Abstract

Significantly Important Financial Institutions (SIFIs) have long dominated the financial market without being subjected to scrutiny of regulation and supervision. The role of these institutions in the financial system is significant not only because of its complexity and its systemic impact in the economy but also because it has challenged the governance of the financial market. On the verge of the financial crisis, global financial markets have responded in different manners from state aid to state intervention or bailout; a spur of the moment reaction to avoid major financial disruptions in the economy. Presently, the process of overhauling the regulation and supervision of SIFIs is not only a domestic issue but also a global issue. This paper examines the governance in the European Union and its Member States based on the standard set by the international standard setting bodies.

Keywords: banking regulations and supervision, SIFIs, financial market regulatory institutions, European Union
List of Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision (Basel)</td>
</tr>
<tr>
<td>CRD</td>
<td>Capital Requirement Directive</td>
</tr>
<tr>
<td>CRR</td>
<td>Capital Requirement Regulation</td>
</tr>
<tr>
<td>EBA</td>
<td>European Banking Authority</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EMU</td>
<td>European Monetary Union</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>ESA</td>
<td>European Supervisory Authority</td>
</tr>
<tr>
<td>ESFS</td>
<td>European System of Financial Supervisor</td>
</tr>
<tr>
<td>ESMA</td>
<td>European Securities Market Authority</td>
</tr>
<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
</tr>
<tr>
<td>FICOD</td>
<td>Financial Conglomerates Directive</td>
</tr>
<tr>
<td>G-20</td>
<td>Group of 20</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
</tr>
<tr>
<td>LOLR</td>
<td>Lenders of Last Resort</td>
</tr>
<tr>
<td>MS</td>
<td>Member States</td>
</tr>
<tr>
<td>PRA</td>
<td>Prudential Regulation Authority</td>
</tr>
<tr>
<td>SIFI</td>
<td>Systematically Important Financial Institutions</td>
</tr>
<tr>
<td>SRM</td>
<td>Single Resolutions Mechanism</td>
</tr>
<tr>
<td>SSB</td>
<td>Standard-Setting Bodies</td>
</tr>
<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism</td>
</tr>
<tr>
<td>TBTF</td>
<td>Too Big to Fail (Banks or SIFIs)</td>
</tr>
</tbody>
</table>
# Table of Contents

<table>
<thead>
<tr>
<th>Chapter</th>
<th>I</th>
<th>Introduction ..................................................................................................................4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>I.A</td>
<td>Research Question/Methodology ..........................................................................................5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Limitation ................................................................................................................................8</td>
</tr>
<tr>
<td></td>
<td>I.B</td>
<td>What is Systematically Important Financial Institutions? ..................................................8</td>
</tr>
<tr>
<td>Chapter</td>
<td>II</td>
<td>Theoretical Framework .........................................................................................................11</td>
</tr>
<tr>
<td></td>
<td>II.A</td>
<td>Constructivist Institutionalism ............................................................................................12</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CI Approach in EU Integration ...............................................................................................14</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CI in Financial Regulation ...................................................................................................15</td>
</tr>
<tr>
<td></td>
<td>II.B</td>
<td>Rational Institutionalism .......................................................................................................16</td>
</tr>
<tr>
<td></td>
<td>II.B</td>
<td>Economic Nationalism ............................................................................................................17</td>
</tr>
<tr>
<td>Summary</td>
<td></td>
<td>Summary ................................................................................................................................20</td>
</tr>
<tr>
<td>Chapter</td>
<td>III</td>
<td>Domestic Regulatory Process in the European Union ................................................................20</td>
</tr>
<tr>
<td></td>
<td>III.A</td>
<td>De Larosiére Report ..............................................................................................................22</td>
</tr>
<tr>
<td></td>
<td>III.B</td>
<td>European System of Financial Supervisor (ESFS) ...................................................................23</td>
</tr>
<tr>
<td></td>
<td></td>
<td>European Supervisory Authority ............................................................................................23</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Institutional changes in developing regulation ...................................................................24</td>
</tr>
<tr>
<td></td>
<td></td>
<td>European Systemic Risk Board (ESRB) ...................................................................................27</td>
</tr>
<tr>
<td></td>
<td></td>
<td>European Central Bank ..........................................................................................................27</td>
</tr>
<tr>
<td></td>
<td>III.C</td>
<td>Overview of European Union’s Banking Regulation ................................................................28</td>
</tr>
<tr>
<td>Summary</td>
<td></td>
<td>Summary ................................................................................................................................30</td>
</tr>
<tr>
<td>Chapter</td>
<td>IV</td>
<td>EU’s Existing Regulatory Measures for SIFIs .......................................................................30</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financial Conglomerate Directive ............................................................................................30</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capital Requirements Directive/Capital Requirements Regulation ........................................32</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Recent Regulatory Mechanisms ..............................................................................................35</td>
</tr>
<tr>
<td>Summary</td>
<td></td>
<td>Summary ................................................................................................................................36</td>
</tr>
<tr>
<td>Chapter</td>
<td>V</td>
<td>International Regulatory Setting Bodies ..............................................36</td>
</tr>
<tr>
<td>----------</td>
<td>----</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td></td>
<td>V. A  Basel Standards ........................................................................37</td>
</tr>
<tr>
<td></td>
<td></td>
<td>V. B  Financial Stability Board and the G-20 .....................................39</td>
</tr>
<tr>
<td>Summary</td>
<td></td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Chapter</td>
<td>VI</td>
<td>Member States (MS) banking reforms ....................................................41</td>
</tr>
<tr>
<td></td>
<td></td>
<td>State Aid/Recapitalization Program ....................................................41</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Resolution and Banking Union ................................................................42</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Implementation of EU Regulation .........................................................42</td>
</tr>
<tr>
<td>Chapter</td>
<td>VII</td>
<td>Theoretical and Empirical Reflection ....................................................45</td>
</tr>
<tr>
<td>Chapter</td>
<td>VIII</td>
<td>Conclusion .............................................................................................49</td>
</tr>
</tbody>
</table>
I. Introduction

Significantly Important Financial Institutions (SIFIs) have long dominated the financial market without being subjected to scrutiny of regulation and supervision. Business operation of SIFIs has gone through without much regulatory intervention of its government before the financial crisis. Furthermore, even if the world’s financial market integration is not as perfect as every government wants it to be, still SIFIs have contributed to the global financial claims offering a faster earnings than trade and global GDP as Classens et.al (2010) posit\textsuperscript{1}. The financial market has provided the global economy a large scale of benefits through allocations of capital and liquidity worldwide, encouraging competition, facilitating trade and the exchange of technology and know-how that go beyond borders spreading like a spider’s web. In these developments, SIFIS have the most contributions especially from its cross-border transactions.

While the linkages of the financial market grew, encouraging intermediation of banking and non-banking sector, unregulated financial activities also grew avoiding institutional regulatory mechanisms\textsuperscript{2}. The gaps between borrowers and lenders also increased that led to the failing control mechanisms of banks to monitor and screen risky investments\textsuperscript{3}. Furthermore, the pace of financial market interconnection grew rapidly, overtaking the international financial regulatory structure. The growing interconnection of SIFIs did not only contribute to the complexity of cross-border transactions but also to the \textit{systemic risk} that posed a threat to the financial market. \textit{Systemic risk} is a risk caused by a failed bank, transmitted to the entire financial system that could paralyze the entire system because of their interconnectedness. This is comparable to a dangerous virus or disease transmitted globally through the movement of people around the globe. On the first hand, the financial crisis revealed that the structure of financial regulation was out-shadowed by the development of the financial market. But on the other hand, the financial crisis has also shown us the vulnerability of the financial market. Furthermore, this vulnerability has many faces namely; failures in risk management, flawed regulatory and policy measures, excessive risk investment of banks of which can be placed in one headline as a failure of global prudential regulation. Governments did not have solid tools to resolve the problems of SIFIs during the crisis that could have prevented the spill-over in the global financial market and the intermediation of governments with their respective ailing banks in terms of bail-outs or

\textsuperscript{1} S. Claessens, et.al, A Safer World Financial System: Improving the Resolution of Systemic Institutions, (“The Future of Regulatory Reform, Geneva Reports on the World Economy 12, Center for Economic Policy Research, 4 October 2010),

\textsuperscript{2} I. Ötker-Robe, et.al., Impact of Regulatory Reforms on Large and Complex Financial Institutions, (IMF Staff Paper, Nov. 3, 2010), p 7

\textsuperscript{3} Ibid.
state aid\(^4\). The financial crisis was the catalyst for the reforms especially in regulating the SIFI on the grounds that the interconnections of these similar banks are growing, and the cross-border transactions are getting more complex. For these reasons, governments have found resolutions for ailing SIFIs through immediate financial support even it could mean putting the economy in play\(^5\).

When the financial crisis in 2007 hit some of ailing SIFIs, the response of their respective government is almost identical; an immediate resolution that could prevent the destabilization of the global financial market avoiding the spill-over in the economy. Some member states of the European Union responded to the financial crisis by providing state aid or bail-out funds specifically for the banking sector. The European Union which still has the problem of its slow-moving European banking integration tolerated its member states that granted state aid to its own SIFIs just to keep the stability of EU’s financial market. The action just explains that there was no immediate regulatory response against SIFIs that posed systemic risk and put the economy nearly in catastrophe. The reactions of some member states also proved that “blood is thicker than water” in the case of saving their own ailing SIFIs. International financial regulatory authority like the Basel Committee on Banking Supervision (BCBS) has added additional mechanisms to strengthen international banking regulation, and most specifically to regulate SIFIs. However, some Basel Standards which were designed earlier before the crisis are either not yet completely implemented or not implemented at all. The core regulatory structure of BCBS is the Basel III\(^6\) (tougher capital requirements) which is not accepted with open arms by the global financial market or has encountered domestic regulatory resistance. Coordinating with the BCBS, the Financial Stability Board (FSB) which is the regulating body of G-20 member nations (and non-members) also proposes measures to improve the regulatory framework not only for the G-20 nations but of the global financial market that would prevent moral hazard and future systemic risk in the entire economy. Thus, the effort of EU to strengthen the regulatory mechanisms imposed by Basel will also have to weigh from its enforcement power and the commitment of its member states to accept and implement the new standards. This thesis should allow clear understanding on the process of financial market governance after the financial crisis. In this regard, it will assess specific regulatory standards for SIFIs and compare different approaches at the institutional level (global and domestic) and the national level.

I.A Research Question and Methodology


\(^5\) Ibid, p 18

\(^6\) Basel III covers both macro-prudential and micro-prudential regulation that strengthens capital requirements of banks, specifically SIFIs
The purpose of this thesis is to examine the process of the implementation of financial market regulation and assess the strength of actors in the global level to the EU level and the national level (MS) in response to the new regulatory measures for SIFIs. With this regard, this research will also trace out limitations and effectiveness of institutional authorities in the implementation process. The methodological design of this paper is based on a comparative strategy which aims to assess the behavior of actors within the regulatory process of the banking system, targeting the regulatory frameworks for SIFIs. The focus of this paper is based on the recent banking regulations and policies framed by the international setting bodies, and will be distinguished between the national (Member States) and domestic (EU) perspective. The main actors in this thesis are the global regulatory institutions (Basel and FSB), EU regulatory institutions and the national governments (random). Empirical materials to be examined are firstly: regulatory standards applicable specifically or indirectly to SIFI (indirect measures are those for the banking institutes generally) secondly, the regulatory measures in EU and lastly, the regulatory enforcement in the national level. After examination and assessment, this master thesis intends to answer the main research question:

*How are SIFIs regulated by international setting bodies, by the European Union and in the national regulatory authorities?*

*What are the limits to establishing effective international institution and what are the roles of national governments on this?*

This paper is a qualitative study on regulating SIFIs. However, comparative analysis is crucial to answer the research question of this thesis. Analysis is done in a random way to assess on how EU and its Member States regulate SIFIs. The selected theories will explain the behavior of the actors from the institutional structure to domestic set up and down to the national level. In order to compare the different degree of regulating SIFIs, the theory of Constructivist Institutionalism (CI) will be applied to describe the role of these institutions as initiator of these regulatory frameworks. Basel Committee, Financial Stability Board, and the European Union will be analyzed as institutions. Even if EU served as a mediator on the regulatory process, still they will be considered as institutions. Thus the effectiveness of these institutions depends on the influence of the rationalist behavior considering that CI could not be perfect at all. Rationalist Institutionalism (RI) gives insights on the limitation of these regulatory institutions on establishing effective policy based on their preferences and choices. There are some beliefs that EU member states assert banking regulation according to their own discretion therefore framing banking regulation more favorable to their own SIFIs. Economic Nationalism (EN) will help us assess the role and behavior of national governments in terms of regulating SIFIs. First, theories will be explained individually and why are they relevant to the explanation of this paper. To have a plausible understanding of
what SIFIs are and how they function in the global financial market, this paper will assess first its role and then its distinguishing characteristics. Here, we will take a short view about SIFI. However, it is not the responsibility of this paper to explain the methodology on how to measure systemic risks. The next parts will reveal how SIFIs are being treated in the international level, the domestic level, and the national level. In this part, the regulatory design in the international level will be examined giving insights on the framework set by Basel Committee on Banking Supervision. Then it will shed light on the coordinating policy set by the Financial Stability Board for the G-20 member states (which is also applicable to non-members). In the domestic level, this paper will look at how the European Union designs its own regulatory framework in conjunction with the international regulatory bodies. In order to test if there is an interaction between CI and EN or not, or if RI place some limitation on the effectiveness of these actors, this thesis has provided some variables to be tested (based on the meta-regulation set by Basel Committee). These variables will be represented by Directives or Regulations in the EU adapted specifically for SIFIs. Through these, we will examine the power of EU regulatory bodies in implementing international financial standards. In the EU and global level, this thesis will examine the strength of these institutions (CI influence) and its limitations (RI Influence). In the national level, we will see how far the cooperation and commitments of Member States (EN influence) when it comes to adhering financial market regulations and what hinders them to comply. This will give insights on the level of cooperation by the Member States to implement financial regulation in their respective area of responsibility. Assessment of regulatory mechanisms will only be limited to banking regulation to serve the purpose of this thesis. Other regulations on financial market such as regulation affecting insurance companies are not discussed in this paper.

