THE RISING POWER OF THE ECB: THE CASE OF THE SINGLE SUPERVISORY MECHANISM

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The euro area was routinely criticized for its handling of the sovereign debt crisis, charged with doing 'too little, too late' in order to alleviate market pressure. Its inaction / delayed reaction may have worsened the impact of the crisis. Within the context the European Central Bank emerged as an indispensable institution in euro area governance. ECB President Mario Draghi is even credited with saving the euro thanks to his speech in July 2012 in which he vowed to do "whatever it takes."

This article considers the evolving role of the ECB in euro area governance, specifically financial supervision. Whereas at the start of the crisis, the ECB's increasingly important role in crisis management was termed as largely incremental (cf Salines et al. 2012; Schwarzer 2012), the ECB has increased its capacity and its competences significantly since onset of the global financial crisis. From a technical standpoint, this decision could be viewed as a natural outgrowth of central bank responsibilities (over half of the euro area national central banks were already responsible for financial supervision in their respective countries). From a political perspective, however, this change had important consequences regarding the centralization of authority in an already-powerful institution. Moreover it concerns the supervision of a major industry in Europe that has long enjoyed national regulatory forbearance and close relationships with national governments. Finally, the designation of the ECB as SSM is inextricably connected with the decision to forge ahead with Banking Union, the most important change in EU governance since the introduction of the euro.

Why was the ECB designated as the Single Supervisory Mechanism? Can such an important change be understood as "incremental" and explained with mid-range theories like historical institutionalism? Or does the game-changing nature of Banking Union mean that one should return to theories like neofunctionalism and liberal intergovernmentalism to understand the latest 'grand bargain'? Heipertz and Verdun (2010) pleaded for an "eclectic"

use of theories to better understand the integration process, and this paper will take a similar approach of examining the selection of the ECB through several theoretical lenses.

The first part of this paper presents background information on financial cooperation in Europe and the events leading up to Banking Union. The next section presents the theoretical framework and the expectations derived from the following theories: neofunctionalism, intergovernmentalism, and historical institutionalism. The conclusion offers suggestions for further research.

Background: European Financial Supervision pre-Banking Union

This section gives a brief history of EU-level financial supervision. Beginning with the onset of EMU and the development of the Lamfalussy framework, it follows the development of closer financial cooperation being forged through crisis. First, in response to the global financial crisis the European Systemic Risk Board and the European Supervisory Authorities were created. The sovereign debt crisis and increasing possibility of a euro area breakup then precipitated Banking Union and the designation of the ECB as the Single Supervisory Mechanism.

When the euro was introduced in 1999, banking supervision remained a national competence. Although numerous central banks in the euro area were responsible for domestic financial supervision, a “double separation” was created (geographical and functional) between the tasks of financial supervision and monetary policymaking (Padoa-Schioppa 1999, p.297). At the European level, a Banking Supervision Committee was created that gathered together national supervisors. This lacuna of EU-level financial supervision was later referred to as the “birth defect” of EMU (Wyplosz 2012).

Financial cooperation continued with the 2001 Lamfalussy framework for asset market regulation, which in 2004 was extended to banking and insurance. The so-called Level 3 committees comprised of national supervisors thus coordinated banking supervision at the European level. Therefore cooperation was strengthened, but financial supervision remained a national competence. Table 1 outlines the legislative framework for financial supervision at the European level.

Table 1 The 2008 EU framework for safeguarding financial stability

Functions	**Structures for cross-border cooperation**	**Legislative framework**
Crisis prevention		
Supervisory functions	Level 3 Committees for the convergence of supervisory practices Colleges of Supervisors	National laws, largely harmonised by EU legislation
Financial stability monitoring by central banks	ESCB Committees	EU Treaty, ESCB Statute, and national central banking laws
Crisis Management		
Supervisory measures	Colleges of Supervisors EU MoUs	National laws, largely harmonised by EU legislation
Provision of liquidity by central banks	Eurosystem	National central banking laws
Actions on payment systems	ESCB Committees EU MoUs	ESCB Statute, and national central banking laws
Crisis Resolution		
Private sector solutions	EU MoUs	n/a
Public sector measures by finance ministries	EU MoUs	National laws EU competition law
Reorganisation and winding-up of financial Institutions	Bilateral relationships between the competent authorities of Member States	National laws, partly harmonised by EU legislation
Deposit guarantee schemes	Bilateral relationships between the competent authorities of Member States	National laws, partly harmonised by EU legislation

Source: ECB 2008, p.80

Regulatory competition among national supervisors contributed to the failure to prevent the crisis in 2008, soon leading to calls for a single EU banking authority (Beetsma and Eijffinger 2009; Tabellini 2008). Nevertheless experts noted it was still "somewhat unrealistic" politically (Beetsma and Eijffinger 2009, p.3) to transfer such authority to the supranational level despite the worst financial crisis in decades.

