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Financial regulation in the European Union: A research agenda

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ABSTRACT

Over the past two decades, the European Union (EU) has become a central actor in financial regulation and developed complex institutions to fulfill its roles. Pre-financial crisis scholarship has provided key insights into the functioning of this institutional cobweb and its evolution over time. However, the financial crisis has highlighted four facets of EU financial regulation (EUFR) that deserve more scholarly attention than they have received so far: (1) the permissive pre-crisis consensus on the merits of financial liberalization and integration, (2) the embeddedness of financial regulation in the political economy of EU integration at large, (3) preference formation of public and private stakeholders in EUFR, and (4) the global economic and regulatory context of EUFR. This paper presents the key scholarly challenges across these four areas. Addressing them promises not only academic insights but also promotes the relevance of EUFR research for real-world policy dilemmas.

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Introduction

In the decade prior to the financial crisis, European Union (EU) institutions such as the Commission have become central players in financial regulation, both vis-à-vis member states and on the global stage. In response, EU financial regulation (EUFR) has emerged as a distinct field of study that has analyzed regulatory and institutional reforms and the drivers behind them. Beginning in 2007, the financial crisis triggered a wave of reforms on the national and European level, including temporary short-term measures. For several years, scholars of EUFR had their hands full simply keeping up with current events (e.g. Quaglia, Eastwood and Holmes 2009). With key EU regulatory responses now in place, time has come to take a step back and assess how the maturing of EUFR as a research field on the one hand and the financial crisis on the other have spawned new questions and hence reshaped the research agenda (cf. for financial governance more generally Helleiner and Pagliari 2011).

The financial crisis has inspired researchers across the social sciences in general, as a stroll through any academic bookshop will readily reveal (Lo 2012). To avoid intellectual overstretch, the suggestions for fruitful research avenues laid out below are limited in three respects: they concentrate on the role of the European Union in financial regulation rather than on individual member states. They ignore the financial fire-fighting during the crisis through crucial but short-lived policies (for example bans on short-selling). And the choice of focal points is inevitably subjective, which is not meant to deny the potential relevance of those not discussed here. This paper highlights four themes to structure the discussion:

(1) Pre-crisis evolution of EUFR was dependent on a permissive consensus regarding the benefits of EU financial integration. The shattering of this consensus has generated new questions, both about past scholarly insights and about the future evolution of policy and institutions.

(2) In particular, the role of financial regulation in the political economy of EU integration as a whole remains insufficiently understood. In the first instance, this concerns the place of financial markets in economic projects such as the creation of the single European market or the Lisbon agenda. But financial regulation has also interacted with other policy areas in less obvious and planned ways. Fiscal policy is one example: cheap household credit delivered through deregulated financial markets has relieved fiscal pressures (Crouch 2009); ensuing financial crises have burdened public budgets. Such links matter greatly to analyses of regulatory policy, but they have thus far been underappreciated by EUFR scholars.

(3) Before the crisis, the policy preferences among public and private stakeholders in financial regulation appeared relatively stable and hence self-evident to scholars. Ceteris paribus, policymakers championed cheap credit, and competitive firms cheered unfettered cross-border market access. As stakeholders have been forced to reassess these and other policy stances, their preference formation deserves much more theoretical attention. How do public and private stakeholders make sense of the regulatory options they face?

(4) Finally, in its attempts to reregulate financial markets, the EU faces constraints in globally mobile capital and financial services, and global opportunities in unprecedented levels of regulatory cooperation. On top, EU policymakers are embedded in transnational policy networks that may channel new regulatory ideas, both from elsewhere into the EU and vice versa. Taken together, these factors make the global context central to understanding EU policy and its efficacy.

After a review of recent EUFR scholarship, this paper will set out the core questions for each of these four areas, arguing that answering them will help addressing the real-world regulatory challenges that the crisis has revealed so clearly.