Most Similar System Design in a comparative method

In order to answer the questions of this research, empirics will be assessed using the Most Similar System Design. Adapted from Mills’ System of Logic this method is one of the most common methodologies in social science and comparative politics that finds out and investigates relationships within a cluster of actors. Comparative methodology is widely used in political science because it served as the best alternative to experimental science. Application of MSSD will help researcher clarify validity of theories applied in a scientific research. The chosen objects should be similar except the phenomenon being researched to keep the stability of the variables. In order to test the validity of its theory, MSSD tests the effect of an explanatory independent variable against the dependent variable which can be

---

done in a systemic level\textsuperscript{9}. Variables which are important for the analysis of a social system are grounded in the systemic level. In other words, countries of analysis should be similar in some factors but are different in the account of a phenomenon. However in this paper it will present explanatory variables and this should be tested against the different unit of analysis. MSSD is previously used for analyzing in the systemic-level but it can also be applied in a sub-unit analysis\textsuperscript{10}, which would be very helpful for this research. Through comparative analysis we will be able to assess the balance between the empirics and the phenomenon being described based on real issues. Without trying to ignore the abstract principle of a quantitative research, this paper will focus more on the quality of the results. The result of the analysis will not be based on a mathematical kind but on a qualitative one.

1. EU regulatory institution with its mechanisms will be explained and assessed
2. Measures adopted by Member States will also be assessed
3. Basel and FSB will provide the models of the explanatory variables as the meta-regulation.

<table>
<thead>
<tr>
<th>Global Regulatory Mechanism</th>
<th>Response (EU)</th>
<th>Response MS (Random)</th>
<th>Possible Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory Requirements for establishment of SIFI</td>
<td>-Financial Conglomerates Directive (FICOD) -Capital Requirement Directive (CRD) -Capital Requirement Regulation (CRR) -Recovery and Resolution Directive</td>
<td>1---completely implemented 2---partially implemented 3---delayed implementation</td>
<td>-goals and preferences of MS and regulatory institutions -economic and political position of MS</td>
</tr>
<tr>
<td>Basel Standards on Capital Requirement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FSB/G20- Resolution and Recovery Program</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Limitation of this research**

The purpose of this thesis is to find out if there are some gaps in the way SIFIs are treated in the European Union and the Member States using the standards set by Basel and FSB. However after finding out the answer, this research is not bound to find out those factors behind the phenomenon because of the limitation of its scope. Furthermore, the assessment of this paper remains in the context within the relationship of EU, its Member States and their governance of SIFIs and the banking sector. The time scope of analysis this thesis is from the financial crisis of 2007 (although policies behind 2007 were also mentioned) up to the present´s regulatory policy.

\textsuperscript{9} Ibid, p 391
\textsuperscript{10} Ibid, p 395
I.B What is Systematically Important Financial Institution? And how are they pivotal to systemic risk?

There is no accepted common definition of SIFIs\textsuperscript{11}. SIFI could create the best of good sides, especially the financial benefits it could bring to the economy and could cause the worst of bad sides (this is where most of the definitions were drawn from). Literally, the reason why SIFIs are considered important is because of how they have influenced the economy. SIFIs are also relevant for the functioning of financial market, especially the economic contributions they make for the public good\textsuperscript{12}. In the European Union, financial claims from combined assets of banks, insurance corporations, pensions and investment funds are considered to be its highest financial resources\textsuperscript{13} that added up to a country’s gross domestic product. However, most of the definitions that were given to SIFIs are mostly related to its potential for destruction\textsuperscript{14}. In this concept, the impact of the systemic risk that could be triggered by one ailing financial institution is reflected in its liabilities to the rest of the financial market\textsuperscript{15} and of course the economy. By looking at this meaning, a risk posed by individual institution can lead to a systemic risk through the spill-over effect\textsuperscript{16} in the financial system. In this case, Moore and Zhou (2012) argued that a bank can limit its individual risk through diversifying its business activities. But there is a causal effect on this that leads to systemic risk because through diversifying its portfolio, transactions will get more complex\textsuperscript{17} and difficult to manage.

The Financial Stability Board defined SIFIs as “financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity”. A financial institution becomes complex when its operation goes beyond a normal banking transactions like lending, saving, or over-the-counter transactions. However, diversification of services offered banks a higher financial return, so banks tend to create concepts that yield higher financial returns. Cross-border transactions, portfolio diversification and investment in what they called ‘shadow banking’ make the banking system more complicated and riskier. Shadow banking is a modern type of banking that deals with short term but uninsured funds and which is not part of the regulated banking system\textsuperscript{18}, (for example hedge funds) of which mostly are operated by SIFIs. Important considerations applied to SIFIs are its size, size, complexity, and interconnectedness.

\textsuperscript{11} C. Weistroffer, Identifying systematically important financial institutions (SIFIs), (Deutsche Bank Research, August 11, 2011), p 3
\textsuperscript{12} Ibid.
\textsuperscript{13} Basel Committee on Banking Supervision, Basel III regulatory consistency assessment (Level 2) Preliminary Report: European Union, October 2012, p 17
\textsuperscript{14} Ibid.
\textsuperscript{15} Ibid, p 4
\textsuperscript{16} K. Moore, C. Zhou, Identifying systematically important financial institutions: size and other determinants July 2012, p 3
\textsuperscript{17} Moore and Zhou argued “that analogous to the notion of portfolio diversification, determinants of the individual risk and the systemic importance may work against each other”.
international cross-border transactions, amount of its contributions to country’s GDP (gross
domestic product), established branches globally, and its diverse and complex portfolio. SIFIs can also be differentiated with other banks from its functional structure. Moreover, SIFIs functional outcome; good or bad is pivotal to the whole economy. If SIFI is doing well, it could contribute to the general welfare of the economy giving the benefits to other sectors; but if SIFI is ailing, it could become the problem of its government and the global economy, hindering the proper functioning of the financial market. SIFI creates a benefit for the few, but can also create an unaccountable disaster or cost for many. Clearly, the bad impact is lest welcomed in the global financial market. In order to assess the systemic importance of a bank, some scholarly works identify criteria to be considered like; the size of its market share through cross-border transactions, value of deposits which is not covered by deposit insurance, ratio of the balance sheet and the GDP and of course the risk profile of company. Systemic risk in this case is the bad side of being a SIFI but only in certain circumstances. The interests of SIFIs of course account for regulations with lower compliance cost, regulation that give them access to foreign markets, and government guarantees that give them edge over other institutions.

By examining the functional structure of SIFIs, systemic risk can be channeled through its interconnection in case one of these institutions failed. The worst thing about the systemic risk is not much of its trigger but more on its transmission mechanism and its impact in the global financial system. The impact of the systemic risk will cause uncertainty in the economy that could lead to market breakdown. To have a clear understanding of the systemic risk caused by SIFIs and its effect to the global economy, we will look into one, but very significant SIFI that has shaken the economies of the biggest financial markets of the world. There were several SIFIs shaken by the financial crisis; like Northern Rock of the UK, Royal Bank of Scotland and Lehman. Although Lehman Brothers is not one of EU’s SIFI, it is a relevant example to discuss its case as perfect model of a highly complex institution that has caused systemic risk internationally. LBHI is the most famous case of bank failure in the global financial market that even a layman has heard about. Lehmann Brothers Holdings International (LBHI) was one of the largest banks in the United States and was an investment

20 Swiss Financial Market Authority (FINMA), Addressing “Too Big To Fail”, The Swiss SIFI Policy, June 23, 2011, p 6
24 Liikanen Report, High Level Group on reforming the structure of the EU banking sector, 2012, p 60-61
bank that deals with diverse portfolios with a reported asset of almost $700 billion\textsuperscript{25}. LBHI was able to establish 433 subsidiaries in twenty countries in few years\textsuperscript{26}. On the first hand, investors of LBHI include governments of leading economies of the world. And on the other hand, it also caters the need of big corporations, institutions, speculator and investors, municipalities, as well governments through funding (creditors). Operational transactions of Lehman Brothers include commercial banking, insurance, mortgage backed securities, and investment business, trading activities such as money market funds and hedge funds. All of these contributed to the complexity of its cross-border transactions. The bankruptcy of Lehman Brothers is the consequence of excessive risk-taking and leverage, balance sheet manipulation\textsuperscript{27} and excessive business speculation. Considering that Lehman Brothers maintained an asset of nearly $700 billion, these are however long-term assets compared to its excessively huge short term liabilities to be financed each day. Daily transactions of Lehman Brothers however continued its operation funded by the short-term repo* markets and enormous amount of money from counterparties\textsuperscript{28}. Because of its strong cross-border characteristics and international representation, Lehman Brothers’ failure has shaken major financial markets in the world. Although Lehman Brothers is not one of the SIFIs bailed out by its government, regulations specifically for SIFIs became the priority of the international financial regulatory authorities after drastic measures of some governments were extended to save ‘Too Big To Fail’ banks hit by the financial crisis.

II. Theoretical Framework

Constructivist Institutionalism’s account conveyed in this thesis is used to analyze the behavior and interactions of these institutions vis-à-vis national regulatory authorities. It is important to know how the process of implementing regulation in the financial market works in EU especially after the financial crisis. CI will analyze the position and role of domestic (EU) and global (SSBs) regulatory institutions in regulating SIFIs. Unlike many institutional theories, CI portrays the importance of what an institution can do. Contrary to CI, Rationalist Institutionalism (RI) will explain how ideas of CI failed in certain cases because of the behavior of actors. This will also to find out the limitation and influence of these institutions to establishing effective regulatory policies and the role of national authorities in this regard. Furthermore this will also assess their strength and weakness when it comes to enforcing financial regulation. Economic nationalism (EN) on the other hand will assess the behavior and interest of national governments. The idea conveyed by EN is focused on economic preferences, political legitimacy of states while trying to adhere to moral orders.


\textsuperscript{26} Ibid.


\textsuperscript{28} Ibid. * Repo-repurchase agreement: According to Dictionary of Banking and Finance, (A&C Black, 2009) “an agreement where a bank agrees to buy something and sell it back later (to raise a short-term finance)”.

11
The chosen theories should be able to analyze the presented theme of this paper; how are SIFIs regulated, what are the limits to establishing effective regulatory institutions and what roles do national authorities play on this?

II.A Constructivist Institutionalism (CI)

Regulation of financial market has evolved overtime triggered by the financial crises and so are the role, interest and behavior of institutions. This has led to the different approaches in the study of institutionalism. Considering these approaches to study regulatory institutions and considering the objective of this research, constructivist idea of institutionalism is so far the most appropriate approach to assess the concept of these institutions on regulating SIFIs. In a constructivist’s perspective according to Searle’s (2005) institutions must have three necessary characteristics namely; a collectively accepted system of rules, assignment of function with a virtue, and a status function (although with some degree of limitation) that is legitimized and authorized. Whereas Schmidt (2008) posits that institutions are present in policies, programs and philosophies and very particular in its communicative and coordinative discourse. Schmidt’s Discursive Institutionalism (DI) also shares the same analytical concept with the Constructivist Institutionalism, but this thesis will stick to use CI in detail. Institution is any system of constitutive rules that provides an institutional foundation of all social life. CI strengths is found on three important factors; communicative discourse based on its relationship with its citizen and strength to deliver and convince them about new ideas; coordinative discourse which is based on its relationship with policy makers, scholars to gather new ideas, and their beliefs on lastly deliberative democracy that help them legitimize this ideas after an open dialogue with concerned parties. For example many of EU’s regulation or directives are guided with the principle of subsidiarity that encourage a level playing field in the policy-making process. The constructivist’s position, considers institutions as ideas and practices they uphold and what they believe. Considering the importance of an institution, however, it is not only about the structure of an institution (subjective) but on what they are bound to do base on these ideas and norms (objective) that enable them to strengthen their status and prove their sovereignty and autonomy. Institutional power does not depend on the strength of the

---

29 For example: T. Christiansen, et al. (The social construction of Europe, Journal of European Public Policy, 1999, 6:4) “European Integration itself has changed over the years, and it is reasonable to assume that in process agent’s identity and subsequently their behavior have equally changed.”

30 V. Schmidt, Discursive Institutionalism: The Explanatory Power of Ideas and Discourse (Annual Review Political Science No.11, 2008) p 1

31 J. Searle, What is an institution? (Journal of Institutional Economics, 1, June 2005), p 10


33 V. Schmidt, Taking ideas and discourse seriously: explaining change through discursive institutionalism as the fourth new institutionalism, (European Political Science Review, 2010)


35 Ibid.
position but by the strength of its ideas and how they deliver these ideas.\(^{36}\) Moreover, CI is also capable to enhance or reduce this power adjusting to the demand of situation or to their purpose.\(^{37}\)

The position of constructivist institutionalism focus more on rule-guided behavior rather that interest and preferences optimizing.\(^{38}\) Thus these rules are not control mechanism but rather to define a set of practices that organize a social activity in accordance with the rules. Their preferences originated from ideas, culture and discourse.\(^{39}\) Contrary to the preference of Rational Institutionalism on the logic of calculation as structure of incentives, CI pursues the logic of communication and coordination.\(^{40}\) CI does consider the importance of the being of institutions however it focus more on the value of ideas and how they are shared through interaction. CI agents are also rational the way they think aiming for their goals but according to what they believe and what is reality. Agents being open on their intentions, beliefs, and thoughts are also capable to self-reflection and are willing to reverse actions accordingly.\(^{41}\) In the realm of ontology, CI envisages the real modern world, the dynamics of interaction and communication. Although constructivist defines social structures through shared understanding, expectations or knowledge, they also accept material power that affects social relations.\(^{42}\) Thus, social structures in this sense do not exist in material power but in practices.\(^{43}\) CI adheres to a rule-guided behavior that actors tried to do the right thing rather than serve its self-interest.\(^{44}\) The most important characteristic of actors in CI is that they can easily adapt strategically in complex objectives.\(^{45}\) The rules of the game for the constructivist are the ideas and interaction that explains the dynamics of change that answer the questions *what is, and what is going to happen?*\(^ {46}\) Institutions influence behavior not in a strictly prescriptive manner but rather suggestive or descriptive through constitutive rules.\(^ {47}\) Furthermore, for CI, adapting to changes could strengthen the legitimacy of the institution in

---

\(^{36}\) V. Schmidt, Taking ideas and discourse seriously: explaining change through discursive institutionalism as the fourth new institutionalism, (European Political Science Review, 2010) p 18

\(^{37}\) Ibid, p 18

\(^{38}\) Ibid, p 148

\(^{39}\) Ibid, p 146

\(^{40}\) V. Schmidt, Taking ideas and discourse seriously: explaining change through discursive institutionalism as the fourth new institutionalism, (European Political Science Review, 2010) p 2

- Discursive Institutionalism: The Explanatory Power of Ideas and Discourse, (Annual Review Political Science, 2008) p 1,

\(^{41}\) Ibid, p 17


\(^{43}\) Ibid, p 74

\(^{44}\) Cf. T. Risse, Social Constructivism and European Integration (A. Werner, T. Dietz eds. European Integration Theory, 2nd Ed., 2009), p 148


\(^{46}\) V. Schmidt, Taking ideas and discourse seriously: explaining change through discursive institutionalism as the fourth new institutionalism, (European Political Science Review, 2010)

\(^{47}\) P. Hall and R. C.R. Taylor, Political Science and the Three Institutionalisms, (MPIFG, Discussion Paper 96/6, 1996) p 15
a broader social environment. Discarding the intention of realism in an interaction, a constructivist approach might settle for a compromise or use persuasive ideas in order to reach agreement and build consensus.

