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

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## **CHAPTER 6: SHIFTING PREFERENCES AND THE RE-LAUNCH OF FINANCIAL MARKET INTEGRATION**

The endorsement of the Financial Services Action Plan (FSAP) by the European Council in 1999 was a milestone in the history of EU financial market integration (e.g. Bieling 2003, McKeen-Edwards et al. 2004, Jabko 2006). The FSAP listed 43 projects the Commission felt needed to be addressed to complete financial market integration. The proposals covered the breadth of financial services from consumer credit and insurance to asset management and bond listings.

In the form of the FSAP, the changes in market structures recounted in the previous chapter started to translate into regulatory change. It marked the beginning of a transition that was to have largely harmonized European rules as its end point. But the FSAP was also an important departure in another respect. It was pushed by a coalition of firms with international ambitions and the European Commission—the first transnational public-private alliance in EU financial markets. Over the years to come, these actors' shared preferences for integration were to be institutionalized in supranational patterns of governance.

The 'upgrading' of the ISD was not high on the list of projects the FSAP suggested. This is noteworthy for in the following years the Market in Financial Instruments Directive (MiFID), as the ISD's successor was christened, became the centrepiece of financial market reform in Europe. No directive has been more important for the organization of EU capital markets, the future of European financial centres and the prospects of the financial industry's different branches. No directive has attracted more attention from bank lobbyists. Now, a little less than a decade later, most of the legislative tasks set out in the FSAP have been completed (European Commission 2007a) and in the eyes of practitioners (Securities Expert Group 2004) and the Commission, there is little left to be done other than 'tidying up' (European Commission 2005c, see also the industry responses to the Commission proposals in European Commission 2005a).

To be sure, an important step remained in the transition of EU securities markets governance from the ‘international constellation’ towards the transnational one: the formalization of supranational institutions, covered in the next chapter. The momentum for new patterns of governance depended on renewed vigour in legislative activity, which itself stemmed from changed preferences of core constituencies. Here the FSAP played a crucial role in spurring the emergence of the supranational institutions that today govern European capital markets.

The Commission obviously played an important role in the FSAP. It was, after all, a Commission document. But the Commission’s agency was relevant in a wider sense too. In the debate over the leeway of supranational institutions to independently affect policy (Moravcsik 1993, Pierson 1996, Moravcsik 1998, Pollack 1998), the re-launch of financial services integration was clearly an area where the Commission identified room for manoeuvre—and used it skilfully (Gottwald 2005, Posner 2005, Jabko 2006).

However, the European Commission’s visibility in re-launching financial market integration does not confirm whether it was really the crucial driving force. As chapter 4 argued, its support was a necessary but not sufficient condition for integration to move forward. The Commission’s initiatives around the ISD and the CAD were for the most part defeated around 1990; it was left with a regime full of loopholes that fell far short of its original ambitions. What was different this time? This thesis argues that widespread industry support for cross-border integration was the crucial factor: firms pushed the Commission and convinced national governments of the necessity for change. The argument here is not that the industry set the Commission’s agenda. The Commission had already reached its position in favour of further integration—preferably through regulatory harmonization (implying more competencies for EU actors). The argument, rather, is that without industry support for the integration project, it could never have gone forward.

Few written documents containing empirical information on the involvement of private actors in EU policy-making are publicly available. As evidence of corporate influence could cause

serious political damage to the integration project, even the slightly more formal consultations that industry representatives had with the Commission around 1998 were conducted under Chatham House Rules, effectively limiting what participants could communicate about what was said (Gottwald 2005). The Commission also limited the availability of written documents from these consultations, for example by producing the summary of industry opinion itself. Given this scarcity of available material, the first half of this chapter relies on confidential interviews with national and European public officials, regulators, and firm and association lobbyists. The chapter's second half, which focuses more on the 'official' EU policy process, again makes use of public documents and academic studies of EU policy in addition to interview material.

### **Shifting industry preferences in the 1990s**

In principle, the more a firm's business strategy builds on cross-border economic transactions, the more it should support transnational integration (Schmitter 1970, Milner 1988, Stone Sweet and Sandholtz 1998, Mattli 1999). In some cases, firm-level factors may complicate the picture. Managers may have political loyalties that contradict a firm's business interests. Or they may fail to identify promising opportunities. In general, though, strategies of business internationalization should correlate with a shift policy preferences in favour of easier cross-border market access.

Support for market integration does not fully specify the content of a firm's policy preferences, however. In the case of regulation for the single European market, there are at least two ways to abolish inter-state barriers. Mutual recognition leaves firms to operate under home country rules; regulatory harmonization mandates all firms to follow a roughly similar rule set.

So what determines firms' support for or opposition to these strategies? Other things being equal, pro-integration firms from countries with 'light' regulatory regimes should prefer mutual recognition to achieve market integration as potential competitors from states with more costly regulatory regimes are disadvantaged. Firms from costly regulatory regimes, in contrast, should favour regulatory harmonization, which puts them and their competitors on an 'equal footing', particularly if downward adjustment of regulatory costs associated with the home

country regime is not a desirable or politically viable option. By the same token, opponents of transnational market integration will be in favour of protectionism if the regulatory costs imposed by their home country regime are high, or will be indifferent if the regulatory costs are low, for they will have no competition to fear. We would only expect them to voice opposition when regulatory harmonization looms on the horizon, for it would constitute market opening on relatively unfavourable terms. These different positions are summarized in table 3.

**Table 3: Hypothetical policy preferences of firms**

		<i>Relative regulatory cost of home country standards</i>	
		High	Low
<i>In favour of pan-European market access</i>	Yes	<b>Harmonization</b>	<b>Mutual recognition</b>
	No	<b>Protectionism</b> (=opposition to mutual recognition)	<b>Indifference (+ wariness vis-à-vis harmonization)</b>

Whether a growing interest in transnational market integration translates into support for regulatory harmonization or mutual recognition should therefore depend on the regulatory regime of the home country and its competitive implications.

