

VILNIUS UNIVERSITY

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**THE POLITICAL ECONOMY OF EUROPEAN FINANCIAL SERVICES  
REGULATION: EXPLAINING EU BANKING POLICY STABILITY AND  
CHANGE**

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## List of Abbreviations

BIS	Bank for International Settlements
BRRD	Bank Recovery and Resolution Directive
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DGS	deposit guarantee scheme
DGSD	Deposit Guarantee Schemes Directive
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council of Ministers
EDIF	European Deposit Insurance Fund
EDIS	European Deposit Insurance Scheme
EEC	European Economic Community
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
ESA	European Supervisory Authority
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRC	European Systemic Risk Council
ESRB	European Systemic Risk Board
EU	European Union

FSA	Financial Services Authority
FSAP	Financial Services Action Plan
GIIPS	Greece, Ireland, Italy, Portugal, and Spain
IMF	International Monetary Fund
LI	liberal intergovernmentalism
MSF	multiple streams framework
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
PET	punctuated equilibrium theory
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system

*Our plans may be technically all right. They may fit into the present economic context. But our chances of realising them will be slim if we seem to be approaching the problem merely in a technocratic way or as a routine matter. Our ideas will only 'sell', to use a marketing expression, if we can prove their political and social utility. We should, therefore, think of the broader context of what we are trying to achieve.<sup>1</sup>*

Christopher Samuel Tugendhat, British  
Member of the European Commission, 1981

## **Introduction**

In the history of European integration, the second half of 2012 will come to be known as the start of an unprecedented overhaul of the European Union (EU) banking policy. In response to the destructive 'vicious circle' between strained banks and indebted sovereigns in the euro area<sup>2</sup>, at the historic June 2012 Euro Summit the euro area member states committed to implementing a fundamental change in their banking policies. Notwithstanding the fact that the actual decisions were less ambitious than the initial proposals, the implemented reforms shifted a significant part of national control over banking supervision and resolution to the supranational level. Moreover, by placing the European Central Bank (ECB) at the centre of the new EU supervisory system, they also substantially expanded the role and powers of the central bank. These landmark changes, which soon came to be universally known as the 'banking union', have been viewed as the most significant step towards

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<sup>1</sup> Tugendhat, C. (1981) Speech to the Legal and Economic Committee of the European Federation of Building Societies. Quoted from Murlon-Druol, E. (2016) Banking Union in Historical Perspective: The Initiative of the European Commission in the 1960s – 1970s. *Journal of Common Market Studies*. 54(4), pp. 913–927, p. 924.

<sup>2</sup> Euro Area Summit (2012) *Statement*. Brussels, 29 June. Available from: [https://www.bankingsupervision.europa.eu/about/milestones/shared/pdf/2012-06-29\\_euro\\_area\\_summit\\_statement\\_en.pdf](https://www.bankingsupervision.europa.eu/about/milestones/shared/pdf/2012-06-29_euro_area_summit_statement_en.pdf) [Accessed 9 September 2017].

deeper EU integration since the start of the euro.<sup>3</sup> Emphasising their transformational nature, some policymakers have even described the initial proposals as a greater pooling of sovereignty than the creation of the single currency itself.<sup>4</sup>

In general, the term ‘banking union’ refers to the transfer of national competence over banking policy to the EU level. In response to the lessons of the financial and sovereign debt crises, in 2012 the EU Member States reached a rapid political agreement, concluding that the banking union would consist of a European banking supervisor and a European bank resolution scheme. There also appeared to be a broad consensus on the principle that the new EU banking policy architecture should be based on common bank regulatory requirements, otherwise known as the ‘single rulebook’. Nevertheless, the start of practical discussions soon revealed substantial differences in the Member States’ willingness to surrender banking policy autonomy as well as share possible bank risks. These differences influenced not only the ‘breadth’ of the established banking union, or the necessary elements of a fully-fledged new EU banking policy framework, but also its ‘depth’, i.e. the actual ambition of deeper integration in the EU financial policy domain.

This dissertation aims at answering two interrelated questions. *First*, why did the euro area member states decide to surrender national

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<sup>3</sup> Draghi, M. (2013) Address at the new year’s reception of the Frankfurt Chamber of Commerce and Industry, Frankfurt am Main, 22 January; Wolf, G.B. (2014) European banking union and financial integration. *Bruegel* [blog]. 19 December. Available from: <http://bruegel.org/2014/12/european-banking-union-and-financial-integration/> [Accessed 22 August 2015]; Howarth, D. & Quaglia, L. (2014) The Steep Road to European Banking Union: Constructing the Single Resolution Mechanism. *Journal of Common Market Studies*. 52 (Annual Review), pp. 125–140, p. 125.

<sup>4</sup> E.g. Bowles, S. (2013) Banking Union is a greater pooling of sovereignty than signing up to the Euro. Available from: <http://sharonbowles.org.uk/en/article/2013/0689223/banking-union-is-a-greater-pooling-of-sovereignty-than-signing-up-to-the-euro-sharon-bowles-mep> [Accessed 7 February 2015]; Buti, M. (2013) Economic governance: Restoring confidence and anchoring stability. Presentation at the conference ‘The Blueprint for a deep and genuine EMU: Debating the future economic, monetary and banking and political union’, Brussels, 7 May.

control over their banking systems by creating an EU banking union? Or, more precisely, why did governments decide to transfer national competence over bank supervision and resolution to the EU level in 2012–2013 despite the fact that similar proposals had been constantly rejected since the start of drafting the statute of the ECB? *Second*, what accounts for the content of the established banking union? Why did the EU Member States agree on such an EU-level resolution framework in which they are likely to bear the initial fiscal costs for supranational supervisory failures and decisions on whether and how to resolve troubled banks? And did an isolated German vision of an EU banking union with limited supranational supervisory powers and a relatively low degree of bank risk sharing actually prevail over more ambitious proposals? From a broader perspective, the research work analyses the recent overhaul of the EU banking policy with an attempt to shine new light on, first, why and when the EU Member States decide to transfer national competence to the supranational level and, second, what factors determine whose policy preferences will ultimately prevail.

The dependent variables of this research are the *timing* of the creation of the banking union and its *content* or form. While the first variable derives from the first of the above-mentioned research questions and is related to the process of European integration in the long run, the second variable stems from the latter puzzle and is linked to the results. The content variable is further broken down into four values, which are presented as ‘ideal’ types of the banking union, namely the ‘full banking union’, ‘corrective banking union’, ‘preventive banking union’, and ‘incomplete banking union’.

It is argued that the timing of the creation of the banking union can be best explained by four explanatory variables. To begin with, the research sees the European sovereign debt *crisis* as a necessary but insufficient condition for the creation of the banking union. Building on

elaborated punctuated equilibrium theory (PET), it, therefore, argues that the timing of the decision can be best explained by changes in two intervening variables: the *banking policy image* held by key national governments and the *banking policy-making venue*. The former variable is understood as prevailing assumptions about the current challenges that the banking policy is expected to address as well as the most effective ways of dealing with them, while the latter – as a closed circle of policymakers who take authoritative policy decisions. It is showed that the timing of the creation of the banking union was determined by, first, a rapid shift in the main objectives of the EU banking policy – from ‘preventive’, i.e. future-oriented, to those also including ‘corrective’ (crisis management) aspects – and, second, substantially increased politicisation of the policy that resulted from the involvement of new political actors in the previously mostly expert-led EU banking policy domain. This picture of how the crisis led to the transformation of the EU banking policy domain would, however, be incomplete without a third intervening explanatory variable – *interdependence* among the euro area countries. As it will be showed, mutual interdependence was the primary source of change in both the EU banking policy image and the policy-making venue, at the same time reinforcing the links between them.

Regarding the second dependent variable, the research proposes that the content of the banking union corresponds to the *preference intensity* of Member States and the *political legitimacy* of national positions, which forced Germany – the country with the lowest preference intensity – to make concessions to others. It is showed that while at the final stages of negotiations Germany preferred an ‘incomplete’ form of the banking union, and the majority of other decision-makers – a ‘complete’ one, the final agreement could be defined as a ‘preventive’ type of the banking union. It is also suggested that while the France-led group of countries, including the EU institutions, agreed to limit their preferred

degree of bank risk sharing, Germany made relatively larger concessions on the scope of transferring decision-making powers to the EU. In this context, the research highlights an open-ended ‘definition’ of the banking union and ‘constructive ambiguity’ with regard to its final form that contributed to reaching politically-difficult agreements.

With a view to answering the afore-mentioned questions, the research contributes to three bodies of scholarly literature. *First*, it adds to the literature on the political economy of EU financial services regulation in general and, more specifically, to emerging research on the political economy of the banking union. In this regard, it aims at filling the gaps in research on the timing and content of the banking union: the research offers a theoretical contribution on the ‘varieties’, or ‘ideal’ types, of the banking union and an empirical one on the evolution of the post-crisis EU banking policy. *Second*, by identifying conditions necessary for policy stability, as well as incremental and transformational policy change, this work advances the theory of the policy process<sup>5</sup>. *Finally*, the research also adds to the theory of European integration. More precisely, with the aim of explaining the content of the banking union, the author combines rational and sociological explanations of the EU bargaining process into one analytical framework. The empirical analysis suggests that the explanatory strength of the proposed analytical framework is superior to individual (either rational or sociological) accounts and transcends the main theories of European integration.

The dissertation consists of four parts. The *first* part reviews several bodies of scholarly literature on the banking union and identifies its gaps. The *second* part introduces the research design. More specifically, it presents independent, explanatory variables and the theoretical

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<sup>5</sup> As it will be mentioned in the second part of the dissertation, the research assumes that the theories of the policy process originally developed for the analysis of national policy can also be applied to EU decision-making and its institutional transformation, i.e. not only to a change in policy, but also a change in polity.



framework, i.e. the main causal mechanisms that are most likely to explain, first, the timing of the decision to create the banking union and, second, its content or form. The *third* – empirical – part examines the timing of the banking union. Finally, the *fourth* continues with an explanation of the content of the agreements, including both the ‘breadth’ and ‘depth’ dimensions of the banking union. The research concludes with a summary of findings and discussion on the implications of the results.

## **1. The Politics of EU Financial Services Regulation**

The first part reviews several bodies of scholarly literature relevant to this research. With a view to identifying the state of the art and the main gaps in academic research, in the first section the author turns to the emerging literature on the banking union. The second section focuses on the theory of European integration to distil the most likely explanations of, first, the timing of the creation of the banking union and, second, the content of the Member States’ agreements. It also aims at assessing the extent to which the dominant theoretical perspectives are capable of providing convincing answers to the two questions of the research.

### ***1.1. Literature on the Banking Union***

#### **1.1.1. Rationale and Institutional Structure**

The pre-crisis literature on banking regulation in the EU emphasised challenges created by the emergence of pan-European banks on the one hand and national accountability for financial stability, notably banking supervision and bank crisis resolution, on the other. As famously pointed

out by Mervyn King, former Governor of the Bank of England, banks are ‘global in life but national in death’<sup>6</sup>. This issue was also raised and explored in the early literature related to the banking union, which proposed possible policy solutions.

In an IMF Working Paper of 2007, Čihák and Decressin proposed to address the problem by creating a ‘European Banking Charter’, ‘equivalent to a 28<sup>th</sup> regime for the operation of financial institutions in Europe’.<sup>7</sup> According to the proposal, the creation of such a Charter would allow European banks to freely choose between a European licence, distinguished by fully-harmonised EU-level banking regulation, and national licenses based on different national-level regimes. The authors argued that for the Charter to work it should meet two conditions: first, national supervisory authorities should have joint responsibility and accountability for EU-chartered banks and, second, these banks should operate under ‘a complete EU-wide financial stability arrangement’. According to the authors, the latter arrangement should have to encompass ‘harmonized supervisory powers and practices’, ‘uniform prudential regulation’, ‘a single deposit insurance scheme’, and a Charter-specific bank insolvency regime.<sup>8</sup> At the same time Véron<sup>9</sup> argued for establishing ‘a two-tier financial stability framework’ with a similar ‘EU-level regulatory and supervisory regime’ for pan-European banks. However, in contrast to Čihák and Decressin, he went even further, proposing to transfer ‘some supervisory functions’ to one or several EU agencies<sup>10</sup>.

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<sup>6</sup> FSA (2009) *The Turner Review: A regulatory response to the global banking crisis*. London: FSA, p. 36.

<sup>7</sup> Čihák, M. & Decressin, J. (2007) The Case for a European Banking Charter. *IMF Working Paper*. WP/07/173, p. 13. In 2007, the EU consisted of 27 Member States.

<sup>8</sup> *Ibid.*, p. 14.

<sup>9</sup> Véron has been recognised for his ‘early advocacy of European banking union’. See Bruegel (2015) *Nicolas Véron*. Available from: <http://bruegel.org/author/nicolas-veron/> [Accessed 25 October 2015].

<sup>10</sup> Véron, N. (2007) Is Europe Ready for a Major Banking Crisis? *Bruegel Policy Brief*. 2007/3, pp. 6–7.

More recently, Schoenmaker proposed a well-known formal illustration of the issue. Similarly to the famous Mundel-Flemming's monetary trilemma, the scholar put forward the concept of 'financial trilemma', stating that governments are able to reconcile only two out of three objectives at a time: (1) financial stability; (2) financial integration; and (3) national financial policies. According to Schoenmaker, governments have an incentive to opt for the nationally-cheapest solutions to ailing cross-border financial firms despite the fact that they may be sub-optimal from a broader financial stability perspective. Emphasising the aforementioned tension between cross-border banking and national financial stability arrangements, the financial trilemma, therefore, implies that financial stress and the search for financial stability forces the EU Member States to choose between two options: either to reverse financial integration and achievements of the single market or to transfer national banking policies to the EU level with no national bias.<sup>11</sup>

Schoenmaker's economic arguments are echoed in the former United Kingdom single supervisor's – the Financial Services Authority's (FSA) – review of the causes of the global financial crisis. In response to the lessons of the collapse of the Icelandic banking sector, the FSA argued for 'more Europe' or 'more national powers' in financial regulation.<sup>12</sup> The supervisor criticised the current rules of the EU single market, according to which any bank from any EU or European Economic Area country is entitled to operate in another Member State as a branch, which – in contrast to a subsidiary – is subject to home country supervision. As a result, before the global financial crisis, Icelandic banks were able to raise deposits in the United Kingdom without being supervised by the FSA. But when they faced financial difficulties, the 'too big to save' size of the Icelandic banking sector prevented the Icelandic government from bailing

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<sup>11</sup> Schoenmaker, D. (2011) The financial trilemma. *Economics Letters*. 111(1), pp. 57–59.

<sup>12</sup> FSA (2009), p. 100.

them out or immediately compensating the banks' depositors. As a possible solution to the problem, the FSA even suggested to consider the introduction of a 'pan-European arrangement for the deposit insurance of banks operating across-border in branch form'.<sup>13</sup>

Other authors have recently emphasised additional arguments in favour of the banking union. Gros analysed the nexus between the banking and fiscal unions. Building on the US experience, he argued that 'the US Banking Union', which consists of common bank supervision, resolution and deposit insurance, provides a greater shock-absorbing capacity than explicit federal transfers. Against this background, he suggested that in order to ensure stability, a well-functioning banking union did not need a fiscal union.<sup>14</sup> Similarly, the staff of the European Commission offered a more detailed assessment of cross-border risk sharing in the euro area and the US. According to their findings, in comparison to the US, where around 75% of an asymmetric output shock is shared among different states, in the euro area this share is only around 25%. The main reason for the gap comes from the insufficiently-developed European capital markets.<sup>15</sup> The Commission has, therefore, ardently argued that 'enhancing private risk sharing in the euro area <...> through the completion of the Banking Union <...> and a true Capital Markets Union' is 'a key policy priority'<sup>16</sup> and 'the most effective way to increase the resilience of the Eurozone as a whole, and each of its member states, to economic shocks'<sup>17</sup>.

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<sup>13</sup> Ibid., p. 102.

<sup>14</sup> According to the author, it naturally follows that a monetary union with a fully-fledged banking union does not need a political union too. See Gros, D. (2013) Banking Union instead of Fiscal Union? In: Allen, F., Carletti, E. & Gray, J. (eds.) *Political, Fiscal and Banking Union in the Eurozone?* Philadelphia, PA: FIC Press, pp. 65-77, p. 73.

<sup>15</sup> European Commission (2016) *Quarterly Report on the Euro Area*. 15(2), Luxembourg: Publications Office of the European Union, p. 5.

<sup>16</sup> Ibid.

<sup>17</sup> Buti, M., Leonardo, J. & Nikolov, P. (2016) Smoothing economic shocks in the Eurozone: The untapped potential of the financial union. *VoxEU.org* [online]. 25 August. Available from: <http://voxeu.org/article/smoothing-economic-shocks-eurozone-untapped-potential-financial-union> [Accessed 3 December 2016].

Research emphasising rationale of the banking union is inevitably linked to the analysis of its institutional features and optimal form. At one end of the spectrum, the majority of authors stress the importance of establishing all three pillars of the banking union: (1) single supervision, (2) common resolution, and (3) common deposit insurance. For instance, Herring argued that the first pillar of the banking union – the Single Supervisory Mechanism (SSM) – alone would neither be effective, nor able to ensure financial stability, although he recognised that it was much more difficult to agree on the other two pillars of the banking union than on the first one.<sup>18</sup> The IMF staff also highlighted the need for progress on all three pillars.<sup>19</sup> In line with this view, Gros and Schoenmaker concentrated on the ‘crisis management stage’ of the banking union and argued for combining the second and the third pillars of the new EU banking policy framework into ‘a European deposit insurance and resolution authority (EDIRA) with financing from a European deposit insurance and resolution fund’.<sup>20</sup>

At the other end of the spectrum, White questioned the importance of the SSM and, building on the US experience, argued that ‘the most important elements of a banking union are the resolution and recapitalisation functions, followed by deposit protection’.<sup>21</sup> The author, however, pointed out the political purpose of a single supervisory authority – to give ‘some control over the way in which banks in other

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<sup>18</sup> Herring, R. J. (2013) The Danger of Building a Banking Union on a One-Legged Stool. In: Allen, F., Carletti, E. & Gray, J. (eds.) *Political, Fiscal and Banking Union in the Eurozone?* Philadelphia, PA: FIC Press, pp. 9–28.

<sup>19</sup> Goyal, R. et al. (2013) A Banking Union for the Euro Area. *IMF Staff Discussion Note*. SDN/13/01.

<sup>20</sup> Gros, D. & Schoenmaker, D. (2014) European Deposit Insurance and Resolution in the Banking Union. *Journal of Common Market Studies*. 52(3), pp. 529–546, p. 530; also see Schoenmaker, D. (2015) Firmer foundations for a stronger banking union. *Bruegel Working Paper*. 2015/13.

<sup>21</sup> White, P. (2012) *What a banking union means for Europe*. London: Centre for European Reform, p. 3.

countries are supervised and run' for countries that may be asked 'to contribute to bank rescues outside their borders'.<sup>22</sup>

As it will be elaborated in the next part, since the time of Maastricht the dominant argument against pan-European banking supervision was its negative fiscal implications for Member States. In other words, national governments did not accept the possibility of having to pay up the costs of supranational actions (or lack thereof). Spendzharova, for instance, found the potential fiscal consequences of supranational supervisory decisions to be the main reason why in the aftermath of the crisis the EU governments rejected calls for bigger integration of national supervisory policies.<sup>23</sup> This argument, nevertheless, highlights the importance of alignment between the levels on which financial institutions are supervised and resolved, thus emphasising the mutual interdependence of all three pillars of the banking union.<sup>24</sup>

To summarise, this body of literature deals with the rationale of the creation of the banking union, including its institutional form. It emphasises the importance of the historic move for the stability of the EU financial system and offers arguments in favour of establishing all three pillars of the banking union: supranational supervision, resolution and deposit insurance. However, the same pieces of work tend to overemphasise the benefits of the banking union, failing to elucidate distributional consequences of the historic move. Given their search of an 'ideal' institutional structure of the banking union, these accounts also tend to overlook related political obstacles in the way of establishing the proposed framework. Finally, this body of literature leaves a gap in more formalised (in contrast to normative) work on the elements of the banking

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<sup>22</sup> Ibid.

<sup>23</sup> Spendzharova, A. (2012) Is More 'Brussels' the Solution? New European Union Member States' Preferences about the European Financial Architecture. *Journal of Common Market Studies*. 50(2), pp. 315–334, pp. 318–319.

<sup>24</sup> E.g. Gros, D. & Schoenmaker, D. (2014), pp. 535–536; Schoenmaker, D. (2015).

union that are necessary for it to bring more stability than national arrangements.

### **1.1.2. National Preference Formation**

The *second* body of research focuses on the national level with the aim of explaining government preferences on the new EU banking policy framework. In one of the initial accounts Howarth and Quaglia reviewed intergovernmental debate on the banking union and key policy actors' positions in negotiations.<sup>25</sup> Despite their implicit emphasis on domestic political economy considerations, their work, however, did not offer any comprehensive framework for explaining national preference formation. Nevertheless, in their more recent contribution the authors proposed a 'financial inconsistent quartet' concept that they applied to explain the key determinants of national positions on the Single Resolution Mechanism (SRM)<sup>26</sup> and the SSM<sup>27</sup>. The authors argued that 'the effective absence of the 'lender of last resort' function at the national level in EMU and its legal elimination at the supranational level' makes it more difficult for the euro area governments to deal with financial instability, 'especially in the context of the growth in cross-border banking and the rapid expansion of bank balance sheets during the first seven years of the single currency'.<sup>28</sup> Therefore, in addition to the 'financial trilemma'<sup>29</sup>, created by the interplay between cross-border banking on the one hand and national financial policies on the other, Howarth and Quaglia proposed to consider

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<sup>25</sup> Howarth, D. & Quaglia, L. (2013) Banking union as holy grail: Rebuilding the single market in financial services, stabilizing Europe's banks and "completing" economic and monetary union. *Journal of Common Market Studies*. 51 (Annual Review), pp. 103–123.

<sup>26</sup> Howarth, D. & Quaglia, L. (2014).

<sup>27</sup> Howarth, D. & Quaglia, L. (2015) The Political Economy of the Single Supervisory Mechanism: Squaring the Inconsistent Quartet. Paper presented at the 14<sup>th</sup> Biennial Conference of the European Union Studies Association (EUSA), Boston, 5–7 March.

<sup>28</sup> Howarth, D. & Quaglia, L. (2014), p. 126.

<sup>29</sup> Schoenmaker, D. (2011).

the fourth element – participation in the single currency. Building on the concept, the authors argued that fewer tools at the euro area countries' disposal to safeguard financial stability reinforce the rationale for the creation of a banking union. At the same time the 'inconsistent quartet' suggests that the non-euro area Member States, whose national central banks are able to issue currency and buy government debt without limit (i.e. the lender of last resort functions remain intact), have fewer incentives to opt in. Besides the proposed framework, the authors also identified additional explanatory factors, arguing that national preferences of the euro area member states are influenced by moral hazard concerns stemming from existing 'BU-level' financial support and configuration of their national banking systems, notably, the degree of their internationalisation.<sup>30</sup>

Similarly to Howarth and Quaglia's argument about the importance of the structure of the domestic financial sector in determining government preferences, Spendzharova explicitly focused on two explanatory variables: foreign ownership of the national banking system<sup>31</sup> and internationalisation of domestic banks<sup>32</sup>. In her early account of the official positions of ten Central and Eastern EU Member States on the post-crisis de Larosière financial regulatory reform proposals, Spendzharova found a positive correlation between foreign ownership of a country's domestic banking system and its government's reservation about transferring regulatory competence to the EU level.<sup>33</sup> Her empirical analysis suggested that general Euroscepticism of governing political

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<sup>30</sup> Howarth, D. & Quaglia, L. (2014), pp. 127–128.

<sup>31</sup> Spendzharova, A. (2012); Spendzharova, A.B. (2014) Banking union under construction: The impact of foreign ownership and domestic bank internationalization on European Union member-states' regulatory preferences in banking supervision. *Review of International Political Economy*. 21(4), pp. 949–979.

<sup>32</sup> Spendzharova, A.B. (2014).

<sup>33</sup> Spendzharova analysed Member States' reservations on three policy issues: the division of national and supranational supervisory competences, national discretions, and the proposed dispute settlement mechanism. See Spendzharova, A. (2012).



parties mattered as well.<sup>34</sup> In her later analysis of the EU Member States' preferences on the post-crisis banking supervision reforms<sup>35</sup>, she put forward an additional explanatory variable, notably, internationalisation of domestic banks. According to the findings, there is 'sufficient empirical evidence' in support of her hypotheses that 'countries with low levels of foreign ownership and high internationalization of domestic banks <...> are in favour of further banking supervision harmonization at the EU level', while 'countries where foreign ownership is very high and domestic bank internationalisation low <...> favour more autonomy'.<sup>36</sup> The author, nevertheless, acknowledged that the two variables cannot fully account for the observed variation in preferences of all Member States and proposed two alternative explanatory variables: government Euroscepticism and dominant ideas about European integration and the single market. However, Spendzharova found them to be only complementary to her research.<sup>37</sup>

In a recent explanation of national preferences on the threshold for direct ECB supervision, Howarth and Quaglia proposed an implicit improvement to Spendzharova's work. They criticised aggregate internationalisation measures, such as the presence of cross-border banks in a national banking system and international exposure of domestic banks, due to their failing to account for the full picture of internationalisation.<sup>38</sup> However, instead of discarding the variable<sup>39</sup>, the

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<sup>34</sup> Ibid., p. 327.

<sup>35</sup> In this work Spendzharova analysed the following issues: preferences on binding regulatory powers of European Supervisory Authorities (ESAs), the distribution of competence between the home and host supervisors of cross-border financial firms, and national discretions in the IV Capital Requirements Directive (CRD IV). See Spendzharova, A.B. (2014).

<sup>36</sup> Ibid., p. 973.

<sup>37</sup> Ibid., pp. 971–972.

<sup>38</sup> Howarth, D. & Quaglia, L. (2016) Internationalised banking, alternative banks and the Single Supervisory Mechanism. *West European Politics*. 39(3), pp. 438–461.

<sup>39</sup> While Spendzharova's interpretation of internationalisation distinguishes between foreign ownership of the domestic banking system and cross-border activities of

authors put forward the concept of the ‘reach of internationalisation into a national banking system’ defined as ‘the extent to which even smaller banks were exposed to foreign banking operations’.<sup>40</sup> In their comprehensive analysis of national banking systems in seven EU Member States, the authors found the reach of internationalisation as the core explanatory factor for their governments’ positions on the threshold for direct EU-level supervision. According to them, the more smaller banks were internationalised in terms of holding international assets and, more importantly, exposed to larger banks with a strong international presence, the more they supported direct ECB supervision.<sup>41</sup> Although in all seven EU countries larger financial institutions supported direct supervision of all banks, Howarth and Quaglia’s research emphasised the importance of preferences of smaller banks to explain the full variation of national positions.

One should also mention Lombardi and Moschella’s research on domestic regulators’ preferences, providing an alternative perspective on the creation of the SSM.<sup>42</sup> Motivated by the fact that structural characteristics of the domestic economy and the banking sector fail to explain domestic regulators’ views, i.e. they did not always align with those of the domestic financial sector, the authors put forward an original institutionalist framework to address the puzzle. In their comparison of the German and Italian banking regulators’ preferences on the SSM, Lombardi and Moschella found that the institutional environment in which a regulator operated had significant influence. Specifically, the authors argued that regulators with responsibility for the stability of the financial system as a whole (the so-called macro-prudential competence)

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domestically-owned banks, this distinction in Howarth and Quaglia’s research is not explicitly clear.

<sup>40</sup> Howarth, D. & Quaglia, L. (2016), p. 438.

<sup>41</sup> *Ibid.*, p. 440.

<sup>42</sup> Lombardi, D. & Moschella, M. (2016) Domestic preferences and European banking supervision: Germany, Italy and the Single Supervisory Mechanism. *West European Politics*. 39(3), pp. 462–482.

and those with concentrated monetary and supervisory mandates were more likely to support the SSM than their counterparts with only micro-prudential responsibilities and those which operated in institutional arrangements with separate monetary and supervisory authorities.

An alternative account of the national preference formation has also been recently offered by Skuodis and Kuokštis. Motivated by the fact that high foreign ownership in the Lithuanian banking system and low internationalisation of its domestic banks fail to explain the country's support for the transfer of banking policy autonomy, the authors focused on this relatively small Baltic financial market.<sup>43</sup> In contrast to the dominant explanations in the literature, Skuodis and Kuokštis did not find empirical evidence that the structure of the national banking system was an important determinant of the national position. Their research, however, argued that Lithuania's support for further banking policy integration 'can be explained by the general pro-European orientation of the political system in the context of ambiguous aggregate economic costs and benefits of the new institutional framework'.<sup>44</sup>

Finally, a number of works analysed what factors determine a country's position on whether to join the banking union or to opt out. As it has already been mentioned, Howarth and Quaglia suggested that the ability of non-euro area national central banks to perform the lender of last resort function and its effective absence at the euro area level create fewer incentives for the non-euro Member States to opt in.<sup>45</sup> In a more comprehensive account, Schimmelfennig put forward 'a historical-institutionalist path-dependency argument' to explain this variation.<sup>46</sup>

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<sup>43</sup> Skuodis, M. & Kuokštis, V. (2018) Explaining National Preferences in the New European Banking Policy Framework: The Case of Lithuania. To be published in *Journal of Baltic Studies*.

<sup>44</sup> Ibid.

<sup>45</sup> Howarth, D. & Quaglia, L. (2014), p. 127.

<sup>46</sup> Schimmelfennig, F. (2016) A differentiated leap forward: spillover, path-dependency, and graded membership in European banking regulation. *West European Politics*. 39(3), pp. 483–502.

Having observed that the current pattern of participation in the banking union ‘does not reflect the international interdependence and competitiveness of the banking sector, nor is in line with governance capacity and policy paradigms of the member states’<sup>47</sup>, the author focused on original differentiation between the euro area member states and non-euro area countries, which, according to him, resulted in different paths of integration. More specifically, the scholar argued that the banking union was designed to address specific pressures, notably for the euro area. Moreover, ‘its institutional setup reinforced the original reasons why NEA<sup>48</sup> member states decided to abstain from the euro area’<sup>49</sup>, thus even widening the gap between the euro area and the remaining countries. Therefore, according to Schimmelfennig, the current variation in membership could be best explained by membership in the euro area.

Meanwhile, Spendzharova and Bayram partly built on Schimmelfennig’s work to explain why Sweden decided to opt out of the banking union despite the fact that its banks had a large cross-border presence in Estonia, Latvia and Lithuania – the three Baltic States that are all members of the euro area and the banking union.<sup>50</sup> The authors argued that Sweden’s position was shaped by three domestic considerations: inability to equally participate in the decision-making process of the SSM (as compared to the euro area member states), reluctance to assume fiscal and accountability risks associated with the possible recapitalisation or resolution of non-Swedish banks, and preference for greater regulatory autonomy in crisis management situations. In the meantime, for the three Baltic States, ‘the overriding political decision was whether to join the

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<sup>47</sup> Ibid., p. 484.

<sup>48</sup> Non-euro area.

<sup>49</sup> Schimmelfennig, F. (2016), p. 484.

<sup>50</sup> Spendzharova, A.B. & Bayram, I.E. (2016) Banking union through the back door? How European banking union affects Sweden and the Baltic States. *West European Politics*. 39(3), pp. 565-584.

eurozone'<sup>51</sup>, meaning that the banking union would be joined as an automatic result.<sup>52</sup>

The explanatory power of the proposed accounts on the national preference formation in general as well as preferences of particular policy actors still need to be tested with respect to both different elements of the banking union and different EU Member States. Besides, this body of research tends to focus on separate policy issues, which prevents from identifying the full picture of the vision of the new EU banking policy framework that different policy actors were bargaining for. Although this research aims at filling the latter gap, it is, however, most closely related to the third body of literature overviewed in the following subsection.

### **1.1.3. Intergovernmental Negotiations**

The *third* stream of research has looked at the politics of intergovernmental negotiations. In an insider's account of the management of the euro area crisis, a former governor of the Central Bank of Cyprus emphasised the dominant role of politics (in contrast to economics) in the governments' response to it. Although the author did not elaborate on the creation of the banking union, he briefly noted that 'a true banking union' appeared out of reach due to the prevalence of 'local political considerations', also typical to policy initiatives in other areas.<sup>53</sup> Emerging research on the EU bargaining process has produced similar findings. For instance, Donnelly analysed the distributional conflicts and power politics behind the decision to have a 'strong transfer of supervision to the European level, but significant conservation of national authority in deposit insurance, resolution and provision of public

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<sup>51</sup> Ibid., p. 574.

<sup>52</sup> Also see Skuodis, M. & Kuokštis, V. (2018).

