Integrating rules, disintegrating markets: 
the end of national discretion in European banking governance?

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The basic design of the Single Market in financial services was that centralized European rules would be implemented and enforced locally by national supervisory authorities. Since the onset of the financial crisis, a series of reforms have ostensibly replaced this arrangement in the banking sector. Key prudential rules now apply directly to credit institutions as a consequence of the so-called ‘Single Rulebook’ and most euro area banks will soon be subject to centralized supervision through the ‘Single Supervisory Mechanism’. This article seeks to explain this apparent transformation. To do so, it examines the scope for national divergence that existed within the Single Market framework; the consequences of such divergence prior to and during the financial crisis; and the dynamics of the current shift towards more supranational governance. The article finds that while the fragmented system of rule-implementation and supervision contributed to competitive distortions prior to the crisis, it did not present an insurmountable obstacle to financial integration. By contrast, in the context of widespread financial stress, the existence of nationally fragmented regulatory and supervisory regimes has become a central impediment to the continued cross-border integration of financial markets. While the experience of fragmentation is motivating the shift to greater supranationalisation, national authorities have carved out key areas of discretion, reflecting perennial concerns over competitiveness and financial stability.
Introduction

Since 2009, the EU has adopted or proposed a series of reforms that are rapidly enhancing the power of supranational institutions in banking regulation and supervision. Two of the most significant reforms agreed so far are the ‘Single Rulebook’, whereby key prudential standards will be subject to ‘maximum harmonisation’ across the EU; and the ‘Single Supervisory Mechanism’ (SSM), which will see most euro area banks subject to centralised supervision by the European Central Bank (ECB) as of mid-2014. These reforms ostensibly override the institutional foundations of the Single Market in banking, which, since its creation in the late 1980s, was constructed on the basic premise that centralised European rules would be implemented and enforced locally by national supervisory authorities.

A puzzling feature of these reforms is that while they were agreed in the context of the financial crisis, they do not address problems of financial instability per se. Maximum regulatory harmonization primarily enhances the smooth functioning of the Single Market: it limits the scope for competitive distortions between different jurisdictions and lowers the cost of regulatory compliance for international firms (de Larosière 2009, p27). Similarly, the SSM ensures consistent application of the Single Rulebook, ‘unfettered by other, non-prudential considerations’ (Council 2013, Recital 10). To be sure, both of these reforms could have the secondary benefit of bolstering financial stability, especially if they succeed in raising prudential standards across the board or if they prevent actions taken in one country resulting in financial instability elsewhere. Yet this is by no means axiomatic: supranationalisation could produce financial instability if local financial or macroeconomic circumstances are overlooked. Since financial integration equates to interconnectedness between national financial systems, it also contributes to cross-border contagion risks in the event of future adverse ‘shocks’ (Turner 2013).

If these reforms are only tangentially associated with financial stability, how can their adoption and timing be explained? To answer this question, this article examines the consequences of the nationally fragmented system of rule-implementation and supervision that the reforms themselves aim to make obsolete.
This article makes three specific claims. First, in contrast to much of the scholarly literature on European financial integration (Posner 2007, 2010; Mügge 2006, 2010), it argues that on the eve of the financial crisis in 2007, the integration of financial governance remained highly incomplete. Focusing on the content of pre-crisis prudential banking regulations, and the operation of multilateral mechanisms for cooperation between national banking supervisors, the article demonstrates how the basic legislative structure of the Single Market provided for significant cross-national regulatory and supervisory divergences, even after substantial financial reforms in the late 1990s and early 2000s.

Second, the article suggests that although uneven rule-implementation and divergent supervisory practices were not the primary causes of the banking crisis, since the crisis began these factors have emerged as key propagators of fragmentation and instability. Inconsistent regulations and supervisory approaches have fuelled uncertainty over banks’ prudential positions, contributing to the freeze in interbank lending. Most significantly, national supervisory authorities have pushed local banks to build up capital buffers whilst insisting that ‘core’ services – such as lending to domestic companies and households – be maintained. This has resulted in a faster pace of ‘deleveraging’ overseas than domestically, and hence disintegration of European banking markets.

Third, the article suggests that while policymakers have shown broad willingness to move towards more supranational governance as the price for reinforcing the Single Market, national authorities are retaining significant competencies in the emerging framework. This holds especially for authorities outside the SSM, although even within the SSM, member states will exercise ‘constrained discretion’ over certain macro-prudential tools. Taken together, these claims suggest that member states and their national supervisory authorities have dominated the architecture for banking governance until now and will continue to exert a powerful influence in the emerging regime. This suggests that this policy area has conformed more closely to the ‘liberal intergovernmentalist’ conceptualisation of European integration than much recent scholarship has maintained.

