Explaining the Reform of Banking Supervision in Europe: An Integrative Approach

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National frameworks for banking and, more generally, financial supervision in various European countries have undergone significant changes in the last decade or so. What explains these supervisory reforms? This work addresses this question by examining the recent reforms in the United Kingdom, Germany, and Italy, engaging in a structured, focused comparison, mainly using process tracing and adopting an analytical framework articulated across three levels of analysis. It is argued that while international and EU factors acted as antecedent variables, establishing the background for the reforms, they were mediated by national factors—to be precise, by two independent variables—that account for distinctive modes and outcomes of reforms. In addition, the institutional strength of the central bank—the intervening variable—can make a difference to the process of reform by either inhibiting or catalyzing change.

1. Introduction

From 1997 onward, the frameworks for the regulation and supervision of financial services in several European countries have undergone significant changes, many of which have been intertwined with the reform of the national central banks. The United Kingdom took the lead in 1997, followed by Germany in 2002, and Italy in 2005. In the same period, the Netherlands and Belgium also reformed their national supervisory frameworks. In all these cases, well-established institutional arrangements for financial services supervision, many of which had not been amended for decades, were substantially restructured, leading to the creation of a single financial supervisor for the entire financial sector—with the exception of Italy, where the scope of the reform was limited to taking away from the central bank competition policy in the banking sector.

National financial supervisory frameworks are important for three main reasons. They can affect the overall financial stability of the countries in which they are embedded, they can impinge on the competitiveness of national financial centers as well as the competitiveness of the financial industry based in a certain territory, and they influence the relations

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between the central bank and other supervisory authorities, as well as the relations between the central bank and the government. Hence, any major reorganization of these supervisory arrangements has implications for all these issues.

What explains the wave of supervisory reforms that took place in the EU after decades of overall stability? This article tackles this question by focusing on the change of framework for banking supervision in three EU countries, namely the United Kingdom, Germany, and Italy, engaging in a structured, focused comparison, mainly using process tracing. These policy episodes have been selected for comparative analysis for two reasons. First, they are of interest in their own right, as they resulted in significant changes of the supervisory framework and concern large countries with extensive financial sectors. The degree of change is relatively small in the policy episode in Italy in comparison to those in the United Kingdom and to a lesser extent Germany, although the amendments introduced in 2005 appear remarkable when compared with the *ex ante status quo*.

Second, the timing, dynamics, and degree of change vary across the chosen case studies. The change of the supervisory framework was remarkable and was carried out swiftly in the United Kingdom in 1997. Conversely, while it was significant in Germany, it required lengthy negotiations during 2001–2002; in Italy the change was highly contested and preceded by time-consuming bargaining in 2002–2005 and eventually fell short of expectations. A comparative analysis permits us to elicit the specific factors that account for differences and similarities across policy episodes, so as to avoid ad hoc explanations for a specific case.

The *dependent variable* (or "case outcome," cf. Ragin 1987) of the research is the change of institutional arrangements for banking supervision. As explained below, these countries had different starting points for the reform process, that is, the configuration of the supervisory framework prior to the reform, although there were some similarities between the United Kingdom and Italy. There were also different end points, that is, the configuration of supervisory frameworks after the reform, although important similarities can be identified between the United Kingdom and Germany with the creation of a single supervisory authority, even though the German model of "modified" single supervisor retained an important role for the central bank in the supervisory framework; hence, in Ragin's conception, it would be a "half-case." In contrast, banking supervision remained assigned to the central bank in Italy. Here, the interest is less on the detailed content of the legislation, including its objectives, instruments, strategies, and practices (that is, regulation), and more on the institutional arrangements through which banking supervision is performed, paying special attention to the role of the central bank.

From a theoretical point of view, this research feeds into the scholarly debate on what triggers institutional change, and, in particular, the role and the interplay of international, domestic, and organizational factors

(see Campbell 2004). An integrated analytical framework is articulated across three levels of analysis to explain the reform of the supervisory framework in the selected case studies and, by extension, in Europe. It is argued that developments at the international and EU levels set the background for the reform, and therefore they constitute antecedent variables in the explanatory model. Taken on their own, they would be expected to stimulate similar reforms in the various member states, promoting a certain degree of convergence across countries. However, national factors enter analysis as independent variables, accounting for the distinctive modes of reform and their outcomes. Finally, at the micro-institutional level, the institutional strength and the assets of the central bank can make a difference, acting as intervening variables, by inhibiting or catalyzing change.

Some qualifications concerning the scope of this research are necessary. First, banking supervision is one of the three traditional macro-sectors in which financial supervision is divided, the other two being the supervision of securities and insurance markets. Given the interaction and increasingly blurred boundaries between these three sectors, the reform of banking supervision needs to be contextualized within the broader supervisory reforms of the financial sector, and this also requires a reference to the reform of the respective national central bank.

Second, banking supervision includes a variety of supervisory functions, such as ensuring systemic stability, conducting prudential supervision (solvency of banks), and the monitoring of transparency and correct practices, with emphasis placed on the first and second functions. It does not include banking competition policy, which is generally dealt with by national competitions authorities, such as the *Bundeskartellamt* and the Länder competition authorities in Germany or the Competition Commission and the Office of Fair Trading in the United Kingdom. Prior to the 2005 reform, Italy was an exception, as the central bank—not the competition authority, the *Autorità Garante della Concorrenza ed il Mercato*—was responsible for competition in the banking sector. This is included in the discussion of the Italian reform.

Finally, as a result of space constraints, the analysis presented in this article mainly focuses on the domestic level. Discussion of the EU and international levels is concise and made without creating a distinction between them. Likewise, the micro-institutional level is touched upon only briefly. Part of the empirical data presented in this article was gathered through semi-structured elite interviews with current and former policymakers from the case studies and in some EU organizations. Moreover, market participants and qualified observers were also interviewed. The interviews were confidential, triangulated, and cross-checked against available information, derived from published primary documents and a systematic survey of press coverage.

