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**EU Banking Regulation During  
the Financial Crisis:  
Establishment and Design of  
the European Banking Union**

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# Table of Contents

Acknowledgements .....	iii
List of Figures .....	iv
List of Abbreviations.....	v
<b>1 Banking Regulation: Now More than Ever.....</b>	<b>1</b>
<b>2 Towards a European Banking Union .....</b>	<b>5</b>
<b>3 Banking Regulators: Network, Agency or Institution?.....</b>	<b>11</b>
<b>4 Theoretical Approaches: Explaining Creation and Design of the Banking Union.....</b>	<b>17</b>
4.1 The Demand Side: The Functional and Interest-Based Approach.....	17
4.2 The Supply Side: The Political and Power-Based Approach .....	19
4.3 Combining Functional and Political Explanations .....	23
4.3.1 <i>Introducing a Combined Functional-Political Approach .....</i>	<i>24</i>
4.3.2 <i>Making Theory Applicable: Observable Implications for the Combined Approach.....</i>	<i>26</i>
4.4 The Institutional Idea: Alternative Explanatory Approaches.....	30
<b>5 Methodological Approach and Research Design for the Case of the Banking Union.....</b>	<b>34</b>
<b>6 The European Banking Union .....</b>	<b>38</b>
6.1 The Single Supervisory Mechanism: Delegating Power to the ECB.....	38
6.1.1 <i>Functional Reasons for Creation: From a Regulatory Gap to Strong Supervision.....</i>	<i>38</i>
6.1.2 <i>Political Reasons for Design: Germany Protects its Public Banking Sector .....</i>	<i>52</i>
6.2 The Single Resolution Mechanism: Creating a New EU Agency .....	66
6.2.1 <i>Functional Reasons for Creation: Costs and Uncertainty Due to Non-Regulation .....</i>	<i>67</i>
6.2.2 <i>Political Reasons for Design: Who Pays How Much for Resolution? .....</i>	<i>78</i>
6.3 Alternative Explanations: How Functional Needs Become Visible.....	89
<b>7 Conclusion: Functional and Political Considerations Shaped the Banking Union .....</b>	<b>93</b>
<b>Bibliography.....</b>	<b>97</b>
<b>Statutory Declaration .....</b>	<b>116</b>

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## **List of Figures**

F 1	Types of Regulatory Authorities along the Continuum of the Integration Level (own illustration)	16
F 2	Observable Implications for the Functional Part (H1) of the Causal Chain (own illustration)	28
F 3	Observable Implications for the Political Part (H2) of the Causal Chain (own illustration)	29
F 4	Small Banks in the Euro Area (derived from Verón 2014)	58
F 5	Decision-Making Structures of the SSM and its Mode of Operation (own illustration according to information provided by the SSM (SSM 2015a; SSM 2015b))	65
F 6	Decision-Making Structures of the SRM and its Various Involved Actors (own illustration according to information provided by the SRB (SRB 2015))	89

## List of Abbreviations

CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEPS	Centre for European Policy Studies
CESR	Committee of European Securities Regulators
CLS	Legal Service of the Council
EBA	European Banking Authority
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EMU	European Economic and Monetary Union
EP	European Parliament
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
HI	Historical Institutionalism
H1	Hypothesis 1
H2	Hypothesis 2
IFO	CES Ifo Institute Center for Economic Studies
IMF	International Monetary Fund
NRA	National Regulation Authority
PA	Principal-Agent Model
SI	Sociological Institutionalism
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism

# 1 Banking Regulation: Now More than Ever

“It’s not just more regulation that is needed, it is better regulation”, said banking and finance expert Jacques de Larosière in 2009 (Brussels Economic Forum 2009). Back then, he did not refer to the latest regulatory device in the realm of EU banking governance, the European Banking Union, but to its predecessors. However, his statement is true for the Banking Union as well: By creating the Banking Union in order to combat the financial and banking crisis, EU actors intended to improve regulation and thus increased its amount and rigour.

In **Chapter 2** the financial crisis and its influence on the EU banking sector is outlined. De Larosière was one of the persons who had a lot of influence on European banking regulation in recent years, since he chaired a high-level EU expert group on financial supervision (Willis 2010). The report of de Larosière tried to give answers to pressing questions of the financial, sovereign debt and banking crisis in the Eurozone. The global financial crisis had slopped over to Europe after a real estate crisis in the USA had led to a financial crisis and eventually to the bankruptcy of the US bank Lehman Brothers in 2008. The crisis made it clear that financial markets in EU countries are highly interconnected – and that a vicious circle between national debt records and liquidity problems of banks existed (Berschens 2013a).

**Chapter 3** provides detailed conceptualizations and background knowledge on networks, agencies and institutions as a starting point for the analysis of the Banking Union. In 2009, the report of de Larosière highlighted, that banking supervision was no longer “fit for purpose” and concluded to create the European Banking Authority (EBA) (Ottow 2014: 126). This agency was supposed to replace the previous Committee of European Banking Supervision (CEBS), a loose network of national regulatory banking authorities (NRAs) which was too inflexible and lacked powers to issue binding decisions (Ottow 2014: 128f.). Consequently, de Larosière suggested a banking agency would provide better regulation. Such agencification is a new phenomenon in the European Union (EU). Over the past two decades the number of agencies has grown remarkably (Rittberger/Wonka 2010: 730). Before 1990, the EU only counted two half-autonomous agencies (Dehousse 2008: 2). By today, more than 40 EU agencies exist (EU 2014) and a lot of them are concerned with regulatory issues, although the regulatory space was traditionally dominated by nation states (Coen/Thatcher 2008: 815).

With the creation of the EBA in 2011 agencification took place in the realm of EU banking regulation. But in 2012, the EU member states decided to reform banking regulation yet again (McPhilemy 2014: 1473ff.): They agreed on establishing a Single Supervisory Mechanism (SSM) and thereby to transfer banking supervision to a European institution, the European

Central Bank (ECB). The SSM is the first pillar of the European Banking Union. Later on, the second pillar was created, the so called Single Resolution Mechanism (SRM), which established an own agency for the resolution of failing banks (Howarth/Quaglia 2014).

The creation of this Banking Union is the most recent and extensive reform of banking regulation in the EU and certainly was an attempt “to learn all the lessons from the crisis and create a safer and sounder financial sector” (Commission 2014a: 1). However, it is intriguing, how the institutional structure of the Banking Union can be explained. While member states delegated the supervision task to the ECB, they created a completely new agency to care about banking resolution. The goal of this paper is to analyze why the Banking Union was created in the first place and why it was designed the way it is today. Looking at banking governance in particular and keeping in mind that there is a trend for agencification in the EU in general, it is highly interesting why EU actors opted for this particular kind of solution for banking regulation. After all, the development of the Banking Union is a good example of Majone’s (1996; 1997) and Tallberg’s (2002) claim that there is a general political trend in Europe towards growing governance beyond the nation state and greater specialization and institutionalization of regulatory functions.

**Chapter 4** will first review existing theoretical explanations, then introduce the suggested approach of this paper and finally reflect on some alternative accounts. There are different theoretical approaches which aim at offering adequate explanations to the creation of EU institutional set ups like the Banking Union. In short, two major approaches compete with each other: First, there is the functional approach based on a principal-agent model which suggests that the Banking Union was created and accordingly designed because there was a gap between current institutional capabilities of EU banking regulation and a complex problem in the realm of banking like the financial crisis which led to high costs for the member states (Majone 1996; Majone 1997; Egeberg/Martens/Trondal 2012; Dehousse 2008). The result of this gap is the functional need for an institution like the Banking Union which can tackle the problem of banking supervision and resolution (Thatcher 2011; Rittberger/Wonka 2011: 781). The second approach tries to explain the creation and design of the Banking Union by looking at political preferences of the main actors as well as their power to enforce their own interests (Kelemen/Tarrant 2011; Kelemen 2011; Rittberger/Wonka 2010). It indicates that delegation is shaped by political actors’ concerns for power and office instead of by functional considerations (Christensen/Nielsen 2010: 10).

However, inspired by Rittberger and Blauburger (2014) this paper suggests that the functional and political approach should be combined to increase explanatory power.

Especially the research on a highly complex construct like the European Banking Union can profit from the integration of different theoretical perspectives. After all “no complex problem can be truly understood by looking at it through one single theoretical lens” (Verdun 2015: 232). Therefore this paper develops in a combined functional-political approach which aims at explaining the creation and design of the European Banking Union. This combined approach is based on the following two assumptions: First, functional needs can account for the creation of the SSM within an EU institution and the creation of the SRM as an EU agency. Second, the particular design of the SSM and SRM (for example decision making procedures or control mechanisms) are the result of political and power-based interests of the most important EU actors. In Chapter 4, two hypotheses are deduced from these assumptions. Hypothesis H1 is thereby considering the functional part and H2 the political part of the causal chain of the here suggested combined approach:

**Hypothesis 1 (H1):** If a regulatory, operational or capacity deficit in EU banking supervision and resolution was present before the SSM and SRM, this functional gap must have been the reason for EU policy makers to create the SSM and SRM with an institutional structure which is best suited to solve the particular functional problem.

**Hypothesis 2 (H2):** If there was a distributional conflict in banking supervision and resolution and especially if this conflict burdened one or a few EU actors more than others, they will have tried to keep a high level of control over supervision and resolution.

**Chapter 5** will introduce the method of how to assess if these hypotheses are valid. The methodological approach of this paper is the execution of a case study. By using process tracing and looking closely at empirical data, the process which led to the creation and the particular design of the Banking Union shall be reproduced step by step. To support the combined functional-political approach, the two hypotheses should be able to be confirmed when looking at empirical evidence from the case of the European Banking Union. To conduct this analysis, observable implications are deduced in order to know what needs to be observed in the case of the Banking Union to support or falsify the hypotheses.

In **Chapter 6**, the empirical data will be examined eventually. By relying especially on primary sources like position papers, statements or press releases from the main EU actors, it is explored how it came to the creation and particular design of the SSM and SRM. The operationalized functional-political approach will be compared to the empirical evidence to reproduce the causal process which led to creation and design of the SSM and SRM.

The in-depth analysis shows: Both hypotheses can be confirmed for the SSM and SRM. Regulatory and capacity deficits were the functional gap which led to the creation of the SSM



within the ECB. Since regulation on cross-border banks<sup>1</sup> as well as a strong regulatory authority ensuring common implementation of supervision rules was missing, EU actors were united in their claim to create the SSM. However, they disagreed on when the SSM should be implemented and how it should be designed in particular. A high distributional conflict about who pays how much in banking supervision fueled these disagreements – especially because the establishment of the SSM was linked to the creation of the European Stability Mechanism (ESM), a common crisis tool which should be able to recapitalize failing banks directly. And especially Germany wanted to shape the design of the SSM because it aimed at excluding its small public banks which enjoyed several benefits in the national supervisory system.

The same goes for the SRM: There was a lack of regulation on bank resolution. EU policy makers realized that common resolution rules were necessary to prevent costs for complicated wind ups and to stabilize the EU financial markets. Thus they agreed on creating an SRM with an own EU agency. Such an agency would have the advantages of minimizing home bias, ensuring common resolution standards across member states and including various actors with their know-how, for example NRAs. Yet again, when it came to the design of the SRM, EU actors were divided: The Commission wanted to gain decision-making power itself, but the member states tried to keep the final say in resolution, too. There was a high distributional conflict about who pays how much for resolution inter alia because the SRM foresaw a mutualized resolution fund. Germany was burdened asymmetrically, because of the special features of its national banking system and because it already had a national resolution fund. Consequently, it pushed for the exclusion of small banks as well as co-determination rights for the Council in the decision-making process. This led to a weakening of the SRM since the decision-making procedure was designed involving a wide range of actors.

It could thus be determined that the Banking Union was created according to functional considerations but its design was highly influenced by political preferences and power-based claims. Nevertheless, some alternative explanations will be discussed to explain why functional needs actually became visible and how path-dependency shaped the outcome.

In **Chapter 7**, the paper will be concluded by a summary of the arguments and an outlook for further required research. The aim of this paper is to better understand the development of EU banking regulation and in particular how and why the European Banking Union was created and designed. Or to express it in accord with the thoughts of de Larosière: This analysis of the European Banking Union will provide valuable insights on why and how more regulation has been put on top of existing regulation in the banking area.

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<sup>1</sup> Cross-border banks are banking groups which operate across more than one EU member state or globally.

## **2 Towards a European Banking Union**

Lately, EU banking regulation and governance has been radically reformed by establishing the European Banking Union. Some EU policy-makers think this is an even “greater pooling of sovereignty than signing up to the Euro” (Bowles 2013). However, financial integration and a single market for financial services in itself had been an important goal within the EU since the 1970s (Commission 1999: 3). In 1972, a Groupe de Contacte was founded. This informal intergovernmental forum brought the supervisors from the then six member states of the European Economic Community together and it was supposed to foster mutual learning and information exchanges (McPhilemy 2014: 1478). But its intention was only to discuss banking issues in a very informal setting – and not to make formal decisions.

Financial integration picked up speed after the Cassis de Dijon ruling of the European Court of Justice in 1979 because it “set the stage for mutual recognition” (McPhilemy 2014: 1478). In 1985, the Commission stated in a white paper three principles for the Single Market in financial services: Mutual recognition, minimum harmonization and home country control (Commission 1985). Member states should recognize regulatory and supervisory arrangement of others and they should adopt some common minimum regulation while supervision of financial institutions would stay with national authorities (McPhilemy 2014: 1477). This meant that most regulations had to be converted into national legislation. Soon, it became obvious that this made it easy for member states to implement them less stringently (McPhilemy 2014: 1477f.). As a consequence, standards for financial regulation in general and banking regulation in particular still diverged extensively.

With the introduction of a common currency, the Euro, the Commission decided to resume financial market integration efforts. It criticized that financial markets remained segmented (Commission 1999: 3). To address the problem, the Commission set up a Financial Services Action Plan (FSAP) as well as group of experts, the “Committee of Wise Men”. The report they issued became known under the name of their chair, Baron Alexandre Lamfalussy. At first, this Committee was only supposed to discuss securities markets but soon it also had to deal with banking supervision and regulation. This was due to the claim of the first ECB’s President Wim Duisenberg as well as his board member Tommaso Padoa-Schioppa: They publicly announced that they were interested in expanding the ECB’s supervisory responsibilities (Quaglia 2010).

It was controversially debated whether or not the ECB should obtain powers of banking supervision, similar to those it now obtained through the implementation of the SSM.

However back in 1999, there was strong opposition from the national supervisory authorities and governments; especially Great Britain and Germany were refusing to give up sovereign power over banking supervision since they saw no need for EU level supervision (Skuodis 2014: 4f.; McPhilemy 2014: 1479). Thus, the ECB was not able to extend its mandate and the supervision of banks remained a national issue. Back then, even the Commission was convinced that banking supervision on the EU level was not necessary. It rather stated that the “key ingredient for successful cross-border supervision” of banks was “mutual confidence” in the effectiveness of financial supervision of other EU member states (Commission 1999: 14). Years later, at the height of the financial and Eurozone crisis, this attitude turned out to be disastrous.

### ***The CEBS: Creating a Network for Non-Binding Cooperation***

Nevertheless, the Lamfalussy framework led to the establishment of the Committees of European Banking Supervisors (CEBS) in 2004 (Commission 2003).<sup>2</sup> The CEBS was an EU network which consisted of the regulation authorities of the member states. It was supposed to increase cooperation between NRAs and foster common implementation of banking regulation. After all, the Lamfalussy process had made it obvious that implementation diverged and that this made the EU banking system too inflexible to respond to new developments in the market (Ottow 2014: 128f.). The main tasks of the CEBS were to issue non-binding guidelines, recommendations and standards as well as advising the Commission on banking regulation (McPhilemy 2014: 1480). But since it was a network located on the intergovernmental level, it lacked the power to make binding decisions. In consequence, not much changed for the member states: they were still able to implement regulation laxly.

Thus, when the Lamfalussy system was reviewed in 2007, national supervisory regimes still varied on a lot of dimensions, for example on the attitude of supervisors towards bailing out troubled banks (McPhilemy 2014: 1480). The loose network of the CEBS did not manage to promote more consistency across the EU member states.

Also in 2007, the global financial system began to crumble. It first became obvious in the residential property market in the United States (US) (Glinavos 2014: 85). On 9<sup>th</sup> August 2007, the French bank BNP Paribas ceased activity in three investment funds specialized in US mortgage debt (Economist 2012). For years, people in the US purchased houses while having only questionable abilities to pay back loans (Glinavos 2014: 86). Eventually, this

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<sup>2</sup> Apart from the CEBS, two other regulatory networks were created in the financial sector: The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR) (Ottow 2014: 127).

housing bubble burst resulting in a dissolving of trust, which is commonly known as the “ultimate glue of all financial systems” (Economist 2013). A credit crunch started. Latest with the resulting bankruptcy of the bank Lehman Brothers in the second half of 2008, the crisis quickly escalated from the US to Europe and around the world. It spread from the housing market to financial institutions and to the real economy.

Soon, also banks in the EU got into trouble and had to be bailed-out by national governments. What had happened? In the decade before the crisis, interbank markets within the EU had become internationalized. Cross-border financial activities had increased strongly and steadily from 1999 to 2008 (ECB 2013: 31). But even if integration in banking de facto flourished in 2008, implementation of banking regulation still took place on a national level. Even if banks internationalized their business and engaged in cross-border banking, supervision was conducted nationally. With the start of the financial crisis, this became a severe problem: Since banks suffered from financial distress, cross-border interbank lending declined by around 30% by 2012 compared to pre-crisis level (ECB 2013: 31). The initially progressive integration of the banking sector came to an unexpected halt. Consequently, the banking market in the EU became increasingly fragmented what in turn worsened the situation on EU financial markets and deepened the financial crisis (Howarth/Quaglia 2013: 104ff). After all, facing financial distress of own assets and not being able to lend money from others meant for a lot of banks to face bankruptcy.

### ***The EBA: An EU Agency which Cannot Tackle All the Problems***

To resolve the problem, the Commission once again relied on a high-level group of experts, this time chaired by the before-mentioned Jacques de Larosière. Their so-called Larosière Report criticized that when the crisis developed, supervisors of different member states denied to cooperate or even to exchange information frankly (Larosière 2009: 41). For example, in the cases of the Belgian-Dutch bank Fortis as well as the Belgian-French bank Dexia, the national supervisors failed to cooperate effectively in supervision and resolution (SPON 2008). Usually only the home state of a bank was responsible for supervision whereas the host state hardly had possibilities to intervene. But the NRAs did not even share important information. Consequently, both banks had to be rescued by governments spending billions of euros on those bail-outs. The Larosière Report therefore called for allowing regulatory authorities in the host states greater powers to intervene (Ottow 2014: 126).

The main suggestion of the Report was however to move away from the network approach of the CEBS and towards the supranationalisation of banking regulation (Larosière 2009: 46).

After all, banks also operated across member states' borders. Therefore, an EU level agency was supposed to be created, the so-called European Banking Authority. The main idea was that an agency – which has more rights and powers than an informal network – would be better able to establish common European banking regulation as well as ensure common implementation of supervisory rules. The Commission followed the recommendations of Larosière to a large extent. In 2011, the European System of Financial Supervision (ESFS) was established, including the new EBA<sup>3</sup> for banking supervision and the European Systemic Risk Board (ESRB) for macroeconomic stability.

The EBA as an EU agency became actually a lot more powerful than the network CEBS. It was allowed to propose and draft technical standards which were usually endorsed by the Commission without objections. Thus, the EBA “became the de facto producer of binding technical regulations for the EU banking sector” (McPhilemy 2014: 1484). Furthermore, it was able to issue guidelines, give advice to the Commission and other EU institutions or take binding decisions if disagreements between NRAs occurred (Ottow 2014: 132). However, the EBA did not have actual supervisory or intervention rights, it did not have the power to issue general binding instructions to banks. The result was again common standards but diverging implementation of these in the EU member states. And after the EBA was established in 2011, the crisis in the Eurozone worsened yet again. A development which had already started in 2009 intensified sharply from mid-2011: The financial and economic crisis turned into a sovereign debt crisis (ECB 2012: 13; Howarth/Quaglia 2013: 108).

The reason was a vicious circle of failing banks and ailing indebted states: A lot of banks were facing bankruptcy during the financial crisis because they had non-performing assets on their balance sheets (Buch/Weigert 2012: 25). Investors lost confidence and thus did not provide them with fresh money. The governments of the states where those banks were located tried to prevent the worst, namely a total collapse of one of the failing banks. After all, this would quite certainly have had contagious effects on other financial institutions. Therefore, the governments provided financial aid to the banks.

Since the governments used public money for these bail-outs, state indebtedness increased constantly. This again meant that rating agencies would devalue the creditworthiness of governments. However, government bonds were in turn mainly held by banks (Schäfer 2015: 8ff.). This process slowly undermined the ability of member states to bail-out banks again. And it eventually resulted in banks holding even more non-performing assets and becoming

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<sup>3</sup> Furthermore, also the CEIOPS and CESR networks were transformed into agencies, namely the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

dependent on yet another governmental bail-out. By requesting a bail-out again, the banks thus triggered this vicious circle again (Schäfer 2015: 8ff.; Beck 2012: 18).

The ECB found that this development reached its peak in the first half of 2012: Highly indebted Eurozone countries like Greece, fragile euro area banking sectors and the resulting speculation about the risk of a break-up of the Eurozone led to a further fragmentation of Euro financial markets (ECB 2013: 9ff.). The main problems were the link between failing banks and increased government indebtedness as well as the tendency of national supervisors to ignore banking problems for too long. Even after the creation of the EBA, the implementation of banking regulation as well as the execution of banking supervision was in the hands of NRAs. The ESRB found several shortcomings in supervision: If banks were failing, national supervisors regularly were tempted to exercise forbearance and thus ignore the problem of their home country banks for a very long time because they feared the macroeconomic consequences of intervention (ESRB 2012: 1ff.). In June 2012, the President of the European Council<sup>4</sup> Herman van Rompuy stated in a report<sup>5</sup> that the European Economic and Monetary Union (EMU) had to be strengthened by implementing an integrated financial framework (van Rompuy 2012: 3). Such a framework was supposed to incorporate common mechanisms for banking supervision and resolution (van Rompuy 2012: 3). Shortly thereafter, European leaders affirmed at the Euro Area Summit on 29<sup>th</sup> June 2012, that it was “imperative to break the vicious circle between banks and governments” (Euro Area Summit 2012). They called for a supervisory mechanism and thereby initiated the creation process of the Banking Union.

### ***The Banking Union: Introducing the SSM and the SRM***

In 2013, the member states agreed on the SSM. But by establishing the SSM, the EBA did not get abolished. Its responsibility became to develop the Single Rulebook (Commission 2013a: 7). It shall contain common banking regulation rules for all EU financial institutions (Commission 2012: 38) and it is the foundation on which the SSM and SRM are built.

The SSM transfers supervisory power from the national level to the EU level by charging an EU institution, namely the ECB, with the task of the prudential supervisor for euro area banks. The ECB is directly responsible for supervision of the 123 big and systemically

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<sup>4</sup> The European Council consists of the EU member states’ heads of state and government. In this paper, it is often simply called the Council. Attention: The Council of the European Union has a different role: The member states’ governments and national ministers meet there in order to coordinate policies or adopt laws. When speaking about the Council of the EU in this context it usually refers to the Economic and Financial Affairs Council (ECOFIN).

<sup>5</sup> Van Rompuy had prepared this report on the EMU in close cooperation with the presidents of the Commission, the Euro-Group and the ECB (Van Rompuy 2012).

important banks of the Eurozone (SSM 2015b). Banks are significant if the value of their assets exceed 30 billion euro or if their assets constitute at least 20% of the GDP of their home country's GDP (Commission 2013a: 2). Furthermore, a bank is also significant if it receives direct assistance from the ESM (Commission 2013a: 2). Smaller Eurozone credit institutions are indirectly supervised by the ECB: Originally the national supervisors are responsible but the ECB can assume the responsibility for these less significant banks at any time if necessary. The ECB has a lot of power over national supervisors: It can send binding general instructions to them and the national supervisors have the duty to notify the ECB of their supervisory decisions (Commission 2013a: 2). Within the ECB a supervisory board has been created to separate its supervision and monetary policy mandates. The board consists of a chair, a vice chair, four representatives of the ECB and one representative of each national supervisor of the participating member states (ECB 2015). The ECB Governing Council can however veto the decisions of the board and is thus the de facto final decision-making body (Bernhard 2013: 5).

In 2014, the member states additionally agreed on a common framework for bank resolution, the SRM. Within the SRM an independent EU agency is created which deals with the recovery and resolution of Eurozone banks. This Single Resolution Board (SRB) takes action if the ECB notices that a bank got into crisis. Additionally, a 55 billion Single Resolution Fund (SRF) was created that banks themselves pay in to (Commission 2013a: 2). This aims at preventing further increases in public debt by using tax money for bailouts (Commission 2013a: 6). According to the Commission the SRM will ensure that if a bank “faced serious difficulties, its resolution could be managed efficiently with minimal costs to taxpayers and the real economy” (Commission 2014d: 1). Primarily, the SRM is responsible for systemically relevant banks and the NRAs care about smaller banks (Commission 2014b: 3). In individual cases, the SRM can however assume this task, too. The SRB will consist of a chair person, four full-time appointed members, the representatives of the national resolution authorities as well as observers from the ECB and the Commission (Council EU 2014b: 2). The SRB should be able to take decisions within 32 hours by developing a recovery or resolution plan. If within 24 hours neither the Commission nor the Council objects, it will come into force. Otherwise, the SRB has to revise its proposal (Commission 2014c: 5f.).

Today, both the SSM and the SRM are in operation. The ECB as EU institution cares about supervision, the SRB as an agency about resolution. An overview over the SSM's decision-making procedure can be found in *Figure 5* on page 65 and for the SRM an overview is provided in *Figure 6* on page 89.

### **3 Banking Regulators: Network, Agency or Institution?**

“I do not believe in the self-regulation of the European banks”, said the former European Commissioner for the Internal Market and Services, Michel Barnier, in 2014 (FAZ 2014). European banks suffered during the crisis due to a lack of securities, some mismanagement and high risk investment forms as well as their failing risk management. The European Banking Union is in response all about a top-down regulation of the ailing banking sector. It intensified and expanded EU banking regulation.

#### ***What Is EU Regulation and What Is It For?***

Rittberger and Wonka (2011: 783) state that one of the “most pressing problems of European integration is to ensure the uniform application of EU regulations in the member states”. This seems plausible, if we think about the former defects of the European banking system which deepened the crisis. Regulation in general means sustained and focused control over activities that are valued by a community (Brown/Collin 2010: 1) – for example sensible risk assessments in banking. A regulation may be a binding legislative act of the EU that has to be applied in all member states. The overall goal is to make targeted actors comply with rules which codify certain forms of social and economic behavior as desirable (Brown/Collin 2010: 3). However, implementation of EU regulation is often difficult because conditions in the member states vary or because member states show little interest in implementation (Coen/Thatcher 2008: 807). For years, this had been a problem in the banking sector. Therefore authority is often deployed in order to monitor or if necessary even enforce regulation (Brown/Collin 2010: 3). EU regulation thus tries to accomplish that the member states – or rather those actors within the member states which are in charge of implementation – behave in a similar manner (Rittberger/Wonka 2011: 783). For example, with the European Banking Union the main actors want to ensure that banks adhere to certain formal banking rules which are supposed to make banking safer and prevent future crisis situations.

#### ***Who Makes, Monitors and Enforces EU regulation?***

At first, it was traditionally the Commission which became responsible for making and implementing coherent EU regulation. However, especially since the 1990s newer hybrid forms for coordinating regulation emerged (Coen/Thatcher 2008: 809) and with them a new regulatory architecture which is expressed in the “extension of regulatory capacities beyond the European Commission” (Levi-Faur 2011: 810): Regulatory networks and agencies



became relevant actors. They took over some of the regulatory tasks formerly dedicated to the Commission or they at least were supposed to help the Commission to make, monitor or enforce regulations. Majone (1996) even speaks of the advent of the regulatory state.

