# ‘The new intergovernmentalism in financial regulation and Banking Union’

**David Howarth (University of Luxembourg)**

**Lucia Quaglia (University of York)**[1]

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## Introduction

In the post Maastricht period, financial market integration gained momentum in the European Union (EU). From the late 1990s the completion of the single financial market became a priority for the EU and its member states. To this end, no less than 42 EU legislative measures were adopted between 2002 and 2007. The international financial crisis that began in late 2007 prompted a revision of financial services regulation in the EU. From 2010 onwards, the banking crisis was followed by the sovereign debt crisis in the euro area, which, amongst other consequences, increased the fragmentation of the single financial market. The EU’s main response was the proposal for Banking Union.

This chapter asks whether the new type of intergovernmentalism outlined in the Introduction to this volume has emerged in financial services regulation and Banking Union. It is argued that in the post Maastricht period, financial market policy

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was an area of intense activism in the EU, as demonstrated by the strides towards the completion of the single financial market (1999-2008) and the attempts to re-regulate it after the global financial crisis (post 2008). Both the pre crisis regulatory push on financial market integration and the post crisis reinforcement of regulation were influenced by the different preferences of the member states, which were mainly rooted in domestic political economy – that is, the configuration of their national financial sector. In this context, the reluctance to delegate regulatory and supervisory power to supranational institutions – which led to the creation of the so-called Lamfalussy committees of national supervisors first and their transformation into authorities ('EU bodies') after the crisis – was in line with the 'new' intergovernmentalism. It confirmed Hypothesis 3: when delegation occurs, it involves the creation of de novo bodies. Moreover, neither pre crisis nor post crisis supranational institutions sought an ever closer union in finance, as postulated by Hypothesis 2: supranational institutions are not hard-wired to seek ever-closer union.

In the debate on Banking Union the traditional intergovernmental debate on fiscal transfer in the EU – which juxtaposed Germany with other member states, such as France and Italy, in the negotiations of the Maastricht treaty – resurfaced. However, unlike in the making of the EMU project, the European Commission was not the 'engine' of Banking Union, confirming Hypothesis 2. In Banking Union, the new bodies to which supervision and resolution have been delegated retain an intergovernmental imprint, especially in the case of resolution (Hypothesis 3). Finally, it is important to note that Banking Union was designed to complete the 'incomplete' EMU agreed at Maastricht and address the 'inconsistent quartet' that ensued from the state of disequilibrium in the euro area. However the Banking Union 'light'

eventually agreed under German insistence casts doubts on the sustainability of the single currency.

## 2. Post Maastricht financial regulation in the EU

Prior to the mid-1990s, financial services legislation in the EU had been a particularly contested policy area among member states. Indeed, Story and Walter (1997) explained delayed and limited financial market integration as the result of a 'battle of the systems'. Progress on several pieces of EU financial legislation – such as directives on capital adequacy, investment services, Undertakings for Collective Investment in Transferable Securities (UCITS) and accounting – had been slow and painstaking. In some cases (notably on accounting standards), progress had been blocked entirely and by the mid-1990s, the European 'Single' market in financial services remained highly fragmented.

In the run up to the launch of the single currency in 1999 and during EMU's first decade, the pace of financial market integration quickened and financial services legislation underwent significant changes in the EU. From the early 2000s onwards, the progression of the single financial market was achieved through a set of legislative measures outlined in the Financial Services Action Plan (FSAP) (Commission 1999). The plan was proposed by the Commission and endorsed by the member states. Previously, financial services legislation in the EU had been mostly based on minimum harmonization, mutual recognition and national supervision. It had mainly dealt with banking. By contrast, the legislative measures that ensued from the FSAP mostly aimed at maximum harmonization and focused primarily on securities markets and insurance (Ferran 2004).

The adoption of 42 pieces of financial legislation between 2001 and 2007 was facilitated by the so-called Lamfalussy reform (Mügge 2006; Quaglia 2007). In July 2000, the Ecofin Council appointed a Committee of Wise Men, chaired by Alexander Lamfalussy. The mandate given to the Lamfalussy Committee was to put forward proposals for the reform of financial regulation and supervision in the EU. It was clearly stated that prudential supervision should not be discussed by the Committee because this was a sensitive issue for the member states, which were keen to retain it at the national level. In the preparation of the report, the Wise Men considered the proposal of creating a single European regulator for the financial sector, but quickly concluded that creating such an agency would require years of intergovernmental negotiations, and that such an agency, if it were created, would be hampered by the continuing diversity of national regulations in the area (Committee of Wise Men 2000: 26). The Lamfalussy report was subsequently endorsed by the Ecofin Council.