The material is organized as follows. Section 2 reviews the state-of-the-art literature on the reform of banking supervisory frameworks and dis-

cusses alternative theoretically informed explanations. It also sets out the analytical framework adopted for this research, which is subsequently applied to the empirical record. Section 3 focuses on the dependent variable, elucidating and comparing the change of the financial supervisory framework in the three case studies. Section 4 analyzes and contrasts the reform processes in these countries, before Section 5 draws a number of general and specific conclusions.

2. Review of the Literature and Explanatory Framework

In political science, there is a limited literature on the reform of financial regulation and supervision in Europe. Westrup (2007), in comparing the 1997 reform in the United Kingdom with the 2002 reform in Germany, adopts an explanation based on partisan politics and domestic political economy. He argues that the expansion of the securities market and the introduction of private pension schemes have increased the number of small investors, making policy failures in this sector politically costly, as small investors are electorally important constituencies, especially for center-left parties. These parties are also keen to improve the accountability of supervisory authorities for ideological reasons.

Lütz (2004) focuses on the regulatory state in finance in the USA, the United Kingdom, and Germany, adopting a comparative historical institutionalist perspective combined with a regime approach. She argues that convergence in banking regulation and supervision is taking place within the diversity of national models of capitalism. Such convergence is triggered by the internationalization of finance and the behavior of market operators, even though domestic institutions prevent total convergence and explain the timing and the extent of the regulatory reform.

Basically, these accounts of supervisory reforms combine both international and domestic political economy explanations, stressing the importance of interests and institutions. An alternative approach would have been to opt for ideas-based explanations, by tracing the ideational diffusion (Simmons and Elkins 2004) and the influence of policy paradigms (Hall 1993) in reshaping the supervisory framework across countries. Ideational explanations have gained significant mileage in the political economy literature on central bank independence and Economic and Monetary Union (EMU) (see Dyson 1994; McNamara 1998). However, as recognized by Busch (2004), there is neither a prevailing policy paradigm nor a widely preferred institutional template in financial supervision (including banking supervision), unlike in monetary policy, something evidenced by the persistence of very different frameworks in Europe and worldwide. There is a lack of consensus among policymakers both internationally and within the EU regarding the best institutional design to conduct financial supervision (see Goodhart and Schoenmaker 1995; Goodhart, Schoenmaker, and Dasgupta 2002; Mayes, Halme, and Liuksila 2001; Padoa-Schioppa 1999, 2004).

For a similar reason, explanations based on policy transfer (Bennett 1991; Dolowitz and Marsh 1996; Evans and Davies 1999; Radaelli 2000) prove unsatisfactory when applied to the case studies under consideration. The literature on public policy suggests that such transfers can take place through (or be promoted by) international institutions or from country to country. Not only are international and EU institutions in the field of financial supervision not very robust, they also deliberately refrain from imposing or promoting specific models, given the fact that the supervisory arrangements vary remarkably from country to country. The Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions, and the EU bodies created or reshaped with the approval of the Lamfalussy framework (such as the Committee of European Banking Supervisors) are fora where member states negotiate and eventually agree upon core principles of banking and financial markets supervision, discuss and benchmark best practices, and promote multilateral cooperation, providing a platform for information exchange between supervisory authorities. However, this is generally done in such a manner as to suit different national institutional arrangements and even the institutional membership of these committees is not entirely homogenous. For example, the Bank of Italy is the sole representative for Italy in the BCBS, whereas the United Kingdom and Germany are represented by both the supervisory authority and the central bank.

Policy and institutional transfers can take place from one country to another, without being imposed or promoted by international or EU institutions when national policymakers draw lessons from each other's (perceived) successful models. Yet, this explanation is also unconvincing. Whereas the framework set in place in Germany in 2002 is, to a large extent, similar to that established in the United Kingdom in 1997, there are important differences both between the two models, as explained below, and between them and the Italian model. With specific reference to the German and British cases, empirical research provides very limited evidence of deliberate lesson drawing, either by Germany from the UK case or by the United Kingdom from the Scandinavian countries, which had established a single supervisory authority in the late 1980s and early 1990s (interviews, London, December 2005).

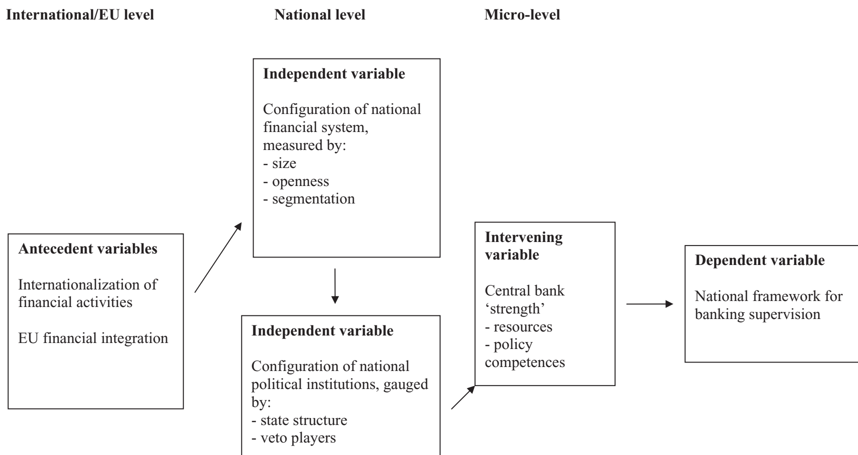
Neither was this an instance of U.S. or German economic or ideational power. The USA, which is often considered as the leading regulator in this field, especially with regard to securities and the stock market (cf. Moran 1991, 1994), has a very different model in place, one that is not based on a single supervisory authority (Westrup 2007). Germany, which had a great deal of structural power in Europe as far as monetary and exchange rate policies were concerned (Dyson 1994; Heisenberg 1999; Loedel 1999; McNamara 1998), was not, however, considered to be a leader in the supervisory field and introduced a single supervisory authority as late as 2002.

