No. 2 / April 2010

research
Observatoire social européen
paper

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Abstract

This paper examines the regulatory response of the European Union to the global financial crisis, addressing the questions of whether, how and why the global financial crisis has changed the 'old' politics of financial services regulation in the EU. It is argued that the crisis challenged the existing model of financial regulation, which had to a considerable extent been influenced by the UK and the financial industry. With a good dose of political opportunism, a less 'market-friendly' approach to financial regulation has gained ground in the EU, empowering the coalition sponsoring that paradigm, notably France and Germany.

Keywords: financial regulation, single financial market, financial crisis, governance

[*] Financial support from the European Research Council (204398 FINGOVEU) is gratefully acknowledged. This paper was written while I was visiting fellow at the Robert Schuman Centre for Advanced Studies, European University Institute, Florence. I wish to thank Jean-Pierre Casey, Michelle Cini, Adrienne Heritier, Dermot Hodson, Madeleine Hosli, Zdenek Kundrna, Harold James, Nieves Perez-Solorzano Borragan and Uwe Puetter for their perceptive comments on an earlier draft of this paper. This paper was presented at the conference on 'Regulatory and Supervisory Responses to the Global Financial Crisis' at the College of Europe in Bruges, the ECPR joint sessions in Muenster, and two research seminars, respectively, at the EUI and at the University of Bristol. I wish to thank all the participants to these events for their insightful comments. Finally, I am grateful to all the practitioners who made themselves available for interview. All interpretation, errors and omissions are mine.

1. INTRODUCTION

The global financial crisis that began in 2007 delivered a major shock to the existing architecture for financial services regulation and supervision. The European Union (EU) was one of the jurisdictions most severely hit by the turmoil, prompting an intense regulatory debate concerning the revision of existing rules and the adoption of new regulatory measures in the EU. This paper examines the regulatory response of the EU to the global financial crisis, addressing the questions of whether, how and why the global financial crisis has changed the 'old' (pre-crisis) politics of financial services regulation in the EU and fostered the emergence of a 'new' politics.

In order to do so, it sketches out the EU's regulatory response, evaluating whether it represents a major break from the past – a policy shift - as could be expected following a crisis of that scale, or whether it is an incremental adjustment, while analysing the regulatory changes undertaken. It then investigates what has shaped the EU regulatory response. Have the regulatory reforms enacted in the EU been underpinned by a realignment of economic interests or a change of regulatory paradigms? Has the global financial crisis altered the power dynamics in the regulation of financial services in the EU? How and why?

The EU's response to the global financial crisis is an important research topic for three main reasons. First, the EU has devoted considerable efforts to the completion of the single financial market in Europe following the Financial Services Action Plan (FSAP) in 1999. After the Plan was completed in 2004, it was agreed that there would be a 'regulatory pause', whereby the focus would be on implementation and monitoring (Commission 2004a). However, in the aftermath of the global financial crisis, the EU has undertaken a series of regulatory changes. Second, EU rules to a large extent provide the framework for national regulatory changes in the member states. Third, the EU is one of the largest jurisdictions worldwide, it is increasingly active in shaping global financial rules in international fora, and it is one of the main interlocutors of the US in the policy debate on this subject (Posner 2010). Whereas the first and second aspects represent the 'internal' regulatory response of the EU to the crisis, which is the main subject of this piece of research, the third aspect represents the 'external' regulatory response of the EU, which, due to space constraints, it is not elaborated further in this paper (on the reform of international financial regulation following the crisis, see Helleiner, Pagliari and Zimmermann 2010).

This research is operationalised as follows. It begins with a review of the literature of the old politics of financial services regulation in the EU prior to the global financial crisis, teasing out the main drivers of and obstacles to financial market integration in Europe, the key players in the making of EU rules for governing finance, the main causes of policy controversies and political conflicts in the EU regulatory process. This section also outlines the analytical framework of the paper, which builds on previous research on financial services regulation in the EU in the 2000s, pointing out the interplay of two competing advocacy coalitions – the 'market-making' coalition and the 'market-shaping' coalition. Finally, the main explanations that can account for the EU's regulatory response to the global financial crisis and the politics underpinning it are singled out.

The third section provides an overview of the regulatory changes enacted or set in motion by the EU in the aftermath of the financial crisis. The focus is on the medium to long term response, hence primarily the legislative measures proposed or adopted by the EU, rather than the short-term crisis management measures taken by the EU (on the short-term

response see Quaglia et al. 2009, as well as the special issue of the *Journal of Common Market Studies* 2009). This section classifies the vast majority of the EU regulatory measures and institutional reforms undertaken by the EU as 'market-shaping', that is regulating previously unregulated financial activities, tightening up existing regulation of regulated entities, and strengthening the institutional framework for financial oversight in the EU. In terms of outcome, the new rules tend to embody several regulatory preferences of the market-shaping coalition.