<sup>53</sup> Orphanides, A. (2014) The Euro Area Crisis: Politics over Economics. *MIT Sloan School Working Paper*. 5091-14, p. 12.

backstops'.<sup>54</sup> He argued that the banking union in its current framework 'serves the interests of the payers best'<sup>55</sup> and criticised the arrangement for actually 'reinforcing the link between national sovereigns and banks that banking union was meant to reduce or eliminate'<sup>56</sup>. Nevertheless, besides implicit emphasis on the negotiating power of the creditors, the author did not elaborate on why and how they imposed their preferences on other EU Member States.

A different point of view on the EU bargaining process was offered by Schäfer. While Donnelly built his explanations on power politics, Schäfer questioned such accounts and advanced a constructivist alternative. According to Schäfer, material interests fail to convincingly explain Germany's preferences. At the same time power-based approaches are not sufficient to account for Germany's concessions during negotiations. In particular, the author emphasised that the concessions made by Germany 'go beyond what could be interpreted as strategic concessions and cheap side-payments'.<sup>57</sup> He, therefore, argued that Germany's preferences could be more completely and convincingly explained by the dominance of the 'ordoliberal paradigm' in the country, while the concessions – by 'the strategic use of the idea of a vicious circle between banks and sovereigns persuasively' by Germany's opponents in negotiations.<sup>58</sup>

In addition to the disagreement about the influence of power politics and ideational factors on the content of the banking union, it is also not yet fully clear which EU Member States had more influence in the EU bargaining process and which had less. For instance, while Donnelly

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<sup>54</sup> Donnelly, S. (2015) The ECB in a Hybrid Banking Union. Paper presented at the Conference of the Council for European Studies, Sciences Po, Paris, 8–10 July, p. 28.

<sup>55</sup> Ibid., p. 2.

<sup>56</sup> Ibid., p. 28.

<sup>57</sup> Schäfer, D. (2016) A Banking Union of Ideas? The Impact of Ordoliberalism and the Vicious Circle on the EU Banking Union. *Journal of Common Market Studies*. 54(4), pp. 961–980, p. 976.

<sup>58</sup> Ibid., pp. 976–978.

claimed that the content of the banking union reflects the interests of the creditors (first of all those of Germany), in their analysis of the politics behind the creation of the banking union Epstein and Rhodes criticised the emphasis placed by many analysts 'on the concessions made to the Germans than on the concessions made by the Germans and their allies'. Similarly to Schäfer, the authors argued that in fact 'Germany <...> failed to prevent agreement on the critical components of the banking union, including a certain degree of mutualisation'.<sup>59</sup> In a more recent contribution, Epstein and Rhodes equally highlighted the role of the ECB and the European Commission in the EU bargaining process, concluding that 'Germany has by and large accepted the vision of banking union put in place by the European authorities'.<sup>60</sup>

Besides the latter accounts of the role of supranational actors in negotiations, research on the influence of EU institutions on the recent EU banking policy overhaul is rare. In this respect it is important to distinguish De Rynck's work on the timing of the creation of the banking union. In one of the first systematic attempts to explain the creation of the SSM, De Rynck argued that in the first half of 2012 the ECB was the one to act as a 'policy entrepreneur' and in the face of extreme uncertainty about the future of the euro helped to create a 'window of opportunity' for centralising banking supervision.<sup>61</sup> The author applied one of the classical approaches of the policy process, the multiple streams framework (MSF), which, however, does not allow concluding whether the decision to transfer national supervisory powers to the EU level was simply a random one.<sup>62</sup>

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<sup>59</sup> Epstein, R.A. & Rhodes, M. (2014) International in Life, National in Death? Banking Nationalism on the Road to Banking Union. *KFG Working Paper Series*. 4(61), pp. 23–24.

<sup>60</sup> Epstein, R.A. & Rhodes, M. (2016) The political dynamics behind Europe's new banking union. *West European Politics*. 39(3), pp. 415–437, p. 432.

<sup>61</sup> De Rynck, S. (2014) Changing Banking Supervision in the Eurozone: the ECB as a Policy Entrepreneur. *Bruges Political Research Papers*. 38, p. 23.

<sup>62</sup> De Rynck's arguments, including their theoretical basis, will be further analysed in the following part of the dissertation.

In the most recent account of the same issue, Glöcker, Linder and Salines proposed analysing the timing of the recent banking policy overhaul from a different perspective. Arguing that ‘the euro area crisis was a necessary but not sufficient condition for the set-up of the SSM’, the authors explained the decision as a ‘situation package deal’ that linked the creation of single supervision to direct bank recapitalisation via the European Stability Mechanism (ESM) – the latter seen as a short-term crisis management measure proposed to respond to the Spanish banking crisis.<sup>63</sup> Although the suggested explanation is not new<sup>64</sup>, their work is valuable in the sense that it puts forward a well thought-out causal mechanism of how the ‘Spanish episode’ of the crisis had led to breaking the so-called three ‘reproduction mechanisms’ whose collapse was ‘separately necessary and jointly sufficient’ for transformational change in banking supervision: first, the Spanish crisis changed the aggregate cost-benefit balance of the previous institutional set-up; second, it altered preferences of some policy actors; and, third, the episode rendered the previous institutional arrangement incapable of accommodating pressure through incremental change.<sup>65</sup> Without denying the proposed causality, this research will offer an alternative account, allowing to identify conditions necessary for both transformational and incremental policy change.

In summary, the third body of research, which concentrates on the politics of intergovernmental negotiations, disagrees on at least four issues related to the recent EU banking policy overhaul. First of all, the role of power politics and ideational factors in the EU bargaining process. Second, which policy actors achieved the most and to what extent

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<sup>63</sup> Glöckler, G., Lindner, J. & Salines, M. (2016) Explaining the sudden creation of a banking supervisor for the euro area. *Journal of European Public Policy*. 24(8), pp. 1135–1153, p. 1136.

<sup>64</sup> For example, De Rynck also stresses the importance of the Spanish episode. See De Rynck, S. (2014), pp. 17–18.

<sup>65</sup> *Ibid.*, p. 14.



Germany influenced the results of the negotiations. Third, given the dominant emphasis on the primacy of intergovernmental politics, some authors criticise insufficient attention to the influence of EU institutions in negotiations. Finally, the emerging research on the timing of the banking union disagrees on the most likely causal mechanism for explaining this transformational change.

#### **1.1.4. What Are the Main Gaps?**

As it has been showed in the previous subsections, the emerging literature on the banking union can be divided into three closely related streams: rationale of the creation of the banking union and its institutional form, national preference formation and intergovernmental negotiations. It is notable in this respect that the proposed distinction is rather relative, since a large number of works tend to cover several of the identified topics. The overview of the literature, nevertheless, reveals that in general the existing research on the banking union still leaves a number of unanswered puzzles related to both the timing of the decision to create a banking union as well as determinants of its content or form.

Broadly speaking, the dominant accounts of the timing of the banking union see it as a response to acute sovereign debt crisis pressures, which at that time evoked serious euro area break-up fears.<sup>66</sup> Although this view might explain why euro area governments took action, only a few works tried to elaborate on the actual causal mechanism between the pressures and the transformational change. Moreover, crisis pressures cannot explain the content of the banking union or, more

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<sup>66</sup> E.g. Véron, N. (2014) Banking Union in Nine Questions. Written statement prepared for the Interparliamentary Conference under Article 13 of the Fiscal Compact, Rome, September 30, p. 3; De Rynck, S. (2014); Véron, N. (2015) Europe's Radical Banking Union. *Bruegel Essay and Lecture Series*, p. 16; Schimmelfennig, F. (2015) Liberal intergovernmentalism and the euro area crisis. *Journal of European Public Policy*. 22(2), pp. 177–195; Glöckler, G., Lindner, J. & Salines, M. (2016).

generally, what actions governments decide to take. In this respect Schäfer noted that neofunctionalists are ‘more specific and predict a fully-fledged banking union’, but they fall short of explaining why the current EU banking policy framework remains incomplete and does not meet the initial expectations.<sup>67</sup> As it has already been mentioned, the existing accounts of the content of the banking union are also either insufficiently elaborated, or disagree on which policy actors reached the most during the EU bargaining process as well as why and how they did that. The presented state of the art has been well summarised by Véron, according to whom ‘the definite history of Europe’s banking union <...> still needs to be written’.<sup>68</sup> As a result, the aforementioned two variables – the *timing* and the *content* of the banking union – have been chosen as the two dependent variables of this research.

Besides contributing to the literature on the political economy of EU financial services regulation in general and the banking union more specifically, the analysis of the recent overhaul of the EU banking policy offers a case for looking at the evolution of European integration from a new perspective. The choice of the object and the two dependent variables of this research are, therefore, equally motivated by an opportunity to shine new light on the traditional questions of European integration: first, why and when governments decide to transfer competence to supranational level and, second, what determined their decisions.

## ***1.2. Insights from Theories of European Integration***

Given the gaps in academic literature on the political economy of the banking union, the second section looks at how the two key questions of

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<sup>67</sup> Schäfer, D. (2016), p. 962; also see Niemann, A. & Ioannou, D. (2015) European economic integration in times of crisis: a case of neofunctionalism? *Journal of European Public Policy*. 22(2), pp. 196–218, p. 213.

<sup>68</sup> Véron, N. (2015), p. 8.

this research could be answered by the dominant theories of European integration: liberal intergovernmentalism (LI) and neofunctionalism. As it will be shown, although the EU response to the crisis has been recently analysed using the two traditional accounts of European integration, almost none of them has dealt with the two questions of this research specifically.<sup>69</sup>

### **1.2.1. Liberal Intergovernmentalism**

LI is often referred to as the 'baseline theory' in the study of European and regional integration, 'an essential first cut explanation against which other theories are often compared'.<sup>70</sup> Developed by Andrew Moravcsik in the 1990s, it has been widely recognised due to its suitability for explaining major historical bargains that led to deeper integration. In the words of its author, LI sees European integration as 'a series of rational choices made by national leaders' in response to mutual interdependence.<sup>71</sup> These choices are influenced by 'the economic interests of powerful domestic constituents, the relative power of each state in the international system, and the role of international institutions in bolstering the credibility of interstate commitments'.<sup>72</sup>

According to LI, the timing of national leaders' decisions to deepen integration could be explained by changes in the patterns of interdependence among countries. Meanwhile, building on intergovernmental bargaining theory, LI suggests that the results of the

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<sup>69</sup> To the best of the author's knowledge, the few exceptions are: Epstein, R.A. & Rhodes, M. (2014), (2016); Schäfer, D. (2016).

<sup>70</sup> Moravcsik, A. & Schimmelpfennig, F. (2009) Liberal Intergovernmentalism. In: Wiener, A. & Diez, T. (eds.) *European Integration Theory*. New York: Oxford University Press, pp. 67–87, p. 67.

<sup>71</sup> Moravcsik, A. (1998) *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht*. Cornell University Press, p. 18.

<sup>72</sup> Ibid.

EU interstate negotiations are determined by those EU Member States which are relatively less economically dependent on others and, therefore, have relatively greater bargaining power. If the theory is correct, the timing of the banking union should have been determined by the need to respond to changes in mutual interdependence among the euro area member states, whereas the content of agreements – by those member states whose national banking sectors were least affected by their public finances, health of financial firms in other countries, and which had sufficient fiscal capacity to autonomously bail them out or wind down. As mentioned further, these hypotheses have been recently indirectly tested in a broader examination of the EU response to the sovereign debt crisis.

Schimmelfennig argued that the EU response to the crisis in the euro area well corresponds to the key assumptions and expectations of LI. According to the scholar, national preferences during the euro area crisis ‘reflected international interdependence as well as fiscal position of the state’ and governments agreed on deeper integration for two main reasons: first, ‘in order to manage a common condition of negative interdependence’ and, second, ‘in order to avoid the prohibitive costs perceived to result from the breakdown of the euro’. Moreover, negotiations were characterised by ‘hard bargaining and brinkmanship’. Meanwhile, the newly-created institutions and policies were designed to stabilise the euro area by ensuring ‘a more credible commitment of member states to stick to and enforce the rules’.<sup>73</sup> Similarly, in an earlier account of the EU response to the crisis, Vilpišauskas found evidence supporting some of the key assumption of LI, for instance, that notably ‘the member states, first of all, Germany set the pace and the tone for the search of the joint solutions acting strategically with a view to their

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<sup>73</sup> Schimmelfennig, F. (2015), p. 191.

economic interests and domestic politics'.<sup>74</sup>

These findings still need to be tested with respect to both the timing of the decision to establish a banking union as well as its institutional form. Nevertheless, in his LI account of the EU response to the crisis, Schimmelfennig briefly acknowledged that LI cannot fully account for 'the concessions that Germany had to make during the legislative process on banking union'<sup>75</sup> despite favourable power asymmetry. Moreover, as already mentioned, having criticised LI on the same grounds, Schäfer offered a constructivist alternative for solving the puzzle.<sup>76</sup> It should also be emphasised that although LI could explain the timing of the banking union by changes in the patterns of interdependence among the euro area member states, the causal mechanism behind the decision is not clear enough and needs further elaboration.<sup>77</sup> Last but not least, as it will be elaborated in the following subsection, it would be wrong to argue that the EU response to the sovereign debt crisis was isolated from endogenous functional pressures emphasised by neofunctionalism.

### **1.2.2. Neofunctionalism**

An alternative account of the creation of the banking union could be offered by the dominant competing theory of European integration – neofunctionalism. Put forward in the late 1950s and early 1960s, the theory emphasises the key role of interest groups and supranational institutions in promoting integration. In contrast to LI, neofunctionalism

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<sup>74</sup> Vilpišauskas, R. (2013) Eurozone Crisis and European Integration: Functional Spillover, Political Spillover? *Journal of European Integration*. 35(3), pp. 361–373, p. 368.

<sup>75</sup> Schimmelfennig, F. (2015), pp. 191–192. See also Schäfer, D. (2016), p. 976.

<sup>76</sup> Schäfer, D. (2016).

<sup>77</sup> E.g. Glöckler, Lindner and Salines built their explanation of the causal processes that led to the banking union on the combination of rational choice and historical institutionalisms. See Glöckler, G., Lindner, J. & Salines, M. (2016).

sees integration as an incremental process, driven by spillovers from one integrated policy area to functionally-related new ones. This expansive logic could be explained by two main forces behind it. First, as it was argued by one of the most influential neofunctionalist scholars Ernst Haas, 'the integration of one sector leads to 'technical' pressures pushing states to integrate other sectors'<sup>78</sup>, since some policy areas are so functionally-interdependent that it is impossible to ensure effective functioning of one of them without integrating the rest. Second, according to neofunctionalism, integration processes create new interest groups and supranational institutions. The latter start a life of their own and respond to demands from interest groups keen on further integration, consequently both becoming important agents in influencing perceptions and decisions of political elites.

If the theory is correct, the timing of the creation of the banking union could be explained by limitations of national solutions to the euro area crisis and a noticeable increase in functional pressures to transfer national competence over banking policy to the EU level. The timing and the content of the banking union should have also been substantially influenced by supranational institutions and interest groups. Although academic research lacks deeper analysis of these questions from the neofunctionalist point of view, the existing accounts of the EU response to the crisis show rather mixed evidence.

On the one side of the spectrum, in their neofunctionalist account of the euro area crisis, Niemann and Ionnou argued that the EU integrative response to the crisis resulted from 'significant functional dissonances that arose from the incomplete architecture created at Maastricht'. According to the authors, 'the absence of credible and sensible alternative solutions' considerably reinforced the 'functional spillover dynamic' and

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<sup>78</sup> Niemann, A. & Schmitter, P.C. (2009) Neofunctionalism. In: Wiener A. & Diez, T. (eds.) *European Integration Theory*. New York: Oxford University Press, pp. 45–66, p. 49.

'increasingly shaped the political discourse'. They also highlighted integrative pressures exercised by such supranational international institutions as the European Commission, the European Parliament and the ECB, transnational interest groups, and, even more importantly, markets.<sup>79</sup> On the other side of the spectrum, despite public discourse about the need for 'completing' or creating a 'genuine' EMU, related initiatives of supranational institutions and pressure from financial markets, in terms of actual outcomes Vilpišauskas found no convincing support for neofunctionalism.<sup>80</sup>

In the case of the banking union, neofunctionalism offers mixed explanations too. On the one hand, as already argued, it fails to account for decisions to establish the banking union in a 'sub-optimal' or incomplete form.<sup>81</sup> On the other hand, the account rightfully emphasises the role of supranational actors in the initiation of the decision as well as influencing the EU bargaining process. For instance, as it has already been mentioned, De Rynck stressed the role of the ECB in advancing the idea.<sup>82</sup> Meanwhile, Epstein and Rhodes distinguished 'a coalition of supranational institutions, member state governments and private actors in the banking sector', which advocated for centralising banking authority.<sup>83</sup> The authors particularly emphasised the key role of the European Commission and the ECB.<sup>84</sup> However, while the timing of the banking union is often explained by the 'need to respond to crisis pressures', which could be interpreted from both neofunctionalist and LI perspectives (depending on whether one assumes national preferences to be endogenous or exogenous to integration), neofunctionalism, nevertheless, has especially limited the explanatory power to account for the content of governments' response.

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<sup>79</sup> Niemann, A. & Ioannou, D. (2015), p. 212.

<sup>80</sup> Vilpišauskas, R. (2013), pp. 367–368.

<sup>81</sup> E.g. Schäfer, D. (2016), p. 962; also see Donnelly, S. (2015); Schoemaker, D. (2015).

<sup>82</sup> De Rynck, S. (2014).

<sup>83</sup> Epstein, R.A. & Rhodes, M. (2014), p. 24.

<sup>84</sup> Ibid. Also see Epstein, R.A. & Rhodes, M. (2016).

### **1.2.3. Beyond the Dominant Theories**

Although LI and neofunctionalist accounts of the overhaul of the EU banking policy are limited, the existing research, however, allows making conclusions about both their advantages and limitations. On the one side of the spectrum, LI fails to explain the concessions made by Germany to other Member States during the numerous negotiations on the banking union. At the other end, neofunctionalism does not account for the incomplete form of the new EU framework. Academic literature also disagrees on the role of different policy actors in the EU bargaining process.

A possible way of reconciling advantages of both accounts was offered by Schimmelfennig in his analysis of the EU response to the euro area crisis: ‘whereas supranationalism explains how earlier integration decisions create endogenous interdependence and preference updates, LI captures how governments negotiate and decide on the basis of the changed constellation of interdependence and preferences’.<sup>85</sup> As it will be showed in the following part, the author advances an alternative explanation of the timing of the banking union, inviting to look beyond traditional views. Meanwhile, as regards the content of the agreements, the research suggests solving the gaps of LI by reconciling the theory with constructivist explanations.

## **2. The Research Design**

The second part introduces the research design. In the first section the author presents the dependent variables, namely, the timing of the creation of the banking union and its agreed content or form. The second

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<sup>85</sup> Schimmelfennig, F., 2015, p. 192.



section introduces explanatory variables and preliminary causal mechanisms that are most likely to provide answers to the key questions of this research. Finally, the third section briefly discusses the methodology.

## ***2.1. Dependent Variables***

As already mentioned, the *dependent variables* of this research are the *timing* of the creation of the banking union and its *content*. The timing variable arises from the first of the two main questions of the research, namely, why the euro area member states decided to surrender national control over their banking systems in 2012–2013 despite the fact that similar proposals had been constantly rejected in the past. Meanwhile, the second variable originates from the second research question – what accounts for the main elements of the recently established banking union, i.e. its content or form. While the definition of the timing is self-evident, the second variable requires deeper elaboration.

### **2.1.1. Varieties of the Banking Union: Four ‘Ideal’ Types\***

In the history of European integration, different reforms of the EU banking policy framework were highly influenced by two closely-interrelated factors. First, the growth of international finance forced Member States to choose between closer supervisory cooperation on the one hand and stronger supranationalism in the area of financial sector oversight on the other. Second, constantly increasing interdependence among national financial systems posed a question of whether Member States should pool

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\* An adapted version of this section has been published in Skuodis, M. (2017) Playing the Creation of the European Banking Union: What Union for Which Member States? *Journal of European Integration*.

financial resources to deal with failures of cross-border financial firms. These two dilemmas – the *scope of supranational financial supervision* and the *degree of financial risk sharing* – have been two of the most controversial issues since the planning stages of the EMU.

In a detailed history on the creation of the EMU, James noted that the question of what powers the EU should have in the area of banking regulation and supervision was at the centre of negotiations on the statute of the ECB. At the time of Maastricht, central bankers saw supervision ‘as at least a potential task for the ECB’, but this move was opposed by national governments.<sup>86</sup> Later the newly-created ECB tried to expand its supervisory powers, but was always met with resistance from national central banks, national supervisory authorities and governments.<sup>87</sup>

One such episode occurred a decade after Maastricht, in 2001, when the ECB reacted to the reorganisation of national supervisory structures in some euro area member states with a diplomatic argument that ‘extensive supervisory responsibilities of NCBs<sup>88</sup> in domestic markets’ and their stronger co-operation at the Eurosystem level ‘would seem appropriate to tackle the changes triggered by the introduction of the euro’.<sup>89</sup> In fact, governments agreed on the need of strengthened supranational coordination of banking supervision and established a Committee of European Banking Supervisors (CEBS) in London in 2004. But it was decided that the Committee should be primarily led by supervisory authorities, with national central banks without competence in banking supervision as well as the ECB being allowed to participate only as non-voting observers.

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<sup>86</sup> James, H. (2012) *Making the European Monetary Union*. Cambridge, MA: Harvard University Press, p. 313.

<sup>87</sup> Quaglia, L. (2008) *Central Banking Governance in the European Union: A Comparative Analysis*. Routledge, p. 137.

<sup>88</sup> National central banks.

<sup>89</sup> ECB (2001) *The role of central banks in prudential supervision*. Available from: <[https://www.ecb.europa.eu/pub/pdf/other/prudentialsupcbrole\\_en.pdf](https://www.ecb.europa.eu/pub/pdf/other/prudentialsupcbrole_en.pdf)> [Accessed 19 October 2014].

A similar debate was lost in a high-level group convened by the European Commission in 2008 with the aim of proposing the post-crisis reforms of the European supervisory system. In the light of international bank failures, the members of the group, chaired by former Governor of Banque de France and Managing Director of the IMF Jacques de Larosière, decided to examine whether the ECB should directly supervise cross-border banks (in the EU or at least in the euro area). As an alternative, they considered a less ambitious option of granting the ECB powers to coordinate the work of the newly-established colleges of national supervisors.<sup>90</sup> Despite the ECB's attempts to lobby for its role in micro-prudential supervision of individual financial firms<sup>91</sup>, the de Larosière report recommended the ECB's involvement only in the macro-prudential, or systemic stability, field. One author of the report later explained that the ECB should not be granted a supervisory function due to the fact that direct supervision of banks could impinge on its independence and the primary price stability mandate.<sup>92</sup> The same arguments were outlined in the de Larosière report.<sup>93</sup> This and many other recommendations of the so-called de Larosière group were soon endorsed by the European Commission<sup>94</sup> and supported by governments of the EU Member States.

The question of whether the ECB should be responsible for banking supervision is closely linked to broader academic debates that are still far from being conclusive. Many authors argue that supervisory information about individual financial institutions can help central banks to make more effective monetary policy, implement their lender of last resort

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<sup>90</sup> De Larosière, J. et al. (2009) *Report of the High-Level Group on Financial Supervision in the EU*. Brussels, 25 February, p. 43.

<sup>91</sup> Davies, H. & Green, D. (2010) *Banking on the Future: The Fall and Rise of Central Banking*. Princeton University Press, p. 204.

<sup>92</sup> Balcerowicz, L. (2012) *The ways out of the euro zone crisis and the interests of non-euro EU member state*. Public lecture at the Institute of International Relations and Political Science, Vilnius University, 22 September.

<sup>93</sup> De Larosière, J. et al. (2009), p. 43.

<sup>94</sup> European Commission (2009a) *Communication for the Spring European Council: Driving European Recovery*. COM(2009) 114 final, Brussels, 4 March, pp. 5–8.

function and evaluate the systemic impact of different financial firms for macro-prudential purposes.<sup>95</sup> A unique insulation from the political sphere may also make them better suited to regulate and supervise financial institutions more objectively than any other authority.<sup>96</sup> On the other hand, similarly to the arguments provided by the authors of the de Larosière report, academic literature warns about possible conflicts between monetary (macro) and regulatory (micro) policies<sup>97</sup>, harmful effects on the credibility of the central bank due to unavoidable supervisory failures<sup>98</sup> and temptation to provide support to insolvent (contrary to illiquid) firms in order to conceal what the central bank, as the supervisory authority, might have done wrong.<sup>99</sup> Despite the independence of central banks, Briault<sup>100</sup> and Goodhart<sup>101</sup> added that monetary policy might actually be undermined due to bigger risk of political pressure arising from an extension of the central bank's role. Moreover, one of the most influential arguments for separating monetary policy from financial supervision is the fear of giving too much power to

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<sup>95</sup> Goodhart, Ch.A.E. (2002) The Organisational Structure of Banking Supervision. *BIS Financial Stability Institute Occasional Paper*. 1, p. 28; Llewellyn, D.T. (2006) Institutional Structure of Financial Regulation and Supervision: the Basic Issues. Paper presented at World Bank seminar 'Aligning Supervisory Structures with Country Needs', Washington DC, 6–7 June; Davies, H. & Green, D. (2008) *Global Financial Regulation: The Essential Guide*. Cambridge: Polity Press, p. 195; Herring, R.J. & Carmassi, J. (2008) The Structure of Cross-Sector Financial Supervision. *Financial Markets, Institutions & Instruments*. 17(1), pp. 51–76; Nier, E.W. (2009) Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis. *IMF Working Paper*. WP/09/70.

<sup>96</sup> Davies, H. & Green, D. (2010), p. 196.

<sup>97</sup> Goodhart, Ch.A.E. & Schoemaker, D. (1993) Institutional Separation Between Supervisory and Monetary Agencies. *LSE FMG Special Paper*. 52, p. 12.

<sup>98</sup> Briault, C. (1999) The Rationale for a Single National Financial Services Regulator. *FSA Occasional Paper Series*. 2, p. 27; Goodhart, Ch.A.E. (2002), pp. 20–21.

<sup>99</sup> Masciandaro, D. (2007) Divide et impera: Financial supervision unification and central bank fragmentation effect. *European Journal of Political Economy*. 23, pp. 285–315, p. 294; Davies, H. & Green, D. (2008), p. 197–198; Herring, R.J. & Carmassi, J. (2008), p. 69.

<sup>100</sup> Briault, C. (1999), p. 27.

<sup>101</sup> Goodhart, Ch.A.E. (2008) Central banks' function to maintain financial stability: an uncompleted task. *VoxEU.org* [online]. 24 June. Available from: <http://www.voxeu.org/article/two-goals-one-instrument-how-can-central-banks-tackle-financial-crises> [Accessed 31 March 2014].

an unelected and independent body.<sup>102</sup>

In the context of academic discussions, the exact balance between advantages and disadvantages of greater ECB involvement in banking supervision has been influenced by one additional factor – a low degree of fiscal integration in the EU. Although central banks can help markets or individual institutions to overcome liquidity problems, such questions as whether to bail out insolvent financial firms using taxpayers' money or wind them down have to be weighted from both economic and political points of view. As a result, EU-level banking supervision without a corresponding degree of supranational financial resources creates a misalignment between the levels on which financial institutions are supervised and resolved.

According to James, this was the dominant logic behind the argument against a Europe-wide supervisory system that was discussed during the negotiations on the Maastricht Treaty.<sup>103</sup> Similarly, Spendzharova identified two main explanations why, despite the lessons from the global financial crisis, the EU Member States rejected calls for bigger supranationalism in banking supervision during the negotiations on the post-crisis de Larosière reforms. Many EU newcomers, whose domestic financial markets are dominated by foreign-owned institutions, raised serious doubts that giving the newly-created European Supervisory Authorities (ESAs) 'the power to issue binding decisions <...> could result in new Member States' footing the bill for bail-outs of foreign branches and subsidiaries operating in their jurisdiction'. At the same time, the UK and other home states stressed that ESAs will not be held accountable for the fiscal consequences of their binding decisions.<sup>104</sup> Given the unwillingness of the EU Member States to increase the then existing level

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<sup>102</sup> Goodhart, Ch.A.E. (2002), p. 19; Llewellyn, D.T. (2006), p. 31; Nier, E.W. (2009), p. 15; Davies, H. & Green, D. (2010), p. 291.

<sup>103</sup> James, H. (2012), p. 219.

<sup>104</sup> Spendzharova, A. (2012), p. 318–319. Also see De Rynck, S. (2014), p. 23.

of fiscal transfers, the EU neither created a pan-European supervision to match the pan-European banks, nor agreed on an EU-wide financial burden-sharing mechanism to support failing cross-border institutions.

The two of the above-mentioned issues – the scope of supranational bank supervision and the degree of bank risk sharing – lay the foundation for analysing the main EU policy actors’ preferences regarding the recent EU banking policy reforms.<sup>105</sup> Since different policy actors may have different preferences on each dimension, the content of the banking union in theory could take four values: a *full banking union*, a *corrective banking union*, a *preventive banking union*, and an *incomplete banking union* (see Table 1 below).

**Table 1. Four ‘ideal’ types of the banking union**

		Scope of supranational decision-making	
		Full	Limited
Degree of bank risk sharing	High	(1) <i>Full union</i>	(3) <i>Corrective union</i>
	Low	(2) <i>Preventive union</i>	(4) <i>Incomplete union</i>

Source: Author’s elaboration.<sup>106</sup>

The first quadrant shows two main conditions for a ‘full banking union’: a high degree of banks risk pooling and full integration of banking supervision. On the opposite side of the spectrum – the fourth quadrant – is an ‘incomplete banking union’ that is defined by a limited transfer of banking policy from the national to the EU level. Besides the latter two models, the proposed table also distinguishes two intermediary types of

<sup>105</sup> Although in theory one could think about additional dimensions, in practice all of the main policy choices related to the EU banking policy reforms can be linked to one of the two: either the division of competences between the national and EU levels or the degree of mutualisation of risks.

<sup>106</sup> Based on Skuodis, M. (2014) *The Political Economy of the European Banking Union: What Union for Which Member States?* Paper presented at the European Consortium for Political Research Joint Sessions Workshop on ‘National versus Supranational Banking Supervision’, Salamanca, 10–15 April.

the new European financial architecture. A ‘corrective banking union’, showed in the third quadrant, is aimed at effectively dealing with national supervisory failures by providing financial resources to recapitalise or wind down failing cross-border financial firms. Meanwhile, a ‘preventive banking union’ that is defined by a limited degree of fiscal integration yet fully-fledged supranational supervision is oriented towards prevention of future bank failures. While the label ‘corrective’ union indicates its orientation towards solving issues inherited from the past, so levelling banks’ funding costs across the euro area, the ‘preventive’ union relates to the objective of forestalling future problems through ensuring supranational control.

Besides offering a theoretical contribution to the literature on the banking union, the proposed analytical framework will be further applied to analyse preferences of the key EU policy actors on all of the main elements of the banking union and assess the extent to which they match the final agreements.

## ***2.2. Explanatory Variables***

Based on the two research questions and dependent variables, the *explanatory variables* are accordingly divided into two groups. *First*, without concentrating on the proposed values of the dependent variable, the research looks at the EU banking policy developments in the long run and asks why the European leaders decided to create a banking union in June 2012 and not earlier. The author concurs with the dominant view in the literature seeing the European sovereign debt *crisis* as the main explanatory variable of the timing of the banking union. However, at the same time the research finds the latter variable insufficient for triggering transformational policy change. Building on adapted PET, it is, therefore,

argued that the timing of the creation of the banking union can be best explained by changes in two independent variables: the *banking policy image* held, first of all, by key national governments and the *banking policy-making venue*, or the banking policy subsystem, understood as a closed circle of experts who make authoritative decisions on the policy. Empirical findings suggest that the crisis affected the latter variables through a third one – mutual *interdependence* among the euro area member states.

*Second*, the research examines the recent medium-term developments and seeks to explain the final result – the agreement on the ‘preventive’ banking union with a relatively broad scope of supranational supervision and a low degree of bank risk sharing (see Table 1). It is argued that the content of the banking union corresponds to the *preference intensity* of Member States and the *political legitimacy* of national positions that has forced Germany – the country with the lowest dependence on establishing the banking union and, therefore, the most favourable power asymmetry – to make concessions to others. Given the fact that rational explanations fall short of explaining the content of the agreements<sup>107</sup>, the author proposes an analytical framework that reconciles insights of liberal intergovernmentalism and sociological institutionalism.