In October 2008 the Commission called for a high level working group chaired by Jacques de Larosiere to offer recommendations on the reform of European financial regulation and supervision. This report was published on 27 May 2009 and adopted by the European Council on 18-19 June 2009. In consequence, the European Banking Authority (EBA) was created in 2011 by Regulation (EU) 1093/2010 as part of the European System of Financial Supervision established by Article 2 of that Regulation and of Regulation (EU) No 1094/2010 of 24 November 2010. The European System of Financial Supervision was an upgrade of the extant Lamfalussy system based on the continued use of national supervisors, and the addition of the European Systemic Risk Board was also a clear improvement. Nevertheless, it was a rather timid response to the global financial crisis, as many of the same problems faced by the cooperation of national supervisors could still be expected.

Why was a rather toothless system for financial supervision created instead of a single supervisor at this time? Schelkle (2014) attributes the scepticism of the European Council and the Internal Market Commissioner Charlie McCreevy towards granting this function to the ECB to its potential fiscal implications. After all, it makes little sense to have a supranational body order bailout if that same body did not possess the funds to do so. Moreover, there were the concerns of non-Eurozone countries with only a limited voice in the ECB.

The move to banking union only came after several years of heavy market pressure. Starting in 2009 with the revelation of the Greek government's high debt obligations, the crisis quickly spread to other countries on the euro area periphery: Ireland, Portugal, Cyprus

all joined Greece in asking for official assistance from the EU. Additional funds and expertise were provided by the International Monetary Fund, and together with the European Commission and the European Central Bank the "troika" took charge of the disbursement of loans and the construction and monitoring of conditionality programs. Other countries including France and Italy suffered from rising interest rates.

In 2012 the crisis reached its apogee as talks of "Grexit" abounded and Spanish bond yields continued to climb. Given the size of the Spanish economy, it was considered "too big to fail". A heated debate had begun on whether to grant the European Stability Mechanism the capacity to directly recapitalize banks, thus taking the costs off of the books of the sovereign (and removing the need for the latter to undertake a conditionality program in exchange for the funding).

As the sovereign debt crisis escalated in the spring of 2012, discussion on the creation of a single supervisory mechanism became urgent. Euro area leaders met frequently and in different configurations to consider the problems in Greece in Spain, direct bank recapitalization, banking supervision, structural reforms, fiscal consolidation, and increased solidarity. On 22 May the leaders of the four main euro area states (Germany, France, Italy and Spain) met in Rome. At an informal dinner of the European Council on 24 May, European Council President Herman Van Rompuy was charged with drafting a report with the other "four presidents" on "how to strengthen the economic union to make it commensurate with monetary union," which included "more integrated banking supervision" (Van Rompuy 2012a).

On 30 May the European Commission (2012a) released a communication urging for "a banking union including an integrated financial supervision" (p.5) without specifying which body should receive this responsibility. While the German Chancellor remained

circumspect on the issue, a senior figure from the Bundesbank specified that it “can only be at the end of a long road.”[1] Considering the urgency of the situation in Spain, this was not an encouraging sign. On 9 June the Eurogroup (2012a) announced that Spain would make a formal request for assistance from the EFSF/ESM to recapitalize its financial institutions, with up to €100b being made available. Spain’s Economy Minister Luis de Guindos took pains to note that “in no way is this a rescue. It’s a loan with very favorable conditions” (The Economist, 10 June 2012).

On 18-19 June at the G20 summit in Los Cabos, the euro area crisis took center stage as Jose Angel Gurria, the Mexican head of the Organisation for Economic Co-operation and Development (OECD), noted that the crisis was "the single biggest risk for the world economy".[2] The G20 summit communique pledged that its euro area members would “take all necessary policy measures to safeguard the integrity and stability of the area, improve the functioning of financial markets and break the feedback loop between sovereigns and banks…..Towards that end, we support the intention to consider concrete steps towards a more integrated financial architecture, encompassing banking supervision, resolution and recapitalization, and deposit insurance” (G20 2012, p.2). During this time, Italian PM Mario Monti and his deputy minister of Finance and Economics Vittorio Grilli unsuccessfully attempted to convince their interlocutors on automatic bond purchases by the ECB when the interest rates of a euro area member state went through a ceiling. Merkel simply replied, “I can’t accept this” (Ludlow 2012), as it would deviate from a host of well-established positions that Germany had on the ECB purchasing bonds without conditionality.