The fourth section explores the new politics of financial regulation in the EU, teasing out the main drivers of and the opponents to the EU regulatory and institutional reforms and process tracing the causal mechanisms at work. It is argued that through the 'window of opportunity' opened by the crisis for both policy learning and the strategic use of ideas for political purposes, the market-shaping regulatory paradigm has gained ground at least temporarily in the EU regulatory space. The global financial crisis served to empower the coalition sponsoring that paradigm, notably France, Germany, Italy, and Spain and to silence the market-making regulatory paradigm advocated first and foremost by the UK, Ireland and the Nordic countries.

This paper contributes to three main bodies of academic literature. It updates the old (i.e. pre-crisis) literature on the politics of EU financial market regulation, which is reviewed in Section 2. It substantially develops the burgeoning literature on the response to the global financial crisis in various jurisdictions. Finally, it feeds into the broader literature on 'ideational politics' and the interplay of interests and ideas in EU financial market regulation, macroeconomic governance, policy change, as well as political economy and regulation more generally.

The research does not attempt to evaluate the effectiveness (or otherwise) of the EU's regulatory response – it sets out to explain the political dynamics underpinning it. However, the conclusions offer some thoughts on this. The reform of the institutional architecture that frames the formulation and the implementation of EU rules is also considered as part of the regulatory response.

2. THE STATE OF PLAY ON THE POLITICS OF FINANCIAL SERVICES REGULATION IN THE EU

The political economy literature on financial services regulation in the EU can be divided into two main bodies, depending on their timing: the works produced prior to the global financial crisis, the vast majority of which tend to deal with the completion of the single market in financial services in the late 1980s and early 1990s; and the most recent works produced in the wake of the global financial crisis, with a specific reference to its implications for Europe.

The pre-crisis literature developed competing understandings of the political economy of financial services regulation in the EU. However, with a handful of exceptions that adopted an 'economic constructivist' approach (Grossman 2004, Jabko 2006), the vast majority of the works reviewed assigned explanatory power to the interests of the main stakeholders, be they the member states, industry or the Commission. Story and Walter (1997) stressed the intergovernmental character of the negotiations concerning financial market regulation in the EU in the 1970s, 1980s and early 1990s. As the title of their book suggests, their work regarded financial market integration as the 'battle of the systems', whereby the member states were keen to set EU rules that were in line with their

domestic regulatory approach and did not create comparative disadvantages or adjustment costs to national industry and the public authorities. However, they also stressed the importance of 'ideas' about regulation, the state and financial services (for a similar argument, see also Grossman 2004). Underhill (1997), like Story and Walter, highlighted how the 'triangle' of the three main financial systems in the EU - the British, the French and the German - played out and shaped EU financial regulation in the 1980s and early 1990s.

In a similar vein, but covering the most recent period from the relaunch of the completion of the single financial market with the FSAP (1999) up to the unfolding of the crisis, Quaglia (2010a, b) points out the competition between the 'market-making' coalition, lead by the UK, and the 'market-shaping' coalition, led by France and comprising Italy, other Mediterranean countries and in several instances Germany. The new member states had not yet joined or had only recently joined the EU when the new set of financial services rules implementing the FSAP were negotiated and agreed upon in the first half of the 2000s. The Commission tended to side with one coalition or another depending on the issue being discussed and the timing, in that the change of the College of Commissioners in 2004 and the appointment of the Irishman Charles McCreevy as Commissioner for the Internal Market moved the Commission closer to the 'market-making' coalition.

A second explanation views the Commission as the core supranational actor driving financial market integration (Posner 2005, Jabko 2006). A third explanation focuses on the role of the private sector, in particular transnational capital, in promoting European financial market integration (Bieling 2003; Mügge 2006; Macartney 2009; Van Apeldoorn 2002). Other scholars have focused on networks of regulators in the EU (Coen and Thatcher 2008; De Visscher et al. 2008; Quaglia 2008), an approach which, however, has limited explanatory power in the making of level 1 legislation (or framework legislation), even though it is more successful when applied to level 2 legislation in which the so-called Lamfalussy committees (or committees of regulators) are the main players.

