The Political Economy of the Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet'

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Abstract

This paper sets out to explain national preferences on the Single Supervisory Mechanism (SSM) concerning: support for creating and participating in supranational banking supervision in the European Union; the division of competences between the European Central Bank and national banking supervisors; the nature of indirect supervision. It is argued that member states in the euro area faced a 'financial inconsistent quartet', whereby they could not secure at the same time: 1) financial stability, 2) financial integration, 3) national financial policies and 4) the single currency. The 'financial inconsistent quartet' reinforced the logic for euro area member states to create the SSM (and other elements of Banking Union) and those seeking to join the euro area to participate. However, the analytical usefulness of this concept to explain national preferences on the SSM relies upon its nuanced application to individual countries taking into account the distinct patterns in the internationalisation of national banking systems.

Introduction

In June 2012, the European Council agreed to deepen Economic and Monetary Union (EMU) by creating 'Banking Union' (BU), which was to be based on five components: a single rulebook of European Union (EU) financial regulation and competition policy; a single framework for banking supervision; a single framework for the managed resolution of banks and financial institutions; a common deposit guarantee scheme; and a common backstop for temporary financial support. The proposals for BU amounted to a radical initiative to rebuild financial market confidence in both banks and sovereigns – especially in the euro area periphery – to stabilise the national banking systems exposed directly to a vicious circle between the international financial crisis and the euro area's sovereign debt crisis (see Hall 2014, Hansen, et al. 2014, Leblond 2014; Mourlon-Druol 2014) and to reverse the fragmentation of European financial markets. BU is also set to bring about a significant transfer of powers from the national to the EU (to be precise, the BU) level.

The first key component of BU to be agreed was the Single Supervisory Mechanism (SSM), which was proposed by the Commission in September 2012 and approved by government leaders at the December 2012 European Council. The compromise reached foresaw that the ECB would be 'responsible for the overall effective functioning of the SSM' and would have 'direct oversight of the euro area banks' (European Council 2012a, p. 2). This supervision however would be 'differentiated' and the Bank would carry it out in 'close cooperation with national supervisory authorities'. Direct ECB supervision (through Joint Supervisory Teams (JSTs)) was to cover those banks with assets exceeding €30 billion or those whose assets represent at least 20 per cent of their home country's annual GDP. Non euro area member states could opt for participation in the SSM through a 'closer cooperation' arrangement.

This paper sets out to explain national preferences on the establishment, membership and the scope of the SSM. The analysis focuses upon the preferences of national policy-makers, first and foremost the ministries of finance, which were the most involved in the SSM negotiations. However, as substantiated in the empirical analysis below -- notably with reference to bank position papers to the Commission's consultation on the SSM -- the preferences of the national authorities were aligned with the dominant preferences of their national banking sector.

National preferences on the SSM are important as they shaped the negotiating positions of the member states and eventually the outcome of the negotiations. Impact on outcome explains the selection of two of our cases. We focus on German preferences given the 'constrained' veto-power exercised by Germany in negotiations on the SSM (Bulmer 2014) and on French preferences given the importance of cooperative Franco-German hegemony in the euro area (Pedersen 1998). The positions on SSM participation of EU member states not participating in the euro area (the euro outsiders) are also relevant for our study because of the latitude of choice on membership they enjoyed -- unlike the euro area member states which had to join even if they were reluctant to do so. (Non)membership of euro outsiders is a clearer indicator of preferences than very reluctant membership by euro area member states.

Theoretically, the paper develops and applies the concept of the 'financial inconsistent quartet', meaning that euro area member states cannot secure at the same time*:* 1) financial stability, 2) financial integration in the context of cross-border banking, 3) national financial policies (regulation, supervision and resolution) and 4) the single currency -- which deprives euro area member states of a lender of last resort and shapes internationalisation patterns notably by increasing euro area bank exposure to the euro periphery. The paper also argues that the analytical usefulness of this concept to explain national preferences on the SSM relies upon its nuanced application to individual countries taking into consideration the distinct configuration of national banking systems.

Our analysis considers: the degree of banking system concentration; the degree of internationalisation; exposure to the euro area periphery and the degree of foreign bank penetration. In a nutshell, German policy was shaped by strong political pressure to protect the country's public sector and cooperative banks from European-level scrutiny. French policy on the SSM was more positive but was also driven by reluctance to cede national control over the day-to-day supervision of the five largest French banks and concerns that SSM supervision would be asymmetric. The non-participation of several euro outsiders can be explained by both non-euro membership and the configuration of the national banking system.

This paper contributes to two main bodies of scholarly literature. First, it adds to the emerging literature on the politics and political economy of BU (Donnelly 2014; Epstein and Rhodes 2014; Howarth and Quaglia 2013, 2014; Schimmelfennig 2014; Salines et al. 2012, Spendzharova 2014) which feeds into the vast literature on EMU and European economic governance, more generally, and national preference formation on EMU, more specifically (for example, Dyson 2000; Dyson and Featherstone 1999; Verdun 2000; Walsh 2000). Rather than focusing on the dynamics of the intergovernmental negotiations on the SSM, this work teases out and explains the preferences of the main member states, rooted in their domestic political economy.

