Multi-level Governance of Banking Regulation in the EU: Evidence from Developing Bank Supervision in Bulgaria and Hungary

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ABSTRACT Recent bank collapses as a result of the global financial crisis have highlighted the need to keep international bank supervision practices up to date with technological and product innovations in the sector. In the 1980s, coordination in international financial regulation resulted from multi-lateral negotiations in which states played a central role. Since then, the international financial system has undergone significant transformation. This article examines the explanatory power of multi-level governance in the case of international banking regulation. According to the first hypothesis tested here, a dense network of public, private, and supranational actors governs the banking sector. The second hypothesis focuses on the role of experts in policy formulation. The third hypothesis probes the role of independent regulatory agencies in policy implementation. The analysis is based on evidence from two new EU member states, Bulgaria and Hungary, that represent the two types of bank supervision organizational structure in the EU.

KEY WORDS banking sector supervision; regulatory politics; multi-level governance; international finance; experts; independent regulatory agencies
I. INTRODUCTION

Following World War II, the international financial architecture was characterized by “embedded liberalism.” Governments endorsed free trade internationally but maintained capital controls to ensure domestic policy autonomy (Ruggie 1982; Helleiner 1994: 48-50). However, since the 1970s, the growing internationalization of the world’s largest economies has generated considerable pressures to liberalize capital flows. Especially after the end of the Cold War, governments have increasingly dismantled capital controls (Helleiner 1994: 146-168). As a consequence of the increased cross-border capital flows, international banks have faced larger negative externalities of risky lending. The bankruptcy of Herstatt Bank in West Germany and Franklin National Bank in the USA in 1974 provided an impetus for rethinking banking sector regulatory practices on the international level (Lütz 2000: 2; Bank for International Settlements 2007). More recently, the failure of Barings (UK) in 1995 after speculation with futures contracts and the collapse of mortgage lenders Northern Rock (UK) and IndyMac (USA) as well as US investment banks Bear Stearns and Lehman Brothers as a result of the subprime mortgage crisis have highlighted the need to keep international banking supervision practices up to date with technological and product innovations in the sector.

In the 1980s, coordination in international financial regulation was considered a successful case of regime development (Krasner 1983; Kapstein 1989, 1994). The impetus for harmonizing regulatory standards came from states, in particular the USA and the UK, using the Basel Committee on Banking Supervision as a venue for multi-lateral negotiations (Kapstein 1989: 339; Genschel and Plümper 1997: 630; Lütz 2000). In that period, banks tried to influence the policy outcome by lobbying institutions in their respective countries such as the Federal Reserve System, the Bank of England, and the Bundesbank (Genschel and Plümper 1997; Lütz 2000).

What important changes have occurred in international finance since then? First, capital markets now account for a larger share of financial intermediation than bank lending (Barth et al. 2006). Second, large institutional investors such as pension funds and mutual funds have become important market players (Lütz 2000: 4). Third, there has been a significant growth in foreign exchange trading and new financial products such as derivatives and credit default swaps (Barth et al. 2006). As a result, a more flexible framework of international banking regulation has emerged since the 1990s. Because the number of risk-takers on international capital markets, especially those channeling private capital flows, has increased significantly, the new regulatory framework requires extensive coordination between the domestic and international level as well as public and private actors (Lütz 2000: 4-5).

We need to examine systematically the emerging decision-making pattern in international finance in light of recent analyses of how economic globalization has challenged the traditional hierarchical framework of the Westphalian state (Caporaso 1996; Keohane and Nye 2000). John Ruggie (1993: 149) has proposed a comparison with the patchwork of overlapping jurisdictions that were common in the medieval period. James Rosenau (1997) has emphasized the growing policy-relevance of professional societies, advocacy groups, and corporations alongside governments. According to Philip Cerny (2005), “global finance today is a patchwork of
hierarchies, markets and networks, stabilised and governed by institutional bricolage, market-led innovation, crisis and response.”

The multi-level governance framework has been used widely in political science and public policy to explain the changing role of the state and the rise of non-state actors in decision-making. This article tests the explanatory power of multi-level governance in the case of international banking regulation. I use Gary Marks’ (1993: 392) definition of multi-level governance as “a system of continuous negotiation among nested governments at several territorial tiers.” Multi-level governance analyses have focused primarily on the structural, cohesion, and regional development policies of the European Union (EU) (Hooghe and Marks 2004), but recently the theoretical insights of this framework have been applied to economic governance as well (Knodt 2004; Perraton and Wells 2004). The European multi-level system is comprised of supranational institutions, member state governments, private, and subnational actors. While the regional and local levels have been prominent in analyzing the EU’s structural and regional policies, in the case of banking sector regulation, private actors such as business organizations and transnational networks of policy experts are more relevant.