In the wake of the global financial crisis, there has been renewed scholarly interest in financial services regulation in the field of public policy and political economy, even though, given the timing of publication, the vast majority of academic works have focused thus far either on the causes of the crisis (see, for example, Gamble 2009), or on the short-term national, EU or international responses to the global financial crisis (for an exception, see Helleiner et al. 2010). A vast array of scholarly works dealing with crisis management and crisis resolution measures can be found in the *Journal of Common Market Studies* (2009) and *South European Society and Politics* (2009).

The Analytical Framework and Research Design

This piece of research sets out to explain the regulatory response to the global financial crisis and the shift from the 'old' to the 'new' politics of financial services regulation in the EU. Hence, adopting a quasi-experimental research design and taking time into account, the global financial crisis is the antecedent variable, which basically assumes two values: the absence of the crisis, prior to 2007; and the unfolding of the crisis, from 2007 onwards. The dependent variable comprises the change of EU rules (mainly hard law) concerning financial services following the crisis and the politics underpinning it. The specific focus is on the shape that the EU response took, notably the scope, the content and the distinguishing features of the new regulatory framework (the outcome). The research also pays attention to the politics surrounding the adoption of such measures (the process). It aims to tease out the independent variables and the causal mechanisms

through which the crisis has triggered regulatory changes in the EU, explaining how these elements have re-shaped the politics of financial services governance in the EU.

The research builds on Quaglia's analysis (2010a,b) which applied a revised version of Sabatier's advocacy coalition framework (Sabatier 1993, 1998) to the politics of financial services regulation in the EU prior to the global financial crisis. Two main competing coalitions of public and private actors struggling to shape the EU's regulatory framework were singled out: the market-making coalition, and the market-shaping coalition. They were coalitions of interests and ideas. Indeed, the main line of division between the coalitions was due to different structures of national financial systems (Story and Walter 1997; Underhill 1997), namely whether the financial system was mainly bank-based or securities-based; whether it dealt mainly with wholesale finance or retail finance; its degree of openess and competitiveness; the links between banks and industry and the presence or absence of small and medium enterprises in the real economy (hence, 'interests').

However, the two coalitions were also divided by different, and at times, competing 'belief systems' (Sabatier 1993, 1998) or 'policy paradigms' (Hall 1993) concerning financial services regulation, in particular its objectives and instruments. To put it crudely, the market-making approach emphasised the objectives of competition and market efficiency, whereas the market-shaping one privileged the objectives of financial stability, consumer protection, as well forms of veiled protectionism. As for instruments, the market-making approach relied on light touch, principle-based regulation and private sector governance. The market-shaping approach favoured prescriptive, rule-based regulation, with a strong steering action by the public authorities. These competing regulatory paradigms were informed by different attitudes to risk and ontological outlooks concerning the functioning of the market: respectively, market trust and market distrust (Quaglia 2010a, b).

Although both coalitions managed to influence the EU regulatory process over the last decade, the very completion of the single market in financial services was a clear success of the market-making coalition (Mügge 2006, Bieling 2003). Moreover, the EU rules adopted prior to the global financial crisis were to a considerable extent based on the belief system of this coalition (interviews, Brussels, March and June 2007; Rome, December 2007; Madrid, March 2009; Lisbon, November 2008; London May 2007, July 2008). In the competition between these two coalitions, the UK-led coalition by and large prevailed because of two interconnected reasons: the evolution of the policy environment, which realigned economic interests in the EU, and a process of learning, which influenced regulatory paradigms in the EU. In the early 2000s, the market-making coalition was empowered by the introduction of the single currency, which increased financial market integration in the EU, and by the renewed competition between the EU and US in this field. In this context, the completion of the single market in financial services became a priority for the EU and the market-making, competition-friendly approach was regarded as the most successful, providing a competitive model for the EU, hence a process of learning across coalitions took place.

The global financial crisis acted as an external shock that fundamentally altered the policy environment in which the competing coalitions operated. Three main independent variables and causal mechanisms concerning the implications of the crisis for financial services regulation in the EU can be postulated and evaluated against the empirical record. These (partly competing) explanations, which are rooted in different understandings of the political economy of financial services regulation reviewed above, should be able to

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account for the shape of the reformed regulatory framework and the politics surrounding it. Their explanatory power is assessed by teasing out observable implications about regulatory outcomes and processes and evaluating these expectations against the empirical record using the congruence procedure and process tracing.