### **2.2.1. What Accounts for the Timing of Transformational Decisions?**

There had been a number of overhauls of the EU banking policy framework since the start of the global financial crisis in 2007, yet the one in 2012 marked a clear departure from the long-term path of stability and incremental policy change. In contrast to earlier incremental reforms of

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<sup>107</sup> E.g. Schäfer, D. (2016).



the EU banking policy, in June 2012 the euro area leaders made a landmark decision to transfer long-defended national control over their banking systems to the EU level. This move has been named ‘the most significant deepening of policy integration since the start of the euro’<sup>108</sup>, ‘one of the most significant developments in European integration since the agreement on Economic and Monetary Union in the Maastricht Treaty’<sup>109</sup> and ‘even greater handing over of sovereignty than when countries signed up to the Euro’<sup>110</sup>.

This radical interruption of the historic pattern of the EU banking policy development raises two questions: first, why had the EU banking policy remained relatively stable for the past several decades and, second, why have the recent policy developments substantially deviated from the long-term historic path?

As it was briefly mentioned in the previous part, a general explanation behind the creation of the banking union has been the need to respond to the European sovereign debt crisis. According to Véron, in the first half of 2012 the banking union was left ‘as the only remaining option to avoid the breakup of the euro area’.<sup>111</sup> In fact, the European leaders’ decision to create the SSM and then allow the ESM to recapitalise troubled financial institutions directly (i.e. without further increasing the already too-high levels of government debt) was reached at the height of instability and uncertainty in the European financial markets. Nevertheless, it remains unclear as to why Member States did not use similar reform opportunities offered by a range of crisis situations, first of all, the global financial crisis, prior to 2012.<sup>112</sup>

A view from a broader perspective suggests that although the

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<sup>108</sup> Wolf, G.B. (2014).

<sup>109</sup> Howarth, D. & Quaglia, L. (2014), p. 125. Also see Draghi, M. (2013).

<sup>110</sup> Bowles, S. (2013). Also see Buti, M. (2013).

<sup>111</sup> Véron, N. (2014). Also see De Rynck, S. (2014); Schimmelfennig, F. (2015); Véron, N. (2015), p. 16; Glöckler, G., Lindner, J. & Salines, M. (2016).

<sup>112</sup> De Rynck, S. (2014), p. 5. Also see Glöckler, G., Lindner, J. & Salines, M. (2016), p. 1136.

European sovereign debt crisis was an important condition that opened a 'window of opportunity' for the creation of the banking union, there might have been other (intervening) explanatory variables that triggered radical policy change in 2012. More generally, incremental EU banking policy developments until 2012 might reveal that large-scale external shocks to the EU banking policy subsystem create insufficient conditions for transformational policy change and, therefore, are insufficient to explain the departure from incrementalism.<sup>113</sup> As it has been discussed in the earlier part, the dominant theories of European integration, notably LI and neofunctionalism, emphasise different determinants of the timing of the banking union and do not offer an explicit causal mechanism to explain how the crisis might have led to radical policy change.

In this context, the theoretical foundations of De Rynck's attempt to explain the creation of centralised supervision deserve additional attention. De Rynck built on the seminal Kingdon's 1995 work that proposed the basic elements of the MSF.<sup>114</sup> With a view to explaining how policies are made under conditions of ambiguity, the approach suggests analysing the linking of three independent streams of (1) the problem, (2) policies that are developed to address them, and (3) politics that refer to the broader political environment within which policy decisions are made. At critical moments in time, termed 'policy windows', policy entrepreneurs attempt to link all three streams into a single package and 'sell' it to decision-makers. This increases the likelihood that decision-makers will adopt a policy change.<sup>115</sup> One of the key assumptions of the MSF is that policymakers operate under significant time constraints which are more important to understanding policy change than the search for

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<sup>113</sup> For example, as it has already been mentioned, Glöckler, Lindner and Salines argue that 'the euro area crisis was a necessary but not sufficient condition for the set-up of the SSM'. See Glöckler, G., Lindner, J. & Salines, M. (2016), p. 1136.

<sup>114</sup> De Rynck, S. (2014), p. 5.

<sup>115</sup> Zahariadis, N. (2014) Ambiguity and Multiple Streams. In: Sabatier, P.A. & Weible, C.M. (eds.) *Theories of the Policy Process*. Boulder, CO: Westview Press, pp. 25–57.

optimal solutions to policy problems.<sup>116</sup> In addition to ambiguity of information and issue complexity in the policy-making process, time constraints increase the importance of entrepreneurial action. Since the main characteristics of the EU allow conceptualising it as a political system<sup>117</sup>, the MSF can be applied not only to the analysis of the policy-making process in a state, but also in the EU. This research also assumes that the theories of the policy process can equally be applied to the analysis of EU institutional transformation, or change in polity.

Drawing on the MSF, De Rynck argued that before 2012 decision-makers viewed the European sovereign debt crisis and the EU banking policy as two separate issues. In the language of the MSF, the policy window on centralising banking supervision could not have been opened, since ‘the dominant approach of national responsibility for fiscal discipline supported by ESM loans left no room for other policy options’.<sup>118</sup> However, in the first half of 2012 the situation shifted. In the face of extreme uncertainty about the future of the euro and increasing costs of inaction, the ECB, according to the author, acted as a policy entrepreneur and was the first to advocate for centralised banking supervision and resolution. The author found that the ECB’s advocacy helped to link the problem, policy and politics streams, at the same time contributing to opening a window of opportunity for the banking union. Although the original MSF states that policy ‘windows are opened by compelling problems or by events in the political stream’ and ‘policy entrepreneurs must immediately seize the opportunity to initiate action’<sup>119</sup>, according to De Rynck, the ECB was able to instigate the opening of a window of opportunity itself and even took part in the EU bargaining process without

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<sup>116</sup> Ackrill, R., Kay, A. & Zahariadis, N. (2013) Ambiguity, multiple streams, and EU policy. *Journal of European Public Policy*. 20(6), pp. 871–887, p. 872; Zahariadis, N. (2014), p. 29; De Rynck, S. (2014), p. 13.

<sup>117</sup> Hix, S. & Hoyland, B. (2011) *The political system of the European Union*. 3rd ed. Palgrave Macmillan, p. 12.

<sup>118</sup> De Rynck, S. (2014), p. 17.

<sup>119</sup> Zahariadis, N. (2014), p. 35.

being a formal decision-maker.<sup>120</sup>

The main drawback of the MSF is, however, the incorporated randomness in the proposed explanation of policy change, since it is not clear under what conditions the three policy streams are linked. Although the MSF provides a useful lens for analysing policy-making under conditions of ambiguity and allows capturing ‘complex interactions among institutions, issues and entrepreneurs’<sup>121</sup>, the approach does not allow predicting policy outcomes. According to Ackrill, Kay and Zahariadis, the fact that the same actions of policy entrepreneurs and promotion of the same policy idea in two different contexts may lead to two different policy outcomes facilitates such claims as ‘this policy entrepreneurial strategy in this situation is successful only in this particular context’.<sup>122</sup> Therefore, following the proposed explanation, one may not reject the idea that the decision to create the banking union was simply a random outcome.

The shortcomings of the MSF, the incremental nature of EU banking policy developments during the past several decades and the radical departure towards deeper integration over the past several years make PET a better-suited instrument of analysis. In contrast to most policy models, it encompasses both elements of policy-making – stability (equilibrium) and change – and sees them as ‘two sides of the same coin’ or policy dynamics.<sup>123</sup> The application of PET to the analysis of policy stability and change in the EU is based on the same assumption that the EU meets the key characteristics of a political system.

Similarly as the MSF, PET builds on the bounded rationality notion, which highlights that individuals are subject to cognitive limitations and

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<sup>120</sup> De Rynck, S. (2014), p. 23. It should be noted that according to a private conversation with a high-level ECB official in 2017, in this respect the central bank took insufficient action. On the contrary – according to the official, the discussions on integrating banking supervision were first of all advanced by the IMF.

<sup>121</sup> Ackrill, R., Kay, A. & Zahariadis, N. (2013), p. 883.

<sup>122</sup> *Ibid.*, p. 879.

<sup>123</sup> Princen, S. (2013) Punctuated equilibrium theory and the European Union. *Journal of European Public Policy*. 20(6), pp. 854–870, p. 855.

information asymmetry in making decisions. Distinguishing between 'serial' and 'parallel' attention as well as processing capabilities, both lenses emphasise that policymakers are able to consciously concentrate only on one thing at a time, therefore ignoring all the others.<sup>124</sup> On the one hand, the organisational structure of modern governments (as well as the EU) allows them to engage in 'parallel' (in contrast to 'serial') processing of information, since day-to-day policy issues are usually dealt with in different issue-oriented and relatively independent circles of experts ('policy venues' or 'policy subsystems').<sup>125</sup> On the other hand, institutional factors further reinforce cognitive limitations of policymakers, since individual governmental organisations are functionally designed to focus only on a limited number of issues at a time.<sup>126</sup> The focus on the allocation of one of the scarcest resources in politics – attention – allows PET to combine both ideational and institutional factors into one analytical framework.<sup>127</sup>

According to PET, the institutional venue, or the policy subsystem, in which policy-making on a certain issue takes place is supported by a dominant 'policy image'.<sup>128</sup> This image encompasses underlying assumptions about problems that a policy is expected to address as well as the best ways of dealing with them. When there is a general agreement on the policy image, policy-making will take place in the same circle of experts who will be oriented towards maintaining the status quo. However, as soon as the dominant image is contested and new aspects of an issue become more salient, it may catch the attention of policy actors

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<sup>124</sup> Zahariadis, N. (2014), p. 27; Baumgartner, F.R., Jones, B.D. & Mortensen, P.B. (2014) Punctuated Equilibrium Theory: Explaining Stability and Change in Public Policymaking. In: Sabatier, P.A. & Weible, C.M. (eds.) *Theories of the Policy Process*. Boulder, CO: Westview Press, pp. 59–103, p. 63.

<sup>125</sup> Baumgartner, F.R., Jones, B.D. & Mortensen, P.B. (2014), p. 62–63. In this research the author uses these terms interchangeably.

<sup>126</sup> Princen, S. (2013), p. 855.

<sup>127</sup> *Ibid.*, p. 865.

<sup>128</sup> Baumgartner, F.R., Jones, B.D. & Mortensen, P.B. (2014), p. 67; Princen, S. (2013), p. 856.

from other interconnected policy subsystems or even the macro-political system whose involvement may break the previous policy monopoly.

To illustrate the argument, national banking supervisors generally have a mission of maintaining the soundness of individual financial institutions with the ultimate goal of protecting their customers. As a result, their actions will be focused on this objective with a tendency to ignore all the rest. The more capital national banks are required to hold, the more protected their consumers will be. Nevertheless, if a national supervisor imposes too-high capital requirements, they will limit national banks' abilities to compete with foreign institutions operating in the same market. According to the proposed explanation, if the existing policy image is based on a supervisor's point of view, the reconsideration of the issue from the perspective of foreign or economic policy may trigger policy change.

Such focusing events as the global financial crisis and the European sovereign debt crisis attracted political attention to the EU banking policy. But how would PET explain the transformational change to the EU banking policy in 2012? According to the theory, the landmark decision to integrate banking supervision and resolution should have been determined by the interaction of changing policy images and different policy-making venues.<sup>129</sup>

Building on PET, the key independent variables that explain the European leaders' decision to create a banking union are, therefore, the *banking policy image* held by the key policymakers, in particular governments of the largest EU Member States, and the *banking policy-making venue*, understood as an issue-oriented circle of experts who make authoritative decisions on the EU banking policy. With the aim of applying the theory for a structured analysis of policy stability and change, the research assumes that the policy image can take two values: 'old' and

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<sup>129</sup> Baumgartner, F.R., Jones, B.D. & Mortensen, P.B. (2014), p. 65.

‘new’. Similarly, the banking policy can be decided in the ‘old’ issue-oriented policy venue or it can be picked up by a ‘new’ one or even several of them. It can also appear on the agenda of macro-level politics, meaning that the policy may attract attention of high-level political actors. Although PET emphasises the dynamics between changes in policy images and policy-making venues to explain policy stability and change, this research advances a deterministic interpretation of the theory. More precisely, the proposed simplifications allow producing a two-by-two explanatory matrix (see Table 2 below), which helps to identify conditions necessary for policy stability and different types of change.

**Table 2. The analytical framework for explaining public policy stability and change**

		Policy-making venue	
		Old	New
Policy image	Old	(1) <i>Stability</i>	(3) <i>Stability</i>
	New	(2) <i>Incremental change</i>	(4) <i>Transformational change</i>

Source: Author’s elaboration based on PET.

According to the proposed framework, different combinations of the ‘old’ and the ‘new’ policy image and the policy-making venue account for four general patterns of policy development. When the banking policy image held by the majority of key decision-makers does not change and the policy-making venue remains the same, in general one should expect *stability* in the EU banking policy framework (first quadrant). Meanwhile, a change in the definition of the banking policy without breaking the banking policy-making monopoly is likely to lead to *incremental* change (second quadrant). The latter pattern of change can be caused by policy learning within a policy subsystem or among several of them. The third pattern – *transformational* policy change – is expected to be caused by a

change in the definition of the previously supportive policy image and a naturally following shift to a new policy-making venue (fourth quadrant). In this regard it should be noted that according to PET a redefinition of a policy image 'is a crucial precondition for a change in venue', since the policy image underpins the policy subsystem in which that policy is decided.<sup>130</sup> However, this research also assumes a possibility of a reverse link, since attraction of new participants to a certain institutional policy-making venue might also change the policy image held by key actors in it. Finally, the fourth combination of the matrix – an 'old' policy image and a 'new' policy venue – is seen more as a *theoretical* value<sup>131</sup> with a *stable* outcome (third quadrant). The proposed deterministic interpretation of PET, which in its original version neither identifies explicit conditions of policy change, nor distinguishes the proposed types thereof, lays the basis for the analysis of the recent evolution of the EU banking policy framework.

Building on the proposed analytical framework, this research argues that the decision to create a banking union could be explained by relating it to two preconditions necessary for 'transformational' policy change: first, a shift in the earlier policy image held by the key decision-makers, notably, the governments of the largest EU Member States, and, second, the previous banking policy decision-making institutional venue, or the banking policy subsystem. To be more specific, the proposed causal mechanism is expected to work as follows.

Different focusing events and shocks to the EU banking policy subsystem, such as the global financial crisis or crisis in the euro area, were important, but insufficient for radical policy change, since policymakers' response depended on two 'intervening' variables. First of all, as long as the main assumptions about the EU banking policy held by

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<sup>130</sup> Princen, S. (2013), p. 857.

<sup>131</sup> One may argue that in practice it would be highly unlikely that a radical change in a policy-making venue would have no effect on the previous policy image.



responsible officials within national governments remained stable, there were no favourable conditions for policy change. However, when an external shock in the form of a severe crisis challenged the dominant policy image, one could expect two outcomes. If the redefinition of the EU banking policy image had occurred within the same circle of officials, it naturally led to adaptation and incremental policy change, but if the redefinition process coincided with heavyweight involvement of new participants, it led to a new policy equilibrium. In simple terms, it is expected that when the balance between the aggregate costs and benefits of the EU-level banking policy within the political systems of the largest euro area member states was redefined and new actors were involved in the EU banking policy-making process, the policy underwent transformational change.

The research assumes that in this case the direction of influence between the two independent variables – image and venue – is irrelevant, since both of them interact and reinforce each other. For instance, consistent with earlier arguments, changes in the banking policy image may challenge the underpinnings of the banking policy-making venue, in which the policy is made. Meanwhile, by challenging the previous policy-making monopoly the involvement of new policy actors in the banking policy-making venue may also challenge the assumptions, which used to dominate in the policy subsystem. The necessary precondition for radical policy change is, however, the reinforcement of links between the two variables, since simple changes in a policy image will not be sufficient for challenging the policy equilibrium.

Besides the advantages of traditional PET and its suggested interpretation over the MSF, the relative advantage of the proposed analytical framework vis-à-vis LI or neofunctionalist explanations of the timing of the banking union is that it offers a more explicit causal mechanism between the crisis and the European leaders' decision to

create the banking union. In addition, the advanced analytical framework also looks beyond the dominant accounts of European integration, allowing to avoid the long-lasting debates as to which of them is superior in explaining European integration. The focus on the two key variables of the framework – the policy image and the policy-making venue – makes the traditional causal mechanisms of integration relevant only to the extent that they influence the proposed two variables. For example, although both LI and neofunctionalists would examine the influence of national governments and supranational actors on the European leaders' decision to change the EU banking policy framework, the proposed analytical framework primarily focuses on how the old policy image was challenged and who got involved in the policy-making process without the need to conclude which actors – intergovernmental or supranational – and to what extent dominated the process. As a result, the proposed framework allows reconciling insights from both classical accounts without getting involved in the debates among the proponents of both theories. It is also equally reconcilable with institutionalist interpretation of the timing of the banking union proposed by Glöckler, Lindner and Salines<sup>132</sup> whose account will be further discussed in the following part.

### **2.2.2. What Accounts for the Outcome of the EU Bargaining Process?**

The analytical framework proposed in the previous subsection intends to explain the timing of the EU Member States' transformational decision to transfer national banking policies to the EU level, but it fails to account for the outcome of the EU bargaining process. As discussed in the earlier part, academic literature on theories of European integration provides a good starting point for filling this gap. In the light of the development of the

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<sup>132</sup> Glöckler, G., Lindner, J. & Salines, M. (2016).

theory of European integration over the past five decades, it is not surprising that the EU's response to the financial and economic crisis has reinvigorated debates between different theoretical perspectives. With a view to explaining the content of the EU bargaining process, LI has offered probably the most elaborated explanation.

If LI is correct, the content of the banking union is likely to reflect German preferences. At first sight, Germany did not experience such market pressure as Southern Member States and was not dependent on reaching quick agreements to the same extent as some other EU members. However, as it has already been argued, LI fails to explain why Germany made significant concessions to other Member States in the EU legislative process<sup>133</sup>, such as on the larger scope of single supervision or the creation of the single resolution fund. Given the limits of rationalist explanations, this research builds on Schimmelfennig's work on the Eastern enlargement of the EU to complement rationalist explanations of the creation of the banking union with a sociological perspective.

According to LI, the negotiating power of Member States is determined by asymmetric interdependence among them. If asymmetric interdependence between two countries is high, the country, which is relatively less materially dependent on the second one, will have greater power in interstate negotiations. Meanwhile, sociological institutionalism highlights that in political discourse Member States need to justify their national interests on the grounds of the institutionalised 'standard of political legitimacy'.<sup>134</sup> In other words, they are obliged to prove their respect for common interests of the community which they belong to.<sup>135</sup>

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<sup>133</sup> Epstein, R.A. & Rhodes, M. (2014), pp. 23–24, (2016), p. 432; Schimmelfennig, F. (2015), p. 192; Schäfer, D. (2016), p. 976.

<sup>134</sup> Schimmelfennig, F. (2001) The Community Trap: Liberal Norms, Rhetorical Action, and the Eastern Enlargement of the European Union. *International Organization*. 55(1), pp. 47–80, p. 63.

<sup>135</sup> Following the previous analytical framework, this 'standard of legitimacy' could be understood as a certain 'policy image' that defines which behaviour is politically acceptable and which is not.

Therefore, the strong political legitimacy of national preferences and the bargaining behaviour may increase the relative bargaining power of more materially dependent Member States and limit the degree to which the most economically powerful countries are able to pursue self-interest. Building on the main assumptions of LI, this research assumes that supranational actors, first of all, the EU institutions, are important to the extent that they contribute to the formation of the standard of EU-wide political legitimacy. These two approaches – LI and sociological institutionalism – allow creating the final two-by-two explanatory matrix that will be used to explain the negotiating power of Member States (see Table 3 below).

**Table 3. The analytical framework for explaining the negotiating power of the EU Member States**

		Economic dependence on agreement	
		High	Low
Political legitimacy	Strong	(1) <i>Rather weak</i>	(3) <i>Very strong</i>
	Weak	(2) <i>Very weak</i>	(4) <i>Rather strong</i>

Source: Author's elaboration based on Schimmelfennig, F. (2001).

When a country has high preference intensity due to economic dependence on reaching an intergovernmental agreement and its national position is based on weak political legitimacy, its negotiating power will be *very weak* (second quadrant). Meanwhile, low economic dependence and strong political legitimacy would give *very strong* negotiating power (third quadrant). The first and the fourth quadrants represent intermediary cases. High preference intensity but strong political legitimacy of national preferences would increase a country's negotiating power to *rather weak*. Meanwhile, low economic dependence on other

Member States and weak political legitimacy would decrease it to *rather strong*.

The combination of LI and sociological institutionalism into one analytical framework allows arguing that low intensity of preferences may not have been sufficient for Germany to impose all of its interests on other EU Member States. The proposed analytical framework also allows taking into account the role of supranational institutions and interest groups in framing the legitimacy of the bargaining positions of the EU members.

### ***2.3. Methodology***

The empirical analysis that follows is based on a qualitative case-oriented study of the EU banking policy developments in the period of 2009–2016. With a view to explaining the timing of the banking union, the author compares the first wave of the post-crisis banking policy reforms in 2009–2010 with the decision to create a banking union in 2012–2013.<sup>136</sup> Meanwhile, the second part of the analysis aimed at explaining the content of the banking union or, more specifically, its ‘preventive’ form focuses on the creation of the banking union in the period of 2012–2016. With the objective of explaining the recent developments, there are some necessary references made to earlier periods as well.

Methodologically, the research employs the congruence method<sup>137</sup> combined with the ‘explaining outcome process-tracing’ research

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<sup>136</sup> One may reasonably argue that an analysis of the EU banking policy image over a longer period of time would lead to more convincing findings. However, the two waves of EU banking policy reforms were chosen due to the fact that in the history of European integration the global financial crisis of 2007–2009 and the European sovereign debt crisis several years later caused the biggest and, therefore, the most comparable shocks to the EU banking policy subsystem.

<sup>137</sup> George, A.L. & Bennett, A. (2004) *Case Studies and Theory Development in the Social Sciences*. Cambridge, MA: MIT Press, pp. 181–204.

design<sup>138</sup>. In the following two empirical parts of the research, the author first follows the congruence procedure to put the hypotheses derived from Table 2 (the analytical framework for explaining public policy stability and change) and Table 3 (the analytical framework for explaining the negotiating power of the EU Member States) to simple congruence tests with the empirical record of the case study. This procedure is used to test the explorative power of the proposed analytical frameworks or, in other words, to investigate whether explanatory variables contribute to (are correlated with) the outcome. Second, the author uses the process tracing method to investigate the causal mechanisms that link the identified variables. In contrast to theory-centric variants of process tracing – theory-testing and theory-building – the primary ambition of the employed case-centric type is ‘to craft a minimally sufficient explanation of a particular outcome, with sufficiency defined as an explanation that accounts for all of the important aspects of an outcome with no redundant parts being present’.<sup>139</sup> The chosen research strategy allows both to explain the particular case-specific outcome as well as to draw more general lessons that could be potentially applicable outside of the analysed case in the EU banking policy domain.

The research draws on a wealth of empirical data from primary sources, such as official documents and statements issued by the EU institutions (the European Parliament, European Council, Council of the EU, European Commission and the ECB)<sup>140</sup> and national authorities, including ministries, central banks and supervisory agencies. A particularly important source of information is the official statements and comments by individual heads of state and government, ministers of finance, and governors of national central banks. As regards secondary

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<sup>138</sup> Beach, D. & Pedersen, R.B. (2013) *Process-Tracing Methods: Foundations and Guidelines*. The University of Michigan Press.

<sup>139</sup> *Ibid.*, p. 18.

<sup>140</sup> To the best of the author’s knowledge some of the documents have been presented in this type of research for the first time.

sources, the research mostly draws on relevant financial media coverage, academic and policy research. Since the initial findings showed that the EU decision-making process on the creation of the banking union was dominated by the largest EU Member States, this fact has motivated to pay the most attention to their preferences.

The empirical data used in the analysis is complemented by relevant practical insights of the author gained through direct and indirect involvement in the formation of national positions on the analysed EU policy initiatives as well as the related EU legislative process. It also includes a number of private conversations with policymakers. Whenever empirical data gathered through personal experience confirmed information in the publicly available documents, research and media reports, only relevant public information was mentioned.

### **3. Why a Banking Union?**

With the aim of explaining the timing of the creation of the banking union this part focuses on the recent developments of the EU banking policy in the period of 2009–2013. Following the proposed analytical framework to explain public policy stability and change, the first section seeks to identify changes in underlying assumptions about the EU banking policy over the past years. In the second section the author continues with an analysis of the actors involved in the EU banking policy decision-making at two critical junctures in 2009–2010 and 2012–2013. The third section provides conclusions. It is argued that the proposed analytical framework sheds new light on explaining stability, incremental and transformational changes of the EU banking policy over the past twenty five years as well as offers a new lens for better understanding the main drivers of integration or lack thereof in other policy areas.

### ***3.1. Changes in the EU Banking Policy Image***

In the history of European integration some of the key issues tackled by the creation of the banking union have been discussed by European policymakers for the past 60 years. In the 1960s and early 1970s the European Commission's predecessor, the Commission of the European Economic Community (EEC), explored ways of harmonising differences in national banking legislations 'with the hope to produce a single all-encompassing directive'<sup>141</sup>. After facing opposition from the members of the EEC, at the start of the 1970s the Commission, however, decided to limit its ambitions mostly to elimination of barriers to the freedom of establishment.<sup>142</sup> At that time the initiatives in the area of banking regulation were motivated by two goals that are still relevant to this day: the aim of creating a single market in banking and the functional logic of monetary union, which was then only a long-term goal. As it has been noted by Mourlon-Druol, 'the Commission's thinking in the 1960s shows that some European policy-makers clearly articulated financial integration, banking regulation/supervision and monetary integration all together'.<sup>143</sup>

Since the Treaty of Maastricht, the development of the EU banking policy could be divided into three periods: (1) from Maastricht to the global financial crisis, characterised by stability and limited incremental banking policy change; (2) from the global financial crisis to the sovereign debt crisis, characterised by the latest incremental developments in the EU banking policy framework; and (3) the current transformational

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<sup>141</sup> Mourlon-Druol, E. (2016), p. 913. Mourlon-Druol notes that today it would be called a 'single rulebook'. See p. 916.

<sup>142</sup> Mourlon-Druol, E. (2013) The EU's latest agreement is still some distance from a fully-fledged banking union. *EUROPP* [blog]. 19 December. Available from: <http://blogs.lse.ac.uk/europpblog/2013/12/19/the-eus-latest-agreement-is-still-some-distance-from-a-fully-fledged-banking-union/> [Accessed 14 February 2016].

<sup>143</sup> Mourlon-Druol, E. (2016), p. 924.



period since the sovereign debt crisis, or the creation of the banking union. The following subsections will examine all three periods in turn.

### **3.1.1. The Pre-Crisis Banking Policy Framework**

During the launch of the post-crisis review of the EU supervisory framework, the European Commission noted that the EU 'supervisory reform has so far relied on an evolutionary approach'.<sup>144</sup> In 1999, the European Commission's Financial Services Action Plan (FSAP) initiated the first over-arching EU level policy aimed at completing the single market in financial services. Launched by the then member of the European Commission Mario Monti for the period of 1999–2005, the Plan meant 'a shift away from mutual recognition to an approach of proactive pan-European harmonization' and, according to Davies and Green, was 'one of the most grandiose' projects that had been undertaken by the EU, 'involving change in a vast range of technical and legal requirements across every type of financial institution and activity'.<sup>145</sup> It was not, however, acknowledged at that time that harmonised rules for the single market also 'implied supranationally integrated supervision'.<sup>146</sup>

With a view to speeding up the adoption of the EU financial services legislation and strengthening cooperation among national supervisors, in 2001 the FSAP was accompanied by the so-called 'Lamfalussy framework'. Its main idea of multilevel legislation, notably, setting out basic high-level

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<sup>144</sup> European Commission (2008) *High Level Expert Group on EU financial supervision to hold first meeting on 12 November*. Press release, IP/08/1679, Brussels, 11 November.

<sup>145</sup> Davies, H. & Green, D. (2008), pp. 131–132. The FSAP comprised 42 measures, almost all of which were adopted by the end of 2004. These results allowed the Commission to conclude that the FSAP 'was delivered on time'. See De Haan, J., Oosterloo, S. & Schoenmaker, D. (2012) *Financial Markets and Institutions: A European Perspective*. 2nd ed. Cambridge University Press, p. 94. Also see EURACTIV (2004) *Financial Services Action Plan*. 18 December. Available from: <https://www.euractiv.com/section/uk-europe/linksdossier/financial-services-action-plan/> [Accessed 8 October 2017].

<sup>146</sup> *Ibid.*, p. 132.

principles, which could then be adapted, updated and clarified, offered a more flexible approach to developing EU financial services law. In broad terms, the Lamfalussy process works as follows. At the so-called Level 1 the Commission proposes 'framework legislation', which is then adopted in the ordinary EU legislative process. The 'framework level' is then supplemented at Level 2 'by more detailed implementation measures' that are 'adopted by the Commission and endorsed by a qualified majority of Member States'.<sup>147</sup> An important feature of the Lamfalussy regulatory approach were the so-called Level 3 committees – the CEBS, the Committee of European Securities Regulators (CESR), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) – which were established to provide technical advice to the Commission in the process of drafting legislation as well as foster supervisory convergence. The committees consisted of national supervisory authorities and were set up along the lines of the traditional functional division between banking, securities and insurance markets. The final – Level 4 – stage is aimed at ensuring compliance with the adopted legislation.<sup>148</sup>

In 2004, the Economic and Financial Affairs Council of Ministers (ECOFIN) concluded that the application of the Lamfalussy framework had not only 'generated additional momentum to, and increased the flexibility of the legislative process' but 'also paved the way for more effective supervisory co-operation and convergence'.<sup>149</sup> The ministers also emphasised the importance of 'the development of Level 3, including enhancing supervisory co-operation and convergence of supervisory practices, and full and consistent implementation as well as enforcement

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<sup>147</sup> House of Commons Treasury Committee (2006) *European financial services regulation: Seventh Report of Session 2005–2006*. London: The Stationery Office, 8 June, p. 12.

<sup>148</sup> *Ibid.*, pp. 11–12. Also see Davies, H. & Green, D. (2008), pp. 141–148.

<sup>149</sup> Council of the EU (2004) *Press release on the 2617th Council meeting, Economic and Financial Affairs*. Brussels, 16 November, p. 11.

of adopted legislative measures'.<sup>150</sup> Similarly, during the subsequent evaluation of the Lamfalussy framework in 2007, the Council repeated its previous call for strengthening implementation of the Level 3 committees' guidelines and recommendations. Nevertheless, it did not suggest upgrading the non-binding status of their actions in order to give them 'more teeth'.<sup>151</sup> Although in 2009 it was widely accepted that the existing Lamfalussy Level 3 committees of national supervisors 'have clearly reached their limits in terms of informal cooperation methods'<sup>152</sup>, the solution of the issue, directly linked to the degree of supranational decision-making, has been one of the most contentious subjects in the post-crisis EU supervisory reforms.

### **3.1.2. The First Wave of Post-Crisis Reforms**

In the aftermath of the global financial crisis, the European Commission set up a High Level Expert Group on financial supervision in the EU, chaired by Jacques de Larosière. The group was asked to advise the Commission on how to strengthen the European financial architecture 'with the objective of establishing a more efficient, integrated and sustainable European system of supervision'.<sup>153</sup> Building on the lessons of the global financial crisis and failures of the European supervisory system in particular, the so-called de Larosière report offered 31 recommendations for concrete EU and global actions. As it has been already mentioned, the majority of recommendations were soon endorsed by the European Commission<sup>154</sup> and national governments.

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<sup>150</sup> Ibid., p. 12.

<sup>151</sup> Spendzharova, A. (2012), p. 317.

<sup>152</sup> De Larosière, J. et al. (2009), p. 77.

<sup>153</sup> European Commission (2008).

<sup>154</sup> European Commission (2009a), pp. 5–8.

Two of the proposals laid the foundation for the current EU supervisory architecture. First, the de Larosière report recommended establishing an independent European Systemic Risk Council (ESRC)<sup>155</sup> responsible for the so-called macro-prudential supervision, or the financial stability of the EU financial system as a whole. Second, the High Level Expert Group proposed to ‘upgrade’ the Lamfalussy Level 3 committees by creating three new European-level supervisory authorities, which would constitute the main pillars of the new European System of Financial Supervision (ESFS).<sup>156</sup>

In the context of the extensive literature on the causes of the global financial crisis, the de Larosière report distinguished itself for its comprehensive overview of specific European regulatory, supervisory and crisis management failures. What is equally important for this research is that the group’s analysis was broadly shared by the EU institutions, national governments and independent experts. As it was noted in the Commission’s communication of March 2009 on European economic recovery, the group’s recommendations contributed to ‘a growing consensus about where changes are needed’.<sup>157</sup> Similarly, in its ensuing communication of May 2009 on the reform of the EU supervisory architecture the Commission praised the report for setting out ‘a balanced and pragmatic vision for a new system of European financial supervision’.<sup>158</sup> The report, therefore, serves as a useful reflection of post-crisis changes in the EU banking policy image. In order to identify possible shifts in underlying assumptions, the author will focus on two broad groups of supervisory failures that caused the most intense debates: first, lack of adequate macro-prudential oversight and, second, fragmentation of

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<sup>155</sup> The ‘Council’ was later renamed the ‘Board’.

