Banking Integration in the EU: a process marked by a battle between systems

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List of abbreviations

BoE – Bank of England

CME – Coordinated Market Economy

DI – Discursive Institutionalism

ECB – European Central Bank

EBA – European Banking Authority

ESA – European Supervisory Authority

ESFS – European System of Financial Regulators

ESMA – European Securities Markets Authority

ESRB – European Systemic Risk Board

EP – European Parliament

EU (**C**) - European Union (Community)

FBD – First Banking Directive

FSA – Financial Services Authority

FSAP – Financial Services Action Plan

HI – Historical Institutionalism

ECJ – European Court of Justice

ECOFIN (Council) – Economic and Financial minister

EIOPA – European Insurance and Occupational Pensions Authority

LI – Liberal Intergovernmentalism

LME – Liberal Market Economy

MS - Member States

NCB – National Central Bank

RCI – Rational Choice Insitutionalism

SBD – Second Banking Directive

SEA – Single European Act

SME – State-influenced Market Economy

US - United States

VOC – Varieties of Capitalism

Abstract

Banking regulation has always been a hot topic in the EU and has been marked by harsh debates between the member states (MS) throughout the decades of this process. Under the pressure of globalization and the need to catch up with the pace of economic development of its competitors, EU members needed to open more their economies. While on the one hand there was the pressure and need for more liberalization, which would lead to an always greater degree of convergence, on the other hand the MS wanted to preserve their (different) national practices and norms as far as their relations with their financial institutions are concerned. Eventually, the process of financial markets integration was marked by "battles" of ideas of the MS about how this integration should be achieved and how far it should go. The last financial crisis brought once more on the surface the already existing cleavages between the MS, whose banks, as we continue to see today, experienced great difficulties. The financial recession hit Europe very hard due to its improper means to prevent it. The level of integration of the regulatory and supervisory frameworks at the EU level was low, as these tasks were carried out by the Member States themselves, who had different ideas about how to do it. But even today, in the so-called "post-crisis" period, when the MS agreed to reform the old system of informal coordination between national supervisors with a new system of formal authorities, real integration is still not achieved as the MS maintain the long considered *political right* to regulate and supervise their banks.

Keywords: *Banking integration, European Union, Member States, national interests, transnational actors, national practices, institutions, ideas*

I. INTRODUCTION

Banking regulation has always been a hot topic in the EU and has been marked by harsh debates between the member states (MS) throughout the decades of this process. Today, it still remains a critical topic of discussion, especially in the light of the recent experience of the financial and economic crisis which started in 2007 and was transported to Europe from the US. This crisis, which many argue is still continuing, has had severe consequences on the real economy of the world, but especially on the economies of the largest economic blocks of the world, the US and the EU[1]. The labeling itself of the last crisis as "a financial and economic crisis", implies problems originating from the financial system which have directly affected the real economies. This problem is proving to be especially poignant in the EU, where the divergences of the ideas about how to regulate these institutions, which are both beneficial and potentially dangerous for the economies of the countries, remain stark. This is so even after a relatively long process of attempts at regional level to bring more integration to the national practices of regulating banks, with initiatives coming from both the national and supranational levels.

Especially in the large and highly industrialized countries of Western Europe, banks have played a central role in the lives of the economies. After World War II, the financial institutions of these countries were of crucial importance to the restructuring of their economies and to giving a boost to the development of industry. During that course of time, the economies of the highly industrialized European countries began to diverge, and this was more clearly expressed in their domestic *institutional set-up* that they had adopted to form the relations between business, industry and the state in order to give way to progress[2]. What may account as less visible are the different *ideas* that the different European states had about state building and their own role in the development of the economy[3] [4].

Following the post-war period of industrial development and growth, the events of the 70's marked the start of new developments not only in Europe, but in the whole world. The oil crisis of the 70's coupled with the dismantling of the Bretton Woods Agreement by the then president of the US, Nixon, who devalued the dollar and eventually abandoned the gold standard, are seen as part of the main causes of the "new start"[5]. This was followed by Germany's *Bundesbank*'s decision to terminate currency intervention to support the dollar, letting the Deutche Mark (DM) float freely - the currency

[1] P. Tridico – *Varieties of capitalism and responses to the financial crisis: the European social model vs the US model*; et al.
[2] P. Hall – *Governing the Economy – the politics of state intervention in Britain and France. 1986.*
[3] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010*.
[4] V. Schmidt – *Putting the States Back into Political Economy by Bringing the State Back in Yet Again. 2009.*
[5] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994;* J. Story & I. Walter 1997; P. Hall 1986;

instability led the European leaders to the idea of creating a monetary union by 1980 to return to currency stability[6]. But, as it is now known, this idea was to be put into effect only two decades later. What has to be highlighted here is the fact that during the ‘70s the economic development in Europe was slowed to a great degree. Growth rates in the European Community (EC) fell from 5% in the ‘60s to 3% during 74-79 and to 1% at the beginning of the ‘80s.[7] “While the Unites States created 15 million and Japan 4 million net jobs from 1973 to the early 1980s, none were created in Europe”[8]. Viewing the situation from the political economy aspect, Western Europe needed a strategy to boost its economic development and improve its negotiating position vis-à-vis the US and Japan. Consolidating a large internal market was a prerequisite to this[9].

The events that followed in the EU, but not only limited to there, are part of the fast developments of the time which is labeled with a term that is used to define our age - *globalization*. This age is marked by a high degree of trade liberalization, which, together with the technological innovations, has given a boost to the development of many new business practices. In view of the need to keep a continuous growth of the economy and of an increased interdependence, trade liberalization has come almost natural. Under the pressure of globalization and the need to catch up with the pace of economic development of its competitors, EU members needed to open more their economies. While on the one hand there was the pressure and need for more liberalization, which would lead to an always greater degree of convergence, on the other hand the MS wanted to preserve their (different) national practices and norms as far as their relations with their financial institutions are concerned[10]. This tension will constitute a central part of this work.

Eventually, the process of financial markets integration was marked by “battles” of ideas of the MS about how this integration should be achieved and how far it should go - this leads to the definition of the topic of this research. The last financial crisis brought once more on the surface the already existent cleavages between the MS, whose banks, as we continue to see today, experienced great difficulties. In the overwhelming number of the cases, the banks experiencing problems, despite their status as transnational operators and multinational institutions, were supported by their home governments, which bailed them out and made evident once more their “feelings” for their financial institutions - as Mervyn King puts it, that situation recalled that “banks are global in life but national in

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[6] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems.* 1997
[7] Ibid.
[8] Ibid.
[9] Ibid.
[10] P. Hall 1986; E. B. Kapstein 1994;

death"[11]. The last financial recession hit Europe very hard due to its improper means to prevent it. The level of integration of the regulatory and supervisory frameworks at the EU level was low, as these tasks were carried out by the MS themselves, which, as already said, had different ideas about how to do it. But even in the "post-crisis" period, when the MS agreed to reform the old system of informal coordination between national supervisors with a new system of formal authorities, real integration is still not achieved as the MS maintain the long considered *political right* to regulate and supervise their banks. This leaves much space for reflection and strongly invites to consider in more detail the factors that impede integration to take place. More integration would in turn increase the possibilities of avoiding crises of such magnitude.

Considering the central position of the financial institutions in this crisis, the degree of force with which the crisis hit the countries and the persistence of the problems in the EU, a closer look at the process and level of banking integration in the EU is quite relevant for the time and with great interest for the study of EU politics. The main aim of this work is to define the main actors and factors that influence this process. This will help to define the reasons why the process of banking integration, as part of the program for completing the Single Market, has proven so difficult and is still far from complete. In pursuit of achieving this aim, this research will describe the process of banking integration in the EU as well as explain it by employing different explanatory tools.

As far as the analytical framework of the research is concerned, it will be made up of two European/regional integration theories, namely *neofunctionalism* and *liberal-intergovernmentalism*, and three approaches that explain state-business relations, namely *Historical Institutionalism*, *Rational Choice Institutionalism* and *Discursive Institutionalism*. The idea of choosing these explanatory tools is to sufficiently cover the actions of the actors in the process of banking integration and explain them at both the EU and national levels. While the two theories of European integration base their explanatory power on the actions of and interactions between the Union and the MS (top-down approach), the three approaches will look further down at the national structures and practices as conditioned by different factors (bottom-up approach). Regarding the two theories of integration, along with the review of their assumptions, a comparison and contrast between the interpretations of those who see a greater influencing role of the supranational level, and those who maintain that states are the only ones who can make decisions about policies is provided. As it will be shown here, none of these views can be labeled as absolutely right or wrong as they can very well be complementary to each other. However, it

[11] D. Schoenmaker – *The European Banking Landscape After the Crisis*.2011 quoting Mervyn King

is within the scope of this work to define the levels of explanatory powers of the two theories, from which, in the case at hand, the liberal-intergovernmentalist view seems to be more accurate. Said this, the research finds it fit to direct the spotlights at the national considerations. Although this work takes mainly a European perspective, because its main interest is in the issue of EU banking integration, it will also give an important place to the national considerations, which will inform the explanations from a bottom-up view. It is obvious that here cannot be covered all the EU states, nor it is possible to discuss the cases of all the important states because of space restrictions, therefore the cases of two of the main countries in this process, namely Britain and Germany, will be brought in as two ideal examples of countries who pursue different policies in their relations to their financial institutions. This is due to their peculiarities in state organization, mainly institution building, the position of the interest groups and the prevailing ideational factors within these states. In this research it is given a greater explanatory weight to the ideational factors, as the main element which gives shape to the societal structures. Going through these observations will help us explain why the process of banking integration has been marked by continuous "battles".

The organization of this work is thought to be made in a way that allows for a clear understanding of the issue at hand by looking at it in different dimensions and considering a relatively large time span, beginning from the first attempts to banking integration formulated in the First Banking Directive in the mid-'70s and ending with the measures taken in the aftermath of the last financial crisis. In this first chapter it was provided a general view of what this research is about, the tools for analyzing the events were presented and a guideline of the study included. The second chapter will bring a description of the main steps that have been taken through time for the integration of financial institutions in the EU. This will allow the transition to the third chapter where the analysis of the events takes place. The third chapter will review the theories and approaches that will help to form an understanding of the relations between the MS and the Union in the process under study, and the types of relations between the MS and their financial institutions. This chapter is central to the understanding of the processes of integration in the EU, as well as to the reasons for the high level of tension that exists when it comes to the integration of the financial sectors of the MS. The fourth chapter will be dedicated to the post-crisis reforms of the EU regulatory and supervisory system - here, the conclusions from the previous chapter will be duly tested. The conclusion of the research will follow in the fifth chapter. It will give an overview of where does all what is discussed leave us and will put forward some proposed solutions.

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II. DESCRIBING THE PROCESS OF BANKING INTEGRATION IN EUROPE – PROCESSES AND OUTCOMES FROM THE FIRST BANKING DIRECTIVE TO THE LAMFALUSSY PROCESS

As already mentioned in the introduction, the 70's marked a new starting point not only for Europe but for the whole world. In the EU, due to external causes such as the oil crisis and the abandonment of the gold standard by the dollar, the world's main reserve currency, and internal reasons such as a quick slow-down of the economic growth and the need to be internationally more competitive, the move towards more cooperation, especially between the MS, took a new boost. The completion of the Internal Market was a prerequisite for the increase of competitiveness of Europe[12]. For the completion of the Internal Market, a major program was the creation of a European Financial Area which would eliminate restrictions on the movement of capital among the MS and for which the establishment of a legal framework for an EU-wide market for financial services was required[13]. The Commission started the promotion of the Internal Market (later to become Single Market) since the '70s with the purpose of ensuring European firms with first-rate access to capital, but also to allow the European corporate economy to have access to a greater amount of capital so that they could grow and be able to compete better with the US multinational corporations[14].

1. The First Banking Directive (FBD)

The first important steps toward an EU regime for banking were materialized in the First Banking Directive (FBD) adopted by the Council in 1977, which provided the legal terms for the freedom of the European Community (EC) banks to establish branches in different MS[15]. After having made several efforts to harmonize bank regulations in the MS at one stroke, which eventually failed, the Commission took a fresh approach based on more gradual steps toward integration, but again trying to harmonize MS laws[16]. The novelties of this directive were mainly two: the introduction of the "home country principle" and the institutionalization of cooperation procedures through the creation of a Bank Advisory Committee, which was composed of senior civil servants from the MS, the Commission and the EU Permanent Conference of Insurance Regulators[17] [18]. This would serve to link more strongly the

[12] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997*
[13] Ibid. (p. 250)
[14] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010. (p. 159)*
[15] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.131-138)*
[16] Ibid. *(p.136)*
[17] Ibid. *(p.131-138).*
[18] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997.* (p. 15)

Commission and the MS in the initiation of legislation in the future[19]. The ultimate objective of this directive was allowing the banks of the EC to set up branches throughout the whole community, with supervision provided mainly by their home country in order to avoid fragmentation[20]. However, it was recognized that this would be a process that would be completed through time[21]. After the implementation of the first directive, there remained several important obstacles to the freedom of establishment of branches in other MS: first, each European bank wanting to establish a branch in another MS had still to be authorized by the host country; second, the banks remained subjected to the supervision of the host country and restricted in the range of permitted activities; third, the branches would have to be provided with "endowment capital", as if they were new banks[22]. Because the MS proved reluctant to authorize the establishment of branches of foreign banks and because, except UK, all MS required branches to maintain capital endowment, the result was a low incentive from the banks to establish branches in other MS and the keeping of almost a *status quo* level of cross-border business in capital markets[23]. This directive, however, was built more as a cornerstone for the identification of the other steps, which would lead to more cooperation, rather than a final structure[24].

2. The Second Banking Directive (SBD)

Following the implementation of the FBD, the Commission, with the support of UK and the Netherlands, who were in favor of capital market liberalization, made several efforts to open the capital markets[25]. The central strategy pursued by the Commission for opening the capital markets in the EU was the using of the principle of mutual recognition – a principle based on an ECJ decision on the case of "Cassis de Dijon", which was then elaborated by the Commission to be used in the case of capital markets[26]. The full application of this principle found its way in the 1985 White Paper and in the 1989 Second Banking Directive (SBD), which moved forward the process of opening the capital markets within the EU[27]. The attempts to create an internal financial market through harmonization of legislations of the MS had proven to be ineffective, as the MS had in place different rules that institutionalized their relations with their banks which they proved reluctant to abandon[28]. Thus, the new system of

[19] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997.* (p. 15)
[20] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.136)*
[21] Ibid. *(p.136)*
[22] M. Gruson & W. Nikowitz – The second banking directive of the EEC and its importance for non-EEC banks, 1988 (p. 210).
[23] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997.* (p. 15)
[24] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.137)*
[25] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (p. 15)*
[26] Ibid. *(p. 15, 16)*
[27] Ibid. (p. 16, 17)
[28] P. Hall – *Governing the Economy – the politics of state intervention in Britain and France. 1986., et al.*

cooperation under the SBD, as part of the program for the completion of internal market services, was based on minimum legal harmonization and mutual recognition – whereby the MS recognized each other's legislations as equivalent of their own, and thus allowed the branches of the banks which were given licenses of operation in their home countries the freedom to set up shop in host countries[29 30]. The SBD confirmed two principles which were previously subject to debate in the EC: one was the unconditional, free movement of capital; and the second, that of non-discrimination on basis of nationality – which was positive for the non European banks as well[31 32]. The SBD fully switched to home country control, which was made possible by the principle of mutual recognition and single licensing. Here it is important to shortly elaborate on the rationale for the home country control principle which made up the one of the core elements of the SBD. As already said above, the harmonization of rules for banking operations in the EC were proving impossible as the financially advanced MS had adopted different rules through time and had different institutional set ups which made these rules work. However, in light of the need for an increased interaction of the MS's financial markets for economic development, having rules at place for the operation of banks was essential. The three basic reasons for building a regulatory regime for banks are: consumer protection (the most basic reason), the role and impact of banks in money supply, and the avoidance of contagion problems[33 34]. In absence of a supranational institution that would regulate all banking operations with standard rules and that would act as lender-of-last-resort for banks in financial trouble, the solution was the adoption of home country control principle - because the home country is the only set of bodies which could make possible the enforcement of the rules and could rescue its banks[35]. Through this practice, it was sought to cover also the concerns that were related to *public security* issues[36], which provided legitimate reasons to the MS to have different practices and to draw boundaries to cross-border operations of banks, especially the retail banks[37]. The Commission had thought that in this way the practices of the countries would slowly go toward more convergence, and integration of the financial markets would be achieved from the bottom-up rather than from the top-down dimension[38]. The implementation of the SBD led to a higher degree of certainty for banking operations throughout the Community by providing the list of banking

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[29] M. Gruson & W. Nikowitz – The second banking directive of the EEC and its importance for non-EEC banks, 1988 (p. 210)
[30] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (253)*
[31] Ibid. *(253)*
[32] M. Gruson & W. Nikowitz – The second banking directive of the EEC and its importance for non-EEC banks, 1988 (p. 210)
[33] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994, (p.17)*
[34] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the case of Banking Regulation*. 2004, (p. 312)
[35] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994,* (p. 15-17)
[36] Ibid. *(p.15-16)*
[37] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (p. 253)*
[38] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994, (p.15)*

activities that were allowed and also liberalized capital movement by including a broad range of transactions in securities[39]. However, the SBD was still far from eliminating the important barriers that emanated from the different realities of the MS. Thus, under the SBD the states reserved the right to suspend the activity of a foreign financial institution if it was found not to comply with their legal provisions[40]. Also, due to the German concerns for controlling its monetary policy and its determination to maintain a firewall between domestic monetary base and short-term capital flows, the Central Bank Governors opined that for legitimate reasons of monetary regulation, limitation of access to the national market should be allowed to be maintained by the MS[41]. This means that the Community law could not take precedence over the national interest when they were at stake.

