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When 'Good Enough' Does Not Suffice

The Impact of Crisis on Institutional Change in European Financial Sector Governance

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Introduction: The Institutional Evolution of European Financial Sector Governance

The 2008 global financial crisis led to a severe economic downturn in advanced industrialised economies. Considering the public outcry against the shortcomings of the financial industry and regulators, the crisis presented an unparalleled opportunity for a bold redesign of financial sector regulation in adversely affected jurisdictions such as the United States (US) and the European Union (EU). The initial trajectory of European financial regulation reforms in 2009 was incremental (Salines et al., 2012; Moschella & Tsingou, 2013). Yet, as the Eurozone sovereign debt crisis escalated in 2010 and 2011, incremental reform proved to be insufficient to reassure financial markets and the EU embarked upon far-reaching institutional redesign, notably, introducing the European Banking Union.

In this article, we first trace the path of European financial regulation reforms from the Lamfalussy framework to the European Banking Union. After that, we discuss our analytical framework about the impact of crisis on

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policy reform, drawing on the public policy literature. In the next part, we probe the role of the Eurozone sovereign debt crisis as a driving force of reform not only in European economic governance but also in European financial regulation. The conclusion summarises the main findings of the paper.

Adopted in 2002, the Lamfalussy framework extended the regulatory principles outlined in the Lamfalussy report for the securities sector to banking and insurance (Lannoo, 2002; Quaglia, 2010; Grossman & Leblond, 2011). The framework institutionalised three level 3 committees intended to foster the exchange of best practices across member states and sectors and facilitate regulatory convergence (European Central Bank, 2007; Grossman & Leblond, 2011). However, they were only authorised to issue *non-binding* recommendations.

In the aftermath of the 2008 global financial crisis, the European Commission launched a new initiative to redesign the European financial architecture following the recommendations of another high-level expert group, chaired by Jacques de Larosière (see Hodson & Quaglia, 2009; Quaglia, 2010). These reforms created the European Systemic Risk Board (ESRB) in charge of macro-prudential supervision. Furthermore, decision-makers set up the European System of Financial Supervisors (ESFS) to complement the ESRB in the area of micro-prudential supervision. The ESFS includes three new European supervisory authorities in banking, securities, and insurance, which are an institutional upgrade of the three level 3 committees (see Amtenbrink, 2011; Quaglia, 2013).

The three European Supervisory Authorities (ESAs) in banking, insurance and finance are de facto European agencies. Thus, it is important to relate the argument developed here to general explanations of agency formation. Groenleer (2011: 559) notes that 'most [European] agencies have a limited mandate ... and only a few agencies have been granted decision-making tasks'. Against this backdrop, our paper sheds light on the how crisis has facilitated the empowerment of the ESAs with far-reaching competences.

The European Systemic Risk Board monitors systemic threats to financial stability in the EU and mostly involves central bankers from the member states and the ECB. The second pillar of the de Larosière framework, the European System of Financial Supervisors, was subject to significant debate. The reforms empowered the new supervisory authorities to issue decisions with *binding* power summarised here in Appendix I. While member states in favour of greater centralisation and harmonisation of financial regulation such as

France and Italy as well as the European Commission and Parliament welcomed the enhancement of the ESAs' powers, other member states such as the UK and the Czech Republic voiced concerns about possible fiscal burden and loss of sovereignty (Buckley & Howarth, 2010; Spendzharova, 2012). The negotiations also gave rise to debates about the lack of an adequate common European deposit guarantees and bank resolution regime (Kudrna, 2012; Schoenmaker & Gros, 2012).

During the next round of institutional reforms in EU financial sector governance, the European Council of 28-29 June 2012 declared its support for setting-up the Single Supervisory Mechanism, thus paving the way for the creation of a European Banking Union. The first part of the Banking Union framework, the so-called Single Supervisory Mechanism (SSM) dealing with prudential banking supervision in the Eurozone has already been adopted, followed by a common recovery and resolution regime and a common deposit guarantee system (Wymeersch, 2012; Véron, 2012). The European Central Bank (ECB) will exercise the Single Supervisory Mechanism function, which was the only available institutional option to set up the mechanism without a revision of the EU Treaties. As Wymeersch (2012) has pointed out, the choice to embed the SSM in the ECB was driven by a concern that giving single supervisory powers over the EU's largest banks to either the European Banking Authority (EBA) or a new independent institution in charge of banking supervision would contradict the Meroni doctrine.