The political preferences of investment firms in the 1990s confirm this general pattern. City investment banks—which include American firms operating from the City—in principle preferred mutual recognition to harmonization. It seemed unlikely, to say the least, that a single rule set would be less onerous than what they already had. This explains why many firms were ambivalent about the new legislative fervour of the Commission in the domain of investment services, even though they did support its goal of more market integration. Only the most savvy of investment banks realized early on that rule harmonization would be the price to pay for true European market integration. As one City investment banker observed with the benefit of hindsight:

We were in favour of mutual recognition and competition but the member states would not buy it without massive harmonization. So you

get a much more detailed framework. (Interview 270206)

In contrast, virtually all continental firms favouring market integration supported harmonization as the route towards a unified market; in this way the competitive advantage of the London firms would at least partly be eroded.

It was in the City that the realization that the ISD and the mutual recognition approach were not going to deliver on its promises first sank in because London firms had been its most ardent supporters. That said, firms approached the issue with varying degrees of urgency. Many of the smaller, traditional City institutions were busy digesting the shake-up of their competitive environment, rooted entirely in domestic changes. In comparison, EU matters seemed a side-show to the real transformation.

EU legislation initially appeared irrelevant to many mid-sized firms. Without ambitions to access clients in the remote corners of Europe, many were content dealing in Eurobonds and Euroequities (Interview 270206). Ironically, the vibrancy of the international business, free of EU rules, allowed smaller firms to underestimate how important these rules could become in the daily running of their businesses. As someone who turned to lobbying in EU investment banking a few years later observed:

In those days, people did not realize that making one small mistake in article 11 [of the ISD] was quite crucial to consolidate the home-host distinctions and things like that. (Interview 300306)<sup>38</sup>

Such misestimations of the importance of EU level developments by the ‘old guard’ of City bankers were also due to another traditional advantage of the City’s business environment. Bankers’ relative freedom from government interference in running their own affairs (Moran 1991) had left them undersensitized to the importance of public regulation—including EU

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<sup>38</sup> Article 11 of the ISD stipulates that member states shall draw up conduct of business rules themselves and implement and supervise compliance. With that, firms stay well inside the arms of the host authorities. Also, it stipulates that the professional nature of the client is to be determined by looking at the end-client, not at another investment firm through which the client may have placed his order. Because end-clients are not readily identifiable in inter-bank trades, banks could not a priori claim that they were only dealing with professionals and should therefore be exempt from local conduct of business rules.

rules—in shaping financial markets. It also left them with few resources to influence government policy (Interview 300306). Hitherto the system had run largely on winks and nods from the Bank of England and the personal ties that bound City bankers in self-regulatory organisations. As one investment banker graphically put it:

We didn't do our homework, collectively, any of us. Historically, regulatory policy has had a very low economic or technical input. Regulators are poor quality people in the government world, compared to central bankers, macro-economic people or even tax designers who are aristocrats in the system. But regulators? Who are they? They are just lawyers, degenerate commercial people... (Interview 300306)

Such attitudes let City firms wake up to the relevance of EU regulatory policy and its potential failings only slowly.

To be sure, this did not apply to all firms. The one large bank active in capital markets that was still in British hands, Barclays, did attempt to stay abreast of regulatory developments in Brussels (Interview 160306.b). All the same, it tended to espouse the EU-sceptical opinions prominent among the small City firms. The real exceptions were the American investment banks that envisioned European futures for themselves. Aware of what they saw as shortcomings within EU rules, they were the first to lobby in Brussels (Interview 070406).

Despite the varying perceptions of urgency, the limitations of the ISD regime did not come to most City firms as a surprise. In 1994, one year after the adoption of the directive, the Bank of England had published research documenting City firms' fears that the ISD might fall short of its goals (Bank of England 1994). The main problem was uncertainty surrounding the applicability of home versus host country rules that resulted from article 11 in the original ISD:

When your trader in Finland needs more than half an hour to figure out whether a trade would be legal, then you're simply not going to do it at all. (Interview 070406)

The fact that the ISD did not harmonize conduct of business rules (CBRs) was where, in the words of a senior lobbyist from a Wall Street investment bank, 'the rubber hit the road'—a

message reiterated by lobbyists to the Commission (Interview 070406). Without harmonized CBRs, they argued, running a pan-European business was bound to remain difficult.

In the late 1990s, one of the things that Citibank would like to do, for certain products, was build a company that could deal on a pan-European basis. And to do that, they needed regulatory approval. And they found that that was far more difficult than they had anticipated. Yes, in principle the ISD already gave them a passport, but in reality [...] how particular products had to be marketed and how you got approval varied widely. And that created a lot of difficulties. (Interview 140306.b)

While some of the old City firms blamed the lack of transnational market access on faulty *implementation* of the ISD, others saw the problem in the ambiguities of the directive itself:

[European governments] never properly accepted the concept of mutual recognition. And the Commission was too cowardly. Mogg [Commission Director General responsible for financial services] always argued: Give me evidence [of governments breaking the rules]. And we [the financial industry] produced numerous reports on evidence. And then he turned around and said... Some City lawyers said: There isn't a clear-cut case where we can build an infringement case. There was the Italian case, of course. But Mogg would argue that the directives are framed in such an ambiguous way that you cannot really guarantee that you could successfully go to court. The feeling was that in order to get such a directive as we have adopted, these ambiguities were built in. (Interview 160306.b)

It did not take firms long to complain. As one UK government official at the time put it:

On the wholesale issues the UK authorities, particularly the Treasury, were getting a very clear message from the industry in London that the ISD passport was very inefficient. (Interview 270206)

If opinion in the City was divided between relative indifference towards the ISD and disappointment over the lack of effective mutual recognition, continental firms were divided between favouring regulatory harmonization—an approach that had yet to be tested in investment banking—and outright opposition to market integration. Prominent members of the 'maximum harmonization' camp included ABN Amro (Shirreff 1999), Deutsche Bank and ING (Interview 140306.b).



