Setting the pace? Private financial interests and European financial market integration

Lucia Quaglia
L.Quaglia@sussex.ac.uk
Sussex European Institute

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University of Sussex, Falmer,
Brighton BN1 9RG
Tel: 01273 678578
Fax: 01273 678571
E-mail: sei@sussex.ac.uk

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Abstract

The regulation and supervision of financial services in the EU has undergone significant change between 2000 and 2005, when the so-called Lamfalussy framework, the Basel 2 agreement and its transposition into the Capital Requirement Directive were agreed. This research examines the preferences of national financial interest groups, the independent variable, in shaping national input and more precisely, the contributions given by the relevant public authorities, into EU and international policy-making processes (the dependent variable). The impact, if any, on the final outputs (the relevant international and EU agreements) is also discussed.

The empirical research presented in this paper focuses on the UK and Germany, which, besides being two of the largest countries in the EU, have been crucial players in the reforms under consideration. The interest groups studied are those in the banking sector, and it is important to distinguish between the level of involvement each interest group has and their degree of influence in policy making processes. The former depends on the *policy content,* namely, whether the policy concerns a broad institutional issue or specific rules, whilst the latter depends on *domestic institutions*, namely state structure, interest representation and political economy institutions.

Setting the pace? Private financial interests and European financial market integration [*]

A Project of the EUSA Political Economy Section

Lucia Quaglia

Sussex European Institute, University of Sussex

Financial services regulation and supervision in the EU has become one of the most active areas of EU policy making, undergoing significant change between 1999 and 2004, when the so-called Lamfalussy framework was devised, negotiated and implemented. Moreover, the EU and its member states were active in regulatory and supervisory fora at the international level, for the negotiations of the Basel 2 agreement were initiated by the Basel Committee of Banking Supervisors (BCBS) in 1999, and concluded in 2004. The content of this non-legally binding international agreement was incorporated into legally binding EU legislation, through the Capital Requirement Directive (CRD) adopted in 2005. The CRD was discussed in the EU almost in parallel with the Basel 2 negotiations, though the most intensive phase of EU negotiations took place after the agreement had been reached in Basel in 2004.

As Howarth and Sadeh (2006) note, there is an ongoing debate in EU studies as to whether socially constructed elements or economic interests drive the ‘construction of Europe’, and it is therefore important to engage in a theoretically-informed and empirically-grounded analysis across a variety of policy areas. This research, which focuses on financial regulation, has both theoretical and empirical rationales. The theoretical rationale contributes to this academic debate by evaluating the role of economic interests and interest groups in the policy making process in one specific policy area. This also involves an investigation of the process of national preference formation and articulation, which is a core component of several integration theories such as liberal intergovernmentalism or the ‘two-level game’. The empirical rationale is to explain the reform of

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financial regulation and supervision both within the EU and internationally, by adopting a 'bottom-up' approach from the perspective of domestic interests groups.

The question that informs this research is whether economic interest groups were merely policy-takers, or instead made substantive contributions to policy-making in this field. In order to do so, this research examines the preferences of financial interest groups (the independent variable) in shaping the national input (more precisely, the contributions made by the relevant public authorities) into EU and international policy-making processes (the dependent variable). The impact, if any, on the final output (the international and EU agreements) is also discussed.

The main *rival explanation* is that the public authorities (national central banks, supervisory agencies, treasuries) defined the 'national interest' and thus the national input into EU and international policy making processes independently of the preferences of the interest groups in the financial sector; in other words, they articulated their own preferences. This is likely to come to the forefront whenever national bureaucratic preferences differ to the preferences of interest groups and where this is the case, it is important to understand under what conditions one set of preferences will prevail over the others.

A second, *complementary explanation* that is not considered in this paper, is that financial groups used channels at the EU level such as lobbying of the Commission or European Parliament, either directly or through European umbrella associations, the submission of documents and consultation with the various EU and international committees, in order to articulate their policy preferences, and in so doing sometimes bypassing the national government. Such lobbying activities at the EU level are bracketed within this research, which specifically focuses on the national arenas.

The proceeding empirical analysis focuses on two country-studies; the UK and Germany, which, as well as being two of the largest countries in the EU, have played crucial roles in the three reforms under consideration, not least because they have the two largest financial sectors across the EU. Moreover, these two countries experienced important institutional and policy changes in financial service regulation and supervision in 1998 and 2002 respectively. The interest groups studied within this paper are those in the banking sector, with a particular focus on national banking associations, and a number of individual banks and investment firms.

Most of the empirical data reported in this paper was gathered through semi-structured interviews with public authorities, interest groups and individual firms in Germany and the UK. Other useful

sources of information were the policy papers and consultation documents produced by the Treasury (or Finance Ministry), the central bank and the supervisory authority in Germany, Britain, the Commission, the European Central Bank (ECB), the BSCB, the European Parliament (EP), and by national and European peak associations and individual firms. A systematic survey of press coverage was also conducted.

Three complementary caveats are needed at this stage. First, it is slightly problematic to consider some financial interest groups or individual companies as purely 'national'. For example, the majority of financial companies in the City are non-British owned and approximately 75% of members of the British Bankers Association are non-British (ie foreign-owned banks). Deutsche Bank, one of the main German banks, conducts most of its investment activities in London. Further, Allianz, one of the main German insurance companies that recently acquired the Drezner Bank, is one of the leading insurance companies in other EU countries, such as Ireland.