The Lamfalussy reform architecture was articulated across multiple institutional levels. At level one, the EP and the Council co-decided framework legislation (mainly directives) proposed by the Commission. At level two, the implementing measures (generally directives, less frequently regulations) of the framework legislation were adopted by the Commission through the comitology process, which involved the so-called level two committees of member states representatives. At level three, the committees of national regulators (the level three committees) advised the Commission on the adoption of level one and level two measures and adopted level three measures, such as non-legally binding standards and guidelines (Coen and Thatcher 2008; Quaglia 2008). This delegation of power to de novo bodies fits well with the account provided by the new intergovernmentalism (Hypothesis 3). There was never any discussion of delegating supervisory functions to

the Commission, which neither had supervisory expertise, nor the capabilities to develop it.

Some authors (Jabko 2006; Posner 2005) have pointed out the pace setting role of the Commission in the completion of the single financial market, with the support of an increasingly powerful transnational financial industry (Van Apeldoorn 2002; Bieling 2003; Mügge 2010). Others authors (Quaglia 2010a,b) have argued that two main coalitions of member states competed in the regulatory process: the market-making coalition, led by the UK, and the market-shaping coalition, led by France and Germany. Overall, the former coalition was more influential than the latter and most of the pre crisis financial services legislation in the EU was indeed market-making, designed to promote financial services liberalization and increase the competitiveness of the EU financial industry or at least, as Mügge (2010) argues, the most transnational part of it. However, these coalitions were far from homogenous: each member state had its own distinctive preferences, rooted in the distinctive features of the national financial system and its link to the real economy.

In the post 1999 period, especially after the FSAP, financial services regulation in the EU was much more consensual than in the past (Posner and Veron 2010), as demonstrated by the fact that no less than 42 new legislative measures were adopted in less than 6 years and comitology was introduced in the regulatory process. This is not to say that post 1999 financial services regulation was harmonious and conflict free. Indeed, the negotiation of certain pieces of financial services legislation was controversial, as in the case of the Markets for Financial Instruments directive.

However, even in these instances, agreement was reached relatively quickly, because of the shared overall objective to complete the single financial market.

In the aftermath of the international financial crisis, a host of new financial regulation was adopted by the EU,[2] suggesting that the regulatory process remained broadly consensual. New EU legislation was issued on rating agencies, alternative investment fund managers, over the counter derivatives as well as capital requirements and liquidity rules for banks. The traditional community process was followed and, as in the pre crisis period, the main line of division tended to fall between the market-shaping coalition on one side and the market-making coalition and affected industry on the other. Although, with some notable exceptions, the new or amended rules were generally resisted by the UK, Ireland, Luxembourg, the Nordic countries and the financial industries directly affected by the new provisions. The main argument used by the coalition eager to tone down the EU's regulatory response was that the proposed rules were over-prescriptive, intrusive and potentially protectionist (*Financial Times* 7 July 2009, 14 July 2009, 16 June 2009, 4 June 2009). The UK stressed the need to retain 'open, global markets' (Darling 2009).

The new or revised rules, as well as the reshaped institutional framework post crisis (discussed below) were actively sponsored, or at least strongly supported, by France, Germany, Italy, Spain and other members of the market-shaping coalition, as

[2] Several special issues and edited volumes dedicated to financial regulation were published in the aftermath of the crisis. See for example, *Review of International Political Economy* (2012) 19, 4; *New Political Economy* (2010), 15, 1; *Journal of Common Market Studies* (2009) 47, 5; Helleiner, Pagliari, and Zimmerman (2010); Maynz (2012); Hardie and Howarth (2013); Moschella and Tsingou (2013).

illustrated by national government responses to the Commission's consultation, newspaper accounts and interviews with policy-makers. The new EU measures were seen as necessary to safeguard financial stability and protect investors. Some of these rules, such as those concerning hedge fund managers, credit rating agencies, over the counter derivatives, also embodied the deeply ingrained Continental dislike of 'casino capitalism' (Strange 1997), which was seen as serving the fortunes of the City of London (*Financial Times* 30 April 2009). The market-shaping coalition was less preoccupied than the UK government with regard to potential international regulatory arbitrage (Quaglia 2010a,b; Zimmerman 2010).

