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Changing Banking Supervision in the Eurozone: the ECB as a Policy Entrepreneur

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Editorial Team

[1] This working paper does not reflect the official position of the European Commission.

Abstract

In 2012, the European Union adopted a transformational change to its banking policy for the Eurozone. It dropped the model of decentralized supervision and regulatory competition between countries, and replaced it with a single supervisor and harmonization. Transferring banking supervision to the ECB also alters the existing constitutional order. The policy process leading to this transformational change was rapid and highly political, which was different compared to earlier incremental changes to banking policy. Kingdon's model, whereby policy entrepreneurs seize opportunities at times when the independent streams of solutions, problems and politics converge, partly explains this transformation. The study of EU banking policy suggests, however, that the multiple streams framework should pay more attention to the way in which entrepreneurs engineer fluctuations within the streams and thereby contribute to creating opportunities for change. This paper identifies the ECB as an effective entrepreneur which also played an active role in political bargaining.

INTRODUCTION

At a summit meeting in June 2012, the European Union (EU) adopted a fundamental change to its banking policy for the Eurozone in response to the financial and sovereign debt crisis. This was not the first change of EU banking policy since the eruption of the crisis in 2008 but it was the only transformational one. It shifted the authority for supervising banks to the supranational level. Furthermore, the decision to entrust the ECB with exclusive banking supervision powers alters the nature of the central bank and its role in the governance of the Eurozone. It also paved the way for the creation of a larger banking union with a common resolution authority and fund.

This paper argues in its first two sections that the change in banking supervision is transformational. In the wider debate on banking union, Epstein and Rhodes also contend that the Eurozone is experiencing a momentous loss of national control orchestrated by supranational actors 'against the perceived interests of many member states'[2]. Howarth and Quaglia call banking union 'one of the most significant developments in European integration'[3] since the Maastricht Treaty. In contrast, others claim that national power politics blocked meaningful reform[4]. Howarth and Quaglia also stress the ambiguity and missing elements of banking union today. Similarly, McPhilemy[5] argues that national discretion survives in a complex regulatory system that is moving towards a supranationalization of banking governance.

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[2] R. Epstein and M. Rhodes, "International in life, national in death? Banking nationalism on the road to banking union", Paper presented at ECPR meeting, Salamanca, 2014, p. 4.

[3] D. Howarth and L. Quaglia, "The steep road to European banking union: constructing the single resolution mechanism", *Journal of Common Market Studies,* 52(s1), 2014, p. 125.

[4] S. Donnelly, "Power politics and the undersupply of financial stability in Europe", *Review of International Political Economy,* 21(4), 2014, p. 1004-1006.

[5] S. McPhilemy, "Integrating rules, disintegrating markets: the end of national discretion in European banking?", *Journal of European Public Policy,* 21(10), 2014, p. 1486-1487.

The third and final section of this working paper uses its case study of banking supervision to propose an avenue for further research on what causes policy transformation. Adjustments in reaction to the banking crisis before 2012 built on the established policy legacy and were mostly prepared by experts inside public administrations. This incremental approach did not cumulate into a transformational change which happened through a different process that was rapid and highly political. Put differently, policy anomalies offered opportunities for change in various crisis situations before 2012. The resulting cognitive dissonance and policy learning were not sufficient factors for overthrowing the established model. Why were such opportunities not used, and what was different in 2012? The third section of this paper uses a multiple streams framework[6] to address this question. Contrary to Kingdon, it states that the actions of a policy entrepreneur, in this case the European Central Bank (ECB), can engineer the opening of opportunities for policy change by helping to join the three independent streams of solutions, problems and politics. Thus, entrepreneurs are able to create and not just seize opportunities. That could only happen in 2012 when European Council politics had changed, partly in response to the actions of the policy entrepreneur at a moment of extreme uncertainty for the Eurozone.

I EU BANKING SUPERVISION BEFORE 2012

With the creation of the single market at the end of the 1980s, the EU liberalized capital movements, and a 1989 banking directive eliminated obstacles to market integration by making the licence of one country valid in all others. The Commission pushed for an expansive set of supervisory powers for the home authority, which took charge of supervising

[6] J. Kingdon, *Agenda's, Alternatives, and Public Policies,* New York, Longman, 2003.

branches and service provision in host countries, while member states insisted on national discretion for host authorities for transposing and applying regulatory standards.