The article proceeds as follows. The next section provides an overview of financial integration reforms and associated scholarship since the first efforts to establish a
European Financial Area emerged in the mid-1980s. The third section explores the scope for national regulatory divergence and the powerful role afforded to national supervisory authorities in the pre-crisis architecture. Next the article discusses the consequences of divergent regulation and fragmented supervision prior to, and during, the financial crisis. The fifth section examines the dynamics of current the shift to greater supranational governance. The conclusion highlights implications of the preceding analysis for wider debates over the drivers of political integration in the EU.

Neglecting national divergence

Before the latest wave of regulatory and institutional reforms, substantive efforts to encourage cross-border provision of financial services in the EU came in two distinct episodes of regulatory reform. The first began in the late-1980s as part of the Single Market Programme. In line with the Commission’s ambitious White Paper on 'Completing the Internal Market' (Commission 1985), a series of regulatory reforms between 1988 and 1993 aimed to establish the Single Market in financial services. The legislation was based on the legislative principles of mutual recognition, meaning that each country would recognise the adequacy of the legislative, regulatory and supervisory arrangements of every other country; minimum harmonisation, meaning that all member states would adopt a set of common basic regulations; and home country control, meaning that the task of supervising cross-border firms would lie with the authorities of the countries in which the firms were headquartered.³

Scholarship on these reforms characterised the policymaking process in line with a liberal intergovernmentalist understanding of European integration (see Moravcsik 1998). Bargaining between key member states, above all Germany, France and the United Kingdom, shaped the content of the various integrating directives, with each country defending their idiosyncratic financial systems, competitive advantages, and modes of governance (Story and Walter 1997; Underhill 1997). In terms of outcomes, there was widespread agreement that the impact in terms of cross-border financial services provision had been modest (Steil 1998). Moreover, it was recognised that the
consequences of mutual recognition and minimum regulatory harmonisation would be persistent divergences between member states’ legislative and administrative regimes (Brown 1997; Hall 1997).

A second episode of integrative reforms began in the late 1990s. In 1999, the Commission launched a Financial Services Action Plan (FSAP), consisting of 42 recommendations for eliminating regulatory barriers to cross-border trade in financial services in order to establish deep, liquid capital markets in the EU (Commission 1999). Almost simultaneously, the ‘Lamfalussy’ reforms – established in the securities sector in 2001 and extended to banking, insurance and occupational pensions in 2004 – instituted a complex multi-level system of committee governance (CWM 2001). So-called ‘Level 2’ committees, composed of national experts and finance ministry officials, were mandated with drafting detailed technical standards to complement framework (or ‘Level 1’) legislation. ‘Level 3’ committees, composed of national financial supervisors, were mandated with providing advice on Level 2 technical standards and promoting consistent implementation and enforcement at the national level. These institutional reforms were credited with expediting the policymaking process in finance, helping to ensure that by 2004, 39 of the 42 FSAP recommendations had been adopted either as legally binding Community legislation or non-binding communications or recommendations (Commission 2007a).

In contrast to the earlier period of reforms, scholars focusing on the FSAP and the Lamfalussy process tended to view the initiatives as a major success (cf. Grossman and Leblond 2011). Focusing specifically on securities markets, Mügge (2010: 2) argued that regulation had been effectively harmonised across the continent. Similarly, Posner (2007: 142) argued that the financial reforms initiated in the late 1990s constituted a “financial revolution”: he noted that the reforms were both more numerous and of greater scope than those introduced in the earlier period, and that they relied to a greater extent on principles of harmonisation and convergence. Quaglia (2007; 2010) was more cautious, noting that important measures of regulation and de-regulation had already been implemented in the earlier phase of reforms and that the Lamfalussy framework itself remained in flux. However, she too regarded the FSAP and the Lamfalussy framework as ‘milestones in the reshaping of financial services governance in the EU’ (2010: 24).
The disjuncture between the first and second phases of financial integration reforms presented in these accounts obscures an underlying continuity: namely, that the principles of *mutual recognition, minimum essential harmonisation*, and *home country control* remained the basic anchors of the legislative framework. To be sure, the volume and complexity European rules increased as a result of the FSAP, but EU directives continued to set *minimum* standards only: member states were still required to transpose EU directives into their national legislation, and they remained free to embellish (or ‘gold-plate’) the rules as they saw fit. Likewise, whilst the Lamfalussy institutional reforms aimed to enhance transnational cooperation between supervisory authorities, it did not alter the basic reality that national authorities retained the exclusive right to apply and enforce rules over the firms headquartered their jurisdictions.