The growing of the EU regulatory state – including the appearance of networks and agencies like the CEBS and the EBA as new actors in the banking sector – can be seen as a form of governance: Governancing focuses on the decentralization of power and the strengthening of informal and experimental systems of governance like granting regulatory tasks to decentralized networks or agencies instead of the centralized and powerful Commission (Levi-Faur 2011: 814).

If the main actors in the EU, that means especially the EU member states and the Commission, want to extend regulation, they thus have various choices nowadays (Kelemen/Tarrant 2011: 923ff.): Conventionally, they can put regulation in the hands of the Commission. Like stated above, the Commission is the “traditional and most capable actor in the EU regulatory regime” (Levi-Faur 2011: 810). The Commission is an EU institution and therefore, it has lots of powers and a high level of independence. Consequently, if it is in charge of regulation, it can do so without major interference from member states.

On the other end of the continuum, regulation can be a matter of the National Regulation Authorities (NRAs) like it was in the days of the Groupe de Contacte. Back then, the NRAs were the only ones in charge of banking regulation. Today, NRAs can still be fully independent from EU law. Or, even if EU regulation exists, the Commission can leave complete implementation to the NRAs at one extreme (Coen/Thatcher 2008: 809). Here, the Commission has little to no control over regulation what often leads to disparities concerning the implementation level of EU regulation in different member states (Ottow 2014). In between these two extremes networks and agencies are located (Levi-Faur 2011: 812). Both are non-majoritarian institutions (Groenleer 2009: 18) and they are said to be administrative innovations, which can complement as well as compete with each other and with older established modes of regulatory governance (Levi-Faur 2011: 811). But networks and agencies mainly differ “in the extent and scope of the formalization of their decision rules, the extent of their administrative capacities and their internal hierarchies” (Levi-Faur 2011: 814).

### ***EU Regulatory Agencies: Formal Organizations with Narrow Boundaries***

EU agencies like the EBA or the Single Resolution Board are public authorities with a legal personality and a certain degree of organizational and financial autonomy. If agencies are created through treaty amendment they can make regulatory decisions outside of the

Commission. Mostly, they are established through secondary legislation. In that case, any recommendation of the agency is subject to the Commission's acceptance (Coen/Thatcher 2008: 814). In general, agencies possess narrow competences and a mandate which is limited to specific issues and technical, scientific or managerial tasks (Gehring 2012; Magnette 2005; Groenleer 2009). Nevertheless, they often have significant influence, because it is legally and politically hard for the Commission to ignore their advice (Kelemen/Tarrant 2011: 927).

Agencies are consequently operating on the supranational level. They regularly enjoy some degree of autonomy (Groenleer 2009). However, their degree of autonomy and formal-institutional independence varies. According to Groenleer (2009) an agency is autonomous if it can choose freely among different actions in order to complete its inflicted tasks. There are agencies which are highly autonomous, as well as agencies which are very dependent on member states or the Commission. And the autonomy of an agency can change over time, depending on its assertiveness. Usually, agencies are closer to the Commission than to national ministries (Rittberger/Wonka 2011: 785). But member states often try to keep control over them by ensuring a seat on their management boards (Rittberger/Wonka 2011: 745).

Not only the SRB was created lately. EU agencies remarkably grew in number over the past two decades and are now an increasingly common characteristic feature of the EU's institutional settings (Rittberger/Wonka 2010: 730). The first community agencies were already created in the 1970s. Back then, they were highly exceptional and very weak institutional constructs (Christensen/Nielsen 2010: 2). Eventually, lots of agencies were created at the beginning of the 1990s in order to support the Commission which was busy regulating the constantly growing EU policy fields (Groenleer 2006: 162). The second major wave of agency creation occurred from 2000 onwards (Rittberger/Wonka 2010). According to Busuioc, Groenleer and Trondal (2012) the pace of agencification has even more accelerated since the start of the financial crisis in 2008. This can be seen especially "in 2010 and 2011 with the advent of the new European Supervisory Authorities in the financial services area" (Busuioc, Groenleer and Trondal 2012: 3), amongst them the EBA. Today, around 40 EU agencies exist (EU 2014). They spend over one billion euros per year, employ around 4000 staff members, are geographically spread throughout the EU and thus they have become a pervasive characteristic of the EU (Busuioc/Groenleer/Trondal 2012: 3; Groenleer 2009: 15).

The EU agencies usually have similar organizational structures, comprising administrative or management boards, an executive director and at least one scientific or technical committee (Groenleer 2006: 166). Their formal independence, their budgetary

provisions, their mandates, objectives and tasks as well as the specific composition of their management boards can vary from one agency to the next (Groenleer 2009: 115ff.).

Agencies as regulatory authorities have several advantages: First of all, they often have a lot of human and financial resources to deeply engage in information and knowledge seeking and thereby they can help to expand the EU's capacity access to specialist knowledge (Christensen/Nielsen 2010: 21). Agencies can also involve various relevant actors in their framework and thus benefit from their expertise. Thereby, they can relieve the Commission from technical tasks so that the Commission with its generalist capacity can focus on political issues (Groenleer 2006: 4). Additionally, since EU agencies are said to be formally independent from member states and EU institutions, they are more transparent and it is easier to make a commitment credible if the task is delegated to an agency (Levi-Faur 2011: 814). A disadvantage of agencies is however the danger of agency slack. This means, an agency might tend to pursue its own goals and agendas instead of the interest of its paymasters (which are the member states or the Commission) (Groenleer 2009: 16f.). Another disadvantage might be that agencies are not fully independent of national governments or the Commission because they seek influence via decision making structures or management boards. Consequently, it is dubious whether an agency has real power and there is a danger of member states and/or the Commission blocking agency decisions (Christensen/Nielsen 2010: 21). The EBA and also the SRB are both EU agencies which operate in the banking sector. Why the SRB with the resolution fund was created and why it was made up as an agency instead of a network – as previously claimed by Germany – will be analyzed in the empirical part of this paper.

### ***EU Regulatory Networks: Loose Ties and Non-Binding Decisions***

Just like agencies, policy networks are perceived as a form of governance in modern political systems (Börzel 1998: 259). Over the years, not only agencies have been established in the EU. Often networks were created even before agencies were put in place (Levi-Faur 2011: 811). But also networks have not become really popular until the 1990s (Levi-Faur 2011).

Contrary to agencies, EU regulatory networks operate on the intergovernmental level. In the CEBS network the NRAS from the EU member states came together to talk about banking supervision. Ties between them were loose. Networks like the CEBS can thus be described as informal but stable relationships between essentially equal agents (Jordan/Schout 2006: 16). The actors within the network often share common interests with regard to a policy or they are even interdependent: They realize that they can achieve common goals better if they cooperate in the network (Börzel 1998: 254). In a network, the NRAs discuss important

issues, exchange information or agree on proceedings. Thus, networks are playing a crucial role in harmonizing EU regulation (Ottow 2014: 125). Since the NRAs meet within the framework of the network, there is of course some degree of institutionalization. Networks enjoy limited power and institutionalized modes of coordination as well as homogenous and defined membership (Coen/Thatcher 2008: 813). But they have flat organizational forms without hierarchies and are often self-organizing and self-steering (Jordan/Schout 2006: 17ff).

However, all decisions taken in the network are non-binding. That means, entrusting certain regulatory responsibilities to a network guarantees member states that they keep national autonomy on the topic (Kelemen/Tarrant 2011: 930). The Commission or other EU institutions have usually little or no say in networks. For their creation, not even an EU legislation process is needed. NRAs can establish a network themselves and the Commission can grant such networks an advisory role afterwards (Kelemen/Tarrant 2011: 927).

The big advantage of a network is its informality: It offers the NRAs the chance to communicate with and to learn from one another and develop a degree of trust (Jordan/Schout 2006: 359) without having to give up sovereign power over the issue. In turn that means that only if they NRAs are really willing to cooperate, networks can produce collective EU regulations. Networks are thus a softer mode of governance (Brown/Sott 2010) and can help to encounter a complex and dynamic environment, especially where hierarchical coordination is difficult (Börzel 1998: 263), because networks do not need a high degree of political commitment (Levi-Faur 2011: 814). Cooperation in a network can make NRAs aware that they are interdependent and that working together might help to achieve common goals.

Disadvantages of networks are however the lack of permanence and resources compared to agencies (Christensen/Nielsen 2010: 4). And if some NRAs block agreements in the network because of their own interests, no coherent regulation can be achieved (Börzel 1998: 263). Since agreements are not binding, the national NRAs might not adhere to them. This was one of the big problems of the CEBS: Even though it enabled some coordination of banking supervision, supervisory standards in EU member states kept varying to a big extent (McPhilemy 2014: 1480). This shows that there is a threat of regulatory networks achieving only weak regulation or failing to ensure implementation. Kelemen and Tarrant (2011: 925ff.) even suggest that networks hardly ever lead to the harmonization of regulatory rules.

Even though the CEBS network obviously did not achieve a broad harmonization of banking rules, Germany later supported a single resolution mechanism based on network structures when it came to the creation of the Banking Union. Why an agency was created anyway, will be the focus of discussion in the following chapters.

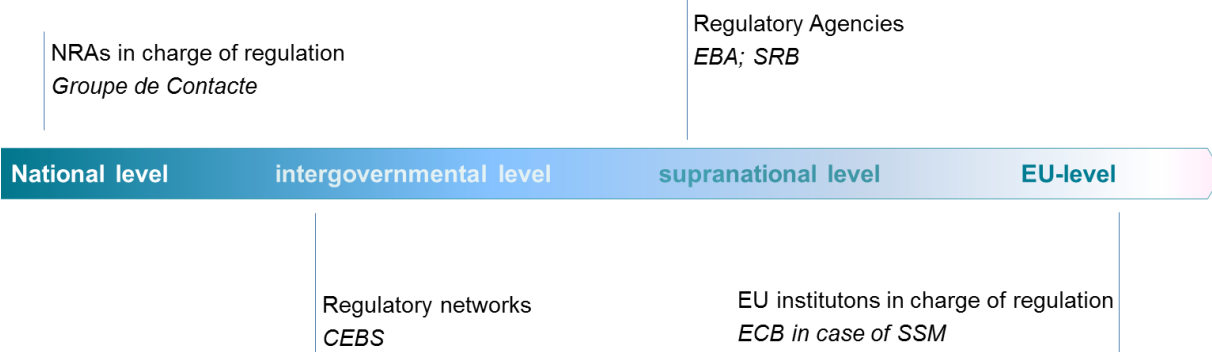
**Different Types of Regulatory Authorities: But Why?**

In summary, regulation can be put in the hands of one of the following authorities (see also continuum shown in *Figure 1*): (1) First, EU member states can regulate everything on their own in the domestic context by establishing national regulation authorities. (2) Second, there can be an intergovernmental approach to regulation, by NRAs meeting within EU networks to exchange information and take non-binding agreements. (3) Third, the member states can delegate authority to an independent EU agency on the supranational level (Egeberg/Trondal 2011). But the agency can also be subject to member states control. (4) As a fourth possibility, the member states can delegate regulatory tasks to one of the supranational EU institutions, for example to the Commission or to the ECB as was done in the case of the SSM.

It is necessary to be aware that there is not only one kind of agency or network. The exact design of agencies and networks can vary intensively. One agency may be very independent and very supranational, while another might be tightly controlled by member states and consequently has less supranational power. When the Commission and national policy-makers have a big influence on agencies, those might even appear closer to networks than to independent bodies (Thatcher 2011: 791). And while some networks are loose, others might be organized more rigidly and therefore they become more supranational in operation, too.

The question which keeps political scientists busy is why regulatory power is delegated to a supranational institution in one case, while in other instances the main actors can only agree on the creation of an agency or even just a loose regulatory network. Or in the context of the European Banking Union: Why was regulatory power for supervision delegated to the ECB while a new agency was created for resolution authority? And this even though some member states like Germany advocated for a resolution network! In the next section, theoretical political science approaches will be introduced which aim at explaining such outcomes.

**Figure 1: Types of Regulatory Authorities along the Continuum of the Integration Level (own illustration)**



## **4 Theoretical Approaches: Explaining Creation and Design of the Banking Union**

As shown above, EU decision-makers obviously had a variety of choices creating and designing the Banking Union. The two most prevalent accounts which try to explain why and how institutions originate are the functional approach and the political approach. These accounts, as well as alternative explanations shall be introduced in the following in order to illustrate possible reasons for the creation and design of the Banking Union.

### **4.1 The Demand Side: The Functional and Interest-Based Approach**

According to the functional approach, the Banking Union was created the way it is out of functional reasons: There was a strong necessity to standardize banking in the euro area because otherwise the financial and sovereign debt crisis would have torn the Eurozone apart. The ECB was charged with supervisory power, because only such a strong institution seemed powerful enough to enforce common supervision and an EU agency like the SRB was literally necessary to guarantee common resolution standards. Any other design, would not have been ‘as good’ in reaching the goal, namely establishing a common banking regime.

Looking at it from a more general point of view, the functional or interest-based approach builds on the necessity of an institution and on its practical advantages. One of the first ‘functionalists’ was Giandomenico Majone. He pioneered when he drew scholarly attention to the EU regulatory state in the 1990s. He described EU agencies as an important institutional phenomenon and classified them in realistic terms (Christensen/Nielson 2010: 3). According to Majone, EU agencies are developed if there is a gap between existing institutional capacities and current complex policy problems (Majone 1996: 1533). If this gap cannot be closed and thus the particular policy problem not tackled, agencies are needed which carry out the specific functions in demand. Regulatory authorities are thus established because they are the functionally adequate institutional solution (Majone 1997, Rittberger/Wonka 2010).

This functional and interest-based approach is therefore explaining the emergence of regulatory bodies by looking at the useful functions which they can provide. These functions may be: Helping the main actors to credibly commit themselves to a certain future behavior, shift blame for the implementation of unpopular policies, reducing transaction costs of decision making and policy implementation, facilitating EU-wide cooperation, or in general overcoming collective action problems (Egeberg/Martens/Trondal 2012: 29; Groenleer 2006:

163ff.; Groenleer 2009: 100ff.; Blauberger/Rittberger 2011: 4ff.; Thatcher 2002: 130f.; Rittberger/Wonka 2010: 736). Additionally, regulatory bodies can help to increase efficiency in knowledge-intensive policy fields by providing expertise, information and time resources (Groenleer 2009: 100ff.; Magnette 2005: 5f.).

One of the most important reasons for delegation is credible commitment. Advocates of the functional approach often refer to this problem when suggesting that a functional need leads to the creation of a regulatory authority (Majone 1997; Thatcher 2011; Christensen/Nielson 2010). Regularly, the EU member states have a hard time ensuring that they will commit themselves to a certain policy regulation. The underlying root of this problem is that policy makers are tempted to breach on the basic principles of regulation as soon as situational contingencies make it political advantageous to do so (Christensen/Nielson 2010: 7). By tying their own hands member states can solve this credible commitment issue. If they delegate regulatory competencies for example to an independent EU agency, they limit their possibilities for direct political interventions (Rittberger/Wonka 2010: 734). The states thereby confirm that they accept regulatory decisions even if these decisions run counter to their own interests (Christensen/Nielson 2010: 7). By delegating power to EU authorities, principals send a strong signal of regulatory stability (Rittberger/Wonka 2010: 734). Credible commitment could possibly have been an important argument for the creation of the SSM or SRM, because at the height of the crisis, member states were supposedly interested in sending such strong signals of regulatory stability in order to calm down financial markets.

The functional approach typically cares about the “demand side” (Rittberger/Wonka 2011: 782) of the creation of regulatory bodies: If there is a demand for a certain function, a regulatory body which can provide this function will be established as a result. Therefore this account is also referred to as ‘interest-based’ because these useful functions like credible commitment are beneficial to the main actors, the principals, and thus it is in their interest that the agent fulfills these functions. For example, it could have been in the interest of the EU member states to delegate banking supervision to the ECB because this reduced costs: Insufficient banking supervision in the past cost the Eurozone billions of euros because it aggravated the financial and sovereign debt crisis. The member states are interested in the ECB fulfilling its new role as supervisor if this promises to reduce costs for further failing banks and further crises in the future. According to the functional logic, a regulatory body like the ECB takes over special tasks for example for the EU member states and thus, the member states would no longer have to deal with those tasks by themselves and they would save costs and time (Blauberger/Rittberger 2014: 9f.).

This idea is based on a principal-agent (PA) model, which is the analytical expression of the functional logic (Egeberg/Martens/Trondal 2012: 29). In PA-theory, a principal delegates some of his powers to an agent, if this provides the principal with functional efficiency benefits (Thatcher 2002; Kassim/Menon 2011; Hawkins et al. 2006; Maher 2009). In the case of the Banking Union, the member states are the principals, since it is their supervision or resolution power which is delegated. The agents are the ECB and the SRB.

The functional approach indicates: The member states always delegate<sup>6</sup> regulatory tasks if it increases efficiency and saves costs. It is based on the assumption that all actors are rational in their decisions: When actors are faced with different possible courses of action, they first make a means-end calculation based on their current knowledge and assumptions (Jupille et al. 2003: 11f.). They choose the course of action which they think is most likely to have the best overall outcome for them (Jupille et al. 2003: 11f.). In the realm of the functional approach, rational is what increases efficiency and lowers costs. Conversely, principals will not delegate regulatory tasks, if the costs exceed the benefits<sup>7</sup> (Magnette 2005).

## **4.2 The Supply Side: The Political and Power-Based Approach**

The political and power-based approach is a rival to the functional account. It also offers an explanation for the creation and design of institutions like the Banking Union. In short, the political approach would assert that the Banking Union was created and designed because this was a crucial and core interest of at least some member states or EU institutions.

Advocates of the political approach, like Kelemen and Tarrant (2011), criticize that the functional argument is too much focused on the functions although the creation of regulatory bodies is often about politics, preferences of powerful decision-makers and power struggles between the main actors. The political reasoning is that only because actors know they want a regulatory body to fulfill certain functions, they do not know for which kind of regulatory body they should decide. For example, only because EU policy makers know that supervision is needed, they do not know whether to delegate it to a network, an agency or an institution.

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<sup>6</sup> Theoretically, principals can revoke the delegated regulatory authority from the agent, if they are not content with the actions and the behavior of the agent. However, in reality it can be difficult for the principal to enforce and to justify such a revocation of regulatory authority, especially when the regulatory body manages to establish itself in the EU system.

<sup>7</sup> Delegation decisions always come at certain costs since potential conflicts of interests and asymmetric information strain the relationship between principal and agent (Rittberger/Blauberger 2014: 4). Costs arise because the principal has to oversee the agent. Agents can develop behavior (shirking and slippage) which does not please their principals. Shirking indicates that the agent is minimizing its efforts to perform its tasks adequately, while slippage stands for the agent pursuing its private interests that are contrary to those of the principal (Rittberger/Blauberger 2014: 4).



Advocates of the political approach believe that the functional account cannot explain institutional choices (Kelemen/Tarrant 2011: 924; Rittberger/Blauberger 2014). If the functional logic was true, EU member states would always delegate regulatory tasks to the Commission which would be able to fulfill these tasks because it is independent of national interests and combines executive and statutory authority (Christensen/Nielson 2010: 7f.). So why do member states decide to delegate power to agencies or networks instead?

The political answer to this question is that regulatory authorities are created because they are the results of bargaining processes and power struggles between the most important EU actors. Whereas above regulatory authorities are seen as functional solutions dealing with a perceived need, the political approach considers regulatory authorities as political instruments through which member states and EU institutions act (Busuioac/Groenleer/Trondal 2012: 4). Therefore, this is also called a power-based approach: It is all about power distribution, preferences and about which actor is powerful enough to assert its own interests. Political explanations view the establishment of regulatory bodies as “driven by the motivations of the major players in EU regulatory politics to enhance their institutional power and secure influence over policy outcomes” (Rittberger/Blauberger 2014: 8).

Advocates of the political approach thus have an explicit explanation for why agencies are created instead of networks or why it is the other way round. The general idea is that the actor who has the most power resources and the best negotiating position has the most influence on the institutional design of a regulatory body that is supposed to be created. The political approach thus deals with the supply side of the creation of regulatory authorities: In order to understand design choices it is necessary to look at political power-based considerations and strategic interaction among the main actors (Rittberger/Wonka 2011: 782). The political approach explains the different institutional designs by looking at the preferences of the main actors and especially the will of the member states to keep their sovereignty over policy-outcomes. “Policy makers favor organizational and institutional designs guarding either their own long term influence on administrative decisions or the influence of stakeholders whose interests they want to protect” (Christensen/Nielson 2010: 9). Thus, the most powerful EU actor should have been able to highly influence the design of the Banking Union. Therefore, the political approach, too, is based on rational choice, with the difference that a decision in the power-based context is rational if it provides the actor with (more) power (Jupille et al. 2003: 11f.). The three most important actors in the EU are the Commission, the European Parliament (EP) and the member states. These three were also the crucial actors in the legislative process for the Banking Union. Their general preferences will be explained next.

### ***The Commission's Goal: Extending EU Regulatory Power***

The Commission always wants to increase supranational regulatory authority on the EU level and thus get the member states to consent to more integration. The first priority of the Commission thereby is to expand its own regulatory powers: It wants the member states to delegate regulatory power to itself. For example, the first legislative proposal of the Commission for the resolution mechanism intended to delegate final decision-making power to the Commission itself (Commission 2013b). However, resolution authority was delegated to the SRB as an agency eventually. According to the power-based idea, member states are often reluctant to strengthen the Commission because they fear that the EU institution becomes too powerful. Therefore, the second best solution for the Commission usually is to lobby for the creation of agencies on the EU level because they are supranational bodies. Agency creation can consequently increase the regulatory capacity of the EU without directly expanding the size or power of the Commission (Groenleer 2006: 164). But the Commission is often anxious to make sure that it is able to influence EU agencies by having many controls over them (Thatcher 2011: 790).

Generally, the Commission does hardly support the creation of networks because it has little influence on those and because they operate on the intergovernmental level. Naturally, it is also not in the Commission's interest, to leave regulatory responsibility completely with the NRAs because this often results in weak regulation or implementation. And sometimes the Commission even dismisses the support for agency creation out of fear of losing its extensive powers in a policy field (Groenleer 2009: 106f.). This shows clearly: When push comes to shove the Commission will always fight for keeping and extending its own powers. Only if the preservation or the extension of its own power is not possible, will the Commission advocate for the creation of an agency which it can at best control.

### ***The Member State's Goal: Staying in Power – Especially in Cases of Distributional Conflicts***

The preferences of EU member states are somewhat different to those of the Commission. They are in a difficult position: On the one hand they often want new regulation, but on the other hand they are very reluctant to delegate and thereby lose their power to the EU (Kelemen 2011: 4). In the realm of banking, member states wanted a Banking Union to prevent further crises but at the same time they had a hard time agreeing on giving up sovereign power over supervision and resolution.

Political advocates say that member states will always try to avoid extending the power of the Commission because therewith they lose influence over the regulatory task completely.

However, they are sometimes willing to delegate regulatory authority to agencies. The agency option is acceptable because by appointing representatives to the agencies' management boards member states can still have a lot of control on EU regulation (Kelemen 2011: 929ff.; Groenleer 2009: 105f.). But of course member states are also aware that EU agencies can be a threat to existing national regulatory authorities and regulation standards (Groenleer 2009: 105). Whenever the member states' governments are faced with a distributional conflict and unfavorable redistributive consequences in a particular policy field, they will "jealously guard their remaining autonomy in implementation" (Rittberger/Blauberger 2014: 8). Therefore, they will reject agency creation and only create a loose regulatory network (Kelemen/Tarrant 2011: 930). After all, in an intergovernmental network, they keep the final say in all concerns.

Distributional conflicts are conflicts about who gets what and how much. Usually, the "item to be distributed is tangible", e.g. "money, land, better houses, better schools" etc. (Burgess 2004). However, distributional conflicts only arise, when a good is scarce. "If there is plenty for everyone, then everyone takes what they need or want, and no conflict develops" (Burgess 2004). On the other hand, if resources are limited, every rational actor will try to gain the most or keep the most of the particular resource. Distributional conflicts are thus attributed by tangibility, scarcity and competition. One could speak of a distributional conflict in the Banking Union context if the distribution of the financial burden between member states was concerned (Koschyk et al. 2013: 8), for example, when member states had to negotiate who pays how much for a particular policy measure in supervision or resolution. The degree of a distributional conflict thereby affects the choice of design (Rittberger/Wonka 2011: 782).

### ***The European Parliament's Goal: Strengthening the EU Level***

Eventually, the political approach also highlights the European Parliament (EP) as one of the main actors when it comes to the creation of EU regulatory bodies. But the EP did not play a major role until the mid-1990s, after its powers had been increased through the Maastricht and Amsterdam Treaties (Groenleer 2009: 107). The EP is – similar to the Commission – interested in extending EU regulatory authority and integration in general (Kelemen/Tarrant 2011: 928ff.). However, it also wants to increase its own capacities and powers and therefore strives for surveillance competences over agencies, networks or even institutions (Kelemen/Tarrant 2011: 928ff.). Furthermore, the EP wants to increase transparent and accountable regulation authorities – also in order to increase its popularity amongst its EU electorate (Kelemen/Tarrant 2011: 928ff.).

### 4.3 Combining Functional and Political Explanations

In the political science literature on EU regulation there is a strong divide between the political and the functional approaches (Groenleer 2009: 100ff.). Usually both accounts are strictly separated and regulatory authority is explained functionally or politically. However, functional or power-based explanations should not be discarded as either incorrect or mutually exclusive (Rittberger/Blauberger 2014: 2ff.). Because gridlocked conflicts about theories tend to hinder theoretical dialogue and the exchange of ideas (Jupille et al. 2003: 16). Of course, the goal of research is to establish parsimonious theories. But this must not be to the detriment of the explanatory power. Jupille, Caporas and Checkel (2003: 16) therefore claim that less time should be spent on asserting the superiority of any preferred theory and more should be spent at a practical and operational level. And for the operational level, namely the research and valid explanation of the creation and design of the European Banking Union, it seems appropriate and helpful to combine the functional and political approach.

Rittberger and Blauberger (2014: 9ff.) state that it needs both approaches to adequately explain the emergence of regulatory bodies. They reason that explanatory leverage can be gained by combining both accounts (Rittberger/Blauberger 2014: 1). In their paper on EU regulation they focus on networks. However, the suggestion of this thesis is that it is beneficial to combine the functional and the political power-based approach no matter whether the regulatory authority lies with networks, agencies or institutions. This can increase the conceptual and explanatory added value of the research on the European Banking Union.

Other authors also support the assumption that explanatory power can profit from combining different theoretical perspectives: Groenleer indicates that in reality different reasons for agency creation “cannot be distinguished so clearly” as it is usually done by the functional or political camp (Groenleer 2009: 111). Likewise, Egeberg, Martens and Trondal (2013: 36) suggest that different reasons may “supplement” each other and jointly have influence on creation and design. And Amy Verdun (2015) points out, that complex problems often cannot be solved by only looking at them from a single theoretical angle.

In order to build bridges between two different theories (Jupille et al. 2003: 17ff.) and to healthily combine them so that they improve the ability to explain findings in the empirical world, it is necessary to determine “the respective turfs and home domains of each theory” (Jupille et al. 2003: 21). It is necessary to know exactly how the explanation of the particular theory works. Therefore, the functional and political approach, their scope conditions, and their relation to one another have been specified independently in the section above. The

challenge now is to integrate them in a larger picture, in an additive theory that provides more explanatory power for the case of the Banking Union than both theories would separately do (Jupille et al. 2003: 21). Therefore it is crucial to identify specific domains of application for both theories.

