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THE EUROPEAN UNION AND
GLOBAL FINANCIAL HARMONISATION

Lucia Quaglia

EUROPEAN UNIVERSITY INSTITUTE, FLORENCE
DEPARTMENT OF POLITICAL AND SOCIAL SCIENCES

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LUCIA QUAGLIA

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European University Institute
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Abstract

This research examines the influence of the European Union (EU) in international financial harmonisation over the last two decades. It asks why the EU ‘uploads’ international financial regulation in some (few) cases, ‘downloads’ it in (many) other cases, or neither uploads or download rules. It sets up an analytical framework that combines the concepts of ‘international regulatory capacity’ and ‘EU regulatory capacity’, considering their variation across financial services as well as over time. Such a framework is then concisely applied to a variety of significant empirical case studies of prudential regulation of banking, securities, and insurance.

Keywords

European Union; financial regulation; international standards; banking; securities, insurance

Introduction

The global financial crisis that began in the US in 2007 and subsequently spread worldwide brought into the spotlight the political salience of financial governance. The regulation of financial services has become increasingly complex due to the internationalisation or globalisation of finance (Cerny 1995; Cohen 1996; Helleiner 1994) and the large numbers of international, regional, transnational and national public and private regulatory bodies involved (Porter 2005, 2003). The governance of financial services is characterised by two main interrelated regulatory phenomena: the interaction between institutions and rule-making processes across multiple arenas, and the 'accommodation' or 'coexistence' of their outputs.

This multifaceted regulatory process is complicated further in regional jurisdictions, such as the European Union (EU), where an extra (supranational) level of regulation exists, beside that taking place in national, international and transnational arenas. Over the 2000s, the EU has devoted considerable efforts to the completion of the single financial market in Europe, promoting regulatory harmonisation within its borders and strengthening the institutional framework for financial regulation and supervision (Donnelly 2010; Mügge 2010; Macartney 2010, 2009; Posner 2009; Quaglia 2010). In so doing, the EU has become one of the largest financial jurisdictions in the world.

Amongst regional regulatory regimes, the EU is by far the most advanced because its rules (directives or regulations), are legally binding in the member states, the European Commission is in charge of monitoring their implementation, and the European Court of Justice has jurisdiction on the compliance with those rules. Furthermore, the establishment of Economic and Monetary Union (EMU) in 1999 and the Financial Services Action Plan (FSAP) in 1999 have given new momentum to financial market integration and regulation in the EU, facilitated by the establishment of a new rule-making framework, the so-called Lamfalussy architecture, as explained in Section 3.

This research evaluates the influence of the EU in international financial harmonisation, defined as the approximation of regulation across jurisdictions through the deliberate creation of international standards (see Drezner 2007; Simmons 2001; Singer 2007). The focus on international harmonisation is explained by the fact that financial services are inherently borderless. Therefore, their effective regulation requires to some extent harmonised rules across jurisdictions to prevent regulatory gaps and arbitrage, but also to facilitate cross-border activities (Bach 2010). Yet, international regulatory harmonisation has transaction costs when it is negotiated and it has implementation costs when domestic rules are changed to comply with either international rules or rules from third countries (Simmons 1998).

The research starts with a puzzle: in some (few) cases, the EU 'uploads' its financial services regulation internationally; in other (many) cases, the EU 'downloads' international financial rules; in some instances, neither uploading or downloading take place. 'Downloading' is defined in this research as the incorporation of international financial 'soft' rules (standards, principles, guidelines) into EU legislation. 'Uploading' is defined as the incorporation of EU legislation (or parts of it) into international financial regulation. Why does the EU upload international financial regulation in some (few) cases and download it in (many) other cases?

More broadly, what is the influence of the EU in international financial harmonisation? Has this changed over time, especially after the EMU, and the single financial market, or after the global financial crisis?

Academically, there is a major gap in the EU literature and in the international political economy literature, which so far have not paid enough attention to the influence of the EU in regulating global finance (for some exceptions, see Bach and Newman 2007; Posner and Véron 2010; Posner 2009, 2010). From a policy-oriented point of view, some of the most salient issues in world politics today concern the making of international regulation and regulatory disputes (Drezner 2007: 6; Farrell and Newman 2010).

The paper proceeds as follows. Section 2 takes stock from the scholarly literature, and outlines the research design. Section 3 empirically discusses the main explanatory variables, namely EU regulatory capacity and international regulatory capacity. Section 5 examines a variety of case studies of international financial harmonisation, with a view to assesses the predictive power of the analytical framework.