To sum up, regulatory reforms in the banking sector (as in other sectors) can be explained by regime theory, ideational diffusion, policy transfer, and institutionalism, all being theoretical approaches that are not mutually exclusive. Institutionalist approaches mainly focus at the domestic level; hence, they are better suited to explain different reform processes and outcomes across countries, except when countries have similar domestic institutions. Yet, given the fact that institutions do not change easily, the question remains as to what triggers the reforms in the first place. Moreover, an analytical focus on the domestic level overlooks dynamics at play beyond national borders, which are important for the financial sector, one of the most internationalized sectors. Regimes, ideational diffusion, and policy transfer approaches tend to focus on the international level and have greater explanatory power in accounting for the causes of the reforms and similar outcomes across countries. Yet, these approaches, taken on their own, are not well equipped to explain different processes and outcomes across countries, leaving open the question of why the reforms take place in some cases but not in others. This would require an analysis of the domestic arena. Moreover, marginal attention has been paid so far to the specific features of the supervisory agencies involved. This micro-institutional analysis is important because certain supervisory bodies can be powerful actors (especially whenever the supervisory tasks are performed by the central bank), able to exert substantial influence on the reform.

To address these issues, this work adopts an *integrative analytical framework* that is articulated across three levels of analysis: international and EU, national, and micro-institutional (cf. Quaglia 2005a; see Figure 1). The starting point of the analysis is situated at the *international and EU levels*, and international and EU factors are therefore the *antecedent variables* that set the background for domestic reforms. These variables have increased during the last decade. The increasing internationalization of financial activities (including banking), the deepening of the process of European financial market integration, and the development of international and EU institutions and their norms exert pressure on the existing national supervisory arrangements. Such pressure is mainly indirect because international and EU (or EMU) institutions and their norms do not prescribe or even suggest specific institutional templates to be adopted by supervisory authorities of the member states. By contrast, indirect pressure can be applied through two main mechanisms.

First, financial internationalization and European financial market integration increase the risk of cross-border banking failures with systemic implications, and this is particularly significant in the EU following the creation of EMU. This risk can be caused by financial operators engaging in "venue shopping" between jurisdictions in order to take advantage of the lowest supervisory standards and exploiting loopholes in the regulation and supervision of cross-border activities (Lütz 2004). Member states and the national supervisory authorities have responded to this challenge

FIGURE 1
The Explanatory Framework of Banking Supervision Reform in Europe



by negotiating international and EU agreements that set common standards and core principles, regulate cross-border financial activities, and promote cooperation between national supervisors. The Basel 2 Agreement, the Capital Requirements Directive, and the Lamfalussy framework represent formal steps in this direction, but, as mentioned above, they do not impinge upon the national institutional arrangements for financial supervision.

Second, financial internationalization and European financial market integration promote the blurring of boundaries between various segments of the financial sectors, traditionally banking, securities, and insurance (The Group of Ten 2001). Together with the formation of financial conglomerates, this augments the complexity of supervisory activity. Here, the issue at stake is not only the combined effectiveness of separate supervisory authorities, which, in the worst case scenario, can result in supervisory failures, paving the way to supervisory reforms. Another issue is also the compliance costs imposed on the supervisees in different jurisdictions (Schüler 2005). A one-stop supervisor is likely to reduce costs of compliance with supervisory practices and is expected to simplify the supervisory procedures for the financial actors that are engaged in various segments of the market. Moreover, financial internationalization and European integration increase the number of international players present in national markets. A single supervisor in each national jurisdiction would streamline the supervisory practices and would reduce compliance costs for financial operators engaged in cross-border activities. Both of these issues are particularly important for the main financial centers, such

as London and Frankfurt, which compete with each other in order to attract investors (Westrup 2007).

The effects of internationalization and European integration (including some indirect effects of EMU) mentioned above apply to all EU countries, including those outside the Eurozone, such as the United Kingdom—the City of London has by far the highest number of financial conglomerates in Europe and the most internationalized financial sector in the EU. Despite this, there can also be specific effects of EMU on the national central banks that are members of the Euro-system and which face the issue of redefining their role and policy competences, for example, extending them to banking (or financial) supervision. It is true that Eurosystem central banks have faced adaptational pressure and have undergone adjustment processes, but this does not seem to be the driving force of financial supervision reforms in the EU or in the Eurozone. Indeed, only two central banks in the Eurosystem have expanded their supervisory tasks (the Dutch and Irish central banks), and both of them already possessed supervisory powers in the banking sector prior to EMU.

As argued in the literature on globalization and Europeanization, external pressure produces different effects across countries, because it is mediated by factors at the *national level*. In this respect, two types of *independent variables* are particularly important. The first variable is the configuration of the financial system, measured by its size, the degree of integration between the macrosegments of the financial sector, including the presence of financial conglomerates and the degree of the sector's internationalization. The second variable is the nature of domestic political institutions (Lijphart 1999), operationalized by looking at the state's structure and the presence (or absence) of institutional veto points.

A financial sector that is highly internationalized, characterized by the presence of financial conglomerates and the interpenetration between various segments of the sector, is likely to support, or even actively lobby for, the creation of a single supervisor. This is the case both in the United Kingdom and Germany, at least for the main market players, although it is not yet the situation in Italy. Since the national authorities are aware of the preferences of market operators and the main financial centers, London and Frankfurt, are keen to attract large international investors, the governments in these countries are willing to invest political capital to engage in the reform of the supervisory framework.

Depending on the configuration of political institutions, the speed at which this will be achieved will vary (Lütz 2004, 188). A country, like the United Kingdom, that has a unitary state structure, majoritarian political institutions (Judge 2005), and is lacking institutional veto points is likely to undertake major and swift reforms, once the political decision to do so is taken. The opposite is generally true for those countries with a federal state structure, characterized by power-sharing institutions, such as Germany (Schmidt 2003), and political systems characterized by power fragmentation and multiple veto points, such as Italy (Bull and Newell 2005).

Finally, there is the *micro-institutional level* of analysis, which focuses on the institutional strength of the central bank, gauged by considering its resources, such as credibility and expertise, and existing policy competences (for a more detailed discussion, see Quaglia 2005b). This was largely the case regarding the Bank of Italy and, to a lesser extent, the Bundesbank. Moreover, ties to international and EU central banking networks might provide additional resources to the central bank, which might enable it to resist attempts to exclude it from banking supervision. It should also be remembered that previous policy failures deteriorate the micro-institutional assets of the central bank, weakening its ability to resist change, as was the case in the Bank of England, and to some extent, the Bank of Italy in 2005.