Advocates of the financial tri-lemma[7] would predict that market integration cannot be combined with financial stability in the absence of centralized supervision. Indeed, coordination of supervisors was a constant concern during the phase of building the single market. EU rules were changed to impose more information exchanges and harmonize reporting, and colleges of supervisors were created in order to improve cross-border cooperation and settle disputes. New committees uniting all national authorities received a mandate for creating more convergence. Some analysts questioned whether this 'trans-governmental networking' of national bodies would change the regulatory model and evolve into a new, independent source of authority[8]. Others, however, stressed the value of national flexibility and regulatory competition between countries for achieving economic efficiency, making a single supervisor undesirable[9].

The 2008 banking crisis revealed important anomalies which were endogenous to this 'poly-archic European governance'[10]. Contagion spread across borders as soon as interbank lending froze. Given regulatory failure with the absence of loss-absorbing capital, governments had to resolve cross-border banks without prior planning and in spite of having memorandums of understanding for such contingencies, as required by EU law. A report for the European Commission[11] listed various failures in the run-up to the crisis, including the

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[7] D. Schoenmaker, "The financial trilemma", *Economics letters*, 111(1), 2011, p. 57-59.
[8] E. Posner, "The Lamfalussy process: polyarchic origins of networked financial rule-making in the EU", p. 58, in C. Sabel and J. Zeitlin (eds), *Experimentalist governance in the European Union. Towards a new architecture*, Oxford, Oxford University Press, 2010.
[9] K. Lannoo, "Supervising the European financial system", *CEPS policy brief 23*, Brussels, Centre for European Policy Studies, 2002, p. 6-8.
[10] D. Mügge, "The political economy of Europeanized financial regulation", *Journal of European Public Policy*, 20(3), 2013, p. 464.
[11] J. de Larosière, "Report of the high-level group on financial supervision in the EU", Brussels, European Commission, 2009, p. 39-42.

lack of willingness by peers to challenge home supervisors, lack of information exchange and co-operation, and ineffective supervision in countries that left loopholes in the single market. This collective action failure led to prisoner's dilemma type of interactions between governments with suboptimal outcomes for taxpayers.

The Commission's initial response on resolving cross-border banks deepened 'the pre-crisis coordinated regime'[12] by insisting on national resolution and clearing national bank rescue plans under state aid rules. On supervision, the 2009 report by Jacques de Larosière rejected the option of a single supervisor as unrealistic and recommended the creation of a European Banking Authority (EBA) to organize a more formal coordination of national supervisors. The core functions of EBA relate to preparing regulatory standards that the Commission adopts in an attempt to foster more supervisory convergence, as well as settling disputes between supervisors through various forms of mediation.

The Commission agreed at that time that a 'heavy-handed top-down approach' was not necessary[13], while some within the ECB unsuccessfully tried to nudge decision-makers toward more centralization[14]. They did so without the support of the governing council where many members feared that taking charge of banking stability would threaten the discipline of an independent monetary policy. A policy window for creating a more integrated approach faded away.

During the codecision process with the European Parliament (EP), many member states opposed envisaged EBA powers for giving direct instructions to their banks and generally resisted giving up regulatory autonomy. Germany's concern was fiscal liability for

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[12] Z. Kudrna, "Cross-border resolution of failed banks in the European Union after the crisis: business as usual", *Journal of Common Market Studies*, 50(2), 2012, p. 296.
[13] J.-M. Barroso, "Europe: working together to shape a new financial system", Speech, 16 June 2009, p.3.
[14] J. de Larosière, *op. cit.*, p. 42.

bank failures, while the UK protected its sovereignty and oversight of the City. Smaller countries in Eastern Europe resisted a weakening of their own supervision over foreign bank subsidiaries, especially those with high foreign ownership in their markets[15]. The compromise solution foresaw that EBA can overrule a national authority in narrowly defined conditions.

2 THE CREATION OF A SINGLE SUPERVISOR AND THE NEW POLICY MODEL OF 2012

The June 2012 Eurozone summit and European Council signified a breakthrough for transferring banking supervision to the ECB. It asked finance ministers to agree on this urgently given that effective European supervision became a precondition for the European Stability Mechanism (ESM) to directly recapitalize fragile banks without further liability for the sovereign, which was most crucial for Spain. This then developed over the next two years into the larger policy change of a banking union with common supervision, a single rulebook, harmonized amounts for national deposit insurance, and a semi-European resolution mechanism with gradually more common funding between 2014 and 2022.