The EU as a mature power in financial regulation

Since the late 1990s, EU scholars have clarified key aspects of financial regulation in the EU. It is largely undisputed that supranational bodies now play central roles in EUFR, such that their actions and impact are not reducible to bargaining between member states. The European Commission stands out. But the European financial authorities that have emerged in 2011 out of the Lamfalussy committees also matter in both the formulation and the implementation of policy (Moloney 2011a, Moloney 2011b). While financial regulation is not an exclusive EU competence, few of its facets remain untouched by binding European rules.

As scholars have discarded the obsolete dichotomy between supranationalism and intergovernmentalism, they have revealed the real-world complexity of policymaking in this domain (Quaglia 2007). Since the early 2000s, the European Parliament, the Council and the Commission have been complemented by new comitology committees, regulatory networks (the Lamfalussy committees), regulatory committees for accounting and auditing, as well as numerous sounding boards and advisory committees (Moloney 2010, Mügge 2010, Quaglia 2010). Scholarship on the first wave of EU financial regulatory integration was firmly rooted in political economy analyses (Coleman 1996, Story and Walter 1997, Underhill 1997): member state governments battled each other over market access abroad for their own firms. But as policy competences have moved to supranational bodies, and the institutional web has grown thicker, the emphasis has shifted towards conceptual apparatuses common in other fields of EU regulatory competence, such as airlines, telecoms, environmental, health and safety standards (Quaglia, De Francesco and Raedelli 2008).

This institutionalist scholarship has introduced new drivers behind and obstacles to the further evolution of regulatory integration (Thatcher and Coen 2008): rational institutionalism has highlighted veto players, and historical institutionalists have pointed to path dependency and sequencing (e.g. Bach and Newman 2010). The complexity of financial regulation has spawned expert committees in which bargaining has partially been supplanted by genuine deliberation about appropriate answers to regulatory challenges (Quaglia 2008). Indeed, because many institutional innovations have defied categorization as either EU committees or inter-governmental bodies, their study as (transgovernmental) regulatory networks has gained traction (Baker 2010, Posner 2010, Maggetti and Gilardi 2011).

The pre-crisis consensus revisited

The pre-crisis shift in emphasis from intergovernmental bargaining to committee governance and from powering over market access to puzzling over best practice has mirrored the real-world evolution of policymaking in EUFR. With the benefit of hindsight, however, it is clear that this shift was temporary and not, as much pre-crisis work had assumed, a secular trend.

Scholars of EU finance had commonly assumed that market integration and the institutional evolution supporting it would continue into the foreseeable future. The Lamfalussy-reforms had made clear that institutional innovation need not imply exclusive supranational competences, and that networked forms of governance, with divided competences between national and supranational bodies, could equally aid market integration. And in spite of their differences, European political elites agreed on the merits of pan-European financial integration and the necessity of legislative activity to spawn it (Grahl and Teague 2005, Donnelly 2010).

Key hallmarks of pre-crisis financial regulation followed from this consensus: first, agreement on the desirability and overall direction of financial integration allowed significant delegation of rule-making to non-majoritarian bodies prone to eluding principals' control. Second, financial regulation was hardly politicized among European citizens. Bureaucrats and experts could work with little external scrutiny. Regulatory networks as detached policy spaces flourished in this environment. Third, in the prevailing pro-financial industry climate this depoliticization produced dense ties between policymakers and the financial industry. Finally, the prevailing consensus championed not only financial integration throughout the EU, but also further financial innovation and securitization. Agreement on their merits allowed regulators to coordinate regulatory details while sidestepping principled debates about the appropriate place of finance in contemporary societies.

The financial crisis has shaken this pro-integration consensus. The extent of ideational damage is yet unclear, but it clearly affects the agenda of EUFR research. At the very least, post-crisis governance may exhibit dynamics different from those before the crisis. Additional stakeholders have entered debates about financial regulation, for example trade unions or advocacy networks like the Brussels-based FinanceWatch. Such developments need not invalidate insights about pre-crisis governance. But they highlight their contingency on benign market conditions and on a permissive societal consensus favoring regulatory liberalism (Gamble 2009). They also challenge scholars to develop conceptual tools that capture key facets of post-crisis governance, laid out further below.