3. The Change in Institutional Framework for Banking Supervision in the United Kingdom, Germany, and Italy

The United Kingdom

Prior to the 1998 reform, the Bank of England was responsible for the supervision of the banking sector, as well as for the overall financial stability. The Bank of England had always possessed a considerable degree of policy capacity on these matters, partly due to the expertise it possessed, partly as a result of its strong links with the city, and partly because the government was less interested (or, at least, less willing to be directly involved) in these matters. Besides banking supervision, the Bank of England also exerted significant influence over the reform of the securities' regulatory and supervisory framework that took place in the 1980s (see Moran 1991).

The Financial Services Act 1986, which outlined the supervisory framework in place before the 1997 reform, was introduced to provide a statutory-based system of regulation, replacing the dispersed corporatist arrangements that were previously in place in the financial services sector (Moran 1991). The Act delegated supervisory powers to Self-Regulatory Organizations (SROs) in different sectors, overseen by the Securities and Investment Board (SIB), which was a private, not a public, body, financed by levies on the industry, with a chairman appointed by the secretary of state in agreement with the governor of the Bank of England. The other members of the board were appointed by the governor of the bank, in agreement with the secretary of state. In the case of financial conglomerates, the Bank of England was established by the Act as the lead regulator, and it also retained a significant role in the securities markets (Coleman 1996, 194).

The most far-reaching institutional reforms of the Bank of England took place in 1997, when the newly elected Labour government, and more precisely, Chancellor Gordon Brown, granted operational independence to the central bank, reshaped its governance structure, and removed its

powers of banking supervision. Operational decisions on monetary policy were assigned to a Monetary Policy Committee and banking supervision was assigned to the Financial Services Authority (FSA).

The current model of financial services regulation and supervision in the United Kingdom is based on a single agency, the FSA, which possesses responsibility for micro-stability, prudential supervision, conduct of business, and transparency of the entire financial sector. Financial stability must be pursued with cooperation between the FSA and the Bank of England; the details of this are outlined in a memorandum of understanding. The new regulatory structure also ended the two-tier system that divided responsibility between the SIB and the SROs.

Germany

Unlike the Bank of Italy and the Bank of England prior to the 1997 reform, the Bundesbank was not, before its 2002 reform, responsible for the supervision of the banking system, even though, de facto, the Bundesbank had been involved in it, in cooperation with the Banking Supervisory Authority, the BaKred. The BaKred had been established in 1962 as a legally independent federal authority, reporting to the Finance Ministry. Since the BaKred did not have its own administrative apparatus at the Landër level, it worked closely with the Bundesbank, which had branches in each Land. Information and data were collected by the Länder central banks (the regional branches of the Bundesbank), which then forwarded it to the BaKred and the Bundesbank center in Frankfurt (Stern 1999, 137–138).

The Bundesbank and the BaKred were to inform each other of any observations and findings that could be significant for their functions. The Bundesbank could request specific information from credit institutions and the BaKred was entitled to initiate investigations on specific banks and involve itself in the management of any bank with financial difficulties. Further, the president of the BaKred retained the faculty to attend the Bundesbank's meetings on occasions where banking supervision was discussed, and in turn, the Bundesbank was entitled to express an opinion on the appointment of the president of the BaKred (Coleman 1994, 286).

The system of financial services regulation and supervision in Germany was, however, overhauled in 2002 when a single body, the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) was established to supervise the entire financial sector, taking over functions previously performed by the three different authorities responsible for banking, securities, and insurance. When the Act concerning the integrated supervision of financial services entered into force in May 2002, the Federal Banking Supervisory Office, the Federal Supervisory Office for Insurance Enterprises, and the Federal Supervisory Office for Securities Trading were amalgamated in order to form the German Financial Supervisory Authority.

The Bundesbank and the BaFin have also spelled out the details of their respective roles in day-to-day supervision in a memorandum of under-

standing in order to avoid the duplication of work. Under the agreement, the Bundesbank is assigned the majority of operational tasks in banking supervision, consistent with the past. The Bundesbank continues to analyze the documents, reports, annual accounts, and auditors' reports submitted by the institutions; while both the Bundesbank and the BaFin can conduct on-site inspections, they must inform each other of the intention to do so.[1] According to an informal "gentlemen's agreement," the BaFin mainly supervises large banks (both private and public), whereas the Bundesbank focuses on savings banks, cooperative banks, and small private banks (interview, Frankfurt, January 2006).

Although the reform introduced in Germany bears some similarities with the 1997 reform undertaken in the United Kingdom, there are significant differences between the two models. First, the BaFin, unlike the FSA, is not an independent authority, but a constituent body of the Finance Ministry. Whereas the FSA reports to the Parliament and consults with the Bank of England and the Treasury, the BaFin reports directly to the Finance Ministry. Second, the BaFin is still organized according to the traditional market segmentation (between banking, securities, and insurance), whereas the FSA is structured according to functions. Moreover, the BaFin has two bases: one in Frankfurt (for securities) and one in Bonn (for banking and insurance), although it is currently in the process of increasing the capabilities of its Frankfurt office in order to assume responsibility for banking supervisory matters. Third, the central bank in Germany is still involved in the operational side of banking supervision. In both countries, the supervisory authorities are funded with levies from industry.

Italy

The Bank of Italy is responsible for the systemic stability of the financial sector and the prudential supervision of banks and financial intermediaries dealing with securities. The *Commissione Nazionale per le Società e la Borsa* (CONSOB) oversees the Italian securities market and aims to protect the public by ensuring transparency, encouraging the disclosure of information from listed companies (including banks), and monitoring market participants' behavior. Prior to the 2005 reform, the central bank was also in charge of competition policy in the banking sector, and hence, mergers and acquisitions were subject to the authorization of the Bank of Italy.

Further, the central bank has inspective powers, for it can conduct on-site and off-site inspections, as well as regulatory powers, as it can issue secondary legislation (regulations) under principles fixed by law (primary legislation). Traditionally, there is ample room left in Italy for the creation of secondary legislation in this sector (Ciocca 2005, 43). The Bank of Italy is also consulted in the drafting of primary legislation and because of the expertise it can master as well as its constructive relations with the Treasury at the senior official level, it has a remarkable input into the

creation of legislation. Two noticeable examples were the Consolidated Banking Law (1993) and Consolidated Finance Law (1998).

