The Politics of Financial Regulatory Reform and the Privatization of Risk

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Draft…comments welcome

Britain and Germany, two of the European Union's largest economies, have made radical changes to their financial regulatory institutions over the past decade. Both states have created a new single financial regulator, replacing the functional separation of responsibility between banking, securities and insurance regulators. However, the study argues that the change is more fundamental than just a functional redesign and perceives two defining characteristics of the new regulatory regimes of both states, albeit to a more limited degree in the case of Germany. First, the replacement of a corporatist regime characterized by a high level of self-regulation to one controlled by a single, powerful, state actor that is clearly accountable to the government and parliament. Second, a diminution of the role of the respective central banks in financial regulation, with in Britain the complete removal of the Bank of England in its role as a regulatory actor, while in the case of Germany, a major rebuff to the Bundesbank in its attempts to expand its regulatory role. Both characteristics can be indicated as a desire by state, and in particular, political actors to increase their oversight of financial markets.

Given the significant role of financial regulation in determining the 'rules of the game" as they apply to the conduct of savings and investment markets, an increased oversight role for state actors is therefore important. These rules are important in shaping policy outcomes that have significant distributional consequences so private and state actors can be assumed to have distinct preferences about the design and structure of regulatory institutions, particularly the balance between self-regulation and the role of the state. An explicit decision by political actors therefore to limit the role of private actors in financial regulation and to increase state oversight of financial markets in an attempt to ensure the accountability of markets to political institutions, can therefore be perceived as an important change in the relationship between the state and markets

The paper argues that arguments used to explain previous changes in regulatory regimes such as American regulatory hegemony, Europeanization, the pursuit of economic efficiency, and the role of ideas and epistemic communities cannot adequately explain this shift from a corporatist to a state regulatory regime[i]. Instead it is argued that the new regime is best explained by understanding the changed incentives of political actors arising from the increased salience of financial regulation as a political issue and the subsequent desire to create a regulatory institutional actor that is clearly accountable to political actors. A determining factor in increasing the salience of financial regulation is the shift in financial risk to the household sector, described here as the privatization of risk (IMF 2005) This shift has two important components; first, in terms of pensions, the increasing exposure of individuals to investment risk due to the reluctance of both the state and firms to provide guaranteed returns and second, the increase in risk assets as households shift out of bank deposits to increased stock holdings. For politicians such a risk exposure creates a situation where the pursuit of policies designed to protect the interests of these potential voters in terms of regulation becomes electorally attractive, and creates an incentive to challenge the regulatory status quo as in the corporatist/self-regulatory model.

The paper argues that political actors, as recognized by Polyani in a previous era, have incentives to insulate individuals from economic risk, and in this situation to create regulatory institutions accountable to the political system to pursue this objective (Polanyi 1944). However, the paper recognizes that political actors are not the only state actors interested in regulatory change, but are joined by government actors as represented by the

Treasury (or Finance ministry), concerned to ensure an efficient system of financial regulation in order to ensure the competitiveness of the domestic financial sector.

The paper uses therefore a "coalitions theory", initially espoused by Gourevitch and later by Frieden, Rogowski and others, which explains institutional change by tracing the evolving preferences of the relevant state and private actors and the changing coalitions that they form (Gourevitch 1986, Rogowski 1990, Frieden 1991). In terms of financial regulation this was an approach that Moran pursued in his study of the evolution from a self-regulatory to a corporatist regime in Britain in the eighties, and Luetz in her study of change in German securities regulation in the early nineties (Moran 1991, Luetz 1998). However, where the paper differs from previous coalition theory constructs is an explicit examination of the preferences of elected politicians as a specific state actor. The paper argues that the separation of elected politicians' preferences from those of other state actors is warranted because the changes in savings markets triggered by the privatization of risk has made electoral incentive relevant, where previously there was little incentive for political actors to become involved in a policy area that could be described as classic "low politics".

It examines therefore the preferences of three distinct state actors; elected politicians, the officials at the Treasury/Finance ministry, and central bankers. In terms of private sector actors, the paper examines banks, investment banks, pension funds and insurance companies by tracing the preferences of the trade groups that formally represent them. The paper argues that the shift to the new state regime was explained by a new coalition between elected politicians and Treasury/Finance officials and that this new coalition led to the subsequent exclusion of central banks which had been deeply involved in the design of the previous corporatist regimes.

The paper therefore perceives financial regulatory regimes as politically contested Polyani (1944) (Zysman 1983), with institutional "winners and losers" and central bankers identified as the losers. The evolution of the new regulatory regime provides support therefore for Thelen's argument that all political institutions depend upon political support for their continued existence (Thelen 2004). In this case, the privatization of risk has led to specific incentives for political actors, thereby ending the cohesion of the state actors involved in designing the previously corporatist regimes.

This separation of state actors allows therefore for an explicit exploration of the role that partisan politics has played in the creation of the new regulatory regimes and allows for a hypothesis as to why in both cases it was center-left parties that decided upon the change. The paper argues that, there was a clear electoral strategy for center-left parties in reaching out to potential voters affected by the changes in savings markets by offering policies that protected the consumer interest in financial markets. It also offered an appeal to traditional left support as it also asserted the state's role in its relationship with financial markets.

The paper looks therefore to an endogenous explanation of regulatory change as opposed to the exogenous explanations contained in much of the literature looking at financial regulation. Moran looked primarily to "Americanization", where the "agenda of regulatory change in Britain was an agenda set by American events and American influences" as an explanation where British state and private actors had little choice but to acquiesce if London was to remain a competitive financial center (Moran 1991: 132).[ii] Such an argument is closely related to Strange's notion of American "structural power" in financial markets (Strange 1996). Luetz in her study of German securities' reform in the late eighties and early nineties again points to the influence of the American Securities and Exchange Commission as a catalyst in persuading key state actors of the need to create a securities' regulator (Luetz 1998). Coleman, in his study of financial regulatory regimes in the US, Britain, Germany, France and Canada describes a pattern of closed networks, high levels of self-regulation (Coleman 1996). Vogel in his study of regulatory change again argued that state actors were primarily motivated by exogenous pressures to reform the governance of British financial markets (Vogel 1996). For Laurence, it was the "exit" threat of increasingly mobile investment capital that was important, a different variant of the American structural power argument, given that the vast majority of global capital was American in origin (Laurence 2001). A further variant is that of Simmons who sees the US as a dominant "regulatory innovator" that through strategic interactions with other state and private actors has triggered international regulatory harmonization (Simmons 2001).

This paper argues that the hypotheses put forward are of obvious importance in explaining why corporatist regulatory regimes were created but cannot adequately explain the shift to the state regimes observed in the two cases and that we must look at partisan politics and changing incentives of political actors in order to understand the change in regime. There are obvious parallels with some of the arguments of Cioffi and Hoepner and Gourevitch and Shinn in their analysis of changes in corporate governance regimes. They also point to the increased incentives for center-left parties and union actors to promote change in corporate governance regimes and to develop "transparency coalitions" alongside those of owners (Cioffi and Hoepner 2004) (Gourevitch and Shinn 2005).

