National Filters: Europeanisation, Institutions, and Discourse in the Case of Banking Regulation

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The banking industry, like much of the financial industry, has been confronted with substantial challenges and undergone momentous changes in the last three decades.[1] While the post-World War II system (also known as the Bretton Woods system) in most countries had – in line with then prevailing economic policy dogma – imposed capital controls in order to regulate interest rates and manage the domestic economy (as well as protect the new welfare state from capital flight), the 1970s saw stark changes after decades of stability. Technological change in the areas of computerisation, a telecommunications revolution, but above all changes in international markets and politics – such as the breakdown of the system of fixed exchange rates and the two oil-shocks of the 1970s – substantially altered the conditions under which financial markets operated.

As most economies were confronted with deep economic crises (spiralling inflation, rising unemployment and sluggish economic growth), economic policy concepts changed. Keynesian ideas, which had guided many countries through the decades following World War II (Hall 1989), were increasingly replaced by economic concepts that focused on supply-side policies rather than the attempt to steer national economies by means of demand-side management. As an increased reliance on markets came to be seen as an antidote to the recessionary environment that had followed the end of the golden age of capitalism in the early 1970s, liberalisation and the abolition of the many barriers that separated national markets were the logical complement in the international sphere. Indeed, governments actively encouraged and engineered the lowering of national barriers, above all in financial markets and banking, for a variety of reasons (Kapstein 1994), for example, by lowering and eventually abolishing capital controls that had relied on the logic of a system of fixed exchange rates. These changes had enormous consequences – indeed, it has been claimed that the 'internationalization and integration of capital markets has been the most

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significant change in the political economy of the industrialized countries over the last three decades. ... No other area of the economy has been so thoroughly internationalized as swiftly as have capital markets since the 1970s' (Simmons 1999: 36).

At the European level, these moves towards internationalisation were matched by an attempt to create an integrated European financial market. This was an enormous task, as European financial markets and, above all, banking systems had historically developed in very different ways (Pohl 1994). Differences were evident in various dimensions: while some national banking systems were quite liberal, others were heavily regulated by the state;[2] some national markets were heavily concentrated and dominated by only a few big banks, while in other countries there was a multiplicity of small banks; and there were also significant differences in the role banks played in relation to industry – leading to a differentiation between capital market-oriented and credit-oriented financial systems (on the latter distinction see Zysman 1983; Cox 1986; Story and Walter 1997).

The challenge of making these different national heritages compatible and congruent at the European level was exacerbated by the fact that financial markets changed substantially as a result of the aforementioned developments. Competition in the banking industry increased (which led to shrinking profit margins), and while the new liberties created new business opportunities, they also brought new risks. Given the central role that a functioning banking sector plays in a national economy, states faced significant challenges as regulators in the attempt to adapt to new circumstances and, at the same time, reach the goal of increased European integration.

UNCERTAINTY, DISCOURSE AND EUROPEANISATION

It is only with the hindsight of nearly 30 years that one can detect distinct patterns in the responses to the fundamentally altered circumstances. To policy-makers at the time, drastically changed circumstances meant that they were confronted with a situation characterised by a high degree of *uncertainty*. For while it was clear that the environment for banking policy would change, the extent and direction of that change were almost wholly unpredictable. The central governance task was thus 'coping with innovation', and the key challenge therefore one of 'governing without precedents', a non-standard challenge to policy-makers that seemed to rule out the entrenched response of 'incremental politics as usual' (Bovens *et al*. 2001a: 13ff.).

As the oil shocks of the 1970s plunged economies into recession and put strain on the international financial system, countries started to abolish the capital controls that had relied on the logic of a system of fixed exchange rates. International bank lending increased dramatically, and with it new risks arose that had to be supervised and regulated. Policy-makers thus found themselves in unchartered territory – without a map that could guide them as they were grappling with the problem of choosing policy. At issue were such topics as preventing bank failures, ensuring the stability of the national banking system and – electorally most important as this concerned the vast majority of the population directly – guaranteeing deposits through some kind of deposit protection.

Under such conditions, when no standard exists for deciding whether a policy is rational, decision theory tells us that actors have to rely on internalised assumptions to guide them in their decision-making – their 'ideologies' or 'mental maps' (Denzau and North 1994; Haas 1992). Ideational factors or discourses, we can thus assume, will have played an important role in deciding the paths taken by banking policy after the mid-1970s.

Analysing the influence of such 'ideational' and 'discoursive' factors on public policy-making has become a popular topic in political science in recent years. Ranging from areas as diverse as national foreign policy-making and supranational policy co-ordination by 'epistemic communities' to science policy, many studies have used concepts like the 'advocacy coalition framework' (Sabatier and Jenkins-Smith 1993), 'policy paradigms' (Hall 1993) or the 'réferentiel' (Jobert and Muller 1987) to explain policy choices.[3] A more recent addition to this literature is the 'discourse framework' put forward by Vivien Schmidt (2002). Its advantage is not only that it distinguishes between an 'ideational' and an 'interactive' dimension in the policy discourse, but also that it predicts systematic variation in the latter depending on characteristics of the national system of political institutions (Schmidt 2002: chapter 5). In national single-actor governance systems, the 'co-ordinative discourse' is expected to be thin, as policy decisions do not have to be agreed with other relevant actors; the 'communicative discourse' with the public, however, is expected to be elaborate. The opposite is to be expected in national multi-actor governance systems, where the emphasis is on the co-ordinative discourse between the various participants, while the communication with the public is less elaborate. Given the expected importance of ideational factors in this policy area, comparing policy reactions in banking supervision should be a good test case for these hypothesised differences in national discourses.