From a methodological standpoint, I use the flexibility of multi-level governance to reconcile rationalist and constructivist explanations of policy change. This article relies on the rationalist approach to study the pattern of actor mobilization and coalition formation in banking sector regulation. The multi-level governance framework provides us with tools to examine the changing constellations of actors on different levels of policy-making. At the same time, the article also incorporates constructivist insights about the importance of ideas, knowledge, and learning in policy-making. I investigate the accumulation and transmission of knowledge across international networks of policy experts.

Liesbet Hooghe and Gary Marks (2003) have drawn an important distinction between two types of multi-level governance. **Type I** multi-level governance comprises general-purpose jurisdictions that bundle together multiple functions and a range of policy responsibilities. In this setting, citizens are located in a set of nested jurisdictions, where only one relevant jurisdiction applies at any particular territorial scale (Hooghe and Marks 2003: 236). By contrast, **Type II** multi-level governance is composed of specialized jurisdictions and is fragmented into functionally-specific components such as monitoring water quality or adjudicating trade disputes. Type II multi-level governance jurisdictions tend to be lean and flexible, their number is potentially large, and the scales on which they operate vary significantly (Hooghe and Marks 2003: 236).

I argue that Type II multi-level governance describes more accurately current developments in banking sector regulation. According to Hooghe and Marks (2003: 240), Type II multi-level governance jurisdictions are best suited to solve particular problems such as “managing a common pool resource and setting a technical standard.” Both characteristics apply to banking sector regulation: Adopting prudential regulation standards can be regarded as a collective good; agreement on shared technical standards to evaluate banks’ capital adequacy is essential for cross-border regulatory coordination. A distinctive characteristic of Type II multi-level governance, as analyzed by Hooghe and Marks (2003: 238), is that policy-making is less hierarchical and rigidly structured. The policy outcome is shaped by a “wide range of public and
private actors who collaborate and compete in shifting coalitions” (Hooghe and Marks 2003: 238).

Sections II, III, and IV of this article present and elaborate on three hypotheses derived from the multi-level governance framework. Section V tests those hypotheses in the case of developing bank supervision in Bulgaria and Hungary. According to the first hypothesis, a dense network of public, private, and supranational actors governs the banking sector. The second hypothesis focuses on the role of experts in the policy formulation stage. The third hypothesis probes the role of independent regulatory agencies (IRAs) in policy implementation. While the first two hypotheses have been discussed in previous studies, the third hypothesis is a novel attempt to establish a link between the multi-level governance literature and that on regulatory governance and the regulatory state. Section VI summarizes the findings of this article.

II. GOVERNING THE BANKING SECTOR AND REGULATORY INNOVATION IN THE EU AS A RESULT OF THE LAMFALUSSY PROCESS

Hypothesis 1: A network of public, private, and supranational actors governs the banking sector.

Multi-level governance provides important insights about the changing role of the state in banking sector regulation. This section presents evidence that while public authorities still play an important role, supranational and private actors have become active and salient participants in banking sector governance. Previous research on multi-level governance has demonstrated that the European integration process pulls authority away from national governments and empowers subnational and supranational actors (Bache and Flinders 2004: 197). To explain regulatory change in the EU, we need to examine how policy is made in its multi-layered system of decision-making. At the same time, Guy Peters and Jon Pierre (2004: 76) have pointed out that “multi-level governance should not be seen as an alternative but rather as a complement to intergovernmental relations.” National banking sector regulators, usually a supervision department in the central bank or a separate supervisory agency, continue to be very important actors in the regulatory process because they are located closest to the regulatees and carry out all routine supervisory tasks.

Since the late 1980s, public regulators have started to interact more frequently and extensively with international and private actors. First, let us examine the influence of the Basel Committee on Banking Supervision (BCBS). Then I will discuss the role of private actors and that of the EU. The Basel Committee on Banking Supervision is the main international forum for cooperation on issues of bank supervision. It was established in 1974 by the central bank governors of the so-called “Group of Ten” following serious disturbances in international currency and banking markets. The Basel Committee is hosted by the Bank for International Settlements (BIS) and aims to “improve the quality of banking supervision worldwide by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding” (BIS 2007).

The BCBS is not based on a founding treaty and does not issue binding regulations. According to Dieter Kerwer (2005: 619), the committee’s main functions are “to act as an informal forum to find policy solutions and to promulgate standards.” In 1988, the committee
introduced a capital measurement system, commonly known as the Basel Capital Accord or Basel I, which stipulated a minimum capital adequacy standard of 8 percent and provided a common approach to credit risk measurement. This framework has been widely implemented by virtually all countries with internationally active banks (BIS 2007: 2). In 1999, the committee issued a proposal for a revised Capital Adequacy Framework, known as Basel II, that was adopted in 2004 after extensive consultations with banks, industry groups, and national supervisory authorities (BIS 2007: 3). Yet, as I noted earlier, the Basel Committee has no legal authority to impose its codes and standards (BIS 2007: 1). In the EU, Basel II has been incorporated in the EU’s Capital Requirements Directive (CRD) adopted in 2006 and is legally binding for all EU member states.