2. State of the Art and Research Design

The early academic literature on international financial regulatory harmonisation has stressed the importance of the preferences and the power of the 'hegemonic' country, the US, for or against international harmonisation (Simmons 2001). The assumption is that international regulatory cooperation benefits some countries more than others, and has therefore redistributive implications (Oatley and Nabors 1998).[1] Hence, international cooperation and regulatory harmonisation will take place only when they are in line with the preferences of the US, reflecting its market power. Subsequently, other works have questioned the hegemony of the US in regulating global finance by considering other jurisdictions that have large financial markets, such as the UK and Japan (Singer 2004, 2007) and more recently the EU (Drezner 2007). Like Simmons, these works mainly focus on market size in order to explain the bargaining power of the various jurisdictions. In several financial services, however, the EU has the same market size of the US, with the exception of securities markets, reflecting the bank based nature of financial systems in continental Europe (Allen and Gale 2000) (see Table 1).

[TABLE 1 ABOUT HERE]

A less state-centric perspective emphasises the role of private sector governance in financial services (Tsingou 2010, 2008; Underhill and Zhang 2008; Underhill et al. 2010). According to this perspective, international regulatory convergence reflects the interests of industry, i.e. the rules that financial industry finds more advantageous (or less burdensome). It is undoubtedly true that the financial industry is a powerful lobbyist, with plenty of financial, human and technical resources at its disposal (Baker 2010). However, this explanation is more problematic if one considers the diversified interests of industry on several key

[1] This approach contradicts early 'functionalist' explanations of international financial harmonisation, such as Kapstein's (1992) account of the making of the Basel I accord, which argued that regulators promote international regulatory harmonisation as a way to solve common problems or to realise joint gains.

regulatory issues. For example, in the negotiations of the Basel III accord, banks had different preferences depending on their business model and the configuration of the national financial system in which they operated, as explained in Section 4.

Recent historical institutionalist works on international market regulation (see Bach and Newman 2010a, 2007; Mattli and Büthe 2003; Posner 2009, 2010) have challenged the market power explanation, arguing that 'domestic regulatory institutions are the sources of both power *and* preferences on the global stage' (Drezner 2010: 794). A key concept used by this literature is 'regulatory capacity' defined as 'a jurisdiction's ability to formulate, monitor, and enforce a set of market rules' (Bach and Newman 2007: 831). It links market size to power in international market regulation because neither market size alone nor regulatory capacity alone are sufficient to regulate a certain market (Bach and Newman 2007).

In line with the historical institutionalist literature reviewed above, the key explanatory variable in this research is 'regulatory capacity'. This concept can be applied not only to national jurisdictions but also*, ceteris paribus*, to regional polities, such as the EU. It can also be applied to international bodies, which, however, do not produce legally binding legislation and hence, by definition, have weaker regulatory capacity compared to national jurisdictions – in particular, they lack enforcement powers.

In this research, regulatory capacity comprises two main institutional aspects. This first concerns the bodies regulating specific financial services: their date of establishment (the older the regulatory bodies, the stronger their regulatory capacity); their membership, that is whether they have 'club' or 'universal' membership, and the level of seniority of their members (the more restricted and the more senior the membership of the regulatory bodies, the stronger their regulatory capacity); the resources at their disposal, such as recognised expertise and human resources (the greater the expertise enjoyed by the regulatory bodies, the stronger their regulatory capacity); and their legal powers, such as the authority to monitor implementation and to impose costs for non-compliance.

The second component concerns the rules issued by those bodies: the presence of policy-templates concerning specific financial services creates a first mover regulatory advantage, setting in place a process of path-dependency, and strengthening the regulatory capacity of the bodies that issued those rules. The scope of application of such rules is also important, in particular whether they can exclude financial actors headquartered in other jurisdictions (the presence of equivalence clauses strengthen the regulatory capacity of the bodies that issued those rules).

A two by two explanatory matrix can be created, with weak/strong EU regulatory capacity on one side and weak/strong international regulatory capacity on the other (Table 2). The harmonisation of international financial regulation and the role of the EU therein depend on the combination of EU and international regulatory capacities.

When EU regulatory capacity is weak and international regulatory capacity is strong, the EU will mainly download international rules, performing a 'passive' role in international financial harmonisation. When the EU regulatory capacity is strong and international regulatory capacity is weak, the EU is able to upload its rules, performing an 'active' role in international financial harmonisation. When both the EU and the international regulatory capacities are strong, the EU downloads international rules, but has an active-passive role in international

regulatory harmonisation. When EU and international regulatory capacities are weak, neither uploading or downloading take place.

[TABLE 2 ABOUT HERE]

This research design considers EU and international regulatory capacities as independent variables: their different combinations give rise to different values of the dependent variable, namely the role of the EU in international financial harmonisation. However, what can explain the existence of different regulatory capacities? This question, which considers regulatory capacity as the dependent variable to be explained, goes beyond the scope of this paper. Nonetheless, drawing from the literature on EU financial regulation and international financial harmonisation, the building up of regulatory capacity in the EU and internationally can be explained by the role of powerful policy-entrepreneurs and the convergent (or at least compatible) interests of the main jurisdictions and their industry, as detailed in the following section.