The notion that the 1999-2006 reforms represented a radical departure in the course of European financial integration was also reflected in a parallel body of literature that focused on the Level 3 committees as examples of ‘new modes of governance’ in the EU. Eberlein and Newman (2008), for example, suggested that the Level 3 committees were examples of a new kind of transgovernmental network: by ‘incorporating’ politically independent national authorities into the supranational policymaking process they had the potential to overcome member states’ traditional resistance to sharing sovereignty in sensitive areas. In a similar vein, Posner (2010: 45) suggested the formation of transgovernmental networks of national supervisors had the potential to unleash autonomous political authority that would be ‘larger than its constituent parts’. Exploring the nature of transnational cooperation within the Lamfalussy Committees’ Quaglia (2008: 565) concluded that the Level 3 committees were generally characterised by expert deliberation, rather than intergovernmental bargaining. While she recognised that supervisors’ bureaucratic prerogatives could obstruct cooperation, she nevertheless suggested that such committees had originated a ‘distinctive type of informal governance’ over EU financial markets. Overall, these scholars suggested that the Level 3 Committees had the potential to transcend national interests, acting as autonomous drivers of deeper coordination and harmonisation of national administrative processes (for a dissenting view see Coen and Thatcher 2008).
In the empirical sections that follow, this article highlights the scope for national regulatory divergence that existed within the European framework for prudential banking regulation; the powerful position afforded to national supervisory authorities in the overall regulatory and supervisory architecture; and the incapacity of the pre-crisis transgovernmental network of banking supervisors to produce substantive convergence in supervisory practices on-the-ground. This exercise is useful from an empirical perspective because identifying the extent of non-integration in banking governance until now helps reveal what is at stake in the current reform process. It is also useful from a theoretical perspective. The apparent successes of the FSAP and the Lamfalussy reforms have frequently been explained through the lens of ‘supranational governance’ (see Stone Sweet and Sandholz 1998). The driving forces behind the FSAP and the Lamfalussy reforms have been identified variously as transnational financial firms (Mügge 2006, 2010); policy entrepreneurs in the European Commission (Jabko 2006); and the self-propelling incremental accumulation of capacities by supranational institutions (Posner 2007; 2010). Quaglia (2007) provides a partial exception by suggesting that supranational governance is best suited to explaining the agenda setting stage of the regulatory process, while liberal intergovernmentalism better captures the decision-making process. Yet if member states’ dominance over processes of rule-implementation and supervision meant their residual power in the overall governance process was greater than these accounts suggested, attributing primacy to transnational actors in this policy domain may have been mistaken. This criticism applies even were we to restrict our gaze only to the agenda-setting phase of regulatory process, since significant pooling of sovereignty over rule-implementation and supervision was effectively excluded from serious consideration prior to the financial crisis.

**The non-integration of banking governance**

*Regulatory loopholes*

The Single Market in banking was established in 1989 through the adoption of the Second Banking Directive. Together with the 1989 Own Funds Directive and the 1989
Solvency Ratio Directive this transposed into European law the non-binding agreement of the Basel Committee on Banking Supervision (BCBS) on capital adequacy ratios (‘Basel I’) that had been reached a year earlier. In keeping with the principle of minimum harmonisation, this legislation permitted member states to impose tougher standards if they so chose. The Own Funds Directive set out the maximum range of financial instruments that could be included in the calculation of a bank’s ‘Original’ and ‘Additional Own Funds’ (Tier 1 and Tier 2 capital in the Basel terminology) and set limits on how much of each item could be included in the total calculation. Member states were then free to permit fewer items to be included and/or to impose more restrictive limits on the relative quantities of each item (Directive 89/299/EEC: Article 2(2)). Similarly, the Solvency Ratio Directive set the overall ratio of 8% capital to risk-weighted assets, but allowed national authorities to apply a higher ratio as they saw fit (Directive 89/647/EEC: Article 10).

While these Directives set minimum standards, they hardly set an inviolable baseline for capital adequacy regulation. In fact, member states were afforded numerous opportunities to impose less stringent standards as well. For example, the Own Funds Directive stipulated that any funds could count as Additional Own Funds as long as (1) they were freely available to absorb normal banking risks, (2) they had been previously disclosed in internal accounting records, and (3) that their amount had been determined by the banks’ management, externally audited, and previously supervised by the relevant authorities (Directive 89/299/EEC: Article 3(1)). Similarly, the Solvency Ratio Directive contained numerous options and loopholes including inter alia exemptions for banks specialising in interbank lending and public debt markets; the possibility of allowing home country control of subsidiaries of foreign banks; and national discretion in relation to risk-weightings in several areas (see Directive 89/647/EEC: Articles 1(2), 3(4,6), 7, 8).

A decade on, the FSAP led to the adoption of several directives, regulations, communications, and recommendations relating to the banking sector (for a review see Malcolm et al. 2009). The most significant did not emerge until 2006, when the ‘Capital Requirements Directive’ (CRD) replaced the Second Banking Directive as the main framework legislation for the European banking sector. The CRD incorporated into EU law the Second Basel Accord (Basel II), which had been agreed by the BCBS in 2004.
While it was intended to lower regulatory burdens on firms by minimising regulatory diversity across the EU, political compromises in the drafting process led to the inclusion of at least 152 options and national discretions (CEBS 2008). Although not all of these provisions had a significant economic impact, ambiguities and leeway in key prudential areas facilitated regulatory arbitrage and enabled member states to use prudential regulation as a source of competitive advantage. Areas of national regulatory discretion with the greatest economic impact included the scope of application the directive, with some member states imposing a more restrictive interpretation of the term ‘credit institution’ than others; and the precise treatment of the various financial instruments that were permitted in banks’ calculations of Tier 1 and Tier 2 capital (de Larosière 2009: 27-28).