A reform took place in 2005 in the wake of a scandal that involved the Governor of the Bank of Italy, Antonio Fazio. The Law on Savings, which had been in the making since 2002 and was eventually adopted in December 2005, introduced three important amendments to the legislation concerning the central bank. The first change concerned the ownership structure of the central bank, with only the State and public bodies now allowed to hold shares of the Bank's capital. The second change concerned the governance structure of the bank, which was rendered less hierarchical, as explained below. The reform essentially left the extensive supervisory powers of the central bank untouched, although the tasks concerning banking competition policy were effectively transferred to the Competition Authority. Whereas the Bank of Italy would conduct its evaluation while taking into consideration "sound and prudent management issues," the Competition Authority would base its assessment on the competitive effects of acquisitions and concentrations.

4. The Reform Process in the United Kingdom, Germany, and Italy

The United Kingdom

The reform process in the United Kingdom was swift and efficient, as the new framework was proposed and agreed in less than three months and implemented within a year. The policymaking process was characterized by the absence of significant veto points. Even the central bank, the domestic institution that stood to lose the most from the reform of the supervisory framework, did not offer opposition, although the governor did briefly consider the possibility of resigning.

Before the 1997 elections, the shadow Chancellor of the Exchequer, Gordon Brown, had informed Governor Eddie George that, if elected, the Labour Party would retain the existing central banking framework but also establish a monetary committee that would hold responsibility for providing advice to the Chancellor (*The Times* April 4, 1997 and May 7, 1997). Only after the evaluation of this arrangement's function could greater independence for the Bank of England be contemplated by a Labour government, and no reference was made to changes concerning banking supervision. Shortly after taking office in May 1997, the Chancellor of the Exchequer, who, together with his economic adviser Ed Balls, was the main engineer of the reform, announced the plan to reform the Bank of England and its accompanying supervisory framework, a move that was met with surprise (King 2005). The ensuing legislation that implemented these changes, the Financial Service Act, was adopted in 1998, and the FSA was created shortly after.

This institutional change was a major blow for the Bank of England and was unexpected. Due to the lack of consultation regarding the reform

program, the Governor considered tendering his resignation and the Chancellor also contemplated not reappointing him, although neither course of action eventually occurred (*The Guardian* November 7, 1998; *The Independent*, May 22, 1997, p. 23). However, unlike the Bundesbank and the Bank of Italy, the Bank of England did not engage in a significant rearguard battle following the reform for the reasons mentioned below.

The economic rationale for granting operational independence to the Bank of England was to increase macroeconomic credibility by giving the signal that monetary policy was no longer conducted according to political considerations, as had been the case in the past, a policy which had, on several occasions, created policy failures (interview, London, December 2005; *The Times* April 4, 1997). Moreover, because of the economic policy disasters of the Labour government during the 1970s, the absence of New Labour's credibility in this regard was significant when it was elected in 1997 (Goodhart 2002, 194). In addition to the economic reason behind the hasty program, there was a political rationale: The creation of an operationally independent central bank would enable the diversion of blame away from the government in the event that high interest rates were necessary in order to combat inflation (Elgie and Thompson 1998).

Three fundamental reasons explain the change of the supervisory policy framework in Britain in 1997. First, the increased complexity and interpenetration of financial activities in the United Kingdom made the creation of a more comprehensive statutory regulation and a unified approach to supervision necessary (Treasury statement May 20, 1997), especially for financial conglomerates, which had substantially increased in number in the United Kingdom. According to a list compiled by the European Commission, the United Kingdom is the country that has by far the highest number of financial conglomerates in the EU (Commission of the European Communities 2006). Prior to the reform, the system in place was regarded as inefficient, confusing for investors, and lacking in accountability, as a result of the fact that responsibilities were not clearly allocated (Treasury statement May 20, 1997). The creation of a single regulator for the entire financial sector, the FSA, was welcomed by the main financial companies operating in multiple segments of the financial services sector; indeed, the 1997 reforms were, broadly speaking, supported by the financial sector (interviews, London, May 2006).

Second, the background to the change included the policy failures of the early 1990s, not only in the banking sector, but also in the two-tier system of the SIB (*The Independent* May 22, 1997). For example, the misselling of private retirement pensions had a great deal of political salience (Westrup 2007). Moreover, the effectiveness of the existing supervisory system and policy capacity of the Bank of England in prudential supervision had been challenged by the Bank of Credit and Commerce International (BCCI) affair in 1991, and the Barings scandal in 1995. Following the former, the Treasury and Civil Service Committee produced a report criticizing the Bank for their failure to accurately apply the law (see the

Report on Banking Supervision and BCCI produced by the Treasury and Civil Service Committee 1993). These events weakened the micro-institutional assets of the central bank as supervisory authority, diminishing its ability to resist the change.

Third, at the micro-institutional level, there was a need to prevent an excessive concentration of power being vested in the Bank of England once it was assigned operational independence with respect to monetary matters, an issue of specific concern for the Treasury (interview, London, October 2005). Thus, the Bank was deprived of the function of banking supervision in return for its operational independence. As a result of both this and the pragmatic understanding that any opposition from the Bank was likely to be futile due to the strong Parliamentary majority held by the Labour Party, the Bank of England did not try to prevent or modify the reform (Westrup 2007).

Germany

The reform process in Germany was not as swift as in the United Kingdom, taking almost two years to be agreed upon. The negotiations were characterized by the search for political compromises in order to overcome numerous institutional vetoes inherent in the German political system, which is characterized by a federal state structure with a powerful and independent central bank; indeed, the main obstacles to the reform were the Länder and the Bundesbank (*Die Frankfurter Allgemeine* January 27, 2001). The new law, repeatedly obstructed by the Bundesrat, the federal chamber of the Länder, was eventually approved in a rather unusual manner. Unlike the Bank of England, the Bundesbank engaged in an ultimately unsuccessful battle to safeguard and expand its supervisory competences. However, the creation of EMU weakened the micro-institutional assets of the central bank, which became a less powerful institution than before, both domestically and internationally (Dyson 2003). It should also be said that within the Bundesbank, there were different views concerning the expansion of supervisory competences (interviews, Frankfurt, January 2006).