A somewhat special case was the international Basel III Accord on capital and liquidity requirements for banks (BCBS 2010a,b). As in the case of Basel I and II, after the accord was agreed internationally, it was to be incorporated into EU legislation. To this end, in July 2011, the Commission adopted a legislative package designed to replace the CRD III with a directive that governs the access to deposit-taking activities (Commission 2011a) and a regulation that establishes prudential requirements for credit institutions (Commission 2011b) – this package is often referred to as the CRD IV. After its approval, the proposed directive will have to be transposed in the member states in a way suitable to their own national environment.[3] On Basel III and the CRD IV, the 'traditional' positions of the competing coalitions were inverted. In a nutshell, the UK authorities called for 'tougher' rules, that is a more restrictive definition of what counts as capital, higher capital requirements and liquidity rules. France and Germany advocated a broader definition of what counts as

[3] At the time of writing (March 2014), the Council has yet to adopt the final text of the CRDIV legislative package.

capital, a moderate increase of capital requirements and non-compulsory liquidity rules (Howarth and Quaglia 2013a).

The global financial crisis revealed the weaknesses of existing macro-prudential oversight in the EU and the inadequacy of nationally-based supervisory models in overseeing integrated financial markets with cross-border operators. In 2009, a group of high level practitioners and financial experts, chaired by the former governor of the Banque de France, Jacques de Larosière, produced an eponymous report on the issue, (de Larosière Group 2009). The report outlined the blueprint for the post global financial crisis reform of the institutional framework for financial supervision in the EU. The report was endorsed by the member states and most of its recommendations were implemented.

The European Systemic Risk Board (ESRB) was established to monitor macro-prudential risks in the EU. The so-called level three Lamfalussy committees were transformed into independent EU bodies with legal personality, an increased budget and enhanced powers.[4] The newly created bodies, namely the European Banking Authority (EBA), the European Insurance and Occupational Pension Authority (EIOPA) and the European Securities Markets Authority (ESMA), were charged with the tasks of coordinating the application of supervisory standards and

[4] It can also be noted that the legal basis of the authorities (114 TFEU) makes it easier for member states to assign them additional powers (through Qualified Majority Voting in the Council, rather than unanimity).

promoting stronger cooperation between national supervisors.[5] The decision-making board of each of the authorities consists of officials coming from appropriate national supervisory authorities who serve as independent experts working to uphold collective EU interests – and not officially as national representatives. Other supranational institutions (the Commission and the ECB notably) and representatives of the other authorities only have observer status in the boards. While, the Commission retains the power to intervene in the operation of the authorities in exceptional circumstances, the authorities enjoy considerable autonomy.

In the negotiations on these institutional reforms, there were concerns about giving the new authorities powers over national regulators and the possibility of supervising individual financial cross-border institutions – with the UK, Ireland and Luxembourg the most reluctant (Buckley and Howarth 2010). The British government was particularly reluctant to grant decision-making powers to EU-level bodies, given that public funds to tackle banking crises came from national budgets. Prime Minister Gordon Brown secured a guarantee that the new supervisory system would not include powers to force national governments to bail out banks. That said, a number of other member states, including France and Germany, favoured the limited reform approach and were hesitant about transferring substantive power to the EU level (Buckley and Howarth 2010).

[5] The Commission also proposed a directive amending the existing directives in the banking, securities and insurance sectors and a Council decision entrusting the ECB with specific tasks in the functioning of the ESRB.

As postulated in the Introduction to this volume, the institutional design of the new authorities (the former Lamfalussy committees) reflected 'a clear reluctance on the part of member states to delegate politically sensitive functions to the European Commission and a preference for innovative institutional arrangements in which national representatives dominate' (Hypothesis 3). As in the case of the Lamfalussy reform, the possibility of delegating some of these functions to the Commission was never contemplated because the Commission was seen as lacking the necessary expertise and manpower. Moreover, national governments were eager to safeguard the competences of national supervisors in this field, at least until the proposal for Banking Union was put forward. Finally, in neither the pre nor the post financial crisis period did supranational institutions, including the Commission, officially propose or push actively for an 'ever closer union' in the area of financial supervision (Hypothesis 2).

**3. The new intergovernmentalism in the push for Banking Union**

The June 2012 European Council and euro area summit agreed to deepen Economic and Monetary Union (EMU) creating 'Banking Union' (Euro Area Summit statement 2012).[6] The aim of proponents has been to stabilise the national banking systems exposed directly to the sovereign debt crisis by breaking the dangerous link between the high and rising sovereign debt in the euro area peripheral member states and domestic banks, which had come to hold an increasing amount of this debt. At the same time, Banking Union was an attempt to address the increasing fragmentation of

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[6] On Banking Union, see Schoenmaker and Wagner (2011), Schoenmaker (2012, 2013), Veron and Wolff (2012) and Wyplosz (2012).

financial markets in the EU, which was a consequence of the crisis. (See Howarth and Quaglia 2013b for an overview.)