Theoretical Framework: Analysing Crisis as a Window of Opportunity for Institutional Change

In analysing crisis as a window of opportunity, we can build on the work by Kingdon who identified three, relatively independent, streams – problems, solutions (or policies) and politics – that come together at critical times: '[a] problem is recognized, a solution is available, the political climate makes the time right for change, and the constraints do not prohibit action' (Kingdon, 1995: 94). The problems stream consists of the recognition and framing of problems, influenced by shock events or new scientific data. The solutions, or policy, stream includes the 'wide variety of ideas floating around in the policy primeval soup' (Zahariadis, 1999: 76). In the politics stream, elections, elected officials and what Zahariadis (1999) calls the 'national mood' are relevant. The coupling of these streams is most likely when a 'policy window' is open.

A window is a fleeting 'opportunity for advocates of proposals to push their pet solutions, or to push attention to their special problems' (Kingdon, 1995: 165). These windows are opened by compelling problems such as natural disasters or crisis or by events in the political realm such as a new government coming to power (Kingdon, 1995). At the same time, policy entrepreneurs need to seize the opportunity for policy change and pro-actively connect problems and policy solutions (Zahariadis, 2007: 69; see also Ackrill et al., 2013).

Before we apply this theoretical framework, we need to understand what a crisis is and outline the conditions under which we expect crises to actually open a window of opportunity, thus spurring institutional change. We use Boin et al.'s (2009: 83-4) definition of crises as 'events or developments widely perceived by members of relevant communities to constitute urgent threats to core community values and structures'. A crisis is often triggered by a 'focusing event' (Kingdon, 1995), which is an 'event that is sudden, relatively rare, can be reasonably defined as harmful or revealing the possibility of greater potential future harms' (Birkland, 2006: 2). A crisis might lead to a situation in which core values and structures dominant in a particular policy community are threatened or disrupted, thus indicating policy failure of the preceding governance arrangement (Alink et al., 2001; Birkland, 2006).

Furthermore, Boin (2009: 368; see also Boin et al., 2013) argues that crises are increasingly transboundary because modern societies are consisting of a 'tightly woven web of critical infrastructures' crossing geographical borders and policy boundaries. Transboundary crises are particularly hard to manage due to the fragmentation of authority and thus a lack of clear ownership and responsibility for tackling the crisis at hand. What implications does this have on the governance of such crises? As Boin points out, the current trend in policy-making is that decisions are made by 'small informal groups of senior policy-makers' in a network comprising a wide variety of response organizations that usually do not work together (Boin, 2009: 372).

A crisis can *potentially* lead to policy change, but not necessarily so. Birkland (2006) illustrates that crises can also successfully be framed as policy failure, thus pushing for changing the status quo. He identifies the following factors that influence whether a crisis is expected to lead to change: (1) the more serious the crisis, (2) the higher the likelihood of the crisis happening again, (3) the more the crisis reveals policy failure, and (4) the higher the consensus over the right policy direction after the crisis, the more likely that groups will mobilise to press for reform and thus the higher the chance of

policy change occurring (Birkland, 2006: 167; see also Copeland & James, 2014).

Drawing on these insights of the public policy literature, we now turn to examining the empirical evidence regarding the impact of crisis on the recent institutional reforms in EU financial sector governance. In order to trace the reform process, we use primary EU sources, official reports evaluating the Lamfalussy and de Larosière frameworks, and secondary literature.