Case Selection

The two states chosen for selection as cases can be justified in terms of a “most different” argument in terms of both their political and economic institutions (Przeworski and Teune, 1970). Britain is in Lijphart’s classic typology, a majoritarian state with relatively few veto points (Lijphart 1999). In terms of its economic system, it is classified as a state where equity based financing of firms has played a decisive role (Zysman 1983). Germany, by contrast, is characterized as a consensual state, with its federal political structure ensuring many political veto points (Lijphart 1999). In terms of its economic system, it is traditionally characterized as a bank based financial system with a significant level of state-ownership (Zysman 1983). In terms of political economy, the two states are generally considered to be the classic examples of the two ideal types, with Britain as a liberal market economy and Germany as a coordinated market economy (Hall and Soskice 2001).

The paper proceeds as follows. First, it describes the evolution of the previous regulatory regimes in the two states. Second, it examines why existing hypotheses struggle to explain the perceived shift from corporatist to state regimes. Third, it describes the privatization of risk and the pension reforms in both states before explaining its implications for financial regulation. Fourth, it argues why the privatization of risk has offered center-left parties an electoral opportunity to appeal to voters that are also financial consumers. Fifth, it proceeds with a description of the changing preferences of the state and private actors in both states. Finally, it draws implications from a comparison of the cases before considering some conclusions.

The Evolution of the Corporatist Regimes:

Britain

The evolution of the financial regulatory systems reflects the different institutional endowments of the two states' contrasting political and economic systems. As Moran describes, British financial regulation, with the exception of insurance, was originally what he terms a club-based system (Moran 1991). This was characterized by little if any statutory regulation of either the banking or the securities industries but instead a system organized by self-regulatory groups. There was no statutory role for the Bank of England as the formal regulator of the banking system until the 1979 Banking Act (Reid 1982, Moran 1986). Securities regulation was effectively determined by the self-regulatory code of the Stock Exchange until the passing of the 1986 Financial Services Act. The passing of the second piece of legislation established what Moran has termed as a *meso-corporatist* regulatory regime with the statutorily empowered Securities and Investment Board (SIB) overseeing a range of Self Regulatory Organizations (SROs) that were created from previously existing self-regulatory groups.

In terms of why club regulation was ultimately replaced, Moran, Vogel and Laurence all point to essentially exogenous explanations of change with differing variants of "Americanization" perceived as key. The central actors in promoting change were those of the state and not the market, with the Department of Trade and Industry (the Treasury took responsibility for securities regulation in 1991), and the Bank of England ending their support for Stock Exchange self-regulation due to the need to ensure the continued competitiveness of the City of London so that firms with access to capital could compete with the increased threat of the power of well- capitalized US financial institutions. In terms of the role of the state, the 1986 legislation was a decisive step away from self-regulation to a regulatory system that loosely resembled the US regime with the SEC and the Federal Reserve overseeing self-regulatory organizations. The new British regime was also clearly corporatist because significant regulatory powers were left in the hands of the self-regulatory bodies or practitioner bodies.

If state actors were largely motivated by desires to ensure the competitiveness of the City amid increased competition, none of the accounts point to private market actors as having played a decisive role. Initially, domestic institutions in the securities markets were clearly primarily interested in protecting their domestic franchise from foreign competition and opposed any change in the regulatory status quo. However, it is also clear that private financial actors were not a monolithic bloc with the larger merchant banks, in particular, desirous of change so as to allow them to play on a larger financial stage (Vogel 1996).

The Unraveling of Corporatism

The new regulatory regime was controversial almost immediately. Two major scandals came to light in terms of pensions, both of which were deeply embarrassing to the government and the SIB/SRO regime. The financial collapse of the Maxwell media empire following the death of Robert Maxwell in 1991, brought to light evidence that the pension assets of the Mirror group were being used to provide financial collateral for other parts of the family business and that the relevant SROs had neither detected the fraud or had sufficient powers to prevent it. However, it was evidence of pension misselling that caused even greater political embarrassment for the Conservative government. The Thatcher government had introduced private pensions in 1988 that used fiscal incentives to encourage some 7 million people to opt out of both SERPS (State Earnings Retirement Pension Scheme) and occupational schemes to take up a personal pension in their place (Institute of Fiscal Studies 2000). However, evidence quickly came to light that many people were persuaded to opt out of schemes against their best interests, thereby provoking a major pensions' mis-selling scandal that proved to be highly politically controversial. Again, the regulatory regime had neither flagged the problem nor had the SROs proved to be effective in quickly punishing the relevant institutions or pointing the figure at senior figures within the miscreant firms.

The regulatory failures were not only related to pensions and the securities industries. Two major banking failures in the first half of the nineties brought the supervisory role of the Bank of England under major review. The BCCI failure in 1991 was a high profile supervisory embarrassment, bringing into doubt the Bank's ability to oversee institutions with major overseas operations. However, it paled into insignificance as compared to the collapse in February 1995 of Barings, one of the most venerated names in the City of London, following the failure to observe a derivatives trader's massive losses (Gapper and Denton 1996). The failure prompted both a independent inquiry and a House of Commons Select Committee inquiry into the Bank's supervisory role, both of which were very critical.

<u>Creation of the FSA</u>

The New Labour government, some two weeks after winning the General Election in May 1997, announced the creation of a single regulatory authority. While the new regulator initially retained the name of the previous statutory regulator, the SIB, it was markedly different in terms of its powers. First, the self-regulatory organizations, the SROs were disbanded and their functions were merged into the statutory body. Second, the supervisory functions of the Bank of England for the entire banking system were transferred to the new entity. Some few months later, the organization was renamed the

Financial Services Authority (FSA). Given these new powers, the creation of the FSA clearly marked a dramatic shift in the relationship between the British state and financial markets by sweeping away all vestiges of the self-regulatory regime, stripping the traditional conduit between the City and the government of its oversight function and creating what can described as a new regulatory paradigm.

Germany

The German financial regulatory regime was quite different to that of Britain for two reasons. First, the tradition of corporatism was much more deeply embedded, reflecting the consensual nature of the political system. Second, and more fundamentally, it reflected the limited role of capital markets in the German economy and a financial system that was clearly bank based.

The role of the state in banking regulation has had a relatively long history, dating back to the banking failures of the thirties, but in a modern context was formalized with the creation of the Bundesaufsichtamt fur das Kreditwesen (BaKred) in 1961 (Muller 2002). However, given the limited role of formal regulation at this time, the legislation did not formally differentiate the role between the BaKred and the newly created Bundesbank, but an informal agreement was arrived at where the BaKred determined regulatory policy and the Bundesbank, using its federal structure, carried out the actual mechanics of site supervision. [iii]

A defining comparative element of the German regulatory system was the lack of a federal securities regulator prior to the creation of the Bundesaufsichtamt fur den Wertpapierhandel (BaWe) in 1994. Luetz describes how the “Frankfurt coalition”, made up of both state and private financial actors, had lobbied for securities reform since the late eighties as the private banks, in particular, were concerned that their competitive position was undermined by the lack of formal regulation, damaging Finanzplatz Deutschland and risking access to global capital markets (Luetz 1998). The key members of the Frankfurt coalition, as described by Luetz, were the Bundesbank, the Finance ministry and the private bankers' trade association, the Bundesverband Deutscher Banken (BdB). As in Britain in its securities reform, the key state actors, the Finance ministry and the Bundesbank were in agreement on the need for securities regulation. Karl Otto Pohl, President of the Bundesbank made a strong statement in 1989, committing the central bank to reform. The key difference with Britain was the importance of key private sector actors in advocating for new regulatory institutions.