In January 2001, the Social Democratic Finance Minister, Hans Eichel, presented two complementary reform proposals: one concerning the reform of the Bundesbank's governance structure and one the reform of the banking supervision framework (and more generally financial supervision) in Germany. The first of the Finance Minister's proposals envisioned a single-tier governing body for the Bundesbank, the members of which would be appointed by the federal government. The Länder central banks were to be replaced with regional offices. Although Eichel's proposal was opposed by the Länder, especially in Bavaria, it was supported by the executive board, first and foremost by the president of the Bundesbank, Ernst Welteke (interview, Frankfurt, January 2006).

The second proposal concerned financial services supervision in Germany, whereby banking supervision, together with securities and insurance supervision, would be centralized within one body, the newly created BaFin. Thus, Finance Minister Eichel proposed the creation of a single "super-regulator," replacing and assuming the supervisory functions of the three existing federal authorities that had previously dealt with the main segments of the financial sector. Banking supervision, which had previously been performed by the BaKred in conjunction with the Bundesbank, would consequently be transferred to the single regulator.

This reform had the full support of the large private banks (*Financial Times* June 12, 2001), which favored a one-stop regulatory body for the whole financial sector, as a result of the changes concerning political economy institutions in Germany, as elaborated below. By contrast, the Bundesbank was not only keen to carve out a greater role in banking supervision, it also aspired to become responsible for integrated financial market supervision (Dyson 2002, 222).[2] Likewise, many Länder were unhappy with the government proposal concerning banking supervision due to the necessary consequence that it would endanger the competencies of the Länder central banks in this field (*Financial Times* June 12, 2001), given that they were de facto heavily involved in supervisory activities.

As the Bundesrat (or chamber of the Länder) opposed both these proposals, and the Bundesbank opposed the second one (some Länder central bank presidents also opposed the streamlining of the governance structure of the Bank), the Federal Government made two amendments to its original plan. Instead of the six-member Executive Board that had initially been proposed, an eight-person single-tier Board of the Bundesbank was to be created, with the nominations shared equally between the Federal Government and the Bundesrat, an amendment that represented a clear concession to the Länder (Engelen 2002). Moreover, the amended plan entitled the Bundesbank to exercise joint banking supervision with the BaFin, a clear concession to the Bundesbank (interview, Frankfurt, January 2006).

The modified proposal was eventually approved by the Federal Parliament after the Bill was passed by the Bundesrat when the CDU members, many of whom opposed Eichel's reform proposal—as did the SPD-led Land of North-Rhine Westfalia (hence this was not only a party political division)—had walked out in protest at the immigration bill. Subsequently, a protocol was issued by the Federal Government in order to clarify the relations between the Bundesbank and the BaFin, as well as the central bank's competences in banking supervision.[3]

The European Central Bank (ECB) was consulted by the Federal Government on these reforms in August 2001 (ECB Legal Opinion on the Reform of the Bundesbank CONV 2001/17) (ECB 2001b) and November 2001 (ECB Legal Opinion on the Law Establishing an Integrated Financial Services Supervision in Germany, CONV 2001/35) (ECB 2001a). The ECB provided external support to the Bundesbank in its domestic institutional

battle, first to extend its supervisory competences and failing this, in keeping the national central bank involved in supervisory matters. The rationale articulated by the ECB and the Bundesbank was that this had implications for the stability of the financial system, which is a priority for central banks. This was an interesting case of a two-level game in which the Bundesbank attempted to use its micro-institutional assets, in this instance its ability to mobilize the resources available to the central bank as part of the Eurosystem (to be precise, the support of the ECB), in order to tip the balance in its favor in domestic policy disagreements.

The rationale of the reform of the governance structure was to make the decision-making process within the Bundesbank more efficient in order to allow a more effective articulation of its interests in the ESCB/Eurosystem (*Financial Times* February 12, 2001). Prior to the reform, the decentralized governance structure of the Bundesbank made decision-making processes slow, and the Bundesbank Council members undermined the authority of the President within the Eurosystem on several occasions by making public statements on monetary policy and exchange rate policy in the euro area, which sometimes contradicted the ECB's stated position (*Financial Times* June 15, 2000).

The rationale of the second reform, which implied the creation of BaFin, was to increase the competitiveness and attractiveness of Germany as a financial center by adopting the model of the FSA and thus providing an improved regulatory framework (Westrup 2007). Unlike in the United Kingdom, the reform in Germany was not a response to major policy failures but was instead triggered by an incremental change of the configuration of the financial system, in particular the increasingly blurred boundaries between segments of the financial sector and the formation of large financial conglomerates (Schüler 2005), such as Allianz-Drezner and Munchner Ruck/HypoVereinsbank (bank-assurance) and the internationalization of this sector (Lütz 1998).

Since the creation of EMU and the new impulse that it gave to financial integration in the EU, *Finanzplatz Deutschland* has become an important goal for the Federal Government and the Bundesbank (*Financial Times* June 20, 2000), with a view to make Frankfurt the most important financial center in the Eurozone (interview, London, December 2005). The fact that the BaFin is responsible for all segments of the financial markets constitutes an important locational advantage for foreign companies that had previously had to deal with several supervisory offices in Germany (interview, Frankfurt, January 2006). In addition, the single supervisor carries more weight in international regulatory fora, where German interests can be represented more effectively (interview, Frankfurt, January 2006).

Italy

Unlike the quick process of reform in the United Kingdom and the more drawn out one in Germany, the reform of the supervisory framework in

Italy was very time consuming and essentially resulted in few changes. It was debated by the Government and the two parliamentary chambers for approximately three years, going back and forth several times. Given the fact that both chambers have the same powers it eventually fell short of expectations for an overhaul of the system because no political agreement could be reached on the changes that were to be introduced, and de facto veto points prevented any attempt to forcibly push through the reform. Moreover, the central bank managed to fend off attempts to reduce its supervisory powers, as elaborated below.

