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

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CHAPTER 5: REVISITING THE 1990S CAPITAL MARKET REVOLUTION IN EUROPE

The face of European finance was transformed in the 1990s. Continental European equity markets moved from the fringes of national economies into the limelight. Banks previously focused on their domestic markets began to build cross-border investment banking empires. Stock exchanges were transformed from members-only clubs into for-profit companies. This chapter explores the relationship of these changes to the supranationalization of EU capital market governance.

On the broadest level, this thesis argues that in ‘competition politics’ the evolution of market structures, the business strategies of leading firms, regulatory policy and patterns of governance are mutually interdependent. This chapter addresses a specific part of this larger feedback loop: the co-evolution of market structures and the business strategies of core (investment) banks in Europe in the 1990s. While the behaviour of financial firms is commonly depicted as adaptation to changes in their environments (e.g. R. Smith and Walter 2003), changes in (macro-)market structures not only *cause* change in firm behaviour—they *result* from them as well. In a market dominated by a dozen (investment) banks, changes in their behaviour will translate into altered market patterns.

In highly concentrated markets, firms do not confront ‘market structures’ as something external to them. Rather, the *strategic* behaviour of core firms plays a central role in structuring markets and explaining core changes in them. The first part of this chapter therefore takes issue with the view that market evolution ‘determined’ adaptation in firm behaviour. It would be more accurate to say that the changes firms perceived or anticipated in their environment inspired (further) modifications of their business strategies. In addition, changing market structures bore the impression of both national and European-level regulatory reforms of the preceding years—reforms in which firms themselves had been strongly involved. Market changes were thus not ontologically prior and exogenous to the reorientation of national market incumbents, which was

later to translate into further pressure for regulatory and institutional change.

This chapter goes on to explain the internationalization of capital market business throughout the 1990s. This cross-border expansion of firms was both a response to and an anticipation of further opportunities as international capital markets grew in size. In addition to past regulatory reform itself, European universal banks were inspired by US competition and the decline of profits in the traditional lending business to internationalize and amplify their capital market operations. For the American investment banks, this was an extension of existing strategy; for most continental firms, it was a major reorientation. The new business interests were most apparent in the resources invested by continental firms to expand their international investment banking operations.

Given its focus, this chapter in principle lends itself to the use of quantitative data. But as the next section argues, the available data has serious limitations. The following sections then address changes in German and French capital markets, the main factors behind their rise, the Europeanization of the investment banking industry, and a specific development in EU capital markets relevant to contemporary politics: the demutualization of stock exchanges. Regulatory changes were crucial in all of these developments.

Measuring change in EU investment banking markets

This chapter considers the relationship between three factors: macro market structures, business strategies and regulatory change. Data on the first two are less reliable than may appear at first sight. How do we, in hindsight, identify the business strategies of firms? Documents produced by the firm at the time may seem the answer but annual reports and other public pronouncements of corporate strategy have their shortcomings. The image they provide of firms' strategies may be distorted by their aim to please investors. If European investment banking is the fashion of the day, managers may wish to score easy points by declaring it a priority regardless of their true intentions.

Annual reports, with their numerical overviews of business activities, contain potentially more relevant data. For example, the relevance of international versus domestic business and capital market versus traditional banking activities might be measured by their contribution to the firm's overall profits. Such measures, however, are a weak proxy for corporate *strategy*. After all, entry into new market segments identified as strategic priorities are normally costly—they initially generate little revenue. It is the *expectation* of profits that motivates firms to enter new markets, not their immediate realization.

In addition, firms differ both in the manner and the level of detail with which they report their capital market operations. They may employ different criteria depending on where their cross-border financial services are 'booked'—abroad or at home. International differences in both taxation and accounting regulation are likely to affect figures. Accounts are rarely sufficiently detailed to distinguish business segments with volatile profits (particularly proprietary trading) from others such as underwriting or brokerage. In sum, strategy announcements and operational data are not fully reliable as sources for determining corporate strategy.

Finally, time inconsistency—organizations may be motivated by their expectations of the future as much as by events of the past—complicates the task of identifying *causes* for changes in corporate behaviour more generally. For example, firms may anticipate regulatory reforms and buy into a new market before new laws come into effect. In spite of the timing, one could still argue that legal changes triggered the change in behaviour.

For aggregate macro data, the picture is also bleaker than one might suspect. Quantitative measures for all aspects of banking markets are aplenty. For example, OECD data on credit businesses have their own NACE category, allowing systematic exploration of the sector's profile over time. But no such thing exists for various aspects of investment banking. In data collections using the NACE industry categorization, they are likely to be lumped under 'Other monetary intermediation'. Eurostat, the leading institution for comparative data on the EU, only has financial services data for 'credit institutions', 'insurance services' and 'pension funds'. Capital

market services do not appear as a separate category.²⁵ The absence of useful macro measures for the development of the investment banking *industry* (as opposed to capital markets, see below) explains the dearth of studies in this field, particularly quantitative ones. Again, much has been written about banking proper, but next to nothing about investment banking.

Macro measures of developments in markets for specific financial instruments offer a mixed picture: obviously, data on the issuance, stock, valuation and trading of particular (kinds of) securities are widely available, most obviously in the form of time series for stock market indexes such as those published by the Bank for International Settlements. Data on financial *services* provision is more difficult to come by. There is no agreement on what constitutes cross-border financial service provision, and how firms should treat it in their corporate accounts (OECD 2000).²⁶ National accounting systems differ to such an extent that international comparison is hampered. For example, French figures for trade in financial services in the early 1990s are widely seen as unrealistic and unreliable.²⁷

Valid and reliable measures of that holy grail of single market policy—market integration—are even more difficult to find. The strategy commonly used by the European Commission is to compare prices for similar products throughout the Union. However, international price differentials are influenced by numerous factors that are difficult to separate analytically. In wholesale finance, banks typically supply several services to their clients simultaneously. Even when available, the ‘price tags’ for individual services may not reflect the true internal cost calculations of banks. Apart from the most commodified services, products are often too complex to compare. And when prices decline for these commodified services, for example brokerage or underwriting, it is likely the result of commodification itself rather than

²⁵ This applies to most stylized comparative overviews as well as to generalized comparisons of the ‘trade openness’ of European countries in these service sectors. Gjersem’s OECD working paper, to give only one example, has measures for trade openness in banking (that is, credit) and insurance services only. See Gjersem 2003: 12.

²⁶ On how ‘trade in services’ defies established notions of territoriality—and thereby also measurement systems based on them—see Ruggie 1993. Ruggie approvingly quotes Jagdish Bhagwati who suggests dropping the notion altogether. See Bhagwati 1987.

²⁷ In the relevant OECD publication, readers are cautioned that the figures appear anomalous. See OECD 2000: 28. In the corresponding WTO publication, they are simply omitted. See World Trade Organization 1997: 13.

international market integration. After all, sophisticated firms that use cutting-edge services to generate profits use ‘cheap’ off-the-shelf products to squeeze their smaller competitors out of the market. Thus even where reliable and comparable price data are available, they are not a particularly valid proxy for market integration. The first serious attempt to generate an encompassing picture of market integration in EU financial services (European Commission 2005b) therefore combined available data from different studies to generate an overall ‘impression’ of current developments.²⁸ A single measure of market integration is nowhere in sight.

Due to these limitations, this chapter focuses primarily on qualitative data and existing research, even though quantitative measures (where available) will be used for corroboration. Arguably, the best indicator of firms’ strategies are their material investments. More specifically, heavy investment in international investment banking justifies the claim that a firm has identified it as an important part of its strategy. Luckily, the number of firms that play a significant role in EU capital markets (measured by a market share of more than, say, 2 per cent) is small; international expansion can thus be assessed on a case-by-case basis. If it emerges that all these companies invested heavily in international capital market operations—as is indeed the case—this is probably as good of an indicator of a general shift in the industry’s strategy as the data is likely to allow.

Market concentration as a source of economic and political power

Market concentration within EU investment banking heavily influences the economic and political dynamics within the sector. The fact that less than a dozen firms control more than half the market in just about every market segment means that forms of economic interaction other than those allowed or suggested by traditional economic models are possible; in a nutshell, firms

²⁸ The most comprehensive collection of data on EU ‘financial integration’, drawing on a variety of sources (ECB, OECD, FESE, ISMA, ISDA, etc.), has been compiled by the Commission itself. The compilations are a great step forward even if fundamental definitional issues remain unaddressed. European Commission 2005b.

can interact strategically rather than just parametrically (on the distinction, see Abell 2003).²⁹ In highly concentrated markets, for example, firms can collude to narrow markets and dictate prices. This concentration is even greater for stock exchanges, discussed separately towards the end of this chapter.