The Impact of Crisis on Institutional Change in European Financial Sector Governance

Problems Stream

In line with Boin et al. (2013), we observe that the global financial crisis has transboundary characteristics, which have posed a different set of challenges in the beginning of the crisis period and, more recently, during the escalation of the Eurozone sovereign debt crisis. Drudi et al. (2012: 881-882) have divided the 2007-2012 financial crisis into three main phases: financial turmoil (9 August 2007 – 14 September 2008); global financial crisis (15 September 2008 – 7 May 2010); and Eurozone sovereign debt crisis (8 May 2010 – present).

Importantly for our analysis, the Eurozone sovereign debt crisis spread not only across countries but also across policy domains (Jones, 2012: 61-62). The last phase is most relevant for our analysis. From mid-July 2011, financial market tensions intensified and economic confidence declined. The escalation of the Eurozone crisis threatened to cut off market funding for a significant portion of the banking sector in the Eurozone (Drudi et al., 2012: 889). Several banking systems of Eurozone countries such as Greece, Portugal, and Spain were severely affected. While the ECB was initially reluctant to take direct action, considering the deteriorating market conditions and threat to financial stability, it changed course and intervened through the Securities Markets Programme (SMP) (Drudi et al., 2012: 889).

In the problems stream, the global financial crisis mostly put the spotlight on the need for better coordination among national supervisors and better information exchange (see Moschella & Tsingou, 2013; Carstensen, 2013). As the European sovereign debt crisis escalated, however, the problem definition shifted from an emphasis on coordination among supervisors to distributional

issues of how national deposit guarantee schemes would cover the liabilities of cross-border banks (see Schoenmaker & Gros, 2012; Hodson, 2013). The transboundary nature of the Eurozone crisis and emphasis on distributional consequences after the Greek bail-out are reflected in the solutions stream, which we discuss next.

Solutions (Policies) Stream

In the early period of the crisis, the policy solutions put forward by decision-makers were geared toward better coordination among national supervisors in the EU within the existing institutional framework. For example, EU expert committee assessments as well as ECOFIN Council conclusions show that the initial focus of the level 3 Lamfalussy committees was on advisory work, especially in the preparation of urgent sectoral legislation such as the CRD, MiFID, and Solvency II EU directives. Later on, as member states started the implementation process, the regulatory harmonization tasks of level 3 committees came to the foreground, and so did the issue of their powers (FSC, 2007: 6). The committees faced mounting challenges due to the increased speed of market integration and growing prominence of financial conglomerates.

Despite considerable functional pressures to enhance the powers of the three Lamfalussy supervisory committees, in 2007 and 2008, the ECOFIN Council of Ministers still preferred to maintain the system of *non-binding* powers. In its December 2007 review of the Lamfalussy process, ECOFIN invited the committees to strengthen the national application of their guidelines, recommendations, and technical standards yet *without* changing their legally non-binding nature (Council, 2007: 5; Council, 2008: 2). The Inter-Institutional Monitoring Group (IIMG), also stressed that its members were divided about the need for giving more powers to these essentially advisory bodies. Overall, we notice some enhancement in the supervisory discretion of level 3 Lamfalussy committees, but this occurred *without* changing the committees' legal basis, and within the framework of issuing *non-binding* decisions. Thus, we observe a very incremental process of reform immediately after 2008.

By 2010, however, the incremental reform in European financial sector governance was not sufficient to reassure financial markets. The increasing pressure to provide bail-out funds to weaker Eurozone economies such as Greece, Ireland, and Portugal called for more decisive action at the European level, especially in the realm of bank recapitalisation and resolution (Schoen-

maker & Gros, 2012; Hodson, 2013). In line with Boin et al.'s (2013) and Kingdon's (1995) conceptualisation of crisis as a focusing event discussed in the theoretical section, we argue that the linkage between reforming EU economic governance and the Union's financial supervision architecture is crucial (see also Salines et al., 2011: 31).