Second, the Allianz-Drezner case highlights another important caveat, namely, the increasingly blurred boundaries between different segments of the financial sector, a trend that is well underway in Britain and has more recently gained momentum in Germany. For this reason, this discussion will utilise the term 'financial' interests groups rather than 'banking' interest groups, unless reference is made to specific banking associations.

A third and related point, is that some interest groups (for example, the main banking associations in the UK and Germany) and individual companies (Deutsche Bank) engaged in lobbing and consultation activities at the EU level, thus bypassing the national authorities (cf Quaglia forthcoming). However, these activities are not reviewed in the following sections, with the focus instead falling on the national arena.

This paper is organised as follows. Section 2 provides an overview of the main features of the financial (banking) sector and mode of interest representation in Germany and the UK. Sections 3, 4 and 5 deal with the contents and policy-making processes of the Lamfalussy framework, the Basel 2 agreement, and the CRD. Each section discusses the policy preferences of the main financial interest groups in Germany and Britain and the involvement of these groups in the policy-making process at the national level, especially their interactions with the public authorities. Section 6 conducts an overall assessment, before Section 7 discusses whether the findings can be extrapolated to apply to other EU policies.

By investigating three case studies in the same policy area and by considering two countries, the research design permits the identification of intervening variables that explain different degrees of interest groups involvement and influence in financial sector policy making. These two intervening variables also determine the conditions under which the bureaucratic preferences of the national authorities are likely to prevail when shaping national contributions to the EU and international policy making processes.

Financial Interests Configuration in Germany and the UK

This section outlines the structural features of the financial system in Germany and the UK, with a particular focus on the banking system, the mode of interest representation and the channels of access to policy-making at the national level. A reference is also made to the national framework for regulation and supervision, and this domestic political economy analysis assists in the identification of German and UK interest groups' preferences with respect to the policy issues discussed in the following sections.

Germany

The banking and insurance markets in Germany are amongst the largest in Europe, with a number of significant European market-players located in the country. Until the late 1990s, the financial system tended to be mainly bank-based, in that use of credit facilities was amongst the highest in Europe, with the use of debt securities amongst the lowest (Allen and Gale 2000). However, since the late 1990s, the financial system has become more market-oriented, though the universal banks maintain an important role due to their prominence as leading traders of securities.[1]

In Germany, the universal bank model is widespread, even though there has recently been a kind of increasing specialisation of universal banks (cf the strategy chosen by Deutsche Bank and Drezner Bank, *Financial Times Deutschland* 22/11/2002). The universal banks in Germany can be divided into three main sectors: private commercial banks, savings banks and cooperatives, and there are also a number of specialised banks (e.g. *bausparkassen*) that are often part of universal banking groups. It is important to note however, that group competition (*gruppenwettwerb*) has been widespread in Germany, leading to a lack of individual competition and rather a tendency towards collaboration within the three groups, each of which has powerful peak associations.

[1] For an analysis of the evolution of the financial system in Germany see Deeg 1999, Lutz 2004, 1998.

The private bank sector is mainly composed of the four big banks: Detusche Bank, Dresdner Bank, Commerzbank and Bayerische Hypo und Vereinsbank, with a number of other smaller (often regional and local) banks; and foreign banks. The common features of such private commercial banks are that they are active abroad; they privilege short-term credit, and have a high degree of capitalisation. The 'big four' detailed above possess a market share of 16% when measured against the total aggregate balance sheet of all banks in Germany, with all private commercial banks having a share of 28%. Public sector banks, which include savings banks and landesbanken, have a larger market share of 36% when measured against the aggregate balance sheet total of all banks in Germany, with cooperatives possessing a share of 20% (*Financial Times Deutschland* 12/6/2002).

Foreign banks have only penetrated the German market to a relatively low degree, though their limited activity in retail banking contrasts with the more significant activity in the wholesale market (mergers and acquisitions and investment banking). The retail market is dominated by savings banks and cooperatives, whereas private commercial banks currently face difficulties in expanding their market quotas; one of the reasons why the big German banks have expanded abroad by acquiring European or US banks. This is especially so in the case of investment banking (*Financial Times Deutschland* 22/11/2002).[2]

In recent times, there has been a general trend towards consolidation (or concentration) in the banking sectors, under the stimuli of EU and domestically inspired competition. Between 1999 and 2005, the number of banks fell by 40%, but bank density (the number of banks in relation to the population) in Germany remains twice as high as the EC average (excluding Germany), due to the presence of so many savings banks (Detusche Bank 2004).

Small and Medium Enterprises (SMEs) or mittlestand, account for approximately three-quarters of German output, and have a large political voice (*The Banker* 4/4/05). All banks, but in particular public banks, used to make extensive loans to *mittlestand*, at low margins (*Financial Times Deutschland* 22/8/2002), even though this practice was challenged by the pressure exerted by EU and domestic reforms.

In Germany, interest groups are highly integrated within the policy making process, and public authorities often consult with the peak associations (Coleman 1994: 282), albeit this is primarily true for the savings and cooperative banks. Moreover, regulatory duties are shared between the

[2] For example, the Deutsche Bank also acquired the US Bankers Trust and the Hypovereinsbank acquired the Bank of Austria in 2000 – all acquisitions in investment banking.

public authorities and peak associations of the three banking groups (Busch 2004). There are three main peak associations in the banking sector representing the three main categories of banks, all of which are members of comparable European umbrella associations.

