The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet'

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Abstract
This paper seeks to explain national preferences on the Single Supervisory Mechanism, on which the three main issues were: whether the ECB should directly supervise all banks in the euro area or only the main (cross-border) banks, the nature of indirect supervision, and the relationship with non-euro area member states. Here it is argued that specific political economy considerations -- detached from financial and legal considerations -- account for member state preferences on the SSM. We borrow from and develop Schoenmaker's (2013) concept of 'financial trilemma' -- in which countries cannot expect to achieve financial stability, in the context of cross-border banking while retaining national financial policies (regulation, supervision, support and resolution). We add euro membership to the trilemma of cross-national banking, financial stability and national control, to create a 'financial inconsistent quartet', which reinforces the logic for euro area member states to create Banking Union. We also argue that the analytical usefulness of this concept to explain national preferences on the SSM relies upon its nuanced application to individual countries and a consideration of distinct national banking systems.

Introduction

In June 2012, the European heads of state and government agreed to deepen Economic and Monetary Union (EMU) by creating 'Banking Union' (BU), which was to be based on five components: a single rulebook of EU financial regulation and competition policy; a single framework for banking supervision; a single framework for the managed resolution of banks and financial institutions; a common deposit guarantee scheme; and a common backstop for temporary financial support. In September 2012, the European Commission proposed a regulation for the establishment of a Single Supervisory Mechanism (SSM), which was approved by government leaders in December 2012.

The proposals for BU amount to a radical initiative to rebuild financial market confidence in both banks and sovereigns – especially in the euro area periphery – to stabilise the national banking systems exposed directly to a vicious circle between the international financial crisis and the euro area's sovereign debt crisis and to reverse the fragmentation of European financial markets. BU is also set to bring about a significant transfer of powers from the national to the EU (to be precise, the BU) level. The decision to create BU represents a major development in European economic governance and European integration history more generally. BU is also significant because not all EU member states will join: it will include all the countries in the euro area as well as the countries that decide and are able to opt-in. Hence, BU will increase the trend towards differentiated integration in the EU, which in itself poses a major challenge to the EU as a whole and to the opt-out countries – first and foremost the UK, given the size of its financial sector and its interconnection to the euro area.

Much has been written on national positions on BU dictated by the relative gains from the stabilization effects of resolution fund mutualisation and the financial contribution / receipt of different member states and their banks. The assumption of these claims is that the creation of the SSM is a crucial stepping stone to the creation of the Single Resolution Mechanism. German (and other) concerns of a dangerous conflation of the ECB's monetary and micro-prudential powers has also received press coverage.[1] This

[1] The Bundesbank argued that the December deal on the ECB's role in supervision lacked 'a long-term solid legal basis' and that the mediation committee operating between the bank supervisor and the Governing Council could be attacked in the courts for insufficiently insulating monetary from prudential policy (*Financial Times,* 17 December 2012). The Bundesbank President, Jens Weidmann, also challenged the

paper explains national preference formation on the establishment, scope and membership of one of the main elements of BU, the Single Supervisory Mechanism (SSM), and in particular the criteria to be used to determine which banks should be supervised directly by the European Central Bank (ECB) and which should continue to be supervised by national supervisory authorities. The precise threshold for 'systemically important' – set over the months following the December 2012 agreement on the SSM – meant than the ECB would have direct supervisory responsibility for approximately only 130 banks. We also consider, secondarily, national preferences on the participation of non-euro area member states in the SSM.

Theoretically, the paper develops and applies what we label the 'financial inconsistent quartet'. The starting point is Dirk Schoenmaker's 'financial trilemma' (2013) which examines the interplay of financial stability, cross-border banking and national financial policies, arguing that any two of the three objectives can be combined but

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logic of transforming the ECB into a prudential supervisor and expressed concern that the ECB's new supervisory role would not be sufficiently separate from its monetary policy role (and the goal of price stability) to ensure independence (*Financial Times*, 27 September 2012; *WirtschaftsWoche*, 22 December 2012). Many other observers and policy makers, including the EP's Economic and Monetary Affairs Committee expressed similar concerns (*Financial Times,* 29/30 November 2012). Weidmann, however, argued that at best the ECB should operate as a transitional supervisor, while another entirely independent body was set up. On MEP concerns see, http://blogs.deloitte.co.uk/financialservices/2013/09/european-parliament-agrees-single-supervisory-mechanism-regulation.html.

not all three: one has to give. While Schoenmaker presents an economic analysis to explain the existence of the trilemma, this paper examines national preference formation with regard to the three objectives of the trilemma and how this shaped policies on the main elements of Banking Union. However, we argue that in the European Union (EU) there is a fourth element to be considered, namely participation in the single currency. Hence, the trilemma becomes an 'inconsistent quartet'.

We also argue that the analytical usefulness of this concept to explain national preferences on the SSM relies upon its nuanced application to individual countries and a consideration of distinct national banking systems. Our analysis considers: the degree of banking system concentration; the degree of internationalization; the degree of foreign bank penetration; and systemic patterns in bank funding. There has been some press discussion of German reluctance dictated by a desire to protect the country's three-pillared banking system from European-level scrutiny (see, for example, Reuters 2013), and notably under-capitalised public sector banks. However, this is rarely couched in a comparative systemic analysis of national banking systems and national preferences. Also, the standard 'protectionist' take on German policy on the SSM fails to explain why the German government eventually allowed all of its Landesbanken to be included in the list of systemically important banks and thus subject to direct ECB supervision (through Joint Supervisory Task Forces, JSTF). French policy on the SSM was driven by a reluctance to cede national control over the supervision of the five large French banks but also concerns that SSM supervision would be asymmetric. The British opt-out can be explained in terms of non-euro membership. However, the configuration of the British banking system further diminished British interest.

