DELEGATING CONTESTED REFORMS OF

EU FINANCIAL MARKET REGULATION

By Zdenek Kudrna

Submitted to Central European University
Department of International Relations and European Studies

In partial fulfillment of the requirements for the degree of

DOCTOR OF PHILOSOPHY

Supervisor: Professor Laszló Csaba

(Word count: 77,700)

Budapest, Hungary
August 31, 2011

Abstract

This thesis aims to contribute to an understanding of institutional change within the EU's multilevel system of governance, as applicable to the single market in financial services. The single market requires regulatory integration, understood as the adoption of a single set of harmonized EU rules and their consistent implementation across all EU countries. Regulatory integration is essentially an institutional change from multiple national regulatory frameworks towards a single EU framework. This process is complicated by several obstacles: conflicting policy preferences of member states for important aspects of EU financial regulations, supermajoritarian EU decision-making requirements, as well as member states' control over implementation of EU rules. The EU addresses these complications by delegating regulatory powers to technocratic committees, leading to the question of whether and how this delegation of power enhances regulatory integration. The three strands of new institutionalist literature in political science suggest alternative causal mechanisms that could account for effects of delegation on regulatory integration. The historical institutionalist explanation relies on reinterpretation, and the sociological one is based on deliberation and the rationalist one relies on bargaining. Each of these explanations implies different patterns of policy compromises: hence their relative explanatory power can be empirically tested. The thesis concludes that the evidence from three longitudinal case studies of EU regulations of bank capital, investment services, and cross-border bank resolution is most consistent with the rationalist explanation of institutional change. The delegation of regulatory powers to autonomous, but accountable committees reduces the transaction costs of EU policy making, enabling committees to propose and monitor more complex and more harmonized package deals than was possible before the delegation. Although these committees can enhance regulatory integration of even the most politically contested aspects of EU financial regulations, their effects are limited and provide no substitute for difficult political choices about the most appropriate rules for the single market in financial services.

Declaration

I hereby declare that no parts of the thesis have been submitted towards a degree at any other institution different from CEU. To my knowledge, the thesis neither contains unreferenced material or ideas from other authors.

Table of content

List of tables

List of charts

List of abbreviations

BA	Basel Accord
BAC	Banking Advisory Committee of the Commission
BCBS	Basel Committee on Banking Supervision
BSC	Banking Supervisory Committee of European System of Central Banks
CBD	Consolidated Banking Directive (2000/12/EEA)
CBSG	Cross-border stability groups
CEBS	Committee of European Banking Supervisors
CEBS	Committee of European Banking Supervisors
CRD	Capital Requirements Directive (2006/48/EEA and 2006/49/EEA)
CRD2	Amendment of the CRD adopted in September 2009
EBA	European Banking Authority (CEBS replacement since 2010)
EBA	European banking authority
EBC	European Banking Committee
EBC	European Banking Committee (Level 2 Lamfalussy committee)
ECB	European Central Bank
ECJ	European Court of Justice
EEA	European Economic Area
EEC	European Economic Community
EFC	Economic and Financial Committee of the Council
EP	European Parliament
EU	European Union (also used to refer to European Communities or European Economic Community)
FSAP	Financial Services Action Plan
GdC	Groupe de Contact
Level 1	Decision-making on framework legislation by co-decision
Level 2	Decision-making on implementation measures by EBC
Level 3	Decision-making on supervisory convergence by CEBS
Level 4	Monitoring and enforcement of the banking rules
MoU	Memorandum of Understanding
OFD	Own Funds Directive (1989/299/EEC)
SEA	Single European Act
VSCA	Voluntary Specific Cooperation Agreement

Introductory chapter:

Theories of institutional change and expert committees

The European Union's single market in financial services is being completed for the third time in as many decades.[1] Integration of national markets requires the harmonization of the regulatory framework on the EU level: differences in regulation fragment the single market along national lines, undermining EU objectives such as competition, financial stability and consumer protection. Two previous attempts at regulatory integration — the Single Market Project (1985 to 1992) and the Financial Services Action Plan (1999 to 2004) — were only partially successful and left numerous politically contested issues. As in the past, the regulatory integration will be presently difficult to achieve due to a combination of divided policy preferences, highly consensual decision rules, and national control over implementation. However, this time the EU can rely on reformed committee infrastructure, introduced the decade before the recent financial crisis, to support the adoption and implementation of its financial regulations. This thesis asks if and how the delegation of regulatory powers to the expert committees affected regulatory integration.

The analytical framework of the thesis is derived from new institutionalist literature in political science, adapted to the EU policy-making process. Institutionalist theories propose alternative explanations of the effect that delegation of power to expert

[1] To avoid complexities of appropriate historical and legal references to either European Economic Community or Economic Community or European Economic Area to which many banking rules actually apply, we use a summary reference to the European Union, although this is formally correct only since the adoption of the Lisbon Treaty.

committees has on regulatory integration. The explanations are derived from historical, sociological, and rationalist strands of institutionalist literature (see Hall and Taylor 1996, Aspinwall and Schneider 2001, Mahoney and Thelen 2010 for overviews). The EU policy-making literature describes the specific context in which regulatory integration happens, and highlights the characteristics that hinder its progress and that the EU tries to address by delegating powers to expert committees (see Wallace 2010, Hix 2005, Nugent 2006, Versluis et al. 2011, Falkner 2011a, Richardson 2001 for overviews).

The single market in financial services remains ever incomplete, because financial markets are simultaneously one of the most regulation-intensive and fastest changing sectors of modern economy. The single market requires regulatory integration, which in turn requires the adoption of reasonably harmonized EU rules and their consistent implementation across all EU member states. However, there are important differences in market structures and in regulatory approaches across the EU economies. These differences shape policy preferences of member governments and lead towards conflicts over the most appropriate common regulations.

These conflicts make the adoption of common regulatory standards difficult. In order to comply with various self-imposed deadlines, the EU adopts common rules, even in the absence of a clear consensus. However, such legislation is often fuzzy and difficult to implement consistently, since member states — that retain full control over the application of EU rules in their respective jurisdictions — tend to implement them as close to their preferences as possible. The EU rules are therefore applied differently in different member states, leading to regulatory fragmentation of the single market that undermines functional as well as the normative goal of developing single European market. Therefore, it is not only the intensity and innovation of the regulation, but also the political contestation of some key regulatory provisions that prevents complete regulatory integration.

Since the onset of European integration, the EU has innovated its decision making and implementation procedures in order to facilitate regulatory integration that would help to remove all non-tariff barriers — such as technical and regulatory standards — to the free movement of goods, capital and services. Until the mid-1980s, regulatory integration required unanimous agreement on fully harmonized common standards. This proved essentially unworkable; even for the core six members it was difficult to agree on more than ten directives per year (Pelkmans 1987). During the early 1980s, the European Court of Justice case law facilitated emergence of a new approach to regulatory integration that relied on the combination of minimal harmonization and mutual recognition. This approach — complemented by the introduction of qualified majority voting in the Council by the Single European Act in 1987 — was instrumental in the completion of the Single Market project, requiring the adoption and implementation of nearly 300 legislative instruments. However, the single market in finance proved one of the most difficult to integrate even under the new approach (Grossman and Leblond 2011, Young 2005, Lannoo and Levine 2004). This was recognized in the broader context of monetary integration and the Lisbon agenda on competitiveness, which led to the formulation of the Financial Services Action Plan in 1999 and the subsequent Lamfalussy reforms of financial market comitology in early

2000s. This reform was characterized by the delegation of more decision-making and enforcement powers to lower level technocratic committees (Quaglia 2008, Pollack 2003a, Lannoo and Levine 2004, Hertig and Lee 2003).

The evolving structures of EU multi-level governance gradually provided new mechanisms for coping with an increasing diversity of policy preferences among an expanding number of EU member states. Under unanimity and full harmonization, policy conflicts on secondary legislation could only be settled by the treaty-like 'grand bargains', when member governments explored asymmetries in each others' policy preferences to compile a package deal that was acceptable to all (see Moravcsik 1998). Under the single market approach, the intense policy conflicts were often settled by vague legal provisions and relegated to mutual recognition. Such compromises enable the EU to adopt single market directives formally, but shifted policy conflicts from the adoption to the implementation phase. Member state authorities tend to exploit the ambiguity of legal provisions on contested aspects and interpret these rules to their liking, which reintroduces the differences across EU jurisdictions. This phenomenon shifted the attention to implementation issues, and led to the delegation of powers to various EU level committees.

There are additional reasons for shifting the policy conflicts to the technocratic level. As the EU expands in size and scope, the traditional 'grand bargains' linking cross-policy concessions are increasingly more difficult. Decisions are made by the specialized Council configurations, which makes horse trading of concessions, say, on agriculture for concessions on financial regulations more difficult to orchestrate. Even more importantly, the full co-decision rights of the European Parliament may easily distort such package deals. The deepening also makes EU regulations more complex and technical, increasing the dependency of key institutional players — the Commission, Council and European Parliament — on technical expertise during the process of policy formulation, adoption and, subsequently, implementation. In short, as the EU political system and its policy domains mature, the responsibility for reconciliation of policy conflicts shifts to the lower, more technocratic levels of EU policy making (Peters 1997, Pollack 2003a).

The lower levels of EU policy-making are known in EU parlance as 'comitology'. In strict legal terms, comitology refers to the four procedures that structure the relationships between the Commission and implementation committees consisting of member state representatives overseeing policy execution by the Commission (Pollack 2003a, Blom-Hansen 2011). In broader terms, the 'comitology' refers to all kinds of governance arrangements that rely on some form of committees, which may include various Council and Commission expert groups, committees of European Parliament, or even more specialized bodies such as colleges of supervisors or cross-border stability groups that also deal with EU-wide policy issues (see Chapter 4). This thesis adopts the broader understanding of EU expert committees as any formalized network of national and supranational authorities with some mandate and capacities related to specific policy domain, such as financial market regulation.

The EU committees are becoming prime sites of institutional change, at least in the domain of financial market regulation. While exercising their formal and informal powers, they tend to promote small and incremental adjustments that may gradually result in significant transformations of the prevailing rules. This kind of endogenous change poses an interesting challenge for institutionalist, theories, particularly the rationalist stream, as they tend to explain discontinuities by exogenous shocks, evidenced by the frequent use of concepts such as critical junctures, policy windows or punctuated equilibrium. However, a more recent wave of institutionalist theorizing pays more attention to endogenous changes, and this thesis may thus contribute to the empirical testing of these causal mechanisms, reviewed in the next section.

1. Puzzle and three hypotheses

The analytical puzzle of this thesis is: How does the delegation of regulatory powers from the legislative to technocratic levels affect the adoption and implementation of policy compromises on the most contested aspects of financial regulation? Although the delegation of powers to the financial sector committees is a recent development, technocratic actors are not new in the EU policy process. They were always present, at least in an advisory capacity. Hence it is not *a priori* obvious why a mere reshuffling of regulatory competences should increase the EU's capacity to adopt and implement harmonized rules. After all, it is still the same set of actors, still harboring the same set of underlying policy preferences, and still subject to the same set of legislative constraints of the EU policy-making and implementation processes.

In theoretical terms, regulatory integration is a problem of institutional change. It represents a change from the status quo, where each member state adopts and implements its own set of financial regulations, to a situation where all member states consistently adopt and implement the common EU regulations necessary for a seamless integration of the single market in financial services. Hence, we turn to institutionalist theories that provide alternative causal explanations of institutional change.

Political science in general, and EU studies in particular, relies upon three distinct strands of institutionalist literature, historical, rationalist and sociological, for analysis of EU policies and policy-making (see Hall and Taylor 1996, Rosamond 2010, Pollack 2010 for reviews). Each of these strands, to some extent, provides different explanations of the effects of institutions on actor behaviour, the persistence of institutions over time, and the mechanisms of institutional change. They also provide different conceptualizations of endogenous institutional change that cannot be easily explained by the exogenous shocks to the system (see Hall 2010, Mahoney and Thelen 2010). The three branches provide three alternative explanations of the role of EU committees in driving endogenous changes of politically contested financial regulations. This thesis adopts these explanations as three hypotheses — drifting, deliberative, and bargaining hypotheses — that are rooted in the historical, sociological and rationalist strands of the literature, respectively. Each hypothesis is rooted in a different 'logic' of collective action. Consequently, together they provide three competing views on the potential effects of committee governance on institutional changes in financial market regulation, and institutional change in general. However, before proceeding to the testing of these hypotheses, there is a hurdle to overcome: demonstrating that the delegation has any effect at all. Indeed, the policy literature includes claims that the delegation is, at best, redundant and, at worst, counterproductive (see Hertig and Lee 2003). Hence, the Null Hypothesis presuming no effect at all needs to be considered as well.

The Null Hypotheses gains some credibility in light of several preliminary assumptions, derived from the review of the EU policy-making literature (see Chapter 1). The literature on the political economy of the EU financial market regulation contends that prevailing structural differences across EU economies lead to a 'battle of the systems', whereby member governments strive to adopt the EU regulations closest to their national status quo (Story and Walter 1997, Quaglia 2010a,b, Grossman and Leblond 2011). The ‘battle of the systems’ leads to policy conflicts concerning important aspects of EU-level financial regulation. The conflicts are mediated by the EU legislative process, requiring a high degree of consensus to clear its supermajoritarian decision criteria. This is often difficult to achieve, given the divided preferences. Moreover, the resulting EU rules are transposed and implemented by national authorities that have considerable leeway over the interpretation and enforcement, thus making it unlikely that contested rules will be implemented consistently. Hence, further theoretical analysis is based on the three assumptions derived from the EU policy-making literature: (i) member states hold conflicting preferences over some aspects of the EU level financial regulation, (ii) there is a bias towards consensual decisions due to the supermajoritarian decision requirements of the EU legislative process and, finally, (iii) member states tend to use their control over the implementation of EU rules to interpret them according to their policy preferences. These three factors conspire to make EU regulatory integration — in the sense of institutional change towards a single set of harmonized and consistently enforced rules — a lengthy and difficult process.

Although stability is the definitional characteristic of institutions as shared across all strands of institutionalist literature in political science, their contested nature and inevitable incompleteness are potential sources of endogenous institutional change. Formal institutions, such as those regulating EU financial markets, are outcomes of a policy-making process, that is inherently political therefore includes 'distributional instruments laden with power implications' (Mahoney and Thelen 2010:8). Political actors are endowed with heterogeneous resources that influence outcomes, and to some extent the resulting institutions reflect such disparities. In some cases a dominant coalition of actors may impose their preferences on others, but over time, the underlying balance of power may shift, opening a path for endogenous change of otherwise stable institutions (Mahoney and Thelen 2010:8, Palier 2005, Hall and Taylor 1996). In short, although institutions are durable, they are also vulnerable to changes in the coalition that supported their adoption.

The second source of endogenous change is the inherent incompleteness of formal institutions. Even rules that are codified with great prescriptive detail remain incomplete, because there is no way to provide for all possible future contingencies that might have some bearing upon a given institution. The incompleteness is a result of information and cognitive limitations that prevent any actors from writing complete contracts (Williamson 2000, Pollack 2003b). The incompleteness of institutions makes them subject to "interpretation and implementation [that] can have profound consequences for resource allocations and substantive outcomes … as [c]oalitions form not only as representatives of alternative institutions but also as movements seeking particular interpretations of the ambiguous or contested rules of a given institution" (Mahoney and Thelen 2010:11). Moreover, all formal rules rest upon the non-contractual basis of contracts, as they are embedded in informal norms and traditions that are necessary for implicit understandings held by the relevant community that ensure efficacy of formal rules (Williamson 2000:597). Implicit understandings may differ across time and space, thus leading to uneven compliance and subsequently to endogenous change. Furthermore, since formal rules are typically adopted by the legislative branch, but implemented by the executive and judiciary, there is another opening for change arising from the implementation experience. Enforcers must decide how and when rules are to be implemented, and this implies possibilities for change, both through "slippage" or through expansive interpretations and applications (Mahoney and Thelen 2010).

In short, although institutions are generally conceptualized as stable and changing primarily in response to external shocks, their roots in coalitional politics and inherent problems with their incompleteness provide analytical space for incremental change – even in the absence of obvious external shocks. Some actors have incentives to explore loopholes and press for change or reinterpretation of the aspects that no longer enjoy political support of the dominant coalition, thus paving the way of endogenous institutional change.

In the context of EU policy-making, the actors that are most likely to propel gradual, endogenous changes of regulatory institutions are technocrats in the myriad of EU expert committees. The theoretical question is: how can they affect such a change, given the three complicating assumptions of divided policy preferences, supermajoritarian decision-making and national control over the implementation? The three institutionalist theories summarized in the following sections provide plausible explanations.

1.1 Historical institutionalism: Drifting Hypothesis

Historical institutionalism is interested in the long-term effects of past institutional choices, and aims to explain subsequent policy outcomes in terms of path-dependency (Hall and Taylor 1996). It emphasizes the lock-in effects of past institutions and their unintended and unforeseen consequences in a changing environment (Rosamond 2009:111). When studying change, historical institutionalists focus on policy pathways, and study how past agreements influenced subsequent policy choices.

More recent research explicitly addresses the problem of endogenous institutional change, and tries to establish a set of systematic relationships between the characteristics of political systems and modes of institutional change. Streeck and Thelen (2005) argued that, although there is a wide variety of institutional changes, it is not infinite. They provided an empirically-grounded, influential classification of types of institutional change that reconciles analytically different aspects of stability and change. They delineated four modes of endogenous institutional change:

displacement, layering, drift and conversion.[2] This typology was later integrated in a systematic analytical framework that connects, through a set of probabilistic statements, the four modes of institutional change to the (i) characteristics of political system, (ii) characteristics of the institution in question and the (iii) type of dominant change agent (Mahoney and Thelen 2010). The thesis relies on this framework to formulate a hypothesis on the mechanism of institutional change characteristic for the historical institutionalist approach.

Characteristics of two sets of EU institutions are crucial for the study of regulatory integration: (i) those that frame the EU legislative process and (ii) those that frame the implementation. These characteristics are also primary inputs in the Mahoney and Thelen (2010) model of endogenous institutional change. They operationalise them by looking at the veto opportunities provided by the political system and the discretion over the interpretation and enforcement provided to the implementing actors.

Numerous or strong veto players, can block institutional change, or at least block formal change (see Tsebelis 2002). A veto-player analysis that focused specifically on the EU political system demonstrates that the EU legislative procedures provide strong opportunities for veto players and, hence, are biased in favour of the policy status quo and against institutional change (see Tsebelis 1994, 2002, Tsebelis and Yataganas 2002, Crombez at al. 2000 and Chapter 1). Although the Council and European parliament can pass single market legislation with qualified and absolute majorities, respectively, these still represent a high hurdle, especially in the Council. The qualified

[2] Steeck and Thelen (2005) included a fifth type of institutional evolution, the exhaustion, indicating a prolonged stalemate, which eventually collapse into one of the four modes of change.

majority necessary to pass any directive requires around seventy percent of weighted votes, which preserves the supermajoritatrian character of Council decision-making (Selck 2005). It is certainly a more demanding threshold than a simple majority, which is the only rule that does not discriminate between the defenders of the status quo and the promoters of policy reform (Scharpf 2006: 848). It is also higher than in most federal systems such as Germany (Benz 2011), Canada (Banting 2008), Switzerland (Armingeon 2000), and some of the Scandinavian countries (Blom-Hansen 1999).

The formal institutional framework of the EU financial markets is specified primarily in directives co-decided by the Council and European Parliament; although many rules are also defined by agreements of lesser legal status (see Chapter 4). Directives in general define only policy objectives, but leave implementation for the member states. Directives need to be transposed to national laws and are enforced by national authorities (see Chapter 1). Unlike in competition policy or monetary policy of the Euro zone, there is little direct enforcement of financial regulation from the supranational level. Hence, the financial market regulation provides member states with high level of discretion over interpretation and enforcement of financial market directives.

In the Mahoney and Thelen (2010) analytical framework, the combination of high veto opportunities with high discretion over enforcement renders 'the drift' the most likely type of institutional change. 'The drift' occurs when rules formally remain the same, but their impact changes as a result of shifts in external conditions (Hacker 2005, Streeck and Thelen 2005). In other words, when actors are unable to respond to changes in financial market by adopting and implementing new EU regulations, the most likely mechanism of institutional change is the reinterpretation of existing rules under the new conditions, i.e. ‘the drift’. This, however, also depends on the behavior of the dominant change agents.

Mahoney and Thelen’s historical-institutionalist framework does not rely exclusively on structural characteristics of the political regime, but also looks at the role of dominant actors (2010:23). Each combination of veto power and enforcement discretion, they argue, will generate distinct situations, each likely to be dominated by a specific type of change agent. In turn, the specific type of agent either reinforces or subdues the tendency of the given institutional context to adopt the specific mode of endogenous change. Hence, the propensity of the EU policy-making process towards ‘the drift’ as the typical mode of institutional change can be strengthened or weakened by the dominant change agents. Member states remain the dominant agents within the EU political system. Despite the co-decision rights of the European Parliament, the EU legislative process is not dominated by the party groups, but by the member governments deciding in the Council (see Scharpf 2011, Thomson and Hosli 2006). This is only reinforced by the implementation process, where there is no direct supranational involvement beyond the threat of infringement (see Chapter 1). In short, the member states remain the dominant agents in the process of adoption and implementation of EU financial market regulation.

The Mahoney and Thelen (2010) model specifies four types of dominant agents: ‘subversives’, ‘symbionts’, ‘insurrectionaries’ and ‘opportunists’. These types reinforce the tendency of the given political systems respectively towards: ‘layering’, ‘drifting’, ‘displacement’ and ‘conversion’ modes of institutional change. Specifically, they argue that strong veto possibilities and high discretion in implementation will favor symbiontic dominant agents, whose presence reinforces the tendency towards ‘drifting’. Mahoney and Thelen (2010: 24) define symbionts as actors that try to have it both ways; on one hand, they support the contested institution, because they depend on it in achieving their long-term goals, such as gains from EU market integration. On the other hand, they do not shy away from exploiting the institutions for particular private gains that contradict the spirit or purpose of the institution, thus undermining it over the long run (Mahoney and Thelen 2010: 24). 'Symbionts' flourish in settings where expectations about institutional conformity are high, but the actual capacity to enforce these expectations is somewhat limited. They are more likely to persist in political systems where (i) high veto powers block opportunities to close the regulatory gaps by introducing new legislation and where (ii) discretion over the interpretation and enforcement complicates consistent implementation. Symbiontic dominant actors thrive in such systems and reinforce their tendency towards a 'drift'.

The behaviour of the member states, regarding EU financial market regulation, closely matches the defining characteristics of the symbiontic dominant agents; hence, they reinforce the proclivity to ‘drift’. Member governments face conflicting incentives over the financial market regulations. On one hand, they are keen to benefit from integrated financial markets, and thus are open to the idea of regulatory integration. On the other hand, they wish to retain control over financial firms operating in the domestic market, support their international competitiveness by supportive regulation, and minimize the regulatory reforms by ensuring that EU rules are as close to the national status quo as possible (see Chapter 1, Kapstein 1994, Story and Walters 1997, Tarullo 2008). Member states therefore, balance long term benefits of regulatory integration with short term benefits of regulatory fragmentation, and are aptly characterized as 'symbionts'.

The historical-institutionalist framework leads towards the 'Drifting Hypothesis' about the effects of delegation on regulatory integration. It predicts that delegation of powers to committees may enhance regulatory integration by allowing the technocrats to reinterpret existing formal rules to match evolving market realities. The endogenous change of formal rules is expected to be blocked by the combination of characteristics of the EU political system reinforced by the symbiotic behaviour of member states dominant in the policy-making process. The Drifting Hypothesis predicts that there will be no change in the formal rules, but conceded the likelihood of endogenous change through reinterpretation of existing rules by the more autonomous committees. It puts the EU committees into a reactive position vis-à-vis financial markets. The informal changes are linked to market developments and thus limited to cases when regulatory integration of contested aspects is essentially a fait accompli delivered by some technological or structural developments in financial markets rather than proactive regulatory policy.

Despite the focus on the dominant actors in the policy process, the historical institutionalist modeling of change is sensitive to the role of non-dominant contenders,. These include the Commission and expert committees that strive to counter-balance the symbinotic behavior of member states. These supranational actors may seek to displace regulatory provisions that provide national authorities with excessive discretion, but they are still constrained by the veto opportunities afforded by the EU political system. Nonetheless, a delegation of powers to regulatory committees could be interpreted as a reduction of discretion in interpretation and enforcement that provides an opening for the type of cumulative change that Streeck and Thelen (2005:22) label as 'layering' (see also Schickler 2001, Thelen 2003). It occurs when new rules are attached to existing ones, thereby changing the ways in which the original rules structure the behavior of financial firms. 'Layering' does not replace old rules with new ones, because the pro-reform change agents are too constrained by the legislative system. Nonetheless, they use all policy space available to push for marginal amendments, revisions, or additions to existing rules. Cumulatively, the modifications can change the underlying policy compromise.[3]

The Mahoney and Thelen framework (2010) is one of the most systematic and advanced historical institutionalist approaches linking the characteristics of the political system and its dominant agents to a typology of endogenous institutional change. As other approaches to historical institutionalist analysis it emphasizes the path-dependency of regulatory reforms, when current policy decisions are codetermined by past decisions as well as by the applicable legislative and implementation rules that are also inherited. Given the three starting observations about divided preferences, supermajoritarian decision rules, and national control over implementation, the historical institutionalist approaches can be expected to predict a protracted policy stalemate and, also, very limited room for endogenous change.

[3] The layering strategy is analytically indistinguishable from the Bargaining Hypothesis of the rationalist stripe described below. In both cases the delegation of powers provides greater role for technocratic agents, who may be able to formulate more complex policy compromises than proved possible during legislative bargaining among the Commission, Council and European Parliament. Hence, we do not specify the layering as a separate hypothesis and only note this relationship between the historical and rationalist conceptualizations of institutional change.

1.2 Sociological institutionalism: Deliberative Hypothesis

Sociological institutionalism emphasizes the role of deliberations within the EU's multi-level system of governance in the process of institutional change. It stresses the need for normative and political legitimacy of institutions, and the role of informal norms and shared identities in creating such legitimacy for the new institution (Hall and Taylor 1996, Checkel 2003, 2005, Pollack 2010). Unlike the two alternative strands of institutionalist literature, sociological institutionalism assumes that preferences are not exogenously given, but established during the negotiation process (Jupille, Caporaso and Checkel 2003). When applied to European Union studies, this strand of institutionalism bears a close resemblance to neofunctionalist theories, which emphasize role of functionalist, political, and ideational spillovers in shaping the process of European integration (see Joerges and Neyer 1997, Jupille, Caporaso, Checkel 2003, Pollack 2003b, Blom-Hansen 2011).

The sociological institutionalist view presents EU committees as a forum of relatively disinterested experts who seek to formulate the most efficient solution to a common policy problem. It does not deny the role of interests, but argues that under specific circumstances economic interests may be dominated by 'softer' factors that enable agreement on common standards. It stresses that, instead of bargaining, the EU committees often engage in ‘problem-solving’ style of negotiations (Scharpf 1988), whereby member states representatives follow the 'logic of appropriateness' rather than the consequencialist logic typical for bargaining (March and Olsen 1989:23).

Advocates of the deliberative view of the EU expert committees stress that, although the committees were initially designed to provide member states with control over Commission's implementation decisions, they evolved towards 'supranational deliberation' fora (Pollack 2003a) that ensure that all member states are represented during the deliberations on common standards.

Sociological institutionalism predicts that decisions about EU financial regulations are formed through interaction between the functional demands of the sector, and expert ideas about the best ways of addressing these demands (see Joerges and Neyer 1997, Dehousse 2003, Pollack 2003b, Blom-Hansen and Brandsma 2009). This view does not deny the role of perceived national interests in the formulation process of EU rules, but argues that, at least under some circumstances, the expert consensus can be an equally or even more important determinant (Checkel 2003:220). The learning and persuasion processes are predicted to dominate the consensus-building on the expert level in EU committees and, therefore, formal voting rules are presumed to be of minor importance. Moreover, proposals backed by expert consensus are expected to trigger less legislative-level contestation because member governments are inclined to support consensual proposals backed by all stakeholders represented in the deliberations of committees (Joerges and Neyer 1997).

The sociological institutionalist literature list five factors that increase the likelihood of deliberative problem solving within EU committees (see Checkel 2003, Risse 2000, Joerges and Neyer 1997, Pollack 2005). First, when actors operate in a novel or uncertain environment, they are more likely to analyze new information and consider policy options that may not be aligned with their short term economic interests. Second, consensus-building is easier when the national actors do not have deep ingrained beliefs about the optimal policy design. Third, a strong policy consensus on the technical characteristics of the optimal policy design, within the relevant epistemic community, is likely to forge common ground in negotiations. Fourth, deliberation is more likely to occur when the parties involved avoid lecturing, engage in a genuine debate, and are open to persuasion. Finally, the fifth factor conducive to deliberation is the insulation of the negotiation from the intensely political arena. The presence of at least some of these factors is plausible in the committee negotiations over EU financial regulations.

There are some contested aspects of financial regulation that are both novel and subject to considerable uncertainty. Financial market regulation, as such, is not a particularly novel policy domain; however, fast-paced innovation often presents novel policy problems. Moreover, regulation increases in complexity as financial products and services become increasingly specialized. The complex environment introduces uncertainty about intended and unintended effects of regulatory changes across the interconnected parts of financial markets. The complexity also makes distributive consequences of regulatory reforms less certain, thus complicating extrapolations of national interests and inducing national representatives to engage in collective problem-solving. The uncertainty that induces deliberation may also be heightened by external shocks, such as the recent financial crisis that make policy-making more prone to deliberation (see Puetter 2011).

On the other hand, the focus on the most contested aspects pre-supposes a history of the given regulatory issue. Much political contestation stems from the fact that national authorities developed policy solutions that work well in their national contexts and they try to 'upload' them to the EU level (Quaglia 2011, Börzel and Panke 2009). Hence, the traditional regulatory issues are less conductive to expert deliberations than novel aspects of regulation, because national experts hold deeply ingrained beliefs about possible policy designs. This factor may act against deliberative problem solving.

Financial market regulators form a cohesive epistemic community with a long tradition of international cooperation. The financial markets tend to concentrate into major centres that are closely interconnected. Every international crisis forces them to coordinate their resolution effort, and thus induces regulators to establish connections. This has the longest tradition in banking, where central banks established the Bank for International Settlements as a forum for debate and information exchange in the 1930s (see Wood 2005). Over the last three decades global cooperative bodies have proliferated to all segments of financial regulation (Davies and Green 2008). These arrangements support the formation of an epistemic community that transmits its key ideas outwards, to all financial systems. Although there is never a perfect consensus, the basic precepts of financial regulations tend to be shared and often codified as international standards (see Chapter 2). Hence, any EU negotiations that take place in the context of the debates in the international epistemic community are likely to be conductive to expert deliberations (see Haas 1990).

The openness to persuasion may be somewhat limited when it comes to the most contested aspects of financial regulations, precisely because of their contested history. At the same time, the material interests may not necessarily stand against persuasion. When there are potentially large mutual gains from cooperation, member states might be open to the idea that a model other than their own is more suitable for EU-level regulation. The same may be true even when the distributive consequences are negligible or not known. Moreover, the long-term interaction among committee members may result in a gradual socialization that moves the views of national representatives closer to a common consensus. Over time, they may become more receptive to shared formal and informal norms for addressing contested policy problems, and thus open to be persuaded on a policy design that they did not initially support (Joerges and Neyer 1997, Lewis 2003, 2005).

The technical complexity of regulatory issues in financial markets insulates committee deliberations from direct political interference. At the same time, committee proposals must be approved through the applicable decision-making process, which inevitably adds a political dimension into any technical deliberations. The delegation of regulatory powers to committees increases their insulation; although it also imposes new accountability mechanisms on committees (see Chapter 1). The distinction between the technical and political is therefore becoming one of the most important issues within the policy-making process (see Chapter 1, interview 2). Nonetheless, the delegation increases autonomy of the EU committees and thus is generally conductive to deliberation.

As the brief review above highlighted, the delegation of powers to technocratic committees in the domain of financial market regulation generally favors the presence of five factors conductive to deliberative problem solving that were identified by the research informed by the sociological and constructivist theories. This makes the Deliberative Hypothesis a plausible causal explanation of effects of delegation on regulatory integration. At the same time, the operationalization of Deliberative Hypothesis requires attention not only to the process of policy-making in the committees, but also to the characteristics of the policy outcomes. If the EU rules were produced by a deliberative process, then they should be structured as genuine common standards rather than bargains that accommodate and reconcile policy preferences of key member states or advocacy coalitions (see Chapter 1, section 2).

Much of the existing research on EU comitology committees uses the characteristics of the policy process as the dependent variable. It examines whether committee behavior is dominated by bargaining, deliberation, or both in some specific combination (Joerges and Neyer 1997, Peters 1997, Lewis 2003, Blom-Hansen and Brandsma 2009, Blom-Hansen 2011, Tallberg 2002). However, the characteristics of the policy process within committees should also leave observable traces on the rules that the committees adopt. By observing these characteristics we can draw inferences about the causal mechanisms through which delegation of regulatory powers to committees affects regulatory integration. Hence, the specification of the dependent variable in this thesis differs from the EU comitology literature. Instead of focusing on classification of the comitology working mode in general, it analyzes specific policy outcome in order to establish which causal mechanism enabled the committee to foster regulatory integration in that particular case (see more in section 2).

The emphasis of sociological institutionalism on deliberation and consensus-building leads to the expectation that committees can agree on new common standards that would avoid extensive accommodation of specific national concerns. Whereas the Drifting Hypothesis predicts that rules remain the same, but the underlying interpretation changes, the Deliberative Hypothesis predicts that the new rules would be genuine common standards. Successful expert deliberations are expected to result in converging preferences on a single set of common rules that avoid complex accommodation of competing interests. The shift towards common standards that abandon detailed accommodation of competing policy ideas is the key empirically observable characteristic of the outcome of the deliberative process that distinguishes it from a similar outcome generated by the 'drifting' or 'bargaining' processes.

1.3 Rationalist institutionalism: Bargaining Hypothesis

Rationalist institutionalism, as applied to the analysis of the EU governance, accentuates the role of bargaining in the process of institutional change (Hall and Taylor 1996, Pollack 2002, Hall 2010). It stresses the need for voluntary agreements among actors motivated by mutual gains arising from implementation of the new set of rules. This strand of institutionalist literature relies on the standard set of rational choice assumptions including the fixed preferences of actors, their instrumental behaviour motivated by attainment of outcome with highest expected payoff, and the strategic anticipation of responses of other actors involved (Hall 2010). In the context of EU literature, rationalist institutionalism is a close kin of intergovernmental theories that stress the role of member state governments and authorities, their preferences, and relative bargaining power in explaining the path of European integration (Moravcsik 1999, 1998, 1993).

The rational-institutionalist approach portrays the EU expert committees as miniature versions of the Council, dominated by intergovernmental bargaining of national representatives, who seek to resolve a series of collective action problems in order to realize gains from mutual cooperation (Pollack 2009). At the same time, each national representative in the committees calculates the expected impact of alternative agreements on the perceived national interests, and strives to steer common EU policies as close to their preferred national policy as possible (see Pollack 2003a, Hertig and Lee 2003, Franchino 2000). In this view, committees follow the consequentialist logic of voluntary agreements on institutional changes that balance the expected costs and benefits of a sufficient number of member states to pass the legislation. Hence, the formal procedural and decision-making rules that structure the bargaining process are much more important than in the historical-institutionalist approach that relies on informal reinterpretation or sociological-institutionalist view that expects high degree of expert consensus (Pollack 2003, Blom-Hansen 2011).

The rationalist explanation of institutional stability rests on the conceptualization of institutions as equilibrium outcomes of a voluntary bargaining process. If actors accepted the proposal, they expect to benefit from its implementation, and thus they are likely to behave as anticipated by the given rule. This also provides institutions with some self-enforcing capacity.[4] At the same time, it also links the stability of institutions with the stability of the interest coalitions that supported its adoption (Hall 2010). This delineates a possible sources of institutional change; institutions change when preferences of actors forming the supporting coalition change. However, preferences are assumed to be farsighted and stable; therefore rationalist institutionalism often requires some exogenous shock to established preferences in order to explain why actors agree to new rules that they opposed earlier (see Hall 2010, Mahoney and Thelen 2010).

The endogenous institutional change does not necessarily require the transformation of preferences, however. Rationalist bargaining models conceptualize strategies of luring pivotal actors into agreements by side-payments of various kinds in order to form a coalition with a sufficient number of votes to pass new rules. Such strategies of overcoming policy conflicts within the EU are amply documented by the historical decisions on Treaty changes that are often achieved through 'grand bargains' (Moravcsik 1998). Nonetheless, it is also a common approach to resolving policy conflicts on secondary legislation in the Council (Heritier 1999, Hayes-Renshaw and Wallace 2006, Young 2010). The side payments, package deals, or log rolling are possible ways of overcoming stalemates caused by conflicting preferences of member states (Scharpf 2006, Peters 1997). They enable the competing policy coalitions to form the majority necessary for the decision. Side payments are typically policy mechanisms

[4] The self-enforcement capacity is typically limited by incentives for free-riding and other strategic behavior.

that materially compensate the perceived 'losers' of the new policy, through the regional or cohesion policy, for example. The package deals explore preference asymmetries among member states by bundling together two or more policy issues and adopting the measures at once, enabling member states to exchange support on issues they care less about for support on issues they are more concerned about. The log rolling is essentially a package deal spread in time, whereby the governments do not insist on combining the policy issues into a package set for one vote, but rely on 'diffuse reciprocity' in which they expect that they support for policy they cared less about, would be reciprocated when issues more salient to them come up for vote (Peters 1997).

If side payments are important to achieve agreements on the most contested aspects of EU financial regulation, then the delegation of powers to committees could be detrimental to regulatory integration. The traditional political actors are much better positioned to use these strategies than the lower level technocratic actors. The latter have no control over resources that could be used as side payments compensating perceived losers of policy reform. They are specialized to act within a single policy domain and thus do not have the capacity to develop cross-issue linkages that would create acceptable package deals. Moreover, the technocratic actors cannot commit to log rolling any better than political actors, since any of their decisions can be recalled by the political actors. The wisdom of delegation, justified by the desire to resolve policy deadlocks caused by conflicting preferences, can therefore be questioned on these grounds:

> "The existence of the [committee] will be futile when taking so-called technical decisions on which there is little political disagreement – as these decisions could have been taken without [committee] participation. If, however, there is political disagreement over a particular issue, then the establishment of the [committee] will not help resolve such disagreement. On the contrary, exactly the same battles and compromises that so slowed down and diluted the results of the previous legislative structure, will arise in the activities of the [committee]" (Hertig and Lee 2003: 8).

This argument essentially formulates a Null Hypothesis about the effect of delegation on regulatory integration. It points out that formal changes in competences do not necessarily provide any new stimulus to the deadlocked negotiations, and thus cannot be expected to have an independent causal effect. However, rational institutionalist literature often invokes the concept of transaction costs as an intervening variable in the EU decision-making process, which was not considered by Hertig and Lee (2003) when they formulated the Null Hypothesis.

There are at least two definitions of transaction costs used in institutionalist literature on the European Union. The first presents them essentially as a tax on cross-border transactions hampering exchange that can be quantified, at least in principle. Sandholz and Stone Sweet (1998) relied on this definition in their influential explanation of European integration as being motivated by the wish of various interest groups to eliminate these costs. The second definition emerged from comparative institutionalist research, where transaction costs are understood as reasons for the emergence of governance (Pollack 1997, 2003b). In this view, transaction costs arise from inherent informational and cognitive limitations of any actors that try to adopt and implement any agreement, such as agreements on common regulatory standards (Williamson 2000, Dixit 1996). They can never write complete contracts that would cover all possible future contingencies, because they have neither all necessary information nor the cognitive capacity to process them. Hence, all contracts are inevitably incomplete and thus fraught with risks that any party would misuse their incompleteness. These contractual risks can be reduced by governance arrangements that increase credibility of actors' commitment to the execution of given contract. The latter understanding of transaction costs essentially presumes that they can never be reduced to zero, but that different governance arrangements reduce them to a different extent. The more governance reduces the transaction costs, the more complete contracts can be adopted, the lower are the risk of malimplementation and, therefore, the more welfare enhancing exchanges can take place (Williamson 2000, 2010). This thesis adopts the comparative institutionalist definition of transaction costs defining them as inevitable consequence of information asymmetries and bounded rationality that can never be fully avoided, but can be reduced by well-developed governance arrangements.

Since any Treaty and any secondary EU legislation can be regarded as an incomplete contract among member states to implement common policy consistently, the comparative institutionalist definition of transaction costs has been utilized in EU research. It is often invoked in the literature on legislative or regulatory politics. For example, Tsebelis (2002:28) notes that transaction costs increase the status quo bias of any decision-making system by preventing two veto players with identical policy preferences to act as one. A similar argument is made by Scharpf (1988:254, 2006:

848-851) when he points out that, even if the member state policy preferences converge, the Council may still not escape the joint-decision trap due to the transaction costs of multi-actor bargaining (see also Majone 1996 or Moravcsik 1999). Transaction costs were more systematically used in the literature on delegation in the EU. Pollack (1997, 2003b:378), for instance, argues that the patterns of delegation to the Commission and ECJ can be explained by the transaction cost hypothesis. It predicts that member states would delegate greater powers and discretion to a supranational body when this body would provide policy-relevant information, credible commitment, or speed up the decision-making by one of three methods. First, by monitoring compliance, second by filling in the details of incomplete contracts, by adopting credible and expert implementing regulations, or finally by setting the formal agenda for the legislative process to avoid cycling of proposals and counter-proposals in case of contested policies (see also Francino 2007).