The regulation and supervision of financial services in Germany underwent an important reform in 2002, which was designed to streamline the existing framework. Following this reform, which also coincided with a reshaping of the governance structure of the central bank, a single supervisory authority, the BAFIN, was established for all segments of the financial sector. However, banking supervision remained a shared task between the single authority, BAFIN, which has a specific division dealing with banking supervision, and the Bundesbank, whose regional offices are responsible for operational supervision, the collection of data and information and its transmission to BAFIN, which, like its forerunner BAKRED, does not have units based in the lander.

Both the Bundesbank and BAFIN were involved in the negotiations of Basel 2 and, though the central bank remained an important player, BAFIN displayed more institutional clout than its predecessor, the BAKRED, which had taken part in the negotiations of Basel 1 in 1988. In contrast, in the EU negotiations on the CRD and the Lamfalussy process, the Federal Finance Ministry was in the driving seat, albeit with significant input from BAFIN and Bundesbank.

The federal state structure in Germany created repercussions not only on power-sharing between the public authorities, but also on interest representation, thus strengthening the voice of the public banks (saving banks and landesbanken) and SMEs, which have excellent access to policy-makers in the lander (cf Deeg and Lutz 2000). Given the federal structure of the Bundesbank before the 2002 reform, lander-based interest groups were also given a sympathetic audience in Frankfurt. Big private banks however, have instead tended to have better access to both federal policy-makers, and policy-makers at the EU level.

The UK

The financial system in Britain is highly developed, with the traditional distinction between the three segments of the financial market receding earlier than in the rest of Europe. This led to the creation of powerful financial conglomerates, with the UK now hosting the largest securities market in Europe, one that competes directly with the financial centres of the US.

As a result of both the impact that EU legislation has made, and the largely domestically-driven reforms of the banking system that took place in the 1980s, there are two 'bank circuits' in the UK: retail banking (mainly large domestic banks dealing with consumers credit and loans to SMEs), and investment banks (dealing with corporate finance, mergers & acquisitions, international banking), many of which are foreigners. There are, however, no public banks in the UK, in stark contrast to Germany.

Investment banking is closely related to securities, the main source of corporate finance (Allen and Gale 2000). Investment banks and, more generally, investment firms that perform some banking tasks, tend to be concentrated in the City, which hosts the largest number of foreign banks in Europe. In domestic retail banking, there are only a few providers, creating a *status quo* that was criticised by the British competition commission (cf the Cruickshank Report 2000), with reference to the banking services offered to consumers, and specifically with reference to the provision of funding to SMEs. Further, the concentration of banks in London is amongst the highest in Europe, leading to a greater concentration also of profitability and efficiency (*Financial Times* 22/8/2002).

The British Bankers Association is the principal professional association for banks in the UK, with members holding 90% of UK banking sector assets and 95% of all banking employment. 85% of the members are involved in wholesale banking and 75% of members are of non-UK origin; from 60 different countries. Further, the London Investment Banking Association represents investment banks and firms, mainly of which are foreign owned. It should also be noted that in addition to this are the various associations of building societies and mortgage lenders.

The main business associations in Britain are not 'peak associations' as they are referred to in Germany, but 'umbrella associations'; the structure of 'peak associations' is more hierarchical, thus creating coherent positions and the enforcement of internal discipline. However, previous studies on British policy-making in the financial sector portray the mode of interest intermediation as 'meso–corporative' (Moran 1991) with substantial input from the sector in shaping policy. Others, taking a policy network approach, portray the system of financial interest representation and interaction with the public authorities as one that is, in contrast, open and horizontal (Josselin 1996).

Financial services regulation and supervision in Britain underwent a watershed reform in 1998, in conjunction with the restructuring of the Bank of England, which, though losing its responsibility for banking supervision, was given operational independence in monetary policy. The governance structure of the bank was also changed with the creation of the Monetary Policy Committee; the

Financial Services Authority was established, with responsibility for the whole financial sector, including banking supervision, though it should be noted that the Bank of England remained responsible for overall financial stability.

Until the creation of the FSA in 1998, the Bank of England had been the only negotiator for Britain in Basel 1. In Basel 2 however, both the Bank of England and the FSA were involved in the negotiations. Most of the implementation studies concerning Basel 2 and the CRD were conducted or coordinated by the FSA, whereas the Treasury was in charge of coordinating the consultation on the CRD in order to define the British negotiating position. With regards to the Lamfalussy process, the Treasury and FSA were mostly involved in EU negotiations.

The Lamfalussy Framework

In July 2000, the ECOFIN Council appointed an *ad hoc* 'Committee of Wise Men', led by the former central banker Alexandre Lamfalussy, to discuss the best means of adopting the Commission's FSAP and adapt EU regulations to an ever-changing financial marketplace. The Committee invited the member states, regulatory authorities and the industry itself to submit contributions and take part in confidential hearings (Committee of the Wise Men 2000: 32-35) before the Report was completed in December 2000. It proposed the framework described at the end of this section, though there was only a reference to securities, and after the question of parliamentary scrutiny was resolved in February 2002 on the basis of a compromise between the EP and the Commission, the Lamfalussy framework was endorsed by the Stockholm European Council.

In May 2002 ECOFIN, following the proposal of the German Finance Minister Hans Eichel and the British Chancellor Gordon Brown, decided in favour of extending the fast track procedure of reporting to banking and insurance (*Financial Times* 15/4/02). The issue was negotiated throughout 2002, and in December of that year, ECOFIN approved a proposal of the Economic and Financial Committee for the extension of the Lamfalussy framework to other sectors, taking into acount the ECB's request for involvement (Economic and Financial Committee 2002). The new framework was then implemented during 2003 and 2004.