2. State of the art and theoretical framework

The paper takes as a starting point Dirk Schoenmaker's 'financial trilemma' (2013 and Wagner and Shoenmaker 2011), which examines the interplay of financial stability, international banking and national financial policies, arguing that financial stability in the context of cross-border banking requires the transfer of financial policies (regulation, supervision and even financial support and resolution) to the supranational level. Schoenmaker focuses upon global bank governance but he dedicates a couple of pages in his conclusion to the prospect of European Banking Union. While Schoenmaker presents an economic analysis to explain the existence of the trilemma, our paper examines national preference formation with regard to the three objectives of the trilemma and how this shaped policies on the SSM.

We argue that in the EU, to be precise in Economic and Monetary Union, there is a fourth element to be considered, namely the single currency. Hence, the trilemma becomes an 'inconsistent quartet'. We borrow from Padoa-Schioppa's (1982) use of the term, applied to the context of European monetary integration, just as Schoenmaker's trilemma borrows from Mundell-Fleming. On the one hand, the single currency reinforced financial (banking) integration in the euro area. On the other hand, the single currency undermined national financial policies, because the function of lender of last resort can no longer be performed at the national level and the adjustment tool of currency devaluation was eliminated. Moreover, national support powers are constrained by EU competition policy and national resolution powers by fiscal rules. Increased incentive was thus created for euro area member state governments (in some cases with great reluctance) to move to BU. The UK did not

have the fourth element of the quartet, namely the single currency, thus British policy makers had less incentive to seek participation in BU. Central and Eastern European member states of the EU that had banking systems dominated by foreign (mostly euro area) owned banks had an incentive to join BU because they were not in a position to safeguard financial stability domestically. The countries that faced the quartet because they were members of EMU had however different preferences on the various elements of BU, depending on the concern of national policy makers for moral hazard (of particular relevance for the creation of the resolution and recovery mechanisms) and the configuration of their national financial systems.

Our focus on national banking systems draws from a small but growing political economy literature (Zysman 1983; Allen and Gale 2000; Deeg 1999; Deeg 2010) which generally upholds a dichotomy between bank credit-based and capital market-based financial systems which is assumed (but rarely examined) in the varieties of capitalism (VoC) literature. In bank-based financial systems, banks perform the function of financial intermediation between household-savers and firms, providing funding to the real economy. In the capital market-based financial systems, markets are the main source of (rather volatile) credit to the real economy. In this typology, all the main European continental countries were classified as bank-based financial systems. The UK and the US were classified as market-based financial systems. Recent scholarship (notably, Hardie and Howarth 2013; and Hardie et al. 2013) questions this analytical and even descriptive usefulness of this dichotomy in addition to the financial system assumptions of the VoC literature. They develop the concept of ‘market-based banking,’ noting that banking over the last decade has become mostly market-based, meaning that banks fund themselves in the wholesale market

(market-based liabilities) and invest in non-traditional banking activities (market-based assets). Rather than categorising with difficulty a range of financial systems into an artificial dichotomy, different financial systems can be described as more or less market-based. Furthermore, different banking systems can be described as more or less market-based (noting the distinction between market-based liabilities and assets). This research informs our understanding of cross-border banking which goes beyond that developed by Schoenmaker in that we examine the cross-border nature of both assets *and* liabilities and we examine the extent to which these cross-border assets and liabilities are market-based. While all cross-border activities increases interest in supranational regulation and supervision (etc.), we argue that 'market-based' activities intensify this interest. As Hardie and Howarth (2013) show, the higher the market-based assets and liabilities, the greater the exposure of national banking systems to the global banking crisis.

Some of political economy work on individual national banking systems is of direct relevance to and supports the central arguments made in this paper: on the UK (Hardie and Maxfield 2013), France (Howarth 2013), Germany (Hardie and Howarth 2013), Italy and Spain (Quaglia and Royo 2014). Epstein (2013), Spendzharova (2013), Johnson and Barnes (2014) underscore the high degree of foreign bank penetration -- especially euro area banks -- in central and eastern Europe, pointing out the problems that this poses for domestic (host) supervisors in charge of safeguarding financial stability in these countries. Epstein (2013) argues that foreign banks in the CEECs did not 'cut and run' during the crisis because they had set up profitable subsidiaries in these countries, not so much because of the so-called Vienna initiative. Spendzharova (2013) examines how the high degree of foreign bank penetration has

influenced the attitudes of CEECs towards BU as well as the CRD IV. Johnson and Barnes (2014) discuss the financial nationalism in the response to the crisis in Hungary which, however, was somewhat an outlier amongst CEECs, in that no other countries in the region embraced financial nationalism in response to the crisis.

Methodologically, this paper deploys a two-step political economy analysis. First, it investigates the preferences of the main member states on key aspects of the SSM. This is done through textual analysis of policy documents, a systematic survey of press coverage and semi-structured elite interviews with policy makers across the EU. Second, it undertakes a comparative political economy analysis of national banking systems, examining their main features, namely concentration, internationalisation (abroad and at home) and funding. This analysis is undertaken with the aim of explaining how the configuration of national banking systems shaped national preferences on the 'inconsistent quartet' and thus national preferences on the SSM.

3. The negotiations on the SSM

In September 2012, the Commission adopted a set of legislative proposals concerning the setting up of the SSM, as first steps towards Banking Union: a regulation giving strong powers for the supervision of all banks in the euro area to the European Central Bank (ECB) (Commission, 2012a); a regulation with limited specific changes to the regulation setting up the European Banking Authority (EBA) to ensure a balance in its decision making structures between the euro area and non-euro area member states (Commission, 2012b); and a communication on a roadmap for completing the Banking Union over the coming years, covering the single rulebook, common deposit protection and a single bank resolution mechanism (Commission, 2012c).