The period between the creation of BaWe in 1994 and the decision to merge the regulators in 2001 was not marked by the high-level financial failures as in Britain. However as is discussed later, there was an important shift in German savings markets as the shift out of cash deposits into risk assets gathered momentum following the privatization of Deutsche Telekom and the dramatic rise in equity markets in the late nineties.

Creation of BaFin

In Germany, the SPD/Green government announced the creation of a single financial regulator, BaFin in January 2001. This new institution merged the three existing regulators, BaKred the banking regulator, BaWe the securities regulator, and BaV, the insurance regulator. The announcement followed what Schuler describes as "a heated public debate" that went on for almost two years reflecting the federal, consensual nature of the polity before Hans Eichel, the Finance minister announced his decision (Schuler 2004: 12). The minister used similar terminology to that of Gordon Brown as he claimed that the new regulator would be both more efficient for Finanzplatz Deutschland and that it would serve the interests of financial consumers.

Alternative Hypotheses

At this stage of the paper, it is appropriate to assess why existing hypotheses used to explain regulatory change struggle to explain the shift from corporatist to state regimes in the two cases.

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Americanization/Europeanization hypothesis

The term Americanization understands regulatory reform as an "American creation and a response to American circumstances", to use Moran's definition (Moran, 2002: 266). Other variants use the term regulatory hegemony, and as a broad concept is perhaps the most widely used hypotheses as an exogenous explanation. The causal mechanisms in explaining change in this argument are, therefore, the increasing importance of American financial firms, both globally but particularly in Europe, which has forced European governments to adopt U.S. style regulatory regimes, if they wish their financial centers to be attractive to U.S. firms, and if they wish to allow their firms be able to participate in the American market. However, a quick comparison of the very diffuse US regulatory system, which has key roles for the Federal Reserve as overseer of the banking system, the SEC for the securities markets, state regulation of insurance companies, and a range of other regulatory agencies for other financial institutions, means that is little evidence of a regulatory impulse from Americanization (Government Accountability Office 2004)[iv]. Indeed, corporatism is still a defining feature of US financial regulation, as the continued, if controversial, self-regulatory roles of institutions such as the New York Stock Exchange prove. The removal of the Glass Steagal restrictions on different types of banking activities, has allowed for a greater degree of financial conglomeration, but there is little evidence that financial firms are advocating regulatory consolidation. In terms of state actors, the Federal Reserve chairman Alan Greenspan, has specifically ruled out the case for consolidation (GAO 2004).

Europeanization, defined by Risse et al as *emergence and development at the European level of distinct structures of governance* (Cowles, Caporoso and Risse 2001) has also played no role to play in the shift from corporate to state regimes. Given the diverse designs of national regulatory structures, with major states in the European Union, such as France, Italy and Spain maintaining functional separation, both the Lamfallussy proposals, the Financial Services Action Plan and the European Parliament have shied away from proposing unanimity in regulatory design. However, there are interesting parallels with the German and British cases, when EU governments decided not to give the ECB a role in overseeing the supervision of banking despite very active lobbying for such a role (Padoa-Schioppa 2004). Instead they decided to create functional EU level regulators, with a banking regulator in London, securities in Paris, and insurance in Frankfurt, thereby retaining the right to merge them at a future date. (Davies 2004).

Economic Efficiency Hypothesis

Financial institutions, and the products that they sold, began to become increasingly similar during the nineties. The rise in both the number of financial conglomerates, the bancassurance model, and a situation where banks, insurance companies and securities houses all sold each others' products, began to make the case for a division of regulators on functional grounds, appear increasingly anachronistic (Lumpkin 2002). For financial firms there was the attraction of reduced transaction costs in interacting with fewer regulators. For Treasury/Finance actors there was the appeal of a more efficient regulatory structure, improving the competitiveness of domestic financial centers while also allowing for a better appraisal of financial firms' total risk, thereby reducing the risk of regulatory failure (Davies 2004, Padoa Schioppa 2004).

However, for central banks, such changes created two specific problems. First, such changes took them away from their areas of banking expertise, and exposed them to consumer regulatory issues which they traditionally had little experience. Second, it raised the issue of moral hazard in so far as the question as what financial institutions were to be covered by the central bank's traditional lender of last resort function (Goodhart 2002). These problems coincided with an important change in the relationship between governments and central banks, as the Bundesbank paradigm of monetary policy independence became increasingly the norm following the Maastricht Treaty, leaving the question as to the accountability of central banks' prudential responsibilities in an awkward position. A further question arose in states that signed up for European Monetary Union and thereby relinquishing responsibility for monetary policy to the European Central Bank, as to what exactly was the role and continued responsibilities of a central bank. Central banks were placed therefore in an awkward dilemma that proved to have important consequences for their regulatory roles.

A financial efficiency hypothesis appears therefore to offer some strong arguments. For state actors, there was a clear incentive in terms of improving the ability to assess the risk of financial institutions. For private financial actors, there was the attraction of lower transaction costs. Is it possible to argue that the pursuit of increased economic efficiencies could alone explain regulatory reform? There are three important arguments as to why such an argument is not sufficient to explain the regulatory change we have observed.

First, it would be a fair assumption that states with the most integrated financial institutions would have the greatest incentive to merge their regulators. However, as

Table 2: Bank and Insurance Market Share of Financial Conglomerates

	% Banking	% Insurance	Total
Britain	57	12	69
Germany	10	75	85
France	67	30	97
Italy	37	21	58

Prast and van Lelyweld (2004)

Table 2 points out, this does not appear to be the case as neither Britain and Germany have comparably different level of integration as compared to France and Italy which have chosen not to integrate their regulatory structures. Second, the fact that the United States, the state with the largest financial services sector economy in the world has chosen not to merge its regulatory structures appears to indicate that other hypotheses are required. This assumption is supported when it is considered that three large EU member states; France, Italy and Spain have also chosen not to merge their regulators. Third, particularly in the British case, Treasury/Finance actors were not able to persuade right of center political actors when in power to agree to regulatory reform. Economic efficiency arguments therefore depend upon government actors to be persuaded upon their political advantage.

However, where economic efficiency does play a role in explaining change was the added impetus the creation of the FSA gave to both German state and private actors interested in promoting regulatory change, an argument that without a single regulator, Finanzplatz Deutschland was again placed at a competitive disadvantage.

Ideas/Epistemic Communities Hypothesis

The role of ideas and epistemic communities in explaining change in economic institutions has become increasingly popular over the past few years (Haas 1992, Hall 1993, McNamara 1998, Schmidt 2002, King 2005). McNamara has laid out a useful three-stage ideational model that explains how ideas and the epistemic communities that promulgate them can be significant in explaining change based on policy failure, paradigm innovation and policy emulation (McNamara 1998). In the case of Britain, there was a clear case of policy failure in the corporatist regulatory regime. However, for the state and private sector actors interested in promoting change during the mid-nineties, there was no obvious regulatory paradigm to turn to when considering reform of their regulatory structures. The only OECD states that had chosen to consolidate their regulatory structures into a single regulator were the three Scandinavian countries, Norway in 1986, Denmark in 1988 and Sweden in 1991, and as Taylor and Fleming describe, they were different from virtually all other OECD states in so far as their respective Central Banks had never had responsibility for banking supervision (Taylor and Fleming 1999). As described, the US, the regulatory regime that had provided the paradigm for the previous iteration of regulatory change, did not change its functional separation of regulatory responsibilities.