Europeanisation can also be expected to have played an important role in banking policy. There are two main reasons for this. On the one hand, European countries were largely confronted with similar new challenges in this policy area, and as the European Union (or the European Community, as it was for most of the time under consideration here) is acknowledged to be a major forum for policy transfer and learning (Radaelli 2000), one could expect countries to adopt similar solutions through such mechanisms as 'emulation', 'elite networking', 'hybridisation' or 'inspiration'.[4]

European integration influenced policy in this area also directly through measures like the First (1977) and Second (1989) Banking Directives. The 1977 Directive established the principle of 'home country control' and laid down ground-rules for bank authorisation throughout the Community. Although it left much detail open to interpretation by the member countries, this was a first step towards addressing the issue on the supranational European level. The 1989 Directive went on to provide banks with a 'single passport' that allowed them to do business throughout the European Union without having to obtain further authorisation from the host country. In addition, minimum capital standards were harmonised.[5]

COPING WITH NEW CHALLENGES: THE CASES OF BRITAIN AND GERMANY

The previous section argued that – given the high degree of uncertainty with which policy-makers were confronted – ideational factors and discourse should have influenced policy choices as actors were largely ignorant about their interests and how policy would affect them. In addition, policy transfer, not least through mechanisms of European integration, should play an important role.

In the following section, two case studies will be used to test these hypotheses. We examine two European countries, Britain and the Federal Republic of Germany, over a time period ranging from 1973 – the breakdown of the Bretton Woods system of fixed exchange rates – to the introduction of the Euro and the start of the Basel II round in 1999. In choosing empirical cases, there is obviously a trade-off between detail and generalisability. In order to accommodate the pledge by the editors for solid empirical analyis, the decision was made to limit the detailed empirical discussion to only two cases. The analysis, however, will be informed by a wider sample of case studies.[6]

The cases of Britain and Germany are interesting because of their combination of differences and similarities. Institutionally, there are marked

differences between the countries: a federal political system characterised by coalition government and the existence of many veto players on the one hand, a unitary Westminster democracy of single-party government unconstrained by rival centres of power on the other. But there are also remarkable similarities: both countries are of roughly equal economic and political weight in the European Union, both have traditionally favoured liberal approaches to economic governance, and have, for the time period under consideration, been governed largely by parties of the same ideological family. Whether any of these factors will eventually prove to be important for the analysis of banking policy remains to be seen. Methodologically, a bottom-up approach is followed which takes events on the level of the nation state as its point of departure and relies, among other sources, on detailed analyses of legislative papers and interviews with policy actors.

From Club to Market: The End of Supervisory Informality in Britain

The British system of banking supervision has changed fundamentally in the last three decades, for 'up to the 1970s, there was effectively no formal system of bank supervision as we know it today' (Gardener 1986a: 70). Together with a group of other countries (Australia, Canada and New Zealand), Britain had no formal or legal regulations regarding bank supervision (Pecchioli 1989: 45ff.). That does not mean to say that nobody was supervising British banks – just that the way this supervision took place was characterised by a high level of flexibility and informality.

Central to that system was the Bank of England (BoE), the country's central bank. It had a long history, having been founded in 1694, and had gradually grown into a supervisory role besides its main task, monetary policy. Nationalised only in 1946 and immensely proud of its long-standing involvement with the London financial markets, the Bank functioned like a buffer between the City and the government, acting 'as spokesman both for the City within the government and for the government within the City' (Vogel 1996: 98). The Bank's authority over the banking industry, however, did not emanate from legal regulations,[7] but from the central role it played in the 'club-like' culture of the City, where the 'raised eyebrows' of its Governor were the ultimate sanction that would be strictly followed by everyone.

The fundamental transformation of the City's 'club culture' into a modern supervisory system, however, was not brought about by influences from the international or European level, but mainly by domestic events. After a long period of stability in the banking industry – even the 1930s

banking crises that rocked most other Western countries had left Britain unharmed – the 'Secondary Banking Crisis' of 1973 to 1975 came as a shock and was by many considered to be 'the most serious to hit the industry this century' (Metcalfe 1986: 126). It is named after the so-called Secondary Banks that had sprung up since the 1960s as a result of there being no legal definition of what constituted a bank. While the BoE had regular contact with the established banks, it had none with these new banks, and was therefore surprised when they faced problems. The crisis was triggered ultimately by consequences that arose from changes in the Conservative government's strategy of credit policy and an ensuing tightening of monetary policy.[8] Rising interest rates and collapsing house prices meant that many of the small banks faced problems of liquidity and even solvency.

In order to prevent the small banks' crisis from contaminating the established banks, the BoE launched a rescue operation. Its character was typical for the prevailing regulatory regime, since the BoE only contributed 20 per cent of the required sum, while most of the costs were borne by the four big clearing banks (Metcalfe 1986: 127). The fact that they were willing to pay so much money without being in any way legally required to do so is an excellent indicator for the functioning of the informal regulatory system in which feelings of solidarity and commonality were more important than pure profit considerations. Although resolved without major problems, the Secondary Banking Crisis did not remain without consequences. The crisis had fuelled debates in the governing Labour Party about nationalisation of the clearing banks and the creation of a National Investment Bank that was supposed to funnel capital into the crisis-ridden manufacturing sector. In order to fend off a further politicisation of the situation that could have led to a fundamental reshaping of the sectoral governance mechanisms,[9] the Governor of the Bank of England decided to build up a formal system of banking supervision.