<sup>156</sup> De Larosière, J. et al. (2009), pp. 44–48.

<sup>157</sup> European Commission (2009a), p. 5.

<sup>158</sup> European Commission (2009b) *Communication from the Commission: European financial supervision*. COM(2009) 252 final, Brussels, 27 May, p. 2.

national supervisory systems. The response to them built the basis for the EU banking policy framework before the banking union.

### *Lack of adequate macro-prudential oversight*

The High Level Expert Group heavily criticised the pre-crisis EU supervisory framework for its insufficient emphasis on financial supervision from the macro-prudential (systemic) side. More specifically, it was acknowledged that in the run-up to the crisis supervisors put most of their effort in supervising individual financial firms<sup>159</sup>, or conducting mainly micro-level supervision. Nevertheless, the rapid contagion from the US mortgage market, increased global uncertainty and the successive liquidity squeeze revealed unprecedented interconnectedness of modern financial firms that had not been properly understood before 2007. Besides inadequate macro-prudential oversight at the national level, there was also no EU-level institution explicitly responsible for identification of potential risks to the financial stability in the EU.

According to the authors of the de Larosière report, common or correlated shocks to different parts of the financial markets are in principle much more perilous to the system as a whole than a failure of one (although economically important) financial institution.<sup>160</sup> As emphasised by the then Financial Counsellor of the IMF José Viñals, such supervision is necessary to control mainly two – ‘cross-sectional’ and ‘time-series’ – risks.<sup>161</sup> The former means that effective macro-systemic supervision should in principle prevent financial institutions from failing all at the same time. Meanwhile, the latter objective should mitigate credit and financial cycles that have negative effects on the real economy.

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<sup>159</sup> De Larosière, J. et al. (2009), p. 39.

<sup>160</sup> Ibid., p. 38.

<sup>161</sup> Vinals, J. (2010) *Towards a New Financial System*. Public lecture at the London School of Economics and Political Science, 9 November.

Recognising the EU failure in overseeing macro-systemic risks, the de Larosière group recommended establishing a new independent EU body – the ESRC.<sup>162</sup> Referring to this recommendation, the European Commission later officially proposed that this new body ‘would not have any legal binding powers’, but would issue early macro-prudential risk warnings and recommendations with a mandatory follow up.<sup>163</sup> When drafting the proposal, the Commission had the benefit of taking into account the views expressed in a public consultation on the proposals of the de Larosière group. For instance, the Swedish central bank expressed ‘strong’ support for the ‘establishment of a macro-prudential body at EU-level’.<sup>164</sup> Likewise, the City of London recognised ‘a clear case for the creation of a European Systemic Risk Council’ and also emphasised its concurrence with the ‘Commission position that the ESRB should not be able to oblige individual Member States or authorities to act’.<sup>165</sup> As it was summarised by the Commission, the consultation showed that none of the responses from the public sector opposed the ESRC.<sup>166</sup> Although the largest EU Member States did not send official replies, the Commission’s proposal on enhancing macro-prudential supervision in principle did not meet opposition.

The ESRB was established in 2010 as an independent EU body within the ECB<sup>167</sup>, replacing the ECB’s Banking Supervision Committee. According to the final agreement, notably, the regulation of 2010 on

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<sup>162</sup> De Larosière, J. et al. (2009), p. 44.

<sup>163</sup> European Commission (2009b), p. 5.

<sup>164</sup> Sveriges Riksbank (2009) *Response by Sveriges Riksbank to the Consultation on Commissions Communication of 27 May 2009 on European Financial Supervision*. 1 July, p. 1.

<sup>165</sup> City of London (2009) *European Commission Communication on European Financial Supervision: Response from the City of London*. 15 July, p. 4.

<sup>166</sup> European Commission (2009c) *Summary of public submissions received on the proposals of the de Larosière report regarding financial supervision in Europe*. Available from:

[http://ec.europa.eu/internal\\_market/consultations/2009/fin\\_supervision\\_en.htm](http://ec.europa.eu/internal_market/consultations/2009/fin_supervision_en.htm)

[Accessed 24 February 2016].

<sup>167</sup> The ECB hosts the ESRB and supports its Secretariat.

establishing the ESRB, it was empowered to pass confidential warnings, recommendations or use its biggest power – to make warning and recommendations public.<sup>168</sup> Although the Board's recommendations are passed on a 'comply or explain' basis, the final decisions of how to respond to them are, nevertheless, made by the Member States. However, within the ESRB the governors of national central banks dominate the decision-making process.

### *Fragmentation of national supervisory systems*

Besides criticising insufficient attention to macro-prudential supervision, the de Larosière group also pointed out a number of weaknesses in national supervisory systems. Drawing on the lessons of the crisis, the report highlighted the importance of well-qualified, sufficiently staffed and independent supervisors. In addition, in the context of unequal powers given to supervisors in different Member States, the de Larosière group urged to align 'supervisors' competences and powers on the most comprehensive system in the EU'.<sup>169</sup> Although some authors question whether public authorities are overall able to control modern financial firms<sup>170</sup>, the group put forward a number of recommendations such as 'increasing supervisors' remuneration' or 'facilitating exchanges of personnel between the private sector and supervisory authorities'<sup>171</sup> that offered cost-effective and, at the same time, noticeable results. Since good rules or adequate supervisory powers are insufficient as long as they are not properly enforced, these recommendations on how to improve

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<sup>168</sup> Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board. *Official Journal of the European Union*, L 287, Vol. 56, 29 October, Articles 16, 18.

<sup>169</sup> De Larosière, J. et al. (2009), pp. 40, 49.

<sup>170</sup> Woods, N. (2010) *Expiring or Expanding? International Economic Organizations and the Restructuring of World Power*. Public lecture at the London School of Economics and Political Science, 13 October.

<sup>171</sup> De Larosière, J. et al. (2009), p. 49.

supervision attracted special political attention.<sup>172</sup> Nonetheless, an effective European system of financial supervision required one additional component – facilitated cooperation between national supervisors.

Differences between national jurisdictions as well as lack of cooperation between competent national authorities did not correspond to the rapid expansion of international financial institutions and growth of cross-border financial conglomerates. At the one end of the spectrum, these challenges had existed for many decades and, therefore, were not new. At the other end, the crisis revealed their systemic importance. In the system of numerous cross-border financial entities, which, depending on their legal structure, are supervised by the host or by the home state, lack of legal instruments and mechanisms for collaboration prevented competent authorities from reaching quick solutions to urgent problems. At the same time fragmentation in supervision and different legal obligations impeded the cooperation process itself, at the same time imposing excessive compliance costs on international financial firms.

This collection of problems attracted, perhaps, the most attention in the de Larosière report, which can be easily noticed from the identification of numerous related failures and advice on subsequent response. However, one recommendation – the creation of an ESFS – was among the most discussed in the EU decision-making process. Building on this recommendation, the European Commission proposed to establish three new ‘European Supervisory Authorities’ (ESAs): a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). According to the proposal, the three authorities had to replace the so-called Level 3 supervisory committees (respectively, the CEBS, the CEIOPS, and the CESR) and be given ‘a legal personality’ as well as broad

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<sup>172</sup> E. g. Council of the EU (2009a) *Press release on the 2948th Council meeting, Economic and Financial Affairs*. Luxembourg, 9 June, p. 10.



competences in relation to decreasing supervisory fragmentation and solving cross-border collaboration problems.<sup>173</sup> The final decisions on establishing the authorities were made by the Council and the European Parliament in 2010; the ESFS became fully operational in 2011.

The creation of the ESFS was seen as a noticeable step towards a common pan-European supervisory framework, since the new ESFS, built on three new authorities, required deeper integration of national policies. However, in 2009–2010 both the de Larosière group and the EU Member States firmly rejected any further ambitious moves. As it was mentioned in the earlier part, it was ‘put forward to the Group that the ECB could become responsible for the direct supervision of cross-border banks in the EU or only in the euro zone’.<sup>174</sup> This scenario required a radical transfer of national competences to the ECB. Alternatively, the group analysed a less radical option of granting the ECB only ‘a leading oversight and coordination function in the micro-supervision of cross-border banks’, including ‘binding mediation role to resolve conflicts between national supervisors’.<sup>175</sup> Although evidence shows the ECB’s attempts to lobby for its role in micro-prudential supervision<sup>176</sup>, members of the de Larosière group recommended tasking the ECB only with the responsibility of ensuring macro-prudential oversight. According to the report, the group was concerned that direct supervision of banks could impinge upon the ECB’s monetary stability mandate and independence.<sup>177</sup> These two motives were also publicly repeated by one of the authors of the report<sup>178</sup>. The same arguments, however, lost their importance in 2012, when EU governments decided to transfer supervision to a single pan-European supervisor within the ECB.

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<sup>173</sup> European Commission (2009b), pp. 8–9.

<sup>174</sup> De Larosière, J. et al. (2009), p. 43.

<sup>175</sup> *Ibid.*

<sup>176</sup> Davies, H. & Green, D. (2010), p. 204.

<sup>177</sup> The report also mentions additional reasons. See De Larosière, J. et al. (2009), p. 43.

<sup>178</sup> Balcerowicz, L. (2012).

In 2009 Austria in fact publicly expressed appetite for deeper integration in the medium-term. For instance, in their response to the public consultation on reforming the EU supervisory system, the Austrian Ministry of Finance, the Financial Market Authority and the central bank suggested that in the medium- to-long term the EU should aim to create ‘a decentralized integrated European supervisory system in accordance with the principle of subsidiarity (like the ESCB), in which one central European supervisory authority is responsible for the supervision of large cross-border financial institutions and groups (decision-taking function)’.<sup>179</sup> This position corresponded to the first option analysed in the de Larosière report. Nevertheless, at that time this opinion represented views of only a small minority of decision-makers.

According to Spendzharova, during the negotiations on the de Larosière reforms, the main reasons for Member States’ reservation about transferring more powers to the EU level were related to possible fiscal implications and accountability concerns.<sup>180</sup> These arguments were especially highlighted by those Member States whose domestic financial markets were dominated by foreign banks. The scholar argued that countries in Central and Eastern Europe were concerned that ‘giving the European Supervisory Authorities the power to issue binding decisions on individual cases could result in new Member States’ footing the bill for bail-outs of foreign branches and subsidiaries operating in their jurisdiction’.<sup>181</sup> The same argument was also well summarised by the EU Committee of the UK House of Lords, according to which the establishment of a single supervisory authority could not happen ‘unless there is a facility or burden-sharing arrangements on the bail-out of

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<sup>179</sup> Bundesministerium für Finanzen, Österreichische Finanzmarktaufsicht and Österreichische Nationalbank (2009) *Austria’s Position on a European Financial Framework*. 20 July, p. 7.

<sup>180</sup> Spendzharova, A. (2012), pp. 318–319. Also see De Rynck, S. (2014), p. 23.

<sup>181</sup> *Ibid.*, p. 319.

financial institutions at an EU level'.<sup>182</sup> It is notable in this respect that the Commission based its official proposal for establishing the ESFS on the same confines, emphasising that at that time day-to-day micro-prudential supervision of individual firms had to remain the responsibility of national authorities, since 'the financial means for rescuing financial institutions remains at the Member State level and with national tax payers'.<sup>183</sup>

The decision to enhance powers of supranational institutions without corresponding moves in the area of burden-sharing explains why the main area of contention among Member States was the proper distribution of competences between the newly-created ESAs and national authorities. The most intense debates revolved around the proposal that, in contrast to the pre-crisis EU supervisory framework, the three authorities would be empowered to issue binding decisions. With the aim of ensuring consistent application of EU rules, EU governments, nevertheless, reached a much less ambitious compromise of giving the three authorities competence of legally binding mediation between national supervisors with diverging views. Overall, the EU Member States agreed to entrust the ESAs with the tasks of: ensuring a single set of EU rules by developing technical standards in their respective sectors; ensuring that EU rules would be applied consistently; ensuring a common supervisory culture and consistent practices; collecting micro-prudential information; exercising direct supervision of credit rating agencies; and coordinating response in crisis situations.<sup>184</sup> However, the move towards deeper integration in the area of financial regulation and supervision was actually narrowly defined and rather limited.

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<sup>182</sup> House of Lords European Union Committee (2009a) *The future of EU financial regulation and supervision, Volume I: Report, 14<sup>th</sup> Report of Session 2008–2009*. London: The Stationery Office, 17 June, p. 33.

<sup>183</sup> European Commission (2009b), p. 9. For more information on national positions on the de Larosière reforms, see Spendzharova, A.B. (2014).

<sup>184</sup> Council of the EU (2009b) *Press release on the 2981st Council meeting, Economic and Financial Affairs*. Brussels, 2 December, p. 7.

The limits of the transferred supervisory competence to the ESAs are well illustrated by the Member States' agreement on two national safeguards. First, the Member States agreed on the so-called 'triple-lock' safeguard regarding decisions taken by the three EU-level supervisory authorities. First of all, it was decided that any Member State would be able to appeal to the ECOFIN to suspend a decision. As a second option, a simple majority of at least 14 Member States would be able to overturn it. Finally, if the first two options would not work, it was agreed that a Member State could appeal to the European Council.<sup>185</sup>

Second, it was decided that 'decisions taken by the ESAs would not impinge in any way on the fiscal responsibilities of the member states'.<sup>186</sup> It should also be noted that the composition of the main decision-making bodies of all three ESAs in principle meant that the key decisions would be taken not by supranational officials, but by representatives of national competent authorities, who, together with the permanent chairman of each authority, were given voting rights in making the most important regulatory decisions.

Despite the identification of key weaknesses in the EU supervisory framework and the proposal of politically feasible recommendations on how to respond to them, the report, however, lacked elaboration on possible financial burden-sharing in cases of default of cross-border financial firms. In this respect, some scholars, for instance, advanced an idea of establishing a European fund, similar to the European Investment Bank.<sup>187</sup> But at that time the report went no further than recommending

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<sup>185</sup> EURACTIV (2009) Ministers approve financial watchdogs, giving safeguards to UK. 3 December. Available from: <http://www.euractiv.com/section/uk-europe/news/ministers-approve-financial-watchdogs-giving-safeguards-to-uk/> [Accessed 5 March 2016].

<sup>186</sup> Council of the EU (2009b), p. 7.

<sup>187</sup> Goodhart, Ch. & Schoenmaker, D. (2009) The de Larosiere report: two down, two to go. *Financial Times* [online]. Available from: <http://blogs.ft.com/economistsforum/2009/03/the-de-larosiere-report-two-down-two-to-go/> [Accessed 8 March 2010].

Member States to amend the existing agreements between them with 'more detailed criteria on burden sharing'.<sup>188</sup>

To summarise, the first wave of post-crisis reforms of the EU supervisory system and related political discourse, which was well reflected in the de Larosière report, allow making several conclusions about the dominant policy image of the EU banking policy in 2009–2010. Besides necessary changes to the EU regulation of financial services in general, the crisis revealed the importance of adequate macro-prudential policy, stronger micro-prudential supervision and more integrated EU regulatory, supervisory and crisis management frameworks. Despite the fact that the shape of European financial firms in principle required matching pan-EU supervision and a pan-EU mechanism to resolve crises affecting cross-border financial firms, at that time the dominant banking policy image was based on the assumption that the same goals could be achieved by strengthening cooperation and coordination among competent national authorities. In its response to the idea of establishing a pan-EU level supervisor for international financial firms, the de Larosière group concluded that 'this matter could only be considered if there were *irrefutable*<sup>189</sup> arguments in favour of such a proposal'. The authors of the report mentioned that the idea could have become 'more viable' if the EU Member States had decided to move towards bigger political integration, but at that time the group had serious doubts about more ambitious reforms due to too-high 'complexities and costs entailed by such a proposal <...>, its political implications and the difficulty of resolving cross-border burden-sharing'.<sup>190</sup> Taking into account the dominant positions of Member States regarding centralisation of supervisory decision-making and bank risk sharing, it was only politically feasible to create a stronger EU coordination centre with limited transfer of national

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<sup>188</sup> De Larosière, J. et al. (2009), p. 36.

<sup>189</sup> Emphasis by the author.

<sup>190</sup> *Ibid.*, p. 58.

competence and, at the same time, national safeguards. As a result, as recently well summarised by Kudrna, ‘the supervisory regime after de Larosiere reform remained intergovernmental for all practical purposes’.<sup>191</sup> In contrast to 2009–2010, in 2012–2013 the post-crisis banking policy image, however, experienced radical change.

### **3.1.3. The Response to the European Sovereign Debt Crisis**

The decision to overhaul the post-crisis EU banking policy framework was made at the landmark 28–29 June 2012 Euro Summit as a way of implementing the European leaders’ commitment ‘to break the vicious circle between banks and sovereigns’.<sup>192</sup> The summit surprised the financial markets by announcing the intention to establish a single supervisor for the euro area banks and concluding that after this step the ESM, or the permanent euro area rescue fund, ‘could <...> have the possibility’ to recapitalise troubled financial institutions directly.<sup>193</sup> At the height of the Spain’s banking crisis, the commitment provided a future prospect for vulnerable member states to solve their banking problems without further increasing the already alarming levels of government debt. In return, the euro area members made a general commitment to transfer a significant part of sovereignty over banking policy to the EU institutions.

The June 2012 political agreement was the first result of the so-called ‘Four Presidents’ Report’ that was officially presented by Herman Van Rompuy, President of the European Council and of the Euro Summit, shortly before the famous Euro Summit and prepared in ‘close collaboration’ with President of the European Commission José Manuel

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<sup>191</sup> Kudrna, Z. (2016) Financial market regulation: crisis-induced supranationalization. *Journal of European Integration*. 38(3), pp. 251–264, p. 255.

<sup>192</sup> Euro Area Summit (2012).

<sup>193</sup> Ibid.

Barroso, President of the Eurogroup Jean-Claude Juncker and President of the ECB Mario Draghi.<sup>194</sup> Drawing from the lessons of the past, the report outlined a vision of strengthening the EMU by better integrating the financial, budgetary, economic and political domains. Back then Van Rompuy suggested that the first building block of the EMU reforms – an integrated financial framework – should consist of three elements: ‘single European banking supervision’, a ‘European deposit insurance scheme’ (EDIS), and a ‘European resolution scheme’. It was also mentioned that with a view to ensuring credibility of the new financial framework, the ESM ‘could act as a fiscal backstop’ to both insurance and resolution schemes. Furthermore, all three elements of the integrated financial framework, which soon came to be universally known as the three pillars of the banking union, had to be built on a comprehensive single rulebook.<sup>195</sup> However, despite historic public statements, there seemed to be substantial differences in the willingness of Member States to move forward as well as the interpretation of what had been agreed.

The first major disagreement appeared to be the ESM direct recapitalisation instrument aimed at breaking the bank-sovereign negative feedback loops. Soon after the Euro Summit a senior EU official explained to the Wall Street Journal that the ESM could recapitalise banks directly ‘only against full guarantee by the sovereign concerned’.<sup>196</sup> In contrast to the expectations of the financial markets, the disagreements on a wider pooling of financial risk called the declared resolution of breaking the bank-sovereign loop into question. Even more doubts were raised in September 2012, when the Dutch, Finnish and German ministers of finance declared a joint position that the ESM could be used only for future

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<sup>194</sup> Van Rompuy, H. (2012a) *Towards a Genuine Economic and Monetary Union*. 26 June.

<sup>195</sup> Ibid., pp. 4–5.

<sup>196</sup> Forelle, Ch. (2012) Will Europe Really Break the Spanish Sovereign-Banking Loop? *The Wall Street Journal* [online]. 6 July. Available from: <http://blogs.wsj.com/marketbeat/2012/07/06/will-europe-really-break-the-spanish-sovereign-banking-loop/> [Accessed 31 March 2014].

problems that would occur under the new European supervisory system and only as a last resort after using private sources and national public funds.<sup>197</sup>

The second principal disagreement was brought to light during the discussions on the necessary elements of a fully-functional banking union. The final version of the 'Four Presidents' Report' published in December 2012 did not mention one of the three initial pillars of the banking union – the EDIS. Instead of a single deposit insurance system, supported by many commentators, including the staff at the IMF<sup>198</sup>, the report opted for a less ambitious goal of harmonising national deposit insurance systems.<sup>199</sup> Similarly, although the European Commission vaguely advocated for 'a common system for deposit protection' in its September 2012 communication on the roadmap towards a banking union<sup>200</sup>, it did not propose to create a pan-European deposit guarantee scheme in its later much-discussed blueprint for a 'deep and genuine' EMU<sup>201</sup>. One member of the Commission explained that there was no sufficient support for a common deposit guarantee system at that time, and for that reason the European Commission decided not to proceed any further.<sup>202</sup> However, it was not rejected that a common deposit guarantee could complement the new framework at a later stage.<sup>203</sup> In fact, the so-called 'Five Presidents'

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<sup>197</sup> Finish Ministry of Finance (2012) *Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland*. 25 September.

<sup>198</sup> Goyal, R. et al. (2013).

<sup>199</sup> Van Rompuy, H. (2012b) *Towards a Genuine Economic and Monetary Union*. 5 December.

<sup>200</sup> European Commission (2012b) *Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union*. COM(2012) 510 final, Brussels, 12 September.

<sup>201</sup> European Commission (2012d) *Communication from the Commission: A blueprint for a deep and genuine economic and monetary union: Launching a European Debate*. COM(2012) 777 final, Brussels, 28 November.

<sup>202</sup> Šemeta, A. (2012) *Besikeičiantis ES ekonomikos ir finansų modelis: kuria kryptimi judame?* [The changing EU economic and financial model: in which direction are we moving?] Public lecture at the Institute of International Relations and Political Science, Vilnius University, 13 December.

<sup>203</sup> Dijsselbloem, J. (2013) *The future of EMU: Deepening the Debate*. Speech at the conference 'The Blueprint for a deep and genuine EMU: Debating the future economic,



Report' prepared in 2015 by the new President of the European Commission Jean-Claude Juncker 'in close cooperation' with President of the European Council and of the Euro Summit Donald Tusk, President of the Eurogroup Jeroen Dijsselbloem, President of the ECB Mario Draghi and President of the European Parliament Martin Schulz argued that 'a European Deposit Insurance Scheme' was necessary to complete the banking union.<sup>204</sup>

In general, the banking union refers to the transfer of competence over banking policy to the EU level, but the illustrated debates indicate divergent views on which components are necessary to have a complete EU banking policy architecture. Building on the conclusions of the 28–29 June 2012 European Council Summit<sup>205</sup>, the European Commission's two legislative proposals on establishing the SSM<sup>206</sup> and communication of September 2012 on the roadmap towards the banking union<sup>207</sup>, Howarth and Quaglia concluded that the banking union consists of five main elements: 'a single EU rule book for financial services (and specifically banks); an SSM for banks; a single framework on bank resolution; a common deposit guarantee scheme; and a common fiscal backstop for struggling banks'.<sup>208</sup> Seeing the common fiscal backstop as a necessary prerequisite for robust common resolution and deposit insurance frameworks, i.e. their integral part, this research treats the complete banking union as the EU banking policy framework consisting of four<sup>209</sup> key components:

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monetary and banking and political union', Brussels, 7 May; Economic and Financial Committee (2013) *A comprehensive approach to Banking Union: Discussion Note*. Ares(2013) 1618994, Brussels, 29 May.

<sup>204</sup> Juncker, J.-C. (2015) *Completing Europe's Economic and Monetary Union*. European Commission, 22 June.

<sup>205</sup> European Council (2012) *European Council 28/29 June 2012 Conclusions*. EUCO 76/12, Brussels, 29 June 2012.

<sup>206</sup> See SSM and EBA Regulations in Table 4.

<sup>207</sup> European Commission (2012b).

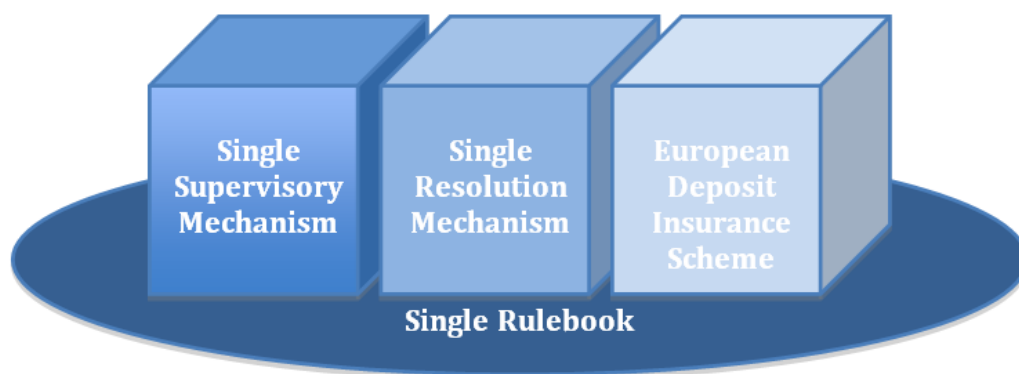
<sup>208</sup> Howarth, D. & Quaglia, L. (2013), p. 107.

<sup>209</sup> Also see Schäfer, D. (2016), p. 961.

1. The *Single Supervisory Mechanism* (SSM) that places the ECB as the central prudential supervisor of banks in the euro area and in other Member States should they decide to join.
2. The *Single Resolution Mechanism* (SRM) that places the newly-established Single Resolution Board (SRB) and the Single Resolution Fund (SRF) financed by bank levies at the centre of ensuring effective and efficient resolution of failing banks covered by the SSM.
3. The *European Deposit Insurance Scheme* (EDIS) that at the time of writing is only being discussed.
4. *The single rulebook* aimed at ensuring consistent application of EU regulatory banking requirements across the EU and whose common implementation in the banking union is ensured by the SSM and the SRM.

The first three elements could be seen as the three pillars of the banking union, while the single rulebook – as the foundation on which the three pillars stand (see Figure 1 below).

**Figure 1. The main elements of the complete banking union**



Note: The fiscal backstop to the SRM (and the EDIS) is treated as its (their) integral part

and, therefore, is not distinguished separately. At the time of writing, neither the fiscal backstop, nor the EDIS was agreed.

Source: Author's elaboration.

The single rulebook could be further divided into three parts related to the three pillars of the complete banking union: (1) common rules for bank capital; (2) common rules for bank recovery and resolution; and (3) common rules for deposit insurance schemes. In contrast to the three pillars of the banking union, the single rulebook is applied consistently across the entire single market, i.e. the entire EU, and, therefore, is not limited to the euro area. The key legislative texts on the banking union are listed in Table 4 below.

**Table 4. Key legislative acts on the banking union**

Element	Legislation
<b>Single Supervisory Mechanism (SSM)</b>	<b>SSM Regulation:</b>  <i>Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions</i>
	<b>EBA Regulation:</b>  <i>Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013</i>
<b>Single Resolution Mechanism (SRM)</b>	<b>SRM Regulation:</b>  <i>Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010</i>

Element	Legislation
	<p><b>Intergovernmental Agreement:</b></p> <p><i>Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund</i></p>
<p><b>European Deposit Insurance Scheme (EDIS)</b></p>	<p><b>EDIS Regulation:</b></p> <p><i>Proposal for a Regulation of the European Parliament and the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme</i></p>
<p><b>Single Rulebook</b></p>	<p><b>Capital Requirements Regulation (CRR):</b></p> <p><i>Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012</i></p> <p><b>Capital Requirements Directive IV (CRD IV):</b></p> <p><i>Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC</i></p> <p><b>Bank Recovery and Resolution Directive (BRRD):</b></p> <p><i>Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council</i></p> <p><b>Deposit Guarantee Schemes Directive (DGSD):</b></p> <p><i>Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes</i></p>

Source: Author's compilation.

A number of scholars, policymakers and institutions argue that all the above-mentioned elements are necessary for the banking union to bring more benefits (stability) than the previous system which was based

on national banking policy frameworks.<sup>210</sup> The required content of each of these elements has also been hotly debated in the literature as well as policy fora. These debates will be elaborated in the following part of this dissertation. Meanwhile, the main puzzle of this section is to test whether and how the EU banking policy image changed in 2012–2013.

As discussed in the previous section, soon after the global financial crisis the idea of creating a single EU supervisor and a pan-European resolution framework was neither assumed to be necessary, nor had political support. In 2009, the de Larosière group rejected proposals to task the ECB with micro-prudential supervision due to possible negative consequences to its monetary policy mandate and independence.<sup>211</sup> At the same time, given little willingness of Member States to deepen political integration, the group overall did not find ‘irrefutable arguments’ in favour of transferring supervision of cross-border banks to the EU level.<sup>212</sup> In particular, the de Larosière report noted that ‘the complexities and costs entailed by such a proposal <...>, its political implications and the difficulty of resolving cross-border burden-sharing are such that the Group has doubts of it being implemented at this juncture’.<sup>213</sup>

In fact, as it has previously been mentioned during discussions on the proposals of the de Larosière group, the consensus was unfavourable for deepening banking policy integration. Worried that binding decision-making powers of supranational institutions might have negative fiscal implications, Member States opted for strengthening coordination and cooperation among national supervisors rather than transferring more regulatory and supervisory competence to the EU. Likewise, the European Commission argued for a similar vision – ‘a strong co-ordinating centre on

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<sup>210</sup> E.g. Goyal, R. et al. (2013); Herring, R.J. (2013); Véron, N. (2013) *A Realistic Bridge Towards European Banking Union. Bruegel Policy Contribution. 2013/09*; Gros, D. & Schoenmaker, D. (2014); Schoenmaker, D. (2015).

<sup>211</sup> The report also listed additional reasons. See De Larosière, J. et al. (2009), p. 43.

<sup>212</sup> *Ibid.*, p. 58.

<sup>213</sup> *Ibid.*

the policy side at European level with day-to-day supervision at the national level', since more ambitious moves were understood to be 'too early' and not feasible due to the misalignment between the levels on which banks would be supervised and resolved.<sup>214</sup> At that time it was broadly agreed that single supervision would require a pan-European burden-sharing arrangement for resolving cross-border banks, but such a move towards greater risk sharing was not politically feasible too. Nevertheless, in less than three years these assumptions underwent transformational change.

Scholarly literature argues that since the creation of the ESRB and ESAs, the EU 'member states have gone through a rapid learning process in which they have begun to understand that in order to escape the <...> problems afflicting a purely intergovernmental response to Europe's banking crisis, their interests would be best served by a supranational solution'.<sup>215</sup> This 'ideational shift'<sup>216</sup> to supranationalism occurred at the height of the European sovereign debt crisis, when it became clear that the existing institutional set-up of the EMU did not allow effective response to immense market pressure. Despite the announcement of the EFSF's/ESM's financial assistance to Spain for indirect recapitalisation of its banking sector and Eurogroup's commitment to 'provide an effective backstop covering for all possible capital requirements <...> with an additional safety margin'<sup>217</sup>, in June 2012 the Spanish 10-year government bond yields rose beyond 7%, so reaching the highest levels since the introduction of the euro. At the same time fears of possible contagion pushed the Italian long-term borrowing costs beyond 6%. As it will be showed in the following part, such a dramatic increase in bond yields of

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<sup>214</sup> House of Lords European Union Committee (2009b) *The future of EU financial regulation and supervision, Volume II: Evidence, 14<sup>th</sup> Report of Session 2008–2009*. London: The Stationery Office, 17 June, pp. 107–108.

<sup>215</sup> Epstein, R.A. & Rhodes, M. (2014), p. 6. Also see De Rynck, S. (2014), p. 21.

<sup>216</sup> De Rynck, S. (2014), p. 21.

<sup>217</sup> Eurogroup (2012) *Statement on Spain*. 9 June.

the fourth and third largest economies of the euro area was clearly unsustainable over a longer period of time. This, in turn, led to a widespread belief that should the two economies need fully-fledged financial assistance, the ESM would not have sufficient lending capacity to provide it. The situation was additionally heated up by the Greek parliamentary elections in June, since it appeared that an anti-bailout leftist Syriza party had a high chance of winning.<sup>218</sup> Besides the souring Italian and Spanish borrowing costs, there was increasing evidence that ‘companies were making emergency plans for a euro break-up. Eurozone banks were holding day-to-day cash in far-flung subsidiaries – an expensive policy but one that would protect them if the euro split apart’<sup>219</sup>.