#### **4.3.1 Introducing a Combined Functional-Political Approach**

On the one hand, following Rittberger and Blauberger (2014), the domain of the functional approach is to explain the establishment of a certain kind of regulatory body. Functional accounts can provide us with insights into why and under what circumstances EU regulatory bodies are established in the first place (Rittberger/Blauberger 2014: 1). That is, the functional logic can show why an agency is created instead of a network or why an institution is established. It is able to do so, because institutions, agencies as well as networks all provide a specific functional advantage (Rittberger/Blauberger 2014: 10). EU actors choose that kind of regulatory authority that can best cope with the functional problems.

The domain of the political approach is on the other hand the specific design of these institutions, agencies or networks. If we look closely at regulatory bodies it is obvious that their inner structures vary. Networks can show loose network structures or a higher level of organizational rules (Rittberger/Blauberger 2014: 16). An agency can be very independent or the member states can have a high level of influence on it. As mentioned above, there is a continuum between the national level and the supranational level and along this continuum different kinds of networks and agencies are located. Some official agencies might actually even resemble networks or vice versa (Thatcher 2011). That means the institutional design is not mainly about NRAs, networks, agencies or institutions but about how these are designed on the inside, for example who has the most influence on decision making procedures or who controls the management boards. This particular inner design has a high influence on the daily work of the respective regulatory body: For example, a very independent agency will probably have more regulatory influence than an agency which is highly dependent and cannot make its own decisions.

This is where the political approach steps in: Even if the main EU actors make terms on creating a supervision or resolution mechanism in order to address a functional deficit in banking governance, they can still highly disagree about how to specifically implement mechanisms for supervision and resolution (Rittberger/Blauberger 2014: 16). This disagreement is due to political power-based reasons: there might be redistributive conflicts which make the member states want to stay in control, there might be power struggles

between the actors or disputes about how to efficiently solve certain problems (Rittberger/Blauberger 2014: 16). The higher the distributional conflict, the more will member state governments push for tight control mechanisms via management boards or the like. No matter whether they officially create a network, an agency or an institution, if there is a distributional conflict, they will try to keep the final say and power in regulatory issues as well as control over the regulatory body. Consequently, the political approach can help us identify the reasons for why a regulatory body like a network or an agency has a specific institutional design, like loose structures or a high level of independence.

Inspired by Rittberger and Blauberger (2014), the idea of not seeing the functional and political approach as competitive but rather as complementary is here used for the explanation of the European Banking Union. The combined functional and political approach displays explanatory power in two different domains, namely creation and design (Rittberger/Blauberger 2014: 20). Thus, it seems sensible to suggest the following two main assumptions based on this combined functional-political approach:

- (1) Initially, the SSM / SRM were **created** as an institution / agency because of **functional needs** in the realm of banking supervision / resolution.
- (2) The **particular design features** of the SSM and SRM (for example decision making procedures or control mechanisms) are the **result of political power-based interests** of the most important actors in the areas of supervision and resolution.

The causal chain thus consists of two parts: (1) functional reasons which led to the creation and (2) power-related reasons which led to specific design characteristics. To assess whether these assumptions are valid, it is necessary to examine whether the causal chain of the introduced combined functional-political approach is present in the empirical case of the Banking Union. This will be done by testing hypotheses which are derived from the combined approach. The first and functional assumption will be tested by the following hypothesis:

**Hypothesis 1 (H1):** If a regulatory, operational or capacity deficit in EU banking supervision and resolution was present before the SSM and SRM, this functional gap must have been the reason for EU policy makers to create the SSM and SRM with an institutional structure which is best suited to solve the particular functional problem.

The second and at the same time political power-based assumption shall be explored by applying the second hypothesis:

**Hypothesis 2 (H2):** If there was a distributional conflict in banking supervision and resolution and especially if this conflict burdened one or a few EU actors more than others, they will have tried to keep a high level of control over supervision and resolution.

These hypotheses will be tested by examining carefully the case of the Banking Union. If they are falsified, it weakens a combined functional-political approach, whereas, if they are confirmed, they could at least strengthen the combined approach by showing that it can explain the complex case of the Banking Union. For being able to transfer the theoretical assumptions onto the empirical context, and thereby being able to support or falsify these hypotheses, it is necessary to make the theories applicable in the next section by deducing observable implications.

#### **4.3.2 Making Theory Applicable: Observable Implications for the Combined Approach**

After elaborating the theories and respective hypotheses in detail, it is important to operationalize them. The goal is to find out whether the combined functional-political approach suggested in this paper can actually account for the creation and design of the Banking Union. This can only be tested, if it is defined what needs to be observed according to the combined approach in the empirical case to eventually confirm the hypotheses.

##### ***Functional Observations: Regulatory Deficits and Core Advantages of Regulatory Bodies***

At first, we would have to observe that the creation of the SSM and the SRM was due to functional reasons. Hypothesis H1 indicates that a functional reason for creation would be given, if a functional gap existed. For example, a regulatory deficit could account for such a gap: If regulatory supervision or resolution rules are missing, this can lead to upheavals in the banking sector of the Eurozone. After all, no or incomplete regulation would result in the authorities in charge not knowing how to supervise or wind up a bank. This in turn can aggravate the situation for the bank and possibly even the overall situation on EU financial markets due to contagious effects within the banking sector. It is furthermore not enough if supervision and resolution rules only exist on the national level because many banks in the euro area are big cross-border banks which operate on the EU level. Consequently, NRAs have to be aware of how to handle transnationally working banks. Additionally, a regulatory deficit would also be present if regulation existed but implementation of it was not efficient and thus failed because the member states had missed to establish a strong regulatory authority to ensure compliance. If regulation exists but member states do not comply a regulatory deficit emerges and this, too, can lead to problems with ailing or even collapsing banks. Summarizing, a regulatory deficit exists if crucial banking regulation is missing, if there is uncertainty about how to supervise or wind up banks or if an efficient regulatory authority is missing which is able to make sure that member states comply with the rules.

Such a regulatory deficit would eventually lead to the failing of banks or even to the aggravation of the banking sector's crisis.

Furthermore, a functional gap could be observed if there was an operational deficit. In this case, supervision and resolution rules would have existed while implementation had obviously failed. Implementation would have to fail because of insufficient or deficient regulatory standards which do not work out in practice. If implementation of banking rules failed, this also would have led to ailing banks and a worsening of the banking crisis.

Eventually a capacity deficit would represent a functional gap, too: Maybe the EU level was lacking the tools to tackle a specific banking governance problem. For example, on the national level as a countermeasure to quickly prevent the failure of a bank, governments, central banks or other lenders of last resort often directly recapitalize banks. However, this is hardly possible on the EU level since the ECB is officially not allowed to act as a lender of last resort. In summary, if policy makers simply lack the tools and thereby the capacity to guarantee proper banking governance and if this has negative impacts on supervision or resolution, a capacity deficit exists.

Of course, the functional gap must also have been the trigger for EU policy makers to take action and start discussions about the creation of the Banking Union. Therefore, it would be necessary to observe EU policy makers directly referring to banking governance deficits and using these deficits as arguments to advocate for the creation of the SSM or SRM.

Beyond that, hypothesis H1 also suggests that EU actors decide on an institutional set up which is best able to solve the particular functional problem. That means when policy makers decide to create the SSM within an institution like the ECB or within a new agency like the SRB, they do so out of particular functional advantages of such an institution or agency. That means: an institution would have to be best suited to solve the functional problem in supervision and an agency would have to provide advantages for banking resolution. As explained above, networks, agencies and institutions have different qualities. For example a network has the advantage of informality, an agency can guarantee a higher level of integration but at the same time the inclusion of various actors and an institution has more power to enforce rules or to exert pressure on the member states. Such functional advantages would have to be present in the argumentation of EU actors when deciding for the creation of the SSM and SRM. Or if we look at it the other way round: The reason for delegating regulatory authority to the ECB and the SRB must not be the result of political power struggles but of functional considerations. An overview of the observable implications for H1 can be found in *Figure 2* on the next page.



**Figure 2: Observable Implications for the Functional Part (H1) of the Causal Chain (own illustration)**

Functional parameters	What needs to be observed
<i>Functional gap in banking governance exists; it aggravates the banking crisis and causes costs</i>	<ul style="list-style-type: none"> <li>▪ <b>Regulatory deficit</b> leads to failing banks; common EU rules for supervision and resolution are missing and result in uncertainty; or there is a lack of a regulatory authority which creates rules and ensures their implementation</li> <li>▪ <b>Operational deficit</b> leads to failing banks; common implementation fails because of deficient and not implementable regulatory standards</li> <li>▪ <b>Capacity deficit</b> leads to failing banks; EU actors lack the capacity to guarantee proper supervision or resolution, they do not have the possibility to provide certain necessary functions (e.g. lender of last resort)</li> </ul>
<i>Functional gap triggers the SSM / SRM creation process</i>	<ul style="list-style-type: none"> <li>▪ EU actors <b>become aware of at least one functional deficit</b> and constantly refer to this gap when making suggestions for the SSM / SRM</li> <li>▪ EU policy makers offer the creation of the SSM / SRM as an solution to the specific <b>functional deficits</b></li> </ul>
<i>Regulatory authority (ECB / SRB) is chosen according to functional advantages to close the functional gap</i>	<ul style="list-style-type: none"> <li>▪ <b>ECB</b> is chosen as SSM institution because only an institution has enough power to (if necessary) enforce common supervision and ensure compliance with supervisory rules across member states</li> <li>▪ <b>SRB</b> is created as SRM agency because only an agency can guarantee a common level of resolution standards as well as the involvement of all relevant actors and their particular know-how on bank resolution</li> </ul>

### ***Political Observations: Distributional Conflicts and Asymmetrical Burdens***

After having researched the first hypothesis, the political and power-based hypothesis (H2) will be examined. H2 claims that if there was a distributional conflict in the areas of banking supervision and resolution, this would have led to fights between the EU actors about how to exactly implement the SSM and SRM. For the most part, a distributional conflict arises between different EU member states. This is because a distributional conflict is usually about who pays how much for a certain policy measure and about how things – for example financial aids for banks – are distributed among member states. Such a conflict could be observed in the case of the Banking Union if – after having agreed on creating the SSM and SRM in general – especially the member states were fighting over how to exactly organize supervision and resolution on an EU level. After all, every member state has the political preference to reduce costs for him by pushing for certain design proposals. An observation for H2 could for example be that member states argue about when to start the implementation at all, how many banks to include into EU supervision or resolution or how to distribute financial burdens (for example financial aid for banks) within the Banking Union.

According to H2, these disagreements become even worse, if it is not just a distributional conflict but an asymmetrical distributional conflict. That means it is not just about who pays

how much for example for failing banks, but that one or a few member states are burdened more than others. For example, they have higher adaption costs to the SSM or SRM because of special national features of their banking systems. Or they fear that they generally will have to pay more for a policy measure than others, for instance because they have a very stable banking sector and are not dependent on EU aid whereas other member states desperately need such financial support. Since it is about their costs, they will be highly reluctant to give up control over banking supervision or resolution. If they have to bear these costs, they at least will try to keep power over the SSM or SRM by wanting control rights, veto powers or quite generally a final say in supervision and resolution issues. By pushing through these political interests, they extensively influence the design of the SSM and SRM, inter alia by establishing specific decision making procedures or by determining what kind of actors get involved in EU level supervision and resolution. However, to confirm H2, it must not be observed that member states refuse to delegate supervision or resolution authority altogether. It rather means that they delegate authority to a regulatory body but at the same time they at any rate try to weaken these agents by applying tight control mechanisms via management boards or the like, by claiming veto powers or a final word in decision-making procedures. The observable implications of H2 are summarized below in *Figure 3*.

**Figure 3: Observable Implications for the Political Part (H2) of the Causal Chain** (own illustration)

Political parameters	What needs to be observed
<i>Distributional conflict exists</i>	<ul style="list-style-type: none"> <li>▪ <b>High costs</b> for member states to create Banking Union (e.g. adaption costs due to specific features of their national banking sectors)</li> <li>▪ Negotiations about <b>who pays how much</b> for SSM or SRM or in particular for failing banks or the wind up of such banks</li> <li>▪ <b>Giving up sovereign powers</b> and thereby losing control over national financial issues (e.g. funds for bank rescues)</li> </ul>
<i>Leads to disputes about exact implementation of supervision / resolution mechanisms</i>	<p>EU actors disagree about ...</p> <ul style="list-style-type: none"> <li>▪ <b>Decision-making</b> procedures and involvement of different actors in the SSM / SRM</li> <li>▪ <b>The Scope</b> of the SSM or SRM</li> <li>▪ <b>Veto powers</b> and <b>control mechanisms</b> of the SSM or SRM</li> </ul>
<i>Asymmetrical distributional conflicts makes the member states want to keep a high level of control over supervision / resolution</i>	<ul style="list-style-type: none"> <li>▪ <b>At least one member state is more burdened by the SSM or SRM</b> than the others or the member state at least fears to be more burdened in the future</li> <li>▪ <b>The asymmetrically burdened member states advocate for tight control mechanisms</b>, for example through management boards, decision-making procedures and veto rights</li> </ul>

## 4.4 The Institutional Idea: Alternative Explanatory Approaches

Besides the functional and political accounts which are mainly based on the rational choice of individual actors, two alternative approaches shall be discussed briefly. Those approaches mainly focus on institutions, their role in shaping integration outcomes and endogenized behavior. Since the 1980s, common theories of integration have been criticized for not taking into account the role of institutions in the integration process. Therefore, different theories were developed which stand for the “institutionalist turn” (Aspinwall/Schneider 2000: 2ff.). They share the basic premise that already existing institutions affect outcomes (Aspinwall/Schneider 2000: 3). In the following, two of these theories, namely the historical (HI) and sociological institutionalism (SI), shall be examined in more detail because both seem relevant for the case of the Banking Union. They accord institutions very independent roles by saying that institutions provide a political environment or a cultural context which influences human behavior and they suggest that sometimes contingent events are crucial for the creation of new institutions (Aspinwall/Schneider 2000: 6). This could be important for the assessment of the Banking Union since it was created in light of extraordinary events of the financial crisis and because at least partially EU banking bodies existed even before the Banking Union and this could have shaped the outcome.

### ***Historical Institutionalism: Critical Junctures and Path-Dependency***

Even if political explanations figure prominently within the institutional design literature nowadays, advocates of the historical-institutionalist approach are convinced that such power related aspects are not the key to explaining institutional design (Yesilkagit/Christensen 2009: 55ff.; Van Thiel 2004). Instead, it is necessary to focus on evolutionary change and historical aspects of institution building.

Especially crucial to historical institutionalists are previous versions of institutions as well as critical junctures. According to them, critical junctures are particular moments in history, where a “phase of institutional fluidity” (Kelemen/Capoccia 2007: 354) provokes new outcomes. These outcomes would not have been possible without some previous special event. Such events – the so-called critical junctures – can be seen as turning points (Soifer 2012: 1574). Generally, the period before a critical juncture can be characterized as highly path-dependent and politically stable. On the contrary, during the occurrence of a critical juncture extensive changes become possible (Kelemen/Capoccia 2007: 341f).

However, change alone makes no critical juncture since there of course can be other reasons for change than external shocks (Soifer 2012: 1590f.; Kelemen/Capoccia 2007: 348).

Therefore, historical institutionalists have developed a permissive condition and a productive condition which jointly determine a critical juncture. The core of the permissive condition is that the window of opportunity opens and change becomes possible, whereas the main aspect of the productive condition is that there is a high range of policy options available and that policy makers have a higher influence on the outcome and are more likely to trigger a path-dependent process (Soifer 2012: 1575ff.). Furthermore, a critical juncture can also be a catalyst meaning that it is actually required to set off a causal chain of action. In physical processes chain reactions are initiated by the decay of atomic nuclei and quite similarly some political event – a critical juncture – can be the cause which triggers a certain reaction and outcome in the political process (Lebow 2007: 109).

This could be of interest for the assessment of the case of the Banking Union. After all, the Banking Union was created in an environment with a multitude of fast-paced events due to the financial crisis. Maybe there was a critical juncture which actually triggered the creation of the SSM or SRM. Possibly the HI can complement the combined functional-political approach by offering an explanation for an issue which the combined approach misses to account for. In the case of the Banking Union, the following would have to be observed to state that a critical juncture was at work:

**Observable Implications for the Permissive Condition:**

- **Period of Stability:** No major policy changes took place in banking supervision or banking resolution prior to the creation of the SSM and SRM.
- **High Level of Uncertainty:** The event has to be rare and its outcome for banking regulation has to be unclear. This could be observed if policy makers were highly indecisive about how to solve a problem in the realm of banking supervision or resolution. At the same time the window of opportunity which is created thereby would have to be narrow so that policy makers would have to decide quickly on the SSM or SRM issues.

**Observable Implications for the Productive Condition:**

- **High Range of Policy Options:** The contingent event makes a high range of policy options for supervision and resolution available which would not be feasible in the usual political environment. Additionally, politicians do not have a specific political preference at the beginning.
- **High Influence of Decisions:** It is more likely than under usual conditions that the choices of policy makers will affect the outcome (for example that a new mechanism for supervision or resolution is created) and that this will even trigger a path-dependent process and thereby determining the future of EU banking regulation.

If there was a critical juncture before the SSM or SRM this would mean that it at least influenced the SSM's or SRM's creation by making change possible. Furthermore, a critical

juncture would also be a catalyst for the SSM or SRM if it could be confirmed that without the critical juncture, the SSM or SRM would not have been created at all.

Another aspect of historical institutionalism which should be kept in mind is the path-dependent evolution of institutions. Historical institutionalists suggest that regulatory bodies develop by previous institutions being reformed and remodeled due to trial-and-error insights (Coen/Thatcher 2008: 808; Gocaj/Menier 2013: 240). What they mean is that a new regulatory body always depends on what has happened before in the particular regulatory policy field. And if it is observed that an institution which already existed is not functioning properly it is often redesigned instead of abolished. HI thereby offers a dynamic explanation for how and why institutions evolve. For historical-institutionalist supporters it is crucial that institutions change in such path-dependent ways because present structures strongly constrain and shape new ones (Pierson 1994; Coen/Thatcher 2008). This possibly also adheres to the Banking Union: After all, especially the SSM was not created from a tabula rasa. The intergovernmental network CEBS got transformed into the EU level agency EBA and eventually, supervision was completely delegated to the EU institution of the ECB. Maybe this was because member states had triggered a path-dependency by deciding for the CEBS and/or the EBA and thus they were forced to implement a Banking Union. Path-dependency could be observed if the following had happened: Banking problems occurred in the Eurozone and therefore some kind of regulatory body was created. However problems emerged again. Consequently, policy makers have to keep in mind what they did before and derive thereof what to do next. They explicitly learned from previous mistakes or deficiencies. Consequently, they have to stick to a path-dependent way and build upon or rather improve their former institutional choice.

### ***The Sociological Institutionalism: Isomorphism and Mimicry***

While for SI institutions are just as important as for the HI, it mainly draws on institutional isomorphism and mimicry. According to DiMaggio and Powell (1983) isomorphism is a constraining process. This process forces that one institution resembles other institutions that face the same kind of environmental conditions (DiMaggio/Powell 1983: 149). That means, if agencies are the typical tool used in banking regulation across the EU, a newly created banking regulation institution would also be an agency or would become an agency over time. According to this idea, an agency is created on the EU level because agencies are already in operation for example on the national level and policy makers have certainty as to how they work and how they will affect their interests (Yesilkagit/Christensen 2009: 71). A specific

form of institutional design has become seen as legitimate in the EU and consequently a new regulatory body is created which shows this institutional design. Here, culture plays a crucial role: “It contains the bedrock cognitive similarities that cause people to share perceptions of the world around them” (Aspinwall/Schneider 2000: 8) and shapes the idea of what kind of institution is legitimate or adequate in a specific context. However, this also means that organizations might be created due to legitimacy or normative considerations rather than efficiency outputs (Finnemore/Barnett 1999: 703).

Egeberg, Martens and Trondal (2012) as well as Groenleer (2009) suggest that especially the creation of agencies is actually a trend in public policy, a fashionable idea within the realms of the so called new public management. In a lot of Western EU countries agencies have developed over the last few years. As a consequence, they became seen as legitimate and actors also started to create them on EU level – they mimicked the national agencies. The fact that EU agencies popped up within a fairly short period of time in the 1990s and post-2000s illustrates the strength of fashionable ideas about legitimate and efficient government (Egeberg/Martens/Trondal 2012): Before the 1990s, other forms of governance were more popular, but this trend shifted and thus when agencies became popular and were seen as a successful governance tool, a lot of them were created within the EU.

At first sight, this approach does not seem appropriate for explaining the creation and design of the European Banking Union since the Banking Union consists of two pillars with different designs. If the reason for design had been that agencies were fashionable, it would be only logical to assume that the whole Banking Union was designed as an agency. However, this is not the case, since at least one part of regulatory authority has been delegated to the ECB – which is not an agency. It thus seems like the sociological cultural argument cannot apply for the creation and design of the Banking Union.

However, when researching a case like the Banking Union, it is crucial to also control for other possibly explanatory variables. Especially DiMaggios and Powells (1983) mimetic isomorphism should be kept in mind: They state that when the environment creates symbolic uncertainty, organizations are likely to imitate other successful organizations (DiMaggio/Powell 1983: 151f.). If it is observed in the case of the Banking Union, that environmental uncertainty due to the Eurozone crisis led to the Banking Union being built upon the example of other successful – maybe national – regulatory bodies, the SI approach could nevertheless offer some explanatory value.

## **5 Methodological Approach and Research Design for the Case of the Banking Union**

The topic in question is: Why was the European Banking Union established in the first place and why was it designed with its particular institutional settings for supervision and resolution? To answer this research question, a process analysis shall be carried out in form of a case study about the Banking Union (Gerring 2006: 21). The population of cases would of course consist of all current developments in banking regulation. However, the aim of this paper is not to generalize when or why certain regulatory bodies are established. It rather wants to explain why it happened in this particular way in the special case of the Banking Union.

The European Banking Union is the most important EU agreement on integration since the Maastricht Treaty (Schäfer 2015: 1) and the adoption of it can be seen as the most “significant leap forward since 1999” (Howarth/Quaglia 2013: 120). Therefore, it is essential to understand how and why it was created by the main actors of the EU. The Banking Union is an important case since it is the most recent and extensive reform of banking regulation in the EU. It is a great step towards more integration in the banking sector and it occurred even though some political scientists were convinced that the Euro crisis would hinder further developments in integration (Moravcsik 2012).

### ***Process Tracing: Piecing Together the Causal Mechanism like a Detective***

To conduct the case study, process-tracing is used in this paper. By using process tracing, it should be retraced step by step why the SSM and SRM were established and why the main actors decided on the particular institutional designs. The strength of process tracing is not only to explain how an independent (X) and a dependent variable (Y) are connected, but how exactly X led to Y. These so called causal mechanisms which show why something happened are “defined as a complex system, which produces an outcome by the interaction of a number of parts” (Beach/Pederson 2013: 1). Therefore, process tracing and the uncovering of causal mechanism is especially important in a case which is marked by complexity and multiple interaction effects (Hancké 2009; Beach/Pederson 2013; George/Bennett 2005), where a certain outcome cannot easily be traced back to one single factor. To understand such complex connections it is therefore necessary “to go beyond merely identifying correlations between independent variables (Xs) and outcomes (Ys)” (Beach/Pedersen 2013: 1). Only process tracing can open the black box of causality and make us understand, why something

happens (Collier 2011) – or in this case why the Banking Union was created and accordingly designed.

Especially when researching the case of the Banking Union, these strengths of process tracing are especially important. The case of the Banking Union is very complex: First, because it occurred in a difficult and highly interrelated environment, namely the financial crisis. At the peak of the financial crisis one incident caused the next in no time. Several EU member states suffered severely from the financial crisis. These states had started to support their ailing banking sectors with billions of public money. This drove national debt records to new highs (Berschens 2013a). Thus, a vicious circle between the liquidity problems of banks and increasing state indebtedness was created and consequently, the financial crisis is characterized by a high level of complexity. Therefore, it is necessary to look closely at the context of the financial and Euro crisis. Second, the case is characterized by complexity, because already before the implementation of the Banking Union, a complex structure of EU banking regulation emerged (for example the CEBS and the EBA). Thus, the predecessors of the Banking Union have to be included in the analysis. And third, the Banking Union itself is a highly differentiated construct with two pillars which vary in institutional structures and designs. These differences shall be examined carefully and it shall be understood why they were developed. The advantage of process tracing is that it offers the possibility of an in-depth study of the Banking Union taking into account all these diverse aspects and to trace the outcome back on specific sufficient and necessary conditions. Thus, the internal validity is high, which is an advantage in order to make reliable statements. Applying process tracing to the Banking Union resembles the practice of a detective trying to find out who was responsible for a crime: It is necessary to look at cues and suspects and to piece together a persuasive explanation (Brady/Collier/Seawright 2010: 165ff.).

The method of this paper can be summarized under the term of theory-testing process-tracing. From the functional and political theories and previous political science literature on the creation of regulatory authorities, the hypotheses are deduced. The hypotheses generally suggest that functional reasons account for the creation of the Banking Union, while political reasons were the cause for its design. Therefore, a combined functional-political approach is needed in order to explain the establishment of the Banking Union. The goal is to test whether evidence shows that each part of this hypothesized causal mechanism – consisting of a functional (H1) and a political part (H2) – is present (Beach/Pederson 2013: 3) in the case of the Banking Union.



However, when examining the empirical case of the Banking Union, it is necessary not only to look whether the suggested hypotheses are true, but also to control for other variables (Jupille et al. 2003: 20). Therefore, alternative explanations were stated above and when researching the empirical case of the Banking Union it will be observed whether any of the assumptions of these alternative explanations might provide an explanatory value.

To execute process tracing and thus to examine whether the assumptions of the combined functional-political approach are valid, it is necessary to look at different observable data points in time, so called causal process observations (CPOs). These empirical observations give us information about the case and make the identification of causal inference possible. To correctly analyze the CPOs, observable implications are necessary. Observable implications are empirical evidence which has to be present in the specific case to indicate that a particular causal mechanism is at work. The observable implications need to be deduced from the different theories: While the theories present abstract information about their causal chain, observable implications give concrete examples of what should be observed in the empirical case if the assumptions of the theory are right.

#### ***Relevant Sources: How to Retrace the Process that led to the Banking Union***

The observable implications for the combined functional-political approach were already presented above in *Chapter 4.3*. In the next chapter, the empirical case of the Banking Union is examined carefully in order to assess whether these observable implications actually were present. But how is the information about the Banking Union obtained? To find out why and how the Banking Union was created, it is necessary to analyze the positions of the most important actors. Amongst them are the following EU institutions: the Commission and the European Parliament, because they were involved in the legislative process of the Banking Union's establishment and the ECB as the maybe most crucial actor in combatting the Eurozone crisis and as new banking supervisor under the SSM. The positions of these actors can best be detected by examining official documents like position papers of these institutions, their press releases and statements on the Banking Union as well as speeches of the institutions' presidents and representatives. Additionally, another important EU institution for this case is the Council as a representative of the preferences of the member states. Therefore, position papers and statements of the Council should also be assessed.

To learn more about the member states' requests, it is helpful to look at two countries in detail, namely at Germany and France. During the financial crisis, a North-South divide of the EU member states emerged. The main representatives of the resulting two camps were

Germany and France: While Germany and some Northern EU countries stood up for slow but sustainable changes in banking governance, the France-led group of countries, including southern states like Spain or Italy, often advocated for a quick and strong implementation of banking solutions (Skuodis 2015: 8ff.). The opinions of Germany and France on the SSM as well as on the SRM varied a lot before member states finally reached an agreement. Consequently, positions of these countries should be examined in particular. Suitable for this purpose are speeches, statements and press releases from the heads of government and the respective ministers of finance.