Ultimately, these regulatory loopholes were a product of political compromises in the negotiation of the framework legislation (the CRD did not distinguish between Level 1 and Level 2 measures and consequently was negotiated entirely through the traditional Community Method). However, the scope for regulatory divergence was also a product of the choice of legislative instrument: like the legislation it succeeded, the CRD was a directive requiring transposition into national laws before having legal force. As before, this not only permitted member states go ‘gold-plate’ European standards, but also provided various opportunities for them to 'tin-plate' them (to coin a phrase) too.

Supervisory discretion

The CRD revolutionised the permissible methodologies for risk-weighting banks’ assets, shifting responsibility for calculating capital requirements from supervisors to supervised firms. Paradoxically, this reinforced the discrete and powerful role that national supervisory authorities occupied within the European supervisory architecture. In line with Basel II, the CRD introduced three different approaches by which banks could risk-weight their assets. A standardised approach was similar to that which had pertained under Basel I: different categories of assets were assigned to various ‘risk buckets’, with the assets in each bucket carrying the same pre-specified weightings, irrespective of their underlying riskiness. Alternatively, banks with sufficiently developed credit-risk
measurement capabilities were permitted to apply for authorisation to use one of two Internal Ratings Based (IRB) approaches (Directive 2006/48/EC: Article 84). The overall impact was to place new emphasis on banks’ internal processes and control mechanisms. This, in turn, required supervisors to ensure the integrity of banks’ own internal control functions, including the predictive power of the models used to calculate their capital requirements.

Under Basel II, the business of authorising banks’ internal models – ‘model validation’ – became a central element of prudential supervision. However, the CRD contained few legally binding provisions concerning this activity. By their very nature, banks’ internal credit-risk models are highly idiosyncratic, relying on information and processes peculiar to the individual banks themselves. As Blochwitz and Hohl (2011: 251) argue, supervisors' validation techniques need to be as individual as the ratings system they are used for. While the Committee of European Banking Supervisors (CEBS) (discussed below) issued non-binding guidance on model validation in 2006 (CEBS, 2006a), in practice national supervisory authorities developed different approaches in this area (Interview 31/05/2012).

The CRD gave explicit recognition to the importance of supervision by including the ‘Supervisory Review Process’ (SRP) as one of the three pillars of the capital adequacy framework. The SRP ('Pillar 2') was designed ‘not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks’ (BCBS, 2004: 158). In line with this approach, the CRD set out a supervisory process that had an emphasis on dialogue and close cooperation between firms and supervisors. As with model validation, supervisors retained considerable scope for divergence in performing the SRP, as recognised by the CEBS: ‘different supervisory authorities will use different types of evaluation processes… [with] differences in the emphasis on qualitative versus quantitative judgments and the degree of automation within a system’ (CEBS, 2006b: 26). Perhaps the most obvious area of national discretion in the Pillar 2 process related to the range of permissible interventions that supervisors could make when a bank’s own internal controls were found to be inadequate. The CRD contained a list of measures available to supervisors, which was both extensive and
banks to hold Own Funds above the minimum level laid down under Pillar 1, to
prohibiting banks from engaging in some or all of their business activities.

That the CRD ensured a prominent role for supervisors is attributable to the nature of
the Basel II: as a product of its own time, it encouraged supervisors to exercise judgement
and discretion in overseeing banks’ risk-management processes. However, Basel II did
not ordain that supervision should remain at the national level. In fact, the perpetuation of
the nationally fragmented supervisory structure prior to the financial crisis was the
product of an explicit political choice on the part of key EU member states. In 2002, the
ECB’s then-President Wim Duisenberg and its head of banking supervision Tomasso
Padoa-Schioppa made public the ECB’s long-standing interest in taking on a more
prominent role in banking supervision (Crooks 2002). This move was quickly rebuffed in
the Council under strong opposition from the Finance Ministers of Germany and the
United Kingdom, neither of whom had any interest in seeing greater central bank
participation in prudential supervision at the time (Barber 2002).9

*Cooperation without convergence*

While member states blocked direct ECB involvement in prudential supervision, the
Council agreed over the course of 2002 to encourage greater cooperation between
national financial supervisors by extending the Lamfalussy committee system from
securities to banking, insurance and occupational pensions. In the banking sector, this led
to long-standing informal groupings of national supervisors being ‘incorporated’ within
the policy-making process and provided with explicit mandates to promote supervisory
cooperation and convergence around common standards (Eberlein and Newman 2008).
Thus in 2004, the CEBS was established in London with a mandate to advise on
legislation and to encourage cooperation and convergence in supervisory practices. As a
‘Level 3’ committee, the CEBS was composed of one voting senior representative from
each country’s national supervisory agency as well as one non-voting representative from
each country’s central bank. Representatives from the ECB and the Commission
participated in its meetings, as did the Chairs of the Banking Supervision Committee10
and the *Groupe de Contact* (an informal network of European banking supervisors established in 1972).