The incomplete EMU agreed at the Maastricht Summit created a state of disequilibrium in the EU, to be precise in the euro area – as purported by Hypothesis 1: Deliberation and consensus have become the guiding norms of day-to-day decision making at all levels. At the international level, Dirk Schoenmaker pointed out the 'financial trilemma' (2013; see also Schoenmaker and Wagner 2011) based on the interplay of financial stability, cross-border banking and national financial policies, arguing that any two of the three objectives can be combined but not all three: one has to give. In EMU, there was a fourth element to be added to this trilemma, which became, what we label, an 'inconsistent quartet' (Howarth and Quaglia 2014). The single currency undermined national financial policies, because the function of lender of last resort could no longer be performed at the national level. Moreover, national resolution powers were constrained by fiscal rules in the euro area.

Consequently, the safeguard of financial stability was outside the control of the national authorities and could only be achieved at the euro area level. For these reasons, euro area member state governments agreed (in some cases with great reluctance, as explained below) to move to Banking Union. Banking Union is to replace the third element of Schoenmaker's trilemma, namely national financial policies which include regulation, supervision and resolution. The European Council proposal of June 2012 had four elements: an EU deposit guarantee scheme; an EU framework for bank recovery and resolution; a Single Supervisory Mechanism (SSM) for banks; a Single Resolution Mechanism (SRM) and a common fiscal backstop for

struggling banks. The fifth element of Banking Union was the so-called single rule book (notably, financial regulation and competition policy rules) which was to apply to all EU member states.

The Deposit Guarantee Scheme (DGS) Directive and the Bank Recovery and Resolution (BRR) Directive were legislative proposals put forward by the Commission prior to the proposal for Banking Union.[7] A DGS Directive, dating back to 1994, set the minimum level of deposit protection schemes in the EU at €20,000 per depositor. The directive was based on minimum harmonization, hence national deposit guarantee schemes continued to differ in several important respects, such as the definition of eligible deposits, the level of cover, the types of funding mechanism, and the calculation of member contributions.

In July 2010, the Commission (2010: 5) put forward a legislative proposal to amend the DGS Directive with a view to promoting the 'harmonization and simplification of protected deposits, a faster pay-out, and an improved financing of schemes'. The proposal aimed to establish a network of guarantee schemes as a first step towards a 'pan-European deposit guarantee scheme' to cover all European Union-based banks (Commission 2010: 5). Such a pan-European scheme, however, presupposed full harmonization of national schemes and could only enter into force

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[7] The principal logic behind the establishment of national guarantee schemes – which reimburse part of the amount of deposits to clients of banks that have failed – is to prevent a 'bank run', that is panic withdrawals of customer deposits from a bank because of a fear of collapse.

after a minimum fund of 1.5 per cent of eligible bank deposits had been reached in each of the member states.

One of the most contentious provisions in the proposed directive was the establishment of a mandatory mutual borrowing facility, whereby if a national deposit guarantee scheme is depleted, it can borrow from another national fund. Several member states tried to remove this provision while discussing the proposed directive in the Council[8]. The mutual borrowing facility could be the first step towards a pan-EU deposit guarantee scheme, which was even more controversial. Indeed, in the preparation of the directive, the Commission considered setting up a single pan-European scheme. However, it soon realised that there were complicated legal issues that needed to be examined (Commission 2010) and therefore the idea of a pan-European scheme was shelved by the Commission for the time being. In this case, the Commission did not pursue an ever closer union, in line with one of the hypotheses of the new intergovernmentalism (Hypothesis 2). Ultimately though, the problem was political – it would have meant fiscal transfers (of taxpayers money) amongst the member states. The creation of a pan-European scheme would have implied pooling national sovereignty to an extent inacceptable to most of the member states at that time (i.e., in 2010).

Member states were principally divided on the pan-European scheme between those that feared that they would be net contributors to the scheme, notably Germany, and those facing dangerous instability in their banking systems, notably Spain and Ireland, and which were more likely to resort to the scheme. Moreover, Germany had

[8] Interviews, Brussels, July 2012

a high level of depositor protection and a rather complex system of public and private deposit guarantee schemes. The creation an EU-wide scheme brought to the forefront the old debate, dating back to the Maastricht treaty, of 'fiscal union' or 'transfer union', whereby some states were set to be net beneficiaries of the transfers and others net contributors.