Against this background, Véron claimed that with a view to responding to extreme market pressure, the euro area member states had only two options: to break the interdependency between banks and sovereigns ‘either on the sovereign side, or on the banking side’.<sup>220</sup> On the sovereign side, the only solution was to agree on joint debt issuance that would have weakened market pressure on fragile member states. However, Germany had consistently been against it. There was also no majority of other members in favour of moving towards deeper fiscal integration, not to mention related legal and political constraints. Since the euro area break-up was the least favourable option, with a view to calming down the financial markets, the EU Member States were left with the

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<sup>218</sup> On 17 June 2012 Syriza actually finished second. On secret EU and IMF preparations for a possible ‘Grexit’, see Spiegel, P. (2014c) Inside Europe’s Plan Z. *Financial Times* [online]. 14 May. Available from: <https://www.ft.com/content/0ac1306e-d508-11e3-9187-00144feabdc0> [Accessed 1 October 2017]. For an overview of the situation in late 2011, see Spiegel, P. (2014b) How the euro was saved. *Financial Times* [online]. 13 May. Available from: <http://ig-legacy.ft.com/content/f6f4d6b4-ca2e-11e3-ac05-00144feabdc0#axzz4uFTCw3UE> [Accessed 1 October 2017].

<sup>219</sup> Spiegel, P. (2014d) If the euro falls, Europe falls. *Financial Times* [online]. 15 May. Available from: <https://www.ft.com/content/b4e2e140-d9c3-11e3-920f-00144feabdc0> [Accessed 26 February 2017].

<sup>220</sup> Véron, N. (2014), p. 3.

remaining banking-side solution, which required a fundamental change of policy incentives by terminating ‘banking nationalism’<sup>221</sup> and changing the ‘most jealously guarded domain of national sovereignty – banking governance’<sup>222</sup>. As Lithuania’s former minister of finance who took part in the discussions at the ECOFIN in 2012 remembers, the early EBA stress tests of European banks did not reveal the severity of troubles in the Spanish banking system; at the same time, in the face of economic, financial and political crises in Greece, there were intensive talks of ‘Grexit’. One could, therefore, feel the urgency of ‘impressing the markets’ in general and ‘doing something’ with banking supervision more specifically.<sup>223</sup>

The ideational shift could be seen from the fact that before the landmark decision of June 2012 to create the SSM and allow direct bank recapitalisation by the ESM the prevailing approach in dealing with the debt crisis had been through the sovereign side. De Rynck argued that notably the ‘dominant approach of national responsibility for fiscal discipline supported by ESM loans left no room for other policy choices, and the idea of European banking supervision was never discussed’.<sup>224</sup> This is well illustrated by the solution to the banking crisis in Ireland, which, according to emerging evidence, in 2010 was forced to enter the bailout designed by the IMF, European Commission and the ECB.<sup>225</sup> In this context, De Rynck claimed that notably Spain’s ‘refusal to take out Eurozone loans for nearly one year <...> put the spotlight on its

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<sup>221</sup> Ibid.

<sup>222</sup> Epstein, R.A. & Rhodes, M. (2016), p. 416.

<sup>223</sup> Šimonytė, I. (2014) Personal communication with the author. March 13.

<sup>224</sup> De Rynck, S. (2014), p. 17.

<sup>225</sup> E.g., Mahony, H. (2014) Letter shows ECB threat ahead of Ireland bailout. *EUobserver* [online]. 6 November. Available from: <https://euobserver.com/economic/126410> [Accessed 13 March 2016]; The Telegraph (2015) Ireland ‘pushed into bailout’. *The Telegraph* [online]. 18 June. Available from: <http://www.telegraph.co.uk/finance/economics/11683995/Ireland-pushed-into-bailout.html> [Accessed 13 March 2016].



deteriorating banks'<sup>226</sup>, since speculation on their capital needs and, at the same time, weakening Spain's capacity to refinance its debts impelled policymakers to start looking for alternative approaches. While EU governments pursued the post-crisis changes to the EU banking policy with the objective of better identification of systemic or individual risks and effectively dealing with them, the sovereign debt crisis extended this objective to the means of dealing with the ongoing crisis. In other words, the necessary reforms of the EU supervisory system started to be understood not only as 'preventive', i.e. future-oriented, but also as 'corrective', or as a response to the urgent crisis management needs.

Of course, it is generally acknowledged that in order to prevent moral hazard issues single supervision was treated as a prerequisite for direct recapitalisation of banks by the ESM, i.e. breaking the sovereign-bank link from the banking side. This has been stated by the European leaders themselves, who concluded that 'the ESM could <...> have the possibility to recapitalize banks directly' only after establishing 'an effective single supervisory mechanism'.<sup>227</sup> Also, Véron found evidence of a causal link between the European leaders' decision to initiate the banking union and the launch of the ECB's so-called Outright Monetary Transactions (OMT) programme<sup>228</sup>, whose announcement calmed down the financial markets. Still, these arguments do not refute the fact that in the first half of 2012 the fundamental overhaul of the EU banking policy framework was started to be seen as a necessary means for reducing uncertainty in the financial markets by offering a reliable promise of deeper integration.<sup>229</sup> The emphasis of the main objectives of the EU banking policy shifted from 'preventive' ones to those also including 'corrective' aspects. This ideational shift in the EU banking policy image

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<sup>226</sup> De Rynck, S. (2014), p. 17.

<sup>227</sup> Euro Area Summit (2012).

<sup>228</sup> Véron, N. (2015), p. 18. See also Spiegel, P. (2014d).

<sup>229</sup> Positions of key policy actors will be discussed in the following part.

has been well-summarised by former President of the European Council Van Rompuy, who noted that before the crisis ‘the notion of centralised supervision was simply ‘politically unthinkable’.<sup>230</sup>

### ***3.2. Changes in the EU Banking Policy-Making Venue***

The comparison of EU banking policy developments in 2009–2010 and 2012–2013 shows that in both cases the EU banking policy image underwent change. However, following the proposed analytical framework (see Table 2), besides the redefinition of the old policy image, transformational banking policy change should have only followed after coinciding with changes in the old policy-making venue or, to be more specific, the heavyweight involvement of the new decision-makers. So is there any empirical evidence to support this view?

Until the global financial crisis of 2008, financial regulation in general and banking supervision more specifically had little political salience. One possible explanation of this pre-crisis trend could be the high complexity of financial regulatory issues which in general require specific technical knowledge to understand them. Nevertheless, this argument does not withstand the fact that the complexity of financial regulation and the need of technocratic expertise to deal with it have not changed. The Great Recession, however, had a significant impact on the politicisation of the topic.

Baker explained that massive bailouts that were financed by taxpayers as well as cuts in public expenditure during the crisis had illuminated distributional consequences of financial regulation.<sup>231</sup> At the same time negative externalities caused by the financial sector bore most

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<sup>230</sup> Quoted from Lombardi, D. & Moschella, M. (2016), p. 474.

<sup>231</sup> Baker, A. (2010) Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance. *International Affairs*. 86(3), pp. 647–663, p. 656.

heavily on the general public, including ordinary households. While normally the opaque impact of financial policy over non-financial groups tended to constrain the attention the general public paid towards regulatory issues, the consequences of the crisis triggered electoral pressure on policymakers to take into account the distributional consequences of finance and get directly involved in regulatory reforms.

It is generally acknowledged that the public's capacity to understand international (in contrast to national) financial regulation is further constrained. Pagliari noted that international institutions, which set global regulatory standards, are further removed from domestic politics. Moreover, members of these institutions as well as the key actors that drive international cooperation in finance are independent regulatory agencies that are not subject to similar political pressure as directly elected politicians.<sup>232</sup> While prior to the crisis it was rare for political leaders to engage in direct discussions even on the regulation of national financial industries, the crisis reversed this trend at both national and international levels. For instance, whereas in 2007 Singer wrote that 'the rules of global financial governance are increasingly the creation of international committees of regulators and private actors rather than heads of government acting in concert'<sup>233</sup>, after the crisis Helleiner and Pagliari observed a strikingly different involvement of politicians: the scholars, for example, noted that the 'US and European leaders used the G20 leaders process from November 2008 to lay out unprecedentedly

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<sup>232</sup> Pagliari, S. (2013) *Public Salience and International Financial Regulation. Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds*. A thesis presented to the University Waterloo in fulfilment of the thesis requirement for the degree of Doctor of Philosophy in Global Governance, p. 91.

<sup>233</sup> Singer, D.A. (2007) *Regulating Capital: Setting Standards for the International Financial System*. Ithaca, N.Y.: Cornell University Press, p. 124. Quoted in Helleiner, E. & Pagliari, S. (2011) The End of an Era in International Financial Regulation? A Postcrisis Research Agenda. *International Organization*. 65(1), pp. 169–200, p. 178.

detailed priorities and timetables for their own officials and international financial technocrats to follow'.<sup>234</sup>

In the context of these general pre-crisis trends, it is not surprising that the EU banking policy mostly developed in a rather closed community of experts. Of course, issues related to the deepening of the EU integration and transfer of national competence to the EU level have always fell within the remit of European political elite. But at the same time banking sector protectionism had been entrenched in the politics of West European states.<sup>235</sup> In this context Epstein and Rhodes observed a paradox: although politicians have frequently advocated for deeper financial integration and supranational banking supervision, they 'have, even more assiduously, fought it in practice'.<sup>236</sup> This was evident during the discussions on both the de Larosière reform package and the banking union.

A closer look at the policy-making process of the de Larosière reforms and the creation of the banking union, however, reveals different dynamics of EU banking policy decision-making. According to De Rynck, the first wave of post-crisis reforms (before 2012) 'built on the established policy legacy' and was 'mostly prepared by experts inside public administrations'. Meanwhile, the 'transformational change' of establishing the banking union – in contrast to the previous reforms – 'happened through a different process that was rapid and highly political'.<sup>237</sup> In other words, the policy-making venues of the two waves of post-crisis reforms were dominated by different groups: the de Larosière reforms – by experts, while the banking union – by politicians.

It is important to note that in both cases the approval of reforms required legal or political involvement of the key EU institutions. Nevertheless, the involvement of the highest political leaders in the EU

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<sup>234</sup> Helleiner, E. & Pagliari, S. (2011), p. 178.

<sup>235</sup> Epstein, R.A. & Rhodes, M. (2014), p. 7.

<sup>236</sup> *Ibid.*, p. 12.

<sup>237</sup> De Rynck, S. (2014) p. 5.

legislative process serves as a good indicator of politicisation of the issues. In the first case, the European Commission played a central role in setting up the High Level Expert Group on financial supervision in the EU, whose report framed the ensuing discussions on how to strengthen the EU supervisory framework. In fact, the majority of the proposals were approved in the form in which they were proposed by the de Larosière report. Meanwhile, in the second case, the banking union was officially initiated by the highly political 'Four Presidents' Report' and the final agreements on the Commission's proposals were reached only after numerous meetings of the European Council, tense negotiations among the governments as well as between the Council and the European Parliament in countless trialogues. As noted by President of the ECB Mario Draghi, the 'decision to establish the SSM and entrust the ECB with supervisory tasks was a fundamentally political one'.<sup>238</sup> Different degrees of politicisation of the reforms are also evident from political discourse in the media, which in the case of the banking union thoroughly covered the entire process of negotiations.<sup>239</sup>

### ***3.3. Explaining the Timing of the Banking Union***

In the previous two sections the author analysed to what extent EU banking policy stability and change can be explained by different combinations of the 'old' and the 'new' banking policy image as well as the policy-making venue. As it was argued, both the de Larosière reforms after the Great Recession and the banking union reforms in response to the European sovereign debt crisis followed changes in underlying

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<sup>238</sup> ECB (2015) *ECB Annual Report on supervisory activities 2014*. Frankfurt am Main: ECB, p. 3.

<sup>239</sup> Media reports provide an indispensable source of empirical data on the key policy actors' preferences with regard to the main elements of the banking union. These positions will be analysed in the following part of this research.

assumptions that the key decision-makers had about the problems that the EU banking policy was expected to address and the best ways of dealing with them. However, despite relative politicisation of financial regulation after the global financial crisis, only the initiative of the banking union (in contrast to the de Larosière reforms) was discussed in a truly new policy-making subsystem, including frequent involvement of the highest EU political leaders. The transformational decision of establishing the SSM and, later, the SRM is, therefore, congruent with the two conditions identified as necessary for transformational policy change: the redefinition of the previously supportive policy image and involvement of new actors in the EU banking policy-making process (see Table 5 below). But to what extent is the consistency between the crisis, the identified changes in both variables, and the outcome of the analysed case of causal significance?

**Table 5. Explaining EU banking policy stability, incremental and transformational change**

		Policy-making venue	
		Old	New
Policy image	Old	<i>(1) Stability</i>	<i>(3) Stability</i>
	New	<i>(2) Incremental change</i> <b>De Larosière reforms</b>	<i>(4) Transformational change</i> <b>Banking union</b>

Source: Author's elaboration.

One way of testing the proposed causal link is to look at alternative explanations. The first group of them is offered by the dominant theories of European integration, whose theoretical insights seem to support the proposed deterministic interpretation of PET. For instance, it is reasonable to argue that the redefinition of the EU banking policy image from 'preventive' to 'corrective' is fully compatible with the LI interpretation that the creation of the banking union should have been

caused by the urgent need of managing changes in the patterns of interdependence among the euro area governments. Similarly, according to the neofunctionalist account, the EU banking policy image should have been decisively altered owing to no feasible alternative solutions to the substantially increased functional pressures for deepening the EMU. Moreover, the LI emphasis on the key role of governments and neofunctionalism's focus on supranational actors are both fully congruent with the proposed framework's analysis on the degree the new policy actors got involved in the previously closed policy-making process. According to the proposed explanation, changes in the policy-making venue reveal the extent to which the EU banking policy was picked up by new policymakers and became a broader issue. This broke the previous issue-oriented EU banking policy monopoly and, at the same time, contributed to the redefinition of the policy. The advanced explanation of the timing of the banking union, however, offers a clearer causal chain of how the crisis led to decisions on deepening integration. Its second relative advantage is that it also allows reconciling insights from both theoretical accounts.

Besides the above-mentioned theoretical accounts, the most elaborate explanation of the timing of the banking union so far has been proposed by Glöcker, Linder and Salines, who explained the timing of the banking union by the simultaneous collapse of the three 'reproduction mechanisms'. As it has been mentioned in the literature review, the authors argued that the Spanish episode of the crisis led to the creation of the SSM due to three reasons: first, the episode changed the overall cost-benefit balance of the existing institutional arrangement (increased the demand for change); second, it decisively altered the policy preferences and bargaining power of individual policy actors (the key actors took up functional needs for change); and, finally, the existing institutional set-up became incapable of accommodating pressure for change through gradual

institutional alternations (the creation of the SSM became the only option).<sup>240</sup> Building on the historic institutionalist approach, the authors argued that the third mechanism ‘is key to explaining whether change takes place and determining its nature and institutional design’.<sup>241</sup>

Since the interaction of the identified ‘reproduction mechanisms’ takes place through the two explanatory variables of this research, the latter account does not challenge the advanced explanation as well. First of all, functional pressures that ‘are likely to challenge the existing status quo and increase the demand for change’<sup>242</sup> were necessary yet insufficient for challenging the existing supportive policy image held by the key decision-makers. Second, according to the advanced explanation, the image was redefined based on the degree these functional needs were ‘taken up by the key political actors and translated into policy preferences and situational bargaining power’<sup>243</sup>. Finally, as regards the third ‘reproduction mechanism’, the availability of options to respond to the demand for change (transformational or incremental) was determined by the redefinition of the policy image and involvement of new policy actors in the previously closed policy-making circle. Similarly, an alternative De Rynck’s explanation of the timing of the banking union by the ECB’s entrepreneurship and learning of the Member States<sup>244</sup> highlights changes in the policy image as well as the ECB’s involvement in redefining it.

To sum up the unique interaction between the two variables of the proposed analytical framework, the timing of the banking union can be explained by: first, the redefinition of the previous ‘preventive’ banking policy image<sup>245</sup> to include ‘corrective’ objectives that required supranational solutions; and, second, the collapse of the previous policy-

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<sup>240</sup> Glöckler, G., Lindner, J. & Salines, M. (2016), pp. 1139–1148.

<sup>241</sup> *Ibid.*, p. 1147.

<sup>242</sup> *Ibid.*, p. 1140.

<sup>243</sup> *Ibid.*

<sup>244</sup> De Rynck, S. (2014), p. 21.

<sup>245</sup> The post-crisis incremental policy options were understood to be fully fit for purpose.



making venue, caused by a substantial increase in the politicisation of the policy and involvement of the highest political leaders<sup>246</sup>. From a broader perspective, following the general acknowledgement in academic literature the identified changes in the two variables were caused by the Spanish episode of the sovereign debt crisis, making the ESM direct recapitalisation indispensable to respond to growing market pressure and joint banking supervision, absolutely necessary to prevent moral hazard resulting from the availability of direct European-level financial support.

However, the advanced account does not seem to be complete without explaining why the crisis, or the external shock to the EU banking policy domain, actually caused the identified changes in both intervening variables. Although PET leaves this answer unclear, it could be found in the empirical data that has already been briefly discussed. The existing data primarily allows identifying the third intervening variable – *interdependence* of the euro area member states – that seems to have caused the redefinition of the EU banking policy image and, at the same time, challenged the previous banking policy-making monopoly. In short, it is reasonable to argue that should the Spanish episode of the crisis had not risked having contagious effects on other vulnerable as well as supposedly ‘strong’ member states, the idea of the ESM direct recapitalisation instrument in relation to the banking union probably would not have been even discussed. Specific vulnerabilities of the largest euro area member states on both the sovereign and banking sides of the sovereign-bank nexus will be analysed in the part that follows.

It is important to acknowledge that the advanced explanation could be criticised for its too-general nature. More specifically, despite the proposed deterministic interpretation of PET, the advanced framework’s application needs to pay particular attention to the dynamics between the

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<sup>246</sup> According to PET, the collapse happened because the EU banking policy caught attention of policy actors from other interconnected policy subsystems and even appeared on the agenda of macro-level politics.

explanatory variables, whose reciprocal reinforcement of each other pushes the related policy to a fundamentally new equilibrium. However, the proposed explanation’s advantage over the competing ones is the identification of more explicit conditions necessary for different types of policy change, more precisely, differentiation between incrementalism and transformation, so offering a more precise and, at the same time, simpler alternative model for a general understanding of changes in various EU public policy domains.

#### 4. Why a ‘Preventive’ Banking Union?

The fourth part analyses negotiations on the banking union with a view to explaining the final agreements. In the first section the author focuses on the key policy issues that triggered the most intense debates in the EU legislative process and compares the main policy actors’ preferences with the final agreements. Following the proposed analytical framework for explaining the negotiating powers of the EU Member States, the author then turns to the assessment of which EU governments were the most economically-dependent on agreements. The third section looks at the political legitimacy of the bargaining behaviour of the largest EU countries and its influence on the outcome of the EU legislative process. The fourth section provides conclusions.

The most important events, which are relevant to the following analysis, are illustrated in Table 6 below.

**Table 6. Timeline of the creation of the banking union**

Date	Event
June 2012	The Euro Summit decides to create a ‘banking union’
	The initial version of the Four Presidents’ Report proposes three pillars of the banking union: ‘single European banking supervision’, a ‘European deposit insurance scheme’, and a

Date	Event
	'European resolution scheme'
September 2012	The Commission proposes a Single Supervisory Mechanism (SSM)
December 2012	The final version of the Four Presidents' Report does not foresee the creation of a 'European deposit insurance scheme'
	The Council agrees on the SSM
March 2013	A political agreement on the SSM between the Parliament and the Council
July 2013	The Commission proposes a Single Resolution Mechanism (SRM)
December 2013	The Council agrees on the SRM
March 2014	A political agreement on the SRM between the Parliament and the Council
November 2014	The start of the SSM
June 2015	The Five Presidents' Report proposes to establish a European Deposit Insurance Scheme (EDIS)
November 2015	The Commission proposes an EDIS
February 2016	The start of the SRM

Source: Author's compilation.

#### ***4.1. Preferences of the Key Policy Actors\****

The following section focuses on seven policy issues that have been chosen from broader legislative packages on the banking union (see Table 4). Their choice was motivated by their dominance in the EU policy agenda. Consistent with the earlier outline of the second dependent variable of this research – the content of the banking union – the analysis will first examine the key policy issues related to the scope of supranational decision-making in the area of EU banking policy and, second, the degree of bank risk sharing. As it will be showed later, although in the final stages of negotiations the majority of EU policy actors preferred the 'full' banking union option, the recent agreements better correspond to a 'preventive' banking union form (see Table 1). Since the following analysis will focus on the final stages of negotiations, with a view to better understanding how national preferences changed over time, it is first of all essential to briefly look at the initial positions of the largest

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\* An adapted version of this section has been published in Skuodis, M. (2017).

countries.

### *Financial support versus supranational control*

The first clash of visions on EU banking policy reforms could be seen from the early stages of negotiations when, at the 28–29 June 2012 Euro Summit, the member states linked the creation of the SSM to the ESM direct bank recapitalisation instrument, seen as ‘a short-term crisis management measure’<sup>247</sup> at that time. When the German government made it clear that the latter instrument could only become possible after the establishment of effective joint supervision of banks that needed such support, France suggested to create a ‘licensing’ system in which national supervisory authorities would act ‘on behalf of the ECB’<sup>248</sup>. However, for the Germans such a system without a real transfer of competence and supranational control was a non-starter. Germany, Finland and the Netherlands also emphasised that in the new supervisory system ESM direct recapitalisation would be conditional on imposing losses on the creditors of failing banks and exhausting national public sources.<sup>249</sup> This position contradicted the French, Spanish and some other countries’ view of the banking union reforms primarily as a step towards bank risk sharing and common banks’ funding costs across the euro area.<sup>250</sup> According to the latter group of member states, the purpose of the banking union was not only to forestall future problems, but also to contribute to solving issues inherited from the past.<sup>251</sup>

The initial stages of negotiations, therefore, indicate a clash of

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<sup>247</sup> Glöckler, G., Lindner, J. & Salines, M. (2016), p. 1136.

<sup>248</sup> Howarth, D. & Quaglia, L. (2013), p. 113.

<sup>249</sup> Finish Ministry of Finance (2012).

<sup>250</sup> Breidthardt, A. & Emmott, R. (2014) Time runs short as Europe haggles over banking union reform. *Reuters* [online]. 11 March. Available from: <http://www.reuters.com/article/eu-banks-idUSL6N0M812G20140311> [Accessed 16 August 2017].

<sup>251</sup> White, P. (2012), p. 5.

preferences for ‘supranational control’, or a ‘preventive’ union, on the one side of the spectrum and ‘financial support’, or the ‘corrective’ type of the framework, on the other. Nevertheless, the analysis of later stages of negotiations indicates a fundamental change in both the France- and Germany-led coalitions’ positions, both of which will be emphasised below.

#### **4.1.1. The Scope of Supranational Decision-Making**

In the area of transferring national authority over banking policy to the EU level, the chosen scope of supranational decision-making has been influenced by the key policy actors’ preferences on three issues: (1) the scope of the SSM; (2) the scope of the SRM; and (3) the governance of the SRM.

##### *The scope of the SSM*

In the draft regulation on the SSM, the Commission proposed that the ECB should be ‘responsible for carrying out key supervisory tasks for all credit institutions established in participating Member States, regardless of their business model or size’.<sup>252</sup> However, the final agreement between the EU Member States and the European Parliament reduced the proposed scope of direct supranational supervision to the most significant banks that meet at least one of the three criteria: (1) the total value of their assets exceeds €30 billion or (2) 20% of the participating Member State’s GDP or (3) a national supervisor considers them to be important for the domestic

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<sup>252</sup> European Commission (2012c) *Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*. COM(2012) 511 final, Brussels, 12 September, p. 4.

economy<sup>253</sup>. In addition to these criteria, it was also agreed that the ECB would directly supervise three most significant banks in each participating Member State, those banks that would request or receive direct public financial assistance from the European Financial Stability Facility (EFSF) or the ESM<sup>254</sup> as well as those that the ECB might consider significant on its own initiative due to their cross-border activities<sup>255</sup>. As a result, with the exception of 129<sup>256</sup> systemically important banks that meet the aforementioned criteria, the majority of approximately 6,000 euro area credit institutions were exempted from direct ECB oversight.

Rejecting the French proposal of a 'licensing' system of banking supervision, Germany, nevertheless, preferred a very limited scope of supranationalism, constraining the ECB's direct control to principally its two largest banks: the Deutsche Bank and Commerzbank.<sup>257</sup> To put it differently, officially arguing that the ECB could not be able to supervise all euro area banks, the German government advocated for a two-tier European supervisory system: one for large banks, and one – for small. Germany's opposition to a low supervision threshold directly aligned with that of its locally-oriented and politically influential public banks (savings banks, known as *Sparkassen*, and regional *Landesbanken*) as well as the cooperative sector, all of which prominently opposed direct ECB oversight of smaller German credit institutions.<sup>258</sup> At the final stages of negotiations Germany's Minister of Finance Wolfgang Schäuble even threatened that 'it

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<sup>253</sup> According to the Regulation, the ECB has to take a decision confirming the significance.

<sup>254</sup> The ESM direct recapitalisation instrument was adopted only on 8 December 2014. See ESM (2014) *ESM direct bank recapitalisation instrument adopted*. Press release, 8 December. Available from: <http://www.esm.europa.eu/press/releases/esm-direct-bank-recapitalisation-instrument-adopted.htm> [Accessed 28 December 2015].

<sup>255</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. *Official Journal of the European Union*, L 287, Vol. 56, 29 October, Article 6.

<sup>256</sup> Schoenmaker, D. & Véron, N. (eds.) (2016) *European banking supervision: the first eighteen months*. Brussels: Bruegel, p. 9.

<sup>257</sup> Howarth, D. & Quaglia, L. (2016), p. 423.

<sup>258</sup> *Ibid.*; also see Epstein, R.A. & Rhodes, M. (2016), p. 431.

would be very difficult to get approval by the German parliament if (the deal) would leave supervision for all German banks to European banking supervision'.<sup>259</sup>

However, given high concentration of the French banking system, dominated by five large banks that were all likely to end up under direct ECB supervision, the French government found such an imbalanced framework unacceptable.<sup>260</sup> Against this background, France started to lead a broad counter-coalition of Member States, including Spain, Italy and the Netherlands among others, that advocated for the ECB's responsibility for all banks.<sup>261</sup> In contrast to its initial position, the French government maintained that without full coverage Europe would not have a 'real system of banking supervision'<sup>262</sup>. This position was also shared with the ECB which emphasised that 'the inclusion of all credit institutions' under its new mandate was 'important to preserve a level playing field among banks and prevent segmentation in the banking system'.<sup>263</sup> In fact, in the period before the adoption of its official opinion, ECB Vice-President Vitor Constâncio had explicitly expressed the ECB's opposition to any limitations on its authority over all credit institutions, declaring that the ECB 'would be against any sort of two tier system'<sup>264</sup>. The same argument was later repeated by President of the ECB Mario Draghi who indicated that a framework, in which the ECB would not have supervisory powers

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<sup>259</sup> Fox, B. (2012) Franco-German rift derails banking union deal. *EUobserver* [online]. 5 December. Available from: <https://euobserver.com/economic/118415> [Accessed 17 August 2017].

<sup>260</sup> Howarth, D. & Quaglia, L. (2013), p. 112; (2016), p. 451.

<sup>261</sup> E.g. Schäfer, D. (2016), p. 967.

<sup>262</sup> Fox, B. (2012).

<sup>263</sup> ECB (2012) *Opinion of 27 November 2012 on a proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and a proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) (CON/2012/96)*, p. 3.

<sup>264</sup> Barker, A. (2012) Quest for EU single bank supervisor stumbles. *Financial Times* [online]. 13 November. Available from: <https://www.ft.com/content/0c423b16-2dbd-11e2-8ece-00144feabdc0> [Accessed 16 August 2017].

over all banks, would prevent it from carrying out the new tasks effectively and pose serious reputational risks.<sup>265</sup> Besides the 'level playing field' issue, the German view was also publicly questioned on the grounds that the recent history of, for instance, Spanish *cajas* illustrated perfectly that banking crises did not only originate with big financial institutions, but also with much smaller, fast-expanding financial firms.<sup>266</sup>

The final compromise ended in a one tier, but clearly differentiated the EU supervisory system: although the ECB is 'responsible for the effective functioning of the SSM'<sup>267</sup> as a whole and publicly states that it 'oversees all significant and less significant banks in the participating countries through direct and indirect supervision'<sup>268</sup>, direct supervision automatically affected only the largest European banks. It is, however, important to highlight that in the case of necessity 'to ensure consistent application of high supervisory standards', the compromise entrusted the ECB with 'emergency' powers to assume direct supervision of any 'less significant' credit institution.<sup>269</sup> As a result, although Germany's savings banks and cooperatives are formally excluded from direct supervision, 'all German banks fall under ECB monitoring'<sup>270</sup>. Also, in contrast to Germany's initial preferences, almost all *Landesbanken* fell under direct ECB oversight.<sup>271</sup> As it will be summarised below, notably for these reasons the research assumes the final compromise to be relatively closer to the France-led coalition's preferences.

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<sup>265</sup> Steen, M. (2012) One regulator for all banks, says Draghi. *Financial Times* [online]. 6 December. Available from: <http://www.ft.com/intl/cms/s/0/3a3730b4-3fd1-11e2-9f71-00144feabdc0.html#axzz2y2ktEzEe> [Accessed 31 March 2014].

<sup>266</sup> Münchau, W. (2012) Politics undermines hope of banking union. *Financial Times* [online]. 16 December. Available from: <http://www.ft.com/intl/cms/s/0/705ef19a-4535-11e2-838f-00144feabdc0.html#axzz2y2ktEzEe> [Accessed 31 March 2014]. Also see Howarth, D. & Quaglia, L. (2016), p. 451.

<sup>267</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013, Article 6.

<sup>268</sup> ECB (2017b) *Who supervises my bank?* Available from: <https://www.bankingsupervision.europa.eu/banking/list/who/html/index.en.html> [Accessed 17 August 2017].

<sup>269</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013, Article 6.

<sup>270</sup> Epstein, R.A. & Rhodes, M. (2016), p. 431.

<sup>271</sup> Schoemaker, D. & Véron, N. (eds.) (2016), p. 89.



### *The scope of the SRM*

Similarly to the initial proposal on the scope of the SSM, the Commission proposed that the second pillar of the banking union – the SRM – should cover all credit institutions established in the participating Member States of the SSM.<sup>272</sup> In other words, the Commission advocated for a comprehensive European resolution framework, in which all key decisions on winding down failing banks would be made at the EU level. Despite this, the Council and the European Parliament agreed on establishing a differentiated resolution system, in which a new supranational body – the Single Resolution Board (SRB) – would be responsible for preparing resolution plans and winding down those ailing banks that were directly supervised by the ECB and operated cross-border.<sup>273</sup> Similarly to the differentiated nature of the SSM, national resolution authorities were to be responsible for all the remaining credit institutions, with the exception of special cases in which the resolution of those institutions involved the use of the newly-created Single Resolution Fund (SRF) or the concerned participating Member State decided to transfer its direct responsibility for all banks to the EU level.<sup>274</sup>

Seeking to exclude their smaller banks from the pan-European resolution framework, German policymakers argued for limiting the SRM coverage to the number of banks directly supervised by the ECB.<sup>275</sup> According to an internal document of the Council, this position was

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<sup>272</sup> European Commission (2013) *Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council*. COM(2013) 520 final, Brussels, 10 July, p. 8.

<sup>273</sup> European Commission (2014a) *European Parliament and Council back Commission's proposal for a Single Resolution Mechanism: a major step towards completing the banking union*. Statement/14/77, 20 March, p. 2.

<sup>274</sup> *Ibid.*

<sup>275</sup> Howarth, D. & Quaglia, L. (2014), p. 133.

‘mainly dictated by the fact’ that at that time the country was not ‘satisfied that national resolution authorities <...> would play a visible role to influence the resolution proceedings’.<sup>276</sup> On the opposite side of the spectrum, the Commission emphasised that a limited scope of the SRM would fail to cover all cross-border credit institutions. Besides other arguments, it also pointed out that, contrary to day-to-day supervision conducted by the SSM, the number of banks that would be likely to fail or be in resolution at any given time would be limited.<sup>277</sup> At the same time the majority of governments raised concerns that by decreasing market risks for directly supervised institutions the German proposal would distort the single market, divide the banking union, and overall be hardly workable in practice.<sup>278</sup>

Although Germany seemed to be effectively isolated on this issue<sup>279</sup>, by consistently pushing towards a differentiated resolution framework it partially succeeded in limiting the scope of the SRM. As a compromise it was, however, agreed that the SRM would bear the ultimate responsibility for the effective functioning of the entire new framework and, if necessary, would be able to ‘exercise directly all the relevant powers’ in respect to any bank in the banking union.<sup>280</sup> Similarly to the earlier case, for the latter reason it can be summarised that the final compromise was again relatively closer to the France-led coalition’s preferences.