**CI Approach in EU Integration**

Some scholars argue that constructivism is most popular in the study of international relations rather than in EU and some scholars also claim that it is not a substantive theory but rather a social inquiry. However, studying the institutional set-up in EU should not limit the researcher's idea based on popular theories that have been dominating the study of EU (i.e. liberalism, functionalism, rationalism, federalism and all the neo-s).

Evidently institutional theories evolved over the years and so is the role of regulatory institutions in the European Union. European integration has caused an impact that transformed the EU wide system, its constituents as well as their behavior and interests. According to Christiansen, et al (1999 p 537) it is the constructivist's idea that can critically transform the process of integration and can carry the study of European integration forward. European Union has evolved from a political and legal-based regime to an institution that is shaped by shared norms, commonly accepted rules and decision-making process that confirms the constructivist idea. This transformation has developed the nature of EU system not only its relationship with its MS and its citizens but also strengthen its governance within the EU giving them a solid character in the global arena. Although they were able to maintain some legalistic aspects of EU regulation, soft laws also play a significant role in EU law-making. Moreover, Donnelly (2010) argued that soft constructivism has shaped the preferences of national authorities in dealing with international and supranational regulatory authorities of which might challenge the concept of CI. Hence, the study of rules and norms has not just become an important aspect in the process of European integration but has also contributed to the dynamic of institutional and policy analysis of EU. Furthermore discourse, language, and ideas are now prominent aspect of European polity that shaped and influence its policy decision-making. Risse (2009) posits that constructivism contributes to the study of EU by way of considering and understanding the constellation of institutions, structure and its impact in its constituents and how they influence each other. The principle of constructivist institutionalism compliments other

---

48 Ibid, p 16
49 Cf. J.T. Checkel, Constructivist approaches to European Integration (ARENA Center for European Studies, University of Oslo, WP No. 06, February 2006), p 2
50 Cf. T. Christiansen, et al. (The social construction of Europe, 1999, 6:4) p 530
51 Also: Cf. J. Jupille, et al., Integrating Institutions, Rationalism, Constructivism, and the study of European Union, (Comparative Political Studies, Vol. 36 NO. 1/2 Feb/March 2003) p14
52 Ibid, p 539
55 Ibid, p 539
theories of institutionalism that help enhance the relationship within EU in terms of domestic policies, polities and politics\textsuperscript{56}. Constructivists should learn how European law, rules and policies affect and shape identities and interest of actors taking consideration of their competing factors\textsuperscript{57}. However this process can still be impeded by some rationalist influences that change the preferences and behavior of actors. 

\textbf{CI in Financial Regulation}

History shows that financial regulation has been executed mostly by national authorities even if their activities have extended across borders that strongly adhere to the concept of rationalism. The development of financial market has on the first hand contributed to national economic development while on the other hand, leads to the diminishing role of International regulatory institutions. The governance of financial market regulation has evolved through the years getting along with the pace of globalization. The wave of globalization has impacted on the waxing cross-border activities of these financial institutions which also contributed to the complexity of financial market regulatory process. The complexity leads to a trade-off whether financial institutions like SIFIs should be nationally accountable or internationally when it comes to regulation. Consequently, the financial crisis has triggered the pursuit to change the architecture of financial regulation. The clamor for changes in institutional set-up to enhance the governance in financial market regulation is growing especially in the European Union. These changes are crucial to the regulation of SIFIs and the role of regulatory authorities.

The role of institutions is significant in the implementation of regulatory measures in EU as well as in the international set-up. The benefit of financial integration in terms of production and growth is highly dependent on the good quality of institutions\textsuperscript{58}. This is evident in less-developed countries where growth and development of financial market is very poor\textsuperscript{59} compared to the developed countries where most of these regulatory institutions in financial market were initiated. The impact of the financial crisis has led to awaken the interests of the epistemic community to analyze the institutional change within the international financial market. As Maynitz (ed., 2012) posits “financial market can also be regarded as institutions\textsuperscript{60}” considering the norms from which it is being shaped and standards of which are being agreed upon by the actors.

Scholarly works on constructivism that study financial market regulatory institutions are nascent compared to other studies that focus strongly on existing meta-theories. The role of these institutions remained in the sideshow waiting for national authorities to acknowledge

\textsuperscript{56} T. Risse, Social Constructivism and European Integration (, (European Integration Theory, 2009, eds. A. Wiener, T. Dietz), p 157
\textsuperscript{57} Ibid, p 158-159
\textsuperscript{59} Ibid,
\textsuperscript{60} R. Maynitz, (ed. Crisis and Control, Institutional Change in Financial Regulation, 2012), p 21
and give them a free hand for the regulatory measures. Academic world has underestimated the significance of financial market regulatory institutions that explains the ample amount of studies applying existing theories that portray institutions as self-interested agents that seek to maximize their interest other than constructivist idea. The significance of these institutions can only be acknowledged and understand through the constructivist approach. In the study of financial market regulation, Porter (2002) believes that constructivist approach can shape actors to conceptualize their interests. Even if institutions are created by actors, he believes it is based on underlying rules, norms and ideas that serve as a focal point for communication and coordination to share their common interest. Autonomy and legitimacy of these institutions are earned through their underlying ideas and which are envisaged by reaching out to its audience. Thus, institutional power of CI can only be proved through the compliance of the states with the regime rules, specificity of rules, ability to learn strategically based on previous problem, flexibility over complexity, a free hand in decision-making.

Functions of these regulatory institutions were normally found in informal setting. However after several financial crises, financial institutions like Basel and IOSCO have showed significant changes (gradually from the 1970 financial crisis) in its supervisory role showing the constructivist influence in the institutional set-up of the financial market. Interaction amongst regulatory institutions has since waxed especially on dealing with capital requirements. In fact, Basel, IOSCO, FSF (now FSB) and other financial regulatory institutions and surprisingly also national regulators have strengthened its relationship working together towards the development of the financial market regulation. Basel was able to enhance its legitimacy proved by the compliance of member states. Although it is not as perfect as one would expect it, compliance is turning positively. To think that none of these regulatory institutions has a clear constitutional mandate in the policy decision-making, still its power and legitimacy is slowly being acknowledged as a rule in the financial market. Porter (2002) argued that financial regulatory institutions have now earned its political power however it is not the competitive and individualistic power portrayed by other theories of institutions but rather a power that has been developed through its structure and its work. These institutions act as guardians to keep the financial stability and main actors in regulatory reforms especially during the financial crisis. It seems that the catalyst of institutional change is the financial crisis that nearly broke down the global financial market.

II.B Rational Institutionalism (RI)

---

62 Ibid, p 57
63 Ibid, p 59
64 Ibid.
However, as life is not perfect and so is the effectiveness of Constructivist Institutionalism (CI). The effectiveness of these institutions is sometimes hindered, constrained by the motives and behavior pursued by RI influence. While CI embraces institutional changes being dynamic, RI on the other hand remains static on the being of institutions. Power of institutions is defined on the status of its position, where agent’s strategic interest is derived and which does not take account of ideas. Decision making of regulatory institutions can be influenced by the logic of calculation where actors put more weight on maximizing their interest therefore ignoring the importance of ideas. Considerations on the importance of ideas however are only the ones that inspire actors on their interest to decide on which alternatives to take. This is something like a closet rationalist in CI. Material interest prevails as the basis of institutional incentives sometimes understood as one and in the context of material reality. While CI strongly adheres to discursive character of communication, RI having considered its unimportance believes that action speaks louder than words because of its incapacity to deal with interactive discourse. Actor in RI believes that interaction is simply based on manipulation, on how to influence others to satisfy their own interest. Without having to elaborate deeper the theory of Rational Choice Institutionalism, these traits of RI could pose limitation on the ideals of CI.

II.C Economic Nationalism (EN)

The interest of states and economy do not really exist in a world of mutual admiration, although the existence of one is relevant to the other and vise-versa. If one tries to understand what denotes economic nationalism, one would think about mercantilism, protectionism, statism, and protectionism. The idea of nationalism can be traced back to List (1841) who propagated this concept during his communist time. Drawn from List’s ideology, nation states are divided, and each of these states should be working to bring forth their distinctive national interest may it be material, power, culture or identities. List believes that the goal of economy should serve national interests and its objectives. The strength of national economy lies in the predominant role of the nation in international relations as the tool of economic development. Nation states were able to dominate

66 V. Schmidt, Taking ideas and discourse seriously: explaining change through discursive institutionalism as the fourth ‘new institutionalism’ (European Political Science Review, 2010), p 1
67 Ibid, p 4-10
68 Ibid, p 4-10
69 Ibid, p 8
70 Ibid, p 4-10
71 Ibid, p 17
72 R. Gilpin, The Political Economy on International Relations, 1987, Chapter 2, p 31. However, Gilpin stated that economic nationalism should be subordinate to the goal of state building and the interest of the state.
74 Ibid, p 314
among many other actors (transnational and international organizations) to bring forward its economic influence in the international arena to serve their own advantage\textsuperscript{76}.

But through the years economic nationalism has been shifting away from the plain context of protectionism, capitalism, mercantilism and everything that used to envisage the idea of nation states. Does it mean the end of economic nationalism? Scholars of new generation are now trying to recast this idea applying into the context of globalization and economic liberalization. According to Pickel (2003) economic nationalism is much more interesting to be explained as an “explanans” (to explain a phenomenon through evidence, empirics and facts) rather than as “explanandum” (explaining a phenomenon itself). EN cannot be examined through an abstract economic framework because its context goes beyond that. In order to analyze economic nationalism, it is important to view it in the context of nation and nationalism (giving consideration on the historical, political, cultural and social context) and not delimiting it to ideology or policy doctrine\textsuperscript{77}. This should explain real socio-economic issues like policy implementation, regional integration and integration according to Pickel (2003) “as part of a theoretical framework that can tie together processes of economic change at global and national levels”\textsuperscript{78}. Pickel (2003) called this a process within a “nationalizing mechanism framework” which is embedded in the transnational process of integration or disintegration of political economies and societies\textsuperscript{79}. This mechanism is crucial to explain nationalism for the dynamics and outcomes of economic globalization though internal legitimation and external integration\textsuperscript{80}. EN is a reconceptualization of a broader and complex mechanisms and relationships that include political legitimacy of states, epistemic and moral orders pivotal to the coordinated action of politics and economy, national discourse, and national identities of the society as a result of collective action\textsuperscript{81}. Furthermore, Abdelal (2005) also a protagonist of EN posits that economic nationalism is a set of policies that adheres to national purpose and direction, characterized by a shared national identity. Thus, the degree of economic nationalism depends on national purpose and its direction\textsuperscript{82}.

Economic patriotism (Cliff & Woll, 2012) also shares the same ideology as economic nationalism that economic objective is subordinate to the protection and interest of the nation state. Economic choices is influenced and shaped by concerns for the best interest of

\textsuperscript{76} Ibid.
\textsuperscript{77} Cf. A. Pickel, Explaining (with) Economic Nationalism, (Nation and Nationalism, Vol. 9, Issue 1, 2003), p 15 and;
\textsuperscript{78} A. Pickel, Explaining (with) Economic Nationalism, (Nation and Nationalism, Vol. 9, Issue 1, 2003), p 15
\textsuperscript{79} Ibid.
\textsuperscript{80} Ibid, p 21
one’s homeland. Like nationalism, economic patriotism strongly adheres to defend its stance without having to specify its boundaries. Economic activities are now interconnected with each other, crossing more borders and discovering new possible market that has contributed to the positive development of nationalism. Globalization, market liberalization has led to the reshaping of economic governance. Thus nation state remains to be the main actor in all political economies and in economic decision-making. In today’s economic nationalism, nations have embraced the dynamic of globalization through economic liberalization, support competition, and encourage market-shaping and market-making. Regulations of economic activity has changed its pace and getting more global thus adjusting to both national and international economic governance. However, behind this openness there is some subtle intention to discriminate others in favor of its own economic position. Each of these nations has an interventionist instinct in them depending on a policy issue they are interested. Interests of countries are framed in a dichotomy. One the first hand, they want to be players in the global market and are obliged to adhere to international economic governance, and on the other hand, the priority to put forward national identities and interest still persist. Thus according to Busch (241:2012) assessing national interest can only be done according to policy area but not in general.

EN is also present in the regulation of financial market, although this is not the conventional view of nationalism but rather the new ideas about EN (Pickel and Helleiner 2005, Cliff and Woll, 2012). In fact, the global financial governance was dominated by the interests and perspective of the major financial center of the world. Cross-border financial supervision and international arrangement were asymmetric favoring more national interest whereas financial institutions enjoy policies that were more favorable to their advantage.

History shows that states do not trust the financial market to produce result suited for their interest. Nation states had to established international arrangements in order to protect their own financial institutions while enjoying the benefits of financial market. However, evidently looking at what happened during the financial crisis, it didn’t serve the purpose of nation states anymore. Furthermore, the growing participation of the civil society limits action that serve a one sided interest. Even in economic nationalism, there is norm and common accepted rules and an expected consequence should one nation dare to infringe.

We have now an open society where people, nations and even institutions bring forth their interests and concerns to be discussed and dealt with. The most agreed will survive and

---

86 Ibid.
88 Ibid. p 7
prevail. Presently, there might be a plethora of changes in the regulatory governance of the financial market, thus economic nationalism with its new ideologies and principle may still continue to persist in some ways trying to cope within the force of globalization and the civil society.