After prolonged consultations, the Commission put forward a formal legislative proposal for a directive on Banks Recovery and Resolution[9] in June 2012 (Commission 2012d). The proposed directive had the same scope of application as the CRD IV (hence, credit institutions and certain investment firms). It distinguished between powers of 'prevention', 'early intervention' and 'resolution'. The harmonized resolution tools and powers outlined in the directive were designed to ensure that national authorities in all member states had a common toolkit and roadmap to manage the failure of banks. Amongst the tools considered, there was a bail-in tool, whereby banks would be recapitalized with shareholders' stakes wiped out or diluted, and creditors would have their claims reduced or converted into shares. Resolution colleges were to be established under the leadership of the group resolution authority and with the participation of the European Banking Authority (EBA), which was to act as binding mediator if necessary (Commission 2012d & 2012e).

[9] 'Bank resolution' is the organization of an orderly failure, which maintains the continuity of banking service. It is an alternative or complementary mechanism to deposit guarantee schemes in the event of bank failure.

The legislation envisaged the creation of resolution funding, which would raise contributions from banks proportionate to their liabilities and risk profiles and would not be used to bail out banks. There was a link between this piece of legislation and the amendment to the DGS Directive, proposed by the Commission in 2010 which was to provide funding for the protection of retail depositors. Member states would be allowed to merge these two funds, provided that the scheme had enough funding to repay depositors in case of failure (Commission 2012d & 2012e).

The Commission noted that ideally, a single pan-European fund should be established with a pan-European resolution authority to manage its disbursal, but the absence of a single European banking supervisor and insolvency regime would make this unworkable.[10] Hence, the Commission backed down from proposing a single fund. In both this case and that of the DGS Directive, the Commission did not act as an engine of integration (Hypothesis 2). In both cases, the obstacles to these far-reaching changes were ultimately political, the main line of division running between potential net contributors and net beneficiaries of these schemes.

Unlike the other aforementioned components of Banking Union, the SSM applies only to the euro area member states and to the non-euro area member states that decide to join Banking Union. In the SSM, responsibility for banking supervision is assigned to the ECB and national competent authorities (NCAs) working collectively in one system. During the negotiations on the SSM, there were two main

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10 http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/416&format=HTML&aged=0&language=EN&guiLanguage=en accessed in December 2013.

areas of disagreement among member states: first, the scope of ECB supervision, in particular whether the ECB should directly supervise all euro area based banks (plus the banks based in opt in countries) or only the main (cross-border) banks – and the definition of the threshold between 'significant' and 'less significant' banks; and, second, the relationship between the SSM and non-euro area member states, in particular those that chose not to opt in.

The Germans opposed a broad scope for ECB supervision, in particular they resisted the ECB's supervision of the country's public Landesbanks and savings banks (Sparkassen). These banks were seen as having a 'public' function in Germany with strong ties to local and regional governments and traditionally reliant on the Länder for financial backing (Hardie and Howarth 2013). The French government expressed concern over the unequal treatment of member states given that its banking system was dominated by five very large institutions which would all end up being directly supervised by the ECB (*Financial Times*, 14 November 2012). Yet, while the extent of the delegation of supervisory power to the ECB was a controversial issue for the member states, different positions were not an insurmountable obstacle to a final agreement.

Over the years prior to the launch of the Banking Union debate, some senior ECB officials (for example, Tommaso Padoa-Schioppa) expressed support for the ECB to assume control over supervisory functions (Howarth and Loedel, 2005). However, this was never previously an official ECB policy. Nonetheless, the ECB endorsed the Commission's initial September 2012 proposal on the SSM of allocating all supervisory competences to the ECB, regardless of the size of banks. President

Mario Draghi made clear that being a decisive supervisor included oversight of all 6,000 banks to ensure a level playing field (*Financial Times*, 8 November 2012). But in several speeches he also reiterated that day-to-day tasks would remain with national supervisors (see for example*,* ECB, 2012.).

In the end, the agreement reached at the December 2012 European Council foresaw that the ECB would be 'responsible for the overall effective functioning of the SSM' and would have 'direct oversight of the euro area banks' (European Council 2012: 2). This supervision however would be 'differentiated' and the ECB would carry it out in 'close cooperation with national supervisory authorities'. Direct ECB supervision was to cover those banks with assets exceeding €30 billion or those with assets representing at least 20 per cent of their home country's annual GDP. The agreement permits the ECB to step in, if necessary, and supervise any of the 6000 banks in the euro area to bring about the eventual restructuring or closure of banks faced with insurmountable difficulties. In this instance, supervisory functions were delegated to a supranational institution, the ECB, which partly contradicts the third hypothesis of the new intergovernmentalism. It is however noteworthy that the Supervisory Board of the SSM (in operation from January 2014) consists principally of representatives from NCAs (currently 18 out of 24 Board members). This national presence is similar to that in the Governing Council of the ECB – where currently 18 of the 24 members are governors of national central banks. However, in both the Supervisory Board and the Governing Council, national officials serve officially (if not necessarily in practice) in an ad personam capacity as independent experts are not to take instruction from governments or other bodies in the pursuit of their objectives.