On 22 June, Italian Prime Minister Mario Monti invited the leaders of Germany, France, and Spain to Rome. No firm agreements were made apart from approving the

[1] http://www.ft.com/intl/cms/s/0/f3853c48-ae39-11e1-b842-00144feabdc0.html#axzz3DMiJFFri
[2] http://www.bbc.com/news/business-18496985

Compact for Growth and Jobs, but the leaders arranged for their finance ministers to meet in Paris on 26 June to continue discussions. In addition to these finance ministers, Van Rompuy's chef de cabinet Frans Van Daele, Euro Working Group chairman Thomas Wieser, and Commissioner for Economic and Financial Affairs Olli Rehn also attended. German Finance Minister Wolfgang Schäuble broke the impasse when he surprisingly announced that Germany would consent to the direct recapitalization of banks by the ESM if a single European supervisory mechanism were in place for the banking sector (Veron 2014). Wieser and Marco Buti (Director-General for Economic and Financial Affairs) were tasked with writing a paper for consideration of the Euro Working Group on 28 June (which was also joined by sherpas) (Ludlow 2012).

On 26 June the "four presidents" (European Council President Herman Van Rompuy, European Commission President Jose Manuel Barroso, Eurogroup President Jean-Claude Juncker and European Central Bank President Mario Draghi) issued their report, "Towards a Genuine Economic and Monetary Union" that similarly advocated "an integrated financial framework …[that] elevates responsibility for supervision to the European level" (Van Rompuy 2012b, p.3). It referred to the possibility of conferring this authority on the ECB as one that "would be fully explored" (p4). The report had been written within one month and had gone through eleven drafts, indicating how controversial the issues contained within were (Ludlow 2012).

In his opening remarks at the 28 June Euro working group/sherpa meeting, Van Daele urged his colleagues to focus on three issues: the seniority of ESM debt; the feasibility of a decision to authorise the ESM to recapitalise the banks directly and the conditions to which should be attached; and the scope for ESM/EFSF bond purchases and the conditions which should be required of EA member states wanting assistance of this kind. The discussion on recapitalization grew into the eventual deal in which direct bank capitalization would be able

to occur when a single supervisory mechanism was in place. Despite efforts by Spain and its allies to negotiate the direct recapitalization of Spanish banks while the SSM was still being established, Merkel, Draghi, Katainen and Rutte demurred. Merkel insisted on a credible SSM being created by the end of the year (Ludlow 2012).

On 29 June the Euro Area Heads of State and Government designated the ECB as the Single Supervisory Mechanism in charge of bank supervision in order "to break the vicious circle between banks and sovereigns" (Euro Area 2012). The statement noted that this would be done through the use of TFEU Article 127 (6):

> "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions".

On 12 September was the release of the Commission's communication that named the ECB as the SSM (Commission 2012c). A full consideration of the parameters of the ECB's powers as SSM is beyond the scope of this paper. I will just note the major issue being which banks would fall under the direct supervision of the ECB, all 6000 banks of the euro area or only the largest banks. On 15 October 2013 the Council adopted Regulation 1024/2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions that gave it direct control over banks deemed as significant credit institutions.

Explaining the Choice of the ECB

The designation of the ECB as the SSM was the latest coup for an institution that had seen its authority expand considerably since the global financial crisis. Its swift response to

the global financial crisis and its expansive interpretation of its mandate during the sovereign debt crisis won widespread praise as well as ire. The praise came from its advocates that credited it as a crucial crisis manager that acted where the Member States refused to, even going so far as pushing Member States towards further integration (Yiangou, O'Keeffe and Glöckler 2013). The ire came primarily from the German Bundesbank, which viewed the ECB's actions as a betrayal of its mandate to pursue price stability. The ECB also comprised part of the troika supervising the conditionality programmes of countries receiving funding from the euro area. Moreover, the ECB's appointment as the SSM presaged the ECB's Outright Monetary Transactions announcement, which is widely credited with saving the euro.

How can we explain this important part of banking union, the biggest game changer in the EU since the introduction of the euro in 1999? While this had the advantage of avoiding a Treaty change (as noted in the summit statement), the ECB was not the only option for financial supervision. The European Commission, for example, had obtained new powers in financial stability support since the onset of the crisis with its involvement in balance of payments assistance, the European Financial Stabilization Mechanism, the European Financial Stability Facility and the subsequent European Stability Mechanism (Bauer and Becker 2014). Moreover the European Systemic Risk Board (which the ECB president chairs) had already been operational since 2011 as a result of Regulation (EU) No 1092/2010 that gave it the task of monitoring and assessing systemic risk as part of the new European System of Financial Supervision. On the other hand, euro countries in the periphery considered the European Banking Authority to be the preferred option,[3] though this failed to gain much traction. Reportedly this was also favored by the Commission and non-euro area countries, as it would not pose the same governance concerns for euro-outsiders that using

[3] http://www.ft.com/intl/cms/s/0/25c39204-ab01-11e1-b875-00144feabdc0.html#axzz3DMiJFFri

the ECB would,[4] and it allowed the Commission to continue to serve as the primary body for making rules.[5]

After dominating European integration studies, the theories of neofunctionalism and liberal intergovernmentalism fell out of favor in recent years after the rise of mid-range theories that better explained the day-to-day operations of the EU in the absence of the grand bargains of earlier eras. Do these grand theories still provide insight into the political dynamics that led up to the ECB's declaration as SSM? This section examines the selection of the ECB as the SSM through the lens of neofunctionalism and liberal intergovernmentalism.