Summary

<table>
<thead>
<tr>
<th></th>
<th>Constructivist Institutionalism</th>
<th>Economic Nationalism</th>
<th>Rational Choice Institutionalism</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Explanation</strong></td>
<td>Can be better explained through ideas and interaction (coordination, cooperation, communication)</td>
<td>Can be better understood and explained in the context of nation and nationalism, focusing on historical, political, and social context.</td>
<td>Explains the behavior of actors through its interest</td>
</tr>
<tr>
<td><strong>Focus</strong></td>
<td>ideas, discourse, self-reflection, and their willingness to adopt to change</td>
<td>Economic preferences, political legitimacy of states in accordance to moral orders</td>
<td>Strategic calculation for incentive reward, fixed preferences</td>
</tr>
<tr>
<td><strong>Disclaimed</strong></td>
<td>Interest and preferences optimizing</td>
<td>Traditional protectionism, capitalism, statism and mercantilism</td>
<td></td>
</tr>
<tr>
<td><strong>Way of Influence</strong></td>
<td>Suggestive, prescriptive, consultative</td>
<td>Pushing economic identity on certain policy interest.</td>
<td>Political coalition formation - power of position</td>
</tr>
<tr>
<td><strong>Driver of changes</strong></td>
<td>Comes from within</td>
<td>Brought by modern economic world</td>
<td>Unexpected Influence by outside factors</td>
</tr>
</tbody>
</table>

III. Domestic Regulatory Process in the European Union

It is not the first time that European Union tried to strengthen the regulation of its banking sector. We should not forget that banking integration is still on its way and that gives incoming regulation a long and winding road to take. Though competition in banking sector has increased when cross-border barriers were eliminated, it did not give regulators and supervisors an easy opportunity to implement an EU-wide regulatory framework. Furthermore, banking integration in Europe is the driving point for the emergence of SIFIs and their increases cross-border transactions through establishing subsidiaries in other...
Member States or offshores and which also increases the danger of systemic risks. Considering that initiatives of supervising SIFIs was already born under the Financial Conglomerates Directives (FICOD) in 2002 dealing with problems of what we have known now as systemic risk, however, EU as usual, has left the supervisory authority at national authorities’ discretion. Furthermore, not only the structure of the Directive is problematic, there were also issues regarding supervisory tools especially if a conglomerate is operating as mixed holding companies (i.e. insurance and banking together in one holding)\(^\text{90}\). And what makes matter worst, is the lack of skills and information to identify the kind of operations of these companies that make them conglomerates or SIFIs. Considering that countries have more or less differences or similarities when it comes to adopting international financial standards, dealing with the problems of SIFIs is another thing. Regulation mechanisms for SIFIs were weak because the regulation of SIFIs was subject to the ‘home country’ principle which placed ‘host countries’ in a very weak position. The home country principle prohibits host country to impose stringent financial regulations on SIFIs already regulated in their country of origin. Evidently the Directive has created some loopholes because there are some prudential issues which were not covered by the Directive (i.e. regulating hedge funds, banking consolidation or supervision of insurance groups)\(^\text{91}\).

Some national regulatory authorities adhere to commit on international banking standards only when these standards do not set limitations on the existence of their own SIFIs. Considering the implementation of international financial regulation (IFR), there is an evidence of two dichotomies. On the first hand, members of G-20 that mostly dominated the financial market are the driving force behind the efforts of international regulatory authorities\(^\text{92}\). Thus, on the other hand, they prefer to have regulatory standards that conform on their domestic financial regulation or worst, they prefer to have standards without legal entity, so they can bend their own domestic policies and avoid litigation. The second dichotomy shows that while enjoying a great economic status being in a possession of SIFIs, these countries are the most vulnerable to systemic risk these SIFIs could create.

The financial crisis in 2007 was a significant event for the European Union’s financial regulators to see the loopholes not only on the architecture of its banking supervision but specifically that of the Too-Big-To Fail banks regulation. EU regulators have now realized that there is also some problem of its institutional framework that exposed a missing ‘iron hand’ to regulate its banking sector that could have prevented the financial crisis in the EU zone.

\(^{89}\) J. Goddard, P. Molyneux, and J.S. Wilson, Banking in the European Union (The Oxford Handbook of Banking, eds. A. Berger, P. Molyneux, J.O. Wilson, 2010), p 808


\(^{91}\) See, Financial Conglomerate Directive, FICOD (Financial Services Authority or http://www.fsa.gov.uk/pages/about/what/international/pdf/fcd%20(pl).pdf

For the first time in EU’s financial regulation, systemic risk posed by SIFIs now plays a pivotal role in the financial regulatory architecture. Though, there were already worries about a potential EU-wide systemic risk just the beginning of the European Monetary Union and before the 2007 financial crisis because of the danger of the ‘home country principle’ that allow banks to operate all over Europe with a single license. Cross-border expansion can be done through establishing subsidiaries “that allowed banks to form single legal entities that can freely operate across EU and enables them to convert from subsidiaries to branches.”

Note that for establishing a branch, a bank does not need a separate legal entity because it operates as part of an organization. It means that a branch does not need a separate license and a separate capital requirement. A subsidiary on the other hand is a legal entity which is financially independent and self-sufficient even if is owned by a parent company. The decision was left for the SIFIs to decide of course to their own advantage to operate with a branch or a subsidiary outside its jurisdiction. Furthermore, because of the home-country principle, European regulatory authorities did not have an easy access to regulate and monitor the activities of SIFIs.

The effort of the European Union to strengthen its financial market integration and supervision did not just start after the crisis. There were many but unsuccessful initiatives done in the Eurozone, however only the significant ones will be discussed that are considerable for the purpose of this paper.

III.A  De Larosiére Report

The De Larosiére Group was established to propose some remedies after EU was hit by the financial crisis in 2007. The De Larosiére Group is not a supervisory authority in itself, however, its task is to assess EU’s flawed regulatory structure and find out EU-wide solution for its financial market. In this paper EU admitted significant failures that led to the financial crisis. EU has considered many issues as the catalyst of its weakened financial market. These are; macroeconomic issues (mortgage fiasco in the US, ample liquidity-low returns, and credit volume), risk mismanagement, the role of Credit Rating Agencies (CRA), corporate governance failures, and the failure of global supervisory authorities for not having enough mechanism to understand or evaluate systemic risk.

Regulatory reform agenda of the Group embraces issues from banking problems, crisis management and resolution, to solving EU supervisory problem. Clearly, EU also admitted the incompetence of national supervisors and the weak authority of EU institutions to oversight the stability of its financial market.

93 See, for example M. Schüler, How Do Banking Supervisors Deal with Europe-wide Systemic Risk? (Centre for European Economic Research (ZEW), Discussion Paper No. 03-03) “We argue that cooperation between national supervisors even in the new framework will not be sufficient for safeguarding financial stability” in EU, instead EU needs a single supervisory power that is responsible in dealing systemic risk.


95 J. Fiechter, İ. Ötker-Robe, A. Ilyina, M. Hsu, A. Santos, and J. Surti, Subsidiaries or Branches: Does One Size Fit All? (IMF Staff Discussion Note March 7, 2011 SDN/11/04) p 7

96 See, The High-Level Group on Financial Supervision in the EU, Brussels, 25 February 2009

97 Ibid.
Both EU regulators and national regulators have failed to deal with the cross-border nature and the complexity of SIFIs’ operations globally. Because of the failure of the previous supervisory colleges, it is imperative to strengthen the macro-supervision and micro supervision at the EU level through the creation of a supervisory system within EU, equipped with a corresponding legal entity (i.e. sanctioning) to execute their functions accordingly.

III.B European System of Financial Supervisor (ESFS)

As proposed by the De Larosiére Group, the ESFS was created in response to the crisis caused by flawed regulatory structure of EU’s financial market in 2010. ESFS represents a network of supervisory colleges responsible for gathering together national supervisors for the stability of EU’s financial market. ESFS is mandated with a legal personality. ESFS is an umbrella of the European Supervisory Authorities (ESA) and the European Systemic Risk Board (ESRB). The system is responsible to establish a common standard applicable EU-wide and also the consistent implementation of these standards. Now equipped with a legal mandate (thus, only ESA and not ESRB) supervisory standards and regulatory decisions are binding. But the question remains, how binding is binding? The ESFS aimed to use the respective powers entrusted to the three supervisory colleges to deal with cross-border operations of systematically important financial institutions. New regulatory standards envisaged by the ESFS would minimize bank failures, therefore protecting taxpayer’s money and avoid state aid action of affected Member States. Although ESFS is given a robust network of national regulators, the legal power with regard to sanctions in case of breach is not to be found in its function especially on MS fiscal policies of bailing out ailing SIFIs98. Giving recommendation alone may not be sufficient to prove the legal power entrusted to ESFS. Strange as it is, cross-border supervision which is the pivotal aspect of regulating SIFIs however remains weak99, although admittedly, the new supervisory authority is now enjoying a more defined role than before. Lastly, when it comes to voting, the legal obligation of these authorities is only to vote for EU interests and not for any other interest100.

European Supervisory Authorities (ESA)

As one of the umbrella of ESFS, ESA is responsible to undertake micro-prudential supervision in the European Union. Supervisory authorities are delegated to banking sector (European Banking Authority), to insurance (European Insurance and Occupational Pensions Authority), and to the securities markets and credit rating agencies (European Securities and Markets Authority). Each of these colleges is empowered to have a legal mandate. The core function of ESA is the European Banking Authority (EBA) responsible for safeguarding of micro-prudential supervision and the harmonization of these regulations in the national level.

98 K. Alexander, Reforming European financial supervision: adapting EU institutions to market structures, (Academy of European Law, 2011:12), p 244
99 See: Memo/09/404, Brussels, 23 September 2009 on FAQ: European System of Financial Supervision: „The Regulations creating the authorities do not grant them any direct supervisory power over any institutions...”
100 See: Memo/09/404 Brussels, 23 September 2009 on ESFS (FAQ)
Together with ESMA and EIOPA, each focusing on its designated sector will ensure the consistent implementation of rules to financial institutions\textsuperscript{101}. Representatives from these three supervisory authorities formed a Joint Committee to strengthen the regulation of SIFIs or conglomerates applicable EU-wide. All decisions taken by the Committee are binding for Member States and financial institutions provided it should not impinge on the fiscal responsibilities of the Member States\textsuperscript{102}. The structure of ESA is supported and strengthened by a group of highly technical expertise in banking, securities markets and insurance. Through this expertise, ESA will develop draft proposal for technical standards that will be endorsed by the Commission to strengthen its legal capacity\textsuperscript{103}. Relevant to the legality of these technical standards is its compatibility to EU law and the application of the principle of proportionality\textsuperscript{104}. In this regard, prior to the application of these standards, the Authority has to consult experts from different interest groups like, academics, investors, big or small enterprises, consumers, working forces and of course experts from financial institutions itself. The Authority shall be accountable to the Parliament and to the Council\textsuperscript{105}, of which have the authority over the ESA to revoke its power. The Commission on the other hand, will work consistently with the Authority in the entire process on the development and implementation of regulatory technical standards. The Commission is empowered to adopt regulatory technical standards (also after the same process of consulting interest groups) should the Authority failed to produce a draft within its given timeframe\textsuperscript{106}. According to EU Regulation 1093/2010, \textit{“the Authority shall enjoy the most extensive legal personality accorded to legal persons under national law”}\textsuperscript{107}. ESA or the Authority is also provided with a robust funding to ensure its independence and financial autonomy so it can fulfill its function without interference. The Board of Supervisors as the principal decision-making organ will carry out the tasks of the Authority accordingly\textsuperscript{108} as part of its legal entity. The Board of Supervisor is represented and by relevant competent authorities in each national government and is headed by the Chairperson\textsuperscript{109}. The Commission, so as the European Central Bank (ECB) and representatives from ESMA and EIOPA are also members of the Board, however with no voting rights. Other than their regulatory or enforcement functions, Authority can also issue guidelines and recommendations to national authorities or financial institutions extending the application of its authority without due legal basis.

Previous regulatory measures on financial market have left more space for Member States’ discretion. The present supervisory authority is now given a more defined role not to

\textsuperscript{101} See, Micro-prudential Supervision; \url{www.bafin.de}


\textsuperscript{103} Ibid.

\textsuperscript{104} Ibid, p 15

\textsuperscript{105} Ibid, p 22

\textsuperscript{106} Ibid, 15

\textsuperscript{107} Ibid, p 22

\textsuperscript{108} Ibid, p 19

\textsuperscript{109} See, EBA Organizational Structure; \url{http://eba.europa.eu/Aboutus/Organisation/}
mention its legal entity, to require cooperation among national governments and financial institutions. The scope of its authority has been extended from supervision to regulation. Supervision of SIFIs and everything with cross-border character is now entrusted in the hand of the new supervisory colleges thus, the supervision of domestic financial institutions remains at the national level. Granting that these new authorities will change the regulatory environment in EU financial market, it could enhance coordination between financial institutions and national authorities and could lead to the stability of the financial market.

**Scope of ESA’s legal status**

Regulation (EU) No 1093/2010 has guaranteed the legal entity of the European Supervisory Authority. Based on Article 2\(^{110}\) on regulation establishing the European Banking Authority, the task conferred to them shall be in the scope of previous regulatory mechanisms namely; Capital Requirements Directive (CRD), Financial Conglomerates Directive (FICOD), on Information of Transfer of Funds and on Deposit Guarantee Schemes Directive (DGS). Within the scope of this legal status, the Authority can also act on issues related to banking, insurance and investment which are not covered by previously mentioned regulatory mechanisms including reporting, auditing and corporate governance\(^{111}\). The scope of its authority includes Significantly Important Financial Institutions and its corresponding national supervisory authorities. Furthermore the Authority can issue guidelines and recommendations to competent authorities and financial institutions as well as issue opinions to the Commission, Parliament, and the Council\(^{112}\). However, national authorities and financial institutions have no legal obligation to comply with the guidelines and recommendations. By failure to adhere to these standards, and after due process of investigation and recommendation, the Authority will confer with the Commission to take necessary action according to Article 258 TFEU and in worst case, after due process, “the Authority may adopt an individual decision, addressed to a financial institution requiring necessary action to comply with its obligations under EU Law including the cessation of any practice”\(^{113}\). The role of the Authority in keeping the stability of EU’s financial market is to respond to systemic risk at all times by assisting ailing SIFIs through facilitation of recovery and resolution programs and arrangement of funding. They of course need the cooperation of crisis managers in each national authority to ensure a level-playing environment.