The Commission and the French government called for an end of year deadline to finalise the first element of Banking Union, the Single Supervisory Mechanism. However, it became clear in the autumn that implementation would be delayed to the spring of 2014. There were two main controversial issues concerning the SSM. The first one was the scope of ECB supervision, in particular whether the ECB should directly supervise all banks in the euro area or only the main (cross-border) banks. The second one was whether non euro area member states should be allowed to join the SSM and the relationship with non euro area countries.

The German federal government sought to assign real investigation and auditing powers to the ECB – but only over Europe's biggest cross-border banks. German policy-makers initially opposed ECB supervision of the country's public Landesbanks and savings banks (*Financial Times*, 5 December 2012). These banks were seen as having a 'public' function in Germany with strong ties to local and regional governments and traditionally reliant on them for financial backing – through credit guarantees for the Landesbanks (with new guarantees banned from 2005), long-term loans ('silent participations') and covered bond holdings – which also created a competitive advantage for these banks which could lend at lower rates (Fischer *et al*. 2011). Yet these public banks also tended to be under-capitalised according to Basel III guidelines, although the permissibility of 'silent participations' as Tier 1 capital under the CRDIV improved their position. German policy-makers preferred them to be subject to national supervision. By the December 2012 European Council, however, it had become clear that the German federal government was willing to set the threshold to extend direct ECB supervision to the LB.

The Commission and the French government pushed for ECB involvement in supervision to cover all euro area banks. However, the French pushed for a de facto national supervision to continue through a 'licensing' system in which national supervisors would work on behalf of the ECB and according to common rules (*Financial Times*, 5 December 2012). They argued that the division into larger and smaller banks made little economic sense, given that banking crises often originated with smaller, fast-expanding banks (such as Spanish *cajas*) (Royo 2012). The French government also expressed concern over the unequal treatment of member states given that its national banking system was dominated by five very large institutions which would all end up being directly supervised by the ECB (*Financial Times*, 14 November 2012). Indeed, the agreed threshold would result in direct ECB supervision of thirteen French financial institutions holding over 95 per cent of national banking assets compared to 25 German banks and 50 per cent of national assets. French opposition to differential treatment reflects French government insistence of a lack of a 'Too big to fail' problem facing French banks and a longstanding strategy of constructing large national champions engaged in a range of banking activities (Howarth 2013).

The compromise reached at the December European Council foresaw that the ECB would be 'responsible for the overall effective functioning of the SSM' and would have 'direct oversight of the euro area banks' (Council 2012, p. 2). This supervision however would be 'differentiated' and the Bank would carry it out in 'close cooperation with national supervisory authorities'. Direct ECB supervision (through the JSTF) was to cover those banks with assets exceeding €30 billion or those whose

assets represent at least 20 per cent of their home country's annual GDP (*Financial Times,* 13 December 2012). This meant that a significant number of banks with no cross-border retail operations or subsidiaries would be covered by direct ECB supervision and that these banks would include all the German LB but *only one* Sparkassen (and this the atypical Wüstenrot Bausparkasse). This compromise contradicted a significant element of the structural logic behind Banking Union, demonstrated by the 'inconsistent quartet'. The outcome was a compromise between the German position which sought direct supervision but only for the largest banks and the French position which sought non-direct supervision for all banks but according to common rules. Capturing a number of Spanish saving banks (Cajas) with the 20 per cent threashold was also a consideration for both French and German policy makers (interviews, June 2013, Ministry of Finance, France). While a common rule book would be applied to the less significant banks, national variation would be tolerated, the rule of proportionality would be applied, and direct supervision would remain with national supervisory authorities.

The ECB (2014) later clarified that there would be direct ECB supervision (through the JSTFs) of approximately 130 euro area banks. However, the agreement also permits the ECB to step in, if necessary on the grounds of inadequate national supervision, and extend its direct supervision to any of the 6000 banks in the euro area, to bring about the eventual restructuring or closure of banks that found themselves in difficulties. The European Council agreed that the SSM would allow the ESM to recapitalize banks in difficulties directly, subject to 'double majority' voting by both the ECB and the EBA -- a point confirmed in the European Recovery and Resolution directive adopted in July 2013.

The euro-outsiders interested in participating in the SSM were opposed to the European Commission's proposed regulation of September which placed the ECB at the centre of the mechanism. The wording of the draft suggested that non-euro Member States would be excluded from decision-making as they lacked a vote on the ECB's Governing Council. The Commission's draft also appeared explicitly to limit membership by defining 'participating Member State' as a 'Member State whose currency is the euro' (Commission, 2012a). The euro-outsiders were supported by the EP's Economic and Monetary Affairs Committee which formed its own position on the status of the ten EU Member States not in the euro area, deciding that 'opt-in' countries should be able to sit on a new ECB supervisory board with equal voting powers but not on the decision-making Governing Council (*EUObserver* 29 November 2012). The December Council agreement on the SSM satisfied some euro-outsider concerns. Notably, the revised regulation changed the definition of 'participating Member State' to 'a Member State whose currency is the euro or a Member State whose currency is not the euro which has established a close cooperation', defined as adopting the necessary legal framework and cooperating with the ECB along the lines codified in the draft regulation.

Amongst the reasons that encouraged CEEC euro-outsiders to seek membership, participation in the SSM was seen in terms of improving the credibility of national prudential arrangements, overseen by the ECB. The ECB would possess information about the banks' headquarters and subsidiaries, allowing more effective supervision and decision-making. However, there were also several reasons not to participate in Banking Union. Non-euro Member States were worried about their second-class

status, with limited decision-making power as compared to euro area members. The ECB might be less prone to focus on the risks building in non-euro and smaller Member States. The as yet undetermined implications of full Banking Union also encouraged some non-euro Member States to adopt a cautious position on the SSM. The majority of non-euro Member States adopted a favourable ‘wait and see’ policy. This included Denmark, which had a formal opt-out on EMU. By the December European Council, it was clear that the United Kingdom, Sweden and the Czech Republic would opt not to participate in the SSM. Poland sided towards non-participation.