Particularly the German and French firms suffered from varying degrees of what one respondent described as ‘schizophrenia’ (Interview 160306.b). They were torn between the growing pull of the City and a cosmopolitan business perspective on the one hand and embeddedness in and loyalty to the traditional ‘home market’ on the other (Brady 1992). The contradiction was much less relevant for firms from smaller countries, particularly the Netherlands, which had limited home markets to begin with (Interview 270206, cf. Jabko 2006). These differences between the banks became apparent in their lobbying.

### **The emergence of EU-level lobbying**

Lobbying around capital market issues in 1990s Brussels was the preserve of the large banks. The alleged beneficiaries of financial market integration—largely non-financial firms in search of capital and investment managers seeking high returns—stayed outside of the political process unfolding in Brussels. As one seasoned City lobbyist summarized:

The issuers... I mean, where were the issuers [of securities]? Every paper that we [an international trade association in finance] ever wrote talked about the supply side, trying to improve the efficiency of European capital markets. Why? Reduces the cost of access to the capital market. Increases choice, for the consumers it lowers price. Actually nothing about profits for the intermediaries. And where is the voice of the consumer? Nothing, nowhere. Absolutely nowhere in that debate. Where is the voice of even the institutional investor? Nowhere. And Europe has huge asset managers. And where were the issuers? Nowhere. (Interview 270206)

The message that ‘the market’ sent to policymakers involved the commercial concerns of financial firms, not the public goods that an integrated capital market might generate.

One of the most seasoned Brussels lobbyists in financial services, John Houston, estimated in 1999 that in the financial services domain, 25 federations and roughly 120 individual lobbyists were present in Brussels (Shirreff 1999). As this included insurance, asset management, stock exchange and many other sub-sectors in addition to banking and investment banking, the number appears small. To make matters more extreme, Houston felt that only 6 per cent of those

federations and lobbyists lobbied actively—that is, one or two federations and not many more than seven lobbyists. Yet, given the concentration in the industry, these few could still represent a significant share of the market and hence wield considerable influence. Most of the lobbyists outside this active group functioned largely as one-way communication channels, relaying information from Brussels trade associations to their members and to the rest ‘waiting for the phone to ring’.

Even when second-tier banks did allocate resources to regulatory developments in Brussels, this often happened in the context of their legal departments, charged with ‘keeping track of EU developments’. This was a far cry from actively trying to shape the policy agenda. After all, when continental banks had most of their capital market operations in London but were still tightly controlled from their headquarters, identifying a clear corporate interest was no easy task. As was the case with securities issuers and institutional investors, ‘objectively identifiable’ interests and stakes in EU capital market policy were not enough to ensure second-tier banks’ voices were heard in Brussels—if, indeed, there was a message at all.

Houston’s list of pro-active firms in mid-1990s Brussels includes ABN Amro, Deutsche Bank, Barclays, Citibank, Morgan Stanley and Goldman Sachs, and among the federations, the European Banking Federation (EBF). Interview respondents largely confirmed this pattern. When prompted for the most active lobbyists, the above list normally surfaced with minor variations: Citibank was not always included while ING sometimes was (Interview 160306.b). In 2006, one US investment bank lobbyist described the circle of ‘peers’ in lobbying as ABN Amro, Barclays, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS (Interview 070406).

Among them, the American firms stand out as the most active; they were also the first to lobby in Brussels professionally (Interview 270206, Interview 021205.a). Goldman Sachs—described not without admiration by one insider as a ‘very aggressive, very active, very professional organization’ (Interview 300306)—is generally credited with being the first in

Brussels, setting up its ‘European government affairs office’ in 1992/93 (Interview 070406).

Morgan Stanley—the ‘aristocrat’ among the bulge bracket firms—followed in 1995. Furthermore, they tended to stay ahead of the regulatory curve. As one representative of a national lobbying association remembers,

[y]ears ago our federation went to see John Mogg [the Director General at the European Commission responsible for financial services in the second half of the 1990s]. And he said: ‘Oh yeah, I thought I’d see you guys.’ ‘Oh yeah, why is that?’ ‘The American investment banks came here with this problem six months ago. I can always tell the difference. They always come in before anyone knows the problem. You guys always come in afterwards.’ (Interview 021205.a)

Among the European firms, Deutsche Bank, ABN Amro and Barclays stand out.

Deutsche set up its Brussels office in the early 1990s; ABN Amro followed with its ‘Liaison Office’ late in 1996 (Mijs and Caparrós Puebla 2002). Barclays lobbyists mainly operated from the City, made easy by the completion of the Eurostar train link between Brussels and London in 1994. As pointed out above, the German and French firms were often seen as having ‘two souls’ in lobbying (Interview 070406). In the early days, this complicated coordination with other firms, particularly the American ones. Even if Deutsche’s London investment bankers shared a common position with them, ‘Frankfurt’ might still not have it. As a result, cooperation across the channel was rare in the beginning.

Part of this split within the investment banking community simply had to do with limits to the overlap of interests. Pro-integration banks still differed on the question of harmonization versus mutual recognition. The savvier of the City-based firms realized that integration without harmonization was unlikely, given the need to get member states on board. Nevertheless, they kept pushing for less intrusive EU rules whereas the French and Germans clearly saw the advantages of far-reaching harmonization. These views were shared by their governments. In an article co-authored by two representatives of Deutsche Börse and the director responsible for capital markets in the German ministry of finance, the goal was ‘welfare-optimization through

harmonization' guided by the idea of 'the most far-reaching harmonization of rules and markets to safeguard fair and intensive competition' (Asmussen et al. 2004: 28, translated from German). The French had even stronger views, advocating not only a shared rule-set but a single European regulator as well (institutional change will be picked up again in the next chapter).