It took shape in only three months and consisted of a system in which banks would write reports about their assets and liabilities to the BoE, which would then conduct formalised interviews with the board members of the business banks. Furthermore, in order to gain control over the use of the word 'bank', the government announced its intention to introduce a Banking Act in autumn 1975. The Act, which entered into force in October 1979, largely codified the practices of the BoE supervisory system and was characterised by an absence of precise measures, for example, for own capital, relying instead on the Bank's judgement. Two categories of institutions were distinguished, namely 'recognised banks' and 'licensed

institutions', which more or less reproduced the old distinction between primary and secondary banks. Drawing consequences from the recent crisis, stricter rules were put in place for the latter – the former, for example, were not legally required to give information to the BoE; it was simply assumed that they would do so voluntarily. Thus many aspects of the old, informal 'Club system' survived codification.

The new system faced its first severe test when in 1984 a bank from the 'recognised' category faced problems, namely Johnson Matthey Bankers (JMB). In its attempt to launch a rescue operation, the Bank of England had to realise that regulatory changes had altered the atmosphere of the London City. The big clearing banks were no longer prepared to bear most of the costs and consequently refused the BoE's proposal that they should pay 90 per cent of the required £150 million. Instead, they claimed that faulty banking supervision was to blame for JMB's problems, and that the central bank should therefore pay most of the costs (Reid 1988: 227). The introduction of a formalised system, together with increased competition in the City, had thus led to a change in the whole culture, and to a reduction of the Bank's power to impose its will on the banking community.

In addition, the Bank's handling of the issue drew criticism from the Treasury. Embarrassed by communication problems over the amount of public money needed for the rescue operation, the Chancellor of the Exchequer appointed a committee to look into necessary reforms of the supervisory system. While it was chaired by the Governor of the Bank of England, high-ranking Treasury officials were put on the committee in order conduct a thorough investigation of the soundness of the BoE's practices (Lawson 1992: 405ff).

The Committee's report recommended a number of changes to the existing system. All banks should be treated the same in the future, and the distinction between two classes of lending institutions should be abolished; accountancy firms should be more directly involved into the supervisory process and be allowed to co-operate directly with the BoE; giving false information to the BoE should be punishable; and more – and better trained – personnel should be made available to the supervisory arm of the Bank (Committee 1985: 22ff.). The Treasury accepted these proposals and added to them the creation of a Board of Banking Supervision (BoBS) within the BoE, consisting of three members from the Bank and six 'independent' members who were supposed to bring external expertise to the process and advise the Governor. Thus, incentives for the Bank to co-ordinate its actions better with other government agencies were increased, and the position of the Treasury vis-à-vis the Bank strengthened. The Banking Act 1987

incorporated all these changes into law and further reduced the informality of the regulatory regime (Hall 1999: 39).

Having created a formal system of supervision in the 1970s and adapted it in the 1980s, the 1990s saw two more incidences of high-profile failures that eventually paved the way for a fundamental institutional reform of the system – the cases of BCCI and Barings Bank.

In July 1991, after receiving report from their accountancy firm PriceWaterhouse that uncovered 'massive fraud' within the bank, the BoE closed BCCI (the Bank of Credit and Commerce International), an international conglomerate whose main place of business was London. While criminal allegations against BCCI ranged from money-laundering to supporting drug trade and terrorism (and triggered consequences in international banking supervision practice[10]), it also led to highly critical questions being asked about the supervisory practices of the Bank of England. Both the report commissioned from Lord Justice Bingham and a report by the House of Commons Treasury and Civil Service Select Committee found significant faults in the Bank's practices and raised severe criticisms against it. Suggested reforms included increased on-site inspections of banks, the development within the banking supervision branch of the BoE of capacities for early detection of fraudulent and criminal business practices, improved co-ordination and communication both within the BoE and with the Treasury, and a strengthened role of the BoBS which should also receive more resources to fulfil its task (Bingham 1992: chapter 3). Transferring the task of banking supervision from the BoE to an independent agency was considered, but eventually not included in the reform proposals (Bingham 1992: 181).

While BCCI could be considered a rogue bank and an exception, it came as a shock when in February 1995 Barings Bank, which epitomised respectability in the City (and counted the Queen among its customers) had to be taken into receivership by the Bank of England. This followed fraudulent behaviour by a futures trader in the bank's Singapore subsidiary, who had engaged in bets on the development of the Japanese Nikkei-Index and run up very high negative positions.[11] Prior to the bank's collapse, the Bank of England had tried in the traditional manner to organise a 'life boat' for Barings, but had failed to do so. Given the nature of the Barings futures contracts, a guarantee would have had to be unlimited – something the City bankers were unwilling to put forward. The BoE was also unable to guarantee this and, as a consequence, Barings was not taken over by the central bank (as had been the case a decade ago with JMB), but was taken directly into receivership.

The Chancellor of the Exchequer asked the Board of Banking Supervision for a detailed report into the case, which uncovered severe failures on the part of Barings management and clear negligence on the part of the Bank of England's supervision (BoBS 1996). A detailed list of reforms was part of the report, and it included an independent assessment of the BoE's supervision practice by a management consultancy firm. This assessment was conducted by Arthur Andersen, and produced yet another report suggesting improvements to the supervisory practice, including a more formalised and structured approach, labelled the RATE (Risk Assessment, Tools of Supervision and Evaluation) system (Andersen & Co 1996). It also pointed out that some of the weaknesses had to do with personnel problems.[12]

Another report by the House of Commons' Treasury and Civil Service Committee was far more critical in its analysis. It suspected that the BoE had become a victim of 'regulatory capture' and recommended more distance between the Bank and the business banks. It even threatened that 'it may be necessary that in order to bring about the necessary cultural change banking supervision will have to be taken away from the Bank of England' (Treasury Select Committee 1996: xxxvi). The fact that this report was passed in a committee in which MPs from the governing Conservative Party had a majority indicated clearly that politicians were losing patience with the existing system of banking supervision and its regularly recurring crises. Already for some time questions had been asked whether the BoE might be overburdened with its multiplicity of tasks, which ranged from managing the deposit insurance system, conducting banking supervision, advising the Chancellor on monetary policy, to promoting the City and other things (*The Economist* 1993).