This concentration within the industry has political consequences. It gives banks considerable political clout in their home markets. It further allows the opinions of a handful of firms to stand in for what 'the market' thinks. If the top dozen banks agree on a position in consultations with the European Commission, this is taken as consensus in the industry. Concentration also means that firms find it easy to cooperate politically: they can use industry associations to coordinate their political strategy and smooth out internal differences. As the following chapter will show, the legitimacy of the Commission's actions largely depends on the preferences and support of stakeholders. This makes a consensus that represents, say, 90 percent of market share in a particular market segment difficult to resist.

So how have European investment banking markets been carved up? A glance at industry figures dispels the myth that the world of finance approximates orthodox economists' ideal of the 'market'. Underwriting in both equities and bonds is instructive: the Group of Ten found that throughout the 1990s, the top five firms captured between 44 and 50 per cent of the combined *global* market (Group of Ten 2001: 55f). US firms dominated the industry, not least as the global preponderance of US stock markets grew in the 1990s due to the dot.com bubble. US equities market capitalization as a share of global market capitalization rose from 32.7 per cent in 1990 to 49.1 per cent in 1998 (R. Smith and Walter 2003: 148). In US IPOs, the three top firms, Merrill Lynch, Morgan Stanley and Goldman Sachs, captured more than 50 per cent of the market (Group of Ten 2001: 454f).

²⁹ Under parametric conditions the environment that actors confront (including for example price levels that appear as 'given' for individuals) is not responsive to the actions that they take. Under strategic conditions, actors can illicit reactions from others and try to calculate those (for example in an oligopoly).

European markets were likewise heavily concentrated throughout the 1990s.³⁰ In 1995, the top 20 underwriters for bond issues in euros (or legacy currencies) had no less than 98.9 per cent market share—and 95.8 per cent of that was attributable to euro area firms (Cabral et al. 2002: 27, see also Santos and Tsatsaronis 2003). The US firms among the top 20, in contrast, only commanded 2.1 per cent of the market. By 2000 the top 20 still had almost 95 per cent of the market, but now only 43.2 per cent was booked by euro zone firms whereas 40.6 per cent had gone to the American banks.³¹ In absolute terms, the business volume of the European firms had remained roughly constant through those five years, whereas that of the US firms increased rapidly. Since then, matters have stabilized. In 2004, the seven European firms among the top ten corporate bond underwriters in euros held 45.7 per cent of the market (Casey and Lannoo 2005: 34).³² Equity underwriting shows a roughly similar if less pronounced picture. Between 1995 and 2000, the market share of euro zone firms among the top 20 fell from 64.2 to 41.4 per cent, whereas that of US players rose from 10.8 to 35.7 per cent (Cabral et al. 2002: 28). By 2000, US investment banks had captured an estimated 70 per cent of the fee-income on ‘European capital markets and corporate finance transactions’ (R. Smith and Walter 2003: 367). Such concentration, however, was not a new phenomenon. For euro legacy currencies between 1994 and 1998, the top 5 firms in countries such as France, the Netherlands and Italy never had combined market shares below 70 per cent (Santos and Tsatsaronis 2003: 10).

The rise of capital markets and investment banking in Europe

The real boost to European capital markets came in the second half of the 1990s when stock market capitalizations, share trading volumes and bond issuance sky-rocketed. The opportunities

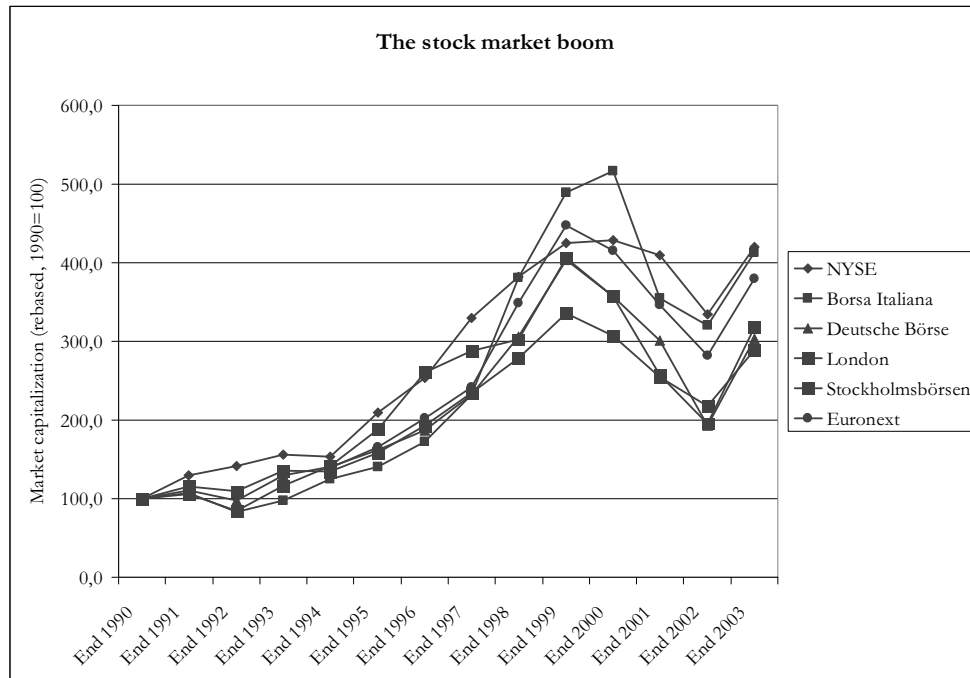
³⁰ Examples that will not be discussed in further detail but are important to complete the picture include secured money markets, where the top quintile of participants consistently held over 80 per cent of the market share between 2000 and 2004. Over the same period, the top 10 players held 60 per cent of the repo market. In over-the-counter forward rate derivatives, the market activity share of the top quintile of players approached 95 per cent in 2004. European Commission 2005b.

³¹ 2001 shows a similar picture, even if slightly less pronounced. The respective figures are 46.6 per cent for euro-area firms and 32 per cent for American ones.

³² The top four were Deutsche Bank, BNP Paribas, Barclays and Société Générale (in that order); the other three EU firms among the top ten were ABN Amro, Dresdner KW and HSBC.

created by this boom convinced many banks hitherto focused on domestic credit markets to reorient themselves. The boom was largely the result of previous political choices: domestic coalitions had pushed through regulatory changes to enable the development of national capital markets (see chapter 3), governments had chosen to privatize everything from utilities to telecoms, and firms had revamped business structures in anticipation of future opportunities.

The stock market boom was the most noticeable development within continental financial markets; major stock market indexes quadrupled over the 1990s. The market capitalization of the London Stock Exchange tripled (see graph 2). Nor was the boom specific to Europe. Market capitalization of the New York Stock Exchange (reproduced in the graph for comparison) also quadrupled over the course of the decade, reflecting the transatlantic correlation of stock market developments reaching back to the 1960s (Duménil and Lévy 2005: 36). The Hong Kong market rose seven-fold; many other emerging markets showed similar increases, even if some never recovered from the crises that spread from Asia after mid-1997.