At present, the Basel Committee on Banking Supervision is at the core of a dense international network of finance experts and professionals. Susanne Lütz (2000: 7) has examined the changing role of the committee from a forum for multi-lateral negotiations in the 1970s and 1980s to what she calls “a repository of best practices” that shapes policy-makers’ and practitioners’ approach to bank supervision. In March 1998, the BCBS founded the “Institute for Financial Stability” which trains national supervision personnel. The committee also participates in the “Forum of Financial Stability” that brings together public supervisory authorities and international financial organizations such as the IMF, World Bank, BIS, OECD, and IOSCO.

How influential have private actors been in banking sector governance? There is convincing evidence that large international banks have increasingly lobbied policy-makers directly on the international level. As Rainer Eising (2005: 28) has demonstrated, in highly internationalized sectors such as banking, actors affected by international regulations dedicate considerable resources to exert influence on the international level. Private actors have lobbied successfully the BCBS to include a flexible supervision approach in Basel II that allows banks to use their own models for risk assessment in order to determine capital adequacy (Larsen 2006; Claessens et al. 2007). Organizations such as the European Banking Federation, the European Savings Bank Group, and the European Financial Services Round Table are salient representatives of European private banks in EU decision-making.

Basel II also reflects a change in the relationship between public regulators and private banks: The primary responsibility for assessing risk lies with banks. National regulators review periodically banks’ calculations and invoke sanctions if a bank fails to meet or attempts to evade the capital adequacy criteria. Banks that are more accurate in their risk estimations face lower costs of insuring against risk. In a recent comprehensive analysis of the structure, conduct, and impact of bank supervision practices across the globe, James Barth, Gerard Caprio, and Ross Levine (2006) have argued strongly in favor of strengthening private regulatory mechanisms. The authors advocate “a more limited role of government that focuses on information disclosure and strengthening private market discipline of banks” (Barth et al. 2006: 13).

What EU legislation provides the framework for banking sector regulation? Initially, the Capital Adequacy Directive (93/6/EEC) and the Consolidated Banking Directive (2000/12/EC) stipulated capital requirements for banks and investment firms in EU member states. From 2006 onwards, the key banking sector legislation has been the Capital Requirements Directive, which consists of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit
institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions. Two additional pieces of relevant legislation are Directive 2000/46/EC regarding the taking up, pursuit of and prudential supervision of the business of electronic money institutions and Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

The Financial Services Action Plan (FSAP) proposed by the European Commission in 1999 provided the first overarching policy on the EU level in the realm of financial markets and services for the period 1999-2005. However, due to the slow implementation of the FSAP, in 2000, the ECOFIN Council appointed a Committee of Wise Men chaired by Alexandre Lamfalussy. The committee had a mandate to develop measures that would lead to convergence in regulating securities markets in the EU. In 2000, the committee presented its four-level approach shown here in Appendix I. The so-called “Lamfalussy framework” was adopted in 2002 after lengthy negotiations between the European Commission and the European Parliament. In fact, the principles outlined in the Lamfalussy report for the securities sector were extended to banking and insurance (Quaglia 2007b: 278). In 2004, the European Commission reviewed the Lamfalussy process and engaged in extensive consultations in order to fine-tune its implementation. The Commission’s White Paper on Financial Services 2005-2010 succeeded the FSAP (European Commission 2005b).

According to Lucia Quaglia (2007b: 279), the European Commission and the Committee of Wise Men clearly acted as policy entrepreneurs in developing financial services legislation on the EU level. In her analysis, Quaglia (2007b: 280) points out that “the Committee of Wise Men deliberately and strategically elicited the input of a vast array of nongovernmental actors, including first and foremost financial companies and independent experts.” Commission officials and policy-makers drafting the Lamfalussy report intentionally sought input from financial market operators, which suggests the presence of lobbying paths for international banks directly in Brussels.

As noted in the beginning of this section, the national level is still very important in governing the banking sector. Quaglia (2007b: 282) insightfully stresses that while the role of supranational and private actors has increased substantially in agenda-setting, the final decision-making stage is characterized by the strong influence of national governments in ECOFIN meetings and European Council sessions. For example, member states’ finance ministers in the ECOFIN council were instrumental in deciding to extend the Lamfalussy framework to the entire financial sector, rather than apply it only to the securities sector as was the original plan. Within ECOFIN, the agreement between British Finance Minister Gordon Brown and his German counterpart Hans Eichel was the driving force behind the successful adoption of the FSAP (Quaglia 2007b: 282).