Since 2004, the governance of the financial service sector has been based on a complex multi-level system of EU rule-making and enhanced cooperation between national supervisory authorities, underpinned by newly created EU committees (such as the Securities Committees, set up in 2001),

and reformed committees (such as the Banking Advisory Committee and the Insurance Committee, which date back to 1977 and 1992 respectively). The functional division between banking, securities and insurance remains and specific arrangements for the supervision of financial conglomerates have been set in place. Further, as the Lamfalussy report recommended, the EU institutions established an inter-institutional monitoring group, which consists of Council, Commission and EP representatives.

If the British and German Governments were amongst the main players in the establishment of the Lamfalussy framework, this does not mean that domestic interest groups in those countries were formally consulted or *de facto* involved in the policy-making process at the national level. To be sure, the BBA expressed full support for the Lamfalussy model with references to securities and subsequently for the extension of the model to banking and similarly, the main players in the City (some of which had been consulted by the Committee of Wise Men) were supportive of the new regulatory architecture.

The association of German private banks expressed support for the Lamfalussy framework, as did a number of big market players, some of which had been consulted by the Committee of Wise Men, or had senior executives sitting on it, albeit serving in their personal capacity and not representing their companies' interest. It should also be noted that in Germany, whereas the big private banks expressed clear views in favour of the revised regulatory framework, the public banks, traditionally more inward-oriented and less keen on market integration, omitted to take a position on it.

Overall, the most competitive and outwards oriented part of the banking industry in both Germany and the UK endorsed the Lamfalussy framework in a way to promote further market integration and cooperation amongst supervisors, possibly leading to a convergence of supervisory standards. Moreover, the European Banking Federation, to which the two main banking associations in Germany and the UK belong, also endorsed the Lamfalussy architecture. However, the both intensive and extensive consultations that took place with reference to Basel 2, and especially on CRD, did not take place in relation to the Lamfalussy process either in Germany or the UK, and only some of the big companies volunteered to provide their opinions on it. Some of the main market players even put forward innovative proposals that went beyond what was eventually agreed upon; for example the Deutsche Bank proposed the creation of a European System of Supervisory

Authorities (similar to the ESCB), which would include but not be limited to a European Financial Service Authority.[3]

The public authorities (primarily the Treasury Ministries, and to some extent the supervisory authorities, namely, the FSA for the UK and the BAFIN and Bundesbank for Germany) largely defined national preference in accordance with their own priorities, opposing any extension of the ECB's supervisory competences as well as the creation of a single European regulator, two options which were instead welcomed by parts of the banking sector that had contributed to the debate. Furthermore, it is certainly true that the industry's drive for the establishment of a fully integrated and more stringently regulated single market in financial services provided the trigger for the reform, but is also the case that this goal was supported by both the British and German authorities possessing the two largest (and possibly expanding) financial centres and financial markets in Europe. The British authorities have always been quite outspoken regarding their objective of maintaining the City's position as the leading financial centre in Europe (Moran 1991; interview, London, December 2005) and towards the end of the 1990s, the German Government has also taken a similar approach to the Frankfurt finanzplatz (interview, Frankfurt, January 2006).

The Basel 2 Accord

International standards for capital requirements had been established by the Basel 1 agreement signed in 1988, which was then revised and integrated by the Basel 2 Accord signed in 2004. The rationale for the revision was to more closely tailor the capital requirements of banks to the actual economic risk that they faced, while also taking account of innovations in financial markets and risk management strategies.

The Basel 2 accord based capital requirements on three pillars (BCBS 2005).[4] Pillar One was concerned with the minimum capital requirements, covering three types of risk: credit risk, market risk and, innovatively, operational risk. Innovations were also introduced with reference to risk measurement. Pillar 2 was the supervisory review process aimed at covering external factors that were not fully taken into account when computing the minimum capital requirements. Supervisors were therefore enabled to take measures which, if necessary, could go beyond the minimum capital requirements. Finally, Pillar 3 was the discipline imposed by the market, facilitated by transparency

[3] In 2002, ERROFI 2000, an association of officials and market participants based in Paris published a report arguing that building on the Lamfalussy process, a European regulatory and supervisory system should be established following the ESCB model.

[4] See also http://www.bis.org/publ/bcbs118.htm, accessed in December 2005.

requirements. The assumption was that well informed market participants would reward a risk-conscious management strategy and effective risk control by credit firms and would penalise risky behaviour accordingly.

The Basel Committee of Banking Supervisors, where the Basel 2 Accord was proposed, negotiated and eventually agreed, is composed of the central banks and supervisory authorities of 13 countries (nine EU member states, in addition to Canada, Japan, Switzerland and the US). Further, the European Commission and ECB participate as observers, both in the general Committee and in the various tasks forces (for example, on risk management, capital ratios etc) that report to the Committee.

The negotiations on Basel 2 gained momentum in June 1999, with the publication of the first consultative paper by the BCBS, followed by a second consultative paper in January 2001 and a third in May 2003. Further, the BCBS conducted four quantitative impact studies (QISs) in 2001 (QIS1), 2002 (QIS2), 2004 (QIS3) and 2005 (QIS5) concerning the implementation of the new rules and such assessments were conducted in aggregate terms, that is, they were not country or sector specific. For example, for QIS5, the BCBS requested that banks in 90 different countries carry out a series of data studies to strengthen the models for the Basel 2 Accord, three years after the conclusion of the QIS3, which included data from 350 banks and 43 countries. However, since not all countries were satisfied by the results of the QIS3, the US, Japan, South Africa and Germany decided to conduct national impact studies, which became the QIS4.