When the incoming Labour government in 1997 unexpectedly introduced a complete institutional shake-up in this field, taking banking supervision away from the BoE and putting the newly founded Financial Services Authority (FSA) in charge of it (and supervision of all other aspects of financial markets), the consequences of repeated failure to reform were drawn.[13] Over a century of informal (and a quarter-century of formal) responsibility for banking supervision on the part of the Bank of England thus came to a sudden end, and the Bank was predictably unhappy about this.[14] Putting the necessary legislation into place took another three years – mainly due to consultations conducted with consumer, financial industry and professional associations[15] – but by the end of the twentieth century, British banking supervision had found a new institutional shape and been rolled into a single legal framework of supervision of the financial services industry.

The Calm after the Storm: Shock and Supervisory Stability in Germany

Compared to the series of incidents that plagued British banking supervision in the 1980s and 1990s, the German system has, for the last 30 years, been characterised by a greater degree of stability. But if most of this time span was pretty uneventful in Germany – at least in terms of banking supervision – the period directly after the breakdown of the system of fixed exchange rates certainly was not. For the Federal Republic's banking system entered this new era of liberalised currency trading with a failure that caused ripples through the entire world financial system – the collapse of Herstatt Bank in 1974.

This collapse was the most significant bank failure in Germany since the banking crisis of the early 1930s. Back then, the insolvency of Danat-Bank had caused a bank run that forced the government to guarantee the banks' deposits and thereby, in practice, nationalise most of the banking system (Born 1977: 500). While in the coming years all state shares in banks were sold back to the private sector, an all-encompassing system of supervision and regulation was put in place and codified in the *Kreditwesengesetz* (KWG) of 1934. This regulation enlisted the help of the peak-level associations of the three historically developed banking sectors,[16] and proceeded to create cartel-like structures to limit competition in the banking system and thereby enhance its stability – a strategy also adopted in other countries like the United States at the time to cope with the then crisis of the American banking system.

But while the regulatory straitjacket in the United States was to survive for decades, post-World War II Germany liberalised at a comparatively early stage, abolishing all interest rate regulations by the mid-1960s (Alsheimer 1997). This liberalisation – imposed by the Ministry of Economics in spite of scepticism from the banking industry[17] – rekindled a public debate about the safety of deposits that had surfaced sporadically in Germany since the late nineteenth century. Taking up concerns in that direction, the Federal Parliament asked the government to produce a report on the issue of depositor protection (Ronge 1979: 98). In 1968, the government report diagnosed increased competition between the sectors of the banking industry and recommended the introduction of a system of deposit insurance, emphasising that a failure to do so might lead to problems in the future.[18] Since both the savings banks sector and the co-operative banking sector had already set up their own systems of depositor protection in the 1930s, the main target of these recommendations was the commercial banking sector. Already a year later, in 1969, its peak

association (the Bundesverband Deutscher Banken or BdB) announced that it was voluntarily setting up a scheme that would protect individual deposits up to DM10,000 per person.

Five years later, in June 1974, the system was tested thoroughly for the first time. Herstatt Bank, a comparatively small commercial bank in Cologne, defaulted over a forward currency deal gone sour. Together with Franklin National Bank in New York, Herstatt became one of the major victims of the drastically increased volatility in currency markets and showed that the enormous new profit opportunities were, at the same time, accompanied by massively increased risks (Kapstein 1994: 31, 39ff.).

The closure of Herstatt Bank – although it only ranked number 80 in size among German banks – induced a bank run and threatened a major crisis of the banking system.[19] Deposits were withdrawn, not only by private depositors, but also by insurance companies and public-law institutions. It became quite evident that the existing system of deposit insurance was insufficient to prevent a bank run (Franke 1998: 297ff.).

At this point, political intervention was required. Relying less on informal means of co-ordination than the British system at the time, an attempt by the central bank to organise a ‘life boat’ for Herstatt had failed before. But, within the confines of that formalised system, the state was actually held at arm’s length by the industry, which played a significant self-regulatory role. The main supervisory body, the Bundesaufsichtsamt für das Kreditwesen (BAKred), was then a comparatively small organisation of around 200 officials, who were supervising some 3,000 credit institutions. This could only work if the system did not rely on on-site inspections, but primarily had to check auditors’ reports on banks for compliance with the legal requirements laid down in the KWG.[20]

The Herstatt crisis, however, with the politicisation of the issue of banking supervision, opened up a major ‘window of opportunity’ to redress the sectoral balance of power between the state and the industry in favour of a much stronger direct role for the state. The government took the initiative to propose a three-step reform of the system:

1. a quick amendment of the KWG should give the BAKred more powers and decrease credit risk by putting a cap on the maximum size of loans;
2. a comprehensive system of deposit insurance should be set up and run by the state;
3. a commission of experts should be asked to review ‘fundamental questions of the banking system’ and prepare a report on proposals to reform it.