Overall, we have seen in Section II that a dense network of public supervision entities and national decision-makers, international actors such as the BCBS and the EU, and private actors is responsible for governing the banking sector. Now let us examine closely how banking regulations are formulated and developed.
III. THE ROLE OF EXPERTS IN DEVELOPING BANKING REGULATIONS

**Hypothesis 2:** International networks of experts are instrumental in formulating and developing banking regulations.

Experts have become very important participants in policy-making because of their knowledge and grasp of complex technical issues. David Levi-Faur (2005) has examined the trend toward formalizing regulation and the growing influence of international networks of experts since the 1980s. As Levi-Faur (2005: 956) has emphasized, “the role of knowledge and in the public policy process is increasingly relevant to political and policy analysis.” Earlier, the policy-making process used to be structured rather differently. Mark Thatcher (2002b: 966) has shown that policy-making was “largely the preserve of a small and closed policy community, dominated by civil servants and powerful incumbent interests, especially suppliers.” Levi-Faur’s (2005) empirical observations concerning the importance of experts in policy-making confirm the insights of the multi-level governance framework. According to Gary Marks (1993: 402-3), “supranational, national, regional, and local governments are enmeshed in territorially overarching policy networks.” Furthermore, Michèle Knodt (2004) has proposed that the accumulation and transmission of knowledge across expert networks are crucial components of multi-level governance.

What is the role of experts in developing banking regulations in the European Union? Franco Bruni (2008: 9) has noted that “due to asymmetric information and opacity,” technical competence is essential in drafting European banking regulations, and the participation of private interests is extensive. Lucia Quaglia (2007a) has analyzed in-depth the use of comitology in the so-called “Lamfalussy committees.” As Marks et al. (1996: 368) have discussed, comitology was originally developed in order to provide member states with a control mechanism to oversee the activities of the European Commission. However, over time, comitology has become instrumental in providing subnational authorities and private actors with access to policy-making on the European level (Marks et al. 1996: 368). The latter function of comitology is very clear in banking sector regulation.

The multi-level nature of banking sector governance in the EU and the crucial role of experts are reflected in the structure of Lamfalussy committees. Level 2 Lamfalussy committees represent member state governments, whereas level 3 committees represent public regulators. Let me elaborate on these points. Level 2 Lamfalussy committees such as the European Banking Committee (EBC) have comitology functions and some advisory functions (Quaglia 2007a: 5). They are predominantly “fora for policy debate and opinion forming” that deal with broad policy issues rather than technical details (Quaglia 2007a: 5). For example, the EBC drafts provisional proposals that take into consideration exclusively member states’ preferences. By contrast, level 3 committees such as the Committee of European Bank Supervisors (CEBS) consist of representatives of member state supervisory institutions. According to Quaglia (2007a: 10), CEBS contributes extensively to the drafting and implementation of the actual standards and guidelines in banking. CEBS also conducts consultations with a considerably wider range of actors such as market participants and consumer groups and is very active in the policy implementation stage (Quaglia 2007a: 13). Thus it is level 3 committees that develop European
banking sector regulations in practice: Experts from the member states’ public supervision organizations agree on common regulatory principles that will eventually become European law.

IV. THE ROLE OF INDEPENDENT REGULATORY AGENCIES IN IMPLEMENTING BANKING REGULATIONS

**Hypothesis 3:** Independent regulatory agencies, rather than government ministries, implement banking regulations and subsequently monitor compliance.

I have argued that a dense network of public, private, and supranational actors governs the banking sector. Furthermore, experts have gained a prominent role in formulating banking regulations. This section examines the role of independent regulatory agencies in monitoring policy implementation and ensuring compliance.

As noted earlier, due to their proximity to regulatees, national regulators are important actors in the banking regulatory process. National banking regulators in Europe are either bank supervision departments in the central bank as is the case in the Netherlands and Bulgaria or separate financial sector regulatory authorities such as the Financial Services Authority (FSA) in the UK and the Financial Supervisory Authority (PSZÁF) in Hungary. Those organizations carry out on-site bank examinations, monitor compliance with banking sector regulations, and initiate sanctions against banks that have violated the rules.

Yet we need to analyze the role of national banking regulators in the context of the deep transformations of European economies. Since the 1970s, European states have become less involved in direct ownership and steering of the market. Instead, they have engaged extensively in “the correction of market failures via rule-making” (Thatcher 2002a: 860). This change has led to the rise of independent regulatory agencies (IRAs). Following Mark Thatcher’s (2002b: 956) definition, “an IRA is a body with its own powers and responsibilities given under public law, which is organizationally separated from ministries and is neither directly elected nor managed by elected officials.” According to Giandomenico Majone (1994: 89), the high level of technical expertise concentrated in IRAs and their ability to support very specialized policy-making provide an important rationale for setting up such agencies in different policy areas.