However to generally prevent bias, mainly such statements should be analyzed which are not directly linked to the Banking Union outcomes. After a political decision is taken, policy makers of the EU and of member states usually want to present themselves in a good light and therefore try to convince the public that the negotiation result is exactly what they had intended. This could lead to heads of governments stating that they wanted the SSM – even though they had different intentions in the first place. Believing such statements without at least questioning them critically increases the threat of bias. Thus it seems favorable to rely on statements which policy makers made *before* entering in important negotiations or before taking crucial decisions on the SSM and SRM.

Besides gathering evidence of the positions of these main actors, the preferences of other stakeholders in EU banking governance should be determined. Amongst them are mainly national regulatory banking agencies as well as national banks and banking associations. They might have had a genuine interest in either the creation of the SSM / SRM or in preventing this creation since it has direct influence on their daily business. Therefore, they might have at least tried to lobby for their purposes and convince their governments of specific viewpoints. Since Germany and France are representing the attitude of different Eurozone wings, since they are the two biggest and most important economies in the EU and due to the length of this paper, mainly German and French banking stakeholders are analyzed. Here too, it is necessary to look at position papers, speeches or press releases.

To gain additional information on all these actors as well as the ongoing financial and Eurozone crisis, reliable media sources are examined carefully. The focus is again on media from Germany and France. However, also international media – especially economic and finance media – are studied. Renowned economic magazines like “The Economist” or “The Financial Times” can help to increase the understanding of the context of the financial crisis. Furthermore, of course also political science literature concerning the crisis as well as EU banking governance is consulted.

## **6 The European Banking Union**

In March 2013, the Vice-President of the ECB, Vítor Constâncio, tried to explain the importance of Banking Union and said the following in a speech with the title “The Nature and Significance of Banking Union”:

“As Victor Hugo once remarked, ‘you can resist an invading army; you cannot resist an idea whose time is come’. I believe that Banking Union is just such an idea. But it now depends on us – as policymakers [...] – how it is turned into reality” (Constâncio 2013b).

Hereafter, exactly these aspects shall be assessed in detail: First it will be examined if the time for the idea of the Banking Union has come due to a functional necessity and the need for common supervision and resolution. Second, it will be revealed to what extent the political interests and power-based preferences of the main EU policy makers influenced and shaped the design of the SSM and SRM.

### **6.1 The Single Supervisory Mechanism: Delegating Power to the ECB**

On 4<sup>th</sup> November 2014, the ECB took over its role as EU banking supervisor (ECB 2014b). The ECB, being an EU institution, is responsible for the effective and consistent functioning of the SSM and thus conducts supervisory reviews and investigations, grants or withdraws bank licenses, assesses banks’ acquisitions, ensures compliance with EU prudential rules and sets capital requirements in order to counter financial risks (SSM 2015b). Today, the ECB supervises 123 banks directly which hold approximately 82% of banking assets in the euro area (SSM 2015b). For smaller banks, the NRAs are responsible, even though the ECB can step in if necessary. The member states which participate in the Eurozone are automatically participating in the SSM, whereas other member states can join voluntarily. Supervisory decisions are usually taken in the ECB’s Supervisory Board but the ECB Governing Council nevertheless has the final say. Why this SSM was created within the ECB’s institutional framework and who influenced its particular design, shall be assessed in the following. An overview of the SSM’s basic mode of operation can be found in *Figure 5* on page 65.

#### **6.1.1 Functional Reasons for Creation: From a Regulatory Gap to Strong Supervision**

In June 2012, the Commission first suggested to implement a common supervisory mechanism for European banks. Prior to this proposal, the crisis in the euro area had dramatically worsened. The ECB stated in its Financial Integration Report 2012 that financial

integration in the EU had slowed down significantly. Especially since 2011, the steadily intensifying financial and sovereign bond crisis resulted in a deterioration of the integration of the banking markets (ECB 2012).

As early as May 2012, a member of the Executive Board of the ECB prodded to several gaps or rather problems the EU had to face in the realm of banking governance. While he did not yet refer to the creation of a supervisory mechanism, he pointed out deficits in banking regulation, the lack of a “financial union” and the absence of a strong regulatory institution (González-Páramo 2012). First, it shall now be assessed whether there were functional gaps which aggravated the banking crisis.

### ***Lacking a Strong Supervisory Authority: Home Bias, Non-Compliance and other Failures***

A regulatory deficit could be confirmed if necessary common EU rules for supervision or an efficient regulatory supervisory body were missing and this lack consequently led to the failing of banks. At first it seems as if such a regulatory gap was unlikely, because already in 2011 the EBA was created in order to establish a common set of banking rules called the Single Rulebook. The idea of this Single Rulebook was to close regulatory loopholes and guarantee an EU-wide single set of harmonized prudential rules (EBA 2015). The EBA, being an EU agency, was not equipped with particular intervention rights. It had little authority for direct action and had to collaborate closely with national banking authorities (Elliott 2012: 8). Nevertheless, the EBA did set a range of new standards for EU banking regulation which was its main duty. Thus, banking rules as well as an institution were actually present.

However, even if the EBA provided banking regulation, it did not provide the member states with adequate rules on how to solve problems occurring at banks which operate in several countries at the same time. In June 2012, one and a half years after the EBA entered into operation, the Commission warned that “the question of how to deal with cross-border banks” was still not settled (Commission 2012b: 1). Also the ECB criticized that clear regulation was missing for cross-border banks what in turn resulted in coordination problems amongst NRAs (González-Páramo 2012). And if such coordination problems or disagreements between NRAs occurred, it would have been the genuine task of the EBA to mediate between them and take decisions. According to its constituent document, the EBA had a “legally binding mediation role to resolve disputes between competent authorities” (EU Regulation No 1093/2010, Art. 21 (3)). Furthermore, the EBA could even take supervisory decisions “directly applicable to the institution concerned” in emergencies (EU Regulation No 1093/2010, Art. 21 (3)). However, the European Court of Auditors determined later that the

EBA had failed at resolving several disputes between NRAs (European Court of Auditors 2014). The Council already concluded in 2012 in its interim report that effective crisis management was hindered by a weak institution like the EBA which only focused on coordinating functions (Council 2012a). This obviously shows that the EBA did not manage to put effective cross-border bank regulation into practice. Consequently, important supervisory regulation and key decisions on transnational disputes were missing.

However, the EBA also failed at other tasks. Even though the case of the Belgian-French bank Dexia mainly occurred before the EBA was created, the EBA had its own troubles with Dexia later on. Since French and Belgian supervisors did not manage to coordinate their actions, the big cross-border bank Dexia had to be saved by the two states granting money amounting to several billions (SPON 2008). In 2012 however, Dexia was again in desperate need of guarantees amounting up to 90 billion euros and had to be saved by governments once again (Handelsblatt 2012a). That happened despite the fact that the newly created EBA had recently completed a stress test of banks and had suggested in 2011 that Dexia was “one of the safer banks in Europe” (European Court of Auditors 2014: 30). Likewise, the EBA stress test did not foresee the banking crisis in Spain. In 2012, Spain had to request financial aid from the EU for its ailing banking sector. Over the last few years, bad investments of Spanish banks resulted in a housing bubble. Only six months after the stress test which did not indicate any kind of danger or crisis in Spain, the Spanish housing bubble burst in 2012 and especially small banks which had dealt in housing loans got into financial distress (Merkel 2012a).

Consequently, in the course of the first half of 2012, the situation in the EU seemed to spiral out of control once more. Besides constant problems with a highly indebted Greece, Spain was the first of the big European economies in danger of bankruptcy and collapse (Deutsche Welle 2012). The investigations of financial market experts quickly indicated that one of the major problems in Spain had been its banking supervision (van Roosebeeke 2012). For too long, the national banking authorities had known that Spanish banks invested in dubious financial products. The NRAs exercised forbearance because they feared that an intervention might give rise to a national credit crunch (ESRB 2012). However, this behavior only made things worse when the bubble finally burst.

This kind of non-compliance is often called “home bias”, meaning that national supervisors like in Spain turned a blind eye to the risky behaviors of their national banks. A lot of member states were reluctant to reveal weak banks to the public because they were scared to put their whole banking sector at a disadvantage compared with other euro area countries (Véron 2014). According to Jörg Asmussen, the German member of the Executive

Board of the ECB, the underlying problem is a genuine conflict of interests: National supervisory authorities are supposed to make sure that the European financial market functions properly. But at the same time they are accountable to national taxpayers and are thus likely to put the interests of their own taxpayers above the smooth functioning of the European financial market (Asmussen 2012a). The ESRB noticed this forbearance behavior early on and therefore already called in 2012 for the establishment of a strong and powerful European body which can offer a higher standard of banking supervision (ESRB 2012).

In the forerun of the crisis, the NRAs of several EU member states did either not comply with EU regulation or had been overly tolerant with the behavior of their national banks. Eventually, several EU banks failed. Only between 2008 and the end of 2011 governments had to help financial institutions across the EU with 4.5 trillion euros of state aid measures – that is the amount of 37% of the EU's common GDP (Commission 2012b).

Undoubtedly, this regulatory deficit, namely the non-existence of a strong regulatory body, made it possible for national banking authorities to pursue their own interests and implement banking regulation insufficiently (Praet 2012; McPhilemy 2014). Even though member states were supposed to adhere to the same EU regulation, they engaged in regulatory competition to attract business (González-Páramo 2012). Because of that compliance became fragmented along national borders (González-Páramo 2012). In 2012 a report of the renowned German CES Ifo Institute (Center for Economic Studies) indicated that countries wanting to strengthen their financial location deliberately allowed loopholes in banking regulation to gain business (Burghoff 2012: 3). This was a promising attempt as long as other EU member states were complying with the stricter EU rules. Since the member states did not have to fear any enforcement measures taken by the EBA nor any powerful stress tests, they engaged in this kind of behavior which endangered the financial stability of the euro area.

Consequently, the regulatory gap consisted of a lack of banking rules on cross-border banks and especially a weak agency which was not able to control the NRAs. This in turn led to cooperation problems amongst NRAs, implementation deficits as well as the trend of NRAs favoring their home country banks. Together, these developments entailed two major problems: First, it worsened the crisis and fueled the vicious circle since aid measures for banks were delayed due to concealments: The Commission President, José Manuel Barroso claimed that the link between failing banks, bail-outs with public money and thus highly indebted states was the main reason for the aggravation of the crisis and had severe effects on the real economy (Barroso 2012). And second, these developments led to a credibility crisis. For quite some time governments managed to save banks by granting public money.

However, this caused them to get highly indebted and thus credibility for both, banks and states, declined rapidly. The sovereign-debt crisis was born. In 2012, this lack of credibility had increased to the extent that investors started to bet against the euro (Deutsche Welle 2012). This made it difficult for single member states to bail-out their banks.

All of this shows that the regulatory deficit was rather huge, caused a whole lot of costs and severe problems in the EU banking sector that deepened the crisis. An operational deficit, on the other hand, cannot be explicitly found in the case of banking supervision. Of course implementation failed, but this was not due to misguided regulation which was not feasible. The reason for failed implementation was the lack of a strong EU level regulatory authority for efficient monitoring and enforcement of common regulation on banking supervision.

Eventually, there was also a certain kind of capacity deficit in the EU: A lender of last resort was missing in EU banking governance. There was no capacity to directly provide money to failing euro area banks. Usually, countries with independent monetary systems can use several policy measures to react to financial crises. Like many other central banks the ECB claims that it is no lender of last resort. This is quite sensible because otherwise it would create moral hazard by providing banks with a guarantee to bail them out when in trouble. However, for central banks in countries with own currencies the following applies: “It is understood, that the central bank would step in if a serious bank crisis were to occur” (Wyplosz 2012: 20).

For the ECB however, this is difficult. First, the ECB has limited real-time knowledge of the situations of single banks in the euro area (especially because NRAs tend to disguise trouble) and second, the ECB could suffer losses which consequently would have to be borne by taxpayers from all member states (Wyplosz 2012: 20; Beck 2012: 12ff.). However, this kind of mutualisation of debts is not intended in the euro area to date. According to Howarth and Quaglia in the euro area the “effective absence of the lender of last resort function at the national level, and its legal elimination at the supranational level created greater potential for financial instability” (Howarth/Quaglia 2014: 126). And this lack of capacity has a lot to do with banking supervision. After all, if the euro area provided a common financial backstop, it would be only logical that it also controlled what the banks do with the money. However, before the SSM no strong banking supervision existed, the ECB had no extensive insights into the banks’ balance sheets and thus the ECB was neither able nor willing to play the role of a lender of last resort.

### ***Stop the “Procrastination of EU Banking Problems”: Policy Makers Call for a SSM***

The capacity and regulatory deficits, which obviously constitute functional gaps, were both present before the SSM first got mentioned in May 2012. Following the functional logic, these gaps should be the trigger of the SSM. Thus, the direct consequence of these gaps should be that the EU policy makers started to take action on banking supervision. This could be best shown by the policy makers directly referring to the underlying functional problems and at the same time pointing at the possible solution, a mechanism for supervision.

The discussion about a possible banking supervision picked up speed in June 2012. Before a first initial decision was taken at the Euro Area Summit on 29<sup>th</sup> of June, several actors already talked about the topic. On May 30<sup>th</sup> 2012, the Commission insisted in its communication on “Action for Stability, Growth and Jobs” that banks should be obliged to show their full extent of indebtedness and that it is necessary to regain confidence in the financial stability of the Eurozone (Commission 2012c: 2ff.). It thereby indicated that it would be a sensible idea to move towards an “integrated financial supervision” (Commission 2012c: 5). A few days later, the Commission stated that in the future a banking authority would need the power to assess the banking situation in a country early on – before a severe crisis occurred (Commission 2012b: 1f.). This could guarantee a reaction to banking problems at an early stage. Tackling a banking crisis in time is a highly functional consideration: When Caprio and Klingebiel (1996; 1997) examined data on bank insolvencies from the late 1970s to the 1990s; they came to the conclusion that banking problems should always be addressed as early as possible because a delay usually results in an even more serious crisis.

On the 26<sup>th</sup> of June, the Commission President Barroso gave a speech about how to move Europe forward. There he called for the creation of an EU banking supervision due to the current heightened tensions and the problems the euro area had to face over the recent months. He criticized the insufficient supervisory coordination in the euro area and indicated that the vicious circle could only be broken if banks were efficiently supervised (Barroso 2012: 3). Barroso also stated that integrated financial supervision would be incredibly helpful to foster stability and confidence in the EU (Commission 2012b).

The Council President Herman van Rompuy also took a stand on banking supervision as early as May. In a report on the future of the European Economic and Monetary Union, van Rompuy complained about the shortcomings of banking regulation and stressed how important it was to ensure compliance (van Rompuy 2012: 2ff.). Thereby he obviously hinted at the random implementation of banking rules in the member states as well as the lack of assertiveness of the EBA.



The member states soon started lobbying, too – all particularly in favor of some kind of supervisory mechanism. The French President François Hollande emphasized in a statement on 28<sup>th</sup> of June the importance of quickly setting up a common supervisory solution in order to restore credibility (Capital France 2012). And Chancellor Angela Merkel criticized frankly in a government declaration which actually concerned the G20 meeting in Cabos on 18<sup>th</sup> of June that in the past, national banking regulators as well as the EBA had failed at executing tasks that were crucial to ensure a stable financial market (Merkel 2012b). Therefore, Merkel called for a common EU banking supervision. According to her, an independent and actually efficient banking mechanism was necessary to prevent the on-going procrastination with respect to the addressing of banking problems in EU member states (Merkel 2012b). She even already indicated that she would welcome delegating banking supervision to the ECB due to the ECB's power and independence (Merkel 2012b). She repeated the same demand at a German business meeting on 15<sup>th</sup> June 2012 (Merkel 2012a).

Before the Euro Area Summit, all these main policy actors seemed to agree that especially the regulatory deficit was a huge problem and they obviously had a common goal: the establishment of an integrated banking supervision. The media also observed their common intentions: The German public news programme *Tagesschau* for example reported that the actors' ideas of the creation of a single supervisory mechanism were very similar and corresponding even though the details were yet to be discussed (Jakubowski 2012). Furthermore, the press picked up on the main functional problems due to which a banking supervision seemed necessary: Journalists especially said that fostering confidence was necessary to calm down the financial markets but that this goal could only be reached if common implementation of banking rules was ensured in the future and thus home bias was stopped (Gammelín 2012; Die Zeit 2012c; Weiland 2012; Volkery 2012; Botín 2012, The Guardian 2012; Wirtschaftswoche 2012b). Likewise, all EU policy actors made it very clear that to solve the credibility problem they only saw one solution: They had to get rid of failed implementation and home bias by establishing a strong oversight. The ECB's executive board member Benoît Cœuré emphasized at the beginning of June that in order to contain the crisis it was necessary to map out a credible path towards a stronger Europe and strict compliance with common banking rules was essential to that end (Cœuré 2012).

Eventually on the Council meeting on 29<sup>th</sup> June 2012, the heads of the euro area declared that it was essential for the future of the euro to revive growth and stability. They called on the Commission to present proposals for a single supervisory mechanism involving the ECB (Council 2012b). By that, they firstly aimed at advancing the creation of the Single Rulebook

in order to ensure common EU banking regulation in all member states (Council 2012b) – thereby referring to the regulatory gap which especially occurred in the realm of cross-border banking. Second, they intended to restructure the banking sector and to guarantee implementation by strengthening EU level supervision. Consequently, they wanted to resolve the problem of the absence of a powerful supervisory body, thereby break the vicious circle and create credibility on the EU financial markets (Euro Area Summit 2012; Council 2012b). This addressed the regulatory deficits that occurred during the last months of the crisis.

Additionally, they decided to link a potential supervisory mechanism to the possibility of directly recapitalizing banks through the European Stabilization Mechanism (ESM) as a permanent successor of the temporary European Financial Stability Facility (EFSF) (Euro Area Summit 2012). Today the intergovernmental ESM is the permanent crisis resolution mechanism of the euro area and it can grant financial assistance to its member states. It was established by the Council in autumn 2012. However, already in June 2012 the idea which the ESM was based on was extraordinary: The council planned to use the ESM to directly recapitalize financial institutions. In that case, the ESM will be an instrument of last resort and come into action when other financial resources<sup>8</sup> are insufficient to return an institution to viability (ESM 2015). However from the beginning, policy makers made the creation of such a lender of last resort ESM conditional upon the introduction of an EU level supervisory mechanism for banks (Euro Area Summit 2012). The heads of the euro area thereby wanted to face the capacity deficit of no available lender of last resort. They argued that they could only accept the ESM as a lender of last resort if the euro area, namely the ECB, had full access to the bank's balance sheets as well as control over their behavior (Council 2012b). Even though the ESM was a key demand of Spain which hoped to be able to help its ailing banking sector with ESM money (Tagesschau 2012; Die Zeit 2012a), the main reasons for a SSM-ESM linkage were functional. Since Spain's suffering financial sector was also dragging the national budget down, Spain applied for EU emergency credits. However, if these emergency credits came directly from a mechanism like the ESM, the state would not get caught in the fire line of the investors and speculators on the financial markets (Sueddeutsche 2012). Consequently, an ESM would help to break the vicious circle and the SSM would make sure that the ESM funds were used properly by national banks.

Ultimately, especially the regulatory deficit but also the capacity gap were the main triggers for this first step towards SSM creation. In the aftermath of the Euro Area Summit of

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<sup>8</sup> Other financial resources are here the bail-in of investors and contributions from the later created resolution fund as part of the SRM.

course discussions about a supervisory mechanism deepened. The member states had already included the ECB in their Euro Area Summit statement (2012), suggesting that regulatory banking supervision authority should be established within this EU institution. Thereby, they proposed delegating supervision to the highest EU level which would of course involve giving up sovereignty.

The next essential step towards creation was the Commission's initial proposal for the SSM on 12<sup>th</sup> September 2012 (Commission 2012e). After the Commission's proposal, design details of the original draft were modified. But the idea to delegate supervisory authority to the ECB was accepted and finally adopted by the Council and the Parliament in 2013. After the Commission's proposal, the biggest part of the discussions on the SSM focused on its specific implementation and design – not on its creation in principle.

### ***The ECB's Functional Advantage: Making a Credible Commitment Possible***

In a next step, it should thus be analyzed whether this delegation to the ECB can be explained with the functional logic. Did the EU policy makers see specific functional advantages in charging the ECB with banking supervision? Was the ECB a better functional alternative than for example an agency like the EBA or a network? Or was the real reason for the commissioning of the ECB nevertheless some political power-based struggle?

First of all, it is interesting how the ECB reacted to the idea that it should get involved in banking supervision. In July 2012 – long before the initial Commission proposal – the ECB stated that it stands ready to play the supervisor role but at the same time pointed out that it needs to be ensured that the ECB's tasks of monetary policy and banking supervision are strictly separated (Asmussen 2012b). Several critics, amongst them the head of the German central bank Jens Weidmann, feared that if the ECB as a supervisor someday failed at supervising properly and if this failure became public, it could lead to a decrease in the ECB's credibility (Handelsblatt 2012b; Handelsblatt 2012c; Elliott 2012). After all, a central bank like the ECB is extremely dependent on a high level of credibility because it can otherwise hardly soothe monetary markets and thus guarantee its key task: price stability (Skuodis 2014: 6). However, while the ECB did not explicitly lobby for becoming the new banking supervisor, it did try to invalidate these accusations by referring to functional advantages: The ECB's Vice President Vítor Constâncio (2012) indicated that combining monetary policy and supervision under the roof the ECB is advantageous because the ECB as a responsible for monetary policy has an intrinsic and deep interest in a stable financial system. Therefore, the ECB is also interested in avoiding situations like the failure of banks which endanger the

stability of the financial market. It thus aims at ensuring that banks are stable because money markets are amongst the first to be impaired if there are doubts about the solvency of a bank in the euro area (Constâncio 2012).

Of course, it cannot be rejected for certain that the ECB did not also have a genuine interest in obtaining new powers through the SSM. And certainly the dispute between the ECB and the head of the German central bank Jens Weidmann about whether or not the ECB was a capable EU level supervisor (Handelsblatt 2012c) was related to power interests. After all, if the member states delegated supervisory power to the ECB this meant an increase of power for the ECB and at the same time a severe loss of power for the national supervision authorities like the German Bundesbank. However, even though such a political power struggle existed between ECB and Bundesbank, this dispute did not decide the outcome of the SSM. It had no decisive influence on whether or not the Commission or the member states preferred a SSM in the hands of the ECB.

The main EU policy actors highly favored the delegation of supervision to the ECB because of several functional considerations. First of all, the Commission saw a functional connection between supervision and monetary policy: The deficits in banking regulation caused the credibility problem and this again led to fragmentation in the banking sector, meaning that cross-border lending of banks almost stopped completely (ECB 2012; ECB 2013). This fragmentation undermined the single market for financial services and thereby negatively affected the transmission of monetary policy to the real economy throughout the euro area (Commission 2012e). Consequently, an EU banking supervisory mechanism would help to reduce fragmentation and at the same time increase the ECB's chances to implement effective monetary policy. Over the course of the financial crisis it had become obvious that the bankruptcy of one big and systemically important euro area cross-border bank could drag several other banks into the abyss, too. This can cause significant risks for the euro area as a whole due to speculations on the capital markets. Eventually this can also endanger the two main goals of the ECB, price stability and economic stability. Due to "pooled monetary responsibilities in the euro area and closer financial integration, there are specific risks in the euro area in terms of cross-border spill-over effects in the event of bank crises" (Commission 2012f). For the Commission, this interconnection of banking supervision and monetary policy was an important functional advantage that made the ECB capable of closing the functional gap (Commission 2012e).

Consequently the Commission also clearly stated that mere intergovernmental coordination between national banking regulators was no longer an option (Commission 2012f). Such

coordination had formerly taken place through a network and later through the EBA. The Commission claimed that coordination between supervisors was vital but that the crisis had shown that only relying on such coordination was not enough in the context of a single currency (Commission 2012e). Instead of only cooperating loosely, there was a need for strong common decision-making in order to restore credibility. Consequently, the Commission could not have opted for another supervision network, because networks usually tend to produce only weak regulation. Also the delegation of supervisory authority to the EBA was questionable since the power and especially the reputation of the EBA had been tarnished already. And therefore, the Commission affirmed that it was necessary to confer strong powers to a strong institution, namely the ECB (Commission 2012e). The ECB's functional advantage was thus, that being an institution it has more power and is especially renowned – also because it was and is to date one of the most crucial actors when it comes to solving crises on the Eurozone financial markets. Barroso stated a SSM including the ECB would help to “restore confidence in the supervision of all banks in the euro area” (Commission 2012e). It could restore this confidence because it has a great reputation in the financial world.

Another important policy actor was strongly opposing to create the SSM within the already existent EBA because this would undermine the functionality of the supervisory mechanism: Angela Merkel harshly criticized the EBA for its inefficient stress tests and for failing to foresee the severe problems in the Spanish banking sector (Merkel 2012a). For the German Chancellor this clearly showed that the EBA did not prove effective. Merkel also emphasized that one of the greatest problems of the agency was that the NRAs still had too much to say (Merkel 2012a). Therefore, she thought it was clear that neither a network nor an agency could properly fulfill the function of an efficient EU banking supervisory authority; but only a powerful institution could (Merkel 2012a; Merkel 2012b). According to Merkel, a “credible” banking supervision was needed and the ECB would be able to fulfill this function very well since it was an EU institution and would thus show little consideration for single national interests (Merkel 2012c). And even if Merkel and her French counterpart, President François Hollande, had several disputes about the exact design and implementation of the SSM later on, Hollande also emphasized that the SSM needed to be located at the ECB in order to foster credibility and break the vicious circle of failing banks and indebted sovereigns (Hollande 2012a; Hollande 2012b). The subsequent disagreements with Germany were all about when and how to implement the SSM exactly – but not about whether it should be created at the ECB in principle (Gammelín, Cerstin/Cáceres, Javier/Hulverscheidt, Claus 2012; Volkery 2012).

To a large extent banking experts also agreed with Merkel: They criticized the EBA's stress test saying that the EBA had included too little crisis dimensions into the analysis (Handelsblatt 2011), that it did not work transparently or that the EBA especially failed in the assessment of the functionality and resilience of cross-border banks (Euractiv 2011; Euractiv 2014a). Additionally, they complained that the only recently created EBA would not have the competency to effectively ensure the solvency of EU banks (Wirtschaftswoche 2011). Even if the EBA did not acknowledge these shortcomings back in 2012, later on the European Court of Auditors came to the conclusion that there were de facto several deficits in the EBA stress test. Shortcomings were quite generally identified "in the functioning of cross-border banking supervision" as well as the "assessment of EU banks" and the report indicated that the EBA did not enjoy enough authority to "make or enforce decisions on supervisory convergence" (European Court of Auditors 2014: 8).

All of this shows that it would have been very difficult to make the EBA a strong EU banking supervisor. Even if EU policy makers had decided to delegate banking supervision to the EBA and provided the agency with more competences, it would have been likely that the EBA would have had a hard time enforcing standards. After all, it had already suffered from bad reputation and was perceived as a weak agency with a lack of influence. This could have affected the functionality of a new SSM negatively, especially since one main goal of the SSM was to regain credibility. But a credible commitment can hardly be made by delegating authority to an agency which is already perceived as weak in the public opinion. Peter Praet, member of the Executive Board of the ECB, referred to the EBA in spring 2012 by saying that the crisis has shown severe shortcomings in the institutional set up of banking governance (Praet 2012). And also the President of the Council, van Rompuy (2012), criticized that the EU had yet not managed to set up the right kind of regulatory authorities. The only logical consequence to guarantee an improvement and the smooth functioning of the SSM was to delegate supervision not to an agency but to take it one level further, namely to an institution.