Graph 2: Source: World Federation of Exchanges statistics

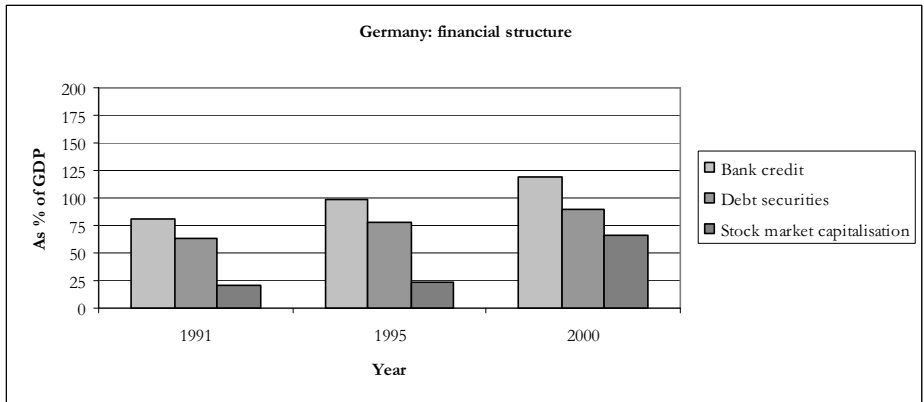
Did rising stock markets in continental Europe signal a change in financial structures from bank-based financial systems towards capital market-based systems (Rajan and Zingales 2003)? Morin, for example, has argued that France in this period witnessed a shift from a ‘financial network economy’ towards a ‘financial market economy’ (Morin 2000, see also Clift 2004). At its peak, French stock markets indeed reached levels that had only been known in Anglo-Saxon economies: in 1999, market capitalization stood at 110 per cent of GDP (Commission des Opérations de Bourse 1999: 18).

But once financial structures are considered in broader terms, we see that other aspects—the weight of bank loans and debt securities (mainly bonds) relative to GDP—remained relatively stable (graphs 3 – 5). Around 2000, roughly 60 per cent of financial flows in Europe still passed through the balance sheets of banks; in the US, the figure was 25 percent, down from 75 per cent in the 1950s (R. Smith and Walter 2003: 361). Continental Europe was thus still far from what prevailed in the US or the UK.

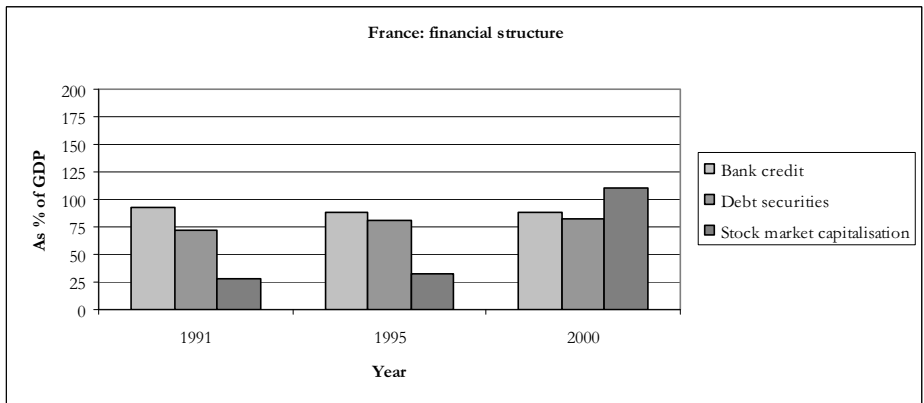
The rise in stock market values—one of the core business opportunities for investment banks new and old—did not imply ‘deep’ financial transformation. For the German case, Vitols found that

these [changes] can be characterized as changes at the margin rather than a fundamental transformation of a bank-based financial system. Elements of a US-style market-based regulatory system have in fact been introduced in Germany, and the large banks have made considerable efforts to build up their market-based activities. However, with the exception of a flurry of new company listings on the stock market (initial public offerings, or IPOs) during the bubble years of 1998-2000 and the introduction of a moderate form of "shareholder value" by large listed companies, remarkably little has changed in the pattern of corporate finance in Germany in the past decade. (Vitols 2004: 1f, cf. Deeg 2001)

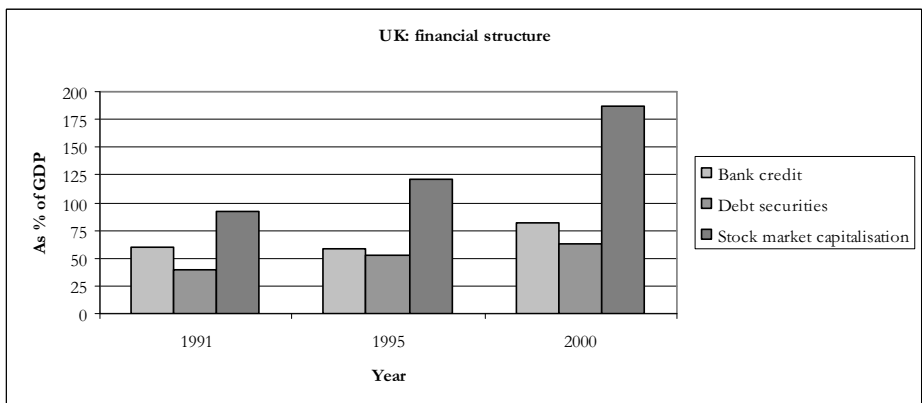
Nevertheless, the stock market boom generated a kind of excitement from which governments were not immune—what Alan Greenspan famously characterized as ‘irrational



Graph 3. Source: European Commission 2003, also for France and UK .



Graph 4



Graph 5

exuberance'. As the next chapter will show, the stock market boom also created a political window of opportunity for banks and other actors in favour of future market integration. One German government official at the time recalls how

we also had the hope that we would be able to challenge London to some degree. That was the boom of the DTB [the German derivatives exchange], also of the Deutsche Börse. And the banks were also actively playing along. That lasted for two, three years. Then we realized that we could not keep up and that in fact, we had to be careful that we didn't lose too much ground. (Interview 020506, authors translation from German)

Governments fuelled the stock market boom with large-scale privatizations, which in turn led them and many others to believe that a revolution was sweeping European finance. The French government, for example, had already privatized some major banks and sold France Telecom (1998) and Air France (1999) on the stock markets just as they were reaching their heights. In Germany, the public listing of Deutsche Telekom in late 1996 was one of the catalysts for the stock market boom. The value of the company's shares rose seven-fold in less than four years and fuelled an optimism that seemed unbreakable.

The boom was still gathering steam at the end of the 1990s when key decisions were taken over the future of EU capital market governance. The issuance of European corporate bonds really took off after 1997; it rose by 70 per cent in 1999 alone (Belaisch et al. 2001: 37). The international portion of this business was growing too: between 1998 and 1999, the issuance of international bonds more than doubled to over \$536bn (Danthine et al. 2000: 57), though domestic bonds still outweighed international ones four-to-one.

These changes were paralleled by transformation within the investment banking industry. Where the picture at the beginning of the 1990s was one of highly concentrated, nationally focused capital market industries (where they existed at all), most of the important firms developed European—and sometimes even global—ambitions over the next decade. To be sure,

many of these firms had long been represented in international financial centres, particularly in London. Their foreign outlets, however, were important primarily for servicing the needs of domestic customers. At least in the ambition of the leading continental banks, the distinction between national and international markets now vanished in favour of a transnationally integrated market place. This brought them closer to the American investment banks which had been pursuing an international strategy through the City of London since the 1980s.

As pointed out above, this shift in business strategy is harder to trace than one might suspect. This section therefore focuses on actual corporate expansion through overseas investment, typically in the form of corporate acquisitions. Where available, other indicators of strategy shifts will be used to corroborate the findings. In particular, Slager (2004) has studied the internationalization strategies of the most important banks in the United States and Europe. The firms under scrutiny typically engage in both the traditional credit business and investment banking; his Trans Nationality Index (TNI) unfortunately does not distinguish between the two.³³ Nevertheless, it serves as a useful indicator of overall corporate strategy—where the trend is clear enough.

European investment banking markets are concentrated, not only in a small number of firms, but geographically as well: all the relevant banks (indirectly in the case of US investment banks) are based in the UK, France, Germany, the Netherlands and Switzerland. As we will see, all domestic incumbents in the investment banking business developed international strategies in the 1990s. For the sake of simplicity, the banks are grouped by home country; the results are summarized in the appendix of this thesis, with European market shares in 2001. Taken together with the most important US firms, these banks were responsible for around 80 per cent of the market in both bonds and equities. For comparison, the table also lists the Eurobond market shares for these firms in 1986 (or their precursors, in cases of later mergers or acquisitions). The

³³ The TNI is the mean of three ratios: foreign assets/total assets, foreign income/total income and foreign staff/total staff. For details, see Slager 2004: 555ff.

firms that remain dominant in the new millennium then had a cumulative market share of over 56 per cent. A high degree of continuity thus prevailed among US and European firms; Japanese firms, which had more than 20 per cent of the market in 1986, hardly play a role in European markets today (cf. Augar 2005).