The selection of cases for empirical research ensures variation between the explanatory variables, namely EU regulatory capacity (strong/weak) and international regulatory capacity (strong/weak), and the dependent variable, that is uploading, downloading, neither. The unit of analysis are sets of rules that represent significant regulatory developments across financial services and they are of interest in their own right. They all concern prudential issues: that is capital requirements for banks, investment firms and insurers. Prudential regulation is a key component of financial regulation and given its implications for systemic stability there are considerable incentives for international regulatory harmonisation and cooperation. The case studies cover the period from the late 1980s, to the establishment of EMU and the completion of the EU financial market, to the post global financial crisis. Hence, they provide snapshots of EU role in international financial harmonisation over time and across the main segments of the financial sector.

Methodologically, the paper uses the congruence procedure across case studies and within case studies over time (George and Bennett 2005). Hence, the hypotheses or empirical expectations derived from Table 1 are assessed against the empirical record of the case studies, to confirm (or not) at first cut the explanatory power of the framework. Some process tracing is also carried out with a view to explaining how the building up of EU regulatory capacity affected its ability to influence international regulation. As mentioned before, this aspect is often overlooked in the literature. These are 'plausibility probes' rather than systematic tests, which would require a much longer piece of research in order to present all the empirical evidence.

3. Regulatory Capacity in the EU and Internationally

EU Regulatory Capacity

Since the late 1970s, financial market integration in the EU has gone hand in hand with the building up of regulatory capacity: it was mostly a process of deregulation at the national level and reregulation at the EU level (Jabko 2006). The main change in EU regulatory capacity took place in the 2000s, following the FSAP and the Lamfalussy process.

The rules (mainly directives, which then have to be adopted by the member states in national legislation) issued by the EU in the 1970s sanctioned the right of establishment for banks, subject to host country control. In the 1980s, the 'home country' principle was introduced in EU legislation, meaning that financial firms could operate across the EU on the basis of rules set by the country where firm headquarters were located (Story and Walter 1997). After the re-launch of the Single Market in the mid-1980s and prior to 1999, financial services regulation in the EU was based on the principle of national regulation, coupled with 'mutual recognition' and 'minimal harmonisation' of national rules through EU rules (Padoa-Schioppa 2004). EU rules were issued through a cumbersome legislative process: the European Commission proposed legislation, which was co-decided by the Council and the EP. The negotiations on technical details could last for decades, sometimes with no agreement, as in the case of accounting standards (Leblond 2011). Some advisory committees composed of national regulators, such as the Banking Advisory Committee, advised the Commission, but had very limited resources and expertise and no real power.[2]

The so-called Lamfalussy reform in the early 2000s changed the rule-making process in banking, securities and insurance (Mügge 2006; Quaglia 2007). In the new architecture, the Council and EP codecided framework (level 1) rules, whereas implementing measures were adopted by the Commission through the 'comitology' process, which involved committees of member states representatives (the so-called level 2 committees). Committees of national regulators (the so-called level 3 committees) were established to advise the Commission on the adoption of level 1 and 3 measures. They also had implementation tasks and could adopt non-legally binding standards and guidelines. This institutional change sped up the rule making process for the adoption of the forty or so legislative measures envisaged in the FSAP. Moreover, the level 3 committees composed of national regulators came to enjoy authority and legitimacy vis-à-vis public and private actors because of their membership, expertise and contacts with market participants (Posner and Véron 2010: 405). The completion of EMU gave new impetus to financial market integration in the EU. However, the establishment of the ECB did not have direct effect on regulatory capacity in the banking sector, given the fact that banking regulation and supervision were not transferred to the ECB and the responsibility for supervision basically remained at the national level.

From the early 2000s onwards, the completion of the single financial market was achieved through a set of legislative measures that in many cases aimed at maximum harmonisation (Ferran 2004). These measures mainly focused on securities markets, in which the EU had lagged behind the US.[3] In the US, the powerful Securities and Exchange Commission (SEC), established in 1934, had clearly assigned competences and consolidated expertise in regulating securities markets. US legislation to a large extent informed the content of EU rules in this period (Posner and Véron 2010).

By contrast, in the insurance sector, the EU was a pace setter when compared to the US. The Solvency II directive (European Parliament and Council of Ministers 2009), proposed in 2007 and agreed by the Council and the EP in 2009, set in place a state of the art risk-based, principle-based approach to the prudential regulation of insurance companies. It replaced the outdated Solvency I directive that, unlike Solvency II, was based on minimum harmonisation.

[2] The equivalent of the BAC in securities markets, the Forum of European Securities Commissions (FESCO) was defined by its former director as a 'group of nice people getting together' (interview).

[3] For an historical overview of the link between international rules and securities market legislation in the EU, see Coleman and Underhill 1998.