Among the investment banks, French banks adopted a relatively low profile on policy issues. Several factors account for this. Even though French firms were not against market integration, they tended to favour it on different terms than the American investment banks. Taking a strong stand within the London investment banking community would have exposed differences without political gain. While French banks were members of the most important City trade associations, their influence was insufficient to sway these bodies. Not sticking their necks out was thus a sensible strategy. More importantly, French state-market relations, themselves a product of the idiosyncratic evolution of French capitalism (e.g. Schmidt 1996), favoured opinion formation at the national level and reliance on state actors rather than trade associations or lobbyists to push their case in Brussels.

In the UK, if the government takes a position that the industry doesn't like, then the industry will say so very strongly. In France, there is much more discipline. If the Trésor decides a line, then that is it. That also gives them a strong position in negotiations. Whereas in the UK or in Germany they [the associations] might very well say 'Well, this is rubbish. We want something else.' (Interview 021205.a)

As French banks were privatized over the course of the 1990s, they became increasingly involved in financial sector policy. As traditional sectoral associations dropped in relevance for the largest banks (Interview 160506.a, cf. Lalone 2005), they founded more initiative-based organizations, most notably EuroFi, a big bank-sponsored think tank meant to emulate the Finanzplatz Deutschland initiative that had been set up in the early 1990s to boost Frankfurt's international standing. One respondent characterized the initiative as follows:

You had in France an American-in-phile faction, who were happy to learn English, who went to business schools, were in investment banking or the academic community. You then had the very big banks, like BNP

and SocGen, who were aware of the need to develop an international vocation rather than just stay inward looking, and they were always keen to create a kind of internationally competitive Paris rather like Finanzplatz Deutschland. And they were quickly able to attract the support of the French institutions. (Interview 300306)

The main aim was not to lobby Brussels directly, but to enlist domestic political actors to the goals of openness and internationalization.

Smaller financial market participants—likely to lose out from market integration and the concentration and consolidation that it was bound to usher in—were also notably absent from the Brussels lobbying game in the 1990s. The very small players, including savings banks and cooperative banks, had their own national associations united in the European Savings Bank Group and the European Association of Co-operative Banks. Both were relatively late to take positions on EU issues and remained largely reactive (Interview 061205). Collective action problems—there were thousands of savings banks in Germany alone—delayed their response to new developments, even when common positions could eventually be found (cf. Olson 1965).

The most important reason for small firms' absence from the Brussels lobbying scene was their opposition to the agenda of the European Commission. Private-public interaction in Brussels became increasingly formalized after 1999 with fixed open consultations, ostensibly 'representative' committees of market participants to consult, etc. With its agenda firmly set on the integration path, informal direct lobbying by firms with protectionist impulses seemed a lost cause. Their preferred route was through national associations with access to member state governments, even if collective action problems put them at a disadvantage to larger firms. Furthermore, research suggests that the Commission prefers contact with European business associations to national ones (Bouwen 2002) and direct contact with individual firms to associations in general (Eising 2007). This was clearly the case within financial market integration when the cooperation of large banks was necessary to achieve politically important goals, for example the creation of a Single European Payments Area (Interview 231105).

The growing split between large and small firms left second-tier firms caught in the

middle. National understandings about market orders—conceptions of control in Fligstein’s (2001) terms—began to fray as large firms pursued their own interests. National associations such as the *Bundesverband der Deutschen Banken* (Association of German [commercial] Banks, BdB) lost their relevance vis-à-vis other industry-government communication channels (cf. Cowles 2001) and left second-tier firms without a body to represent their interests (Interview 220506). Mijs and Caparrós Puebla summarize the process as follows:

In this world, only 15 or 20 years ago, the national federations represented the sector and the accumulated view was presented to the European institutions by the European federations [...]. Domestic mergers in the late 1980s and early 1990s created a number of large banks in Europe [...]. In the 1990s these banks became more and more ambitious to set up operations outside and throughout Europe. At this time these large banks started to realize the direct impact European legislation had on their business. Today most of the large banks in Europe are represented, either by an office in Brussels or by a specialized department (Mijs and Caparrós Puebla 2002: 262).

National sectoral associations such as the BBA, the BdB and the FBF were not the only ones trying to influence European politics, each in their own way. Other prominent organizations included the London Investment Banking Association (LIBA), the European Banking Federation (EBF) and a number of professional associations focussed largely on wholesale markets such as the International Swaps and Derivatives Association (ISDA) and what eventually became the International Capital Market Association (ICMA). LIBA emerged out of what used to be the Accepting Houses Committee, a club of leading City merchant bankers that had functioned throughout the twentieth century as a quasi-trade association of the industry as well as a link to government and the Bank of England (Thompson 1997). In the course of the 1980s, this bastion of ‘gentlemanly capitalism’ (cf. Augar 2000) changed its composition to reflect the growing importance of foreign, particularly American investment banks; in 1989 it changed its name to the British Merchant Banking and Securities Houses Association (normally abbreviated as BMBA) (Filipovic 1997). Five years later, the name was changed again as ‘British’ no longer reflected the composition of its membership (*Observer* 1994). It was now christened the London

Investment Banking Association, a trade association with roughly 40 members representing the top brass of global investment banking.