### *The governance of the SRM*

The third closely related issue that allows identifying the key policy actors’

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<sup>276</sup> Council of the EU (2013c) *Brief for the President on the Single Resolution Mechanism [First reading]*. Brussels, 13 November, p. 13.

<sup>277</sup> European Commission (2013), p. 8.

<sup>278</sup> Council of the EU (2013c), p. 13.

<sup>279</sup> Agence Europe (2013) Germany isolated on two key aspects of bank resolution scheme. 7 November.

<sup>280</sup> European Commission (2014b) *A Single Resolution Mechanism for the Banking Union – frequently asked questions*. Memo 14/295, Brussels, 15 April, p. 3.

preferences on the scope of supranational decision-making in the banking union is the governance of the SRM. According to the initial legislative proposal, the Commission chose itself to have the final say on initiating resolution.<sup>281</sup> But as a concession to a Germany-led group of countries, the Member States' final compromise opted instead for the Council's final role. More precisely, it was agreed that the SRB's decisions on placing a bank into resolution 'would enter into force within 24 hours of their adoption, unless the Council, acting by simple majority on a proposal by the Commission, objected or called for changes'.<sup>282</sup> The outcome of the inter-institutional negotiations between the Council and the European Parliament, however, restricted the Council's involvement only to those cases when the Commission modifies the SRB's proposal on the 'amount of resources drawn from the Single Fund' or it thinks that 'there is no public interest in resolving the bank'.<sup>283</sup>

Initially almost all governments opposed the Commission's final role in triggering resolution.<sup>284</sup> Germany, the United Kingdom and a number of other delegations stressed that 'if the Commission, being "the guardian" of the Treaties, internal market and financial stability, is entrusted with resolution tasks, the concentration of power in the hands of one institution becomes unprecedented'.<sup>285</sup> A month before the governments' agreement on the SRM, the staff of the Council indicated that 'this very argument may serve to principally shift the decision making to the Council'<sup>286</sup>. However, after it became clear that the EU legal framework did not allow the SRB, which includes representatives of national

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<sup>281</sup> European Commission (2013), p. 10.

<sup>282</sup> Council of the EU (2013e) *Council agrees general approach on Single Resolution Mechanism*. Press release 17602/13, Brussels, 18 December.

<sup>283</sup> European Commission (2014a).

<sup>284</sup> Barker, A., Spiegel P. & Wagstyl S. (2013) Berlin gives ground in banking union debate. *Financial Times* [online]. 6 December. Available from: <http://www.ft.com/intl/cms/s/0/0ba3d460-5e97-11e3-8621-00144feabdc0.html?siteedition=intl#axzz2y2ktEzEe> [Accessed 31 March 2014].

<sup>285</sup> Council of the EU (2013c), p. 116.

<sup>286</sup> *Ibid.*

resolution authorities, to have the final say and, therefore, limited the available options to the Commission or the Council, the Commission eventually secured the majority's support. As it has been well summarised in an EU document on the progress of negotiations, the main rationale behind the majority of the Member States' support for the Commission was that the Council was seen 'as the less efficient alternative due to a number of legal, procedural and timing constraints'<sup>287</sup>. Consequently, Germany remained almost the only country that demanded the final say on winding down banks for national governments and confronted not only France, Italy and the Netherlands among others, but also the EU institutions: the Commission, the Parliament and the ECB.<sup>288</sup> The importance of the issue for the German government was revealed by the agreement between the coalition partners under which 'a body attached to the European finance ministers <...> would decide when to close failing banks'.<sup>289</sup> It should, nevertheless, be mentioned that in the end all Member States settled on a view of limiting the powers of the Commission 'to the legally permitted minimum'.<sup>290</sup>

In this context it should be noted that the Member States' initial agreement on who triggers resolution met German preferences much

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<sup>287</sup> Christie, R. & Brunsdon J. (2013) Brussels Should Make Call on Bank Failures. *Bloomberg* [online]. 3 December. Available from: <http://www.bloomberg.com/news/2013-12-03/brussels-should-make-call-on-bank-failures-document-says.html> [Accessed 31 March 2014].

<sup>288</sup> Agence Europe (2013); Carnegy, H. & Barker, A. (2013) Germany and France close on banking union deal. *Financial Times* [online]. 9 December. Available from: <http://www.ft.com/intl/cms/s/0/fc594a38-60d7-11e3-b7f1-00144feabdc0.html#axzz2y2ktEzEe> [Accessed 31 March 2014]; Schäfer, D. (2016), p. 967; ECB (2013) *Opinion of the European Central Bank of 6 November 2013 on a proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (CON/2013/76)*.

<sup>289</sup> Rinke, A. and Sobolewski, M. (2013) Exclusive: German parties reach deal on banking union – sources. *Reuters* [online]. 9 November. Available from: <http://www.reuters.com/article/2013/11/09/us-europe-banks-germany-idUSBRE9A808320131109> [Accessed 31 March 2014].

<sup>290</sup> Council of the EU (2013c), p. 116.

better than the final compromise between the Council and the Parliament, so illustrating the Parliament's influence in the EU legislative process. Having achieved that the Council would be 'involved only at the Commission's express request', the Parliament claimed to have accommodated 'a key concern' for its members, notably, of avoiding 'pervasive political interference in individual resolution cases'.<sup>291</sup> This and other concessions of the Council that will be mentioned below allowed the members of the European Parliament to officially claim that they 'rescued' the 'seriously damaged bank resolution system'.<sup>292</sup>

### *Between full and limited supranationalism*

The analysis of the key policy actors' preferences on the three main policy choices related to the scope of supranational decision-making in the new EU banking policy framework indicates that in all cases Germany was effectively isolated or supported only by a minority of Member States. While Germany tried to limit the transfer of national authority only to the largest European banks and retain power of influencing EU decisions on resolution, in the final stages of negotiations the majority of governments and EU institutions preferred a higher degree of supranationalism (see Table 7). Although the final agreements on the banking union resulted in a significant transfer of decision-making powers to the EU level, the summary below illustrates that the majority coalition, nevertheless, accommodated some of the German concerns.

As an attempt to conduct a more precise comparison of the initial preferences and the final outcome of negotiations, Table 7 presents them as approximate points in a policy space. According to the chosen methodology, preferences on each policy issue were first assessed with a

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<sup>291</sup> European Parliament (2014) *Parliament negotiators rescue seriously damaged bank resolution system*. Press release, 20 March.

<sup>292</sup> *Ibid.*

view to identifying opposing coalitions, where ‘0’ was given to preferences for the lowest scope of supranationalism and ‘1’ – for the highest. With the aim of evaluating the results of negotiations, each policy space was then divided into four equal segments. As a result, numerical estimates of the outcome of negotiations indicate which coalition achieved the most in the decision-making process on each issue (closer to ‘0’ or ‘1’) as well as the scope of supranational decision-making in general. The research will return to these quantitative estimates in the final subsection.

**Table 7. Preferences on the scope of supranational decision-making in the banking union and the final outcome of negotiations**

Policy issue	Preferences		Outcome of negotiations
<b>Scope of the SSM</b>	<b>All banks</b>	<b>Largest banks</b>	<b>Direct supervision of ‘significant’ banks; ‘less significant’ if necessary</b>
	<i>FR, IT, NL, ES COM, ECB</i>	<i>DE</i>	
	1	0	
<b>Scope of the SRM</b>	<b>All banks</b>	<b>Directly supervised banks</b>	<b>‘Significant’ and cross-border banks; other if resolution involves the SRF, on a Member State’s or the SRB’s own initiative (if necessary)</b>
	<i>FR, IT, ES, NL COM, ECB</i>	<i>DE</i>	
	1	0	
<b>Governance of the SRM</b>	<b>COM triggers resolution</b>	<b>Council triggers resolution</b>	<b>COM; Council involved only under two conditions</b>
	<i>FR, IT, NL COM, ECB, EP</i>	<i>DE</i>	
	1	0	
<b>Total</b>	<b>3</b>	<b>0</b>	<b>2</b>

Note: 1 – a ‘full’ scope of supranational decision-making; 0 – a ‘limited’ scope. FR – France; DE – Germany; IT – Italy; ES – Spain; NL – the Netherlands; COM – European Commission; ECB – European Central Bank; EP – European Parliament.

Sources: Agence Europe, Bloomberg, Council of the EU (2013c), EU legislation, Financial Times.

#### 4.1.2. The Degree of Bank Risk Sharing

Regarding the second group of choices related to the banking union, the Member States' and EU institutions' preferences on pooling bank risks can be identified by looking at four most contentious issues: (1) the funding principles of the SRM; (2) the bail-in tool; (3) the common fiscal backstop; and (4) the EDIS.

##### *The funding principles of the SRM*

With the objective of ensuring orderly resolution of ailing banks and safeguarding the financial stability in the banking union, the European Commission proposed to back up the SRB by a SRF of around €55 billion, or 1% of covered deposits in the participating Member States. The Commission argued that by pooling financial resources from all banks that operate in the banking union, the Fund would serve as an insurance mechanism, contribute to breaking the vicious circle between banking crises and the fiscal position of sovereigns as well as guarantee the necessary alignment between the levels on which credit institutions are supervised and wound down.<sup>293</sup> For the SRF to reach its target level, the Commission foresaw a transitional 10-year period. Although later the Council made a concession to the Parliament and agreed on a shorter period of eight years, it had been decided that during the transition the Fund would comprise 'national compartments', which would be only progressively mutualised<sup>294</sup>.

The German government initially ardently opposed the creation of a joint resolution fund. Two months before the Commission's announcement of the legislative proposal for a SRM, Wolfgang Schäuble

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<sup>293</sup> European Commission (2013), pp. 14–15.

<sup>294</sup> European Commission (2014a).

had publicly warned in the Financial Times that ‘today’s EU treaties <...> do not suffice to anchor beyond doubt a new and strong central resolution authority’. Against this background, he suggested a ‘two-step approach’ to start with, leaving bank rescues in the hands of national authorities until the EU revises its treaties.<sup>295</sup> The German view, however, undermined the very initial idea of pooling resources to deal with failing banks and was contradictory to the position of a large France-led coalition of Member States and EU institutions. In contrast to the German opinion, French Minister of Finance Pierre Moscovici maintained that ‘a single resolution fund is a necessity’<sup>296</sup> and argued for mutualisation ‘as quickly as possible’<sup>297</sup>. Similarly, in its official support for ‘a single mechanism’, the ECB highlighted that ‘coordination between national resolution systems has not proved sufficient to achieve the most timely and cost-effective resolution decisions, particularly in a cross-border context’.<sup>298</sup> Mario Draghi joined the criticism of the German stance by even calling for mutualising national contributions in a much shorter period of five years.<sup>299</sup>

According to the staff of the EU Council, ‘most of the delegations’ agreed ‘on the principle that SRM should comprise a Single Fund as one of the key elements of the whole Banking Union’.<sup>300</sup> However, the Lithuanian Presidency of the Council of the EU ‘focused at bringing the initial proposal closer to the position of Germany, trying to <...> convince the rest of Member States <...> and EU institutions keen on setting up a

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<sup>295</sup> Schäuble, W. (2013) Banking union must be built on firm foundations. *Financial Times* [online]. 12 May. Available from: <http://www.ft.com/intl/cms/s/0/8bdaf6e8-b89f-11e2-869f-00144feabdc0.html#axzz2y2ktEzEe> [Accessed 31 March 2014].

<sup>296</sup> Carnegie, H. & Barker, A. (2013).

<sup>297</sup> Spiegel, P. (2014a) Schäuble signals German concession on EU bank rescue fund. *Financial Times* [online]. 18 February. Available from: <http://www.ft.com/intl/cms/s/0/5e35baa0-9893-11e3-a32f-00144feab7de.html#axzz2y2ktEzEe> [Accessed 31 March 2014].

<sup>298</sup> ECB (2013), p. 2.

<sup>299</sup> Spiegel, P. (2014a).

<sup>300</sup> Council of the EU (2013c), p. 14.



common fund and pooling financial risks across the eurozone, that Germany was too important to be marginalized'.<sup>301</sup> In his assessment of the Lithuania's EU Council Presidency, Vilpišauskas found that the option of submitting SRM regulation to a qualified majority vote was, therefore, ruled out.<sup>302</sup>

Contrary to initial expectations, the final compromise of only a progressively mutualised SRF could be seen as a 'delayed' solution, meaning that in the medium term the financial burden of winding down troubled banks would continue to remain on the shoulders of the Member States. This was also well reflected in the Member States' decision on how to deal with those banks that could be in trouble before the launch of the new system. According to the Member States' agreement, any capital shortfalls revealed by the ECB's comprehensive assessment, which was conducted in 2014 for then soon to be directly supervised banks, had to be addressed through, first, private sources, then national arrangements and only then euro area/EU level solutions.<sup>303</sup> Nevertheless, given Germany's clear initial opposition at the highest political level, the very creation of a single bank rescue fund (although over an eight-year period) can be seen as one of the biggest concessions of the German government in negotiations.<sup>304</sup>

### *The bail-in tool*

The discussion on the funding of the SRM was closely linked to the application of the bail-in tool under the Bank Recovery and Resolution Directive (BRRD). With the aim of limiting public sector involvement in

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<sup>301</sup> Vilpišauskas, R. (2014) Lithuania's EU Council Presidency: Negotiating Finances, Dealing with Geopolitics. *Journal of Common Market Studies*, 52 (Annual Review), pp. 99–108, p. 104.

<sup>302</sup> Ibid.

<sup>303</sup> Council of the EU (2013d) *Council statement on EU bank's asset quality review and stress tests, including on backstop arrangements*. Brussels, 15 November, p. 2.

<sup>304</sup> Schäfer, D. (2016), p. 968; also see Epstein, R.A. & Rhodes, M. (2016), pp. 427–429.

rescuing failing banks, the Commission proposed under the BRRD to give competent national authorities 'the power to write down the claims of unsecured creditors of a failing institution and to convert debt claims to equity'.<sup>305</sup> In other words, the Commission put forward a new 'bail-in' instrument, which ensures that shareholders and creditors of a failing bank bear the costs of its resolution. While the bailout term defines injection of fresh capital into a failing financial institution to help it meet debt obligations, the bail-in tool was proposed to accomplish the same goal with different means – 'bailing-in' liabilities.

In the draft directive of 2012, the Commission proposed the provisions of the bail-in tool to be applied only from 2018<sup>306</sup>; in June 2013 the Council endorsed it<sup>307</sup>. Nevertheless, soon after the governments started discussions on the SRM Regulation, Germany, the Netherlands, Sweden and a number of other countries decided to link negotiations on the financing principles of the SRM with the application of the bail-in instrument. Seeking to limit public sector involvement in resolving failing banks, they argued for bringing the bail-in to an earlier start of 2015, or the date of the then anticipated entering into force of the SRM Regulation<sup>308</sup>. According to a publicly available report from the Presidency to the Council, the Germany-led group of countries suggested that, alternatively, the SRM could have become effective from the agreed date of the application of the bail-in tool.<sup>309</sup> Although France, Italy and Spain,

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<sup>305</sup> European Commission (2012a) *Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010*. COM(2012) 280 final, Brussels, 6 June, p. 13.

<sup>306</sup> *Ibid.*, p. 18.

<sup>307</sup> Council of the EU (2013a) *Note from the General Secretariat of the Council to Delegations on the BRRD*. 11148/1/2013 REV1, Brussels, 28 June, p. 25.

<sup>308</sup> Council of the EU (2013c), p. 17; Council of the EU (2013b) *Report from the Presidency to the Council on the Single Resolution Mechanism [First reading]*. 15868/13, Brussels, 11 November, p. 6. Available from: Christie, R. & Brunsden J. (2013).

<sup>309</sup> Council of the EU (2013b), p. 6. Also see Council of the EU (2013c), p. 17.

among others, shared the goal of shifting resolution costs to banks, they, nevertheless, warned about possible negative effects of its early application on the financial markets and, therefore, argued for sticking to the initial agreement.<sup>310</sup>

Despite the divergent preferences of Member States, the Council settled on a compromise that both the bail-in instrument and resolution functions would apply from 2016.<sup>311</sup> The negotiations with the European Parliament ended in an unchanged compromise.

### *The common fiscal backstop*

The third policy choice related to pooling bank risks was a common financial backstop to the SRM. The 'Four Presidents' Report' on strengthening the EMU explicitly stated that a credible pan-European resolution framework needed to have 'an appropriate and effective common backstop'<sup>312</sup>, which would be available as a last resort. The report also suggested that it could be ensured by the ESM. Due to a high divergence in Member States' preferences, the Lithuanian Presidency of the Council of the EU tried to separate discussions on the backstop issue from negotiations on the SRM.<sup>313</sup> Although the Council reached a compromise to develop a common backstop during the 'transitional period' agreed for the creation of the SRF<sup>314</sup>, the Parliament succeeded in securing a partial solution of allowing the Fund to borrow from the markets<sup>315</sup>.

Looking at the lessons from the recent crisis, even the EU officials identified a risk that the SRF of only €55 billion might be insufficient to

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<sup>310</sup> Barker, A., Spiegel P. & Wagstyl S. (2013); Council of the EU (2013c), p. 17.

<sup>311</sup> Council of the EU (2013e) p. 3.

<sup>312</sup> Van Rompuy, H. (2012b), p. 7.

<sup>313</sup> Council of the EU (2013c), p. 14.

<sup>314</sup> Eurogroup and ECOFIN Ministers (2013) *Statement on the SRM backstop*. 18 December.

<sup>315</sup> European Parliament (2014); European Commission (2014a), p. 3.

cover large or several consecutive bank failures.<sup>316</sup> This question became even more important in light of the agreement on the transitional period of mutualising the national compartments of the Fund. Against this background, during the EU legislative process France, Italy and some other Member States argued that with a view to ensuring a credible supranational resolution framework, the ESM should be able to provide an emergency credit line to the SRM.<sup>317</sup> As it was argued by Italy's Minister of Finance Fabrizio Saccomanni, 'a common backstop' was needed to be 'operational during the transitional phase <...> and provide contribution to the cost of the resolution without conditionality'. He even threatened that it was a precondition for the transfer of sovereignty that the governments were about to agree on.<sup>318</sup> On the opposite side, being concerned that agreement on a public backstop would create moral hazard in the banking sector, Germany consistently opposed any related proposals. In particular, Wolfgang Schäuble maintained that 'the only way to the ESM is through the nation state'.<sup>319</sup>

Given the high divergence in the EU governments' preferences, it was decided to separate negotiations on the SRM from the backstop issue, leaving the latter to be agreed at a later stage. Although at the time of writing the issue was only being discussed, some commentators have recently criticised the idea, arguing that the bail-in tool, which used to be 'seen as anathema' in the past, in fact 'obviates the need for a fiscal backstop'<sup>320</sup>.

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<sup>316</sup> E.g. Council of the EU (2013c), p. 11.

<sup>317</sup> Howarth, D. & Quaglia, L. (2014), p. 134; Steinhauser, G. (2013) Italy's Saccomanni Attacks German Bank-Resolution Plan. *The Wall Street Journal* [online]. 17 December. Available from: <http://blogs.wsj.com/brussels/2013/12/17/italys-sacomanni-attacks-german-bank-resolution-plan/> [Accessed 31 March 2014].

<sup>318</sup> Steinhauser, G. (2013).

<sup>319</sup> Spiegel, P. & Barker, A. (2013a) ECB blow to European bank backstop. *Financial Times* [online]. 18 December. Available from: <<https://www.ft.com/content/6449c452-678a-11e3-a5f9-00144feabdc0>> [Accessed 17 August 2017].

<sup>320</sup> Sandbu, M. (2017) The utopia of fiscal union. *Financial Times* [online]. 2 August. Available from: <https://www.ft.com/content/1f8dd500-7768-11e7-90c0-90a9d1bc9691> [Accessed 26 August 2017].

## *The European Deposit Insurance Scheme*

The final policy choice, which allows identifying preferences on the politically-acceptable degree of bank risk sharing, is related to support for a supranational deposit insurance scheme. As it has already been mentioned, the idea of an EDIS was first put forward in the initial version of the 'Four Presidents' Report' entitled 'Towards a Genuine Economic and Monetary Union'<sup>321</sup>, but in its final version the 'Four Presidents' limited their proposals to the 'harmonisation of national deposit guarantee schemes'<sup>322</sup>. It was widely acknowledged that the main reason why the single deposit guarantee scheme (DGS) was not put forward neither by the 'Four Presidents', nor by the Commission in its blueprint for a 'deep and genuine' EMU<sup>323</sup> was pressure from Germany<sup>324</sup>. In this context, at the beginning of 2014 the Barroso Commission officially stated that 'it is not envisaged to equip the banking union with a single supranational DGS at this stage'.<sup>325</sup> However, in 2015 the 'Five Presidents' Report' on 'Completing Europe's Economic and Monetary Union' returned the idea to the EU policy agenda, arguing that a single deposit insurance scheme was necessary to complete the banking union.<sup>326</sup>

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<sup>321</sup> Van Rompuy, H. (2012a), p. 4.

<sup>322</sup> Van Rompuy, H. (2012b), p. 8.

<sup>323</sup> European Commission (2012d).

<sup>324</sup> Persson, M. & Ruparel, R. (2012) *The eurozone banking union: A game of two halves* [online]. London: Open Europe. Available from: <http://archive.openeurope.org.uk/Content/Documents/Pdfs/bankinguniontwohalves.pdf> [Accessed 16 September 2017], p. 4; House of Lords European Union Committee (2012) *European Banking Union: Key issues and challenges, 7<sup>th</sup> Report of Session 2012–2013*. London: The Stationery Office, 12 December, p. 37; House of Lords European Union Committee (2014) *'Genuine Economic and Monetary Union' and implications for the UK, 8<sup>th</sup> Report of Session 2013–2014*. London: The Stationery Office, 14 February, p. 45.

<sup>325</sup> European Commission (2014c) *A comprehensive EU response to the financial crisis: substantial progress towards a strong financial framework for Europe and banking union for the eurozone*. Memo 14/57, Brussels, 24 January, p. 8.

<sup>326</sup> Juncker, J.-C. (2015), p. 11.

Despite Germany's continuing opposition<sup>327</sup>, the new Juncker Commission<sup>328</sup> soon made an official legislative proposal on creating an EDIS. Taking into account differences in funding levels of national DGSs and related moral hazard problems, the Commission proposed to introduce the scheme in three steps: to start from a 'reinsurance'-based system, which would later evolve into a 'co-insurance' scheme, followed by a fully-mutualised EDIS until 2024. With a view to reaching this goal, it was proposed to create a European Deposit Insurance Fund (EDIF), which would be financed by the banking sector and managed by the SRB. According to the proposal, in the first – reinsurance – phase, a participating national DGS would be able to access the EDIF only after having exhausted its own funds. In the second – co-insurance – phase the EDIF would provide a certain share of the funding and bear the same share of the loss the participating national DGS would incur from reimbursing depositors or contributing to resolution. Meanwhile, in the final – full insurance – stage the EDIF would provide full funding and cover all losses.<sup>329</sup>

Similarly to the motives behind the creation of the SRM, the Commission argued that a pan-European deposit insurance system would increase resilience of national deposit schemes against local shocks, contribute to breaking the sovereign-bank link and help achieve 'the overall objective of financial stability which underpins the economic and monetary policy of the Union'.<sup>330</sup> It particularly emphasised that an EDIS was necessary to 'restore' a level playing field in the single market by limiting situations in which depositors and banks might be at a

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<sup>327</sup> Brunsten, J. (2015) Berlin fights Brussels push for deeper financial integration. *Financial Times* [online]. 10 September. Available from: <http://www.ft.com/intl/cms/s/0/df1cf84a-57be-11e5-a28b-50226830d644.html#axzz3vzx1WVUj> [Accessed 1 January 2015].

<sup>328</sup> The Juncker Commission started its term on 1 November 2014.

<sup>329</sup> European Commission (2015a) *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme*. COM(2015) 586 final, Strasbourg, 24 November, pp. 9–12.

<sup>330</sup> *Ibid.*, p. 4.

disadvantage due to the location of their deposits or banks. Furthermore, following neofunctionalist logic, the Commission also argued that because of the creation of the SSM and the SRM, 'the circumstances in which a national DGS has to pay out insured depositors or contribute to resolution are to a large extent no longer under national control'.<sup>331</sup> As it has already been mentioned in the earlier parts of this research, during both the negotiations on the Maastricht Treaty and the post-crisis de Larosière EU supervisory reforms the unwillingness of national governments to pool financial risks had been one of the main reasons behind the argument against single supervision.<sup>332</sup>

Seeing common deposit insurance as a step towards debt mutualisation, during the initial discussions of 2012 all the main German parties were unanimously against it.<sup>333</sup> Unsurprisingly, the coalitional agreement between the largest German parties – CDU/CSU and SPD – in 2013 explicitly rejected the idea.<sup>334</sup> After the Commission's official proposal, Wolfgang Schäuble repeated that his country 'will not accept it, no way, so long as we don't have an amended treaty' and went as far as declaring that his 'government would be ready to go to court'.<sup>335</sup> According to Schäuble, until the EU has taken additional steps in reducing risk-taking in the banking system, an EDIS was 'politically unthinkable' as well.<sup>336</sup> This fact notwithstanding, France, Italy and a number of other countries continue to see the single deposit guarantee framework as the

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<sup>331</sup> European Commission (2015b) *Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Towards the completion of the Banking Union*. COM(2015) 587 final, Strasbourg, 24 November, p. 6; also see Gros, D. & Schoenmaker, D. (2014), p. 535; Schoenmaker, D. (2015).

<sup>332</sup> James, H. (2012), p. 219; Spendzharova, A. (2012), pp. 318–319.

<sup>333</sup> Open Europe (2013) *All Change? Why the German elections are unlikely to fundamentally alter eurozone policy* [online]. London: Open Europe. Available from: [http://archive.openeurope.org.uk/Content/Documents/130910\\_German\\_Election\\_Briefing\\_FINAL\\_VERSION.pdf](http://archive.openeurope.org.uk/Content/Documents/130910_German_Election_Briefing_FINAL_VERSION.pdf) [Accessed 16 September 2017].

<sup>334</sup> Koalitionsvertrag zwischen CDU, CSU und SPD (2013) *Deutschlands Zukunft gestalten. 18. Legislaturperiode*, p. 94.

<sup>335</sup> Brunsdon, J. (2015).

<sup>336</sup> *Ibid.*

final pillar of the banking union, which is necessary to cut the link between the perceived strength of sovereigns and risk of deposit flight. At the time of writing the governments have agreed to start political negotiations on the EDIS ‘as soon as sufficient further progress has been made on the measures on risk reduction’ in the banking sector<sup>337</sup>, which indicates a lack of political support for further risk sharing.

*Between a high and low degree of risk pooling*

The overview of national preferences on deeper integration in the area of bank risk sharing shows that Germany’s insistence on limiting the degree of risk pooling came in sharp contrast to the French and the majority of other Member States’ views. The only exception was the negotiations on the application of the bail in-tool, when Germany was supported by a similar coalition of countries (see Table 8). In addition, it is notable that the German position on a credible resolution framework and supranational deposit insurance scheme undermined the very initial idea of the banking union and its main objective of breaking the bank-sovereign link. Consistent with the earlier table, Table 8 represents the initial preferences and the outcome of negotiations on a policy space, where ‘0’ represents a low degree of bank risk sharing and ‘1’ – a high degree.

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<sup>337</sup> Council of the EU (2016) *Council Conclusions on a roadmap to complete the Banking Union*. Press release 353/16, Brussels, 17 June.



**Table 8. Preferences on the degree of bank risk sharing in the banking union and the final outcome of negotiations**

<b>Policy issue</b>	<b>Preferences</b>		<b>Outcome of negotiations</b>
<b>Funding of the SRF</b>	<b>SRF</b>	<b>Network of national funds</b>	<b>Progressively mutualised SRF</b>
	<i>FR, IT, NL, ES COM, ECB, EP</i>	<i>DE</i>	
	1	0	<b>0.75</b>
<b>Bail-in tool</b>	<b>From 2018</b>	<b>From 2015</b>	<b>From 2016</b>
	<i>FR, IT, ES</i>	<i>DE, AT, DK, FI, NL, SE</i>	
	1	0	<b>0.25</b>
<b>Fiscal backstop</b>	<b>From the start</b>	<b>No backstop/delayed</b>	<b>To be developed during the transitional period; the SRF allowed to borrow from the markets</b>
	<i>FR, IT, ES COM, ECB, EP</i>	<i>DE</i>	
	1	0	<b>0.25</b>
<b>European Deposit Insurance Scheme</b>	<b>Third pillar</b>	<b>Not anticipated</b>	<b>Not yet decided</b>
	<i>FR, IT COM, ECB</i>	<i>DE, NL</i>	
	1	0	<b>0</b>
<b>Total</b>	<b>4</b>	<b>0</b>	<b>1.25</b>

Note: 1 – a ‘high’ degree of bank risk sharing; 0 – a ‘low’ degree. AT – Austria; FR – France; DE – Germany; IT – Italy; ES – Spain; NL – the Netherlands; SE – Sweden; DK – Denmark; FI – Finland; COM – European Commission; ECB – European Central Bank; EP – European Parliament.

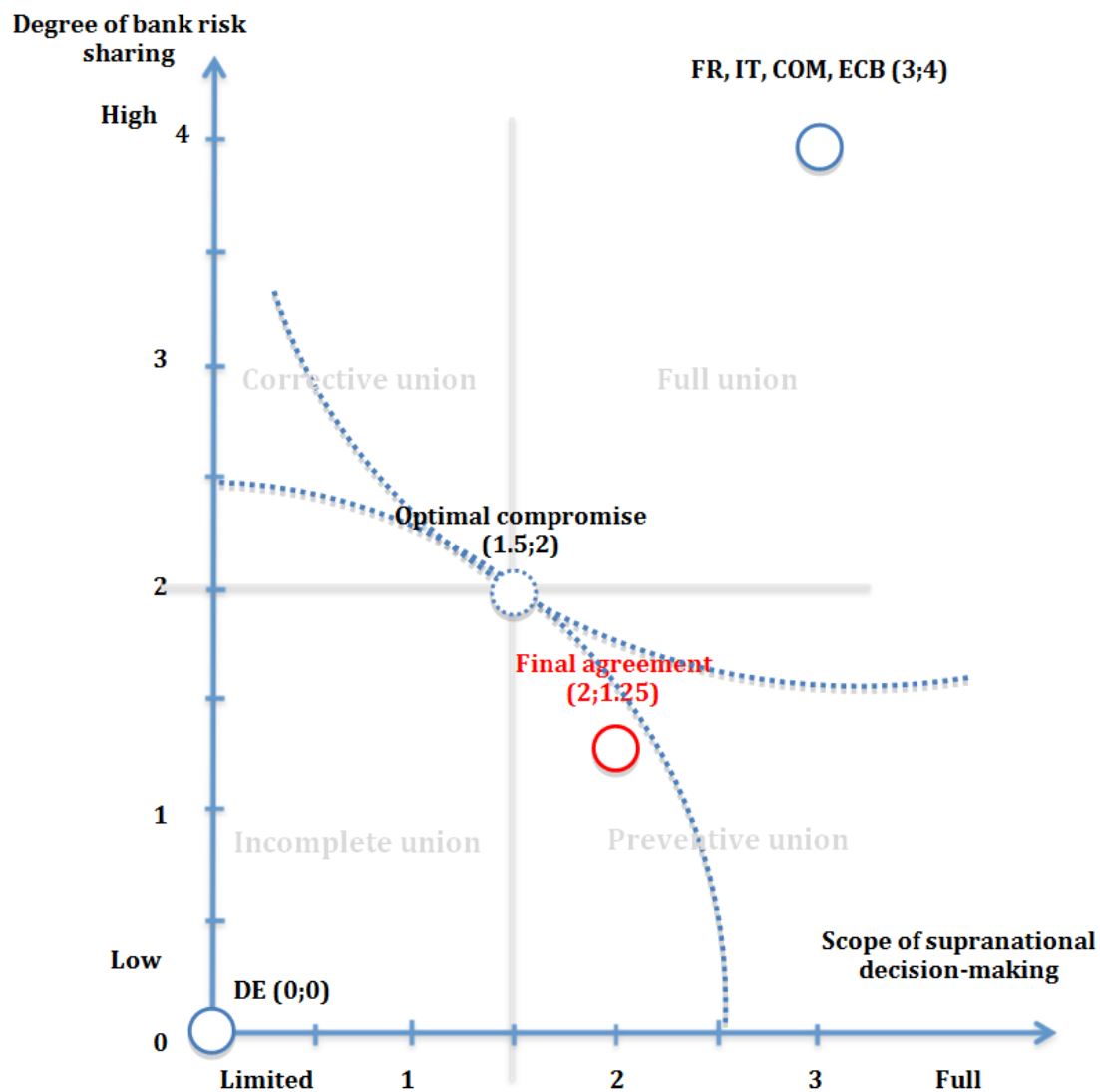
Sources: Agence Europe, Bloomberg, Council of the EU (2013c), EU legislation, Eurointelligence, Financial Times.