While CEBS chalked up some early successes in its standard-setting capacity – issuing twelve sets of guidance on implementing the CRD in 2006 – its impact on day-to-day supervisory practices prior to the financial crisis was not as substantial as initially hoped. In 2007, a review of the Lamfalussy Committees found that national supervisory regimes continued to differ along a myriad of different dimensions including the frequency of on-site versus off-site examinations; the predilection for principles-based versus rules-based approaches; the range of tools available to remedy instances of non-compliance; and the attitude of supervisors towards bailing out troubled banks (CEBS 2007a, 2007b; Commission 2007b; IIMG 2007).

Pre-crisis cooperation between senior supervisors was considered to be generally constructive and characterised by expert deliberation over optimal policies (author interview 30/10/2012; cf. Quaglia 2009). However, areas of divergence were not always discussed openly at senior levels, leaving unresolved differences to be tackled by lower level officials (author interview 01/03/2013). Furthermore, with the onset of the financial crisis, the tendency for supervisors to represent parochial national interests increased (author interview 30/10/2012).

The CEBS was also inhibited by a lack of effective instruments. The guidance it produced was not legally binding, meaning that member states were free to choose what to adopt and what to disregard. Before 2008, the CEBS did not even have a ‘comply or explain’ mechanism requiring member states to justify instances of non-compliance. A further problem was that CEBS guidance tended to take the form of generalised principles rather than detailed rules, thereby leaving open possibilities for divergences at the national level. This was in line with the preferences of industry bodies, as expressed in consultations (CEBS 2007a), but was also attributable to the operational requirement for member states to be in consensus over any guidance issued.

For its part, the CEBS recognised that the obstacles to convergence were not only a product of member states’ desire to protect their competitive advantages, but stemmed also from fundamental institutional and legal differences between them. This included the existence of idiosyncratic company-law and tax regimes; the regulatory diversity
permitted by core EU legislation; and ‘significant and stratified differences in national banking sectors, financial markets and supervisory traditions’ (CEBS 2007a).

**The consequences of fragmented governance**

It is difficult to ascribe a direct causal link between regulatory and institutional reforms at the EU-level and changes in the markets themselves (although see Malcolm et al. 2009). By the time of the Second Banking Directive, the internationalisation of banking had already been underway for some two decades. Technological change, national financial liberalisation, and developments associated with the creation of the single monetary policy would likely have resulted in significant cross-border integration, even in the absence of the FSAP of Lamfalussy reforms. Conversely, it is difficult to establish with certainty whether markets would have become significantly more integrated had European rules been transposed more consistently into national laws, or had supervisory authority been exercised at the European level.

That being said, market practitioners and supranational policymakers frequently highlighted regulatory harmonisation and national supervisory divergences as inhibitors of deeper market integration before the crisis. A 2005 survey revealed that practitioners from large financial institutions considered multiple reporting requirements, divergences of supervisory practices, and the complexity of supervisory approval processes to be amongst the most significant deterrents to cross-border mergers and acquisitions (Commission 2005a). Similarly regulatory diversity and disparate approaches to the supervisory review process (‘Pillar 2’ of the CRD) were recognised as major contributors to the regulatory burden on firms (Malcolm et al. 2009).

Whatever the costs of regulatory and supervisory inconsistency, however, it was not enough to prevent an overall trend of integration in European banking markets in the decade prior to the crisis. Interbank (or ‘wholesale’) markets and capital-market related activity were subject to the greatest degree of internationalisation. This is largely attributable to their proximity to the single monetary policy and the associated infrastructural developments, such as the integration of Large-Value Payments Systems (ECB 2013). Integration in corporate banking also increased, with cross-border bank
lending to non-financial corporates more than doubling between 1997 and 2009, albeit from a very low base (ECB 2009). Retail banking remained the most fragmented area of bank activity, reflecting the lack of an integrated retail payments infrastructure and the inherent obstacles banks encounter in expanding directly into overseas retail markets. However, even in retail banking there were signs of integration: price-based indicators, such as the interest paid on deposits or charged on new loans, showed convergence between national banking systems until 2008 (ECB 2013). Also, the value of cross-border mergers and acquisitions in the banking sector grew substantially between 2005 and 2008, even if this reflected a small number of very large cross-border deals.