The main priority of the British government – which had no intention of joining the SSM – was to avoid a potential euro area block within the single financial market. The British, supported by seven other non-euro Member State governments, threatened to block Banking Union if there were insufficient safeguards put in place for the ‘euro-outsiders’ (*Financial Times*, 8 November 2012). Crucially, the British feared the adoption of subsequent financial legislation that would be detrimental to the British financial sector. However, the broader issue of concern was the satisfactory co-existence of a more integrated euro area core and the non-core Member States. Banking Union became a kind of test case for Britain's role in a two-speed Europe (*Financial Times*, 13 December 2012). In the European Banking Authority (EBA) – the supervisory body responsible for EU-wide bank stress tests – the British feared a euro area majority able to impose its rules on non-euro area members. Hence, as early as the summer of 2012, the British demanded an EBA voting reform: that any decision by the Authority should be approved by a minimum number of Member States outside the Banking Union and thus effectively by a

‘double majority’ of Member States inside and outside the Banking Union. The outcome of negotiations was a compromise involving the creation of a double majority system until the number of non-Banking Union Member States dwindled to less than four.

4. National financial systems and the comparative political economy of the SSM

This section engages in a comparative political economy analysis of the SSM by focusing on core features of national financial / banking systems in the main European countries. Our analysis considers: the degree of banking system concentration, measured in terms of the share of total bank assets held by the five largest banks (Table 1); the degree of internationalisation / Europeanisation is measured as the percentage of international / other EU versus domestically held bank assets (Figure 1; see also Table 2 for individual banks) and the relative importance of domestic bank lending to the overall activities of banks (Figure 2); the degree of foreign bank penetration, measured as a percentage of total national bank assets that are held by foreign banks (Table 3) and the percentage of national credit provision provided by foreign banks and the subsidiaries of foreign banks (Table 3); and the funding of different banking systems (and specifically the extent this is short-term (less than one year) funding on wholesale markets (largely inter-bank and cross-border) (Figure 3; while Table 5 shows the customer funding gap which demonstrates varied reliance on wholesale funding).

Germany

According to Gros (2012), among others, German savings banks (Sparkassen) would sink Banking Union. While Gros will likely be proven to be wrong, it is clear that

Sparkassen concerns determined the contours of the Banking Union agreed between December 2012 and March 2014 and dictated the reach of ECB direct supervision. The German banking system was both the least concentrated in Europe (see Table 1) and one of the least internationalised (see Figure 1). Although Germany was home to one very big, highly internationalised, commercial bank – Deutsche Bank – and a second very big commercial bank with a significant European presence – Commerzbank – there were also thousands of undercapitalized public and small local banks which provide the bulk of funding to, and maintain close relations with, small and medium sized enterprises. Almost one-third of the euro area's banks were German. These banks were, what we label, Germany's 'local champions'. The bulk of bank assets were nationally held with the exception of the biggest two (Figure 1) and a small number of other much smaller commercial banks. Reliance on short-term wholesale market funding was very limited and only concerned a small number of commercial banks (Figure 3). The public sector (and many of the commercial) banks relied on stable long-term wholesale market funding (*Pfandbriefe*) and silent participations, while the more traditional cooperatives relied largely on deposits to fund bank lending. Thus, with limited internationalisation on a range of measures, applying the 'inconsistent quartet' to Germany, we would expect less interest in Banking Union generally and, more specifically, in the transfer of supervisory powers to the ECB -- despite German participation in the single currency. The very limited cross-border banking of all but the two largest commercial banks suggests an interest in setting a high threshold for ECB direct supervision. Initial German policy positions on the SSM in the autumn of 2012 conform largely to these expectations stemming from an application of the 'inconsistent quartet'. However, while German success at blocking ECB oversight of the country's cooperative and savings banks conforms to

expectations, German agreement to allow direct ECB supervision of the public sector Landesbanken does not. We attempt to explain this surprising shift in policy below.

The German banking system was a central pillar of the country's Coordinated Market Economy (CME) by providing 'patient capital', either through cross-shareholding by the large commercial banks (which had declined significantly by the late 2000s) or 'relational banking' (Deeg, 2010; Hackethal, 2004). The German CME involved a strong reliance of non-financial companies on bank loans (see Figure 2) and a limited role for equity capital; a strong institutional link between banks and non-financial companies through formal bank representation on the board of large firms; and a long-term relationship of trust between the Mittelstand (SMEs) and their 'Hausbank' as a lender with a special responsibility. 'Relational banking' thus reflected and reinforced the crucial position of small retail banks in the German system.

The slightly more than 420 Sparkassen and 1200 Cooperative banks (2011 figures) were local or regionally based banks with a vested interest in the local economy and a strong presence in local community life. In late 2012, the largest Saving Bank had a balance sheet of approximately €40bn about one-fiftieth that of Deutsche Bank and more than 100 had less than a billion euros in assets (*Financial Times*, 2 December 2012). The bulk of German Sparkassen enjoyed a lower cost of capital compared to their commercial rivals because they relied disproportionately on high levels of funding through local government held long-term debt ('silent participations') and were under no obligation to make pay-outs to their local municipalities -- although the financial difficulties of a growing number of local authorities suggest that Sparkassen financing of sports and cultural facilities and events might not be sufficient to ensure

their political backing in some places in the future. Furthermore, the Sparkassen (and Landesbanken) benefited from the German regulatory practice that considered loans between these banks as risk-free -- which meant that no capital had to be held against such exposures. Sparkassen directors appeared to be unanimous in their view that home regulators better understood their characteristics and way of doing business (Simpson 2013; *Financial Times*, 2 December 2012). The Sparkassen were not required to file combined accounts as a single financial group and accounts were first overseen by auditors from within the saving bank group, not external auditors. Similarly, the Sparkassen opposed any participation in a European deposit guarantee scheme on the grounds that they benefited from a joint liability scheme (Haftungsverbund) (although such a scheme in place for the Landesbanken did not save German taxpayers from bail-outs and some Sparkassen did not contribute the level of aid that corresponded to their ownership stakes).