Indeed, the crisis shifts our attention towards this permissive consensus itself. The operation of pre-crisis governance depended on the reproduction of beliefs about the inner workings of financial markets and, flowing from that, the desirability of cross-border market integration and regulatory liberalism. At the time, these ideas seemed natural not only to most policymakers, but also to the scholars studying the latter. Now we ask to what degree this belief system was sustained by ideational or institutional inertia or by specific material interests. To be clear, the task is not to demonstrate the dominance of either ideas or interests in isolation (cf. Sil and Katzenstein 2010), but to understand their mutual constitution – a perennial social-scientific quest – through the study of pre-crisis EUFR.

Going one step further still, has the consensus surrounding regulatory liberalism and supranational integration contributed to the crisis itself? More specifically, to what degree have the pre-crisis evolution of EU financial markets and their governance been wound up in the build-up of financial vulnerabilities that were unsustainable and would necessarily collapse? The supranationalization of EU financial regulation has been intimately connected to regulatory liberalism as a reform program (Mügge 2010). But if the pre-crisis evolution of EU financial governance was part and parcel of what some scholars have called financialization (for a comparison of European countries, see Stockhammer 2007), the shift in political dynamics associated with the crisis may not have been an exogenous shock but an endogenous one. Was the pre-crisis mode of governance necessarily unsustainable because it systematically generated overly lax and hence unsustainable policy? The suggested causal chain is long, meaning that careful empirical research will be necessary to establish its validity. But both its practical and its theoretical implications are too significant to dismiss or accept it without thorough assessment.

The political economy of EU financial regulation

The role of EUFR in the build-up of economic vulnerability in Europe is exemplary of a more encompassing research agenda: the place of financial regulation in the political economy of EU integration as a whole. Three sets of questions in particular arise.

First, who have been the winners and losers of regulatory reform? This question was a minor concern when by and large there seemed to be only winners, and when political dissent against financial liberalization was minimal. Distributive questions about financial regulation arise around the globe, but

Europe is particularly fruitful to explore them: comparable rules have been rolled out across the continent over the past decade, influencing for example credit availability to households and small businesses, patterns of government borrowing, and financial sector restructuring. With the diverse political economies it combines under one regulatory roof, the EU is a perfect environment to study comparatively the impact of regulatory reforms and the factors that condition it. The identification of net winners and losers are an important part of that agenda.

Analyses of such issues will have to heed a second insight that (re-)emerged from the crisis: finance is special. As regulatory battles unfolded in EUFR over the past decades, scholars of European Studies have often compared them to developments in other regulatory arenas such as telecoms, utilities and airlines. Financial regulation was not seen primarily as an instrument to shape the flow and accumulation of credit and debt, but as a tool to channel financial services – commodities not fundamentally different from, say, transport services.

The crisis has reminded us that, while parallels exist with other regulatory fields, finance is not just another business sector. Financial markets pervade the economic fabric of advanced industrial societies. That entails linkages with fiscal and monetary policy. Developments in other economic domains (for example real estate or energy markets) impinge on financial market functioning. In this respect, finance is more complicated than a sector such as telecoms. And its range of stakeholders is much broader, both of actors who are affected and of those who seek to bend regulation to their advantage.

In consequence, EUFR scholarship stands to gain from a deeper engagement with financial economics and sociology in its various forms. Delving into actual financial market functioning is inevitable when assessing whether regulation is meaningful. Scholars used to share a vague sense (and hence refused to define precisely) what made regulation for example 'intrusive', 'successful', 'liberal', 'market-friendly' or 'effective'. None of these qualities are self-evident anymore, and EUFR scholars will need to draw on the substantive debates to define what they mean when they use these labels.