These accounts use transaction costs to explain why certain functions are delegated to supranational bodies, but avoid testing the effects of delegation on specific policy outcomes.[5] However, Pollack's (2003b:378) argument predicts the effects of delegation on the regulatory integration. He essentially argues that, if the delegation reduces

[5] Moravcsik (1999) is partial exception when he argues that supranational actors had no effect on the outcomes of the Treaty bargaining as the 'grand bargains' were invariably struck by member governments without traceable effect of supranational entrepreneurs. However, Moravcsik's application of the transaction cost approach is truncated by two related limitations, both of which he acknowledges. Firstly, and contrary to much of the transaction cost literature in economics, he discusses only the ex ante costs related to information-gathering and negotiations (Moravcsik 1999: 270). He excludes the ex post transaction costs that arise from implementation of agreements. Secondly, Moravcsik focuses exclusively on 'grand bargains' on Treaty amendments, which also helps to justify exclusive focus on ex ante transaction costs. If the analysis was extended to everyday policy making within the EU, the ex post transaction costs (of implementation) would likely become much more important, thus potentially increasing the role of supranational actors in enhancing the transaction cost efficiency of the EU policy-making (Moravcsik 1999:302).

transaction cost of EU policy making, then it may reduce the contractual incompleteness by formulating more comprehensive proposals. By reducing the transaction costs through the reduction of information asymmetries and cognitive limitations, committees can produce more complex package deals on the micro-level. This gives them a potential comparative advantage over the legislative bargaining in the Council, which lacks both access to detailed information and the technical knowledge to process it. Hence, the delegation of regulatory powers may have positive effect on regulatory integration, if it reduces the transaction costs of negotiating package deals that can be adopted and implemented consistently. This observation provides theoretical grounds for the rationalist hypothesis about effects of delegation on regulatory integration.

The Bargaining Hypothesis predicts that policy conflicts that hamper the Council's adoption of harmonized rules on contested aspects of EU financial regulations will be replicated in the regulatory committees (as asserted by the Null Hypothesis). However, due to better information and better understanding of the technical aspects of financial regulation, the committees are expected to be able to strike more complex package deals on micro-level rules. Whereas the Deliberative Hypothesis predicted common standards with limited accommodation of specific interests, the Bargaining Hypothesis predicts complex package deals that extensively accommodate policy preferences of competing advocacy coalitions. The Bargaining Hypothesis does not expect a convergence of preferences, but rather tortured compromises increasing the harmonization of contested aspects by prescriptive rules preventing differentiated interpretations and implementation across EU countries. In this sense, the Bargaining

Hypothesis expects more gradual progress towards common standards through a series of complex policy compromises enabled by reduced transaction costs of policy-making.

Complex package deals accommodating competing policy preferences are an observable hallmark of committee bargaining. They are empirically distinguishable from the common standards arrived at through deliberation in committees. The Deliberative Hypothesis predicts the convergence of preferences, whereby one policy coalition persuades others of the merit of its proposal, or when they agree on a new common standard not initially proposed by any of the policy coalitions. Such common standard should be more than a sum of the competing approaches, therefore it should be distinguishable from complex bargains reconciling competing proposals by detailed rules as predicted by the Bargaining Hypothesis.

1.4 Summary of hypotheses

To summarize, the institutionalist literature applied to EU governance conjectures three competing explanations of the effects of delegation on regulatory integration (see Table 0.1). The Drifting Hypothesis posits that changing market circumstances will open possibilities of a reinterpretation of existing rules by the expert committees, leading to a higher degree of regulatory integration. The Deliberative Hypothesis postulates that the deliberation of national experts in the committees leads to a gradual convergence on a single set of common European standards. The Bargaining Hypothesis suggests that reduced transaction costs of policy-making may allow committees to strike more complex policy compromises than were possible without the delegation.

Table 0.1: Hypothesized causal mechanisms of institutional change

Hypothesis	Causal mechanisms of institutional change
Null	Delegation of powers to committees does not affect regulatory integration, because committees were always part of the process and delegation of powers does not change their chances to propose more adoptable and implementable EU rules.
Drifting	Delegation of powers to committees can increase the degree of regulatory integration by enabling committees to reinterpret existing rules to fit new market realities.
Deliberative	Delegation of powers to committees can increase the degree of regulatory integration through gradual convergence of policy preferences towards common EU standards that the epistemic community perceives as appropriate solution.
Bargaining	Delegation of powers to committees can increase the degree of regulatory integration through reduced transaction costs of policy-making that facilitates adoption and implementation of more complex package deals.

The purpose here is not so much to ascertain the 'best' theory, as to learn about the process of regulatory integration of contested aspects of financial regulation without overlooking any important factor considered by institutionalist literature on the EU. Each strand of the institutionalist literature emphasizes different factors (see Table 0.1). Historical institutionalism stresses the constraints that past decisions influencing the nature of the EU political system impose on the subsequent policy pathways. Sociological institutionalism notes the fact the shared ideas and continuous interaction influence the shape and intensity of policy preferences, thus consensus may replace discord over time. Finally, rationalist institutionalism maintains that institutional changes are only possible when some *pareto-optimal* policy package can be compiled, but also recognizes that some actors may be better positioned to produce such proposals because of their informational and cognitive advantages.

The first step in the empirical analysis is to evaluate the Null Hypothesis by establishing whether or not the delegation of regulatory powers to committees was followed by an increase in the degree of regulatory integration of some of the most contested aspects of EU financial regulation. If such progress can be identified, then the second step is to discriminate among the three hypothesized causal mechanisms, identifying the one that is most consistent with empirical evidence. This can be established by the analysis of the structural characteristics of policy documents produced by the committees, because each of the three hypotheses makes different predictions (see Table 0.2). If regulatory integration was facilitated by 'drifting', then committees were unable to introduce new rules, but reinterpreted existing ones. The case studies should therefore uncover guidelines or communications reinterpreting exiting rules in a more harmonized way that allows for more consistent implementation. If regulatory integration is to be explained by 'deliberation', then the committees produced new rules based on common expert consensus not plagued by extensive accommodation of competing policy interests. Finally, if the regulatory integration is driven by 'bargaining', then the committees generate more complex compromises that explicitly accommodate competing policy preferences.

Table 0.2: Alternative institutionalist views of regulatory committees

Hypothesis	Potential role of committees	Mode of interaction in committees	Characteristics of policy outcomes
Null	replicate Council stalemates on contested issues	bargaining without any value added	conflicts papered over with fuzzy rules
Drifting	reinterpretation of existing rules in light of market changes	reactive responses to market developments (fait accompli)	same rules interpreted differently
Deliberative	expert deliberation on common solutions to common policy problems	deliberative problem solving	new rules based on genuine common standards
Bargaining	bargaining over the more complex, more harmonized package deals	strategic bargaining	new rules based on complex compromises

All four hypotheses are *a priory* plausible explanations of effects of delegation on policy outcomes. The Null Hypothesis predicts that delegation is merely a formality that does not affect the adoption and implementation of contested financial regulations, and hence has no effect on regulatory integration. It also suggests the possibility that the delegation may actually undermine the process of regulatory integration, because it makes it more difficult to strike political package deals. If the EU policy-making gets stuck in a stalemate and the regulatory gap between existing rules and market developments increases, then member states may decide to (re)introduce national financial regulations, which could effectively (re)fragment the regulatory framework of single financial market, and thus reduce the degree of regulatory integration. The Drifting Hypothesis is also skeptical about any effects of delegation on adoption of more harmonized regulations, but expects that increased autonomy of committees enables them to increase the *de facto* degree of regulatory integration by reinterpreting existing rules in novel ways, thus preventing complete stalemate or even backsliding of regulatory integration.

The Deliberative Hypothesis expects that delegation of regulatory powers to committees would exert an independent effect on regulatory integration through converging preferences, first of national experts and subsequently of legislators and regulators passing and implementing harmonizing amendments. The Deliberative Hypothesis shifts the attention to the fact that expert committees are staffed with members of a vibrant epistemic community, who deal with complex technical matters. Moreover, financial innovations — including regulatory arbitrage — makes the distributive consequences of regulatory changes less predictable, thereby reducing the bargaining incentives and increasing incentives to agree on the 'best' technical standards. Furthermore, these committees have operated with increasing intensity over the past years and decades, therefore on some contested issues there was ample time to develop some common understanding and shared approach across the EU. All these factors are conductive to the deliberation and gradual formation of the common standards.

The Bargaining Hypothesis also asserts that delegation may have an independent causal effect on regulatory integration. This hypothesis is derived from the rationalist approach to institutional analysis that rests on the assumption of fixed preferences of key actors. However, rationalist institutionalism — in contrast to the pure rational choice theories — makes space for asymmetric information and bounded rationality of actors, prime sources of the transaction costs within the policy making system (Dixit

1996, Pollack 2003b). If the delegation provides means to reduce these transaction costs, it opens up the possibility for progress in regulatory integration despite the continued conflict of policy preferences.

The three hypotheses generate different expectations regarding the optimal distribution of the policy-making agenda across the different levels of the EU system. If the committees successfully adapt existing regulations by their reinterpretation, as assumed by Drifting Hypothesis, then the EU could shift towards the more principle-based regulation and let the committees ensure harmonized interpretation and implementation. This would facilitate the decision-making burdens on the legislative level. Similarly, if the committee deliberation generally leads to consensual common standards satisfying all stakeholders, then the committees should be allowed to set the agenda, even on the political level. However, if committees enhance integration merely through bargaining that abides by existing configuration of interests, then they are unlikely to play the agenda-setting role on the political level. In that case, the effect of committees should not be expected to transcend beyond the technical improvements on the micro-institutional level.

Whether the committees influence institutional change only by reinterpreting existing regulations in new ways, or through agreements on common standards, or by making ever-more complex bargains is an empirical question. Empirical evaluation requires the operationalization of the dependent variable and specification of the research design, discussed in the next sections.

2. Regulatory integration: defining the dependent variable

Regulatory integration is an institutional variable consisting of a rule and its enforcement characteristics (North 1990). The rule is specified in EU level agreements among all member states, whereas the enforcement characteristics are derived from the implementation of the given rule by national authorities in each EU member state. The rule is an outcome of the EU legislative process, whereas the enforcements characteristics are consequences of national administrative processes.

Regulatory integration is high when all actors face the same set of rules consistently enforced within the given market. It means that the structure of regulatory incentives faced by any financial market participant is practically the same in all 27 EU countries. In contrast, regulatory integration is low when the structure of regulatory incentives differs in different EU countries. It is low either when there is no single set of EU rules and/or when there are important differences in enforcement of EU rules. A possible benchmark for regulatory integration in the single European market is the degree of regulatory integration comparable to (federal) states. In federal states, the regulated entities do not have any incentive to move from one federal province to the next, because both the rules and their enforcement are practically the same.

The opposite of regulatory integration is fragmentation. Differences in transposition of EU rules and inconsistencies in their enforcement fragment the regulatory framework along national lines, and prevent progress from an advanced customs union to a fully integrated single market (Pelkmans 1987). Regulatory fragmentation serves as a non-tariff barrier distorting competition among financial market entities based in different EU countries, and may also undermine other EU policy objectives such as free movement of capital, freedom of establishment, or financial stability and consumer protection.

Regulatory integration is a latent institutional variable, effects of which are not directly measurable. Effects of regulatory fragmentation on traditional economic and financial indicators are dominated by more immediate factors such as business cycle, structure of the sector, or maturity of given markets. Nonetheless, as in any other segment of the single market, regulatory integration is important to reap the market's efficiency benefits, which is also a consistent conclusion of all EU reports that assessed the issue over the past decades.[6] Apart from reducing efficiency gains, regulatory fragmentation also undermines the ability of the single market to adapt to shocks such as financial crises, requiring the close cooperation of national authorities across borders to prevent beggar-thy-neighbor responses under pressure. Such effects are even more difficult to estimate quantitatively, but they can be traced through qualitative analysis of such shock events.

Regulatory integration requires member states, firstly, to agree on a single set of sufficiently harmonized rules and, secondly, to implement them consistently enough that they do not materially distort incentives of market participants. Adoption is challenging due to heterogeneous policy preferences combined with supermajoritarian

---

[6] See Segré Report (in 1966), the Schmidt Report (1977), the Wymeersch Reports I-III (1978-80) , Cecchini Report (1988), Lamfalussy report (2000) London economics report (2002) or Lisbon agenda (2000, 2004).

decision rules. Implementation is also challenging, because it remains under the purview of national authorities and thus may be influenced by the differences in national preferences. Moreover, there is a potential trade off between adoption and implementation, as what may be easy to agree on may prove difficult to implement and, vice versa. The analysis of regulatory integration needs to recognize its qualitative nature as well as the micro-level interaction between the adoption and implementation phases, which makes the case study the most suitable approach.

An important aspect of the institutionalist definition of regulatory integration is its neutrality regarding the content of the financial rules. The concern of this thesis is with the effect of delegation of regulatory powers to committees on institutional change in the domain of the EU financial market regulation, not with the economic effects of EU financial regulation. It is not the question here whether the EU rules should adopt a more *laissez-faire* or the *dirigiste* framework, but whether any such rules can be adopted and implemented consistently so that they are the same all across the single market. As long as the EU rules are adopted and consistently implemented, regulatory integration is measured on the higher end of the scale. To the contrary, even if each and every country had its own very efficient system of financial regulation, the dependent variable would be at the low end of the scale, because that translates into regulatory fragmentation on the level of single market. This approach sidesteps the heated and inconclusive debate on the most appropriate regulatory model for the single market in financial services.

2.1 Formal aspects of regulatory integration

The starting point for the assessment of the evolution of regulatory integration over time is a review of the formal characteristics of the legal rules that define the regulatory framework on EU level, combined with the evaluation of respective enforcement mechanisms. In the EU context, both of these dimensions can be traced to a qualitative scale with clear values in its extremes and some in between ones (see Table 0.3).

Table 0.3: Formal characteristics of Regulatory Integration

	Types of formal rules	**Types of enforcement mechanism**
high integration	regulation	single EU institution
in between	directive framework directive enhanced cooperation directives Open Method of Coordination	agencies European authorities regulatory committees advisory committees policy networks
low integration	declarations & memoranda	purely intergovernmental

There is a pecking order of EU rules and enforcement mechanisms that can be used to operationalize regulatory integration for the purposes of qualitative comparison. When the EU agrees on a fully harmonized common standard, then it is most likely to be formulated as a regulation. A regulation is a type of formal decision that is legally binding both in terms of substance and manner of implementation and becomes applicable without any additional decision-making process on the national level. In contrast, a directive is binding only in substance, but the manner of implementation is left to the member state parliament to decide. Directives are used to formulate common rules that preserve some flexibility for the member states to adapt them to their local circumstances. These adaptations are decided by national parliaments during the 'transposition' of the directive into national law. In practice, directives are the most important instrument of regulatory harmonization. When the diversity of preferences and circumstances in member states is too high, they may opt to pass framework directive, which is less specific regarding binding common standards. When at least nine member states agree on common rules that some other member states categorically refuse to join, they may adopt a Directive or Regulation, which is applicable only for signatory states (so-called enhanced cooperation). Formal EU rules may also be defined in various non-binding documents generally referred to as a soft law. These may range from voluntary, non-binding declarations accepted by all member states on an ad hoc basis, to more specific commitments under the open method of cooperation. The latter are more developed and include joint specification of implementation and monitoring procedures embedded in various guidelines, benchmarking indicators, and best practices. The non-binding nature of these rules means that there are no sanctions for failing to meet these commitments, although some pressure on implementation is generated by informal methods such as peer pressure and naming and shaming.

The enforcement characteristics of EU financial regulations can also be mapped on a qualitative scale with two clear extremes and various 'in between' mechanisms. These come on the top of the generic EU enforcement procedure, which relies on monitoring by Commission and infringement rulings of the European Court of Justice (see Chapter 1). The enforcement powers on the EU level may be delegated either to domain-specific committees (for instance, European Banking Authority covers the domain of banking regulation) or even rule-specific committees (such as various advisory or management committees set up solely for the implementation of a single directive). The types of 'committees' may range from fully supranational ones, such as the Commission in the competition policy and European Central Bank in the domain of monetary policy of Euro zone, to purely intergovernmental committees that do not even include representatives from the Commission. The in-between category encompasses various policy networks that combine national and EU stakeholders, formally established advisory and expert committees, various committees established under the EU comitology (see Pollack 2003a, Blohm-Hansen 2011) or fully formalized EU agencies operating on the basis of formal mandates and with EU financial support (Groenleer, Kaeding and Versluis 2010). This range presents the menu of governance options that can be used to support execution and enforcement of EU financial market regulation.

The delegation of regulatory powers to committees guarantees a formal change of the applicable enforcement mechanism. By definition, it is a movement towards more integrated enforcement. Given the existing pecking order, we should expect a higher degree of regulatory integration to follow. However, as the review of the institutionalist theories in previous section has indicated, formal delegation may or may not have desired effect on regulatory integration. Hence, a mapping of the formal aspects of regulatory integration on the above scale is only the first step in the analysis of the effects of delegation. Knowing whether the rules are stipulated in a directive or regulation is not sufficient for an assessment if there was any institutional change that affected the behavior of market participants in the desired direction. Such a question requires more focused qualitative enquiry.

2.2 Regulatory integration of the most contested aspects

The evidence of institutional change comes from changes of actor behavior, not just from changes in formal rules and enforcement mechanisms. If the delegation enhances regulatory integration, then the committees need to change the rules and their enforcement characteristics in such a way that the relevant actors — financial firms or national authorities — start to behave differently. In this sense, regulatory integration increases only when the adopted rules are enforced consistently, so that financial market entities shift from nationally specific strategies to the EU-wide strategies.

A great majority of legal provisions in each EU directive are consensual. They follow from the functional logic of financial markets and there is little reason for any actor to contest the obvious. Analyzing this bulk of the EU rules is thus unlikely to produce new insights about effects of delegation on regulatory integration. However, the key directives often contain a few articles or paragraphs that evade consensus for months and years and occasionally trigger open political contest among various advocacy coalitions. This thesis refers to these provisions as 'the most contested aspects of EU financial market regulation' and, accordingly, narrows the empirical definition of the dependent variable from the regulatory integration in general, to the regulatory integration of the most contested aspects.

Narrowing the focus to the most contested aspects requires increasing analytical depth — truly micro-institutional analysis. It requires a shift from a simple comparison of formal characteristics of the applicable legal instrument and enforcement mechanism before and after delegation, to a detailed analysis of the specific legal provisions stipulating the most contested rules. It also requires attention be given to the way the committees contribute (or not) to the enforcement of these rules. It is only at this level of detail that the four hypotheses can be tested. It is not sufficient to assume that if a contested provision was formulated as a paragraph in a Regulation (rather than Directive) and is overseen by a regulatory committee (rather than a mere advisory committee), a higher degree of regulatory integration is guaranteed. Instead, an empirical evaluation of the hypotheses requires detailed assessment of the specific content of the most contested provisions in the light of the competing policy proposals as well as their implementation record to date. Only then can the causal effects of delegation on regulatory integration be established.

In short, discriminating among the three explanatory hypotheses requires a micro-institutional perspective. Each of the three hypotheses implies a distinct pattern of policy compromise and implementation characteristics that can be evaluated and compared empirically. The Drifting Hypothesis presumes that legal rules remain the same, but changing financial market circumstances result in their reinterpretation during the implementation phase. The Deliberation Hypothesis expects progress towards common standards that avoid excessive accommodation of conflicting national preferences and that are relatively easy to enforce due to their consensual nature. The Bargaining Hypothesis then contends that progress in regulatory integration would be achieved through increasingly complex policy compromises, whose adoption and consistent enforcement is facilitated by a reduction in the transaction costs of policy-making. By mapping the observed policy outcomes stemming from greater involvement of EU level committees on these three hypothetical outcomes, we can judge which mechanism can explain the progress in regulatory integration of the most contested aspects of financial regulation.

To summarize, the dependent variable of this thesis is the regulatory integration of the most contested aspects of EU financial regulations. Regulatory integration is understood as the institutional variable encompassing the two dimensions: the formal rule itself, plus its enforcement characteristics. The evaluation of regulatory integration requires both analysis of the degree of harmonization and subsequent implementation experience, in order to establish if and how the delegation to committees affects regulatory integration of the most contested aspects. This can be done by longitudinal case studies that cover at least two rounds of the policy cycle, to allow for the comparison of regulatory integration of contested issues before and after the delegation of regulatory powers to the technocratic committees. This approach is outlined in the next section.

3. Research design: longitudinal case studies

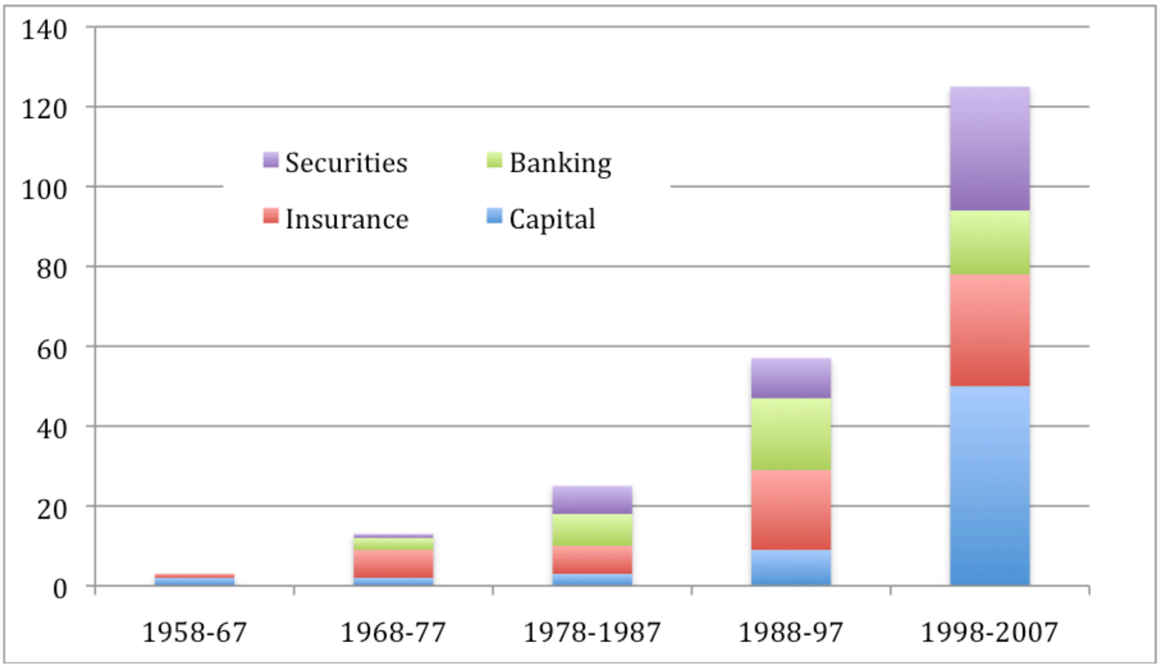
This thesis addresses two research questions. The exploratory research question asks how the EU adopts and implements contested financial market regulations. The answer is provided in Chapter 1, which reviews the evolution of the EU approach to harmonization of regulations underpinning the single market. In the context of the financial markets, the current answer is the delegation of regulatory powers to expert committees. This finding invites the analytical research question of how the delegation affects regulatory integration of the most politically contested aspects of financial regulations. Since regulatory integration is essentially an institutional change, the thesis reviews the three main strands of the institutional theories applied to EU studies and formulates three alternative hypotheses about causal effect of delegation on integration. Furthermore, the thesis argues that it is possible to discriminate among the three explanations on the basis of the characteristics of the policy proposals produced by the committees.

The testing of the three hypotheses requires longitudinal case studies that trace the patterns of coevolution of regulatory integration and delegation in order to establish any causal relationship between the two. The case also need to control for other explanations of regulatory integration, such as technological changes that make the contested issues obsolete or exogenous shock that dramatically changes the perceived preferences and interests and thus facilitates exogenously driven institutional change. More specifically, each longitudinal case study needs to establish the following: first, it needs to define the specific content of the dependent variable by identifying the most contested aspect of the given set of EU financial market rules. Second, the case studies need to evaluate implementation experience over time in order to find out if there was any change in the degree of regulatory integration that could be associated with the delegation of powers to committees. Third, the case studies need to review the applicable governance procedure, because the delegation is not necessarily uniform across the different sets of EU regulations. The fourth step of the analysis is to probe into the question of whether the change in regulatory integration can be associated with the work of the committees, i.e. whether such a change was possible even without delegation of powers. The final step of the analysis is the evaluation of the findings vis-à-vis the three hypotheses.

The research question requires a selection of several cases with sufficient history to observe potential effects of delegation. So far the EU has adopted over 900 binding legislative acts in the domain of the financial regulation, composed of four sub-domains: freedom of capital movement, banking, insurance, and securities (Chart 0.1). However, not all of these legal acts are equally relevant. The great majority of them are minor amendments of existing rules or deal with auxiliary issues that do not elicit any political contestation. There are a few fundamental directives that were essential for the financial as well as regulatory integration of the EU.[7] These directives cover the most important regulatory issues that put the domestic financial industry under harmonization pressure, and thus are politically contested. It is these fundamental directives that that represent the relevant pool of cases for the study of the capacity of EU governance mechanism to deliver regulatory integration.

[7] See Commission (1989b) for the list of the 30 most important financial sector directives. The current list is on the DG's Internal Market website http://europa.eu/legislation_summaries/internal_market/single_market_services/index_en.htm.

Chart 0.1: Adoption of the EU financial market regulation



Source: EUR-Lex database

The optimal case selection would cover the most important directive from each of the three segments of financial markets — banking, insurance, and securities. However, a crucial condition for the case selection is that there are at least two generations of the given set of rules; one that was adopted and implemented before the delegation of power to regulatory committees and one that was done after the delegation. This condition makes for an easy choice in the securities segment, where by far the most important and contested set of rules was specified by the 1993 Investment Services Directive (ISD), whose second generation — Market in Financial Instruments Directive (MiFID) — was adopted in 2004 and implemented by 2007.

Somewhat less straightforward, is the choice of the case for the banking segment. As in the case of securities markets, the most important EU level banking rules are stipulated in the single piece of secondary legislation — the 2006 Capital Requirements Directive

(CRD). However, the first generation of the single market banking directives was more fragmented and consisted of five directives, out of which the 1989 Own Fund Directive and 1989 Solvency Directives were most contested. They covered the most novel aspects of banking regulation negotiated both on the global and European level at the time. The original policy issues covered in the Solvency directive received a lot of research attention recently as they constituted the core of the so called Basel II reform implemented between 2004 and 2008 (see Tarullo 2008 for comprehensive review). The definition of bank capital dealt with in the original Own Funds Directive received less research attention, hence we focus on this case.

In the insurance segment of the financial markets, there is as of yet, no second generation of the key directive. The massive Solvency II directive, which will constitute the single most comprehensive EU financial market directive ever, is only entering the final stages of the decision making process in 2010 and thus cannot be considered for this thesis.

The regulation of investment services and bank capital constitute the traditional topics in the EU regulatory debates. However, as the financial markets integrate across the internal borders, they present EU policy-making with new challenges, unforeseen by the traditional regulatory approaches derived from national experience. One of these issues is the cross-border resolution of systemically important banks. Cross-border bank resolution has emerged as an increasingly prominent policy issue at the turn of the millennia in response to monetary integration and a wave of cross-border banking mergers. It also proved to be an important aspect in the management of the banking crisis in late 2008, and subsequently during the protracted financial stability problems of Eurozone and its banks. The novelty and policy-relevance of cross-border bank resolution makes it an interesting control case for other more traditional regulatory debates. The Council put cross-border bank resolution on its agenda in 1999. However, it proved so controversial that the Council refused to consider any binding EU level legislation and endorsed a series of non-binding memoranda of understanding instead. Part of this policy was delegation of some of the most controversial aspects to technocratic committees that were created for this purpose. This only makes this case more interesting, because it extends the analysis beyond the delegation to Lamfalussy committees to even more micro-level structures.

All three cases meet the condition of at least a decade of policy-making history on the EU level, during which there was some delegation of regulatory powers to technocratic committees. The debates on the definition of bank capital started in the late 1980s and were reflected in the two generations of directives adopted in 1989 and 2006. The regulatory integration of investment services became an EU level policy issue in the wake of the single market project and there are two generations of the key directives that were adopted in 1993 and 2004. The cross-border resolution surfaced to the EU policy agenda only in 1999, but by 2008 it was already in the third generation of the soft law agreements harmonizing the elementary rules of crisis management and resolution of cross-border banks. Hence, each of the cases has policy history suitable for the longitudinal analysis of the research questions.

The empirical evidence on the three case studies is gathered primarily through process tracing. The study relies on qualitative evidence and some indirect quantitative indicators of institutional change. The main sources of evidence are the EU documents analyzing the legislative status quo and alternative proposals, industry documents about the relevant regulatory issues, and debates about these issues in the financial media. Scholarly research in economics, law, and political science that deals with the relevant financial market directives is also utilized. The evidence from process tracing is complemented by a dozen semi-structured interviews with experts participating in EU the policy making process, who were in the position to compare the workings of the EU committees before and after delegation (see appended List of interviews).

The process of analyzing the documents and interviews is structured by a simple game-theoretic framework, where it helps to highlight the policy dilemmas faced by member state governments or national authorities. This is a particularly fruitful approach in the chapters 3 and 4, where the strategic constellations resemble a non-cooperative game with two actors making a simultaneous decision.[8] In short, the chapters are structured as analytic narratives that benefit from interaction between the rigid and parsimonious model of the decision situations and the fluid historical narrative (see Scharpf 1997, Bates et al. 1998).

[8] In chapter 2, the process of negotiation disentangles into a sequential game, which can still be used to describe the process, but it is less analytically useful then in non-cooperative settings.

4. Outline of the thesis

This introductory chapter established the puzzle discussed in this thesis. It noted that regulatory integration of the single market in financial services is a difficult task that the EU attempts to approach through delegation of regulatory powers to expert committees. It is a problem of institutional change and hence the institutional theories should provide a theoretical explanation for potential causal effects of delegation. It reviewed the three strands of institutionalist literature that dominate the study of European integration and formulated three hypotheses about causal mechanisms that may justify the expectation of the positive effect of delegation on regulatory integration. The chapter argued that these hypotheses can be tested empirically by analyzing the characteristics of the policy outcomes produced by the expert committees. Specifically,it operationalized regulatory integration by focusing on the characteristics of policy compromises on the most contested aspects of any given set of financial regulation, which can be evaluated against predictions of the Null Hypothesis as well as the three explanatory hypotheses. The remainder of this introduction outlines the content of the following chapters of this thesis.

Chapter 1 positions the question of regulatory integration in the literature on the political economy of the EU, financial market regulation, and EU policy making. It argues that progress in regulatory integration achieved through delegation is puzzling, because the applied literature would predict a protracted stalemate. The political economy research points out that although regulatory integration in EU financial markets is desirable, it is undermined by the 'battle of the systems' stemming from structural and historical differences among the financial sectors of member states that divide their policy preferences. These conflicts are only exasperated by general characteristics of the EU policy-making process, which requires a high degree of consensus both for the adoption of harmonized rules and their consistent implementation. The second part of Chapter 1 then reviews the evolving answer to the question of how the EU adopts and implements contested financial regulations, given the existing political economy and policy-making constraints. It demonstrates that the current EU strategy is to achieve harmonization through delegation of regulatory powers to committees, which invites the theoretical questions discussed in this introduction.

Chapters 2 to 4 present three longitudinal case studies that provide the empirical evidence for the evaluation of the relative explanatory power of the three hypothesized mechanisms of institutional change. Empirical chapters follow the uniform structure dictated by the research design. First, they identify the most contested aspects of the given set of EU financial market rules (see Table 0.5). Specifically, the three chapters demonstrate that the most contested issues are persistent over time although they tend to get more specific. In the case of bank capital, the most contested issue shifted from the general problem of eligible capital items to a more specific issue of eligibility of hybrid capital instruments. Similarly, the issues that were contested during the ISD adoption, were contested during MiFID negotiation, although their technical specifications were somewhat different. Finally, all successive Memoranda of Understanding stipulating the crisis management and resolution rules for cross-border banks grappled most with the information and burden sharing rules, although they were increasingly comprehensive.

Table 0.5: Politically contested dimensions of the selected cases

Policy domain	Case	Most contested aspects
Investment services	ISD (1993)	Conduct of business rules and parameters of regulated markets
	MiFID (2004)	Best execution and pre- and post-transparency rules (same as above in more specific terms)
Bank capital	Own funds (1989)	Financial instruments eligible as bank capital
	CRD amendment (2009)	Hybrid capital instruments
Bank resolution	MoUs (2003/05)	Coordination responsibilities and fiscal burden sharing
	MoU (2008)	Coordination responsibilities and fiscal burden sharing

Note: ISD = Investment Services Directive, MiFID = Market in Financial Instruments directive, Own Funds = Own Funds Directive, CRD = Capital Requirements Directive, MoU = Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European union in crisis management situations.

The second section of empirical chapters evaluates the degree of regulatory integration of the most contested aspects over time, in order to find out if there was any improvement. The empirical evidence suggests that when agreement on common standards is difficult, member states tend to resort to fuzzy, incomplete rules that merely shift the policy conflicts from the adoption to implementation phase. Nonetheless, some reduction of regulatory fragmentation on at least one of the most contested aspects can be identified in each case (see Table 0.6).

Table 0.6: Regulatory integration of the most contested aspects

Policy domain	Case	Implementation of the contested aspects
Investment services	ISD (1993) vs. MiFID (2004)	The MiFID rules on conduct of business and market transparency were implemented more consistently than the respective provisions of ISD
Bank capital	Own funds (1989) vs. CRD amendment (2009)	Consistent rules on eligibility of hybrid capital instruments were introduced and implementation is monitored by the EBA
Bank resolution	MoUs (2003/05) vs. MoU (2008)	The first Voluntary Specific Cooperation Agreement introduced explicit information and burden sharing rules

Thirdly, the case studies review the applicable governance procedure, because the delegation was not always uniform across the different sets of EU regulations. Much of the literature on the governance of the EU financial markets argues that banking, insurance, and securities markets are governed uniformly following the blueprint of the Lamfalussy process (see Quaglia 2010b, 2008, Davies and Green 2008, for example), but the micro-institutional analysis reveals additional levels of governance committees (see especially, Chapter 4). Over the last decade, the financial market domain became a venue of some of the most innovative governance reforms within the EU. It produced not only a brand new comitology procedure — regulatory committee with scrutiny — but also European Supervisory Authorities, supervisory colleges or cross-border stability groups that may become models for other policy domains. The regulatory powers may be delegated to committees operating on different levels (see Table 0.7). They can be delegated to the traditional comitology committees such as European Banking Authorities equipped with the right to pass binding regulation by qualified majority, or they can be delegated to European Supervisory Authorities that can issue binding guidelines unanimously, or they can be delegated further down the governance chain to colleges of supervisors or stability groups that can adopt non-binding agreements unanimously. In short, where there used to be a single regulatory committee that oversaw the Commission's execution of the EU policy, there are now several levels of committees equipped with different mandates and capacities. The committee arrangements supporting any given set of EU financial regulations can be combined and recombined in an increasingly complex manner, and the legislators' choice of the governance arrangement is likely to impact both the process of adoption and implementation and thus the regulatory integration.

Table 0.7: Committee governance in the three cases

Policy domain	Case	Implementation of the contested aspects
Investment services	ISD (1993)	High Level Securities Supervisors Committee
	MiFID (2004)	European Securities Committee Committee of European Securities Regulators
Bank capital	Own funds (1989)	Banking advisory committee Groupe de contact
	CRD amendment (2009)	European Banking Committee Committee of European Banking Supervisors
Bank resolution	MoUs (2003/05)	Colleges of supervisors for individual banks Committee of European Banking Supervisors
	MoU (2008)	Cross-border stability groups for individual banks European Banking Authority

The fourth step of the analysis is to probe into the question whether the change in regulatory integration can be associated with the change in committee governance. This section evaluates the Null Hypothesis that predicts no effect of delegation on regulatory integration. Only where there is evidence that delegation to committees enhanced regulatory integration by moving it beyond the pre-delegation status quo, can we ask the question about which of the three hypothesized causal mechanisms delivered that effect. The comparison is entirely relative to the historical precedent, not any external benchmark, which is consistent with the focus here on endogenous institutional change taking place at the margin. In all three cases there was some improvement in regulatory integration of the most contested aspects following the delegation of more powers to committees (see Table 0.8). This evidence is most conclusive in the case of investment services, where delegation led to the adoption and consistent implementation of prescriptive MiFID rules. In both banking cases the implementation record points in the expected direction, but to date, it remains too short for similarly firm conclusions as in investment services.

Table 0.8: Effect of delegation to committees on regulatory integration

Policy domain	Case	Implementation of the contested aspects
Investment services	ISD (1993) vs. MiFID (2004)	Reformed committees were instrumental in the adoption of highly complex compromises that reconciled policy conflicts by technical measures
Bank capital	Own funds (1989) vs. CRD amendment (2009)	Reformed committees enhanced the commitment to regulatory integration by the preset date; their transparency, accountability and monitoring capacity was instrumental in delivering the harmonization amendment on time
Bank resolution	MoUs (2003/05) vs. MoU (2008)	Cross-border stability groups delivered the most developed cooperation agreements, but political safeguards imposed on the European Banking Authority still undermine their credibility

The concluding chapter contains the final step of the analysis — the evaluation of the case study evidence against the three institutionalist hypotheses. The thesis concludes that the predictions of the Bargaining Hypothesis are most consistent with the observed characteristics of the policy compromises that advanced regulatory integration. The characteristic feature of policy packages is that they are more harmonized, but also more complex in order to accommodate preference asymmetries of the disagreeing advocacy coalitions of member states. The delegation of regulatory powers reduces the transaction costs of policy making, because technocrats interacting on the EU level develop a better understanding of the policy disputes and generate more comparative information. This reduces both information and cognitive limitations that are the key sources of transaction costs. At the same time, it enables them to orchestrate more complex package deals than are possible on the legislative level.

The conclusion points out that the delegation has independent effects on the legislative process itself. The delegation was predicated on prior enhancement of the accountability of respective technocratic committees, which makes legislators more prepared to delegate as they remain in control and can prevent technocratic excesses. Moreover, the formal mandates for the committees tend to increase their capacity not only to draft viable policy compromises, but also to monitor their consistent implementation. Furthermore, separation of the political decisions on directives from the formulation of technical measures reduces the political stakes involved in the legislative process. Contested aspects can be delegated to committees that adapt them quickly when they generate unexpected or unintended consequences. The possibility to change rules without reopening the whole package makes member states and other stakeholders more receptive to policy experimentation that might not be accepted if all rules were stipulated in the directives. The increased reliance on the new policy flexibility is evidenced by an increase in the number of dated review clauses in the EU financial market legislation, which are likely to lead to a gradual harmonization through smaller but more frequent adaptations of the EU rules. Finally, the delegation option and review clauses became bargaining chips of their own and can be instrumental in tipping the pivot voters in the Council or European Parliament.

The conclusion that governance changes may affect policy outcomes puts this thesis into the large 'governance matters' camp in EU policy-making literature, but it extends the existing debate by providing the answer to the question how it matters. It shows that if the delegation reduces the transaction costs of policy-making, then the committees may propose and monitor more complex package deals than those possible on the legislative level. This argument extends the application of the transaction cost theory to the analysis of EU policy-making, by showing that it not only can explain what tasks are delegated to EU bodies (Pollack 2003b), but also how the delegation affects the policy-relevant outcomes such as regulatory integration. At the same time, the thesis also contributes to the ongoing debates on political economy of EU financial regulation, by confirming that the 'battle of the systems' remains an apt characterization. It also contributes to EU policy making research by suggesting that changes in committee governance may reduce the likelihood of policy stalemates despite the divided preferences, supermajoritarian decision-making, and national control over implementation. The conclusion also summarizes some interesting empirical findings from the individual case studies, and suggests pathways for future research that can utilize case study findings for a more systematic testing of hypotheses. Conversely, it also points out the constraints on the ability to generalize the conclusions of the thesis, stemming from its reliance on case study research.

Chapter 1:

Regulatory integration and the EU policy process

This chapter briefly reviews the literature on the policy making in the European Union that motivates the institutionalist puzzle about the effect of delegation on regulatory integration (see Introductory chapter). The chapter provides the general overview of the EU policy making relevant for the financial market regulation and outlines the specific context for the micro-institutional analysis contained in empirical chapters (Chapters 2 to 4). The review makes two claims. First, it points out that progress of regulatory integration of politically contested aspects of financial regulation is puzzling, because much that we know about the EU policy making in financial market regulation would predict protracted stalemate on these issues. Second, it shows that the EU approach to regulatory integration has evolved over time and the increased delegation of regulatory powers to expert committees is the most recent EU strategy phased in over the last decade.