Different from the retail banking, financial services, which include the trading of securities and company operations through the stock markets, had lagged behind as they had proved to be the least amenable to legislative activity[42] [43]. In 1989, the *fifth listing company directive* was implemented, in which the principle of mutual recognition was extended to security markets[44]. This directive, implemented on the course of a battle between the differing opinions on capital adequacy of investment firms, would serve as the basis for the building of a new EU regulatory regime for financial services, which took due attention only at the end of the 1990s[45]. The difficulties to go forward in this area of capital markets meant that the level of mistrust was high and competition prevailed over cooperation. Taxes differed and ideas of the MS about the role of capital markets were often far different from each other[46].

3. The Lamfalussy process

By the end of the '90s, the liberalization of capital markets and the programs of the Single Market and Economic and Monetary Union (EMU) increased the interpenetration of financial markets and cross-border financial flows[47]. At this time the completion of a single market in financial services, which was fragmented and was marked by a relatively low level of cross-border activity, was seen as crucial for economic development and job creation in the EU[48]. For the reason of building a single

[39] M. Gruson & W. Nikowitz – The second banking directive of the EEC and its importance for non-EEC banks, 1988 (p. 215-216)
[40] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997*. (253)
[41] Ibid. (256)
[42] Ibid. *(p. 25)*
[43] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007* (p. 269)
[44] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010. (p. 160 - 161)*
[45] Ibid. *(p. 161)*
[46] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (p. 25)*
[47] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU*. 2007 (p. 279)
[48] European Commission – Commission decision of *establishing the Committee of European Securities Regulators* [draft].*2001*

financial services market in the EU, in 1999 the Commission issued the Financial Services Action Plan (FSAP)[49]. The Lisbon European Council of 2000 welcomed this action plan as part of the broader goal to make Europe the most competitive country in the world, which was set in that Council[50]. A Committee of Wise Men was set up by ECOFIN Council in 2000 with the mandate to:

- "assess the current conditions for the implementation of the regulation of securities markets in the European Union;

- assess how the mechanism for regulating securities markets in the European Union can best respond to developments underway on those markets; and

- in order to eliminate barriers and obstacles, to propose scenarios for adapting current practices in order to ensure greater convergence and cooperation in day-to-day implementation and take into account new developments on securities markets"[51].

It was clearly established that the Committee would not deal with prudential supervision matters, which had to stay with the MS[52]. The working method of the Committee was to gather opinions from a large variety of policy actors in an open way, among which: the European Parliament (EP), the MS, the regulatory authorities of the MS and the participants of the financial industry itself[53]. After the consultations with the interest groups, the approved report, which came to be called the Lamfalussy process (the name of the leading appointee for building the report), contains a four-level regulatory framework, the first two levels dealing with legislation and technical standards, while the last two levels with their implementation in cooperation and supervision[54]. More concretely the multilevel framework looked like this:

Level 1 - consisted of directives or regulations. The Commission would make proposals on the implementing measures after consulting *level 2*, where the implementing measures were decided, and then would present these measures to the Council and the EP, who would adopt them under the co-decision procedure.

Level 2 – technical implementing measures adopted by the Council, where there would be laid down the procedures for the exercise of implementing powers conferred to the Commission;

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[49] European Commission – Commission decision of *establishing the Committee of European Securities Regulators* [draft].*2001*
[50] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU.* 2007 (p. 276)
[51] European Commission – Commission decision of *establishing the Committee of European Securities Regulators* [draft].*2001*
[52] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU.* 2007 (p. 277)
[53] Ibid. (p. 277)
[54] European Commission – Commission decision of *establishing the Committee of European Securities Regulators* [draft].*2001*

Level 3 – the key objective of level 3 committee was to ensure consistent and timely implementation of *level 1* and *2* acts by enhanced networking and cooperation between EU securities regulators through the newly formed Committee of European Securities Regulators;

Level 4 – Commission and the MS should strengthen the enforcement of Community law[55].

The so called Lamfalussy report was adopted by the yearly Council of 2001 in Stockholm, but it triggered strong debates on the issue of the regulation and supervision of the financial system as a whole. In 2002, following the proposal of the German Minister of Finances and the British prime-minister, the ECOFIN Council decided to extend the newly built regulatory framework also to banking and insurance[56]. The ECB initially opposed the extension of the Lamfalussy process especially to banking, but once the proposal had gained momentum, the ECB engaged in rearguard action calling for its inclusion and the inclusion of national central banks in the regulatory committees[57]. The new framework which now included banks and insurance was set in place during the following years and established in 2005[58] [59].

The FSAP marks a very important reformation as it represented a change in EU strategy away from negative integration of markets (i.e. mutual recognition of the different legislations) towards common measures, but also in the sense of the increased involvement of the EU institution in the regulation of financial markets[60]. It sought to develop a deep, liquid capital market in the wholesale (bank-to-bank trade of securities) and retail (loans and other traditional banking operations) sectors, keeping, nevertheless, a high level of confidence in the quality and supervision of company information[61]. Between 1999 and 2005, EU policy on the regulation and supervision of financial services moved on from a rather minimal set of rules and thin institutional arrangements to a more developed and institutionalized framework. The new EU policy framework was based on a complex multilevel system of EU rule-making and enhanced cooperation between national supervisory authorities represented in newly created EU committees, such as the Securities Committees, set up in 2001, and in the already existing but reformed Banking Advisory Committee (dating in 1977) and the Insurance

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[55] European Commission – Commission decision of *establishing the Committee of European Securities Regulators* [draft].*2001*
[56] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU.* 2007 (p. 278)
[57] Ibid. (p. 278)
[58] Ibid. (p. 278)
[59] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010, (p.5)*
[60] L. Quaglia – *Completing the single market in financial services: the politics of competing advocacy coalitions*. 2010 (p.1007) [my brackets in the sentence]
[61] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010. (p. 195).* [my brackets in the sentence]

Committee (dating in 1992). The functional division between banking, securities and insurance was maintained[62].

However, the Lamfalussy process was deficient in several aspects: one is company regulation, the other is regulatory complexity, and not less important the non-binding nature of cooperation[63]. As far as company regulation is concerned, the four-level regulatory framework failed to build an EU regime for the regulation of firms operating in the Single Market. The multiplicity of rules to be abided by the companies and their multilevel supervision by national and host supervisors led to a very complex system of reporting between supervised entities and home and host supervisors[64]. In cases of transnational companies' affiliates (subsidiaries) incorporated in a host country, they had to be subjected to the legislation of that country, while if they established merely a branch in a host country, in theory they would fall under the supervision of their home country - but, again, especially in cases of investments, the host countries had their word to say[65]. This meant that this framework of cooperation did not really solve the problem of fragmentation in supervision, the efficiency of which was to be tested shortly after by the financial crisis. Also, the lack of a European private (contract) law and the legal divergences between the states in consumer protection matters constituted a barrier to further banking integration[66]. It means that the firms operating in the Single Market would need to apply for and acquire different operation contracts in different MS, which in turn makes it impossible the use of the same business model for the entire Single Market[67]. Mandatory rules are found either in contract law itself or in a variety of other laws applying to international transactions - like consumer law, bankruptcy law, securities law, corporate law[68]. As far as consumer protection is concerned, it goes hand in hand with the lack of a European contract law as "diverging national consumer protection rules hamper the provision of pan-EU retail banking products and thus hinder the exploitation of potential economies of scale on a cross-border basis"[69]. EU legislation on consumer protection is limited, and the firms have to comply with different consumer protection rules (of the different MS) deriving from the so called

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[62] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007* (p. 272)
[63] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010, (p.6), et al.*
[64] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010. (p.6)*
[65] Ibid. *(p.6)*
[66] C. Walkner & J. P. Raes – *Integration and consolidation in EU banking – an unfinished business. 2005.* (p. 33) [my brackets in the sentence]
[67] Ibid. (p. 33-34)
[68] Ibid. (p. 33)
[69] Ibid. (p. 34)

"general good" concept[70]. "The diversity and uneven level of consumer protection legislation – rather than consumer protection as such - acts therefore as a brake on cross-border banking consolidation"[71].

And to conclude with, it is important to point out that the Lamfalussy system had merely advisory functions on technical issues and didn't include issues of prudential supervision[72]. The implementation of the laws and the supervision was still to be carried out by the different governments, who didn't face any responsive mechanisms in case of non-compliance or non-action[73]. This is considered as the biggest flaw of the Lamfalussy regulatory structure.

The developments of the beginning of the new millennium account for a stronger convergence of the wholesale financial services than retail banking. Cross-border retail banking operations, for which it is needed the establishment of branches in host countries, is embroiled in the more complex realm of company law, where the normative values which construct it, are often very different in different MS. This is reflected also in the cross-border banking consolidation (mergers & acquisitions) level – the picture of wholesale bank consolidation is rather mixed, while there is little evidence of consolidation at the retail level[74]. The argument for the less successful achievements in the integration of retail banking are most importantly linked to the difficulty of changing the normative values embedded in the rules governing them. The principle of home country control, which continued to dominate the regulation of financial institutions in the EU, coupled with the keeping of the functional difference between the retail and wholesale financial services accounts for no more than a fragmented regulatory regime that would prove its ineffectiveness with the coming of the economic and financial crisis of 2008 in Europe.

This was a fairly detailed description of the most important steps that have been taken in the direction of banking integration at the EU level until 2005. Apart from the informative function, the empirical observations on the events through years in banking in the EU will serve as a background for the further analysis through the selected theories and approaches which will be operationalized in the following chapter.

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[70] C. Walkner & J. P. Raes – *Integration and consolidation in EU banking – an unfinished business. 2005.* (p. 34)
[71] Ibid. (p. 35)
[72] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010.* (p.7)
[73] Ibid. (p.6-8)
[74] C. Walkner & J. P. Raes – *Integration and consolidation in EU banking – an unfinished business. 2005.* (p. 18)

III. HOW HAS BANKING INTEGRATION BEEN ACHIEVED IN THE EU?

As it is enunciated already in the introduction, this chapter will be about the explanation of the process of regulation of financial markets and institutions in the EU. The explanation offered here will be guided first by theories of European integration, hence a top-down perspective, and lastly by established approaches employed for the explanation of the process from a bottom-up perspective. In both cases, the empirical observations of the process will be used to provide the theories with background information for their explanations. By having a theoretically rich and empirically grounded explanation of the policy reforms, the research will be able to offer a good explanation of the "how" of the integration process.

1. The Relations Between the Member States and the Union Explained through *Neofunctionalism* and *Liberal-Intergovernmentalism*.

The first part of this chapter is about the explanation of the reforms viewed from the aspect of the relations between the MS and the Union, for which the dichotomy of theories of European integration, neofunctionalism and liberal intergovernmentalism, is employed. Here the relations between the states and the Union are discussed as relations between two blocks: the block of EU institutions or other supranational bodies seeking to increase as much as possible their role in policy-formation and policy-administration, and the block of the MS trying to resist these attempts by seeking to maintain their role as primary policy makers and administrators by delegating as little responsibilities as possible to the supranational bodies. In the following section there will be provided the assumptions of each of the "grand" theories, and will also be made a comparison and contrast between them. Done that, the theories' assumptions will then be employed to interpret the empirics of banking policy evolution in the EU. Finally, this will allow the research to draw conclusions about which of the theories can explain best the process of banking integration. Adopting the dichotomy of the so called "grand" theories of European integration, which represent two of the most prominent and opposing forces, both active in the EU albeit to different degrees for different cases, the research has the capacity to cover sufficiently the range of views of the way integration is achieved at the EU level.

a. The assumptions of neofunctionalism and liberal-intergovernmentalism

• *Neofunctionalism*

Since its inception, neofunctionalism regarded itself as a "grand" or general theory applicable to all the cases and at every time[75]. Integration is regarded as a process and cannot be understood as an outcome of isolated events (such as treaty negotiations) like intergovernmentalists assume. In this sense integration processes evolve over time and take on their own dynamic[76]. This theory is pluralist in nature, as it does not regard the states as being unified but as realms made up of actors, who have the capacity to form their preferences through learning and who can interact and build coalitions across the national frontiers and, thus, achieve more integration. Implied to this is that the governments of the states are not the only relevant actors in the process of integration. As Sandholtz and Stone Sweet argue, the non-state actors involved in transnational exchange are those who fundamentally drive integration - this is due to their direct involvement in providing transnational exchange, their ability to be organized in supranational organizations and to exert pressure directly at EU level for lowering the barriers and, thus, achieve more integration[77]. The rationale behind this movement is that these interests need European standards, rules and dispute resolution in order to run their businesses successfully. This assumption is supported and further developed for the case of financial markets by other scholars, such as Mügge (2004), who argues that because the private actors operating at the international level are now more numerous, important and powerful than the domestic operators, the states have eventually conformed to their preferences – here emphasizing that harmonization of rules in banking industry is made possible fundamentally by the pressures exerted by the transnational groups and their organized lobbying directly to the EU institutions[78]. What is implied here among others, but which is explicit in the neofunctionalists' assumptions, is that the supranational institutions are bodies which have acquired enough authority in policy-making, as they can effectively translate such preferences of the actors into policy. This drives the transnational actors to often prefer lobbying the institutions at EU level rather than those at the national level. Moreover, neofunctionalists assume that once created, the supranational institutions progressively escape the control of their creators by simultaneously being more influential in the integration processes and increasing their own powers[79]. According to them, this is explained by the increased number of EU legislation and the involvement of non-state actors in the making of these legislations. And lastly, among the central assumptions of this theory is the "spill-over" or path-dependency effect, which means that each step taken towards more integration creates the need and leads to other steps which continuously tie the nations more closely

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[75] A. Wiener & T. Diez – *European Integration Theory*. 2009. (p. 47-48)
[76] Ibid. (p. 47-48)
[77] Sandholtz & Stone Sweet – *European Integration and Supranational Governance,* 1997
[78] D. Mügge – *Financial Liberalization and the European integration of Financial Market Governance*, 2004
[79] A. Wiener & T. Diez – *European Integration Theory*. 2009. (p. 47-48)

together[80]. As far as the level of transnational exchange is concerned in the case at issue, it is assumed that the current increased levels of transnational exchanges have come as a result of previous steps that have been taken in liberalizing international transactions[81]. From the institutional point of view, the spill-over effect of policy evolution means that the supranational (EU) institutions gained always more importance due to the increased activity at the international level, and, thus, the need for more rule-making and control at the supranational level. All this, the neo-functionalists argue, came to a great degree as a result of unintended consequences – more liberalization meant more interdependence, which itself brought the need for building and clarifying international rules, that in turn were accompanied with the strengthening of supranational institutions[82] [83]. Eventually, it is assumed, the states have lost much of the power they used to have in the past due to the increased interdependence and the rise of supranational actors who control the increased international activities[84].