Furthermore, there was a strong economic logic to retaining a tolerant supervisory framework: with negligible reliance on short term wholesale market funding, the Sparkassen and cooperative banks repeatedly demonstrated their ability to maintain lending when commercial banks were more reticent. Figure 4 demonstrates bank lending patterns during the recent financial crisis. The risk-free calculation of inter-Sparkassen / Landesbanken lending resulted in what the IMF describes as ‘a de facto underestimation of capital requirements’ that could encourage more leverage and interconnectedness to the detriment of stability (IMF 2011). The application of Basel III rules to the Sparkassen would have resulted in massive deleveraging and a considerable drop in lending to the real economy.

Critics of the sector argued that the Sparkassen presented themselves as small and systematically less relevant but then benefited from being part of a large closely linked network and collectively one of the largest financial groups in the world with more assets (€1tn) than Deutsche bank, a collective 38 per cent share of German bank lending and almost 37 per cent deposits (Bundesbank, end 2012 figures). The Sparkassen representative association, the VOB, denies the relevance of the Spanish caja precedent (*Financial Times*, 20 June 2013). Savings banks were also bound up, through ownership stakes, loans and mutual guarantees, with the regional Landesbanken (LB) which were in turn backed by regional (Land) governments – officially, until the elimination of new government guarantees on their borrowing from July 2005 (Grossman 2005), and unofficially since. Land governments also funded the LB through 'silent participations'. The German position on extending direct ECB supervision to only systemically important banks reflected the preference to maintain existing Sparkassen supervisory practices.

Given the similar capital position and semi-protected status of the LB, it is perhaps surprising that the German government accepted a supervision threshold that assured their direct supervision by the ECB. The position of the association representing the Landesbanken (the VOB) was clear in its opposition to the extension of direct ECB supervision to the LB (*Financial Times*, 9 September 2012). However, the damage caused to some LB during the financial crisis, large government bail-outs, Commission-imposed restructuring and stagnant lending placed the LB in a politically weakened position. Combined with the push for Banking Union, this created a window of opportunity for the German federal government to shift the supervision of LBs to the ECB and impose more stringent asset quality review which would entrench

the on-going reform process. German federal governments and the Bundesbank have long called for the consolidation of banks in this sector (Hardie and Howarth 2009; 2013). Finally, the willingness of German authorities to subject LB to direct ECB supervision and asset quality review demonstrates the far-reaching EU Commission-imposed restructuring of four of the remaining LB -- following government bail-outs in the aftermath of the financial crisis. The publicly owned LB that survived the crisis -- NordLB, HSH Nordbank, Helaba, BayernLB and Landesbank Baden-Württemberg (with the possible exceptions of HSH Nordbank, suffering massive losses in 2013, and Helaba which the German government repeatedly shielded from European Banking Authority stress tests) -- were by 2013 in a much stronger capital position than they were at the on-set of the crisis in 2007 and on track even to meet Basel III rules by 2019 (*Financial Times*, 20 June 2013). Notably, they reduced their foreign exposure, writing down billions in toxic assets and retreating from lending in Central and Eastern Europe (their principal exposure elsewhere in the EU). The LB also increased their capital holdings, following the lead of NordLB which arranged to have a €15bn portfolio of assets part-guaranteed by its two state owners – the Länder governments of Lower Saxony and Saxony Anhalt (*Financial Times*, 25 July 2012) a move echoing the British government's Asset Protection Scheme and allowing the LBs to significantly improve their capital ratios. In 2012, the LB provided a quarter of lending to the German corporate sector and LB profit levels reached their highest level since 2006. The head of the VOB -- although still opposed to the extension of ECB supervision -- expressed keen support for cross-border mergers involving the LB, not in the immediate future but after a decade of on-going restructuring (*Financial Times*, 9 September 2012).

The direct supervision of the LB by the ECB -- like the Spanish cajas -- does not fit well into our analysis which draws a strong correlation between international (and specifically cross-border European banking) and interest in supranational supervision. Over the past five years the LBs have become much more domestically focused in terms of their assets, while their liabilities were never cross-border. But our analysis is about national preference formation and not about the intergovernmental compromise on the scope of ECB direct supervision. We focus principally on German reluctance on the SSM -- while accepting that other motives might have permitted the German government to accept a lowering of the threshold. At the same time, our analysis goes some way to explaining the dynamics behind the intergovernmental bargaining and it is French preferences, explained largely by the structure of their banking sector, that drove down the threshold for ECB direct supervision.

France

The French government's position on the SSM threshold was dictated directly by the structure of the French banking system and the concern that a far higher percentage of French bank assets (over 80 per cent) would be subject to direct ECB supervision than any of the large European banking systems. The French banking system was somewhat more concentrated than the British (Table 1) and the five largest French banks could best be described as major European players (what we label 'European champions'), while three also have a significant global presence (Figure 1; Table 2). At the same time, the five largest French banks relied far more on domestic retail banking than the largest British banks. The retail presence of the three large French commercial banks (BNP-Paribas, Société Générale and Crédit Agricole) in other EU

member states (and notably other euro area member states) was also far greater than British and German banks (Table 2).