The institutionalist theories reviewed in the previous chapter provide varying explanations of how the delegation of regulatory powers may affect regulatory integration. The competing hypotheses emphasize three plausible causal mechanisms of institutional change that are relevant not only for the theoretical debates in EU studies, but also for the practical policy making. The three hypotheses generate different expectations with regard to the optimal distribution of the policy-making agenda across the different levels of the EU system. If the committees successfully adapt existing regulations by their reinterpretation as assumed by Drifting Hypothesis, then the EU could shift towards the more principle-based regulation and let the committees to ensure harmonized interpretation and implementation. This would ease the decision-making burdens on the legislative level. Similarly, if the committee deliberation leads to consensual common standards that are acceptable to all stakeholders, then they should be allowed to set the agenda even on the legislative level as such proposals would most likely pass through Council and EP. However, if committees enhance integration through more complex bargaining, then they are unlikely to play the agenda setting role on the legislative level and should remain limited to the technical role. This chapter shows that these questions are not new. The EU was forced to innovate its approach to harmonization ever since the Treaty of Rome came to force, and the delegation strategy represents the latest approach.

The EU policy making literature is largely descriptive, but it generates some expectations about the process of adoption and implementation of EU financial market legislation. It suggests that albeit the regulatory integration is generally perceived as necessary for the success of the single market, it is also unlikely as long as the key member states hold conflicting policy preferences. This prediction stems from the combination of the four related debates about the policy making in the field of financial market regulation. The first debate focuses on the desirability of regulatory integration. The second one studies the political economy of financial market regulation and suggests that the 'battle of the systems' hinders progress of regulatory integration. The third debate probes the EU decision-making processes and suggests that divided policy preferences in combination with supermajoritarian decision requirements are likely to result in policy stalemates. Finally the forth related debate is about implementation of politically contested EU legislation that tends to be poor due to its fuzziness or misfit. Combining these four debates creates a puzzling paradox: the policy literature insists that regulatory integration is necessary, while the policy-making literature predicts that it is unlikely, given the typical constellation of policy preferences, decision-making rules and implementation procedures.

This chapter is structured as follows. The next two sections briefly outline the key arguments used to justify the need for regulatory integration on the one hand, and some reasons why member states often disagree on the design of EU rules on the other. The third and fourth sections summarize the decision-making hurdles imposed by the EU legislative process and the expected difficulties of consistent implementation of contested regulations, respectively. Finally, the fifth section reviews the evolution of the EU approach to harmonization of technical standards that culminated into the Lamfalussy reform that delegated more powers to EU committees. The purpose of this chapter is not to provide exhaustive overview of the literature, but a concise summary of debates that jointly motivate and justify the research question about the effects of delegation on regulatory integration. The concluding section outlines the expected contributions of the thesis to the EU policy-making literature.

1. The necessity of regulatory integration

The need for regulatory integration stems from the EU's single market agenda. The basic objective was set by the Treaty of Rome that established the goal of creating a customs union and subsequently of establishing a common market based on the four freedoms. The free movement for goods, services, capital and labor embedded within a single set of EU rules on competition required some degree of regulatory harmonization. This was recognized in the Treaty by articles that prohibited quantitative restrictions on imports and all measures that have equivalent effect. The Treaty also laid out the procedure for the approximation of laws that directly affect the common market (Young 2005:94). As the EU progressed beyond the customs union, the technical barriers to trade became the chief obstacle for development of common market in services. Hence, the attention shifted from removing restrictions on trade to regulatory integration.

Financial markets are regulation intensive sector and the differences in national regulations can impede free movement of capital and services. These differences can easily reinforce barriers to trade within common markets in financial services, even when the traditional restrictions on capital mobility are removed. Hence, the first justification for regulatory integration stems from the effects of regulatory fragmentation on the free movement of services and competition in EU-wide financial markets. The differences financial regulations may certainly generate effects equivalent to restrictions on trade and are thus prime candidates for the approximation of laws envisaged by the Treaty.

The policy significance of regulatory integration in financial markets is increased by the externalities generated by financial integration. Financial market integration creates considerable benefits for participating economies, but also imposes potentially high costs. These costs and benefits can be conceptualized in terms of externalities. For example, one of the benefits of the market integration is better pooling of liquidity and risks across large markets and greater variety of market participants. This reduces the cost of borrowing for all borrowers within the integrated market, regardless of their direct involvement in the financial integration. However, market integration also creates negative externalities. This is much more pronounced in the markets for financial services than in the markets for tangible goods and services. Thus financial markets require much more complex regulation to ensure financial stability and prevent contagion between healthy and ailing financial institutions.

At the onset of the financial market integration in the EU, the externalities — especially the negative ones — were internalized on the national level. The national regulation, supervision and resolution regimes were designed to keep the national financial firms stable and, in case the failure was imminent, to resolve the crisis. This has changed with the integration of financial markets across the border, when the national regulatory frameworks are no longer capable internalizing externalities created by cross-border finance. The positive externalities are internalized more easily by the private actors, who benefit from them. However, the negative externalities need to be internalized on the cross-border level, by a set of EU level regulations.

The regulatory integration is playing a catch up game with the market integration, as the traditional EU strategy is to put market first and to integrate the regulatory framework only in response (Stone Sweet and Sandholz 1998). The political economy virtue of this strategy is that actors benefiting from market integration create a constituency supporting regulatory integration. However, it also creates a regulatory gap, when the newly integrated markets are vulnerable, because the regulatory tools to prevent and manage new risks and crises are simply missing or underdeveloped. Closing the gap is a challenge for the EU policy-making process, especially if member states hold differing views about the most appropriate regulatory policy.

Closing this gap requires introduction of seamlessly integrated regulatory framework that could internalize the externalities of market integration at least to a comparable degree as was the case with national regulatory frameworks. At the time, financial markets were national with limited cross-border involvement, thus national actors - financial regulators, ministries of finance and central banks - were responsible for policies ensuring financial stability and managing crises. As EU financial markets started to integrate and progress towards the single market in financial services, the cross-border externalities became increasingly important. Till late 1980s, the EU regulatory reforms were biased towards negative integration, dismantling the barriers to capital mobility and the freedom of establishment of banks, insurance companies and investment firms (Scharpf 1996, Kudrna 2009). This was somewhat easier to agree on, then positive integration that requires EU members to agree on common regulatory definitions and tools, which inevitably clashes with the diversity of the national regulatory approaches to financial sectors, which evolved over previous decades, if not centuries (see Table 1.1).

The EU rules substantively constrain the policy space of the member states, who can no longer adopt national regulations that would internalize or prevent cross-border spillovers. The standard operating procedure where the EU finds it difficult or impossible to act jointly is to invoke subsidiarity and allow member states to introduce necessary regulations that could close the regulatory gap. However, in the case of financial regulations the very success of European economic and monetary integration constrains national action. Many of the policy instruments that were used in the past to prevent cross-border spillovers are either outright illegal or at least contestable on the grounds of the single market or competition law. The member states cannot regulate financial flows within the EU or prevent a financial firm from opening a local branch. In short, nationally specific regulation of financial services is no longer possible. Member states cannot avoid or suppress the cross-border scope of financial markets, therefore the only way to close the regulatory gap between transnational financial entities and national regulation is developing an integrated regulatory framework on European level. The EU is doomed either to the preservation of the status quo, when cross-border externalities of finance are not fully addressed, or adopting and implementing joint regulatory regime.

Regulatory integration is a necessary prerequisite for single market in financial services. This view can be traced throughout the most important EU policy documents since the onset of the debate on single market. "Unifying this market presupposes that member states will agree on the abolition of barriers of all kinds, harmonization of rules approximation of legislation and tax structures, strengthening of monetary cooperation and the necessary flanking measures to encourage European firms to work together" was the opening sentence of the 1985 paper on completing the internal market that launched the 1992 project (Commission 1985:4). Similarly the Commission paper outlining specific proposals for the single market financial directives defined the aim of the program as: "to break down national regulatory barriers which obstruct freedom of establishment and free trade in services which could be left untouched even after exchange controls are fully removed. Common rules for the supervision of financial operators are being drawn up to ensure that capital does not flow to centres where monitoring arrangements are more superficial, finally, broadly equivalent standards for investor protection are being drawn up" (Commission 1989b:3). This demonstrates that the EU was explicitly committed to the regulatory integration from the early days of the single market drive.

A decade after the initial single market legislation was implemented, there was a series of evaluation reports that concluded that despite progress some important aspects of the EU regulatory framework remained fragmented or became outdated (Commission 2002a:35, 1999). The Vienna European Council in December 1998, asked the Commission to prepare the action plan that would address remaining fragmentation of markets and their underpinning regulation. The result was the Financial Services Action Plan, arguing that "Union's financial markets remain segmented and business and consumers continue to be deprived of direct access to cross-border financial institutions … action to secure the full benefits of the single currency and an optimally functioning European financial market [requires inter alia] … closer co-ordination of supervisory authorities" (Commission 1999:3). Similarly, the last Commission paper on policy priorities before the financial crisis highlighted the progress in wholesale markets, but also pointed out that "retail internal market is a long way from completion. A better functioning risk capital market is needed to promote new and innovative firms and to raise economic growth. So, consolidating progress; completing unfinished business; enhancing supervisory cooperation and convergence; and removing the remaining economically significant barriers are the key axes of Commission policy for the next 5 years" (Commission 2005b:4). Hence, the regulatory integration remains an important policy objective to this day.

Regulatory integration obviously transpires from the most important policy documents to any of the hundreds of the lower level policy documents that address specific issues (see Chapters 2 to 4 for plentiful examples). At the same time, there is observable progress in regulatory integration over the last three decades, as the problems that cause continued fragmentation are increasingly specific. Moreover, there was also a shift in the focus from the adoption of the common EU rules to their consistent implementation (Commission 2005b). Nonetheless, despite these improvements amply documented in empirical chapters, regulatory integration remains an ongoing policy challenge.

2. The difficulty of regulatory integration: battle of the systems

The political economy of the regulatory integration of the EU financial market received some attention in the scholarly literature after the single market project was completed in early 1990s. Before that the attention was paid to the generic process of internationalization of financial sectors of individual EU countries - primarily the UK, Germany and France — as there was hardly any EU-level integration to analyze (Kapstein 1994). Until 1985 the policy debates in the EU concentrated on mutual opening of financial markets; it was the White paper that put the idea of the single market in financial services on the policy agenda (Story and Walters 1997). However, scholarly analyses of its evolution quickly established that creating single market in finance would be more complicated than single market in goods (Grossman and Leblond 2011, Quaglia 2010a,b, Young 2005, Story and Waters 1997).

The study that set the research agenda on political economy of the EU financial services was Story and Walter (1997), who framed the analysis in terms of the 'battle of the systems'. They argued that different political economies responded differently to the internationalisation of the business of banking. Namely, that UK co-opted financial markets, and became the leading exponent of single market, German government sought to extend joint regulatory reach over the London mariners through the BIS and the EU, while the French sought to restrict the access of US and Japanese institutions based in London or Luxembourg to the EU's unified markets (Story and Walter 1997, chapter 10). Consequences of this rivalry were observable during the negotiations of single market directives for banking, insurance, investment services and capital mobility during the 1986 to 1993 period. These negotiations were characterized by the effort of the Franco-German alliance to reduce the pressure on internationalizing their financial sectors the 'Anglo-Saxon' way. This conflict was observable not only during the negotiations of the EU directives, but also during the negotiations of international banking standards under the auspices of the Bank for International Settlements in Basle and during the GATT negotiations on services.

The financial sector is a fundamental part of any national economy and many European economies used it to intervene and coordinate their economic policies. This was especially the case of the more 'coordinated market economies' such as Germany, France or Austria (Soskice and Hall 2001). Over time, different starting conditions and different approaches to financial markets evolved into distinct nationally specific structure of financial sectors. Hence, some EU economies rely more on bank financing, whilst other rely more on bond and equity market one (Allen and Gale 2000), some host major financial center and serve as headquarters for transnational financial corporations (see Moran 1991, Deeg and Lutz 2000), some retain a more domestically oriented financial sectors and some have entirely foreign dominated one. In some economies financial services have a large share of GDP, in others less so. In some countries securities markets are entirely dominated by large institutional investors, yet in some Southern Member States retail investors own as much as 25% of the stocks. In some financial sectors publicly owned financial institutions play important role, in others they are entirely absent. This variety is complicated further by different legal traditions, different taxation regimes and different public perceptions of the 'national champions' in the financial sector that all affect policy preferences of the Member States with regards to financial regulation (Story and Walter 1997, Lannoo and Levin 2004).

Table 1.1: Some structural difference in EU15 financial sectors in 2004

	Bank Assets / GDP	Home of EU top 20 bank	Stock Capitalization / GDP	Retail investors
Austria	124%	0	35%	11
Belgium	103%	1	150%	19
Germany	138%	1	43%	15
Denmark	171%	0	64%	21
Spain	145%	2	85%	24
Finland	74%	0	102%	na
France	108%	6	84%	6
UK	155%	5	134%	14
Greece	98%	0	60%	25
Ireland	145%	0	57%	18
Italy	102%	2	45%	26
Netherlands	174%	3	109%	11
Portugal	147%	0	39%	13
Sweden	115%	0	110%	18

Sources: Column 1 and 3 - Beck et al. (2008). Column 2 - The Banker Top 1000 (2006). Column 4 - FESE (2006).

In general, the research on the political economy of EU financial market regulation suggests that economies with less internationalized and less globally competitive financial sector tend to prefer only gradual removal of barrier to competition. When the single market negotiations were taking place, these countries preferred to provide their financial firms with time to adapt to increased European competition (Coleman and Underhill 1998, Underhill 1997, Story and Walters 1997, Story 1997). Moreover, the latter research also suggests that this tendency did not fade away in time as some of the structural differences are rather persistent.

In a recent review Grossman and Leblond (2011) argued that the battle of the systems in the Story and Walter (1997) tradition continues to be dominant explanation of the evolution of European financial markets. They have argued that because there is no convergence to the single model of capitalism, many of the contested aspects on the micro-level derive from the differences on the level of system. At the same time, the conflicts are getting more subtle and it no longer takes place in all financial services, but concentrates primarily to retail — not wholesale — markets. This view is also supported by other recent studies that generally find continued policy conflicts, but on ever more micro level of financial regulation (see Posner 2007, Quaglia 2010a, Mügge 2010).

Much of the political economy analysis of EU financial regulation is based on the comparison of the three dominant countries — the UK, Germany and France — that do have structurally different financial sectors and are likely to prefer different regulatory policies. However, the policy conflicts extend beyond these three countries. Quaglia (2008, 2010a) extends the battle of the systems argument to all EU members by relying on the policy advocacy coalition approach developed by Sabatier (1998). She demonstrates that on the most contested aspects, the smaller member states tend to align behind policy proposals of key state that is the closest to their perceived preferences on the given contested issue. This often leads to the formation of competing coalitions each of which supports a distinct policy position. These coalition patterns can be traced empirically during the negotiation phase and — in case that no unanimously supported compromise was found — also in the voting records of the Council. These suggest that the 'battle of the systems' is not limited to the largest three EU economies, but extends to all EU members.

The core of the advocacy coalitions tends to be formed by the large member states and the smaller states aligned with them. This dynamics often leads to a formation of two informal coalitions during the negotiations of the contested financial regulation. One tends to form around the policy proposals of France and Italy with some other 'Southern' or 'Continental' member states also gravitating towards supporting these proposals. The other coalition tends to be lead by the UK, which receives support in EU negotiations from the 'Northern' or 'Anglo-Saxon' countries (see Quaglia 2008, 2010a,b, Tison 1999, Kudrna 2011). These informal coalitions are rooted in the structural similarities of the economies forming them and assume that policy preferences are aggregated on the national level, which may not be the case in countries such as Germany, whose financial sector includes the globally competitive financial firms as well as protected public banks and financial cooperatives (Quaglia 2010b, Mügge 2010).

The 'battle of the systems' and resulting policy coalitions are no more than an empirical regularity that tends to reappear in the literature on the political economy of the EU financial regulation. This research notes that these coalitions are rather fluid and commitment of member governments is only informal and thus it is uncertain how cohesive they might be when it comes to voting in the Council and European Parliament that might force member states to reveal their policy preferences. At the same time, many policy conflicts can be mapped on some variations of the Anglo-Saxon vs. Continental coalitions, hence, the coalitional dynamics derived from the 'battle of the systems' remains a dominant view of the political economy of financial market regulation in the EU. It provides a useful starting point for the analysis, which needs to be evaluated against the empirical evidence of given case.

The 'battle of the systems' argument implies that as much as the regulatory integration is politically and economically desirable, it is also difficult to achieve. Policy preferences divided by the deep structural factors that change only gradually complicate the search for efficient, yet consensual EU level financial regulations. This search is not made easier by the structure of the EU decision making process that requires considerable degree of consensus for any proposal to become EU legislation.

3. The difficulty of regulatory integration: legislative politics

The EU policy-making literature is rooted in the traditional theories of European integration that debated the balance between the intergovernmental and supranational factors in explaining the path and speed of integration (Rosamond 2000, 2010). However, in recent decade there was a remarkable shift from the attention to the history-making decisions, to the day-to-day policy-making within the maturing political system of the European Union (see Wallace, Pollack and Young 2010, Cini and Perez-Solorzano Borragan 2010, Richardson 2001 for authoritative overviews). Subset of this literature focuses on the analysis of the formal EU legislative process and points out the high degree of consensus necessary for single market legislation to pass through the qualified majority in the Council. Hence, in the case of divided preferences (see section 2), this literature predicts some kind of policy stalemate, when disagreements prevent policy reforms generally deemed necessary (see section 1). These predictions are variously conceptualized as joint-decision trap (Scharpf 1988, 2006), policy stability of status quo (Tsebelis 1994, 2002), policy deadlock (Heritier 1997, 1999) or policy gridlock (Hix 2008).

The possibility of policy stalemates arises from the specific characteristics of the EU policy making process in the single market domain. Wallace (2010:92) labels this process a regulatory policy mode, which is one of the five typical modes to adopt and implement EU policies.[9] The regulatory mode frames the relationships among governments, economic actors and supranational bodies that shape the micro-level decisions and rules. Wallace (2010:95-96) lists the following characteristics typical for the regulatory mode. First, as in any other EU policy making mode, the Commission has the monopoly over the initiation of the legislative process, although it usually works with other stakeholders in preparation of its proposals.[10] Second, the Council serves as a primary forum for agreeing the minimal standards and the broad direction of harmonization. Third, the ECJ — backed by national courts — oversees the consistent implementation of rules and provides access to redress in case of non-implementation or discrimination. Fourth, the European Parliament has full codecision rights over the rules, but little influence over their implementation; it often raises the non-economic aspects of the regulatory issues and provides stakeholder with a venue for lobbying. Finally the fifth typical feature is important role for regulatory agencies both on European and national level.

[9] The other four are a Community method used primarily in the Common Agricultural Policy, Distributional mode relied upon in budgetary and cohesion policies, Policy coordination typical for employment or economic policies, and the Intensive transgovernmentalism characteristic to justice and home affairs policies (Wallace 2010:92).
[10] The European Council — comprising of heads of states — is rather effective in setting up the policy agenda in the financial market domain as the Commission responds to its conclusions (Lannoo and Levine 2004, Chapter 4).

The EU financial market regulations, as any other single market legislation, are adopted by the codecision procedure.[11] The codesision process starts with the Commission that holds the monopoly on the legislative initiative. The Commission submits a legislative proposal to the European Parliament and Council. If, at the first reading, the Parliament adopts the proposal and if the Council approves the Parliament's wording, then the act is adopted. If not, then the Council adopts its own position and passes it back to the EP with explanations. The Commission also informs Parliament of its position on the new Council version. At the second reading, the act is adopted, if Parliament approves the Council's text or fails to take a decision. The EP may reject the Council's text, leading to a failure of the law, or modify it, and pass it back to the Council. The Commission gives its opinion once more. Where the Commission has rejected amendments in its opinion, the Council must act unanimously rather than by qualified majority. If, within three months of receiving Parliament's new text the Council approves it, then it is adopted. If it does not, then the Conciliation Committee — chaired by the Commission and composed of the Council and an equal number of MEPs — is convened to draw up a joint text on the basis of the two positions. If within six weeks it fails to agree a common text, then the act has failed. If it succeeds and the committee approves the text, then the Council and Parliament (acting by majority) must approve the text. If either fails to do so, the act is not adopted.

The codecision procedure was introduced by the Maastricht Treaty and replaced the cooperation procedure in the EU decision-making on financial market regulation.

[11] The Lisbon Treaty renamed the codecision procedure to 'ordinary legislative procedure', but since this thesis focuses on pre-Lisbon legislative developments, we use the legacy terminology.

Compared to the latter, it had strengthened the role of European parliament that gained full veto right as its disagreement could no longer be overturned by the Council. When adopting a proposal to be submitted for codecision the Commission decides by the simple majority of Commissioners, although voting is rare as the Commission tends to the consensus. The Council decides by the applicable qualified majority (see Table 1.2), unless it is overturning Commission's disagreements with amendments which requires unanimity. The European Parliament decides by the simple majority of those present, or — it the legislative act is in second reading — by the absolute majority of MEPs. Since the 'battle of the systems' argument (section 2) suggested that the policy preferences tend to be aggregated on the national level, it is the Council decision-making rule that defines the required quorum in the absence of the unanimous consensus. Hence, the Council is the most likely venue for appearance of policy stalemates or deadlocks.

Table 1.2: Evolution of the qualified majority in the Council

Year	MS	Total votes	Qualified majority: votes	Qualified majority: percent	Min. MS forming the qualified majority	Min. MS forming the blocking minority
1958	6	17	12	70.59	3	2
1973	9	58	42	72.41	5	2
1981	10	63	45	71.43	5	2
1986	12	76	54	71.05	7	3
1995	15	87	62	71.26	8	3
2004	15	124	88	70.97	13	4
2004	25	321	232	72.27	12	4
2007	27	345	255	73.91	14	4

Source: Opinion of the Commission, 'Adapting the institutions to make a success of enlargement', COM (2000) 34 as quoted in (Tsebelis and Yataganas 2002:289). The information for 2004 and 2007 is from Bertelsmann Reform Spotlight 2004/01.

The decision-making procedures of the Council of Ministers have evolved over time (see Table 1.2), but they never lost their supermajoritarian character (Selck 2005).

Whether expressed in terms weighted votes, simple number of countries or proportion of population (see Tsebelis and Yataganas 2002:289), the qualified majority in the Council was always more demanding than the simple majority, which is the only rule that does not discriminate between "the defenders of the status quo and the promoters of policy reform" (Scharpf 2006:848). It is also higher than in most federal systems such as Germany (Benz 2010) or Switzerland (Armingeon 2000). All these comparisons suggest that when policy preferences are divided, dissent of mere four or five countries may be enough to block the legislation. This aspect of the Council decision-making and its empirical consequences did not escape analytical scrutiny.

The theoretical specification of the impact of the supermajoritarian decision making on the policy outcome was the model of joint-decision trap (Scharpf 1988, 2006, 2011). Scharpf argued that if (i) policy preferences are divided, (ii) the central government decisions are directly dependent upon the agreement of constituent governments, and (iii) the agreement of constituent governments must be nearly unanimous, then the most likely outcome is either non-decision or a sub-optimal policy based on the lowest common denominator. These conditions occurred within the federal system of Germany as well as within the emerging political system of European Union, where the Council decided by unanimity or highly demanding qualified majority. Scharpf linked the joint-decision trap to the "European malaise [that] may be systematically explained as the consequence of a characteristic pattern of policy choices under certain institutional conditions" (1988:242).

Another theoretical conceptualization of the impact of divided policy preferences and decision rules on policy outcomes is provided by the veto player theory (Tsebelis 2002). The theory was applied and tested extensively on the EU legislative politics with much attention paid to the relative power shifts among the Commission, Council and European Parliament (Tsebelis and Yataganas 2002, Tsebelis and Garrett 2001). However, on the basic level the veto player theory predicts that in situations when winsets of the status quo solution are already small due to divided policy preferences, adding a new veto player generally increases policy stability, i.e. makes policy reform less likely (Tsebelis 2002:25).[12] Moreover, the theory also suggest that the more demanding the majority necessary for reform, the higher is the policy stability of the status quo (Tsebelis 2002, Chapter 2). Hence, the logic of the veto player theory would lead to the conclusion that extending the codecision rights to the European Parliament and increasing the threshold of qualified majority in the Council would only increase the likelihood of policy stalemate beyond the level already suggested by the joint-decision trap.

There are also less rigorously specified, but more empirically grounded concepts striving to capture the impact of divided preferences and supermajoritarian decision rules on policy outcomes. Heritier (1997, 1999) discusses the general tendency of the EU policy-making system towards a deadlock over the contested measures of the EU environmental policy, where there is a divide among those EU countries that prefer stringent standards and those do not welcome them due to high costs of compliance. She points out that under the unanimous decision-making EU environmental legislation

[12] The winset is a set of policy outcomes that can replace the status quo and the size of the winset of the status quo determines the policy stability (Tsebelis 2002).

often ended in a deadlock and had to be withdrawn (Heritier 1997:176). Similarly, Hix (2008) defines the policy gridlock as one of the three most important problems of the EU.[13] However, he argues that the gridlock is not primarily rooted in the EU institutional design, which is by his account sufficiently majoritarian, but in the shift of the policy agenda from market building to economic and social reforms (Hix 2008).

The literature on the EU policy making not only outlines the risk of policy stalemate, but also suggests various ways to avoid it altogether or mitigate its impact. Sharpf (1988) acknowledged that the impact of the joint-decision trap on EU policy making can be mitigated by the traditional bargaining strategies such as package deals, side-payments or log rolling. Tsebelis (2002:21) notes that reduced transaction costs that allow veto players with similar preferences act as one, could make the reform more likely. Heritier (1999) develops the concept of subterfuge, whereby low level policy entrepreneurs in capitals and in the Commission anticipate the possibility of a deadlock and strive to avoid it by innovative use of EU rules and procedures. Hix (2008) outlines the recipe for curing gridlocks by extension of qualified majority voting and EP codecision powers into new policy domains and by changing the way Commission is elected.

The above accounts of EU policy-making generated considerable response specifying varied strategies that can be used to mitigate the risk of stalemate arising from combination of divided preferences and supermajoritarian decision rules (see Falkner 2011a for recent overview). Peters (1997) speaks of bureaucratic politics' capacity to

[13] The other two are declining popular legitimacy and lack of democratic accountability (Hix 2008).

segment the decisions along sectoral lines and ensure repeated nature of the legislative game to increase the likelihood of a consensus. Additional strategies were generated by the constructivist research on European Union that highlights possible solidaristic transformation of preferences created by a "process-level dynamics and informal norms, habits, and obligations that [persuades] through discourse and principled debate, the collective legitimation of standards" (Lewis 2003:120), which is likely to occur during the continued interaction among the staff of EU institutions and national authorities (Christiansen et al. 1999, Checkel 1999, Hayes-Renshaw and Wallace 1997, Lewis 2003). The actors working in committees ranging from COREPER down to the last technical body can agree on the substance of the policy, anticipate the constraints imposed by the national interests and also change these constraints by shifting the perceptions of the national policy preferences and framing the policy issues to make them acceptable in the capitals (Peters 1997).

The common denominator of the case studies analyzing the strategic responses of EU actors to the possible stalemate is the emphasis on the capacity of lower level bureaucratic actors to pre-empt it. This is the point, where this literature connects to the institutionalist debates on the role of the expert committees discussed in the Introductory chapter. There is a debate between the rigorous analysis of the EU policy-making and the case study-based literature. The former predicts protracted stalemates on contested issues, whereas the latter points out cases, when stalemates were avoided. However, the case study literature lacks a theoretical explanation of the role of expert committees in resolving or avoiding policy stalemates. Hence, the evaluation of the three institutionalist hypotheses can provide new insights in this debate, by suggesting the causal mechanisms that sometimes allow committees to enhance regulatory integration of contested issues despite divided policy preferences and supermajoritarian decision rules.

4. The difficulty of regulatory integration: consistent implementation

The implementation of the EU legislation is neither automatic nor purely technical process. Rather naturally, national and stakeholder policy preferences interfere as actors try to explore any loophole or fuzzy provisions to their advantage. This is particularly pronounced in the financial sector, where regulations are important sources of competitive (dis)advantages. Hence, the ultimate success or failure of EU financial market regulation is determined by the consistency of its implementation. Even the best of legislation that is not implemented cannot provide the regulatory underpinning for the competitive and stable financial market (Versluis et al. 2010:180).

The difficulties created by the combination of divided policy preferences and supermajoritarian decision-making are often sidestepped by resorting to fuzzy concepts and “rhetorical compromises” in order to facilitate agreement (Treib 2008:5, Lamfalussy 2000). By definition, fuzzy rules are difficult to interpret and implement consistently, therefore they increase the likelihood that the EU regulatory framework would remain fragmented. All that is achieved by such compromises, is the shift of policy conflicts from the adoption phase of the policy-making to the implementation phase. Member states' authorities transpose the fuzzy provisions into national law and enforce it on the 'street level' in the way most consistent with their own preferences, which may preserve the differences that undermine regulatory integration. This is enabled by the fact that the implementation of the EU directives is a responsibility of member states. It is the national parliament that decides on the exact transposition of the EU directives and assigns implementation responsibilities to domestic authorities. Moreover, the structure of the financial market authorities implementing EU rules differ considerably across the EU as there are different numbers of ministries and regulatory authorities in different member states (see Masciandaro, Nieto and Quintyn 2009, Lannoo and Levin 2004). The structural differences only complicate the EU level oversight of the implementation process and communication among national authorities across borders. However, whether the national implementation of a directive is consistent with its provisions is also overseen by the Commission and ultimately by the ECJ.

The Commission is responsible for ensuring that EU laws are properly implemented in all member states. This stems from its role — together with ECJ — of the guardian of the treaties. Member states are liable for failure to transpose the directive properly and on time, which in itself constitutes an infringement of EU law. If the Commission concludes that a member state has failed to transpose the directive, it launches the 'infringement procedure'. First, it sends a letter to the member state, giving reasons for its conclusion that the member state infringes EU law and sets a deadline for the member state to comply. If this does not settle the problem, the Commission or any other EU member state can submit the case to the ECJ. If the ECJ investigation concludes that the member state infringed the law, then the member state is obliged to amend its legislation to comply with the directive. Should the member state fail to do so, the ECJ can impose financial penalties payable until the member state complies with the ruling (see Hix 2005:119).

The transposed directive becomes part of the national law that is interpreted and enforced by national courts and other administrative agencies. The fundamental principle of the single market construction is that the authority and responsibility to investigate, detect and prosecute breaches of Community law by any of the regulated firms falls on member states. The national courts are thus also 'guardians' of the EU law and the responsibility to review the administrative implementation rests with national judicial systems. Hence, if the financial regulator or any aggrieved party considers that a regulated entity has breached a law that transposed the EU directive, it must petition national courts first. If national courts are in doubt how to interpret EU law, they may or in some cases even must, refer the matter to the European Court of Justice for a 'temporary ruling'. The national court must then respect ECJ ruling and apply the law accordingly without modifying or distorting it (Hix 2005).

The infringement procedure and ECJ ruling represent the ultimate enforcement mechanism, that is resorted to relatively infrequently (Falkner 2011b). Private parties rarely use the recourse to ECJ as this route towards consistent enforcement is long, expensive and fraught with risks for both governments and financial firms (see Hertig and Lee 2003, Genschel 2011). The EU system of multilevel governance provides more flexible, lower level mechanisms to deal with inconsistent implementation. Most of the interpretation and implementation issues are addressed within the policy networks that evolved around the execution of EU policies (Lannoo and Levin 2004, interviews 3 and

5). The Commission and its committees are at the centre of these networks that also include national authorities involved in financial market regulation, such as national financial supervisors, ministry of finance and central bank.

The formal status of the committees is determined by the relevant comitology procedure. The Treaty delegates some powers to execute EU policies to the Commission. This includes not only monitoring and enforcement, but also deciding on technical adjustments and non-essential implementing measures (Blom-Hansen 2011). Member governments supervise this process via the 'comitology system' created to ensure that they retain control over the execution of common policies (Pollack 2003a). In some policy domains, the comitology system is complemented by various types of European agencies (Versluis et al. 2010:182).The comitology committees are composed of member state representatives, with whom the Commission consults draft proposals before submitting them for codecision by the Council and EP. In short, the comitology is the mechanism that allows member states to consult and supervise common policies throughout the policy cycle from the identification of a policy issue, drafting, adoption, implementation and evaluation of given policy in a continuous manner. Hence, the comitology committees play important role during both the adoption as well as implementation processes, which is also reflected in the existing research on EU implementation.

The EU implementation literature puts forward two principal reasons why member states may not implement common regulations consistently (see Treib 2008 for overview).[14] The first set of reasons relates to the clarity of EU legislation and the national administrative capacity. The second type of factors relates to the misfit between the EU rules and the pre-existing national arrangements which determines the costs of compliance. Both of these explanations suggest that contested financial rules might not be easy to implement consistently. If contestation is resolved by fuzzy provisions, then the rules obviously lack clarity and member state may spend its administrative capacities on favorable interpretation rather than consistent implementation. If however, EU adopts clear rules by qualified majority, the minority of countries that opposed them may find implementation difficult due to the large misfit with their pre-existing arrangements.

The emphasis on clarity of rules and administrative capacity was characteristic for early implementation research.[15] It stemmed primarily from legal and administrative studies and tended towards an apolitical view of the implementation process. The inconsistent implementation was to be prevented by "clearly worded provisions, effective administrative organization and streamlined legislative procedures at the domestic level" (Treib 2008:7). This presumed that involvement of national parliaments and other stakeholders would resolve contested issues and avoid fuzziness that could hamper implementation. Under such circumstances the implementation problems were to be addressed by capacity building programs, which is a recommendation broadly shared

[14] Treib (2008) adds that there is a third set of explanations relying on the 'worlds of compliance' metaphor referring to broader cultural factors that make some states more or less likely to comply (see Falkner et al. 2005). However, this explanation refers to the general characteristics of given polity rather than to characteristics of the specific directive and governance arrangements supporting its implementation on EU level.

[15] As joint-decision trap (see section 3), the research on implementation of EU rules has its roots in studies of federal systems. However, this research took off only after the single maker project was completed (Treib 2008).

with the 'management view' of compliance with international legal regime (Tallberg 2002). This view also received some support from quantitative analyses of EU implementation, where the only factor significant in most studies was the administrative capacity (see Kaeding 2006; Börzel et al. 2007, Steunenberg 2006).

The latter generation of implementation research resorted to more political conceptualization of implementation problems, stemming from misfit between national and EU rules. It presented member state authorities as "guardians of the status quo … protecting national legal-administrative traditions" (Duina 1997: 157) and trying to export domestic policy models to the EU level (Knill and Lenschow 1998, 2000). Member governments supposedly strove to 'upload' their own policies to the EU level in order to minimize subsequent implementation costs that could arise from a forced 'download' of less compatible EU model (Börzel 2002). The misfit approach generated skeptical hypothesis on the EU capacity to implement politically contested regulations. The fact that rules are contested, means that — if rules avoid fuzziness — there is a misfit with pre-existing rules in some countries. Hence, national authorities would be unwilling to implement EU rules consistently without some external pressure stemming from the Commission (Börzel 2003) or from external shocks such as appointment of new government with different policy preferences (see Treib 2003).

The national control over the implementation process only compounds the policy challenge of regulatory integration. Even if EU rules are adopted despite conflicting preferences and supermajoritarian decision rules, they may not be implemented, if they lack clarity, are not backed by sufficient administrative capacity or are too incompatible with the pre-existing regulatory regime in a larger subset of EU countries. The EU needs an effective governance arrangements addressing both adoption and implementation challenges. It needs to prevent shifting the policy conflicts from the adoption and implementation phase by some fuzzy provisions that are easy to agree upon, but difficult to implement. How these governance arrangements evolved in financial regulation since 1950s is the subject of next section.

5. The EU harmonization strategy: from legislation to delegation

The first EU approach to regulatory integration was full harmonization. Since the late 1960s the EU strove to unify various technical aspects of goods and services produced within the single market, with the aim to replace national rules with common EU standards that were then subject to unanimous agreement in the Council. Full harmonization proved almost impossible to achieve. The EU was producing mere ten directives per year, which took so long time to negotiate that they were often made obsolete by technical innovations even before coming to force (Pelkmans 1987). Moreover, the minuscule progress of full harmonization made the EU processes seem irrelevant to domestic actors, including national politicians (Lannoo and Levin 2004). In short, the full harmonization approach was too ambitious even in times when there were only six member states involved. The EU needed more pragmatic alternative.

The alternative relying on the combination of minimal harmonization and mutual recognition was developed by the ECJ case law, starting with the case of Cassis de Dijon in 1979. The new approach asserted that a product or service that is lawfully produced and marketed in one member state has to be granted free access to national markets of all member states, without additional conditions imposed by authorities in other member states (Pelkmans 1987). This is known as mutual recognition. However, to instigate confidence that single market would not be flooded by deficient products and services, at least minimal harmonization was needed. The Treaty granted the EU the possibility to issue EU legislation harmonizing the most essential aspects of laws and regulations that affect the relevant features of products and services. These principles were utilized to ensure minimal harmonization that complements the mutual recognition.

The new approach was put forward by the Commission in the Mutual Information Directive of 1983. This was the first piece of legislation to use these principles and provide a formal process of consultation and peer review for adoption of the minimally harmonized common standards, instead of fully harmonized ones. This approach came to the fore with the 1985 White Paper (Commission 1985) that listed 283 legislative initiatives needed to establish a single market by the end of 1992. All these initiatives would apply minimal harmonization and mutual recognition principle. However, at the time the minimally harmonized common standards would still require unanimous agreement.

Changes to the decision-making procedures were instigated by the Single European Act (SEA) that amended the Treaty with provisions deemed necessary for the successful implementation of the Single Market project. The SEA introduced qualified majority voting that replaced unanimity in matters related to the implementation of the single market. The shift to qualified majority was motivated by the need to increase the ability to reach decisions and prevent deadlock in situations when all but a few member states agree with the proposed measures (see Scharpf 2011). Subsequent Treaty changes have expanded the qualified majority voting beyond the narrow single market domain.

The minimal harmonization, mutual recognition and qualified majority voting became the three elements propelling the Single Market agenda. They allowed for mutual opening of member states' markets without the need for full harmonization and helped the conclusion of negotiations on reduction of non-tariff barriers to trade in goods and services (Sun and Pelkmans 1995). This approach was instrumental in creating and sustaining the political coalition supporting the single market, because member states in favor of liberalization praised the progress in market opening, whereas member states more concerned about mediating the impact of global competition on their economies and societies greeted the new approach as a way to retain some regulatory control (Woolcock 2001). In the end, the new approach to harmonization assisted the approval of nearly all 283 legislative initiatives that were necessary for the single market by their 1992 deadline.

In the domain of the financial market regulation, the principles of minimal harmonization and mutual recognition were embedded into the concept of the single EU 'passport' for financial services which allowed EU financial firms to operate freely across all member state markets. The key idea of the passport is that entities operating across the single market should be subject to regulatory oversight in their home country only. The host countries should rely upon the home country regulators and avoid adding requirements that would force financial firms to adapt their products and services specifically for the given host market (Commission 1989b).

The single passport requires the EU to adopt sufficiently harmonized rules, which was by and large achieved in time for the 1992 single market deadline. The necessary legislation was adopted and was formally in force by 1996 at the latest. However, in practice the regulatory integration of the financial markets was generally less advanced than in product markets, although the problems were less severe in banking and insurance than in securities markets. There obstacles to the provision of cross-border financial services remained high (see Lannoo and Levine 2004:7, Young 2010 and Chapter 3). The degree of harmonization of the single passport rules proved insufficient to overcome obstacles to consistent implementation. The EU securities legislation was in place, but it was vague and left too much discretion to the member states in implementation (Lamfalussy 2000, Lannoo and Levine 2004). The Commission was slow in enforcing more consistent implementation, because there was no previous experience with EU level securities regulations and the analytical and enforcement capacity was only being built up (interview 1 and 5). Moreover, the 1990s were also a period of rapid development in financial markets, which made some of the legislation outdated and thus even more difficult to implement consistently (Lannoo and Levine 2004:8).

The launch of the monetary union in 1999 created a new sense of urgency for the development of home financial market for the new currency. The EU policy response was to launch the Financial Sector Action Plan (Commission 1999), which was part of the broader Lisbon agenda.[16] However, the experience with the inconsistent interpretation and implementation of insufficiently harmonized rules loomed as a threat ti these ambitions (see Chapters 2 to 4 for specific examples). The regulatory integration of financial markets required more than just minimal harmonization. It needed maximal harmonization with minimal accommodation of national specifics. This in turn required a change in EU approach to adoption and implementation of financial regulation (Lamfalussy 2000).

There was a distinct possibility of failure to accomplish the FSAP goals in the securities markets by the end of 2004 deadline. In July 2000 the French presidency proposed to form a committee of distinguished financial market practitioners to recommend possible solutions. The Council agreed, although it limited its mandate to assessment of the adoption and implementation processes, not the actual content of the legislation. The committee chaired by the former chairman of the European Monetary Institute baron Lamfalussy was to suggest reforms of the existing comitology arrangements in order to improve speed of adoption of EU rules, their quality and the consistency of their implementation. Within a few months, the committee proposed a novel four-level governance mechanism that introduced a distinction between framework legislation and its implementing rules and redistributed responsibility for each of them among existing and new committees. The new structures created more intensive relationships between the EU and national authorities dealing with financial regulations. The process was initially introduced in 2001 in securities and expanded to banking and insurance four years later.

[16] The FSAP itself was one of the clearly defined parts of Lisbon agenda that was actually completed on time, unlike some of the other Lisbon commitments (see Csaba 2005).