• *Liberal Intergovernmentalism (LI)*

Like neo-functionalism, LI is part of the group of "grand" theories, which seek to explain the broad evolution of regional integration. In one of its most basic assumptions about how international politics is conducted, LI argues that the real influencing actors in the processes of international agreements are the states [85]. The EU, like the other international institutions, can be profitably studied by treating states as the critical actors in a context of anarchy – meaning that states achieve their goals through intergovernmental negotiation and bargaining, rather than through a supranational authority making and enforcing political decisions[86]. As Moravscik puts it, "the European Community is best seen as an international regime for policy coordination, the substantive and institutional development of which may be explained through the sequential analysis of national preference formation and intergovernmental strategic interaction"[87]. Thus, LI has two main components: a liberal component of national preference formation by social groups and an intergovernmental component of interstate bargaining, where the larger and economically powerful states often lead the processes. This makes sense calling into attention the importance of the Council of Ministers in the EU legislation and the

[80] A. Wiener & T. Diez – *European Integration Theory*. 2009. (p. 49-50)
[81] D. Mügge – *Financial Liberalization and the European integration of Financial Market Governance*. 2004
[82] Sandholtz & Stone Sweet – *European Integration and Supranational Governance*. 1997
[83] A. Wiener & T. Diez – *European Integration Theory*. 2009. (p. 49-50)
[84] Sandholtz & Stone Sweet – *European Integration and Supranational Governance*. 1997
[85] A. Wiener & T. Diez – *European Integration Theory*. 2009. (p. 68)
[86] Ibid. (p. 68)
[87] A. Moravcsik – *Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach*. 1993 (p 480)

prominent role of the larger and powerful countries there, the summits of the leaders of states to discuss about problems and solutions, as well as their sometimes strong oppositions for certain policies which may not converge to their national preferences. This is linked to a fundamental assumption of this theory, which regards states as rational actors, which, after having calculated the profitability of different courses of action, choose the one which maximizes (or satisfies) their profits[88]. The interests of the states are defined at their domestic level, where various societal actors (interest groups) "struggle" between each other and with the government to advance their own preferences[89]. After the preferences of the groups are articulated, the governments' task is to aggregate and channel them into their intergovernmental bargains[90]. From this assumption it can be protracted that the clashes between the states may have the source from the differing interests within the domestic realities, which the representatives of the states strive to protect in international bargains. The liberal focus on domestic interests and state-society relations is consistent with the motivations for governments to support or oppose European integration[91] - in view of the increased importance of transnational societal actors, it can be argued through this theory, the states have decided to liberalize more in pursue of their interests. Agreement to establish international institutions and cooperate through them is explained to be the result of a collective outcome of interdependent rational state choices and intergovernmental negotiations[92]. This means that EU institutions are there to fulfill the task of providing coordinative means for the MS, who do not give up from their role as masters and from their primacy in policy-making. In practical terms, this can be explained by the observation that the supranational institutions, such as the Commission, have to get the green light from the MS in furthering a policy and by the heavy involvement of the MS in discussing the terms of the policies to be later incorporated in the EU structures. Summarizing, decisions to cooperate internationally can be explained in a three stage framework: first, states define their national preferences; second, states get involved into substantive bargains; and third, states create or adjust institutions to actualize those bargains in the face of future uncertainty[93].

• *Neofunctionalism vs Liberal-intergovernmentalism: main points of contest.*

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[88] A. Wiener & T. Diez – *European Integration Theory*. 2009. (p. 68)
[89] A. Moravcsik – *Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach*. 1993 (p 481-483)
[90] Ibid. (p 481-483)
[91] Ibid. (p 484)
[92] A. Wiener & T. Diez – *European Integration Theory*. 2009. (p. 68-71)
[93] Ibid (p. 69-73)

These two theories of European integration constitute the primary theoretical divide in EU studies. In their explanations of European integration, they are divided in many important points, if they converge at any point at all. The interesting fact about these two theories is that although they assert opposite assumptions, they still are both prominent in the study of European integration processes. The scholars who champion either one or the other depart from a very different fundamental assumption. Neofunctionalists maintain that the state is continuously being eroded due to increased interdependence, and non-governmental actors and supranational institutions continuously gain primacy in policy-making over the states. Continuing this logic, it can be said that the outcomes of the process reflect the preferences of the supranational actors over the preferences of the states. On the other hand the Li scholars, although attributing a great importance to non-governmental actors at the domestic level and accepting the increased interdependence, maintain that international politics is driven exclusively by the states, and the outcomes of their bargaining should be in conformity to the aggregate domestic interests of the states, especially the larger ones. Another point of strong debate between this dichotomy of theories is the way the process of integration evolves: neofunctionalists are famous in stating their assumption that integration advances uninterrupted and as a result of a "spill-over" within the same policy area as well as from one policy area to another. The idea of unintended consequences and the increased independence of supranational actors, stresses the always more loosened control of the states on the process. The Li scholars contest this view by saying that states are in control of the integration processes, as intergovernmental bargaining is central to these processes and determinant for the degree of further advancement. Here, several important contesting elements can be extracted from this theoretical debate and further concentrated: the first contesting point is about the centrality of either the supranational actors or the states in the processes of integration; the second point, which is connected to the first, is about the division of the opinions between the theories on the outcomes of the process, favoring either the supranational actors or the states; and the third point, which is also attached to the others, is about a contest of the views on the control of the process of integration, with the neofunctionalists stressing the development of integration as a result of path-dependency, and the opposing camp maintaining that states are in control of the process and they choose to delegate to supranational institutions for coordination purposes.

Given that both of these views are prominent in the European integration studies, it may mean that both have their strengths and weaknesses in explaining such processes. It is in the scope of this paper, primarily in pursue of giving an answer to its main question, to define which of these views has stronger explanatory powers for the case of banking integration in the EU. The following section will employ the main assumptions of the dichotomy of theories discussed here to interpret the policy evolution in financial markets in Europe and then draw its conclusions.

b. Explaining policy evolution through neofunctionalism and liberal-intergovernmentalism

The First Banking Directive

In the case of the FBD it can be argued that the Commission has had a large part of the credit for its creation and implementation. The Commission insisted on the adoption of the home control principle as the core element of the directive, which subsequently was maintained, leaving space to arguments for preference reflection of this supranational institution. However, considering the aim of the Commission to create more integration in the banking area and to liberalize the movement of capital, what in fact happened was far from that. These efforts were undermined by the reluctance of the states to provide cross-border services. This argument can be made by the observation that branch establishment in a host country required prior authorization by the MS, but also from the practical actions of the states, which were reluctant to give such authorization[94]. The activity of the EU institutions – the most prominent at the time being the Commission and the ECJ - was focused mostly at the agenda-setting rather than the decision-making stage of the process. The FBD was adopted eight years after the establishment by the Commission of an ad hoc working party made up of national bank supervisors, whose task was to eliminate the legislative and administrative disparities of banking operations and to harmonize the control systems which they were subject to[95]. Later, this group of national regulators was transformed into an important informal club and had a crucial role in shaping EC banking legislation. In 1972, the same group adopted the principle of home country control for the purpose of establishing a comprehensive EC law and with the reasoning that supervision of a bank should be conducted by the authority which is willing to bail out that institution in times of trouble[96]. With the adoption of the FBD, a Banking Advisory Committee was created – it was made up of national regulators, which would specify the terms for a durable framework that would lead to a further financial integration. "In the absence of a supranational community, the development of a single market has been left to a process of multilateral bargaining", the policy outcomes of which "must be acceptable not only to the member states involved in the negotiations, but also to domestic polities…"[97]. Furthermore,

[94] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (p. 14)*
[95] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.132-133)*
[96] Ibid. *(p.134)*
[97] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.134)*

different MS, like Italy and France, but also Belgium, which was far more liberal than the first, were opposed to “too much integration”[98]. Especially Italy and France used the “general economic reasons” to prevent the establishment of foreign banks[99]. Observing the process and outcomes of the FBD, it can be said that it was highly characterized by intergovernmental bargaining and greatly conformed the preferences of the MS, who retained the right to restrict free establishment of foreign banks and limit the scope of foreign banks activities by including these rights to put restrictions in the FBD. Nevertheless, the actions of the Commission did not prove completely futile – through its more modest proposal to minimal harmonization it removed some rust from the gears of integration, and through its continuous work to open capital markets it caused EC banks to take a greater interest to grow international[100]. This would make transnational banks always more important in pushing for more integration.

The Second Banking Directive

The Second Banking Directive (SBD) is a big step forward regarding the freedom of capital movement throughout the Community. This was made possible due to the incorporation of the principle of mutual recognition in the SBD - a principle which had been produced by the ECJ in one of its rulings and adopted by the Commission to the case of financial integration. The Commission had a very important role in the agenda-setting process and in setting the terms for the SBD, and it can be said that its preference was reflected to a great degree with the adoption of the mutual recognition principle. This directive led to an increased level of capital transactions throughout the Community space, which had also been the aim of the Commission. The implementation of this directive can account for an increased level of the Commission’s preference reflection in further liberalizing capital movement. However, in order for this analysis to be complete, there must be considered some other very important observations. Here it is useful to introduce the setting around which the policy was developed. The SBD was embedded within the framework of the SEA, meaning that it was already expected a greater integration of financial markets[101]. The Commission was advancing in completing the SEA program mainly because of two reasons: it tried to avoid overregulation as much as possible, advancing with the building of the single market structure based on the principle of mutual recognition, and even more importantly, the process was supported by the major players – Britain, France and Germany – which

[98] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.135)*
[99] Ibid. *(p.135)*
[100] Ibid. *(p.135-136)*
[101] Ibid. *(p.142)*

were all committed to the liberalization of the European marketplace[102]. Also interesting to us here is to point out that the brief reference of the SEA to the "progressive realization of economic and monetary union" in 1985 came as a result of an agreement between Chancellor Kohl and President Miterrand, in which France would liberalize foreign-exchange controls if Germany would renew its recognition of monetary union as a goal[103]. On different tables, both Chancellor Kohl and Prime Minister Thatcher considered liberalization as a precondition to progress on the internal market[104]. However, consensus was not so easy to reach over the details of the SBD. Among the most controversial matters was the scope of the directive – to which institutions would it apply and how? Given that different MS had different financial structures, the way toward an agreement for a comprehensive EC regulation was deemed to be marked by battles. More concretely, Britain had (has) a *capital market* system in which equity capital is the main source of financing, while Germany, by contrast, had (continues to have to a great degree) a *bank-based* system in which the universal (multi-function) banks dominate capital markets[105]. None of these MS were willing to give up their particular systems, and in general all the MS wanted to retain their discretionary powers on their institutions. The SBD, which referred to the liberalization of credit institutions, introduced separate definitions for the different types of institutions (mostly part of the German and French systems) and financial institutions (mostly British). This was a very important step for the application of the principle of mutual recognition, which was based on an agreed list of activities that these institutions were allowed to do. By putting forward a list of activities, the Commission and the MS who were in favor of stricter rules, sought to avoid a race to the bottom in banking regulation in the different MS. What is interesting to point out here is that in its definitions, the SBD excluded central banks, postal savings banks and state and mortgage banks in Germany, as well as Crédit Foncier and Crédit National (powerful industry creditors) in France, thus leaving outside of the scope of the directive whole swathes of German and French financial system[106]. Furthermore, the home-country control principle underwent important modifications due to prudential supervision issues invoked by the MS[107]. The primary capital requirement for banks setting branches in other MS was abolished in the SBD because it created disincentives for banks to set up branches in other MS, as noticed from the time of the FBD. However, MS powers to restrict the establishment of foreign branches was preserved due to their right to invoke the *general interest clause*, which allowed the MS to close the

[102] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.140)*
[103] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (p. 17)*
[104] Ibid. *(p. 17)*
[105] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.150)*
[106] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (p.259-260)*
[107] Ibid. *(p.260-261)*

credit institution's operations if these were seen as running contrary to the general interest of the country[108]. The inclusion of this clause was especially a concern of Germany. Capital adequacy for financial institutions operating in security trading proved more difficult to be agreed on by the MS than the other directives on banking, and this was a result of the very different philosophies inherent in the countries like Germany, which required higher capital levels for the financial firms, and Britain, who took a light-handed approach to regulation and required less capital in order to favor competition[109]. The capital adequacy issue turned to be largely about power and reflected the differing financial structures of the MS. In 1992, the Commission finally adopted a compromise set of investment services and capital adequacy directives in which Germany got what it wanted regarding the capital requirement standard, and Britain won a victory with an expanded definition of capital[110]. All these events tell us that the process of liberalizing the capital markets embedded in the SEA was again heavily marked by intergovernmental negotiations and bargaining, and the outcomes mostly conformed with the larger MS. The Commission's task, apart from that of the observer, was mainly to materialize the MS's agreements into legislation, while the implementation of the directives was left to the MS. This means that Community law and the institutions representing it could not take precedence over the national interests.

The Financial Services Action Plan (FSAP) and the Lamfalussy process

As it was just shown above, the financial services remained far from complete, despite the overall success in completing the 1992 Single Market program. Nevertheless, at the time when the FSAP was launched the capital markets had become more European, the transnational exchange had increased very considerably and the aim to increase the competitiveness power vis-à-vis the international competitors (now chiefly US) continued to occupy a central place in the EU agenda. At the outset of the explanation, it must be said that just like in the case of the SEA, by the end of the 1990s and beginning of 2000s there was already basic agreement between the MS on the need to advance with the regulation of financial markets by moving towards EU regulation and supervision[111]. However, the directives on the financial services negotiated throughout the beginning of the new millennium proved once more to be very controversial[112]. As for the cases above, for the process of financial

[108] J. Story & I. Walter – *Political Economy of Financial Integration in Europe – the battle of the systems. 1997 (260-261)*
[109] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.149-150)*
[110] Ibid. *(p.151)*
[111] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007* (p. 283)
[112] L. Quaglia – *Completing the single market in financial services: the politics of competing advocacy coalitions*. 2010 (p.1007)

markets integration of the new millennium will be provided an interpretation, first as seen through the lens of the neofunctionalists and then through those of LI scholars.