Neofunctionalism

Neofunctionalist explanations credit "ideational entrepreneurs" that are well-placed take advantage of information asymmetries and form transnational coalitions to further integration (Sandholtz and Zysman 1989). Liberal integovernmentalist advocates have also recognized the need for such entrepreneurs "in exceptional cases", such as the negotiation of the Single European Act (Moravcisk and Schimmelfennig 2009, p.71; Moravcsik 1999a). Through this process, supranational actors accrue more power as they are able to satisfy the needs of transnational coalitions better than national actors. Traditionally neofunctionalist accounts have focused on the European Commission, but the European Central Bank is another important supranational institution with the capacity to promote integration and enhance its own influence in the process. Another important concept in neofunctionalism is that of spillover, according to which integration in one policy area leads to integration in related policy areas. In the case of banking union, monetary integration had spillover effects on financial integration, thus necessitating the need for banking union.

[4] http://www.ft.com/cms/s/0/1c94e340144feabdc0.html#ixzz3DNv6b4YL e-b958-11e1-a470-0
[5] http://blogs.ft.com/brusselsblog/2012/06/12/three-designs-for-an-banking-union-and-the-turf-war-ahead/

The ECB as Policy Entrepreneur

The ECB had long been a proponent of acquiring additional supervisory authority; shortly after the introduction of the euro, it already argued for the merits of assuming this role (ECB 2001). After the global financial crisis, the ECB renewed its efforts for a greater role in financial supervision. ECB Vice President Lucas Papademos suggested that the ECB could work together with national central banks and take over the supervision of cross-border banks (*Wirtschaftswoche*, 4 January 2009). Numerous academic economists also agreed on the need to add financial stability to the mandate of central banks (Eichengreen et al. 2011). Therefore the ECB was suggested to the High Level Working Group (including by ECB representatives) to conduct financial supervision, but it was rejected out of concern for potential conflicts of interest between the ECB's conduct of monetary policy and its micro-supervisory role (De Larosiere 2009, pp.43-4; see also Goodhart and Schoenmaker 1995). Nevertheless the ECB did acquire a role in the macro-supervision by heading the new European Systemic Risk Board, which would replace the Banking Supervision Committee of the ECB. However, the institutional weakness of the new European Banking Authority made it difficult for it to be able to perform effectively, particularly its lack of independence (Masciandaro, Nieto and Quintyn 2011).

As the crisis wore on, the ECB continued to lobby for the need for European-level financial supervision. On 25 April 2012 Mario Draghi spoke before the European Parliament and argued "Ensuring a well-functioning EMU implies strengthening banking supervision and resolution at European level" (Draghi 2012). The ECB had heavily supported euro area banks during the sovereign debt crisis, and Draghi preferred to centralize financial supervision, though he did not name the ECB directly and other bodies were speculated as possibilities. Others at the ECB were more forthright in their support for the ECB to assume

banking supervision; French Central Bank Governor Christian Noyer connected the ECB's successful track record to its potential to serve as a credible banking supervisor:

> "Building on the success of the single monetary policy, we must now establish a single supervisory system organized along the same lines: centralization of decision-making and decentralization of implementation. The ECB and national central banks are well-equipped to be the backbone of the financial union." (Noyer 2012)

ECB Vice President Vitor Constâncio outlined the benefits and costs of giving the central bank supervisory powers in a speech delivered on 7 September 2012 (Constancio 2012). He briefly noted five main arguments: 1) an "intrinsic and deep interest in a stable financial system"; 2) "close relationship between micro-prudential control of individual financial institutions and the assessment of risks to the overall financial system, which constitutes the central bank's macro-prudential responsibility"; 3) synergies between banking supervision and the oversight of the payments system; 4) central bank "expertise on the financial sector"; 5) the central bank's political independence. The downsides focused on potential reputation risk (see also Goodhart 2000) and conflicts of interest between the central bank's responsibilities towards monetary policy versus financial stability. Constâncio concluded that "Indeed, the experience during the financial and sovereign debt crises has demonstrated the benefits of including banking supervision under the central bank's purview."

Insider accounts attest that "Draghi and Asmussen played a central role in redefining the terms of the euro debate…[and] have kept up the pressure both within the group of four presidents and beyond it" (Ludlow 2012, p.28). ECB representatives also tried to have the ECB involved in supervision before the mechanism was established, though such an interim arrangement did not prevail (Ludlow 2012). At the European Council meeting of 28 June 2012, Mario Draghi persuasively argued that supervision should be conferred to the ECB on

the basis of Article 127 (6), and he explained how ESM recapitalization could take place retroactively (Veron 2014, p.30).