In terms of the epistemic communities, neither of the two key academic reports suggested a single regulator, but rather a "Twin Peaks" model where the prudential and the conduct of business activities of regulation were to be housed in separate regulatory institutions (Taylor 1995, Goodhart 1996).[v] However, there is no evidence that British Treasury actors actively considered the adoption of the Twin Peaks model when deciding upon the new regulatory architecture. Britain decided therefore, in McNamara's terms, to create a new regulatory paradigm.

For Germany, the use of McNamara's model does offer some interesting applications. While the previous regulatory regime did not fail in a dramatic sense, the creation of the FSA and the apparent success of its new paradigm, did offer German actors interested in promoting a new regime a template that could be used as an example when promoting regulatory change. Policy emulation was therefore potentially significant in explaining the creation of BaFin. However, as with the economic efficiency argument, there is considerable doubt as to whether a CDU/FDP government had been elected in 1998, BaFin would have been created even with the existence of the FSA model.

Privatization of Risk

At this stage it is important to expand upon the term privatization of risk and to tease out why it is important in explaining the changed political incentives of political actors and, in particular, center-left parties. As the IMF has pointed out, there has been a marked shift in the bearing of financial risk from the state, firms and financial institutions to the household sector over the past decade (IMF 2005). The result in terms of pensions is that households have had to take on "more responsibility for ensuring sufficient contributions to their defined plans, for generating adequate investment return from those plans and for coping with the longevity risk" (IMF GFSR April 05: 4). They also point to the "growing use of mutual funds and direct holdings of stocks and bonds by retail investors have exposed the household sector to market fluctuations". There are important differences between Britain and Germany in the degree to which the privatization of risk has occurred, with change happening earlier and more radically in Britain. In terms of the British case, the Conservative government of Margaret Thatcher had changed the pension system in 1988 by giving fiscal incentives to encourage individuals to shift out of the both SERPS (State Earnings Retirement Pension Scheme) and occupational schemes into private funded schemes where both the level of savings and the degree of investment risk passed to the individual. Such schemes proved to be very popular with some 7 million people taking advantage of the incentives (IFS 2002). However, this was only one component of other changes in the pension system. Parallel to the change in the state system, was the decision by increasing number of firms in the nineties to alter their pension systems from one of defined benefit to defined contribution schemes (Pension Commission 2004: 85). Again, this shift meant that instead of the firm guaranteeing an employee a pension of a certain percentage of salary, the decision on both the level of pension savings and the type of investment risk was transferred to the individual. The Pension Commission estimated that almost one in five firms changed their schemes between 1995 and 2000 (Pension Commission 2004: 85). For the government and firms, the incentive was clearly to reduce costs as demographic changes made pensions an increasingly large future liability (Pierson and Myles 2001). For the individual, the defined contribution pension meant a very explicit exposure to the volatility of financial markets in terms of determining the ultimate size of their pension savings.

The major changes to the German pension system were not enacted until 2001 with the introduction of what became known as the Riester reforms (WEP 2005). The fundamental nature of these reforms was the introduction for the first time of a defined contribution occupational scheme where employees receive fiscal incentives to participate and where the funds have to be invested in the financial markets. These funded schemes leave the decision to the individual worker to decide where to invest their contributions. While the uptake of the new scheme was initially disappointing, and further changes followed in 2003, the reforms marked a major long-term shift away from state pension provision to one dependent upon financial market returns.

However, the introduction of funded pensions was only one, if very significant element of the privatization of financial risk. Both governments have offered tax incentives over a prolonged period to encourage long-term savings, which while structured differently, had a similar effect of encouraging individuals to switch their savings out of bank deposits into risk assets such as stocks and mutual funds managed by financial institutions. The encouragement of citizens to buy shares in privatized state companies was a further aspect of the state's encouragement of the purchase of risk assets. In the German case, a significant element of the structuring of the financial risk continues to be borne by financial institutions due to the tradition of a guaranteed return on investment products. The risk of failure of a German financial institution has therefore potentially significant consequences.

Table 1. Composition of household assets (in % of gross financial assets)

		1980	1990	2000

Britain	Deposits	43	31	22
	Risk Assets	53	61	74
	Bonds	7	1	1
	Equities	12	12	17
	Institutions	30	48	56
Germany	Deposits	59	48	34
	Risk Assets	33	44	60
	Bonds	12	16	10
	Equities	4	7	16
	Institutions	17	21	34

Source: Davis 2003

Privatization of Risk and Regulatory Reform

What does this transfer of risk from governments and firms to individuals mean for the politics of financial regulation? There are two, related paths that can be identified as important in influencing the incentives of political actors. First, the increased exposure of voters to the viscitudes of the financial markets gives politicians a clear incentive to ensure that that the interests of these financial "consumers" are represented in the governance of those markets. Second, there is an increased incentive for political actors to ensure that savings institutions, such as banks, mutual funds and insurance companies, where voters place their savings, are well run and remain financially solvent. It is clear that the incentive for state actors to ensure that financial institutions do not fail is not new. The introduction of deposit insurance and lender of last resort mechanisms to ensure confidence in the banking sector is evidence of such an incentive. However, the argument here is that the shift in risk to the individual raises the political costs of financial failure thereby making the prevention of such failure more desirable.

However, as the privatization of risk increased and with it the number of voters exposed to financial markets, it was the incentive to create a regulatory institution with a strong consumer mandate that became a new phenomenon. An institution with such a mandate can be seen both to play a proactive role in creating suitable safeguards for financial consumers while also allowing for a level of blame avoidance when regulatory failures do occur.

It is important to point out that this objective of consumer protections can, however, come into conflict with the political incentive to promote other macroeconomic goals. In this regard, Lindblom's famous phrase " the privileged position of business" in capitalist democracies encapsulates the regulatory dilemma faced by government actors as states depend upon private entrepreneurs to develop and run businesses that generate wealth (Lindblom 1977). A regulatory regime must therefore balance the interests of financial consumers with those of private financial actors that have played an increasingly important role in the economy while also determining the capacity of business to generate wealth by providing credit and the means by which savings are invested in the economy. Such private financial actors are quick to point out the onerous nature of regulation in terms of cost and the effect on a financial center's competitive position.