2.1 The Eurozone supervisor and the harmonization of standards

While national leaders set out broad principles and a timeline on transferring sovereignty to the ECB, important decisions were still needed on the actual powers and governance of the central supervisor. The Commission worked closely with the ECB on these

[15] A. Hennessy, "Redesigning financial supervision in the European Union (2009-2013)", *Journal of European Public Policy,* 21(2), 2014, p. 158; A. Spendzharova, "Is more 'Brussels' the solution? New European Union member states' preferences about the European financial architecture", *Journal of Common Market Studies,* 20(2), 2012, p. 321-323.

questions in preparing its proposal that would have a decisive impact on the final outcome, which was agreed by the EP and Council in 2013.

The new legislation that entered into force in November 2014 gives the ECB significant new powers. First, the central bank is exclusively in charge of issuing and withdrawing bank licenses, and must permit acquisitions and disposals of shareholdings. Thus, future national attempts to shield any Eurozone bank from foreign capital are likely to meet ECB resistance. Second, the ECB replaces national authorities for the direct supervision of approximately 130 institutions, which represent 85% of bank assets. As most of these banks operate across borders, the single supervisor will replace the current mechanisms for cooperation and dispute settlement between home and host supervisors.

Third, the ECB gets all micro-prudential powers and can conduct on-site inspections. This is a remarkable shift in national preferences compared to two years earlier when the Council had opposed such powers for EBA. The broader implication of the transfer of micro-prudential powers is that states give up influence over credit allocation by banks in their economy. The new micro-prudential powers are based on EU rules that implement the Basel 3 recommendations, also known as Capital Requirements Regulation and Directive 4 (CRD4). Although the EU watered down some Basel guidelines[16], the rules introduce more stringent capital standards and give supervisors more intrusive instruments. They scrap more than 100 national discretions[17]. Specifically for the Eurozone, a large part of the national flexibility which the Council obtained compared to the Commission's proposal of maximum standards will be regulated by the ECB.

[16] D. Howarth and L. Quaglia, "Banking on stability: the political economy of new capital requirements in the European Union", *Journal of European Integration*, 35(3), 2013, p. 336.
[17] L. Quaglia, "Financial regulation and supervision in the European Union after the crisis", *Journal of Economic Policy Reform*, 16(1), 2013, p. 20.

Fourth, the ECB can impose measures to prevent the deterioration of a balance sheet, such as divestments or remuneration limits. It can dismiss managers and trigger resolution whereby the new Single Resolution Board will have to restructure or wind down a bank. Hence, the ECB gets de facto powers over property rights in national jurisdictions, with limited redress for shareholders and creditors under new EU resolution rules.

Fifth and at the request of the ECB[18] (2012), macro-prudential powers and oversight over smaller banks will be shared with national supervisors. On the latter aspect, while Germany had initially argued for purely national supervision for its large number of smaller institutions, it eventually conceded to an integrated system with decentralized implementation. Within Germany, large cross-border banks, such as Deutsche Bank, lobbied for a single system against the association of saving banks.

2.2 Why do new capital rules and a single supervisor transform banking policy for the Eurozone?

The 2012 reform is not the continuation of an adjustment process but the introduction of a new approach. Harmonized rules and centralized supervision will put an end to an era whereby member states used the model of regulatory competition and mere supervisory coordination for protecting or expanding domestic banks. Giving exclusive powers to the ECB, with direct supervision over 85% of bank assets, changes the role of national governments in banking. Information on domestic banking systems will no longer be guarded nationally, and ECB powers will insulate supervision from national politics. The reform is also a choice for a hierarchical model that replaces attempts to reach supervisory convergence through trans-governmental networking, although that model survives for the whole of the single market through the EBA.

[18] European Central Bank, "Opinion of the European Central Bank of 27 November 2012", CON/2012/96.

Beyond banking policy, transferring supervision to the ECB is a change of a constitutional order that alters parliamentary accountability. For this reason, the EP postponed its opinion on the draft legislation until the conclusion of a detailed inter-institutional agreement with the ECB, which includes transparency requirements, regular reporting and confidential hearings. Finally, obtaining supervisory powers also changes the nature of the ECB itself. The new governance structure installs a supervisory board that operates independently from the governing council which remains focused on monetary policy. Yet, the supervisory board still needs the tacit approval of the council. A new mediation board will deal with differences of opinion, though the governing council keeps the ultimate authority in line with the Treaty. Entrusting the ECB with both a monetary and a banking stability mission reflects a deeper shift in economic thinking, as it drops the assumption that monetary stability and low inflation are sufficient conditions for deregulating the financial sector and maintaining stability.