Until this reform decisions regarding regulatory integration in financial markets followed the standard comitology procedure (see Bergström 2005, Blom-Hansen 2011 for overview). The Lamfalussy reform reorganized the process of adoption and implementation into four levels that correspond to the usual policy cycle. The first level constitutes the initiation phase of the legislation making, whereby the Commission proposes framework legislation and the Council and the European Parliament decide by the usual co-decision procedure. The second level committees composed of Member State representatives are then responsible for the adoption of the implementing powers, which specify technical rules implementing the framework legislation approved on Level 1. The third level committees, composed of representatives of Member States' financial supervision authorities, aim at strengthening the consistency of the day-to-day enforcement of financial regulations and are also charged with drafting implementing powers for decisions on Level 2. Finally, monitoring of transposition and enforcement is to be done on the fourth level.

At Level 1, decisions are made by the co-decision procedure. As in all other the EU policy domains, the Commission has the sole right to initiate the legislative process and the Council and European Parliament codecide on the proposal. The Lamfalussy process does not affect this arrangement, although all Lamfalussy committees are also involved in the initial consultative process and often charged with preparing a proposal for the Commission. The only departure from the standard comitology procedures is that the Commission may propose to delegate the specification of implementation measures pertinent to specific articles of the directive to the Level 2 or Level 3 committees. The delegation is fully at the discretion of the legislators. They may delegate the implementation powers to all articles of the directive or to none.

The formulation of the implementing rules starts with consultations between the Commission and Level 2 Lamfalussy committees. Depending on the financial market segment that the proposed legislation concerns, the Commission consults with the European Securities Committee (ESC) or the European Banking Committee (EBC) or the European Insurance and Occupational Pensions Committee (EIOPC). Members of these committees are high level representatives of national governments — typically deputy ministers of finance — who represent views of member states. Committees are, however, chaired by the Commission representative and may decide by qualified majority vote. Usually, Level 2 committees meet three times a year to vote on the proposals submitted by the Commission. The Commission submits proposals for vote only after they pass through extensive consultations with Level 3 committees. The implementation measures may take a form of either Commission Regulation or Commission Directive. Under the so called 'Meroni doctrine' no comitology committee can legislate directly, thus all implementing measures have to be formally published by the Commission.

There are three Level 3 committees, one for each segment of the financial market.[17] Specifically, the Committee of European Banking Supervisors (CEBS) for banking, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPC) for insurance and the Committee of European Securities Regulators (CESR) for securities

[17] This description represents the situation till the end of 2010, when the Level 3 committees were turned into European Supervisory Authorities (see Chapter 4).

markets. Each Level 3 committee is composed of representatives of relevant national regulatory authorities and supported by the secretariat provided by the Commission services.

Level 3 committees shoulder most of the consensus seeking burden during the policy making process. They are often charged with drafting concrete proposals of Level 1 legislation as well as Level 2 implementing rules and are hence responsible for the open and transparent consultations with all stakeholders to which the Commission committed under the 'better regulation' agenda (Commission 2005b). The Level 1 proposals are used by the Commission as an input for its formal proposal that undergoes the standard consultation and codecision process. The Level 2 proposals are also reviewed by the Commission and Level 2 committee, which votes on them. Providing a favorable vote, the Commission issues the final draft of the proposal, which is submitted to the Council and European Parliament that are continuously informed in line with the comitology rules related to 'regulatory committees with scrutiny' and have power to reject it, if the proposed measures exceed the scope of implementing powers that were approved on Level 1. This mechanism keeps the Lamfalussy committees accountable to the Commission, Council and European Parliament and keeps their autonomy at check.

Level 3 committees were delegated the power to formulate joint recommendations on the interpretation of EU financial rules, drafting joint standards for issues not covered by EU legislation and preparing peer reviews that compare supervisory practices. These are typically prepared by ever growing network of temporary expert committees that are overseen, supported and managed by Level 3 committees. The underlying goal for the Level 3 committees is to achieve convergence in day-to-day financial supervision across all EU states, which is sometimes referred to as maximal harmonization (Strohbach et al. 2011, interview 1 and 2). Until 2010, the Level 3 guidelines were formally non-binding, but with the transformation of these committees to European Supervisory Authorities (see Chapter 4) consensually adopted guidelines are binding.

At the fourth level the Commission monitors consistent transposition and application of measures adopted at Level 1 and 2. The Commission plays its role of the guardian of the Treaty by monitoring compliance of member states with EU legislation. The Lamfalussy procedure did not introduce anything new to the compliance monitoring. Level 4 has been included largely to stress the need for strong political commitment to transpose and enforce rules of the single market in financial services.

The four level Lamfalussy network is complemented by additional comitology committees that provide their opinion to the Commission on new standards in cross-cutting areas of the EU financial market agenda. These include the Accounting Regulatory Committee dealing with international accounting and financial reporting standards, the Audit Regulatory Committee reviewing international standards of auditing or the European Group of Audit Oversight Bodies that coordinates public oversight systems of statutory auditors and audit firms within the EU.

The Lamfalussy process has affected the institutional balance among EU bodies, member state governments and regulatory bodies (Bradley 2008, Schusterschitz and

Kotz 2007, Christiansen and Vaccari 2006). The power to make decisions about rules that affect the wellbeing of European economies and citizens has been partially shifted to technocrats in Level 2 and 3 committees and away from the Council and the European Parliament that have a stronger claim on political legitimacy. The shift was justified by the need for faster policy making, which was widely accepted. Nevertheless, the Council and Parliament sought more checks and balances to ensure that the delegation of powers to the Commission and the Lamfalussy committees does not go too far. This was the subject of several rounds of negotiations between 2001 and 2006.

The Council, reflecting concerns of some of the member states, has sought to ensure that the Commission and Level 2 committees do not push implementing powers too far towards one model of financial regulation. This has been safeguarded by the so-called Prodi declaration of 2002, which commits the Commission not to go against a "pre-dominant view" of the Council when adopting Level 2 rules.[18] There is no definition of what constitutes "pre-dominant" (IIMG 2003: 14) so the clause merely introduces an element of uncertainty into decision-making.

The second mechanism that compensated the shift of decision-making powers to Level 2 is a "sunset clause". It required all Level 1 directives to specify the period of time (generally four years), within which the Commission and Lamfalussy committees may

[18] Pollack (2003a) reports that German Finance Minister was reportedly concerned that the Commission would push through securities legislation favoring securities trading in London over Frankfurt and attempted to reintroduce the old safeguard when a simple majority could block a Commission decision. Commissioners responded by pointing out that the size of a predominant view has never been specified, although given existing procedures is must be somewhere between 50% and the qualified majority (Pollack 2003a: 151).

exercise the powers delegated to them. At the end of that period the Council and the Parliament have to decide again on the scope of the delegated powers, but may also decide not to renew the mandate. The "sunset clause" was to be superseded by the Treaty establishing a Constitution for Europe that proposed a call-back right for the European Parliament. However, since the Treaty was rejected in French and Dutch referenda, the Parliament was left without such an option and thus in sub-par position vis-à-vis its partners within the codecision procedure.

In reaction, the Parliament initiated discussions on the reform of comitology in September 2005. The outcome was an agreement on a new type of comitology committee - Regulatory committee with scrutiny – which, unlike the other three types, must allow the Council and the European Parliament "to carry out a check prior to the adoption of measures of general scope designed to amend non-essential elements of a basic instrument adopted by co-decision". In the event of opposition on the part of the Council or Parliament, the Commission may not adopt the proposed measure. This process guarantees the Parliament three months to react to any draft implementing measures and one month to review the final draft in order to ensure that all regulatory rules stay within the limits of implementing powers delegated to the Commission on the Level 1 of the Lamfalussy procedure.[19]

The amendment of the comitology procedures has concluded the process of rebalancing the decision-making powers triggered by the Lamfalussy reform. The new mode of governance represented by the Regulatory committees with scrutiny is now

[19] In urgent cases the periods for review of the Level 2 drafts of implementation powers can be shortened.

firmly embedded in EU decision processes and available for use in other policy domains.

The Lamfalussy reports (2000, 2001) stressed the need for regular monitoring of the procedure to ensure that it meets its objectives. These evaluations were prepared by the Inter-Institutional Monitoring Group (IIMG) of six experts, two of whom were nominated by the Commission, the Council and the European Parliament respectively. The IIMG conducted annual consultations with all relevant stakeholders and prepared regular reports until 2007, when the Lamfalussy procedure was fully accepted as successful innovation.

The initial rationale for the Lamfalussy reform was threefold. First, the Lamfalussy group concluded that the EU decision-making procedures were too slow and lacked a rapid mechanism to update directives. Second, it identified problems with the fuzziness of existing regulations that failed to cover some important issues or covered them in a highly ambiguous manner. Finally, it pointed out the implementation problems that arose through delayed transposition, inconsistent interpretation and uneven, uncoordinated enforcement (Lamfalussy 2000). Given these concerns, the speed, clarity and implementation represented natural criteria for the evaluation of the early experience concerning the effectiveness of reformed committee governance.

The IIMG reports as well as other evaluations (see de Visscher et al 2007, ECB 2007, Commission 2004, for example) indicate that the procedure had delivered the expected results in terms of speed. The four directives have been delivered via the

Lamfalussy process to date - Transparency (2004/109/EC), Prospectus (2003/71/EC), Market Abuse (2003/6/EC) and Markets in Financial Instruments (MIFID; 2004/39/EC) – took about 20 months to adopt despite the need for considerable consensus building (Commission 2004). This compares well with average time of 36 months for similar directives (Lamfalussy et al. 2000) and with the 30 to 100 months it took to adopt the previous generation of directives in the field of securities (Commission 2004:6). The Lamfalussy procedure thus seemed effective in supporting timely adoption of all directives listed in the Financial Sector Action Plan (IIMG 2007: 8). Moreover, the Lamfalussy procedure improved the input legitimacy of new directives through the open and transparent internet-based consultation process (de Visscher and Varone 2006:4). The faster and more inclusive decision-making process was later one of the key arguments for the extension to banking and insurance.

The comparison of the decision making speed is possible only for the above four directives that were adopted within bounds of the Lamfalussy process from the beginning. Amendments of some other directives such as the Capital Requirement Directive (2006/48/EC and 2006/49/EC) were processed through the Lamfalussy structure and delegated some powers to Level 2 and 3 committees (see Chapter 2). Whether such amendments are adopted faster is impossible to say as there is no obvious benchmark. Similarly, evaluation of the 'fuzziness' of the Lamfalussy directives can be done only on the basis of detailed comparison with previous directives, which is a subject of three empirical chapters of the thesis. The same applies to the evaluation of the implementation experience. These require an in-depth qualitative analysis left for the Chapter 2 to 4.

6. Conclusion

The research question about the effects of delegation on regulatory integration (Introductory chapter) can contribute in two ways to the debates within the EU policy-making literature summarized in this chapter. The empirical contributions stem from the comparison of the policy making in the financial market regulation domain before and after Lamfalussy reforms. The theoretical contribution stems from the discussion of alternative causal explanations of effects of delegation on regulatory integration.

The first empirical contribution is the analysis of how the EU policy-making works after recent reforms. The regulatory mode of EU policy-making applies to many policy domains ranging from transport, to energy, to financial markets. However, there tends to be a strong variation in its application both over time and across policy sectors. These variations result from continued experimentation with the new forms of government and governance and also from functional differences between policy domains (Wallace 2010: 90-91). Hence, it is always topical to ask how is the regulatory mode of EU policy-making currently applied in the financial market regulation and how is it different from its past constellations.

The second empirical contribution provides an answer to the puzzle arising from the policy-making literature reviewed here. This literature would in general predict a protracted policy stalemate on the most contested aspects of the EU financial market regulation due to the combination of conflicting policy preferences, supermajoritarian decision rules and national control over the implementation process. Under these circumstances, the existing policy analysis sides with the skeptical predictions of the Null Hypothesis (see Introductory chapter) that postulates no effect of delegation on regulatory integration. The third empirical contribution can be expected form the analysis of the specific micro-level rules that have not been studied before. This is especially the case of the banking rules on hybrid capital (Chapter 3) and cross-border bank resolution regime (Chapter 4), where there are few secondary sources of information.

The theoretical contribution stems from the evaluation of the three causal hypotheses (see Introductory chapter). The EU policy-making literature is largely descriptive and focuses on question of how and why the policy-making processes change (Wallace 2010,Young 2010). The literature excels in describing the evolution of the EU approach to legislative harmonization starting from the full legislative harmonization of the 60s and 70s, to the combination of minimal harmonization and mutual recognition of the 80s and 90s, and finally, to the maximum harmonization aspired to by the Lamfalussy reform. However, it lacks systematic explanations of how these changes affect regulatory harmonization. It points out effects of the successive EU approaches on policy output, but without specifying the theoretical mechanisms that deliver the effect of changed governance arrangements on the micro-level structure of policy outcomes. The EU policy-making literature is generally better in explaining why regulatory integration might be difficult, then in suggesting why it might be possible. Hence, evaluating the alternative institutional explanations can provide novel insights into the causal effects of reforms of the policy-making process on policy outputs.

This chapter provided the general overview of the EU policy making relevant for the financial market regulation and the broader context for the micro-institutional analysis contained in empirical chapters (Chapters 2 to 4). It also pointed out that regulatory integration of EU financial markets was often part of the flagship initiatives such as single market project or Lisbon agenda. Especially, the latter is generally perceived as a failure, however, this thesis also shows that although "[n]ot being on schedule, not meeting the quantitative targets exactly, [and being characterized by] laboring over compromises and a lot of muddling through" (Csaba 2009:141) such initiatives are a standard modus operandi of the EU that can deliver results despite political contestation. This is somewhat reassuring finding for the post-crisis financial reforms that appear equally chaotic and insufficient as their many predecessors in past. Nonetheless, they may yet again show that the yet another EU crisis is yet another complicated episode towards more integrated Europe (see Csaba 2009 for past examples).

The EU policy making process is analyzed in great detail in the next three empirical chapters that focus on regulatory integration of specific EU rules. These chapters follow the same structure, starting with the introduction and overview of the negotiating process that identifies the most contested aspects of the given set of financial regulations. The next section of each chapter analyzes the regulatory integration of the most contested aspects achieved over the period of observation. The fourth part reviews and compares the governance arrangements supporting adoption and implementation at difference points in time. The fifth section evaluates the effects of delegation on regulatory integration of contested aspects. The chapter-specific conclusions follow. The findings from the three empirical are evaluated against the four hypotheses in the Concluding chapter.

Chapter 2:

Bank capital regulation in the EU

Common definition of bank capital is a prerequisite for the single market in banking. Rules defining eligible capital items are a corner stone of the banking regulation with fundamental consequences for the financial stability and competitiveness of banks. Modern banking regulation is based primarily on the risk-weighted ratio of capital to assets, therefore, what counts as capital is a crucial policy decision.

The purpose of bank capital is to absorb risks and sustain shocks while allowing the bank to continue as going concern. Initial banking capital is needed to finance the corporate infrastructure of a bank and later it serves as a buffer, allowing the bank to write off losses and buy time for adjustments to adverse business developments. It is also crucial for maintaining public confidence in bank stability, as it ensures that bank shareholders have an incentive to supervise bank management and prevent risky business strategies that could result in excessive losses.

However, capital is expensive for the banks and the bank management is always on the lookout to reduce its amount and its costs. Therefore, regulation and supervision is necessary to ensure that banks' capital bases are not reduced beyond some predetermined minimum. The technical regulation of bank capital relies on two components - rules that define the capital composition (own funds rules) and rules that stipulate required level of capital (solvency rules). This chapter focuses on the political economy of the own funds definition in the European Union during the 1985 to 2009 period.

Regulation of capital may be an important source of competitive advantage for banks. National regulatory regimes developed specific definitions of capital that countries and banks were reluctant to give up. Countries with lenient definition of capital and lower capital requirements provide their banks with competitive advantage over their international competitors. They allow them to reduce the costs of capital and thus make more competitive offers to potential clients. The downside of the lenient approach is lower protection against financial instability. Nonetheless, any attempt to negotiate a common definition of capital across several countries with widely different capital regimes is bound to be heavily contested.

There was no common international definition of bank capital before the late 1980s, not globally, or within the European Union. However, the expansion of international financial markets and introduction of a single market in banking required regulatory harmonization to prevent undercapitalized banks from destabilizing the system, as well as to level the playing field for banks competing internationally. Regulatory harmonization requires introduction of a common definition of capital, which in turn requires agreement among countries with very different status quo rules. How did the EU countries manage to agree on a contested capital definition? How did they implement it nationally? Was there any convergence to a harmonized set of rules? Were the rules implemented consistently across all EU countries? Did delegation of regulatory powers described in Chapter 1 enhance regulatory integration? These are the questions addressed in this chapter.

The questions are approached from the micro-institutional perspective outlined in the Introductory chapter. The first section reviews the negotiation process of the 1988 Basel Capital Accord, which coincided and predetermined the 1989 Own Fund Directive of the EU. It highlights the political contestation of the common definition of bank capital and the two-tiered compromise that enabled the G10 and EU countries to adopt common standards despite conflicting preferences. It also traces the evolution of the legislation through the consolidation of the banking directives in 2000 to their recasting in 2006 and substantive amendment in 2009. The second section evaluates the regulatory integration over the two decades that followed the adoption of the OFD. It shows that there were neither harmonizing amendments of the directive nor substantive progress in consistent implementation. To the contrary, the financial innovation in the form of hybrid capital instruments led to increased divergence in the harmonized definition of the Tier 1 capital. The third section traces the evolution of the governance arrangements that supported implementation of the EU bank capital legislation from when there was no delegation of any powers from the Council, to the delegation of technical powers to the advisory committee and finally to the growing role of Lamfalussy committees in decision-making, monitoring and implementation. The fourth section analyzes the interaction between the OFD implementation and the applicable governance procedure. It demonstrates that the commitments to further regulatory integration — that were included in the successive versions of the OFD — were more credible when supported by greater delegation of power to technocratic committees with greater resources and autonomy to analyze and adapt the definition of bank capital. The final section concludes that the combination of three elements — (i) a review clause used to identify politically contested policy issues, (ii) governance reforms delegating more powers to technocratic committees and (iii) a shift from the positive to negative harmonization — is emerging as a successful strategy in reducing the deadlock on politically contested financial regulations. It has been relatively successful in the case of harmonization of common EU rules on hybrid capital and it will be tested on many more disputed issues in the near future.

1. Negotiating Own Funds definition during the 1980s

The process of adoption of the EU legislation on bank capital cannot be understood separately from the parallel negotiations in the Basel Committee on Banking Supervision (BCBS) that led to the Basel Capital Accord.[20] The Accord largely pre-determined the outcome of the EU negotiations, not least because eight of twelve EU members were directly involved. Both of these processes had the same ambition of defining international prudential standards that could serve as a basis for international policy coordination. They also occurred simultaneously and it was not clear what process would be concluded first. The Basel process had run to a stalemate by the time the Commission made the first proposal for the Own Funds Directive in 1986.

[20] The BCBS issues non-binding but authoritative recommendations on the prudential supervision of banks that are usually translated into EU banking legislation. The BCBS seeks improve the banking supervision worldwide by researching and exchanging information on national supervisory arrangements; by improving the effectiveness of techniques for supervising international banking business; and by setting minimum supervisory standards. It does not possess any formal supranational supervisory authority and its standards do not have any legal force (see Wood 2005 for detailed description).

However, the US-UK bilateral agreement triggered a speedier conclusion of the Basel adoption process, the results of which were then incorporated into the EU directives.

The Basel adoption process was politically contested as national negotiators tried to minimize the adaptation costs for their domestic banks and limit the impact on their respective competitive advantages (Tarullo 2008, Quillin 2008, Kapstein 1994). Apparently, the most contested issue was the definition of capital — what capital items should be included and what should be excluded from banks' capital base. Each of the G10 countries hoped to include all capital items that were important to their banks, which ran the negotiations repeatedly to the ground. The eventual solution of these policy conflicts was distinctly EU-like: a combination of minimal harmonization of the least contested capital items and mutual recognition of the most contested aspects of the definition. It was thus no surprise that the Basel Accord provided both the technical and political template for the adoption of the Own Funds Directive, although some of the policy conflicts were replayed again on the EU level.

1.1 Adopting Basel I: policy conflicts and their accommodation

The 1988 Basel Accord (BA) was negotiated by the G-10 countries as a voluntary non-binding international standard, which was subsequently implemented by all signatory states as well as over 100 other economies worldwide (BSBC 1999).[21] The negotiations of the Basel Accord started in early 1980s and quickly turned into a strenuous process

[21] Basel Committee at the time comprised of eight EU Member States (Belgium, France, Germany, Italy, Luxembourg, Netherlands, Sweden and United Kingdom) plus the United States, Canada, Japan and Switzerland, although formally Switzerland and Luxembourg were not G10 members.

that appeared to be on the brink of collapse several times (see Kapstein 1994, Woods 2005, Quillin 2008, Tarullo 2008). The Accord required a consensus of the 12 members of the Basel Committee on Banking Supervision that had to accommodate different national approaches to capital definition and risk weighting as well as unique regulatory and accounting terminologies.

The goal of the Basel Accord was twofold: (i) to increase the stability and financial soundness of the G10 internationally active commercial banks, and (ii) to reduce the competitive distortions by inducing regulatory convergence. The first goal followed from the internationalization of major banks after the collapse of the Bretton Woods system, which was enabled by communication technologies and domestic deregulations of banking. Banks expanded across borders and competed intensely for clients and market share worldwide. The intensified competition, in turn, created incentives for regulatory arbitrage, exploiting the differences in national regulatory regimes and conducting business from jurisdictions with the most advantageous regulations. The potential for arbitrage was also increased by financial innovations that introduced new products circumventing traditional regulatory approaches that were ill-suited for dealing with off-balance sheet derivatives and hybrid securities, for example.

The intensified competition forced banks to search for new and more risky business opportunities and introduce new products whose risk-return profiles were less understood. As a result, there was growing concern about the increasing fragility of the largest banks in developed countries (BCBS 1983). This was intensified after oil shocks, when international banks engaged in recycling of petrodollars through less regulated

Eurocurrency markets into lending to less developed economies in Latin America and Eastern Europe. The amount of capital of major international banks was not only decreasing, but also getting more difficult to evaluate. Domestic bank supervisors could inspect and regulate only a limited part of an international banking network and were thus poorly equipped to detect a buildup of large risk exposures in foreign units.

New risks became apparent during occasional banking crises. The failures of Herstatt and Franklin National in the 1970s had shown that collapse of marginal, but densely connected banks can freeze the international banking system (Kapstein 1994). This lesson established the regulators' dilemma of how to enjoy the benefits of international economic activity, while containing the risks and their impacts on the domestic economy (Kapstein 1989).[22] This problem continues to haunt banking regulators to this day.

The central bankers who were accustomed to international cooperation through the Bank of International Settlements (BIS) — established during the 1930s depression in Basel — created a new BIS committee to trying to address the problem.[23] In 1974 the committee — formally named Basel Committee on Banking Supervision in 1990 — produced the first international agreement: the Basel Concordat, which declared basic principles for international crisis management. These were little more than declarations of good intentions, nonetheless the Concordat established the G10 sponsored BCBS as

[22] In the context of international competition the dilemma is related to the 'race to the bottom' dynamics, whereby countries try to attract more banking business by providing more lax regulatory regime that, in turn, makes it difficult for other countries to contain risks and ensure financial soundness.
[23] The original name was Committee on Banking Regulation and Supervisory Practices.

the preferred cooperation platform. The 1980s debt crisis provided the big push for its use (Kapstein 1994, Woods 2005).

In 1981, the BCBS set to devise multilateral bank capital standards ensuring that internationally active banks are adequately well capitalized, thereby reducing the probability of their collapse, which could destabilize the system. The set goal was "greater convergence with regard to national definitions of bank capital for supervisory purposes" (Norton 1992). The G10 states recognized from the onset that legal harmonization would not be achievable, but even less ambitious convergence proved difficult.

The BCBS drafted numerous complex methodologies for constructing a common standard able to incorporate the specific characteristics of national capital adequacy regimes into a unified framework. Initially, the idea was to define "functional equivalents", but sharp distinctions in the G-10 states' definitions of capital made consensus elusive. Germany and France did not make the agreement easier when they suggested that it was not possible to derive a single, generalizable definition of capital, as the capital adequacy depended on the entire scope of a bank's activities and its management quality as it did upon its bank book portfolio (Kapstein 1989:341). Moreover, when regulators returned from Basel to G10 capitals with successive proposals, it triggered domestic political pressure from banks that insisted on their regulatory priorities, which made unanimous agreement across G10 elusive (Woods 2005, Quillin 2008). Despite the impetus created by the debt crisis, the Basel negotiations ran into a deadlock by 1985.

The deadlock was broken by the US and UK decision to introduce a bilateral capital adequacy agreement in 1986. Both countries had been implementing regulatory reforms in response to the debt crisis that were more stringent than in other G10 countries, and they were frustrated by slow progress of Basel negotiations (Kapstein 1994). If they completed domestic reforms before the multilateral agreement, their banks would be required to carry higher levels of capital then their competitors from other G10 jurisdictions. Their banks were very vocal in pointing out this problem through political channels, thus increasing pressure on their regulators (Tarullo 2008, Reinicke 1995). Moreover, the US reform was introducing the risk-weighting approach to capital adequacy championed by the Bank of England (Woods 2005), which reduced their differences with regard to solvency measures (Quillin 2008). The conflicting preferences over capital composition were resolved by a structured compromise, which allowed domestic banks to maintain some forms of capital that the other country did not recognize. It distinguished between the first tier capital, including only high-quality and mutually acceptable elements, from the second tier including idiosyncratic capital instruments of lower-quality, such as general bad debt provisions in the UK or preferred stocks in the US. To prevent bias in favor of the second tier, its total amount was limited to the 50 percent of the total capital.[24]

The US-UK agreement changed the strategic nature of Basel negotiations. In game theoretic terms the Basel negotiations could be understood as a cooperative game of simultaneous coordination, whereby all G10 countries preferred multilateral

[24] The required amount of capital was set at 8% of risk-weighted assets (RWA), thus the Tier 2 was limited to 4% of RWA.

agreement, but could not decide on its specific content (see Chapter 3 for a version of this game). However, the capacity of the US and UK agreement to serve as an ultimatum offer to other G10 countries, changed the game to non-cooperative, sequential game. It was no longer an issue for simultaneous coordination, but take-it-or-leave-it offer. Tarullo (2008: 50) notes that such ultimatum strategy is frequently adopted in trade negotiations, when the US threatens a bilateral deal with key partners in order to push through the multilateral solution. To make the ultimatum more credible, the US Federal Reserve even published the US-UK agreement as a bilateral agreement to be reflected in domestic legislation, but it never materialized as other G10 members were sufficiently worried that it may become de-facto international standard substituting for multilateral compromise (Reinicke 1995:169).

The ultimatum aspect of the bilateral agreement was also furthered by the US focus on getting Japan to agree to the proposal, before returning to the multilateral negotiations of all 12 countries in Basel. Moreover, the European negotiators were worried that the UK may use the agreement to preempt efforts to construct an agreement on the Own Funds and Solvency Directives in the parallel EU negotiations (Kapstein 1991:266). Some even argued that Britain could be in violation of the 1958 Rome Treaty, when it did not inform its EU partners about the upcoming agreement up until the day before it was made public (Quillin 2008).

The US representatives approached their Japanese counterparts in 1986 seeking the possibility of them joining the US-UK position (Woods 2005). At the time, the US-Japanese economic relations were strained by the booming success of latter's exports to the US markets, which also included exports of financial services by expanding Japanese banks that were keen to sustain their access to US market. The US Congress was responsive to suggestions that weaker capital standards provide Japanese banks with unfair competitive advantages and prepared to adopt protective measures in the absence of international agreement on capital standards (Quillin 2008). Moreover, both the US as well as the UK stated that they may require compliance with their capital standards for foreign banks seeking to acquire domestic banks or even merely to do business in their jurisdictions, which would restrict access of Japanese financial firms (Tarullo 2008:51). Under these circumstances, Japan was prepared to consider the US-UK proposal, but the definition of capital represented a key hurdle. The capital base of Japanese banks was generally lower than in the US or UK and a large part of their capital was formed by unrealized capital gains in their portfolios (Quillin 2008). Hence, Japan insisted on recognition of these implicit gains as eligible capital item. The US and UK conceded to inclusion of unrealized capital gains into the Tier 2 capital (Tarullo 2008:50), thus the US-UK proposal became trilateral.

The new negotiating position of US, UK and Japan covered the three largest financial centers in London, New York and Tokyo. The remaining G10 countries recognized the fact that the core of the trilateral proposal was there to stay and focused on tweaking the auxiliary provisions towards their perceived interests.[25] Germany, which had the

[25] Substantively, the Basel Accord consisted of three main parts: (i) the definition of bank capital, (ii) definition of the risk weighting rules, (iii) rules for conversion of off-balance sheet items. The idea was to assign each asset or off-balance-sheet item held by a bank to one of five risk categories, calculate the capital required for each such item based on the risk weighting, and then add all these amounts together to produce the total minimum capital to be held by the bank. The political compromises actually introduced two such minimums. The tier 1 was to be at least 4 percent of risk-weighted assets, whereas the minimum of total bank capital, which also included tier 2 capital, was set at the 8 percent of risk-weighted assets.

strictest definition of bank capital among the G10 at the time, pushed for relegation of some of the weaker capital instruments to Tier 2 and introduction of quantitative limits on their allowable proportion in total bank capital. France persuaded others to extend the lower risk weighting for a bank's credit to cover all banks in OECD countries, not just those in a bank's own country. The US — not to miss an opportunity for quid pro quo — negotiated inclusion of perpetual noncumulative preferred stocks to Tier 1, not just Tier 2 as originally proposed (Tarullo 2008, Quilin 2008, Woods 2005, Kapstein 1994). With such amendments the final definition of bank capital was formally adopted in July 1988.

On the global level, the 1988 definition of bank capital remains in place until 2013, when the recently negotiated Basel III definition comes to force. Surprisingly, the basic definition was not changed for 25 years despite all the changes in international banking markets. There were only minor clarifications of the basic rules. The first change took place in 1991, when BCBS clarified the rules on loan-loss provisions and made eligible some claims collateralized by securities of public sector entities. Following the introduction of the 1993 EU Capital Adequacy Directive, the BCBS responded by creating 'Tier 3' capital to cover market risks in the same way as in the EU (Quillin 2008) and I also allowed for more netting in off-balance-sheet exposures in (Tarullo 2008:61). In 1998 the BCBS grew concerned with increasing proportion of innovative capital instruments in Tier 1 capital and recommended a new eligibility criteria and quantitative limit in the so-called 'Sydney press release' from 21 October 1998. Unlike the risk weighting rules that were completely changed during the Basel II negotiations (1999-2004), the capital definition was changed only marginally.

This was the case on the EU level as well, although with some important differences.

1.2 Adopting OFD: replay of Basel negotiations

The Basel Accord was transposed to the EU legislation by the Own Funds Directive (OFD) that defined assets eligible as bank capital. Together with the Solvency Directive the OFD complemented the Second Banking Directive that defined the EU legal framework for licensing, regulation and supervision. These three directives stipulated the core legislation for single market in banking, which included the single passport and home country control principles necessary for banks' freedom of establishment and freedom to provide services across the single market.

Although the Basel Accord largely pre-determined the outcome of OFD negotiations, there was scope for some adjustments that were fully utilized by the key member states. Two issues were contested the most — the definition of bank capital and the comitology procedure. Whereas the capital definition put member states on different sides of the debate, it was the Council, Commission and European Parliament that clashed over the comitology.

The EU harmonization agenda for the common financial market was formulated in 1983 and adopted in the 1985 White Paper on completing the single market (Tarullo 2010). The Commission submitted the first proposal for the Own Fund Directive in September 1986, and until the US-UK bilateral agreement it was plausible that Brussels would conclude before Basel.

The OFD proposal went through the standard cooperation procedure applicable at the time. However, neither the Council nor the EP adopted the Commission proposal without amendments during the first reading so the process had to be repeated. The EP issued its amended text in July 1987 and the Commission agreed only with some of the changes. The Council approved yet another amended proposal in January 1988. Hence, all three EU legislative bodies entered negotiations on a common position, which were concluded in December 1988. Nonetheless, the EP again amended the common position in the second reading due to continued disagreement over the comitology procedure.[26] These changes were refused both by the Commission and the Council in March and April of 1989, respectively. The OFD was thus formally adopted in April 1989 after 31 months of negotiations. It was in line with the final text of Basel Accord and both documents shared the implementation deadline of January 1993.

The comparison between the Basel and EU rules reveals very close compatibility in substance, although there are some differences. The EU adopted a twin-tier structure, calling tier 1 'original own funds' and tier 2 'additional own funds' and definitions of the eligible capital items in OFD match the Basel Accord closely (see Tables 2.1 and 2.5). The Solvency directive that accompanied the OFD took over the specifications of risk charges for on-balance sheet as well as off-balance sheet items and conversion factors. The EU directives also introduced the same quantitative limits on each type of capital as well as the overall 8 percent minimum of the capital adequacy ratio.

[26] At the time, the cooperative procedure essentially limited the EP into a consultative role and its decisions could be ultimately overruled by the Council decision as it happened in this case.

Table 2.1: Comparison of Basel and OFD capital definitions

Basel terminology	EU terminology	Basel items	EU differences from Basel
Tier 1 capital	**Original own funds**	• Paid-up share capital/common stock; perpetual non-cumulative preference shares • Disclosed reserves Minority interests in equity of subsidiaries less than wholly owned • Current year profits	• Current year profits included only if verified by auditors • Funds for general banking risks included without • limits as a separate category
Tier 2 capital	**Additional own funds**	• Undisclosed reserves • Asset revaluation reserves (including latent reserves) • General provisions/general loan loss reserves • Hybrid (debt/equity) capital instruments • Subordinated term debt	• Latent revaluation reserves not allowed • Commitments of cooperative members specified as included
Deductions	**Deductions**	• From Tier 1: goodwill • From Tier 2: investments in unconsolidated banking and financial subsidiaries; investments in capital of other banks and financial institutions and financial institutions under certain conditions	• From Tier1: goodwill and other intangibles; own shares held at book value; current year losses • From Total: investments in capital of other banks
Limits	**Limits**	• Minimum 8 percent capital to risk-adjusted assets • Tier 2 limited to maximum of 100 percent of Tier 1	

Source: Compiled from BAC (2001), CEBS (2006b) and Quillin (2008)

Where the OFD departs from the Basel Accord, these differences tend to be closely correlated with the policy preferences of the key member states. The OFD definition of the original own funds (tier 1 capital) is more lenient in inclusion of general banking reserves (called "Funds for general banking risks") that are not created as provisions for any specific loan. This item was introduced at the insistence of France, whose banks built up such provisions to 40 percent of their exposure to countries involved in the 1980s debt crisis (Reinicke 1995:174, Story 1997:258). Initially, the general banking reserves were included in the tier 1 capital only on provisional basis. Since France failed to persuade the G10 representatives in BCBS, but succeeded in the Council, it was not certain that this departure from Basel Accord would be acceptable on an international level. Thus the OFD Article 6 (2) bound the Commission to propose a decision whether general reserves should be included in the first or second tier capital within six months after the OFD implementation date. After some consultations, the BAC and the Commission concluded that such a departure is acceptable, and proposed to keep baking reserves in the tier 1.[27]

The French negotiation success was however balanced on the EU level with more stringent deductions. In addition to the Tier 1 deductions already included in the Basel Accord, the OFD required banks to subtract their own shares (goodwill), intangible assets as well as material losses of the current financial year from the Tier 1 capital. These deductions largely reflect the German preference for the stricter definition of capital (Quillin 2008).

As the Basel Accord, the OFD also included a provision stating that other capital items, which are immediately available to absorb losses and clearly disclosed in the internal accounting may be counted towards the Tier 1 capital. This provision provided one window for inclusion of the innovative capital instruments that combine features of both debt and equity as "Other items" (Article 3). The OFD was only marginally more

[27] Council resolved the issue in its Directive 91/633 in December 1991.

stringent than Basel by requiring that such items are verified by an independent auditor and disclosed to supervisory authorities. The OFD allowed for inclusion of hybrids such as preferred shares or securities with an incentive to redeem as "Other items" in Tier 2 as well. When it was adopted in 1989, the "other items" were rather exotic and marginal sources of capital, but their importance grew as banks innovated their design during the subsequent years (Tarullo 2008).

The tier 2 capital was introduced to provide the flexibility needed for the political acceptability of the proposal on the G10 level. Its OFD equivalent — additional own funds — served the same purpose on the EU level, thus it is not surprising that it is more differentiated. France, along with all other EU members — except for the UK and Germany — demanded that unrealized appreciation in physical assets, such as buildings, be included in the capital definition, because their accounting rules traditionally accepted as such capital items (Quillin 2008). Whereas the BA recommended application of the 55 percent discount rate, the OFD allowed EU banks to include the valuation adjustments in full (Commission 2000a).

The final set of differences between the OFD and Basel Accord is related to cooperative banks or banks with some form of state involvement. The BA was intended for large, private, internationally active banks, but many banks in the EU were rather small and based on some specific legal forms such as Landesbanken or cooperatives. The OFD was adapted to reflect these specifics by clarifying that public credit institutions must not include in their own funds guarantees granted to them by any member state or local authorities; cooperative banks were allowed to count commitments of their members towards the additional own funds (OFD Article 4).

Overall, the OFD represented a marginally adapted version of the 1988 Basel Accord. The political contestation of the OFD definition of banks' capital was reduced by the presence of the G10 compromise. Nonetheless, the OFD adoption provided the key member states with an opportunity to advocate the preferences that they were not able to get accepted in BCBS. The OFD also replicated the Basel mechanism for accommodating these demands by allowing for inclusion of the contested capital items in the Tier 2 capital. Where the EU allowed for an extra item in the Tier 1 capital, it compensated this provision by more numerous deductions. The OFD is thus a classic example of how minimal harmonization and extensive mutual recognition allows the EU to adopt politically contested financial regulations.

1.3 Amending the OFD: twenty years of stability

The OFD was adopted more than two decades ago. Given the rapid evolution of the financial markets, it would be reasonable to expect that the definition of capital has evolved beyond the political compromise adopted in late 80s. However, the key provisions of the OFD remain substantially unchanged; only numbering of the key articles is different (see Table 2.2).

Table 2.2: Articles defining bank capital in successive EU directives

	OFD 89/299	CBD 2000/12	CRD 2006/48
General principles (own fund items and deductions)	Art 2	Art 34	Art 57, 58, 61
Conditions imposed on Other Eligible Items	Art 3	Art 35	Art 63
Subordinated loans, preferential shares and cooperatives	Art 4	Art 36	Art 64
Consolidation	Art 5	Art 37	Art 65
Deductions and limits	Art 6	Art 38	Art 66
Provision of proof to competent authorities	Art 7	Art 39	Art 67
Governance of technical amendments	Art 8	Art 60	Art 150-151

The Basel II Accord — transposed to the EU legislation in the 2006 Capital Requirements Directive (CRD) — overhauled the risk weighting mechanisms of Basel I Accord beyond recognition, but it did not amended the definition of bank capital.[28] At the onset of the Basel II negotiations, the redefinition of capital was considered as desirable (Tarullo 2008). However, when the BCBS issued the first consultative paper on Basel II in 1999, it clearly stated that capital definition would be considered separately, after the agreements on the solvency and risk-management were completed (BIS 1999). The debate on the global level was thus postponed until after the Basel II implementation in 2008.

The same is the case for the definition of capital in the EU directives. There were only marginal changes and clarifications. The merger of several banking directives into a single Consolidated Banking Directive (CBD) in 2000 brought changes to the governance arrangements, but otherwise added only one paragraph reaffirming the

[28] Technically, the Capital Requirement Directive consist of two directives - 2006/49/EEA specifies the rules for banks, whereas 2006/49/EEA specifies capital adequacy rules for investment companies and bank's trading books. The CRD references in this Chapter refer only to the bank related part of the CRD (i.e. the Directive 2006/49/EEA).

need to comply with the OFD definition of bank capital.[29] The Capital Requirement Directive adopted in 2006 introduced only two new deductions from own funds that were not particularly contested.[30]

An important amendment of the CRD was adopted in March 2008. Again, it did not affect the definition of own funds, but overhauled the supporting governance arrangements by introducing the Lamfalussy procedure to banking (see Chapter 1). The latest amendment — discussed in section 4 of this chapter — was adopted in September 2009 and introduced changes to the definition of own funds by defining explicit criteria for inclusion of the hybrid capital instruments. This was the first substantive change to the EU definition of own capital in 20 years. In principle, the lasting stability of the own funds definition should be supportive for consistent implementation, but the next section shows that this was not quite the case.

2. Regulatory harmonization: no progress for two decades

The implementation of the EU banking directives has at least two dimensions of interest. In order to accommodate the structural differences and politically contested aspects, the EU financial regulations are codified as directives that need to be formally

[29] Added text in Article 34 (1) stipulated that "wherever a Member State lays down by law, regulation or administrative action a provision in implementation of Community legislation concerning the prudential supervision of an operative credit institution which uses the term or refers to the concept of own funds, it shall bring this term or concept into line with the definition [given in this directive]."
[30] The CRD stipulated that holdings in insurance and reinsurance firms need to be deducted from total own funds. It also required banks to deduct certain amount for specific securitization exposures as well as for expected losses from certain equity exposures.

transposed to the national legislation.[31] The actual implementation that impacts the economic and financial standing of banks takes place only after the transposition. This section briefly reviews studies of both transposition and implementation, to ascertain whether the OFD resulted in regulatory integration — defined as consistent implementation of harmonized EU rules across all member states (see Introductory chapter) — or, to the contrary, regulatory fragmentation that preserved or even deepened the differences in capital definition across the EU.