Although the ECB pressed its case for assuming supervisory authority, it did not receive strong support from the other major supranational institution, the European Commission. Barroso supported the establishment of "banking union….[as] more integrated financial supervision and also more integrated deposit guarantees" (Commission 2012b) but preferred that supervision to fall under the European Banking Authority.[6] Prior to the selection of the ECB, the Commission argued in favour of strengthening the EBA (*Handelsblatt*, 14 June 2012).[7] Once the ECB had been decided upon, the Commission still attempted to tinker with the proposal in favour of the EBA. According to *Der Spiegel*, Commission officials (Michel Barnier, Joaquin Almunia and Olli Rehn) drafted a proposal that would have the EBA assume most responsibility for financial supervision, with the ECB being delegated specific tasks relating to the euro area (*Der Spiegel*, 8 July 2012).

Nevertheless, the ECB had powerful allies in the European Council, as will be seen in the intergovernmentalist account below. The Commission and Draghi were in agreement in their desire for the central regulation of all Eurozone banks (Eurointelligence, 31 August 2012), despite "some senior ECB officials" expressing sympathy with Germany's contention that direct supervision of all financial institutions would be beyond its capacity (FT, 30 August 2012).

Economic spillover

The introduction of the euro was based largely on an intergovernmental logic that rested on political imperatives rather than economic ones (Moravcsik 1998). Numerous economists noted the weaknesses inherent in EMU, such as the absence of an optimum currency area in the euro area (Bayoumi and Eichengreen 1997), the lack of a lender of last

[6] http://www.ft.com/cms/s/0/1c94e34e-b958-11e1-a470-00144feabdc0.html#ixzz3CGQzJ5qe
[7] http://www.handelsblatt.com/politik/international/finanzaufsicht-ezb-soll-europas-banken-kontrollieren/6753570.html

resort, and the continued national supervision of financial institutions (Schoenmaker 2011). Thus a functional logic can be identified in which monetary union would require integrated financial supervision in order to be stable. The rise of cross-border financial institutions across Europe has made contagion across markets an increasingly important concern for policymakers. The global financial crisis had already exposed the vulnerability of European financial institutions to events outside national borders (Hardie and Howarth 2013). The sovereign debt crisis showed how a small economy like Greece could snowball into a crisis affecting major euro area economies like Spain and Italy by calling into question the integrity of the euro area (Chang and Leblond 2015). Therefore it was important for the euro area to restore market confidence and prevent liquidity crises from turning into solvency crises. Banking union with common supervision was a critical component of this, though it did not necessarily lead to the ECB playing this role.

Legal spillover

From a legal perspective, the designation of the ECB as the SSM was the most straightforward in that it could be based on Article 127 (6) and therefore would not require a treaty change. The EU had still not recovered from the lengthy process of ratifying the Lisbon Treaty, and none were eager to repeat the experience. A treaty change would not only delay the implementation of banking union, it would open up the possibility of new deals being negotiated that would further complicate its passage. The requirement of some countries (like Ireland) to put treaty changes to a national referendum introduced further uncertainty.

Moreover, the ECB had accumulated a considerable amount of credibility, and the new banking union could conceivably benefit from a halo effect. On the other hand, the ECB had already emerged as a powerful institution, and responsibility for financial supervision could make it too powerful and insufficiently accountable (Pisani-Ferry, Sapir, Veron and Wolff 2012).

Liberal intergovernmentalism

Intergovernmentalism posits that the major actors in European integration are the large Member States (Grieco 1996). They dominate negotiations due to their superior economic and political weight, and their consent is indispensable to further integration, particularly measures that involve a large delegation of authority to the supranational level. Such integration takes place as a result of "exogenous functional challenges" (Moravcsik 2005, p.358). The global financial crisis and subsequent sovereign debt crisis could be considered exogenous to the extent that the former originated in the United States and precipitated the latter (though underlying weaknesses in the euro area were already apparent). According to the liberal intergovernmentalist variant, the Member States strive to defend national economic interests (as opposed to geostrategic motivations or those related more broadly to support for European integration) (Moravcsik 1998; Moravcsik and Schimmelfennig 2009).

In European integration in general and in economic and monetary affairs in particular, France and Germany historically have played the role of the engines of integration (Krotz and Schild 2012). Nevertheless by the time of the sovereign debt crisis, Germany had risen to an even more prominent position in Europe's economic hierarchy. As European economic governance was renegotiated, Germany's preferences (particularly in fiscal policy negotiations) dominated outcomes so much that one author referred to her as "Merkiavelli" (Beck 2013). This section thus considers first the EU-level negotiations (intergovernmentalism) and then explains the preferences that were derived from domestic politics (liberal intergovernmentalism).

Strong differences of opinion regarding banking regulation were already manifest during the negotiations for the latest iteration of the Capital Requirements Directive (CRDIV) that would transpose the Basel III agreement into EU law. The final legislation substantially

altered and watered down the Basel III guidelines in order to accommodate German demands for greater leniency towards its *Landesbanken*, while the UK sought to hew more closely to the original Basel agreement (Howarth and Quaglia 2013a). France and Germany were able to find common ground after the global financial crisis; both pushed for stronger bank reporting obligations and strengthening regulatory cooperation, particularly in regards to hedge funds (Hardie and Howarth 2009).