Second, the paper contributes to the (limited) comparative political economy literature on national financial systems (Allen and Gale 2000; Deeg 2010; Hardie and Howarth 2013) by examining how the specific features of national banking systems can direct government preferences on both national and supranational financial regulation and supervisory frameworks. This paper also adds to Peter Hall's (2014) analysis of varieties of capitalism and the sovereign debt crisis, even though the focus of this paper is on the different configurations of national banking systems across the EU, rather than varieties of capitalism as such.

This paper is structured as follows. The next section reviews the existing literature and outlines our analytical framework, explaining how different EU member state positions in the 'inconsistent quartet' led some to push for Banking Union, others to accept with great reluctance and some euro outsiders to opt to stay out. Sections 3 to 5 explain how national preferences on the key aspects of the SSM were shaped by the configuration of national banking systems in Germany, France and non euro area member states (notably the UK), interacting with considerations stemming from the 'inconsistent quartet'.

2. The theoretical framework: the inconsistent quartet and national banking systems

The paper takes as a starting point Dirk Schoenmaker's 'financial trilemma' (2013; Wagner and Schoenmaker 2011), which examines the interplay of financial stability, international banking and national 'financial policies' and leads to the argument that financial stability in the context of cross-border banking requires the transfer of 'financial policies' (regulation, supervision, financial support and resolution) to the supranational level. Schoenmaker focuses upon global bank governance but he dedicates a brief conclusion to the prospect of European BU. While Schoenmaker presents an economic analysis to explain the existence of the trilemma, our paper examines national preference formation with regard to the three objectives of the trilemma and how this shaped national policies on the SSM.

We argue that in the EU, to be precise in EMU, there is a fourth element to be considered, namely the single currency, which deprives member states of a lender of last resort. Hence, the trilemma becomes an 'inconsistent quartet'. We borrow from Padoa-Schioppa's (1982) use of the term, applied to the context of European monetary integration, just as Schoenmaker's trilemma borrows from Mundell-Fleming. On the one hand, the single currency reinforced financial (banking) integration in the euro area and -- of particular relevance in the context of the sovereign debt crisis -- increased euro area bank exposure to the euro periphery. On the other hand, the single currency undermined national 'financial policies' because the function of lender of last resort could no longer, legally, be performed at the national level[1] and the adjustment tool of currency devaluation was eliminated. Moreover, national support powers were constrained by EU competition policy and national bank resolution powers by fiscal rules.

National governments can only have three of the four elements of the quartet. EU member state government that had no intention of joining the euro area in the near future (notably, the United Kingdom, Sweden, Denmark and the Czech Republic) did not have the fourth element of the quartet, namely the single currency. They could in effect cope better with the instability created by cross-border banking -- and thus the financial trilemma -- because they retained their lender of last resort powers (for

[1] At the beginning of the third stage of EMU there was an intense debate about the function of lender of last resort in EMU (see Goodhart 1999, 2000; Begg et al, 1998a,b).

banks) through both monetary and fiscal policy. Thus policy makers in these countries had less incentive to seek participation in BU.

However, national governments that sought to maintain their euro area membership in the context of cross-border banking, were compelled to surrender control over national bank regulation and supervision in order more effectively to cope with financial instability. Euro area member state governments (in some cases with great reluctance) had more incentive to move to BU. If national authorities wanted to maintain control over regulation and supervision they were compelled to accept the loss of either euro area membership or cross-border banking (or both) in order better to combat financial instability.

The inconsistent quartet also suggests that, ceteris paribus, a euro area member state less exposed to cross-border banking would be more reluctant to lose control over regulation and supervision because this member state is less subject of financial instability coming from abroad. Central and Eastern European member states of the EU that had banking systems dominated by foreign (mostly euro area) owned banks had an incentive to join BU because they were not in a position to safeguard financial stability domestically. The prospective of euro area future membership also shaped national interest. Thus, the first of two hypotheses tested in this paper:

H1: Euro area membership is neither a necessary nor sufficient condition for MS support for the SSM / Banking Union. However, membership encourages support especially by having eliminated lender of last resort and by having distorted patterns of internationalisation.

Although the quartet applies to all countries in the euro area, its effects vary depending on the level and nature of national banking system internationalisation. There is a small but growing political economy literature on financial systems, starting with Zysman's (1983) pioneering work, followed by Allen and Gale (2000), Busch (2009), Deeg (2010) and Hardie and Howarth (2013) – which engage in a comparative analysis of financial (or specifically banking) systems. Other political economy authors have focused on specific national banking systems, such as Germany (Deeg 1999; Hardie and Howarth 2013), the UK (Hardie and Maxfield 2013; Macartney 2014), France (Clift 2012; Howarth 2013), Italy and Spain (Quaglia and Royo 2014; Royo 2012) and the CEECs (Epstein 2013; Johnson and Barnes 2014; Spendzharova 2014).