While there was little dispute that some form of reform was necessary, the government's proposals would have abolished the voluntary deposit insurance schemes of the savings and co-operative banking sectors and would have voided 15 years of lobbying from the commercial banking sector against a state-imposed deposit protection scheme.

The problem was particularly acute for the latter sector, as customers began to move their deposits to the other banking sectors because of the existence of their protection schemes. This powerfully conveyed the message that deposit protection could be a competitive advantage. As the availability of liquidity in a crisis had just been improved through the setting up (under the leadership of the Bundesbank) of an institute designed specifically for that purpose,[21] deposit protection emerged as the main problem left to be solved.

It was a thorny issue, given that commercial banks compete with each other, yet were forced to co-operate were they to set up their own deposit protection system. Moral hazard and free rider issues had to be solved, quite apart from the technical details of such a solution. But eventually, after protracted negotiations both within the commercial banking sector and between the three banking sectors, a solution was found within the commercial banking sector. That system would provide a higher level of protection for the individual depositor than the government's proposed scheme and, at the same time, remain in the private sector, under the control of the commercial banks' peak association. It became clear that the commercial banks preferred associational authority over state authority.

The BdB managed to forge a compromise with the government, which resulted in the latter dropping its proposal in favour of a voluntary and group-specific deposit protection scheme. The government accepted the deal, pointing out that the level of depositor protection was the highest in the world, and that it would come without any cost for the government.[22] Indeed, in retrospect, it seemed that the government had used tactical behaviour to increase the banking sector's propensity to compromise, which, as seasoned observers admitted, was eventually much higher than had been originally expected (Knapp 1976: 876). As a result, the other instrument which the government had put forward to threaten the industry into compliance, namely the Commission on Fundamental Questions of the Credit System, was no longer of great importance. Initially, the industry had been quite fearful that such a commission might be manned with critics of the existing system, and might propose wide-ranging reforms that could even lead to a nationalisation of the banking system.[23] But after a compromise had been found, the commission's report was delayed by two

years, and when it eventually made mild proposals for reform, even these were not enacted.[24]

As a consequence, policy change at the end of this decisive policy episode has to be judged as rather limited. The 'window of opportunity' to alter the balance of power in the policy sector was not used, and apparently consciously so by the state, which agreed to compromise with the banking industry rather than impose its own dominance.[25] Compared to the British case, the 1970s certainly showed markedly less change in the field of banking regulation, as Germany was a case of cautious re-adjustment of an existing system rather than one of wholesale change, as had been the case in Britain with the introduction of a formal system of supervision for the first time.

The re-adjusted German system proved stable throughout the 1980s and 1990s. While a few small banks did experience problems, the system was not troubled by any more high-profile accidents or bank failures. No depositors lost any money, and no public money had to be used to bail out troubled or failing banks. Given the level of change in the financial industry during that period and the problems experienced by many other countries,[26] this was a substantial success. Evidently, the system worked very well in terms of the stability of the banking system – a marked contrast over the British case, which experienced a number of embarrassing failures that could, at least to some extent, be ascribed to an inadequate set-up of the regulatory system (see above).

POLICY CHANGE, INSTITUTIONAL PERSISTENCE AND THE CASE OF THE MISSING MODEL

What accounts for the differences and similarities in the two case studies? This question will guide analysis in the following section, and it will focus on the extent of policy change, the importance of institutional differences, and the role played by political discourse.

Policy Change

Looking at the extent of policy change – that is, the reaction of the regulatory systems and their adaptation to challenges posed by market changes – in Britain and Germany, we find stability and change in both cases, albeit to a different extent. In both cases, using Hall's (1993) terminology, we can observe first and second order changes, but no revolutionary third order changes. In other words, while the setting of goals and the use of instruments changed in the period under investigation, we

find in neither country a revolutionary change of the policy paradigm. The closest thing to such a paradigm change took place in the UK immediately prior to 1973, namely when the legislation on 'Competition and Credit Control' abolished the system of credit allocation as an instrument of monetary policy.[27] In making this change in 1971, Britain took a liberal stance in economic policy-making that many other European countries only adopted much later.[28]

Policy change of the first and second order took place in Germany only on one occasion (namely in 1974/75), while in Britain there were repeated adjustments to the newly introduced system of formalised banking supervision – in 1984/85, 1991/92 and 1995–97. In the German case, the upheaval caused by the failure of Herstatt Bank opened a 'problem window' (Kingdon 1995: 173ff.) for political intervention that could have led to a third order change or sectoral paradigm shift, with the state taking over responsibility for the whole system of supervision and deposit insurance. However, as the case study showed, the German state only used this as a threatening device and was ultimately not interested in taking on these duties – for various reasons. In the British case, rather than one 'big bang', we find a series of adjustments sprinkled across the 25 years of the case study, with the most substantial ones occurring towards the beginning and the end – the introduction of a formalised system of banking supervision through legislation, and, more recently, the major institutional change of the creation of the Financial Services Authority which took over banking supervision completely from the Bank of England.

Institutional Persistence

If we want to understand these differences in the way the two states handled quite similar changes in the area of banking policy, institutional differences and their persistence are a good starting point.