Also financial regulators themselves have become much more uncertain about the nature of the animal they try to tame (Financial Services Authority 2009).[1] Their regulatory challenges may be so intractable as to prevent sweeping reform. But in order to assess whether reforms are wide-ranging or only amount to tinkering at the margins we need a clear yardstick: what is the realm of plausible reform? Given post-crisis disagreement on this point, EUFR scholars themselves will have to judge regulatory content. Engagement with the substance of financial regulation, not only the process of its creation, is imperative.

Zooming out once more, scholars of both international and comparative political economy have long debated whether advanced industrialized countries have converged around liberal political-economic arrangements.[2] The EU Commission itself had regularly portrayed the USA and its financial markets as examples worth emulating, and it used legislation to promote cross-border financial integration and financial disintermediation. The resultant evolution of EUFR chimed with a putative neo-liberal trend in the European economy as a whole. But these links were rarely explored in detail. Convergence-arguments often relied on structural explanatory factors such as capital mobility (Glyn 2006), the spread of technology or the dominance of particular class interests (Bieling 2003, Bieling 2006, Macartney 2009). In contrast, EUFR scholarship had mostly zoomed in and traced institutional complexity and context-specific constellations of interests in a circumscribed

1 The introduction of the Turner review is exemplary of this debate, as are the various discussion forums hosted by the *Financial Times*, arguably the most important newspaper in this field.

2 The debate is much more nuanced than this proposition suggests; its gist – convergence towards an Anglo-Saxon model or not – has remained intact nevertheless.

circle of stakeholders.

So how does EUFR fit into the more encompassing transformations of European economies over the past decades? Has it been a driver, enabling financialization to arise (Stockhammer 2007)? Has it been a corollary (and Achilles heel) of a general neo-liberal trend in the European economy, without direct causal significance? And if the intellectual climate in Europe is turning against neo-liberalism, however ill-defined, what does that imply for the future of regulatory politics in European finance?

Preference formation in financial regulation

One particularly useful way of approaching this question is to pry open the preference formation of key stakeholders in EU financial regulation. Most pre-crisis research was content with assuming seemingly obvious preferences: ceteris paribus, EU politicians favored cross-border financial integration because of the economic benefits it offered. Commission bureaucrats cheered supranational integration because it put policy competences in their hands and because they believed in the merits of European integration (Posner 2009). And globally, great regulatory powers pushed their own rules largely to reap the benefits of cross-border integration without having to impose adjustment costs on domestic financial players (Simmons 2001, Drezner 2007).

Private-actor preferences were also considered unproblematic. Financial institutions with sufficient size or a competitive edge championed cross-border integration for commercial reasons, so the assumption (Mügge 2010). Smaller firms tended to resist integration, following the same reasoning. Additional axes of conflicting commercial interests could be added to the big versus small-divide: the UK government eagerly defended the preeminence of the City in EU financial markets against German and French attempts to boost Frankfurt and Paris (Story and Walter 1997, Underhill 1997, Mügge 2010).[3] And firms with competing business-models (for example regulated stock exchanges and universal banks) clashed over regulation that would privilege one or the other (for the case of the Markets in Financial Instruments Directive, see Ferrarini and Recine 2006).

Post-crisis, the role of financial firms in policymaking is still high on the scholarly agenda (Mosley and Singer 2009). But whereas stakeholders' preferences have long been portrayed as self-evident and in no need of fine-grained theorizing, the crisis has exposed the frailty of the belief systems underpinning them. For example, while Buckley and Howarth (2011) analyze EU hedge fund regulation largely as a battle of the financial industry against intrusive regulation, Quaglia (2011b) argues that differing ideas about appropriate intervention have played a key role, too.