The Dutch banks

In both Dutch and international capital markets, ABN Amro has been by far the most important Dutch bank. It was born of a merger between two domestic firms in 1991. This merger gave the new firm sufficient capital to embark on an internationalization strategy that was formulated in the early 1990s and which included becoming a 'global player' in the field of investment banking (de Vries et al. 1999: 463, cf. Slager 2004: 236). The strategy was motivated not least by the saturation of the Dutch banking market (Ibanez and Molyneux 2002: 52) combined with the declining profit margins in the credit business that affected banks throughout Europe.

To achieve its aim, ABN Amro invested heavily in building an international investment banking operation, even if profitability was initially low (de Vries et al. 1999: 471). In 1992 it bought the London brokerage Hoare Govett; three years later, it expanded into Scandinavia with the acquisition of Alfred Berg A/B. ABN Amro then entered into investment banking joint ventures in Italy and Spain and finally started a joint venture with the Rothschild investment banks in 1996. By 2000, ABN Amro had 60 per cent of its activities abroad (Slager 2004: 224) and its TNI rose from a little more than 30 in the early 1990s to over 70 in 2000 (Ibid.: 233).

The German banks

Deutsche Bank was probably the first continental European bank that systematically expanded throughout Europe and made international investment banking one of the pillars of its corporate strategy (Slager 2004: 313, cf. also chapter 3). By the early 1990s, the bank clearly had strong European and even global ambitions, even if only 10 per cent of its profits came from non-German European subsidiaries (Brady 1992). One executive declared at the time that 'our aim is

to become the leading banking and securities house in Europe' (Ibid.).

Two strategic decisions exemplify Deutsche Bank's strategy: in 1989, it bought one of the leading City merchant banks, Morgan Grenfell, for £900m—a price that was considered exorbitant at the time (Augar 2000). Five years later, in 1994, it decided to move all of its investment banking operations to London and merge it into a single unit, thus obliterating the distinction between German and non-German business (Fisher and Cohen 1994). In the same year it also created corporate banking units in Italy (*Financial Regulation Report* 1994b).

The years that followed brought further expansion, this time into North America—a decision that was crucial for the consolidation of Deutsche Bank's position as one of the few firms still on par with the leading American investment banks. In 1999 it bought the Wall Street investment bank Bankers Trust and the investment boutique Alex. Brown. The new head of Deutsche Bank's North America division, Carter McClelland, explained:

The US investment banks have begun to enter the European market. Only seven years ago firms such as Goldman Sachs, Morgan Stanley and Merrill Lynch only had small bridgeheads in Europe. Nowadays, these firms can boast with relatively large and successful market positions there thanks to a focussed expansion strategy, extensive securities sales networks and an aggressive, American-style investment banking. In such an environment Deutsche Bank simply cannot wait. (McClelland 1997, translation of the original German quote by the author)

As was the case with ABN Amro, Deutsche Bank's TNI increased significantly over the 1990s, from a little more than 20 to around 60 in 2000.

The two smaller members of the 'big three' German commercial banks also pursued Europeanization strategies, though less ambitious than Deutsche Bank's. Dresdner Bank was late entering the acquisitions game when in 1995 it bought one of the few 'old' City firms that remained independent, Kleinwort Benson. The latter's prestige immediately established Dresdner Bank in the City, and towards the end of the decade it even appeared among the top 10 in some league tables. Commerzbank never made any major acquisitions in the City but chose to build its own operations instead. While it had moved all of its non-DM trading and sales to London in

1994 (*European Banker* 1994b), the decision to expand only came in 1998 when it started investing heavily and doubled its investment banking staff to more than 500. Even the state-owned Landesbanken fell for the attraction of investment banking: both the Hessische Landesbank (Helaba) and the Westdeutsche Landesbank (WestLB) began investing in their London operations in the mid-1990s (*European Banker* 1995a). The latter bought the City brokerage Panmure Gordon in 1996 (Slager 2004: 327). After the dot.com bubble burst, most of the smaller banks' forays into investment banking were exposed as costly and unrealistic adventures (Jenkins 2004). At the time, however, faith that this was the business of the future was pervasive.

The French banks

The growing French presence abroad over the course of the 1990s featured five main players: Banque National de Paris (BNP), Paribas, Société Générale (SG), Crédit Lyonnais (CL) and Indosuez (*European Banker* 1994a). The most 'sophisticated' and commercially oriented, Paribas was the first to develop an international capital market focus. It set up operations in London in 1984 and in the mid-1990s extended its strategic focus to include the US market (Kraus 1994). It bought JP Morgan's European custody business in 1995 and further boosted its US securities team in 1997. The three-way takeover battle between Paribas, SG and BNP that dominated the French banking scene in 1998 and 1999 temporarily diverted attention away from international expansion (Bream 1998). BNP's takeover of Paribas in 1999, it was hoped, would soon give it a leading position in European equities (Slager 2004: 343).

Société Générale also followed an expansion strategy that brought it within the European top 20 by the end of the 1990s. It bought the securities house Strauss Turnbull in 1993; three years later it acquired a majority stake in Crosby securities in Hong Kong. It added the banking business of Hambros merchant bank in the UK as well as two small Wall Street investment banks to its operations in 1997 and 1998.

Crédit Lyonnais internationalized even more aggressively, driven both by the state strategy to create a national champion equalling Deutsche Bank and the personal ambitions of its

chief executive, Jean-Yves Haberer (Story and Walter 1997: 197ff). The bank, however, failed spectacularly in the mid-1990s and was dismembered by the French government, which still owned it (Coleman 2001). Indosuez, finally, was taken over by Crédit Agricole (CA) in 1996. In keeping with its status as a mutual bank, CA put less emphasis on internationalization and used the newly acquired investment banking capacity mainly to service its domestic clients. Nevertheless, it started to become more active internationally after it took over what remained of Crédit Lyonnais' investment banking, fused under the Calyon brand in 2004.

Banks from other European countries

The UK and Switzerland are the only other European countries from which banks with serious pan-European or global ambitions emerged. Firms from Italy or Spain never made significant attempts to enter London's international capital markets (*European Banker* 1995b). At the time of writing, Barclays is the only British commercial bank that still plays a significant role in investment banking. All merchant banks, brokers and jobbing firms were bought up by larger, mostly foreign firms in the decade following the Big Bang in 1986. With the sale of S.G. Warburg to the Swiss Banking Corporation (SBC) in 1995, the last of the big merchant banks lost its independence. Only three years later, SBC was taken over by Union Bank of Switzerland, making UBS a major player in investment banking, too. Barclays scaled down its formerly global ambitions with its subsidiary Barclays de Zoete Wedd (BZW) in 1997 after poor management had led to mounting and seemingly unstoppable losses (Augar 2000). Until then, Barclays had been the most ambitious British firm, certainly the most active one in Brussels lobbying (Ipsen 1995).

The final firm with a significant role in European (and indeed global) capital markets is Credit Suisse First Boston (CSFB), formed as a joint venture between Credit Suisse and First Boston in 1978. In the mid-1990s, Credit Suisse took over First Boston and made CSFB—by then an established brand name in investment banking—its capital markets subsidiary. Even

though CSFB is formally a Swiss firm, in practice it operates and is perceived as a Wall Street investment bank.

Explaining internationalization

The emergence of a cross-border European investment banking industry can be traced to a variety of causes: the decline of traditional credit as a source of profits, domestic and legal changes that provided new (if circumscribed) opportunities for banks, the rise of competition from US firms, the (pending) introduction of the euro, and not least, the growth of business in investment banking itself. What is noteworthy about these sources of business internationalization (discussed in detail below) is that most of them are endogenous to competitive dynamics within the industry. Market internationalization was bolstered by political decisions such as market liberalization—in which banks themselves played a significant role. The rise of US competition was crucial for it suggested corporate expansion and internationalization as routes to business success for European firms. And the growth of business in capital markets was itself partially endogenous to banks' changing business models as much of the international business was in fact inter-bank. In this way, regulatory developments, market changes and firms' strategic reorientation are interrelated facets of one integrated, if open-ended structuration dynamic.