One of the harshest critics of the SSM's design was the German Finance Minister Wolfgang Schäuble. The press regularly reported about how he was challenging the design of the supervisory mechanism (Bloomberg 2012; Financial Times 2012a; Die Zeit 2012b). However, not even Schäuble actually opposed the idea of creating the SSM within the ECB. On the contrary, he thought it was necessary to guarantee a powerful SSM: He stated in an interview in the beginning of September 2012 that the SSM should definitely be delegated to the EU level and it had to include the ECB because of its great expertise and technical knowledge about banking governance (Schäuble 2012a). Additionally, he emphasized that a

supervisory mechanism was functionally necessary if the capacity deficit was to be closed: After all, the ESM should only provide capital to euro area banks if an EU institution had an overview over what those banks were actually doing (Schäuble 2012a). He claimed that a too weak supervision had caused most of the banking problems in the euro area (Schäuble 2012b). Consequently, EU supervision was needed to improve EU regulation and increase compliance with EU regulation. To ensure this, the supervisory institution should even have the power to impose sanctions (Schäuble 2012b). Therefore, establishing the SSM at the ECB instead of at an agency or even a loose network was seen as a functional necessity by Schäuble. This is underlined by his statement that he thought the SSM proposal of the Commission (which suggested making the ECB the supervisor) was a good foundation for the establishment of the European Banking Union (Schäuble 2012b). The aspects about the SSM which Schäuble was criticizing had little to do with its creation or the delegation to the ECB: He mainly opposed France when Hollande pushed for a very fast implementation of the SSM and he aimed at excluding some of Germany's smaller banks from the SSM (Schäuble 2012b; Euractiv 2012a; Wirtschaftswoche 2012a). Concerning the ECB, Schäuble only found fault with blending monetary policy and supervision. Therefore, he claimed to literally build a "Chinese Wall" between those two ECB tasks in order to separate them strictly (Schäuble 2012b; Euractiv 2012b).

Besides Schäuble, important critics of the SSM were the German banking associations. Later on, when discussions emerged about the exact scope and the implementation of the SSM, they became a crucial actor in shaping the German position on the SSM. From the beginning, a lot of them had negative attitudes towards the SSM. Especially the smaller public German banks, like *Sparkassen* or *Raiffeisenbanken*, were reluctant to submit themselves to a tough EU banking supervision since they enjoyed diverse benefits in the German banking system compared to private banks. And of course they wanted to keep these benefits. This is clearly a politically motivated idea. But even from their very skeptical point of view, they supported that the ECB got the mandate of EU banking supervision because of functional reasons. The president of the *Sparkassen* association (DSGV) expressed his consent for ECB supervision already in June 2012 (DSGV 2012a). He said that Europe had to take action in areas where national levels needed help (DSGV 2012a) and thereby referred to supervision of big cross-border banks. The ECB would be well suited for this task because only a powerful EU level institution like the ECB could really solve the problems of cross-border banks which were also known as 'too big to fail' because their failure would endanger the stability of the whole euro area (Handelsblatt 2012b). However, he criticized the idea of including small and

supposedly safe banks – like *Sparkassen* or other public banks – into the SSM (DSGV 2012a). But this is certainly not a question of creation but of implementation and design. Uwe Fröhlich, the president of the German association for *Raiffeisenbanken* (BVR) as well as Hans Reckers, managing director of the German association for public banks (ÖVR) also admitted that the ECB would be a good choice to supervise big cross-border banks (BVR 2012a; ÖVR 2012). ÖVR board member Gerhard Hofmann also argued that it would functionally be a natural choice that banks which receive money from the EU level (that is from the ESM) are controlled by a strong EU supervision located at the ECB (Handelsblatt 2012b). The public banking associations therefore did not oppose the ECB supervision in itself.<sup>9</sup> They thought it was a helpful tool to combat the existing regulatory and capacity deficits.

### ***Interim Conclusion: H1 Is Correct – A Functional Gap Led to the SSM’s Creation***

In summary, the observable implications for hypothesis H1 were present in the case of the SSM: One can see that the main EU policy makers decided to take action on banking supervision due to regulatory and capacity deficits, namely because a powerful regulatory body was missing and because there was some lack of banking regulation. Furthermore, a supervision mechanism became necessary to be able to provide a financial backstop by the ESM. The member states chose to delegate supervisory authority to the ECB out of functional advantages. In a nutshell, these advantages are: The ECB is a highly recognized, renowned and powerful EU institution. Since delegating to the ECB means delegating to the highest EU level, the member states bind their own hands. They will lose substantive supervision authority and it is unlikely that the ECB will be easily impressed by national preferences. With the SSM located at the ECB, the NRAs are bound by the ECB’s instructions. And in case they don’t comply, the ECB can take over all kinds of supervision tasks. Therefore, delegating to the ECB provides the function of committing credibly to better banking supervision standards. A network could never have provided this credibility function because the CEBS failed at it in the past (Larosière 2009) and networks are known to often only provide weak regulation. The EBA as an agency was again too weak for credible commitment<sup>10</sup>, mostly because of its reputational deficits. The ECB can only provide this

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<sup>9</sup> The private banking association was of course in favor of the SSM, arguing that the ECB would be a lot more competent to exercise supervision than national supervisory authorities (BdB 2012). However, this should not be overrated since the private banks in Germany had a genuine political and competition-inspired interest in eventually achieving equal treatment for public and private banks.

<sup>10</sup> It is questionable, whether an enhanced and strengthened EBA would nevertheless have been an adequate supervision agency had it not suffered from loss of reputation beforehand. This shows that some kind of path-dependency was crucial here: The behavior of the EBA after its creation and the loss of reputation reduced the



credibility function because it seems highly likely that it can actually reduce implementation deficits across euro area member states as well as stop home bias and forbearance of national supervisors. Thus, the ECB is well suited to functionally tackle the regulatory deficit. However, the EBA was not totally abolished. It is still in charge of creating a Single Rulebook. Nevertheless, it has to cooperate closely with the ECB. And since the ESM became directly linked to the SSM, the supervision located at the ECB also closes the capacity deficit.

The delegation of supervisory authority to the ECB was not at all a controversial subject between the main EU actors. The Commission did not try to seize power for itself or give power to an agency which it could control. Instead, it immediately suggested delegating power to the ECB out of functional reasons. Furthermore, no power struggle between the member states was observable. On the contrary: All observable implications of the functional logic applied when we look at the creation of the SSM within the ECB. While the ECB's new supervision mandate was not contested, things looked rather different concerning the exact design and implementation of the SSM.

### **6.1.2 Political Reasons for Design: Germany Protects its Public Banking Sector**

In a speech in September 2012, German Finance Minister Wolfgang Schäuble again stressed how big the confidence in the ECB was since all member states had agreed that a European supervisory mechanism could only be credible if it was located at the ECB (Schäuble 2012c). The German *Handelsblatt* reported at the same time, that all the EU policy actors obviously were in complete agreement during summer (Berschens 2012). However, the good understanding vanished into thin air after the Commission's official proposal for the SSM in September (Berschens 2012). Disputes did not arise about the delegation to the ECB. But when it came to details about implementation and design of the designated SSM, opinions and preferences of EU institutions as well as member states started to differ extremely.

According to the combined functional-political approach, political and power-based considerations should be able to explain the final design of the SSM. In a first step it can be seen that the trigger for the disagreements about the exact design of the supervisory mechanism was a distributional conflict between the member states.

#### ***Disputes about Distributional Conflicts: Restricting Access to Public Money in the ESM***

The main conflict about the SSM's design and implementation arose between Germany on the one hand, supported by a northern coalition with countries like Finland or the Netherlands,

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EU actors' range of choice when it came to delegating supervision authority. The importance of path-dependency for the case of the SSM will be discussed in the section on alternative explanations (*Chapter 6.3*).

and France on the other hand, which became the new representative of the interests of several southern member states, amongst them Spain and Italy (Schäfer 2015: 4). This Franco-German dispute had several components, the first being the timing of the SSM.

Like the political approach would predict, the Commission of course intended a strong supervisory mechanism when making its proposal in September 2012. Therefore, it wanted the ECB to take over the full range of supervisory competencies for all banks – at least across the euro area. And this should happen quickly. The Commission wanted EU member states to agree to a SSM until the end of the year. Michel Barnier, the former EU Commissioner for the Internal Market and Services, admitted that the deadline was difficult but also necessary (Barker 2012). However, Germany and several others<sup>11</sup> called for “a more realistic negotiating timetable” (Barker 2012) to adequately resolve existing problems. Schäuble already said in his speech in the beginning of September – which was even before the Commission’s official proposal for the SSM – that he believed in the motto “quality before speed” and that the supervisory mechanism should not be rushed but rather carefully planned (ARD 2012). His Swedish counterpart, Finance Minister Anders Borg agreed and publicly stated that it was “undecidable and not acceptable to aim for a deal by the end of the year” (Barker 2012). At the same time, France was convinced of the opposite. They wanted to push SSM regulation through as quickly as possible and thus start ECB supervision at the earliest date possible. In a joint statement with the Spanish Head of Government Mariano Rajoy, French President François Hollande stated in October, that it was of utmost priority for the EU member states to adopt the new rules on the SSM by the end of the year (Hollande 2012d). The former French Finance Minister Pierre Moscovici<sup>12</sup> also repeatedly called for a quick and strong implementation of the SSM: He said that no time should be wasted and that the initial operation of the SSM should not be delayed (Euractiv France 2012). According to him, this was necessary because of the urgency of the crisis and because crucial economic actors anticipated the SSM (Le Monde 2012). Moscovici said to the *Financial Times* that wasting time on the SSM’s implementation would be a mistake because otherwise banking supervision remained theoretical whereas the banking problems were concrete (Barker 2012).

According to France, Germany tried to delay the start of the SSM out of an underlying distributional conflict: Already in June 2012, the EU heads of state and government decided that the SSM should be linked to the ESM: Once the SSM is established and banks overseen by the ECB, the ESM should be able to directly recapitalize failing banks in order to support

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<sup>11</sup> Especially Sweden, Poland and the Netherlands supported the German position (Barker 2012).

<sup>12</sup> Moscovici was the finance minister of France from 2012 to 2014. Since 2014 he is EU Commissioner for Economic and Financial Affairs, Taxation and Customs.

member states and break the vicious circle of state indebtedness. This obviously means that member states pay into the ESM and thereby end up financing the failing banks of others. For example, Germany also pays for the ESM and the ESM could eventually rescue Spanish banks. And since this could be difficult to convey to the German public and especially German voters, French President François Hollande accused Angela Merkel to only slow down the SSM efforts because of the upcoming elections in Germany in 2013 (Liberation 2012; Hasselbach 2012).

No matter whether this assumption about the influence of the German election is right or wrong, it is a fact, that a distributional conflict was present. First of all, fiscal costs could be the result of a supervision failure under the new system (Barker/Spiegel/Johnson 2012) because obviously the member states which participate in the SSM would have to pay for such failure. Secondly, there is a danger of footing the bill for bank failures in other member states through the ESM (Skuodis 2015: 9ff.). Especially difficult are inherited liabilities. By claiming a fast introduction of the SSM, France and Spain wanted to make it possible for Spain to quickly rescue its banks by recapitalizing them with ESM money. However, this was especially problematic for Germany since the Spanish banking failures occurred before the EU member states even had discussed a common SSM and thus before they could supervise and control the doings of these banks. Germany did not want to pay for past bank failures. According to Angela Merkel, the ESM should only recapitalize financial institutions, which were previously under SSM supervision (Merkel 2012d). In a speech at a German industry conference, she unmistakably stated that not until the SSM is up and running and not until it had the necessary intervention rights, should the ESM distribute money (Merkel 2012d). Merkel even said towards Germany's international broadcaster *Deutsche Welle* that she was worried about German depositors paying for Spanish banks (Hasselbach 2012). And Finance Minister Schäuble also repeatedly said that the ECB supervision and thus the usage of the ESM could not start in January 2013, because too many aspects were not clarified yet (Schäuble 2012d; ARD 2012; FAZ 2012a). The *Financial Times* reported that this German resistance was motivated "by opposition to the idea of German taxpayers sharing the risk of weak non-German banks" (Barker 2012).

At the same time however, it can hardly be believed that France and its southern European allies were only interested in the fast implementation of the SSM because this seemed necessary to ensure stricter supervision in the EU's future. On the contrary: They had genuine financial interests, too. While the Germans wanted to reinforce fiscal policy commitments and implement measures to prevent further crises, the French sought support mechanisms which

would help member states to overcome urgent problems, especially by offering some kind of lender of last resort like the ESM (Howarth/Quaglia 2013: 111). The French President François Hollande repeatedly argued how important it was for member states to obtain the possibility to recapitalize their banks through ESM money (Hollande 2012d). To the French press, Hollande said that the EU member states had to agree on a SSM framework quickly in order to make use from the ESM already in 2013 and thus make it possible for Spain to finance its banks “dans de bonne conditions”, under sound conditions (Liberation 2012). Especially before the October Council summit on 18<sup>th</sup> October 2012, Spain lobbied for being able to use the ESM soon (FAZ 2012a). Merkel however repeated eagerly that it was not enough to agree on the establishment of the SSM to actually use the ESM, but that it needed a properly working SSM beforehand (Merkel 2012f).

This discussion about timing was not yet concerning the explicit design of the SSM, but merely its initial starting point. However, it reveals the underlying distributional conflict: The implementation of the SSM was all about who pays how much under which circumstances because the SSM was undeniably linked to the ESM from the beginning. France, Spain and Italy wanted to use financial resources from the ESM as soon as possible to finance their bank liabilities. Since they knew, Germany would only accept an ESM framework if a common European supervision was set up, they tried to rush the SSM’s implementation. At the same time, especially Germany was highly reluctant to give the southern EU member states a free ticket for restructuring their banks through ESM money without having sufficient oversight over these financial institutions via a strong SSM. In a government declaration in October 2012, the German Chancellor once more stated that at the Council summit in October she would only negotiate with the other member states and would not take any final decisions on the SSM (and thus on the ESM, too) before at least December 2012 (Merkel 2012e). This however ruined any plans to actually start a SSM in January 2013 after all the European Parliament had to be included in the legislative process on the SSM and this usually needs some time, too (Merkel 2012f).

### ***The Intention to Keep Power: Restricting the SSM’s Scope Due to Asymmetrical Burdens***

The distributional conflict surrounding the SSM-ESM connection had however another impact: Since it was also an asymmetrical conflict, it fueled debates about the internal design of the SSM and mainly Germany tried to keep a say in banking supervision.

The distributional conflict has various asymmetrical dimensions. One was that the southern EU member states had more severe banking problems than most of the northern member

states and that therefore it were mainly the southern ones which needed aid from the ESM. Therefore, not only member states like Germany were worried about financing failing banks from others, but also countries like Sweden, the Netherlands, Finland or Poland (Barker 2012). It is remarkable, that some of these member states which were allied with Germany are not part of the euro area. This is, because the Commission actually wanted to establish a SSM for the whole EU (Commission 2012e). In July 2012, the responsible Commissioner Barnier stated in a speech addressing the European banking problems, that of course no non-Eurozone country could be forced to join the SSM, but that he especially wanted and intended to build a banking union for all back then 27 member states making non-euro area states join the SSM voluntarily (Barnier 2012a: 5).

However, including the non-Eurozone member states in a supervisory mechanism which was located at the ECB turned out to be difficult. After all, usually only those member states have voting rights on the ECB's Governing Council which have joined the euro area. This of course, made non-Eurozone member states upset: They wanted a SSM with equal voting rights for every country – especially if it was them who should eventually foot the bill for others' failing banks through the ESM. Sweden's Finance Minister Anders Borg said that before the SSM could start its work the severe problems about the voting rights had to be settled (Barker/Spiegel/Johnson 2012). The Financial Times reported, that the United Kingdom – even though it was never intending to join the SSM – and also Poland were extremely worried about non-Eurozone member states having to obey to ECB decisions without having means to influence these decisions (Barker 2012). They all called for discussing these implementation problems before actually kicking off the SSM.

Germany agreed with its northern European allies: In September Finance Minister Schäuble claimed that if non-Eurozone states wanted to opt-in they should be provided with voting rights in the ECB (Schäuble 2012e). Also Angela Merkel emphasized that it was important to clarify how euro area states and non-Eurozone member states should act in future if common banks were in trouble and that it was necessary to talk about voting rights (Merkel 2012f). She thereby concluded once more that it was necessary to slowly proceed with the SSM and thus to address these open questions (Merkel 2012f). For Germany, the discussion about the non-Eurozone member states' voting rights was the perfect pretext to first, prolong the debate about the SSM and second, to secure its own voting rights. Since the northern European member states, and especially Germany and the non-Eurozone member states called for equal voting rights, this ended up influencing the final design of the SSM. In December 2012, the member states agreed on creating a SSM located at the ECB. However, not the ECB

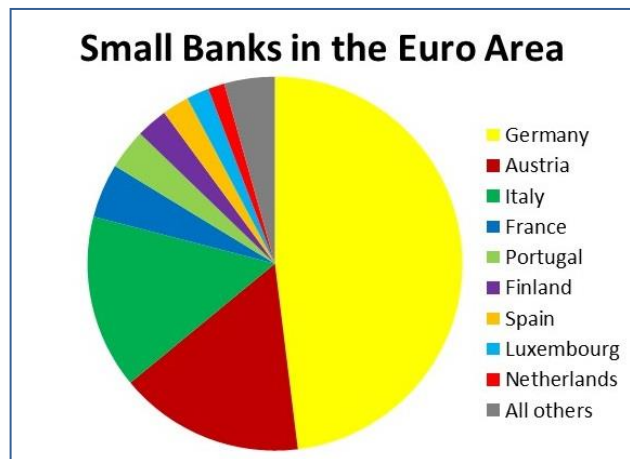
Governing Council should usually be in charge of day-to-day supervisory business, but a newly created agency within the ECB. This so-called Supervisory Board today is composed of an appointed chair (who is not from the ECB's Executive Board), a vice chair (who is chosen from among the members of the ECB's Executive Board), four ECB representatives and representatives of national supervisors from all member states participating in the SSM<sup>13</sup> (Council EU 2012; SSM 2015a). The Supervisory Board takes the decisions on supervision issues according to a non-objection procedure. That means a decision is adopted if the Governing Council of the ECB does not reject the draft of the Supervisory Board (Council EU 2012; SSM 2015a). In turn, this shows that this supervision agency is not very autonomous but highly dependent on the ECB itself. If the Governing Council and the Supervisory Board cannot agree, a mediation panel will step in. This institutional set up within the ECB guarantees that all member states of the euro area as well as those outside the Eurozone have full and equal voting rights within the SSM (Council EU 2012). This was highly important to the member states since it guarantees them to at least keep some say in the ECB's decision on supervision of their banks. But it also means that EU level supervision could be softened once again by the member states taking influence in the Supervisory Board – even though supervision was actually delegated to the ECB. Of course it will be difficult though for a single member state to influence the board's decisions.

While negotiating the SSM, a second distributional conflict eventually weakened EU banking supervision. It was not linked to the distribution of money through the ESM but still had a high impact on the arrangement and the scope of the SSM. In its initial proposal, the Commission wanted to put *all* euro area banks under the supervision of the ECB no matter their size. Big, medium-sized and small banks were all supposed to be overseen equally by the ECB. Since this would amount to approximately 6000 euro area banks, the ECB would of course also rely on the help of NRAs (Commission 2012e). But generally, if it was up to the Commission to decide, the ECB would be responsible for all kinds of euro area banks. This is in line with what the political approach would predict for the behavior of the Commission: It wants as much Europeanization as possible. This approach of including all banks was highly supported by France as Hollande stated for example in one of his speeches in September 2012 (Hollande 2012c). And also the southern EU countries like Spain or Italy were in favor of a supervisory mechanism which comprised all kinds of banks.

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<sup>13</sup> Euro area member states are automatically a member of the SSM. Non-Eurozone member states can opt-in voluntarily.

For Germany however, this idea was unacceptable. To understand Germany's position and the underlying distributional conflict, it is crucial to look at the German banking sector compared to those of other member states (see *Figure 4*): The banking system in Germany is divided into public and private banks. The public banks are mostly smaller, regional banks like municipal *Sparkassen* or *Volksbanken* and *Raiffeisenbanken*. Often cities or districts



**Figure 4: Small Banks in the Euro Area** (derived from Verón 2014)

are the sponsors of those banks. Originally, *Sparkassen* were for example founded in order to foster the regional economy (Bundesbank 2015a). Today, *Sparkassen* as well as *Volksbanken* and *Raiffeisenbanken* are essential because they provide loans to small and medium-sized enterprises, which in turn build the backbone of the German economy (Bundesbank 2015a). Since those public banks usually serve some public task, they enjoy several advantages in supervision and control, for example regulatory simplifications or special privileged rules (Siekmann 2011: 32ff.). The inverse conclusion suggests that if Germany had to hand over supervision over those public banks to the ECB, these specific rules would no longer be applied to them. This again would result in extremely high implementation costs for EU regulation and thus a high administrative burden for Germany's public banks. Moreover, Germany is the member state who has by far the largest number of small banks in the euro area (see *Figure 4*). According to research of the Bruegel Institute, "Germany, Austria and Italy together are home to almost four-fifths of all small banks, and Germany carries the lion's share" (Véron 2014). On the contrary, France has a banking sector which is highly concentrated. In France, four big banking groups – namely BNP Paribas, Groupe Crédit agricole, Groupe BPCE and Société Générale – dominate the banking system and of course they all engage in cross-border business.

This reveals an asymmetrical distributional conflict: If the SSM was responsible for all euro area banks, Germany would suffer from higher adaption costs for its multitude of small and medium-sized regional banks. First, with a common ECB supervision Germany's small banks would undoubtedly lose their preferential treatment. Second, they would have a hard time adapting to the new rules and regulations. Since public banks like *Sparkassen* are generally owned by public entities (for example administrative districts), public money would

have to be used at least partially to bear the adaption costs. Third, of course an inclusion of public banks would imply that the German government would have to face severe opposition from those public banks and thus would be faced with high reputational costs.

This distributional conflict is quite obviously asymmetrical, with Germany suffering more from SSM supervision over small banks than most of the other member states. For France for example, it was clear that most of its bank would fall under EU level supervision anyways, because it mainly had big and cross-border banks. This is due to the fact that the French regional banks are usually consolidated into groups and those groups would be large enough to be subject to the SSM anyway (Véron 2014). Thus, following the political approach, Germany should have an extremely high interest in pushing through its own preference of excluding the small banks. This was actually observable during the SSM negotiations. The German concerns led to tough negotiations about the implementation scope of the SSM. Originally, Germany wanted to exclude small banks from the ECB's supervision completely.

In September 2012, EU member states were negotiating about the SSM. In this context, Angela Merkel claimed that the principle of subsidiarity had to be protected (Merkel 2012d). Therefore, decisions about regional banks should be taken at the national or even regional level (Merkel 2012d). Her finance minister also called for applying the SSM only to big, cross-border and systemically important banks (Schäuble 2012e). Allegedly, Schäuble was worried about the feasibility of a SSM which comprises all kinds of banks. After all, the ECB could hardly handle the supervision of as much as 6000 euro area banks with very different regional characteristics (Schäuble 2012e). He emphasized these worries as well as his demand to restrict ECB supervision to systemically important banks at an informal meeting of the EU finance ministers in Cyprus in September 2012 (Bundesfinanzministerium 2012). However, it is likely that Merkel and Schäuble did not only want to reduce the implementation costs for small banks but also wanted to please the German public banking sector with their demand. The German government certainly had no interest in frustrating the strong lobby of the public banks (Sueddeutsche 2012) – especially not in the run up to German parliamentary elections. Only a few months earlier, the German newspaper *Die Zeit* had called the association of the German savings banks (*Sparkassen*) one of the most influential lobby groups in the whole of Germany (Schieritz/Storn 2012). And the public banks as well as their associations highly disapproved of their own supervision being located at the EU level.

Georg Fahrenschon, the president of the German *Sparkassen* association called it “not wise” (DSGV 2012b) to delegate supervision of small banks to the EU level. He said that the *Sparkassen* would like to see only the cross-border and systemically important banks under



ECB supervision (DSGV 2012b). Fahrenschon's colleague, Uwe Fröhlich, president of the *Volksbanken* and *Raiffeisenbanken* association (BVR), agreed with him, indicating that the BVR strongly opposed the suggestion of the European Commission to establish a supervisory mechanism which treats all banks equally (BVR 2012b). Fröhlich especially emphasized the stability of the small public German banks. According to him, public banks had proven during the crisis that they are very secure and that they have sound business models (BVR 2012b). Fahrenschon and Fröhlich were convinced that it would be enough for the ECB to only supervise the approximately 120 big Eurozone banks because it was allegedly those which had major banking risks and which could cause trouble to the whole euro area (BVR 2012b; DSGV 2012b). In a speech in September the *Sparkassen* president indignantly complained that he did not see the purpose of supervising small public banks at the EU level, because first, the ECB would not have enough expert knowledge about the regional banks and second, they would not harm the entire stability of the euro area anyway (DGSV 2012c). Of course, this shows impressively, that the public banks made an effort to prevent the new ECB supervision and thereby the loss of their privileged status in the German banking system. And obviously, they managed to influence the German government, since the Chancellor as well as the Finance Minister tried hard to negotiate the exclusion of the small banks from the SSM.

The Commission was not pleased at all with Germany's attempt to limit the supervisory power of the ECB. Commissioner Barnier indicated that small banks had to be included since the crisis had shown that it were often small and medium-sized financial institutions which had run into difficulty, for example the Spanish Bankia or the Franco-Belgian Dexia (Reuters 2012). The final report of a high-level expert group on reforming the structure of the EU banking sector, which was chaired by Erkki Liikanen, supported Barnier's point of view. It said that even though small banks usually do not account as "too big to fail", they might as well be "too many to fail" since systemically dangerous problems may arise when many small banks operate similar businesses and thus are exposed to common shocks (Liikanen 2012). The report calls this being "systemic as a herd" and it especially suggests that such small banks caused trouble in the Spanish banking sector (Liikanen 2012).

On this basis, François Hollande criticized Germany for wanting a differentiated supervisory mechanism. From an economical point of view, it is questionable if the German public banks could really be compared to the problematic local banks in Spain. That is because the small banks of Germany "usually only serve local customers and it is unlikely that they will all suffer from the same problems and thus become systemically relevant as a herd" (Véron 2014). Nevertheless, the French President Hollande insisted that all banks – big

and small – should be included in the SSM just to make sure (Liberation 2012). This claim is not surprising for France and characterized by political interests because most French banks would fall under EU supervision anyway – even if small banks were excluded. The same goes for banks of other member states, for example Spain, Finland, the Netherlands and to a lesser extent also Austria<sup>14</sup> (Véron 2014). Consequently, for the other member states it seemed more adequate and fair if also all German banks were supervised by the ECB.

Due to the high distributional conflict which on the one hand was linked to the ESM and on the other hand connected with particularities of the German banking system, and due to the asymmetrical involvement of Germany, namely that Germany had several small banks whereas other member states did not, this resulted in Germany being determined to push through its preferences and seek influence on the SSM's scope and implementation. During the October 2012 Council summit, Germany insisted that small banks should be excluded. In December, the ECOFIN wanted to take a final decision on the SSM. However, the German-French dispute continued. A week before the meeting, talks between the finance ministers had broken down because Germany rejected the inclusion of all banks in EU supervision (Pop 2012). Only on 12<sup>th</sup> December 2012, one day before the actual meeting, France and Germany managed to agree on a compromise (FAZ 2012a; Uken 2012). However, just as the political approach suggests, Germany was not willing to give in on the aspect of the distributional conflict which was highly asymmetrical, the involvement of its small banks.