**Institutional changes in supranational level in developing regulation**

The new authorities have the sole responsibility to develop draft proposals for technical standards after consulting interested groups to ensure the consistency of financial market

---


\(^{111}\) Ibid

\(^{112}\) Ibid, p 23

\(^{113}\) See Art. 15 Par. 6 Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010, establishing a European Supervisory Authority (European Banking Authority) p, 27
regulations. These regulatory standards should be technical (based on market analysis\textsuperscript{114}) and should not cover strategic decisions or policy issues\textsuperscript{115}. These regulatory standards are developed in consideration of EU’s principle of proportionality and the fundamental principle of internal market. The Commission is not empowered to change the content of the draft unless granted permission by the Authority. However, the legality of these technical standards depends on the endorsement from the Commission through amendment or incorporation in EU law. On a temporary and urgent basis, the Commission with its power can exert pressure and tighten the requirements of macro-prudential measures for certain activities and exposures\textsuperscript{116}. The Parliament and the Council may object to these standards that would extend the period of its process. According to Regulation (EU) No 1093/2010 national authorities and financial institutions like SIFIs are to adhere to the new regulatory standard however it should not constraint the financial responsibility of a respective Member States. Failure to do so, the Authority shall in accordance with its legal status, undertake infringement action against Member States of these national authorities or may refer to the Court of Justice to act accordingly\textsuperscript{117}. Hence, with regard to creation and application not to mention the legality of EU Law, there are some pivotal issues to be considered. This could explain the bureaucratic regulatory process in EU. History shows that application or enforcement of EU a policy depends on the strength of a policy. Strength could mean the relevance of a policy to the member states, or a legal status of a policy that leaves less option for MS to adhere. Just to get a view of the sources of EU law, it is important to have a short explanation on how it is going. The first source of law is the Treaty on the Functioning of European Union\textsuperscript{118}. It is the Treaty that gives the legal status of an institution to act on certain matter applicable to its power. The second sources or law which is laid down in Article 288 TFEU are relevant to the analysis of this paper among other criteria. \textit{Directives} and \textit{regulation} are the most pivotal sources of EU law regardless if there is legal entity or not. \textit{Decisions} are not relevant to all MS but only to those who are being addressed\textsuperscript{119}. \textit{Recommendation} and \textit{opinions} and \textit{guidelines}, (although also relevant) are the weakest form of sources of EU law. So as not to go beyond the scope of this paper, we will only discuss the difference of Directive and Regulation because of the limited scope of this paper. \textit{Regulations} are policies that are legally binding and ensure general application to all Member States\textsuperscript{120} without due national measures or without transforming it to national law.

\textsuperscript{114} Dictionary of Banking and Finance: A & C Black, London (technical- “referring to influences inside a market, (..), based on market analysis.)


\textsuperscript{116} CRD IV-Frequently Asked Questions, MEMO/11/527, Brussels, 20 July 2011


\textsuperscript{120} Ibid.
This aimed to impose a uniform application of law EU-wide\textsuperscript{121}. Directives on the other hand do not impose general application of law as it gives option to which (MS) and what (option) should be considered. Directives must not be applicable in general to all MS. Furthermore, rights and obligations become effective only once they are incorporated as national law that give them a legal status in that MS\textsuperscript{122}. Therefore, allowing MS an option or self-discretion to adjust policies in accordance to its own national measures\textsuperscript{123}. While it is the obligation of MS to work towards the goal of EU, hence it is up for the national authorities to decide on the date of their implementation of a certain directive.

**European Systemic Risk Board (ESRB)**

As part of the ESFS, ESRB is responsible for the macro-prudential supervision in EU. Its significant task is to monitor and assess systemic risk. Closely working with ESA, it has to detect early signs of systemic risk to avoid its contagious effect in the entire financial market like what happened in the previous financial crisis. Contrary to the legal status of the ESA, ESRB is not mandated with a legal entity even if it has taken the sole responsibility for EU’s macro-prudential supervision. The weight of systemic risk, considered as the major problem in the previous financial crisis is not at par with the role given to ESRB in terms of regulating the SIFIs. Paradoxically, as macro-prudential supervisor responsible to assess and detect systemic risk, ESRB was not designated a direct supervision on SIFIs, instead it was tasked to work with other bodies of ESFS and also with financial institutions. ‘Working with’ could mean that ESRB has no authority over national authorities and financial institutions especially on decision making. Thus, admittedly, ESRB also contributes to the harmonization of existing technical standards by gathering information pivotal to EU’s financial stability. Parts of ESRB’s task is to gather and analyze data related to systemic risk. Even if the European Central Bank has dominated the organizational structure of ESRB\textsuperscript{124} it is still as powerless as the former, with regard to regulating SIFIs. In case of another systemic risks happen, ESRB can issue warnings and recommendations to the designated authority like EU Institutions and ESA, but has no direct authority to act against it. However, being a part of ESFS, ESRB can rely on the emergency power delegated to ESA to act when such matter occurs. To consider, a legal personality may not be significant to get the ears of national authorities especially when it comes to systemic risk. Furthermore soft law may not be a hindrance to act as an authority and influence participants of the financial market\textsuperscript{125}.

**European Central Bank (ECB)**

\textsuperscript{121} Ibid.
\textsuperscript{122} Ibid.
\textsuperscript{123} Ibid.
\textsuperscript{124} See, Organizational Structure of ESRB at www.esrb.europa.eu
\textsuperscript{125} E. Ferran, K. Alexander; Can Soft Law Bodies be effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board (Legal Studies Research Paper Series, University of Cambridge, 2011), p 23 or see: http://www.law.cam.ac.uk/ssrn/
Aside from being the guardian of the European Monetary Union (EMU) and managing price stability in EUs financial market, ECB exercised the core function of the all national banks in EU that formed the EUROSYSTEM\textsuperscript{126}. Although equipped with a legal personality, the scope of its authority is only within the jurisdiction of its mandate which is related to EUROSYSTEM and the financial stability. Its function includes the implementation of the monetary policy in EU, foreign exchange, managing foreign reserves to keep the smooth-running of the payment system\textsuperscript{127} and most of all, the lender of last resort. During the financial crisis, ECB has sustained the liquidity in EU Banking System\textsuperscript{128} by providing lower interest rates to banks. ECB is also one of the major players in the new supervisory authorities getting most of the seats in the ESRB organizational structure\textsuperscript{129}. Like the ESRB, the ECB has no direct influence of regulating SIFIS, although it is exercising its function to contribute to the purpose of the EBA. However, because ECB is closely working with BCBS, it has its obligation to endorse regulatory and supervisory standards set by the Basel Committee. As of the writing of this paper, the Commission’s proposal for the Single Supervisory Mechanism (SSM) was welcomed by the European Council and the Parliament. The provisions of SSM will enhance the supervisory and investigatory power of ECB and the governance of the financial market (among others).

III.C An Overview of European Union’s Banking Regulation- past to present

As we observed, regulatory process in the European Union runs like a carousel effect or a ‘pro-cyclical effect’. The First Banking Directive (FBD) of 1977 and Second Banking Directive (SBD) are part of EU’s initiative to harmonize its financial market. FBD allows financial institutions to operate in other member states in the same manner as the domestic banks after authorization of operation is granted by the host country. Foreign banks were however subject to supervision of host countries to monitor their solvency and liquidity. But because this Directive has constrained financial institutions on international capital flow and considered as a hindrance to market integration it was replaced by the SBD. The goal to harmonize internal market has led to a lighter regulatory framework giving an easy way for the movement of capital. Contrary to the First Directive (FBD), the Second Directive (SBD) sets minimum capital requirements for all retail banks. Thus, SBD also adapted the universal banking model that encourage banks to offer multiple services which helped them diversify its financial activities and increased its cross-border activities. Through the SBD, investment financial institutions, financial conglomerates and insurance institutions were encouraged to expand their cross-border activities in Europe without being accountable to host country regulatory authorities, thus leaving a limited role for host country. Once provided with a “European Passport” a financial institution can operate across Europe without the approval

\textsuperscript{126} H.K. Scheller, The European Central Bank, History, Role and Functions, or visit: http://www.ecb.int/pub/pdf/other/ecbhistoryrolefunctions2004en.pdf

\textsuperscript{127} Ibid.

\textsuperscript{128} D. Schoenmaker, Banking Supervision and Resolution: The European Dimension (Duisenberg School of Finance Policy Papers, No. 19, Jan. 2012), p 3.

\textsuperscript{129} See, Organizational Structure of ESRB at www.esrb.europa.eu
of host country regulators. To explain, a financial institution only needs license from its home country, supervision and regulation is also the responsibility of the home country. It is the obligation of the home country to control financial institution, its financial capability with regard to solvency and liquidity. Financial institutions enjoyed a minimum set of regulations, on banking license, capital, and large exposure limits\textsuperscript{130}. However, the question whether a financial institution operates as a \textit{subsidiary} or a \textit{branch} is important to consider. In the first chapter we talked about the status of a financial institution operating as a subsidiary or a branch. Normally EU allows financial institutions to enjoy the benefit of home-country principle for establishing branches outside its national perimeter; because as a \textit{branch}, a financial institution will be operating with the same license as the mother financial institution in its home country. In principle, a \textit{branch} is legally dependent on its mother financial institutions. With this, a \textit{branch} is only accountable for its home-country regulatory authorities. On the other hand, a \textit{subsidiary} is a legal entity operating with its own license and own capital. A financial institution established in EU has the right to open a subsidiary in other member states however, as a single, legal entity it would be subjected to the regulation of this other country with the same regulation applied to its national financial institutions\textsuperscript{131}. Since this ‘host-country’ will now be its ‘home-country’. But what happened is that the single market has resulted to deregulation of banking sector. Financial institutions have taken advantage of the single market to engage in cross-border mergers that lead to a web-like structure of banking operation of one holding company having several branches and subsidiaries\textsuperscript{132}. With this, cross-border activities and transactions continue to be complex that makes the process of regulation more complicated as well\textsuperscript{133}. The growing entry of non-EU financial conglomerates or SIFIs in EU is also encouraged by the provisions of SBD provided that there is a mutual agreement between EU and their home states. To conclude, notwithstanding the capital requirements, SBD was able to implement the universal banking model that contributed to the growing activities of financial conglomerates. The universal model and the financial conglomerates adhere to the activities of SIFIs as what it is called nowadays. Currently, supervision and regulation SIFIs is now governed by the provisions of FICOD, the Capital Requirements Directive (CRD) and the Insurance Groups Directive (IGD)\textsuperscript{134}. Thus, because of the limited scope of this paper IGD will not be included in the assessment.

\textsuperscript{131} Ibid. p 5
\textsuperscript{132} Ibid, p 47
\textsuperscript{133} Ibid.
IV. EU’s Existing Regulatory Measures for SIFIs


Regulation and supervision of conglomerates used to vary from country to country. In the US regulation of commercial banking was separated from securities banking\(^{135}\). In Europe, there was no specific regulatory framework for conglomerates. Instead there was a separate regulation of capital banking, investment banking, and insurance. And mostly, supervision is done in the national level\(^{136}\). Financial Conglomerates usually engaged in banking and insurance activities either in sectoral operation or mixed operation. It is observed that activities of conglomerates have been growing since the implementation of the Single Market that led to a stronger call to improve the regulation of conglomerates in the EU. FICOD was first adopted in 2002, and at that time regulatory authorities already aimed to deal with potential risks caused by financial conglomerates. FICOD takes over or supplemented the normal supervision of financial institutions based on sector (e.g. either banking, capital or insurance) when activities of a financial institution became diverse (combination of insurance, banking and capital) that made them a conglomerate. However, the regulation and supervision of conglomerates is as complex as its structure. First it is

---


\(^{136}\) EU Business, Revision of the Financial Conglomerates Directive, 16 August 2010, or visit: [http://www.eubusiness.com/topics/finance/conglomerates.10-08-16/](http://www.eubusiness.com/topics/finance/conglomerates.10-08-16/)
important to identify the structure of conglomerates considering if it is a `mixed’ financial holding companies (MFHC), or financial holding companies (FHC) and insurance holding companies (IHC)\textsuperscript{137}. The supplementary regulatory function of FICOD can be exercised once a bank or an insurance group that used to be under the sectoral supervision becomes part of a conglomerate (cross-sector)\textsuperscript{138}. This means that sectoral group supervision can only be applied in a group level with one entity, for example banking entities or insurance entities while sectoral group supervision is no longer applicable in a cross-sectoral group of a holding company\textsuperscript{139}. FICOD allows supervisor to exercise consolidated supervision (banking supervision and insurance supervision) at the top level of a group\textsuperscript{140}. FICOD supplementary supervision aimed to focus on managing cross-border risk and conflict of interest by prohibiting multiple used of capital requirements.

FICOD requires for a stronger cooperation between regulatory authorities and financial institutions since it was incorporated into EU law. However, the financial crisis in 2007 has proven that the scope of supplementary supervision did not cover some of the legal structures of financial conglomerates. FICOD still needs some polishing especially in assessing the structure of financial conglomerates or SIFIs. Even if most SIFIs are conglomerates the Commission does not consider that all SIFIs should be regulated by FICOD considering that “systemic risks are not necessarily the same as group risks”\textsuperscript{141}. There are still fragmented issues on the threshold requirements for conglomerates that limit the scope of the supplementary supervision because there are some financial conglomerates included in the threshold which are not necessarily exposed to group risk, and there are conglomerates which could be exposed to group risk but not covered by the threshold. Moreover, national authorities did not have enough technical knowledge to calculate between available capital and required capital of the conglomerate, that leave them no choice but to use sectoral application. The coverage of FICOD regulatory measures includes financial institutions and insurance companies.

Evidently, there are also differences in the interpretation of the Directive in the member states (MS) because most of them consider that one supervisory measure can also be applied to all conglomerates\textsuperscript{142}. Moreover, even if the Directive includes a provision that take an action against infringement, it failed to include a specific framework for a sanction regime. Because of these loopholes of the Directive, EU regulatory authorities now aimed to address the scope of FICOD in adding some criteria of identifying conglomerates to ensure an effective application of existing provisions and a comprehensive EU-wide rule book. A mandatory stress testing procedure will also enhance risk management. Also, the technical

\textsuperscript{138} Ibid,
\textsuperscript{139} Ibid,
\textsuperscript{140} Ibid, also Council of the European Union, Inter-institutional File: 2010/0232 (COD), 5127/13, Brussels, 9 January 2013
\textsuperscript{141} Council of the European Union, Inter-institutional File: 2010/0232 (COD), 5127/13, Brussels, 9 January 2013
\textsuperscript{142} Ibid.
standards used to calculate the capital requirements of a conglomerate should be adjusted in compliance with the Basel III or CRD IV. The proposal for a revision includes additional powers for regulatory authorities on access of information, investigative function, and enforcement and disciplinary powers (i.e. imposing sanction) when it comes to infringement. The proposed revision will also cover supervision and regulation of SIFIs or conglomerates and should be in accordance to the new supervisory structure of EU’s financial market namely the ESA. The Commission is expected to set some proposal on enhancing the role of ESA in this issue in the revised Directive, but for the time being, ESA plays a limited role in FICOD except of course the monitoring role. Now that there is an on-going consultation process to evaluate the provisions of FICOD, it is expected that implementation of the law will be first put on hold. The implications and arguments on our theories therefore are not influence by this regulation because so far all concerned banks have already complied with the requirements on establishing financial institutions. Thus, what matters in the future are the provisions and changes which are proposed (meanwhile pending) for the future of FICOD.