As the sovereign debt crisis unfolded, France became vulnerable as its deficit level more than doubled since the global financial crisis began. Deficit levels climbed to 7.5% in 2009 and remained at 7% in 2010, bringing its debt/GDP ratio to 83% in 2010. Large French banks briefly lost access to financing in dollars during the summer of 2011, constituting a turning point as the previous consensus on the need to maintain national sovereignty in banking gave way to support for banking union. For Treasury Director Ramon Fernandez, banking union was an indispensable part of Europe's response to the crisis, and he led the charge in Brussels (Veron 2014).

Concerning banking union, France and Germany upheld their traditional roles in EMU negotiations dating back to the "locomotive versus coronation" debates in the 1970s (Dyson 1994). France sought stronger support mechanisms without straying into 'political union' that would give further control to the EU level over national fiscal and economic policy. Germany wanted the sequence to be reversed, with fiscal control coming beforehand. France's interest in speeding up banking union largely lay in their concern over breaking the doom loop between banks and sovereigns (Howarth and Quaglia 2013b).

At the informal European summit of 23 May 2012, newly elected French President Francois Hollande had arrived with three main proposals: growth, banking union, and

financial stability.[8] Germany European Central Bank executive board member, Jörg Asmussen, said prior to the summit that the euro zone should be backed by “a fiscal union and banking union as well as a democratic legitimised political union”. [9] Asmussen’s position neatly summarized the conventional wisdom in Germany: banking union requires fiscal union, and fiscal union requires political union. Therefore one would expect banking union to come at the end of a process of more integration, not as an immediate quick fix to a crisis.

The results of the informal meeting therefore inconclusive as “colleagues expressed various opinions on issues such as eurobonds in a time perspective, more integrated banking supervision and resolution, and a common deposit insurance scheme” (Van Rompuy 2012a). Upon leaving the summit, Hollande again expressed his desire for a more integrating banking supervision and common deposit guarantees (Veron 2014).

Hollande quickly emerged as the champion for the ECB to take over financial supervision in the euro area.[10] Draghi also wanted the ECB to assume supervisory tasks, an idea supported by European Council President Herman Van Rompuy. The latter favored this as the pragmatic solution, as banking union could proceed more quickly this way.[11] Thus an important coalition was formed between the French president, ECB president and European Council president.

An exogenous change caused German chancellor Merkel to reconsider the previous German position on European financial supervision occurring only at the end of a long process and after a Treaty change: the threat of the collapse of the euro area. Rising Spanish bond yields and the prospect of the need for a full-scale bailout along with continued

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[8] http://www.franceinfo.fr/emission/tout-info-tout-eco/2011-2012/crise-de-l-euro-convergence-paris-rome-06-15-2012-09-50

[9] http://www.euractiv.com/euro-finance/eu-prepares-new-stage-economic-u-news-512943

[10] http://www.ft.com/cms/s/0/1c94e34e-b958-11e1-a470-00144feabdc0.html#ixzz3CGQzJ5qe

[11] http://www.welt.de/print/wams/politik/article107256056/Rompuys-neues-Europa.html

speculation of Grexit altered German preferences in favor of banking union, as the costs of delay had become unacceptably high. On 4 June, Merkel indicated that European leaders would discuss placing systemically important banks under European supervision (Bundesregierung 2012), indicating a softening of German intransigence towards banking union. The discussion of banking union was inextricably tied with that of direct bank recapitalization, and two proposals came under consideration. A 'big bang' approach was advocated by France, Italy, and Spain with the support of the ECB and the IMF that would allow both direct bank recapitalization immediately upon the decision to transfer supervision to the EU level. On the other hand, Germany, Finland and the Netherlands supported a 'supervision first' approach that would be more gradual (Veron 2014, p.40).

The prospect of the ECB assuming supervision created some unease among the euro outs. Swedish Prime Minister Fredrik Reinfeldt voiced the concern that "you start with 27, but we all know that you are principally concerned with the 17," receiving support from British Prime Minister David Cameron (Ludlow 2012). The concern over the integrity of the single market in financial services sat uneasily beside the need to quickly respond to market speculation on the collapse of the euro.