Banking sector regulators in Europe can indeed be classified as IRAs. We need to note here that IRAs are not part of government ministries and their decisions are more consequential than those of purely consultative agencies and committees. Fabrizio Gilardi (2005: 97) has demonstrated empirically that “independent regulatory agencies have spread in all Western European countries and well beyond utilities, financial institutions, and the regulation of competition.” As we saw earlier in the case of level 3 Lamfalussy committees, the rise of independent banking regulators on the domestic level has boosted cooperation among experts from the public and private sectors and professionals working in different countries (Thatcher 2002a: 860; Coen and Thatcher 2005: 337).
V. THE EVOLUTION OF BANKING SECTOR SUPERVISION IN BULGARIA AND HUNGARY AFTER 1989

Why are Bulgaria and Hungary, two new EU member states, compelling cases to investigate the dynamics of banking regulation in the Union? New EU member states had to adopt all EU level financial regulations as part of the pre-accession process. At the same time, following the collapse of communism in 1989, Eastern European countries sought to transform their economies and imported extensively best practices from Western industrialized states. Thus new EU member states offer important evidence about policy influences from the EU level due to the accession process and the international level due to economic globalization.

Bulgaria and Hungary also represent the two types of banking supervision organizational structure in the EU. In Bulgaria, a supervision department within the central bank is in charge of monitoring banks and initiating sanctions. In Hungary, an independent agency, the Hungarian Financial Supervisory Authority (PSZÁF), oversees the entire financial sector. Moreover, among new EU member states, Bulgaria and Hungary represent late and early reformers, respectively. Bulgaria experienced a prolonged period of partial reforms and economic stagnation until the late 1990s. In Hungary, market economy transformations took place fairly quickly in the early 1990s (Dobrinsky 2000; Vachudova 2005). Considering evidence from the two cases, let us evaluate the three hypotheses regarding banking regulation in the EU presented earlier.

Hypothesis 1: A network of public, private, and supranational actors governs the banking sector.

Is there evidence that national banking regulators in Bulgaria and Hungary use international supervision rules and interact with private actors? The Basel Accords developed by the BCBS for advanced industrialized countries and later taken up by many emerging economies have been adopted in Bulgaria and Hungary as well. Yet despite the existence of legal provisions to implement the Basel I capital adequacy ratio of 8 percent, the governments of both countries lacked political will to enforce compliance in the early 1990s (Piroska 2004: 13; Ignatiev 2008, personal interview). In both countries, the banking sector supervisory organizations did not have sufficient operational independence from the government to pursue rule enforcement single-handedly (Piroska 2004: 13; Ignatiev 2008, personal interview). The implementation of Basel I and, subsequently, Basel II was stricter and more successful following the completion of bank privatization in Hungary by 1997 and economic reforms in Bulgaria after the 1996/97 financial crisis.

Both Bulgaria and Hungary had to harmonize their national legislation, including in the banking sector, with that of the EU before they could become members of the Union. Hungary applied for EU membership in 1994 and started accession negotiations in 1998, while Bulgaria applied for EU membership in 1995 and started accession negotiations in 2000. From the 31 accession negotiation chapters, Chapters 3 (Freedom to Provide Services) and 11 (Economic and Monetary Union) are the most relevant for banking. Let us now review Bulgaria and Hungary’s progress in adopting and implementing EU level banking regulations.
Bulgaria closed provisionally Chapter 3 very quickly compared to other policy areas: It took less than a year to harmonize the country’s legislation and practices with those of the EU (European Commission 2008a). As summarized in the Commission’s monitoring report, by the time of accession in 2007, the Basel II capital requirements were fully incorporated in national legislation. Furthermore, “banking supervision is well equipped and competently supervises the banks… the capacity and expertise of the supervision has been constantly upgraded (European Commission 2005a: 31). It took only a month to harmonize Chapter 11 legislation (European Commission 2008b). As we will see in the next sections, the fast pace of harmonization with EU banking regulations in Bulgaria can be explained by the far-reaching economic transformations following the 1996/97 financial crisis and the implementation of international best practices in banking even before the formal start of EU accession negotiations.

Hungary opened Chapter 3 in 1999 and closed it provisionally in 2000 (European Commission 2008a). Similar to the dynamics in Bulgaria, Chapter 11 was closed faster, for several months in 1999 (European Commission 2008b). According to the European Commission’s assessment, “the Hungarian Financial Supervisory Authority essentially has the required infrastructure and human resources to deal with the acquis-related tasks in the field of financial institutions” (European Commission 2003: 22). With respect to Chapter 11, the Commission concluded that “Hungary has met the commitments and requirements arising from the accession negotiations and is in a position to implement the acquis” (European Commission 2003: 33).

Thus we have found support for Hypothesis 1: National banking sector regulators in Bulgaria and Hungary have endorsed international standards such as the Basel Accords and have adopted all relevant EU level banking sector legislation.