In a first consent, French and German negotiators made terms stating that there will be a differentiated approach to ECB supervision (FAZ 2012a; Uken 2012). While the ECB should be only directly responsible for the oversight of the 120 to 200 big, cross-border and systemically important banks, national supervisors should keep control over smaller banks (Uken 2012). However, if problems occurred, the ECB should be able to take over supervision of smaller financial institutions, too. This might seem as if Germany had to make concessions by accepting that the ECB could also supervise regional banks if necessary. However, German Finance Minister Schäuble had already suggested this in September 2012. Back then, he had stated that even if he wanted that small banks are supervised by national authorities, the ECB should have the power to also control these institutions in emergencies (Schäuble 2012e). This seemed necessary to Germany to prevent failures of local banks in other member states like for example in Spain (Schäuble 2012e). And by establishing such a differentiated supervision, it became quite unlikely that the ECB would actually supervise

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<sup>14</sup> Even though Austria also has a big amount of small banks, many of the savings banks (*Sparkassen*) are consolidated within *Erste Group* and the *Volksbanken* are consolidated under the *Österreichische Volksbanken AG* (Véron 2014). These banking groups would have fallen under ECB supervision anyway.

German public banks since the threat of them failing and becoming systemically relevant was low. On 13<sup>th</sup> December 2012, the Council of the EU agreed on exactly this solution. Consequently, Germany was able to defend and keep its own power over its public banks and thereby has highly influenced the scope of the SSM. Eventually, the public banking lobby was very pleased about this outcome and welcomed the decision that the national supervisors generally stayed responsible for the supervision of small banks (BVR 2012c).

Additionally, France and Germany also managed to agree on a time frame for the SSM. Germany pushed through that it would take time to set up a proper working SSM and that it would not start before 2014. However, in extraordinary circumstances, the ESM could recapitalize a bank earlier – but only if the ECB then immediately took over supervision of this particular bank (Barnier 2012b). Germany met France and the southern EU member states halfway but enforced that ESM money would only be distributed if the ECB would supervise and control what the banks were actually doing with that money.

And another demand of Germany was considered, too: Even though this was not due to a distributional conflict, but more due to the experiences Germany had made with central banks in the past<sup>15</sup>, Finance Minister Schäuble kept calling for a “Chinese Wall” between the monetary policy of the ECB and its new supervisory tasks (Schäuble 2012b; Euractiv 2012a; Wirtschaftswoche 2012a). Schäuble wanted to strictly separate monetary and supervisory decisions in order to prevent that supervision negatively affects the monetary policy of the ECB (Wirtschaftswoche 2012). This German attempt was however – in contrary to the time frame, voting rights or the scope of the SSM – hardly a controversial subject. The ECB President Mario Draghi himself claimed that it was necessary to take these concerns seriously and stressed the importance of a strict separation of these two ECB tasks (Draghi 2012a; Riecher/Hamilton 2012). During a hearing at the EP, Draghi stated in late 2012 that he was positive that a separate Supervisory Board could successfully avoid conflicts between monetary and supervisory policies (Draghi 2012a). Eventually, the Council of the EU agreed in December that such an additional board for supervision should be established at the ECB to guarantee a rigorous separation of the tasks (Council EU 2012). Until today, critics argue

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<sup>15</sup> Since World War I, Germany had suffered two hyperinflations due to failed monetary policy (Liebler 1996). Consequently, when Germany created the German central bank (Deutsche Bundesbank), it decided that its most important objective should be price stability. When the ECB was created, Germany was scared that giving countries which were less inflation averse a fair say in European monetary policy would inevitably fuel inflation (Singleton 2011). Eventually, Germany negotiated that the ECB should be modeled on the German central bank (the Bundesbank), also dedicating itself to price stability. Until today, Germany tends to fear inflation a lot and thus tries to ensure price stability more rigorously than other EU member states. Economists especially from Germany believe that the more independent a central bank is the lower are levels of inflation (Waller 2011). Having this background knowledge, it is only logical that Germany tried to prevent that the ECB's monetary policy might be weakened by supervisory considerations.

whether or not this separation was successful, since the Governing Council of the ECB – which is responsible for monetary policy – still has the last say on all supervisory issues<sup>16</sup>.

However, in the aftermath of the December Council of the EU, the ECB suddenly started an attempt at increasing its own power. During the 2012 negotiations about the SSM, the ECB kept calm most of the time. The ECB of course supported the Commission's proposal to transfer supervision over all banks to itself. Mario Draghi argued that complete oversight was necessary to “ensure consistency across the euro area and to prevent regulatory capture” (Draghi 2012b). At the same time, he tried to reassure Germany by stating that day-to-day supervisory tasks would stay with the national supervisors anyway due to capacity issues (Draghi 2012a; Financial Times 2012b). He also supported the separation of monetary and supervisory policy. This seems, like the ECB was not too much concerned with power related issues – maybe because it was optimistic to gain EU supervisory power anyway. But in spring 2013, the ECB tried to grasp more power. Draghi and the ECB aimed at strengthening the vice chair of the SSM by charging him with extensive responsibilities whereas the actual chair should only obtain representative tasks (Berschens 2013b). The press reported about this goal of the ECB and stated that this would weaken the separation of monetary and supervisory policy (FAZ 2012c). After all, the chair of the SSM should be an independent person, while the vice chair is usually someone elected from the ECB's Governing Council. Consequently, if the vice chair is strengthened and the chair weakened, this means that the ECB's monetary section has more influence over supervision. From a political point of view, it is very normal for an institution like the ECB to try to extent its own power as much as possible.

But another crucial EU actor, namely the European Parliament, put a spoke in the ECB's wheel. The President of the EP, Martin Schulz, had constantly supported the creation of a SSM located at the ECB (Schulz 2013). However, he also regularly called for a credible and neutral supervision which can also be made accountable for its actions (Schulz 2012). The EP of course had to be involved in the legislative process of SSM creation. In March 2013, it eventually agreed with the Council and the Commission on a basic framework for the SSM. This agreement included a concession that the EP would have a say in the nomination of the chair and the vice chair of the ECB's Supervisory Board on an equal footing with the Council of the EU (Berschens 2013c). The *Handelsblatt* as well as the *Neue Züricher Zeitung* reported that this was genuinely new, because until then the EP did not have the right to co-determine any leaders of the ECB (Berschens 2013c; Höltschi 2013a). Additionally, the EP managed to be granted the possibility to impeach the SSM's chair in emergencies (Die Zeit 2013a;

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<sup>16</sup> Also see explanation of the non-objection procedure on page 59.

Höltzchi 2013a). Furthermore, the EP also pushed through more parliamentary control by making the SSM accountable towards the EP and national parliaments, which are allowed to summon and question the ECB supervisors (Berschens 2013c; Die Zeit 2013a).

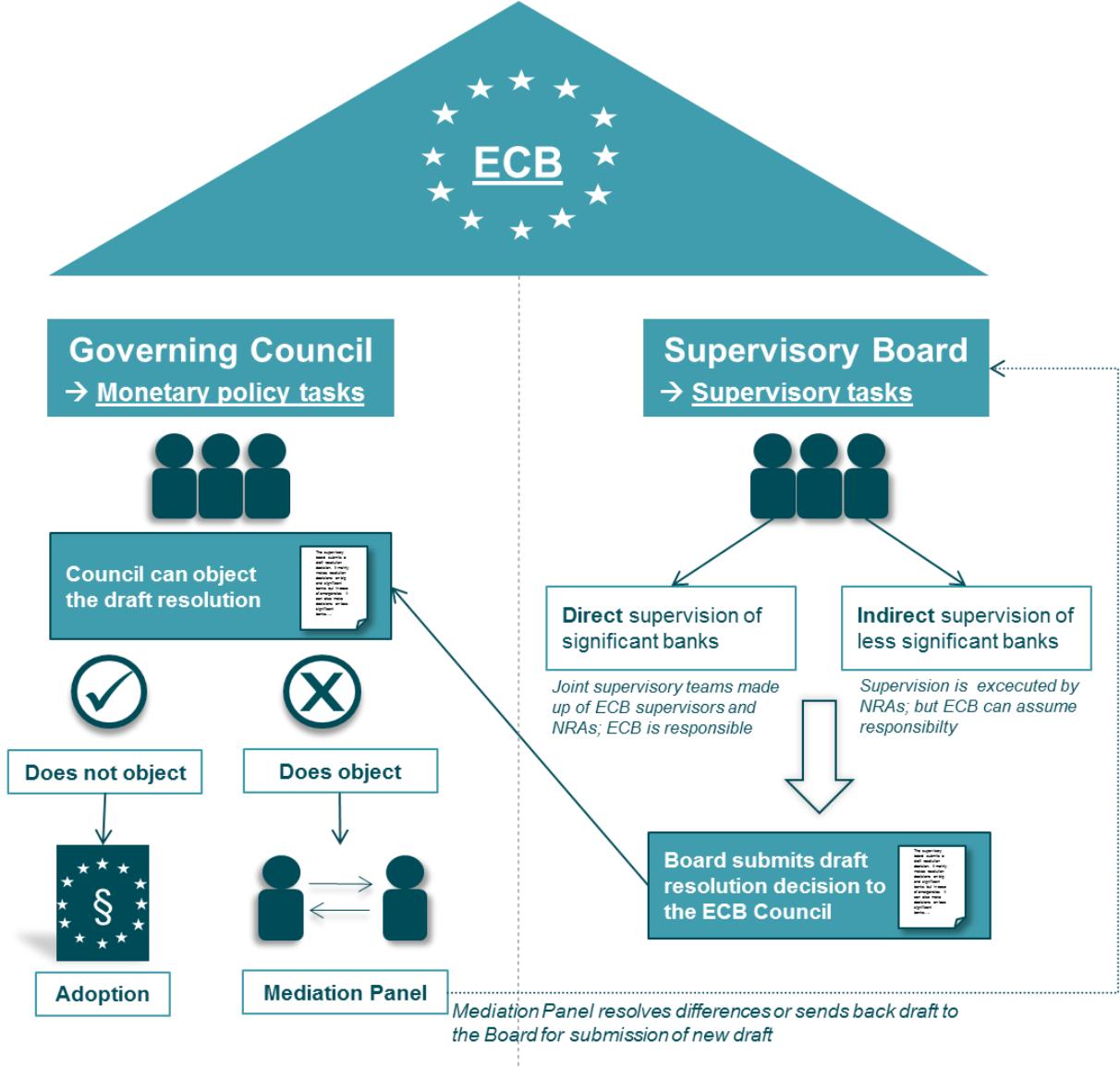
The demands and the success of the EP can also be explained if we look at the political approach. First of all, the political power-based idea suggests that the EP always tries to strengthen Europeanisation as well as its own institutional power. By supporting the SSM but preventing a too strong influence of the monetary policy branch of the ECB, the EP firstly aimed at having a strong, powerful and especially neutral supervisory mechanism and second at extending its own power by gaining a say in the nomination of the SSM's chair and vice chair. Usually, the EP has a hard time pushing through its own preferences if member states resist. However, in this case, member states were also interested in a separation of tasks within the ECB (Schäuble 2012e; Schäuble 2012f). And also the Commission had highlighted before that it wanted to make sure that monetary and supervisory tasks are rigorously separated and also had supported the idea that the ECB's SSM branch should report to the EP (Barnier 2012b: 4). Therefore, the ECB could not extend its own power, whereas the EP was actually able to strengthen itself. On 12<sup>th</sup> September 2013, the members of the European Parliament eventually adopted the legislation on the SSM (EP 2013a; FAZ 2013) and after the annual time period, the SSM officially started working in November 2014.

***Interim Conclusion: H2 Can Be Confirmed – The Combined Approach Explains the SSM***

In summary, it can be said that the power-based observable implications – namely a distributional conflict that leads to disputes about implementation and which is characterized by asymmetry – were present in the case of the SSM. The design of the SSM was highly influenced by asymmetrical distributional conflicts. On the one hand, there was the question about who pays how much for the ESM, which was very clearly linked to the SSM. Consequently, especially Germany and some northern EU member states tried to delay the start of the SSM to prevent paying for inherited liabilities. Additionally, they all demanded to have voting rights on EU supervision within the ECB also if they represented member states which had not (yet) joined the Eurozone. The consequence was the establishment of a Supervisory Board within the ECB in which all members obtained these equal voting rights. This agency mainly shapes the design of the SSM. However, the Governing Council of the ECB still has the last say. The Supervisory Board furthermore serves to separate supervisory tasks from the ECB's monetary task in order to also guarantee price stability in the future. Last but not least, especially Germany suffered from an asymmetrical distributional conflict

concerning the involvement of its small banks in the SSM. Since Germany has a lot of small size public banks which enjoy specific rules and privileges within the German banking system, implementation and adaption costs for common EU supervision would have been high – especially because the German public banks are an influential lobby and the German government had to keep an eye on upcoming elections. Consequently, Germany was not willing to include small banks in the SSM. Eventually, it achieved its goal since small banks were only put under indirect ECB supervision so that national supervisors primarily stayed in charge. Eventually, the ECB tried to gain even more power by strengthening its main representative on the Supervisory Board (the vice chair). However, the EP countered this approach – backed by member states and the Commission – and instead slightly extended its own powers over the SSM.

**Figure 5: Decision-Making Structures of the SSM and its Mode of Operation** (own illustration according to information provided by the SSM (SSM 2015a; SSM 2015b))



This shows impressively that the design and implementation of the SSM was all about politics and power related interests. All actors were trying to expand their influence over the SSM and shape it according to their preferences. Like the political approach predicts, especially Germany, as a member state who suffered from an asymmetrical distributional conflict – meaning that it unilaterally was more burdened by the SSM due to its specific national banking sector – pushed through its own preferences in the end. But also the EU institutions tried to gain as much power as possible. This highly supports hypothesis H2: All the assumptions of the political approach which had been suggested beforehand could be observed in the case of the SSM's design. Since H1 was already confirmed above, the combined functional-political approach is actually able to explain the creation as well as the design of the SSM. In the next chapter, it shall be assessed whether the same applies for the single resolution mechanism SRM.

## **6.2 The Single Resolution Mechanism: Creating a New EU Agency**

Already in January 2015, the Single Resolution Board – the independent EU agency of the SRM – took up work. By now, it is capable of developing resolution plans and by January 2016, it will be fully operational with a complete set of resolution powers (SRB 2015). This SRB is the resolution authority of the EU and thereby the key element of the newly established SRM. EU policy makers had agreed that the common resolution mechanism would – just like the SSM – be obligatory for Eurozone member states whereas member states with other currencies can join on a voluntary basis. Also like the SSM, the SRM is only directly in charge of the biggest and systemically important banks – as well as of those which receive financial aid from the Single Resolution Fund (SRF). The SRB is the core decision-making body of the SRM: It drafts decisions on bank resolution, ensuring that resolutions are executed effectively with minimal costs for EU taxpayers. It additionally manages the appertaining SRF which is financed by bank levy and also aims at disburdening taxpayers and bailing in shareholders and large-scale investors of banks. Even though this seems like the SRB is a strong EU agency with a lot of own powers and capabilities, this is not the whole truth: Today, the decision-making process has been complicated by involving quite a number of EU actors. It will now be assessed why the SRM was established in the first place and why policy makers decided for an EU agency, to eventually examine who influenced the complex design of the SRM. An overview of the decision-making process within the SRM and the therein involved actors can be found in *Figure 6* on page 89.

### 6.2.1 Functional Reasons for Creation: Costs and Uncertainty Due to Non-Regulation

Even before the Single Supervisory Mechanism was actually launched, it positively affected the situation in the EU. In its Financial Integration Report, the ECB stated in spring 2013, that the mere decision to set up the SSM had already restored a little confidence in euro area financial markets and had improved market sentiments (ECB 2013: 9). Market fragmentation had started to retrench slowly (ECB 2013: 9ff.).

However, as early as June 2012 the Council's President van Rompuy stated in his review about a genuine and economic monetary union that only establishing an European supervisor was by far not enough: He argued that for an integrated financial framework which would actually minimize the costs of bank failures within the EU "common mechanisms to resolve banks" were urgently needed (van Rompuy 2012: 3). Many EU policy makers as well as financial experts agreed with him. The question now is whether there was some kind of functional gap which at least threatened to make the financial crisis in the EU even worse and which consequently would have made a common resolution mechanism a necessity. For example, a regulatory deficit would represent such as a functional gap, if important EU regulation on how to restructure or resolve failing banks was missing and if this resulted in severe and costly problems in the EU's banking sector.

#### ***No Resolution Rules, No Authority: A High-Level of Uncertainty in the Case of a Crisis***

In contrast to banking supervision, no particular regulatory authority existed for banking resolution prior to the SRM. There was not even a common European framework for how to proceed when a bank actually failed. Although the Commission suggested such a framework already in 2012, it was not until spring 2014 that all crucial EU actors finally agreed on and adopted a Bank Recovery and Resolution Directive (BRRD)<sup>17</sup>. Since neither a common regulatory framework nor a regulatory authority was available, a lot of EU countries had trusted in general corporate insolvency proceedings to deal with bank failures (IMF 2013: 16). Resolution was the task of the NRAs. According to analyses of the International Monetary Fund (IMF) this induced complex and lengthy wind ups as well as nationalizations, including significant economic costs (IMF 2013: 16).

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<sup>17</sup> The BRRD is part of the Single Rulebook which forms the basis not just for the SSM but also for the SRM. In detail, the BRRD provides a harmonized toolbox for NRAs including principles on how to deal with the resolution and recovery of banks, how to guarantee efficient early intervention, or how to take preventive measures for a swift resolution in the future (e.g. crisis-planning mechanisms) (Constâncio 2013a; IMF 2013: 11f.). It also especially addresses cross-border banks. Today, the SRM governs the resolution of big cross-border banks and coordinates the application of the resolution tools of the BRRD (Constâncio 2013a).



The lack of regulation was especially problematic in the case of failing cross-border banks where it led to a lot of confusion and errors. The IMF detected that the wind up of the cross-border banks Dexia and Fortis were protracted and costly because a resolution authority was missing (IMF 2013: 16). In the case of the international Fortis Group, the concerned member states – Belgium, Luxembourg and the Netherlands – all agreed on contributing public money to save Fortis. But soon liquidity pressures increased even further and this agreement of the NRAs of the three member states quickly fell apart (IMF 2013: 16). As a result, the bank was broken up along national lines: The Belgian parent company sold the shares of the Dutch parts of Fortis to the Netherlands government and afterwards agreed with Luxembourg to sell their banking arms to BNP Paribas (IMF 2013: 16). The IMF concludes that this difficult and lengthy resolution process resulted in a “setback to financial integration in the Benelux” and it was a lot “more costly than a first-best joint solution for the group” (IMF 2013: 16). Although the EBA had the right to take supervisory decisions in case of severe disputes between NRAs (EU Regulation No 1093/2010, Art. 21 (3)) it did not have the possibility or power to dictate them a resolution procedure. The main problem in the case of Fortis was that common rules on how to resolve cross-border banks were missing as well as an authority which could have taken drastic measures to ensure rapid and efficient corrective action or resolution and the minimization of costs. The same applies for the Dexia bank which was also segmented along national lines after a prolonged and cost-intensive resolution period and which likewise had to be rescued with taxpayer support from France, Belgium and Luxembourg (IMF 2013: 16).

Ever since the start of the crisis, euro area banks had been saved by governments bailing them out like in the cases of Dexia and Fortis. This in turn increased the vicious circle of defaulted banks and increased state indebtedness. And if a government did not have enough own financial power to bail-out its banks, it requested aid from the other EU member states, like for example Spain or Greece. Aid programs were issued because banks were considered as ‘too big to fail’. This suggested that if they failed, it would probably have contagious effects on other ailing EU countries. In consequence, the ones paying for failing banks were regularly the EU taxpayers. There was no regulation which suggested any alternative to bail-outs with tax money.

A regulatory deficit concerning banking regulation thus was observable: Common resolution rules were missing. There was no authority which guaranteed efficient resolution of failing banks. This especially prolonged resolution processes for cross-border banks and thus increased costs for resolutions. Eventually, the public bail-outs of these banks fueled the sovereign-bank loop which was one of the most crucial factors in the crisis. An operational

deficit can again not be confirmed here. Since there were hardly any common banking resolution rules, there was nothing to be implemented on the member states' side. The same goes for a capacity deficit: Until 2012, the EU was not even making an effort in guaranteeing common and smooth bank resolution but rather left it to the NRAs. This was not because the EU was lacking resources. In point of fact it was missing the awareness that resolution had to be streamlined on the EU level. Therefore, no capacity deficit existed in the case of the SRM.

However, the regulatory deficit and the fact that a common resolution approach was still not established in spring 2013 caused severe problems in the euro area, even though it seemed at first as if the Euro crisis had started to ebb away. The ECB had stated that financial markets were doing better shortly after the announcement of the SSM (ECB 2013). In February, Olli Rehn, at that time EU Commissioner for Economic and Monetary Affairs and the Euro, praised the latest steps towards more financial integration and also emphasized that stress in the financial markets had been significantly reduced (Rehn 2013b). It almost seemed, as if the financial sector as well as taxpayers slowly got used to the ongoing rescue of failing banks (Hildebrand 2013). It appeared to be common sense that banks were generally 'too big to fail'. And even if some rescue packages really came last minute, never, in the history of the European financial banking crisis had an ailing bank not been bailed-out by public money.

But these developments obviously were only the calm before the next storm. In spring 2013, a severe banking crisis broke out in the small euro area state of Cyprus. The problem in Cyprus was its extensively oversized banking industry. The Cypriot banking sector was mainly characterized by attracting foreign deposits by offering very favorable conditions and only enforcing poor risk management practices (Rehn 2013a). Consequently, if the size of its banking sector was measured in relation to the GDP of Cyprus, Cypriot banking assets accounted for 409% of GDP (ECB 2014a: 8). The primary problem which eventually destabilized Cyprus was however, that the two major Cypriot banks, the Bank of Cyprus and the Laiki Bank (former Marfin Popular Bank), had increased their balance sheet totals by strengthening financial ties with Greece (Kopf 2013: 233). Cyprus thus was a large holder of Greek government and corporate bonds. By June 2011, private banks in Cyprus had a Greek exposure of 29 billion euros – that makes 160% of the Cypriot GDP (Kopf 2013: 233ff.). Since Greek bonds suffered from a crucial loss in value due to the crisis in Greece, these bonds had a highly negative impact on Cypriot banks, which eventually were dependent upon aid from the EU in 2013.

But what has this to do with a lack of regulation on banking resolution? After all, the Cypriot banks could simply have been bailed-out – like so many other euro area banks before.

However, the problem was that for Cyprus, its inflated banking sector was actually not ‘too big to fail’ but ‘too big to save’. Already in 2012, gross government debt reached 87% of gross domestic product (Wolf 2013). Consequently, the Cypriot state simply could not have saved its banks by providing them with taxpayers’ money. Therefore, Cyprus asked the EU for help. But as the *Financial Times* reported, the EU was not able to lend Cyprus the 17.2 billion dollars it needed – because this would have brought sovereign debt to 160% of GDP and this certainly would have been an unsustainable burden for Cyprus (Wolf 2013). The EU eventually agreed on a rescue package of 10 billion euros, which was the maximum of liabilities which Cyprus could possibly handle according to EU financial experts (Wolf 2013).

There it was, the Cypriot dilemma: Those 7.2 billion dollars had to be found somehow and this meant: Closing banks and especially involving depositors in the recapitalization of the banks. Since Cyprus banks were near collapse and the government near bankruptcy, time was short. Consequences of an unorganized bankruptcy were unpredictable and could have reached from high economic losses within Cyprus to the exit of Cyprus from the Eurozone or even a clash of the whole European financial market (Kopf 2013: 233ff.). The EU Economic Affairs Commissioner Olli Rehn thus stated, that the situation was too pressing to find ideal solutions (Riedel/Berschens 2013).

However, a bail-in had never been carried out before in the Eurozone and neither proper regulation nor a guideline or best practice was at hand for how to proceed with a resolution and a bail-in. This caused a whole lot of uncertainty and resulted in various ideas about how to close the Laiki Bank and how to burden shareholders. The situation finally became chaotic, when EU leaders – amongst them especially Angela Merkel – even called for imposing a tax on savings worth less than 100,000 euros and thereby burdening small and private depositors (Weiland/Wittrock 2013; Levush 2013). Suddenly, there was a very high level of insecurity among the European people, about whether bank deposits were still secure. And while EU politicians were fighting about how to solve the Cypriot crisis, at least some people in Cyprus tried to remove their money from the banks. Eventually, small savers were spared from the bail-in. But even if the worst did not happen, the Cypriot banking crisis would have been a perfect scenario for a bank run resulting in a severe financial and economic crisis with contagious effects to the whole Eurozone.

The uncertainty which emerged during the crisis in Cyprus was all due to a regulatory deficit. If there had been common rules and procedures on how to resolve or restructure banks in the euro area, there would not have been deficient ad hoc suggestions which caused anxiety on the financial markets and which ended in heightened costs for resolution. The same applies

for other – less startling cases of bank resolution – like in the cases of Fortis or Dexia. Additionally, these extremely difficult bank recoveries and resolutions added to the sovereign and bank doom loop, since tax money was always used for bail-outs. Only during the Cyprus case, it became obvious that due to high indebtedness a public bail-out was hardly possible and that another way to recapitalize banks should be found and formalized. However, again regulation was missing on who pays how much if a bail-in becomes necessary. The functional gap due to regulatory deficits was consequently high before the SSM's creation.

### ***Failed Bank Resolution is the EU's "Achilles Heel": Policy Makers Call for the SRM***

Between summer 2012 and summer 2013, the major EU policy makers all became aware of this functional gap. They constantly referred to the functional problem – namely a lack of regulation – when calling for some kind of common resolution mechanism. After van Rompuy in June 2012, the Commission President Barroso issued a warning about this regulatory gap: Suggesting a common resolution framework with the BRRD at its core, he indicated that the crisis had shown several times that there were serious shortcomings in the existing rules and arrangements for banking resolution (Commission 2012b: 4). Barroso also stated that taxpayers should be protected “from the impact of any future bank failure” (Commission 2012b: 1). Eventually in September 2012, the Commission put its ideas for future bank resolution in a more concrete form: In its roadmap towards a banking union, it made clear that a supervisory mechanism was not sufficient. After all, even a strong supervision cannot prevent completely that a bank fails. Thus, for the case that a banking crisis occurs nevertheless, it was necessary to ensure that institutions can be resolved in an orderly manner. In its September roadmap, as well as in a blueprint in November 2012, the Commission therefore concluded that an effective banking union needs not only a single supervisory mechanism but also a common resolution mechanism to deal with banks in difficulty (Commission 2012d: 18; Commission 2012e: 9). The SSM had to be complemented by the SRM. The past had shown that a “lack of euro-area wide bank resolution institutions resulted in powerful and damaging negative loops emerging between the banking system and the sovereigns [...]” (Commission 2012d: 3). The Commission referred to past experiences with “too big to fail-banks” which were not resolved orderly because of decentralized resolution across borders and to the “damaging of the fiscal standing of the sovereign” (Commission 2012e: 9). Therefore, the Commission concluded that it wanted to make a proposal for some kind of single resolution mechanism in 2013 to fill the regulatory gap which caused costs and deepened the Eurozone banking crisis. In January 2013, the

Commission President emphasized once more the functional need for a common resolution authority: He criticized that too often solutions on failing banks had to be designed ad hoc and that “structural and permanent replies are needed” in order to prevent uncertainty on the financial markets and high costs for taxpayers (Barroso 2013: 4f.).

During the European Council meeting in December 2012, the member states, too, already agreed that a resolution mechanism was necessary. They decided that the Economic and Monetary Union should be strengthened by the creation of the SSM as well as by new rules for recovery and resolution of banks (BRRD) and that these steps will be “completed by the establishment of a single resolution mechanism” (Council 2012c: 1ff.). The Council stated that a SRM was important to protect public funds (Council 2012c: 4ff.). Additionally, the Council also thought that the SSM would not be efficient on its own. A supervisory mechanism on EU level could only ensure that difficulties of a bank were detected. But a SRM would be required to efficiently resolve failing banks (Council 2012c: 4).