From 2008, the integration of European banking went into reverse. This was manifested inter alia in the declining proportion of banks’ assets held in non-home country branches and subsidiaries, the virtual cessation of cross-border M&A activity, and widening divergences in the interest rates charged on new loans in different member states. The disintegration of European banking was most pronounced in wholesale markets with interbank lending declining by approximately 30 per cent between 2008 and mid-2012 (ECB 2013). Even in retail and corporate banking, the period from 2008 to 2012 was one of diminished cross-border lending and retrenchment behind national borders.

What can explain this reversal? The decline in interbank lending was a manifestation of the central vulnerability in the European financial system since 2011: namely, the ‘pernicious interdependence’ of distressed euro area sovereigns and their teetering domestic banks (see IMF 2012). Cross-border interbank lending was critically undermined by the widespread perception that recession-struck national governments lacked the wherewithal to stand behind their domestic banks should the latter become insolvent. At the same time, banks’ creditworthiness was damaged by their excessive exposure to distressed sovereign debt and by the deteriorating condition of their domestic loan portfolios. Integration in European banking was also affected by the potential break-up of the euro – what central bankers refer to as ‘the re-emergence of currency redenomination risk’ (ECB 2013).

The patchwork of national regulations and the fragmented nature of supervisory authority were not the primary causes of these problems: a level playing field in
Integrating rules, disintegrating markets.

European banking would not have avoided the build-up of excessive leverage prior to the crisis, the mispricing of euro area sovereign debt; or the inflation of asset price bubbles. However, regulatory inconsistency and nationally fragmented supervision have played an important role in aggravating and propagating the crisis since it began. In 2008, the Commission’s High-Level Group on Financial Supervision, Chaired by former IMF Managing Director Jacques de Larosière, identified the lack of a coherent set of rules as a key contributor to the difficulties of managing cross-border bank resolutions (Commission 2008). More generally, the lack of a consistent set of rules has contributed to the lack of transparency and comparability of banks’ financial positions, which in turn has exacerbated the unwillingness of banks to lend to one another.

More seriously still, national supervisors have encouraged individual banks to strengthen their prudential position by raising capital relative to their risk-weighted assets. The easiest means by which banks can achieve is to restrict lending and divest assets (i.e. to deleverage). At the same time, national authorities have sought to ensure that banks’ maintain lending to their domestic economies. This has led to a process of national retrenchment as banks deleverage more quickly in foreign than in domestic markets (Goyal et al. 2013). From the perspective of the EU as a whole, such policies constitute to a fallacy of composition in which supervisory decisions that appear rational from the national point of view generate sub-optimal outcomes at the regional level.

The misalignment of supervisors’ incentives with those of the EU as a whole has also played an important role in prolonging the banking crisis. National supervisory authorities in countries with troubled banking sectors have permitted their banks to engage in excessive forbearance towards borrowers: that is to say, they have turned a blind eye to banks which choose not to write down non-performing loans in order to conceal from creditors the extent of bad loans on their balance sheets and hence to be able to operate with book capital at higher levels than would otherwise be the case. National authorities face a strong incentive to engage in this ‘double forbearance’. This is because large-scale write-offs can result in bank insolvencies, which in turn could provoke a self-perpetuating spiral of credit contraction, fire sales and falling asset prices (ESRB 2012). Since financial supervisors are accountable to national parliaments and ultimately national publics, they also face a strong incentive to avoid forcing national
institutions into insolvency, lest they be held responsible for costly financial failures ‘on their watch’.

**Supranational governance at last?**

Since the onset of the crisis, EU policymakers have agreed numerous financial sector reforms, many of which have significantly enhanced the power of supranational institutions in banking regulation and supervision. Member states officially endorsed the objective of ensuring the maximum harmonisation of prudential regulations in 2009 (Council 2009). In the banking sector, this has been partially realised through the adoption of the ‘CRD IV Package’, which entered into force in mid-2013. The CRD-IV Package consists of a regulation (the ‘CRR’) and a directive (the ‘CRD-IV’); together they transpose into European law the Basel III agreement of the BCBS (see Howarth and Quaglia 2013).

The CRR is the centrepiece of the Single Rulebook in banking. It contains key prudential standards in relation to own funds, including definitions of capital and methodologies for calculating capital charges in relation to credit, market, operational and settlement risk. It also contains requirements on large exposures, provisions on liquidity ratios, key prudential reporting requirements and public disclosure requirements (Regulation 525/2013 Article 1). As a regulation, these provisions do not require transposition into national legislation before having legal force in member states. As such, many opportunities for gold- and tin-plating of prudential standards in national rulebooks have been removed.