The stability in the definition of own funds makes the evaluation of the regulatory integration somewhat easier over time, although it still remains a complex technical exercise. The studies of implementation of the Basel Accord in the European Union are dominated by the single-country case studies conducted solely for the policy purposes by the relevant national authorities (see BCBS 1999 for review). However, there were several comparative studies that allow for tracing the convergence or divergence on the EU level. Quillin (2008) compiled a database comparing the pre-OFD and post-OFD definitions of capital in 12 EU countries, which allows for comparison of differences in transposition over time. The European Commission (2000a) compiled an implementation report in 2000, which dealt not only with the transposition, but also the economic significance of the differences in definition of bank capital. Finally, the most comprehensive comparison was prepared by the CEBS during the 2004 to 2007 monitoring exercise requested by the Commission. Together these documents allow for

[31] An alternative would be to codify the rules in a Regulation that is directly applicable to national legislation without prior transposition. Regulations generally reduce the potential for fragmented implementation of EU rules, but are more difficult to agree upon than directives.

tracing of the degree of regulatory integration with regard to bank capital from late 1980s till late 2000s.

2.1 The first decade of the OFD implementation

Quillin (2008) collected the national legislation implementing the OFD in 12 EU states at two points in time. The first comparison was taken at the time of OFD adoption in 1989, whereas the second a decade later. He developed a database of respective provisions in national legislation regarding (i) the Tier 1 definition, (ii) Tier 2 definition, (iii) deductions and (iv) numerical ratios limiting proportions of various classes of assets in total own funds. Subsequently, he coded these provisions on an ordinal scale, where the lowest score (score 1) captures a below-minimum implementation of Basel Accord, the next is minimum implementation score (2), then a reasonably strict interpretation (3), and finally the highly strict interpretation (4). The sum of these scores — ranging from 4 to 16 — provides an index capturing the stringency of the OFD transposition into national legislation (see Table 2.3).[32]

Table 2.3: Pre-OFD and post-OFD index of capital definition

	Tier 1 definition		Tier 2 definition		Deductions		Limit ratios		Total index	
Year	1990	2000	1990	2000	1990	2000	1990	2000	1990	2000
AUT	3	2	3	3	2	2	2	2	10	9
BEL	2	2	3	3	3	3	2	2	10	10
DNK	3	3	3	3	2	2	3	3	11	11
FIN	1	2	2	2	2	2	2	3	7	9
FRA	2	2	3	3	2	2	2	2	9	9
GER	4	3	4	3	2	2	2	2	12	10

[32] Quillin (2008) also codes for the asset risk-weights and conversion factors for off-balance-sheet items, which were, however, codified in the Solvency directive and are thus not relevant for the analysis of the OFD transposition and implementation.

IRL	2	2	2	2	2	2	3	2	9	8
LUX	2	3	4	4	2	2	2	2	10	11
NED	3	3	2	2	2	2	2	2	9	9
SPA	2	2	4	3	2	4	2	2	10	11
SWE	3	3	3	3	2	2	2	2	10	10
UK	2	2	2	3	2	4	2	2	8	11
Mean	2.42	2.42	2.92	2.83	2.08	2.42	2.17	2.17	9.58	9.83
SD	0.79	0.51	0.79	0.58	0.29	0.79	0.39	0.39	1.31	1.03

Source: Quillin 2008

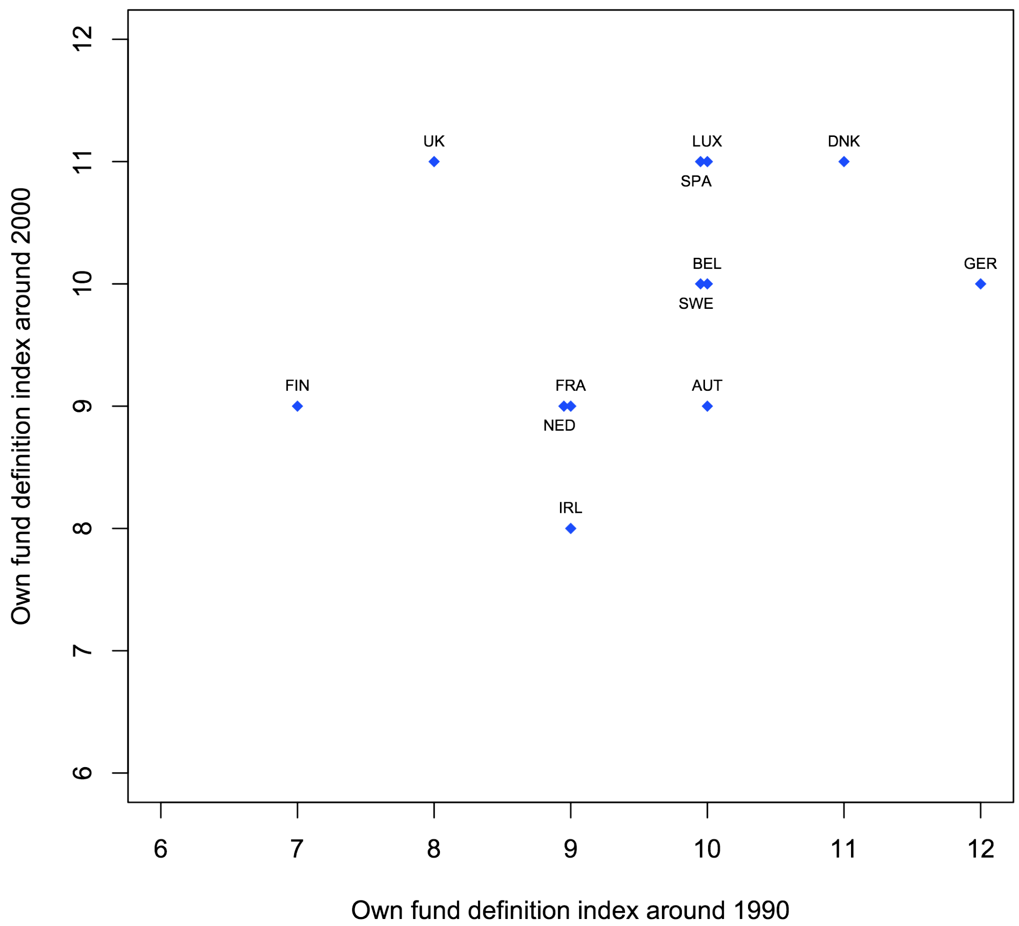
Quillin's data suggest marginal degree of convergence towards more demanding definitions of own funds in the 12 EU countries. All countries, save for Finland,[33] met the minimal OFD requirements already before its implementation date in 1993. By 2000 only Irish legislation transposed the most minimalist interpretation of the OFD and all remaining EU states in the sample progressed beyond the minimum in at least one aspect. Over the decade between the two observations, the mean value of the index has increased by a mere 3 percent, whereas the standard deviation measuring the dispersion from the mean was reduced by some 20 percent. This indicates that there was a degree of convergence in terms of the stringency of the OFD transposition of the definition of bank capital, but nothing close to harmonization.

In terms of the four components of the capital definition covered by Quillin's (2008) data, the EU member states implemented the ratios limiting inclusion of various classes of assets rather consistently at the minimal level required by the OFD with only two countries opting for more stringent regulation at each period of observation. The same applied to the definition of original own funds (Tier 1), where Austria and Germany reduced stringency of their definition, while Finland and Luxembourg tightened theirs.

[33] Finland adopted a broad definition of Tier 1 capital that permitted inclusion of 50 percent of the value of trading assets and investments. These are essentially revaluation reserves that ought to be included in Tier 2 (Quillin 2008:58).

Tier 2 definitions — unsurprisingly, given their role in accommodating conflicting policy preferences — and of deduction remain more dispersed. The deductions also display increasing dispersion, which is consistent with the qualitative evidence in the latter part of this section. Overall, these data suggest that the stringency of transposition of the OFD provisions was not uniform (see Chart 2.1).

Chart 2.1: Own fund definitions in late 1980s and late 1990s



Source: Based on data from Quillin (2008)

The Quillin's (2008) coded database provides a useful proxy for the differences in transposition, but it contains no information on convergence in implementation or the economic significance of these differences. This type of information requires more detailed inquiry such as the First Commission report to the European Parliament and the Council on the implementation of the own funds Directive (Commission 2000a), which provided both quantitative and qualitative assessment of the OFD transposition and implementation.

Table 2.4 captures some of the differences in structure of bank capital across the national banking sectors in the then 15 EU countries. The second and third columns highlight wide dispersion in reliance on different capital items. It shows that, in some countries, some of the eligible items are not utilized at all (minimum at 0 percent), whereas in other countries they form a large proportion of total bank capital. For example, subordinated loans were not used at all in some of the 15 EU countries, whereas in other countries they formed up to 27 percent of capital. Similarly, the hybrid capital instruments classified as 'Other items' under Article 3 (1) and (2) of the OFD, where not used at all in some jurisdictions, while in others they formed up to a quarter of capital, with the EU average at around 7 percent (see also Chart 2.2).

Table 2.4: Own funds composition in EU, end of 1996

Item defined in OFD	Min [%]	Max [%]	Avg [%]
Original own Funds (Tier 1)			
Subscribed capital	11.0	60.0	26.2
Reserves and allocated final results	6.8	76.8	43.4
Funds for general banking risks	0.0	5.9	1.9
Additional own funds (Tier 2)			
Revaluation reserves	0.0	5.6	2.3
Value adjustments	0.0	6.4	1.8
Other items: General provisions	0.0	10.4	1.0
Other items: according to Art 3(1)	0.0	12.1	2.8
Other items: according to Art 3(2)	0.0	13.5	4.1
Commitments of members of cooperatives	0.0	2.9	0.6

Fixed term cumulative preferential shares	na	na	na
Subordinated loan capital	0.0	27.0	15.8
Deductions			
Own shares	0.0	0.6	0.1
Intangible assets	0.0	10.3	1.8
Material losses	0.0	4.3	1.1
Holdings in other financial institutions (over 10%)	0.0	3.8	1.3
Holdings in other financial institutions (under 10%)	0.0	4.6	1.0

Note: The minimum and maximum in columns 2 and 3 refer to the aggregate figures for the whole banking sector. A zero in the minimum column means that the given capital items is not used at all in at least one EU country.

Source: Compiled from Commission (2000a)

Although some of the differences in the composition of bank capital are economically justified as they reflect different bank business models across and within each economy, more often the bank preferences for different capital items stems from differences in national accounting and taxation regimes (Commission 2000a, CEBS 2007b). The economic parameters of different capital items in individual EU jurisdictions differ, which inevitably fragments the single market in banking. Moreover, it creates legal uncertainty for cross-border banks that cannot issue the same type of capital in all EU countries. Furthermore, the differences in definition create incentives for regulatory arbitrage within the single market, which may trigger the 'race to the bottom' as EU financial centers try to attract more banking business by offering the less stringent regulatory requirements. Banks headquartered in jurisdictions that allow for lower quality of own funds benefit from the lower cost of capital and thus seemingly higher returns on equity. At the same time, the depositors are not equally protected from adverse shocks, when the composition and quality of capital differs materially across jurisdictions. Some of the qualitative differences observed during the late 1990s are summarized in the Table 2.5, which also notes the differences with the original Basel Accord.

Table 2.5: OFD implementation and comparison with the Basel Accord

Item	**Implementation experience by 2001**
Original own funds (Tier 1)	
Subscribed capital	Transposed by all MS, but some EU supervisors accepted cumulative preference share structures as Tier 1 capital, despite their exclusion in BA. Moreover, not all EU states adopted the 15% limit on inclusion of hybrid instruments. Subscribed capital is relatively low in E, NL, A and SW.
Reserves and allocated final results	Transposed by all MS, but only 12 of them use the OFD discretion to include interim profits (B, DK, E did not). MS accepted Commission interpretation that interim profits need to be audited externally, although some initially accepted internal audit as sufficient.
Funds for general banking risks	Transposed by all MS without problems. Although this item is unique to OFD and not explicitly included in BA definition of Tier 1, it fully complies with BA conditions for inclusion of provisions into capital.
Additional own funds (Tier 2)	
Revaluation reserves	Most MS allow for inclusion of revaluation reserves generated from tangible fixed assets. The OFD is more lenient than BA, which applies 55% discount to such items.
Value adjustments	Although recognized in most MS, they only play significant role in B, D and L. Not included in BA, but comply with BA conditions for inclusion of general provisions and general loan-loss reserves.
Other items: General provisions	Many of these items are closely linked to the particularities of national accounting systems MS interpretations of this provision differ to some extent. Majority of MS favored exclusion of Art 3(1) items, but there was no consensus so the Commission proposed application of discount factor of 55% as envisaged by BA. B, DK, EL, NL and FIN did not adopt the "other items" based on Art 3(1). The hybrid capital instruments - that are attractive to banks due to their cost-effectiveness and tax-efficiency - tend to be included under other items.
Other items: according to Art 3(1)	
Other items: according to Art 3(2)	
Commitments of members of cooperatives	Adopted only by D, NL and A, where there are cooperative banks. The BA was intended for large international banks and thus does not include this provision.
Fixed term cumulative preferential shares	These shares are attractive due to their cost-effectiveness and tax-efficiency. They cannot be included in Tier 1, unless truly non-cumulative. 11 MS allow them for Tier 2, although DK, F, I and A do not allow them at all. BA lists these items as "hybrid debt capital instruments" and it is one of the most debated items in both EU and G10.
Subordinated loan capital	This is one of the most significant capital elements and OFD stipulates clear conditions regarding its maturity and

	discounting during the last 5 years. Although the OFD does not specify a fixed discount rate of 20% p.a. as BA, most MS make the discounting subject to supervisory agreement.
Deductions	
Own shares (from Tier 1)	OFD is stricter than BA, which does not include this deduction, which has been transposed by all MS without particular problems.
Intangible assets (from Tier 1)	Transposed by all MS and implemented without substantial problems. OFD is stricter than BA as it requires deduction of both goodwill and formation expenses.
Material losses (from Tier 1)	OFD is stricter than BA, which does not include this deduction, which has been transposed by all MS without particular problems.
Holdings in other financial institutions (over 10%)	Implemented in all MS, although B, D, EL, L, FIN and UK implemented a temporary waiver for financial assistance in case of holding of over 10% and A, D, EL, FIN, IT, SW implemented waiver for credit institutions include in consolidated supervision. The OFD is more lenient than BA, which excludes bank's holdings of capital issued by other banks.
Holdings in other financial institutions (under 10%)	

Notes: BA stands for the 1988 Basel Accord, MS for member state. Country codes: Austria (AT), Belgium (BE), Bulgaria (BG), Cyprus (CY), Czech Republic (CZ), Germany (DE), Denmark (DK), Estonia (EE), Greece (EL), Spain (ES), Finland (FI), France (FR), Hungary (HU), Iceland (IC), Ireland (IE or IR), Italy (IT), Liechtenstein (LI), Lithuania (LT), Luxembourg (LU), Latvia (LV), Malta (MT), Netherlands (NL), Norway (NO), Poland (PO), Portugal (PT), Romania (RO), Sweden (SE or SW), Slovenia (SL), Slovakia (SK), United Kingdom (UK).

Source: Summarized from Commission (2000a).

The stated goal of Commission's report was to "describe and assess the way in which the provisions of this Community text have been implemented as well as to present possible measures to be taken at European Union level in order to achieve a more harmonized definition of own funds to prevent distortions of competition and reinforce the strength of the European Union banking system with the ultimate benefit for consumer confidence and security" (Commission 2000a:2). The report was, however, stronger in describing the divergence than suggesting reforms. It concluded that due to the cost advantages often based on favorable tax treatment of hybrid capital instruments, banks have an incentive to replace permanent subscribed capital with new hybrid instruments of lower quality. The Commission went on to argue that the capital base — especially the Tier 1 capital — should not be weakened even if the OFD "may not appear to explicitly exclude those instruments from being recognized as own funds" (Commission 2000a:26). The report suggested two measures for greater harmonization. First, if member states have doubts regarding the eligibility of certain “hybrid” capital instruments, they should discuss them in the appropriate EU forum. Second, to adopt a maximum limit on the inclusion of hybrid instruments into own funds at the 15 percent of Tier 1 capital, as suggested by the BCBS in October 1998. However, no legislative proposal resulted from this exercise due to unresolved conflicts of policy preferences over the eligibility criteria for hybrid capital instruments that is discussed later in this chapter.

2.2 The second decade of the OFD implementation

The next EU initiative aimed at harmonization of own fund rules took place only in 2004 when the Banking Advisory Committee issued a call requesting a technical advice on the definition of own funds from the newly established Committee of European Banking Supervisors (see Chapter 1). The CEBS report, published in 2006, reaffirmed the findings of the original report published in 2000. It identified the differences in treatment of hybrid capital instruments as the most important source of regulatory fragmentation (CEBS 2006b).

Some member states accepted hybrid instruments as original own funds (Tier 1) on the grounds that they have similar characteristics, while others did not recognize them at all. The CEBS survey identified 13 economically relevant characteristics of hybrid instruments that can be combined differently in order to maximize comparative advantages arising from specific domestic legal and taxation regimes.[34] Inevitably, this category of capital included vastly different instruments. some of which were close to common equity, while others represented capital of poor quality. Formally, supervisors were expected to follow BCBS recommendations from October 1998 that defined 11 eligibility conditions and imposed a 15 percent limit on hybrids included in Tier 1 capital. As any other BCBS standard, this recommendation was non-binding and member states interpreted it differently. The Table 2.6 reveals that the new member states did not accept hybrid capital almost at all, and, while the old EU members accepted them, they imposed very different quantitative limits on different types of hybrids.

Table 2.6: Maximum supervisory limits on Tier 1 hybrids

	Hybrids with step up (incentive to redeem)	Hybrid limit excluding non-cumulative preference shares	Limit on non-cumulative preference shares
CZE	0	0	0
EST	0	0	0
LAT	0	0	0
POL	0	0	0
SLK	0	0	0
ROM	0	0	0
BUL	0	0	0
MLT	15	0	0
DNK	15	15	0
LUX	15	15	0
FRA	15	25	0
GER	15	50	0
SPA	15	30	30
BEL	15	33	30
LIT	0	0	33

[34] These characteristics include seniority, voting rights, convertibility, dating, call, step-up, principal write down, cumulation, suspension of payments, coupon payment, limits on principal stock settlement, issuance vehicle, currency denomination (see CEBS 2007b).

SLO	15	15	49
ITA	15	15	50
UK	15	15	50
POR	20	20	50
AUT	15	30	50
FIN	15	33	50
NED	15	50	50
HUN	0	15	100
CYP	15	15	100
SWE	15	15	100
GRE	15	30	100
IRL	15	50	100

Sources: Compiled from CEBS (2007a) and Commission (2008)

When member states recognized hybrid instruments as eligible, many of them complied with the 15 percent limit recommended by the BSBC in 1998. However, the differences are greater for the total volume of hybrid instruments eligible as own funds. The differences in the limits are economically significant for two reasons. Firstly, they provide potential competitive advantage to banks based in some countries that is not available in other countries. Secondly, the differences may undermine the quality of bank capital. The Table 2.7 illustrates the general trend within the EU to replace the higher quality Tier 1 capital with the lesser quality Tier 2 capital, observable during the decade from 1996 to 2006.

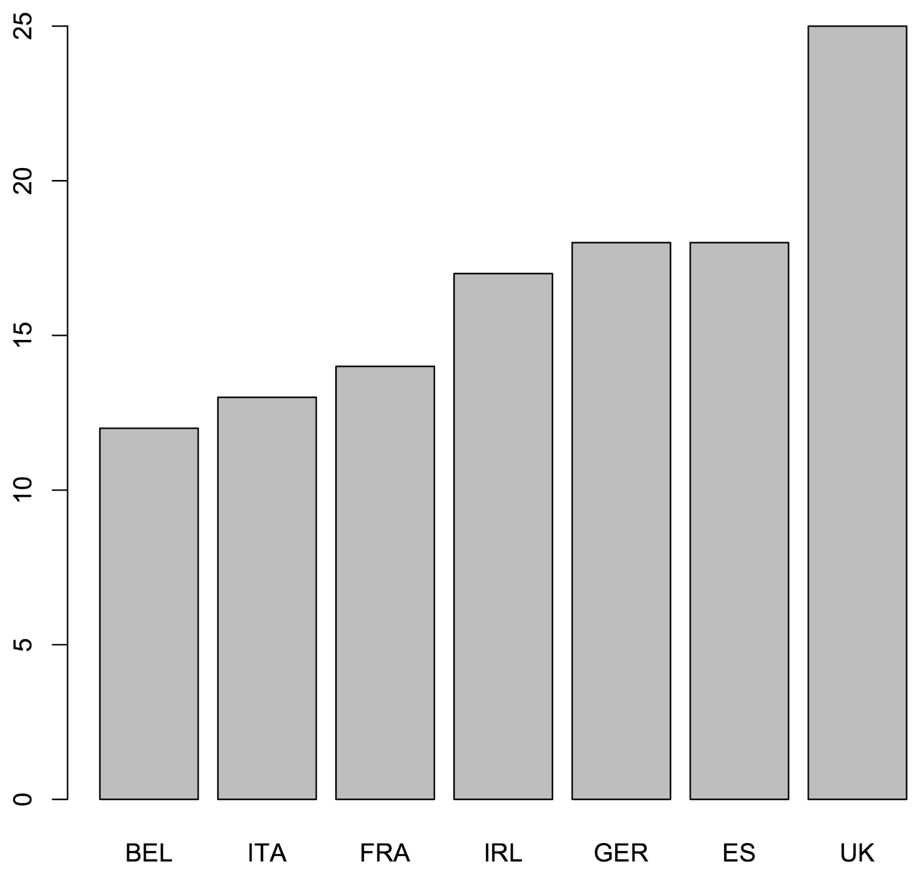
Table 2.7: Own Fund composition 1996 vs. 2006

	1996	**2006**
Original own Funds (Tier 1)	71.5	64.0
Additional own funds (Tier 2)	28.4	34.0
Deductions	(5.3)	(7.4)
Ancillary Own Funds (Tier 3)	Not relevant	2

Source: Data for 1996 compiled from the Commission (2000a) and for 2006 from CEBS (2007b).

The numbers on own fund composition, however, mask the increasing proportion of hybrid capital in the Tier 1, which was, furthermore, concentrated within banking sectors of 8 EU countries. At the end of 2006 their volume was approximately €213 billion, which was 11.5% of total own funds of all surveyed EEA banks. Moreover, 89 percent of the issued hybrid capital concentrated in eight EU jurisdictions - the UK, Germany, Spain, France, the Netherlands, Ireland, Belgium and Italy (CEBS 2007b). In these countries, on average 18 percent of Tier 1 capital consisted of hybrid instruments (see Chart 2.2).

Chart 2.2: Hybrids' share of original own funds (Tier 1) in EU countries with most hybrids



Source: CEBS (2007b)

The CEBS surveys of the OFD implementation (CEBS 2006b) and its quantitative analysis of eligible own funds (CEBS 2007b) provided a very detailed and comprehensive picture of the differences in implementation of own fund rules across member states. They confirmed the findings of the earlier reports on OFD implementation: it was not consistent across the member states. The problem was not only the absence of any further harmonization of the formal definition of the Tier 2 capital, but even the supposedly harmonized Tier 1 capital rules were implemented in increasingly diverging manner.

All the assessments of the OFD transposition and implementation clearly demonstrated that the two-tiered compromise definition preserved the differences in bank capital composition and did not provide the legislative grounds to prevent divergent approaches of member states to the increasingly important hybrid capital items. Banks utilized all the flexibility to preserve competitive advantages provided by the national financial and taxation laws and innovated the design of hybrid instruments to create new advantages. The OFD implementation clearly did not result in harmonization, as the regulatory framework remained fragmented and suffered from new sources of fragmentation. On this basis, the European Banking Committee concluded that different rules on hybrids "raise level-playing field issues for credit institutions and opportunities for regulatory arbitrage; it has an impact on the structure and quality of own funds and it may create significant competitive (dis)advantages in the market, not just between Member States but also cross-sectorally between credit institutions and insurance entities" (EBC 2006:5).

2.3 Financial crisis and bank capital

The economic risks inherent in the prevailing fragmentation were revealed in the 2007 to 2009 financial crisis. Although, by far, the most important problem was that many banks simply had way too little capital given the amount of risks they accumulated during the pre-crisis boom, the composition of capital mattered as well. The empirical research linking the differences in capital composition to differences in bank performance during the crisis is only starting to emerge. There are no EU-specific studies, but analyses using multi-country bank-level data clearly suggests that the composition of bank capital made a difference. Demirguc-Kunt et al. (2010) find that, although before the crisis differences in capital did not have much impact on stock returns, during the crisis, a stronger capital position was associated with better stock market performance (and thus the survival chances) especially for larger banks. Moreover, the higher quality forms of capital, such as Tier 1 capital and tangible common equity were more important. This suggests that in stress situations the financial markets evaluate the composition of capital and put a premium on the high-quality capital. The banks that relied on hybrids and national regulatory regimes that were permissive towards hybrids learnt that many hybrid instruments were poor loss absorbers (Resti and Sironi 2010). Indeed, Buehler et al. (2010) concluded that the low level of the high-quality capital — measured as tangible common equity — to risk-weighted assets at the onset of the crisis was the single strongest predictor of bank distress during the crisis from among all commonly measured capital ratios. This experience shows that the capital composition and the rules that influence it, never ceased to be an important policy issue.

Inevitably, the crisis put the definition of capital on the global and EU regulatory agenda. In September 2009, the G20 committed to developing "rules to improve both the quantity and quality of bank capital and to discourage excessive leverage . . . with the aim of implementation by end-2012 … [that would include] higher level and better quality capital requirements" (G10 2009). This commitment was based on the BCBS document noting that crisis revealed "the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that [prevented] the market to fully assess and compare the quality of capital between institutions" (BIS 2009:5). Thus the gist of the global and EU reforms of capital definition will be reinforcing the role of common shares and retained earnings in Tier 1 capital, phasing out some of the innovative hybrid capital instruments in order to simplify and harmonize the definition of capital and introducing additional prudential deductions (BIS 2009, Commission 2010a). This response to the crisis only confirms that lack of harmonization of bank capital rules across the EU and internationally undermined financial stability during the pre-crisis period by inducing banks to replace expensive high-quality capital, with cheaper low-quality capital items.

The renewed attention to the bank capital definition emphasized the paradoxical effect of the increasing use of hybrid instruments. Two decades after the beginning of international policy coordination on global and EU levels, some banks could have as little common equity as in the early 1980s. At the onset of Basel I negotiations, the US banks complained bitterly that their Japanese and European (particularly French) competitors could undercut them because their capital ratios were as low as 2 percent

(Kapstein 1994, Quillin 2008). In 2009, the BCBS pointed out that the Basel II rules allowed banks to "hold as little as 2 percent common equity to risk-based assets" (BIS 2009:2). The remaining 6 percent to the required 8 percent limit was lower quality Tier 2 and Tier 1 hybrids. In a way, the financial regulation came full circle, when the achievements of the regulatory harmonization were eliminated by financial innovation not adequately constrained by the prevailing regulations.

3. Governance structures: from generic comitology to EBA

This section describes the evolution of the EU level governance arrangements supporting adoption and implementation of the OFD between mid-1980s and mid-2000s. In order to ascertain the role of the evolving governance arrangements in regulatory harmonization, as the first step, we need to understand how they evolved and differed. The evolution of the respective adoption and implementation procedures is summarized in the Table 2.8.

Table 2.8: Decision procedures and decision bodies in banking regulation

<table>
<tr><th>Decision</th><th colspan="3">Bodies involved in the decision-making and implementation; applicable decision procedure</th></tr>
<tr><td></td><td>OFD 1989</td><td>CBD I 2000</td><td>CRD II 2006</td></tr>
<tr><td>Global level</td><td colspan="3">Basel Committee on Banking Supervision sponsored by G10</td></tr>
<tr><td>Level 1: framework directive proposed by the Commission</td><td colspan="2">Council; qualified majority
European Parliament in cooperation procedure</td><td>Council; qualified majority
European Parliament in co-decision procedure; majority</td></tr>
<tr><td>Level 2: implementing measures</td><td>Council; qualified majority (1989 – 1993)</td><td>Banking advisory committee - regulatory committee; unanimity (1993 – 2005)</td><td>European Banking Committee - regulatory committee with scrutiny; qualified majority</td></tr>
<tr><td>Level 3: consulting, drafting and monitoring</td><td>Commission and Banking advisory committee; unanimity</td><td>Commission and Banking advisory committee; unanimity</td><td>Committee of European Banking Supervisors (CEBS); unanimity</td></tr>
<tr><td>Level 4: monitoring and enforcement</td><td colspan="2">Commission and ECJ</td><td>Commission supported by CEBS; ECJ</td></tr>
</table>

Note: The distinction among levels derives from the structure of Lamfalussy procedure explained below and in Chapter 1.

On the global level, the G10 sponsored Basel Committee on Banking Supervision (BCBS) — which includes 8 EU members and lately also the ECB and Commission as observers — negotiates the voluntary international banking standards.[35] On the EU level, the banking directives are adopted by the community method as applicable to the single market legislation, whereby the Commission makes proposals and the Council adopts them either by consensus or qualified majority. The role of the European parliament evolved during the studied period from mere consultative one to full co-decision rights that put the EP on par with the Council not only during the

[35] The Committee's members include Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, United Kingdom and United States. The European Commission (Internal Market DG) and the ECB participate as observers. The BCBS meet four times a year at BIS in Basel that also provides a secretariat.

legislative phase, but also in its role of supervising the committees who were delegated implementation powers on Level 2 of the Lamfalussy procedure (see below).

The OFD was unique among the 3 single market banking directives as it did not include any delegation of powers from the Council to the Commission and its comitology committees when adopted in 1989. This contrasted with the Second Banking Directive and Solvency Directive that delegated technical adaptations powers to the Commission and its Banking Advisory Committee. However, this anomaly was corrected already in 1991 with the first OFD amendment. By their implementation deadline in 1993, the governance mechanism was the same for all three directives. This was reinforced in 2000 when the three directives were consolidated into a single text and the unified governance mechanism was applicable to all of them. The Banking Advisory Committee would play an increasingly important role in OFD implementation; even more so after being transformed into the European Banking Committee (EBC) by the Lamfalussy reform in 2004. This reform also transformed the lower level supervisory cooperation by creating the Committee of European Banking Supervisors (see Table 2.9 for a summary).

Table 2.9: Evolution of the OFD governance arrangements

Year	Applicable governance arrangements
1989	No governance arrangement beyond the generic monitoring by the Commission
1992	Banking Advisory Committee given a comitology role for technical adaptations
2000	Governance of banking directives consolidated by CBD with central role of BAC
2005	Lamfalussy reform extended to banking with central role of EBC and CEBS
2010	European Banking Authority replaces CEBS*

Notes: BAC - Banking Advisory Committee of the European Commission; CRD - Capital Requirements Directive; EBC - European Banking Committee, CEBS - Committee of European

Banking Supervisors. * Transformation of CEBS to EBA from 2011 is beyond the empirical scope of this chapter.

As argued in the next section, the capacity and accountability of these committees may matter in the adoption and implementation of the contested EU financial regulations. It may be an important determinant of the EU's capacity to progress beyond the status quo — towards more harmonized and more consistently enforced regulatory framework despite the continued contestation. Before addressing this question, it is useful to summarize the evolving nature of the comitology mechanism as applicable to the banking regulation since 1989 till 2009.

3.1 Banking committees

The Banking Advisory Committee (BAC) was attached to the European Commission since it was established in 1977 under the First Banking Directive. It was operational till 2005, when it was replaced by the European Banking Committee, which was in turn replaced by the European Banking Authority from 2011. The BAC comprised of high level representatives of member states' banking supervisory authorities, finance ministries, and central banks, and was chaired by elected representative. The BAC's primary role was to assist the Commission in preparing legislation for the supervision of the EU banking sector, and to give advice on any other issue concerning banking regulation and supervision in the EU. On these affairs, it acted as a consultation channel between the EU and national levels.[36] The BAC issued a formal opinion on any proposal for EU banking legislation that was transferred to the internal market

[36] The BAC also advised the Commission in negotiating co-operation and information exchange agreements between EU and third countries.

commissioner responsible for EU banking regulation.[37] The BAC also acted as a regulatory committee under the 'comitology' procedure and — where specified explicitly in the directives — had the competence to amend technical provisions by means of a Commission directive.[38] The BAC did not discuss issues relating to individual banks, which is a domain of the 'Groupe de Contact' (GdC).

The GdC was the first EU committee concerned with banking supervision. It was formed in 1972 by mid-management banking supervisors of the member states, who were involved in the day-to-day supervision of banks. Although its role was acknowledged in EU banking directives, it was not formally attached to any of the EU institutions. The GdC served as a forum for the exchange of confidential information on individual cases relevant to banking supervision. The GdC reviewed developments in members' supervisory systems and it discussed and prepared comparative reports from the perspective of banking supervisors on supervisory and regulatory issues. The GdC became one of the working groups of the Committee of European Banking Supervisors in 2005.

The Banking Supervision Committee (BSC) of the European System of Central Banks was set up in 1998, although it existed as a committee attached to the European Monetary Institute since 1994. The BSC comprises high level representatives of Member States' banking supervisory authorities and central banks, and is chaired by a representative of a national central bank. Its main task is to assist in a conduct of

[37] The Commission noted that it has never proposed any banking legislation that would not gather majority support in the BAC (Commission 2000b).
[38] The comitology committees may not issue any legislative decision directly; it must always be adopted formally by the Commission (see Chapter 1).

supervisory and financial stability policies, especially on a macro-prudential level. The committee reviews evolution of the banking and financial systems and promotes cooperation between the Eurosystem and banking supervisors by preparing the ECB's opinion and proposals on EU and national banking legislation. The BSC also examines developments or incidents in the EU banking systems of systemic relevance and their implications.

The above committees assist the Commission, the Eurosystem, and national supervisors in coordination during the legislative and implementation processes specifically related to banking. Their less specialized counterpart in the European Council is the Economic and Financial Committee that handles the broader work related to the economic and financial situation, the euro exchange rate, and relations with third countries and international institutions. It also manages the dialogue between the Council and the European Central Bank. In response to the growing financial regulation agenda, the ECOFIN Council composed of EU finance ministers, set up a Financial Services Committee (FSC) in 2003 to oversee cross-sectoral issues, prepare longer-term strategy, assess implementation, and provide political advice on single market financial regulation and external issues related to G10/20 or WTO. On the side of the European Parliament, the banking regulation agenda is dealt with in the Economic and Monetary Affairs Committee. However, these committees play primarily procedural and political roles during the legislative process, whereas those associated with the Commission (i.e. BAC, GdG and later also BSC) tend to review the implementation and draft the substantive proposals (see Chart 2.3).

3.2 Setting up the comitology procedure

The Commission included a comitology provision in its 1986 OFD proposal; however, it became a source of a policy dispute among the Council, Commission, and European Parliament. They all agreed that technical adaptations were necessary in order to (i) ensure uniform application, (ii) to take account of the relevant developments on the financial markets, and to (iii) bring the OFD definitions in line with that of subsequent directives on financial regulation (Commission 1989c:5). However, there was a disagreement over the adequate comitology procedure (see Chapter 1 for the overview of these alternatives). The European Parliament argued for the management committee, the Commission proposed the Banking Advisory Committee[39] to act as a regulatory committee, but the Council refused any delegation. It was concerned that technical adjustments could undermine carefully crafted political compromises and thus decided to stay in full control.[40] The OFD stipulated that even the most minutiae technical adjustments were to be adopted by a qualified majority in the Council on the basis of the Commission proposal.

The Council was uncertain whether the departures from the Basel Accord would not be questioned in the BCBS. Especially, the inclusion of the general banking reserves in the Tier 1 capital, which France failed to secure at G10, but succeeded in the EU, was a

---

[39] The directives typically do not refer to a specific committee, but describe its composition. The BAC is legally and technically a separate committee, but its composition matches the prescription of the Second Banking Directive and some of the related directives. In practice thus the BAC changes its chairmanship in its meetings to permit the Commission to assume the chair and acts and adopts the opinion of the technical adaptations (Commission 2000b). As a short hand, we refer directly to BAC, which was the envisaged committee in the Commission's proposal of OFD.

[40] The coordination procedure applicable at the time, did not guarantee full co-decision rights to the European Parliament, thus the Council could overrule EP's amendments as it happened with the OFD comitology.

source of uncertainty.[41] Nonetheless, the BCBS members did not raise the issue, thus the Commission resubmitted its earlier proposal and Council adopted it in March 1992 (Council directive 92/16). Powers to issue technical amendments were delegated to the Banking Advisory Committee which aligned the OFD comitology with the Second Banking Directive, Solvency Directive. The role of the BAC was solidified in 2000, when all three banking directives were consolidated into the Consolidated Banking Directive (2000/12/EEA or CBD). The BAC mandate included the preparation of new proposals, clarification of delegated definitions in response to financial markets developments, information exchange and handling of various exemptions.

3.3 Lamfalussy reform

The governance arrangements in banking worked reasonably well in comparison with insurance or investment services (Lannoo 2005, Interview 6). Therefore, the Lamfalussy procedure was extended to banking only in 2005, after its review concluded its effectiveness in supporting regulatory integration in securities regulation (see Chapter 1). In banking, the Level 2 is inhabited by the European Banking Committee (EBC) that is responsible for the adoption of the implementing measures based on the mandate specified in the Level 1 framework legislation and the Committee of European Banking Supervisors charged with strengthen the consistency of the day-to-day enforcement of securities regulations.

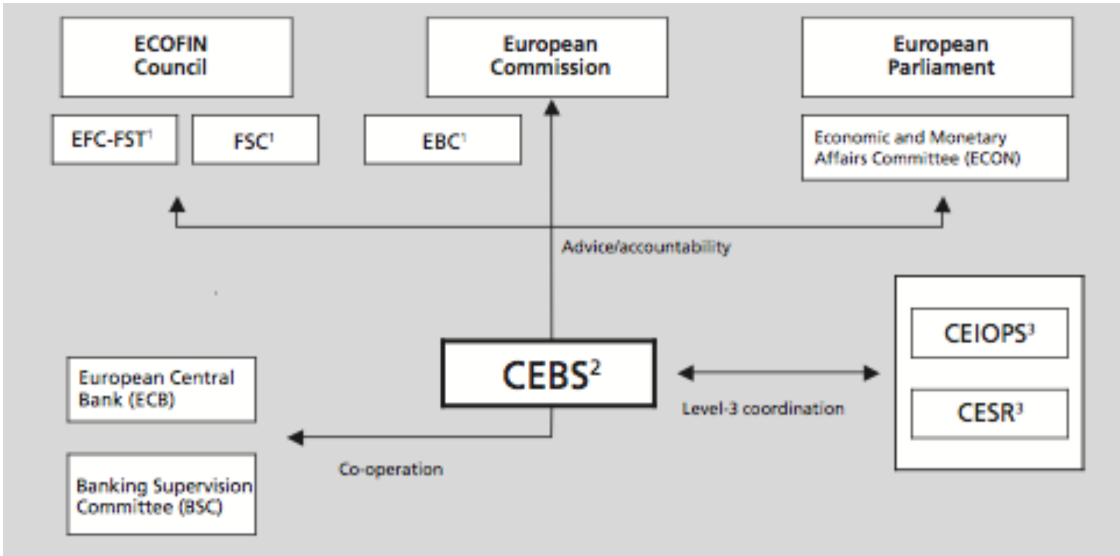
[41] Article 6 (2) of the OFD noted that general banking reserves were included only provisionally and that the Council would decide on their inclusion either as Tier 1 or 2 capital by mid-1994.

The European Banking Committee (EBC) is formally a 'regulatory committee with scrutiny' that replaced the Banking Advisory Committee. It provides advice for the Commission on policy issues related to banking activities from the vantage points of member states. The EBC was also delegated powers in order to adopt implementing temporary responses to narrowly specified economic circumstances and statistical reporting, (Article 150 (2) of CRD as of April 2006) which were gradually expanded by subsequent amendments. The Committee is composed of high-level representatives from member states — mostly from ministries of finance — and observers from ECB and CEBS. The EBC is chaired by a high-level representative of the Commission and the secretariat is provided by the Commission. It usually meets three or four times a year and decides on the implementing measures by the same qualified majority formula as the Council.

The single most important change introduced by the Lamfalussy reform was the establishment of the Committee of European Banking Supervisors, which demonstrated higher capacity to contribute towards harmonization and consistent implementation of EU banking rules than the BAC-centered comitology arrangement. Whereas EBC replaced the BAC, the CEBS took over the activities previously in the domain of the GdC and various working groups of BAC (see section 4.1). Formally, CEBS was an advisory committee to the Commission and to the EBC with no binding powers of its own. However, its capacity to resolve or work around decision-making deadlocks turned it into a driving force for the little harmonization of the own funds definition observed during the 1989 to 2009 period. The comparatively higher capacity of CEBS was rooted in: (i) explicit mandate that included both regulation and supervision roles,

(ii) more accountable framework for working groups, (iii) independent expert and financial resources.