In March 2002, the European Council asked the Commission to prepare a report on the consequences of the Basel 2 Accord for all sectors of the European economy, with particular attention placed upon SMEs in light of the fact that the Accord's content was to be transposed into EU legislation.[5] During the negotiations, the Commission maintained the primary objective of ensuring that the application of the Basel 2 rules to the EU Single Market was suitable, and that the Commission's service review of capital requirement took place in parallel with the activities of the BCBS. The issue of the transposition of Basel 2 into EU legislation also informed the attitudes of the member states negotiating in Basel. It should be noted that the Basel and EU processes ran for five years, and throughout this period, the BCBS, the Commission and the national authorities maintained a constant policy of industry consultation on the proposals formulated.

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[5] The report prepared by Price Waterhouse Coopers estimated a beneficial outcome for SMEs.

The following account, though incomplete, focuses on the main issues that were raised during the negotiations of the Basel 2 Accord and were of direct relevance to industry. Some of these issues, which concerned both pillar one and two, such as the use of internal rather than external rating, the need to counteract the pro-cyclical effects of the Accord and the potential negative effects for SMEs and mortgage lenders, were partly addressed throughout the negotiations in Basel. Other issues, such as the 'solo' or 'consolidated' model of supervision, the role of the leading or consolidating supervisor, and the risk weighting for intragroup exposure, featured more prominently during the discussions regarding the transposition of the Accord into the CRD (see below).[6]

An important issue, settled early on in the negotiations, concerned the initial US-led proposal to use *external rating* in order to assess the credit risk that is part of the first pillar. The public authorities and banking sectors in Britain and Germany instead suggested the use of *internal rating*, which was regarded as more reliable. This proposal was endorsed by the BCBS, and it was thus included in the CP2.

A key issue in shaping Basel 2 concerned the implications of the new capital rules relating to the terms of, and access to, bank credit for *small and medium-sized enterprises*. During the negotiations towards the proposed Accord, a concern was voiced that risk weights for SMEs would remain the same as for that when lending to large unrated corporates due to the fact that most SME borrowers do not have external credit ratings. This issue was prominent for the SMEs in Germany, the mittlestand, which largely rely on bank loans for their funding and the German authorities were so concerned about the domestic impact of Basel 2 that they decided to conduct a QIS of their own accord (QIS4). The changes that were subsequently made to the rules of Basel 2 regarding these issues can largely be ascribed to the activity of the German representatives, which joined forces with the Italian authorities, also worried about the implications for SMEs. As a result, the process of lending to SMEs under the proposed Accord is how seen by many observers to be attracting more favourable treatment than is the case under existing arrangements.

More sophisticated approaches to risk calculation, as those foreseen in Basel 2, may serve to impact on the competitive structure. There was a concern that the *competition* between *large* and *medium to small credit firms* would be distorted due to the latter either failing to adopt or qualify for the more sophisticated approaches, which on average would result in reduced capital requirements. This issue was particularly sensitive in Germany, where a great many small credit institutions exist,

[6] For industry's comments received by the BCBS on CP 3 see http://www.bis.org/bcbs/cp3comments.htm accessed in December 2005.

mainly in the form of saving banks and cooperatives. The German delegation was outspoken and, overall, successful in its negotiations on this issue, as impact studies conducted on the final agreement suggest the existence of an overall positive impact for small-sized banks in Germany.

The Basel Accord introduced a second pillar for *supervisory review*, which, in allowing supervisors to impose additional capital requirements, raised the concern that excessive additional capital requirements may be imposed. This was an important issue for both the British and the German banking sectors, also with reference to the CRD; they felt that additional capital requirements should, in fact, be exactly that – 'additional', rather an automatically imposed measure.[7]

If the UK authorities (namely the FSA and the Bank of England) were not concerned about SMEs and small-sized banks, one of their main priorities was the *trading book review*, a measure agreed by the Basel Committee and IOSCO (the International Organisation of Securities Commissions) in July 2005. Essentially, the trading book introduced advanced rules for trading activities in which several investment firms in the City are involved, and is to be incorporated into EU legislation.

With regards to Basel 2, the preferences of financial interests groups were more intense than those presented during the Lamfalussy framework. In the UK, direct policy input was mainly provided by a few internationally active banks, those to which Basel 2 applies. However, if anything this proved a hindrance for the national public authorities involved in the negotiations, as they would have welcomed more information from industry. In contrast to the low domestic political salience that Basel 2 had in the UK, it was high in Germany, with interest groups mobilising intensively and extensively, in particular with regard to the issue of the implications for SMEs. Not only did the national public authorities in Germany engage in an in-depth consultation process, they also received a great deal of position papers from the public.[8] Whilst the Bundesbank engaged in several hearings before the federal parliament, political pressure was exerted upon it, along with the BAFIN, both at the lander and federal levels, accompanied by the lobbying activities of various sectors of society (interview, Frankfurt January 2006).