The institutional architecture for financial regulation has also been subject to significant overhaul. On January 1st, 2011 a new European System for Financial Supervision came into operation consisting of three European Supervisory Authorities (ESAs), which replaced the existing Level 3 committees, and a European Systemic Risk Board (ESRB). The ESA in the banking sector is the European Banking Authority (EBA). Although it is an executive agency of the Commission, its principle decision-making body is a Supervisory Board composed of national supervisors with decisions on regulatory matters taken under qualified majority voting. The EBA has a mandate to
Integrating rules, disintegrating markets.

Like the CEBS before it, the EBA oversees cooperation and convergence between national supervisory authorities. To this end, it has carried forward work to improve the delegation of tasks and exchange of information within ‘colleges’ of supervisors in which officials from different member states cooperate over the supervision of specific cross-border banks. It has taken forward CEBS initiatives to forge a common supervisory culture through staff training and secondment programmes. It has also coordinated pan-EU stress tests, which are carried out at the national level by national supervisory authorities.

The architecture of banking supervision will be further transformed with the creation of the SSM. The SSM will see the ECB take on strong powers to oversee some 6000 banks in the euro area and other participating countries. The ECB will take on the power to authorise banks and ensure their ongoing compliance with the provisions of the CRD-IV package (Council 2013, Recitals 15-17). While SSM will operate as a decentralised system, with national supervisory authorities carrying day-to-day verifications (Council 2013, Recital 22), the ECB will be responsible for issuing guidelines and setting the supervisory framework to guide national supervisors’ actions (Constâncio 2013).

Overall, these regulatory and institutional reforms constitute major strides towards supranational governance of EU banking. However, the ability for national authorities to vary regulatory and supervisory requirements at the national level has by no means disappeared. The CRD-IV Package did not alter the basic structure that centralised European rules would be applied and enforced by national supervisors. While the SSM will largely eliminate the potential for national supervisory divergences amongst the countries participating in it, there is no guarantee that supervisory practices in non-SSM area countries will also converge. Indeed, ambiguities and explicit national discretions within the CRD-IV Package point to the perpetuation of regulatory and supervisory divergence. One such ambiguity is the drafting of the CRR in relation to so-called ‘Basel I floors’, which set a baseline for minimum capital relative to risk-weighted assets. The CRR permits a range of methodologies for calculating Basel I floors, leading to substantial variations in risk-weighted capital requirements (Interview 01/03/2013). Since this ambiguity originates from political choices enshrined in framework legislation, it
cannot be addressed through the elaboration of technical standards by the EBA. Nor can the EBA launch legal proceedings to address a ‘breach of law’ (Interview 01/03/2013).

In future, the degree of harmonisation achieved in such areas will depend on the ability of the EBA to encourage consistent supervisory practices between SSM and non-SSM countries. However, in practical terms, the scarcity of the EBA’s limited resources relative to the ECB and the Bank of England (which will constitute the two most significant supervisory authorities in the EU) may inhibit its ability in this regard. Moreover, changes to the EBA’s voting modalities to strengthen the position of non-SSM countries vis-à-vis SSM countries are unlikely to encourage convergence.

Even within the SSM, national variations may persist. This is because the CRD-IV Package explicitly permits national discretion (Council 2013: Recital 26a) in relation to certain macro-prudential instruments. The CRD-IV (directive) requires national authorities to impose a countercyclical capital buffer of up to 2.5% of banks’ total risk exposure. It also permits national authorities to set a systemic risk buffer to mitigate structural (non-cyclical) financial stability risks, which will be applicable to all credit institutions, or specific sub-sectors including various categories of systemically important financial institutions. In addition, the CRR provides member states scope to impose a range of other macroprudential instruments, other than those contained within the CRD-IV directive, where they detect the existence of local systemic risks.

The precise breakdown of responsibilities in relation to macro-prudential tools will emerge only when the SSM comes into operation; it remains possible that the ECB will emerge as the de facto macroprudential authority in respect of SSM banks. Still, the discretion afforded to national authorities in respect of macroprudential tools provides an insight into forces shaping the supranationalisation of European governance in the EU. These rules constitute a significant derogation from the principle of maximum harmonisation. The main impetus for the inclusion of national discretion in this area came from the national central banks and supervisory authorities. Opposition to maximum harmonisation in this area was articulated in a series of public and non-public letters from the Chair of the European Systemic Risk Board to the Commission, the Council and the Parliament (see ESRB 2012). Coming at a late stage in the negotiations over the CRD-IV Package, this highly controversial intervention was an example of an incorporated
Integrating rules, disintegrating markets.

transgovernmental network exerting authority to shape the policymaking agenda in the EU. However, in contrast to previously documented examples of transnational actors in European policymaking (for example Newman 2008), the transgovernmental network in this case conspired to guide policymakers away from a supranational solution.