Other pillars of banking union beyond the single rulebook and supervision have not seen a similar quantum leap so far. National vetoes remain in place for activating the ESM allocation of €60bn for direct recapitalizations. The Commission shied away from proposing a European deposit insurance scheme. In resolution the picture is more blurred. On the one hand, Germany diminished the degree of supranational autonomy for a resolution mechanism advocated by member states such as France, Italy and Spain. But on the other hand, its agreement for German banks to pay levies into a European fund is a major breakthrough for a truly integrated market, even though the absence of a European backstop may still lead to divergences in national bank funding costs[19]. This development towards more solidarity and

[19] A. Ubide, "How to form a more perfect European banking union?", *Policy Brief 13-23*, Washington DC, Peterson Institute for International Economics, 2013, p. 6.

joint approaches could only happen in the presence of a European supervisor that should guarantee the elimination of national supervisory forbearance.

3 EXPLAINING POLICY CHANGE

In 2010, during negotiations with the EP on the creation of the EBA, Eurozone countries resisted taking steps towards a transfer of authority to the supranational level while they embraced such a transfer two years later. What can explain this redefinition of national preferences in such a short time? Students of EU banking policy have often found analytical strength in political economy factors, deriving national preferences for policy choices from the structure of the domestic industry. But that cannot account for the 2012 reversal. Another argument would claim that the internationalization of major banks and their powerful lobbying for streamlined rule-making contributed to centralization. Yet, in Europe banking has retrenched to national markets since 2008 and lobbying by cross-border banks in 2012 was not different from earlier years. Other explanations would stress the role of ideas and policy learning on how to govern a single banking market better as a result of the crisis. Yet again, even when crisis moments revealed policy anomalies before 2012, advocacy for transformational change failed and the response was incremental. Hennessy[20] attributes this to the member states' uncertainty over the cost distribution that would follow centralization.

What was different in 2012 is that the development of the sovereign debt crisis had become an opportunity for changing EU banking policy, whereas decision-makers had earlier kept those two issues separate. Thus, a crucial question is by whom and how were these two spheres linked? The following section uses the model of the three *independent* streams of

[20] *Op. cit.*, p. 164-165.

problems, solutions and politics which contends that time is a more important factor for understanding policy change than a rational search for an optimal output. It shows, as expected, that the coupling of the streams was needed for transformational change. It also suggests, however, that entrepreneurship can engineer such a coupling and open window of opportunities for change. Kingdon's proposition is that opportunities open 'because of some factor beyond the realm of the individual entrepreneur'[21], such as exogenous shocks, problem indicators or political changes. Hence, this study of change in EU banking policy contains an avenue for further research on how to strengthen the causality of Kingdon's widely used model[22] by stressing more strongly the strategic motivation of entrepreneurial action. In this case, that action was located at supranational level inside the ECB.

3.1 The policy stream: banking union as a recombination of existing ideas

The idea of entrusting the ECB with supervisory powers has been floating in policy circles for more than twenty years. In the Maastricht Treaty, negotiators settled on an enabling clause that empowers the Council to give prudential powers to the ECB by unanimity. Member states resisted going further, in particular Germany for fear of compromising the central banks' independence and because the Bundesbank argued that a prudential task 'could be misinterpreted as a lender-of-last-resort function'[23].

The idea that a currency union with free capital flows could have banking stability without centralized supervision was contested early on by international organizations,

[21] *Op. cit.*, p. 182.

[22] Recently: R. Ackrill et al., "Ambiguity, multiple streams, and EU policy", *Journal of European Public Policy,* 20(6), 2013; P. Copeland and S. James, "Policy windows, ambiguity and Commission entrepreneurship: explaining the relaunch of the European Union's economic reform agenda", *Journal of European Public Policy,* 21(1), 2014.

[23] H. James, *Making the European Monetary Union. The role of the committee of central bank governors and the origins of the European Central Bank,* Cambridge MA, The Belknap Press of Harvard University Press, 2012, p. 292.

academics and senior ECB staff. The IMF[24] deplored the lack of institutional clarity on the handling of a bank crisis, while the OECD[25] predicted that the unsecured nature of interbank lending would propagate instability across borders. It urged the ECB to anticipate a credit crunch by spelling out its policy for collateral requirements in exchange for liquidity, and concluded that the central bank should be the supervisor. With foresight, De Grauwe[26] designed a scenario of a Spanish asset boom fuelled by low interest rates and capital inflows from other Eurozone countries in the absence of any exchange rate risk and proper assessment of the banks. ECB board member Padoa-Schioppa[27] called for a 'collective euro area supervisor' that should work as effectively as 'within a single nation', anticipating a formal request by the ECB[28] to the Council to become a supervisory hub.