The European Parliament concurred with the opinions of the Commission and the Council. In a report which was published in February 2013, the EP’s Economic and Scientific Policy Department highlighted that past crises had convincingly demonstrated that until then insolvency processes for banks were unsuitable and that uncertainties arose due to badly designed resolution regimes (EP 2013b: 8). The EP experts criticized the current handling of failing banks. They claimed that delays in restructuring or resolution of large banks as well as the break-up of multinational banks along national borders harmed the single market (EP 2013b: 19). Therefore, they stressed the importance and functional necessity of a centralized resolution regime and an exclusive decision-making authority (EP 2013b: 19ff.). Additionally to the EP, also the IMF demanded that the EU would create a strong resolution authority. According to the IMF, regulation on an integrated banking system was incomplete if only supervision power was delegated to the EU. A SSM alone would not be able to break the vicious circle (IMF 2013: 4ff.).

Furthermore, the ECB was vigorously calling for a SRM to complete the SSM for quite some time. In October 2012, the ECB President Mario Draghi made clear that the absence of an EU-wide resolution regime had made the handling of bank failures more complicated, especially in cases of cross-border banks (Draghi 2012a). These complications made bank failures more expensive – at the cost of the European taxpayers (Draghi 2012a). In a speech before the Committee on Economic and Monetary Affairs of the European Parliament in the beginning of 2013, Draghi listed several functional reasons to emphasize the necessity of a resolution mechanism. He said that it was required to complement the SSM because only a

SRM could guarantee timely and impartial decision making without national bias once the SSM had classified a bank as failing (Draghi 2013). In addition, he claimed that only a resolution authority could credibly commit to a resolution strategy. By being more efficient than NRAs, such an authority could actually minimize the costs for taxpayers (Draghi 2013). Consequently, Draghi had already realized in 2012 that some kind of resolution mechanism was needed to fill the previous regulatory gap. However, when the Cyprus crisis eventually was full blown in spring 2013, he and the ECB called even more intensively for a quick creation and implementation of a resolution mechanism. After all, the Cypriot case had shown that missing rules and a missing resolution authority had led to questionable ad hoc solution attempts in the EU and this had highly increased the uncertainty and thereby endangered the stability of the financial markets (Cœuré 2013b). If it was up to the ECB, improvised decision making on bank resolution had to stop right away. Instead, legal certainty and predictability had to be fostered by establishing a responsible and strong resolution authority and a common resolution framework which ensures the possibility to bail-in large-scale investors and thereby protect taxpayers (Asmussen 2013; Cœuré 2013b). The ECB Vice President Vítor Constâncio put the functional gap and the consequent request for the SRM in clear words by saying in February 2013: “As we all know, the swift and orderly resolution of cross-border banks is the Achilles heel that needs to be addressed” (Constâncio 2013a).

With the ECB lobbying for the creation of a resolution mechanism, one could easily suspect that functional reasons were only a pretext and that in reality, the ECB wanted to gain even more power by also becoming the resolution authority. However, this assumption can be rejected quite easily. Members of the ECB’s Executive Board emphasized several times that a resolution authority should under no circumstances be placed within the ECB in order to prevent any potential conflict of objectives, that a strict separation between supervisor and a resolution authority should be ensured and that thus the creation of a new EU body for resolution would be preferable (Mersch 2013; Cœuré 2013a; Asmusen 2013).

In addition to those EU actors, also the member states called for a resolution mechanism including some kind of strong authority due to functional reasons. German Finance Minister Schäuble thought that mere cross-border supervision was not enough (Schäuble 2013b). In a guest commentary in the *Financial Times* he wrote that the difficult rescue of Cyprus had shown that the EU lacked predictability about how to proceed when restructuring or closing banks and about to what extent shareholders would be bailed-in (Schäuble 2013b). Therefore, a common resolution mechanism was needed. The member states should no longer rely on ad hoc approaches because a mechanism to wind up banks in an orderly fashion throughout

Europe would be the best antidote to the vicious sovereign-bank nexus (Schäuble 2013b). Furthermore, Schäuble also said that current resolutions caused high costs for taxpayers and that they had to be protected through better regulation in the future (Schäuble 2013a; Schäuble 2013b). German Chancellor Angela Merkel agreed: She, too, believed that a lack of centralized resolution caused delays in the recovering or closing of banks and consequently increased costs for taxpayers (Merkel 2013a; Merkel 2013b).

France also favored a resolution mechanism because of the regulatory gap. The French President François Hollande repeated regularly that the crisis had shown that bank resolution in the EU had often failed and that a common mechanism to actually resolve ailing banks was necessary to prevent further crisis (Hollande 2013a; Hollande 2013b; Déclemey 2012).

In July 2013, the Commission eventually made an official proposal for the creation of the SRM. There, it summarized the many functional reasons for the establishment which were previously stated by the various EU policy actors mentioned above. The Commission suggested that the EU had to learn from mistakes made in Cyprus and that ad hoc resolution approaches had to be replaced by strong regulation and a resolution authority which ensures the compliance with resolution rules and procedures (Commission 2013b: 11f.; Commission 2013e). Additionally, it also named for example the cross-border bank Dexia as a negative example for failed resolution and a lack of regulation (Commission 2013c: 1). Furthermore, the SRM was functionally needed to complement the SSM, to efficiently deal with failing banks, to minimize costs for taxpayers and thus help to break the vicious circle, to avoid national bias in bank resolution and to ensure broad compliance with bank resolution (Commission 2013d). The Commission also emphasized that a resolution authority was needed and that a mere framework for resolution like the BRRD was not enough – because the past experiences in the EU (especially concerning banking supervision) had shown that compliance with banking regulation cannot be ensured by only establishing rules without a strong authority to watch over the implementation of those rules (Commission 2013e).

### ***The Functional Advantage of the SRB: EU Level Resolution and Expertise***

Quite obviously, EU actors decided to create some kind of resolution mechanism in order to solve the regulatory problems concerning resolution and to close the functional gap. However, it would also be necessary that they chose to create the Single Resolution Board, namely an EU agency, because it provided functional advantages. When looking at the events prior to the final decision to create the SRM including the SRB, it first seems as if this implication was not given because Germany seemed to lobby for the creation of a network while the

Commission wanted to usurp the resolution role itself. This seems to hint at political reasons for the final compromise on a resolution agency. However, if the case of the SRB is researched in detail, it becomes obvious that actors eventually agreed to create an agency due to functional reasons and that they were only concerned with power issues when it came to the more specific design and especially decision-making arrangements within the SRM.

In its July proposal on the SRM, the Commission outlined in detail how it thought a resolution mechanism should operate. And it made clear that the establishment of a network was out of question because it would endanger the SRM's functionality. In a statement on bank resolution the Commission said that the Cyprus crisis had shown the importance of an EU level resolution body to prevent uncertainty. Even an intergovernmental network of NRAs could not ensure that bank resolution was conducted efficiently at the national level without stirring insecurity on the financial markets and risking contagious effects (Commission 2012e). And especially in the cases of cross-border resolution, a network could hardly improve resolution procedures. After all, the crises had shown that coordination between NRAs frequently failed (Commission 2012d: 6). According to the Commission, a network therefore "would not be sufficient for member states which share a common currency or are supervised by the ECB in the Banking Union" (Commission 2012e: 1f.).

In its SRM proposal, the Commission enumerates three main reasons why a central agency with decision-making power provides major advantages for member states, taxpayers, banks and the financial stability of the EU compared to a loose regulatory network (Commission 2013b; Commission 2013e):

- (1) Only an agency can **guarantee strong central decision-making** which will make sure that resolution decisions across member states will be taken efficiently and quickly. A network would again rely on decentralized coordination among member states and probably lead to further uncoordinated action and thus have negative impacts on financial stability (Commission 2013b: 4ff.).
- (2) Only an agency can provide **centralized bank resolution expertise** (Commission 2013b: 4). Establishing one powerful EU resolution authority minimizes costs compared to fostering strong resolution authorities in different member states. Therefore, it provides advantages in terms of economies of scale compared to a network (Commission 2013b: 5).
- (3) Only an agency can really **reduce the need for financial support and save public money**. Since a centralized authority can take decisions quicker and more efficiently, it will **reduce costs** which occurred from the delayed restructuring or closing of banks (Commission 2013b: 4; Commission 2013e: 2).

By presenting these arguments, the Commission called for the establishment of an agency, the Single Resolution Board, which should be composed of representatives from the ECB, the Commission and the relevant NRAs. Thereby, the Commission suggested an agency with



slight network structures, because it intended to involve many different actors, especially the NRAs. This should guarantee to have the benefits of a centralized agency without losing the know-how of these relevant actors (Commission 2013b). The SRB should prepare the resolution or recovery of a bank. Besides, the SRB should also decide on whether to use money from a newly created Single Resolution Fund<sup>18</sup> consisting of bank levy from all participating member states and it should oversee resolution processes which are eventually carried out by national authorities (Commission 2013c: 2). This shows that the Commission wanted to establish an agency – and not settle EU bank resolution directly within the Commission itself. However, the Commission did claim to have the last say in resolution procedures and thereby having final decision-making power (Commission 2013c: 2). This was eventually not accepted by the member states. Nevertheless, it is obvious that this was not a discussion about the creation of a resolution agency in principle but it concerned particular and detailed design modifications. Therefore, it will be discussed in the next section.

Here, it becomes obvious that the Commission had several functional arguments for stating that an agency would be the best way to solve the regulatory problem in EU bank resolution. A network would have been too loose, whereas locating the SRM completely at the Commission and making the Commission the resolution body in charge, would have made it hard to involve other actors as the ECB or the NRAs (Commission 2013b). An additional reason why an agency became necessary was that with the SSM, EU banking supervision should take place on the EU level in the future. Consequently, it was only logical to also go for a resolution mechanism on the same level of authority in order to prevent tensions between the supervisor and NRAs which could emerge over how to deal with ailing banks and their resolutions and which could lead to redundant accusations (Commission 2013d: 6).

Additionally, another functional argument for the creation of an agency is credibility. The SRM aimed at reducing uncertainty and foster credibility across EU financial markets by guaranteeing a strong resolution mechanism without any future ad hoc decisions which could cause turmoil. Delegating resolution power to a network would have undermined this credibility, since networks are a priori perceived as regulatory bodies which can only make loose arrangements and which only provide weak regulation (Kelemen/Tarrant 2011: 925f.).

Independent financial and banking experts found that the Commission was right by proposing to create a resolution agency because of functional aspects: For example, scientists analyzed that a central agency would be better at efficiently restructuring or closing banks

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<sup>18</sup> The SRF aimed at bailing-in large scale shareholders, investors and creditors and thereby to protect taxpayers (Commission 2013b).

than NRAs within a network because NRAs had more limited resources (Koschyk et al. 2013: 6). Furthermore, the resolution of cross-border banks was difficult to execute on the national level and cooperation between NRAs was typically difficult. Therefore, an EU level agency would be better at solving these resolution problems (Koschyk et al. 2013: 8).

However, Finance Minister Schäuble called for the creation of a network. Does that mean he had political interests, wanting to keep national power over bank resolutions? Actually, Schäuble did not want to create a mere network but lobbied for a two-step approach: He suggested creating a network of NRAs first because strengthening EU-wide resolution was necessary in time with the launch of the SSM in 2014 (Schäuble 2013). And in a second step he wanted to transform this network into a strong EU agency. One could suspect that this was political delaying tactics aiming at preventing the delegation of resolution authority to the supranational level. However, Germany brought forward functional arguments for this delay: According to Schäuble, the legal basis for a strong SRM and within that especially a common resolution fund was doubtful. After all, the fund would mutualize money of the member states and this was a highly controversial issue. Germany did not want to support a SRM on a questionable legal framework because this could lead to lawsuits against resolution decisions (Schäuble 2013c). In turn, this would make resolution insecure and endanger financial market stability yet again (Schäuble 2013c). Therefore, Schäuble was convinced that to create an EU level SRM, the EU treaties would have to be changed and this would take up too much time – or in other words, it could not be done by the launch of the SSM in 2014 (Schäuble 2013d). That is why he suggested creating a network first. He stated that with his proposal he wanted to “buy time for the creation of a legal base for our long-term goal: a truly European and supranational banking union, with strong, central authorities, and potentially covering the entire single market” (Schäuble 2013b).

That Germany did not only want to prevent the delegation of resolution authority to the EU level, but that its concerns about the legal framework were justified, was eventually shown by a report of the Legal Service of the Council (CLS). The CLS concluded after detailed research that the initial proposal of the Commission was actually not in line with the EU Treaties or the case law of the European Court of Justice (ECJ) (CLS 2013). Consequently, Germany’s two-step approach to a resolution agency was borne out of functional considerations. After all, if decisions of a resolution authority would be likely to be sued in front of the ECJ, the SRM would not be able to function in the sense of providing certainty or strong and uniform regulation or credibility. This legal uncertainty eventually even led to the outcome that an essential part of the SRM – namely the regulation for the common fund – was excluded from

the usual EU legislation process and an intergovernmental agreement was adopted in order to establish the SRF (Barnier 2014). Consequently, Germany was right about its legal concerns, even though the EU eventually found another solution than Schäuble's two-step approach. With the controversial fund and the resulting mutualisation of money excluded from the actual SRM legislation, an agency could be created nevertheless. Currently, there are considerations to include the intergovernmental SRF agreement into common EU law after a treaty change in the future.

### ***Interim Conclusion: H1 Accounts for the SSM – Regulatory Gap Leads to Agency Creation***

Looking at the observable implications, it can be seen that the SRM in principle was created due to functional reasons: There was a huge functional gap because regulation on how to handle failing banks was widely missing. The main EU actors all referred to the functional problems with resolving EU cross-border banks or with fighting off the Cyprus banking crisis when they called for a common resolution scheme. Even more so, they all agreed that an EU agency was needed in order to improve future resolution because of the functional advantages of an agency which would enable EU level resolution but at the same time incorporate the know-how of different crucial actors. In contrast, a network would only provide loose regulation and the Commission as resolution authority could hardly include all relevant actors. Therefore, the assumptions of the functional hypothesis H1 are valid here. In the next section, the emerging disagreements of the main actors concerning the specific design and especially decision-making rules of the SRM will be discussed.

### **6.2.2 Political Reasons for Design: Who Pays How Much for Resolution?**

The SRM was created because of functional reasons. This can also be seen if one makes a quick cross check by executing a simple thought experiment. If we follow the original political approach by Kelemen and Tarrant (2011) (and not the combined functional-political idea which is suggested in this paper) member states should never delegate authority to the EU level if there is a distributional conflict. In the case of the SRM, some member states – especially Germany – called for a network, while the Commission tried to draw up decision making powers itself. With the two actors trying to gain power and to enforce their preferences this seems like a political struggle. However, in the end the EU actors agreed on the compromise of strengthening the SRB which is a fully independent EU level agency (Commission 2014d). This can only be explained by the functional reasons stated above because the distributional conflict was extremely high in the case of the SRM as it will be outlined on the next pages.

### ***Arguing about the Distribution of Costs and Money: Who Pays How Much if a Bank Fails?***

The resolution of banks usually includes specific legal regimes for the orderly restructuring and as the case may be the liquidation of ailing financial institutions (EP 2013b: 10). This is also the core of the SRM as suggested by the Commission in July 2013. As already outlined above, in the past the main problems at unwinding banks arose when it came to the distribution of financial burdens across different EU member states (Gstädtner 2013: 8). And since the NRAs could often not agree on how to distribute those arising expenses, cross-border banks were segmented along national lines. This in turn led to even higher resolution costs (IMF 2013: 16). The reason for the discordance of the NRAs was obviously the question of who pays how much for the wind up of the particular bank. Consequently, a distributional conflict is inherent to the subject of transnational bank resolution in general.

For the member states of the EU, it is crucial to know who bails out banks. While in the past, the NRAs were asking which country has to pay how much, this question got even more differentiated over time. The decision to recover or wind up a bank as well as how this wind up is executed, affects a lot of parties: the bank itself, but also customers, investors, business partners and possibly even the state where the bank is located if public money is needed for a bail-out (Gstädtner 2013: 8). Ever since the Cyprus crisis, EU policy makers were discussing controversially how to make investors or even depositors pay for failing banks. They were considering that such bail-in rules would eliminate moral hazard. Usually, moral hazard occurs because bankers feel safe to gamble and invest in high-risk assets if they a priori assume that the state will bail their banks out anyway in an emergency. However, by making it clear from the beginning that they have to partake in bearing the costs for a bank failure, moral hazard shall be prevented. The distributional conflict therefore is additionally about whether the private sector or the governments have to pay for bank resolutions.

In the particular case of the SRM, a high distributional conflict was present because it was all about: Who pays how much for future bank resolutions and who decides on these costly wind ups? When the Commission suggested creating and implementing a common resolution mechanism, a distributional conflict was obvious right from the start. This was due to the fact that the Commission was not only calling for the bail-in of large scale investors and shareholders, but also for a common resolution board with a mutualized resolution fund. The implementation of the SRM would thus mean that member states suffer from costs for the fund. Additionally, the SRM makes them lose sovereign power over when a bank gets resolved as well as over how much they have to pay in cases of cross-border resolutions. This distributional conflict led to severe disputes of the EU actors about the exact implementation

and design of the SRM. The main points of discussion were first, who obtains the right to take final resolution decisions; second, how the fund is designed; and third, whether small savings banks should be included or not.

According to the initial proposal, the resolution board with the Commission as its final decision-maker was supposed to determine whether or not a bank should be recovered or wound up. The Commission argued that with its role as a guardian of the EU Treaties, it is the best suited among EU institutions to take decisions on resolution because it can “ensure that final decisions fully respect the principles underpinning the functioning of the EU and are consistent and equal across the Single Market” (Commission 2013b: 6). Germany and other member states were however highly reluctant to delegate that much power to the Commission because the decision on bank resolution interferes with the sovereignty of EU member states. After all, even if the resolution board was supposed to involve NRAs in its draft decision, the Commission would have the final say in the resolution of cross-border banks (Commission 2013b: 8ff.). However, such a wind up can eventually lead to the government having to step in and pay for the indebted bank if other financial means (like bail-ins) are not enough.

Additionally, the Commission intended to use the ESM to resolve banks during the transition phase, namely before the SRM fund was completed – and the ESM is naturally filled with taxpayers’ money (Commission 2013b: 7f.). In consequence, the member states (in particular Germany) were worried that granting ultimate resolution power to the Commission could indirectly lead to the Commission deciding on the usage of taxpayers’ money (Schäuble 2013d). Germany indicated that it must not be the Commission who takes the final resolution decisions because it allegedly would be caught up in conflicts of interests between being an aid authority and a resolution authority (Schäuble 2013d). Schäuble instead argued that the Council and thereby the member states themselves should gain final decision making power over resolution.

In December 2013, the member states wanted to decide on the design of the SRM. Since Germany was not willing to move away from its position and other member states were obviously also reluctant to delegate that much power to the Commission (Höltzsch 2013b; Reuters 2013; Kafsack 2013), the final report on their agreement included the following: The SRB was supposed to draft a decision and within 24 hours not only the Commission but also the Council of the European Union was allowed to veto the resolution by simple majority (Council EU 2013a: 2). This gave a lot of power back to the member states which thereby wanted to obtain the possibility to influence and to reject a resolution. Even though the SRB was supposed to act on the EU level, it would be hard to prevent national influences in this

resolution model. However, in the end the EP at least partly scotched this plan of the member states as will be shown below.

### ***The Intention to Keep Power: Germany Does Not Want to Accept Higher Adaption Costs***

But before coming to the final agreement of the SRM, it is necessary to look at further disputes which arose due to the distributional conflict especially the question of how to design the resolution fund. And this dispute was not just characterized by a distributional conflict but also by the asymmetry of distributional concerns. Germany was again more affected by the implementation of the SRM than for example France and therefore, Germany was especially keen on keeping an eye on resolution procedures and especially payments for resolution.

In its July proposal, the Commission introduced the idea of creating a Single Resolution Fund – and obviously it was clear to all EU actors, that such a fund was needed out of a functional necessity: A resolution mechanism which does not have the financial resources to actually recover or close a bank if money from a bail-in is not enough, is eventually useless.

But opinions varied widely about how to exactly design such a fund. The Commission wanted to create a common fund financed by bank levy from the different member states. The target size of the fund as determined by the Commission was at least one percent of covered deposits in the banking system of the participating member states (Commission 2013b: 14f.). This would have meant all banks covered by the SRM would have to build up a fund which eventually should contain 55 billion euros to ensure orderly resolutions in future crises. The fund would be used if the money provided by bailing in shareholders, creditors and investors with up to eight percent of the total liabilities and funds of the institution under resolution was not enough (Commission 2013b: 14). These 55 billion should thus be used to help banks in great financial distress (Commission 2013e: 3ff.). Thereby, the money which the member states' banks gave to the fund would be mutualized and as a result member states would commonly bear liabilities for failing banks. National funds of the member states were supposed to be merged into this joint EU resolution fund – and this is where the asymmetrical distribution problem started.

Germany was once again leading the way in the EU as it had already established a national resolution fund long before the EU put this issue on the agenda. Germany had implemented a so-called “restructuring law” in 2010 and this law included the necessity to build up a national resolution fund financed by bank levies in order to have an emergency funding for failing banks (Merkel 2014). In the long-term, the German resolution fund aims at generating 70 billion euros through bank levies (Bundesbank 2015b). This highlights two important issues:

First, Germany did not necessarily need a single resolution fund. They already had their own structures for resolutions up and running and did not see an advantage by engaging in a strong centralized SRM with a common fund. It is noteworthy that the EU resolution fund SRF was only supposed to contain 55 billion euros (Commission 2013b: 14), whereas the national resolution fund of Germany should contain 70 billion euros, to also guarantee the smooth resolution of large-scale banks. For Germany, the concept of the SRF therefore must have seemed pathetic without any major benefits for itself. At the same time, the contrary was true for France or many southern EU member states: Up until then, they had not created any kind of national resolution fund (Godin 2013b; Uken 2013). However, they had several failing banks which were in desperate need of EU aid. They were interested in an effective resolution mechanism which could easily grant mutualized money to failing banks. Schäuble therefore feared that if money was mutualized within the SRF, Germany would end up paying the bills for those foreign banks – especially during the build-up phase when other member states were yet struggling to create own funds (Schäuble 2013d). And Chancellor Angela Merkel also emphasized that Germany always preferred to accept as little mutualisation of risks and money as possible (Merkel 2014).

Second, the SRF even resulted in a disadvantage for Germany: Even though Germany was already building up a resolution fund and had never needed EU assistance when restructuring a German bank, they were now supposed to give up sovereignty to the central EU level and let the Commission decide what would happen with their money, even though a national resolution fund was seen as a special asset of the state (Bundesbank 2015b).

Consequently, Germany was affected asymmetrically by the SRM proposal of the Commission and consequently called for designing the Single Resolution Fund quite differently than the Commission had intended – that is with a lot more national control: It wanted to establish a fund which merely consists of national resolution funds and therefore is some kind of fund network (Schäuble 2013b). And if mutualisation takes place, this should happen slowly and only after several years, to prevent Germany from paying for inherited liabilities. Schäuble emphasized that the budgetary sovereignty of member states should remain untouched (Schäuble 2013d). As media coverage showed, Germany was highly worried about burdening taxpayers further and about paying for inherited liabilities and previous banking mistakes of other member states (Schmitz 2013, Kafsack 2013). The German Finance Minister furthermore claimed that the ESM could only be used as a mere emergency solution. Before that, investors had to be bailed in and the national resolution fund

of the country in which the failing bank in need of restructuring is located should pay the bill (Schäuble 2013d; Handelsblatt 2013).

However, France for example did not like that idea. French Finance Minister Pierre Moscovici called for the mutualisation and a true common fund (Uken 2013). The French press criticized Germany's demands harshly saying that Germany only wanted to protect its own public money which was supposed to flow into the ESM and that it tried to establish a SRF which focuses on the status quo, namely national resolution funds (Le Monde 2013; Boutelet 2013; Godin 2013a). A French journalist wrote about Germany already having its own national resolution fund while other countries had not and he complained that it would be hard for those countries to quickly build up such a national fund (Godin 2013b). He accused Germany of only trying to push through its own preferences (Godin 2013b). This was what Germany intended: By designing the SRF in form of a fund network, Germany could simply have kept its own national resolution fund and thereby it could have ensured to keep implementation costs extremely low, whereas the opposite, namely a mutualized fund, meant increased expenses for Germany.

However, this was not the only asymmetrical conflict about the distribution of costs. Similarly to the SSM's design considerations, the problem with Germany's small savings banks (*Sparkassen, Volks- and Raiffeisenbanken*) popped up again and made Germany demanding tight national control mechanisms. The distributional problem here was again fueled by the opposing standpoints of Germany and France including the southern EU states. France, with its banking sector which is mainly made up of big banks, of course wanted that all banks got included into the SRM as foreseen by the Commission (Hollande 2013b). The same goes for France's southern allies. After all, those countries had the lowest public funds so far but the strongest temptation to save banks ex post and they had the closest link between the banking sectors and their governments (Gros 2013: 2ff.). For example, in Italy and Spain approximately every tenth euro in the banking system was on loan to governments in 2013 (Euractiv 2014b). Therefore, those countries had a high interest in breaking the link between sovereigns and banks by establishing a strong mutualized European resolution fund. It would presumably be those member states which profit the most from a common resolution mechanism and a single fund.

At the same time, the situation was different in Germany. And Germany's small and regional banks again lobbied for their exclusion. The BVR stated that any kind of mutualized resolution fund on EU level was not acceptable due to moral hazard. Such a fund would only support venturesome behavior of big banks and discriminate small ones which are usually



more stable and secure (BVR 2013; Reuters 2013). The Commission at first intended to include all approximately 6,000 different kinds of EU banks – not only large and systemically important ones – under the single resolution scheme (Commission 2013e: 2f.). Germany rejected this idea. Georg Fahrenschon, the president of the association of German savings banks supported Germany even in both demands: First, he made clear that he thought it was violating the national budgetary law if the Commission was taking the final decisions (DSGV 2013) and second, he advocated for the exclusion of small banks from the SRF. According to him, there was no reason to burden local banks with the liabilities of such a fund, since they had their own institutional security agreement (DSGV 2014). He wanted that contributions to the fund depend on how risky banking businesses are and on whether those banks work across EU borders (DSGV 2014).

The French press accused Germany of only wanting to benefit its own banking system with its unique feature of public banks (Boutelet 2013; Godin 2013a). And some truth could actually be found in these accusations. At the beginning of 2014, Chancellor Merkel highlighted in a speech the importance of small public banks to the German financial sector (Bundeskanzleramt 2014). And pursuant to Merkel's statement, the public banks were even the supporting pillar of the German economy (Bundeskanzleramt 2014). Therefore, Germany advocated for the exclusion of the small banks yet again.

On 18<sup>th</sup> December 2012, the member states met in the Council and actually managed to find a compromise on the SRM – but it was very obvious that Germany had influenced this compromise to a high extent. In general, the compromise showed the attempt of the member states – and especially the asymmetrically burdened Germany – to increase its influence on resolution decisions and procedures. First, the member states weakened the role of the Commission. If the ECB notified the board that a bank was failing or if the board observed this itself, it should take action by adopting a resolution scheme and determining the application of resolution tools (Council EU 2013: 2). Eventually, not only the Commission but also the Council of the EU should have the right to veto the board's decision within 24 hours. Decision-making became increasingly complex: Various rules which the member states had come up with were defining which actors had to be involved under what circumstances (Höltzsch 2013b; Council EU 2013). This design of involving many EU actors – especially the Council – into decision-making obviously shows that Germany pushed through with its claim to keep influence over resolution decisions.