Despite this relative importance of retail banking, French banks relied heavily upon short-term funding on wholesale markets (interbank lending). The international financial crisis demonstrated the dangers of such funding, and French bank reliance declined somewhat. Nonetheless, French banks continued to rely on short-term funding on wholesale markets and more than most other EU-based banks. Furthermore, unlike short-term funding of UK and Dutch banks (much of which came from the US based-banks), French short-term funding came largely from other banks headquartered in the EU. This fact further reinforced French interest in EU (or euro area) level measures to boost the stability of other European national banking systems.

The United Kingdom

The UK banking system was dominated in part by three 'international champions': highly internationalised and well-capitalised institutions with limited reliance on the domestic real economy (figures 1 and 2). The British banking system appears only moderately concentrated in terms of total bank assets (Table 1). However, the British retail banking market is highly concentrated in part because many of the foreign banks with London-based subsidiaries are involved little in retail banking. In the 2000s, the bulk of lending to domestic nonfinancial companies and households (consistently over 80 per cent) was provided by the largest six banks (Bank of England, 2013). Yet at the same time, domestic lending forms only a small part of most of these banks' assets (Figure 2). Foreign bank assets held in the UK are

significant and they are the most international (extra-European) of any large EU member state.

The three largest UK-headquartered banks are major international players and were among the world's ten largest banks in terms of asset size throughout most of the 2000s. All three held a majority of their assets internationally and a large majority of these international assets beyond Europe (Figure 1). As for liabilities, British banks relied more than most upon short-term / normally inter-bank funding prior to the outbreak of the international financial crisis. However, by 2012, all UK-based banks had cut their reliance upon this funding source, with total levels dropping well below French levels. During the international financial crisis, the British Government required two of the banks (RBS and Lloyds-HBOS) to accept state funding (with share purchase reaching 78 per cent for the former and 18 per cent for the latter) but intervention in bank management was minimal and 'nationalization' was officially presented as being limited in duration (Woll and Grossman, 2014).

Other euro area outsiders -- mixed views

The banking systems of the Central and Eastern European Member States were dominated by foreign institutions (see Table 3). Some have argued that non-participation in Banking Union might have a devastating effect on domestic banks as depositors shifted their accounts to banks headquartered in Banking Union Member States (Darva and Woolf, 2013) However, it has transpired that for several member states (including Bulgaria, Poland and the Czech Republic) this was not a sufficiently convincing fear to shift policy in favour of participating in the SSM -- despite the expectation of future euro area membership. These stand as counter-examples to the

importance of banking system structure to policy preference. However, the majority of euro outsiders conform to expectations. The Swedish government's decision not to participate in Banking Union owed largely to the fact that no bank assets in the country were held by EU-owned subsidiaries (the lowest percentage in the EU) yet the bulk of bank assets (almost 90 per cent) would be covered by direct ECB supervision (Darvas and Wolff, 2013). This lack of EU-bank presence in the Swedish market weighed more heavily than the very strong international (and specifically Euro area) presence of Swedish banks -- and notably in Finland and the Baltic States (including the Hansabank subsidiary of Swedbank). The Swedish government also expressed concern as to the second-class position of non-euro Member States in the SSM (*Financial Times*, 11 December 2012). Latvia and Lithuania, also dominated by subsidiaries of Swedish banks, had less interest in joining Banking Union given Swedish non-membership, although Latvia's intention to enter the euro area in 2014 pushed its government to support the form of membership on offer. We might think that Denmark would follow the Swedes in expressing a clear preference against membership: the country will not be participating in the single currency for the time being and less than 15 per cent of total Danish bank assets are held by EU-owned subsidiaries. Despite its EMU opt-out, Danish interest in the SSM and other elements of BU -- with a positive 'wait and see' policy stemmed from limited monetary policy autonomy (Denmark maintained its currency in the ERM II) and the massive size of the country's financial sector (compared to GDP as the third highest in the EU).

Conclusions (to develop)

Euro area member states that faced the 'inconsistent quartet' had different preferences on the various elements of BU, depending on the configuration of their national

banking (and more broadly financial) systems. The very small number of German-based banks with major cross-border operations meant that one of the four elements of the inconsistent quartet was less relevant for German policy makers, thus decreasing German interest in the SSM (and BU more generally). German policy makers resisted the ECB's supervision of the country's public Landesbanken and savings banks (what we label 'local champions'). These banks, subject to a distinct regulatory and supervisory regime, were seen as having a 'public' function in Germany with strong ties to local and regional governments and traditionally reliant on Land governments for financial backing. German interest in supranational European supervision of the country's two largest commercial banks was also limited given that their cross-border presence was more international than euro area / EU focused -- although these two banks expressed strong support for the SSM and Banking Union more generally. The German compromise on the threshold -- and the inclusion of LB in the list of systemically important banks subject to direct ECB supervision -- reflects both domestic motives (a long-standing federal government preference in favour of consolidation in the sector) and the dynamics of intergovernmental negotiations.

French government policy was directed by its opposition to the unequal treatment of member states given that France's banking system was dominated by five very large institutions with a strong euro area presence (what we label 'European champions') which would all end up being directly supervised by the ECB. Countries that had ailing banking systems, such as Spain or potentially Italy because of the fragile position of the sovereign, also supported SSM membership (BU). Both countries were

also home to several large banks with significant cross-border operations elsewhere in the euro area.

EMU member states not participating in the euro area opted for different policies on the SSM (BU), even though they all retained national currencies and the lender-of-last-resort powers. Policy difference depended on anticipation of future euro area membership but more importantly on the configuration of their banking systems. Central and Eastern European countries with banking systems dominated by foreign (mostly euro area) banks had an incentive to join BU because they were not in a position to safeguard financial stability domestically. However, we also note that some of the countries (notably Bulgaria, Poland and the Czech Republic) -- while initially open to possible participation in the SSM and Banking Union -- eventually came out against participation.