The on-going Eurozone sovereign debt crisis provided impetus for European decision-makers to seek such collective action solutions in the financial regulation policy domain (see also Jabko, 2010: 332). The problem stream shifted from more coordination to cross-border bank supervision, recapitalisation, and resolution. Similarly, the solution stream shifted to more extensive institutional redesign, in particular, the creation of a European Banking Union. The economic governance and banking supervision reforms undertaken in 2011-2013 aimed to create a more robust governance structure in the Eurozone (Buti & Carnot, 2012: 909). In particular, the so-called 'Six-Pack' and 'Fiscal Compact' legislative packages were intended to prevent and correct economic and fiscal imbalances more effectively. The temporary European financial stability facility (EFSF) and the permanent European Stability Mechanism (ESM) were set up to provide liquidity to EU member states that could no longer borrow at sustainable interest rates at the global financial markets (Buti and Carnot, 2012: 909). Referring to Birkland's (2006) evaluation of when crises are likely to produce policy change, the Eurozone crisis appears to be both serious enough and ongoing in order to pressure the main EU institutional players to seek consensus over the desirable next steps in institutional reform. The following section examines the negotiations that led to policy change.

Politics Stream

Identifying the main policy entrepreneurs and their preferences helps us understand how the problems stream was coupled with the solutions stream in the recent reforms of European financial sector governance. We start with the period of incremental policy change immediately following the global financial crisis. While most of the 2009-2010 institutional reforms in European financial regulation were adopted by Council and the European Parliament using co-decision, the trajectory of redesign was influenced by the regulatory reforms in the US and discussions in global fora such as the Financial Stability Board (FSB) and G-20 meetings (Mügge, 2014; Quaglia, 2014). By contrast, internal EU dynamics have been more prominent drivers of the latest series of institu-

tional reforms due to the Eurozone crisis. During this period, the European Commission and the European Central Bank have been key players in addition to the Council and the European Parliament.

During the early phase of financial sector institutional reform, in the June 2009 ECOFIN Council of Ministers meeting, member states agreed to give the ESAs powers to take binding decisions in order to promote harmonised and consistent supervision of financial institutions across the EU. They also put in place the so-called 'triple-lock' safeguard mechanism which gives member states multiple appeal mechanisms to contest decisions taken by the ESAs (EurActiv, 2009). The October 2009 ECOFIN Council conclusions provided a detailed roadmap for the EU regulatory framework (Council, 2009). This, in turn, paved the way for the official adoption of the three European Union Regulations (1093/2010, 1094/2010, 1095/2010) that set up the European supervisory authorities and European Union Directive 2010/78/EU that specified their powers in November 2010. The newly launched European Supervisory Authorities were an institutional upgrade of level 3 committees, yet there is very close correspondence in terms of their core mandate, staff, and location. The main difference is that the ESAs have more binding powers and tasks, shown here in Appendix I. Nevertheless, as Quaglia (2013) has pointed out, implementation will constitute a major test of the ESAs' enhanced competences. We are still to see what the impact of the new ESAs' powers will be, as the implementation phase for many pieces of new EU financial sector directives such as the CRD IV, AIFMD, and amended EMIR directives has just started.

During the latest episode of policy reform, in 2013, the EU legislative institutions adopted the so-called Single Supervisory Mechanism (SSM) as the first pillar of a European Banking Union, followed by the Bank Recovery and Resolution Directive (BRRD) in 2014 (Wymeersch, 2012; Véron, 2012). Also negotiated in 2014, the Single Resolution Mechanism (SRM) gives the ECB even more powers to trigger a resolution process when it deems a large European bank to be no longer viable (Barker, 2014).

Schimmelfennig and Winzen (2014) have shown the differentiated integration dynamics of setting up the European Banking Union. While Eurozone member states pushed forward with the creation of a European Banking Union, other member states such as the UK have opted out. At the same time, Véron (2012) has emphasised that 'the radical nature of this endeavor [European Banking Union] must not be underestimated'. Highlighting the strong

interdependence between banking union, fiscal union and political union, he has argued that when we consider the initial trajectory of the Lamfalussy financial regulation reforms, it would be almost unthinkable to place the ECB at the forefront of banking sector supervision for Eurozone countries (Véron, 2012).