Center-Left parties and Consumer Protection

The paper argues that it is not a coincidence that center-left parties in both our cases have initiated regulatory change. It can safely be assumed that political parties seek policy areas that increase their chances of election (Downs 1957). In this regard, Kitschelt points to the incentives for parties “to map new issues onto an existing unidimensional space of competition” so as “to take advantage of opportunities offered by the dynamic of competitive party democracy’ (Kitschelt 2001: 265). The paper argues that there are two reasons why the issue of protecting the interests of financial consumers raised by the privatization of risk is attractive to center-left parties such as New Labour and the SPD/Green coalition. First, the attraction of such an issue is that it is clearly consistent with the consumer orientation of left and green parties and their traditional suspicion of financial institutions and the role of financial markets. Second, and more importantly, it offers the opportunity to appeal to all those voters that had become exposed to financial markets through the changes in the long-term savings markets. Such a policy has added electoral attraction at a time when center-left parties have struggled to find issues that lay out explicit differences across the ideological spectrum (Garrett and Lange 1991).

However, the electoral advantage of creating a single new regulatory agency was also attractive because it could also be couched in efficiency terms, appealing to a wider business audience that “new” left parties interested in a third or Mitte Weg did not want to alienate.

The paper now turns to an examination of the preferences of the specific state and private actors in light of the privatization of risk.

State Actors:

Treasury:

For senior Treasury officials, the readily apparent failings of both the SIB/SRO regime and those of the Bank of England prompted serious concerns. The Treasury’s first priority, which as a government department had only assumed responsibility for the regulatory framework from the Department of Trade and Industry in 1992, was to ensure the continued competitiveness of the City of London because of its major contribution to the national economy. This concern was heightened because of a perception that much of the City's activities were not naturally rooted in the economy and that regulatory duplication and failure could undermine their competitive position (Interview: London 11/8/04). The Treasury's reaction to regulatory failure and the increased political salience of financial regulation due to the privatization of risk was therefore a conscious attempt to improve its efficiency.

By 1996, the management board of the Treasury had agreed in principle that the regulatory structure should be consolidated into a single regulator, but did not consider that there was a possibility that the Bank of England would agree to give up its supervisory role of the banking sector. There was a realization that such a change was fundamental given that no other major economy had attempted a similar move, but it was argued that there was no other realistic policy alternative. However, the Conservative Chancellor, Ken Clarke, when presented with the proposal, showed no interest in it. (Interviews: London 11/8/04 and 11/9/04). The option of handing over regulation to the Bank of England as a means of consolidating all regulation was not seriously considered as it was felt that would have entailed "too many conflicts of interest", due primarily to fears of contamination of the Bank's monetary responsibilities (Interview: London 11/8/04). Such a transfer of powers would also have entailed a serious loss of responsibility for the Treasury and given the clear, if low-key, rivalry between the two institutions, it was never realistically considered.

For the Treasury as an institution, economic competitiveness and efficiency arguments were clearly prevalent. However, due to the lack of interest from the Conservative chancellor, they had no means of implementing their desire for change.

Bank of England;

Having played a pivotal role in the decision to remove "club government" from the City in 1982, and in designing the SIB/SRO structure that was decided upon in 1986, the Bank was the clear regulatory "loser" among the regulatory actors during the nineties as its supervisory role came under serious scrutiny and was ultimately removed.

The Bank defended itself vigorously following BCCI and Barings by arguing that failure was inevitable under any regulatory regime and that the Barings failure had not meant any loss of government moneys (George 1995). It did not officially discuss any formal change in its supervisory role but in internal discussions, considered creating an agency such as the Commission Bancaire in France, which while formally controlled by the Banque de France, was a separate agency that undertook supervisory responsibilities (Interview: London 5/18 2004).

However, if the failure of BCCI and Barings had put the supervisory role under a major cloud, the Bank began to assume a more public role in terms of its monetary policy role following the Conservative government's decision to publish the minutes of the meetings between the Chancellor and the Governor of the Bank in 1994. (King 2005). New Labour's decision to grant operational independence to the Bank for conduct of monetary policy days after the May 1997 election victory was greeted with great elation by both the financial markets and the bank. However, the Chancellor's statement at the time announced that it was *the government's intention to consider transferring part of the*

Bank of England's responsibility for banking supervision to another statutory body. (Brown May 6th 1997). This was taken by the Bank to mean that this was a proposal to be discussed so there was major surprise when on the 20th May, the Chancellor informed the Governor that all supervisory responsibilities were to be removed and a new single financial regulator was to be established (Brown May 20th, 1997)[vi]. The news was described by two former senior Bank of England officials as "*a bolt from the blue"* and that it *"came as a thunderclap"* with the result that it was widely reported that the Governor consider resigning (Interviews: London: 5/17/04, 5/18/04).

The Bank of England, in contrast to the Bundesbank, did not publicly comment after the FSA decision, issued no formal statement and did not lobby against the decision . There was a realization that given the political realities, there was no choice but to accept the loss of regulation and consequent prestige. It is easy to point to the failures of both BCCI and Barings as the key factors in New Labour's decision to remove supervision from the Bank. However, it is clear from a comparative perspective that banking failures do not always mean that governments choose to strip central banks of their oversight role. The example of Credit Lyonnais in France, which was bailed out in spectacular fashion in 1995 and ultimately cost the French government some 24 billion dollars, led to no change in the supervisory role of the Commission Bancaire and its overseer, the Banque de France (Coleman 2001).

Private Actors

There is little formal evidence that private financial actors or their representative groups lobbied for a single financial regulator. None of the four key trade groups that represent the City firms, the London Investment Banking Association (LIBA), the British

Bankers Association (BBA), the Investment Managers Association (IMA), nor the Association of British Insurers (ABI) sought such a change, either formally or informally. There was undoubted dissatisfaction expressed by both LIBA and the IMA to the Treasury about the cost of regulatory duplication caused by the SRO structure. However, it is clear all four groups were shocked at New Labour's decision to create a single regulator and, in particular, to remove the Bank's powers of supervision (interviews).

There were four important reasons for this surprising acquesance. First, New Labour had just been elected with a very large majority and could claim a decisive electoral mandate to implement their manifesto, making it politically awkward for financial firms to oppose the new governments' policies. Second, the institutional ownership of the City in terms of the securities markets was unrecognizable from that of a decade earlier. Virtually all the major stockbroking firms and investment banks had sold their businesses to American or continental firms, leading to the term Wimbledonisation, where as with the tennis tournament, no British player could win but the tournament was always a success (Augar 2001). The consequence of this was evidence of a significant disruption in the long established networks between the City and state actors during the nineties as compared to a decade previously. Third, the consolidation and conglomeration among financial firms that had taken place over the previous decade, created a collective action problem in terms of firms and their industry groups in terms of presenting a cohesive position (Interview: May 2004). For example, investment bankers had different regulatory priorities from fund managers and it was difficult for individual firms to present a coherent regulatory position. Fourth, the creation of a strong regulator with the power to oversee markets, may well have been in the institutions' interests in terms of assuaging the concerns of investors as to the credibility of their savings following the high-profile regulatory failures. Financial firms had been, not surprisingly, a major supporter of the Conservative government's policies that promoted the privatization of risk. The pension reforms of 1988, privatization and the promotion of shareholder capitalism, and tax induced long-term savings plans were all policies that were of major benefit to City firms. It is clear therefore that evidence of the pension misselling and other regulatory failures came to light during the nineties, it was difficult for financial firms to actively oppose a major regulatory reform.