The high profile of its membership did not mean, however, that BMBA/LIBA was ahead of regulatory developments in Europe. To the frustration of its members who favoured integration (Interview 070406), the organization in the mid-1990s remained absorbed in domestic UK issues (Interview 300306). In later years, certainly after the re-launch of EU legislative activity in 1999, LIBA shifted its focus towards European matters—with one insider claiming it consumed 80 per cent of LIBA's resources by 2006. That said, its voice in Brussels as the de facto mouthpiece of the investment banking industry is tarred by the 'L' in its name. One US investment banker confided that he had repeatedly tried to have 'London' struck from its name (Interview 070406). The British firms among the members, however, were clearly against this. Another respondent voiced regret on the same point:

[I]f LIBA would change its name to European Investment Banking Association, that would improve its abilities in Brussels at the stroke of a pen. (Interview 021205.a)

Though the European Banking Federation (EBF) could boast an 'E' in its name, it had difficulty reaching common positions, certainly until the late 1990s. As a federation of national associations of commercial banks, the EBF needed unanimous support for its statements, which were unsurprisingly hard to reach. Over time, however, trade association officials became more pro-active (Interview 160306.b).

Later in the 1990s they changed their strategy. They would come out with their statement and there would be a very obscure footnote saying "Not all members agree with this..." And that was always the French, almost. (Interview 160306.b)

Recognizing the authority with which the EBF could speak in Brussels, an ABN Amro representative took the lead to establish a separate capital markets committee within the federation that could focus on investment banking issues, reach decisions relatively quickly and exploit the apparent representativeness of the EBF.

### **EU action and industry-Commission contacts ahead of the FSAP**

Contacts between individual banks, industry associations and EU bodies, particularly the Commission, had existed since the inception of the single market programme (Interview 030406). Yet it was only in the mid-1990s that firms began devoting resources to lobbying the Commission and later the Parliament, setting up 'government affairs' offices in Brussels and charging lobbyists with influencing EU developments. Even though contacts were still irregular and informal, American firms in particular started to communicate their dissatisfaction with the state of affairs in EU capital market integration.

A sense of dynamism returned to financial services policy in 1995 when the Santer Commission succeeded that of Jacques Delors. David Wright, who worked as an advisor to Santer and became Director of Financial Services Policy and Financial Markets in the Internal Market Directorate General in 1999, emerged as one of the key figures in the renewed drive towards further integration. John Mogg, Director General of that same directorate since 1993, had also played a leading role on the side of the Commission. An exchange representative remembered that they had held informal consultations with industry representatives already in the mid-1990s (Interview 240506.b). There was then interest in some sort of comitology procedure, which would allow the Commission to update bits and pieces of legislation without having to put them to the Council (Wessels 1998, Bergström 2005). Indeed, such an arrangement had been envisioned for the original ISD. But when the ISD deal was finally struck in 1993, member states' enthusiasm for collective financial services policy was exhausted (Jabko 2006) and the proposals were never followed up.

The most important communication channel between the Commission and industry representatives was an informal group that various respondents as well as four written documents referred to as the Financial Services Strategy Review Group, the Financial Services Strategy Group or the High Level Strategy Review Group (the written sources which could be identified are Shirreff 1999, Bishop 2001, Mijs and Caparrós Puebla 2002, Gottwald 2005). For the sake of



coherence, this account will stick with the first label, abbreviated FSSRG, even though it is uncertain whether this was the one used by its members at the time. The FSSRG was informal and meetings were held under Chatham House rules. No written records of these meetings are available, just as there are no lists of the FSSRG's members, the dates on which it met, etc. Given the political sensitivity of financial market policy, the Commission made clear efforts to avoid publicity around this group; as soon as word spread, the Commission was quick to make amends by establishing further consultative groups and at least pretending to take into account the opinions of governments and other stakeholders. Even during interviews for this thesis, Commission officials remained deliberately vague on the FFSRG:

In pre-98, there was also a discussion paper, but the process was not as developed as it is now. [...] In the past we had a document. We showed it to a number of people. We asked their reaction, and that was it. [...] There was no formal group pre-FSAP. But we had some people, meetings. It was not formally a group that was established. (Interview 141205)

The FFSRG was convened by the European Commission, and John Mogg specifically, to study 'what was wrong with the single market' (Interview 021205.a). As one member described it, the Commission established the FSSRG in 1998

to draw together the current "wish list" of market participants in the light of the imminent arrival of the euro and the breath-taking pace of technological change since the original work on the Single Market a decade earlier. (Bishop 2001)

FSSRG members consisted of roughly 20 representatives of financial firms that had considerable stakes in a deeply integrated European financial market (Gottwald 2005).<sup>39</sup> ABN Amro for example supplied a member to the group; according to two people working for it at the time, this was considered a major lobbying success (Mijs and Caparrós Puebla 2002: 259).

The FSSRG held little more than half a dozen meetings in which the themes that were later to structure the Financial Services Action Plan were identified. Once it became clear that there was strong support for action within the group, Mogg informed Mario Monti,

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<sup>39</sup> Another respondent reported 18 members. Interview 160306.b

Commissioner for the Internal Market and Financial Services, that there were clear suggestions about what should be done and that current political and economic conditions provided a window of opportunity to push for change. The members of the group presented their ideas to Monti, something that reportedly helped secure his support (on this point and the following paragraph, see Gottwald 2005: 127ff).<sup>40</sup>

That Commission officials felt it necessary to consult industry members and involve them in the re-launching of financial market integration already says much about their importance. Once the industry and the Commission had effectively joined forces, getting the Council to agree on the new legislative programme proved much less of a problem. This did not mean that the Commission simply transcribed industry demands. For both political and practical reasons, the report that was eventually put to the Council was drafted by the Commission. This also gave the Commission space to insert some of its own ideas into the document.

As pointed out previously, there was disagreement over the route to further market opening among the pro-integration investment banks: City firms (including the US banks) preferred mutual recognition as envisioned in the original ISD while most continental firms were in the ‘maximum harmonization’ camp (Shirreff 1999). The question of whether new legislation was necessary or desirable thus split the pro-integration banks, with the City clearly against further legislation (Interview 160306.b). The Commission felt differently on this point. For the Commission as an organization, drafting new legislation is its most important power in the EU, effectively its *raison d’être*. At the same time, it realized that some degree of regulatory harmonization would be the political price to pay for effective market opening.