Chart 2.3: CEBS[1] position in the European context



Notes: 1- consists of representatives of ministries of finance, 2- consists of representatives of supervisors and central banks, 3- consists of representatives of supervisors, EBC - European Banking Committee (Level 2), EFC - Economic and Financial Committee of the Council (FST - Financial Stability Table), FSC - Financial Services Committee of the ECOFIN Council, CEIOPS - Committee of European Insurance and Occupational Pensions Supervisors (Level 3 in insurance), CESR - Committee of European Securities Regulators (Level 3 in securities)

Source: CEBS (2005:8)

The CEBS received the mandate to improve EU financial market regulation and was charged with three specific tasks: (i) to provide advice to the Commission on EU legislation in the banking sector, (ii) to contribute to consistent implementation of EU legislation across the EU, and (iii) to promote convergence of supervisory practices, foster co-operation between supervisors and support evolution of common supervisory culture across the member states (CEBS 2005:3). The CEBS was expected to draft and comment on possible amendments of banking directives to be adopted on Level 1 as well as implementation measures adopted on Level 2. On its own, it could issue guidelines, recommendations, and standards that member states were expected to adopt on a voluntary basis. It could also mediate possible differences among national authorities, although it could not issue any binding decisions.

The decision-making in BAC was dominated by representatives from national ministries of finance and national supervisors played secondary role. The latter acted largely as advisors and also carried out most of the work in BAC working groups (interview 1). These groups operated on the basis of largely informal mandates and the BAC was not obliged to consider their recommendations in its decision-making or pass them on to the Commission. Under the Lamfalussy arrangements, representative of ministries and supervisory authorities are institutionally separated in to EBC and CEBS respectively. The separation increased the influence of supervisors over implementation measures on Level 2 as well as on directives on Level 1, because they now formally submit advice both to the EBC and the Commission. An increased role of supervisors shifts the attention from the issues adoption of new regulations — that traditionally dominated BAC agenda — to implementation. The supervisors are responsible for day-to-day enforcement of EU regulation and thus they are naturally more concerned with implementation than the ministries that tend to protect the existing national arrangements, especially if they provide some form of competitive advantages to national banks (interview 1). Therefore, a separate mandate for CEBS strengthened to role of supervisors and resulted in rebalancing of priorities towards implementation.

The second effect of the Lamfalussy reform was increased accountability of CEBS and its working groups. Whereas BAC's working groups were accountable only to BAC, their CEBS equivalents were effectively accountable to the European Parliament, the Council and the European Commission through the CEBS' annual work program. CEBS was obliged to present its prioritized annual agenda and subsequently evaluate its achievements in annual report. Even more important accountability mechanism — that was non-existent under BAC — stems from the open and transparent consultation process. The CEBS mandate requires it to publish all consultation documents and seek feedback from financial industry and other stakeholders at every stage of the policy process that starts with concept releases and consultative papers and progresses through public hearings and roundtables to written, internet-based consultations, with formal summaries of the feedback. All resulting documents are made public.

The BAC consultations included a narrow circle of national supervisors and ministry representatives in behind-the-scene debates. Such settings made it easier to postpone repeatedly decisions on the most contested aspects of the banking regulation. It was much easier to let such issues fade away from the active policy agenda. This is not so easy under the CEBS arrangements. If there was an explicit disagreement that prevented further progress on harmonization, then the CEBS would have to disclose it when justifying its failure to reach common position. This reduced likelihood of deadlocks, unless the member state representatives perceived the conflict as vital and were willing to state it publicly.

The external accountability of CEBS provided the decision-making and monitoring system with credible deadlines. As a seasoned national representative who served both in BAC and CEBS observed:

> "Experts can discuss any disputed issue endlessly. National representatives, who oppose harmonization, because of its impact on domestic banks, can always argue that it would be better to [address the disputed issue] later. However, this became more difficult with CEBS" (interview 1).

The improved consultation process not only made CEBS more timely, but also more credible. It no longer represented just a sum of the national views, but also the comments of the industry and other stakeholders. This made it harder to ignore on both Level 1 and 2, thus increasing the likelihood that if CEBS can propose a compromise on further harmonization, then dissenting member states would not block it.

The credibility of CEBS proposals was further enhanced by its own expert capacity. Like BAC and its working groups, the CEBS and its task forces relied on the work of experts made available from the national supervisory authorities. However, the CEBS came closer to having its own expert capacity, because more than a dozen national experts were seconded to its London bureau on a long term basis.[42] Therefore, CEBS had its own expert capacity to consider a genuinely European view transcending the simple collection of national views. Whereas the BAC secretariat was merely an administrative body coordinating cooperation of national experts, the CEBS bureau had its own policy formulation capacity. Moreover, the intensity of interactions within

[42] Unlike BAC, CEBS has independent budgetary resources collected from membership contributions. It spends more than 50% of its budget on secondment fees in order to create its own expert capacity (CEBS 2009a:68).

CEBS networks increased considerably. Although, CEBS itself met only three or four times a year — as was the case with BAC — the expert meetings were much more frequent under CEBS (interview 2). During the first 42 months of its operation, there were 260 expert meetings on various issues, which amounts to more than six meetings of international experts a month (CEBS 2007).

A greater role of supervisors in general and a greater role of CEBS experts in particular enhanced their tendency to arrive on workable compromises. The ministry representatives in BAC and EBC tend to be concerned about the competitiveness of banking sectors in their country. When national regulatory specifics provide their banks with some competitive advantage, they are apt to protect them and try to avoid or postpone harmonization (interview 1 and 2). This contrasts with the approach of national supervisors, who also tend to protect their national regulatory arrangements, but they share a common concern for financial stability and are thus more inclined to seek harmonization. This tendency strengthened over time as the role of transnational banks that favor regulatory and supervisory harmonization also increased (see Chapter 4). In short, greater capacity and a greater role of supervisors in EU regulatory debate, ceteris paribus, increases the likelihood of harmonization.

The increased tendency towards a common policy compromise was important because the CEBS remained reliant on unanimous decisions. All Level 3 measures, such as guidelines, recommendations and standards, had to be adopted unanimously - despite the fact that they were not legally binding. If any of the member states decided not to apply these measures, they could do so, although the CEBS charter obliged the national authority to state their reasons, clarifying in detail the legal, political or technical impediments preventing the application (CEBS 2009a). This provision is designed to increase the peer pressure on dissenting countries, however, in practice, there was no dissenting non-application so far. Instead, CEBS goes at length to find some extraordinarily complex, but unanimously acceptable compromises (interviews 2). The only type of decision that CEBS could take by qualified majority is the advice to the Commission, although its charter emphasizes that it needs to strive for consensus before resorting to a vote (CEBS 2005).

Table 2.10: Summary of differences between BAC and CEBS working groups

	BAC	**CEBS**
Mandate	Undisclosed internal mandates driven by the regulatory agenda of ministry representatives	Public mandates driven by supervisory focus on consistent implementation
Accountability	Internally accountable to BAC only; most policy outputs not in the public domain	Externally accountable to the Commission, Council and EP through work program and annual reports; all policy outputs are public and consulted with stakeholders
Resources	Fully dependent on national authorities; only administrative secretariat	Independent budget from membership fees; in-house expertise with EU-wide view, relying on seconded staff

To summarize, the key difference between the generic BAC-based comitology arrangements and Lamfalussy process was the central role of CEBS. Although CEBS did not invite any new actors to the policy-making process, it increased the role of supervisory authorities in the adoption and implementation of EU banking regulation and its most contested aspects. The CEBS developed much higher capacity to analyze and compare regulation and supervision across EU countries and turn this analysis into policy proposals that are extensively consulted with all stakeholders (see Table 2.11). The Lamfalussy reform delegated greater responsibilities to CEBS and provided it with greater resources to support regulatory integration. It also made it more accountable, by imposing more open and transparent operations. How these differences contributed to the process of harmonization of own funds definition is discussed in the next section.

4. Harmonization beyond the 1989 minimum: hybrid capital

The EU adopted the contested rules on bank capital composition through the combination of minimum harmonization and mutual recognition (see Chapter 1). This approach was successfully utilized during the adoption of bank capital definition on both EU and G10 level (see section 2). However, the two-tiered regulatory compromise created limited incentives for convergence, because it allowed for inclusion of nationally-specific capital items, which in turn preserved the differences in capital composition of banks in different EU countries. This approach to regulatory integration also failed to contain a new source of regulatory fragmentation stemming from different national interpretations of the eligibility rules of Tier 1 innovative hybrid instruments (see section 3). Eventually, however, the rules on hybrids became the only contested aspect of the own funds definition that was harmonized during the 1989 to 2009 period. The remaining question is the specific role of Lamfalussy committees in this process.

In 1989, the EU legislators were aware that OFD was a political compromise that provided insufficient degree of harmonization. In recognition of this fact, they included a mandatory review clause in the text of the OFD committing the Commission to report in 1996 on the implementation experience and propose harmonizing amendments by 1998 (Article 2 (2) of OFD). The review clause expressed the EU commitment towards faster harmonization and distinguished the OFD from the Basel Accord that contained no such aspirations. Ultimately, however, this commitment was not honored. The next generation directive — the CRD adopted in 2006 — also contained a review clause committing the Commission to submit harmonizing proposal by 2009 (Article 62 of CRD). The CRD review commitment was met on time; the Commission submitted a harmonizing proposal in December 2008 and the Council with European Parliament adopted it in September 2009.

The review clause seems to be an increasingly popular policy instrument to acknowledge insufficient degree of harmonization of EU financial rules and to create a commitment towards further regulatory harmonization by a set date (see Table 2.12). However, as the experience with the OFD and CRD review clauses demonstrates, the harmonization may or may not happen. What distinguishes the failures and successes of the commitment to harmonization is thus an important policy question.

The remainder of this chapter argues that difference between the failure of the OFD review clause in 1998 and success of the CRD review clause in 2009 can be traced to the differences between the generic BAC-based comitology and Lamfalussy arrangements. Groups of member states held conflicting policy preferences over the hybrid eligibility criteria — especially the fundamental loss absorbency criteria — that proved impossible to reconcile during the earlier attempt and that resurfaced in the latte one. However, the Lamfalussy reform allowed the legislators to delegate the dispute to CEBS, which proved capable of formulating more complex technical compromise. The successful delegation to the lower level technocratic committee was predicated on its increased accountability and capacity. The accountability — to the Commission, Council, and EP through the 'regulatory committee with scrutiny' procedure and to the industry through a transparent consultation process — provided the necessary confidence that CEBS would avoid adopting something clearly damaging to any of the key stakeholders. The capacity to analyze and monitor the implementation — both during the policy formulation and subsequently during the implementation — assured member states and other stakeholders that unexpected consequences would be identified and addressed quickly, without a need to reopen the legislative bargaining on Level 1.

In short, this case suggests that the credibility of the EU commitment to timely harmonization of contested aspects of financial regulation can be enhanced by delegation of powers to technocratic committees. This is predicated on the assumption that the EU legislators — who were previously unable to identify any acceptable policy compromise — deem the technocratic bodies: (i) sufficiently capable to formulate more complex policy compromises than those that seemed achievable on the legislative level and (ii) sufficiently accountable so that political acceptability of their proposals is likely. Without the capacity and accountability, the technocratic bodies on Level 2 and 3 possess no obvious comparative advantage in negotiating an acceptable policy compromise on contested issues. In addition, this case also suggests that the capacity for ongoing monitoring may allow the EU to successfully implement rules that rely on negative, rather than positive, harmonization[43]. Since negative harmonization defines only what is not allowed, it is generally easier to adopt.[44]

4.1 Failed attempt at harmonization: OFD review clause

In order to fulfill the OFD review commitment, the Commission contracted external consultants to review its implementation. However, the report proved difficult to compile, given the level of technical complexity involved in assessment of national transposition, and was submitted with a one year delay. Moreover, when the BAC reviewed its accuracy, a number of member states submitted additional comments (Commission 2000a, BAC 2001). The background report was thus finalized only in 1998. This episode suggests that the analytical and monitoring capacity, per se, may become an important factor in meeting the review clause commitment. Nonetheless, the Commission delayed the further release of the report until the amendment of the Capital Adequacy Directive (93/6/EEC) — which relied heavily on the OFD definition of capital — was adopted in June 1998 (Commission 2000a). The report was finally submitted to the Council and European Parliament only in February 2000, more than four years after the review clause deadline.

[43] The EU's website on better regulation defines positive harmonization as introduction of common standards throughout the EU, whereas the negative harmonization is defined by being limited to the suppression of national rules. The definition is a variation on the Scharpf's (1996) distinction between positive and negative integration.
[44] The reform of hybrid capital rules were concluded only recently, thus the impact of the shift from positive to negative harmonization on actual implementation remains an issue for future research.

The report assessed the way that the OFD provisions were implemented, and presented possible measures to be taken at EU level in order to achieve a “more harmonized definition of own funds to prevent distortions of competition and reinforce the strength of the European Union banking system with the ultimate benefit for consumer confidence and security" (Commission 2000a). Since the assessment relied on the 1996 data, the first recommendation of the report was that the BAC should prepare updated assessment (Commission 2000a:2). The second conclusion was to wait for the outcome of the planned redefinition of bank capital by the BCBS.

The Commission report was discussed in the European Parliament, which concluded that "while there are clearly issues which have arisen in the ten years since the adoption of the Own Funds Directive, notably due to innovation in the financial services sector and the development of new and more cost-effective capital instruments, it seems advisable in view of the ongoing Basel discussions to wait for the results of the regulatory capital review before considering any changes to the framework for own funds" (European Parliament 2001:361). The EP called on the Commission to propose interpretative communication or a revised directive that clarified the rules of inclusion of new capital instruments, but again stressed the need to ensure consistency between the definitions of own funds used in the EU and internationally. Importantly, the EP failed to set a new deadline for the harmonizing proposal that would replace the original deadline of 1 January 1998 stipulated in OFD. In short, the Parliament seconded Commission's suggestion to wait until new definition of capital emerged from Basel.

The postponement of the harmonization proposal was paradoxical for at least two reasons. First, although the EU was more ambitious to achieve further harmonization, by 1998 the EU rules on hybrids were actually less harmonized than the Basel rules. The BCBS agreed on the most elementary rules for inclusion of hybrid instruments into Tier 1 capital and recommended the 15 percent limit in its 'Sydney press release' from October 1998 (noted in section 2.1). However, these recommendations were never transposed into the EU legislation. It remained a non-binding recommendation that EU members interpreted very differently (see section 3.2). Second, the Basel Committee announced already in its first consultative paper issued in June 1999 that "with respect to the definition of regulatory capital, the Committee will maintain at this stage the existing rules as set out in the 1988 Accord" (BIS 1999:12, see also MARKT/1123/99:18). The BCBS did not plan any reform of the rules on capital composition as part of the Basel II reform, therefore, the expectation that it would initiate reforms any time soon was not realistic.[45] The more important factor in the decision to postpone was the continuing conflict of policy preferences among two groups of member states that the BAC report labeled as 'Anglo-Saxons' and 'Continental European' (BAC 2001:18).

The BAC (2001) report captures the conflict with regard to the Tier 1 hybrid instruments. Their most important characteristic is loss-absorption, i.e. ability of the given capital item to incur a loss and thus enable the bank to remain solvent even if distributable reserves are zero. It permits a bank to write off losses without risk of

[45] The BCBS initially intended to complete Basel II negotiations in 2001 and get the new standards implemented from 2004. In practice, they were concluded only in 2004 and the final implementation deadline moved to 2008. Furthermore, the financial crisis shifted the attention of the BCBS to the deficiencies of the Basel II framework, further delaying the discussion on capital definition till 2010.

investors invoking a default and triggering its liquidation. However, two different approaches concerning accounting and legal practices for loss absorption have evolved in the EU. "In the 'Anglo-Saxon' methodology, loss absorption is completed by the possibility for the issuer to defer the payments on innovative instruments whereas under the 'Continental European' methodology loss absorption comes down to a substantial decrease into the capital instrument's face value" (BAC 2001:16). The latter was relied upon in France and Italy, whereas the former was typical for the UK, Netherlands, Germany and Finland. The BAC concluded that "[w]hile the amount of total equity capital is the same under both accounting conventions, it is questionable if the ability to absorb losses on a going basis is as strong under [the Anglo-Saxon] method as under [the Continental European] method" (BAC 2001: 18).

Loss-absorbency is the key purpose of bank capital, and thus its most important characteristic. Yet the two approaches to the assessment of the capacity of hybrid capital instruments to absorb losses proved difficult to reconcile. The 'Anglo-Saxon' countries opposed the stricter approach to loss-absorbency that would constrain fast growing markets of hybrid capital instruments and create a problem with compliance of existing instruments with new conditions. At the same time, countries with a more conservative approach to loss absorbency and those that did not accept hybrid instruments as eligible Tier 1 capital were reluctant to weaken their rules (interview 1). The debates in BAC and its working groups did not produce any compromise that could reconcile the two approaches, and the BAC working group thus concluded that "[e]ven if this item is crucial for the interpretation of the Basel Committee's requirements, the Working Group considers that it is so closely linked to company law that any recommendation on this topic would exceed its mandate" (BAC 2001:19). The group effectively agreed to disagree.[46]

Given the absence of the policy compromise on loss absorbency, the Commission could submit no harmonizing amendment on Tier 1 hybrid capital to the Council and EP. After all the delays and despite all the reports that recommended further harmonization, the OFD review clause commitment was allowed to fall through.

4.2 Successful harmonization: CRD review clause

The Basel II rules were transposed to the EU legislation by means of the Capital Requirements Directive (2006/48/EEA) in 2006. The CRD articles defining the composition of banks' own funds were identical — almost word for word — to the same articles of the OFD adopted 17 years earlier, spare for marginal changes on deductions (see section 2.3). As in 1989, the lack of harmonization was 'flagged' by the review clause in Article 62, which imposed an obligation on the Commission to propose a harmonizing amendment by January 2009.

The review clause with a 2009 deadline was included already in the first Commission proposal submitted in July 2004 (COM(2004) 486 final). The Commission called on CEBS to prepare the necessary background analysis, including a survey of implementation of own funds rules, qualitative and quantitative analysis of new capital

[46] The BAC working group proposed that "[p]rovisions should be included to ensure that innovative instruments are able to absorb all the losses within the credit institution or investment firm on a going-concern basis and that they are not cumulative" (BAC 2001:53), without any specification of how this could be achieved.

instruments and to develop new guiding principles for own funds definition (Commission 2005b). The CEBS wrestled with the task; in particular, gathering the quantitative data proved so difficult that the initial deadlines had to be postponed.[47] Nonetheless, it concluded the requested analysis and in December 2007 submitted a draft proposal for a common definition of Tier 1 hybrids (CEBS 2007a).

The proposal underwent two rounds of stakeholder consultations — first as the CEBS proposal and later as the Commission proposal. During both consultation processes, the most disputed issues — apart from the definition of loss absorbency criteria — was the balance between the principles and prescriptions and the question of whether the EU should move ahead of the Basel Committee. The industry associations across member states coordinated their response and stressed that the proposal was too prescriptive. As the European Banking Federation (EBF) put it: "The document's major weakness is that it is not based on general principles… the proposed new requirements are the weighted sum of the requirements in many [EU] jurisdictions. As a result, the document fails to bring sufficient clarity" (EBF 2008:2). The industry preferred more general principles, feared prescriptive rules and supported higher limits on inclusion of hybrid capital items. This position matched closely the policy preferences of the 'Anglo-Saxon' countries that were home to large banks that issued large amount of hybrid capital instruments.[48]

---

[47] See letters from the Commission from August and October 2006 available at EBA website www.eba.europa.eu.
[48] This is also observable from responses to the CEBS consultations submitted by the banks and banking association from 'Anglo-Saxon' countries such as the UK or Ireland.

The second criticism was related to the timing of the document. Virtually all 32 responses received during consultations stressed the point that Basel Committee is starting a review of the own capital definition and thus the EU should not run ahead of the global process. The EBF again argued that: "It would, therefore, be damaging if CEBS proposals … were to be transposed into EU legislation before the Basel Committee will have adopted a common view" (EBF 2008:2). The industry would have preferred postponing further harmonization by several years until after the BCBS decision.

Arguments invoked in opposition to the harmonization of the Tier 1 hybrid rules closely resemble those used in 2000 and 2001 to postpone the earlier attempt at harmonization. As then, it was argued that the BCBS was just about to start negotiations on global rules and it would be "(i) damaging to the European industry (as EU banks will be obliged to adapt twice to a new regulatory environment within a relatively short time frame), (ii) damaging to the hybrid market (as its practices will be overhauled twice, which is likely to bring confusion and provoke litigation); (iii) damaging to legal certainty in the interim period" (EBF 2008:2). However, this time the harmonizing proposal was not postponed, for reasons largely related to the governance reforms during the intervening period, which enabled the member states to agree on more harmonized rules for hybrid capital by the 2009 deadline.

Effects of the Lamfalussy reform were twofold. First, the transparent consultation process made the commitment to reform more credible by making it public. Second, the Lamfalussy reform enabled the EU to shift from the positive harmonization requiring prescriptive compromises enshrined in EU legislation, to negative harmonization based on general principles that can be adapted frequently by the decisions of the Level 2 and Level 3 committees. This delegation enabled the member states to resolve the conflict over the loss absorbency criteria, which proved insurmountable during the previous harmonization attempt. In addition, the process of final adoption of the CRD amendment in September 2009 benefited from the political momentum for regulatory reform that was created by the financial crisis experience. However, the crisis influenced only the final phase of the adoption, as the proposal was prepared and codified before September 2008, when the crisis hit EU banks with full force (see Chapter 4 for specific example).

4.2.1 Credible commitment through transparent consultations

The principal difference between the BAC and CEBS was in terms of the transparency of the consultation process (see section 4.3). The mandate of the 2001 BAC working group was almost identical in substance to the 2005 mandate of CEBS (see BAC 2001:5 and Commission 2005a). However, CEBS immediately made the call public and kept all intermediate documents in public domain and consulted them extensively with national authorities and the industry.[49] This contrasts with the behind-the-scenes

[49] These documents included in chronological order: Commission call for advice (March 2005), CEBS questionnaire on Own Funds (November 2005), Survey of implementation of Own Funds (June 2006), Analysis of capital instruments created by the industry (June 2006), Further specification of calls for advice from the Commission (August and October 2006), Quantitative analysis of hybrid capital instruments (March 2007), Call from the Commission for the general principles on hybrid capital instruments (April 2007), Quantitative analysis of Own Funds in EEA (June 2007), complete set of documents for the CEBS open hearing (November 2007), Draft proposal for common EU definition of Tier 1 hybrids (December 2007), Proposal for common EU definition of Tier 1 hybrids (March 2008). The fully transparent documentation trail continued when the Commission took over, starting the legislative consultations in July 2008, leading up to the adoption of the CRD amendment in September 2009.

consultations of the BAC working group, when not even the final report was released to the public domain.[50]

Given the technical complexity of the bank capital definitions in differing legal, accounting and taxation systems of member states, the diagnostic reports proved difficult to compile. The background analysis for the Commission (2000a) was massively delayed and CEBS also experienced minor delays. However, the open and participatory nature of the consultation process ensured continued interaction and clarification from both national authorities and industry practitioners. Therefore, the CEBS produced a more comprehensive analysis — including quantitative specification — in a shorter period for all 25 jurisdictions (BAC report covered the then 15 member states).

The transparency and openness of the consultation process was important not only for the quality and timeliness of the analysis, but also for the commitment to the CRD target date. The CEBS consultations clearly signaled Commission's intention to complete the process and make the harmonizing proposal by the deadline. Such a commitment was much more credible than the behind the scenes deliberations in BAC, which had no clear deadline as the process was more than 3 years overdue. Failure to make the proposal by the 2009 would be much more visible and damaging for both the Commission and CEBS than it ever could be for Commission and BAC.

[50] Author was able to get access to the BAC (2001) only through a formal request of the document on the basis of the Regulation 2001/1049/EC regarding public access to European Parliament, Council and Commission documents.

4.2.2 Shifting from positive to negative harmonization

The improved consultation process explains why the harmonizing amendment could not be postponed so easily as in 2001. However, it cannot explain why member states accepted common rules on loss absorbency despite their disagreement just a few years earlier. The 2001 BAC report made it clear that member states were divided on this criteria; some countries such as France and Italy preferred the 'Continental' approach, where the loss absorbency stems from the capacity to write-off the face value of the hybrid instrument, whereas other countries such as the UK or Germany supported the 'Anglo-Saxon' approach, where the loss absorbency stems merely from capacity to cancel any payment of coupon or dividend on the hybrid instrument. The documents from bank associations in 'Anglo-Saxon' countries clearly indicate the concern of their members about the stricter definition of loss absorbency that the CEBS proposed in 2007 (see, for example, BBA 2008 or Barclays 2008). What made all member states to agree to a harmonizing proposal when they refused to formulate one just six years earlier?

This puzzle can be explained by the effect of the increased capacity and accountability of CEBS on the nature of the compromise necessary for adoption of the harmonizing proposal. The CEBS facilitated a shift from the 'positive legislative harmonization' to the 'negative technocratic harmonization'. Earlier attempts to define common standards on hybrids that would be sufficiently stringent to exclude low quality instruments accepted in some EU jurisdictions, tended towards a sum of requirements from all EU jurisdictions, which were too complicated to be enforceable (interview 1, EBF 2008:2).[51] This approach rested on the assumption that harmonization of hybrid rules requires prescriptive common standards as anything short of this 'positive legislative harmonization' seemed likely to preserve the fragmented status quo.[52] However, the Lamfalussy reform facilitated two changes. First, the distinction between the Level 1 legislation, which defines basic principles that do not change frequently,and Level 2 implementing measures that fill in the details that need to change more often, shifted the debate from a legislative to technocratic level, while keeping the Level 1 legislators in control through the new accountability mechanisms. Second, the adaptability of the Level 2 and 3 rules, combined with an increased monitoring capacity of CEBS, reduced the need for the detailed prescriptive common standards, thus facilitating a shift from a positive to negative style of harmonization. The negative harmonization requires agreements only on rules that need to be suppressed to achieve regulatory harmonization and is generally easier to adopt then positive harmonization, which requires a formulation of a common standard. However, negative harmonization also requires greater monitoring capacity on a continuous basis to ensure that distorting national rules are identified and suppressed.

The opportunity to shift from the positive legislative harmonization to the negative technocratic harmonization is a general consequence of Lamfalussy reform, and it may or may not be utilized. It certainly was used in the case of 2009 harmonizing

[51] One reason for the tendency to list all the technical details in the legislation stems from the positivist nature of the continental legal systems that cannot accommodate 'principle-based' legislation as easily as common law systems (interview 1).
[52] The OFD and CRD defined general eligibility rules for 'Other items' that could be included in own funds (see Section 3.1), but these general principles seemed insufficient to prevent the fragmentation caused by different interpretation in different countries (see section 3.2).

amendment of hybrid capital rules. The Article 63a, added to the Capital Requirements Directive by the CRD2 reform, stipulates that:

> " The provisions governing the [hybrid capital] instrument shall provide for principal, unpaid interest or dividend to be such as to absorb losses and to not hinder the recapitalisation of the credit institution through appropriate mechanisms, as elaborated by the Committee of European Banking Supervisors … The Committee of European Banking Supervisors shall elaborate guidelines for the convergence of supervisory practices with regard to the [hybrid capital] instruments … and shall monitor their application." (CRD Article 63a (4) as of September 2009).

In other words, the CRD — as the Level 1 legislation — stated only the most general requirement that hybrid instruments must absorb losses and not hinder recapitalization. The CRD delegated all implementation rules to CEBS on Level 3. This was the basis for a shift from legislative to technocratic agreements in case of hybrid rules.[53]

The shift from positive to negative harmonization is observable in the Level 3 implementation guidelines for hybrid capital instruments (CEBS 2009b). The CEBS did not provide positively defined common standards of loss absorbency criteria. Instead, it stipulated that any hybrid instrument is deemed loss absorbent, if (i) it does not allow the holder to petition for insolvency, if (ii) it is not taken into account for the purpose of determining insolvency and if (iii) it does not hinder recapitalization (CEBS 2010: 19-22). This definition is a *prima facie* example of negative harmonization. Although the

[53] Interestingly, the Level 3 rules — unlike Level 2 implementation measures — are not formally binding (see section 4.3). This brings up a possibility that a member states or hybrid issuer may comply with the general rules of Article 63a, but fail to comply with the CEBS' implementation guidelines. The guidelines are non-binding, but they are referred to in a binding directive thus their legal status is not entirely clear. The consequences of such a partial compliance remain to be tested in courts (interviews 1 and 2).

three negatively defined parameters seem straightforward, in practice, the loss absorbency is a consequence of complex interactions among the national corporate, accounting, taxation and financial laws. Therefore, ensuring that these three conditions are met consistently across all EU countries requires considerable legal expertise and monitoring capacity.

A crucial aspect that facilitated the agreement on the CRD2 harmonizing proposal was the capacity of CEBS to draft complex policy compromises that reconciled the 'Anglo-Saxon' and 'Continental' approaches to loss absorbency.[54] The BAC working group in 2001 simply concluded that it was beyond its mandate to try to bridge this divide. The CEBS, however, came up with a compromise that distinguished between going and gone concern loss absorbency, which applied the 'Anglo-Saxon' approach to the former and 'Continental' to the latter. As long as the bank is a going concern venture — i.e. it stays clear of insolvency — the loss absorption is assured by 'Anglo-Saxon' method, when bank's financial stability under stress is supported by its right to delay any payment to holders of hybrid instruments. However, when the bank becomes a gone concern by entering into liquidation, the loss absorbency of hybrid capital is assured by subordination of these instruments to all asset classes except common equity. This means that their holders are paid out only after all other stakeholders save for shareholders.[55] This comes close to the write-down of the face value of the hybrid

[54] The CRD amendment also included generous grandfathering provisions that allow banks to keep existing hybrid instruments for certain period of time in order to avoid any abrupt changes in the markets. Therefore, the more harmonized conditions will eventually apply only to newly issued hybrid instruments.

[55] CEBS guidelines explicitly forbid any “small print“ covenants that could "legally or economically enhance the seniority of the claim vis-à-vis the institution" (CEBS 2010).

instrument advocated by the more stringent 'Continental' approach.[56] This is a more complex policy compromise than adopting either of the rival views, nonetheless, it increased the gone concern loss absorbency of eligible hybrids in the EU, while preserving more flexibility when the bank is a going concern. In addition, it proved to be politically acceptable as the implementation guidelines were adopted unanimously by all member state representatives in CEBS.

Whereas the superior capacity of CEBS to draft complex policy compromises was essential for smooth adoption of the CRD2 amendment, its monitoring capacity will be essential to for harmonized implementation of the negative technocratic agreements. This type of agreement is easier to adopt, but more difficult to enforce than prescriptively defined common standards delivered by positive harmonization. As has been argued in section 4.3, the CEBS' mandate and monitoring capacity made it more likely that divergent implementation of hybrid rules would be identified and addressed.[57] CEBS had developed an on-line supervisory disclosure framework that makes information on applicable national supervisory requirements easily available (ECB 2007, interview 2). Easy access to information on national transposition of CRD and other banking directives makes monitoring and peer review much easier than in the past. Moreover, when CEBS was replaced by EBA in 2010, its mandate to define a single supervisory rulebook was further strengthened, thus increasing chances of not only sustained monitoring, but also harmonized implementation. The continued

---

[56] Incidentally, the distinction between going and gone concern capital was utilized by the BCBS for the new definition of bank capital published at the end of 2010.
[57] The transformation of CEBS to EBA that has even stronger mandate to develop a single rule book as well as further enhanced capacity, also increases the chances that action would be taken in case that harmonization of hybrid rules proves insufficient for consistent implementation.

attention to the implementation of the negative technocratic compromise is also assured by another review clause introduced by the CRD2 amendment and stipulating: "By 31 December 2011, the Commission shall review the application of this Article and shall report to the European Parliament and the Council together with any appropriate proposals to ensure the quality of own funds" (CRD Article 63a (6) as of September 2009). The new hybrid rules entered to force only very recently and their implementation cannot be evaluated yet. Nonetheless, the increasing analytical, monitoring, and decision-making capacity of CEBS and now EBA provides some assurance that the consistent implementation of new hybrid rules would be possible and thus the negative technocratic compromises would suffice for sustained regulatory harmonization.

Table 2.11: The nature of harmonizing amendment: BAC and CEBS compared

	BAC approach	**CEBS approach**
Harmonizing amendments	Only legislative amendments on Level 1 possible	They can propose changes of legislation (L1), implementation measures (L2) or guidelines (L3)
Harmonizing definitions	Only positive common standards possible.	Also negative delineation of what needs to be suppressed is viable.
Monitoring & enforcement	Commission	CEBS and Commission
Amendments by	Co-decision at Level 1	Co-decision at L1 Qualified majority at L2 Unanimity at L3

The Lamfalussy reform created a novel mechanism for coping with deadlock over the politically contested financial regulations by opening the possibility of negative harmonization by technocratic committees. The reform, as was its stated purpose, facilitated the shift from legislative to technocratic compromises. At the same time, the increased capacity and accountability of technocratic committees facilitated a further shift from positive to negative harmonization. These effects combined changed the nature of the compromise required for adoption of the harmonizing amendments from the positive legislative compromises to the negative technocratic compromises (see summary in Table 2.11). The effects of this change were observable in negotiations over harmonization of EU rules on the hybrid capital instruments, where they prevented reappearance of the deadlock over the hybrid rules that derailed the EU commitment to further harmonization few years earlier.

5. Conclusion

This case study of the evolution of EU rules defining the composition of bank capital reveals that suboptimal policy compromises can remain in place for decades. When the Own Funds Directive was adopted in 1989, the EU decision-makers were well aware that it was insufficiently harmonized for a single banking market. The definition did not guarantee that when banks from different EU jurisdictions complied with the 8 percent capital ratio, they did so with capital items of comparable quality. Some might have 8 percent of common equity, while other banks could have as little as 2 percent of common equity and 6 percent of lower quality capital items. The composition of bank capital varied systematically across the EU banking sectors as the two-tiered definition accommodated number of nationally specific capital items, and as the national regulators treated the increasingly important hybrid capital items differently.

There were several reports specifying the distorting effects of the insufficiently harmonized own funds definition on the competition, financial stability and consumer protection within the single banking market. However, when member states started to discuss harmonizing proposals in the respective committees, conflicts over the design of common rules resurfaced and changes were postponed. Despite the mandatory review clause committing the EU to further harmonization by 1998, there was no report till 2000. Then the Commission and EP agreed to postpone new rules on bank capital until after the Basel II implementation in 2008. Therefore, there was no progress towards more harmonized definition of bank capital and the two tiered compromise, including all accommodations of specific national concerns, remained in place from 1989 till 2009.[58]

The only politically contested aspect of the own fund definition that was harmonized during this period were the eligibility rules for Tier 1 hybrid capital instruments. Banks maximized advantages offered to them by national financial, accounting, and taxation laws in order to issue the most cost - and tax-efficient capital items, and they innovated to make these items accepted under the EU rules. This deepened the differences in implementation of EU rules across EU countries and increased fragmentation along the national lines. The most severe distortions arose from different interpretation of the rules related to hybrid capital. All EU countries accepted hybrid instruments as Tier 2 capital, but some also allowed to count them for Tier 1 capital, while imposing different qualitative requirements and different quantitative limits, leading the European Banking Committee to observe that the differences "raise level-playing field issues for

[58] The Basel Committee on Banking Supervision adopted new definition of capital only at the end of 2010 and the Commission plans to transpose it by the CRD4 amendment in 2012.

credit institutions and opportunities for regulatory arbitrage; it has an impact on the structure and quality of own funds and it may create significant competitive (dis)advantages in the market … between Member States" (EBC 2006:5).

There were two attempts to harmonize hybrid eligibility rules, both triggered by the review clause deadlines set in the subsequent generations of banking directives. The first attempt was not completed, because the harmonization proposals run into opposition from transnational banks and their home countries that preferred the more lenient status quo, and argued that the EU should postpone any harmonization of hybrid rules until the BCBS agrees on a completely new definition of capital. The conflicting policy preferences were revealed in the dispute over the loss absorbency criteria that divided the member states representatives in the committees into a 'Anglo-Saxon' and 'Continental' camps that advocated different technical definitions. As there was no consensus in 2001, the harmonization was postponed. Although, analogous policy conflicts reappeared during the 2004 to 2007 debate, this time the process was successfully concluded by the deadline set in CRD. The success can be traced to the Lamfalussy reforms of the EU financial market governance that increased the capacity of the comitology committees to identify divergence in implementation and to commit towards the harmonizing reforms through transparent consultation process. Moreover, the increased capacity and accountability of these committees made the high-level decision-makers comfortable to delegate the rule-making powers and accept a shift from the positive legislative harmonization to the less demanding negative technocratic harmonization.

The comparison of the two harmonization attempts provides an important insight into the effects of delegation of regulatory powers to committees on the regulatory integration of politically contested financial regulations. The EU law-makers tend to acknowledge insufficiently harmonized provisions of a directive by a review clause committing the Commission to assess its implementation by a fixed date and, if appropriate, make a new harmonizing proposal. However, the credibility of this commitment also depends on the applicable governance arrangements. The higher their capacity to monitor implementation of financial regulation and to formulate complex technical compromises the more likely is the progress towards increased harmonization. Moreover, when the formulation of positively defined common standards proves too demanding due to policy conflicts among member states, then a shift to the negative harmonization — which defines what national rules need to be suppressed in order to achieve harmonization on the EU level — may also help to avoid deadlock over harmonizing proposal and facilitate regulatory integration.

The importance of the harmonization strategy based on review clauses, reformed comitology and negative harmonization is bound to increase exponentially in the next few years (see Table 2.12). The three most important single banking market directives from 1989 contained four review clauses as did the Consolidated Banking Directive from 2000. However, the subsequent generation of the banking directive contained nine review clauses, including one regular review clause committing the CEBS to report annually on the convergence of supervisory practices throughout the EU (Recital 55 of CRD 2006/48/EEA). Furthermore, the number of CRD review clauses nearly doubled between 2006 and 2009, as every amendment adds more of them. The planned CRD3 and CRD4 amendments will add more. Clearly, the inclusion of a review clause became a tool of choice — especially for the European Parliament — for ensuring continued policy attention to harmonization.

Table 2.12: Mandatory review clauses embedded in the banking directives

Directives	**Number of review clauses**	
	One off	**Regular**
1. Three single market directives (1989)	4	0
2. Consolidated Banking Directive (2000/12)	4	0
3. Capital Requirements Directive (2006/48)	8	1
4. Capital Requirements Directive after CRD2 (2009)	14	2

Note: The table counts instance of commitments to further harmonization included in the text of the directive and its annexes, which include explicit deadline (either one off deadline or regularly repeated deadline). The three single market directives are the Second Banking Directive (89/646/EEC), Own Funds Directive (89/299/EEC) and Solvency Directive (89/647/EEC).

The findings of this chapter are limited by the fact that it is a single case study. Although, the Table 2.12 demonstrates that review clauses were occasionally used in other directives, it is not clear whether governance reforms and shifts to negative harmonization were necessary and or sufficient conditions for harmonizing contested aspects of financial regulation flagged by the review clause. However, this chapter suggests a plausible hypothesis that could be tested by more systematic empirical data. It is quite likely that some of the self-commitments to further harmonization may expire unheeded, whilst others will result in timely reports and harmonizing proposals. This chapter proposes that the potential variation in outcomes could be explained by the variation in the applicable governance arrangements and the approach to harmonization (positive or negative).

Finally, as to the question from the Introductory chapter of whether and how the delegation of regulatory powers affects regulatory integration through drifting, deliberating or bargaining. This chapter has shown clearly that Lamfalussy reform was instrumental for overcoming the deadlock on the EU definition of loss absorbency. Delegation of the rule making power on this issue to the Level 3 committee enabled the EU to produce complex compromise reconciling the two competing approaches to loss absorbency. This suggest that the evidence comes on the side of the Bargaining Hypothesis. What allowed for adoption of more harmonized rules was neither reinterpretation of existing rules, nor convergence of policy preferences on a single proposal. Instead, the ECBS rules represent the complex policy compromise that utilized both competing approaches. The 'Anglo-Saxon' approach was adopted for the going concern loss absorbency, whereas the 'Continental' one was adopted for the gone concern loss absorbency. It is no accident that such a compromise emerged only in 2007, and not in 2001, as the necessary preconditions for such a compromise were created by the Lamfalussy reform in 2005. The reform not only delegated more powers to expert committees, but also increased their capacity. Hence, this reform enabled the CEBS to succeed where BAC failed.

Chapter 3:

Investment services regulation in the EU[59]

The European Union has undergone important reforms of its decision-making procedures over the last three decades reviewed in the Chapter 1. Have these reforms enabled the EU to resolve persistent policy conflicts over the most contested aspects of investment services regulation? This chapter provides a positive albeit qualified answer. The comparative case study shows that mere introduction of the qualified majority voting in 1987 did not suffice for adoption of clearly defined rules and that the generic comitology arrangement provided insufficient support for consistent implementation. Proposals for EU securities regulation tend to split Member States into similarly sized coalitions that both prefer regulatory integration, yet disagree on some of its fundamental features. This makes the outcome of a qualified majority vote uncertain and creates incentive for fuzzy policy compromises. However, when the qualified majority voting was complemented by Lamfalussy process in the early 2000s, the combined effect of these two reforms provided the EU with additional capacity to search for common standards. The detailed scrutiny of the implementation of EU financial regulation in each Member States by the Lamfalussy committees, reduces the likelihood of a reoccurrence of inconsistencies that hampered regulatory integration in past. This is the case even though the Member States' preferences over some key features of financial regulation remain divided.