Centre-left governments at the time, however, were moving in an opposite direction. Following the twin peaks model, Germany and the UK took powers away from their central banks, which kept a monitoring function while a new body took charge of actual supervision with an eye on the possible creation of a single supervisor for banks and capital markets. This happened at a time when German banks became more active in international trading and investment. After a clash with the ECB, EU finance ministers decided in 2002 to create a Committee of European Banking Supervisors (CEBS). Together with a European Banking Committee, these forums allowed national supervisors to shape technical standards and exchange information in an attempt to harmonize implementation. Like with EBA later on, however, coordination was ambiguous as the model also aimed at fostering regulatory

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[24] International Monetary Fund, "International capital markets – developments, prospects, and key policy issues", Washington DC, International Monetary Fund, 1998, p. 106.
[25] Organization for Economic Co-operation and Development, "EMU one year on", Paris, OECD, 2000, p. 71-72.
[26] P. De Grauwe,"The euro and financial crises", *Financial Times*, 20 February 1998.
[27] T. Padoa-Schioppa, "EMU and banking supervision", Speech, 24 February 1999.
[28] European Central Bank, "The role of central banks in prudential supervision", Frankfurt, 2001.

competition and national discretion, leaving CEBS unable to produce substantive convergence[29].

The idea of a European supervisor disappeared from policy discussions once the 2002 window of opportunity in the Council had not been used. Furthermore, the problem stream did not generate negative feedback. On the contrary, up to 2007 interest rates in the Eurozone converged and the Economic and Monetary Union (EMU) displayed its expected impact of channelling excess savings from surplus countries into investments elsewhere. A light touch national regulation seemed to allocate capital more efficiently across borders also in the single market as a whole, with many banks expanding operations in Eastern Europe.

When the banking crisis hit in 2008, advocacy for policy change by decision-makers focused initially more on joint efforts for bank restructuring and resolution than on central supervision. In October 2008, the French EU presidency mooted an idea for a European guarantee scheme which Germany rejected because of fiscal liability concerns. The IMF argued from the start of the sovereign debt crisis in favour of a European resolution authority 'armed with the mandate and the tools to resolve large cross-border banks'[30]. For creditor countries, this raised the danger of moral hazard whereby they would have to clean up the consequences of irresponsible bank behaviour and failed national supervision in other countries. The idea of sequencing the policy by creating a European supervisor before committing jointly to bank liabilities failed to emerge on the decision agenda.

In 2011 the concept of banking union started taking shape outside of decision-making circles. The think tank Bruegel drew attention to the need for 'banking federalism'[31] and

[29] McPhilemy, *Op. cit.*, p. 1480.
[30] W. Fonteyne et al., "Crisis management and resolution for a European banking system", *Working Paper 10/70,* Washington DC, International Monetary Fund, 2010, p. 5.
[31] N. Véron, "Testimony on the European debt and financial crisis", *Bruegel policy contribution 2011/11*, Brussels, Bruegel, 2011.

demonstrated that the fate of banks and sovereigns was intertwined to the point that solid banks in weaker countries would have to shrink their balance sheet, while poorly run ones in stronger economies could expand[32]. This situation aggravated the economic imbalances between Eurozone countries, and the higher investment cost in vulnerable economies compared to the Eurozone core started a vicious circle with an increase in non-performing loans for banks which in turn threatened the sovereign's credibility due to possible bailouts. All the same, this vicious circle did not affect the definition of the problem by the separated policy communities in banking and sovereign debt matters. The concept of 'banking union' to break the bank-sovereign doom loop only started getting some mileage after it appeared for the first time in a December 2011 editorial by Véron[33]. To reach the decision agenda, however, the Euro crisis needed to be defined as a banking issue. Such redefinition of the problem is beyond the powers of policy experts.

3.2 The changing recognition of the policy problem

In the initial period of the debt crisis from early 2010 until the end of 2011, attention of policy-makers went mostly to national fiscal discipline in order to regain bond market confidence. The template was one of loans in exchange for market-oriented reforms and privatizations in Greece, Ireland and Portugal. The structure of that policy, designed firstly for Greece, was applied for the second time to Ireland at the end of 2010, when the Irish two year unlimited guarantee for bank deposits, debt and securities ended. The reproduction of the policy template for Greece avoided the recognition of the Irish case as a banking problem.