All in all, without the increased pressure for reform from the sovereign debt crisis, the trajectory of EU financial regulation reforms might have remained incremental. We argue that the EU sovereign debt crisis – rather than the global financial crisis preceding it – opened a window of opportunity for far-reaching institutional redesign. Which were the main policy entrepreneurs in this process? Since the beginning of the 2008 crisis, the European Commission and Parliament have clearly favoured a further transfer of powers to the European supervisory authorities in order to enhance regulatory convergence in the Union and ensure stronger sanctions in case of failure to comply (EurActiv, 2010; Tait, 2010). Qualia's (2013: 71) analysis highlights that the European Commission has been the main change agent in reforming European financial sector regulation (see also Copeland and James 2014: 4). Furthermore, the Eurozone sovereign debt crisis empowered larger Eurozone economies countries such as France, Germany, Italy and side-lined member states opposing more centralised financial sector regulation such as the UK (Buckley & Howarth, 2010; Grossman & Leblond, 2011; Quaglia, 2013; Spendzharova, 2014).

Conclusion

The 2008 global financial crisis presented an unparalleled opportunity for a bold redesign of European financial sector governance. This paper has shown that the incremental changes in EU financial sector regulation that took place in 2009 and 2010 were insufficient to reassure financial markets. We argued that as the Eurozone sovereign debt crisis escalated in 2010 and 2011, the need to provide bail-outs to struggling Eurozone economies such as Greece, Ireland, and Portugal catalysed more decisive collective action at the European level. While the initial episode of the global financial crisis led to incremental reform, the subsequent Eurozone sovereign debt crisis opened the window of opportunity for far-reaching institutional change. The seriousness of the crisis as well as its transboundary character and contagion effects pushed the EU legislative actors to seek consensus on a mutually acceptable set of reforms. Our analysis

suggests the latest series of institutional changes such as conferring greater direct supervisory powers over the Eurozone's largest banks to the ECB would be unlikely absent the pressure for further institutional redesign due to the Eurozone crisis.

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Appendix I: Increased Powers of the European Supervisory Authorities

Tasks and Powers of the ESAs after the 2009 EU Regulatory Reforms

Sources: European Union Regulations 1093/2010; 1094/2010; 1095/2010; European Union Directive 2010/78; ECOFIN Council Conclusions 2009.

1. Ensuring that a single set of harmonised rules and consistent supervisory practices is applied by national supervisors, by two means:
   - Developing *binding* harmonised technical standards in the areas to be specified in Community legislation.
   - Drawing up non-binding standards, recommendations and interpretative guidelines, which the competent national authorities would apply in taking individual decisions.

2. Ensuring a common supervisory culture and consistent supervisory practices, and ensuring uniform procedures and consistent approaches across financial groups by:
   - Issuing guidelines on practical supervisory issues with a view to a common framework for supervision.
   - Coordinating ex ante the supervisory analyses of the risks and behaviours of financial institutions and groups.
   - Conducting peer analysis across financial institutions and groups, to ensure consistency in supervisory outcomes.
   - Participating as appropriate as observers in supervisory colleges, so as to identify and address possible inconsistencies.

- Collecting practical issues emerging in the implementation of Community legislation and ESAs' standards and ensuring that there is consistent interpretation across the Single Market.
- Developing on a much broader scale common training for supervisors and staff exchanges.
- Coordinating international issues, including technical arrangements and preparation of equivalence assessments.

3. Collecting micro-prudential information:
   - The ESAs should be responsible for the definition, collection and aggregation of all relevant micro-prudential information emanating from national supervisors.
   - A central European database should be established and managed by the ESAs. The information would be available for the relevant authorities in colleges of supervisors and should be shared with the ESRB subject to specific confidentiality agreements.

4. Ensuring consistent application of EU rules, in cases to be further clearly specified in Community legislation such as:
   - Manifest breach of EU law or ESAs' standards.
   - Disagreement between national supervisors or within a college of supervisors. If, after a phase of conciliation, national supervisors or colleges of supervisors have not been able to reach an agreement, the ESAs should, through a *binding decision*, settle the matter.

5. Using full supervisory powers over some specific pan-European entities such as credit rating agencies and EU central counterparty clearing houses.

6. Ensuring a coordinated response in crisis situations.