British policy makers were less interested in participating in the SSM because three of the four largest British banks were major international players (what we label 'international champions' with more internationally-held assets outwith the euro area than inside), with the fourth (Lloyds TSB-HBOS) more nationally focused. Moreover, in the UK, like in many Central and Eastern European countries (CEECs), a large percentage of bank assets are held by foreign owned banks; at the same time the percentage of these assets held by non-euro area banks is the highest in the EU (approximately 25%). The extra-EU nature of cross-border banking in the UK discouraged participation in the SSM and Banking Union.

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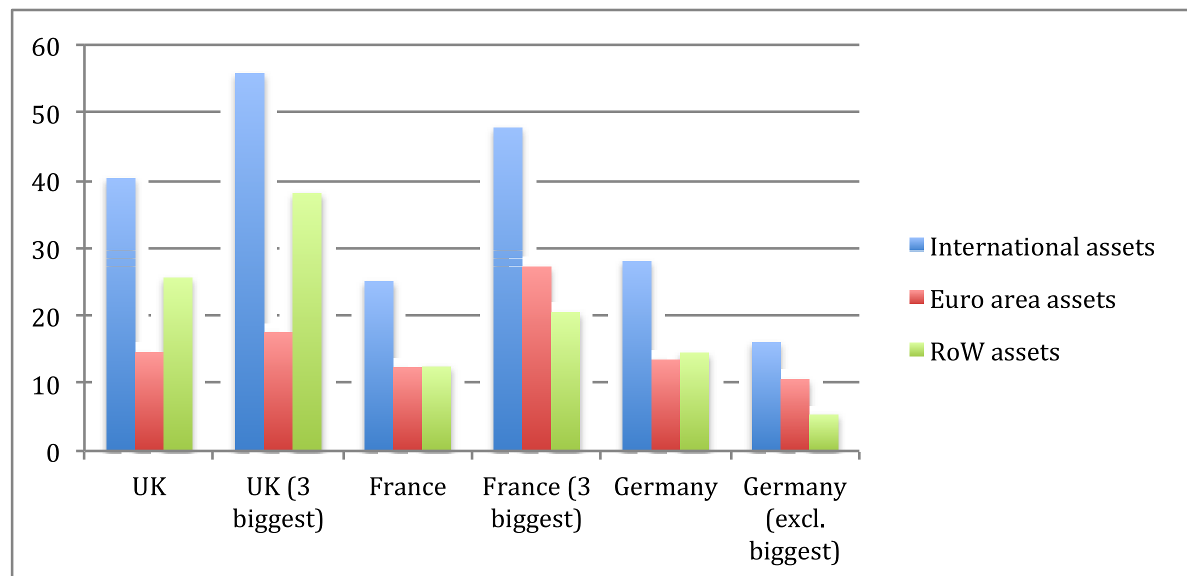
Tables and Figures

Table 1 Banking System Concentration (Share of total assets of the five largest credit institutions (Herfindahl index))

	2005	**2009**
UK	36.3	40.8
France	51.9	47.2
Germany	21.6	25

From European Central Bank (2010) *EU Banking Structures*, September, p. 36.

Figure 1 Bank internationalization (per cent of total bank assets, 2007-2011 average)



Sources: Bank of England, Banque de France, Bundesbank statistical databases. Registration documents for Royal Bank of Scotland, Barclays, HSBC, BNP Paribas, Crédit Agricole and Société Générale. Notes: The three largest Germany-headquartered banks (measured by assets) became two with the forced merger of Dresdner and Commerzbank.

Table 2 Geographic Spread of European Bank Assets (as a % of total)

Bank	Rest of World	Rest of EU	Home country
Standard Charter	85	0	15
BBVA	57	2	41
HSBC	56	17	27
Barclays	45	16	39
Santander	39	30	31
Deutsche Bank	37	33	30
UniCredit	35	24	41
RBS	25	19	56
BNP-Paribas	21	34	45
Rabobank	21	14	65
ING	20	37	43
Groupe BPCE	18	5	77
KBC	17	36	47
Société Générale	17	27	56
Crédit Agricole	15	23	62
Nordea	8	71	21
Commerzbank	8	20	72
Lloyds	4	4	92
Dansk Bank	3	44	52
Intesa	3	19	79
Landesbank Baden-Wurttemberg	3	16	81

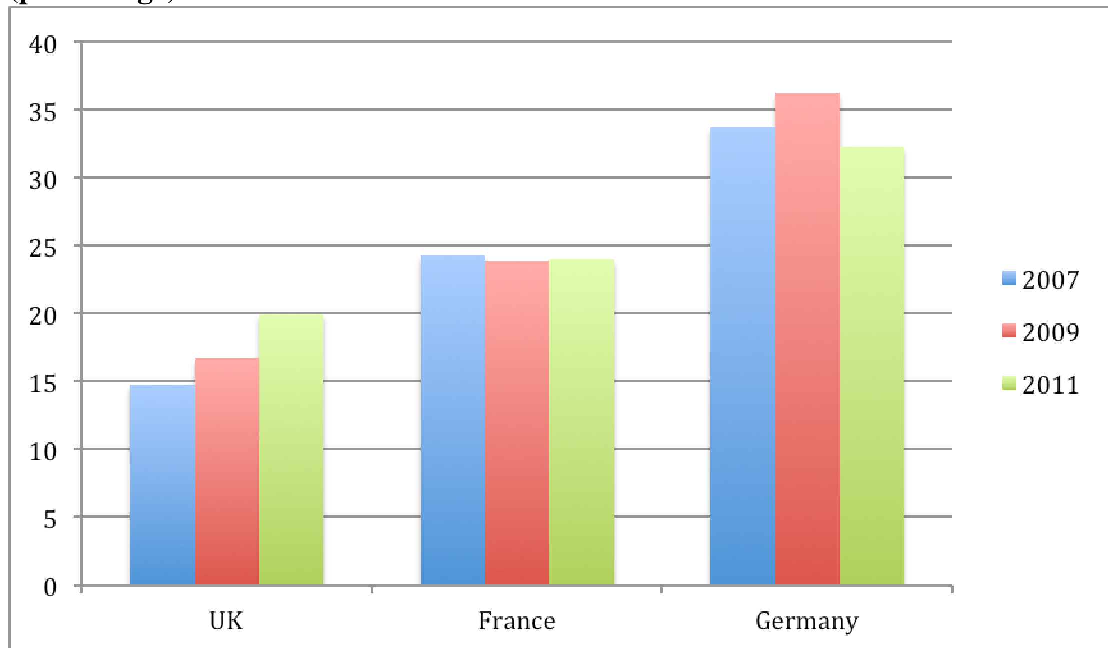
Source: Liikanen Report, 2009 figures.
Note: Highlighted figures are for UK-based banks.