[59] Shortened version of this Chapter was published in Falkner, G. (ed.) (2011) The EU's decision traps: Comparing policies. Oxford and New York: Oxford University Press

The single market in financial services is one of the basic goals of the European Union stipulated in the Treaty of Rome. This reflects the expectations of economic benefits that a single financial market may generate as well as a political and legal commitment towards its realization. The gains derived from genuinely integrated, liquid and transparent securities markets should include efficient allocation of capital, enhanced liquidity which benefits all companies large and small, the lower cost of capital, higher returns for investors and lower costs of transacting.[60] On the macro level, such benefits should convert to higher productivity of capital and labor, thus contributing to higher growth and employment.

Reaping the benefits of single market in financial services without incurring excessive risks requires financial integration to proceed hand-in-hand with regulatory integration that would ensure financial market integrity and stability. This is especially important in financial markets that are more 'regulation-intensive' than markets for goods and non-financial services. This differences are rooted in greater information asymmetries between buyers and sellers and the elusive nature of financial products and services (Dermine 2000, Mishkin 2001). Moreover, finance also connects all parts of national and international economies thus a relatively minor change in regulations may have distributive consequences, which only compounds economic and legal complexities of financial reform by political considerations.

The limited progress of regulatory integration not only foregoes the benefits of single markets, but also creates new risks and fragilities within the European financial system.

[60] This argument rests on the economics literature analyzing the role of financial sector in economic growth which is summarized, for example, by Levine (2004).

Over the last two decades, the speed of integration in securities markets outstripped the speed of regulatory integration, which created a gap arising from the fact that increasingly trans-European firms were regulated on a national basis with very weak cross-border overlay (Mügge 2010, Vives 2001). The recent financial crisis laid bare these drawbacks.

It is not for the lack of trying that regulatory integration remains incomplete. Seven out of the 279 measures proposed by the 1985 White Paper on completion of the internal market were aimed directly at regulatory integration of securities markets (Commission 1989a). The political saliency of the Single Market project compelled Member States to adopt these directives, despite continuing disagreements on the core principles. The resulting legislation often combined the lowest common denominator of non-controversial provisions, with vague legal clauses open to numerous interpretations that papered over prevailing policy conflicts. Some of the contested provisions remained fuzzy and merely shifted prevailing conflicts from the decision-making process into the implementation as member states interpreted them to their liking and implemented them with additional provisions that diverged from the applicable rules in other Member States.

The results were predictably disappointing on both functional and normative level. The single market generation of securities directives significantly reduced barriers on the cross-border trade in financial services, but failed to integrate the regulatory framework. Some of the key aspects of financial regulation remained fragmented along national jurisdictions. Financial firms took advantage of single market freedoms, but still had to cope with specificities of national regulations to a much larger extent than expected. It was the classic paradox of EU integration: "frustration without disintegration and resilience without progress" (Scharpf 1988: 239).

The EU has learnt from that experience and introduced reforms of its decision-making and monitoring procedures. This chapter addresses the question whether and how the decision-making reforms enabled the EU to progress towards more harmonized and consistently enforced securities regulation, i.e. to progress towards the regulatory integration of securities markets. The research design takes advantage of the fact that the same conflicts over financial regulation were replayed under two different decision procedures generating qualitatively different legislative outcomes. We compare the adoption and transposition of the 1993 Investment Service Directive (ISD), with the Market in Financial Instruments Directive (MiFID), which has replaced it in 2004. We argue that MiFID had avoided the fundamental pitfalls of the ISD thanks to the Lamfalussy reform that amended decision-making and monitoring procedures and thus made the fuzzy legislation that cannot be implemented consistently a less likely occurrence.

The next section casts the key strategic dilemma that arises from conflicting preferences of member states in terms of a coordination game with two Nash equilibria and briefly reviews the negotiation process of the ISD and MiFID directives. The subsequent section reviews the implementation experiences of ISD and MiFID and its outcomes in terms of regulatory integration. The fourth section provides an overview of the key differences between the governance arrangements supporting ISD and MiFID adoption and implementation. Finally, the fifth section addresses the effects of delegation in the micro-institutional detail necessary for the testing of the three institutionalist hypotheses. The final section concludes that the most important effects of delegation stem from increased availability of information and knowledge about the regulatory regimes in individual member states, which suggests the transaction cost hypothesis as the most compelling explanation of the relative success of MiFID.

1. Negotiating investment services directives

The policy preferences on the EU financial market regulations are traditionally heterogeneous, because the national financial systems and regulations differ substantially across member states (Mügge 2010, Quaglia 2010b; Story and Walter 1997). The conflicts are observable during the negotiation period, as well as when it comes to voting in the Council. Financial directives often get adopted by qualified majority, with several countries voting against, which contrasts with the general preference for consensus (Dehousse 2009). In case of investment services directives, the member states tend to cluster into two advocacy coalitions that make it uncertain, whether the directive can gather sufficient support even under the qualified majority rule. Quaglia (2010a) and Tison (1999) map the conflicting preferences over the investment services regulation onto 'Southern' coalition that coalesces around the policy proposals of Italy and France, and the 'Northern' coalition that rallies behind the views of the UK.[61]

[61] During the ISD negotiations, the 'Southern' coalition included France, Italy, Belgium, Spain, Greece, and Portugal whereas the 'Northern' coalition consisted of the UK, Germany, Luxembourg, the Netherlands, Ireland, and Denmark. During the MiFID negotiations the same coalitions resurfaced, with

The two coalitions agreed easily on a bulk of regulatory measures, yet they were divided by some key provisions that affect incumbent firms and small securities investors. The 'Southern' states were wary of full deregulation and liberalization that would expose their incumbents to competition from all other securities firms within the EU and that would potentially reduce the protection of retail investors that are more prominent in the 'Southern' securities markets. The 'Northern' states prefer more pro-competitive regulation and greater reliance on reputation and self-regulation as means of consumer protection (see below for details).

The presence of the two stable advocacy coalitions allows us to conceptualize the decision on investment services regulation as a simple game with two equilibrium policy outcomes (Table 3.1). Both coalitions prefer some form of regulatory integration, but they disagree on whether the EU regulations should be more pro-competitive (C) or more protectionist (P). This set-up corresponds to the 'Battle of the Sexes' game, which generates two Nash equilibria, but no obvious mechanism of choosing between them (see Scharpf 1997). Which of the two equilibria is chosen depends on the EU decision-making process and whether it is consistently implemented depends on the governance mechanism that encompasses both the negotiation and implementation of the directive.

Sweden and Finland joining the 'Northern' one and Austria aligning with 'Southern' one. The coalitions were entirely informal and their members held varying views on many subsidiary issues. Nevertheless, the division over the key measures was observable (see Quaglia 2010a and Tison 1999).

Table 3.1: The Battle of Sexes game in choice of the EU financial regulation

		'Northern' coalition	
		Protectionist (P)	Competitive (C)
'Southern' coalition	Protectionist (P)	3, 2*	1, 1
	Competitive (C)	0, 0	2, 3*

Note: * Nash equilibrium. The higher the number in cell, the more preferred the outcome for given coalition. Preferences are expressed in terms of pay-offs to actors; the highest payoff (3) is the most preferred solution of a given actor.

The Battle of the Sexes game generates four possible outcomes. The worst possible outcome for both coalitions is (C, P—bottom left) that would force the 'Southern' coalition to adopt strongly pro-competitive regulations, but the 'Northern' to opt for regulations that protects incumbents. This is largely a hypothetical outcome that would not be chosen, as both coalitions strictly prefer any of the three alternatives.[62] The status quo, unilateral outcome (P, C—top right), is where the member states simply preserve the existing national rules in the most contested regulatory provisions. If both coalitions are fully informed and certain that there is no acceptable compromise between their positions, then the status quo is the most likely outcome. The 'Northern' members would stick with their more pro-competitive regulations and the 'Southern' ones would continue to provide more protection for incumbents and retail investors. As a result, the progress towards higher degree of regulatory integration will be stalled and the regulatory fragmentation will be preserved.

[62] This outcome could be chosen due to some unforeseen shocks to established preferences. For example, if the financial institutions from the 'Northern' coalition suffer far more from the financial crisis than those from 'Southern' countries, the pro-competitive countries may temporarily support protectionist regulations that would reduce market gains of the 'Southern' financial firms, whereas the 'Southern' coalition may temporarily push for more pro-competitive regulation to support expansion of its firms.

Both policy coalitions prefer any of the two Nash equilibria to the status quo. The competitive Nash equilibrium (C, C—bottom right) is preferred by both advocacy coalitions to the two outcomes above, yet it is the more preferred option for the 'Northern' coalition. The protectionist Nash equilibrium (P, P—top left) is preferable to the first and second outcomes for both coalitions, yet it is a solution that is more advantageous for the 'Southern' coalition. The two Nash equilibria are not identical in terms of pay-offs for each actor, so although neither coalition has an incentive to defect to the first two outcomes, one of them would inevitably be less satisfied, as it would receive a higher pay-off in the alternative Nash equilibrium. Whether, any of them would be agreed upon depends on the EU decision-making process that facilitates the selection between the two equillibria. Whether the chosen option would be implemented without lapsing to the status quo, also depends on the governance arrangements that support both the negotiation and implementation of the directive.

1.1 Investment services directive: papering over the conflicts

The purpose of the Investment Services Directive (ISD) was to introduce the single market for investment services by specifying the common rules for authorization and prudential supervision of investment activities such as brokering, dealing, portfolio management, or investment advisory services (Commission 1989b). Following the ISD implementation, any financial company operating in several member states was to be controlled by the authorities in its home country, except for consumer protection purposes in specified cases. The integrated regulatory framework was intended to allow investment firms to set up branches and provide cross-border services without further authorization or additional layers of supervision in host countries. The negotiations of ISD were complicated by two controversial issues. The first, centered on the conduct of business rules that protect consumers from unfair business practices; and the second concerned the permissible degree of competition among stock exchanges across the EU (Ferran 2004; Interview 3; Tison 1999).

The conduct-of-business rules are important for the protection of retail investors, who may become victims of unfair business practices or market manipulations. The plethora of information asymmetries in financial markets makes it more difficult to judge the value of the products and services without access to trustworthy information from credible professionals. The credibility of such information can be enhanced by adherence to the code of conduct that addresses problems such as conflicts of interests and information disclosure. The Commission's initial ISD proposal favored the full harmonization of the conduct of business rules on a basis of detailed rules derived from the British code. It also presumed that only the supervision over compliance would be left to mutual recognition (Tison 1999: 3). However, France and some other member states argued that harmonized rules would encourage delocalization of investment activities to the member state with the most lenient enforcement regime and thus start a 'race to the bottom' undermining market trustworthiness and stability. Therefore, the final provisions in Article 11 of the ISD represented a compromise shifted in favor of mutual recognition. An element of minimal harmonization was preserved, but reduced from specific rules to seven briefly specified principles. Their precise legal wording as well as supervision and enforcement were to be defined during the process of transposition in each member states. This solution allowed for an agreement, but opened a door for member states to add separate layers of regulation.

Table 3.2: Article 11 of the Investment Services Directive (93/22/EEC)

The member states were expected to draw up rules of conduct that implement the following principles that ensure that an investment firm:

1. acts honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market,
2. acts with due skill, care and diligence, in the best interests of its clients and the integrity of the market,
3. has and employs effectively the resources and procedures that are necessary for the proper performance of its business activities,
4. seeks from its clients information regarding their financial situations, investment experience and objectives as regards the services requested,
5. makes adequate disclosure of relevant material information in its dealings with its clients,
6. tries to avoid conflicts of interests and, when they cannot be avoided, ensures that its clients are fairly treated, and
7. complies with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its clients and the integrity of the market.

The initial 1989 proposal of the Commission also suggested no restrictions on the execution of securities transactions. Investment firms with a European passport would be free to choose any stock exchange or trading platform authorized in any other member state. However, France again objected to the idea of full liberalization and proposed a distinction between regulated and over-the-counter markets, whereby the investment firms could choose freely only among the regulated markets, where transparency, fairness, and integrity would be assured by authorization (Tison 1993: 2). However, apart from its effects on consumer protection, the concentration rule also provided a mechanism to protect national stock exchanges from competition of exchanges in other countries and from investment banks that increasingly served as alternative venues for securities trading.

The Commission tabled a new ISD proposal in February 1990, which included the concept of regulated markets. Yet, the controversy continued. The 'Southern' and 'Northern' coalitions disagreed on the key parameters of regulated markets, above all on the concentration rule. The conflict lasted for over two years and became acrimonious as the French and British officials publicly accused each other of deliberately undermining the proposed compromises.[63] The conflict kept ISD on the priority list of four EU presidencies and on the brink of being scrapped altogether. Eventually, a solution that could garner a qualified majority in the Council was found and the ISD was approved in May 1993, five months after the single market deadline.[64]

The compromise on regulated markets guaranteed investment firms nondiscriminatory access to regulated markets in host countries, providing that they met all obligations under the Capital Adequacy Directive (93/6/EEC). However, the ISD compromise left it up to the member states to draw a list of regulated markets within their jurisdiction. Hence, those member governments that wished to force all investment firms operating within its jurisdiction to use the incumbent infrastructure providers could do so. They could also block entry of any competitors by simply not putting them on the list of regulated markets (Article 16). As in the case of bank capital regulation, the contested provision was 'flagged' by a review clause requesting the Commission to publish list of regulated markets and propose amendments to the definition of regulated market by the end of 1996.

[63] The intensity of the debate is reflected in financial press articles on the ISD from 1991 to 1993.
[64] At the time there were no rules on the transparency of the votes in the Council, thus there is no official record of which member states voted against the ISD. The Council introduced the procedure of legislative transparency only in 1995 (Author's communication with Council's Press Office). However, the advocacy coalitions noted above could be derived from the press reports and secondary literature, namely Quaglia (2010a) and Tison (1999).

1.2 Market in Financial Instruments Directive: complex compromises

The negotiation of the next generation of ISD — the Market in Financial Instruments Directive (MiFID) — started in 2000 and the original controversies quickly resurfaced. This time the ‘Southern’ coalition accepted that the concentration rule was a disproportionate measure, but insisted on a strict regime relying on pre- and post-trade transparency rules (Casey and Lannoo 2006, Quaglia 2010a), which requires the publication of prices and volumes of traded securities, thus ensuring the availability of price and liquidity information necessary for efficient market functioning and for the prevention of market manipulations. The detailed transparency rules can protect incumbent stock exchanges from the competition of investment banks that operate as systematic internalizers, though. Investment banks have incentives to publish price and volume information only after they have settled larger numbers of transactions internally and thus prefer delayed publications of price and volume data (Lannoo 2001). Predictably, the ‘Northern’ coalition advocated less stringent transparency requirements that suited investment banks, whereas the 'Southern' coalition favored stricter transparency regime that protects the competitive position of the traditional stock exchanges (Quaglia 2010b, Mügge 2010).

The MiFID draft submitted to the Council was closer to the position of the ‘Southern’ countries, putting emphasis on the strong pre-transparency rules (Ferran 2004; Interview 3). This was due to the political intervention by the then President of the Commission, Romano Prodi, who had been lobbied by the French and Italian stock exchanges (Quaglia 2010a:85, Mügge 2010:135). The negotiations took place under the Greek and Italian presidencies, which used their agenda-setting power strategically. The Italian presidency truncated the negotiations by submitting the Directive to a vote in the Council, which was an unusual move given that the standard modus operandi tends towards negotiations of broader consensus (Interviews 5 and 7; Quaglia 2010b). A qualified majority, with the UK, Luxembourg, Sweden, Finland, and Ireland voting against, adopted the MiFID text. This made the MiFID one of the 5 per cent of Council votes in the 2002–4 period when a coalition of more than three member states was outvoted (Dehousse 2009), underlying the continued political contestation.

The persistence of diverging preferences on the national level is somewhat surprising, given the continued internationalization of the most important players in the investment services industry — the stock exchanges and investment banks (Mügge 2010). Nonetheless, the conflict in the Council was not substantially different from the case of ISD, with the partial exception of Germany, where the domestically oriented and globally oriented parts of the financial sector could not agree on a common position. This made the vote in the Council uncertain, as Germany could potentially cast the decisive vote either way (Interview 5; Quaglia 2010a). In the end, Germany sided with the 'Southern' coalition proposal. Hence, the adopted text of MiFID was close to the protectionist Nash equilibrium (P,P) — see Table 3.1 — although, whether this would be the overall outcome also depended on negotiations over the implementation measures and subsequent implementation experience.

The MiFID negotiations were complicated by the same policy issues as the ISD negotiations. In both cases, the final text of the directive was approved by the Council only by the qualified majority, with unusually high number of countries voting against. In short, the MiFID was at least as contested as the ISD, so the question is whether it resulted to a better outcome in terms of the regulatory integration.

2. Regulatory integration: MiFID and ISD compared

The regulatory integration was defined as consistent implementation of single set of harmonized rules. The ISD negotiations started off with proposals of detailed and prescriptive 'conduct of business' rules aiming for high degree of harmonization. However, in the end the adopted rules were reduced to seven declaratory principles giving member states nearly full control over their specification in national legislation. Similarly, all characteristics of regulated markets were left to mutual recognition, with the minimal harmonization was limited to a stipulation of non-discriminatory access. For both of these contested aspects the combination of divided preferences and high discretion were likely to lead to inconsistent implementation.

This expectation was largely confirmed by the implementation experience. Although, the ISD implemented the single passport principles and induced more cross-border operations, it failed to reduce the regulatory fragmentation along national lines (Mügge 2010, Lamfalussy 2001, Commission 2000c). The ISD suffered from two fundamental problems. First, it failed to keep up with rapid market developments, and, second, it could not prevent the re-emergence of additional national regulations. The former was inevitable given the frantic developments in the financial markets during the 1996–2007 period when the ISD was in force. The latter, however, can be traced to conflicts that were resolved neither during the ISD negotiations, nor during its implementation. The two most disputed ISD provisions were also the two weakest points in its implementation. This indicates that the conflict was simply shifted from negotiation to implementation phase as the Council resorted to 'legendary ambiguity' (Lamfalussy 2001: 15) to avoid a collapse of ISD negotiations by agreeing to fuzzy provisions.

The conduct of business rules were specified as seven general principles (see Table 3.2), which allowed member states to opt for interpretation closest to their preferences. In principle, these rules were applicable only to retail investors and not to professional investors operation on the wholesale markets. However, the ISD did not provide any distinctions between the two client categories, leaving the member states free to expand the protected retail category and impose host country rules (Mügge 2010:111). Hence, the combination of vague specification of rules and definitions of types of investors resulted in 'gold plating', whereby member states added 'layer upon layer of regulatory additions that go beyond the Directives themselves . . . thus stifling the benefits of a single set of EU rules and adding unnecessary burden and costs to European [financial] industry' (Commission 2005b: 6). This resulted in substantially different rules across the EU and market fragmentation that required financial products and services to be marketed differently in individual EU states.

The MiFID conduct of business rules were everything but vague. Where ISD relied on seven vague principles (see Table 3.2), the MiFID introduced up to three levels of much more detailed rules (see Table 3.3). Not only were the conduct of business rules specified in the directive (Level 1), they were developed further in the implementation directive (Level 2) and in some cases also in guidelines and recommendations of CESR (Level 3). One of the problems of ISD conduct of business rules was that they were too restrictive for professional investors and too vague to protect retail investors. The MiFID addressed the problem by widening the gap between the two categories, strengthening the protection of retail investors and loosening the rules applicable to professional investors and eligible counterparties.[65] Investment firms were made responsible for the classification and compliance with conduct of business rules for each client category.

Table 3.3: Conduct of business rules in MiFID

	MiFID (Level 1)	**Implementation measures (Level 2)**	**CESR guidelines (Level 3)**
Conflict of interest	Art 13, 18, 19, 21, 25	Art 21 to 26	Guidelines on inducements
Best execution rules	Art 19, 21, 24, recital 33	Recitals 56 to 64, Articles 44 to 46	Q&A on best execution
Suitability and appropriateness	Art 19	Art 35 to 38	-
Provision of information to clients	Art 19, 24	Art 64	Consumer's guide to MiFID
Protection of client assets	Art 13	Art 16 to 20	-

Source: CESR/CEBS/CEIOPS (2010)

The MiFID best execution and client order handling rules imposed obligations on investment firms to take all reasonable steps to obtain the best possible result for their clients, taking into account factors such as price, costs, likelihood of execution and

[65] Professional investors are clients who possess the expertise to make their own investment decisions (institutional investors, large companies and public bodies) and eligible counterparties are certain types of sophisticated professional investors such as banks and insurance companies. All other types of investors were classified as retail clients under MiFID.

settlement, when executing orders. When providing their services the firms had to obtain information about their clients to ensure that the proposed services are suitable and appropriate for the given type of the client. They were also obliged to provide information that are clear and reasonably understandable to the given type of client, especially with regard to the risks of the service or product offered. The MiFID also stipulated detailed rules on inducements — fees, commissions and non-monetary benefits — offered to clients and imposed obligation to establish a conflicts of interest policy. All this only underlines that the MiFID — unlike the ISD — was not principle based regulation, but highly prescriptive one.

The MiFID approach proved easier to implement consistently, which is clearly observable from the MiFID review documents (Commission 2010b). Unlike in the case of ISD, the harmonized MiFID conduct of business rules were implemented consistently, thus the 2010 review focused on extension of the existing regime to additional types of assets (such as structured products) and services (such as independent investment advise). The degree of regulatory integration achieved through the MiFID implementation was not questioned, hence it is unlikely that conduct of business rules would become a politically contested issue yet again.

The second most contested aspect during the process of ISD and MiFID adoption were the market transparency rules. The ISD concentration rule provided member states with a discretion to limit regulated markets only to incumbent stock exchanges, thus preventing EU-wide competition among exchanges and among alternative trading platforms. There was no major difference among the numbers of regulated markets authorized in each EU economy (see Table 3.4); their number changed largely in response to mergers and restructuring of exchanges. The concentration rule (ISD Article 14(3)) was used by some national authorities to stipulate that retail investor orders were to be executed only on a 'regulated market' which centralized the trading to incumbent stock exchanges. Other Member States chose not to use this option and develop sophisticated 'best execution' policies that were not needed and thus did not exist in the countries enforcing the concentration rule (Commission 2002b:104). This has resulted in regulatory fragmentation as order-execution methodologies differed widely across countries due to: "discrepancies between national trading conventions, rules on market operation, scope for competition between order-execution platforms, and the behavior of market participants" (Commission 2002b:6). In short, the ISD compromise enabled regulatory integration in a subset of EU countries, but preserved the fragmented status quo within the EU as a whole. This outcome thus corresponds to the status quo in the coordination game (Table, (P,C) cell top-right).

Table 3.4: Number of regulated markets in EU countries

Country	1997	2000	2004	2008
Denmark	1	2	3	2
Finland	2	2	2	1
Germany	9	9	8	10
Ireland	1	1	1	1
Luxembourg	1	1	1	1
Netherlands	2	1	2	3
Sweden	3	4	3	2
UK	7	9	8	7
Austria	2	4	3	2
Belgium	5	4	2	2
France	4	4	4	3
Greece	2	2	3	2
Italy	5	7	7	11
Portugal	4	6	5	3
Spain	4	5	5	5

'Southern'	26	32	29	28
'Northern'	26	29	28	27

Source: Annotated presentations of regulated markets and national provisions implementing relevant requirements of ISD (93/22/EEC) as published in Official Journal in respective years.

Note: Some member states also used the concentration rule more stringently to prevent stock exchange mergers and the entry of new competitors to established exchanges to their domestic securities markets.

The MiFID replaced the concentration rule with transparency rules that were negotiated within Lamfalussy committees. These rules — discussed in detail in section 4 — were prescriptive and complex, but avoided the discretion of national authorities to force all retail trading to regulated markets. Despite their complexity, the harmonized MiFID transparency rules were implemented consistently, which is again supported by the fact that they do not reappear as problematic in the MiFID review process (Commission 2010b, Bowles 2010, Gomber and Pierron 2010). As was the case with conduct of business rules, the reform agenda focuses on extension of existing rules to non-equity assets such as bonds, structured products and derivatives (Commission 2010b). The debate on MiFID 2, which is scheduled for 2011, is entirely driven by the technological changes in the markets and unregulated parts of the markets that proved important during the financial crisis.

To summarize, the MiFID has resulted in much higher degree of regulatory integration than ISD, despite the similar patterns of contestation during the adoption phases of respective directives. The MiFID rules were sufficiently harmonized to be implemented consistently across all EU economies, thus the problem with fragmented implementation did not reappear. MiFID's most contested aspects — conduct-of-business-rules and transparency rules — are no longer on the EU legislative agenda.

The discussion concentrates on their extension to heretofore uncovered products and services. Hence, the evidence suggests that MiFID delivered much higher degree of regulatory integration. The remaining question is whether the delegation of regulatory powers to committees played any role in this success. However, before we proceed to it, the next section briefly summarizes the governance arrangements specific to securities regulation.

3. Governance structure: generic comitology vs. Lamfalussy procedure

The ISD negotiation and implementation was supported by generic governance arrangement applicable at the time (see Table 3.5 for summary). The Council decided by the qualified majority and the role of the European Parliament was limited by the cooperation procedure, when its suggestions were non-binding for the Council. There was no formally established comitology committee in the domain of investment services that would support negotiations and implementation of ISD.[66] There was only the Contact Committee established in 1979 that was supposed to facilitate harmonized implementation securities directives, but was largely inactive (Commission 2000b) and the High-Level Committee of Securities Market Supervisors served as informal working group that met 2 to 3 times a year at the initiative of the Commission (Lannoo 2001, Commission 2000b).

[66] The UCITS Contact Committee had a comitology role, but its mandate was limited to the 1985 Undertakings for Collective Investment in Transferable Securities directive.

Table 3.5: Decision procedures and decision bodies in securities regulation

	Bodies involved in the decision-making and the applicable decision procedure	
Directive (period of adoption)	**ISD (1989 – 1993)**	**MiFID (2002 – 2006)**
Level 1: framework directive proposed by the Commission	Council; qualified majority European parliament in cooperation procedure; majority	Council; qualified majority European parliament in co-decision procedure; majority
Level 2: implementing measures	Council; qualified majority *	European Securities Committee; regulatory committees with scrutiny; qualified majority
Level 3: consulting, drafting and monitoring	High Level Securities Supervisors Committee (generic comitology)	Committee of European Securities Regulators (CESR)
Level 4: monitoring and enforcement	Commission and European Court of Justice (ECJ)	Commission supported by CESR monitoring and ECJ

Notes: * Implementing measures were part and parcel of the framework legislation.

By the time the MiFID was negotiated and implemented there were two important changes to the applicable governance arrangements. The role of the European Parliament was increased by the introduction of the co-decision procedure. More importantly, the comitology rules and bodies were overhauled by the Lamfalussy reform, which introduced two new ideas (see Chapter 1). First, it distinguished between the framework and implementing legislation. Second, it created a more deliberative process of proposing, approving, implementing, and evaluating the financial market legislation. The reform added two new levels of committees between the Level 1 (co-decision procedure) and Level 4 (standard process of monitoring of the implementation of EU legislation by the Commission and ECJ). Level 2 was inhabited by the European Securities Committee, composed of member states' representatives, who were responsible for the adoption of the implementing measures based on the mandate specified in the Level 1 framework legislation. The Level 3 committee — Committee of

European Securities Regulators — was composed of representatives of the member states' regulatory authorities and aimed at strengthening the consistency of the day-to-day enforcement of securities regulations.

Although, the governance arrangements applicable to securities regulation are essentially the same as those for banking, their pre-Lamfalussy effectiveness was much lower. The High Level Securities Supervisors Committee never reach comparable degree of activity and relevance as the Banking Advisory Committee (see Chapter 2). This was a consequence of a lower degree of regulatory integration at the onset of the single market project as well as absence of international standards comparable to Basel Accord (Lannoo 2005, interview 6). This problem led the French presidency to invite the Lamfalussy committee to suggest possible solutions in 2000, and hence to the development of the four level architecture that was subsequently extended to banking and insurance as well (see Chapter 1).

The remaining question is whether the delegation of regulatory powers to Lamfalussy committees played any causal role in the success of MiFID in enhancing regulatory integration on the most contested aspects of securities regulation. For the evidence, we need to delve into the details of the adoption and implementation process on each of the four levels of the Lamfalussy process.

4. Regulatory integration under MiFID

A frequent criteria for comparing the efficiency of the negotiation process is the time it took from the initial Commission proposal to the final adoption of the directive (Pollack 2003a, Quaglia 2008). Although, the speed of negotiation does not reveal any policy relevant information, it is still informative indicator. The process of MiFID adoption was no less meandering than the case of ISD. The Commission submitted a formal proposal in 2002 and it was adopted by the European Parliament in September 2003. However, the Council had introduced changes to the common position that were approved by qualified majority in October 2003. The text thus returned to the European Parliament and was approved in March 2004 just before the EP dissolved for the European elections. The Council finally adopted the MiFID in April 2004, just a few days before the Eastern enlargement. The adoption process took a mere 18 months, but — unlike ISD — MiFID presumed adoption of implementation measures for number of its articles. It took European Securities Committee another 26 months to agree on implementing Regulation[67] and Implementing Directive[68] , adding a total to 44 months, which is not substantively faster than the 49 months it took to adopt ISD.

However, MiFID was much more detailed and prescriptive directive than ISD. Where ISD relied on vague principles without specific implementation provisions, MiFID proper and its implementation legislation offered much more exhaustive rules. Whereas the ISD included a mere thirty-two Articles, the MiFID incorporated seventy-three with another ninety-six in its implementation regulation and implementation

[67] Commission Regulation (EC) No 1287/2006.
[68] Commission Directive 2006/73/EC.

directive. The MiFID text is 5 times longer than ISD, which indicated not only increased scope, but also depth of the provisions (Casey and Lannoo 2006). Hence, the Lamfalussy process enabled the EU to adopt more harmonized, prescriptive legislation slightly faster, despite the prevalent pattern of political contestation.

4.1 Level 1: Co-decision procedure

After the Council passed the amended MiFID text that was opposed by the 5 out of 15 member states, it had to return to the European Parliament. There it became a focus of intensive lobbying led by UK investment firms and large UK-based US-owned investment banks, which had strong reservations about the parameters of the transparency regime that protected stock exchanges through demanding rules on 'best execution' (interview 12; Quaglia 2010a, Mügge 2010). Already in the first reading, the EP had approved several amendments reducing the stringency of the Commission proposal. The EP expressed concern about the costs of securities transactions under stricter 'conduct-of-business' rules and proposed to waive their applicability for certain types of transactions. It also proposed to water down the 'best execution' principle by introducing a 'reasonably achievable' qualification, and suggested that the transparency requirements were limited to transactions below a certain 'standard size' that were to be defined in implementing measures (EP 2003). In the second reading, the EP reinstated most of its original suggestions (EP 2004) and moved the balance of MiFID closer to the preferences of the large investment banks and thus of the 'Northern' policy coalition (Mügge 2010:133).

The EP suggestion to leave detailed specification of s ome of the more controversial provisions to implementing measures indicates the effect of the Lamfalussy governance arrangements on the negotiation phase. Unlike in the case of the ISD, it was no longer necessary to achieve full agreement on the Level 1. The member governments, Commissioners and MEPs could shift this burden to Level 2, without loosing political control over the technical decisions. Table 3.6 lists the MiFID articles whose implementation measures were formally delegated to the Level 2.

Table 3.6: MiFID Articles with some parameters delegated to CESR

MiFID	Issue	Directive	Regulation
Article 4	Definitions of key concepts	yes	yes
Article 13	Organizational requirements on firms	yes	yes
Article 18	Conflicts of interests	yes	
Article 19	Conduct of business obligations	yes	
Article 21	Best execution requirement	yes	
Article 22	Client order handling rules	yes	
Article 24	Transactions executed with eligible counter parties	yes	
Article 25	Obligation to uphold integrity of markets, report transactions and maintain records		yes
Article 27	Obligation for investment firms to make public firm quotes		yes
Article 28	Post-trade disclosure by investment firms		yes
Article 29	Pre-trade transparency requirements for multilateral trading platforms		yes
Article 30	Post-trade transparency requirements for multilateral trading platforms		yes
Article 40	Admission of financial instruments to trading		yes
Article 44	Pre-trade transparency requirements for regulated markets		yes
Article 45	Post-trade transparency requirements for regulated markets		yes
Article 56	Obligation to cooperate between member state authorities and with CESR		yes
Article 58	Exchange of information		yes

Note: Implementation measures for the delegated articles were specified either in the Commission Directive 2006/73/EC (column 3) or in the Commission Regulation no. 1287/2006 (column 4).

The European Securities Committee (ESC) decides on implementation measures is composed of member state representatives from Ministries of Finance. The ESC is formally a comitology committee subject to the 'regulatory committee with scrutiny procedure' which makes it accountable to the Economic and Monetary Affairs Committee of the European Parliament and to the Council that both have time to comment or block the proposed implementation measures before they are formally adopted by ESC. Under the 'Meroni doctrine' no comitology committee can legislate directly and all implementing measures have to be formally adopted by the Commission. These are the same accountability measures as applicable to CEBS discussed in Chapter 2 and outlined in general in Chapter 1.

The Council and European Parliament were wary of delegating too much power to technocratic committees so they imposed two political safeguards. The first is so-called Prodi declaration commits the Commission to not go against a ‘predominant view’ of the Council when adopting implementing measures. This was introduced at the insistence of Germany that wished to prevent the Commission from pushing a too ‘neoliberal’ regulatory model (Hertig and Lee 2003), but since there is no definition of what constitutes a ‘predominant’ view (IIMG 2003: 14) the clause merely introduces an element of uncertainty. The second safeguard is part of the new comitology procedure called a ‘regulatory committee with scrutiny’ that guarantees the Council and European Parliament time to react to any draft and to review the final draft of Level 2 implementing measures to ensure that they stay within the political limits of the Level 1 directive.

This contrasts to the ISD governance arrangements, when there was one expert group composed of national regulators with no formal comitology status. The opportunity to delegate, yet stay in control reduced the political stakes on Level 1 thus easing the agreement as the key stakeholders — both public and private — were aware that there will be next round of negotiations, allowing for rebalancing of regulations within the limits of the political decisions made on Level 1 (Lannoo and Levine 2004, interview 4). At the same time, there was less of the concern about potential unintended consequences of implementing measures than about unintended consequences of legislative measures stipulated in the directive. This was largely due to speed of potential amendments. Whereas it takes about two years to pass substantive amendment of a directive through the codecision procedure, with another two years for transposition and implementation, implementation measures can be adopted within months and implemented speedily. The flexible adaptation of implementation measures provides a third policy response strategy in-between the reopening the political negotiations and resorting to non-implementation.

4.2 Level 2: Complex compromises in ESC

The European Securities Committee (ESC) met five to ten times a year and may decided on the implementing measures by the same qualified majority formula as the Council.[69] In its decision the ESC relied on a detailed technical comparisons supplied by the Level 3 committee (CESR), which allows it to discuss implementing measures to much greater depth than would be possible at political Level 1 (IIMG 2003; interviews 3 and 5). This

[69] As part of the post-crisis regulatory reforms the ESC was given explicit legal basis and budget as it became European Securities Market Authority.

is easily observable through comparison of technical details contained in the Level 1 and Level 2 legislation and from the ESC working documents. Most meetings are held at the level of alternates who forge the technical compromises. The full members who have the voting right meet less often to approve implementation measures. The summaries of ESC meetings show that delegations often express opposition to proposals at the level of alternates, but by the time measures are voted upon acceptable solutions have been found. Since its inception in 2001, the ESC never resorted to a qualified majority vote, although it did not avoid controversial issues.[70]

The technical insight of ESC members allows for a distinction between measures that need to be harmonized and those where more flexibility is justified. The necessary information to support these decisions was simply not available during the ISD implementation, when the Commission had to survey national authorities that had very little knowledge of the mutual differences among EU countries. Access to detailed comparisons produced by CESR on Level 3, allows the ESC to codify the key harmonizing measures in a Regulation that is directly applicable in the national legislation and does not require transposition. Other measures are codified in implementing Directive that leave more flexibility during the transposition. This limits the potential 'gold plating' that troubled the functioning of ISD.

However, there is a price to pay for the detailed technical compromises. The Level 2 committees deepen the tendency towards punishingly complex rule-based regulation that are increasingly expensive to implement for the individual financial firms.

[70] See the summaries of ESC meetings available at http://ec.europa.eu/internal_market/securities/esc/index_en.htm (accessed 3 November 2009).

Moreover, the entry of new types of trading platforms that was driven by the abolition of the concentration rule and new technological developments fragments the trading and settlement processes within the EU, thus increasing the costs and complexity of data consolidation (CESR 2010). Therefore, the increased harmonization through complex compromises is also likely to trigger some consolidation within the industry. This point was neatly summarized by a lobbyist for a large European bank as:

> "for us the only advantage [of MiFID] is that the smaller brokerage houses will suffer much more under the new rules and this transparency and best execution, because in relation to turnover and profit the investment expenses are higher" (Mügge 2010:138).

The complex compromise strategy was relied upon also with regard to the most contested issues inherited from ISD debates. The detailed specification of the conduct of business rules — including rules on best execution and conflict of interests — as well as the pre- and post-trade transparency rules were delegated to the Level 2. Hence, what the ISD left for the mutual recognition, the MiFID specified in two levels of binding legislation. At the same time, the conduct of business rules were largely specified in implementation directive leaving more policy space to the member states than market transparency rules that were imposed in a Regulation.

The ISD conduct of business rules were defined in seven general sentences (see Table 3.2), whereas the MiFID definitions were delineated in considerable detail in the Level 1 MiFID directive, as well as its Level 2 implementation regulation (see Table 3.3). The most important aspect that the MiFID clarified was client classification. In order to avoid conflating the retail and professional clients that provided the opening for 'gold-plating' under ISD, the MiFID introduced a three tiered client classification regime with the most stringent rules applied to the services to retail customers (see section 3 above). The MiFID also defined clearly the suitability and appropriateness tests and best execution requirements that force investment firms to prove that clients were appropriately classified and treated as required by the rules applicable for the given class of clients.

Suitability and appropriateness test required the investment firm to gather and analyze information about the customer’s (i) knowledge of and experience with the specific product or service, (ii) her financial standing and (iii) her investment objectives, before making any recommendations. It also required them to communicate to clients how the recommendations fit to their knowledge, goals and resources.[71] The MiFID also developed in detail the best execution rule that requires investment firms to take all reasonable steps to obtain the best possible result for their customer when executing orders on their behalf.[72] The best execution test requires an analysis of market price of the service or product, the cost of provision of the product or service, the speed and likelihood of execution, settlement size and nature of the settlement (Jennings 2007). In short, compared to ISD the MiFID not only provided rather detailed rules, but also placed the onus on the investment firm to be able to prove that suitability, appropriateness and best-execution tests were done as required.

[71] Articles 19 and 24 of MiFID and Articles 36 to 38 of the implementation Directive.
[72] Article 21 of MiFID and Article 44 of the implementation Directive.

The ISD negotiation produced vague rules, because member states held different preferences over the host-country role in protection of consumers. The 'Southern' member governments wanted to retain control over the protection of their retail investors, whereas the 'Northern' members favored more harmonization and liberalization that favored their transnational investment firms. The MiFID reconciled this conflict by expanding the client classification rules. It effectively reduced the burdensomeness of conduct of business rules imposed on trading between large firms by introducing the eligible counterparty category, thus satisfying the ‘Northern’ preferences. At the same time, it increased the protection of retail clients, while harmonizing them, which matched the Southern goals. Hence, it was a structured compromise that allowed the EU to adopt more harmonized conduct of business rules.

The ISD conflicts about the concentration rules, were replaced with the conflicts over the market transparency rules that allow market participants to know at what prices they can buy and sell a share (pre-trade transparency[73]) and at what prices shares have been sold and bought (post-trade transparency).[74] Whereas the concentration rule served to protect less competitive national stock exchanges, the market transparency regime was about protection of all traditional stock exchanges from the competition of multilateral trading platforms and systematic internalisers that emerged due to technological and financial innovations during the decade separating the ISD and MiFID adoption. Despite this evolution, the member states preferences again mapped on the 'Northern' and 'Southern' coalitions, as revealed in the Council voting. Here

[73] Articles 27, 29 and 44 of MiFID.
[74] See MiFID Articles 14, 27, 28, 29, 30, 44, 45 for the post-trade transparency rules.

again, the adopted MiFID provisions bear a clear imprint of a structured policy compromise, especially over the post-trade transparency.

The pre-trade transparency rules were a thorny issue during the MiFID adoption, especially for the systematic internalisers (see Mügge 2010:135, Quaglia 2010a). These investment firms operate outside a regulated market or as multi-lateral trading platforms and execute customer order flow in liquid shares internally their own account. However, meeting the best execution test would require systematic internalizers to make sure that their internal prices are no worse than prices in other trading venues. Such a 'shopping around' would substantially complicate their business model and favor traditional stock exchanges whose business is to publish pre-trade data in real-time. In the dramatic Council vote, the stringent market transparency regime prevailed despite 5 member states voting against (see above). Nonetheless, subsequent negotiation in European Parliament and negotiations of the Level 2 implementation measures softened the pre-trade transparency rules, by introducing a system of waivers based on the market model, or the type and size of orders.[75] The waivers effectively provided an opt out for all larger transactions settled by systematic internalizers, thus limiting the impact of the pre-trade transparency regime on them.