While ESM loans confined the zombie state of Irish banks to the national arena, another policy response weakened sovereigns with fragile banks. After EU banking policy

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[32] C. Angeloni and G. Wolff, "Are banks affected by their holdings of government debt?", *Bruegel working paper 2012/07,* Brussels, Bruegel, 2012; see also P. De Grauwe, "The governance of a fragile euro zone", *CEPS working document 346,* Brussels, Centre for European Policy Studies, 2011.

[33] N. Véron, "Europe must change course on banks", Vox CEPR's Policy Portal, 22 December 2011.

incurred a loss of credibility with financial markets following the EBA stress tests, the European Council decided in October 2011 to bring the tougher Basel 3 capital ratio's forward in time. Where markets would fail to provide new capital to banks, 'national government should provide support' if necessary by taking out an EU loan[34]. This decision coincided with the negotiations on public borrowing limits in the fiscal compact. One month after the summit, the German Chancellor attempted at the G20 to cajole Spain and Italy into a preventative adjustment programme but failed in doing so[35].

This episode is important for understanding that politics prevented the opening of the policy window on banking union in 2011. The dominant approach of national responsibility for fiscal discipline supported by ESM loans left no room for other policy choices, and the idea of European banking supervision was never discussed. Furthermore, the counterfactual is crucial. If Spain had consented to an adjustment programme before spring 2012, the window of opportunity for banking policy would most likely not have opened. Bank recapitalizations would have been managed in negotiations with the Troika. Spain's power to shape the policy agenda lied in its refusal to take out Eurozone loans for nearly one year, which put the spotlight on its deteriorating banks, something Ireland had never managed to do. By the time Ireland called on support in 2010, its budget had incorporated huge bank liabilities while Spain still had a manageable debt to GDP ratio of around 60% at the end of 2011. Yet, speculation on the uncertainty of its banking sector amounted to an extra capital need of nearly 10% of Spanish GDP and weakened the sovereign's capacity to refinance itself. The

[34] Euro Area Summit Statement, 26 October 2011.

[35] J.-L. Zapatero, *El Dilema. 600 días de vértigo,* Madrid, Planeta, 2013, p. 290-292; F. Van Damme and M. Peeperkorn, "Mario Monti: Ik heb Russische roulette gespeeld met de toekomst van Italië", *De Morgen,* 12 April 2014.

banking issue in Spain served as a 'focusing event'[36] that redefined the nature of the Euro crisis, thereby creating conditions for a more innovative decision agenda.

From its side, the ECB under governor Draghi announced in December 2011 a change in its bank liquidity support that would reinforce bank exposures to their own sovereign. Up until then the ECB had expanded its bank funding toolbox with emergency and medium-term liquidity operations. The new action of a Long Term Refinancing Operation (LTRO) had an unprecedented maturity of three years. The bulk of the net injection of around €520bn went to Spanish and Italian banks whose states faced major debt refinancing operations at that particular time. Thus, the ECB took a stopgap action to reduce market pressure, knowing that the nexus between banks and sovereigns would intensify. Earlier, in summer of 2011, it had contained sovereign refinancing problems via the Securities Market Programme which had bought bonds for a value of around 2% of Eurozone GDP. Such purchases were made conditional on fiscal rigour and market reforms. Continuing this bond purchasing in 2012 would have resulted in accumulating more Italian debt on the ECB balance sheet and a reputational risk.

3.3 European Council politics and policy entrepreneurship

In 2012, the ECB was the first EU actor to advocate a centralization of supervision and resolution, before the Commission, member states, or the President of the European Council. At the same time as the LTRO and in the space of six weeks, three relatively new members of its executive board publicly requested radical change. In February 2012, Peter Praet was the first to depart from the prevailing discourse and urged to step up the level of

[36] J. Kingdon, *Op. cit.*, p. 94-100.

ambition beyond the supervisory authorities such as EBA[37]. Praet proposed a more centralized architecture and pushed for an ESM mandate for recapitalizing big banks. One week later, Benoit Coeuré proposed pan-European financing for resolution and urged policy-makers 'to be more ambitious – now'[38]. Later in March, Jörg Asmussen, the German replacement of Jürgen Stark who had resigned over the ECB's bond-buying programme, echoed the need for 'a special fund for bank resolution' but specifically 'at the euro area level accompanied by the establishment of a joint supervisory and resolution regime'[39]. Proposing a specific Eurozone approach for financial services broke a taboo on the integrity of the single market and the inclusion of London's City in EU financial regulation. One month later, Mario Draghi[40] made his first public call for European banking supervision and resolution.