Despite concern within Germany over the need for banking union and its concomitant fiscal obligations to be done within the framework of a (lengthy) treaty change, market pressure intensified and threatened the euro's survival. Markets reacted negatively to the Spanish bailout, and interest rates continued to climb. Spain was not Greece; its economy was 'too big to fail' and would send shockwaves throughout the euro area and globally. Having already agreed to the principle of the integration of financial supervision, the next step was operationalizing it by deciding on the single supervisory mechanism. Under enormous market pressure, Merkel agreed to the French proposal for the ECB to assume responsibility for

financial supervision.[12] On 13 June, Merkel went public with her support for the French plan (*Handelsblatt*, 14 June 2012).[13]

At the 28 June summit, the French government proposed a package of measures that included ECB supervision along with direct recapitalization of banks through the ESM (Financial Times, 13 June 2012).[14] This plan involved the ECB being able to supervise systemically risky banks and shut them down, if necessary. The ECB would also use stress tests to judge a bank's viability, with the ESM's resources being made available to recapitalize banks.[15] An important benefit was the exclusion of Germany's small but political powerful regional banks (see next section). Although the Commission proposal gave the ECB a wider remit over all euro area banks, this was quickly rebuffed.

Domestic politics

Why would Germany support European supervision but try to limit such supervision over its own banks? The answer has to do with the fragility of the German financial system and the privileged position of publicly owned banks within it. Germany's financial system had traditionally been described as a conservative bank-based system that focused on relationship banking, characterized by patient capital that supported Germany's coordinated market economy (Hall and Soskice 2001; Deeg 2010). It rested on three pillars: commercial banks, public savings banks (*Landesbanken* and *Sparkassen*); and the cooperative banks that specialized in specific sectors. Each pillar had different financial, legal and governance systems. The *Landesbanken* were particularly important to the development of Germany's *Mittelstand* of small- and medium-sized enterprises, as they were required to service public policy objectives (Zimmerman 2012). The German system was "more protectionist and anti-

[12] http://www.ft.com/intl/cms/s/0/7d1842e2-b642-11e1-8ad0-00144feabdc0.html#axzz3DMiJFFri
[13] http://www.handelsblatt.com/politik/international/finanzaufsicht-ezb-soll-europas-banken-kontrollieren/6753570.html
[14] http://www.ft.com/cms/s/0/a732fdbe-b553-11e1-ad93-00144feabdc0.html#ixzz3CGSi6k9z

[15] http://www.ft.com/cms/s/0/a732fdbe-b553-11e1-ad93-00144feabdc0.html#ixzz3DNtB0zQ0

competitive" than that in the UK and France (Hardie and Howarth 2009, p.1020), with implicit public guarantees and the *Landesbanken* and *Sparkassen* "retaining their own fiefdoms" that were free from competition (Hardie and Howarth 2013). Regulation is divided between the Bundesbank and *Bundesanstalt für Finanzdienstleistungsaufsicht* (Bafin), and regulation lacked transparency and was quite fragmented (Zimmerman 2012; 2008).

During the decade preceding the global financial crisis, the German financial system had looked less like its traditional bank-based system and more like market-based banking as banks loaded up on purchases of asset-backed securities, became more international and heavily dependent on wholesale markets for funding (Hardie and Howarth 2009, 2013). Despite these important changes, German regulation remained the same. The Bundesbank had been angling for more responsibility in financial supervision since 2000 in the wake of the introduction of the euro. A new institution was created in 2002 (Bafin) that shared authority with the Bundesbank, and although "the new two-pillar system soon came under massive attack," it persisted (Zimmerman 2012, p.491).

The global financial crisis hit Germany hard; Hypo Real Estate, IKB and *Landesbank Sachsen* all collapsed, and the government responded with credit guarantees, bailouts, and even nationalization (in the cases of *Industriekreditbank*, Hypo Real Estate). Nevertheless Germany's domestic financial reform was characterized by layering rather than punctuated change as *Land* governments resisted the centralization of banking supervision (Zimmerman 2012).

Likewise, the German Bundesbank strongly resisted changes that would transfer more authority to the supranational level. Then-Bundesbank Vice President Sabine Lautenschläger argued that banking union first required fiscal union; without it, banks in weaker economy would benefit, passing on cheaper refinancing costs to their respective government. Banking

union therefore required “comprehensive EU Treaty changes” (Financial Times, 12 June 2012; see also *Frankfurther Allgemeine Zeitung* 1 June 2012).[16] Bafin head Elke König similarly opposed quick moves towards banking union, citing the need for fiscal union as well as more political and economic integration. FDP politician termed banking union “a new and admittedly creative way of taking advantage of the German creditworthiness (Eurointelligence, 6 June 2012). Georg Fahrenschon, president of the lobbying group of German savings banks, wrote a guest column for Financial Times Deutschland against banking union (Eurointelligence, 4 June 2012). Though Merkel decided to go ahead with banking union, the ECB would only supervise systemically important banks, thus protecting its weak public banks. France shared Germany’s preference to limit supervision to large banks, in any case (Eurointelligence, 14 June 2012).