Capital Requirements Directive (CRD)/Capital Requirements Regulation (CRR)

The most important and most disputed regulatory measure not only in EU but also globally is on capital requirements of banks. Although Capital Requirements Directive/Regulation has already been revised, nevertheless, this part will review shortly the past CRDs in accordance with Basel II in order to have better picture of these Directives. Basel II is incorporated in the European Union Law under the Capital Requirements Directive, (Directive 2006/48/EC and Directive 2006/49/EC)) which require financial institutions and national regulatory authorities to implement until the beginning of 2008. CRD was first adopted with a minimum requirement introduced by Basel I. It was afterward revised equal to Basel II standard on capital requirement that would help financial institution adjust its own risks. The amount of capital should be adjusted depending on credit risk, market risk and operational risk\(^\text{143}\). This set a floor on how much capital should credit institutions and investment firms should be required. This would also strengthen the capacity of financial institutions to manage financial risk and be better equipped to absorb shock in the future. However, the Directive allows discretion for financial institutions which method to use in calculating the required capital. Some financial institutions choose to engage credit rating agencies and some prefer to use their own risk model that lead to differences in risk calculation. Evidently, the previous Directive was not able to deal with the volatility of the financial market and the economy. This Directive still reveals some shortcomings especially on the additional criteria of capital requirements (i.e. for securities). There was no clear guideline for cross-border supervision and crisis management\(^\text{144}\) that clearly define the specific role or coordinating role of home country supervision or host country supervision. These Directives are later amended to Directive 2009/111/EC of which is implemented in 2010. In summary, CRD II contains

\(^{143}\) [www.europa.eu/legislation](http://www.europa.eu/legislation), Capital adequacy on investment firms and credit institutions

\(^{144}\) Commission Staff Working Documents, Brussels, 1.10.2008 , SEC(2008) 2533
revisions that strengthen liquidity management, the criteria for capital and risk coverage and the governance of the financial institutions. Furthermore, it creates college of supervisors that deal with the cross-border activities of SIFIs, and give a new definition of the respective role of home and host country regulation. CRD III on the other hand set additional capital requirement on trading books and re-securitization\(^\text{145}\).

Thus, Basel III framework in EU does not completely adhere to the given provisions of Basel Standards. There are some points and issues that are modified or omitted\(^\text{146}\) for the CRD IV. While EU adheres to the previous capital standards set by BCBS, it does not completely copy these standards automatically. EU explained its position on the incomplete transformation of Basel III in EU Law; while Basel III is not a legal instrument, EU must ensure that CRD be transposed into EU law and in accordance with national law to ensure compliance of EU Member States. On the compliance of the Basel III Standard, CRD IV followed to establish additional provisions of the former CRD rules that strengthened capital requirements for trading and re-securitizations and as well as an additional disclosure requirements only for securitization position\(^\text{147}\). Weighing the degree of regulatory and supervisory process in EU, it is not clear if the complexity of the financial market leads to the difficulty of the regulatory process or because the complexity of the regulatory framework and process makes it difficult to be implemented.

As of the writing of this paper, there are proposals and discussions going on to modify previous CRDs to CRD IV and Capital Requirements Regulation (CRR). While current CRDs still include discretion and option for some member states, the future CRD (IV) aim to establish a single rule book to strengthen the effective implementation of these regulations\(^\text{148}\). The Capital Requirements Directive has provided two legislative instruments, a Directive and Regulation instruments. In the previous chapter we have learned from the different sources of EU Law. A **Directive** which is *less prescriptive*\(^\text{149}\) becomes a legal instrument if it is transformed into national law. And this Directive on capital requirements will govern deposit taking activities of financial institutions. On the other hand, a **Regulation** which is *highly prescriptive*\(^\text{150}\) once created, has a direct effect in the Member States and is considered a legal instrument without due process in the national authorities of which regulate the prudential requirements for financial institutions. Provisions of the CRD that will be categorized as Directive are as follows: access to taking up of business, right to freedom of establishment and freedom of movement, prudential supervision, setting up the floor of

---


\(^{146}\) Basel Committee and Banking Supervision, Basel II regulatory consistency assessment (Level 2) Preliminary Report: European Union, October 2012


\(^{150}\) Ibid, p 4
counter-cyclical (capital) buffers and capital requirements on real estate lending (Pillar 1), corporate governance and the sanction measures (Pillar 2)\textsuperscript{151}. These provisions are less prescriptive leaving space for Member States’ discretion fitted to its economic situation. Pillar 2 of CRD that deals with the governance of financial institutions gives national authorities certain discretion to impose a wide range of measures. This includes risk assessment and evaluation on the compliance of financial institutions. If one MS would modify a certain provision, these provisions should be applicable to financial institutions in that Member States as well as foreign financial institutions operating in that country. Pillar 2 also requires financial institutions to develop mechanisms that enhance internal risk management\textsuperscript{152}.

Provisions of Capital Regulation are the setting of capital threshold, liquidity, leverage ratio and the counterparty credit risk that charge higher capital charges on derivatives. These provisions will set a uniformed capital requirement for the regulatory part of the single rule book applicable EU-wide and are highly prescriptive for financial institutions\textsuperscript{153}. In this case, CRD/CRR prohibits any Member States to require financial institutions to hold capital requirements higher or lower than what the law prescribed. CRD/CRR is also applicable to SIFIs. However in Basel III Standard, SIFIs have to comply with a higher capital loss absorption requirements covering higher risk that could endanger the financial market. In the European Union, SIFIs have to comply with an additional loss-absorbency requirement of up to 3.5% effective 2016\textsuperscript{154} which is higher than the threshold set by Basel III. Contrary to FICOD, provisions of CRD/CRR do not include the coverage of insurance institutions but only financial institutions.

As we have mentioned earlier, EU supervisory authorities have proposed to modify some of the standards set by Basel on Capital Requirements. There are slight differences on the definition of capital and the quality of the capital requirement. On the criteria set by Basel III’s common equity (CET1), capital instruments may only refer to ordinary shares of companies (joint stock companies)\textsuperscript{155}. In the EU, supervisory authorities aimed to widen the criteria of these instruments are giving consideration more on the substance rather than its legal form\textsuperscript{156}. As it needs to fit in EU legislative system, Basel III’s new capital standards “should go through a democratic process before it could be transposed into EU Law”\textsuperscript{157}. Evidently, with regard to Basel III, European Union did not completely adopt the entire provision especially on the definition of capital. EU’s proposal on definition of capital does not restrict ordinary shares as the highest form of capital but include those instruments issued by cooperative banks, savings and mutual institutions which are not part of joint-

\begin{footnotes}
\item[152] High-level Expert Group on reforming the structure of the EU banking sector, Brussels, 2 October 2012, p 68
\item[153] Ibid.
\item[154] High-level Expert Group on reforming the structure of the EU banking sector, Brussels, 2 October 2012, p 70
\item[155] Ibid, p 69
\item[156] CRD IV, Frequently Asked Questions, EU Commission MEMO/11/527, Brussels, 20, July 2011, p 15
\end{footnotes}
stock companies\textsuperscript{158}. Furthermore, focusing on ordinary shares as a quality of capital requirement will not ensure homogeneity of instruments considering the diversity of EU banking system\textsuperscript{159}. The core capital requirement required by Basel remained 8\% (of the risk-weighted asset) in Basel III, however there are some changes adopted by the new CRD/CRR that improves or tightened the quality of capital requirement\textsuperscript{160}. Tier 1 capital is raised from 4\% to 6\%, and Common Equity of at least 4.5\% to be fully implemented by 2015\textsuperscript{161}. In order to meet the minimum capital requirement of 8\% financial institutions have the option to use Tier 2 capital up to a limit of 2\%\textsuperscript{162}.

Contrary to the gradual transition suggested by Basel Standards, the Commission however allows Member States immediate implementation of Basel III especially on the of Capital Requirements since most of them have already done some reforms conformed to the Basel III standards\textsuperscript{163}.

**The recent regulatory mechanism**

In accordance with EU’s commitment to FSB’s Recovery and Resolution Program it has implemented proposal for EU-wide rules for bank recovery and resolution\textsuperscript{164}. This should set out plans and crisis management solutions for failing banks and strengthen cross-border interdisciplinary works among financial institutions and regulatory authorities to better cope with future crisis. These mechanisms should protect the interest of taxpayers and business sectors and limit government spending on financial intervention. The Commission has initiated a proposal to strengthen its goal for a banking union. Furthermore, RRP should harmonize EU-wide resolution framework already adopted by some of the member states. Four elements of this proposal are; common EU deposit guarantee scheme for all EU banks, single resolution authority equipped with funds for SIFIs, a single EU supervisor and a common EU rule book\textsuperscript{165}. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) should complement the Commissions’ Recovery and Resolution Proposal. SSM will change the fragmented supervision of EU’s financial market to a more centralized one. SRM is very much disputed compared to the former because of its intervention power to sell part of ailing banks, to establish bridge institutions and to exercise bail-in action\textsuperscript{166}. The resolution plan should help distressed SIFIs or other financial institutions to convert liabilities to equity or liquidity instead of using public funds\textsuperscript{167}. After struggles for months of

\textsuperscript{158} Ibid.
\textsuperscript{159} Ibid.
\textsuperscript{160} Bafin, Federal Financial Supervisory Authority, Basel III/CRDIV, \url{www.bafin.de}
\textsuperscript{161} Ibid.
\textsuperscript{162} Ibid.
\textsuperscript{163} CRD IV, Frequently Asked Questions, EU Commission MEMO/11/527, Brussels, 20, July 2011, p 15
\textsuperscript{165} European Commission, MEMO, Bank recovery and resolution proposal: FAQ, Brussels, 6 June 2012
\textsuperscript{166} Council of the European Union, Council agrees position on bank resolution, Brussels, 27 June 2013
\textsuperscript{167} Bank Recovery and Resolution Proposal: Frequently Ask Questions, or see: \url{http://europa.eu/rapid/press-release_MEMO-12-416_en.htm}
negotiations with the proposal on the supervision of failing SIFIs and the banking union in Euro-zone, the Council and the Parliament finally agreed to pursue on the idea of the Single Supervisory Mechanism (SSM) ignoring some concerns of Germany. Aside from providing ECB overall responsibility on the supervision of EU’s financial market, EU finance ministers also agreed to `reduce` (not exempt; deposits up to 100,000 Euro are protected liability of taxpayers by requiring more accountability and liability from shareholders and creditors. SSM will soon be in force that served as a building block of European banking system. Presently, EU is in the process of discourse on SRM, considering the fragmented opinion and concerns among its Member States. SRM should complement and reinforce the responsibility of SSM. The future of these mechanisms depends on the compliance of the MS and the discursive power of EU institutions.

**Summary**

To summarize, FICOD allows supervisor to exercise consolidated supervision which is applicable to financial institution with more than one sector (e.g. banking and insurance). CRR aimed for the single passport in the EU that strengthen prudential reforms of Basel III and the CRD IV aimed to overhaul remuneration provisions of financial institutions, implement stricter governance and require SIFIs for additional buffer. “CRD IV reduces the probability of bans to fail, while RRP reduces the impact of such failures” The Single Supervisory Mechanism is now being pursued in the EU, granting ECB power at par with the EBA’s. But despite all efforts of EU institutions to strengthen regulatory process EU-wide, fragmented issues of MS tend to limit its effectiveness; but to what extent? Do EU regulatory authorities have to manipulate decisions of MS just to get a consensus on this issue?

**V. International Regulatory Setting Bodies**

Regulatory standards set by the international regulatory authorities are standards adopted in the European Union and other major financial market in the world. These standards are important for international financial market cooperation to keep the financial market stable and avoid systemic risk. International setting bodies like Basel and FSB are regulatory institutions issuing standards, policies, and guidelines for the global financial market. Treaty-based institutions like International Monetary Fund (IMF) and World Bank (WB) also use their mandate to influence countries to adopt such standards to foster cooperation with Basel and FSB. However, standards set by these institutions are `soft laws` which (indirectly) allow national authorities for their own discretion. Notwithstanding legal status, these institutions are in some way capable of exerting powerful influence over national regulatory

---

168 J. Strupczewski, EU leaders push banking union despite German reluctance, (Thomson Reuters, Fri, June 28, 2013)
169 Spiegel online: “EU Deal protects Taxpayers in Bank Bailouts”, 06/27/2013
170 J. Strupczewski, EU leaders push banking union despite German reluctance, (Thomson Reuters, Fri, June 28, 2013)
171 European Commission, MEMO; Bank recovery and resolution proposal: FAQ, Brussels, 6 June 2012
authorities. But how powerful are they to deal with national authorities’ discretion, considering that these bodies have no direct influence on regulating SIFIs especially on day-to-day basis?

V. A Basel Standards

Basel Committee was established by the members of the G-20 countries and is the creator of these banking regulatory standards for the global financial market to be implemented by its Member States which are also applicable to other states. For the purpose of this paper, previous standards will be shortly introduce and standards to be analyzed will only include standards developed in response to the financial crisis and those that are crucial to the regulation of SIFIs. Basel Committee was established in 1974 to solve international currency and banking problems at that time. It was originally an international forum for its member states to discuss issues on banking and its supervision\textsuperscript{172}. It used to be a platform to exchange ideas and information on improving banking regulatory standards. Further on, it has moved to a wider objective to address the growing gaps worldwide in international banking supervision that aimed to develop new standards and techniques adjusted to the growing market. Their goal is to get the compliance of all international members to adhere completely to these standards or at least apply adequate supervision whatever suited for its own financial market\textsuperscript{173}. Through the years, the Committee has authored several standards to close the gaps in the banking sector using the concept of ‘best practices’\textsuperscript{174}. But as we mentioned earlier, Basel has no formal legal status. The legality of these standards depends on the national or regional enforcing supervisory authorities. But true to its objective and goal, it was able to enforce these standards as an international supervisory framework completely or partly. And through the initiatives of its partner like International Monetary Fund (IMF) and World Bank (WB), it was able to foster cooperation among its members most likely than not likely. Knowing that IMF and WB may have influence on countries that are dependent on them, they could put pressure on these countries to cooperate or implement the Basel Standards.

Basel I or the minimum capital requirement

Just to give an overview of the previous accord, the first standard was the Basel Accord also known as Basel I. This accord was agreed upon by central banks of G-10 countries for their banking sector to adapt adequate capital requirement (which is 8% of the risk weighted assets) in order to strengthen financial stability of the banking sector. However, because of the growing development in financial market, Basel II has out-modeled Basel I because of its provision that considered risk in banking. Though out-modeled by the new standard,

\textsuperscript{172} See: History of Basel Committee at \url{http://www.bis.org/bcbs/history.pdf}.
\textsuperscript{173} Ibid
\textsuperscript{174} Ibid
adequate capital requirement is still being implemented in some developed global financial market and developing countries\textsuperscript{175}.