While it is evident that, as in other domains of IPE (Woll 2008, Abdelal, Blyth and Parsons 2010), ideas and interests are linked also in battles over EU financial regulation (Quaglia 2010), it remains unclear how so. With the defects of regulatory liberalism in plain sight and financial markets highly volatile, how do financial firms redefine their regulatory preferences (cf. Leblond 2008)? How deeply have pre-crisis ideas among regulators been shaken, and how do other ideas move in their place? Do we see a growing convergence of ideas, as puzzling over new regulatory directions is now a collective European enterprise in supranational bodies and networks? Or do they diverge, as the crisis permits divergent regulatory conclusions to be drawn from it? How do politicians redefine policy-preferences in light of both cognitive uncertainty and (temporary) politicization of financial governance? And how do citizens, which never before were a force to be reckoned with in financial governance, form opinions about desirable policy changes and make their voices heard?

3 It remains an open question whether the Continental member states have favoured stricter regulation for ideational reasons or to hurt the City and thereby promote their own financial centres and firms. A specific example is the Alternative Investment Fund Managers Directive (Buckley and Howarth 2011).

The global context

To be sure, just as citizens may reclaim a say in financial market regulation, policymakers may find themselves facing tighter global constraints than ever before. After three decades of liberalization, both financial markets and their governance are too globalized to allow ignoring what happens elsewhere in the world. Following Helleiner and Pagliari (2011) and Cohen (2006: 32), Europe's ability to shape its own financial future thus depends both on power-as-autonomy (from external constraints) and on power-as-influence (the ability to bend global regulatory agreements to one's own will).

The constraints come in two varieties. The cross-border mobility of financial services and capital shapes policymakers' choices, for better or worse, even if this mobility is itself an artifact of permissive regulations and hence subject to political manipulation. Debates about the influence of globalization on national policy resurface, this time with financial regulation instead of welfare state regimes and taxation as their object. Competition for capital and financial services revenue, with its tendency to spawn lax standards, is counterbalanced by the danger of financial instability and contagion, the second key constraint (cf. Singer 2007). The negative externalities of financial crises boost the case for global cooperation. The balance the EU strikes between competitive and cooperative imperatives will be a key factor shaping future regulatory reform.

At first sight, the incentives for cooperation have grown over the past years as EU power-as-influence in financial affairs has waxed. Most noticeably, the regulatory one-way traffic that transatlantic rule harmonization used to be (Simmons 2001) has given way to rules travelling in both directions – from the US to Europe and vice versa (e.g. Posner 2009, Eberle and Lauter 2011). Scholarship investigating this shift has taken market size as its starting point (cf. Drezner 2007): states' control over domestic market access is their principal bargaining chip in international regulatory coordination. The concentration of European regulatory competences in supranational hands substitutes one giant financial market for more than two dozen much smaller ones (Posner 2009). EU bargaining power rises, even if the relationship is not linear (Mügge 2011).[4]

On top, it matters whether players in global coordination efforts bring regulatory capacity to the table (Bach and Newman 2007): ceteris paribus, EU influence has grown when it has been able to demonstrate expertise, experience and the capacity to implement policies effectively at home. Taken together, market size, the level of regulatory centralization and regulatory capacity are clearly useful when gauging the EUs role in global financial governance (cf. Quaglia 2011a).

Also in global financial governance, however, the crisis has shaken matters up. Pre-crisis work had largely assumed that global regulatory harmonization would progress for the foreseeable future; the key question was which rules would prevail. Yet as Bieling (2006) anticipated, economic troubles in both Europe and the USA have weakened the intellectual case and domestic support base for further harmonization. How then has the crisis changed the global context for EUFR?

For Helleiner and Pagliari (2011), the inclusion of non-OECD countries in the G20, in the Financial Stability Board and in the Basle Committee on Banking Supervision has ended the Euro-American dominance in global financial governance. But just as new countries have taken their seats in regulatory forums, the appetite for global harmonization has weakened, potentially undoing their new-found influence in global finance. Sidestepping binding global agreements, the EU and the USA may mutually adapt their rules bilaterally (for example in derivatives and credit rating agency regulation) as they did before the crisis, and relegate the G20 and the FSB to a much more modest global role than the two bodies had been promised.