As far as the micro-institutional assets are concerned, until the twenty-first century, the Bank of Italy had traditionally been regarded as an effective supervisor, something to which the absence of significant banking crisis in Italy in the last 20 years or so is testament. Yet, the Cirio's financial crack in November 2002 and the Parmalat's insolvency in December 2003 created tensions both between the Bank of Italy and the political authorities and between the central bank and the CONSOB, which were both responsible for different aspects of supervision. Although these two insolvencies could hardly be ascribed to systematic supervisory failures, they triggered a heated debate on the configuration and allocation of supervisory responsibilities.

Several law proposals were discussed by the executive and by the legislature between 2002 and 2005. The proposal most fervently supported by Treasury Minister Giulio Tremonti envisaged the creation of an independent supervisory authority external to the central bank, assigning competition policy in the banking system to the Competition Authority. If approved, this proposal would have deprived the central bank of its most important remaining functions and for this reason, the Bank strongly opposed these proposals.

By deploying its intangible assets, most noticeably, its expertise and institutional credibility, by engaging in lobbying activity and successfully mobilizing supporters from a cross section of the political spectrum, the Bank has managed to safeguard its prerogatives in this field (interviews, Rome, June 2006); in the end, these changes were not included in the Law on Savings that was finally adopted in 2005. However, two episodes threatened the micro-institutional assets of the central bank, weakening its ability to resist changes of the existing supervisory framework. Thus, these episodes were followed by important amendments to the Law on Savings: Banking competition policy was assigned to the competition authority and the governance structure of the central bank was made more pluralistic.

The most publicized cases, which gained attention across the whole of Europe, were the two proposed takeovers of Italian banks in 2004–2005: one by the Spanish group Banca Bilbao Vizcaya Argentaria of Banca Nationale del Lavoro (BNL) and the other by ABN Amro of Banca Antoniana Popolare Veneta (Antonveneta). In both cases, Governor Fazio intervened to endorse counterbids launched by the Italian banks Banca

Popolare di Lodi and Unipol, respectively, in an attempt to resist foreign takeover bids. Both the foreign banks involved in the attempted takeovers complained to the European Commission, which had given its authorization on the grounds that they did not jeopardize competition in the banking sector. Competition Commissioner Neelie Kroes launched an enquiry on the episodes, and Internal Market Commissioner Charlie McCreevy expressed his concerns in a letter to Governor Fazio in 2005 (*Financial Times* February 18, 2005). What was even more worrisome is that the case was subsequently investigated by Italian magistrates, which began to gather evidence of wrongdoing (insider trading and abuse of office) by the Governor. It also emerged that the Governor and some close collaborators had dismissed the negative opinion on the matter that had been given by the supervisory department of the Bank of Italy; one that denied the authorization to Lodi for the acquisition of the Antonveneta share. This episode then caused an institutional rift within the central bank, between the top management of the Bank and the supervisory department (Quaglia 2008).

The BNL and Antonveneta episodes brought two potential shortcomings of the existing Italian policy framework to the surface. The first was the concentration of powers concerning banking supervision and competition policy in the hands of one person, the governor, given the fact that the Bank, prior to the 2005 reform, had been a monocratic institution. Second, the concentration of supervisory powers and banking competition policy within one institution raised issues relating to trade-offs between different (and at times incompatible) objectives (Goodhart 1995).

Unlike in the United Kingdom and Germany, the banking system in Italy did not lobby for, or even openly endorse, the reform of the supervisory framework for three reasons. First, the presence of international market operators, financial conglomerates, and institutional investors is very limited in Italy, which helps to explain the limited attractiveness of a single supervisory authority for the entire financial sector. Second, the banking sector in Italy is traditionally responsive to the policy preferences of the central bank, which, in this case, was directly affected by the reform and thus had strong institutional preferences. Third, despite the Cirio and Parmalat affairs and the scandal involving the governor, overall Italian banks were satisfied with the existing supervisory framework (interviews, Rome, June 2005).[4]

It should also be noted that during the drafting of the Law on Savings, which amended central banking legislation, the Italian government requested the ECB's legal opinion three times (May 2004, October 2005, and December 2005; see CON/2004/16, CON/2005/34, CON/2005/58). Following the revelations of Fazio's affair, the ECB provided its opinion in October 2005, suggesting the introduction of the principle of collegiality for the executive board's decision making on measures related to non-ESCB tasks, first and foremost, supervisory issues and the introduction of a term mandate, renewable once, for all the members of the executive

board. This suggestion was eventually incorporated into the relevant legislation in December 2005, in that all the central bank's decisions with external implications, except those concerning the activities of the ESCB, are now taken by the five-member executive board[5] and not by the governor alone as had been the case in the past. Moreover, written justifications for the decisions taken, especially in the supervisory field, have to be provided by the Bank. A term mandate for the governor and the executive board is set and the procedures for appointing and dismissing the governor and the executive board give the government a greater say in the process.

5. Conclusions

The aim of this article was to explain the determinants of banking supervision reform, and more precisely, the reform of supervisory frameworks in Europe in a comparative perspective, focusing on the changes that took place in the United Kingdom, Germany, and Italy. These were important changes potentially affecting the overall financial stability and competitiveness of the financial systems in which they were embedded, as well as the relations between the government, the central bank, and the supervisory authorities. This concluding section elucidates how the integrative analytical framework outlined in section 2 applies to the empirical cases (see Table 1), with a view to extrapolate predictive generalizations that could be tested in other case studies.

International and EU factors constituted antecedent variables, as they placed indirect pressure on national supervisory frameworks, by promoting the reshaping of the national financial sector, although this has happened in different ways and to a different extent in various countries, depending on the existing configuration of the sector—one of the two independent variables—measured by its segmentation, openness, and size. Consequently, this has produced different domestic stimuli for the reform of financial supervision.