**Basel II- The revised framework of capital requirement**

Basel II is the revised model of the first accord which added a more comprehensive and broader capital regulation\textsuperscript{176} that would be adjusted to risk calculation. The new accord established in 2004 is set in three Pillars; which is the (1) minimum risk-based capital requirement, (2) supervisory standard that require banks to hold capital buffer other than the capital requirement and (3) a disclosure requirements for financial institutions to increase transparency and market discipline\textsuperscript{177}. The broader coverage of Basel II requires bank to hold capital against future risk that covers from operational risk, credit risk, securities defaults, and losses in trading market value\textsuperscript{178}. Through Directive 2006/49/EC Basel II was incorporated into EU law, however it still leaves certain discretion for financial institutions to design mechanisms that are more adjusted to their own financial structure than that of the EU Directive. Financial institutions can calculate risk based on their internal model or use a standardized approach applied by rating agencies. On the contrary, it provides a limited option for member states to adapt these standards in order to fit in to different market conditions\textsuperscript{179}. Though it is some sort of irony, because on the one side, this mechanism is strengthened by a legal status and on the other side it is weakened by a voluntary agreement between financial institutions and national government. This explains the delayed enforcement of Basel II in Europe in January 2008. However, Basel II is still not the perfect solution for regulating EU’s financial market. The financial crisis has revealed the weaknesses of Basel II. It was not able to buffer unexpected risks caused by the cross-border nature of financial market. Since Basel II has no specific regulatory framework for SIFIs, global and domestic authorities agreed that it has to be reformed to cope with systemic risk\textsuperscript{180}.

**Basel III- new capital and liquidity standards**

Basel III is a modification of the former two standards, of which did not protect the financial market from the recent financial crisis. The aim of Basel III is to improve previous regulatory standards (Basel I and II) to strengthen financial institution’s ability to resist future financial turmoil, improve the governance in the financial market, to create new method of risk management and overhaul transparency and disclosure method in the system. The new Basel Standard will strengthen the micro-prudential regulatory environment in conjunction with macro-prudential rules. Basel III is a modified and better version of Basel II. Pillar I of

---

\textsuperscript{175} M. B. Gordy, E. A. Heitfield, Risk-based Regulatory Capital and Basel II, (The Oxford Handbook of Banking, eds. Berger, Molyneux and Wilson, Oxford University Press, 2010), p 359
\textsuperscript{176} Ibid, p360
\textsuperscript{177} Ibid.
\textsuperscript{178} Ibid p 362
\textsuperscript{179} http://www.bis.org/publ/bcbs128.pdf
the new standard highlights to improve the quantity and quality of capital requirements that include conservation buffer for that capital, and a counter cyclical buffer. Banks are now required to hold a minimum requirement for common equity of 4.5%, and additional conservation buffer of 2.5% that raise the total capital requirements to 7%. A new liquidity standard will focus on risk coverage and leverage ratio of a financial institution. Pillar 2 strengthens the governance and risk management of the financial market. And Pillar 3 aim to improve market discipline through imposing more transparency and disclosure standards. Considering the threat of a systemic risk, this time, Basel III has required SIFIs to have a higher capital requirement than the normal financial institutions. In order to keep the financial stability Basel III with its macro-prudential approach will take into account risks from the cross-border activities and interconnection of SIFIs. SIFIs are now required to hold a higher loss absorbency capacity to cushion the risk they pose to the financial market. Basel III set an additional loss absorbency requirement from 1% to 2.5% of the common equity tier (CET) for SIFIs depending on their systemic importance. Basel III aimed to have a gradual transition to full implementation of these requirements until 2019. Like EU, Basel is also in a way of giving Member States a certain degree of national discretion. According to Basel; “in order to accommodate the structural characteristics of individual jurisdictions, the assessment and application of policy tools should allow for an appropriate degree of national discretion” (BCBS, Oct 2012). Does Basel in a way tolerating economic nationalism? While Basel Standards which have no legal entity are set for the global financial market, it is the responsibility of the respective regulatory authorities to transform them into legal instruments to ensure compliance of their constituents and financial institutions. Basel III shall be fully implemented in 2019. Hence, Basel Committee is concerned about the ‘reframing’ of the capital requirement by the European Union which is stringent than the Basel III. While Basel set capital and liquidity requirements based on the risk posed by conglomerates and its operation, EU set a limit on certain bank activities and their type of operation that in some way may however compliment with each other. Even if the standards are considered soft law, the Committee is consistent in its assessment to push member states for a prompt implementation.

V.B Financial Stability Board and the G-20

FSB was established in 2009 replacing the Financial Stability Forum that aimed to cooperate with other international standard setting bodies (SSBs) to ensure implementation of financial regulatory standards and to safeguard global financial stability. Members of FSB are

---

181 See: Basel III, www.bis.org
182 Basel Committee on Banking Supervision Reforms- Basel III, www.bis.org
184 Basel Committee on Banking Supervision reforms-Basel III (Chart), www.bis.org
185 Ibid.
187 Ibid.
countries of G-20 of which mostly are major financial markets of the world. The main task given to FSB is to foresee the implementation of the financial reforms agreed by the G-20 member states and also non-member states. With its cooperating function, FSB aimed to safeguard the relationship of G-20 to the Emerging Market and other financial market actors with regard to financial market regulation. Furthermore, with its ambiguous position\(^{188}\), FSB acts especially on the interests of the G-20 members, which are the major players in the financial market. Considering that most SIFIs are born in economically developed G-20 members, this could be difficult to bring forward macro-prudential regulatory frameworks on the table and demand compliance. And because of its large and more heterogeneous membership, reaching to a consensus could hardly be achieved\(^ {189}\). The regulation of SIFIs and achieving the consensus of its member states is a big challenge to the regulatory status of the Financial Stability Board.

FSB is working closely with other standard-setting bodies (SSBs) like International Monetary Fund (IMF), World Bank (WB) to strengthen the coordination of monitoring, reporting and implementation of banking standards\(^{190}\). In fact FSB has also been working side by side with other SSBs to strengthen the rules of financial market and even initiated their own proposal to ensure international cooperation. After the financial crisis, FSB wants to strengthen its role and influence as part of the SSBs in the global financial market. Along with the purpose of Basel Committee, FSB also introduced rules and principles to address the problem of regulating SIFIs. To help resolve the problem of SIFIs, FSB established resolution frameworks that support the work of other SSBs like IMF and Basel. This should also promote its influence in the national level\(^ {191}\) covering the issues on strengthening the loss absorption capacity requirement for SIFIs, resolution and crisis management, effective and stringent supervision of SIFIs and strengthening the architecture of the financial market\(^ {192}\). Still lacking a legal capacity, however, the standard set by FSB is quite specific compared to its former body which now sharpens regulatory mechanisms for the financial market and its institutional governance\(^ {193}\). For example, the process of peer reviews and monitoring system help the Board to evaluate the effectiveness of a certain standard. The Board also enhances the compliance of its members on policies and regulation and developed supervisory approaches framed for SIFIs. These include the FSB international resolution and recovery

\(^{188}\) S. Vourloumis, Reforming EU and Global Financial Regulation: Crisis, Learning and Paradigm Shifts
\(^{189}\) E. Helleiner, The Financial Stability Board and International Standards, CIGI G20 Papers | No. 1, June 2010
mechanism for SIFIs\textsuperscript{194}. In the EU, members of G20 are working to fulfill their commitment to adhere to the standards set by FSB. To sum up, FSB is now in the process of institutional change that transform its role and influence and to change the governance and stability of the financial market.

**Summary**

Even without legal authority. Basel Standards’ influence in the global financial market has proved to be effective. True to its objective and goal, it was able to enforce standards that helped bridge the gaps in the governance of financial market. Many of these standards are now considered as an international supervisory framework. Because of the strong impact of the financial crisis, FSB is now working closely with Basel to keep the stability of the financial market. Both institutions only equipped with soft laws and guided by shared norms will prove to enhance their status in the supervision of financial market. SSBs have maintained good relationship with EU and its MS considering slight differences on the implementation of regulatory standards. But the effectiveness of the new institutional setup depends on the response of MS through the implementation of the new standards.

**VI. Member States (MS) banking reforms**

**State Aid/Recapitalization**

The financial crisis has revealed that EU has tolerated actions of member states to execute emergency measures to save ailing financial institutions. Evidently, a massive amount of financial assistance flowed to the banking sector as a form of state aid. In fact, the cost of state aid reached to almost 4.6 trillion of which is approved by the European Commission until 2010\textsuperscript{195} more than 10% of EU’s GDP. Considering that EU’s principle is to avoid discrimination in the internal market, this action was clearly a discrimination of other sectors of the economy that were also affected by the crisis in 2007 and needed a capital injection. While this is not alone the action taken by EU Member States, the Commission has approved with closed eyes every application of state aid on the financial sector giving an account on the financial crisis as exceptional circumstances for this purpose while keeping a level playing field. These include capital injection and bail-out schemes to save ailing banks of some Member States. The Commission also imposed burden-sharing conditions on bailout actions not to distort competition in the market\textsuperscript{196}. Nevertheless this framework is only an

\textsuperscript{194} Please see FSB; Resolution of Systemically Important Financial Institutions Progress Report, November 2012 or [http://www.financialstabilityboard.org/publications/r_121031aa.pdf](http://www.financialstabilityboard.org/publications/r_121031aa.pdf)

\textsuperscript{195} Commission Staff Working Paper, Brussels, 20.7.2011 SEC (2011) 950 Final, Proposal for a regulation on prudential requirements for credit institutions and investment firms

\textsuperscript{196} European Commission; Communication from the Commission, COM(2012) 253 final, Brussels, 30.5.2012 (Report on Competition Policy 2011)
immediate and temporary solution\textsuperscript{197} because banks can only avail of the state aid program if recapitalization is not possible by all means.

**On Banks Resolution and Banking Union**

On the resolution of failing SIFIS, most governments undertook their own crisis management as an emergency mechanism just to avoid a spill-over effect. In Germany, the government has established restructuring fund for its banks\textsuperscript{198}. The resolution power of the Dutch Central bank and the Dutch Ministry of Finance were given authority to sell ailing financial institutions or transfer assets and liabilities either to private party or a bridge institution\textsuperscript{199}. The same power was granted to Spain’s regulatory authorities aside from providing financial assistance to their failing banks\textsuperscript{200}. In UK, the Special Resolution Regime was granted a broader resolution powers with regard to ailing systematically non-bank institutions and financial market infrastructure (FMI)\textsuperscript{201}.

The proposal of EU to harmonize national resolution mechanisms has undergone process of debates and negotiation between MS and the European Union. This resolution mechanism and the banking union proposal are crucial to reduce the link of solvency between national governments and their ailing SIFIs\textsuperscript{202}. In line with RRP, the goal of EU is to finally pursue the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) to be implemented in the national level. Recently, SSM was already approved in the EU level which gives ECB the supervision. There are of course fragmented opinions and concerns in the national level on the provisions of SRM. Germany, pressured by the upcoming election in September is very careful in dealing with the banking union especially when it comes to ‘who would pay how much’ question on bank resolution fund. Furthermore, Germany has casted doubt on the implementation of the banking union for it may need to change the treaty\textsuperscript{203} even if the Commission does not consider such change. The French government has given its complete support to the banking union and to the resolution fund\textsuperscript{204}. However, Germany, the Netherlands, and the Irish government were firmed regarding strict rules on bail-outs sparing taxpayers money therefore giving more responsibility to investors and creditors, while French government favors the opposite. Before SSM was approved in the EU level, some MS are less enthusiastic with the banking union proposal considering the position of its banking sector. Sweden and MS in Eastern Europe for example have no SIFIs.

\textsuperscript{197} Ibid.
\textsuperscript{198} FSB, Resolution of Systematically Important Financial Institution, Progress Report, November 2012, p6
\textsuperscript{199} Ibid p6,
\textsuperscript{200} Ibid.
\textsuperscript{201} Ibid.
\textsuperscript{203} C. Volkery, Battling the Crisis, Disunity Plagues EU Banking Union Talks (Spiegel Online, 05/17/2013) or visit: http://www.spiegel.de/international/europe/
\textsuperscript{204} J. Strupczewski, EU leaders push banking union despite German reluctance, (Thomson Reuters, Fri, June 28, 2013)
operating in other EU countries\textsuperscript{205}. UK has already given its decision not to participate in the banking union. UK criticized the idea of the new ECB supervisory power based on its conflicting role as Lender of Last Resort and as guardian of the EMU.

Proposal for SRM is currently on hold following differences in the national level.

**Implementation of EU Regulations (Random Assessment)**

EU history showed that EU banking regulation that has created options and discretion to Member States have resulted to regulatory patchwork, divergences, loopholes and fragmented regulatory standards. According to Veron (2012) there is a need to change EU’s institutional framework in order to provide authoritative and political decisions that oversee the regulation of EU financial market\textsuperscript{206}. Goldstein and Véron (2011) argue that national governments still dominate in shaping financial regulatory policies that favors in protecting domestic financial institutions\textsuperscript{207}.

Before the complete implementation in EU, CRD IV have created some resistance from financial institutions affected by the higher quality of capital and from supranational institution (Council) concerning the burden their countries should be carrying\textsuperscript{208}. At the beginning, France and Germany were among the first to show resistance on the high capital requirement and the stress-test of their financial institutions\textsuperscript{209}.

Polish authorities have implemented the capital requirement set by Basel II. Even if financial institutions in Poland are adequately capitalized its governance remained to be inadequate\textsuperscript{210}. An infringement case was filed by the Commission against Poland for the incomplete transposition of CRD III (2010/76/EU)\textsuperscript{211}. Like Poland, Italy, Portugal, Slovenia, Spain, Luxemburg, Sweden, and Slovakia all have the same problem in the complete implementation of the additional capital requirement requirements (IV). While the Commission is lenient on the deadline of the implementation of the capital requirements, still, three quarter of its Member States have either not completely implemented the directive or have not yet implemented some provisions of the capital requirements\textsuperscript{212}. Spanish government still has to adopt some technical provisions of CRD II\textsuperscript{213}. And the Dutch

\textsuperscript{205}G. Steinhäuser, To Join Or Not To Join, The Wall Street Journal, March 15, 2013

\textsuperscript{206}N. Veron, Challenges of Europe’s Fourfold Union, Speech at the U.S. Senate Committee on Foreign Relations, August 1, 2012.

\textsuperscript{207}M. Goldstein and N. Véron, “The European Union should start a debate on too-big-to-fail” Article on 14 April 2011, or check: www.vox.eu


\textsuperscript{212}Ibid.