This body of scholarly work has pointed out a variety of important features of national bank systems. For example, Hardie and Howarth (2013) highlight the importance of the degree of 'market-based' assets -- that is to what extent banks invest in non-traditional banking activities. Analyses of banking systems in CEECs have focused on foreign bank penetration – especially by euro area banks – pointing out the problems that this poses for domestic (host) supervisors in charge of safeguarding financial stability in these countries. Building on this literature, our analysis of national banking systems considers their internationalisation (according to different measures) of assets. We thus develop on Schoenmaker's understanding of cross-border banking in order to better understand national preference formation on supranational bank supervision.

Schoenmaker seeks to explain the contribution to international financial instability that large cross-border banks can make. However, his econometric analysis presents only a limited picture of the internationalisation of national banking systems which might motivate governments and supervisors to reinforce international cooperation in bank supervision and even move to supranational control. The analysis in this paper considers three pertinent measures of internationalisation and Europeanisation. First, it considers the percentage of assets held internationally, in the EU and in the euro area versus domestically held bank assets (Figure 2 and Table 1). On this, the prediction is that the higher the percentage of bank assets elsewhere in the euro area the greater the support for supranational supervision to ensure better control over these assets, especially when they are held by a subsidiary.

Second, the analysis considers, more specifically, bank exposure to the euro periphery -- Italy, Spain, Greece, Portugal and Ireland -- in total terms and relative to total bank assets (Table 2). The prediction here is that higher the exposure the greater the support for creating supranational supervision that would cover a range of banks in these countries. Third, the analysis considers the degree of foreign (notably other EU headquartered) bank penetration, measured as a percentage of total national bank assets that are held by foreign banks (Table 3). Foreign penetration through subsidiaries is another important feature of cross-border banking. Here the prediction is that member states dominated by the subsidiaries of foreign banks headquartered in other EU (and specifically euro area) member states will seek supranational banking supervision in order to ensure better and more uniform control of cross-border banking groups with a strong presence in their country.

These three predictions lead to the following, second, hypothesis as to how the configuration of the national banking system shapes/influences national preferences on the SSM.

H2: Higher the internationalisation to other euro area member states and / or higher the foreign penetration from the euro area, greater the support for creating / joining the SSM and widening the scope of direct ECB supervision.

To conclude this section, methodologically, this paper deploys a two-step political economy analysis. First, it undertakes a comparative political economy analysis of national banking systems, examining their internationalisation and concentration -- the latter is a further measure of relevance in particular because higher concentration correlates *grosso modo* with greater internationalisation. Second, this paper examines how these features of the banking system shape policy makers preferences on the SSM. This is done through textual analysis of policy documents, a systematic survey of press coverage and semi-structured elite interviews with policy makers across the EU.

This analysis does not overlook 'politics' (meaning 'political negotiations') either at the European level or at the domestic level (borrowing from Putnam's two-level game (1988)). It rather explains why the main policy makers at each 'level' -- notably ministries of finance -- had certain preferences and sought to pursue them through political negotiations in the EU and domestically. The outcome of the SSM negotiations was a compromise between the main member states, where Germany had most (but, by no means, all) of its preferences on the institutional features of the SSM accommodated because this country had strong bargaining power. Similarly, at the domestic level, there was lobbying from the financial sector in each member state (in some, more than in others). For example, as mentioned in Section 3, the German Sparkassen engaged – collectively through their representative association – in extensive lobbying at home and abroad. The position of financial lobbies also reflected very directly the structural features of national banking systems examined here.

3. Germany and the SSM: defending the *hausbank* model

The German banking system was both the least concentrated (Figure 1) in Europe and, excluding its two commercial giants, the least internationalised of the six largest national banking systems (see Figure 2 and Table 1). Although Germany was home to one very big, highly internationalised, commercial bank – Deutsche Bank – and a second very big commercial bank with a significant European presence – Commerzbank – there were also thousands of undercapitalized public and small local banks which provide the bulk of funding to, and maintain close relations with, small and medium sized enterprises (see also Donnelly 2014). Almost one-third of the euro area's banks were German. The bulk of bank assets were nationally held with the exception of the biggest two and a small number of the other, much smaller, commercial banks.

According to the second hypothesis, with limited internationalisation on a range of measures, one would expect less German support for BU generally and, more specifically, in the transfer of supervisory powers to the ECB -- despite German participation in the single currency. This also confirms the first hypothesis, whereby membership of the single currency is neither a necessary nor a sufficient condition for a country to support the SSM. The inconsistent quartet was less acute for Germany. German policy makers reluctantly agreed to the SSM with clear evidence of backtracking in the weeks following the June declaration on Banking Union (*Financial Times* 10 October 2012) and a repeatedly stated preference that only the two largest German banks -- the only German banks with a significant cross-border presence (more than 5 per cent of total assets) in 2012 should be subject to direct ECB supervision (*Financial Times* 5 December 2012; interviews BaFin official, Berlin, 30 October 2014).