In the British case, a highly concentrated banking industry – both in terms of geography and the number of banks – and a tradition of informal regulation stand out. While the financial services industry as a whole is characterised by an interest group structure that has to be considered as fragmented (Coleman 1996: 50ff., 248ff.), this is not the case for the commercial banking sector, where the British Bankers Association (BBA) plays a central role. However, in terms of policy-making, it is of limited importance: 'Associations are not as important as the big players in the United Kingdom'.[29] On the state side, supervisory responsibility was concentrated (for most of the time under consideration here) in the Bank of England, with its characteristic dual role between market and state. As the

Bank is also in charge of monetary policy, its operations are easily politicised, and therefore it operates under the watchful eye of Britain's most powerful government department, the Treasury. When codification and formalisation reduced the Bank's 'social' power and influence in the City, it did not manage to compensate that through other means. There is no institutionalised co-operation between state and industry, and the implied high flexibility of the ad hoc arrangements when co-operation becomes necessary suits the big players well. Policy-making, as a result, is primarily reactive and triggered by failures – which are small in international comparison, but still significant.[30] A weak parliament has little influence over the shape of these reforms, and the banking industry is content with its level of influence: 'Our philosophy is that it is the role of the government to decide how it wants to regulate, and then the role of the industry is to respond to that'.[31] Policy and policy change are thus handled by the central government, without much input from other actors except – occasionally – the Bank of England. This can account for the ad hoc nature of the changes in British banking policy, each of which only lasted for a couple of years.

In the German case, the banking system is fragmented between three sectors, but highly organised peak-level associations then reduce the number of actors in the policy area to only a few. Even if their respective sectors compete fiercely with each other, these sectoral associations are traditionally committed to co-operation with each other and with the state supervisory authority – indeed, they do much of the latter's work, and they have the manpower to do it.[32] As a consequence, industry associations play an important role in policy-making, and a high level of regular consultations takes place between state and industry. Prior to regulatory changes, consultation with the peak-level associations is mandated by the KWG. In such a system, the state supervisory authority need only be small, as much of the sector is run through 'private interest government' – the deposit protection schemes, as an example, are run by the private sector. Institutions are thus clearly different from the above case – in Germany, comprehensive consultations and an undeveloped state capacity to impose solutions led to negotiated settlements which then lasted for a long time.

Although institutional set-ups differ across the two countries – which, to a considerable extent, can account for the different patterns of interaction and outcomes in the two cases – it also becomes clear that each national case displays a remarkable degree of institutional stability over time.

Policy Discourse

If institutional differences can account for many of the differences we observe in the case studies, what explanatory room is left for policy

discourse? After all, we expected ideational factors to be highly influential in this policy area which seemed so much characterised by uncertainty. Did discourse really play not much of a role, and, if so, how can we account for this? These questions shall guide us for the remainder of this section.

Looking at the way policy discourse is conducted in the two cases, we observe differences that support the distinction claimed by the model of Vivien Schmidt (2002). In the multi-actor system of the Federal Republic, it is indeed the co-ordinative aspect of discourse that is dominant – in terms of negotiations between the policy actors.[33] In the single-actor system of the UK, such co-ordinative discourse is largely absent, and also unnecessary, as solutions are more or less imposed by the central government without much need for negotiation. The communicative dimension, which – according to the model – should dominate the British case, is, however, notably absent.

One reason for this may lie in the nature of banking policy. It is characterised by its highly technical nature, and thus generally considered to be an area of 'low politics' (Moran 2002), unsuited for arousing much politicisation and public debate. This can change if overt failure forces the issue onto the political agenda – although, even then, politicisation need not be the consequence (Busch 2001b). Indeed, the cases of France, Spain, Sweden and the United States show that even considerable costs for the public sector to bail out failing banks or banking systems can remain without substantial political consequences.[34]

But a low 'boredom threshold' alone cannot explain the low incidence and impact of policy discourse. After all, other areas in which ideational factors have been shown to be influential are hardly more exciting – such as the cases of monetary policy and particularly European Monetary Union (Haas 1992; Dyson and Featherstone 1999: 28–33). Why did an 'epistemic community', based on ideational factors such as knowledge and shared beliefs, form in the latter case and massively influence policy, and fail to materialise in the former?

The main reason for this can be called 'the case of the missing model' – in two respects, one empirical, the other intellectual. Let us consider both in turn and contrast them with the area of monetary policy and EMU. Empirically, the model for the institutionalisation of EMU (centred on an independent central bank pursuing an objective of low inflation) was informed by the success stories of those countries that had successfully pursued a policy of price stability in the face of the adversity of the 1970s and early 1980s, which in Europe meant primarily Germany and Switzerland, and, outside Europe, the US and Japan. All of these had independent central banks, and systematic international research showed

there to be a close and stable link between the level of central bank independence on the one hand and low inflation on the other (Alesina and Summers 1993; Busch 1995). In banking regulation, no such empirical case could be made: while there are far fewer systematic comparative studies in this area, those that exist show no clear link between institutional characteristics and performance, for example, in terms of avoiding bank failures or systemic crises (Barth *et al*. 1997; Busch 2001b).

With respect to the intellectual underpinnings of the connection between institutions and outcomes, there is a similar difference between the two policy areas. While monetary economists have written extensively about the theory underlying the superior performance of independent central banks,[35] and the respective theory has obtained the status of an orthodoxy in the meantime, theoretical models in terms of banking supervision are far less developed. What is more, the relevant policy actors in different countries disagree strongly about the desirable characteristics that are to be achieved. While the Bank of England and the Financial Services Authority stress the advantages of keeping monetary policy and banking supervision apart,[36] the Federal Reserve System in the United States – in an effort to stabilise its strong involvement in banking supervision – continues to argue strongly the case in favour of synergies between the two tasks (see, e.g., Peek *et al*. 1999).