4 Note that the concentration of regulatory competences swings free of its success in spawning actual market integration (Grossman and Leblond 2011).

This scenario reemphasizes the importance of two factors highlighted above: preference formation and the economic embeddedness of financial regulation. The question of preference formation is straightforward: what motivates regulatory authorities to seek international harmonization or adaptation? Past scholarship focused on the trade-off between financial stability and domestic firms' competitiveness (Singer 2007). Upon closer inspection, however, the EU's motivation to seek international regulatory influence is unclear (Posner and Véron 2010). Does it promote a European blueprint for global rules to aid financial stability, potentially flowing from the more coordinated market model prevalent on the Continent? Do financial sector interests dominate in the end, causing a focus on the transatlantic axis? Or does the EU pursue power for its own sake? Adjudication between these claims will require much more detailed empirical analyses than we have so far.

The EU's influence is not confined to its muscle in international bargaining. Financial governance is populated by organizations that resist ready categorization as either private or public (Porter 2005, Büthe and Mattli 2011). Examples include the International Accounting Standards Board, the International Organization of Securities Commissions and the International Swaps and Derivatives Association. Very different from great power politics, EU influence in these bodies lends itself rather to principal-agent analysis (Leblond 2011, Mügge 2011). The complex patterns of delegation – from member states to regulators and EU officials, and from them to hybrid standard setters – are yet to be fully explored and understood. Are intra-European divisions an impediment to a strong global presence? Or do they allow Europe to play two-level games and boost its external influence?

Finally, the EU may shape regulation around the world through leadership by example. At present, global financial governance develops not towards full-fledged rule harmonization but to more complex patterns of policy coordination (Helleiner and Pagliari 2011). If decentralized coordination emerges as a key mode of policy evolution, the EU may constitute an enormous repository of blueprints that facilitate cooperation without trampling national sovereignty (Sabel and Zeitlin 2011). Examples include institutionalized opportunities for mutual learning, peer review of policy progress, and a focus on the achievement of overall goals rather than adherence to detailed scripts (Posner 2010).

Whether such modes of policy evolution will flourish hinges on the degree to which divergent stakeholder interests and macro-economic developments redraw the global economic map. As governments discover how financial regulation impinges on economic policy more generally, their appetite for coordination may wane further. Once the sovereign debt crisis dust settles and real interest rates return to normal levels, the European financial sector may be so damaged that regulatory protectionism, not global harmonization, will reign supreme. In addition to understanding better EU financial regulation in its own right, we will have to appreciate how, as one of many interlinked facets of global economic governance, it is at the mercy of a global economic re-shuffle whose endpoint is still unclear.

Conclusion: the real-world relevance of EUFR research

EUFR research derives its ultimate value not from its theoretical sophistication but from its real-world relevance. The questions that animate its agenda are straightforward: which factors shape how Europe governs its financial markets? And how are we to evaluate policy output? Such assessment hinges on the constraints policymakers face: is policy dogged by institutional complexity or bureaucratic inertia, hijacked by corporate interests or populist politicians? Are policymakers shortsighted in failing to nurture global rule harmonization? Or is Europe served better by going it alone? Do policymakers cling to obsolete ideas, ignoring opportunities to learn from reforms elsewhere?

Already, EUFR scholars command key insights to address such questions. Their understanding of institutional dynamics stands out in this respect. Other factors deserve additional attention. This essay has emphasized four out of a long list of candidates: the pre-crisis consensus surrounding financial integration and liberalization, financial regulation's interaction with other economic policies, stakeholders' preference formation, and the global regulatory context. Studying these will help answer a question about which both citizens and policymakers agonize these days: can Europe deliver? Scholars of finance never tire to point out that financial regulation is worth studying because of its enormous impact on citizens' lives. If that is indeed the case, it is imperative to spell out more clearly which forms of governance deserve our support, and which ones do not.

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