Two factors explain the push by the ECB for a banking union *at that particular juncture*, in addition to a long-standing preference for more centralized supervision and a shift in its crisis role from guarantor of price stability to guardian of 'the sustainability of EMU as such'[41]. First, there was a change in governor and board members, which brought in some new thinking. In this reshuffle the new German board member Asmussen took charge of banking union issues and liaised informally with the German government. Second, the scale of the LTRO increased the chances of moral hazard behaviour by national supervisors. Former board member Bini Smaghi[42] writes that a central bank without supervisory powers is 'unable to assess whether the liquidity injected into the banking system […] risked creating

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[37] P. Praet, "Sound money, sound finances, a competitive economy – principles of a European culture of stability", Speech, 27 February 2012.

[38] B. Coeuré, "The reform of financial regulation – priorities from a European Central Bank perspective", Speech, 6 March 2012, p. 3.

[39] A. Barker and P. Spiegel, "ECB policy maker calls for bank crisis plan", *Financial Times*, 30 March 2012.

[40] M. Draghi, "Introductory statement - Hearing at the Committee on Economic and Monetary Affairs of the European Parliament", 25 April 2012.

[41] F. Torres, "The EMU's legitimacy and the ECB as a strategic political player in the crisis context", *Journal of European Integration*, 35(3), 2013, p. 297.

[42] L. Bini Smaghi, *Austerity. European democracies against the wall*, Brussels, Centre for European Policy Studies, 2013, p. 89.

distortions'. Moreover, national supervisors in the single currency area have an incentive to underestimate solvency problems in order to allow their banks to gain access to ECB liquidity, such as the Emergency Liquidity Assistance (ELA). After his mandate, Trichet[43] stated that bank funding schemes had to be 'correctly transmitted by the supervisory authorities in each particular jurisdiction' to be effective.

Only in 2012, however, did the ECB make public statements to end fragmented supervision. Inside the bank a legal team was put to work to determine the maximum level of ambition that was possible under the ambiguity of the Treaty's enabling clause. Those who argued against taking on financial stability tasks for fear of a conflict of interest with monetary policy were curtailed by arguments that emphasized the need for an urgent solution based on an existing legal basis. Thus, unconventional central bank actions and an expansion of ECB tools to tackle the debt crisis ultimately spilled over into a formal expansion of its competences.

The ECB had the reputation and position of authority that form essential features for effective entrepreneurship[44], and it used these to support its advocacy prior to the opening of a window of opportunity. But the ECB lacked a third entrepreneurial feature, namely the political capacity to build a supporting alliance. It worked in tandem with the European Council President who used his agenda-setting capacity for this purpose and became the hub of a deal-making process. In May 2012, national leaders asked the European Council President, at his own suggestion, to submit a report on building a stronger EMU to their June meeting[45]. This was a juncture of the crisis characterized by extreme market pressure with bond spreads at record levels, fuelling expectations of a Eurozone break-up. An intense

[43] J.-C. Trichet, "Unconventional monetary policy measures: principles, conditions, raison d'être", *International Journal of Central Banking,* 9(1), 2013, p. 239.
[44] J. Kingdon, Op. cit., p. 180-181.
[45] European Council, "Towards a genuine economic and monetary union. Report by President of the European Council Herman van Rompuy", 26 June 2012.

process of inter-élite persuasion with eleven versions of the Van Rompuy report happened in the space of a few weeks, whereby the ECB governor became involved in political bargaining on the transfer of supervisory powers to the European level, supported by the French President and Italian Prime Minister.

While the ECB's entrepreneurial advocacy helped shift national preferences and European Council politics, thereby enabling the coupling of a problem to a solution that had been floating for two decades in the policy stream, it was not a sufficient factor to create the right political conditions for transformational change. Member states had gone through a learning process on contagion risks in a single currency area since the creation of EBA in 2010[46]. Beyond this ideational shift, more research is needed on why key member states changed their cost-benefit calculation on centralizing banking supervision. France, for instance, had a general preference for creating joint instruments for crisis management and came to accept centralized supervision as a precondition. At that particular juncture in 2012, an important additional factor was that the cost of supervising national banks had increased due to spill-over effects of the debt crisis. Donnelly[47] attributes French support to an impending credit rating decline. Earlier, in the summer of 2011, US money market funds had reduced their exposure to French banks because of the Euro crisis[48], leading to dollar funding problems. Germany from its side argued that a central control mechanism was needed before it could agree to ESM direct recapitalization. But both central supervision and recapitalization were concessions to a supranational model that Germany had so far resisted, as it would add to the liabilities it had already undertaken for sovereigns. The change coincided with the Chancellor's choice to defend the Eurozone's integrity at all cost and drop the option of