Both empirically and theoretically, we can thus conclude, in banking supervision there is no obvious model that could have served as a point of reference in the policy debate. Or, in the words of the consulting firm Arthur Andersen in its report on this subject for the Bank of England: 'There is no overall model which can be considered "best practice"' (Andersen & Co 1996: 5). In the absence of such a model that could have provided a 'focal point' (Garrett and Weingast 1993; Busch 1999) in the vast range of potential solutions to the problem of banking supervision, states were faced with continued uncertainty and, thus, rather than converge on a common solution, continued to follow their own policy trajectories, with the main influences being own past experiences and present specific challenges.

CONCLUSION

Despite the closer integration of world markets that took place in the last decades, especially in the sphere of financial markets, and despite European integration gaining pace during that time, national financial systems have far from converged, or, as two economists have put it in a detailed study on the subject, '[n]ational financial systems in the EU remain distinct' (Story and Walter 1997: 315).

The same is true for the respective systems of regulation. In terms of regulatory content, there is no 'level playing field' because EU Directives leave room for national implementation, which means that different 'opt-out' clauses and effects of national tax systems result in divergent outcomes (Molyneux 1996: 259–64). That point can be made even more strongly in the dimensions of polity and politics, as the above case studies have shown: both national institutions and policy-making processes have shown a remarkable degree of resilience and resistance to change towards a common model. This fact is often missed by accounts of European-level policy that exclusively take a top-down perspective, looking at action and Directives on the supranational level and analysing how they are being implemented; the bottom-up perspective taken in this article reveals that events at the national level are in large part driven by what is happening in the national system rather than by 'pressure from above'.[37]

This is not only true for institutions, but also for policy discourses. Far from having a common 'master discourse', the dominant debates in different countries varied widely – if there was much public debate at all. In Britain and Germany, it was argued, politicisation of the issue of banking supervision was generally low. In other countries, however, where politicisation was higher, we find that the issues that shape policy discourses are decidedly national in character:[38] in Switzerland, for example, the topic of money-laundering dominated the debate in this policy area in different guises for most of the time under consideration, ranging from the 'Chiasso' scandal in 1977 and secret accounts for various dictators in the 1980s to the debate about the handling of money from Nazi victims in the 1990s. In the United States, long-standing debates about reform of the system of banking supervision were framed in different ways over time as a function of national debates such as that about the perceived 'American decline' in the late 1980s and early 1990s.

Contrary to what one might have expected in the face of increasing integration of financial markets over the last decades, this does not seem to have led to increased policy transfer and emulation on functional grounds. Rather, national patterns of institutions, of politics and policy-making processes have displayed a high degree of stability. Together with country-specific events, these factors have largely determined the policy trajectories of different countries. Like national filters, they have limited the effects of globalisation and European integration.

How do these results fit with other research in this area? Specifically for banking policy, the findings support those put forward nearly a decade ago by William Coleman (1994), who – comparing five countries in Europe and

North America – concluded that there was 'remarkably little convergence' between the different systems and the way they conducted policy, and that none of the mechanisms put forward by the policy transfer literature had had a strong impact (Coleman 1994: 292). More generally, and concerning the impact of globalisation on governance, many recent contributions have stressed the importance of 'bringing domestic institutions back in' (Weiss 2003). With respect to the effects of European integration (which, if anything, should produce even stronger homogenisation as countries respond to common EU Directives and regulations), much recent research has emphasised that 'national institutions and actors matter, in the sense that they have a profound, if not determining, effect on how European integration as a force of polity and politics change plays out in the domestic context' (Hix and Goetz 2000: 20). Moreover, and contrary to many expectations, national administrative systems show a great degree of 'persistence' in the face of such mechanisms as 'coercion', 'imitation', 'adjustment' or 'polydiffusion' that were assumed to operate within the European Union (Page 2003).

Whether a comparative study on 'policy convergence in banking' (Coleman 1994) in another decade's time will come to similar conclusions remains to be seen. Two processes in particular are under way that may change the dynamics in this policy area. On the international level, there are negotiations for a 'Basel II' agreement on banks' own capital ratios that have been going on since 1999.[39] Even after four years of intense negotiations, some issues are still hotly debated between the participants (*The Economist* 2003). A final analysis of this ongoing process, however, will only be possible after an agreement has been reached.

At the European level, any such agreement will affect policy-makers' choices, but a potentially more powerful effect emanates from the introduction of the common currency, the Euro. As a result, one can speculate, pressure may grow to increase the co-ordination of national supervisory systems, and that could result in greater influence for the European level. Recent media reports, however, seem to indicate that movements in that direction are not primarily motivated by practical considerations, but rather by competing political ones: while some wish to install their own supervisory system at the European level – where it would function as a role model – others want to rein in the power of the central banks, and still others are eager to have their country chosen as the seat of such a European-level supervisory body.[40]