German bank exposure to euro periphery sovereign debt might well have piqued German government interest in the development of supranational control. However, this exposure dropped significantly in the years following the outbreak of the sovereign debt crisis (Table 2). Also, in line with the second hypothesis, the stated preference of German policy-makers was that ECB supervision must not extend to cover the country's public Landesbanken (LB) and Sparkassen (savings banks) (*Financial Times*, 5 December 2012). By the December 2012 European Council, however, it had become clear that the German federal government was willing to compromise and set the threshold to extend direct ECB supervision to the LB.

The slightly more than 420 Sparkassen and 1200 Cooperative banks (2011 figures) were local or regionally based banks with a vested interest in the local economy and a strong presence in local community life. In late 2012, the largest Saving Bank had a balance sheet of approximately €40bn about one-fiftieth that of Deutsche Bank and more than 100 had less than a billion euros in assets (Bundesbank; *Financial Times*, 2 December 2012) but collectively they were responsible for 38 per cent of German bank lending and held 37 per cent of the country's bank deposits (Bundesbank, end 2012 figures). Sparkassen directors appeared to be unanimous in their view that home regulators and supervisors better understood their characteristics and way of doing business (Simpson 2013; *Financial Times*, 2 December 2012). The close connections between the Sparkassen and local and other German politicians encouraged federal government support for the protection of existing practices and the policy of extending direct ECB supervision to only systemically important banks (Busch 2009; Deeg 1999).

German government preferences and negotiating positions largely aligned with those of German banks (BDB 2013; BVR/VÖB/DSGV 2012). Only the two largest German commercial banks expressed support for the creation of the SSM yet they criticised the manner in which it was done and notably direct ECB supervision (Deutsche Bank 2012 & 2013; Bloomberg 2012). They were the only German banks to do so. The position of associations representing the publicly owned Landesbanken and Savings Banks (the VOB) and Cooperatives (the BVR) were clear in their opposition to the extension of direct ECB supervision to smaller German banks (BVR/VÖB/DSGV 2012; *Financial Times*, 9 September 2012; *Financial Times* 2 December 2012). The German federal government succeeded in resisting direct ECB supervision of the smaller savings and cooperative banks. However, the damage caused to some Landesbanken during the financial crisis, large government bail-outs, Commission-imposed restructuring and stagnant lending placed them in a politically weakened position (Deeg and Donnelly, this volume). German federal governments and the

Bundesbank have long called for the consolidation of banks in this sector (Hardie and Howarth 2009; 2013; *Financial Times* 14 September 2010).

4. France and the SSM: national champions with a strong European presence

The French government's position on the SSM threshold was dictated directly by the structure of the French banking system and the concern that a far higher percentage of French bank assets (over 80 per cent) would be subject to direct ECB supervision than any of the large European banking systems. The French banking system was somewhat more concentrated than the British and the five largest banks all held significant assets in other EU member states and especially the southern euro periphery. French bank exposure to the euro periphery was the greatest of any EU member state in total and in GDP terms (Table 2), a reflection of the impact of euro area membership which in turn encouraged interest in supranational banking supervision (hypotheses 1 and 2). The retail presence of the three large French commercial banks (BNP-Paribas, Société Générale and Crédit Agricole) in other EU member states (and notably other euro area member states) was far greater than British and German banks (Howarth 2013). Subsidiaries of these banks were also the largest (in terms of both assets and market share) of any foreign institutions in the euro periphery -- with a major retail and commercial presence in both the Italian and Greek banking systems in 2010 -- although retail presence in the euro periphery dropped significantly from 2010.

In line with the second hypothesis, the internationalisation data points to significant French interest in supranational banking supervision to the extent that this contributed to financial stability in the euro area and, specifically, in the euro periphery. In line with the second hypothesis, the French government (supported by the Commission) pushed for ECB involvement in supervision to cover all euro area banks. However, the French pushed for a de facto national supervision to continue through a 'licensing' system in which national supervisors would work on behalf of the ECB and according to common rules (*Financial Times*, 5 December 2012). They argued that the division into larger and smaller banks made little economic sense, given that banking crises often originated with smaller, fast-expanding banks (such as Spanish *cajas*, see Royo 2012).

The French government expressed concern over the unequal treatment of member states given that its national banking system was dominated by five very large institutions which would all end up being directly supervised by the ECB (*Financial Times*, 14 November 2012). Indeed, the agreed threshold resulted in direct ECB supervision of thirteen French financial institutions holding over 95 per cent of national banking assets compared to 25 German banks and 50 per cent of national assets (ECB 2014). French opposition to differential treatment also reflects French government insistence of a lack of a 'Too big to fail' problem facing French banks and a longstanding strategy of constructing large national champions engaged in a range of banking activities (Howarth 2013). However, bank system structure dictated preferences.