The FSA was certainly surprised how little opposition there was to the concept of a single regulator from private sector actors (interview: 11/9/05). All the trade bodies did have an opportunity in the consultative period that followed the announcement to formally outline their positions and both LIBA and BBA formally expressed their support for the concept of a single regulator and the need for robust regulation. However, they also expressed concerns about the powers of the FSA and argued for a regime that recognized the need for international competitiveness and the dangers of overtly prescriptive regulation (House of Commons Treasury Select Committee: 1999).

In terms of private actors, there is therefore evidence of continuity in Moran's observation of the lack of active participation in the shaping of regulatory institutions (Moran 1991). It would be a mistake, however, to interpret this lack of formal involvement as meaning a lack of political influence. The evidence is clear that the Treasury, in particular, were acutely aware of the importance of the financial sector to the broader economy. However, the fact remains that New Labour that decided to create a single regulator without any prior formal consultation with private sector actors and presented the City with a fait accompli.

The Political Parties

<u>New Labour</u>

The Labour party's traditional relationship with the City of London and financial markets was not as confrontational as ideology might suggest. However, the party did oppose the 1986 Financial Services Act, arguing that it provided insufficient protection to the consumers of financial services and that the SIB did not have sufficient powers to oversee the SROs as compared to the SEC in the United States. However, given its apparent lack of interest in reform during its previous long periods in power, it is clear that financial regulation was not a significant political priority.

It was the manifest failings of the SIB/SRO regime, and its inability to prevent the regulatory failures, particularly the pensions misselling scandal and the Barings failure that provided the immediate political opportunity for New Labour to attack the regulatory regime created by the Conservative party and to ensure that financial regulation emerged as a distinct area of policy difference between the parties. Gordon Brown as Shadow Chancellor used these failures to relentlessly attack both the SIB/SRO regime and the Bank of England as a supervisor. He consistently referred to the lack of accountability of the Bank of England and the need to better protect the interests of consumers. Prior to the 1997 General Election, the Labour party committed itself in its Business Manifesto, to reform the regulatory regime when, without giving any details, it promised to create what was termed a "Super-SIB", that brought together the SROs and gave the regulator increased powers (Labour 1997).

It was the decision to give the Bank of England operational independence over monetary policy that provided the opportunity to redesign the regulatory framework and create a single regulator by removing the Bank's supervisory responsibilities and transferring them to the new regulator (interview: London 11/9/2004, Bower 2004). When the Chancellor announced the decision some two weeks after the monetary policy statement, he couched it in distinct terms using both consumer protection and economic efficiency arguments, stating that the new regulator would "*raise the standard of supervision and investment protection that industry and the public have a right to expect",* (Brown 1997).

In terms of political incentives, such a move was designed to play to both a new constituency as well as appealing to what may be termed traditional Labour party interests. First, the consistent emphasis on protecting the interests of the consumer and increasing the accountability of regulation gave New Labour the opportunity to identify what Kitschelt identified in terms of new policy issues. Second, it was designed to allay the concerns that traditional Labour politicians might have over the decision to give the Bank of England monetary policy independence as well as concerns over the relationship between the state and the City.

<u>Conservatives</u>

For the Conservative party, having introduced the SIB/SRO regime in 1986, financial regulation became an issue of considerable subsequent political embarrassment as it was forced into a policy of continually having to justify the very apparent failings of the regime. However, there is no evidence that it ever contemplated changing the corporatist system during its period in office. First, given its ideological disposition about the preeminent role of markets, it was never convinced of the need for state oversight of the financial markets in the first place (Brittan, House of Commons:1986). To increase the role of the state in regulation was therefore never considered as a viable political option (Interview: London 11/9/04). Second, when the cumulative affect of the deficiencies in the regulatory regime became clear in the mid nineties, there was a realization that they were going to lose the next election, so even if they had wanted to reform the system, they had no incentive to initiate it.

However, what is clear is that if they had remained in office, it is extremely unlikely that they would have created a single regulator in the manner of the FSA that involved removing supervisory responsibility from the Bank of England. Described by one former Tory Treasury minister as “a socialist measure”, the party was, not surprisingly, immediately critical of the powers given to the FSA (Interview:11/9/04). Typical of the criticism was a pamphlet, co-written by a Conservative MP that described the FSA as “a too powerful Leviathan, overbearing and unaccountable” (McElwee and Tyrie 2000). In terms of a counterfactual, it is likely that the Conservatives would have consolidated the SRO structure and possibly strengthened the powers of the SIB, but there is no evidence that they would have removed responsibility for banking regulation from the Bank of England. The politics of New Labour can be therefore seen as decisive in the creation of the FSA.

Germany

State Actors: Finance Ministry

The concerns that led the Finance ministry to propose the creation of BaFin had evolved from those of the competitiveness of Germany as a financial center that were central to the decision to set up BaWe six years earlier. While competitiveness remained of crucial interest, particularly after the British government’s decision to create the FSA, there was a deeper concern about the condition of the overall financial system (Interviews Berlin: 5/15/04, 11/15/04). Of particular concern were the low levels of return on capital of the financial system during the nineties as compared to other major EU and OECD states, which increased the vulnerability of individual institutions to economic shocks. As the IMF remarked "the German system appears to be less strong than those of other countries reviewed, owing to lower profitability or weaker capitalization' (IMF 2003). The proposal to increase the funded component of pensions, outlined in the Riester reforms, was a further incentive to ensure that the regulatory regime could ensure the robustness of the financial institutions that would manage the savings products. The Finance ministry was also concerned about the effect of further reforms emanating from the EU challenge to the status of the Landesbanks and the ongoing Basel 11 negotiations, both of which had the potential to further reduce the profitability of the banking system. However, it is clear that given the sensitivities involved in reform, the ministry was very reluctant to be seen to have an explicit view about the role of the Bundesbank, because of their sometimes tempestuous relationship since reunification (Duckenfield 1999). The Finance ministry's concerns about the German financial system were not new but the previous CDU/FDP had expressed little interest in reform. For the Finance ministry, the increased privatization of risk was therefore an important concern from a perspective of the capability of the financial system to avoid significant financial failures

Bundesbank:

It is an apparent paradox as to why the Bundesbank failed in its efforts to expand its supervisory role given its status as one of the key parapublic institutions of the federal Republic due to its identification with postwar economic success (Katzenstein 1987:60). It is clear that the Bundesbank was an important member of the Frankfurt coalition at the end of the eighties that lobbied for regulatory reform in the interests of promoting

Finanzplatz Deutschland (Luetz 1998). However, there is little evidence that its interest in regulation and financial supervision remained particularly profound until the imminent arrival of European Monetary Union towards the end of the nineties. Up until then, it is clear that supervision was seen very much as the poor relation as compared to its vaunted monetary policy role[vii] and that risk of "regulatory contagion" was to be avoided at all costs.[viii]

The effective arrival of EMU in 1999 and the transfer of responsibility for monetary policy to the European Central Bank appear to have triggered a realization that regulation was an obvious task to augment its now diminishing responsibilities. A former president, Karl Otto Pohl, described the Bundesbank as "a very political institution" that "really makes policy, unlike other central banks" (Katzenstein 1987: 60). Evidence of Pohl's assertation began to become evident as both the President, Ernest Welteke and the Vorstand member responsible for regulation, Edgar Meister, began a campaign in1999, to argue that given the Bundesbank's "closeness to the market", the BaKred should "be taken under its roof"(Meister 1999). Welteke, quickly followed up with a more ambitious plan in an interview some months later, when he remarked that there were "many good reasons why the BaWe and BaV should also came under the roof of the Bundesbank (Welteke, 2000). Other speeches and interviews followed during 2000 that reflected their confidence that the government would agree to this solution as a means of reforming the regulatory regime.