Conclusion

When it comes to the supervision of financial services in Europe prior to the current crisis, supranational governance has more often been assumed, based on the agreement of centralised European regulations, than demonstrated through tracing processes of rule-implementation and supervision at the national level. This article has demonstrated that in the two decades between the first reforms to establish the Single Market in financial services and the onset of the sovereign debt and banking crisis, the integration framework in the banking sector preserved ample scope for national regulatory diversity and supervisory discretion. Regulatory diversity was a product of significant loopholes in the European regulations. In turn, these loopholes stemmed from political compromises in the policymaking process and the continued reliance on principles of mutual recognition and minimum harmonisation. Likewise, the wide scope for supervisory discretion was the product of the regulatory framework, which reserved a discrete and powerful role for national supervisors. The incorporation of national banking supervisors into the EU policymaking process did little to produce substantive convergence in supervisory practices.

In the years immediately preceding the crisis, national regulatory diversity and supervisory differences were not enough to stop an overall trend of Europeanisation of banking markets. The reversal of this trend since the onset of the crisis has motivated the overall shift to significantly more supranational governance in banking. Restoring financial integration is widely regarded as an essential prerequisite for restoring the flow of credit to the real economy, especially within the euro area. At the same time, member states, national central bankers, and national financial supervisors have carved out new areas of discretion in the emerging architecture. To the extent that euro area authorities will be able to vary local prudential rules in accordance with national macro-financial
conditions and macro-economic circumstances, such national discretion may provide a vital mechanism for economic adjustment within the confines of the single monetary policy. At the same time, the perpetuation of ambiguities in the legislative framework represents member states traditional concerns over national competitiveness.

What do the persistence of regulatory loopholes and the enduring strength of national supervisory authorities in European banking governance tell us about wider understandings of political integration in the EU? One implication of the preceding analysis is that in seeking to identify ‘who governs’ in a given area of European regulation, it is necessary to examine outcomes all the way through the governance process: that is, from agenda setting, through processes of negotiation, implementation, monitoring and enforcement (Abbott and Snidal 2010). This insight may not be particularly original, but the existing literature on this policy field has too often been skewed towards the agenda setting and negotiating phases, leading to conclusions that privilege the role of transnational exchange and supranational institutions. Moreover, while this article has been focused predominantly on implementation, the case examined in this article also demonstrates that future research could benefit from assessing the various phases of the regulatory process simultaneously. There is a danger of selection bias if scholars focus only on or other phase of the governance process. For example, scholarship focusing on agenda setting and decision-making in relation to specific reforms risks overlooking governance structures and policy areas that never make the negotiating table. In the case of banking, responsibility for key areas of prudential management – including supervision, rescue and recapitalisation, and deposit insurance – are rapidly being transferred to the European level. Such reforms may have seemed unthinkable only a few years ago, but these public functions nevertheless constituted core elements of the overall governance process. This suggests that pluralistic explanations highlighting the agency of different actors at different phases of the governance process could fail to capture the totality of a given actor’s influence in a regulatory domain, be they member states, independent regulatory authorities, transnational actors, or supranational policy entrepreneurs.

Notes
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The SSM is the first component of the proposed ‘Banking Union’ to have been by European legislators. So far only the United Kingdom has ruled out participation in the SSM. A major exception to home country control was that host countries retained the responsibility for conduct of business supervision. Named after Baron Alexandre Lamfalussy, Chairman of the 2001 ‘Committee of Wise Men’, which proposed the institutional reforms. ‘Level 1’ legislation was co-decided by the Parliament and the Council under the traditional ‘Community method’.

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Posner (2010; p.46) noted that the FSAP reforms continued to combine principles of mutual recognition and harmonization, although his overarching concern is to explain the shift from the former to the latter. Quaglia (2007 p.271-272) suggests implicitly that mutual recognition was characteristic of EU financial governance before 1999 only. Mügge (2006; 2010) sets out to explain the shift from mutual recognition and minimum harmonization to supranational governance.

Measures included a voluntary code of conduct for mortgage providers; a directive aiming to eliminate tax distortions in relations to savings accounts; and a series of anti-money laundering directives.

The CRD actually replaced the 2000 Codified Banking Directive, which, in turn, had unified the Second Banking Directive and associated directives into a single document.

The UK Labour Party had established a unified Financial Services Authority shortly after it assumed power in 1997, stripping the Bank of England of its supervisory responsibilities. In Germany, Finance Minister Eichel was at the time locked in battle with the Bundesbank over the establishment of the German federal supervisory authority, the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

The ‘Banking Supervision Committee’ was the Level 2 committee for the banking sector. Comprised of national finance ministry officials, it was also established in 2004.

The directive contains rules on access to the activity of banking; supervisory powers and tools for prudential supervisors; measures to ensure prudential supervision are consistent with the CRR and publication requirements for competent authorities. Unlike the CRR, these measures must be transposed into national laws.

The Commission adopts EBA technical standards as delegated acts.

Currently, a further important area of national discretion is structural restrictions on bank activities such as ring fencing of retail banking and prohibitions on proprietary trading.

The draft SSM Regulation also permits the ECB to vary macro-prudential buffers.

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