In its official policy statements, the French Banking Federation (FBF) explicitly shared the government's policy position: in favour of reinforced euro area rules on supervision but with continued national control (FBF 2012). The two largest nonlisted banks -- Crédit Mutuel and BPCE (a federation of cooperative and savings banks) and the part-listed Crédit Agricole -- expressed concerns -- given their funding structure -- but not opposition (Crédit Agricole 2014). All expressed concern on the potential for uneven supervisory treatment of different sized institutions. The close relationship between administrative elites staffing high-level positions in formerly state-owned banks (Schmidt 1996, Rouban 2010) suggests a significant conflation of private and public interests. Overall, France was the main member state engine of BU and the SSM (see Donnelly 2014, Howarth and Quaglia 2013, interviews with German policy makers 30 October 2014, interviews with Commission officials 13-14 November 2014).

5. The euro outsiders: in or out?

Both hypotheses tested in this paper explain effectively the positioning of the euro outsiders on SSM participation. The UK banking system was dominated by one large nationally-focused bank (Lloyds-TSB) and three large, highly internationalised and well-capitalised institutions with limited reliance on the domestic real economy. UK headquartered bank assets were the most international (extra-European) of any EU member state. The British banking system appears only moderately concentrated in terms of total bank assets (Figure 1) with the most significant foreign presence of any large EU member state (Table 3). However, the British retail banking market was highly concentrated in part because many of the foreign banks with London-based subsidiaries were involved little in retail banking. In the 2000s, the bulk of lending to domestic nonfinancial companies and households (consistently over 80 per cent) was provided by the five largest UK-headquartered banks and a subsidiary of Santander, the Spanish bank (Bank of England, 2013). Had the UK opted to participate in the SSM, over 90 per cent of its retail bank assets would have held by banks subject to direct ECB supervision. Yet at the same time, domestic lending formed only a small part of most of these banks' assets -- the principal exception being the UK subsidiary of Santander (Bank of England data). The three largest UK-headquartered banks were major international players and were among the world's ten largest banks in terms of asset size throughout most of the 2000s. All three held a majority of their assets internationally and a large majority of these international assets beyond Europe (Figure 2). British banks had some exposure to the euro periphery but this was comparatively limited (Table 2).

Overall, the UK government was by and large supportive of BU and the SSM for euro area member states, notably as a way to tackle the sovereign debt crisis afflicting the euro area periphery and to ensure financial stability therein (see, for example, *The Telegraph*, 13 December 2012, 19 December 2012).[2] However, it was clear that the UK did not want to be part of the new institutional arrangements (for example, *Financial Times*, 11 October 2013) – it did not face the inconsistent quartet, confirming the first hypothesis. Its banking system was not only the most 'Europeanised' of the largest six EU member state banking systems in terms of the holdings of other EU-headquartered banks in the UK (as both a percentage and in total terms) and British bank holdings elsewhere in the EU (in total terms), it was also

[2] For example, British Treasury Minister Osborne argued: 'We have consistently said we support the creation of a eurozone banking union, but that the interests of British taxpayers must be protected' (*The Telegraph,* 19 December 2013).

very internationalized in terms of non EU headquartered banks active in the UK and the activities of British banks abroad. The UK was most exposed to the potential instability of globally systemic banks, which affected the British banking system more in relative terms than others in Europe. Hence, British policy makers did not campaign for supranational solutions in the EU. Similarly, all the large British banks by and large supported the creation of the SSM but none sought British participation (BBA 2012).

Both hypotheses are also met in the Swedish case. The Swedish government's decision not to participate in Banking Union owed largely to the fact that so few bank assets in the country were held by EU-owned subsidiaries or branches (the lowest percentage in the EU at the end of 2012) yet the bulk of bank assets (almost 90 per cent) would be covered by direct ECB supervision because of a high level of concentration of the banking system (Darvas and Wolff, 2013). This limited EU-bank presence in the Swedish market weighed more heavily than the significant international (and specifically Euro area) presence of Swedish banks -- and notably in Finland and the Baltic States (including the Hansabank subsidiary of Swedbank). Swedish exposure to the euro periphery was very limited (Table 2) further discouraging interest. The Swedish government also expressed concern as to the second-class position of non-euro Member States in the SSM (*Financial Times*, 11 December 2012, Spendzharova and Bayram 2014).

The expression of a clear Danish preference against membership was also in line with both hypotheses: the country would not be participating in the single currency for the foreseeable future, only approximately 16 per cent of total Danish bank assets were held by EU-owned subsidiaries (2012 figures) and a significant percentage of these by Swedish banks. Only 29 per cent of Danish assets abroad were in the euro area (less than Danish assets in Sweden and Norway alone) and only 5 per cent of total Danish bank assets. By late 2013, only 1.5 per cent of Danish bank assets were in the euro periphery and these principally in Ireland. Despite its EMU opt-out, Danish initial policy on the SSM and other elements of BU can be described as positive ‘wait and see’. This stance stemmed from limited monetary policy autonomy (Denmark maintained its currency in the ERM II) and the large size of the country’s banking sector (four times GDP at the end of 2012) and the even bigger relative size of the country’s financial sector (the third highest in the EU compared to GDP) (interview Danish central bank official, March 2014).