Solvency II was the first directive in the insurance sector adopted through the Lamfalussy architecture, which facilitated its adoption (interview). Insurance regulation was quite outdated in the US and was competence of (state) legislators (Singer 2007). Attempts, for example by the NAIC, to transfer regulatory competence to the federal level and to modernise the legislation, were short-lived (see the Solvency Modernisation Initiative SMI 2008).[4]

In 2002, the EU adopted far reaching legislation about the consolidated supervision of financial conglomerates (European Parliament and Council of Ministers 2002), which are financial entities that combine banking and insurance. By contrast, there was not consolidated financial conglomerates supervision in the US. The use of equivalence clauses in Solvency II and the Financial Conglomerates directive gave the European Commission new bargaining power vis-a-vis the US because the Commission was in charge of making decisions about the equivalence (or otherwise) of rules in third countries, including the US (Dür 2011; Posner 2009).

To sum up, prior to 2000s, the EU had (relatively) weak regulatory capacity across all financial services. This capacity increased as a consequence of the Lamafalussy reform and the FSAP. Afterwards, the EU enjoyed a first mover regulatory advantage by setting in place state of the art regulation in insurance and financial conglomerates. In the case of securities markets, the EU mainly caught up with the US. What explains the strengthening of the EU regulatory capacity in the 2000s? It was a process led by the Commission, eager to complete the single financial market (Jabko 2006; Posner 2009). It enjoyed the support of the main member states (Quaglia 2010), with a view to boost European financial centres in the global competition with the US. The most transnational part of the financial industry was also keen to reap the benefit of a single European market (Macartney 2010, 2009; Mügge 2010). For example, the main European insures supported the Solvency II directive because it was expected to reduce solvency requirements for large insurance groups (see CEA 2007a,b). Therefore, the entrepreneurship of the Commission, and the converging interests of the member states and their financial industry account for the strengthening of the EU regulatory capacity in the 2000s.

International Regulatory Capacity

International regulatory bodies inherently have a weaker regulatory capacity than national jurisdictions or regional jurisdictions, such as the EU, because they do not have legal personality; the international rules they issue are not legally binding; and they lack enforcement power. There are, however, variations across financial services.[5]

Amongst international regulatory bodies, the Basel Committee on Banking Supervision (BCBS), dating back to 1975, has the greatest regulatory capacity because of its composition and the world-wide acceptance of its rules. It is a self-selected group of senior central bankers and banking supervisors from a limited number of countries. Until 2010, it was a 'club' of (some) developed countries (G 10), which shared several regulatory preferences (Drezner

[4] The NAIC's Solvency Modernisation Initiative (SMI) began in June 2008. The SMI is a critical self-examination of the United States' insurance solvency regulation framework, http://www.naic.org/index_smi.htm accessed in June 2011.

[5] Büthe (2008) perceptively notes that researchers should pay more attention to the international institutions regulating global capital.

2007). In 2010, it was enlarged to all the member countries of the G 20. The European Commission and the ECB have observer status in the BCBS.

Despite its small staff hosted at the BIS, the BCBS has recognised expertise in banking regulation (Kerwer 2005; Wood 2005), largely through the input produced by its working groups of national regulators, which discuss the technical details of regulation and meet regularly. The final version of the Basel accords is eventually negotiated and agreed at the level of governors and chairman of the supervisory authorities (or their deputies). Generally, these members have the ability to enact international rules domestically and tend to be independent from the political authorities. Moreover, central bankers, who compose the bulk of the Committee, have an established ability to cooperate and are relatively insulated from domestic politics (Tsinguo 2010). Although the BCBS does not have enforcement powers, it has implementation working groups that monitor how its capital rules are put into practice across jurisdictions. The BCBS first set international capital requirements in the late 1980s (the Basel I accord) and continued to do so afterwards through the Basel II and Basel III accords, all of which had de facto worldwide implementation.

The International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) have weak regulatory capacity, as compared to their counterpart in banking. They were established in 1983[6] and 1993, respectively. Whereas no EU representative as such sits in the IOSCO, the European Commission is a member of the IAIS, without voting power. These fora have 'universal' membership, encompassing more than 100 national jurisdictions, which means that a variety of different regulatory preferences are represented, often slowing and watering down the rule-making process. Unlike the BCBS, the IAIS and IOSCO meet at the very senior level only once a year and do not enjoy the same level of recognised expertise as the BCBS.

One important difference between the IOSCO and the IAIS is that in the former the influence of the SEC is predominant because of the power it enjoys at the domestic level and its cutting edge expertise (Bach 2010). For example, whenever a new idea comes up in the IOSCO discussions, the SEC usually has a well prepared dossier on it (interview). The EU as such is not represented in IOSCO and until the early 1990s, some EU countries did not have securities regulators, or at any rate the power and resources at their disposal were rather limited, as in the case of Germany or Italy. Unlike securities and banking, insurance is entirely a state competence in the US, not a federal competence. Thus, in the IAIS, the US is represented by the NAIC & 56 jurisdictions. The NAIC is not a federal regulatory body, hence is often unable to project a unified US position in the IAIS[7] and cannot guarantee uniformity and consistency in the domestic implementation of internationally agreed rules (Singer 2007).