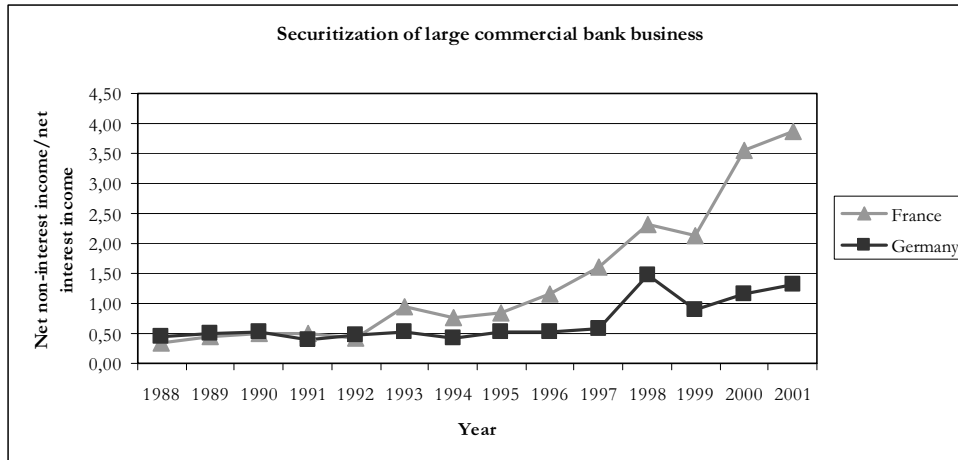
Strategic reorientation as a source of market transformation

Interest margins (in broad terms, profits made through deposit-taking and lending) in Europe had been falling since the 1970s. Throughout the Eurozone, they declined from almost 2.5 per cent in the mid-1980s to a little more than 1.5 per cent in the mid-1990s (de Haan and Prast 1999: 16). Between 1994 and 1998, they halved again in both France and Germany (Danthine et al. 2000: 63). Net interest margins as a source of revenue for French banks declined from 70 to 53 per cent between 1992 and 1998; for Germany, the corresponding figures were 75 and 63 per cent (Belaisch et al. 2001: 24).

The traditional basis of income for banks was thus eroding, necessitating a search for new sources of revenue. The profit margins of the highly commoditized credit business looked even paler in comparison to the more ‘value-added’ products that American firms had pioneered since the early 1980s (see e.g. Partnoy 2002). For many firms, the strategic consequence was to refocus on these more lucrative activities, particularly in international investment banking. As Berger et al. found, this also applied to Europe:

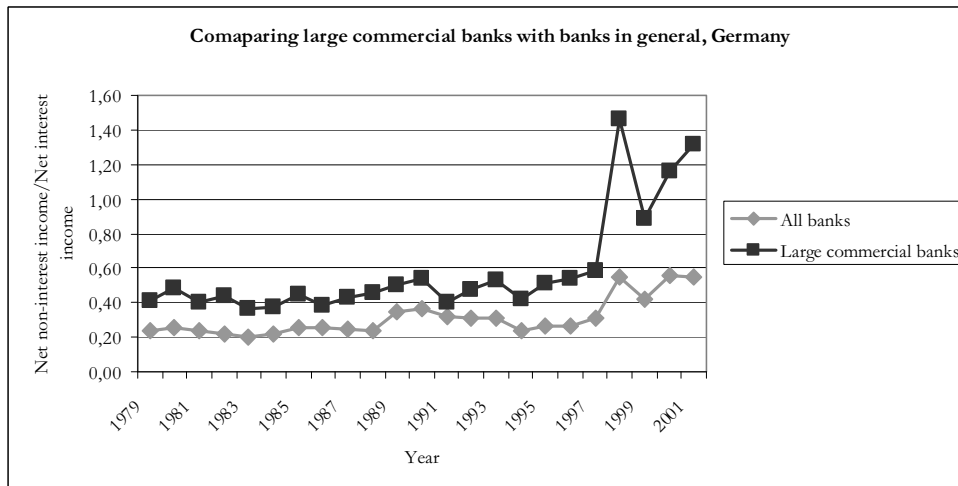
A wave of nonfinancial M&A activity in Europe has already precipitated fierce competition for advisory business. Intra-European merger and acquisition activity between 1985 and 1988 averaged \$43 billion a year versus \$280 billion a year between 1995 and 1998. In order for European universal banks to compete for this business—particularly against U.S. investment banks that have acquired substantial expertise in the M&A advisory business—they either have to develop this expertise internally or have to acquire it externally. It appears, for example, that in part Deutsche Bank has acquired this expertise by purchasing British and U.S. investment banks (Morgan Grenfell and Alex. Brown). (A. Berger et al. 2000: 80f)

The reversal of the relative importance of credit versus fee-based business over the previous two decades (graph 6) was thus not only driven by deteriorating interest margins but by the active development of fee-generating business. Between 1997 and 1999, for example, the net commission income of banking institutions in the EU rose annually by 19 per cent (Eurostat 2001: 9). As seen previously, many of the larger European banks had identified the expansion of such business as strategic priorities much earlier.



Graph 6: Source: OECD Bank Profitability, 1998 and 2002 editions

Unsurprisingly, this trend was most pronounced for the very largest banks (graph 7). The share of non-interest income within gross income for the six largest German and the five largest French banks reached more than 50 percent in the period 1996-2000, compared to a little over 35 per cent a decade earlier (Slager 2004).



Graph 7. Source: OECD statistics

This rising importance of investment banking for continental universal banks had two consequences. First, they grew more interested in developing such activities in their home markets. Second, they became more aware of pan-European competitive issues: the threat of

foreigners taking over for the smaller banks, and the limits to the cross-border market access achieved thus far for the larger ones. In this way, banks' strategic reorientation affected their regulatory preferences, analyzed in more detail in chapter 6.

Still, the question remains what motivated banks to expand as intensively as they did (Cabral et al. 2002, Boot 2003). The basic puzzle of consolidation is that there is little evidence that it enhances shareholder value (for such an argument, see e.g. R. Smith and Walter 2003); if anything, it seems to destroy it (Group of Ten 2001: 254f). A large number of studies have researched economies of scale and economies of scope in financial services and in banking in particular (for an overview, see A. Berger et al. 1999). They almost invariably conclude that economies of scale only exist at the lower end of the size scale while banks with more than \$10bn in assets are likely to suffer from diseconomies of scale (A. Berger et al. 1999: 158).³⁴ While the literature that explicitly focuses on securities markets is much thinner, findings from the early 1990s resonate with those from financial services in general, namely that the unit-cost curve is U-shaped (Lawrence Goldberg et al. 1991). One might argue that advances in IT could have mitigated the eventual rising of unit-costs at the right end of the curve but even then it would not justify consolidation. Data processing economies of scale can often be captured through outsourcing—as indeed happened in many instances, for example in the Irish Stock Exchange using the German Xetra system for trading. Equally, economies of scope are difficult to detect; if anything, the prevailing opinion is that diseconomies of scope are more likely.

The issue looks rather different, however, once we view financial firms not only as adapting to market structures but as their makers. If there is any 'value' in consolidation, it lies in its *strategic* potential (Milbourn et al. 1999). Boot came to a similar conclusion:

[T]he important issue is that strategic considerations are the driving force behind the current wave of consolidation. As I argue, these considerations may have rather little to do with true scale or scope

³⁴ For comparison, Commerzbank, a medium-sized bank by global standards, had more than \$280bn in assets in 1995. Ibid.: 189.

economies. Rather, learning, first-mover advantages, and strategic advantages of market power and associated “deep pockets” may explain the current wave of consolidation and the broad scope of many players in the industry. [...] Strategic positioning might, for the moment, be the rule of the game and an optimal response to the uncertainties and rapid (and unpredictable) changes facing financial institutions today. (Boot 2003: 39, emphasis in original)

Banks’ behaviour is thus consistent with a market structuration view in which they not only react to allegedly ‘exogenous’ market changes but are themselves drivers of market transformation through their strategic behaviour. The market concentration in investment banking only further amplifies this market-making effect of corporate strategy.

In light of the uncertainties Boot pointed to in the quote above, (perceived) developments within a firm’s peer group are central to understanding such corporate strategy. Perceived opportunity costs in the guise of a fear to ‘miss out’ on important trends may be sufficient to lead CEOs down strategic avenues that they would otherwise not have considered. The scramble among City brokers, jobbers and merchant banks that followed the loosening of UK rules after 1983 is instructive (Augar 2000).