The banking systems of most Central and Eastern European Member States were dominated by foreign institutions -- although to varying degrees (see Table 3). Some have argued that non-participation in the SSM (Banking Union) might have a devastating effect on domestic banks as depositors shifted their accounts to banks headquartered in BU Member States (Darva and Woolf, 2013). In line with the second hypothesis, in 2014, Romania and Bulgaria, which have a very high degree of foreign ownership, applied to join the SSM, through a special cooperation arrangement with the SSM which would result in direct ECB supervision of the largest banks in the two countries. In both countries, SSM participation was presented as the first step to full BU membership (Reuters 15 July 2014) -- even though participation in the single currency was unlikely in the near future, which confirms the first hypothesis. In Bulgaria this move was part of a more general effort to stave off a major banking crisis following the collapse of the countries fourth largest bank (*New York Times* 4

August 2014). Latvia and Lithuania, dominated by subsidiaries of Swedish banks, had less interest in joining Banking Union given Swedish non-membership, although Latvia's intention to enter the euro area in 2014 pushed its government to support the form of membership on offer and the approval of Lithuanian euro area membership in July 2014 resulted in accession to the SSM and other BU elements.

Three CEECs made clear their opposition to SSM / BU membership: Hungary, Poland and the Czech Republic. Compared to most CEECS, where foreign bank penetration from EU banks exceeded 70 per cent, in Hungary and Poland it was 'only' 54 and 56 per cent respectively. Hence, according to the second hypothesis, these two countries had somewhat less incentive to join the SSM. Similarly, participation in the euro area was not a priority for the government of either of these member states. The main exception remains the Czech republic, where foreign ownership by EU banks was high, but the country expressed no intention of joining the SSM. Determined Czech government reluctance on joining the single currency – and thus the absence of the inconsistent quartet even in the medium term – shaped Czech policy on the SSM.

Amongst the reasons that encouraged CEEC euro-outsiders to seek membership, participation in the SSM was seen in terms of improving the credibility of national prudential arrangements, overseen by the ECB. The ECB would possess information about the banks' headquarters and subsidiaries, allowing more effective supervision and decision-making. However, there were also several reasons not to participate in the SSM. Non-euro Member States were worried about their second-class status, with limited decision-making power as compared to euro area members. The ECB might be less prone to focus on the risks building in non-euro and smaller Member States.

The as yet undetermined implications of full BU also encouraged some non-euro Member States to adopt a cautious position on the SSM.

The main priority of the British government and British banks (BBA 2012) was to avoid a potential euro area block within the single financial market. The British, supported by seven other non-euro Member State governments, threatened to block Banking Union if there were insufficient safeguards put in place for the 'euro-outsiders' (*Financial Times*, 8 November 2012). Crucially, the British feared the adoption of subsequent financial legislation that would be detrimental to the British financial sector. However, the broader issue of concern was the satisfactory co-existence of a more integrated euro area core and the non-core Member States.

In the European Banking Authority (EBA) – the supervisory body responsible for EU-wide bank stress tests – the British feared a euro area majority able to impose its rules on the euro outsiders. Hence, as early as the summer of 2012, the British (joined by the Swedish and Danish) demanded an EBA voting reform: that any decision by the Authority should be approved by a minimum number of Member States outside the Banking Union and thus effectively by a 'double majority' of Member States inside and outside the Banking Union. The outcome of negotiations was a compromise involving the creation of a double majority system until the number of non-Banking Union Member States dwindled to less than four.

Conclusions

This article has first put forward two complementary hypotheses about national preferences on the SSM and has then applied them to the empirical record in order to assess their explanatory power. The main findings suggests that the limited internationalisation of the German banking system and the very small number of German banks with major cross-border operations meant that one of the four elements of the inconsistent quartet was less relevant for German policy makers, thus decreasing German interest in the SSM (and BU more generally). German policy makers resisted the ECB's supervision of the country's public Landesbanken and savings banks. French government policy was directed by support for the SSM as a stepping stone to the creation of support mechanisms for banks but also by opposition to the unequal treatment of member states given that France's banking system was dominated by five very large institutions with a strong or at least significant euro area presence which would all end up being directly supervised by the ECB.

British policy makers were less interested in participating in the SSM because three of the four largest British banks were major international players and one was almost entirely domestic in its activities. Moreover, in the UK, a large percentage of bank assets were held by non EU foreign owned banks. The extra-EU nature of cross-border banking in the UK discouraged participation in the SSM and Banking Union. The position of the other euro outsiders was determined in most cases by the extent of the penetration of euro area headquartered banks (second hypothesis). Position on euro area membership was a directing factor (first hypothesis) for all the euro outsiders: two about to join the euro (Latvia and Lithuania), two in no hurry to join

(Hungary and Poland) and four unlikely to join (the Czech Republic, UK, Sweden and Denmark).