Furthermore, the member states wanted to create the fund similar to what German Finance Minister Schäuble had in mind. The fund would be initially financed by bank levy on the

national level, meaning that every participating member state had to build up a national resolution fund and these national funds would become “compartments” of the SRF (Council EU 2013: 1). These compartments should be merged gradually over a long time, namely a ten-year transitional period (Council EU 2013: 1). In conclusion, that means that especially in the first years, if banks were failing the national funds were paying the debt. Germany had reached its goal to avoid the usage of its own public money for bail-outs which might become necessary due to inherited liabilities. And the ESM would not fill in before the national governments had not used their own national funds.

Germany also managed to make the other member states agree to exclude small and regional banks to some extent again. Actually, the agreement resembled a lot the design of the SSM: In general, the SRM would cover all banks in the participating member states. However, the board would only be directly responsible for cross-border banks or those big and systemically important banks which are subject to ECB SSM supervision. Thereby, NRAs would keep responsibility for smaller banks and the board would only interfere here if the resolution of such a small bank required the access to the SRF (Council EU 2013: 3).

These concessions of the other member states indicate that Germany had a huge willingness to pursue its own political and power-based goals because it felt more negatively affected by the SRM than others who wanted to profit from a newly created fund. Germany was able to influence the outcome of the Council meeting in that way because it was in a very strong bargaining position. While France and its southern allies needed German support on the SRM, especially in terms of the resolution fund and a public backstop, Germany did not need the SRM. It already had set up an own national resolution fund and until then had never required financial aid from the EU. Therefore, Germany was fine on its own and could credibly convey that it would not agree with a SRM which was contrary to its own preferences. This is a typical case of asymmetric interdependence meaning that the state which has the least interest in and which is least dependent on the successful outcome of negotiations gains the most negotiating powers.

However, the agreement of the Council from 18<sup>th</sup> December 2012 was not the last word on the matter. The legislative process required that the European Parliament adopted the SRM resolution. And the EP partly scotched the plans of the Council to interfere with resolution decision-making after all. The main goal of the EP was to reduce the complexity of the SRM which had emerged because member states were reluctant to give up power and transfer resolution authority to the EU level. The EP criticized that if the Council or respectively the EU finance ministers had to agree to resolution decisions of the SRB, the process would

become politicized and cumbersome (Euractiv 2014b). The Chair of the Parliament's Economic and Monetary Affairs Committee, Sharon Bowles, and her rapporteurs stated in the beginning of March 2014: "We cannot sign off on a deal which establishes a mechanism which is unfit for purpose. [...] A potentially unworkable resolution system will jeopardize banking union and leave taxpayers exposed" (European Parliament 2014a). Thereby, she also referred to the concerns that the resolution procedure as suggested by the Council would be unnecessarily delayed by the complex decision-making structures which aimed at guaranteeing the member states to have the final say in resolution issues (European Parliament 2014a; Euractiv 2014b). The EP thus refused to accept the Council's vigorous involvement in resolution decision-making. Instead of the Council, the SRB should decide upon resolution actions to "avoid political power games and ensure that banks receive equal treatment, irrespective of their countries origin" (European Parliament 2014a).

Additionally, the European Parliament also did not support the idea of splitting the resolution fund into national compartments for such a long time. Therefore, it suggested mutualizing 50% of the national resolution funds already in the first year and the rest over the subsequent two years (European Parliament 2014a).

Eventually, on 20<sup>th</sup> March 2013 the Council and the EP reached an agreement after 16 hours of negotiations and surprisingly the Council gave in to some EP claims. The decision-making process had been simplified. After the SRB takes a decision now, the Commission still got 24 hours to reject the proposal. However, the EU policy makers agreed that the Council will only be involved at the Commission's request (European Parliament 2014b). The Commission can only propose to the Council of the European Union to refuse the adoption of a resolution scheme if it is not necessary in the public interest or to approve or object the amount of funds provided for the resolution (Council EU 2014a: 3; Council EU 2014b: 2). Thereby, the decision-making power of the Council of the EU was restricted again. Additionally, the EP made the Council of the EU agree on a faster mutualisation of the fund. The general time for the completion of the fund was reduced from ten to eight years (Council EU 2014a: 4). And mutualisation of the national compartments will be implemented more rapidly, starting with 40% being mutualised in the first year, 20% in the second year and the rest equally over the remaining six years (European Parliament 2014b; Council EU 2014a). The EP was proud that it was able to make the Council of the EU back down on these issues and emphasized that they had thus rescued a "seriously damaged bank resolution system" by ensuring that due to more efficient decision-making, a "resolution scheme could be approved within a weekend, from the closing of the US markets to their opening in Asia" (European

Parliament 2014b). Policy experts, for example from the Centre for European Policy Studies (CEPS), welcomed this streamlining of the decision-making process by stating that otherwise the SRM would hardly have been able to make quick and strong resolution decisions (Gros 2014). And even if the outcome was still complex and seemed difficult, Gros evaluated it as typical for the EU: “It looks ugly, but appears likely to work” (Gros 2014: 1).

The question is: Why was the EP able to exert so much influence? After all, according to political power-based assumptions, member states should be reluctant to accept a higher level of EU integration and mutualisation if there was a distributional conflict which affected at least some of them asymmetrically. However, there are two reasons for the Council beating a retreat, which are related to the power-based interests of the member states.

Of course, the Council of the EU was not pleased about the demands of the EP. But at the same time, the member states were under a lot of pressure to reach a compromise quickly. The Council of the EU had to include the EP, not in the intergovernmental side-pact for the SRF but in the general SRM legislation procedure (Fontanella-Khan 2014). But already in May 2014, elections for the European Parliament were due. And since election forecasts indicated that especially Eurosceptic parties were attracting voters, the whole venture of establishing a SRM would at least have been incredibly delayed if EU policy makers had not been able to reach an agreement before the elections (Euractiv 2014b). Therefore, the EP found itself in a strong bargaining position. And members of the European Parliament – even from Germany – threatened that they could easily pull the plug and block the adoption of a new resolution regime until after the EP elections (Fox 2014; Fontanella-Khan 2014; Giegold 2014). The chair of the economics and finance committee, Sharon Bowles, even said that “without strong changes in the EU Council’s position there will be no deal” (Fontanella-Khan 2014). Those threats of the EP were very credible in the run-up to the elections.

And the Council was likely to give in, because all member states had a genuine interest to actually create a SRM – even if they had to back down on some design issues. France and the southern member states were dependent on the SRM anyway, because they were in need of a strong way to break the vicious circle of their indebted banks and sovereigns. Therefore, the French Finance Minister Moscovici said that the SRM with the fund was a large scale and very important political project which had to be implemented (Euractiv 2014b). Consequently they had the political preference to find an agreement with the EP.

Eventually, even Germany had the political preference that the SRM legislation would be adopted before the EP elections. First, Germany was in favor because it wanted the SRM to make the SSM more powerful. Schäuble had repeatedly argued that a common supervisor

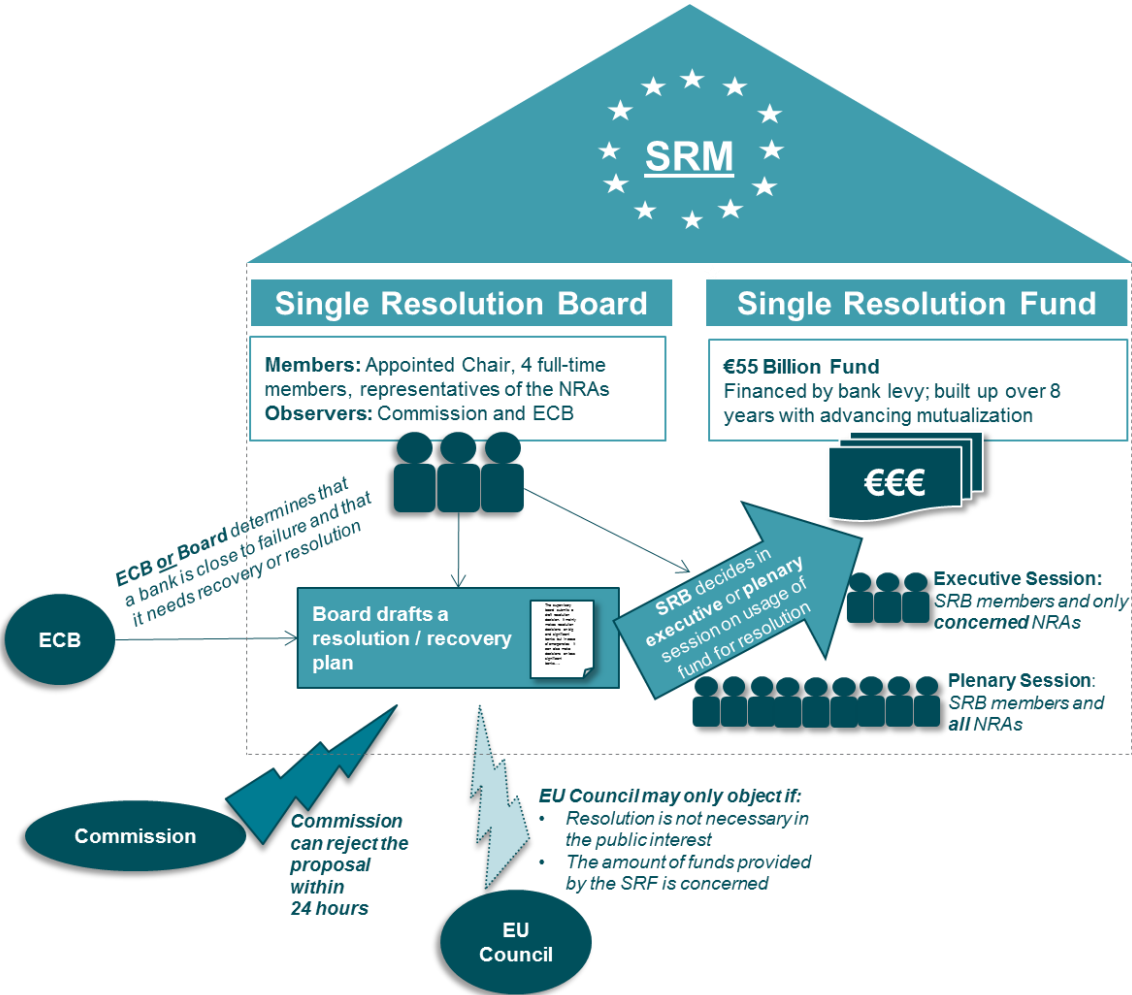
who did not have any possibilities to wind up a bank would be useless to guarantee financial stability (Schäuble 2013b; Schäuble 2013f). After all, it does not only help to know when a bank fails but it is necessary to know how to cut the losses. Germany was highly interested in building up a strong Banking Union to prevent further uncontrolled bank crises which could threaten the stability of the whole Eurozone and could result in new rescue packages financed by taxpayers' money. According to the CEPS, Germany would additionally even profit from the long-run benefits of a SRM and especially even a common fund: If the single resolution fund is used, it does not bail out the big equity holders, but investors and other savers of the bank – many of whom might actually be German companies, considering the large current account surplus of the country (Gros 2013). Because of these reasons, also Germany had the political preference to reach an agreement with the EP.

***Interim Conclusion: H2 Supported by Evidence – Combined Approach is Valid for the SRM***

Nevertheless, the implications of hypothesis H2 could be observed in the case of the SRM: First, the distributional conflict about who pays how much in the case of a bank resolution fueled debates and disagreements about how to design and implement the SRM. Due to an asymmetrical distributional conflict, Germany pushed through on most of its demands: Small banks only fall under the SRM indirectly, the SRF mutualisation happens slowly and the Council of the EU still has some say in the resolution decisions. And at least the NRAs still play a crucial role on the board. Therefore, the decision-making structure of the SRM is still highly complex which can be very well seen in *Figure 6* on the next page. There is a plenary as well as an executive session for decision-making where either only the SRB chairperson, full-time members and the affected NRAs take decisions (executive format) or where the SRB chairperson, the full-time members and *all* NRAs are in charge (plenary format), the latter being necessary for example if more than five billion euros in capital or ten billion euros in liquidity support are needed from the SRF (Council EU 2014a: 3). This shows that the member states still have a lot of influence on the resolution procedure. And it especially highlights that Germany – which was highly affected unilaterally by the existent distributional conflict – pushed for these tight control mechanisms.

Consequently both hypotheses, H1 on the functional part of the causal chain as well as H2 on the political part of the causal chain, were supported by empirical evidence in the case of the SRM: A distributional conflict led to disputes about the design and implementation of the SRM and eventually the asymmetrical distributional burden resulted in Germany being eager to keep power over the decision-making process.

**Figure 6: Decision-Making Structures of the SRM and its Various Involved Actors** (own illustration according to information provided by the Single Resolution Board (SRB 2015))



**6.3 Alternative Explanations: How Functional Needs Become Visible**

All assumptions of the functional-political approach were observable in the case of the European Banking Union and the Hypotheses 1 and 2 can be affirmed. The Banking Union was created because of functional considerations and designed according to political power-based preferences. However, one question which the combined approach does not answer is: Why did a common supervision or resolution mechanism appear on the EU policy makers’ agenda at the precise time in 2012 and 2013? Of course, functional reasons can explain why the SSM or SRM were created and designed. But why did policy makers perceive the functional need in the first place? How did this need emerge? Was it not present before 2012?

The historical institutionalist (HI) approach might be able to explain why the functional need came up in precisely the moment it did. According to HI, it could have been the consequence of a contingency: Some small event might have developed into a critical juncture

and coincidentally triggered the creation of the SSM and SRM. Above, the causal chain of functional and political reasons for the Banking Union's creation and design have been outlined. But following historical institutionalism, a catalyst would have been necessary to set the causal chains off (Lebow 2007: 109). An event is a catalyst if without it the outcome would not have occurred, that means, the causal chain would not have had any influence and the SSM or SRM would not have been created in this case. Such a catalyst could eventually have triggered the functional need for the SSM and SRM or made this functional need at least visible for EU policy makers. For example, following the historical institutionalist approach, the banking crisis in Cyprus could have been such a catalyst for the SRM. For being a catalyst, it firstly would be necessary that the Cyprus crisis was a critical juncture.

The Cyprus crisis had occurred before the discussions about the SRM picked up speed. Pursuing a quick and superficial historical institutionalist analysis of the Cyprus crisis, the following can be noted: Before the Cyprus crisis, there was a period of institutional and political stability. Even though the EU financial crisis cannot be described as a stable phase, the financial sector was calming down in the beginning of 2013 (Hildebrand 2013). Bail-outs of banks had become more ordinary and never in the history of the crisis had an indebted bank not been bailed-out by EU member states. Just then the Cyprus crisis hit the Eurozone. As already outlined above, it resulted in a high level of uncertainty: Policy makers were unsure about how to deal with failing Cypriot banks because the support for public bail-outs decreased. Thus, a high level of uncertainty was given which is necessary for a critical juncture – just like a narrow window of opportunity (Lebow 2007; Kelemen/Capoccia 2007): Time was pressing for EU leaders to find a solution because the Cypriot government and banks were close to bankruptcy. Next, there was a range of policy options from bailing out Cypriot banks to bailing in investors and closing banks. These options became possible, because Cyprus is not like Spain or Greece. The small state of Cyprus was at least not to that extent systemically important. EU decision makers hardly had to fear that a closed bank in Cyprus would drag down other EU states. This increased the number of policy options. Furthermore, the probability that agents' choices would highly influence outcomes was heightened. After all, structural and political indeterminism was given, since EU policy makers were not sure how to respond to the Cyprus crisis, how to wind up banks and how to create or design the SRM. EU policy makers had a high influence on the decisions: Euro-Group President Jeroen Dijsselbloem said early on that resolution procedures in Cyprus were going to be a role model for other failing banks in the EU (Neuerer 2013). Thus, the permissive and productive conditions were given.

Consequently, it can be stated that Cyprus was a critical juncture in the sense of historical institutionalism and thereby made change possible – namely the creation of an EU level resolution authority. To be a catalyst, it would furthermore be necessary that without the occurrence of the Cyprus crisis, the SRM would not have been established. That means no other event or critical juncture could have triggered the SRM. This could best be examined by conducting a counterfactual analysis. Those are usually thought experiments which change small aspects of the past.<sup>19</sup> In this case, one would have to imagine what might have happened if the Cyprus crisis had never occurred (Lebow 2007: 87; Tetlock/Belkin 1996: 6). But such an assessment would go beyond the scope and the length of this paper. Nevertheless, the Cyprus crisis might actually have been a catalyst for the SRM because if a banking crisis had occurred in another, bigger member state it would have been more likely for EU policy makers to decide to bail-out the banks out of fear of contagious effects.

Similarly, historical institutionalism could provide an explanation for how the functional need for the SSM was triggered. The burst of the Spanish housing bubble which resulted in Spanish banks facing bankruptcy also could meet the criteria of a critical juncture. There was at least a short period of stability since the EBA had been created. Nevertheless, Spanish banks got into severe trouble and caused uncertainty of how to handle non-compliance of supervision rules in the EU (van Rooseebeke 2012). The window of opportunity opened, because policy actors realized that they had to find a safe and secure solution for coherent EU banking supervision (ESRB 2012; Merkel 2012a). There was a wide range of policy options since the EU policy makers could have strengthened the EBA, delegated to the Commission or created a new body for supervision. And eventually, this decision would quite certainly determine how EU banking regulation would evolve over the next few years. That is why also the Spanish crisis could have been at least a critical juncture and possibly even a catalyst for the SSM creation. Here again, further in depth research would be necessary.

Additionally, in the case of the SSM we also see that path-dependency – which is an important concept of HI – can play a crucial role for developing a functional need: It is observable that supervision was initially left to the NRAs. Afterwards, when first problems occurred, it was delegated to the CEBS. When this network turned out as inefficient, an EU agency was created, the EBA. And since this agency was still not offering satisfying solutions to the most pressing problems and since it suffered from a severe loss in reputation because it could for example not prevent or even foresee the crisis in Spain, EU policy makers realized

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<sup>19</sup> This is also called making a „minimal rewrite of history“, meaning that one should not change long stretches of history to keep it credible (Tetlock/Belkin 1996: 7ff.).



that a further integrative step was necessary, namely giving supervisory power to an institution, in this case the ECB. HI suggests that regulatory bodies develop “involving gradual reshaping through a series of steps, with previous stages influencing later stages” (Coen/Thatcher 2008: 808). This can be observed here: Maybe a strengthened agency like the EBA would also have been able to guarantee a high standard of EU level supervision. But due to the incidents that happened to the EBA beforehand, it was not an acceptable or functionally adequate regulatory body for supervision at a later point in time. This process is path-dependent. Since policy makers realized in a trial-and-error process that neither a network nor an agency was able to solve the supervision problems, they had to settle for an EU institution.

In conclusion, historical institutionalism can very well complement the functional-political approach. This combined approach can explain why the Banking Union was created and why it was designed in its specific way. At the same time, HI has explanatory power for why EU policy makers became aware of the functional necessity of a banking union. The initial regulatory gap was made visible by critical junctures or potentially even catalyst events. And HI can explain an underlying path-dependency in the establishment of the SSM at the ECB.

Previously, sociological institutionalism (SI) was introduced, too. In general, it cannot be confirmed that the Banking Union was designed according to fashionable ideas or because some specific regulatory body was seen as especially legitimate. The idea that agencies are a common phenomenon in the EU cannot account for the design of the Banking Union since the SSM is located at an EU institution anyway. Yet, the ECB claimed that it made sense to delegate supervision power to itself because it was currently common practice among member states to hand over supervisory tasks to central banks (Asmussen 2013). A decade ago, bank supervision and monetary policy were separated in most EU countries but at present “a majority of euro area central banks, that is 12 out of 17 [...] have full supervisory powers while two others are also involved in supervisory tasks” (Asmussen 2013). Even German Chancellor Merkel stated that the location of supervision at the ECB would be a good idea since a lot of member states were doing the same thing on the national level (Merkel 2012g). This indicates that the sociological institutionalists DiMaggio and Powell (1983) were at least partly right with their isomorphism and mimicry assumption which suggests that in cases of uncertainty, successful organizations which operate in similar environmental conditions are likely to be imitated. The fact that common central bank and supervisory task were successfully combined in different member states was taken into consideration by EU policy makers. Maybe it even made them more inclined to opt for the same institutional design on the EU level. But more research on this topic is necessary to draw firm conclusions.

## **7 Conclusion: Functional and Political Considerations Shaped the Banking Union**

When Jacques de Larosière called in his report in 2009 that more and better EU banking regulation was needed, he probably did not have the faintest idea that only a few years later Europeanization and integration would have led to the establishment of a full-fledged European Banking Union.

Today, the SSM as well as the SRM are in operation – the creation and design of the European Banking Union is completed. It was the explicit goal of this paper to make this creation and design more understandable. After analyzing the empirical case of the SSM and SRM in detail, it can be determined that the combined functional-political approach is indeed well-suited to explain how the Banking Union came about.

Both hypotheses which were derived from functional as well as political ideas and which constitute a combined functional-political approach, could be confirmed by looking at the empirical evidence. Hypothesis 1 suggested that if a regulatory, operational or capacity deficit in EU banking governance was present before the SSM or SRM, this functional gap must have been the reason for EU policy makers to create the SSM and SRM with an institutional structure which can solve the particular functional problem best. While the first hypothesis referred to the functional part of the causal chain, the second hypothesis took up the political and power-based part: Hypothesis 2 indicated that if there was a distributional conflict in banking supervision and resolution and especially if this conflict burdened one or a few EU actors more than others, they would try to keep a high level of control over supervision and resolution.

The case of the SSM supported both hypotheses: Before the Supervisory Mechanism was created there were regulatory and capacity deficits in European banking supervision. Even though the EBA was already created, common regulation especially on cross-border supervision was missing as well as a strong regulatory authority which would have ensured the implementation of EU banking regulation. This functional gap caught the attention of policy makers because it endangered the stability of European financial markets and led to failing banks and high costs in the Eurozone. Therefore, they all called for a creation of the SSM within the strong institution of the ECB to guarantee a well-functioning supervisory mechanism with enforcement powers in the future.

However, even though EU policy makers were united in their claim to create the SSM within the ECB, they suddenly faced several disagreements and severe disputes when it came

to the particular implementation and design of the SSM. This was due to distributional conflicts: Since they had linked the creation of the SSM to the establishment of the ESM, a crisis resolution tool which should eventually be able to directly recapitalize euro area banks by providing public money, some member states – especially Germany and northern EU countries – were suddenly worried about who pays how much. They especially feared having to pay the bill for inherited liabilities, that means mistakes banks in other EU member states had made even before the SSM had been able to control those banks. Therefore, they tried to delay the start of the SSM and at the same time to gain more power and control over EU supervision. This eventually led to the creation of a Supervisory Board with equal voting rights for all member states. Additionally, due to specific features of the German banking sector, the distributional conflict was characterized by asymmetry: Germany has a very specific kind of banking sector with a large amount of very small public banks which enjoy regulatory advantages in the national supervisory system. If those small public banks were put under EU level supervision of the ECB, Germany would have faced higher implementation and adaption costs than most other EU member states whose banking sectors were made up of big banking groups. Furthermore, the German government would have had to fear the resentment of the strong lobby group of the public banks shortly before national elections. Consequently – like Hypothesis 2 suggests – Germany was reluctant to give up supervisory power over small banks and eventually managed to exclude them from the SSM. Those conflicts about political preferences and power issues highly influenced the design of the Single Supervisory Mechanism. Therefore, both hypotheses could be confirmed: Functional needs led to the SSM's creation, whereas the design was shaped by political interests.

The same goes for the SRM: Since hardly any EU regulation on the resolution of banks existed, this led to high costs in the European banking sector. Especially the resolution of cross-border banks failed regularly during the financial crisis. This regulatory functional gap made EU policy makers call for a Single Resolution Mechanism. For them, it was clear that it had to be an agency on the EU level because it offered two core advantages: It was able to minimize home bias (meaning that member states privilege their own national banks) and was supposed to ensure common resolution standards across member states. A network would have been too loose to guarantee strong resolution. And an agency had the advantage over an institution that it was able to include several different actors with their specific know-how, for example the NRAs. The creation of the SRM was therefore again shaped by functional considerations.

But when it came to implementation and design, especially the member states tried to maximize their political influence. The SRM was characterized by a high distributional conflict because it was all about who has to pay how much in the case of the resolution of a failing bank. This was especially due to the fact that the suggestion for a common resolution mechanism also foresaw the creation of a mutualized resolution fund. Several member states perceived this as an interference with their national budgetary rights. Consequently, member states were reluctant to give up power. Furthermore, Germany was again burdened with an asymmetrical distributional conflict: On the one hand, this was again due to the special features of its public banking sector. On the other hand, it was also because Germany had already created an own national resolution fund – and feared that it would have to pay for the failing banks of others during the transitional period until the SRF was fully operational. Together, these factors led to the SRM being weakened by a difficult decision-making process which involves various EU actors. The political and power-based interests of the member states led to this particular SRM design. In conclusion, also for the SRM both hypotheses were confirmed by evidence.

This shows that the combined functional-political approach is able to give an adequate explanation for the creation and design of the European Banking Union. Whereas the creation was motivated by functional considerations and the need for common banking regulation, the design was shaped by political preferences and power struggles among the main EU actors.

When looking more closely at the process tracing analysis, it seems to be surprising at first that in political negotiations for the SSM as well as for the SRM the European Parliament actually managed to push through with some preferences. In the common political approach, the European Parliament is often described as a rather weak negotiator, which nevertheless always aims at strengthening the EU level as well as its own power and capacities (Kelemen/Tarrant 2011: 928ff.). But in the case of the SSM and SRM the EP was able to influence the design because it found itself in favorable negotiation positions. In the case of the SSM, the EP's political preference of strictly separating the monetary and supervisory tasks of the ECB was backed by the genuine interests of powerful member states, especially of Germany. In the SRM, the upcoming elections for the European Parliament increased the bargaining power of the EP, because it could credibly threaten to at least delay the deal for the SRM until after the elections. Therefore, the political part of the causal chain provides sufficient explanatory power to account for the EP's medium negotiation successes.

However, no theoretical approach can account for everything in the empirical world – and this also goes for the combined functional-political approach. What remains questionable

throughout the analysis of the SSM and SRM is why the functional need for both came up at exactly that point in time. However, historical institutionalism – which was introduced as a possible alternative explanation earlier in this paper – offers a plausible explanation. Critical junctures like the Cypriot banking crisis or the burst of the Spanish housing bubble actually made the need for banking resolution and supervision visible. Such critical junctures certainly played a crucial role in the creation of the SSM and SRM. In 2013, Jörg Asmussen, a member of the ECB Governance Council, quoted Jean Monnet who said: “Men only accept change in a time of need – and they only see need in a time of crisis” (Asmussen 2013). Asmussen therefore concluded, that EU policy makers should quickly continue to establish the Banking Union – before the window of opportunity closed (Asmussen 2013). Possibly, those HI critical junctures to which obviously also Asmussen referred even happened to be catalysts for the Banking Union. But to draw firm conclusions this would have to be examined in detail in further studies.

For now, it is necessary to be aware that the EU has opted for more and intensified banking regulation, because functional gaps made it necessary. The European Banking Union was created out of the necessity to react to banking problems and regulatory deficits. Its design however – especially the decision-making procedures – was not the result of functional considerations but rather of political and power-based preferences. Furthermore, Hypotheses 1 and 2 were supported by evidence and thus strengthen the idea to fruitfully combine functional and political power-based ideas. If both theoretical lenses are used and combined, we create eyeglasses which are very well suited to explain the complex case of the Banking Union.

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