It should also be noted that during the Basel 2 negotiations, several national delegations, including the German and British ones, were composed of senior officials from the central banks and the

[7] Amongst the overarching regulatory and competition issues, there was the concern that an *inconsistent implementation* across countries would distort competition and could significantly increase regulatory burdens for those banks operating in more than one country. This was a real issue for the large banks in Germany and in Britain and operating in several countries.

[8] The Bunsdesbank received more than 200 letters and policy documents from the public, including, amongst others, churches.

(banking) supervisory authority. With regards to cooperation between the Bank of England and the FSA, the former was in ultimate control during the Basel 2 negotiations, primarily due to it's technical capacity; for example as a result of previous experience, the Bank boasted staff with experience in the field of 'calibration' (large international banks are actively present in London). Further, whilst the FSA maintained a greater degree of involvement with regards to the drafting of the language of the Accord, all the QIS conducted in Basel were led by senior officials from the Bank of England (interview, London, January 2006).

Similarly, the Bundesbank and the BAKRED/BAFIN had different foci at the working level: whilst BAFIN dealt with regulatory issues, the Bundesbank maintained a focus on economic studies. Overall, the Bundebank proved more responsive than the BAKRED/BAFIN with regard to the policy preferences of the banks, especially the small ones, due to the close and frequent contact that they maintained at the local level (interview, Frankfurt January 2006).

The EU Capital Requirement Directive

Capital requirements were already regulated by existing EU legislation that was issued throughout the 1990s and largely implemented the Basel 1 Accord. When negotiations began on the Basel 2 agreement, the member states agreed that the new capital requirements framework agreed in Basel 2 would be incorporated into EU legislation by the amendment of the existing Directives, the Codified Banking Directive 2000/12/EC and the CAD 93/6/EC, through the re-casting procedure. In late 2004, ECOFIN reached an agreement, under the Dutch presidency, on the draft of the CRD. After the text was transmitted to the EP for co-decision, the Directive was approved by a plenary vote in September 2005 during the British presidency. The CRD will come into force at the beginning of 2007, with the most sophisticated approaches available from 2008, in line with the introduction of Basel 2 rules. The CEBS, created as part of the Lamfalussy framework, is responsible for ensuring consistency and convergence in the application of this new framework.

Though it possessed the same rationale at Basel 2, the CRD had a wider scope of application. The intention of the Directive was to ensure a level playing field between firms competing within the same EU markets and thus it applied to all credit institutions and investment firms as defined by the Investment Services Directive (ISD). In common with the Basel 2 agreement, the CRD is articulated on three pillars: requirements for an internal capital assessment by financial institutions (exposure to credit, market and operational risks); a supervisory review process conducted by supervisors to evaluate the risk profile of each institution; and market discipline.

However, there are three main differences between Basel 2 and the CRD. Basel 2 is an international agreement, signed by 13 countries, including the US, Japan and Switzerland, and *de facto* extending worldwide (for example, Basel 1 was applied by most banks in 100 countries). In contrast, the CRD applies to only the 25 EU member states. Second, Basel 1 and 2 are so-called 'gentleman's agreements', that is, they are not legally binding, whereas the CRD is a legally binding and directly enforceable instrument. Third, Basel 2 applies only to credit institutions (banks), whereas the CRD also applies to investment firms. The first applies only to internationally active banks (for example it is estimated that in the US only up to 10 internationally active banks will be affected by Basel 2, *Financial Times* 8/10/2004), whereas the CRD applies to all banks and investment firms, even if their activities are purely domestic.

On some more specific points, the CRD made were a number of adaptations of the Basel 2 rules.[9] Further, in addition to the issues raised in the context of the Basel process, a number of concerns directly relevant to industry were raised over the EU's implementation of Basel through the CRD. The following account is by no means exhaustive.

The CRD enhanced the role of the *consolidating supervisor* for the supervision of EU cross-border groups, namely, the national supervisor in the member state where the group's parent firm is authorised. The consolidating supervisor is in charge of coordinating the treatment of an application that such a group may make for the approval necessary to use the more sophisticated capital calculation rules. All supervisors concerned are expected to reach an agreed decision on the application within six months, and in the event of a failure to do so, the consolidating supervisor is empowered to make a decision in order not to impose extra burdens on firms dealing with multiple supervisors. Banks with cross-border activities (mainly British-based banks and large private German banks) were largely in favour of the establishment of a fully consolidated supervision, though this was ultimately successfully opposed by the national supervisors.

For the BBA/LIBA, a specific concern related to the initial Commission proposal requiring the calculation of capital requirements at a 'solo' and 'sub-consolidated' level, as well as at the 'aggregate' holding company level. Fundamentally, the 'solo' model insulates the principal regulated entity from other members of its group, whereas the 'consolidated' model allows regulation and supervision to be applied to the top tier (i.e. parent or holding companies) of the

[9] For an overview, see http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/04/178&language=en&guiLanguage=en

group covering all members that provide financial services. British banks, in conjunction with the British authorities, wanted the application of the 'solo' model to remain a possibility in the UK by virtue of the EU legislation, and after an intensive period of lobbying aimed at both the Commission and the EP, this was achieved.

Basel 2 was designed for internationally active banks, while the CRD was created not only for application to the whole range of banks, but also to *investment firms*. However, the wider scope raised the issue of whether the calibration of specific parts of Basel 2 was appropriate for firms whose sole business lies in these areas. For example, the structure of the UK investment sector differs from that in much of continental Europe, where firms offering investment services are required to hold banking licenses, and investment services' business lines are often integrated into the commercial banking activities of major banking groups. In the UK, there is no such requirement for those firms to hold banking licenses and the UK has a very high number of specialised investment firms; over a thousand. This explains why the trading book constituted such a high priority for the British authorities, whilst they also favoured a specific calibration for the capital requirement of investment firms.