\textsuperscript{213}Ibid.
government still has to wait for a bureaucratic legislative process for the decision on the implementation of capital rule (CRD II). Greece and Belgium were slow in enacting the said regulatory measures because of some internal problems. EU regulatory authorities continue to sharpen its measures on capital requirement through CRD III however some of the member states like Belgium and Greece are still coping with the implementation of CRD II. Furthermore, Greece seemed to ignore its obligation to comply with the new regulatory standards set by EBA\textsuperscript{214}. Belgium on the other hand as the center of the European Union, still has to complete the enactment of some provisions of CRD II especially on supervision issues\textsuperscript{215}. In Italy while supervisory authorities have pledged their support to the Basel framework and EU’s regulatory policy on banking, still Italy has to strengthen its bank and insurance supervision, sharpen its regulatory governance, transparency and enhance consumer protection\textsuperscript{216}. There are several gaps and backlogs on the implementation of the Basel Framework especially the capital requirements policy\textsuperscript{217}. Furthermore, another problem of the Italian authorities is that there is no strong legal structure that backs up their banking supervisory policies. In accordance with EU’s regulatory measures, Italian authorities are in the process to implement prudential reforms. However, Italy’s government has expressed several loopholes on the previous Basel Frameworks\textsuperscript{218} (which are already enacted in other national governments) which delayed the implementation of CRD III. In this regard, the Commission was forced to file an infringement case against Italy\textsuperscript{219}.

German financial sector is now undergoing revision process on the regulatory mechanism for SIFIs. However, German authorities still have to strengthen the governance of financial conglomerates or SIFIs. For example the bank levy for SIFIs does not correspond with the risk they posed to the financial market\textsuperscript{220}. Considering the cross-border activities of German SIFIS, national supervisory authorities are aiming to strengthen its regulation in terms of capital loss absorbency\textsuperscript{221}. Some of German banks are owned by their respective Länder, thus there is no clear boundary of responsibilities among the national regulatory authorities (BAfin, Bundesbank and BMF) in some issues. Furthermore, while CRR is directly applicable to any MS, German national authorities claimed that provisions of CRD IV still have to be adjusted according to its remuneration package before it is completely implemented. Germany’s government and constituents have expressed some concern over specific issue on banks’ remuneration process. For this, the complete implementation of both CRR and CRD IV is moved to a new target date in 2014\textsuperscript{222}.

\textsuperscript{214} Ibid.
\textsuperscript{215} Ibid.
\textsuperscript{216} Financial Stability Board; Peer Review of Italy: \url{http://www.financialstabilityboard.org/publications/r_110207b.pdf}
\textsuperscript{217} Ibid.
\textsuperscript{218} Ibid.
\textsuperscript{220} International Monetary Fund, 2011 Country Report (Germany), or visit: \url{http://www.imf.org/external/pubs/ft/scr/2011/cr11169.pdf}
\textsuperscript{221} Ibid.
\textsuperscript{222} Bafin, CRD IV - Capital Requirements Directive IV, May 16, 2013. Or visit: \url{http://www.bafin.de}
The implementation of CRD II and CRD III in the UK came into effect on December 2010 then slowly harmonizing UK rules to the Basel Framework to this date. As of this writing, a new regulatory regime (PRA) in UK was established to replace the Financial Stability Authority (FSA). UK regulatory authorities expressed their intention to adhere to Basel Framework and EU’s risk weighted framework and to work closely with FSB to develop strategies and resolution for SIFIs. About the implementation of CRD II, UK acknowledged the importance of harmonized financial market regulation however they will not impose additional burden on their financial institutions higher than what the CRD II required. CRD IV has been adopted on April 2013 in EU, and after translation is done implementation is set to follow in 2014. Implementation in the UK has to wait after the decision of a public consultation on specific issues. Since EU’s capital standards from I to III are exactly adopted from the Basel Standards, UK has lesser problem to implement the standard. However, with regard to CRD IV, which EU has done some ‘retouching’ catered to EU’s financial market, UK is reluctant considering the disinclination of its constituents towards EU.

VII. Theoretical and Empirical Reflection

“Regulations, no matter how good, cannot overcome poor supervision.” Slowly, EU institutions have realized that in order to ensure an implementation of a common policy in whatever sector in EU, they should have an iron hand to impose new ideas and management approach. Iron hand could mean a legal framework that confirms the power of EU regulatory institutions. However this iron hand should not serve the interest of the constructivist institutionalism, not economic nationalism, but rather the interest of the taxpayers and the entire financial market. In order to put EU’s banking system to a more organized sector, they need only one supervisory authority, thus empowered by a legal status, and recognized by national authorities. In today’s world, banking regulation is strongly influence by the strong impact of globalization, the position of national government and their regulatory mechanisms. European Union is now in the process of minimizing the degree of national discretion in some regards however, some considerations could not be completely eliminated. For example Member States will only have discretion on certain macro-prudential issues or on dealing with systemic risks that reflects national economic

223 Bank of England, Statement on CRD IV Timetable Implementation, or visit: http://www.bankofengland.co.uk/pra/Pages/crdiv/implementationtimetable.aspx
224 Ibid
225 Bank of England, Statement on CRD IV Timetable Implementation, or visit: http://www.bankofengland.co.uk/pra/Pages/crdiv/implementationtimetable.aspx
226 Ibid.
differences or influence by its political position. This chapter should answer the hypotheses formulated for this thesis:

H1  **EU institutions can change the way national government’s view on appropriate regulations with regards to SIFIs**

H2  **Member States will comply on regulatory standards still with some degree of discretion**

**Global level and domestic level**

Considering the persisting influence of rationalist behavior, some impediments to the effectiveness of CI is still present in today’s regulatory mechanism. With regard to EU’s partial compliance to Basel III (note: EU’s CRD IV, definition of capital), in RI account that goals should be pursued in accordance with what they believe about facts and for this EU is encouraged by their own interest and the interest of its MS. This is maybe the only failure of EU with its compliance to Basel’s capital requirement considering that previous Basel standards were already in force EU-wide. Thus, according to Véron (2013) EU’s incomplete adoption of Basel III undermines the global authority of the Basel Committee, encourages other jurisdiction to introduce exceptions of their own, and diminishes EU’s own moral stature in the global financial market. EU’s commitment to adhere to Basel standards proved the account of CI in RI tradition that considers the importance of interest and collective action of its MS. Regarding Basel’s authority, according to CI’s account; whereas position is vital to power, power can also be achieved from actor’s purpose, ideas and discourse that serve actors own interest and of their people. Thus Basel’s authority may be strengthened or undermined in accordance to the need of its constituents and its purpose since according to CI, institutions influence behavior in a suggestive or descriptive manner and not prescriptive (Hay, 2008). On Basel’s requirement to establishing SIFIs, and FSB’s RRP, EU has fulfilled CI’s coordinative nature. Meanwhile FICOD (now in a revision process) and RRP have gained complete commitment of the European Union. All institutions (Basel, EU, FSB) practiced what CI’s focus on communicative discourse, where open dialogue (coordinative discourse), negotiation, interaction is considered crucial to decision-making.

**Domestic level**

If we try to assess EU’s position on the implementation of Capital Requirement there are some evidences that constructivist institutionalism is slowly getting its pace in the European Union trying to influence economic nationalism. Moreover, the financial crisis has

---


231 V. Schmidt, V. Schmidt, Taking ideas and discourse seriously: explaining change through discursive institutionalism as the fourth new institutionalism, (European Political Science Review, 2010) p 4-10

232 On Basel III: Europe’s interest is to comply, p 5; pls. visit [http://voxeu.org](http://voxeu.org)

233 V. Schmidt, Taking ideas and discourse seriously: explaining change through discursive institutionalism as the fourth new institutionalism, (European Political Science Review, 2010)

234 Ibid.
strengthened the position of EU regulatory authorities giving them a stronger stance in the national financial market regulation than before. However, the influence of EU regulatory authorities could only work if the ideas conveyed in CI can convinced Member States that these mechanisms will served the interest of their financial market. To prove CI influence in today’s EU’s regulatory institution, it is imperative to consider some important characteristics of institutions. Considering the aspects of CI/DI outlined by Schmidt (2010), EU’s regulatory measures on SIFIs like FICOD, CRD/CRR including the new proposals (SSM/SRN: considered as ideas’) have gone through first; ‘communicative process’ where a process of framing and re-framing is done, second; deliberative process where participation of civil society is considered in policy-making and third; a coordinative process where discussions among experts are crucial to gather important knowledge and expertise that help legitimize their ideas. EU Financial Regulatory institutions have also gained its power through CI’s ideas and ability to persuade which is strongly evident in the legislative process of SSM proposal which produced a series of negotiations among MS\textsuperscript{235}. With CI’s interaction with EN, this thesis proves that CI can deal with EN’s belief motivated by its goal, collective intentionality and ability to persuade and to cope with changes if there is a need to change.

However, influences of RI tradition could find some limitations on the effectiveness of each of these regulatory institutions but not much on collective intentionality since the ‘logic of appropriateness’ strongly motivate these institutions to pursue their goal. Although RI account is evident on the Commissions’ role in the proposal of SRM in which it tries to maximize its interest strategically wanting to act as a resolution body in response to the suggestion of MS on possible treaty change\textsuperscript{236}. Moreover, EU’s action in tolerating the actions of its MS on state aid was an action influenced by a rationalist view to pursue goals based on subjective ideas (saving distressed banks) and even distorting competition in EU. In a global perspective, EU could be viewed as proponent of rational choice tradition that considers ideas as inspiration to maximize its interest strategically. Thus, the present institutional change has more contribution to the concept of the constructivist idea than to the rationalist material interest.

**National level**

In the early phase after the financial crisis, the implementation of new or revised regulatory standards has created patchwork of regulatory measures in the national level. Some limitations on the compliance of the MS could be economic interest or political pressure. If one thinks of economic interest as a limitation, in the early phase of institutional change, economic nationalism was evident in the ‘negotiation table’ of EU in every policy making. For example France and Germany were among the first to show resistance on the high

\textsuperscript{235} J. Strupczewski, „EU Leaders push banking union despite German reluctance“, (Thomson Reuters, Fri. June 28, 2013), Germany is convinced to agree on SSM Proposal.

\textsuperscript{236} Ibid, “The Commission expressed its intention to act as a resolution body to avoid treaty change with regard to SRM”.

47
capital requirement and the stress-test of their financial institutions driven by political discourse of their governments.

Presently, looking at the implementation of regulatory measures in the national level, taking SSM as an example; Germany has proved to be consistent in its commitment to EU considering its position and being a proponent of the European Union. This proves EN’s reconceptualization of complex mechanism and relationship that include political legitimacy of states in response to the coordinated action of politics and economy and discourse as a collective action without minimizing its national identity (Pickel, 2005). Considering the position of German SIFIs in the global financial market, this could create a strong lobby against EU’s regulatory measures however rational account proved no claim in this decision-making. On the issue of CRD IV, German authority remains firm to delay implementation of CRD IV in response to national political pressure to change the remuneration package of SIFIs, which strongly proves EN’s influence on its decision-making.

Rational account in EN also proves stronger in UK than the rest of EU Member states. UK’s rejection has reinforced EN’s account when it comes to the banking union proposal of the EU pressured by national political situation. Moreover about the CRD IV, UK’s intention to cast lesser burden on their SIFIs is evident of the rationalist tradition. While UK government maximizes its strategy and economic benefits brought by joining EU, thus it is still strongly bound to adhere to economic nationalism’s purpose and direction.

Other MS especially in Eastern Europe have showed no resistance against EU regulatory measures on SIFIs. Most of these countries have no SIFIs but mostly subsidiaries owned by euro-zone banks. The problem of host country or home country regulation is not a concern for this moment because FICOD is in the process of revision. Thus, being in the European Union, these MS strengthen EN’s new idea on national economic gain, considering the promise of solidarity. Of course one cannot disqualify the account of rationalist on the economic rewards that serve their interest in joining EU. Regarding national discretion of the Member States on certain provisions of EU policies, a strong economic nationalism may not be the motivation for it, neither the rational belief of maximizing interest but on some internal domestic differences. 27 EU members with different political condition, culture, and specifically different economic structure; it is not easy to reach a consensus.

However on the implementation of capital requirements, it is important to view these differences based on EN’s consideration of political, historical, cultural, and social context of national governments (Pickel, 2003:15). There might also be some degree of competition, or what Donnelly (2012) called ‘power politics’ between institutions and states however they are limited by the norms and standards they are conformed to. The financial crisis was vital for the institutional change at the EU level, since it has strengthened the function and status

of regulatory institutions. There might still be some delays, hindrances and slight differences on the method of implementation, but optimists believe that change is on the process, and that is what counts most. And these countries have learned their lessons that fragmented regulatory framework and weak governance in the European Union will not save their SIFIs from the financial crisis.

VIII. Conclusion

The financial crisis has triggered the process of institutional dynamics in the European Union. The failure of several SIFIs during the crisis has become an instrument that initiated the changes on the governance of the financial market globally. The weak regulatory mechanisms on the financial market have also revealed the gaps in banking regulation in each of the Member States of the EU.

In the previous chapters, this paper has identified the characteristic of SIFIS and its importance in the banking sector and also the entire economy. It turned on a wake-up call to responsible regulatory authorities in the world to examine their own regulatory frameworks. This thesis has also presented regulatory measures for created by the international regulatory institutions and the response in the European Union and its Member States. The European Union aware of its fragmented banking regulation finally moved to create new authorities to regulate banks strictly than they used to do and enhance these authorities with legislative power. Furthermore, EU has worked closely with other international standard setting bodies like Basel and FSB to develop effective supervision on SIFIs. EU’s standard is based on the standards developed by Basel Committee on Banking Supervision although it has not “copy paste” the complete standards. Standards on Capital Requirements was revised for several times adjusting to economic and banking developments over the time.

Implementation of regulatory mechanisms has again shown some differences which is already familiar in the case of the European Union considering the diversity of its Member States in many matters. Although EU aimed to have a single rule book, minimizing these differences has a long way to go. Thus, the failure of several SIFIs became an instrument and trigger point to strengthen the governance of the financial market. Still with some discretion Member States expressed their commitment to adhere to the new regulatory policies. But considering the impact of failing SIFIs to the entire economic sector, Member States, notwithstanding their preferences for their own SIFIs, will have a lesser option but to adhere to the new regulatory measures. Furthermore, a new institutional set up will change the dynamic of EU supervisory status towards its Member States. Nevertheless, it is maybe too nascent to say but some optimists believe that change is on its way. The assessment on the implementation of EU regulations tries to give an answer to the formulated hypotheses for this thesis. Finally the empirical assessment addresses the strength and limitation of today’s governance of the financial market regulation in EU. Generally, SIFIs are not mentioned in all
aspects of the paper thus, all regulatory measures in the EU banking sector do apply to SIFIs also.