To sum up, international bodies have weaker regulatory capacity than national (or in the case of the EU) regional jurisdictions. The main exception is the BCBS. What accounts for its strong(ish) regulatory capacity as compared to other international financial regulatory bodies? When the BCBS was established, the US and the UK acted as policy entrepreneurs, putting

[6] However, the IOSCO's predecessor dated back to the 1970s.

[7] According to the IAIS statute, the NAIC does not have a right to vote; and (b) the NAIC may, at any one time, designate up to a maximum of 15 of its members who may exercise their rights to vote (art 6.4)

their weight and capabilities behind it (Simmons 2001; Wood 2005). Indeed, for the first 15 years or so, the chairs of the BCBS mainly came from the US and the UK. Once established, the BCBS acquired an institutional status and regulatory capacity on its own, becoming more than the sum of its (club-like) components. By contrast the US did not act as a policy entrepreneur to strengthen the regulatory capacity of IOSCO (Underhill 1995). The US would have had the capability but not the interest to do so: the SEC regulated the largest financial market in the world and was already at the centre of a dense network of bilateral Memoranda of Understanding (MoUs) (Bach and Newman 2010b). To fulfil its domestic mandate, the SEC did not need a stronger IOSCO (Simmons 2001). In the case of the IAIS the US did not have the interest or the capability to beef up the regulatory capacity of this international body (Singer 2007).

Unlike EU regulatory capacity, international regulatory capacity has not changed substantially over time. The IOSCO remains principally a forum for cooperation, especially through multilateral and bilateral MoUs, and facilitates information exchange. In the wake of the financial crisis, the IOSCO was unable to define rules for CRAs, other than revising the voluntary code of conduct already in place (IOSCO 2008). Its report on hedge funds regulation was equally bland. Since the mid-2000s, the EU has been keen to prop up the regulatory capacity of the IAIS (interview). The near failure of the largest insurer in the word headquartered in the US, the AIG, has given new ammunition to those calling for international solvency rules for insurers.

4. Uploading and Downloading Financial Regulation

In banking, the most important standards concern capital requirements for banks, which were agreed for the first time by the BCBS in the Basel I accord (1988) 'International convergence of capital measurement and capital standards'. This was replaced by the Basel II accord (BCBS 2005), which was followed by the Basel III accord (BCBS 2010) in the wake of the global financial crisis. The content of these accords has periodically been incorporated by the EU into the capital requirements directives, revised over time, so as to take into account the regulatory changes introduced by the successive Basel accords. In all these cases, there has been a downloading of international rules by the EU, but with some important differences over time.

The Basel I was to a large extent imposed by a US-UK alliance, eager to enforce international capital requirements onto reluctant continental European countries and other G 10 jurisdictions (Oatley and Nabors 1998). Following the Latin America debt crisis, the US had unilaterally introduced higher capital requirements domestically. US policy makers and US banks, worried about international competitiveness, were keen to extend capital requirements to banks in other jurisdictions (Kapstein 1989; Simmons 2001; Singer 2007). The EU (at that time the EC) did not have its own set of capital requirements, which varied considerably across member states (Underhill 1997). Indeed, they could not even agree on a common definition of 'capital', a problem that surfaced in the negotiations of the Basel I accord (Wood 2005). In the end, the Basel I accord did not provide a common definition of capital, nor did Basel II succeed in doing so. Basel III rather controversially did.

Lacking its own rules, the EU decided to incorporate Basel I into legally binding EU legislation. In this case, the downloading of international rules was a way for the EU to

overcome its internal inability to reach an agreement, due to the different regulatory templates in place in the member states. The initial downloading of international rules set in motion a process of path dependence. Having gone through the process of implementing the Basel I standards (and having sustained the costs of doing so), it would have been very costly for the EU to come up with its own independent set of capital requirements afterward (interview). The downloading of international banking rules was the result of the weak EU regulatory capacity and the strong(ish) regulatory capacity of the BCBS, which enjoyed the support of the US, and UK and could 'bank' on the expertise of senior banking regulators. European policy-makers had very limited influence on the content of Basel I: for the most part they had had to accept what was on offer.

Fast-forward to the Basel III accord (2010). The new rules almost triple the regulatory capital for banks, even though they will be phased in gradually from January 2013 until 2019. In the negotiations on Basel III, the 'old' (i.e. Basel I) divide re-emerged between the US and the UK on the one side, and continental countries on the other side (interviews; *Financial Times*, 15 February 2011). The US and the UK wanted: a stricter definition of capital, to be limited to ordinary shares; higher capital requirements, including capital buffers; a leverage ratio; liquidity rules; a short transition period. Continental countries, in particular France and Germany wanted: a broader definition of capital, including hybrids and silent participations; lower capital requirements, arguing that 'traditional' (continental) banks engaged in less risky trade finance/financial activities. They opposed the leverage ratio, asked for a modification of certain aspects of the liquidity rules and wanted a longer transition period (interviews; *Financial Times*, 15 February 2011). Continental policy-makers were worried about the effect on the real economy of stricter rules on banks' capital, which were instead advocated by Anglo Saxon regulators. They were also eager to set in place capital rules that would not disrupt the business model of their banks and banking system (Howarth and Quaglia 2012).[8]

Despite attempts by the Commission to forge a common position, the EU presented a disjointed stance during the Basel III negotiations (interviews). Not only did the EU not have its own set of capital rules to upload, but also its attempt to project a unified position in the Basel negotiations was hampered by the different configuration of the financial industry across the member states and by the fact bank-industry links are particularly strong on the continent. Unlike Basel I, which was mostly a US-UK 'diktat', Basel III was a compromise between the positions of the two coalitions at play.