Hypothesis 2: International networks of experts are instrumental in formulating and developing banking regulations.

What has been the role of domestic and international experts in formulating banking regulations in Bulgaria and Hungary since 1989? Following the collapse of the communist regime in 1989, the Bulgarian National Bank (BNB) became the country’s central bank. Experts from the bank, including the supervision department, took part in short-term training programs abroad and interacted with their international counterparts (Roussenova 2007, personal interview). However, as one participant pointed out, “political pressure on the BNB was very strong at the time” and that restricted the subsequent implementation of the international regulations and practices to which the national experts had been introduced (Ignatiev 2008, personal interview).

Following a severe financial crisis in 1996/97 and early elections, a new center-right government in Bulgaria embarked on a course of comprehensive economic reforms (Dobrinsky 2000). This government welcomed foreign advisors and respected the independence of the BNB. In the area of banking supervision, my interviewees from the BNB’s Supervision Department singled out USAID as the international organization with the most significant and lasting impact on the development of supervision rules and practices in Bulgaria (Roussenova 2007, personal interview; Petrova 2008, personal interview; Anonymous interview 2008). In the aftermath of the
1996/97 crisis, about 10 USAID experts worked closely with Bulgarian supervisors on a wide range of issues in the period 1998-2003. They helped draft the new Bulgarian Banking Law and develop handbooks for supervisors. They also accompanied Bulgarian supervisors on their on-site examinations and assisted with data collection and analysis (Ignatiev 2008, personal interview). As one interviewee summed up, “the USAID experts provided very useful and relevant advice, they monitored and gave us feedback on how we implemented the new supervision guidelines” (Anonymous interview 2008). Here we have to note the importance of Bulgarian supervisors’ active interest and willingness to learn more about international rules and practices. According to senior supervisor Tatyana Petrova (2008, personal interview), the leadership of the BNB and the Supervision Department recognized the potential benefits of USAID expertise and sought to cooperate with the US agency. Petrova (2008, personal interview) also stressed that Bulgarian experts took an active role in evaluating and choosing only foreign practices that were relevant for the domestic conditions.

The presence of USAID experts over an extended period of time contributed to a process of updating supervision rules in Bulgaria through dialogue and social interaction rather than mechanical rule transfer. Bulgarian supervision professionals took the initiative to “write up, improve, and specify a lot of internal rules and principles regarding licensing, on-site examinations, and sanctions” (Timnev 2008, personal interview). Thus when EU experts visited the Supervision Department in order to evaluate Bulgaria’s readiness to apply the *acquis communautaire* in financial services, they found very few issues that still needed to be resolved. EU financial sector experts spent relatively little time in the organization and had a minimal impact on the way bank supervision is practiced in Bulgaria (Ignatiev 2008, personal interview).

For their part, Hungarian banking sector experts enjoyed a very permissive environment in the early 1990s with respect to the content of the new banking sector laws, including supervision rules. According to long-term supervision professional Klára Csoór (2006, personal interview), experts had a carte-blanche to put in place the policies that they deemed necessary. Private actors also played a role in the development of bank supervision in Hungary. In the early 1990s, the Hungarian supervision organization had limited personnel who could carry out on-site bank examinations. On several occasions, Bank Supervision contracted major international audit companies to conduct on-site bank examinations on behalf of the organization. Thus Hungarian supervisors in the early 1990s could base their risk analyses of banks’ portfolios on reliable internationally-recognized auditing practices (Piroska 2004: 18).

Hungary actively participated in economic reform programs organized by international actors such as the IMF and the World Bank in the early 1990s. The World Bank in particular ran a project to assist Hungarian legislators with drafting the new banking laws and advocated establishing an independent banking supervision agency (Piroska 2004: 10). We need to emphasize here that even though the World Bank organized training seminars for Hungarian bank supervisors, in the end, it was a strategic domestic decision to establish and develop independent banking supervision, recruit and train professional supervisors (Csoór 2006, personal interview). USAID experts helped prepare guidelines for on-site bank examinations in Hungary but they had a more limited role than in Bulgaria (Piroska 2004: 16). According to long-term supervision professional Katalin Mérő (2006, personal interview), the overall stabilization of the Hungarian banking system and introduction of prudential supervision
practices took place by the end of the bank privatization in 1997, well before the beginning of accession negotiations with the EU. The start of the Lamfalussy process in the EU increased transparency and led to better coordination of supervision practices across the Union (Mérő 2006, personal interview). Mérő emphasized that it was not joining the EU that caused the adoption of international bank supervision standards in Hungary. In her own words, “we did that earlier because most Hungarian private banks prefer to operate according to common international rules” (Mérő 2006, personal interview).