Another relatively minor, yet extremely controversial issue was the *treatment of intragroup exposure*, and the German savings and cooperative banks wanted zero risk weighting for this within their sub-sector, and directed intense lobbying at the EP in order to achieve this objective. This provision lowers the capital requirements of savings and cooperative banks, giving them a competitive advantage, and thus it was challenged by private banks in the UK and especially in Germany. However, a compromise solution of zero risk weighting was achieved in the event that certain conditions were met.[10]

The British Treasury and the FSA undertook extensive consultations with industry on the CRD: with the former focusing on issues relating to the overall cost and benefits of the new regulation in order to inform the position and strategy to be taken by the UK in EU fora, and the latter focusing on domestic implementation issues. Between December 2003 and April 2004, the Treasury engaged in a formal consultation exercise on the Commission's proposal for the implementation of the Basel 2 Accord through the CRD Directive. Approximately 100 firms and organisations responded, with representations coming from banks, building societies, consumers groups, investment firms, venture capitalists, small business, private investment managers, stockbrokers, academics and trade

[10] Finally, there was the concern that if the *implementation* of Basel 2 and the CRD was not *simultaneous*, compliance and operation costs for international banks would increase, particularly if they had to run different systems for their EU and non-EU operations. The UK banking sector feared it could be placed at a competitive disadvantage.

associations. The Treasury also held several industry roundtable meetings and small drafting groups in order to consult the market on the Government's negotiating stance in Brussels.[11] The FSA established two groups, the credit risk standing group and operational risk standing group, in order to facilitate discussion with industry regarding implementation, the minutes of which were posted on internet in order to promote transparency and facilitate the flow of information.

The German authorities also engaged in a formal consultation exercise on the Commission's proposal for the implementation of the Basel 2 Accord through the CRD. In order to prepare for the national implementation of Basel 2 and the CRD, the Bundesbank and BAFIN established the 'Implementation of Basel 2' Working Group as well as a number of specialist sub-committees to consider the issues of the Internal Ratings-Based Approach; operational risk; credit protection techniques; securitisation; the Supervisory Review Process and disclosure requirements. Composed of experts from the banking industry, BAFIN and the Bundesbank, the sub-committees' proposals were discussed and examined in a wider context, which included representatives of the banking industry's peak associations. In common with the British model, minutes of the meetings were posted on the internet, thus promoting transparency and information-exchange.

An overall Assessment

The case studies examined above highlight the importance of distinguishing between the degree of involvement and the degree of influence of interest groups in the policy making process. The *degree of involvement* primarily depends on the *policy content*; that is whether broader *institutional issues* (such as the decision to delegate competences and the creation of a regulatory framework) or *specific rules* are negotiated in international or EU fora. In the case of the first, the involvement of interest groups is likely to be low due to the high degree of *uncertainty* usually concerning the effects of broader institutional issues on the activities of interest groups. In addition, such issues tend to have the character of *public goods*; thus removing the incentive for interest groups to engage in lobbying. By contrast, when specific rules are decided, the involvement of interest groups is likely to be higher, and informed by *costs–benefits calculations*.

However, the reverse is true for public authorities. Since institutional issues tend to exhibit a substantial effect on national authorities competencies, they are likely to possess strong preferences that shape national input into international and EU policymaking processes on these matters.

[11] At the end of the consultation process, the Treasury produced a document called Capital Requirement Directives: Regulatory impact assessment (2004).

Instead, when specific rules are negotiated, the national authorities are generally willing to incorporate the preferences of domestic interest groups in defining the national position that will be externally articulated.

The *degree of influence* that interest groups hold in shaping the national input is dependant on *domestic institutions*, first and foremost, the state structure (federal or unitary), which in turn affects the structure of interest representation and political economy institutions, such as the link bank-SMEs in Germany. The distribution of power at the national level is very important whenever there are competing domestic preferences, or more precisely, where there are interest groups with different preferences competing for influence with regard to the definition of the national position in EU and international fora.

The Lamfalussy process, which established a broad regulatory framework for financial services in the EU, did not elicit a high degree of involvement by interest groups. To a degree, it had the characteristics of a public good, which meant that financial associations and private companies had limited direct interest to engage in lobbying activities on this issue; the specific costs of doing so outweighed the diffuse potential benefits. Moreover, the implications of the new framework for the activity of interest groups were highly uncertain. Broadly speaking, the most internationally active large banks supported it (as did their governments) because it was seen as instrumental to further market integration and they were in favour of streamlining the framework for financial service regulation and supervision in the EU. International financial groups also favoured a further transfer of competence to the EU level. By contrast, the national authorities vehemently opposed this institutional change, and the national input into EU fora represented a reflection of their bureaucratic preferences.

With regards to Basel 2, which contains detailed rules on capital requirement and supervisory implementation, the preferences of financial interests groups were less uncertain and more intense than in respect of the Lamfalussy framework. There was therefore a higher level of lobbying activity, though this varied across countries. In the UK, direct policy input was mainly provided by a few internationally active banks, whereas in Germany interest groups mobilised intensively and extensively, primarily on the issue of the implications for SMEs, one that was politically salient in the domestic arena. It should be noted that both the federal state structure and the federal organisational structure of the Bundesbank (until 2002) and of interest representation in Germany, including the banking sector (cf Deeg 1999), account for the influence of lander-based interest groups (savings and cooperative banks) in shaping Germany’s negotiating position.