NOTES

1. For comments and suggestions on earlier versions of this paper I am grateful to Bob Hancké, the editors of this volume, the participants of the Oxford workshop on 'Opening the Black Box: Europeanisation, Discourse, and Policy Change' in November 2002, and an anonymous reviewer. Still, the usual disclaimer applies.
2. For an overview of reasons for state regulation of the banking sector and various means of doing so, see Busch 2001b.
3. For an overview to this literature, see Busch and Braun 1999.
4. For these mechanisms and policy transfer more generally, see Bennett 1991; Dolowitz and Marsh 1996.
5. For a more detailed description and analysis of these directives see, e.g., Molyneux 1996.
6. In particular, analyses of the cases of France, Spain, Sweden, Switzerland and the United States will be taken into account (Bovens *et al.* 2001b; Busch 2003).
7. Although the Bank of England Act 1946 authorised the BoE to issue directions to banks, it envisaged no sanctions in case such directions were not followed. However, the BoE never made use of this instrument anyway (Reid 1988: 207).
8. The so-called Competition and Credit Control legislation of 1971, on which see Hall 1983.
9. A commitment to nationalisation of the 'Big Four' had already been incorporated in the 1974 Labour Party election manifesto, see Schultze-Kimmele 1978: 31.
10. New 'minimum standards' were introduced into the 'Basle Concordate', which resulted at the European level in the 'Post-BCCI' (95/26/EC) Directive (Herring 1993: 84ff.).
11. For a detailed description of the case see Tickell 2001, for the more technical aspects Chew (n.d.), which estimates the value of the futures contracts at the time of the bank's insolvency at US$27bn.
12. For example, personnel fluctuation in the BoE's supervisory branch was twice as high as in other countries, while the average age of supervisors was (at 30) ten years lower, with respective lack of experience (Andersen & Co. 1996: 29).
13. Even insiders were surprised by this move (Interviews, FSA, 15.10.1999; BBA, 6.10.1999), and one can only speculate about the government's motives. Two above all seem plausible: to change what had come to be seen as a 'culture of complacency' in supervision, and to prevent the BoE (which had only two weeks before been given independence in monetary policy) from becoming too powerful.
14. The Governor even pondered his resignation about this matter (*Financial Times*, 22.5.1997).
15. The Financial Services and Markets Act 2000 was only implemented in December 2001.
16. Those were the commercial banks, the communally-owned savings banks and the co-operative banks with their respective sectoral peak associations *Centralverband des Deutschen Banken- und Bankiergewerbes*, *Deutscher Sparkassen- und Giroverband* and *Hauptverband deutscher gewerblicher Genossenschaften* (Busch 2003: chapter 5.1).
17. See Landesbank 1983: 195. This is important to note as it is normally assumed that liberalisation comes about as a result of market pressure. Often, as historical research shows, this is not at all the case. Rather, liberalisation had to be imposed on an industry that lived quite comfortably in strongly regulated and segmented financial markets.
18. Deutscher Bundestag, Drucksache V/3500 (18.11.1968).
19. The following description draws on a more detailed analysis of this policy episode in Busch 2001a.
20. In the case of the savings banks and the co-operative banks, BAKred could also build on the work of the respective peak organisations' auditing arms to which all member banks had to subject their annual reports. See Schneider 1978: 42ff.
21. On the LiKo-Bank, see Wagner 1976: 99ff.
22. See Finance Minister Apel in Deutscher Bundestag, Stenographische Berichte, 7/176. Sitzung, 5 June 1975, 12357ff.
23. Indeed, at the time, there was vocal criticism of the power of the banks both on the political Left and among economic liberals, see Busch 2003: chapter 5.2.2.
24. The report was, however, worthwhile for its comprehensive gathering of important statistics on the German banking system. See Studienkommission 1979.

25. Whether such an imposition would have been successful, however, is not at all certain. Indeed, the Ministry of Justice internally raised constitutional reservations against the initial government plans (Bundesbank 1992: 31ff.). Implementation of it might thus have been time-consuming, costly and with an uncertain outcome, something that will undoubtedly have influenced the strategic choices of the government.
26. Some notable cases: for the United States see FDIC 1997, for France Coleman 2001, for Spain Pérez 2001 and for Sweden Tranøy 2001.
27. A detailed description of this policy episode can be found in Hall 1983: chapters 1 and 2.
28. The result of modest policy change is thus partly a function of case selection in this study. Had systems been selected that were less 'liberal' in the early 1970s, greater policy change could have been observed that would easily qualify as paradigm changes (from isolated, state-run systems to internationally open, market-driven systems). For more detailed studies of such cases (and the motives and problems of making the change) see, e.g., the studies on Sweden by Tranøy (2001) and on Spain by Pérez (2001).
29. Interview Bank of England, 13.10.1999.
30. Whether the reforms that led to the setting up of the FSA in 1997 prove different remains to be seen.
31. Interview BBA, 6.10.1999.
32. The BdB, for example, employs more than 70 people at its headquarters (Interview, BdB, 3.2.2000).
33. Although it has to be said that the number of policy actors is reduced in this particular case, owing to the federal level having exclusive responsibility for banking legislation – which keeps the Bundesrat, the chamber of the *Länder*, from exerting important influence.
34. See the respective case studies of Coleman (2001), Pérez (2001), Tranøy (2001) and Busch (2003: chapter 4).
35. See Kydland and Prescott (1977) as a starting point, or Walsh (1995).
36. An advantage, it has to be said that at least the BoE only really discovered after the events of 1997 forced it to do so.
37. Even the very recent institutional changes in Germany – where in early 2002, the supervisory authorities for banking, securities and insurance were merged under a single umbrella, ending (in the case of banking supervision) more than four decades of institutional stability – seem to support that perspective. For these changes – which at first sight seem to emulate Britain's move with the *FSA* towards a single regulator for all financial industries – were not primarily triggered by pressure from European or international integration, but by the fact that the Bundesbank (after the introduction of EMU) was left without a serious *raison d'être* and tried to take over banking regulation – unsuccessfully.
38. For further exposition of the following, see Busch 2003: chapters 4 and 7.
39. The mere fact that these negotiations were deemed necessary towards the end of the 1990s is a powerful indicator of the remaining differences between national systems of regulation and supervision in this area.
40. *Frankfurter Allgemeine Zeitung*, 13.4.2002, 14.

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