Table 3 Foreign Bank Penetration Q3, 2011 (% of total assets / credit provision to non-banks) (CEECs only at the moment. To come for other EU)

	Foreign-bank	Of which cross-border share of bank credit to non-banks
Romania	97	53
Hungary	86	47
Croatia	100	45
Slovenia	55	43
Latvia	90	42
Estonia	92	42
Lithuania	91	40
Slovakia	99	25
Czech Rep.	100	20

Source: BIS

Figure 2 Loans from banks to domestic NFCs and households / Total bank assets (percentage)



Data from Bank of England, Banque de France and Bundesbank databases, authors' own calculations.

Table 5 Bank customer funding gap (NFC loans - deposits, bn.) As % of loans

	UK	**FR.**	**DE.**
2007	24	29.2	24.5
2008	23.8	28.6	23.1
2009	16	24.5	22.5
2010	10.2	20.3	21.4
2011	8	20.4	17.4

Sources: Central bank data

Figure 3: Bank Reliance on Short-term funding (less than one year) (% of GDP, end 2007 vs 2011)

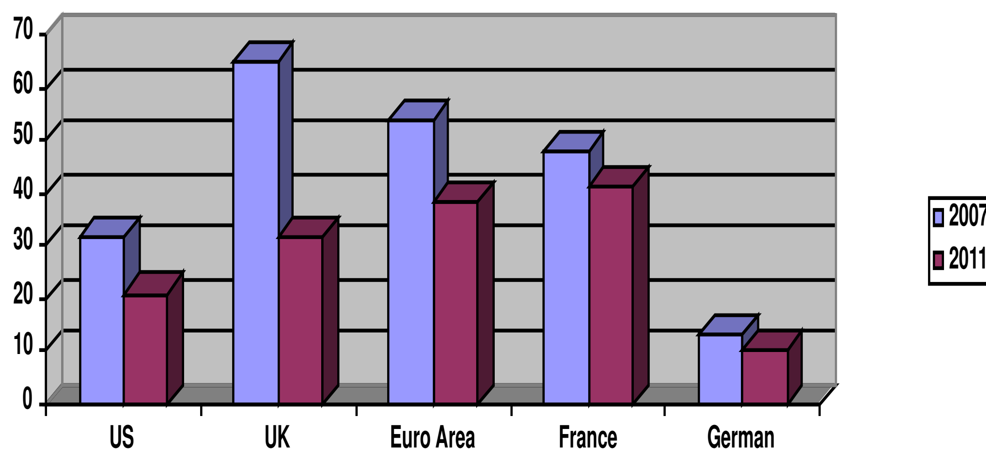
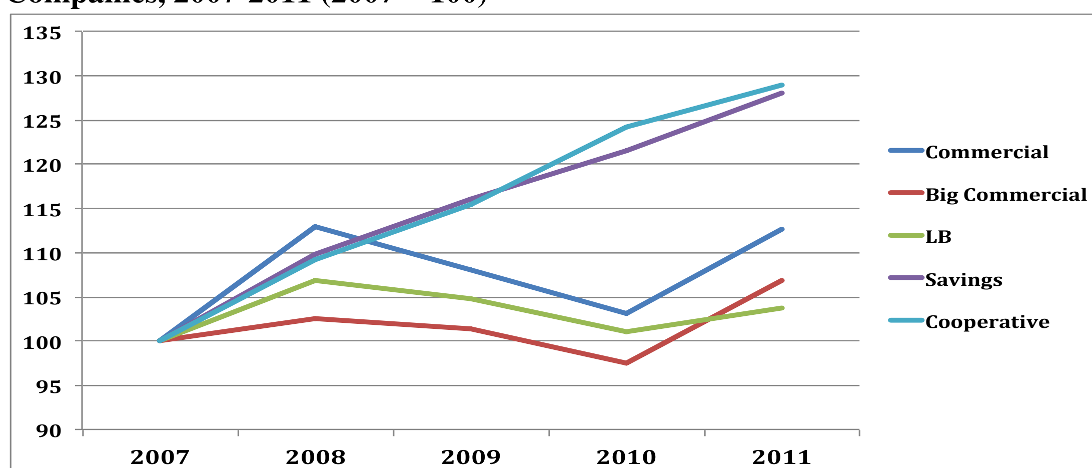


Figure 4: Change in German Bank Lending to Domestic Non Financial Companies, 2007-2011 (2007 = 100)



Source: Deutsche Bundesbank. The big commercial banks include: Deutsche Bank, Commerzbank, HypoVereinsbank (HVB) (now part of Italian UniCredit Bank), Postbank and, prior to 2009, Dresdner Bank