The preferences of interest groups were more intense and widespread in relation to the CRD and its implementation than the Basel 2 negotiations, because the Directive contained specific rules that applied to all credit firms (banks) and investment firms in the EU. The fact that these rules applied to investment firms, which have a stronghold in the City, increased the mobilisation of economic interest groups in Britain. Further, national public authorities in Germany and the UK engaged in extensive consultation processes and were willing to articulate and promote the preferences of the domestic banking sector in international and EU policy-making arenas, also because they did not have alternative bureaucratic preferences.

In the second and third case studies (Basel 2 and CRD), central banks, supervisory authorities and treasuries have generally acted as country representatives, defending the national interests, or more precisely, the interests of powerful domestic groups. By contrast, in the case of Lamfalussy, and on specific issues of the CRD, such as the consolidating supervisor, the public authorities involved in the negotiations partly acted as self-interest bureaucracies, trying to pursue their institutional preferences, successfully safeguarding their competences in this area.

The case study that is more surprising is Basel 2, particularly when compared with the negotiations towards Basel 1 (cf Speyer 2006), which took place amongst national supervisors behind closed doors, with minimal involvement of the interest groups. In the case of Basel 2, it was clear to all the participants that it was not simply an international agreement concerning banking regulation, but instead financial diplomacy, and a very political game in which the national authorities tried to achieve competitive advantages through banking regulation (interview Frankfurt January 2006). The Bank of England has always been keen to promote London as a leading financial centre in Europe, and after EMU, the Bundesbank has become sympathetic to the goal of promoting *finanzplatz Deutschland*.

The drafting of the technical and detailed content of Basel 2 and the CRD also required close cooperation between the public authorities (central banks and supervisory agencies) and the banking sector, which was involved in intensive and extensive consultations, and the provision of data, information and expertise, with information exchange operating in both directions. For example, after each important meeting in Basel, the Bundesbank and BAFIN organised a debriefing session for the German banks, either in Frankfurt or Bonn (interview, Frankfurt January 2006). Before important EU meetings, the national authorities in Germany and UK also engaged in extensive consultation with the industry.

Conclusion

The aim of this paper was to evaluate the role of national economic interest groups in shaping national contributions (or 'input') to EU and international policy making processes, and more generally, to the process of European integration. The explanation that considers financial interest groups as active policy makers, rather than passive policy takers, is broadly confirmed by the empirical record. It has, however, to be qualified, in that it depends on the policy content (interest groups involvement is higher when specific rules are negotiated) and domestic institutions (interest groups are likely to be more influential when the domestic distribution of power gives them preferential access to policy-makers). The rival explanation about the power of bureaucratic preferences in defining the national position in international and EU fora holds in specific circumstances; that is, when the regulatory issues discussed relate to supranational delegation and scope of governance.

It is difficult to say whether these findings can be extrapolated to other policies, because the financial service sector has traditionally been regarded as influential in domestic policy making. It should however be noted that in the case studies of EU and international policy-making considered here, the public authorities also valued the expertise, data gathering and first hand experience provided by the industry, a move that ultimately strengthened its policy input.

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Table 1. Preferences and degree of intensity concerning the 3 reforms of financial regulation and inclusion or exclusion from the final (EU or international) agreement

Preferences of financial groups and degree of intensity	**Preferences of the national authorities and degree of intensity**	**Inclusion into the final agreement**
Lamfalussy framework		
Germany Big private banks in favour of the Lamfalussy framework ++ Big banks in favour of further reform (eg European regulators) ++	In favour of the Lamfalussy framework +++ Against further reforms: safeguarding their competences - -	✓ No further reform
The UK Overall support for the Lamfalussy framework ++ Big banks in favour of further reform (eg European regulators) ++	Support for the Lamfalussy framework +++ Against further reforms: safeguarding their competences - -	✓ No further reform
BASEL 2		
Germany Shared preferences public and private banks, large and small: - Concern for financing of *small and medium-sized enterprises* +++ Preferences of the small (mainly public) banks: concern about *'distortion' of competition between large and medium to small credit firms* ++ Preferences of the large private banks: concern about *supervisory review imposing an extra burden* ++	Supported by the Bundesbank, BAFIN and political authorities +++ Ditto ++ 'accommodation' in implementation by the Bundesbank and BAFIN	✓ ✓
The UK Preferences of the banking sector: - *trading book review (securities)* +++ - *supervisory review imposing an extra burden* ++	Supported by the Bank of England and FSA + 'accommodation' in implementation	✓ ✓
CRD		
Germany		

Shared preferences: concern for SMEs+++ Preferences of large private banks: - Moving further on *consolidating supervisor* ++ - NO Special *treatment of intragroup exposure* +++ Preferences of small (saving and cooperatives) banks: Special *treatment of intragroup exposure* +++	Supported by the Bundesbank, BAFIN and political authorities +++ Not supported by the national supervisory authorities --- No support from the national authorities -- Some support by the national authorities	✓ X Compromise Compromise
The UK - Moving further on *consolidating supervisor* + - Calculation of capital requirements based on '*solo' model* +++ - NO Special *treatment of intragroup exposure* ++	 Not supported by the national supervisory authorities --- Supported by all national authorities +++ Ditto +++	 No further reform ✓ Compromise

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