It was therefore a major surprise when Finance minister Eichel announced in January 2001 that the government had decided to set up BaFin, and leaving it unclear as to whether the Bundesbank would have any regulatory role. The Bundesbank immediately issued a strong statement of disapproval and Meister was quoted that, "banking oversight is not suitable for the business of politics"(FAZ 1/26/01). While the Bundesbank gained support from the Lander government of Hesse and Bayern in its opposition to the government's proposals, it had managed to alienate many of the other Lander governments with its proposal to reduce the number of Lander members of its Vorstand (Busch 2004b). The Federal government did concede some ground when it agreed to leave the Bundesbank's supervisory responsibilities unchanged and the legislation finally clarified the relationship between the Bundesbank and BaFin by outlining its implementary role. However, the failed attempt to expand its regulatory remit was evidence of its diminished role as a parapublic institution in German politics.

Private Sector Actors:

Luetz describes the key role that private sector actors notably the BdB, as the lobby group for the private banks, and Deutsche Bank as the largest private bank, played in the Frankfurt coalition that led to the creation of BaWe in 1994 (Luetz 1998). In terms of incentives, it was a concern to ensure the competitiveness of German financial institutions in an evolving global financial marketplace. This motivation was little changed in the debate about regulatory reform, where both the BdB and Deutsche Bank again played a key role, both in terms of influencing the public debate and lobbying the government as supporters of a new, single regulator. For Deutsche Bank, as Germany's largest bank, the fragmented regulatory structure was considered an impediment to its strategic development (interview: Frankfurt: 11/16/04). A measure of the concern was the bank chairman's Rolf Breuer's unusually forceful speech in February 2000 when he argued that there must be an integrated regulator and that 'the supervisory authority must be subject to a reporting requirement and democratic control' (Breuer 2000). This can clearly be interpreted as an attempt to head off the Bundesbank's ambitions to expand its regulatory remit and is evidence of the robustness of the debate when the central bank and the state's largest bank are willing to enter into a very public disagreement. The BdB also publicly challenged the Bundesbank's attempts to increase its oversight role and, echoing Breuer's earlier comments, described the dual oversight role as outmoded, and argued that banking regulation needed political control, making the Bundesbank unsuitable to be the regulator (Suddeutschland Zeitung 5/30/00).

What was also notable about the debate was the public split between the different financial interest groups, disturbing the usual corporatist consensus, as the BdB assumed the role as the champion of the move to a single regulator, while the DSGV argued in favor of the Bundesbank.[ix]. For the savings and cooperative banks, there was a concern that any change in the regulatory regime might disturb their well-developed network of political support at both a Federal and Lander level.

German Political Parties

In the case of the German political parties, it is clear that there was a high level of political consensus on the need for reform of financial regulation up until the decision to create BaFin in 2001. In the three previous Financial Market Promotion Acts of 1990, 1994 and 1997, all the parties voted in favor of the legislation and the SPD's main criticism (as the opposition party) was that the legislation was continuously too late in being implemented (Bundestag proceedings)[x]. However, as the effect of the first three pieces of legislation was only to bring Germany belatedly into line with the regulatory norms of the other large EU states, and did not involve any contentious decisions about institutional responsibilities, such unanimity was not surprising.

However, such unanimity soon dissipated when the debate began about institutional reform. The issue that was immediately contentious was again the role of the Bundesbank and its ambitions to expand its regulatory remit. What emerged was a clear split between the SPD/Green government who were strongly in favor of the new single regulator, and the CDU and FDP who were equally vehement in their views that the Bundesbank should have its supervisory role expanded.

<u>SPD/Green</u>

The incentives in promoting reform from a partisan perspective were broadly similar to those of New Labour in Britain. The nature of German savings markets changed rapidly in the latter half of the nineties due to the major privatization of Deutsche Telekom and an equity boom that saw a rapid rise in the individual holdings of stocks (DAI 2003). The creation of a regulatory actor that actively promoted the protection of the consumers of financial services can be seen as a strategic response to such a change. However, unlike New Labor, there is little evidence that the SPD/Green government had considered regulatory reform prior to coming to power and the protection of consumers was not a contentious issue during the 1998 election as the financial system had not undergone such high-profile failures (Interviews:11/14/04).

A key difference was that the SPD/Green government were introducing private pension reforms as opposed to the British case where New Labour were reacting to the failures of the previous Conservative government's policy. This meant that the SPD/Greens had to be seen to be creating a new regulatory regime that could protect the interests of prospective savers as opposed to the New Labour case of creating a regime to protect existing savers. It also meant that the SPD/Greens were concerned about the need to prevent regulatory failure because of the potential damage it would cause to the case for transferring pension risk from the state to the individual and the institutions where they committed their pension savings.

For the SPD there were therefore three objectives in terms of promoting BaFin; firstly, a desire to increase the protection of investors, secondly, a clear concern about lack of democratic accountability of the Bundesbank as a regulator and thirdly, concern that financial regulation should function effectively and efficiently. In terms of all three objectives, the proposed Riester pension reforms were clearly a further important impetus (Interview,11/10/04). However, unlike New Labour, the SPD were in coalition, and their partners, the Greens had a strong consumer protection objective as a key component of their electoral strategy across a range of policy areas. An example of this commitment was their promotion of the Ministry of the Rights of the Consumer, which among other policy areas was established to oversee financial claims (Interview, Berlin 11/15/04). For the coalition, both could agree on the creation of a financial regulator with a strong consumer orientation, while also dismissing the claims of the Bundesbank to take control of regulating a policy area of increasing political significance.

CDU/FDP

Neither the CDU nor its previous coalition partner, the FDP, which were in government between 1982 and 1997, had shown evidence of an interest in reforming financial regulation when in power. In part, given the bank-based financial system, there was little electoral incentive for parties to promote reform as a political issue. However, it can also be seen to be a result of both parties' traditionally close relationship with the Bundesbank. While all German political parties pay homage to the Bundesbank, both the

CDU and the FDP were particularly supportive of it as an institution.[xi] As one CDU official stated "We are very pro-Bundebank, historically and today"(Interview, Berlin 11/15/04). Given the Bundesbank's lack of interest in financial regulatory reform until the end of the nineties, neither of the two parties when in government wished to initiate a policy that ran counter to the Bundesbank's wishes.

When the debate began over the future of the regulatory regime, both parties strongly supported the case for an expanded role for the Bundesbank, and opposed the idea of creating a new regulatory institution. When the government announced the BaFin decision, both parties continued to argue in committee and in the plenum sessions of the Bundestag that the case for change was not proven. However, despite the opposition party's majority in the Bundesrat, they failed to prevent the legislation being passed into law because of an extraordinary walkout of the chamber by the CDU leaders in a dispute over immigration policy (FT Deutschland 3/22/02). This meant that the legislation was not sent into the conciliation process that might have delayed the establishment of BaFin for a considerable period.