The ECB Governing Council retains formal decision making power, while the Supervisory Board – which is not a legal entity – possesses drafting power and executes tasks on behalf of the ECB. The maintenance of a 'Chinese wall' between the ECB's prudential and monetary policy making was a significant legal concern given the ECB's monetary policy mandate – to be driven primarily by the goal of price stability – and a major preoccupation for several member states, notably Germany, that feared the dilution of the central bank's monetary policy focus in its pursuit of other objectives. The assumption of the institutional compromise involving the Governing Council and the Supervisory Board is that the intervention of the former will be limited and the policy making autonomy of the latter respected.

As for the relationship with non-euro area members, some euro-outsiders were interested in participating in the SSM and therefore opposed the regulation proposed by the European Commission in September 2012, which placed the ECB at the centre of the mechanism and equated SSM membership with euro area membership. The European Council eventually decided that non-euro area member states could opt into the SSM through the establishment of a 'close cooperation agreement' and that 'opt in' countries can sit on a new ECB supervisory board with equal voting powers but not on the decision-making Governing Council (*EUObserver*, 29 November 2012). The majority of non-euro area member states either signalled clearly their intention to enter Banking Union or adopted a 'wait and see' policy.

The British government had no intention of joining the SSM. Hence its main priority in the establishment of Banking Union was to avoid a potential euro area block within the single financial market. Crucially, the British feared the adoption of

subsequent financial legislation that would be detrimental to the British financial sector. They also feared that the operation of the EBA would be heavily influenced by euro area member states. Hence, the British demanded an EBA voting reform, whereby any decision by the Authority should be approved by a minimum number of member states outside the Banking Union and thus, effectively, by a 'double majority' of member states inside and outside the Banking Union. The outcome of the EU negotiations was a compromise involving the creation of a double-majority system until the number of non-Banking Union member states dwindled to less than four. The reform thus creates the strong probability of an over-representation of non-Banking Union member states in EBA policy making. The reform also demonstrates the intergovernmental character of the EBA, despite legal provisions ensuring the independence of national supervisory authorities sitting on the authority's board.

The proposal and creation of the Single Resolution Mechanism (SRM) in 2013-14 goes beyond the timeframe of the analysis in this volume. However, the creation of an SRM was one of the five elements of Banking Union outlined in the June 2012 agreement. The outcome can be examined briefly here because it was a messy compromise that nonetheless embedded core features of the new intergovernmentalism. In July 2013, the Commission proposed the establishment of a SRM (Commission, 2013), designed to complement the SSM. The Commission's draft regulation envisaged the establishment of a Single Resolution Board, consisting of representatives from the ECB, the European Commission and the national resolution authorities of the member states where the bank has its headquarters as well as branches and/or subsidiaries. A Single Bank Resolution Fund was to be set up

under the control of the Board to provide financial support during the restructuring process.[11] Banks would be required to contribute to the Fund.

The draft regulation gave the ultimate decision making power to the Commission, which would decide whether and when to place a bank into resolution and would set out a framework for the use of resolution tools and the Fund. This would have increased the power of the Commission on bank resolution at the expense of the member states, seemingly contradicting the hypothesis of the new intergovernmentalism that supranational institutions are not hardwired for the pursuit of ever closer union (Hypothesis 2). Yet, the Commission called for a kind of quasi delegation with responsibility for the Single Resolution Board shared between the ECB, the Commission and national representatives. As such, the Commission proposed the creation of a new body to which to delegate competences, confirming the third hypothesis of the new intergovernmentalism (Hypothesis 3).

Why did the Commission not bid for more power in this field? During the consultation stage in the Commission's preparation of the proposal, it became clear that some member states, first and foremost Germany, would not have accepted the delegation of resolution power to the Commission. Even the hybrid solution eventually put forward by the Commission was not acceptable to Germany, which challenged this proposal on legal grounds, arguing the Commission had overstepped its authority and that a treaty change was required for such a far reaching reform (*Wall Street Journal,* 10 July 2013).

[11] http://europa.eu/rapid/press-release_IP-13-674_en.htm accessed in December 2013.