#### **4.1.3. A ‘Preventive’ Banking Union?**

Since the June 2012 Euro Summit, when the euro area member states committed to fundamentally changing their banking policies, public debates on the banking union and the design of its separate elements have exposed a deep conflict of preferences on the fully-functional European system of banking regulation and oversight. On the one side of the spectrum, after changing their initial preferences, the France-led group of

countries started advocating for the new supranational supervisory and resolution framework to have significant decision-making powers and cover all banks irrespective of their size. In particular, given high concentration of its banking system, France could not accept the possibility of the unequal treatment of members of the banking union. Supported by EU institutions, this group also argued for a high degree of mutualisation of financial resources to effectively break the sovereign-bank 'doom loop'. On the other side, Germany insisted on limiting the new EU-level competence to the most significant credit institutions and highlighted the primary objective of imposing losses on the creditors of troubled banks. Taking all the arguments into consideration, in the final stages of negotiations these groups of key policy actors represented the two main competing types of the new European banking policy framework: a 'full' banking union, supported by the majority of Member States and EU institutions, and an 'incomplete' banking union, advanced by Germany (see Figure 2).

**Figure 2. Preferences on the banking union and the final agreement in a two-dimensional policy space**



Note: FR – France; DE – Germany; IT – Italy; COM – European Commission; ECB – European Central Bank.

The figure builds on the previous quantitative estimates of the preferences of key policy actors (see Table 7 and Table 8) and the identified four ‘ideal’ types of the banking union (Table 1) to present a simple two-dimensional spatial model of politics. The horizontal axis represents the preferred scope of supranational decision-making in the banking union, while the vertical axis – the preferred degree of bank risk sharing. If one added all quantitative estimates on the preferences on each

of the identified policy issues in each dimension, one would find the preferred policies of Germany- and France-led groups of countries, including the EU institutions, in the opposite 'corners' of the presented policy space: Germany – in the corner referring to the 'most limited' scope of supranational decision-making and the 'lowest' degree of bank risk sharing (0;0); meanwhile, France, Italy, the Commission and the ECB – in the corner referring to the 'full' scope and the 'highest' degree, respectively (3;4).

If one assumes that the identified positions of the two coalitions represent their 'ideal' policy preferences, the 'optimal' policy compromise would be in the middle of each dimension. In this respect, the coordinates of the 'optimal' compromise would be '1.5' on the horizontal axis and '2' on the vertical one (1.5;2). In theory, each of the two coalitions would prefer to minimise the distance between their preferred policy and the outcome of negotiations, i.e. the policy which is adopted. Germany would, therefore, prefer the policy options on the left side of the supranational decision-making axis and the lower side of the risk sharing axis, while the France-led group of countries – on the right and the upper sides, respectively.

It is already known from the earlier analysis that the coordinates of the final agreement are '2' and '1.25' (2;1.25). The proposed spatial model, therefore, shines a light on which coalition achieved the most in the EU bargaining process. According to the spatial model, Germany made relatively larger concession in the area of transferring decision-making powers to the EU level. Meanwhile, the opposing coalition reluctantly agreed to limit their preferred degree of risk pooling. Although in the final stages of negotiations Germany preferred an 'incomplete' banking union option and the France-led group of Member States, including the EU institutions – the 'full' one, the proposed spatial model shows that the final compromise, nevertheless, ended closer to the 'preventive' banking union

option.

Having said that, if one assumed the final outcome of negotiations to be a package deal and added all the quantitative estimates on each dimension, one would find that in a one-dimensional spatial model of politics the outcome would be close to an 'optimal' compromise, which could be seen as the result of the lowest common denominator bargaining. More specifically, if Germany's preferences were represented by '0' (the lowest degree of supranationalism) and those of the France-led group of countries, including the EU institutions – by '7'<sup>338</sup> (the highest degree of supranationalism), the optimal point would be in the middle – '3.5', while the final compromise – '3.25'<sup>339</sup>. The following sections aim at explaining this outcome, including the extent to which the agreement on the most debated elements of the banking union could be seen as a package deal.

#### ***4.2. Economic Dependence on Agreements***

Following the proposed analytical framework, this section examines which governments were most dependent on reaching the agreement on the banking union and its main building blocks. With a view to identifying the most vulnerable Member States, the author analyses a number of indicators that help to identify countries with relatively bigger and smaller negotiating power. Since the distinction between vulnerabilities on the sovereign side and on the side of the national banking system in the European context is rather relative, before turning to further analysis it is important to look at how they can be transmitted from one side of the bank-sovereign nexus to the other.

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<sup>338</sup> If one adds '3' on the 'scope of supranational decision making' and '4' on the 'degree of risk sharing' dimensions.

<sup>339</sup> '2' on the horizontal axis added to '1.25' on the vertical.

## *The bank-sovereign nexus*

The harmful interdependence between banks and sovereigns has been widely accepted as ‘the root cause of the (negative) contagion before mid-2012’<sup>340</sup>, which the euro area heads of state and government committed to eliminate<sup>341</sup>. With the benefit of hindsight, it can be argued that should the euro area banks have diversified their investment and funding risks by operating across Member States, the euro area would not have experienced unprecedented market pressure. However, despite significant pre-crisis steps towards deeper financial integration, the banking systems of the EU Member States remained, to a large extent, national.

On the one side of the spectrum, this meant that sovereign stress could be transmitted to the national banking system in at least two ways: first, *directly* through banks’ exposure to sovereign debt (holdings of government bonds) and, second, *indirectly* through worsening conditions in the domestic economy and/or rising doubts about the value of implicit and explicit public guarantees on bank debt. On the other side, sovereigns could equally be affected by troubled banks *directly* through the massive fiscal burden (if it is decided to bail them out) and the related increase in sovereign borrowing costs. At the same time, *indirect* exposure might arise due to the negative effect on general funding conditions in the real economy (e.g. ‘credit squeeze’) and ensuing lower economic growth. The following analysis will focus, first, on the sovereign side of the bank-sovereign nexus; it will then turn to the banking side.

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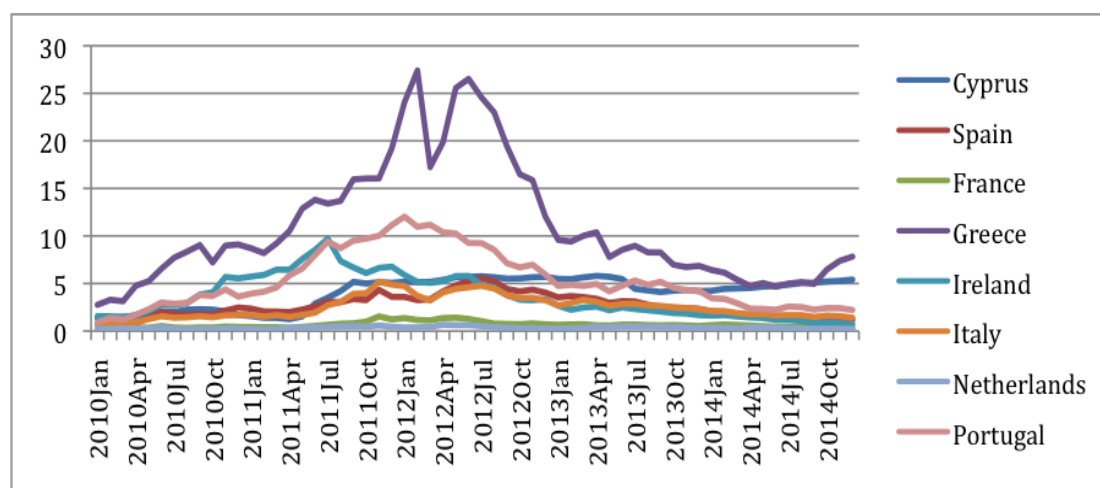
<sup>340</sup> Véron, N. (2015), p. 14.

<sup>341</sup> Euro Area Summit (2012).

### 4.2.1. Vulnerabilities on the Sovereign Side

Until summer 2012 long-term borrowing costs of the euro area governments had been sharply diverging (see Figure 3). While in the first half of 2012 secondary market yields of 10-year German Bunds (long-term interest rates used by the ECB to assess convergence) were on average 1.63%, borrowing costs of other countries varied on average from 2.91% in France to 5.7% in Spain, 5.75% in Italy, 7.12% in Ireland, and 12.31% in Portugal, not to mention 25.1% in Greece.<sup>342</sup>

**Figure 3. Spreads of 10-year government bond rates in selected EU Member States vis-à-vis Germany**



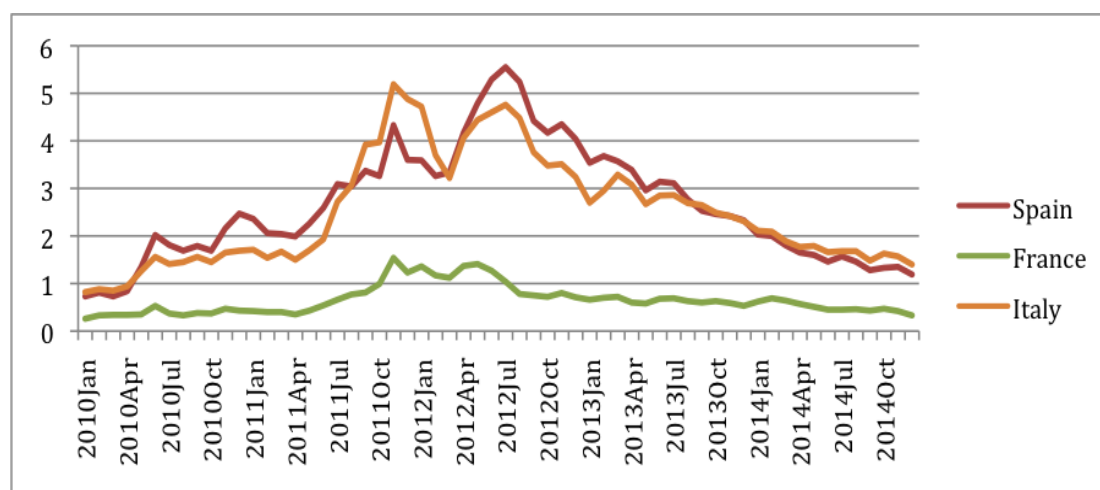
Sources: ECB (2017c), own calculations.

If one focused on the largest euro area members' long-term funding costs vis-à-vis Germany, it would be obvious that before the landmark June 2012 decision to create supranational supervision Spain and Italy (and, to a lesser extent, France) found themselves in a much weaker bargaining position in comparison to Germany (see Figure 4). The turnaround in market perceptions took place only after the famous Mario

<sup>342</sup> ECB (2017c) Long-term interest rate statistics for EU Member States. *Statistical Data Warehouse*; own calculations.

Draghi's commitment in July 2012 'to do whatever it takes to preserve the euro'<sup>343</sup>. This remark at the Global Investment Conference in London on 26 July and the ensuing announcement of the OMT programme on 2 August signalled the ECB's readiness to take responsibility of the lender of last resort in the government bond market with a view to ensuring effective monetary policy transmission throughout all the euro area member states. Nevertheless, despite the following trend of convergence in sovereign spreads, Germany's borrowing costs remained as the lowest benchmark. In fact, Dany, Gropp and von Schweinitz found that due to the 'flight to safety' phenomenon and the 'too accommodating' ECB monetary policy stance 'the German public sector balance benefited significantly from the European/Greek debt crisis', saving more than €100 billion in interest expenses in the period of 2010 to mid-2015.<sup>344</sup>

**Figure 4. Spreads of 10-year French, Italian and Spanish government bond rates vis-à-vis Germany**



Sources: ECB (2017), own calculations.

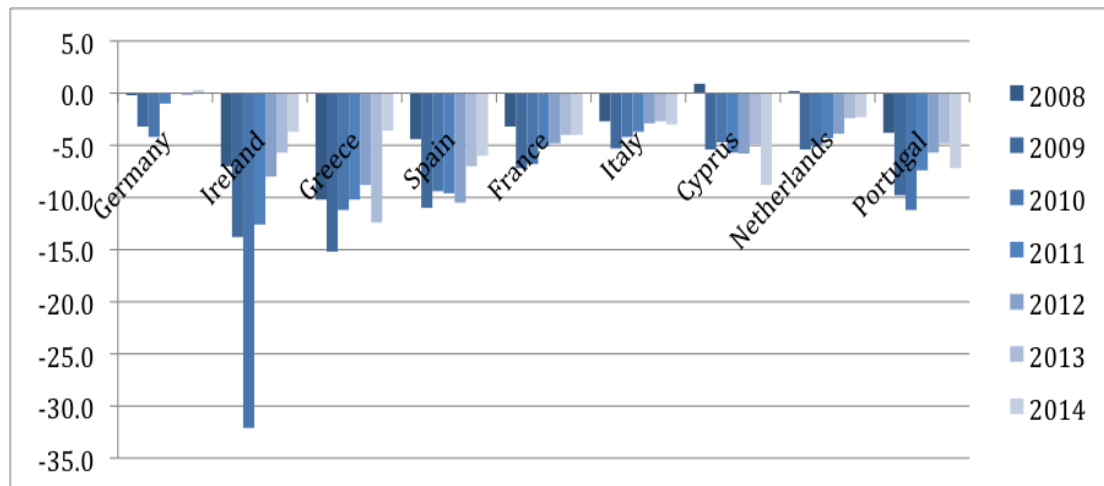
<sup>343</sup> Draghi, M. (2012) Speech at the Global Investment Conference, London, 26 July. Available from: <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html> [Accessed 17 February 2017].

<sup>344</sup> Dany, G., Gropp, R.E. & von Schweinitz, G. (2015) Germany's Benefit from the Greek Crisis. *IWH Online*. 7. p. 1.



Since the global financial crisis, Germany also had much stronger public finances in comparison to other large euro area member states and, therefore, had bigger fiscal capacity to autonomously respond to external shocks. Figure 5 shows that in 2012 Germany was the only country (also in the EU) that had a balanced budget, while France ran a deficit of 4.9% of GDP, Italy – 2.9% of GDP, and Spain – an astonishing 10.5% of GDP.

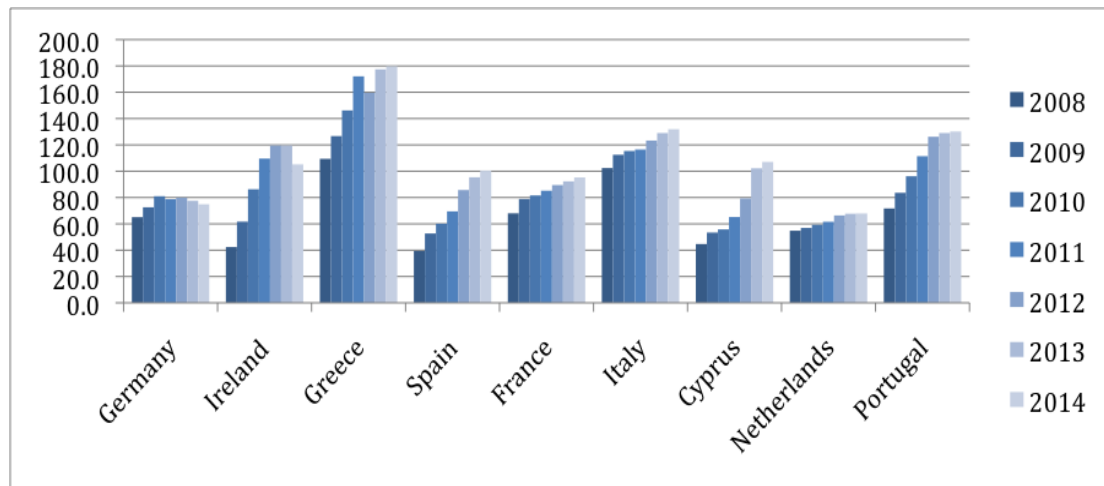
**Figure 5. General government deficit in selected EU Member States (percentage of GDP)**



Source: Eurostat (2017).

Similarly, in 2012, Germany had lower general government gross debt (79.9% of GDP) than France (89.5% of GDP), Spain (85.7% of GDP) and Italy (123.3% of GDP), and was the only country in the latter group of the largest euro area economies that managed to limit its growth (Figure 6).

**Figure 6. General government gross debt in selected EU Member States (percentage of GDP)**



Source: Eurostat (2016).

In general, if interest payments on government debt exceed the GDP growth rate, the debt-to-GDP ratio will keep increasing. Under such circumstances a country will stabilise debt accumulation only if it manages to turn the primary budget deficit into a surplus. Using a simple formula, one can assess the sustainability of deficits and debts in different countries by calculating the growth rate of their debt-to-GDP ratio, or dynamics of debt:

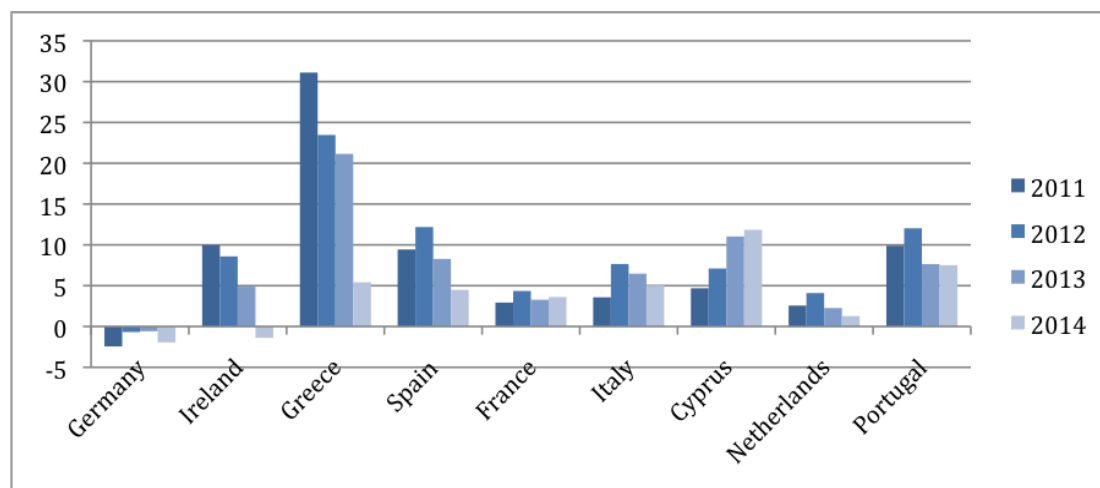
$$\Delta \frac{D}{Y} = (i - g) \frac{D}{Y} + \frac{G - T}{Y}$$

where  $D$  is the level of debt,  $Y$  is the GDP,  $i$  is the interest rate paid on the government debt,  $g$  is the GDP growth rate,  $G$  is the primary budget deficit (government spending without payments on the government debt) and  $T$  is the tax revenue.<sup>345</sup>

<sup>345</sup> Adapted from De Grauwe, P. (2012) *Economics of Monetary Policy*. 9th ed. Oxford University Press, pp. 211–213.

Figure 7 shows estimates of dynamics of debt in the same sample of Member States. According to calculations, in the period of 2011–2014 Germany was the only country that, besides stabilising debt accumulation, also managed to reduce it. Meanwhile, in 2012 the debt-to-GDP ratio was on the path of significant growth in all the remaining largest economies: 4.4% in France, 7.7% in Italy, and 12.2% in Spain, not to mention the exploding 23.5% in Greece. These estimates, however, reflect a very preliminary snapshot of how the dynamics of debt could have been seen at that time, since at the height of the Spanish banking crisis and uncertainty in the European financial markets about the future of the euro it was not fully known how much it would actually cost to finance deficits and meet other existing obligations with variable interest rates. Despite this, Figure 7 clearly indicates the already mentioned fact that due to the strength of the public finances Germany was in a relatively stronger position to meet external pressures than France and other large euro area economies.

**Figure 7. Debt-to-GDP ratio growth rate in selected EU Member States**



Source: Own calculations based on Eurostat 2016 data.

In summary, the analysis of the vulnerabilities on the sovereign side of the bank-sovereign nexus suggests that in 2012 Germany found itself in a relatively stronger bargaining position on the creation of the banking

union than the opposing coalition of Member States and EU institutions. However, the strong macroeconomic fundamentals on the sovereign side do not reveal vulnerabilities in the banking sector.

#### **4.2.2. Vulnerabilities on the Banking Side**

As regards the banking side of the bank-sovereign nexus, there are at least two important dimensions to look at: first, the exposure of banks to other Member States, and, second, sovereign debt exposure to their own state.

Table 9 shows that at the end of 2011<sup>346</sup> German and French banks were much more exposed to stressed euro area economies (GIIPS, or Greece, Ireland, Italy, Portugal and Spain) than Spanish or Italian lenders. Nevertheless, in comparison to France, Germany was in a relatively much better position, since German banks' total exposure to GIIPS amounted to around 12% of GDP, while the exposure of the French national banking sector to the same group of countries was more than one fifth, or 22%, of its GDP. To take a closer look, while German banks had around 4% of GDP in exposure to both Spain and Italy, the exposure of the French banking system to Spain and Italy amounted to, respectively, a striking 14 and 5% of GDP.

Given the possible escalation of the Spanish banking crisis and its contagion to Italy and other vulnerable member states, before the June 2012 Euro Summit the French lenders seem to have been relatively more vulnerable than the German. It is, however, important to note that with regard to total amounts outstanding at the end of 2011 German banks in fact had the highest exposure to Spain in the EU: it stood at around \$146 billion, of which \$53 billion, or more than one third, was exposure to banks (see Table 9). As regards individual financial institutions, in the

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<sup>346</sup> As available to the euro area policymakers approximately before the commitment to create single supervision.

middle of 2012 Germany's largest lender by market value, Deutsche Bank AG, had a gross exposure of €29.7 billion, €7.2 billion of which was exposure to Spanish financial institutions. Similarly, Germany's second-largest lender, Commerzbank<sup>347</sup>, had €13.5 billion in exposure to Spain, of which €4.3 billion was exposure to its financial institutions<sup>348</sup>. As it was then highlighted by Moody's, the 'German banks' sizable exposures to the most stressed euro area countries, particularly Italy and Spain, together with their limited loss-absorption capacity and structurally-weak earnings, make them vulnerable to a further deepening of the crisis'.<sup>349</sup> This fact was one of the reasons why in July 2012 Moody's decided to change its outlook on Germany's triple-A government bond rating from 'stable' to 'negative'.

**Table 9. Exposure of the German, French, Italian and Spanish banks to selected EU Member States (USD millions at the end of 2011)**

	Germany	France	Italy	Spain
<b>Germany</b>				
Public sector	–	40,788	48,521	3,952
Banks	–	59,557	50,716	5,953
Non-bank private sector	–	109,651	135,195	44,584
<b>Total</b>	–	209,996	234,434	54,489
<b>% of GDP</b>	–	<b>9</b>	<b>11</b>	<b>4</b>
<b>France</b>				
Public sector	20,182	–	2,270	5,546
Banks	87,892	–	25,758	9,034
Non-bank private sector	66,788	–	14,960	12,955
<b>Total</b>	174,862	–	43,013	27,535
<b>% of GDP</b>	<b>5</b>	–	<b>2</b>	<b>2</b>
<b>Greece</b>				
Public sector	6,749	6,502	773	302

<sup>347</sup> Following its bail out during the global financial crisis, at that time Commerzbank was 25%-owned by the German government.

<sup>348</sup> Stevens, L. & Henning, E. (2012) State of Europe's Banks: Safe and Stressed? *The Wall Street Journal* [online]. 24 September. Available from: <https://www.wsj.com/articles/SB10000872396390443890304578008534178895560> [Accessed 4 February 2017].

<sup>349</sup> Moody's (2012) Moody's changes the outlook to negative on Germany, Netherlands, Luxembourg and affirms Finland's Aaa stable rating. 23 July. Available from: [https://www.moody's.com/research/Moodys-changes-the-outlook-to-negative-on-Germany-Netherlands-Luxembourg--PR\\_251214](https://www.moody's.com/research/Moodys-changes-the-outlook-to-negative-on-Germany-Netherlands-Luxembourg--PR_251214) [Accessed 4 February 2017].

	<b>Germany</b>	<b>France</b>	<b>Italy</b>	<b>Spain</b>
Banks	759,000	223	146	39
Non-bank private sector	5,847	37,628	1,266	627
<b>Total</b>	<b>13,355</b>	<b>44,353</b>	<b>2,186</b>	<b>969</b>
<b>% of GDP</b>	<b>0</b>	<b>2</b>	<b>0</b>	<b>0</b>
<b>Ireland</b>				
Public sector	2,638	2,151	462	146
Banks	17,883	7,971	4,096	634
Non-bank private sector	74,808	17,340	10,900	7,064
<b>Total</b>	<b>95,329</b>	<b>27,462</b>	<b>15,457</b>	<b>7,844</b>
<b>% of GDP</b>	<b>3</b>	<b>1</b>	<b>1</b>	<b>1</b>
<b>Italy</b>				
Public sector	41,861	66,167	-	8,536
Banks	31,770	31,377	-	2,553
Non-bank private sector	60,323	234,801	-	19,880
<b>Total</b>	<b>133,954</b>	<b>332,345</b>	<b>-</b>	<b>30,970</b>
<b>% of GDP</b>	<b>4</b>	<b>14</b>	<b>-</b>	<b>2</b>
<b>Portugal</b>				
Public sector	7,139	4,208	441	7,070
Banks	10,539	4,461	1,416	4,224
Non-bank private sector	12,530	13,091	1,326	64,656
<b>Total</b>	<b>30,208</b>	<b>21,760</b>	<b>3,183</b>	<b>75,951</b>
<b>% of GDP</b>	<b>1</b>	<b>1</b>	<b>0</b>	<b>5</b>
<b>Spain</b>				
Public sector	24,749	18,621	6,067	-
Banks	53,129	23,381	5,542	-
Non-bank private sector	68,218	72,700	16,115	-
<b>Total</b>	<b>146,096</b>	<b>114,702</b>	<b>27,726</b>	<b>-</b>
<b>% of GDP</b>	<b>4</b>	<b>5</b>	<b>1</b>	<b>-</b>
<b>Total exposure to GIIPS</b>	<b>418,942</b>	<b>540,622</b>	<b>48,552</b>	<b>115,734</b>
<b>% of GDP</b>	<b>12</b>	<b>22</b>	<b>2</b>	<b>8</b>

Sources: BIS (2012) *BIS Quarterly Review: June, Statistical Annex*. Basel: BIS; OECD (2017); own calculations.

Note: The table shows consolidated foreign claims and other potential exposures (ultimate risk basis) on individual countries by nationality of reporting banks (amounts outstanding).

In this context it is important to emphasise the explanation of Greece's former Minister of Finance Yanis Varoufakis of the main German and French interests behind the different bailout programmes for Greece since 2010. In his recent political memoirs Varoufakis built on the same Bank for International Settlements (BIS) data to illustrate that in 2010 France and Germany could not allow Greece to default on its debts due to

hardly bearable contagious effects on the French and German banking systems. To illustrate his main argument with a number of empirical facts, the former Greek minister noted that for France's three top banks to become insolvent and in need of a government bailout it was sufficient for only 3% of their exposure (or €106 billion) to 'the periphery's governments, households and firms' to go bad.<sup>350</sup> In the case of, for example, the Italian, Spanish and Portuguese governments' sudden inability to service their debts to these banks, the needed sum for a bailout could have been 'a cool €562 billion overnight'.<sup>351</sup> Similarly, in another example with Greece Varoufakis mentioned that if at that time the country 'lost its capacity to meet its repayments, German banks faced <...> loss that would require Mrs Merkel another cheque for anything between €340 billion and €406 billion'. Varoufakis also summarised that for these reasons 'the leaders of France and Germany had a stake of around €1 trillion in not allowing the Greek government to tell the truth; that is, to confess to its bankruptcy'.<sup>352</sup> Although by March 2012 the German banks' holdings of Greek public debt decreased to 'less than €795 million' (by October 2011 the same exposure was €91.4 billion) and by December 2012 the French banks had offloaded all of them<sup>353</sup>, Table 9 shows that due to the remaining banks' exposure to the peripheral countries the German and French governments could not be any calmer in the first half of 2012 than in 2010.

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<sup>350</sup> Varoufakis, Y. (2017) *Adults in the Room: My Battle With Europe's Deep Establishment*. London: The Bodley Head, p. 24.

<sup>351</sup> Ibid.

<sup>352</sup> Ibid., p. 26. To be sure, evidence shows that at least in late 2011 and 2012 the German government was discussing its stance on 'Grexit' with some officials, even seeing longer-term benefits of it. For instance, the Financial Times reports that German Minister of Finance Wolfgang Schäuble 'viewed a Greek exit almost idealistically, as something necessary to save a European project that he had worked for his entire political career'. However, this information does not contradict Varoufakis' claims about the first bailout programme for Greece in 2010. See Spiegel, P. (2014c).

<sup>353</sup> Ibid., p. 27.

Besides the high degree of financial interconnectedness, interdependence between sovereigns and banks in the euro area was additionally strengthened by home bias in holding sovereign debt. In its 2015 'report on the regulatory treatment of sovereign exposures', the ESRB found that 'in almost all euro area countries, the sovereign debt exposure of banks is overwhelmingly towards their domestic issuer' and that 'this home bias is particularly strong in the countries where banks' total euro area sovereign exposure is largest (as a proportion of total assets)'.<sup>354</sup> According to the data presented in Table 10, before 2012, Greek, Italian, Portuguese and Spanish financial institutions held larger shares of total euro area sovereign debt than their counterparts in Germany and France and almost all of their holdings were domestic (for example, 92% in Spain and even 97% in Italy and Greece). This tendency strengthened contagion effects from sovereigns to banks and vice versa both within member states and across the euro area through the exposure of non-stressed member states' banks to stressed countries. The latter effect was well reflected in the already mentioned Moody's concern about the German banks' considerable exposures to Italy and Spain.<sup>355</sup> It is notable in this respect that due to existing indirect shock transmission channels from the domestic economy to banks, a reduction in holdings of sovereign debt could have only diminished, but not broken the bank-sovereign nexus.

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<sup>354</sup> ESRB (2015) *ESRB report on the regulatory treatment of sovereign exposures*. Frankfurt am Main: ESRB, p. 73.

<sup>355</sup> Moody's (2012).



**Table 10. Holdings of sovereign debt by monetary financial institution in selected EU Member States (percentage of total assets; average for Q3 2010–Q3 2011)**

	<b>Total euro area sovereign debt (1)</b>	<b>Domestic sovereign debt (2)</b>	<b>Home bias (%) (3) = (2)/(1)</b>
<b>Germany</b>	3.98	2.62	66
<b>France</b>	3.40	1.86	55
<b>Greece</b>	9.31	9.07	97
<b>Ireland</b>	3.09	0.77	25
<b>Italy</b>	6.37	6.16	97
<b>Portugal</b>	4.63	3.92	85
<b>Spain</b>	5.07	4.68	92

Source: ESRB (2015), p. 71.