This political economy analysis contributes to the academic literature in two ways. It explains the domestic sources of national preference formation on the SSM and BU more generally. In so doing, it complements the accounts that focus on the political negotiations on BU, at the EU or domestically, explaining why policy-makers and different parts of the financial industry (or even individual banks, e.g. Deutsche Bank) had the preferences they had. It outlines the different configuration (principally internationalisation patterns) of a range of national banking systems in the EU in order to explain preferences on the SSM and BU. Despite more than sixty years of financial integration in the EU and the near completion of the Single Financial Market, national banking systems remains very distinct, complicating the negotiations on BU and ensuring the persistence of national variation in supervisory practice.

The key argument of this paper is that euro area member states that faced the 'inconsistent quartet' had different preferences on the SSM, depending on the configuration of their national banking systems. Arguably, this two-step political economy analysis could be used to explain national preferences on the other main elements of BU. Further research could therefore assess the explanatory power of the inconsistent quartet and the configuration of national financial system with reference to the Single Resolution Mechanism and the non agreement on the common Deposit Guarantee Scheme (DGS). Obviously, in these cases, an additional element, namely moral hazard, should be taken into account given the ultimately fiscal implications of resolution and the proposed DGS.

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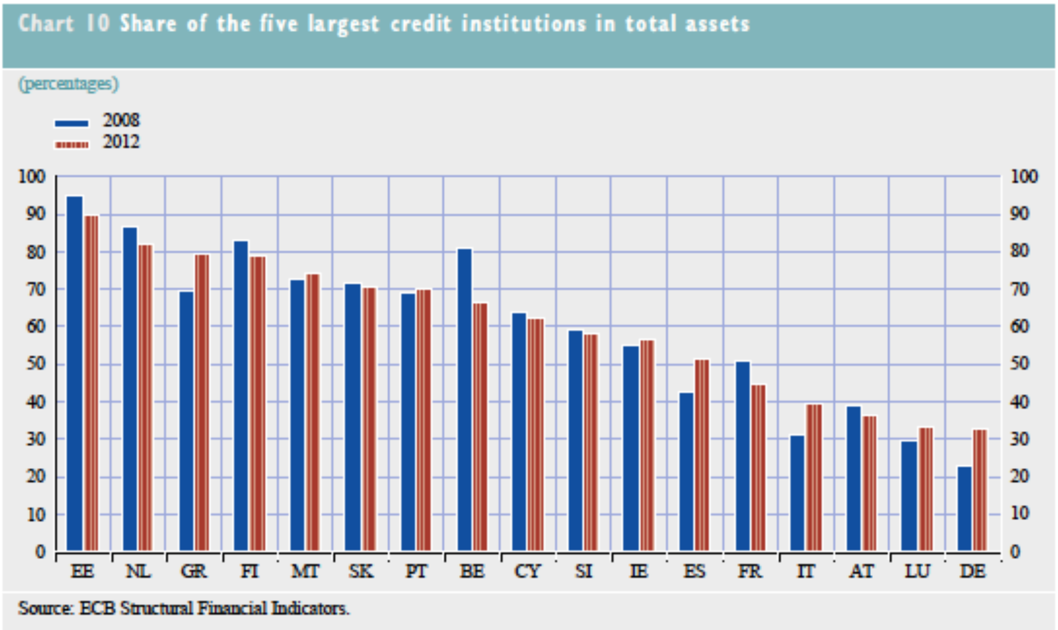
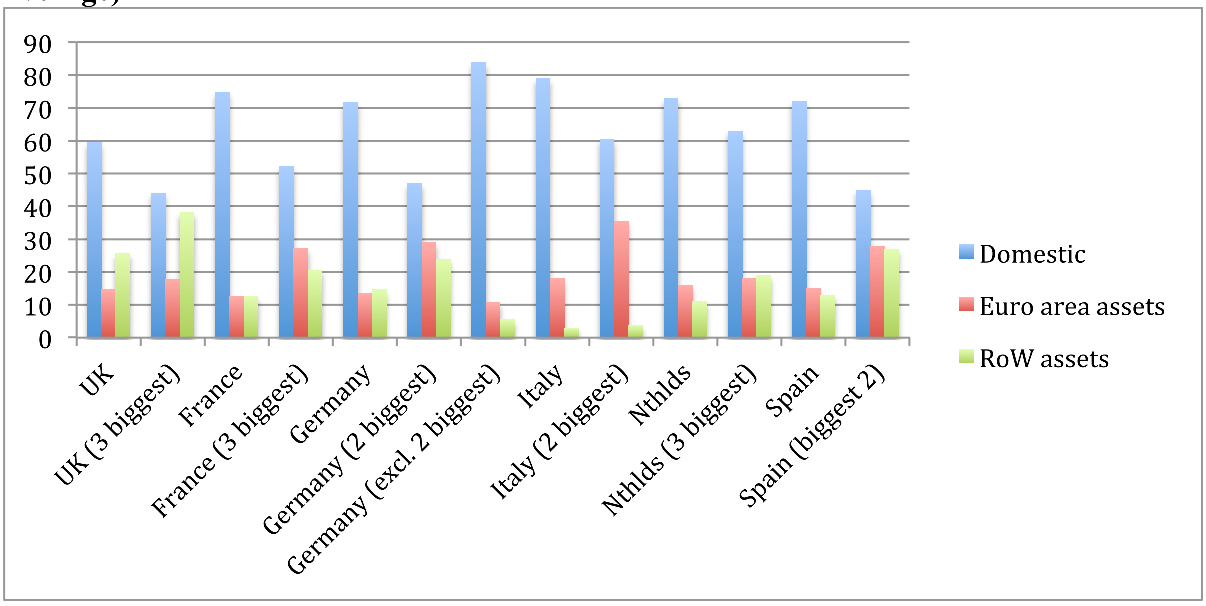
Figures and Tables