The first explanation, which borrows from economists' public interest approach to regulation, draws on the 'public interest' or the 'public good' as the independent variable. The causal mechanism is a functional one, whereby the EU simply responded in a rational way to the crisis, undertaking regulatory and institutional changes designed to address the shortcomings put under spotlight by the crisis and to restore the semi-public good of financial stability (Nieto and Schinasi 2008). This is largely an apolitical explanation. The hypothesis is that the main policy actors, who are also parts of competing advocacy coalitions at work in the pre-crisis period - hence the member states, the Commission, the European Parliament (EP) and to some extent industry – objectively deliberated on the reforms needed to safeguard the semi-public good of financial stability.

Observable implication 1a (outcome): If this hypothesis about a purely functional response is correct, the expectation is that the new rules adopted should be 'first best' solutions in regulatory terms.

Observable implication 1b (process): If this hypothesis is correct through process-tracing one should be able to observe the lack of political conflict concerning the reforms enacted and the agreement between the competing advocacy coalitions.

The second explanation takes a traditional political economy approach (Story and Walter 1997, Underhill 1997, Van Apeldoorn 2002, Mügge 2006), whereby the independent variable revolves around interests meaning that the causal mechanism is interest-based, emphasising the costs and benefits for the main stakeholders with reference to the regulatory process and outcome. The hypothesis is that the global financial crisis, which impinged upon national financial systems, caused the realignment of the interests of the competing coalitions, shifting the balance of regulatory power across coalitions. It should also be noted that to some extent the first explanation is interest-based, whereby the main driver of regulation is the public interest, whereas by contrast in the second explanation it is driven by the specific interests of the main stakeholders.

Observable implication 2a (outcome): If this hypothesis is correct, the expectation is that the new rules should be 'congruent' with the interests of the coalition empowered by the crisis.

Observable implication 2b (process): If this hypothesis is correct, through process-tracing one should be able to observe major changes of national financial systems and shifting policy positions across coalitions.

The third explanation adopts a constructivist take on political economy (Busch 2004, Grossman 2004, Jabko 2006), hence the third independent variables are ideas (or regulatory paradigms) and the causal mechanism is idea-based. The hypothesis is that the global financial crisis, which impinged upon existing regulatory paradigms, shifted the balance of regulatory power across coalitions. In particular, one would expect the crisis to challenge the market-making paradigm favoured by the EU prior to the crisis, giving momentum to the market-shaping regulatory paradigm, which advocated the need to 'reign in' the market (Quaglia 2010a,b).

Observable implications 3a (outcome): If this hypothesis is correct, the expectation is that new rules should be congruent with the beliefs system (or regulatory paradigm) of the market-shaping coalition.

Observable implications 3b (process): If this hypothesis is correct through process-tracing one should be able to observe a revision of the existing regulatory paradigms and shifting policy positions across coalitions.

3. THE EU'S REGULATORY AND INSTITUTIONAL REFORMS OF FINANCIAL SERVICES 2008 10

A host of new regulatory initiatives were undertaken by the EU in the aftermath of the global financial crisis, besides the short-term crisis management measures taken in the midst of the turmoil. The traditional classification of financial services comprises three main segments: banking, securities and insurance,[1] to which one could add accounting and auditing standards and post-trading activities (payment services and clearing and settlement of securities), which can however be regarded as part of the banking sector and securities markets.

The legislative measures adopted or proposed by the EU in 2008-10 involved primarily the banking sector; securities markets; accounting standards and the institutional framework for financial services regulation and supervision in the EU. The global financial crisis also triggered an institutional reform of the EU framework for financial regulation and supervision, following the so-called de Larosière report (2009). These changes are summarised in Table 1, which reports the list of new rules introduced or substantially amended, and their content. The EU's actions that did not result in 'hard' legislative measures are not examined here due to space constraints. Examples of EU soft regulatory measures are the setting of European central counterparties (CCP) to clear complex financial products, such as credit default swaps; corporate governance concerning managers' remuneration and the consultation on the revision of the EU framework for cross-border crisis management in the banking sector.

[1] Financial conglomerates straddle the milieu between these three segments of the financial sector.

Table 1. Overview of the EU's Regulatory Response to the Global Financial Crisis

Regulatory change in the EU: - new rules introduced - existing rules amended - institutions established or reformed	Content of new or amended rules
Banking	
Deposit Guarantee Scheme (DGS) Directive amended (October 2008).	Minimum level of coverage for deposits increased; payment time reduced.
Capital Requirement Directive amended (October 2008 and subsequent revisions); see also Basel 2 revisions (December 2009).	Liquidity risk management, higher capital on trading book and securitisation; sound remuneration practices.
Securities and Investment Funds	
Regulation on Credit Rating Agencies (CRAs) (May 2009).	CRAs compulsory registration and compliance with rules concerning conflict of interest and quality of rating.
Proposed Directive on Alternative Investment Funds Managers (AIFMs) (June 2009).	Legally binding authorisation and supervisory regime for all AIFM, European passport for AIFM.
Accounting	
Commission Regulation adopting amended International Accounting Standards (October 2008); see also IASB revisions (October 2008). Impasse on Subsequent IASB Standards Revisions (November 2009).	Fair value not applied to certain banks' assets.
Institutional Framework for Regulation and Supervision	
Commission's Proposed Directives (September 2009); see also de Larosière report (February 2009).	Transformation of level-3 Lamfalussy committees into European Authorities coordinating the application of supervisory standards and cooperation between national supervisors creation of a European Systemic Risk Board.