The question of new legislation, however, only really surfaced in 2000, and by then the re-launch was well under way. Even the FSAP only vaguely referred to an ‘updating’ of the ISD,

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<sup>40</sup> One respondent, who was a member of the FSSRG, also remembered having personally presented the findings of the group to both Mogg and Monti.

tucked away among 42 other proposed measures. One representative of the mutual recognition camp clearly realized that ‘his’ perspective had lost out in the end:

[W]e [the members of the FSSRG] worked for almost a year, we identified almost all the flaws in the single market, [...] presented the results to Monti and Mogg. And we concluded there is need for very little new legislation. [...] Our main message was ‘enforce’, ‘implement’, tidy up the ambiguities. Then—and this takes us to the FSAP, around Vienna, Cardiff, the Commission wanting to relaunch the single market—then they came out with the FSAP. And we were just amazed. And they sold this to the UK Treasury on the basis of what practitioners wanted. This is not what we had asked for. We said: Hardly any new legislation. We wanted the market to work as intended. But then to say that this is what practitioners wanted is stretching the truth. We wanted a single market. We didn’t want the FSAP. It came as a shock. (Interview 160306.b)

Politically, the FSAP and the regulatory harmonization it entailed became the only viable route to agreement among member states and thus the single market.

The United Kingdom held the EU Presidency in the first half of 1998. The City had made clear to the Treasury that the single market in financial services was not working as intended. As one British respondent, seconded by the UK government to the Commission at the time, remembered,

[t]he UK was very supportive of the whole approach [to relaunch financial market integration]. And many of the financial institutions operating in London were very much in favour. US ones, German ones, French ones. If you talk to the big banks, ABN Amro, Deutsche Bank, BNP Paribas, quite often, on these issues, they will have the same opinion. Their respective governments may not. (Interview 021205.a)

In the UK presidency’s final European Council meeting in Cardiff in June 1998, the Council asked the Commission to produce an action plan to reinvigorate financial market integration (European Council 1998a). The basis of the Council decision was a report produced by the Commission, which drew on discussions in the FSSRG. Ahead of the European Council meeting, members of the FSSRG had coordinated their lobbying: top-ranking officials wrote to ‘their’

ministers to point to the importance of the coming Commission communication. As planned, the European Council asked the Commission to make an official report to be presented at the Vienna Council later that year. In the run up to this meeting, industry representatives were again consulted (Shirreff 1999); one respondent working for a large exchange remembered industry members sitting down with the Commission ‘around that time’ and going through the articles of the ISD one by one (Interview 240506.b). The communication that the Commission presented at the European Council meeting, *Financial Services: Building a Framework for Action* (European Commission 1998), was

the Commission-edited summary of the individual demands of the members of John Mogg’s informal groups. (Gottwald 2005: 130, translated from German, DM)

The Vienna European Council endorsed the *Framework for Action* and asked the Commission to draft a concrete proposal for legislative action, to be presented first to ECOFIN, the Council of finance ministers, and then to the Cologne European Council in June 1999 (European Council 1998b). These proposals were to become the *Financial Services Action Plan* (European Commission 1999c).

There was, however, criticism that the Commission’s consultations had been one-sided, with too much focus on market participants from the City (Shirreff 1999, Interview 160306.b). Governments also asked for a greater voice in the preparation of the FSAP. The Commission thus established the Financial Services Policy Group (FSPG) with high-ranking government officials as members and Monti himself as chair (European Commission 1999d). It met for the first time in January 1999 but was widely seen as a form of politically correct window dressing to assuage government concerns (Interview 021205.a). The ISD, the overhaul of which eventually emerged as the most ambitious element of the FSAP, was not even mentioned in the summary of the FSPG’s first meeting; it was certainly not listed as one of the priorities (European Commission 1999d). It is not implausible that the Commission, which chaired the FSPG meetings, deliberately deflected attention from the changes to the existing legislation that it

had in mind. One Commission official remembers that at the time, the ISD was consciously not included:

On [the] basis of what was in the FSAP, indeed, we [embarked on the wider reform of the ISD]. In the end, nobody really contested that it was part of the FSAP. But initially, it [as new legislation] was not part of it, because it was too recent as legislation. [The original ISD] was regarded as a failure particularly by the Commission. But it was too recent to be part of the FSAP. But we followed, and nobody said anything. [...] The FSAP has also been a success because everybody felt that it was necessary to do something. There was a consensus on the need to do something, to integrate financial services. Nobody saw a problem with incorporating the ISD. (Interview 141205)

At the third meeting of the FSPG, less than two months after its establishment, the Commission identified

strong support for the proposal to review the Investment Services Directive to ensure that this core element of the single market framework measures up to the needs of an integrated financial market place. The idea of a single authority to monitor and enforce market rules was floated. There was support for further consideration of the appropriate infrastructure which will be needed to manage a more integrated EU wholesale market. (European Commission 1999b)

The Commission had been able to use its prior consultations with industry to argue that ‘the market’ was supportive of its plans—which was basically correct if for ‘market’ one understood ‘the leading firms in the industry’. As the FSAP was published a little more than three months after the first meeting of the FSPG, in May 1999, it comes as no surprise that the FSPG’s influence on the document was slight. Most decisions on what would be included in the list of areas that needed legislative action had already been taken. In one way or another, an overhaul of the ISD would be one of them. As it turned out, this overhaul would emerge as the single most important EU legislative project in financial services in over a decade.