The adoption of the FSAP marks a new chapter in the history of the EU. The Commission had presented such a plan to the MS since 1995[113], but its adoption was made possible only four years later when the Council gave the green light. The Commission, as the initiator of this process, had a very active role in the agenda setting phase. By this time, other supranational institutions had been established (the European Central Bank) and existing ones had acquired new powers (the European Parliament). These institutions turned to be active in this process. Starting with the Commission, it can be said that it managed to reflect its preferences on the outcome of the policy by giving a boost to the FSAP[114]. Also, the Commission managed to get involved in the implementation stage due to its tasks at *level 1* for making proposals on the implementing measures after consulting *level 2*, and implementing powers of the technical measures granted by the Council. The Committee of Wise Men, in spite of lacking the status of an agency, can be well considered a supranational actor which contributed to further integration beyond the direct control of the MS. "It … deliberately and strategically elicited the input of a vast array of nongovernmental actors, including first and foremost financial companies and independent experts"[115]. The thesis of the direct involvement of the supranational actors, and more specifically for the case of banking the transnational financial companies, has a central position in the neofunctionalists' claims. The participation of the private interests in the Lamfalussy process seems to strongly support the claims of the neofunctionalists. Overall, the Lamfalussy process was fundamentally about the liberalization of financial markets, which affected the big transnational financial operators. As far as the European Parliament (EP) is concerned, it had acquired new powers by this time. The co-decision procedure with the Council had given the EP the capacity to influence the process. The EP's preference to limit Commission's mandate for the adoption of technical rules to four years was taken into account, although not entirely accommodated as its initially proposed "call back clause" was not adopted[116]. And finally turning to the role of the European Central Bank (ECB), it must be said that although it was an active participant in the process, its preferences were not taken into account in the final plan[117]. This is because the ECB wanted to take a primary role by involving itself and the National Central Banks on the prudential aspect of the plan by creating a single European banking regulator – this

[113] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.*
[114] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007* (p. 281)
[115] Ibid. (p. 280) quoting The Committee of Wise Men 2000
[116] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007* (p. 281)
[117] Ibid. (p. 281)

was not granted to the ECB as finally was adopted the system of multiple committees, which was already proposed, and the prudential aspects continued to stay with the MS. However, the ECB could secure its participation in the relevant committees.

By introducing the FSAP in 1999, the Commission was the main actor in the process of the agenda-setting, while the MS had a minimal role. However, in the process of decision-making the MS, who took decisions through ECOFIN Council, were the main actors[118]. To start with, it was the Council that approved the action plan of the Commission, while the final version of the report of the Committee of Wise Men was approved by ECOFIN Council, where the national finance ministers seat. The newly established four-level framework involved several supranational institutions in the regulation and implementation of the legislation for the financial markets. However, as described in the respective section, the Council was to approve the implementing measures at level 2, while at level 1 it would adopt the legislation in co-decision with the EP. The role of the EP as a co-decider in the process of legislation accounts for an advancement of Europeanization, however, here it should be emphasized that the ultimate implementation responsibilities of the legislation adopted at EU level belonged to the MS. The commitology structure built for the regulation of financial services can be interpreted by the neofunctionalists as a deliberative arena which serves to increase Commission's powers, while LI theory argues that the structure was an instrument that assured MS's control over the process of regulation and supervision as well as over the Commission[119]. Next to the control of policy-making and implementation, MS, notably Germany, sought additional guarantees that the Commission would not use its newly gained powers from the commitology structure to push for legislation that is opposed by a simple majority of MS[120]. This request was followed by a commitment of the Commission not to go against the opinion of the majority, which was included in the final text of the report[121]. The FSAP was originally a plan for the regulation of financial services (i.e. securities trading) but shortly after it was extended into banking and insurance. This happened after the proposal of Britain and Germany, which eventually got the support of France in voting it in the Council[122]. This was seen as a move to prevent the expansion of ECB's competences in banking regulation[123], and is also commented as an agreement between the large countries which have the most advanced and competitive financial services and

[118] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007* (p. 282)
[119] Ibid. (p. 283)
[120] Ibid. (p. 278)
[121] Ibid. (p. 278)
[122] Ibid. (p. 283)
[123] Ibid. (p. 283)

banking sectors and which were more interested in opening the markets[124]. However, the process of legislation was again accompanied by contradictions between the MS and eventually completed through intergovernmental negotiations. As Quaglia (2010) explains, the process of building the four so called Lamfalussy directives, namely the Prospectus Directive, Market Abuse Directive, Transparency Directive and the Market in Financial Instruments Directive (MiFID), which comprised the measures for the regulation of the securities markets, was marked by a clash between two camps: the "market-making coalition", composed by mainly the northern countries and led by the British, and the "market-shaping coalition", composed by mainly the southern countries and Germany and led by France[125]. Prospectus and MiFID resulted especially contentious. The British-led coalition strived to open the markets to a greater degree and have a light-touch regulation on them, which is in conformity to the Anglo-Saxon philosophy and the actual practices in Britain, while the opposing coalition was for a stricter regulation of the financial markets, which conformed to the philosophies of these MS[126]. Although both coalitions managed to influence the outcomes, the overall result leans toward a victory of the "market-making coalition" – this to a great part because of the switch in position from Germany[127]. The outcome was a framework based mainly on an informal networking between the national regulatory authorities, leaving the markets to operate in an environment with minimal regulation at the EU level, despite the greater degree of liberalization. Finally, as far as the direct involvement and influence of the private transnational actors on the EU policy-making is concerned, different authors argue that companies involvement in the Lamfalussy process was low and without much influence[128] [129]. As Quaglia (2006) argues, the Lamfalussy process did not elicit a high degree of involvement of interest groups, as the reform was broadly about creating an institutional framework for the regulation of the financial activity at the EU level, an issue considered to be a *public good* that does not allow for much private interest interference. In such cases, the opposite is true for public authorities, who are much more interested in a process which may potentially affect their competences[130]. Moreover, Grossman (2004) argues that the private interest groups could not influence much on the process of integration due to the institutional fragmentation and uncertainty that characterizes the EU as an ever changing political environment. In face of the "threat" coming from an increased uncertainty, the private actors will be

[124] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007* (p. 283-284)
[125] L. Quaglia – *Completing the single market in financial services: the politics of competing advocacy coalitions*. 2010
[126] Ibid. 2010
[127] Ibid. 2010
[128] E. Grossman – *Bringing politics back in: rethinking the role of economic interest groups in European integration*. 2004
[129] L. Quaglia – *Setting the pace? Private financial interests and European financial market integration*. 2006
[130] Ibid. (p. 20)

organized at the national level and lobby there, thus, reinforcing the existing national structures[131]. As a matter of fact, although the international financial groups favored a further transfer of competences to the EU level, the national authorities vehemently opposed this institutional change, and the outcome of the process was a reflection of the national bureaucratic preferences[132].

• *Conclusions*

The evolution of financial markets policy seems to approve one of the main points of neofunctionalism, which says that integration is an uninterrupted process which develops as a result of path-dependency. The liberalization of the financial markets has been achieved hand in hand with other developments within and outside of the EU area, which have created the conditions and the need for the progressive steps to take place. The FBD, which itself was based on the Treaty of Rome provisions "for the right of establishment and to provide services", as well as "the right to move capital to the extent necessary to ensure the proper functioning of the common market"[133], helped in building the SBD, which confirmed more strongly some of the core principles of the first directive. At the same time, the SBD came as a consequence of the need to have more capital liberalization within the Community in order to make possible the realization of the project of the Single Market (SM) as drawn in the Single European Act of 1985. The creation of the SM and the Economic and Monetary Union (EMU) increased the interpenetration of financial markets and cross-border financial inflows, and created the opportunity for the formation of large-scale investors, which challenged the traditional practices of regulation and supervision[134]. Furthermore, the introduction of the Single Currency triggered the restructuring of the banking system and increased the transnational exchange. Taken together, they facilitated and created the need for a more integrated regulatory and supervisory framework, which was implemented in 2004. Furthermore, it is observed that the supranational institutions have gotten more involved in the process and the legislation at the EU level has increased. However, these are general observations which do not go far into details.

Considering the way the process evolved, it is observed that it was developed by and large through intergovernmental negotiations, with the actions of the supranational institutions gaining momentum only when they got support by the MS, most importantly the large ones. The outcomes of the process have largely reflected the preferences of the MS, especially the larger and economically

[131] E. Grossman – *Bringing politics back in: rethinking the role of economic interest groups in European integration*. 2004 (p. 641)
[132] L. Quaglia – *Setting the pace? Private financial interests and European financial market integration*. 2006 (p. 21)
[133] E. B. Kapstein – *Governing the Global Economy – International Finance and the State. 1994. (p.131)*
[134] L. Quaglia – *The politics of financial services regulation and supervision reform in the EU. 2007 (p. 279)*

powerful ones, who have had much more influencing power either to initiate a process or to modify it in case it went against their preferences. The empirical evidence supports this. While it is observed that there has been a continuous, incremental move towards more Europeanization, there is plenty of evidence on the other side showing that this has been in line with the preferences and needs of the MS. Hence, as it is argued here, financial services liberalization did not come as a result of the lobbying of the supranational institutions from the transnational private interests, but, to a good degree, as a result of their organization at the domestic level and the representation of their interests by the public officials.

In conclusion to this part it must be said that the crucial role of the governments in the process appears to be unquestionable. So appears to be their ability to decide "rationally" about the pace of integration based on the aggregate interests at home which they represent. In a general view, the nations with developed stock markets have supported the further opening of the markets in the EU, while the nations with weaker financial markets did not as they feared for an invasion of large foreign companies. The logic of the rational state choosing on the basis of the national aggregate interests can be continued by saying that some countries, most prominent among which Germany, on one side favored a greater degree of liberalization of stock markets trade, on the other strongly opposed the integration of the retail banking markets. The interests of the numerous domestic actors had to be watched as well as the interests of the powerful transnational actors. The result of this is a greater transnational exchange in wholesale banking, greatly conforming to the preferences of the larger and economically powerful MS, and the preservation of important barriers in cross-border retail banking operations. However, the overall conclusion of this part is not to say that the international pressures did not have any impact on the domestic policies. Indeed, it is in the scope of this work to argue that the international and the domestic politics are entangled in different ways and the final outcomes (in terms of policy and institution building) at both levels are results of cause-effects of both domestic and international politics. In the analysis above it is made well evident that the policies were coordinated at the EU level and the outcomes of the bargains were then applied to the national level. The link between these two levels will be further developed later in this work. It is for this reason that the research proceeds by considering the development of financial markets regulation at the national level. After defining the national actors as the main players in the policy field at issue over the supranational actors, several other questions need answers. The next curiosity of the research has to do with the process of preference formation at the national level and the ability of the public officials to bring change and at the same time to keep almost intact the structural relations between the state and the private actors, which is reflected in the still-existing divergences between the nations. The following section will make an attempt to provide the answers.

2. A Bottom-Up Approach to the Explanation of the Process of Banking Integration in the EU

Following the analysis of the events at the international (EU) level, in this part the research will make an attempt to go further in explaining the process of financial integration in the EU by considering the underlying factors that influence it. Drawing from the above conclusion that the MS are the main actors in the process of financial integration, this work turns to elaborate on the questions: what pushes these states to make the choices they do, and why do they display certain preferences instead of others? To guide such an elaboration, the research adopts a set of approaches[135], namely: *Historical Institutionalism* (HI), *Rational choice Institutionalism* (RI) and *Discursive Institutionalism* (DI). Different from the two "grand" theories that observe the general interactions between the MS as well as between the states and the supranational institutions, the three variables employed here focus on the domestic factors as the ones which influence policy-making at the international level, explaining the states' preferences and thus taking a bottom-up perspective. In order to make the explanation more concrete, the research goes to apply the three institutionalist approaches to two MS, namely Britain and Germany, which have been crucial actors in the policy-making for the financial markets in the EU. France, as we have already seen in the previous sections, was also a crucial player throughout all the process, but because of space constraints it will be left out from the hereto analysis. The main purpose of choosing Britain and Germany, apart from their active roles in giving shape to banking policies, is to give a concrete illustration of the differences that exist within the EU in terms of state institutions and practices, hence to explain why the process of financial markets integration has come to be very difficult. The selection of these two states has been made on the basis of their ideal-typical state actions, which are enliven by the different philosophies that are developed within their distinct structures that shape their policies, institutions and politics. These differences are widely explained by the varieties of capitalism (VoC) literature. It is not within the scope of this research to elaborate extensively on the VoC, however, for the sake of clarity here it is provided a short introduction. In the largest part of the VoC literature, there are defined two VoC: *Liberal Market Economies* (LME), represented by Britain, and

[135] Note: the three variables adopted here are considered to be neither particular theories nor specific methods, but they stand as varieties of institutionalisms – Sven Steinmo (Cambridge 2008), Kathleen Thelen (Northwestern University Illinois, 1999)

Coordinated Market Economies (CME) represented by Germany[136] [137]. However, recently has been defined another variety, which Schmidt (2009) terms *State-Influenced Market Economies* (SME), and whose main representative is France[138]. As already said, France will not be included in the analysis following in this section, but the explanation of the VoC to which it belongs is nevertheless brought here to illustrate the rich variety of economic models that exist within the EU.

- A **LME** is identified by neoliberal policies - the state takes an arm-length approach to settling conflicts between business and labor and relies on self-regulation of firms, with adjustment driven by the financial markets and led by autonomous firms acting on their own, taking comparatively little input from the state or labor[139] [140]. It falls under the category of self-regulating economy[141].
- A **CME** state is typically "enabling" as it intervenes to facilitate the activities of economic actors, often leaving the rules to be jointly administered by these actors, but taking the role of a co-equal with the unions and business in wage bargaining. Adjustment is led by firms and jointly negotiated cooperatively between business, labor, and the state[142] [143];

While in the case of a **SME**, the state is "influencing" as it tends to intervene whenever it sees it fit. Adjustment is led by firms in those domains where business exercises autonomy (such as business strategy, investment, production and wage-bargaining), and it is state-driven where neither business nor labor can exercise autonomy (such as in labor rules and pensions) or where the state sees the need to reshape the general economic environment for competitiveness reasons[144].

Both CMEs and SMEs fall under the category of stakeholder economy[145], in which the affairs of the state are conducted in an institutionalized relation between different societal groups and the government. What is important for the argument of this research is that the states which have adopted different capitalist models have different institutional relations with their financial institutions. Thus, in countries like Germany or France for a long time there has been a strong link between banks and industry, the former exerting a high degree of control on the latter due to the responsibilities of long-term

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[136] C. Crouch – *Models of Capitalism*. 2005
[137] Campbell & Pedersen – *Institutional Competitiveness in the Global Economy: Denmark, the US and the varieties of capitalism*. 2007.
[138] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009.
[139] C. Crouch – *Models of Capitalism*. 2005
[140] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p. 5)
[141] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 50)
[142] C. Crouch – *Models of Capitalism*. 2005
[143] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p. 5)
[144] Ibid. (p. 5)
[145] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 43)

financing[146]. Therefore, in this type of state-banks relationship, the state is much more interventionist even in regulatory reformations. On the other hand, in LMEs like Britain there is no such coordinated relationship between banks and industry. Instead, the state takes a hands-off stance to these relations leaving the private markets decide themselves the direction for their profits. In this environment where uninterrupted market mechanisms are emphasized, the financial actors are eager to exploit the opportunities that foreign markets promise and avoid the implications of positive coordination[147]. "State actors, in turn – no longer able to translate national savings into national investment - may want to attract foreign business and investment through the provision of a level 'playing field'"[148]. In face of these divergences, one would expect LMEs and CMEs to have different priorities in banking regulation, with LMEs giving priority to the serving of the immediate interests of the shareholders and defending minimal regulation for the financial actors (as a way to attract more foreign capital), and the CMEs protecting the ties between the banks and the other societal actors which are so important for the welfare of the public.

This short introduction of the VoC tells already a lot about the divergences that exist between the economically and politically important states in the EU and hence can explain why the policy-making process at the EU level is characterized by often harsh oppositions between the MS. However, the purpose of the following section is to bring further comprehensiveness about the divergences inherent in the VoC that exist in the EU by considering the institutional relations, the importance of the private economic interests and the ideational factors within the states that cause the forming and/or maintaining of such differences.

a. The assumptions of HI, RCI and DI.