Overall, the regulatory changes undertaken by the EU were significant (Posner 2010), if compared to the regulatory reforms underway in other jurisdictions. In some cases, such as credit rating agencies (CRAs) and alternative investment funds managers (AIFMs), the EU rules were stricter than those set in place or discussed in third countries, first and foremost in the US (see for example, Department of the Treasury 2009), or those issued by international bodies, such as the soft rules on CRAs and hedge funds of the International Organization of Securities Commissions (IOSCO) (interviews, Madrid, March 2009; London, August 2009). Yet, the reforms enacted were not as far-reaching as one might have expected in the aftermath of the worst financial crisis since the 1930s. Hence, they should be seen as incremental changes, rather than path-breaking reforms.

On the one hand, in evaluating the outcome, one could argue that the changes undertaken were a functional response to the crisis, which had underscored the need to regulate (or regulate more tightly) certain financial activities and institutions with a view to protect financial stability. On the other hand, they cannot be considered 'first -best' solutions in regulatory terms – several key problematic issues (such as the issue of financial institutions too big to fail, the management of cross-border banking crisis in the EU) were not addressed. The reforms enacted are unlikely to substantially secure the semi-public good of financial stability (observable implication 1a rejected). Indeed, somewhat surprisingly, several regulatory changes concerned primarily securities markets, not so much the banking sector, which was the epicentre of the crisis. Continental European countries have a bank-based financial system and therefore there was little appetite to regulate banks more stringently. Finally, several proposed changes were politically controversial, and the main line of division tended to fall between the market-shaping coalition on one side and

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the market-making coalition and the industry affected on the other side, as elaborated in the following section (observable implication 1b rejected).

The vast majority of the measures adopted can be regarded, by and large, as market-shaping because they either regulated activities or financial institutions that were previously unregulated in the EU and its member states (CRAs) or at the EU level (AIFMs), or imposed heavier, more prescriptive and more burdensome requirements on financial entities that were already regulated prior to the crisis, as in the case of higher capital requirements for banks. The reform of the financial services architecture following the de Larosière report was designed to strengthen financial supervision at the EU level.

The distinctive features of some of the new EU rules, such their prescriptive content, the reduced scope for self-regulation by industry, the potential protectionist effects of the contentious provisions concerning third country jurisdictions were in line with the regulatory preferences of the market-shaping coalition (interviews, London, August 2008). Moreover, the regulation of CRAs and AIFMs had been a long-standing goal of the market-shaping coalition, first and foremost France, Germany and Italy, prior to the crisis, as the activities of these financial institutions were seen as clashing with national varieties of capitalism on the continent (interviews, London, May 2007; Paris, July 2007; Berlin, April 2008; Rome, December 2007) (observable implications 2a and 3a partly confirmed).

A somewhat special case was the revision of the Capital Requirements Directive (CRD), where there was not a stark contrast between the position of France, Germany and Italy on one side and the UK on the other side (Hardie and Howarth 2010). It is however interesting to note that one of the main innovation discussed in policy circles and the object of the Commission's consultation - the introduction of dynamic provisioning - was partly borrowed from the Spanish regulatory framework, though in a revised form, and was indeed referred to in policy documents as the 'Spanish model' (Commission 2010: 45). This was an indication that one element of the regulatory framework of the Southern coalition was seen as a benchmark in reforming financial services regulation in the EU following the crisis. Negotiation over the adoption of new EU rules concerning capital requirements, which are still underway, have been complicated by the fact that parallel ongoing international discussions have been taking place at the Basel Committee on Banking Supervision (BCBS) (2009).

Even the regulatory adjustments that were less controversial, such as the revision of the Deposit Guarantee Scheme (DGS), set the new intermediate and final minimum amount guaranteed closer to the levels already in place in France, Italy and Germany prior to the crisis, and higher than the existing minimum limit in the UK and several new member states, which incidentally were the most reluctant to agree to the new threshold (interview, Paris, May 2009).