Beyond the legal argument, there was a financial and ultimately political argument, as had been the case for the other elements of Banking Union involving financial assistance. German policy-makers feared that their country would be the main contributor to the Single Resolution Fund and that the Commission would take decisions that might have fiscal implications for the member states. Should the Fund not have enough financial resources to intervene, national governments (and ultimately taxpayers) would have to step in.

In the run up to the decisive Ecofin meeting in December 2013, Dutch policy-makers floated the idea of splitting the SRM proposal into two parts, to be discussed in parallel negotiations: one part concerned the scope and decision-making mechanism of the SRM, the other part concerned the Single Resolution Fund (*Bloomberg*, 10 December 2013). With reference to the Fund, a compromise solution proposed by Dutch policy-makers was a system whereby the resolution fund of the bank's home state would be used before other member states' funds were utilised. On 18 December 2013, an agreement was eventually reached in the Council of Ministers on the draft regulation on the SRM.[12] In addition, a decision adopted by euro area member states committed them to negotiate an intergovernmental agreement on the functioning of the Single Resolution Fund by March 2014. With reference to the decision making process on resolution, the main change that had been advocated by Germany was that the Single Resolution Board was to be given the power to decide to

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http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf accessed in December 2013

place a bank into resolution and to decide upon the application of resolution tools and the use of the Single Resolution Fund.

The SRM agreed was to cover all banks in the participating member states. The Single Resolution Board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks, as advocated by Germany. However, the Board would always be responsible if the resolution of a bank required access to the Single Resolution Fund, which in the case of Germany was unlikely. National resolution authorities would be responsible for executing bank resolution plans under the control of the Single Resolution Board.[13] Should a national authority not comply with a decision by the Board, the latter could address executive orders directly to the troubled bank. To guarantee member state budgetary sovereignty – a non-negotiable demand of the German government – the SRM could not require member states to provide extraordinary public support to any entity under resolution.[14]

The version of the regulation agreed in December 2013 created a Single Resolution Fund that would be financed by bank levies raised at the national level. However, the German government refused to include in the regulation the most

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[13] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf accessed in December 2013

[14] Statement from the Commission after the agreement in the Council http://europa.eu/rapid/press-release_MEMO-13-1186_en.htm?locale=en

sensitive elements of the SRM package, notably specific provisions on the transfer and pooling of member state funded compartments into a single mutualised fund. The Germans sought to eliminate EP involvement on these matters and minimise the Commission's role (*European Voice*, 12 December 2013). The German government insisted upon subsequent intergovernmental agreement among participating member states to permit the transfer of national funds towards the Single Resolution Fund and the activation of the mutualization of the national compartments. The German government also insisted upon a delay of ten years during which the mutualization between national compartments would progressively increase.[15] Therefore, while during the first year the cost of resolving banks (after bail-in) would mainly come from the compartments of the member states where the banks are located, this share would gradually decrease as the contribution from other countries' compartments increased. The intergovernmental agreement also endorsed the use of the bail-in rules set by the BRR Directive in the SRM.

During the negotiations, the ECB president Mario Draghi at his hearing before the European Parliament pointed out that 'We should not create a Single Resolution Mechanism that is single in name only…I urge you and the Council to swiftly set up a robust Single Resolution Mechanism, for which three elements are essential in practice: a single system, a single authority, and a single fund' (*Bloomberg,* 16

15 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf

December 2013).[16] The ECB also urged finance ministers to adopt an emergency procedure that would ensure resolution decisions could be taken within 24 hours. Like the ECB, Michel Barnier, the EU commissioner responsible for financial services, remained concerned about the ability of the SRM to take difficult decisions to close a bank quickly or secretly enough, arguing that 'What we are building is a single system and not a multi-storey intergovernmental network' (*The Telegraph,* 18 December 2013). The EP unsuccessfully attempted to bring the elements of December intergovernmental side-agreement into the regulation, winning only limited concessions in the 20 March 2014 compromise with the Council that decreased the period during which the national compartments would merge to eight years, increased the proportion of the Fund shared at an earlier stage, and marginally increased the role performed by the Commission in the Single Resolution Board – allowing the Council to reject resolution proposals only under certain conditions (*Financial Times*, 20 March 2014). Although the Commission is to have a limited role in the SRM, member state governments retain their vetoes on mutualization and an important say on the use of resolution funds. The creation of the Board reflects the preference of member states to delegate powers to new bodies in which member states retain a presence (Hypothesis 2 of new intergovernmentalism).