- Historical Institutionalism (HI) – is an *institutionalist* approach that regards the state as a body of rules, hence institutions, which have been created through time and which persist, shaping political economic institutions' path dependent development[149]. Its emphasis on the institutional regularities and path dependent development means that states are bound by their institutional set-up built through time and thus are inexorable in their choices[150]. As Hall 1986 puts it, "national economic policy is influenced

[146] P. Hall – *Governing the Economy, the politics of state intervention in Britain and France. 1986* (p.235)
[147] D. Mügge – *Financial Liberalization and the European integration of Financial Market Governance*. 2004 (p. 9)
[148] Ibid. (p. 9)
[149] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009.
[150] Ibid. 2009.

most significantly, first, by what a government is *pressed* to do (what is desirable), and secondly, by what it *can* do (what is possible) in the economic sphere… This dualism reflects the fact that implementation is the obverse of the formulation of the policy. Governments are frequently prevented from adopting a policy by the absence of any means to implement it"[151]. In this sense, for historical institutionalists, organization plays the fundamental role in the life of a society - the organization of a society can tell what the actors, public and private, can or cannot do. Among the HI assumptions, the following reasons can be adduced about the crucial importance of organization. First, HI admits that policy is generally formed in response to pressures from interest groups[152]. However, the ease of articulation of these interests and the force with which they can press the policy-makers "is dependent upon the organization of the structures within which they are expressed"[153]. The claim that policy may change whenever coalitions of interest groups shift from one preference to another is not accepted by this approach, which argues that this would not be the case in face of the institutional constraints at place and the continuity of national patterns of economic policy[154]. In this sense, HI scholars would not regard the state as a billiard ball which is pushed around by competing interest groups, because these groups are themselves restricted by the institutional environment where they operate. Put into practical terms, this view can be supported up to a certain point by the observation of the specific structures that exist in the different VoC which prioritize different interest groups, and which persist to some degree. In line with this, another assumption of HI is that the very interests of the actors themselves are critically affected by the organization of the political and economic structures within which they operate[155]. This means that the interest groups existing in a state are organized in the way they do and have a certain degree of influencing power because of the institutional set-up of the country where they are located. In the cases of the German CME and French SME, the banks have[156] a privileged position because of the arrangements existent in those states which give them the opportunity to exercise a disproportionally greater influence over the affairs of industry, or in the case of the British LME the freedom of companies from the intervention of the state is translated as an influential position of these companies over the state. This institutional environment is retained to a great degree in Britain, while in the cases of

[151] P. Hall – *Governing the Economy, the politics of state intervention in Britain and France. 1986* (p.232) [my brackets in the text]
[152] Ibid. (p.232-233)
[153] Ibid. (p.233)
[154] Ibid. (p.17-18)
[155] Ibid. (p.233)
[156] note: Today the situation has changed to a great degree as both the CMEs and SMEs have increasingly switched from internal financing toward external financing.

Germany and France this is true to a lesser degree[157]. Finally, another important assumption of HI is that in order to implement an economic policy, the state relies on access to organizational resources in both the public and private sectors[158]. The specific ways of organization of these two broad groups define the degree of constraint that is put on states in their ability to secure acceptance of their policies from both the private interests and the public[159]. According to this logic, in the case of a coordinated economy and federal state like Germany, policy-making is more difficult as it has to take the consent of many actors at different levels, while in unitary states like France or Britain, the state has greater abilities to take unilateral decisions.

The HI approach, thus, puts an emphasis on the importance of institutions in the definition of the relations between the state actors. Because HI maintains that these institutions are largely inexorable due to the high costs involved for changing them, it accounts for stability of relations between the actors operating within the nation's structural organization. This is to say that neither the public actors nor the private interests can deviate much from "what they are allowed to do" within the institutional set-ups in which they relate. But, even when change occurs, HI explains it mainly by "critical junctures", with little or no change in periods of stability, or by "path-dependence", in which the process of learning allows for very little real deviation from the initially prescribed paths[160]. Up to a certain point HI may be a viable approach for the explanation of the general continuity of traditional state-society relations in the countries under study.

- <u>Rational choice Institutionalism</u> (RCI) – is the most widely used approach to explain international relations and state-society relations and adopted by liberal intergovernmentalism to stress the central place of interest groups in policy-making and institution-building[161] [162]. In one of its main assumptions, RCI maintains that the policies of the states are largely formed in response to the shift in organization of interest groups[163]. In his state-society relationship definition, Moravcsik holds that "state priorities and policies are determined by politicians at the head of the national government, who 'are embedded in domestic and transnational civil society, which decisively constrains their identities and purposes". For RCI too institutions matter as they provide the framework that makes possible the communication and

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[157] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004.
[158] P. Hall – *Governing the Economy, the politics of state intervention in Britain and France. 1986* (p.233)
[159] Ibid. (p.233)
[160] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p.3)
[161] M. A. Pollack – *Rational Choice and EU Politics*. 2007
[162] A. Moravcsik – *Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach*. 1993
[163] Ibid. 1993 1993

interaction between the societal groups[164], however this approach maintains that the institutions are shaped to serve the interests of the most powerful interest groups. As Moravcsik puts it, the state-society relation in democracies is built on the premise that interest groups articulate their interests, while the state aggregates them. The primary interest of the governments is to stay in office – for this to happen, governments need the support of a coalition of domestic voters, parties, interest groups and bureaucracies, whose views are transmitted, directly or indirectly, through domestic institutions and practices of political representation[165]. In this sense, the interest groups get involved in strategic games to further their preferences, from which those of the powerful groups who can have more impact on the position of the officials matter more, and the outcomes are reflected in the institutional set-ups which translate those preferences into actual policy. Another important assumption of RCI is that due to the increased pressures of liberalizing economic forces operating in an always more globalized setting there is always more convergence to neo-liberalism. The VoC literature sees convergence of national capitalism into two main types under the globalization pressures – LMEs, based on stock market financing, self-regulation of business and employment relationships, are expected to reinforce their own policies; while the CMEs are expected to adopt liberal policies which increase their competitiveness, but that, however, complement, not replace, the practices of these economies, in which, nevertheless, companies, employees and investors reinforce their relationships and increase shareholder power for purposes of increasing competitiveness[166].

The view of RCI implies a minimal role of the state on the background, limited to creating the institutional incentives in favor of the powerful economic groups[167] and a maximal role in international politics where it protects the domestic aggregated preferences[168]. In face of a general liberalization of financial markets in the EU, which may account for more convergence between the states in favor of big transnational companies who desire more integration, the RCI seems to have good arguments for the case at hand. However, this has to be confronted with the empirical observation.

- <u>Discursive Institutionalism</u> (DI) – developed by Vivienne Schmidt, is an approach that is part of the idea-centered approaches and which tries to combine ideas and public legitimacy. It appears to have been developed as a result of a discontent from the limitations of HI and RCI, especially from their inability to explain change. The general characteristic of the ideational approaches is that they attribute

[164] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009
[165] A. Moravcsik – *Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach*. 1993 (p. 483)
[166] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 49-50)
[167] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p.3)
[168] A. Moravcsik – *Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach*. 1993

a greater role to the state, as an entity made up by public officials, in deciding about public policies[169] [170]. In this sense, the political ideas developed by the states, can push them in different trajectories expressed in different national arrangements and public policies[171]. Central to these differences is the role of the state in governing the markets and/or the social life of a country – thus, in continental Europe we observe the existence of active states in governing the markets, providing social welfare, training and long-term planning, while in the UK or in the US this is impossible due to the ideas that states have on their own role and responsibility for intervention[172]. Very important for the study here is to emphasize the different attitudes that different states have towards the markets[173]. A strongly active state in regulating the markets develops as a response to a mistrust towards economic actors, while the opposite may be said to be true for the states who take a more friendly approach to the regulation of the markets, like for example the UK, which is well-known for its laissez faire approach to market regulation. All these elements account for the national diversities as a product of political choices made by the governments of the states through time. Turning specifically to DI, the assumption that the state has a greater degree of discretion in deciding about the political choices should be pointed out. As far as the content of ideas is concerned, DI emphasizes the ways in which the ideas of the political actors serve to (re)conceptualize interests and values and to (re)shape institutions. In DI view, the state, made up of public officials, may also develop policies or even reframe the broad political actions against the preferences of the economic interest groups by focusing on the public, "whether conceived of as consumers of the firm's products, as small shareholders whose pensions are tied up in those firms, and/or as voters who will express their views in the ballot box if they feel threatened as consumers or small shareholders"[174]. The action can be taken by the government and other public societal actors (like epistemic communities) by employing the power of ideas and by legitimating these ideas through discourse[175]. Moreover, in DI power is not related exclusively to interests as in RCI or to position as in HI, but it is more strongly connected to ideas, as the actors can gain power from their ideas as they give power to their ideas through discourse[176]. Thus, Schmidt, as the developer of this approach, believes that an intense and persuasive discourse between the policy-actors and the public officials and the voter make the adoption of new and innovative policies, which may be forced by exogenous pressures, more

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[169] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.*
[170] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009.
[171] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 53)
[172] Ibid. (p. 53)
[173] Ibid. (p. 53)
[174] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p. 10)
[175] Ibid. (p. 11)
[176] Ibid. (p. 13)

likely[177]. However, other authors falling under the idea-centered approaches think that the assumption that strong communication leads to institutional adaptation is not very accurate[178]. This is because the outside pressure for policy change may attract the attention of larger publics with competing interests, and, thus, generate a backlash[179]. This other approach within the larger family of ideational ones, calls for more caution when attributing limitless capacity for bringing innovations to the public officials, as their decisions are highly influenced by the importance of domestic interests. Thus, policy change is more restricted in areas where societal actors' interests are more intense[180]. Therefore considerable changes in company law, where a large number of societal actors like firms and individuals are affected, is much less feasible for the governments than bringing innovations in other areas, like financial markets, where the number of people affected is much lower[181]. While this view has strong argumentative power for the case at hand, adding the communicative or discursive element to the further analysis has its values due to the strong implications of discourse with ideas and, hence, with the variety of philosophies which are existent within the EU and that this work seeks to emphasize. Continuing with DI, and more specifically concerning the discourse element, which is used to convey and legitimize ideas, it defines two types of discourses: 'coordinative discourse', which is that used in the policy formation process by the groups and individuals at the center of it, and 'communicative discourse', which is used to convey the policy or idea to the public and search for legitimization from it[182]. Here is where the political institutional context matters for DI. Depending on the political institutional context, discourse tends to be either more coordinative or more communicative. In more practical terms, in compound polities like Germany, there is the need for a more elaborate coordinative discourse among the multiple policy actors, while in simple polities like the UK or France, the communicative discourse tends to be more elaborate[183]. In this view, the state institutions are considered as intervening variables rather than independent ones, because their role in providing the framework of access is considered to be minimal and what really matters is the ideas of public officials of how to respond to the exogenous pressures, and the communication between them and the electorate to legitimize policy change. In a nutshell, DI is an approach which maintains that change is something which is imposed from outside, but that the responses and policies are formed

[177] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p. 13)
[178] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 56)
[179] Ibid. (p. 56)
[180] Ibid. (p. 54)
[181] Ibid. *2010.*
[182] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p. 11-12)
[183] Ibid. (p. 13)

endogenously, i.e. within the national contexts, where the public officials have a great degree of discretion to bring about change. It is a flexible approach as it makes change the source of its explanations, and therefore it is suitable to be adopted here for the explanation of the changes in banking regulation during the last decades

• Key *differences between HI, RCI and DI*

The three approaches introduced here gave us a view of which factors should be considered as most important when discussing about policy-making at the national level. Each of them sees some variables as more important than others, and therefore their explanations stand under different lights. Even their abilities to explain certain developments within a policy field appear to be different. That is why, before confronting them to the empirical observations and assessing which approach works best to explain the policy developments in banking regulation, it is very useful to summarize and make clear the key differences between them. One of the most important differences to be pointed out here is their degree of flexibility in accounting for change: in this respect HI and RCI are static theories while DI is a very flexible one. HI assumes that because it is too costly to change the institutions that have been built through time, the national actors are bound to operate under the positions that are predefined by the old institutions. Whenever change of institutions happens though, HI explains it as an exogenous shock and dismisses any initiative from inside to bring change[184]. RCI, with its emphasis on the importance of coalitions of interest groups for policy-making, presupposes that large, new societal coalitions in support of the issue at question must emerge in order to allow change to happen. Only after the formation of these new societal coalitions can the institutions be changed, as, according to the RCI, they should reflect the preferences of the most influencing groups. Thus, due to the presupposition of fixed preferences of powerful groups expressed via stable institutions, RCI is a static theory which finds it difficult to explain change[185]. Therefore, similar to HI, it posits that change comes as a result of shocks coming from outside, being away from the actors' purview[186]. DI instead allows for change. Indeed, it makes change the main object of its study and the source of its explanations. It posits that the "thinking national actors", by which are meant the people affected directly by the vote of the public, form their ideas about how change must be brought about and then try to legitimize it through discourse. Each of these approaches, then, gives a different view of the state as a construct made up of actors with

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[184] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. 2009.
[185] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 50)
[186] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p.3-4)

differing capacities and of institutions with differing levels of rigidity. Especially when it comes to institutions, in HI and RCI view they serve primarily as constraints on actors, while DI instead regards institutions as simultaneously constraining and enabling structures for the thinking agents, who develop their ideas and conduct their discourse within those institutions, but that are able to engage in discourses which are critical of those institutions and that may result in their changing[187]. By this, the three approaches imply also different levels of ease or difficulty with which new coalitions can be formed and decisions for change can be taken. Although the three approaches share with one-another a core focus on the importance of institutions, they differ in the way they define them, in their objects and logics of explanation and in the way they deal with change[188].

After this introduction to the main approaches which are used to explain policy-making within the domestic context of the nations, thus from a bottom-up perspective, and pointing out the differences between them, it can be now proceeded with the analysis of the empirical observation of policy evolution in the banking sector of the two countries selected in this work: Britain and Germany.

b. Viewing the cases of Britain and Germany through HI, RI and DI approaches

• *Historical Institutionalism in the case of Britain and Germany*

Britain

Before all, two factors of state organization in Britain should be mentioned as especially significant: one is the strict separation between the Treasury, which is responsible for fiscal policy, and the Bank of England (BoE), the body responsible for monetary policy; second, the Treasury's main responsibility after the war has been the control of public expenditures, without any further responsibility for the industrial performance[189] (which was the case in Germany and France). As far as the political system of Britain is concerned, it is characterized by a unitary, Westminister democracy of single-party government which can take decisions unconstrained by other centers of power[190]. Historically, as the home of the first industrial empire, Britain developed a financial sector with worldwide interests since the 19th century, and the City of London (hereafter the City) remained the

[187] V. Schmidt – *Taking ideas and discourse seriously: explaining change through discursive institutionalism as the "fourth new institutionalism"*. 2010 (p. 4)
[188] Ibid.
[189] P. Hall – *Governing the Economy – the politics of state intervention in Britain and France. 1986. (p. 248)*
[190] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 314)

principal banking center of the world, even long after the empire disappeared[191]. Throughout the time that followed the banks operating in Britain maintained their orientation toward international capital[192], and acquired a high status and political influence in the country. As Hall (1986) notes, for most of the postwar period, the British economic policy was perceived as serving more the interests of finance capital rather than that of industry[193]. The financial institutions' privileged status in Britain may also explain their low level of regulation - or, as Busch 2004 terms it *informal regulation* - which was marked by a club-like culture nourished by the relations between the BoE and the established banks[194]. This situation of informal banking regulation started to change in the 70s and 80s, when in each of these periods Britain experienced two waves of bank problems, resulting from the lack of formal supervision[195]. Up to the occurrence of the 'Secondary Banking Crisis' of the mid-70s in Britain, the BoE was able to launch rescue operations using largely capital coming from the clearing banks - the willingness of the big clearing banks to pay so much money without being legally required shows the functioning of the informal regulatory system where the feelings of solidarity prevailed[196]. In the second occurrence of bank problems in the mid-80s, when there were already put in place some formal rules for banking supervision, but which had actually left the major banks largely unregulated, the atmosphere in the City was altered and the clearing banks didn't agree to take responsibilities as in the past[197]. This event was followed by tighter regulatory measures, lowering the authority of the BoE in the City and changing even further the club culture that prevailed in the past. The '90s came in Britain with other bank failures; this time they were high-profile ones. The bank failure occurrences of the '90s paved the way for a more fundamental reform, which culminated with the coming into power of the Labour Government, who established a central independent authority for the regulation and supervision of financial markets: the Financial Services Authority (FSA)[198]. This came as a great surprise to the BoE, which had a long history of pride and a special position in its relations with the City and which had just lost. However, the innovations in financial market regulation did not affect the general pattern of state-business relations in terms of company regulation. Indeed, after an internal battle between the views of Blair to introduce a stakeholder culture and those of Brown to keep the laissez faire approach to company regulation, the latter's view won, and, thus, the companies continued to operate under

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[191] P. Hall – *Governing the Economy – the politics of state intervention in Britain and France. 1986. (p. 249)*
[192] Ibid. *(p. 249)*
[193] Ibid. *(p. 251)*
[194] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 314)
[195] Ibid. (p. 314-316)
[196] Ibid. (p. 315)
[197] Ibid. (p. 316)
[198] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 318)

minimum standards and to self-regulate, reflecting the characteristic voluntarism spirit that has been prevailing for a long time in Britain[199].