4. THE NEW POLITICS OF FINANCIAL SERVICES REGULATION IN THE EU

The regulatory and institutional reforms adopted or proposed by the EU between 2008 and 2010 share three main features as far as the regulatory process is concerned. First, the new rules cannot be regarded as market-friendly. Thus, the market players primarily affected by the new or revised rules, such as CRAs, AIFMs, initially resisted the proposed rules and subsequently engaged in an intense lobbying activity to have them amended on the grounds that they would be over-prescriptive and costly to implement, creating potential regulatory arbitrage vis à vis countries outside the EU, as evinced by their

response to the consultation. This argument was also used by banks that lobbied concerning certain aspects of the CRD's revisions.

Second, although with some notable exceptions, the new or amended rules were by and large resisted by the UK, Ireland, Luxemburg, and a variable mix of Nordic countries, depending on the specific legislative measures under discussion, as demonstrated by the responses to the Commission's consultation, newspaper accounts and interviews with policy-makers. The main argument used by the coalition eager to tone down the EU's regulatory response was that the proposed rules were over-prescriptive, intrusive and potentially protectionist (*Financial Times,* 7 July 2009, 14 July 2009; 16 June 2009; 4 June 2009). They would impose unnecessary costs to industry, damaging the competitiveness of the financial industry in Europe and reducing the attractiveness of European financial centres as a result of regulatory arbitrage. The concern about international 'regulatory arbitrage' has traditionally been at the forefront of policy-makers' minds in Britain,[2] given the fact that London is a leading financial centre, which hosts many non British owned financial institutions and successfully competes with other financial centres worldwide to attract business (interviews, London, May 2007; July 2008).

In the case of the proposed institutional reforms, there were (mainly British) concerns about giving the new authorities powers over national regulators and the possibility of supervising individual financial cross-border institutions (*European Voice*, 4 March 2009, 6 April 2009). Besides the UK, Ireland and Luxemburg were also reluctant to transfer powers away from national supervisors to bodies outside their borders (*Financial Times,* 20 March 2009). The UK government was reluctant to grant decision-making powers to EU-level bodies, while public funds to tackle banking crises came from national budgets. To this effect, Gordon Brown, the British Prime Minister, secured a guarantee that the new supervisory system would not include powers to force national governments to bail out banks. The UK also stressed that the EU's supervisory architecture should fit in with global arrangements and should support the development of 'open, global markets' (Darling 2009).

By contrast, the new or revised rules as well as the reshaped institutional framework were actively sponsored, or at least strongly supported by France, Germany, Italy, Spain and other members of the market-shaping coalition, as illustrated by their responses to the consultation, newspaper accounts and interviews with policy-makers. The proposed EU measures were seen as necessary to safeguard financial stability, and protect investors. Some of the proposed rules, such as those concerning AIFMs and CRAs, also embodied the deeply ingrained continental dislike of 'casino capitalism' (Strange 1997), which was seen as serving the fortunes of the City of London (*Financial Times*, 30 April 2009, interviews, Berlin, April 2008; Paris, July 2007; Rome, December 2007; Madrid, March 2009; Lisbon, November 2008). France, Germany, Italy, Spain and many east European countries gave their full backing to the de Larosière proposals (see for example Sarkozy and Merkel's joint letter in March 2009), of which France was the main sponsor. Unlike in the UK, there was limited concern over potential international regulatory arbitrage. In their response to the Commission's consultation on the proposed measures, many respondents, most notably France and Germany, argued that 'Europe should play an instrumental role in shaping a global regulatory regime' and that 'an EU framework could serve as a reference for global regulation' (Commission 2009b: 8).

[2] This expression is used very frequently in the policy documents produced by the British Treasury, the FSA, and the Bank of England.

Table 2. Overview of Member States and Industry's Positions on Regulatory Changes