Many [banks] feel that a presence in investment banking might be important for their existence as powerful banks in the future. They are willing to accept – for the moment at least – relatively low returns on those activities. The potential, but uncertain, vital role of these activities in the future defines them as a strategic option. (Boot 2003: 71)

This uncertainty stems from banks—rather than responding to existing demand—anticipating market developments or nurturing them themselves, for example in the derivatives business (Partnoy 2002). After all, the investment banking strategies of the largest European players had their origins in the late 1980s and early 1990s, *before* these markets took off. The anticipatory dimension of these strategies is underscored by their frequent failure; continental universal banks in particular burnt their fingers (and money) in a business with which they had little experience (see e.g. Jenkins 2004).

Even when ‘markets’ did develop, it would be highly misleading to think of the demand

for international investment banking services—both on the sell-side (issuers) and buy-side (investors)—as exogenous to the financial services industry itself. As Berger et al. argue,

the development of new financial products has primarily created markets for intermediaries rather than end users of these products. (A. Berger et al. 2000: 81f)

Banks massive exposure to complex derivatives such as collateralized debt obligations (CDOs) and mortgage-backed securities that has become apparent since the outburst of the credit crisis in the summer of 2007 has only underscored this point.

In their in-depth study of European bond markets, Casey and Lannoo found the prime issuers of international bonds to be financial institutions themselves:

International debt issues are largely, and in some EU member states overwhelmingly, dominated by financial institution issues. This result should come as no surprise, since financial institutions continue to be the main source of finance for European firms, and thereby engage in large-scale lending activities for which they must find sources of funding. Due to their expertise in, knowledge of, and experience with financial markets, banks and other financial intermediaries have a long experience of tapping international capital markets for funding purposes. (Casey and Lannoo 2005: 13)³⁵

This is a well-documented but nonetheless remarkable finding. It is largely financial institutions themselves that use international markets to raise funds that they then lend on domestically. In effect this widens the pool of savers to whom financial institutions can sell their own liabilities, placing Spanish savers in competition with German and Finnish ones. In contrast, almost 90 per cent of loans in 2002 still went to banks' domestic, rather than foreign, customers (Cabral et al. 2002: 37). This home-bias is not surprising given the costs involved in assessing the quality of (potential) loans, particularly where such information is not available 'off the shelf' through analysts or rating agencies.

³⁵ It may be worth adding that corporate bonds issued by non-financials account for more than 10 per cent of total international bonds in only four countries in the EU – the three Scandinavian members and France. Financial institutions borrow more in these markets than their respective governments in all but two countries, Greece and Finland.

In international bonds issued by financial institutions, the EU share of the global total further increased between 1999 and 2004, from 50 to 60 per cent (Casey and Lannoo 2005: 14). Almost two-thirds of these bonds are European in origin. This shows that financial institutions still play a central role in channelling capital through the continent, mediating between savers and borrowers not by taking deposits—the lack of pan-European retail networks account for that—but by borrowing at competitive rates themselves.

As noted above, corporate bond issues have increased markedly. But they are dwarfed in comparison to debt sold by financial institutions. In the late 1990s, corporate bonds accounted for roughly 10 per cent of total international bonds (European Commission 2005b: I-11). The demand for capital by sovereign debtors and financial firms—not corporations—has propelled the growth of international markets.

But what about the buy-side—those who invest in international securities? In equities, both investment and pension funds have a growing share of non-domestic holdings in their assets: their share was over 50 per cent in 2000 (European Commission 2005b: II-19). In continental Europe, more than 50 per cent of asset managers (weighted by assets) are owned by banks, and another 20 per cent by bancassurance conglomerates.³⁶ Even in the UK, banks, insurance firms and conglomerates own almost 80 per cent of asset managers. In some European countries, banks control almost 80 per cent of the fund management industry (A. Berger et al. 2000: 81f). This shows that the financial industry did not participate in the rise of capital markets in Europe as an exogenous ‘given’; their strategic decisions lay behind and generated market developments.

Market structuration through regulatory reforms

Even though the strategic reorientation of financial firms was the most visible source of market transformation, legal changes that had begun in the mid-1980s and continued in the wake of the

³⁶ Almost all of the rest are owned by insurance firms. European Commission 2005b.

ISD were a crucial backdrop to these developments. True to the structuration perspective of this thesis, the regulatory preferences of public-private coalitions thus fed back into market evolution. Given the diverse political interests of financial market stakeholders, the effects of reform were contradictory. On the one hand, new rules were often designed and used to defend particular financial centres and the interests of the incumbents within them. On the other hand, the largest firms pushed for and eventually exploited opportunities that the ISD in particular gave them to expand throughout Europe. Legal changes thus both encouraged and hindered expansion. It was precisely this combination that proved unsustainable over the long run.

The ISD was meant to introduce two basic innovations: the possibility of remote access to securities exchanges (discussed in the next section) and permission for investment banks to supply financial services throughout the EU under home country rules. Relieved of having to comply with two sets of rules, foreign firms would be encouraged to set up branches in foreign markets. However, if the service in question could also be provided from abroad, for example electronically, firms could close their foreign subsidiaries and service their markets from a single location.³⁷ In the end, agglomeration effects ensured that the latter prevailed (cf. Bindemann 1999) but certainly in the mid-1990s, both strategies were explored—and faced difficulties.

For example, American firms such as Merrill Lynch were immediately encouraged by new EU legislation to spread across the continent (*Private Banker International* 1996). That, however, was easier said than done. Article 11 of the ISD stipulated that member states could draw up their own conduct of business rules; firms trying to spread out from London soon discovered that member states were ready to use such provisions to halt unwanted change. Investment banks had to establish separate businesses in different member states, individually capitalized and with separate reports (Interview 070406). While such moves protected national incumbents, it also hampered the development of local capital markets and in the end helped

³⁷ One example is the Union Bank of Finland pulling out of France, for under the single market rules it can provide services from London. See *European Banker* 1995c.

London prevail of contenders such as Frankfurt or Paris. Some countries went so far as to dust off old laws to keep competition at bay—the SIMS law in Italy being the most extreme case. Under these rules, a firm had to be based in Italy to sell securities to Italian residents (Colvill 1995). Goldman Sachs, for example, had only one or two investment bankers permanently based in Milan; others were flown in from London when needed. The SIMS law forced Goldman Sachs—and many others—to build up fully-fledged, operationally independent firms in Italy, which were only reintegrated into the rest of their European operations at the beginning of the millennium. Provisions such as the Italian SIMS law plainly contradicted the ISD but there was little firms could do. In this particular case, Goldman Sachs was applying for primary dealership in Italian government bonds and a lawsuit against the ministry of finance would not have helped its cause.

Indeed, firms soon realized that even if they were willing to pursue legal action, success was anything but assured. In a case that stuck in bankers' memories, Barclays tried to sue the French government in the early 1990s for forbidding it to pay interest on chequing accounts in its new French banking operation (Interview 160306.b, Interview 070406). The bank felt this was in clear contradiction to EU rules and sought assurances from the Commission that it would support Barclays in court. When things came to a head, however, the Commission backed down.

In the case of the ISD, France actually met the 1996 implementation deadline (*Financial Regulation Report* 1996c) and combined this with a streamlining of supervisory structures (*Financial Regulation Report* 1995a). Yet in key respects, the French law on the 'modernization of financial activities' violated the official spirit, if not the letter, of the ISD. Locally operating firms still had to follow the rules of the *Conseil des Marchés Financières*, an arrangement meant to undermine the competitive 'threat' of US firms (Bream 1998). Services rendered to the state and the Banque de France—which were, after all, the two largest market participants—fell outside the scope of the new law. It also implemented the concentration rule by stipulating that most securities transactions had to be carried out through regulated markets where these existed. Nevertheless,

the new law abolished the monopoly on the negotiation of transferable securities that the sociétés de bourse had hitherto held (Demarigny 1998: 277).