Germany

With relevance to economic policy, the German state's organization is characterized by a strict division of control over fiscal policy, exerted by the Ministry of Finance and Ministry of Economics, and control of monetary policy, which stays under Bundesbank (the central bank), whose independence is guaranteed by constitution[200]. Germany's political system is a federal one, characterized by coalition governments and the existence of many veto players (the Länder among the most important)[201] which makes it difficult, or sometimes impossible, to take decisions unilaterally. Very differently from Britain, the organization of capital in Germany allowed for a close relationship between the institutions of financial and industrial capital - indeed, the former was allowed to hold equity in industrial firms, making them direct stakeholders and permitting them to exercise a high degree of control on the operations of the latter[202]. In post-war Germany, the banking system was under an all-encompassing regulation, where the help of the peak-level associations of the three historically developed banking sectors (savings, cooperative and commercial banks) was envisaged[203]. Since the mid-60s the sector was liberalized to some degree, as the control of interest rates was abolished and competition ensured, which, however, brought debates about the safety of deposits in the commercial banks where competition was higher and where no such deposit protection schemes as in the other two banking sectors existed[204]. In 1969 the peak-level association of commercial banks announced that the sector was voluntarily setting up a deposit protection scheme, which would protect up to DM 10,000 per every individual deposit[205]. The abolishment of fixed exchange rates in the '70s was associated by the collapse of Herstatt Bank, the most significant bank failure in Germany since the '30s[206]. The failure of the bank included a bank run, making evident that the existing system of deposit protection could not prevent bank runs. German regulation of financial markets was based on a concerted control of these markets by the state, the associations and business itself, which ensured a high level of regulation, but the occurrence of this problem opened a window of opportunity for the state to change the balances and

[199] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 119)
[200] P. Hall – *Governing the Economy – the politics of state intervention in Britain and France. 1986. (p. 234-235)*
[201] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 314)
[202] P. Hall – *Governing the Economy – the politics of state intervention in Britain and France. 1986. (p. 235)*
[203] Ibid. *(p. 234-240)*
[204] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 319)
[205] Ibid. (p. 320)
[206] Ibid. (p. 319)

increase even more its role in banking regulation[207]. The problem was further politicized and became more acute when the deposits started to move from the commercial sector in the savings sector. From the proposals that the public officials made for the solution of this problem, it was clearly noticed a favoring of a stronger regulatory state with a direct power of intervention, which, for the commercial banks that had lobbied for 15 years to the government for more self-regulation, would be unfavorable. Thus, the solution adopted in the end came from within the sector itself, which proposed an even higher level of deposit protection than what was proposed by the government - clearly showing that they favored more the direct control from the associations than that from the state[208]. This episode shows the type of institutional relations that existed in Germany for much of the time after WWII. As Busch (2004) argues, the state consciously made a tactical move by proposing drastic changes to the policy which would serve to increase the sector's propensity to compromise[209]. After this decisive policy episode, the re-adjustment of the system in Germany proved stable for a relatively long time[210], and indeed, as some argue, the system did not really change even after the reformations made during the '90s[211]. But, as a matter of fact, a wave of innovations in the German banking policy-making came by the end of the '80s and throughout the '90s, when the German state liberalized the capital markets sector, favoring dispersed investors over insiders, thus bringing a change in the relationships across the companies and between the companies and the banks[212]. This liberalization, however, was accompanied by strong regulation of financial markets and a more direct and stronger role of the state in the corporate governance than before[213]. By moving away from the insider investment dependence and strengthening its stakeholder position vis-à-vis the other stakeholders of the economy, it can be argued that the German state has changed the institutional balances of the relationships between the actors. But at the same time, Germany reasserted the national practices in company regulation; the national networks between businesses (the ownership ties) have been weakened but still have a powerful effect in creating an enduring national structure for the coordination of economic behavior[214], and the general paradigm of state-business relations remains unchanged.

• *Rational choice Institutionalism in the case of Britain and Germany*

[207] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 319)
[208] Ibid. (p. 321-322)
[209] Ibid. (p. 322)
[210] Ibid. (p. 322)
[211] B. Kogout & G. Walker – *The Small World of Germany and the Durability of National Networks*. 2001
[212] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 91)
[213] Ibid. (p. 90, 91)
[214] B. Kogout & G. Walker – *The Small World of Germany and the Durability of National Networks*. 2001

Britain

RCI's most straightforward assumptions support policy conformity with the powerful interest groups. As the big and powerful groups are often the economic ones who operate in an always more globalized environment, a continuous liberalization of market policies which would rise the profits of those interests follows suit. Implied to this is a continuing convergence between states, which are forced to liberalize under those influences. Neo-liberal policies go in line with the preferences of the presupposed most influential economic groups: the transnational capitalist ones. According to these assumptions, in the case of Britain, as a LME based on stock market financing, it would be expected a reinforcement of its own policies in pursuit of economic competitiveness. The banking industry in this country is highly concentrated, both in terms of geography (the City) and number of banks, with the financial services industry made up of an interest group structure that is considered as fragmented, and a commercial banking sector represented by the British Bankers Association (BBA)[215]. However, in terms of policy influence, associations do not have the weight that the big individual players have[216]. Factually, the pro-market forces in Britain have always been strong enough to resist any attempts to alter the system into some form that would allow more state or other societal actors' control over companies[217]. It can be said that the institutions have been shaped in a way to create a favorable environment for the companies to be governed mainly by the competition laws and to regulate themselves. These facts can support the main points of RCI. However, what RCI would find difficult to explain is the point when change from the standard preferences comes. Thus, while the economic policy paradigm of laissez-faire established in Britain since the second industrial revolution is preserved[218], the changes in the regulatory system of financial markets through the years, and especially the innovation brought in 1997 by the Labour Government, which established the FSA, account for a rather deviating approach from that which existed till then. Hence, this approach can be said to not conform to the general preferences of the transnational financial companies established in Britain, which would prefer the more informal regulation that was at place before. Also, the role of the public officials in bringing the relative changes against the preferences of the big market players, but also against a very important financial institution such as the BoE, is confirmed.

[215] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 323)
[216] Ibid. (p. 323)
[217] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 118)
[218] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 322-323)

Germany

If we regard the neo-liberal measures in financial services that Germany has taken in the recent decades, one can be quick to argue that RCI has a strong argumentative power. However, the scope and extent of the new measures tell the other part of the story. Starting from the end of the '80s, when the SBD was enacted, and especially from the mid-90s and on, the business environment for the financial markets began to change in Germany. Previously, financial markets were seen with distrust and were highly restricted in their operations[219], while during the 90s investments through stock markets started to be accepted as a natural and desirable part of the economy[220]. The measures taken by the German governments during the years from the launch of the Single Market program until the launch of the FSAP account for a drastic change towards a more internationalized orientation of capital, by introducing measures that favor dispersed investors over the insiders. This is both a strong and a weak point on the side of those who see developments through the RCI lens. These developments in Germany account for a convergence to neo-liberalism, where the transnational actors, as part of the powerful economic group, have gained a much more important role in the economy. However, if we go deeper into detail of the German regulation of financial markets, we would see that convergence to neo-liberalism is only partial and the role of the state in bringing changes is very evident. Despite the promotion of stock markets, the German state retains control of them and regulates them through statutory regulation[221]. Moreover, the orientation towards international capital cannot be interpreted simply as an imposed move by the big transnational economic players or the EU – the choice for more liberalization of the capital came as a need to improve the investing environment in Germany, where the closed network of relationships between national banks and companies and across companies was seen as problematic[222]. However, the changes in the orientation of capital absorption did not influence the constitutional nature of the company, as the national practices in company regulation were preserved and the sovereignty of the state in providing the rules for corporate governance was re-asserted even after the changes of the late 90s[223]. Moreover, some cross-company links were maintained, which, as Kogout and Walker (2001) argue, are still significant for keeping alive the ownership ties as in the past decades[224]. Under these conditions it can be summarized that despite the liberalization of capital markets, which can account for a convergence with neo-liberalism, the extent

[219] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 91)
[220] Ibid. (p. 105)
[221] Ibid. (p. 91)
[222] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 106)
[223] Ibid. (p. 90, 91, 106)
[224] B. Kogout & G. Walker – *The Small World of Germany and the Durability of National Networks*. 2001

and scope of that liberalization in Germany account for a partial one, while the state's norms in business regulation are entirely preserved. Comparing such norms in both the countries under scrutiny, we observe a high degree of divergence between them.

• *Taking an ideational approach to banking policy in Britain and Germany: Discursive Institutionalism*

By employing HI and RCI approaches to explain policy-making in Britain and Germany, aside the emphasis on the importance of the institutions as the "playfield" where the actors meet and shape their relations, and on the organized groups which strive for their interests, it was brought into the fore the fact that the institutional regularities and the preferences of the organized interests have been shaken in different moments in time. Furthermore, these two approaches are limited in their explanations when it comes to change. What is clearly noted in the events presented here is the role of the state in the critical moments when change was needed and eventually brought in. As many of the scholars who employ ideational approaches to explain the political economic events argue, the role of the state is crucial in changing or preserving the practices and relationships that lead to the country's policy-making. To explain the dynamics of change as well as of continuity, and why certain policies are adopted instead of others in the case being studied here, the use of ideas and discourse will come to help.

Ideas

In the case of Britain, the liberal idea of the benefits coming from private companies contributing to the general economic welfare were established since the second industrial revolution in the mid-19th century and has remained unchanged so far. The general principle of the freedom of the business from state regulation has been supported by all the governments (albeit with different nuances), which have replaced one another in the governing chair, as well as Britain's union movement[225]. To this day, Britain remains a strong supporter of this philosophy, which it clearly reflects also in the arena of EU policy-making. But, are we to interpret the continuity of existence of this general principle only as a constraint coming from the inexistence of the structures that would make possible more state intervention in regulating the economic actors, or as the incapability of the state to go against the preferences of the economic organized groups? This question deserves an answer in light of the events that are introduced above, which account for an active role of the government in bringing a change in practices of the state in the supervision of financial service companies. The change of attitude

[225] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 117) [my parenthesis]

of the British governments towards financial companies was expressed by introducing a formalized banking supervision system in the ‘80s, which was re-adjusted in different moments following that period and which culminated with the FSA in 1997. This was a break with the until-then status quo in the “institutional” relations between the state and financial services companies and a decision which was separate from the preferences of the main economic actors in Britain. The government actors who formulated the new policy can be said to have acted by being informed from their ideas to ensure a better, or safer, business environment focusing on the interest of the public, who has the power to respond by vote in the government elections. Therefore, it can be continued, the state can reframe the actions of the other players through ideas by changing the institutional structures and by promoting policies which focus on public’s interests, which may be different from the narrow interests of the organized economic groups[226].

When it comes to Germany, it should be said that the business environment has been very different compared to Britain. The state has had a central role in regulating companies and the investments were made in cooperation between insider universal banks. The stakeholder culture was well established in the German nation through time. As far as stock markets are concerned, a feeling of mistrust had existed since 1873, when the crash was blamed on speculative financiers and fraudulent management[227]. By the end of the ‘80s, with the rise of globalization, this atmosphere started to change and throughout the 1990s concrete measures were taken for the liberalization of capital markets and financial products, as now they were considered to be beneficial to the German economy, which at the time was experiencing several problems with the system of insider investment. The favoring of the dispersed investors over insiders is considered to be a big change of the previous institutionalized relationship between industry and capital. These measures went against the interests of domestic economic actors, which, however, could not stop them. Furthermore, regarding company regulation, by the beginning of 2000s, following the problems in corporate governance, the German government of the time made a further change by transforming the state from a simple patron of co-determination into a direct regulator in order to ensure more investor protection. These actions account for a very active role of the state in bringing change, and a strengthening of the long prevailing philosophy that the state is the guarantor of order in business relations. Hence, it can be well argued that these actions took their boost from the ideas of the public officials, who managed to alter the institutional barriers and

[226] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009. (p. 10)
[227] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 105)

overcome the interest groups' oppositions in order to give life to their ideas about a better economic policy for the country.

Discourse

Judging from past events, it can be said that discourse is a very important element in politics and it serves well to the policy-making process. Schmidt (2009, 2010) defines discourse as having two dimensions: one which focuses on the construction of policy and/or politics through "coordination", the other seeking legitimization of the policies/politics developed by ideas produced by the actors involved in the process through "communication"[228] [229]. Discourse, then, goes in the same line with ideas. Indeed, it works together with ideas both in the process of policy-construction and in policy promotion. In compound political systems like that of Germany, it is expected to be made an extensive use of the coordinative dimension of the discourse, due to the plurality of actors and entities that take part in the process of policy-making and policy implementation, while in single-actor systems, like Britain or France where the policies are developed and implemented by the central government, it is expected to be made an extensive use of the communicative dimension. Here it can be pointed out that political institutional contexts matter, as they can influence the level of success of the ideas, which can be more easily translated into policy and implemented faster in the single-actor systems like Britain than in multi-actor system like Germany, where the ideas and policies get filtered in different levels before they come into life[230]. In the case of banking policy, however, there was a general absence of the communicative dimension of discourse[231]. Busch (2004) explains this absence of communicative discourse by saying that, aside the technicality of the issue which makes it "low politics", in banking policy there is "a case of a missing model"[232]. By this he means that, different from the cases such as the Economic Monetary Union (EMU), in which the epistemic community, based on previous success stories, was able to transmit successfully the idea that the policy of price stability and low inflation would be more appropriate for governing the EMU, in the case of banking policy there were no such examples that would inform discourse for promoting a specific successful model[233]. The lack of an obvious empirical and intellectual model that would inform an active public discourse leads to *uncertainty*. In light of an uncertainty for the best model and under the conditions of changes which may be required or caused by

[228] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009.
[229] V. Schmidt – *Taking Ideas and Discourse Seriously: explaining change through discursive institutionalism as the fourth "new institutionalism"*. 2010
[230] Ibid.
[231] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 325)
[232] Ibid. (p. 325)
[233] Ibid. (p. 325-326)

external and internal pressures, the states make recourse to their internalized assumptions, i.e. their ideologies and mental maps, to guide them in forming the policies[234]. In the case of Britain and Germany, this can account for their differences in regulating their financial institutions. In Britain, the informal regulation of banks was very slowly replaced by more formal regulation. But, no government action was taken for more regulation until when big scandals and bank failures informed them to adopt a stronger regulatory system, which climaxed with the establishment of the FSA. However, this didn't lead to any change of the state's general policy paradigm of laissez faire. In Germany, however, the reformations in corporate governance that took place in 2002 aroused a great public interest and were in the main focus during the elections time, showing the sensitivity of the German public on the issue[235]. But, despite the liberalization of the financial services that was being pursued, all the political parties reasserted to the public that the state would remain strong in its controlling abilities and key to making things happen, and searched for legitimization of the changes which would make the country's corporate economy competitive and more attractive to invest[236]. The approach of the strong controlling state which functions in a globalized economy was then translated into policy.