### **The FSAP, the ISD and the Forum Groups**

The FSAP authorized the Commission to start work on a whole host of new directives; the

action plan identified no less than 43 areas in need of attention (European Commission 1999c, for an overview, see HM Treasury et al. 2003). Once the Cologne European Council had endorsed its findings (European Council 1999), work could begin to review existing legislation or draft completely new texts. The Commission quickly identified the ISD as one of the core areas of concern (e.g. Monti in *Handelsblatt* 1999). The Markets in Financial Instruments Directive (MiFID), as the ISD replacement was eventually named, emerged as the keystone of the new regulatory edifice.

State actors were hardly enthusiastic about the FSAP. The arguments with which the Commission and private actors tried to sway them revolved around two themes: ‘getting the most out of the euro’, which was about to be introduced in 1999, and exploiting the growth potential of vibrant capital markets, something that the US stock market boom seemed to irrefutably demonstrate.

State regulatory agencies were noticeably absent in the re-launch of EU financial market integration. In 1997 regulators had initiated their own bottom-up form of cooperation in the Federation of European Securities Commissions (FESCO), loosely modelled on IOSCO (Interview 160506.b, Interview 210306). It began work, for instance, on agreeing common definitions for loosely defined terms in the ISD (Federation of European Securities Commissions 2000). But due to anticipated rivalry between the Commission and the regulators over EU rule-setting, the regulators were largely excluded from the FSAP process—surprising given the stated aim of creating better and more efficient regulation.

The connection between the euro and the re-launch of capital market integration was ubiquitous: in the popular press (Davison 2001), in Commission documents such as the FSAP (European Commission 1999c) and in lobbying strategies (Mijs and Caparrós Puebla 2002). At the same time, several lobbyists confided that the euro was less a driving force for market integration than a convenient hook on which to hang it (Interview 050406, Interview 270206, Interview 070406). Discontinuities between currency areas had not been an obstacle to cross-

border market integration before. To be sure, the euro allowed the convergence of interest rates across Europe and narrowed the spread between eurozone government bond yields (European Commission 2005b). But by themselves, these arguments did little to strengthen those for deepening market integration that were already on the table.

Nevertheless, governments in Paris and Berlin saw the UK's decision to stay outside the eurozone as an opportunity for their national capital markets to compete with the City. In the late 1990s, the prospect of London losing business in the wake of the single currency was still taken very seriously (*Handelsblatt* 1998), a point that was also raised in several interviews. Combined with the location of the European Central Bank in Frankfurt, the potential boost to the German 'Finanzplatz' was a major incentive for the German finance ministry to support the FSAP (Interview 020506). It is ironic then that many of the strongest corporate proponents of the euro-argument in support of capital market integration had their bases outside the eurozone—in the City. They correctly foresaw that in an age of electronically integrated financial markets, the location of a bank vis-à-vis a currency zone mattered little. With the benefit of hindsight, the euro was a blessing for the City: national foreign exchange markets were turned upside down, as were futures markets for currencies (much of the currency derivatives business did actually end up in Frankfurt). More importantly, many firms integrated their national bond trading desks into one eurozone trading desk and relocated their traders from national financial centres to their own European headquarters, normally in London (Interview 140306.b). By increasing the scope for conglomeration through the choice of business location (cf. Bindemann 1999), the euro probably did more to hurt Frankfurt and Paris than to aid them.

Just as the euro was a discursive window of opportunity, the argument linking rapid capital market development to higher economic growth must be taken with a grain of salt. At the time, however, the impressive growth in the United States was seen as a result of the boom in capital markets, particularly the provision of venture capital to young, 'innovative and high-growth' companies (e.g. Rajan and Zingales 2003). As pointed out in the preceding chapter,

continental European governments were susceptible to reform agendas that promised to create a similar dynamic in Europe, something that became clear in the Lisbon Agenda of 2000 (cf. Sapir 2004). Commission president Santer himself made the case for the importance of risk capital to finance SMEs in front of ECOFIN less than two months before the Cardiff Council (ECOFIN 1998), while similar arguments were used to push for a European version of NASDAQ (Posner 2005). National stock exchanges, too, were quick to set up their own 'growth markets'. Risk capital provision was seen as a crucial issue and financial market integration sailed easily under that banner.

Getting and keeping governments on board was only half the work, however: in addition to the FSPG, the Commission set up five so-called Forum Groups in the summer of 1999. This was in part due to continental criticism that there had been an Anglo-Saxon bias in the Commission's consultations with industry. John Mogg thus invited industry associations covering the whole breadth of financial services to nominate members to the Forum Groups—including one on 'updating the ISD' (Shirreff 1999)—in which the Commission would consult market participants to identify concrete future steps. The group concerned with the ISD first met in October 1999, at which point the Commission unveiled a Green Paper that set out the issues for discussion (European Commission 1999a). Several respondents who had been involved in the pre-FSAP consultations, however, felt that the Commission had reached its own conclusions—even as the ABN Amro representatives considered it a great success that their representatives were present in four of the five Forum Groups (Interview 160306.b). One US lobbyist showed clear disdain for these Forum Groups, pointing out that his bank had 'gotten involved' much earlier (Interview 070406). Yet another one complained that

[t]he agendas [of the forum groups] were drafted by the Commission and the papers were drafted by the Commission, supposedly on the basis of what the experts said but sometimes that was not the case. [...] The classic one [where this happened] was market abuse where the industry had a very strong opinion, finding that there was absolutely no benefit to European legislation on market abuse. What was needed was better



enforcement on the national level. And the Commission comes out with a directive. No one on that group thought that that was a good idea. In other groups, it was less clear-cut. You always get some industry people who are in favour and some who aren't. So the Commission is free to pick and choose. (Interview 021205.a)

The question of mutual recognition versus rule harmonization was a good example of this: for its own reasons, the Commission sided with those in the industry who preferred the latter. By 2000, it was busy drafting a new directive to eradicate the shortcomings of the ISD.