[46] R. Epstein and M. Rhodes, *Op. cit.*, p. 4.
[47] S. Donnelly, *Op. cit.*, p. 991.
[48] International Monetary Fund, "Staff country reports – France", Washington DC, IMF, 2013, p. 8-9.

countries exiting the Euro[49]. Finally, the UK had decided in 2011 to abandon its opposition to a two-speed EU financial services policy. It argued for more Eurozone integration and strongly supported a Eurozone supervisor when the idea emerged on the decision agenda in May 2012, partly out of interest for a return to stability in its biggest export market.

The spring and summer of 2012 were particularly turbulent times with high uncertainty over future developments and a wide variety of policy ideas floating around. By June, the cost of inaction could have been enormous. Pollack defines uncertainty and cost of waiting as factors that boost supranational autonomy in agenda-setting. In this context, the ECB's push for a new supervisory architecture became a focal point for bargaining and for the convergence of the 'uncertain preferences of the member governments'[50].

CONCLUSION

This paper demonstrates that there has been an overhaul of Eurozone banking policy with new and exclusive ECB powers for supervision, harmonized rules and standards. This has allowed to kick-start a process towards creating a single European resolution body and fund. In the areas of fiscal and economic union, in contrast, no such policy transformations took place, leaving the Euro exposed to the absence of 'institutional embeddedness'[51]. While fiscal and economic policy saw adjustments in their instruments, they never experienced a radical alteration of their established approach that is today still based on the Maastricht parameters, national flexibility and sanctions for non-compliance.

[49] P. Spiegel, "Inside Europe's plan Z", *Financial Times,* 14 March 2014.
[50] M. Pollack, "Delegation, agency, and agenda-setting in the European Community", *International Organization*, 51(1), 1997, p. 130.
[51] M. Matthijs and M. Blyth, "Chapter 12: conclusion. The future of the Euro: possible future, risks and uncertainties", p. 4, in: M. Matthijs and M. Blyth (eds), *The future of the Euro*, Oxford, Oxford University Press, forthcoming.

Transformational change in banking policy happened through a sudden and highly political process. Without ignoring an element of randomness that characterizes the multiple streams framework, this paper showed the causality behind the decision to centralize banking supervision in 2012 and not earlier. ECB actions helped to engineer the coupling of the solution and problem streams and actively contributed to the opening of the window of opportunity. While not being a formal decision-maker, the ECB became part of the bargaining process whereas Kingdon situates entrepreneurs mostly outside of the decision-making circle[52]. Within the ECB, an important shift in thinking had occurred on the need to combine both monetary and financial stability tasks, partly as a result of a frequent use of new and unconventional instruments to ensure the survival of EMU. The need to act urgently in 2012 marginalized those who argued inside the ECB that taking on banking supervision would conflict with the independence of monetary policy and the setting of interest rates. A few weeks after the European Council had endorsed centralized banking supervision for the Eurozone, the ECB governor further expanded the central banks' toolbox with the Outright Monetary Transactions programme, which entails unlimited purchases of government bonds in secondary markets in exchange for economic reforms.

For member states, the main stumbling block towards a supranational approach before 2012 was national fiscal liability and accountability. Thus, in 2010 the exogenous shock of the banking crisis, rapid policy learning, and the availability of alternative policy solutions were not sufficient to cause transformational change, and no entrepreneur came forward to make a strong case for centralized supervision. The same stumbling block of national fiscal liability was still in place in 2012. Eurozone countries, however, looked at it differently in view of the lessons that they had learnt from the sovereign debt crisis, which altered their

[52] R. Ackrill et al., *Op. cit.*, p. 881.

cost-benefit analysis of banking union in June 2012. While in 2010 member states analysed banking problems in isolation from the debt crisis, that situation had changed dramatically in 2012. The June 2012 moment of high uncertainty over the best way forward for banking policy and for managing the Euro crisis considerably improved the conditions for effective supranational entrepreneurship and making national preferences converge around a major innovation.

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