Regulatory change in the EU: **- new rules introduced** **- existing rules amended** **- institutions established or reformed**	**Member states and industry's positions on regulatory changes**
Banking	
Deposit Guarantee Scheme amended (October 2008).	Fairly uncontroversial, but new EU level of depositors protection close the one in place in France, Germany and Italy; new member states reluctant to endorse higher level .
Capital Requirement Directive (October 2008 and subsequent revisions) see also link to Basel 2 revisions by the BCBS.	No clear cut division, all European countries in favour of hybrid capital and against leverage ratio. Banks opposed major revisions, so did policy-makers. Ongoing discussion about suitability of the 'Spanish model' for the EU.
Securities and Investment Funds	
Regulation on CRA (May 2009).	France, Germany, Italy main sponsors of EU rules. UK, some Northern countries and CRAs reluctant to regulate CRAs in the EU.
Proposed Directive on AIFM (June 2009).	France, Germany, Italy main sponsors of EU rules. UK, some Northern countries and AIFM reluctant to regulate AIFM in the EU.
Accounting Standards	
Commission Regulation (EC) adopting Certain International Accounting Standards (November 2008), endorsing IASB's Revisions of Fair Value Measurement (October 2008). Impasse on the endorsement of revised IASB standards in November 2009.	France, Germany, Italy were the main sponsors of the change. Opposition to the use of fair value as a long standing issue for them; it had instead the full backing of the UK. France, Germany, Italy opposed revised IASB rules as did most of the banking industry.
Institutional Framework for Regulation and Supervision	
Commission's proposals (September 2009), building on the de Larosière proposals.	France and Germany were the main sponsors of the reform; Italy, Spain and many central and east European countries gave their full backing; Britain, Ireland and Luxembourg were reticent.

Table 2 concisely reports the main supporters of and opponents to the regulatory changes undertaken by the EU in the aftermath of the global financial crisis. The content of the new rules was significantly influenced by the market-shaping coalition. Although in the end, those resisting the new rules or parts of their content did manage to have the original legislative proposals amended, at least in certain cases, the very fact that the rules were proposed in the first place suggests that the balance of regulatory power has shifted in favour of the market-shaping coalition and that a less market-friendly regulatory approach has at least temporarily gained ground in the EU (for a similar argument, see also Posner 2010). Why and how did this happen? Was this caused by a realignment of interests triggered by the global financial crisis or was it because a new regulatory paradigm gained ground in the EU?

The configuration of economic interests at play in financial services regulation in the EU was not changed substantially by the global financial crisis. It is certainly true that national financial systems were put under stress (though to a different degree) by the crisis and some significant changes did take place, such as public interventions to rescue banks across the EU. The UK financial system was the most badly hit by the crisis in Europe and some large UK banks were de facto nationalised. Yet, the core features of national

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financial systems mentioned on p. 6, namely, whether they are mainly bank-based or securities-based, whether they mainly deal with wholesale or retail finance, their degree of openness and competitiveness, were not fundamentally changed by the crisis (observable implication 2b rejected).

By contrast, the crisis undermined some of the key assumptions of the market-making regulatory paradigm in the EU. It was a policy learning that largely contradicted the policy learning of the late 1990s and early 2000s, which had heralded the British model as a successful one for the EU in the struggle over the global competition for financial services. Prior to the global financial crisis, British policy-makers and their regulatory philosophy had been very influential in shaping the EU's regulation of financial services (interviews, Brussels, March and June 2007; Rome, December 2007; Madrid, March 2009; Lisbon, November 2008).

Their model was however perceived as discredited by the global financial crisis (*The Economist,* 2 July 2009; interviews, London, August 2009). After the crisis, even in the UK, the stronghold of the market-making coalition, alternative views about financial services regulation began to emerge, at least in some quarters. As the Turner Review acknowledged (FSA 2009: 38-39), the global financial crisis robustly challenged on 'both theoretical and empirical grounds' the existing 'regulatory philosophy' and the 'intellectual assumptions' of 'efficient', 'rational' and 'self correcting markets' on which it was based. The main supporters of the market-making regulatory paradigm, notably UK policy-makers, did not completely abandon it, but advocated it less forcefully and some policy-makers began to question it within the market-making coalition. One of the most notable 'conversions' was that of the Commission, which switched to a market-shaping approach (observable implication 3b partly confirmed).

At the same time, in the wake of the crisis and with some political opportunism, policy-makers of the market-shaping coalition forcefully reiterated their views about financial services regulation, feeling at least partly vindicated by the global financial crisis. The French President Nicholas Sarkozy remarked that 'The idea of the all-powerful market that must not be constrained by any rules, by any political intervention, was mad. ….Self-regulation as a way of solving all problems is finished. Laissez-faire is finished. The all-powerful market that always knows best is finished' (Sarkozy 2009).

Similarly, the German Finance Minister, Peer Steinbruck argued that 'the free-market-above-all attitude and the argument used by 'laissez-faire' purveyors was as simple as it was dangerous and [German recommendations for more regulation] elicited mockery at best or were seen as a typical example of Germans' penchant for over-regulation'.[3] The Italian Finance Minister, Giulio Tremonti, before the crisis erupted in full force, in his book *Hope and Fear* called for more regulation and state interference, arguing against 'the dictatorship of the market' (*The Financial Times,* 23 June 2008).