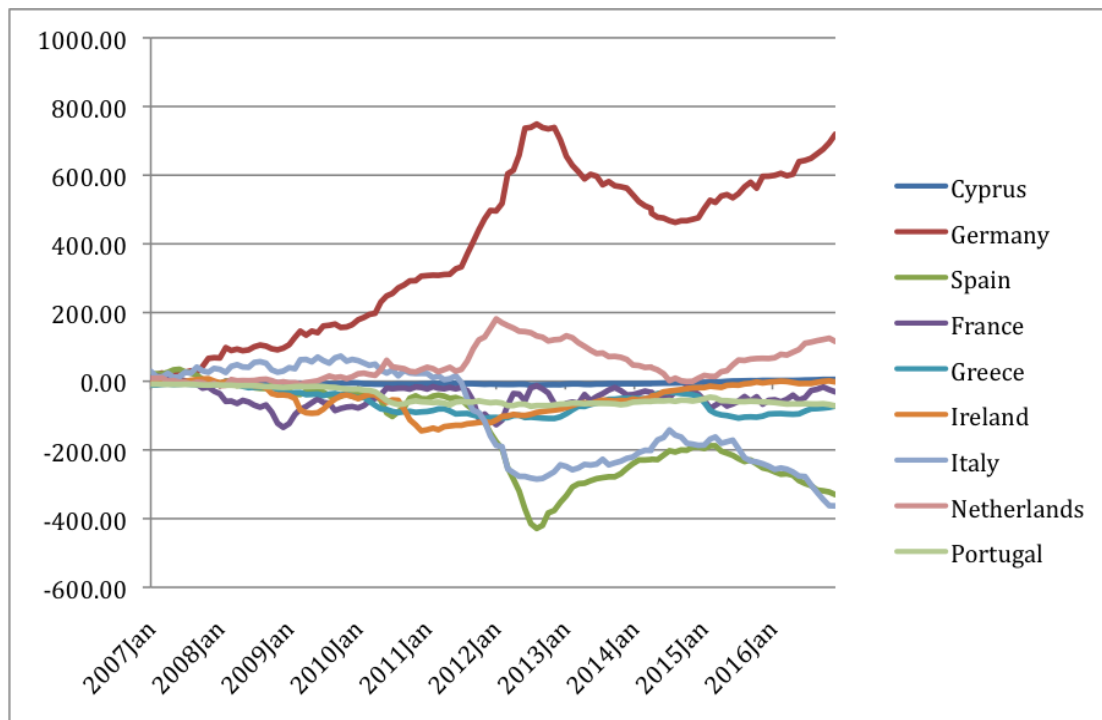
Finally, scholarly literature still pays insufficient attention to the so-called TARGET2 balances, or net claims and liabilities of national central banks vis-à-vis the ECB, and their influence on Germany's and other creditors' dependence on calming down the financial turmoil of mid-2012. Former president of the influential German Ifo Institute for Economic Research Hans-Werner Sinn initiated the debate by criticising what he called the ECB's 'secret'<sup>356</sup> or 'stealth'<sup>357</sup> bailout of the 'peripheral countries' (Greece, Ireland, Portugal and Spain) and raising concerns about the 'bailouts' negative consequences for the German economy and taxpayers. Although a comprehensive overview and criticism of Sinn's arguments as well as his response would go beyond the scope of this research, the initiated dispute, nevertheless, raises important questions related to likely TARGET2 losses in the case of a euro area break-up.

<sup>356</sup> Sinn, H.-W. (2011a) The ECB's Secret Bailout Strategy. *Project Syndicate* [online]. 29 April. Available from: <https://www.project-syndicate.org/commentary/the-ecb-s-secret-bailout-strategy> [Accessed 5 February 2017].

<sup>357</sup> Sinn, H.-W. (2011b) The ECB's stealth bailout. *VoxEU.org* [online]. 1 June. Available from: [http://www.cesifo-group.de/ifoHome/policy/Staff-Comments-in-the-Media/Press-articles-by-staff/Archive/Eigene-Artikel-2011/medienecho\\_16642402\\_ifostimme-voxeu-01-06-11.html](http://www.cesifo-group.de/ifoHome/policy/Staff-Comments-in-the-Media/Press-articles-by-staff/Archive/Eigene-Artikel-2011/medienecho_16642402_ifostimme-voxeu-01-06-11.html) [Accessed 5 February 2017].

In general, TARGET2, or Trans-European Automated Real-time Gross settlement Express Transfer system, is the Eurosystem's large-value payment system for processing cross-border transactions in euro. At first glance, this part of the European financial market infrastructure would have probably remained unnoticed as long as daily transactions among the euro area central banks and commercial financial institutions ran smoothly and effectively. However, what drew public attention was the mounting divergence between the net balances of the so-called 'Southern' and 'Northern' euro area member states (see Figure 8).

**Figure 8. TARGET2 balances (EUR billions)**



Source: Institute of Empirical Economic Research, Osnabrück University (2017) *Euro Crisis Monitor*. Available from: <http://www.eurocrisismonitor.com/index.htm> [Accessed 21 January 2017].

With a view to better understanding the functioning of the system, one can illustrate it by a simple example of a cross-border transaction between two commercial banks. If, for instance, a Spanish bank wanted to

make a payment to a German lender, TARGET2 would work as follows. Since both banks have accounts with their national central banks, after submitting the payment instruction to the system, the Spanish bank's account at Banco de España would be debited, whereas the German bank's account at the Deutsche Bundesbank – credited. At the end of each business day, all such cross-border obligations between the Spanish and German central banks are aggregated and netted out, leaving each of them with certain TARGET2 balances against the ECB. As a result, a positive TARGET2 balance of a participating national central bank shows a net claim vis-à-vis the ECB and a negative balance – a liability.

As it can be seen from Figure 8, in the period of stress and fragmentation in the European financial markets from summer 2011 to summer 2012 TARGET2 balances experienced a rapid increase. Since banks in stressed member states lost access to private sources of funding, they used the opportunity to replace them with borrowing from their national central banks.<sup>358</sup> However, such a rapid increase in balances raised questions as to what would happen if a euro area member state with a large negative balance exited the monetary union.

In an open letter to the *Frankfurter Allgemeine Zeitung* and *Het Financieele Dagblad*, President of the Deutsche Bundesbank Jens Weidman acknowledged that in such a scenario, although 'highly unlikely', 'any losses sustained by the ECB would have to be borne jointly by all Eurosystem central banks, irrespective of the size of their Target2 balance'.<sup>359</sup> Weidman, nevertheless, did not mention that, according to the legal framework governing the ECB, in the case of its insolvency all the

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<sup>358</sup> Draghi, M. (2017) *Letter to Mr Marco Valli and Mr Marco Zanni, Members of the European Parliament*. L/MD/17/34, Frankfurt am Main, 18 January. Available from: [http://www.ecb.europa.eu/pub/pdf/other/170120letter\\_valli\\_zanni\\_1.en.pdf](http://www.ecb.europa.eu/pub/pdf/other/170120letter_valli_zanni_1.en.pdf) [Accessed 4 February 2017].

<sup>359</sup> Weidmann, J. (2012) Text published as an open letter in the *Frankfurter Allgemeine Zeitung* and *Het Financieele Dagblad* on 13 March 2012. Available from: [https://www.bundesbank.de/Redaktion/EN/Downloads/Press/Current\\_Issues/2012\\_03\\_15\\_origin\\_meaning\\_target2\\_balances.pdf?blob=publicationFile](https://www.bundesbank.de/Redaktion/EN/Downloads/Press/Current_Issues/2012_03_15_origin_meaning_target2_balances.pdf?blob=publicationFile) [Accessed 5 February 2017], p. 3.

national central banks would be obliged to recapitalise the ECB in proportion to their subscribed capital key. At that period Germany would have had to absorb up to 27% of all losses.<sup>360</sup> Should the Bundesbank have not had sufficient funds to cover its proportion of credit losses, the costs would have been incurred by the German government. Due to the fact that ‘all member states are liable for the debts in the Target2 system according to their capital shares’, some scholars have compared Target2 balances to eurobonds<sup>361</sup>, which Germany and other member states had actually rejected.

In a recent letter to two Members of the European Parliament, President of the ECB Mario Draghi explicitly noted that ‘if a country were to leave the Eurosystem, its national central bank’s claims on or liabilities to the ECB would need to be settled in full’.<sup>362</sup> Given the outstanding amounts in mid-2012, around the June 2012 Euro Summit the Bank of Greece, for instance, owed approximately €106 billion to the ECB and the central banks of Spain and Italy – €408.4 billion and €274.3 billion, respectively. Meanwhile, the Deutsche Bundesbank had an astonishing €728.6 billion claim.<sup>363</sup> In comparison, at the start of 2017 the capital of the ECB was more than 75 times smaller and amounted to a meagre €10.8 billion.<sup>364</sup>

Of course, the hypothetical losses that the national central banks of the euro area countries would have to cover in the case of a euro area break-up would depend on a number of factors, such as the number of

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<sup>360</sup> Whelan, K. (2011) Professor Sinn misses the target. *VoxEU.org* [online]. 9 June. Available from: <http://voxeu.org/article/there-hidden-eurozone-bailout> [Accessed 5 February 2017].

<sup>361</sup> Homburg, S. (2012) Notes on the Target2 Dispute. *CESifo Forum*. 13 (Special Issue), pp. 50–54, p. 53.

<sup>362</sup> Draghi, M. (2017).

<sup>363</sup> ECB (2017d) TARGET2 balances position at the end of June 2012. *Statistical Data Warehouse*.

<sup>364</sup> ECB (2017a) *Capital subscription*. Available from: <https://www.ecb.europa.eu/ecb/orga/capital/html/index.en.html> [Accessed 5 February 2017].

countries leaving the euro area, the quality of collateral exchanged for the Eurosystem's liquidity and its value after the euro break-up. Therefore, net negative balances do not show precise amounts of likely losses for each central bank. However, the divergence in net balances well indicates both the outflow of money from stressed member states and the related risk for creditor countries should the situation worsens. As it was argued by Moody's in July 2012, 'as the largest euro area country, Germany bears a significant share of <...> contingent liabilities' stemming from 'bilateral loans, the EFSF, the European Central Bank (ECB) via the holdings in the Securities Market Programme (SMP) and *the Target 2 balances*<sup>365</sup>, and – once established – the European Stability Mechanism (ESM)'<sup>366</sup>.

In summary, the analysis of vulnerabilities on both the sovereign side and the side of the national banking system, therefore, shows that, contrary to accepted wisdom in academic literature and media reports, the rising contingent liabilities and sizeable banks' exposure to the two most stressed Member States at that time (Spain and Italy) increased Germany's economic dependence on calming down the financial markets to the degree that one could hardly predict by only looking at vulnerabilities on the sovereign side of the bank-sovereign nexus. It will be argued that this, in turn, decreased Germany's negotiating power vis-à-vis the opposing coalition of the EU Member States and institutions.

### ***4.3. Political Legitimacy of the Bargaining Behaviour***

The euro area governments' decision to implement a fundamental change to their banking policies has earlier been explained by the interaction of changes in the existing banking policy image held by the largest euro area states and the simultaneous collapse of the old banking policy-making

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<sup>365</sup> Emphasis by the author.

<sup>366</sup> Moody's (2012).

venue, both of which pushed the EU banking policy to a fundamentally new equilibrium. It was argued that the changes were caused by the European sovereign debt crisis that affected the variables because of a high degree of interdependence among the euro area member states. In contrast to the timing of the transformational reforms, the explanation of the content of the banking union, nevertheless, poses an additional challenge due to a much longer period of related decision-making. It is not surprising that in the period of 2012–2016 the environment influencing the bargaining power of governments changed, since the unprecedented market turmoil of the first half of 2012 abated, thus substantially decreasing pressure to act. However, without denying the role of asymmetric interdependence in explaining results of intergovernmental negotiations, it is important to emphasise the limits of governments' behaviour in defending their national preferences.

Explanations based on material interests disregard the fact that in the EU decision-making process Member States need to follow, in the words of Schimmelfennig, a certain institutionalised 'standard of political legitimacy'. Following the earlier analysis, this standard of legitimacy could also be seen as a certain 'policy image', which defines what actions and behaviour are politically acceptable to pursue one's goals. Since members of any community are obliged to justify their interests on the grounds of institutionalised values and norms, the latter serve as an 'external institutional resource and constrain', which validate or delegitimise their arguments in political discourse. According to Schimmelfennig, for this reason different actors are able to legitimise their positions by employing 'rhetorical action', or 'strategic use of norm-based arguments in pursuit of one's self-interest'.<sup>367</sup>

But is there empirical evidence to support the claim that in the EU bargaining process on the banking union Member States employed

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<sup>367</sup> Schimmelfennig, F. (2001), p. 63.

‘rhetorical action’ to achieve their political goals? Schäfer argued in favour. According to the author, since Germany signed to the joint objective of breaking the viscous circle between banks and sovereigns, its government fell into a ‘rhetorical trap’: ‘the need for argumentative consistency made the government vulnerable towards demands for an institutional design of the banking union which ensures its capacity to effectively break the viscous circle’.<sup>368</sup>

This argument is at least partly supported by evidence outlined in the first section of this part. For instance, the Euro Summit statement of June 2012 was commonly interpreted as implying that no euro area bank would be effectively excluded from joint supervision.<sup>369</sup> So, although Germany argued for the ECB to be responsible only for the largest credit institutions, other countries and EU institutions responded that such a proposal would not allow reaching the agreed goals. Similarly, it was commonly understood that a properly functioning supranational resolution framework and pooled financial resources were necessary for breaking the viscous bank-sovereign loop, although the initial German preferences were strongly against it. The same could also be concluded about the fiscal backstop to the SRF, which at the time of writing was neither agreed, nor rejected, leaving the agreement to be reached during the transitional period of establishing a fully-mutualised Fund. Equally, the EU Member States’ agreement to link the start of negotiations on the EDIS with ‘sufficient’ progress in reducing risks in the banking system<sup>370</sup> was the most feasible way of keeping the EDIS on the longer-term ‘written’ political agenda.

It should be noted that the opposing coalition did not seek to isolate Germany and move forward without its consent.<sup>371</sup> At the same time,

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<sup>368</sup> Schäfer, D. (2016), 973.

<sup>369</sup> Ibid.

<sup>370</sup> Council of the EU (2016).

<sup>371</sup> E.g. Vilpišauskas, R. (2014), p. 104.

Germany signalled its willingness to reach an agreement. A good illustration of this is the final stages of negotiations on the SRM. Although the deadline for reaching the EU governments' compromise by the end of 2013, in principle, could have been postponed, at the most intense stages of negotiations Germany took initiative and invited the key decision-makers to Berlin for consultations on how to narrow differences.<sup>372</sup> These empirical facts confirm the highly consensual decision-making culture within the Council and, at the same time, show interest of all sides in reaching agreements.

The focus on the political legitimacy of the bargaining behaviour and 'rhetorical action', nevertheless, averts attention from how the banking union was actually perceived among the key decision-makers at that time. The existing scholarship on the banking union implicitly sees it as a relatively clearly defined framework. The earlier empirical analysis, nevertheless, shows that at the final stages of negotiations the Germany- and France-led groups of countries had fundamentally different visions on both the degree of supranational decision-making and bank risk sharing. Since the most recent political discourse confirms that the differences in visions have not yet disappeared, how did the EU manage to reach the related decisions?

The empirical analysis suggests that the answer lies in the intentionally chosen 'constructive ambiguity' related to the final structure of the fully-fledged EU banking policy framework.<sup>373</sup> With the

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<sup>372</sup> AFP (2013) Berlin sees progress on banking union. 7 December. Available from: <https://www.thelocal.de/20131207/berlin-sees-progress-on-banking-union> [Accessed 4 March 2017]; Steinhilber, G., Fairless, T. & Walker, M. (2013) Will Europe Really Break the Spanish Sovereign-Banking Loop? *The Wall Street Journal* [online]. 15 December. Available from: [https://www.wsj.com/news/articles/SB10001424052702304173704579259920479397630?mod=WSJ\\_hp\\_LEFTWhatsNewsCollection](https://www.wsj.com/news/articles/SB10001424052702304173704579259920479397630?mod=WSJ_hp_LEFTWhatsNewsCollection) [Accessed 4 March 2017].

<sup>373</sup> In his professional capacity, the author has experienced this feature of the EU policy-making process both at high-level policy meetings in Brussels as well as in 2014 during a bilateral meeting between Lithuania and a prominent EU Member State. With a view to having a 'shared understanding' of the banking union and its pillars, back then one of



postponement of the most difficult decisions, an open-ended definition of the ‘banking union’ actually allowed the key policy actors to use it strategically to advance their individual and common goals. An all-encompassing and ambiguous term, therefore, helped to accommodate the existing differences to the extent it was possible at that time, at the same time leaving the doors open for further integration.<sup>374</sup> This could be illustrated by the postponement of discussions on the EDIS and the common fiscal backstop, the agreement on a transitional period for mutualising the SRF or the fact that the exact division of day-to-day responsibilities between the EU and national authorities within the SSM and SRM was left to be decided in the process of creating the new supervisory and resolution frameworks. As it has been noted by Wolfgang Schäuble, ‘the merits of a banking union are rarely disputed. But there is a debate about how to shape its governance and accountability; and about what we can deliver in the short term and what our ultimate goals should be’.<sup>375</sup> Notably the differences in visions of the banking union (and the fact that the present EU banking policy framework was established over the period of 2012–2016) also do not support the view of seeing it as a package deal.

#### ***4.4. Explaining the Content of the Banking Union***

In the previous two sections the author analysed to what extent the ‘preventive’ banking union form can be explained by economic dependence on agreements and political legitimacy of the bargaining behaviour in the EU decision-making process. On the one hand, the rising contingent liabilities and German banks’ exposure to the most stressed

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the visited country’s high-level civil servants invited Lithuania’s officials for related consultations.

<sup>374</sup> Skuodis, M. (2017).

<sup>375</sup> Schäuble, W. (2013).

members of the euro area can well explain why Germany agreed to the idea of establishing a banking union. It can also at least partly explain Germany's interest in reaching the agreements that followed.

In fact, the Financial Times has reported that Germany's agreement to share responsibility for dealing with vulnerable European banks in exchange for taking their supervision away from national governments was actually unexpected. According to the newspaper, the decision was, first of all, informally made in June 2012, before the landmark Summit, at a secret meeting of ministers of finance from the four largest euro area economies at Charles de Gaulle airport. It seems that the change of Germany's position surprised France's Minister of Finance Moscovici so much that he went as far as to ask his German counterpart: 'Excuse my question, but have you checked this with your chancellor?' Back then Schäuble replied that he checked with his chancellor 'everything'<sup>376</sup>. Similarly, in an authorised biography of Angela Merkel, Stefan Kornelius argued that the media portrayed the 28–29 June Summit as Merkel's defeat. According to the author, this was caused by Mario Monti, Prime Minister of Italy, who broke the agreement and after all-night negotiations (which ended only at 4:20 a.m. in the morning) 'produced his own version of events'<sup>377</sup>. His announcement that Germany gave way for banks to 'receive direct aid' and for Italy to 'have easier access to the rescue funds' was sufficient to cause a sensation.<sup>378</sup> Although a few days later Monti downplayed his comments, the author argued that 'the Italian Premier had brought matter to a head. The psychology of the crisis had changed; Merkel's supposed defeat had calmed the markets'.<sup>379</sup> However, as it was showed by the meeting at Charles de Gaulle airport, the deal in principle

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<sup>376</sup> Spiegel, P. & Barker, A. (2013b) Banking union falls short of EU goal. *Financial Times* [online]. 19 December. Available from: <https://www.ft.com/content/f1c23942-68cd-11e3-bb3e-00144feabdc0> [Accessed 10 September 2017].

<sup>377</sup> Kornelius, S. (2013) *Angela Merkel: The Chancellor and Her World*. Trans. Bell, A. & Moncrieff, Ch. London: Alma Books, p. 235.

<sup>378</sup> *Ibid.*

<sup>379</sup> *Ibid.*, p. 236.

had been sealed before the landmark Summit and, in the words of Reuters, 'not forced down the German leader's throat in Brussels'<sup>380</sup>.

On the other hand, a substantial decrease in market pressure in the second half of 2012 and its ensuing impact on Germany's preference intensity raise doubts as to why, generally speaking, Germany had to make concessions that went 'beyond what could be interpreted as strategic concessions and cheap side-payments'<sup>381</sup>. As it was argued, the retreat from the initial preferences can be at least partially explained by the 'rhetorical trap' of the German government when it committed to breaking the sovereign-bank nexus. This 'entrapment' made it politically harmful to retreat from initial commitments. At the same time the opposing coalition used the commitment for breaking the bank-sovereign nexus against Germany. It has also been noted that the entire EU bargaining process was substantially facilitated by the open-ended definition of the 'banking union', which allowed different actors to agree on what was politically feasible at that time without betraying individual interests.

The agreed form of the banking union, therefore, seems to be congruent with the proposed explanatory variables. However, similarly to the earlier part of this research, one can still question whether the identified consistency between the advanced analytical framework and the outcome of the case is of causal significance.

This question can be tested by looking at alternative explanations of the content of the banking union. One of the weak links in the proposed explanatory framework can be the fact that the European Parliament managed to push towards deeper-than-initially-agreed integration in the

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<sup>380</sup> According to Reuters, at the highest political level Merkel and French President Francois Hollande had sealed 'the core of the deal' during their bilateral meeting in Paris (on the eve of the European leaders' gathering in Brussels). See Barkin, N., Rinke, A., Bremet, C. & Pineau, E. (2012) What Merkel and Hollande's unexpected, blossoming friendship means for Europe. Reuters [online]. 10 July. Available from: <http://business.financialpost.com/news/economy/what-merkel-and-hollandes-unexpected-blossoming-friendship-means-for-europe> [Accessed 13 August 2016].

<sup>381</sup> Schäfer, D. (2016), p. 976.

EU banking policy domain. As it has been showed in the first section of this part, the Member States' compromise on, for instance, the governance of the SRM reflected German preferences much better than the final compromise between the governments and the Parliament. But this fact can be equally seen as an additional argument in favour of the proposed analytical framework, since Germany had no interest in being the one who prevented reaching the agreed goals.

One may also argue that in the first half of 2012 Germany felt the ultimate responsibility for safeguarding the European project in general and keeping the euro area together more specifically. Merkel's famous phrase of 26 October 2011 to the German Bundestag ('If the euro fails, Europe will fail'<sup>382</sup>) well illustrates this view. Nevertheless, it ignores the previously-discussed fact about the German banks' exposure to the vulnerable Southern Member States at the height of the financial turmoil. At the same time, Germany's constructive response to other Member States' concerns, even when market pressure had abated, could be well explained by the existing 'rules of the game', the 'policy image' or – to summarise – the role of norms in the EU decision-making process.

## **Conclusion**

The creation of the banking union in 2012–2013 is often compared to such historic decisions as the 1992 Maastricht Treaty and the introduction of the euro. The implemented changes in the 'most jealously guarded domain of national sovereignty – banking governance'<sup>383</sup> – shifted a significant part of national autonomy over banking policy to the EU level. At the same time the banking union laid the foundations for 'a paradigm shift'<sup>384</sup> for

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<sup>382</sup> Kornelius, S. (2013), p. 227.

<sup>383</sup> Epstein, R.A. & Rhodes, M. (2016), p. 416.

<sup>384</sup> Schoenmaker, D. (2015).

different stakeholders. The ECB and the newly-created SRB became in charge of the effective functioning of, respectively, the new pan-European supervisory and resolution frameworks. The largest German, French or Italian credit institutions started to be treated as euro area banks. Similarly, as noted by Schoenmaker, at some point in time it may become common for customers to choose a bank from another euro area member state ‘as their ‘home’ bank’<sup>385</sup>.

To be clear, the new EU banking policy framework still has ‘many loose ends’<sup>386</sup>. This could be concluded with respect to both the missing elements of the banking union (notably, the absence of the pan-European deposit insurance and fiscal backstop to the SRF) as well as the content of the already agreed ones<sup>387</sup>. Moreover, the extent to which the new system is resilient in times of stress still needs to be tested. In this context, the recent overhaul of the EU banking policy and its analysis in the emerging literature on the banking union, nevertheless, leave a number of puzzles related to both the timing of the historic decisions and whose preferences have actually prevailed.

With a view to filling these gaps, this work has aimed at crafting ‘a minimally sufficient explanation’<sup>388</sup> of, first, why the euro area member states decided to surrender national control over banking supervision and resolution to the EU level in 2012–2013 (despite the fact that over the past 25 years similar proposals had been constantly rejected), and, second, which actors had the biggest influence on the content of agreements and why. From a broader perspective, these questions directly relate to the two fundamental issues of European integration: why and when governments decide to transfer national competence to

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<sup>385</sup> *Ibid.*

<sup>386</sup> Véron, N. (2015), p. 49.

<sup>387</sup> E.g. *ibid.*; Schoenmaker, D. (2015); Schoenmaker, D. & Véron, N. (eds.) (2016).

<sup>388</sup> Beach, D. & Pedersen, R.B. (2013), p. 18.

supranational institutions and what determines the content of their agreements.

So, why did the euro area countries decide to create the banking union notably in 2012–2013? As it has been mentioned, the dominant accounts in the literature see the landmark June 2012 European leaders' decision as a response to the European sovereign debt crisis, more precisely, its Spanish episode that in the first half of 2012 created unprecedented euro area break-up fears. This research concurs with the latter view, proposing the *crisis* as the main explanatory factor of the timing of the banking union. However, the crisis variable alone fails to explain why different crisis situations, such as the Great Recession of 2007–2009, did not trigger similar transformational changes in the past.<sup>389</sup> In other words, a comparison of the global financial and the European sovereign debt crises suggests that the latter should have been insufficient to cause transformation of the EU banking policy.

Building on a deterministic interpretation of PET, it was proposed that the crisis caused the transformational change through two key intervening variables: the *banking policy image* held by the governments of the largest euro area member states and the *banking policy-making venue* understood as a relatively closed circle of policymakers who make authoritative decisions on the EU banking policy. As it was showed, both the de Larosière reforms of 2009–2010 and the banking union in 2012–2013 followed changes in the underlying assumptions that the key EU decision-makers had about the problems which the EU banking policy was expected to address and the best ways of dealing with them. In other words, both reforms followed the changes in related policy images. However, only the initiative of the banking union – in contrast to the de Larosière reforms – was discussed in a truly new policy-making

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<sup>389</sup> E.g. De Rynck, S. (2014), p. 5. Also see Glöckler, G., Lindner, J. & Salines, M. (2016), p. 1136.

subsystem with frequent involvement of the highest EU political leaders. That is to say, in the case of the banking union both the EU banking policy image and the policy-making venue underwent substantial transformation.

But why and how did the crisis trigger changes in both variables? The research has argued that the answer lays in the third intervening variable – mutual *interdependence* among the euro area countries, which was the source of change in both variables, also reinforcing the links between them. To be more precise, due to high economic and financial interdependence among euro area members, increasing sovereign debt crisis pressures challenged the previous understanding of the EU banking policy as being only ‘preventive’, or oriented towards future problems, to also include ‘corrective’ (crisis management) objectives. In this regard, the fundamental issue was the trade-off between the urgent need for burden-sharing in order to deal with ailing Spanish (and possibly other) banks and Germany’s insistence that this must be preceded by the reinforcement of euro area-level control over those credit institutions that needed such financial support. The crisis pressures and related politicisation of the EU banking policy also triggered involvement of new policymakers in the previous expert-led EU banking policy domain. These changes were sufficient for challenging the EU banking policy status quo and pushing the previous policy equilibrium to a fundamentally new one.

While according to the advanced deterministic interpretation of PET the change in the first two intervening variables can be seen as a general precondition for any transformational policy change, the third intervening variable – mutual interdependence – seems to be specific to the case of the banking union. It, therefore, remains to be seen to what extent the proposed intervening variables that were put forward to explain the causal link between the external shock and concrete results of

integration in the EU banking policy domain are useful in explaining other cases.

Regarding the second question of this work, it was argued that the content of the banking union in general and its 'preventive' form more specifically, can be understood as a compromise between two visions of the new EU banking policy framework that unfolded at the final stages of negotiations: a 'full' banking union, advocated by France, Italy and EU institutions in one coalition, and an 'incomplete' framework, preferred by Germany in the opposing camp. The research also aimed at shining new light on the role of Germany in negotiations. The proposed two-dimensional spatial model of politics suggests that overall Germany made relatively larger concessions on the scope of transferring decision-making powers to the EU, while the France-led group of countries, including EU institutions, had to retreat relatively more in the area of their preferred degree of burden-sharing. Given this divergence of views, the results of the EU decision-making process could, therefore, be seen as the second best option, which is likely to be continuously pushed from the 'preventive' to the 'full' banking union form, preferred by a relatively larger group of key EU policy actors.

Against this background, the research argued that the latter result, or the content of the banking union, can be best explained by integrating rational and sociological explanations, pared-down to two independent variables: the *preference intensity* of Member States and the *political legitimacy* of national positions and the bargaining behaviour. On the one hand, the analysis of the vulnerabilities on the sovereign side of the bank-sovereign nexus confirms the dominant view in the literature and media reports that in 2012 Germany could enjoy a relatively stronger bargaining position on the banking union than France, Italy, Spain and other countries in the opposing coalition. On the other hand, a closer examination of the bank side of the nexus reveals the sizeable exposure of



German banks to Spain and Italy, which were the most stressed euro area countries at that time. In addition, one should not forget the rising contingent liabilities that were stressed by Moody's in mid-2012.<sup>390</sup> The latter fact and – especially – the interdependence patterns of German financial institutions vis-à-vis the Southern euro area member states can, therefore, well explain Germany's commitment on establishing the banking union. However, it is not clear why, despite the substantial decrease in market pressures in the second half of 2012, Germany made concessions that in the case of the SRM went 'beyond what could be interpreted as strategic concessions and cheap side-payments'<sup>391</sup>. According to the research, the answer lays in the political legitimacy of its positions and the bargaining behaviour.

As it was argued, Germany's retreat from the initial positions on the SRM can be explained by the 'rhetorical trap' of the German government when it committed to breaking the sovereign-bank nexus. Moreover, the entire EU bargaining process was facilitated by the open-ended definition of the 'banking union' and 'incomplete' decisions, which allowed different policy actors to agree on what was politically feasible at that time without betraying national interests. The 'constructive ambiguity' related to the finality of the banking union and its different elements helped to accommodate different visions without closing the doors for further integration that was not acceptable at that time.

Looking from a broader perspective, the analysis of the creation of the banking union allows drawing at least five general insights. First of all, although it might be rather obvious that a change in policy needs a trigger, it is not so clear when that trigger is sufficient for causing transformational change. On the one hand, an external shock to a system of interdependent EU Member States may create pressure for deepening

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<sup>390</sup> Moody's (2012).

<sup>391</sup> Schäfer, D. (2016), p. 976.

integration. On the other, significant changes require sufficient attention of high-level political actors and shared understanding that the existing policy cannot accommodate this pressure without substantial alterations. Second, the analysed case re-confirms the dominance of the largest EU Member States in the EU decision-making process in general and the centrality of Germany more specifically. The banking union also suggests that the existing social norms in the EU decision-making process may actually prevent the most economically-powerful actors from imposing their preferences on the rest and, at the same time, constrain the majority of decision-makers from isolating the minority. An important related insight that can be drawn from the analysed case is that 'ambiguity' facilitates reaching politically difficult agreements. Finally, it might be argued that significant differences in preferences of the key policy actors on the one side and pressure for reaching agreements on the other lead to sub-optimal solutions.

With a view to filling gaps in research on the timing and content of the banking union, the ambition of this work was twofold – theoretical and empirical. From an empirical point of view, the work aimed at shining new light on the post-crisis developments in the EU banking policy. For all the inevitable shortcomings, it also aimed at adding a theoretical contribution to the emerging literature on the political economy of the banking union, the theory of the policy process, and the theoretical literature on European integration. Respectively, the advanced 'ideal' types of the banking union, the 'deterministic' interpretation of PET (identification of conditions necessary for policy stability, incremental and transformational change) and the emphasis on the 'constructive ambiguity' related to the finality of the banking union, to the best of the author's knowledge, have appeared in this research for the first time.

The credibility of the findings of this work could, nevertheless, have been relatively strengthened if the research had not faced two

fundamental limitations. First, the author had to deal with limited availability of empirical data on the preferences of the key actors. The fact that some national positions changed over time and that some governments had a very general stance on the creation of the banking union<sup>392</sup> made this challenge even bigger than it had been initially expected. It is also important to mention the limited possibilities to test the existence of the 'rhetorical trap' and conduct a more precise (let alone a quantitative) assessment of changes in some of the proposed explanatory variables, first of all, the EU banking policy-making venue. Besides empirical challenges, the second limitation is related to the chosen strategy of 'parsimony', or 'minimal sufficiency', in explaining the process of the creation of the banking union as well as the overall search for general trends that could be applied outside of the EU banking policy domain. It required careful balancing between the chosen objective of providing a political science-inspired heuristic model for a general understanding of the creation of the banking union on the one hand and an accurate portrayal of what had actually happened on the other. These limitations, nevertheless, offer vast opportunities for further research.

First of all, with a view to explaining the timing of the decisions to deepen European integration and the related outcome of the EU bargaining process, the explanatory power of the advanced analytical frameworks and concepts still needs to be tested with respect to other cases in European integration. In this regard, there is a particular need for better understanding of the conditions necessary for transformational (versus incremental) EU policy change and the role of norms in constraining power politics in the EU decision-making process. Second, the emerging research on the banking union still leaves a number of gaps related to this specific case. Although recent accounts have mostly focused

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<sup>392</sup> Regarding the latter example see, for instance, Skuodis, M. & Kuokštis, V. (2018) on the case of Lithuania.

on the creation of the first two pillars of the banking union, namely, the SSM and the SRM, the existing literature still lacks research on the third pillar – the pan-European deposit insurance scheme. Similarly, there is still a gap in more formalised work on which elements of the banking union are necessary for it to bring more stability than national arrangements. Finally, the existing literature lacks better understanding on the influence of supranational actors, first of all the European Parliament and the ECB, on the content of the agreements.

## **Disclosure Statement**

The author is an employee of the Bank of Lithuania and is solely responsible for the views expressed in this work, which do not necessarily represent the views of the Bank of Lithuania.

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\*\* The Eurostat and OECD data used in the research is mentioned in the text, but not specified in the reference list.

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