Although Germany emerged from the global financial crisis in a strong political and economic position within Europe, its financial system was weakened severely. The German government took pains to protect it in international accords like Basel and continued to do so at the European level with the CRD IV. Moreover the (relatively) rapid developments in European economic governance stoked domestic concerns over German liabilities. The German constitutional court had to weigh in over the ESM Treaty (and would later consider the ECB’s OMT), and the ESM Treaty and the Treaty for Stability, Coordination and Governance needed to be ratified by the German parliament. Although the latter managed to obtain the required two-thirds majority on 29 June, it did not get the “chancellor’s majority” due to defections from MPs in the FDP, CSU and CDU (Ludlow 2012).

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[16] http://www.ft.com/cms/s/0/79c17794-b467-11e1-bb68-00144feabdc0.html#ixzz3CLpoK0xY
http://www.faz.net/aktuell/wirtschaft/eurokrise/im-gespraech-bundesbank-vorstand-sabine-lautenschlaeger-bankenunion-erst-am-ende-des-weges-zur-fiskalunion-11771178.html

Liberal intergovernmentalism sheds light on some important dynamics in the selection of the ECB as the SSM. Germany's consent was obviously critical behind the decision. It was able to protect the interests of its *Landesbanken* and *Sparkassen* by insisting on limiting the direct supervision of the SSM to the largest banks. On the other hand, German domestic politics was quite divided on the idea of banking union and its fiscal implications. Germany was not the major driver of this policy, as liberal intergovernmentalism would predict. Instead the primary champions of the ECB as SSM were the ECB and Francois Hollande. This ambivalence points to the need to look at historical institutionalism and how the need for a rapid decision in the context of the deteriorating situation in the euro area made the ECB the best option.

Historical institutionalism

Historical institutionalism examines the constraints that earlier decisions place on future decisions given the "stickiness" of institutions. A critical concept is that of path dependence in which "dynamics triggered by an event or a process at one point in time reproduce themselves" (Pierson and Skocpol 2002). Therefore at critical junctures, a choice is made that sets policy down a future path that restricts other policy options in the future due to the high costs of switching.

The original critical juncture in this case was the Maastricht Treaty and the now TFEU Article 127 (6). This made the choice of the ECB as SSM easier because it removed the need for a Treaty change. It was not without controversy and there was much speculation about the legality of doing so; prior to the political decision to make the ECB the ESM, numerous actors in Germany insisted that such an important transferal of power would require a Treaty change. While the ECB and the European Commission had insisted that

European financial supervision could occur without a treaty change, Germany had long insisted on it.[17]

Merkel's choices were further constrained by the momentum the ECB had built up during the crisis as a trusted and credible actor. The German government could ill afford to criticize the ECB when no alternative crisis mechanism existed that could take on responsibility for crisis management. The ECB offered the added benefit of joining Germany in urging governments to undertake fiscal consolidation and structural reforms (Schwarzer 2012). In contrast, options like EBA and the Commission had been tainted by the experience of the crisis. The EBA's stress tests that failed to predict bankruptcies like Dexia seriously harmed its credibility. Moreover its location (London) outside of the euro area made it a harder choice for euro insiders, particularly given the increasingly tense relationship with the UK. The Commission had also been sharply criticized for its handling of the crisis and its perceived lack of independence (Chang 2013).

The situation in June 2012 was tense, as the Spanish bailout was received negatively by markets, spurring the need for a quick resolution. The time pressure created an additional constraint on policymakers. Much like the creation of the crisis funds of the EFSF and the ESM were created under high pressure and had consequences for future decisions (Gocaj and Meunier 2013), the banking union decision was done under severe time constraints. Selecting the ECB quickly became the preferred option for financial supervision given it already possessed a potential legal basis and the ECB had already accumulated considerable momentum and credibility. This further explains why the ECB became the SSM.

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[17] http://www.ft.com/cms/s/0/ccb2fda0-b3cd-11e1-8b03-00144feabdc0.html#ixzz3CGSawaU0

Conclusion

The grand theories of neofunctionalism and liberal intergovernmentalism go a long way towards explaining the selection of the ECB as the Single Supervisory Mechanism. Neofunctionalism helps us appreciate the role that the ECB played as a policy entrepreneur, pressing its case for the centralization of financial supervision and for its role of supervisor. While these issues are often conflated, they are in fact separate. While Banking Union is a game-changer and constitutes the biggest change in European economic governance since the introduction of the euro, it is analytically distinct from the designation of the ECB as the SSM. Moreover, such an important decision required Member State approval. Therefore liberal intergovernmental goes far in explaining the critical role of Germany in acquiescing to banking union but cannot account for the lack of leadership that Germany played during these negotiations. Instead, Mario Draghi and Francois Hollande took the lead during this period in pressing for the ECB to become the European financial supervisor. The closest explanation is that of “lowest common denominator” bargaining in which Germany could accept banking union under rather minimalist conditions that continued to protect its Landesbanken and Sparkassen. Historical institutionalism, on the other hand, provides insight into the selection of the ECB given the relative rapidity with which it could assume control over financial supervision. This combined with the momentum the ECB had acquired thanks to its favourably-received crisis management made the ECB more likely to obtain this new position in banking supervision.

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