Over time, the EU has strengthened its regulatory capacity in the banking sector through the creation of the level 3 Committee of European Banking Supervisors (CEBS) and ECB. Neither of these bodies, however, nor the Commission have direct supervisory competences. Moreover, the EU does not have its own rules on capital, hence it has nothing to upload internationally. By contrast, the BCBS has consolidated its regulatory capacity over time and its rules (the Basel accords) have become more detailed (Basel I was 30 pages, Basel II was 347 pages). In the downloading of Basel III rules several issues controversially settled (or papered over) in the BCBS were reopened in EU negotiations. Some member states, most notably the UK (*Financial Times*, 21 July 2011), but also international bodies, such as the IMF (2011), complained that the drafted EU capital rules, currently under discussion, diverged significantly from the content of Basel III.

[8] For example, the definition of capital proposed by the BCBS was not suitable for German or French mutual banks.

'Capital Adequacy Standards for Securities Firms' were drafted by the Technical Committee of IOSCO in 1989 (IOSCO 1989), after years of preparation. Eventually, they were not adopted by the IOSCO General Assembly. The rationale for the proposed rules was to set in place international capital requirements for investment firms similar to those already agreed for banks. The main problem during the negotiations was that there were three competing national regulatory templates being proposed by the main jurisdictions, which tried to upload their rules internationally (Singer 2004, 2007). These templates were: the 'comprehensive approach' applied by the SEC in the US; the 'portfolio approach' used in the UK; and the 'building block approach' adopted by the BCBS in the Basel I accord. The latter was supported by the European Commission and was subsequently incorporated into the capital requirement directive (Dimson and Marsh 1995). Initially, the EU member states were divided on this issue, but eventually coalesced in supporting the building block approach.

Negotiations in the IOSCO were initially influenced by the US, favouring a comprehensive approach. Subsequently, a compromise in favour of a building block approach was agreed between the BCBS and the IOSCO as the basis for an international agreement (BCBS and IOSCO 1992 cited in Dimson and Marsh 1995). Then the problem became to establish the parameters of the building block approach, the choice being between the '4+8' formula supported by the US and the '2+8' formula supported by the Europeans and used into the CAD. Both the BCBS and the European Commission hoped that this formula would form the base for the agreement within the IOSCO (Dimson and Marsh 1995). However, this was not to be the case.

European regulators, led by Britain's Securities and Investments Board, argued that the parameter proposed by IOSCO according to the 4+8 formula were too high, leading to excessive capital requirement as compared to existing capital requirements in European countries (*The Economist*, 31 October 1992). By contrast, the SEC held out for the 4+8 formula, deemed the 2+8 parameter proposed by the EU as too low, as compared to the existing capital requirements in the US. The chairman of the SEC argued that Drexel Burnham, a securities firm that collapsed in 1990, would not have been able to meet its obligations if lower capital ratios had been in place, as proposed by the IOSCO (*The Economist,* 5 October 1991).

The additional problem for the SEC was that whereas securities firms in the EU were subject to consolidated supervision, broker-dealers in the US were not subject to consolidated supervision. According to Singer (2007), one of the reasons why the European and in particular the British authorities were so keen on harmonising capital standards for securities firms worldwide was that it was felt that the proposed rules would have affected the way in which supervision was conducted in the US, moving it toward a consolidated model, as was already the case in Europe. At the last minute, the SEC pulled out of the talks and the deal fell apart.

The lack of international harmonisation meant that national jurisdictions were left free to set their own rules concerning the capital requirements of investment firms. The EU decided to apply the capital requirements for banks to investment firms, basically downloading Basel I (and subsequently Basel II and Basel III) to the securities sector (Underhill 1997). On that occasion, the EU presented a lack of unity, because there were no EU rules on the matter and different models were used across Europe to calculate capital requirements for investment firms (Dimson and Marsh 1995). The Lamfalussy reform and the implementation of the FASP

strengthened the EU regulatory capacity in this sector. In the meantime, however, the EU had already downloaded Basel rules to banks and investment firms alike, and it would have been costly for the EU to set in place its own rules at this later stage.