3. Conclusions

In conclusion to this chapter there will be pointed out some important elements that will lead to more clarity of the analysis and the policy at issue. A clear link between the international level and the national level of policy-making also needs to be provided if we are to understand the importance of both levels in the development of banking policy and regional integration. What is sought from the above analyses is, actually, not to show that the governments in power have limitless discretion in bringing innovations or impeding them when it comes to national policies. While seeking to emphasize the power of ideas in policy-formation, throughout the above analyses was also highlighted the existence of the influences and restrictions coming from various actors and factors, which exist within and beyond the national borders. From the observations of banking policy developments at the EU and national levels it can be drawn a general conclusion that both the international and national levels have had an impact on the development of policy. But, as argued here, the national actors and factors had a greater role in this policy at issue than the supranational actors, who could proceed with their initiatives only after taking the green light from the MS and who were granted only peripheral powers in the

[234] A. Busch – *National Filters: Europeanization, Institutions and Discourse in the Case of Banking Regulation*. 2004. (p. 312, 326)
[235] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 105)
[236] Ibid. (p. 105)

policy-making process. The pressures of globalization, mixed with the countries' internal developments, forced the EU MS to take liberalizing measures. However, each of them did it in its own way. Nevertheless, a degree of level playing field was considered necessary for avoiding races to the bottom and for creating a more secure business environment. The EU structure comes to answer these needs. Banking policy development was conducted in a coordinated way between the national level, where the states pursued policies that would be in the benefit of the largest interest groups, i.e. their publics and large economic groups, and the international (EU) level, where the states have sought to channel their domestic interests or minimize the adverse consequences of foreign developments. This, as termed by Putnam (1988), is called the logic of two-level games[237]. In this two-level coordination the outcome of the policy was influenced by both the coalitions that supported liberalization and integration and those which wanted to retain their discretionary powers and protect their national economies. In accordance to this logic, in this work "the state" is seen not as a unitary actor, but as a structure made up of various actors (public officials, civil society, economic groups, ect.), each of which striving for the advancement of its preferences. As it was shown here, the states undertook some reforms that went against the preferences of some economic actors, but they still preserved many important elements of their relations to these actors, as they did not, and probably could not, radically change their specific business philosophies. The case of Britain keeping its "light touch" approach to regulation of companies, and that of Germany confirming the role of a strong regulatory state and keeping in place the practices of stakeholder economic governance can best tell that when there are too many interests involved, radical change is not much likely to happen. Even the ideas, then, may be said to have some limits in view of such surrounding pressures. However, this observation should not bring us to the misleading conclusion that the states take actions only as being captured or constrained by the economic interests. In established democracies the range of interests that public actors must watch are wider than simply the interests of the powerful economic actors. The primary concern of the public officials in hold of the government is to keep and extend their positions, which depend on the vote of the public[238]. Therefore, either in times when external pressures for change are high, or when change is required because of internal motives, the ideas of those who can enact them of how to respond to those challenges and to minimize the adverse consequences for the public are extremely important. These ideas are about the (re)conceptualization of the problems, and also, if needed, the (re)shaping of the institutions in the view of the need for innovative policies, which would enhance the public's well-being or at least minimize any

[237] R. Putnam – *Diplomacy and domestic politics: the logic of two-level games*. 1988
[238] V. Schmidt – *Putting the Political Back into Political Economy by Bringing the State Back in Yet Again.* 2009.

adverse consequences of eventual problems. As it is shown above in the study cases, the governments of Britain and Germany responded to the international challenges and the internal events by employing their internalized assumptions about what could be the better solution for their economies and, fundamentally, for their publics. It is in this sense that the ideas play a crucial role in the lives of the nations, and it is for the reasons explained here and because empirical observations support this view that this research goes to argue that ideational approaches have greater explanatory power as far as the study of banking policy at the national level is concerned. This also accounts for the differences which exist not only between the countries analyzed here, but also between other EU countries that have in place different practices and defend different ideas about the development of policies. Thus, the MS's perceptions about how the policies should be made are formed at the national level and are reflected at the EU policy-making stage, where, then, the process is often marked by battles between these ideas.

The next chapter will consider the latest reformations of financial markets regulation at the EU level. The interest of this research has its starting point precisely from the observations of this new reformation which seems to break up with the past, but that, at the same time cannot hide the many problems that continue to exist in the regulation of the financial institutions in the EU. The above made analyses and the conclusions drawn from them will help to understand better this reformation and to explain the persisting problems.

IV. POST-CRISIS BANKING REGULATION IN THE EU

1. Describing the "post-crisis" reformation of banking regulation in the EU

By the time when the crisis burst in 2008, the financial services markets had been fully operating at pan-European level. Indeed, they had extended their "tentacles" beyond the European region as they had now grown global[239]. The cause of the crisis was defined to be the ineffectiveness of the supervisory structure at place[240] [241]. For this reason, in the course of the crisis, the Commission invited Jaques de Larosière, a well know expert of finance, to create a group of experts (the High Level Group) that would identify the causes of the crisis[242]. The first mission was detecting the causes of the crisis coming from the lax of the supervision[243].

The High-Level Group led by de Larosière identified problems of supervision at both the macroeconomic and microeconomic levels. The report produced after the study blamed the lack of macroeconomic supervision, especially with regard to liquidity, which had increased exceptionally during the preceding years of the crisis and had stimulated the development of complex financial products with higher profitability than regular assets[244]. At the microeconomic level, the failure of company supervision and communication between regulators were seen as the main problem[245] [246]. The national regulators had failed to figure out the degree their financial institutions had been "infected" by having accumulated capital of high-risk and complex nature, which often was in off-balance sheets[247]. The crisis had an especially bad impact on the banks that had heavily relied on off-balance sheet vehicles such as asset-backed commercial paper conduits or other types of complex vehicles for their funding, as very quickly after the investors realized the size of the bubble they became illiquid financial assets[248]. The asymmetry of information between the market participants and the regulators, as well as between the regulators of the different MS was soon realized to be huge. "Taken together, these developments led over time to opacity and a lack of transparency. This points to serious limitations in the existing supervisory framework globally, both in a national and cross-border context. It suggests that financial

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[239] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010.* (p.12)
[240] Communication from the EU Commission - *European Financial Supervision* 2009
[241] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010.* (p.12-13)*; et al.*
[242] Communication from the EU Commission - *European Financial Supervision* 2009
[243] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010.*(p.12)
[244] Ibid. (p.13)
[245] Ibid. (p.13)
[246] Communication from the EU Commission - *European Financial Supervision* 2009
[247] M. Sevé – *When regulation rimes with supervision: the example of the new European supervisory architecture. 2010.*(p.13)
[248] N. Véron – *The Banking Crisis in Europe. 2010.* (p. 111)

supervisors frequently did not have and in some cases did not insist in getting, or received too late, all the relevant information on the global magnitude of the excess leveraging; that they did not fully understand or evaluate the size of the risks; and that they did not seem to share their information properly with their counterparts in other Member States or with the US"[249].

The EU Council endorsed the report of the High-Level Group in 2009 showing an unprecedented unanimity to agreeing to have financial supervision at the EU level - something which had been vetoed many times by different MS, but primarily by the UK. Having defined the source of the supervisory problems and the unavoidable need to have a combined macro and micro supervisory structure, the de Larosière report suggested the following supervisory framework:

- a **European Systemic Risk Council/Board (ESRB)** – which will play the role of the macro-prudential supervisory body and work on preventing systemic risks for the whole financial system in the EU. It will serve to monitor and assess potential threats to financial stability that arise from macro-economic developments and within the financial system as a whole. "To this end, the ESRB would provide an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks. The creation of the ESRB will address one of the fundamental weaknesses highlighted by the crisis, which is the vulnerability of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks"[250]. This new supervisory institution is largely coordinated by the ECB, because ECB has the responsibility of monetary policy of the EU and the expertise at the macro level[251]. The ESRB does not have legal authority and thus will have only advisory role. Nevertheless, it has the right to decide if its observations and recommendations will remain confidential or made public[252]. Regarding the make-up of the ESRB, it comprises of the president of the ECB as its chair person, a vice-chair person (a non-euro zone representative), the governors of 27 NCBs, the vice-president of the ECB, the chairpersons of the three European Supervisory Authorities (ESAs) and a representative from the Commission[253]. The decision-making about macro-prudential policy and recommendations at ESRB are made through voting in the Council and approval is reached by simple majority. In the makeup of the ESRB are included also observers, which are representatives of national supervisory authorities accompanying the CB governor, but they do not have the right to vote.

[249] M. Sevé 2010 quoting the de Larosière report 2009
[250] Communication from the EU Commission - *European Financial Supervision* 2009
[251] R. Masera – Reforming financial systems after the crisis: a comparison of EU and USA.
[252] Communication from the EU Commission - *European Financial Supervision* 2009
[253] Ibid.

- a **European System of Financial Supervisors (ESFS)** – which will deal with the supervision at the microeconomic level. This structure makes the most important part of the reform as it replaces the old advisory Committees, which proved to be unable and inefficient to prevent the crisis from spreading with that intensity. The ESFS will be made up of three European Supervisory Authorities (ESAs), namely: European Securities Markets Authority (ESMA), European Banking Authority (EBA) and European Insurance and Occupational Pensions Authority (EIOPA). It is obvious that by having three separate authorities, these three areas of financial activity remain still separated. The task of the newly established EFSF is to provide a Community structure that links better the national supervisors by most importantly contributing to build a single rulebook, ensure a consistent application of the rules in the MS, collect data from the MS and offer a better coordination in crisis situations[254]. The great novelty of ESFS is that the states have agreed to transform the previous advisory Committees into authorities, which can imply a legal power for them. The most striking of the new legal powers awarded to the ESAs is their right to bypass national authorities and directly regulate market participants[255]. The ESFS is composed by a Steering Committee, a Board of Supervisors and a Management Board. In the Steering Committee the representatives of each of the three ESAs and one representative from the EU Commission seat to ensure cross-sectoral cooperation as well as coherence of supervisory approaches between the three supervisory authorities. Each new authority has a Board of Supervisors which comprises high level representatives of the appropriate national supervisory authorities and chaired by the appropriate ESA representative. While in the Management Board of each of the ESAs seat the appropriate representatives of national supervisory authorities and the Commission[256].

This newly built framework of financial markets supervision is a particularly important reformation due to its (seemingly) revolutionary aspects which are very interesting from the EU governance standpoint. As the current study is concerned with banking the chapter will continue by analyzing into detail the role of the EBA. This will ensure a stay-on-track in the sense of study relevance and concentration, as well as ensure the consideration of the very important issues of corporate governance, which, as we saw in the previous chapters, are extremely sensitive for the MS. In view of a disastrous financial crisis, there would be expected a correction of the mistakes of the past. A closer look at the newly established EBA will tell if such an expectation is correct as well as will further clarify the ideas that were put forward earlier in this paper.

[254] Communication from the EU Commission - *European Financial Supervision* 2009
[255] S. Donnelly – *The Regimes of Financial Market Regulation in Europe. 2011*. (p.18)
[256] Ibid. (p.18)

2. The role of EBA in EU Regulation - its functions and powers

The force with which the crisis hit the financial system in Europe, the effects of which continue to be present, was an indicator that further steps needed to be taken for the coordination of supervision of financial companies at the EU level. For this reason, a more formalized coordination at the EU level was established in order to prevent crises of that scale. The establishment of the EBA can be seen as an important move in that respect, as with its wide-ranging mandate and its consultation with ESRB can potentially ensure a better supervision of banks. Regarding its structure, the EBA comprises of a Board of Supervisors, a Management Board, a Chairperson, an Executive Director and a Board of Appeal[257]. As envisaged by EU law, the tasks and responsibilities of the EBA are *to contribute* to the establishment of high regulatory and supervisory standards, to consistently apply Union law, facilitate the delegation of tasks to competent authorities, cooperate closely with the ESRB, conduct peer review analysis and monitor and assess market developments in its area of competence[258]. Also, within the legal powers that it has been given, it is supposed to develop draft technical standards, issue decisions and opinions as well as provide opinions to the EU institutions in areas related to its own competence[259]. Divided in separate areas of activity, it should be said that in the field of supervision the EBA's most important task so far has been the regular conduct of risk assessments and of area-wide stress tests aimed at ensuring the resilience of EU banks against the adverse shocks; in the area of crisis management, it is in charge of coordinating recovery and resolution plans for the major European banking groups; while in the area of rule making, the EBA is supposed to generate uniform technical rules to be adopted through instruments that are legally binding and applied by the MS[260]. However, despite the wide range of tasks that this institution has been given, its main activity has been focused almost entirely on the conduct of stress test exercises aimed at assessing the capital adequacy of the largest European banks[261] using the internationally agreed standards on capital adequacy known as Basel standards. However, how much of a role does the capital adequacy play in face of the difficulties for funding the banks is questionable. Considering the legal duties, the raison d'être of the EBA seems to be, however, the development of

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[257] E. Fahey – *Does the emperor have financial crisis clothes? Reflections on the legal basis of the European Banking Authority*. 2011
[258] Ibid.
[259] Ibid.
[260] A. Enria – *Financial integration and stability in Europe: the role of the European Banking Authority* (speech). 2012
[261] Ibid.

standards and issuing of guidelines[262]. The national authorities retain the responsibility for the day-to-day supervision of banks - in this case, the EBA's task is to ensure a common supervisory culture and consistent practices, which would make possible a coordinated response in crisis situations. As far as the EBA's powers are concerned, the overall observation is that they are limited as it has limited decision-making functions and cannot adopt general regulatory measures. The EBA has been given powers to develop regulatory technical standards, but in this process there are involved other institutions, most notably the Commission, which has the right to decide if it will endorse the proposed standards of the EBA and which decides how to proceed after the standards have been created[263]. Thus, the EBA lacks enforcement powers itself, as they take place through the Commission. Moreover, the EBA cannot take decisions that would ask the MS to act in a time of crisis, unless the Council, in consultation with the ESRB and the three ESAs, decides if there is an emergency situation or not[264]. In case an emergency situation is defined and the EBA takes a decision which is not responded by the MS, it can adopt individual decisions which would prevail over those of the individual MS. The right of the EBA (but also of the other ESAs) to bypass national authorities and directly regulate market participants is the most striking of the new powers that has been assigned to it[265]. However, taking into account the fact that the EBA is composed of national authorities and the difficulty of this authority to put aside and act against one of its members - which would be a grave precedent for the mutual respect for national sovereignty and responsibilities - the possibility that the EBA will use this newly acquired power is very questionable[266].