Comparison of Cases

The evidence from the cases points to a couple of significant findings. First in both cases, there were important changes in the interests of two key state actors that prevented the unanimity among them that led to earlier corporatist reforms. The Finance/Treasury actors were active proponents of regulatory change, concerned about the need to promote the competitiveness and efficiency of their respective financial systems. The center/left governments were advocates of regulatory change because of the electoral advantage they perceived in promoting a broad consumer agenda due to the privatization of risk and the changes to savings markets. (In the German case, the prospective nature of pension reform meant that concern for the effectiveness of the regulatory system was also an important to the SPD/Green government). The regulatory losers in both cases were therefore the respective central banks, which as Thelen's argument suggests, was a result of having lost political support for their regulatory roles (Thelen 2004). For both center/left governments, there was a reluctance to allow institutions perceived as insufficiently accountable to the state to assume regulatory powers, in a policy area of such increased political salience. It should be stressed therefore that for both governments, the argument in favor of merging the functional regulators was about more than improving economic efficiency but also about ensuring the political accountability of the new regimes.

In both cases, there are two reasons that make the partisan argument so compelling. First, the right parties previously in power showed little interest in reforming the corporate regimes. Second, when in opposition, both the Conservatives and the CDU/FDP actively opposed the creation of the new institutions and the increased role of the state. Their opposition, in particular, to the reduction in the role of the central banks points to a strong counterfactual argument that without New Labour's electoral success of 1997 and the SPD/Green of 1998; neither the FSA nor BaFin would have been created.

The cases also show up two important differences in the evolution of the regulatory regimes. The first is the difference in the role of private financial actors where in contrast to Germany, British private actors are found not to have played an important role as either advocates of reform, or in opposing it once it was announced. This is an interesting finding in so far as it appears to challenge assertions of the "structural power" of financial firms found in the literature (Cerny 1993, Strange 1995). In the German case, a significant finding is the division the debate caused between the different banking associations, disturbing the usual consensual style of policy making.

The second difference is the very different type of debate that took place in both states reflecting the contrasting political systems. As we have seen, New Labour announced the decision to create a new regime without any formal consultation process. In Germany, by contrast, the debate stretched over an extended period, with state institutions and private sector actors taking very public positions and was only finally resolved by legislation.

Conclusion

This paper argues that partisan politics matters when explaining change in the institutions of financial regulation. It points to the changing interests of two key sets of state actors, Treasury/Finance and elected politicians that can explain the shift from a corporatist to a state financial regulatory regime in Britain and Germany. For Treasury/Finance actors, there was a concern to increase regulatory efficiency, both to reduce the risk of regulatory failure and to promote the competitiveness of each state's respective financial centers. For elected actors, the changing nature of savings markets following the privatization of risk, offered the two center-left governments an opportunity to pursue an electorally attractive pro-consumer policy. The regulatory losers, in both cases, were the respective central banks, because of their perceived lack of political accountability.

However, the cases indicate that neither the economic efficiency arguments of Treasury/Finance actors, nor the ideational example of the FSA in the German case, are sufficient in themselves to explain the changes in regulatory regime. While both economic efficiency and ideas play a significant role, the paper finds that the decisions of center/left governments were necessary for the change in regime to occur.

The implications for the paper are obviously limited by the examination of just two cases, even if they do represent very different political and economic systems. However, it is interesting to note that the three large European states, France, Spain and Italy that have chosen to leave significant regulatory powers with their central banks, have also chosen not to reform their pension systems in such a way as to encourage private funded schemes.

Finally, the paper also has clear normative implications in so far as if and when center-left parties relinquish power in Britain and Germany, given the opposition of the right parties to the removal of the regulatory roles of central banks, there may well be fundamental change to the institutional design of the financial regulators and a consequent lessening of focus upon the interests of financial consumers.

[i] The paper does find that economic efficiency and ideas do play a significant role in explaining the change in regime with economic efficiency important in both the British and German cases, while the ideational example of the FSA was significant in spurring the German debate. However, as discussed later in the paper, they are not sufficient as independent variables to explain the change in regulatory regime.
[ii] Moran's argument does not dismiss the significance of domestic politics in enabling state actors to overcome the resistance of domestic financial actors that were resistant to change, " a pluralist, competitive political system allowed disaffected interests to mobilize for change", but he does not place emphasis on it as a variable as compared to Americanization (Moran 1991: 57).
[iii] As Muller (2002) points out, significant regulatory tasks such as deposit insurance and auditing were delegated by the BaKred to "semi-private" organizations,confirming that banking regulation had a significant corporatist component.
[iv] The Gramm-Riley reforms of 1999, that removed the barrier on banks and investment banks carrying out certain functions, meant that any functional argument against combining regulatory reforms is no longer valid.
[v] The Twin Peaks solution was the model decided upon by the Australian government in 1997 (Wallis Commission 1997).
The Bank of England was however given the formal responsibility for ensuring the overall stability of the banking system.
A former senior Bank of England official describes this view when he outlined how Bundesbank officials would take pleasure in describing the risks to the credibility of UK monetary policy arising from its financial supervisory role.
An account that confirms this impression was the reported reaction of Bundesbank President Helmut Schlesinger during the aftermath of the Barings failure in early 1995, when questioning his officials about the Bundesbank's potential exposure to such an event, he made it clear that the BaKred's responsibility for regulation should be stressed (interview:Berlin:11/15/04).
The SPD member Martin Bury was critical in the 1997 debate about the legislation due to the "big defects in terms of transparency and the protection of investors" but still described it as "a long-overdue step in the right direction, even if it is still to little" (Bundestag proceedings 1997).
Both the SDP and the Greens in the parliamentary debate about BaFin were careful not to criticize the Bundesbank in an overt fashion. As a Green official commented, "it is impossible in German politics to criticize the Bundesbank (Interview: Nov 15/2004).

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[vi] The Bank of England was however given the formal responsibility for ensuring the overall stability of the banking system.

[vii] A former senior Bank of England official describes this view when he outlined how Bundesbank officials would take pleasure in describing the risks to the credibility of UK monetary policy arising from its financial supervisory role.

[viii] An account that confirms this impression was the reported reaction of Bundesbank President Helmut Schlesinger during the aftermath of the Barings failure in early 1995, when questioning his officials about the Bundesbank’s potential exposure to such an event, he made it clear that the BaKred’s responsibility for regulation should be stressed (interview:Berlin:11/15/04).

[ix] One leading financial commentator described it “ as amazing that in Germany it is only the private banking sector that is calling for a legally independent authority in financial supervision. The savings bank sector have been on the sidelines and the cooperative banks openly calling for supervision under the Bundsbank” (Englelen 2000).

[x] The SPD member Martin Bury was critical in the 1997 debate about the legislation due to the “big defects in terms of transparency and the protection of investors” but still described it as “a long-overdue step in the right direction, even if it is still to little” (Bundestag proceedings 1997).

[xi] Both the SDP and the Greens in the parliamentary debate about BaFin were careful not to criticize the Bundesbank in an overt fashion. As a Green official commented, “it is impossible in German politics to criticize the Bundesbank (Interview: Nov 15/2004).