In insurance, the Lamfalussy reform and the implementation of the FASP strengthened the EU regulatory capacity. By contrast, international capacity remained rather weak, though there were some (mainly EU) attempts to build it up (interviews). In this case, the EU was the first mover, reforming its framework for insurance regulation and supervision, setting in place solvency requirements (that is capital requirements for insurers), without waiting for international standards. The state of the art solvency legislation adopted by the EU provided a first mover advantage in shaping embryonic international solvency standards and more broadly in setting the international regulatory agenda.

The Solvency II directive applies to all life and non-life insurance undertakings and reinsurance undertakings, streamlining EU legislation by replacing 14 existing directives regulating insurance services with a single directive (European Parliament and Council of Ministers 2009). The Solvency II approach is articulated across three pillars that deliberately resemble the three-pillar structure of the Basel II accord that set international capital requirements for banks. The first pillar outlines two capital requirements, which have different purposes and are calibrated accordingly: the Solvency Capital Requirement, which enables an institution to absorb significant unforeseen losses, and the Minimum Capital Requirement, below which supervisory action is triggered. Subject to supervisory approval, insurers can use their own internal model to calculate capital requirements. The second pillar of the Solvency II directive consists of a supervisory review process of the overall financial position of insurance undertakings. The third pillar outlines requirements concerning the disclosure of information, with a view to impose market discipline on insurance undertakings. The directive established group supervision, whereby a single authority is to be appointed with coordination and decision powers for each insurance group. The group supervisor has primary responsibility for key aspects of group supervision (group solvency, intragroup transactions, etc.), to be exercised in cooperation and consultation with host supervisors (European Parliament and Council of Ministers 2009).

It is noteworthy that the Solvency II directive contains clauses concerning the equivalence (or otherwise) of third countries legislation, to be decided by the European Commission following the advice of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS, now transformed into an authority). In the case of non-equivalence, non EU insurers would be able to operate in the EU only by setting up subsidiaries with sufficient capital, without relying on group capital. Hence, the scope of EU rules contemplated the possibility of excluding foreign insurers from the benefit on the new solvency rules, giving the Commission and CEIOPS enforcement powers.

The EU model differs widely from the regulatory model in place in the US. It adopts a risk-based, principle-based approach, whereas the US model uses a mix of rule-based and risk-based evaluations. EU legislation adopts the concept of Enterprise Risk Management' (ERM) and relies on market valuation of assets and liabilities, whereas in the US the valuation of assets and liabilities is based on principles and rules. Unlike in the US, the EU envisages the use of internal model of insurers to calculate capital requirements. Similarly, the EU relies on targeting solvency capital to specific confidence levels; it is not so in the US. EU legislation

establishes group supervision, to be performed by colleges of supervisors, whereas in the US there is no group calculation of solvency requirements and group supervision.

It is remarkable that key topics of the IAIS regulatory agenda from the mid-2000s onwards, namely, 'Enterprise Risk Management' (ERM) (IAIS 2008c, d), 'Structure of regulatory capital' (IAIS 2008 a,b; IAIS 2009c,d); 'Use of internal models' (IAIS 2008e,f); 'Group supervision' (IAIS 2009a,b; 2010), 'Mutual recognition of supervisory regimes' (IAIS 2008g), very much reflected EU priorities and perspectives, not the US regulatory model. Key concepts of the Solvency II approach, such as the ERM, market valuation of assets and liabilities, technical provisions, calibration of solvency capital to specific confidence levels, choice of internal model or standardised model, group supervision, found their way into IAIS standards and guidelines (interviews). The IAIS's guidance paper on principles of group wide supervision borrowed from the group regime painstakingly negotiated in the Solvency II directive (*Financial Times*, 10 June 2008; interview).

The IAIS paper on mutual recognition (2008g) provided guidance on cross-border recognition of reinsurance supervision with a view to convince the US to abolish its regime for alien (non US) insurers. The purpose of the IAIS guidance was 'to allow a supervisor to recognise the value of the supervision exercised by another jurisdiction and thus remove significant amounts of unnecessary regulatory and supervisory requirements for reinsurers' (2008g: p. 1). Reportedly, the Commission and the UK representative were instrumental in pushing this issue onto the IAIS agenda (interviews).[9] The main international reinsurers are headquartered in the EU, first and foremost in London.

[TABLE 3 ABOUT HERE]

Preliminary results from the congruence procedure largely confirm the empirical expectations derived from the analytical framework. A combination of weak EU regulatory capacity and strong international regulatory capacity leads to the downloading of international rules by the EU, as in the case of the Basel I accord in banking. A combination of strong EU and international regulatory capacities leads to the downloading of international rules by the EU. This however, increases its bargaining power in the making of those rules. A combination of weak EU and international regulatory capacities means that neither uploading nor downloading take place, as in the case of the failed agreement on capital requirements for investment firms. A combination of strong EU regulatory capacity and weak international regulatory capacity facilitates the uploading of EU rules internationally, as in the case of the embryonic rules on capital (solvency) requirements for insurers.