In sum, we have found support for Hypothesis 2. International experts from USAID provided important assistance to Bulgarian supervision professionals in the period 1998-2003. World Bank and, to a lesser extent, USAID experts conducted training for Hungarian bank supervisors in the early and mid-1990s.

Hypothesis 3: Independent regulatory agencies, rather than government ministries, implement banking regulations and subsequently monitor compliance.

In Bulgaria, Bank Supervision is a department within the central bank – the BNB. As the BNB was not fully independent from political pressure before the 1996/97 economic crisis, the supervision department could not conduct its activities independently either. In the aftermath of the crisis, the new government introduced a currency board and guaranteed central bank independence. The new Bulgarian Banking Law and Law on the BNB, both adopted in 1997, contained stricter and more precise supervision requirements as well as more severe penalties (Ignatiev and Simeonov 1999). Over time, Bank Supervision gained more independence from political interference and also more organizational responsibilities especially in the realm of granting bank licenses and initiating sanctions (Ignatiev and Simeonov 1999). The Bulgarian government established a separate Financial Supervision Commission in March 2003 that is responsible for the integrated supervision of securities, exchanges, insurance, and pension funds. According to senior supervision professional Tatyana Petrova (2008, personal interview), Bank Supervision is well-situated within the BNB organizationally because since the beginning of transition the Bulgarian banking sector has been more developed and complex than securities and insurance.

After 1996/97 crisis, Bulgarian supervisors have taken a more pro-active stance in enforcing bank regulations. Several bank licenses were revoked due to solvency concerns (Ignatiev and Simeonov 1999). Cornerstone reforms in the banking sector and supervision took place by the end of bank privatization. When EU accession negotiations began in 2000, in the words of one supervision professional, “We were able to close the financial services chapters very quickly because after the 1996/97 crisis we introduced better standards and more discipline in the sector” (Timnev 2008, personal interview). Even when EU level bank regulations allow for more discretion in national implementation, Bulgaria’s Bank Supervision tends to adopt a more conservative stance to ensure the stability of the financial system and avoid crisis (Anonymous interview 2008).

How does Bulgaria’s Bank Supervision interact with other public and private actors in the country? Supervision professionals maintain contacts with the commercial banks on several organizational levels: Experts, directors, and even BNB governors if there is a serious issue that
needs to be resolved (Timnev 2008, personal interview). Supervisors aim for active cooperation with their counterparts in the commercial banks and strive for “very professional and respectful relations” (Petrova 2008, personal interview). Especially in the Bank Supervision Policy and Methodology department, headed by Tatyana Petrova, commercial bank experts call often to receive methodological recommendations and practical advice. Those contacts are problem-driven rather than codified (Petrova 2008, personal interview).

Bank Supervision’s Legal department regularly consults the Association of Banks in Bulgaria, the main peak association in the sector, regarding any forthcoming regulatory changes. The Association receives drafts of planned regulatory changes, submits written positions on the drafts, and often takes the initiative and makes suggestions for regulatory changes in line with the needs and preferences of its members (Ivanova, personal interview 2009). In turn, Supervision experts usually take into account the Association’s feedback, as long as it “does not contradict the established goals and principles of the organization” (Timnev 2008, personal interview). Supervisors also maintain contacts with commercial banks’ private auditors in order to check how a different organization assesses banks’ risks and verify the reliability of banks’ self-reported information (Petrova 2008, personal interview).

With respect to the influence of government ministries and political parties, one long term supervision professional stressed that “Bulgaria’s bank supervision has only one God – the Basel Committee on Banking Supervision” in the sense that political interference either from the governing or other political parties is now unacceptable (Anonymous interview, 2008). Unlike in Hungary, since the beginning of transition, Bulgaria’s Bank Supervision has not been influenced significantly by the Ministry of Finance (Avramov 2009, personal interview; Ganev 2009, personal interview).

The Hungarian Financial Supervisory Authority (PSZÁF) that currently oversees banking, securities, insurance, and pension funds was established in April 2000. Before the creation of the single financial supervision organization, Hungary had a joint banking and capital market supervision agency since 1996, and separate entity for overseeing securities, exchange, and pension funds (Piroska 2004). In her comprehensive analysis of the development of bank supervision in Hungary and Slovenia, Dóra Piroska (2004) has argued that since the 1990s international actors have advocated shielding Hungary’s bank supervision from political interference. In Piroska’s (2004: 8) view, there has been a strong consensus among international experts in favor of independent banking supervision that parallels the broad international consensus in support of central bank independence (Maxfield 1998; Marcussen 2005; Epstein 2006; Johnson 2006).