It should however be noted that several continental countries, amongst which the two largest member states, had also been severely affected by the crisis (see Hardie and Howarth 2009). Hence, their regulatory model was not immune from criticisms. In 2009, the appointment of a new (French) Commissioner for the Internal Market, Michel Barnier, was seen as a victory for the French government. He was seen by some (mainly British) policy-makers as 'suspicious of the free market' (*The Economist*, 2 December 2009) (observable implication 3b partly confirmed).

[3] Both interviews are cited in EUobserver, 26 September 2008, http://euobserver.com/9/26814

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Overall, the explanation that has the greatest explanatory leverage in accounting for the content and adoption of the new EU financial rules is an ideational one, without denying that there were substantial economic interests at stakes (see Table 3 for a summary). The crisis does not seem to have substantially altered the existing constellation of financial interests in the EU, which remains largely rooted in domestic political economy and national varieties of financial capitalism. By contrast, reference to ideas and regulatory paradigms is instrumental in explaining the regulatory changes undertaken by the EU following the window of opportunity opened by the crisis. It also explains why one set of policy actors prevailed over another in the new politics of financial services regulation in the EU.

There were two pathways through which ideas affected the EU's regulatory response. To begin with, there was a 'blame game' towards the Anglo-Saxon model of financial capitalism and market-friendly financial services regulation. This points to a form of 'strategic constructivism' (Jabko 2006) that is the political use of ideas by the market-shaping coalition to advance its regulatory preferences. At the same time, there was, at least to some extent, some soul-searching amongst the supporters of the market-making approach challenged by the crisis, which weakened their resolve to defend the Anglo-Saxon approach to financial regulation.

Table 3. Evaluating competing explanations

Causal mechanism/ *Observable implications*	**Functional mechanism**	**Interest-based mechanism**	**Idea-based mechanism**
Observable implications outcome	*1a:* new rules as 'first best' - rejected.	*2a:* new rules congruent with interests of market-shaping coalition – partly confirmed.	*3a:* new rules congruent with ideas of market-shaping coalition - partly confirmed.
Observable implications process	*1b:* lack of political conflict in regulation – rejected.	*2b:* major changes of national financial systems – rejected.	*3b:* revision of regulatory paradigms – partly confirmed.

Conclusions

In the aftermath of the worst financial crisis since the 1930s, the EU embarked on a significant revision of financial services regulation, which however fell short of a full-blown regulatory overhaul. It failed to address key regulatory issues concerning banking, focusing instead on the regulation of financial activities mainly in the securities markets that were not at the centre of the crisis. Far from being the most effective response (or the first best outcome in regulatory terms), the EU regulatory changes were primarily shaped by the policy paradigm of a coalition of actors 'empowered' (or at least not 'silenced') by the crisis - the 'new' politics of financial services regulation in the EU.

What is 'new' about the new politics? The two main coalitions were active well before the crisis erupted and although their leaders remained unchanged, the composition of the coalitions changed partially after the crisis, when some policy-makers, such as the Commission and the new member states moved closer to the market-shaping coalition. Moreover, the regulatory paradigm of the market-shaping coalition gained influence after the crisis, contributing to shifting the balance of regulatory power in the EU. Yet, this is not a fully fledged paradigm shift.

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The crisis acted as an external shock that changed the policy environment and triggered policy learning across existing coalitions, partially reversing what had happened in the 1990s and early 2000s. The crisis was seen as validating the market-shaping regulatory paradigm despite its potential protectionist implications. Consequently, this approach and the coalition sponsoring it have become more prominent in influencing financial services regulation in the EU, at least temporarily. This mechanism of ideational politics was exploited by policy-makers pursuing their political goals, though there was also some genuine reflection on the main shortcomings of the old EU approach to financial regulation.

As for the ‘so what’ question, previous research on the role of ideas or policy paradigms in EU political economy has pointed out the importance of crises in bringing about policy changes through policy learning and a reshaping of the external environment. This research detects a similar process of embryonic policy learning and piecemeal ideational shift with reference to EU financial regulation following the crisis, though to a more limited extent, as compared to previous works, for example, on central banking. Unlike these works, it also stresses the strategic use of regulatory ideas by policy-makers to achieve certain political objectives.

At this stage, it is too early to tell whether this trend will continue in the future or whether the market-making paradigm and the coalition sponsoring it will regain influence as the memories of the crisis fade away and concerns about competition with the US and third jurisdictions re-emerge. Yet, it might well be that the regulatory paradigm has also begun to change outside the EU. Further research in this direction would be warranted.

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