The EU can further international regulatory harmonisation in a passive way, that is by downloading international rules, or in an active way, namely by uploading its rules to international bodies. The latter instance has so far been less common, because the US had an almost hegemonic role in international finance in the past and enjoyed strong regulatory capacity in banking and securities markets, less so in insurance. The strengthening of EU regulatory capacity, especially in areas where the US regulatory capacity is rather weak, as in the case of insurance, enables the EU to exert a stronger influence than would otherwise be the case (for a similar argument in the management of EU-US financial disputes see Posner

[9] The European Parliament and in particular the British MEP rapporteur of the Solvency II directive, had also been vocal on this issue.

2009). It should, however, be noted that the embryonic solvency standards for insurers are still very general and not as advanced as those for banks.

By taking a temporal dimension, the cases studies suggest that there has been an increasing active role of the EU in international financial harmonisation. There are three ways through which greater EU regulatory capacity is instrumental in promoting this outcome. First, a strong EU regulatory capacity enables a more coherent external projection of the EU not so much in international regulatory bodies, where the EU does not have a unified representation, but rather in bilateral relations. For example the decisions on the equivalence of third countries legislation are taken by the Commission, advised by the level 3 committees of supervisors.

Second, the existence of EU regulatory templates (especially if they are based on maximum harmonisation) means not only that the EU has something to upload but also that different preferences of EU members states and their national industries have already been reconciled during intra EU negotiations. Hence, the EU is less likely to present a disjointed position in international fora.

Third, EU rules that contain equivalence provisions or the like are instrumental in 'cross-loading' EU regulatory templates to other countries. 'Cross-loading' is the incorporation of rules agreed in one jurisdiction into another jurisdiction, without the adoption of these rules by international regulatory fora. Cross-loading can occur either from the EU to third countries, first and foremost the US ('active' cross-loading); or from the US to the EU ('passive' cross-loading). Although this aspect is not examined in this research, strong EU regulatory capacity facilitates the active cross loading of EU rules.

Conclusions

This research investigates the influence of the EU in regulating global finance, asking what accounts for the EU's ability (or the lack of it in certain cases) to foster international regulatory harmonisation. The conundrum is explained by different combinations of EU and international regulatory capacities, whereby the increased EU regulatory capacity in some financial services following the completion of EMU and the single financial market accounts for the greater ability of the EU to upload its rules.

These findings feed into the IPE literature on financial harmonisation, showing that the EU plays an active role and a passive role. The passive role is more frequent than the active role because the EU, despite its market size, is still in the process of building up its regulatory capacity. Recently, it has done so with reference to rating agencies, hedge funds and over-the-counter (OTC) derivatives, so one could expect the EU to play an active role in uploading or cross-loading these rules. This research also innovatively links the literature on the politics of international financial harmonisation and EU financial regulation by looking at the external impact of EU institution building and the external effects of EU rules.

The EU has responded to the crisis by strengthening its framework for financial supervision (the so-called de Larosiere architecture) and by reforming its policy templates for the regulation of certain financial activities (such as hedge funds and credit rating agencies). Moreover, the global financial crisis, which originated in the US and was seen as triggered by

the Anglo Saxon model of financial capitalism, has undermined the legitimacy of the US predominance in regulating global finance (Helleiner and Pagliari 2011). It is too early to tell whether the crisis and the regulatory response to it have increased its ability to influence global regulation. This research, however, concludes that EU is now a (sui generis) player in the politics of international financial regulation and although it does not (yet) fully exploit its potential, it can no longer be ignored for a thorough understanding of international financial services regulation.

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Table 1. EU-US Market Size of the Main Financial Services

Banks	Assets		***2008***	***2009***	Source
		US ($)	12,321.0	11,665.6	FRB
		EU ($)	48,528	44,532	ECB
Securities*	Securities Trading				
		US ($)	70,647	31,129	WFE
		EU ($)	22,000	23,088	WFE
Insurance	Total Gross Premiums (life and non-life)				
		US ($)	1,620	2,024	OECD
		EU (euro)	1,991	1,484	OECD

*The figures correspond to the value of trades: number of trades in equities, bonds, and derivatives times their respective price.

Table 2. The Analytical Framework

		International regulatory capacity	
		Strong	**Weak**
EU Regulatory capacity	**Strong**	***EU downloading*** Passive role in international financial harmonisation BUT greater bargaining power in the making of international rules	***EU uploading*** Active role in international financial harmonisation
	Weak	***EU downloading*** Passive role in international financial harmonisation	***No international rules –*** no international financial harmonisation

Table 3. The Empirical Case Studies

		International regulatory capacity	
		Strong	**Weak**
EU Regulatory capacity	**Strong**	**Banking** ***EU downloads* Basel III** (2010) into CRD (ongoing), but new rules reflect EU and US preferences	**Insurance** ***EU uploads* Solvency II** (2009) and reinsurance rules to IAIS standards (ongoing)
	Weak	**Banking** ***EU downloads* Basel I** (1989) into CAD (1993)	**Securities** **Failed international rules on capital requirements** (1989)


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