less explicit industry self-regulation (Germany and the UK), or the state functioning as majority owner of large financial institutions as well as regulator (France), the financial industry's interests are 'built into' what from the outside appears as 'the state'. Banks are insiders in the respective policy communities, not just one stakeholder among others.

In addition, their interests have had a clear transnational dimension. Preferences expressed as 'national positions' have been the result of competitive struggles that transcend national and, as the role of the BCBS and IOSCO showed, even European borders. In the trade-off between effective market integration and regulatory protectionism, many actors chose the latter. Nevertheless, financial markets—notably the Euromarkets—were much more integrated than the international politics of European financial market negotiations suggest. Governments did not act as interfaces between sheltered domestic political processes and international policy coordination. The intergovernmental character of the negotiations can be attributed to the constellation of interests within European securities markets—and not to their taking place in a

world that conforms to the axiomatic division between the domestic and the international that intergovernmentalism as a theory is built on.

Put differently, the specific structure of the struggle over the terms of competition—waged on a transnational plane—was responsible for the intergovernmental character of EU capital market politics. This intergovernmental character was the *dependent* variable, and can be attributed to the overall politico-economic constellation—what we have called the ‘international constellation’. This ‘international constellation’ combined: (1) financial markets still fragmented along national borders, (2) political institutions converging around government apparatuses, and (3) strong ties between financial markets and national ‘varieties of capitalism’. As the previous chapter argued, these three dimensions had co-evolved historically—even if the increasing internationalization of financial markets was starting to unravel the links between them.

Once the CAD and the ISD were concluded, it was up to governments to implement the measures they had agreed—which they proved reluctant to do. Nevertheless, the agreed changes set in motion a further ‘Europeanization’ of market structures. Those actors who had hoped for more far-reaching market integration in the first place did not have to wait for the ISD’s lengthy implementation period to pass. As European capital market structures shifted throughout the 1990s in response to the strategic reorientation of many market incumbents, pressure was building for a second round of market integration—one that would generate not only detailed agreement on supranational rules, but a new institutional framework in which governments surrendered significant elements of national control over capital market regulation. How this happened is the theme of the chapters to come.