Things went even more slowly in Germany (Shirreff 1997). ISD implementation had been promised for 1996, the original target date (*European Banker* 1996b). But rule changes became law only two years later (*Financial Regulation Report* 1998b) due to the conscious government strategy of pushing back the ‘new realities’ (Interview 020506). After all, one of the ISD’s core provisions allowed firms to provide services from a distance: rather than going through local subsidiaries, they could open branches or even provide services without local representation. Developments triggered by the 2BCD were worrying: Merrill Lynch, for example, had closed its subsidiary in Frankfurt in the mid-1990s to service Germany through the branch of its subsidiary in Ireland (Shirreff 1997). Indeed, of the 695 ISD passport applications the German securities supervisor received in 1996, more than 600 came from London and virtually all of them (690) were asking for permission to provide financial services across borders (Bundesaufsichtsamt für den Wertpapierhandel 1997: 33f). To be sure, not all were British or American firms. But it showed that many firms preferred to provide pan-European services from a single location—the City. No surprise, then, that American investment banks were particularly irritated about the slow pace with which Germany—traditionally one of the most ‘liberal’ financial markets in Europe (J. Williamson and Mahar 1998)—reformed its laws and regulations (Financial Times 1997).

That said, it would oversimplify the picture to think of governments as either eager or reluctant to reform financial markets. As chapter 3 argued, reforms were above all strategic, meaning they were attuned to the attainment of specific ends and the satisfaction of particular interests. In 1994 the Second Law for the Promotion of Financial Markets had created the first German securities markets supervisor, the *Bundesaufsichtsamt für den Wertpapierhandel* (BaWe). In doing so, it acted on the realization within both government and industry that ‘internationally acceptable’ supervisory structures were necessary if international business was to come Frankfurt’s way (see also chapter 4 on the CAD negotiations). For example, the Deutsche Börse

in the early 1990s had sought official recognition as a stock exchange from UK authorities; citing the lack of proper regulatory and supervisory structures, the British repeatedly turned it down (Interview 240506.b). For actors with stakes in internationalizing Frankfurt, introducing oversight structures more in line with international standards thus made perfect sense. Also in 1994, the German government relaxed entry rules for American banks, which were henceforth treated almost as EU firms (*Financial Regulation Report* 1994c). Paralleling other market-opening steps, the decision was not unilateral but was negotiated with the US government.

At the same time, many concerns of both foreign and large domestic players remained unaddressed, particularly discrepancies between different national rule sets (e.g. for reserve requirements). Banks had placed their hopes on the coming Third Law on the Promotion of Financial Markets to address them (The Banker 1996a). As it turned out, this law was only one of three accepted by the German parliament to boost capital markets, for example by simplifying equity issues (*Financial Regulation Report* 1998a). As the sense of competition between Frankfurt and London grew, the government realized that a legal environment conducive to financial innovation was crucial.

In any case, by the late 1990s London was more clearly than ever emerging as the centre of gravity for wholesale business. One City investment banker remembers the development as follows:

What was actually happening—many other investment banks did it—was to pull back trading activities from elsewhere in Europe to one location. And nearly every institution that decided to adopt this model chose to carry out their trading from London. You would keep your sales forces within the jurisdictions. But if you were trading Italian government debt or French equities, you would, so far as the law permitted you to do so, do it from London. And that has been the model. And this was driven by two things. One was the fact that the euro was coming in at the time. And everyone could see that that would create a bond market that was driven more by maturities than by national boundaries. And that meant that ideally, all the traders who were previously trading in different jurisdictions in individual countries would go to one location. And so you had your trading desk in London

transmogrified into this multicultural flower. And the other driver which was coupled with that was that most countries started to liberalize their rules with respect to who could be a primary dealer in securities. And that was driven one by the fact that the euro was coming along, two by the fact that the big international players were beginning to be recognized by the governments as the people who actually had the distribution strength to disseminate their bonds, and three by pressure from those large entities and elsewhere to open up the primary dealerships which had traditionally been held by the big banks in the particular jurisdictions, France, Spain, Germany... The point about all of these is that the only element that was an EU element was the euro. *All the other elements had more to do with business strategies.* Having said that, the creation of the euro was a very strong element. Technology was another driver as well. It was easier to deal remotely, too. (Interview 140306.b, emphasis added)

As pointed out previously, legal changes in Europe invited new business strategies. But where legal reforms had been the result of compromise between different stakeholders—in particular between firms with different competitive interests—inconsistencies in the new legislation soon became apparent. These enticed investment firms to push for further change—the topic of the next chapter.

European Bourses: From Members-only clubs to profit-seeking firms

The rise of independent, for-profit securities exchanges was the second major transformation in the capital market industry in the 1990s, and it was the flip-side of (investment) banks starting to disembed from ‘national economies’ and market places and increasingly focus on cross-border business, instead. This so-called demutualization was to have a crucial impact on the future renegotiation of the ISD (discussed in chapter 8), in which bourses emerged as fierce competitors to the new European investment banking incumbents. True to the structuration perspective of this thesis, also in the case of demutualization the strategic decision that (investment) banks made in the 1990s were to come back to haunt them in EU-level regulatory negotiations a decade later.

As Lee has noted, exchanges occupy a peculiar position:

If there is one factor that is universally accepted as being the most important determinant of both exchange behaviour and market

structure, it is competition. The ubiquity of the term has not meant, however, that its nature is clear. [...] [A] Manichean view of exchanges either competing or alternatively cooperating, is too simplistic to represent usefully how exchanges actually relate to each other. (R. Lee 1998: 49)

Historically, bourses have developed as members-only clubs wherein competition was tightly controlled by private interests (Braithwaite and Drahos 2000: 145). Members fixed commissions and divided business amongst themselves, for example by assigning the trading of particular stocks to individual firms or persons (Pagano and Steil 1996). Exchanges, governed by the interests of their members, have thus always tried to protect their monopolies. In theory, this is underpinned by the tendency of trading to concentrate on the most liquid exchange (Schwartz 1996). But as Schwartz points out, things are less clear-cut in practice. Different intermediaries, and even different stock exchange members, may have different interests regarding the concentration of trading on a single platform.

Over time, however, exchanges have faced creeping competition from other trading venues, first from 'alternative trading systems' (or 'ATS', such as Instinet) and eventually from intermediaries (R. Lee 2002). ATS usually have lower transparency requirements and allow big intermediaries to sell large swaths of securities without prices immediately moving against them. Large banks thus have conflicting interests as far as exchanges-as-clubs are concerned. They may appreciate the limits they pose to competition. At the same time, the costs these exchanges generate, both directly for their services and indirectly through adverse price effects, may be considered too high. The result has often been that large intermediaries take part of their trading to alternative venues, thereby fuelling competition for exchanges that they themselves used to dominate. The story of SEAQ International, recounted in detail in chapter 3, is a case in point (Pagano and Steil 1996: 5ff). In the early 1990s, the member firms of established exchanges opted for the application of new electronic systems to repatriate trading, for example IBIS in Germany and CAC in France. Before long, SEAQ's market share dwindled.

Once this competitive challenge to established exchanges had been thwarted (even if large

firms continued to do deals off-exchange, over the telephone), many of the smaller member firms saw little need for further investment in trading technology. They were, in short, rather content with the status quo. But not so the larger members. With the prevailing one member-one vote system, they regularly saw their own interests, for example in developing vibrant domestic equity markets, thwarted by what they saw as the conservatism of smaller members. In the early 1990s, these cracks started to become more visible. In Germany, the president of the Frankfurt stock exchange was traditionally a private banker from a small firm. But in 1992, after one such president's term had ended, Rolf Breuer, board member of Deutsche Bank, took over the post in a sign of clear impatience with developments at the bourse.

Divisions increased when the ISD—for which firms such as Deutsche Bank had lobbied—further opened the possibility of granting foreign firms 'remote access'. Such a move obviously meant loss of business for local firms, which could henceforth be by-passed by foreign brokers. Unsurprisingly, the idea of remote access created resistance particularly among smaller exchange members who feared losing order flow (Interview 240506.b). Thus reaching agreement among Deutsche Börse's members to offer remote access to other firms proved difficult, though smaller firms were eventually convinced by arguments that the overall share-trading pie would grow sufficiently to offset the threat of growing competition. Plans were quickly made to install access points in London and Zurich (*European Banker* 1996c). For larger firms, the overall calculation in any case looked different: while they might lose market share in their (former) home markets, they stood to gain from openness through access abroad.