• *The paradox*

In light of the occurrences during the last financial crisis, when the MS stepped in to bail out their problematic financial institutions - this despite the existence of an EU Competition Policy which prohibits biased state aid[267] - it was expressed the need for the creation of formal legislation for bank recovery and resolution at the EU level[268]. This would ensure more discipline in business-making from the part of banks, and thus a healthier financial industry. In a recent speech, the Chairperson of the EBA emphasized the fact that such formal legislation for recovery and resolution of banks is missing,

[262] E. Fahey – *Does the emperor have financial crisis clothes? Reflections on the legal basis of the European Banking Authority*. 2011
[263] Ibid.
[264] Ibid.
[265] S. Donnelly – *The regimes of financial market regulation in Europe*. 2011
[266] Ibid.
[267] Zahariadis – *Discretion by the rules: European state aid policy and the 1999 Procedural Regulation*. 2010.
[268] A. Enria – *Financial integration and stability in Europe: the role of the European Banking Authority* (speech). 2012

hampering the efforts for an integrated process[269]. This means that the crisis resolution procedures are different in different MS, and the treatment of the cross-border companies is still not equal, despite the general agreement to be so. Next to this, it is highly questionable how efficient and effective can the work of the EBA be when the day-to-day supervision of the financial institutions is still carried out by the separate national authorities, and whether the EBA is capable to impose its decisions on the MS given its composition of national regulators as well as the long existing customary practices of respect for one-another's sovereignty. Moreover, the EBA is an agency that is legally inferior to the other EU institutions, as it depends on the Commission and the Council in order for its decisions to be enacted. The big paradox stands in that after the crisis there was seen the need and there was general agreement for a more coherent supervision and regulation of the financial companies in order to prevent another crisis of such magnitude to happen, but the result was the creation of a European Banking Authority with broad responsibilities but too limited powers to be effective in the meeting of the defined needs. This incompatibility between the proclaimed needs and the real actions is reflected also in the most current debate about forging a banking union, which implies a real shift of powers from the national regulators to a higher European authority as well as the creation of a fund to wind down cross-border lenders in trouble and a common deposit guarantee scheme to protect savers[270]. The stress tests that the EBA has conducted, as admitted by the Chairman of this agency himself, did not, and cannot, fulfill the aim to restore confidence in the European banks, as they are facing problems with getting capitalization funds from investors and their respective countries, especially those which are having financial troubles[271]. This makes it clear that in the current regulatory environment the state budgets and the soundness of the banks are badly entangled together. Thus, a solution of a more coherent nature, a truly EU undertaking, such as the creation of a banking union that would relax the funding troubles, is seen as a prerequisite to the alleviation of the current difficult situation[272]. Such a solution, i.e. having a strong supranational regulator that would bring the incoherent practices to an end, is advised and strongly supported by the private interest groups, IMF as well as some EU institutions such as the Council (its President), the Commission, the ECB and the European Parliament[273] [274] [275]. However, the banking union

[269] A. Enria – *Financial integration and stability in Europe: the role of the European Banking Authority* (speech). 2012
[270] The Economic Times – *Europe takes first stab at building banking union*. 21/06/2012
[271] A. Enria – *Financial integration and stability in Europe: the role of the European Banking Authority* (speech). 2012
[272] European Council – *Towards a genuine economic and monetary union*. 26/06/2012
[273] E. Fahey – *Does the emperor have financial crisis clothes? Reflections on the legal basis of the European Banking Authority*. 2011
[274] Financial Times – *Barroso pushes EU banking union*. 11/06/2012
[275] European Council – *Towards a genuine economic and monetary union*. 26/06/2012

proposal seems to be “dead before arrival”[276]. This is because Britain refuses to be part of any banking union that, as the UK Chancellor Osborne says, “makes its taxpayers liable for recapitalizing eurozone banks or puts the British banks under the watch of an EU supervisor”[277]. Britain seems to be inflicting the debate if the banking union should comprise of just the eurozone countries (which it claims it should be the case) or all the 27 MS. But even within the eurozone, Germany is reluctant to join a potential banking union unless concrete measures are taken in the direction of a fiscal union in the EU[278]. Germany’s central bank, Bundesbank, warns that a banking union without being accompanied by a fiscal union that would allow the control over the national budgets would be risky, as it would be equal to a back-door pooling of sovereign debt[279]. As the vice-president of the Bundesbank said: “whoever accepts liability also has to have a right to control, especially when it is potentially a question of very large sums as in the case of a banking crisis”, as the crisis in one country’s banks can require financial help from taxpayers in other countries[280]. These views of Bundesbank reflect also the broader German opposition to any agreement that would leave the EU’s biggest economy bailing out the banks of the countries with financial problems[281]. Moreover, the German banks have signaled opposition to having their existing deposit guarantee schemes potentially used to rescue banks in other countries[282]. The German stance on this matter seems to be very rigid and without much likelihood to change unless it gets what it is asking for. What this all means is that the established European institutions and agencies dealing with banking supervision will remain limited in their powers and in what they can do to pull the EU out of the crisis until the MS, especially the largest and economically powerful ones, decide to give up for good some of their responsibilities, which, as a matter of fact, lay at the heart of those which are long considered a sovereign political right. In spite of having been assigned the label of an Authority, the EBA’s work is not supported by actual policies from the MS, who are not willing to give up from their right to regulate their financial companies in their own ways.

• *Confronting the last reformation to the conclusions of the research*

After taking a close look at the last reformation of the supervisory and regulatory system of banking at the EU level, it can be said that despite the mobilization of the MS in the middle of the

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[276] MISH’S – *“Dead before arrival”: Bundesbank shoots down EU banking union proposal; eight lessons the EU needs to learn*. 12/06/2012
[277] Financial Times – *Barroso pushes EU banking union*. 11/06/2012
[278] Financial Times – *Bundesbank warns on EU banking union.* 12/06/2012
[279] Ibid.
[280] Ibid.
[281] Ibid.
[282] Ibid.

experience of a catastrophic crisis, which is continuing at the time of writing, the outcome of the reformation was again a hodgepodge of rules and responsibilities, which still leave the European institutions with little of what they can do and which leave intact the powers of the MS to take decisions. What Europe has agreed on in the course of this crisis was not what was expected by many in the regulation community, who had hoped and pushed for a central, more powerful agency that would deal with all the aspects of banking[283]. Instead, a three-pillar structure was established, maintaining and deepening even more the fragmentation between securities, banking and insurance and pensions. The securities pillar, falling under the ESMA, is much more important than banking and insurance as it has been assigned more tasks, requires more committees to perform its tasks and has already issued more directives for the MS to adopt[284]. This is because previous developments within and outside of the countries had opened the way to the financial markets and because previous agreement was reached between the MS to have more constitutive and regulative integration of securities markets, eventually packed in the Lamfalussy process. This means that when the interests and ideas of the MS come together, agreement is easier to reach and delegation to supranational institutions becomes more possible[285]. In the area of banking, where there is a deep implication of different ideas and practices of corporate governance, the MS have not agreed on having a strong regulator at the supranational level. The closer look taken at the EBA confirms this statement. The assignment of the role as an Authority rightly appears to be deceiving, as what this agency can really do is very limited and far from achieving the main purpose of restoring confidence to the markets. But more importantly, by taking a closer look at the last reformation of financial markets supervision in the EU, there is a confirmation of the earlier expectations and conclusions of this research, which maintains that *who* and *what* really matters in banking policy-making are the sovereign MS, especially the larger and economically powerful ones, and their preferences, which are formed within their domestic realities through a process of a clash and aggregation of ideas about how the interests can be better met and, thus, what policies should be produced. The last debate about a potential banking union in the EU reflects again the persisting differences between these ideas and preferences inherent in the MS. On the one hand, Britain, in which the philosophy of laissez faire is dominant, keeps staying away from projects which can put its financial institutions under tougher regulation, while on the other, Germany, where the philosophy of a strong regulatory state dominates, would accept to be part of a banking union only under the agreement for tougher rules and controls on the budgets of the states. It should be emphasized that the claims of both

[283] S. Donnelly – *The regimes of financial market regulation in Europe*. 2011
[284] Ibid.
[285] Ibid.

of these countries go in line with the preferences of their domestic interests, and, at least so far, turn down the preferences of the transnational companies and supranational institutions which strive for a greater shift of governance towards the center (EU) and more integration.

In a nutshell, the authorities that have been established in the course of the financial crisis reflect clearly under what conditions the MS are more willing to cooperate through delegation to the EU and where they want to retain their powers of control. While the securities markets are highly Europeanized, for banking and insurance there is only a thin basis of agreement, and even this basis puts the MS in charge[286]. Issues of corporate governance and financial reporting, which are defined as the main cause of the crisis, remain far from the sight and control of any supranational institution - they make a core concern for some of the largest and economically powerful MS as they are related to the welfare of their publics[287]. And, as it appears from the more recent events, the ties between the EU members and their ideas of how to satisfy better the needs of their publics continue to be very strong. In light of this fact, short-term consensus seems to be difficult.

[286] S. Donnelly – *The regimes of financial market regulation in Europe*. 2011
[287] Ibid.

V. CONCLUSION

The last financial and economic crisis has raised many questions about the safety of the business environment in the developed economies, but has also created great repercussions everywhere in the world, leaving untouched almost no one. However, the region that has been suffering more the crisis effects can be said to be Europe. While some countries and regions seem to be now regenerating themselves, among which also the US, the source of this crisis, Europe continues to be stuck in the mud. Many financial institutions of some EU countries, most importantly those of Spain and Italy, are now experiencing financial problems – what is worse is that, in the conditions of a deep interconnection and interpenetration, their problems would mean danger for other banks and states elsewhere in Europe and around the world. The failure of big banks in some countries, then, would create the risk of a domino effect, especially within the EU, where the financial institutions have a high level of interpenetration among each-other. And the problems do not stop here. The budgets of the governments, i.e. taxpayers' money, are as well heavily involved in this story. In the course of the crisis the states stepped in to rescue their problematic banks injecting huge amounts for their recapitalizations, and to do so, they often had to make recourse to huge amounts of debts, making borrowing even more expensive and worsening further the budget balances. Such practices can most probably undermine the notion of a level playing field within the EU single market, as economically stronger MS would have more capacity to intervene for rescuing their banks than the fiscally weak ones[288]. As we witness today, all this is translated in a contraction of the economies of some important EU states, where many companies have been closed down and, thus, many people have lost their jobs. Fundamentally, this has created a problem of mistrust and loss of confidence among the investors towards Europe. How did it all come about? Despite continuous steps that have been made towards more integration of financial markets and banks in the EU, true integration has remained far from becoming a reality. Europe was unprepared and the mechanisms it had in place proved to be inefficient in preventing a crisis of such dimensions. The lack of macro- and microeconomic supervision and of communication between the regulators was defined as a main reason that led to the catastrophic effects of the crisis. Considering all this, and taking into account the warns that come for even worse consequences in case of further inaction from the MS, the natural question that comes is: why still no action?

[288] N. Véron – *Banking crisis in Europe* 2010

This research took its start from this very basic question. After looking at the events of the process of banking integration, starting from the 70s until the beginning of 2000s, when a new regime of financial markets control was established in the EU, this work turned its focus on the explanation of those events in search of the definition of the actors and factors that have influenced the process. The importance of defining such actors and factors stood in finding out why the process of banking integration has been marked by so many difficulties, clashes and "battles", and remains still far from complete. In helping to define the main actors at the international (EU) level in the process under study, two main theories of integration were employed, neofunctionalism and liberal-intergovernmentalism. After viewing the empirical observations through the lenses of these theories, it resulted that more accurate in explaining the process of banking integration in the EU is liberal-intergovernmentalism. This is because the empirical observations support this theory's assumptions that the main actors who really influence and give shape to this process are the MS as opposed to the supranational actors such as EU institutions and transnational private interests. Nevertheless, the international EU setting, apart from functioning as "a well established and organized gathering point for debate", has the undeniable value for providing coordination of the actions of the sates in shaping and implementing the policies. Because the conclusion of the analysis of the EU level policy-making defines the MS as the main actors who influence the process, the research turns to enquire into the reasons that make the MS defend and push for certain policies. The empirical observations of the case of EU banking policy define as especially influencing in the shaping of policies the large and economically powerful MS, from which Britain and Germany are selected for a closer study. Here, well-established variables for the study of domestic policy-making were employed, namely: Historical Institutionalism, Rational Choice Institutionalism and Discursive Institutionalism. By confronting the assumptions of these approaches to the empirics, this research goes to define ideational factors as particularly important for the formation of policies which "give solution" to the problems coming from external and internal pressures, and which, then, (re)define the relations between the state and the societal actors within the democratic states. The ideas about supporting and developing certain policies from the public officials emanate from and take into account the interests of the larger groups within the states, be they private businesses or publics. This theoretical lesson goes in line with the empirical observation that the number of the affected people in the field of the financial services is far less than the number of people affected in the retail banking area, and the public interests in having more integration in the former are greater than in the case of the latter[289]. Thus, the preferences and the ideas about which policies would suit best to the interests of the

[289] S. Donnelly – *The Regimes of European Integration – constructing governance of the single market. 2010.* (p. 40)

larger domestic groups are aggregated and formed at the national level, to be then channeled into the international debates where a process of clashes between the different ideas takes place. Currently in the EU, different MS still have different ideas about how to organize state-business relations and about what should be the role of the state in the society, which accounts for the main source of disagreement for having common policies at the EU level.

In line with the logic of this conclusion, it can be said that the EU and its members are facing a very difficult puzzle to solve, because, on the one hand, the obligation to meet the domestic interests is central to telling the success of the governments for pushing with reforms, while, on the other hand, keeping the differences which are informed by the different national preferences would mean a pending of a true integration, which is so much needed for the revitalization of the European economy. A retreat to lower integration levels to avoid liabilities of the states towards each other, as some allude that it is more likely to happen, would run against many interests, such as investors, national and transnational businesses and publics, and would catastrophically damage the economic prospects of Europe and probably cause a bigger crisis. Several solutions to this situation come from different scholars. In his book "Why Are There So Many Banking Crises – The Politics and Policy of Bank Regulation", Jean-Charles Rochet (2008) defines as the main reasons of banking crises the intervention of politics to business affairs of the banks, thus damaging market discipline[290]. However, his suggestion is not just to replace supervision by market discipline, because even if the absence of government intervention is anticipated, the credibility of politicians that they would remain indifferent to banking failures remains low. The solution, according to him, would be that bank regulators and supervisors, as in the case of monetary policy, should be independent from political intervention and accountable for their actions[291]. This view is furthered by scholars and EU officials who are supportive to European integration, like the economist Lorenzo Smaghi, a former member of the Executive Board of the ECB, who argues that the assumption that regulation and prudential supervision must be carried out at the national level, with the rationale that it is ultimately the country's taxpayers that have to bear the costs of any bank failures, is mistaken because the errors and negligence arising from one country's regulation also expose others into enormous risks[292]. In view of this fact demonstrated by the Irish crisis, Smaghi's opinion is to create a more integrated mechanism, founded at the European level, with limited scope for discretion by the national authorities and subjecting them to close monitoring[293]. In other words, this would mean to

[290] J-C. Rochet – *Why are there so many banking crises? The politics and policy of bank regulation*. 2008
[291] Ibid. (p.33)
[292] L. B. Smaghi – Wither Europe after the crisis? (speech) 2011
[293] Ibid. 2011

have a truly functional and powerful EBA. But, he continues, because the non-euro countries are those who most strongly oppose banking integration, it requires therefore the ability and strength of the euro countries, which are much more tied politically to each other, to take further steps in the direction of integration and to give themselves greater power with regard to the managing of the Single Market area, although it affects the 27 members altogether[294]. And lastly, but very importantly, proposals come from the circles of epistemic communities, who can cold bloodedly observe the situation and give solutions to it. Emphasizing the relation between the different fiscal capacities of the MS and the competitiveness of their banks, Nicolas Véron *et al* think that the only credible solution to this situation should come in the form of a common, European undertaking, which would make possible the creation of a common pool of fiscal resources for rescuing, restructuring and recapitalizing banks[295]. Comparing the quasi EU fiscal federalism to the genuine US one, it can provide a good lesson for how the solution can be[296] – in the conditions of a deep interconnection and interpenetration, sustainable and credible solutions may only come from a central level, in our case the EU level.

However, in order for the above solutions to be put into practice, there are needed stronger political cohesion and more robust supranational institutions, which, as we saw here, would be made possible only by the consent of the larger and economically powerful MS. At the time of writing, Germany is offering its solution for a way out of the crisis: the creation of a true fiscal union that would give way to the control of the budgets of the members from a central, supranational institution, which would tell the members how much they should spend. This implies a political union. But, yet again, this proposal goes more in line with the German way of doing things, which emphasizes a strong regulatory state that is concerned more about budget stability rather than growth stimulus and which does not necessarily satisfy the preferences of all the members that are invited to join the fiscal union.

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[294] L-B. Smaghi – Wither Europe after the crisis? (speech) 2011

[295] R. Henning & M. Kessler – *Fiscal federalism: US history for architects of Europe's fiscal union*. 2012 (referencing to Posner and Véron 2009, and Véron 2011)

[296] Ibid.

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