As for the common fiscal backstop, a link was established between Banking Union and the European Stability Mechanism (ESM) in the event that temporary financial support was needed. The ESM is a new EU body – with no direct relationship to the Commission – established in September 2012 to replace the

[16] http://www.bloomberg.com/news/2013-12-16/draghi-says-european-bank-resolution-plan-may-be-too-cumbersome.html accessed on 17. 12.13

temporary European Financial Stability Facility (EFSF) (Gocaj and Meunier 2013). The members of its decision-making body are representatives of the member states. The mechanism was to have a full lending capacity of €500 billion by 2014. Member states contributing to the ESM could apply for a bailout from the mechanism if they were in financial difficulty or their financial sector was a stability threat in need of recapitalization. However, the ESM bailouts were to be based on strong conditionality and member states were required to sign a 'Memorandum of Understanding' which would highlight which reforms needed to be undertaken or fiscal consolidation implemented in order to restore financial stability. The Commission and several member states proposed that the ESM be used to support failing banks directly (Howarth and Quaglia 2013b) – initially resisted by the German government. The December 2012 European Council agreed that the SSM would allow the ESM to recapitalize banks in difficulties directly, subject to majority voting in both the ECB and the EBA.

Effectively, the Franco-German debate on Banking Union paralleled longstanding debates on euro area governance and solutions to the euro area's sovereign debt crisis. The French sought support mechanisms; the Germans reinforced fiscal policy commitments (sustainable member state budgets). French support for Banking Union stemmed from their limited success in convincing the Germans to agree to other measures to tackle the crisis and notably massive support mechanisms – what British Prime Minister David Cameron called the 'Big Bazooka' – able to purchase debt directly from euro area member state governments and engage in bank recapitalization (*Financial Times*, 10 October 2011). Banking Union was seen as a way to establish a kind of fiscal backstop to the euro area – via a lender of last

resort style support for banks rather than governments per se. The underlying German and Northern European concern with the fiscal backstop, as with the resolution mechanism, was being forced into a situation of having to contribute more funds to the ESM in order to bail out banks in other member states (Howarth and Quaglia 2013b).

## Conclusions

From the mid-1990s to the mid-2000s, the EU made significant strides towards the construction of a single market in financial services. Following the international financial (banking) crisis, the EU engaged in a major overhaul of its financial services legislation. The massive bailout of banks in a range of EU member states during the crisis highlighted that there was a 'fiscal tag' attached to financial legislation – to be precise, to getting it wrong. The fiscal tag of unfit for purpose financial legislation was not clear prior to the crisis and was generally not present, at least not to the same extent, in other areas of the single market. Hence, post crisis financial legislation acquired greater political salience than in the past – a crucial difference in comparison to other policy areas of the single market.

As a response to the sovereign debt crisis, EU policy-makers put forward proposals for Banking Union. This crisis was partly caused by the state of disequilibrium created by the incomplete EMU agreed in the Maastricht treaty. The initial proposals for Banking Union had far-reaching fiscal and, ultimately, political implications, which went to the heart of national sovereignty – a crucial difference in comparison with other policy areas of the single market. On the one hand, the

Banking Union 'light' that was eventually agreed – largely because of German government reluctance – appeared to cast some doubt on the ability of the euro area to deal with the sovereign debt crisis and future banking crises. On the other hand, even in its much-watered down form – compared to the Commission's initial proposal – and despite concerns for moral hazard, the German government agreed for German tax payers and for German banks to contribute (eventually and under a host of conditions) to the recapitalization and resolution of banks based in other euro area member states.

Finally, it is worth reflecting on an interesting feature of the new intergovernmentalism in economic governance, namely the increasing use of intergovernmental agreements – such as the Treaty on Stability, Coordination and Governance (Fiscal Compact), the Treaty Establishing the European Stability Mechanism and the side-agreement on the operation of the Single Resolution Fund. The logic behind these agreements varied but they all reflect a preference for flexibility not afforded by standard treaty change and the community method. Most of the member states resorted to an intergovernmental treaty on the Fiscal Compact in December 2011 because they refused to give in to British government threats to veto EU treaty change unless it was given concessions on unrelated demands (*European Voice*, 12 December 2013).

In the case of the Treaty Establishing the European Stability Mechanism, member states preferred to avoid EU treaty change which would have required politically difficult referenda in a range of member states. In the case of the Single Resolution Mechanism, the member states reached an intergovernmental agreement in

order to meet German government demands to maintain national veto power over the mutualization of national resolution funds. The German government was also concerned that enshrining some features of the Commission's proposed SRM into EU law would make German tax payers potentially liable for the debts of banks in other member states, and risk rejection by the German constitutional court (*European Voice*, 12 December 2013). These intergovernmental arrangements curtail the powers of the European Parliament and European Court of Justice in new areas of economic governance, and weaken the Commission's control.