The Hungarian case offers an important insight into the tension between government ministries and independent regulatory agencies. Before the PSZÁF asserted itself as the main public regulator in the financial sector, the Hungarian Finance Ministry and the Hungarian National Bank also sought to influence banking sector regulations. According to Piroska (2004: 23), in the early 1990s, the Finance Ministry “often behaved as if the supervision agency was part of its own greater bureaucratic organization.” In fact, the very origins of bank supervision in Hungary go back to the country’s Finance Ministry. In the late 1980s, “6 people at the Finance Ministry supervised the entire banking sector” (Piroska 2004: 21). The HNB has been interested
in managing the macroeconomic parameters in the sector according to its priorities, but has been willing to leave micromanagement issues to Bank Supervision (Csoör 2006, personal interview). For its part, the Finance Ministry has been interested in influencing decisions regarding bank taxation in order to maximize tax revenues. Yet the two big public institutions, the HNB and the Ministry of Finance, could not agree on the precise role of Bank Supervision which, in the long run, boosted the organization’s independent credentials. Successive Heads of Supervision pursued greater independence and legitimacy of the organization. In the words of former Head of Supervision Tamás Rusznák, cited in Piroska (2004: 23), “I wanted the agency not to be supervised by the Ministry of Finance or the government…as in the operation of those two institutions the conflicting goals of fiscal policy and bank supervision become immediately evident.”

Overall, we have found support for Hypothesis 3: In Bulgaria and Hungary independent regulatory agencies monitor and ensure compliance with bank supervision rules. Bulgaria’s Bank Supervision, organizationally situated within the central bank, has enjoyed significant independence from political pressure after the 1996/97 economic crisis and subsequent economic reforms. Hungary’s Bank Supervision, situated within the financial sector regulator PSZÁF, faced challenges from the Finance Ministry but has asserted itself as the main public regulator in banking.

VI. CONCLUSION

This article has demonstrated that the insights of multi-level governance apply beyond the regional development and structural policies of the EU. I found convincing evidence in support of three hypotheses testing the explanatory power of multi-level governance in EU banking regulation. First, rather than states, a constellation of public, private, and supranational actors governs the banking sector. Second, networks of international experts, rather than national civil servants, are instrumental in formulating and developing banking regulations. Third, independent regulatory agencies, rather than government ministries, monitor implementation and ensure compliance with banking regulations.

The influx of more players and private capital in financial markets and the development of increasingly complex financial instruments have exerted strong functional pressures to adjust banking regulations internationally. Regulatory coordination among states is essential to offset the large negative externalities of financial turmoil, and so is the interaction between private and public actors. Consequently, as this article has shown, experts have gained a prominent role in formulating bank regulations. Furthermore, on the national level supervision tasks have been delegated to highly specialized independent regulatory agencies. At the same time, agency clearly plays a role in the recent transformation of banking regulation. We saw in the case of Bulgaria that USAID and domestic experts actively exchanged ideas and cooperated on developing the new Bulgarian supervision guidelines. The Hungarian case has highlighted the importance of leadership: Heads of Bank Supervision consistently pushed for more organizational independence and oversight responsibilities.
NOTES

1 It is beyond the scope of the article to discuss the debate between the rationalist and the constructivist schools. Two excellent pieces that provide an overview of what is at stake in this debate are Finnemore and Sikkink’s (2001) article on constructivism in international relations and comparative politics and Jupille, Caporaso, and Checkel’s (2003) survey article on integrating rationalism and constructivism in the study of the European Union. As an example of convincing synthesis of rationalism and constructivism, Thomas Conzelmann (1998: 9) has employed effectively both rationalist and constructivist arguments in his multi-level governance analysis of Germany’s regional policy.

2 The “Group of Ten” is comprised of 11 industrialized states that consult and cooperate on economic, monetary, and financial matters. Those states are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. Luxembourg and Spain are also members of the Basel Committee.

3 Appendix I provides a diagram of the Lamfalussy process.

4 It is beyond the scope of this article to discuss the pros and cons of having a single supervision entity for the entire financial sector or multiple supervision organizations focusing on specific fields such as banking, insurance, and securities. Kremers et al. (2003) present a comprehensive analysis of the issues in that debate.

5 Since 1998, the European Commission has published annual reports on the progress of each candidate country toward membership in the EU. The *acquis communautaire* has been organized in 31 negotiation chapters based on which the Commission specifies pieces of legislation that need to be adopted or amended to achieve full compliance with the *acquis*.
APPENDIX I: The four-level regulatory approach under the Lamfalussy process

APPENDIX II: List of interviews

Bulgaria


Ivanova, Kalina: Association of Banks in Bulgaria (ABB), 26 March 2009.


Hungary


Csaba, László: Academic; Previously Finance Minister, 11 April 2006.

Csoór, Klára: Senior Counsellor—PSZÁF, 12 April 2006.

Horvath, Julius: Academic, 13 April 2006.

Mérő, Katalin: Managing Director—PSZÁF, 19 April 2006.

Soós, Károly Attila: Researcher; Previously Member of Parliament, 10 April 2006.
BIBLIOGRAPHY