Figure 1: Banking system concentration



Source: ECB (2013) *Banking Structures Report*

Figure 2: Bank internationalization (per cent of total bank assets, 2007-2011 average)



Sources: Bank of England, Banque de France, Bundesbank statistical databases. Registration documents for Royal Bank of Scotland, Barclays, HSBC, BNP Paribas, Crédit Agricole and Société Générale. Notes: The three largest Germany-headquartered banks (measured by assets) became two with the forced merger of Dresdner and Commerzbank.

Table 1: Internationalisation of EU-27 banking systems 2010-2013 (per cent of total assets held outside home member state, average, rounded)

	Domestic	RoW	EU	Euro area
Euro area				
Austria	79	6	15	8
Belgium	83	6	11	8
Cyprus	89	3	4	4
Estonia	99	0	1	0
Finland	94	1	5	1
France	75	13	13	11
Germany	72	15	14	11
Greece	91	0	9	2
Ireland	84	10	6	2
Italy	79	3	18	3
Malta	83	5	12	9
Netherlands	73	11	16	12
Portugal	81	6	13	13
Slovenia	93	0	7	7
Slovakia	99	0	1	1
Spain	72	13	15	8
Non Euro				
Bulgaria	96	1	3	2
Czech R.	97	0	3	3
Denmark	85	2	13	5
Hungary	96	0	4	3
Latvia	98	1	1	0
Lithuania	96	0	4	3
Poland	94	0	6	5
Romania	97	1	2	2
Sweden	84	7	9	5
United Kingdom	60	26	15	14

Source: national central bank data.
*Periphery includes Greece, Ireland, Italy, Portugal and Spain. Excluding domestic market, if one of five euro area periphery countries.

Table 2: European Banking Systems' Exposure to Euro Periphery debt (sovereign and corporate)

	12.2010 (million dollars)	% of bank assets 12.2010	12.2013 (million dollars)	% of bank assets 12.2013	% of GDP 12.2013
Euro area					
Austria	36650	3.2	19890	1.8	5.6
Belgium	91402	11.6	43159	6.7	19.1
Finland	3398	20.1	974	5	13.9
France	647408	7.8	526801	6.2	26.2
Germany	532729	5.3	372755	4.2	12.6

Italy*	52329	1.5	34364	1	2.7
Netherlands	151262	4.8	106837	3.4	13.5
Spain*	127654	2.7	107486	2.4	7.8
Non Euro					
Denmark	19579	1.9	15691	1.5	6.4
Sweden	8604	0.5	6456	0.3	0.9
UK	368718	3.9	282647	3.1	15.3

Source: BIS, ECB statistical warehouse.
*Excluding domestically held debt

Table 3: Foreign penetration into EU-27 banking systems end 2009 / end 2012 (per cent of total banks assets held by subsidiaries and branches of foreign banks) and 2009-2012 change (rounded to the nearest 0.5)

	EU 2009	RoW 2009	EU 2012	RoW 2012	EU 2009-12
Euro area					
Austria	15	4.5	16	6	1
Belgium	54	6	51	5	-3*
Cyprus	33	8	17	16.5	-16
Estonia	95	0	85	11.5	-10
Finland	67	0	67	8	0
France	10	0.5	10	0.5	0
Germany	10	0.5	11	1	1
Greece	21	18.5	16	0	-5
Ireland	36	7	29	10	-14
Italy	12	0.5	13	0.5	1
Luxembourg	65	29	67	26	2
Malta	35	32	32	30	-3
Netherlands	3	1	9	2	6
Portugal	22	1	20	0.5	-2
Slovenia	29	0.5	28.5	1.5	-0.5
Slovakia	96	0	96	0	0
Spain	10	0	9	0	-1
Non Euro in 2012					
Bulgaria	82	2	73	0	-9
Czech R.	90	4	86	5	-4
Denmark	18	2	16	2	-2
Hungary	54	5	54	5	0
Latvia	63	4	47	4	-15
Lithuania	83	0	72	2	-11
Poland	56	8	56	9	0
Romania	76	0.5	71	1	-5
Sweden	7	1	7	3	0
United Kingdom	26	26	17	28.5	-9

Source: national central bank data, ECB (2013) EU Banking Structures (2010, 2013)
*The presence of other EU headquartered banks in Belgium increased markedly from 2008 to 2009. The decrease between 2009-12 should take this into consideration.