**Conclusion: Public and private agency in the re-launch of EU financial market integration**

With the FSAP, the gradual shift in preferences among core constituencies in capital market governance was translated into palpable action. With the action plan, the Commission had won a mandate to draft legislation across a wide range of financial market issues, including those covered by the original ISD. But what does the genesis of this legislative mandate tell us about the political economy of supranational governance? Three kinds of actors played significant roles in this chapter: supranational actors, above all the Commission, national governments, and industry lobbyists, both individually and through trade associations. How is their influence on EU capital market policy to be evaluated?

As pointed out in the introduction to this chapter, North American scholars in particular have emphasised the room for manoeuvre that supranational actors can have in determining policy (Marks et al. 1996, Pierson 1996, Pollack 1997, Posner 2005). Many of their arguments have been in response to the perceived dominance of neoliberal intergovernmentalism (Moravcsik 1991, 1993, 1998). This debate has largely been cast in dichotomous terms—asking whether there is any scope for supranational agency at all—rather than inquiring about how important it may be compared to other actors and factors shaping regional integration. In this sense, the debate has fallen back several decades. For instance Schmitter in 1970 summarized the transformation of political, economic and institutional structures in regional integration as

follows:

The most important transformation in the structure of the model during these stages occurs in the nature of national actors. Up to this point they have been treated as units with a single integrative or disintegrative strategy during any crisis. Now they begin to appear as *differentiated* actors, as a plurality of negotiating units (classes, status groups, sub-regions, *clientelas*, bureaucratic agencies, ideological clusters, etc.). [...] These “subnational” fragmented actors [...] will begin to form stable “transnational coalitions” of support and opposition to particular measures. The policy vector now becomes the product of alliances that cut across national boundaries [...]. National governmental actors may continue to play the preponderant role in the concatenation of strategies, but they can be circumscribed, if not circumvented, by coalitions of other governmental actors with subnational groups and regional *técnicos*. (Schmitter 1970: 864f, emphasis in original)

In many ways, this description still fits the evidence presented in this chapter and, indeed, this thesis as a whole.

State actors have clearly played an important role in re-launching financial market integration. Without their endorsement of the FSAP, the whole project would have stalled. But Schmitter challenges us to look behind the formal procedures and identify the actors and coalitions—social forces in Cox’s (1981) terms—that drive economic and political change. State policy always serves someone’s interests. Possibly but not necessarily these interests are those of a sufficient range of constituencies that one might speak of a public interest being served. Nevertheless, from a political economy perspective the question of who the beneficiaries of state policy are stands centre stage—and its answer is not self-evident.

This chapter has argued that a shift in regulatory preferences among an insider group of leading firms in European investment banking, based on the developments recounted in the preceding chapter, has been the central factor explaining the successful re-launch of market integration. Commission initiatives would have been futile against the unified opposition of market participants. Jabko (2006: 60) has characterized its role in this policy domain as that of a ‘political accelerator of institutional change’.

The measures contained in the FSAP of course did not receive the unanimous backing of the industry. Some measures were stiffly opposed, such as the Market Abuse Directive. Yet from the perspective of this thesis, issues such as insider trading pale in significance to those governed by the ISD. Insider trading and market manipulation rules are seen as a ‘regulatory burden’ by financial firms. They do not, however, reshape the competitive landscape nearly as much as the ISD did. Cross-border market access and the comparative regulatory advantage of for example investment banks versus regulated exchanges were the kinds of issues that really mattered in the long-term perspective of firms in the business. It thus comes as no surprise that ‘upgrading the ISD’ took even longer than the four years spent negotiating the original. The Markets in Financial Instruments Directive (MiFID) was a much longer document that replaced minimum harmonization and mutual recognition with full rule harmonization. As the following chapter shows, member states felt compelled to agree on a new legislative procedure—the Lamfalussy process—to facilitate the design of such an encompassing supranational rule set. Seen from a long-term perspective, this combination of comitology procedures and heavy expert involvement in rule-making completed the transition from the intergovernmental mode of EU governance that prevailed around 1990 to the ‘supranational constellation’ that governs EU capital markets today. To be sure, however, the perceived need for institutional change only arose on the back of the new consensus in favour of integration that this chapter has analysed.

## **CHAPTER 7: EU CAPITAL MARKET INTEGRATION AND THE EMERGENCE OF SUPRANATIONAL GOVERNANCE**

A decade after the re-launch of European financial market integration in 1998, the policy field has been thoroughly Europeanized. The lion's share of new rules and regulations is now European in origin while national legislative room for manoeuvre is restricted. Two new committees have been created to assist the Commission in drafting new legislation and designing implementing measures. The influence of the European Parliament has been expanded whereas that of the Council has been reduced. Industry consultations now largely take place at the European level and have been formalized through the establishment of several 'expert committees' that assist supranational bodies in policy-making. The industry itself uses European associations more than ever before, and only in divisive issues such as clearing and settlement do national positions (and hence national associations) retain precedence. All of this is the flip-side of the transnational ambitions and business models that have emerged within the financial industry over the past two decades. As these changed market structures inspired new regulatory preferences among industry insiders, they generated a constituency in favour of integrated patterns of governance, as well.

This chapter traces the creation of the supranational institutions that govern European capital markets today. Central to the story is the adoption of the so-called Lamfalussy process by the Council in 2001 and the European Parliament in 2002 (see Committee of Wise Men 2001). This new legislative procedure was crucial in institutionalizing the role of two new European committees, the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). This chapter uses first-hand empirical material—in particular interviews with policymakers and industry representatives—to show how industry support and the competitive implications of governance arrangements were crucial for institutional change. Whereas national financial industries earlier relied on national governments to represent their interests, larger firms now prefer a supranational and much more technocratic approach to rule-