The prediction is that the higher the number and the larger the size of financial conglomerates (key indicators of desegmentation of the financial system) present in a country, the higher the incentive for the creation of a single supervisor for the entire financial system, because this is likely to make the activity of the supervisor more effective (e.g., closing supervisory loopholes between various segments of the financial sector or preventing the multiple counting of capital assets within financial conglomerates in order to meet supervisory capital requirements) and less costly for the supervisees. Moreover, the higher the number and the larger the size of international financial companies present in national markets (key indicators of the openness of the financial system), the higher the incentive in favor of a single supervisor. This would streamline the supervisory activity and reduce the compliance costs for those supervisees that

TABLE 1
The Explanatory Framework Applied to the Cases

	Antecedent Variables: International and EU Financial Integration	Independent Variable: Configuration Financial System	Independent Variable: Configuration Political Institutions	Intervening Variable: Strength of the Central Bank	Dependent Variable: Framework for Banking Supervision
The United Kingdom	Increased financial integration	Very large, very open, many financial conglomerates	Majoritarian institutions: no veto players	Central bank weakened by supervisory failures	Single supervisor for the entire financial sector Quick reform
Germany	Increased financial integration	Large, open, several financial conglomerates	Federal state, power-sharing institutions: several veto players	Strong central bank with limited formal supervisory power	Modified single supervisor for the entire financial sector, but central bank involved. Slow reform
Italy	Increased financial integration	Smaller, closer, fewer financial conglomerates	Fragmented and weak institutions: many veto players	Strong central bank with extensive supervisory power and banking competition	Central bank with extensive supervisory competences, but no banking competition Very slow reform

operate across national borders, as they would be dealing with only one supervisory authority in each jurisdiction. Finally, the larger the size of the financial sector (especially if the country hosts an important financial center), the more sensitive the national authorities are to the competitiveness of the national financial center, hence the more likely they are to take into account the issues just mentioned.

Both the United Kingdom and Germany have a high number of financial conglomerates (this is more the case of the United Kingdom, although Germany tends to have conglomerates of a large size), they have a large number of international financial operators (although this is more the case of the United Kingdom), and they host the two main financial centers in Europe. For these reasons, the public authorities in both countries are keen to promote the competitiveness of their respective financial centers. In Italy, the financial system remains relatively segmented, with a limited number of international operators, which was also due to the lukewarm attitudes of the public authorities in promoting (or even permitting) the entry of foreign financial companies. This status quo is slowly changing in Italy, principally as a result of external pressure (international investors eager to enter the Italian market, EU rules, and the activity of the European Commission, etc.), which was also important in pushing through the limited reform that took place in 2005.

Thus, international and EU factors generate different domestic stimuli for supervisory reform—to be precise, it is more a matter of different degrees of pressure—depending on the configuration of the national financial sector. Given this pressure for national supervisory adjustments, the speed and content of domestic reforms depend on a second independent variable, namely the configuration of political institutions, operationalized by considering state structure and veto points. Once the reform is proposed, the prediction is that the more cohesive the state structure is and the lower the number of veto points, such as in the United Kingdom, the swifter the reform is likely to be. In the United Kingdom, reform was eventually agreed without significant changes, of the kind that would be the by-product of protracted negotiations and consensus seeking. The more fragmented the state structure and the higher the number of veto points, the more time consuming the reform process is likely to become, with an eventual watering down of the proposed reform, depending on the micro-institutional assets of the central bank. Italy is a textbook case of a state with weak governance structures, but Germany, due to its federal structure and consensus-seeking practices, is also characterized by several veto points in the policymaking process.

The intervening variable is the strength of a central bank, measured in terms of tangible and intangible resources (among the latter, credibility, expertise, international ties) and existing policy competences, which affects its ability to influence the change of supervisory arrangements. Policy failures can impinge upon the micro-institutional assets of a central bank, undermining its credibility and expertise. The prediction is that a

weak (or weakened) central bank is less able to influence the changes that affect its supervisory competences. The German central bank, unlike the Bank of England, opposed the reform initially proposed by the government, and it was eventually successful in preserving some supervisory tasks in the banking sector (also mobilizing the ECB), even though it was unable to extend its supervisory competences. The Bank of Italy, which was also the competition authority in the banking sector, managed to fend off attempts to reduce its supervisory powers, even though the 2005 reform, which followed the "Fazio affair," meant that it lost the responsibility for competition policy in the banking sector. It should be noted that the Bundesbank was not only confronted with a strong political will to create a single supervisor due to the political economy incentives mentioned above, but also that it was not the formal supervisory authority in the banking sector (hence, it did not possess extensive expertise in this field), and there were some internal divergences on this issue. The opposite was true for the Bank of Italy, which already possessed extensive supervisory powers, hosted considerable expertise in this field and enjoyed a consolidated reputation as an effective supervisor, despite the Fazio affair.

The main caveat to this discussion is that the choice of the case studies might have biased some of the findings. Proposals for further research would thus be to extend the comparative analysis undertaken here to other EU countries, for example, to a group of small countries and/or the new member states, testing the analytical leverage of the explanations extrapolated from this research.

Feeding into the broader scholarly debate on institutional change, the integrative approach used in this article brings together different levels of analysis, which are often treated separately by mainstream theoretical approaches. In so doing, it explores how factors active at the international, national, and micro-institutional levels interact with each other in affecting national supervisory reforms in the financial sector. This interaction is particularly important in the policy area under scrutiny because the financial sector is highly internationalized—even more so in Europe, after the relaunch of financial market integration in the late 1990s—and characterized by the activity of powerful supervisory institutions. Focusing only on one of these factors would provide a more parsimonious model, but would overlook an important part of the explanation.

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Notes

1. http://www.bundesbank.de/download/bankenaufsicht/pdf/vereinbopraeambel_en.pdf
2. In June 2000, the president of the Bundesbank had indicated that he was willing to accept a trade-off under which the central bank would lose its debt responsibilities but gain full responsibility for the regulation of the whole financial sector (*Financial Times* June 20, 2000).
3. http://www.bundesbank.de/download/presse/rundschreiben/2002/20020926_rs_07.pdf
4. Overall, as one of the bankers interviewed put it, they felt safer with the Bank of Italy taking care of banking supervision than with alternative institutional arrangements (interview, Rome, June 2006).
5. The members of the executive board have been increased from four to five, to avoid the case of a tie.

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