Indeed, even though the ISD gave exchanges the *right* to set up screens abroad, the Stockholm exchange—outside the EU at the time—had already pioneered such remote access (*Financial Regulation Report* 1996b, Pagano and Steil 1996: 41f). This, however, only happened once the exchange had been privatised: with 50 per cent ownership in issuers' hands, their interest in gaining exposure to foreign investors trumped the anti-competitive instincts of local brokers. Inside the EU, the Amsterdam exchange was one of the first to use the new ISD rules when in

1994 it allowed CSFB to retain membership even though the investment bank had relocated its Dutch activities to London (*Financial Regulation Report 1994a*). The exception was granted when CSFB pledged to remain a market maker for at least 25 Amsterdam stocks. The other companies with such a broad offering in Dutch shares were all local or at best European in reach (ABN Amro, Mees Pierson, Suez Nederland and Van Meer James Capel). With CSFB, an established Wall Street investment bank, Amsterdam had the potential to access a wide US investor base. Local traders were nevertheless disgruntled, pushing for remote access to exchanges abroad in return for letting ‘foreigners’ in. Remote access technology was thus applied in line with the commercial and competitive interests of those controlling stock exchanges.

The growing split between the interests of their members and the consequences of this fragmentation of preferences for governance led more and more exchanges towards demutualization—meaning they ceased to be controlled by their members or users and became private companies. As a general pattern, the exchanges which were first to demutualize and modernize their governance structures were those that had faced most competition from ATS. The Amsterdam exchange, for example, traded many shares with international appeal (multinationals such as Unilever and Royal-Dutch/Shell) for which vibrant overseas markets had developed in the early 1990s. It was therefore quick to implement changes, for example by switching all operating systems to English and by demutualizing in 1997 (Interview 211105.a). Other mid-sized exchanges, such as the Borsa Italiana in Milan, took similar steps in the second half of the 1990s (Steil 2002b: 26). In contrast, the world’s major exchanges (the NYSE, the NASDAQ, the LSE, the TSE, the CBOT, the CME, etc.) continued to operate as mutuals, largely due to lower competition and thus less conflictual interests among their members.

From the moment exchanges began operating as for-profit enterprises, their own commercial interests were at the heart of their strategic positioning. Even more so than with intermediaries, exchanges are highly concentrated. The top three exchanges’ share of global market capitalisation was more than 60 per cent throughout the 1990s (Schich and Kikuchi 2003:

109). Similar numbers apply within the EU: in 1995, the LSE, Deutsche Börse and Paris Bourse combined commanded just under 70 per cent of the EU total; in 2001, after Euronext was created—integrating the Amsterdam, Brussels, Paris and Lisbon exchanges—it was almost 75 per cent (Schich and Kikuchi 2003: 110). These concentration ratios have generally remained stable over the past decades, indicating that smaller and larger exchanges by and large kept pace in their growth.

There have been few occasions in which an exchange has managed to capture the trading of a ‘foreign’ security from its home country—certainly among developed countries. LIFFE’s temporary success with Bund futures was an important exception, but after the Deutsche Terminbörse (DTB) began trading with up-to-date technology, business eventually returned to Frankfurt (Interview 020506). The episode also brought home the high costs of head-on competition. Shifting alliances notwithstanding, most exchanges respected the division of business between them and recognized what Fligstein (2001) has called the prevailing ‘conception of control’. Exchanges have mitigated competition by for example sharing technology and forming link ups such as the one between the French MATIF and the German DTB derivatives exchanges in 1994 (Gapper et al. 1996). Potential competition—and the impetus for innovation—thus came not so much from established bourses but alternative trading systems and new start-ups (Interview 240506.b). One of the more noteworthy ones, discussed in more detail in the coming chapter, was EASDAQ—an EU Commission-sponsored copy of the US NASDAQ set up in 1996 (Posner 2005). EASDAQ was the Commission’s attempt, together with the European Venture Capital Association, to kick-start the market for the kind of new ‘high-tech’ issues that fuelled the NASDAQ’s spectacular success in the 1990s (*Financial Regulation Report 1996a*). The established exchanges, however, immediately responded by setting up their own ‘new markets’ such as the Alternative Investment Market in London, the Neuer Markt in Frankfurt, the Nuevo Mercado in Madrid and the Nouveau Marché in Paris. EASDAQ thus never attracted more than a handful of listings (based in Brussels, most of them were Belgian).

Until late in the 1990s, the history of European exchanges was notable for its scarcity of successful consolidation, that is, the creation of cross-border securities exchanges (see Cybo-Ottone et al. 2000: 239). Most of the cross-border deals were not full mergers but joint ventures or technology sharing arrangements and even these had a history of failure (Pagano and Steil 1996: 39). Euronext, the most prominent cross-border initiative, combined several exchanges under one corporate roof; it did not create a single entity out of them. Nor did uncertainties over regulatory responsibilities for a truly transnational exchange make such ventures more attractive. Nevertheless, most takeover attempts were defeated not because they did not make sense from a wider market perspective (economies of scale, market depth, synergies, etc.), but because those controlling the exchanges felt the numbers did not add up (R. Lee 2002).

The most prominent example from the 1990s is without doubt the attempt to merge the London and Frankfurt stock exchanges. The tie-up between the LSE and the Deutsche Börse announced in early July 1998 was a major earthquake for EU financial markets. The major banks were strongly in favour of such transnational market integration; as chairman of the Deutsche Börse, Deutsche Bank CEO Rolf Breuer was one of the main driving forces behind the deal. The commentator in the *European Banker* at the time was sure that such an alliance would be 'unstoppable' (*European Banker* 1998). But both banks and other observers underestimated just how independent exchanges had become with demutualization. When the British-German tie-up eventually floundered, it was widely attributed to the particularistic interests of both management teams rather than wider economic rationales. At any rate, the episode demonstrated to investment bankers that exchanges would henceforth be ruled by considerations that could collide with their own interests or, for that matter, with those of other stakeholders including issuers and investors (chapter 8 will discuss such conflicting interests in more detail, for example in the field of clearing and settlement). As one London investment banker reflected with hindsight,

[t]he banks themselves did not anticipate the speed with which the new

management [of exchanges] would adopt profit-maximising instincts and apply them to their monopolistic position. (Interview 300306)

The years to come would show that the rivalry between for-profit exchanges and their former members and rulers involved more than conflicting commercial interests. Much more important for the supranationalization of EU capital market governance were the political differences that emerged once both groups of firms found themselves to be direct competitors for trading business. In an ironic twist of fate, the banks had created their fiercest competitors through the wave of demutualization over which they themselves had presided.

Conclusion

By the second half of the 1990s, European finance had changed for good. Regardless of the 'depth' of the transformation that was taking place, stock markets rose steeply, the M&A advisory business grew rapidly and the issuance of international securities took off. The investment banking industry also transformed, with market incumbents from a handful of continental European countries deciding to build pan-European, and in some cases global, investment banking operations. Whereas around 1990 most were still eager to keep change at bay and American firms in particular off their home turf, they now found themselves buying up City firms, concentrating their investment business in London and investing heavily in sectors such as underwriting, M&A advice and initial public offerings. As the next two chapters will show, the new mood in the industry was central to the re-launching of market integration and the gathering of support for supranational governance institutions.

The changes this chapter discussed were driven by a variety of forces: the interest of banks to develop the capital markets (business) in the face of declining profit margins in the credit business, governments' eagerness to privatise formerly state-owned enterprises, rising US competition, and the rule changes that were effected in the face of all of these. In key respects, these developments grew out of political-economic dynamics within the EU (investment) banking industry itself, rather than coming to the sector as an exogenous 'force', for example in

the guise of globalization or technological 'progress'. The dynamics within the industry would also dominate the decade to come.

As the following chapter shows, the internationalization of many national market incumbents soon exposed the limits contemporaneous, ISD-based regulation imposed on transnational business strategies. A regulatory regime that bore the imprint of the distribution of preferences in the industry around 1990 was thus to fall prey to the preference shifts that the implantation of that same regime eventually triggered. In effect, firms who had opposed more far-reaching integration in the ISD negotiations either emerged as losers from the new regime in spite of the restrictive provisions they had managed to see inserted into it. Or, as was the case for example for large French banks, through a use of the opportunities that the ISD and national reforms did grant, they internationalized and eventually became supporters of further integration themselves. Both trends weakened competitive struggles along national frontiers and thereby removed the central obstacle to a truly integrated European capital market. They also started to undermine the traditional national alliances that had often, if not always, seen small and large banks as well as stock exchange share regulatory preferences. Even if formal patterns of governance remained unaltered for several years to come, the underlying actor coalitions began to show clear strains.