The waivers were granted by national authorities rather liberally, which led to growth of such transactions in some countries, especially in the UK.[76] The rules on grating the waivers proved to be too fuzzy to support consistent implementation. Indeed, the

[75] See Articles 18 and 20 of the implementation Regulations.

[76] In the financial jargon these are referred to as dark pools of liquidity, which is an allusion to the fact that the prices of transaction are not disclosed.

current discussions of the MiFID review suggest that the nationally granted waivers should be subjected to EU level control of ESMA (Linklaters 2010, CESR 2010). Hence, the success of pre-transparency compromise was only partially successful in inducing consistent implementation of the more harmonized MiFID rules.

The post-market transparency rules were implemented more consistently, because they avoided reliance on exceptions under national control. The MiFID required investment firms to publish specified information about any equity transactions in all types of markets. Typically, price information should be made public within 3 minutes after the transaction was concluded. However, large blocks of shares are traded on different prices than standard size transactions and their immediate reporting could distort prices of standard transactions. Since, large transactions are typically conducted outside of regulated markets or multilateral trading platforms, the rules on the deferred publication of price data on large transaction pitted the traditional venues against systematic internalizers. The traditional stock exchanges preferred exception only for very large transactions, because that would protect their business. The systematic internalizers and other investment firms operating over-the-counter, pushed for rules that would except even relatively small-sized transactions.

The policy conflict between traditional trading venues and new competitors again mapped on the two coalitions in the Council. Mügge (2010) provides a detailed account of the process of preference aggregation, whereby the Borsa Italiana and Paris Bourse — that benefited most from the concentration rule — launched effective lobbying campaign through the Federation of European Stock Exchanges (FESE) for stringent post-trade transparency that countervailed the push of UK-based investment firms for easy rules. Consequently, Italy and France pushed for stringent rules and they were joined by Germany, which led to the approval of stringent text of the MiFID in the Council with five member states voting against. However, during the negotiations of the implementation measures in CESR the investment firms pushed for easing of the post-transparency regime. The result was a structured compromise, which included not one threshold for distinguishing between small transactions that ought to be reported immediately and large transaction that can be deferred, but 22 such thresholds. The implementation Regulation allowed for six different delays between 60 minutes and three days, depending on the average daily turnover of a given class of shares and the size of the transaction.[77] Thus the rules on large transactions are fully harmonized, albeit very complex (see Table 3.7).

Table 3.7: Permitted delays for publication of share price data

		Class of shares in terms of average daily turnover (ADT)			
		ADT < EUR 100 000	EUR 100 000 ≤ ADT < EUR 1 000 000	EUR 1 000 000 ≤ ADT < EUR 50 000 000	ADT ≥ EUR 50 000 000
		Minimum qualifying size of transaction for permitted delay			
Permitted delay for publication	60 minutes	EUR 10 000	Greater of 5% of ADT and EUR 25 000	Lower of 10% of ADT and EUR 3 500 000	Lower of 10% of ADT and EUR 7 500 000
	180 minutes	EUR 25 000	Greater of 15% of ADT and EUR 75 000	Lower of 15% of ADT and EUR 5 000 000	Lower of 20% of ADT and EUR 15 000 000

[77] See Commission Regulation (EC) No. 1287/2006, Annex 1, Table 4. Strictly speaking the table defines 33 different thresholds since some are defined as either proportion of ADT or absolute sum.

	Until end of trading day (or roll-over to noon of the next trading day if trade undertaken in final two hours of trading day)	EUR 45 000	Greater of 25% of ADT and EUR 100 000	Lower of 25% of ADT and EUR 10 000 000	Lower of 30% of ADT and EUR 30 000 000
	Until end of trading day next after trade	EUR 60 000	Greater of 50% of ADT and EUR 100 000	Greater of 50% of ADT and EUR 1 000 000	100 % ADT
	Until end of second trading day next after trade	EUR 80 000	100 % ADT	100 % ADT	250 % ADT
	Until end of third day next after trade	-	250% of ADT	250% of ADT	-

Source: MiFID implementation regulation

The complex compromise was implemented rather successfully. Unlike in the case of pre-transparency waivers, the post-transparency rules were fully harmonized and afforded no margin of discretion for national authorities. The 22 categories balanced the conflicting interests rather well and since they were embedded in a Regulation, their implementation was not distorted by transposition process. During the 2010 MiFID review the structure of the compromise was not questioned neither by regulators nor market participants (Linklaters 2010, Norton Rose 2010) and CESR proposed expanding the regime to other financial instruments than shares (CESR 2010). At the same time, the CESR argued for shortening of all delays so that standard-sized transactions delay would be shortened from 3 to 1 minute and the number of delays for large transaction would be reduced from 6 to 3 and shortened so that the longest delay would not extend beyond the end of a trading day. The shortening and simplification reflects the fact that the rules are stable and advances in IT technologies makes faster publication more feasible.

As it became customary in a recent financial market regulation, the MiFID and its implementing Regulation included review clauses that highlighted contested aspects to which the legislators hoped to return soon either to ensure that they work as intended, or to progress towards greater harmonization on given issue. In Article 65 the MiFID stipulates four deadlines and seven specific issues that the Commission was obliged to report on and submit amendments. However, none of these refer directly to issues of conduct of business rules and market transparency. As these contested issues were delegated they were no longer 'flagged' by review clauses in the Level 1 directive, but the practice continued in the Level 2 implementation Regulation. Its Article 40 (3) stipulates that within two years the Commission and CESR should reexamine the 22 thresholds and report to the EP and the Council.

4.3 Level 3: CESR doing the legwork

Finally, the Level 3 committee — Committee of European Securities Regulators (CESR) — consists of representatives of national regulators. They support the negotiations at both Levels 1 and 2 and CESR shoulders much of the monitoring and consensus-seeking burden (Quaglia 2008). The information gathering and processing capacity of CESR is the key to the success of the Lamfalussy reforms. As the CEBS in previous chapter, CESR operates a number of expert groups where the regulatory practices of national regulators are compared and turned into shared practices that increase the consistent interpretation, implementation and enforcement.

The CESR improves the consultation process and resolves many technical controversies before they can turn into political ones (interviews 3 and 4). Moreover, it also ensures more consistent implementation by a detailed comparison of national legislation and related supervisory practices. It has the capacity to mediate among different interpretations and establishes common EU interpretations, some of which are codified in various non-binding standards and guidelines that need to be adopted unanimously (CESR 2009). Although CESR consists of representatives of national regulators, its working groups include experts from industry associations and major players in the markets. This increases the risk that the industry views may become preeminent on Level 3, but at the same time, it enables CESR to propose broadly acceptable policy compromises (Mügge 2010).

4.4 Level 4: Easier monitoring and enforcement

At Level 4 of the Lamfalussy procedure there are no new organizations. Nonetheless, the committees on Level 2 and 3 had a profound impact on the monitoring and enforcement functions by their capacity to produced detailed and comparative information. The work of the ESC and CESR makes the enforcement tasks of the Commission easier despite the doubled size of the EU and quintupled size of the MiFID.

Detailed monitoring also helps to contain any rebound of 'gold plating'. Article 4 of the MiFID allows member states to retain or impose additional requirements and it could be used for measures that fragment the EU regulatory framework. However, unlike the

ISD, the MiFID allows such practices only in exceptional cases, if they can be justified as proportionate. It also imposes an explicit notification requirement. When MiFID entered into force, the UK, Ireland, and France notified the Commission of measures concerning the preservation of auxiliary aspects of the existing national regulations. The Article 4 has not been used since, indicating no demand for country specific measures.

The European Court of Justice (ECJ) is the key player in ensuring the consistent interpretation and enforcement of EU legislation. In principle, ECJ rulings could have clarified the ISD and resolved its weaknesses. However, the permissiveness of the ISD with regard to additional regulations and its ambiguity have reduced the incentive of the Commission or any other party to sue member states for non-compliance (Hertig and Lee 2003: 4). Moreover, it was not an issue of one or two member states implementing the regulation differently, but rather groups of member states disagreeing on the interpretation of key provisions.

The ECJ rulings related to ISD were concerned only with auxiliary issues of taxation that may put some financial products at a disadvantage in some member states, rather than its the most disputed provisions. In contrast, the implementation of the MiFID immediately triggered three infringement cases against members that failed to transpose the Directive on time, but transposed it only after some delay. In addition, various technical implementation problems indicated through the CESR's ongoing monitoring have been resolved during the pre-infringement period (interviews 3 and 6). This experience with MiFID implementation combined with the fact that the implementation problems do not feature in the 2010 MiFID review, suggests that delegation of regulatory powers enhanced the regulatory integration of the EU investment services sector. The committees were instrumental in formulating adoptable proposals and supporting their implementation.

5. Conclusion

The restructuring of the EU decision-making process by the Lamfalussy reform was instrumental in preventing the reoccurrence of fuzzy provisions on the most contested aspects of the investment services regulation. The comparison of the ISD and MiFID cases shows that replacing the unanimity procedure with qualified majority in the Council did not suffice to remove the deadlocks on the policy issues that split member states into two advocacy coalitions with each potentially having a blocking minority in the Council. The most contested provisions of the investment services related to the protection of retail consumers and protection of the dominant role of incumbent stock exchanges indeed spit member government into such coalitions, thus the ISD could be agreed upon only at the expense of clarity of the disputed regulatory measures. This merely shifted the conflicts from the decision-making phase to the implementation phase. The most contested ISD provisions essentially preserved the status quo, when different Member States applied different regulations, which undermined regulatory integration in securities markets.

The Lamfalussy procedure has prevented the MiFID to fall in the same trap. It has delegated some decision-making powers to technocratic committees that are also charged with detailed monitoring and peer-reviewing of transposition and application of EU financial regulations in all Member States. The technocratic actors have the capacity to zoom-in to the technical details and find acceptable solutions that are not easily identifiable on the political level. This reduces the scope for political conflict during the decision-making and ensures consistent implementation and enforcement thereafter. The separation of the political and technical decisions, with new accountability mechanisms that subject the lower level committees to oversight of the Commission, Council and European parliament, thus represents deepening of the traditional EU regulatory mode that relied on such committees only for consultations but not decisions (Wallace 2005:81-82).

The price paid for the Lamfalussy exit mechanism is increased complexity of the EU financial regulation. The political conflicts stemming from different Member States' preferences are accommodated by carefully crafted and forbiddingly detailed rules, which inevitably increase compliance costs. At the same time, the Lamfalussy procedure contains built-in mechanism that can reduce the complexity of implementing measures that prove immaterial. The regulations can be simplified by the Level 2 committees without recasting the whole directive, providing that such changes stay within the mandate given to the ESC by the Level 1 directives. Indeed, the CESR proposals submitted during the 2010 MiFID review indicate a tendency towards simplification of some of the most complex policy compromises.

The delegation of powers to technocratic committees through Lamfalussy procedure can explain why the adopted text of MiFID and its implementing Regulation and

Directive were less fuzzy than ISD and thus easier to enforce consistently across EU. However, it cannot explain why the directive matches more closely the preferences of the 'Southern' advocacy coalition. This is best explained by circumstantial factors that put the representatives supporting 'Southern' proposals into key positions in the Commission and Council Presidency at the time when MiFID decision could no longer be delayed without facing the uncertainty stemming from the 2004 enlargement and European elections.

The Lamfalussy procedure can produce more coherent and uniformly enforced financial regulation, but on its own it guarantees optimal regulation neither in terms of economic efficiency nor political legitimacy. The delegation of some power to technocrats reduces the decision burden on the top level political actors, but at the same time it increases demands on the political supervision and democratic accountability of Lamfalussy committees. Regulators have their own bureaucratic agendas and financial industry maintains a powerful lobbying machinery that can capture the decision-making on regulatory reforms. The committees are receptive to industry proposals due to their technocratic nature and regular communication. Yet, they also fall under the scrutiny of the Council and European Parliament, which should prevent their capture by the paradigms and interests of the financial industry. The institutional balance should help the EU to stay on the fine line between excessive deregulation as well as excessive protectionism that both undermine the single market in financial services.

The introduction of the Lamfalussy procedure enhanced the EU capacity to change regulatory institutions endogenously, without a need for dramatic exogenous shock. The member states recognized that mutual recognition and principle-based regulation is insufficient to allow securities markets to reap all benefits of the single market and monetary union and agreed to delegate the right and obligation to produce harmonized prescriptive rules to politically accountable technocratic committees. They recognized that regulatory integration in fast evolving, technically intensive policy domain characterized by conflicting preferences of Member States can be enhanced by delegating some responsibilities to technocratic actors who are better equipped to deal with technical complexity than traditional political actors.

Chapter 4:

Cross-border bank resolution regime in the EU[78]

The financial crisis has tested the viability of the EU's single banking market and its underlying regulatory framework under severe market conditions. It has highlighted the regulatory gap between the degree of financial integration manifested in the presence of large cross-border banks, on one hand, and limited regulatory integration exemplified by the country-based bank resolution regimes on the other. Although, the crisis presented a considerable shock to the EU regulatory system, it did not induce any discontinuous regulatory reform. Instead, the initial post-crisis reforms continued in the pre-crisis trends.

This chapter reviews the evolution of the EU cross-border bank resolution regime during the 1999 to 2009 decade. Although, the Lamfalussy committees are important actors within the resolution regime, in this case the delegation extends further. Due to its potential impacts on fiscal sovereignty of member states, the Council consistently discouraged the Commission from submitting any EU level proposals on cross-border bank resolution. Instead, the Council adopted soft law rules that delegated the regulatory powers over the resolution of cross-border banks to the supervisory and cross-border stability colleges. These colleges were charged with preparation of resolution plans for the largest financial groups operating within the single market for financial services. Hence, it is in the colleges, where the policy compromises on bank resolution scenarios are formed.

[78] Shortened version of this Chapter is forthcoming in Kudrna, Z. (2012) Cross-border resolution of failed banks in the EU after the crisis: business as usual. JCMS: Journal of Common Market Studies (50)2.

Closing the regulatory gap by the adoption and implementation of the cross-border resolution regime is particularly urgent in the case of systemically important banks that dominate the EU banking market. The economic and political significance of a resolution regime for such banks, national economies, Eurozone and the EU was demonstrated by the Irish debt crisis. In September 2008, during the period of the highest uncertainty after the collapse of Lehman Brothers, the Irish government issued a blanket guarantee on all deposits in Irish banks. This had led the outflow of savings from other EU countries — especially the UK — forcing other EU governments to similar uncoordinated policy responses. Subsequently, the guarantee put the solvency of Ireland into question, thus extending the Eurozone turbulences beyond Greece, and leading to the €85 billion joint EU-IMF program for Ireland. This package contained specific measures for recapitalization, downsizing, restructuring and reorganization of Irish banks (Department of Finance 2010). Had there been a workable bank resolution regime, Ireland could start the restructuring already in 2008 and avoid much of the uncertainty and contagion to the rest of Europe.

The Irish case also demonstrates that even resolution of largely national banks may have important cross-border consequences, but such spillovers are certain if any of the 40 or so systemically important cross-border banks face instability in several EU countries. These banks provide a core financial infrastructure for the daily operations of European economies and, in case of their failure, cannot be simply closed down and liquidated. They need to be resolved as 'going concern' so that their elementary functions — such as payment system, credit supply and monetary transmission — are preserved in order to minimize the damage to wider economy (FSB 2010, Commission 2010c, Cihak and Nier 2009). Hence, this chapter focuses specifically on the cross-border bank resolution regime for the forty or so largest EU financial groups.

1. Adopting the rules for cross-border bank resolution

During the pre-crisis decade the EU had experienced an unprecedented wave of cross-border mergers of large domestic banks fueled by internal dynamics of financial markets and the introduction of euro (Dermine 2000, Veron 2007). At the onset of the financial crisis there were 39 cross-border banks and around 100 other banking groups that have large subsidiaries or systemic branches in another member state (Commission 2009). Although these are a small percentage of some 8300 EU banks, they are the most important ones as they represent about 68% of total EU banking assets. The concentration within the single market for banking services brought the cross-border stability questions onto the EU policy agenda (see Dermine, 2000, Vives, 2001, Vernon 2007).[79]

The wave of the cross-border banking mergers within the EU coincided with the regulatory fallout of the Asian financial crisis. The first debates about the cross-border financial stability took place in this context. The EU had supported establishing the Financial Stability Forum as an international platform charged with formulation of

[79] The crisis has underlined the economic relevance of the cross-border resolution regime even for large banks that did not experience major instability. The market valuations of cross-border banks suffered more than valuations of similar, but primarily national banks (Unicredit, 2009). This is not surprising given that the credit rating agencies explicitly include the likelihood of the publicly financed bailout (called 'implicit and explicit external support elements') into their rating of bank's long-term financial strengths. In case of cross-border banks the external support is more uncertain thus rating of their securities suffers and so does their market valuation.

some guiding principles of cross-border cooperation (European Council in Cologne, June 1999). The ECOFIN Council meeting in April 2000 discussed financial stability issue and commissioned a report from the Economic and Financial Committee (EFC).

Although the Council recognized the policy problem, it was not ready to accept any binding legislation. Instead, it opted for keeping the cross-border bank resolution regime in the intergovernmental domain, relying on voluntary cooperation as recommended by 'Brouwer' reports delivered by EFC in 2000 and 2001.[80] The non-binding nature of the regime was widely criticized by many observers (see, for example, Dermine 2000, Vives 2001, Veron 2007, Walter and Bergheim 2008) as well as the European Parliament (EP 2010:2). Some member states such as the UK and Germany also indicated that new arrangements may be necessary (Hartmann et al. 2003: 37), but there was no consensus on their design. Nonetheless, the Commission feared political defeat and avoided any legislative initiative on cross-border bank resolution beyond the information-sharing in CRD and FCD (see Speyer and Walter 2009:1).

The Brouwer report was prepared by twelve experts, mostly members of the Economic and Financial Committee. They were asked whether the existing arrangements for crisis management are adequate in light of the introduction of the euro and the new trends in the financial sector such as internationalization, cross-border consolidation and disappearing boundaries between different segments of financial markets. The report concluded that the institutional arrangements based on the competence of national

[80] The Commission was formally not a party to any of the MoUs.

authorities required further strengthening of cross-border co-operation and co-ordination (EFC 2001: 17). At the same time, the report argued against developing a binding legal framework for crisis resolution and management arguing that:

> "every crisis is unique, in the sense that its immediate causes, the characteristics of the institution(s) involved, the potential for contagion and so on are different. In order to take these specific circumstances into account, (national) authorities deal with each crisis on a case-by-case basis. Against this background, it is not surprising that there is no blueprint for crisis management, either at the European or at the national level. For the same reasons, this report will not attempt to lay out such a blueprint." (EFC 2001:5-6).

The Brouwer report goes out of its way to stress the uniqueness of each crisis as the key argument against any 'blueprint' (in fact it is mentioned 3 times on 17 pages). Whether to initiate any legislation on cross-border crisis management and resolution was a contested question. The Commission, European Parliament and some member states considered a common regulation necessary (interview 1). However, the UK government was consistently concerned about EU level interference into its financial sector and opposed any Commission initiative, which was seconded several other member governments.[81] At the same time, all member governments agreed that some kind of response to cross-border integration of banks was necessary. Hence, the compromise was to keep the issue firmly in the hands of Council's Economic and Financial Committee (EFC) and rely on the voluntary, non-binding soft law. The Brouwer report was formally endorsed by the Council and non-binding memoranda of

[81] Unlike in the previous chapters, the specific distribution of policy preferences over the alternative designs of the EU cross-border regime is less clear, because there was no formal voting in the Council, European Parliament or expert committees that would force member states to reveal their preferences over these rules.

understanding became the EU legislative tool of choice for the cross-border bank resolution regime.

The Brouwer report praised a system of the bilateral memoranda of understanding (MoU) that clarified the relationships between home and host-country supervisors, and the specific MoUs covering the largest cross-border financial conglomerates. However, it also noted that these MoUs do not explicitly foresee crisis management procedures and should be deepened in this direction (again stressing that the more concrete provisions on the crisis management must allow for the necessary flexibility). The report suggested that the various fora of EU supervisors prepare "procedures for information exchange when a major financial institution runs into trouble, including issues such as the type of information that might be needed, who can produce the information and to whom this can be provided" (EFC 2001: 9). Hence, the policy priority set by the report was information exchange based on the extended memoranda of understanding.[82]

The exclusive reliance on the voluntary cooperation and information exchange seemed justified by the long period of financial stability, which made the cross-border bank resolution framework seemingly unimportant. The EU had experienced occasional crises with cross-border implications, such as the cases of Herstatt, BCCI or Credit Lyonnaise, but these were isolated incidents that did not seem to merit the difficulty of

[82] The memoranda of understanding have their tradition in the world of international finance. They were concluded in the 1970s among the regulators in advanced industrial countries that had to cope with an expansion of international banks following the collapse of the Bretton-Woods system of fixed exchange rates.

developing a common legislation. Hence, the cross-border bank resolution was not included on the list of reforms envisaged by the 1999 Financial Sector Action Plan.

To summarize, the cross-border mergers in banking created a demand for cross-border resolution framework. The Council asked for and endorsed a report, which concluded that crises are too varied in their causes and consequences to be resolved on the basis of a common EU legislation. The Council delegated the task of developing the voluntary cooperation framework to the EFC, which started to develop rules with primary emphasis on information exchange.

1.1 Pre-crisis resolution regime

In principle, the cross-border resolution regime for systemically important banks should consist of three elementary components: (i) rules that support the communication and cooperation of all national authorities potentially involved in a resolution, (ii) governance arrangements that enable decision-making and implementation of the selected resolution strategy in all relevant EU jurisdictions, and (iii) financing arrangements that provide sufficient fiscal resources in case they are necessary (IMF 2010). However, the Brouwer reports singled out only the first element for EU level policy action (EFC 2000, 2001). The Council accepted the suggestion and adopted a series of non-binding Memoranda of Understanding on cross-border cooperation.

The starting point for the EU level cooperation was the system of bilateral memoranda of understanding that individual supervisors of a cross-border banks signed on their own initiative. However, the content, structure and coverage of these MoUs differed from case to case. The Economic and Financial Committee of the Council started a consultation process aiming at standardization of these MoUs to ensure that the information exchange and coordination tasks are covered. It aimed at developing an EU template that could be adapted to the circumstances of individual banking groups.

The first Memorandum of Understanding on high-level principles of cooperation between the banking supervisors and central banks of the EU in crisis management was signed in March 2003. It defined elementary principles for cross-border cooperation, identified authorities responsible for crisis management and specified the required flows of information. It also defined logistical infrastructure and dealt with stages of detection and activation of specific supervisory and central banking tools in financial crises (ECB 2005).

The 2003 MoU was tested by the simulation exercise under the aegis of the Eurosystem's Banking Supervision Committee in September 2003 (Strouzas 2007b). It took place at the premises of the Sveriges Riksbank and included representatives of national supervisors and central banks from all 15 EU countries and ECB. The simulation revealed shortcomings of the 2003 MoU, the most important of which was the absence of the ministries of finance in the decision-making on the cross-border bank crisis management and resolution (Strouzas 2007b).

The second generation of the MoU was adopted In May 2005. This time including also finance ministries among its signatories. The information exchange procedures were deepened and included also sharing the assessment and prospective views among the authorities potentially involved in a crisis situation. The MoU tried to address problems in sharing confidential information by defining procedures for pooling such information at least among the member states directly involved in supervision of given banking groups. It also called for the development of contingency plans, at the national and EU level. At the same time, the information released about the MoU explicitly states that it is legally non-binding and it contains no ex ante burden-sharing arrangement between national treasuries (ECB 2005).[83] Both the 2003 and 2005 MoUs explicitly stipulated their non-binding character and contained no specific provisions on burden sharing (ECB 2005).

The cross-border bank resolution regime was also indirectly supported by some provisions of the financial market directives. These were the only legally binding aspects of the pre-crisis bank resolution regime and they were concerned with the non-core issues, which included information sharing provisions in the Capital Requirements Directive (CRD) and responsibility for information-sharing imposed on the coordinating supervisor by the Financial Conglomerate Directive (FCD) (see Strouzas 2007a:199).

The new MoU was tested in two EU-wide and two Eurozone simulation exercises between 2003 and 2006. These exercises were increasingly decentralized and realistic, mimicking the extent of uncertainty and time pressure of the real banking crisis (Strouzas 2007b). Despite improvements in coordination and information sharing, the overall results revealed the inadequacy of the framework as the cooperation fell short

[83] Neither the 2003 nor the 2005 MoU was released fully to public domain so this information is based on summaries of agreements released by the ECB

of the expectations even under the simulated crisis conditions with limited uncertainty (Pisani-Ferry and Sapir 2010:349, Nyberg 2007:195). This was a serious shortcoming, given that the simulations assumed that the Emergency Liquidity Assistance (ELA) from the European System of Central Banks would be sufficient to contain the crisis. Hence, it did not extend to situations of solvency crisis of systemically important banks, which could require public support for stabilization. In any case, the Council responded by setting up a working group charged with suggesting new arrangements. Nevertheless, at the onset of the financial crisis in August 2007 the two MoUs were all that was in place.[84]

The third generation MoU was signed just before the peak of the financial crisis in June 2008. It strove to address coordination problems among all 114 national authorities potentially involved in a resolution of a cross-border bank active in all EU countries. This was the first MoU that ventured beyond the information sharing and coordination limits set by the Brouwer report in 2001. It introduced novel governance structure — the cross-border stability groups — for the preparation of cross-border bank resolution in normal times and their implementation in crisis times (see section 1). The MoU also developed a set of principles of crisis management and resolution into a common template of the voluntary specific cooperation agreements (VSCA). The CBSG were expected to turn the template into an ex ante, bank-specific agreements on crisis resolution that would include burden sharing rules. As the previous MoUs, the 2008 was non-binding and voluntary. Indeed, without the completed VSCAs the MoU remained a declaration of intent.

[84] There was additional MoU covering the technical aspects of crisis management with regard to the EU payment systems that was signed already in 2001.

The adoption process of the series of MoU revealed that the two most contested aspects were related to sharing of information and fiscal burdens (IMF 2010, Interview 6 and 2). The member states could agree neither on how much information should be shared during the crisis nor on rules of sharing the potential fiscal burdens. It was rather predictable that the fiscal burden sharing rules would represent a contested issue as it entails potential cross-border subsidies. The deep problems with sharing the necessary supervisory information is more surprising.

As the MoUs are essentially non-binding, it is relatively easy to get them adopted unanimously by the Council. They are not adopted through any formal legislative process such as codecision that leaves a track record out of which the policy preferences of member governments and other key stakeholders can be at least partially reconstructed. It is therefore difficult to outline the policy coalitions and their preferred solutions. Nonetheless, the principal disagreements over the cross-border resolution regime map on the relationships between host and home supervisors of the systemically important banking groups.

1.2 Information sharing

The Banking Supervision Committee (BSC) of the Eurosystem conducted a survey of the obstacles preventing the member states from sharing crucial information about stability of each individual banking units in their jurisdiction in 2000. It concluded that there are no legal obstacles to information flows at the national level and in most cases the national laws also allow for cross-border information sharing among supervisors (EFC 2001: 4). At the same time, the survey also observed that some supervisory authorities "do not consider themselves as being entitled to share information on major financial institutions on a regular basis in a multilateral context solely for the purpose of monitoring systemic stability" (EFC 2001:9).

The Brouwer report observed in 2001 that the EU directives neither impose an obligation to share information in crisis situations, nor do they specify the content and timing of the information to be exchanged in such circumstances (EFC 2001: 9). This has changed in 2006 when the Capital Requirements Directive (CRD) imposed the obligation to share information, but avoided any specification of what information needs to be shared under what circumstances.[85] The same is the case with MoUs. Each successive MoU aimed at improving the information sharing processes, but even the most detailed 2008 MoU stays short of creating an obligation to share specific information. In the Annex II it provides a template of "illustrative financial indicators" that might be shared among authorities, providing that this template is in itself included in the Voluntary Specific Cooperation Agreement (VSCA). In turn, the VSCA template expects the participating authorities to have a common database consisting of publicly available data and a template for confidential up-to date data that could be shared in emergency.

However, the most sensitive data such as information on potential systemic implications of financial instability in a given financial group are not expected to be

[85] See Recital 59 of the CDR 2006/48/EC.

available in normal times. The purpose of the template is only to define what must be shared in emergency, although even then the choice of specific indicators to be shared depends on “the type of financial institution, market, infrastructure or crisis under consideration” (MoU 2008:36). In short, a decade and three generations of MoUs later, national authorities may still avoid disclosure of potentially sensitive information. This was also revealed during the simulation exercises that it is "not always easy to define the “right” amount of information to be exchanged when a financial crisis is unfolding, affecting various financial systems to a different extent" (Strouzas 2007b:13).

1.3 Fiscal burden sharing

The contestation of any fiscal burden sharing rules is hardly surprising given their political sensitivity. In the cross-border setting, the public intervention needs to be financed by more than one government, which may create problems with the distribution of costs and benefits of the intervention. On the one hand, all economies benefit when the systemic disruption of their interdependent banking sectors is avoided. On the other hand, no government is keen to subsidize the cost of banking resolution in another EU country, which is a distinct possibility, when the burden sharing formula is not well aligned with the cost, benefits and possibly also other relevant criteria.

There is a multitude of plausible criteria for the fiscal burden sharing, all of which start in some way from the share of assets of the ailing financial group in a given jurisdiction. The common principles for cross-border crisis management endorsed by the ECOFIN Council of 9 October 2007, stipulate that "[i]f public resources are involved, direct budgetary net costs are shared among affected member states on the basis of equitable and balanced criteria, which take into account the economic impact of the crisis in the countries affected and the framework of home and host countries' supervisory powers" (MoU 2008, Section 2 (4)). For practical purposes, the economic impact is proxied by share of assets in a given member state, which means that if 20 percent of assets of the ailing financial group is in a given member state then, its ministry of finance would be expected to cover 20 percent of direct budgetary net costs.

However, the home country authorities bear greater supervisory responsibility for the financial stability of the consolidated group, hence, they should bear greater proportion of direct costs.[86] The 2008 MoU lists this principle, but it does not provide any specification of the weighting formula. Instead, it delegates the issue to the cross-border stability groups that are expected to specify them in the VSCAs. The distribution of powers between the home and host supervisors is a thorny issue, hence, putting a number on this parameter may be difficult even for the CBSGs that prepare the VSCA for individual banking group.

At the same time, there are other potentially relevant criteria that could be used for distribution of fiscal costs of bank stabilization across the participating countries. The de Laroisiere (2009) report that provided a blueprint for post-crisis reforms at the

[86] In case of bank branches, that are supervised almost exclusively by home country authorities, the home country ministries could be expected to bear all costs. This proved to be an issue in the case of Icelandic bank collapse.

request of the Commission, suggested to expand the list of principles by some of the following: the deposits of the institution; the assets (either in terms of accounting values, market values or risk-weighted values); the revenue flows; the share of payment system flows; and the division of supervisory responsibility - the party responsible for supervisory work, analysis and decision being also responsible for an appropriately larger share of the costs. Further ideas can be found in the academic literature. Goodhart and Schoenmaker (2009) provided quantified estimates based on average of foreign assets to total assets, foreign income to total income, and foreign employment to total employment within the banking sector of a member state. However, these variables to not correspond to indicators suggested in the MoU, which limits their usefulness for the policy debate. In short, there is no shortage of possible burden sharing formulas; the problem is to find the one on which all EU member states or at least all national authorities participating in a given CBSG can agree on.

As is developed in the section 3, the cross-border regime needs well defined ex ante rules on burden sharing. On the one hand, the formula must be clearly defined to be credible during the heated moments of the banking crisis, on the other hand, it needs to be sufficiently flexible to adapt to the specific circumstances of each case. If the authorities fail to strike the balance on the credibility-flexibility trade off, it creates strong incentives for ex post opportunism that consequently sets in place a kind of 'backward induction' that can undermine the cross-border cooperation. If member state authorities have doubts about credibility of burden sharing, then they are less likely to cooperate on early intervention and more likely to prepare for the eventuality of unilateral resolution. This in turn may lead the host country authorities to use their remaining supervisory powers to increase the capital and liquidity buffers of banks in their jurisdiction, which inevitably increases regulatory fragmentation.[87] Such actions may undermine the stability of the cross-border group as the liquidity trapped in one jurisdiction could be better used elsewhere.[88]

To summarize, since the cross-border bank resolution was put on the EU agenda by the Brouwer reports, the Council adopted three generations of MoUs defining the basic principles of the regime in increasing detail. However, with the exception of unspecified information sharing provision on the Capital Requirements and Financial Conglomerate directives, all these rules remain voluntary and non-binding. The most contested issues during the adoption of the MoUs are sharing of detailed prudential information necessary for decision-making during the crises and sharing the fiscal burdens after the crisis. The MoUs still respect the decade old Brouwer report conclusion that crises are too varied for systematic EU level legislation. However, they try to address this problem by delegating the obligation to conclude specific resolution agreements to cross-border stability groups that are being established for all systemically important banking groups.

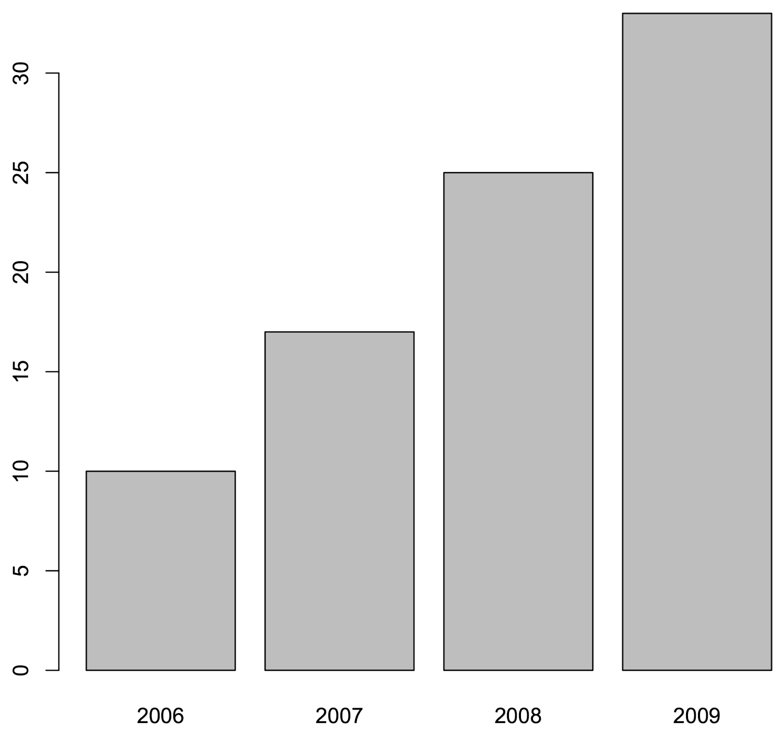
2. Governance structures: ever more complex delegation

The adoption of cross-border bank resolution rules remains firmly under the Council purview. However, their specification and implementation — that is also voluntary and

[87] National authorities may use of supervisory tools to hoard liquidity in the national subsidiary, prevent intra-group asset transfers, insist on country-specific capital increase or divestiture of group assets held within the subsidiary to boost its liquidity.
[88] The same logic provides national regulators with incentive to withhold information about problems in ‘their’ part of the banking group to prevent unilateral action of other supervisors that could produce negative externalities on the bank subsidiary within their jurisdiction

non-binding — is delegated to the supervisory and cross-border stability colleges. Colleges of supervisors bring together authorities from all countries, where the given cross-border bank is active. Some of them were established already under the 1990s system of bilateral MoUs, but they were made compulsory for all cross-border banks in 2009. They operate on the basis of non-binding guidelines issued by the CEBS, and were assigned some formal powers in approving risk models under the CRD and regarding the consolidated accounting of conglomerates. The number of established colleges is raising gradually (Chart 4.1).

Chart 4.1: Number of operational supervisory colleges in the EU



Source: CEBS/EBA annual reports

The cross-border stability groups represent a less well-established governance arrangement. The groups are expected to formulate in good times the voluntary agreements — VSCAs — on the basis of the 2008 MoU template that detail the information sharing, cooperation and burden sharing rules for each banking group, and that could be effectively executed during the crisis times. The groups were proposed by the 2008 MoU in response to the experience from the EU simulations of crisis situations, which revealed the necessity of involvement of central banks and ministries of finance. The supervisory colleges form the core of the stability groups, but the supervisory authority may not necessarily be the 'one voice' for each member state. The national institutions are expected to identify a coordinating institution that would represent the joint national view to its partners on EU level.[89] During the first three years after the 2008 MoU was signed, only one cross-border stability group that covers several of the large banks from Nordic and Baltic countries was formally established. Several other countries such as Austria started negotiations to form additional groups (interview 1), but there is some uncertainty whether stability groups are only temporary governance arrangement that will quickly evolve into some more centralized system or whether they are to stay for the long haul.

One reason to expect more binding basis for the stability groups than the 2008 MoU is their increasing intermingling with the Lamfalussy governance arrangements for banking (discussed in Chapters 1 and 2). Initially, the operation of supervisory colleges and stability groups were supported by other EU financial market committees only indirectly. The Banking Supervision Committee (BSC) of Eurosystem and the Committee

[89] National stability colleges include two to four national institutions, depending on the structure of financial regulation in a given member state. If financial regulation is part of the central bank than the group involves on the bank and ministry. However, if financial regulation is institutionally separated, then the stability group includes the one or two national financial regulators, central bank and ministry (in case of Denmark two ministries are involved).

of European Banking Supervisors (CEBS) jointly drafted recommendations for the MoU (Strouzas 2007b). They also formed a joint committee that organized some of the simulation exercises that tested the MoU framework. Moreover, during the crisis the BSC and CEBS provided a cooperation platform for national supervisors that proved useful in handling the cross-border issues, such as the Icelandic crisis for example (EFC 2009:10, CEBS 2009a). However, more recently role of CEBS in colleges and stability groups increased. The CEBS — now replaced by the European Banking Authority — was given an observer status in all supervisory colleges (CEBS 2010:17). It also developed a Template for Written Cooperation and Coordination Agreements that simplified negotiations of national supervisors about the college charter and mandate. By 2009, 30 out of 33 existing colleges operated on the basis of this template adapted to their specific circumstances (CEBS 2010:18). The CRD II amendment discussed in Chapter 1, made supervisory colleges compulsory for all cross-border banking groups and mandated CEBS to develop guidelines for operational functioning of colleges, which will only reinforce its role in the governance of EU cross-border banking.

The political contestation over the information and fiscal burden sharing rules so far prevented the EU to delegate binding regulatory powers over the cross-border bank resolution to Lamfalussy committees. Nonetheless, the power to prepare for the crisis management and resolution was delegated to system of newly established committees. One of the important consequences of the voluntary and non-binding nature of the MoUs the absence of any formal dispute resolution mechanism. It is practically assumed that when the formulation of specific agreements is delegated to the micro-level committees, they would be able to introduce unanimously acceptable ex ante agreements that would be consistently followed during the crisis. This assumption was tested not only by the simulation exercises, but also by the real crisis. The most direct test of the EU framework was failure of the Benelux banking group Fortis.

3. Regulatory integration: the Fortis test

The most contested aspects of the adoption and implementation of the cross-border bank resolution regime are related to the uncertainty about the size and distribution of potential fiscal costs and information-sharing under sever time pressure. These challenges can be expressed as a Prisoner's dilemma game, when the commitment of national authorities to the multilateral resolution presumed by the MoUs may be undermined by expected distribution of fiscal costs. That the commitment problem is not mere theoretical construction is illustrated by the case of Fortis resolution in September 2008. In this case, the regime proved too week to induce multilateral cooperation expected by the MoUs. However, before proceeding to this example, it is useful to outline the general features of the cross-border bank resolution regime that challenge the commitment to multilateral cooperation.

3.1 The challenges and benefits of cross-border bank resolution

The resolution regime for systemically important financial institutions is a set of legal and administrative rules that authorities employ to support restructuring of an ailing bank. Preserving essential functions of such banks often requires injections of public funds, thus an important objective of the regime is to minimize the fiscal costs of bank resolution (FSB 2010, IMF 2010). However, the need for fiscal backing massively complicates the debate on the EU level regime, because it invites distributional issues related to fiscal burden sharing that impact on fiscal sovereignty of member states. The potential conflicts over the burden sharing are the single most important challenge for the cross-border resolution regime that undermine the credibility of member states' commitment to multilateral cooperation.

The cross-border banks confronted the EU with the classic regulator's dilemma of how to enjoy the benefits of international economic integration, while containing the risks and their impacts on the domestic economy (Kapstein 1989). The national authorities became interdependent in their decisions on resolution strategy, but their tools and mandates to protect financial stability remained exclusively national. This created a strategic situation akin to a Prisoner's dilemma, when multilateral resolution of a banking group as a whole is likely to be the least costly overall, but unilateral resolution may allow some member states to avoid resolution costs at the expense of others. The EU bank resolution regime thus needs to harmonize national resolution tools and contain incentives towards unilateral defection in order to ensure a credible commitment to cooperation that minimizes the overall resolution costs and distributes them across the participating countries according to some legitimate criteria.[90]

There are two additional challenges to the cross-border bank resolution regime. Firstly, financial instability tends to proliferate with incredible speed and decisions with

[90] The harmonization of bank resolution tools such as asset transfer, bridge-banks or nationalizations is a subject of a large technical literature, which is not reviewed here (see IMF 2010, 2009, Cihak and Decressin 2007, Commission 2009). This chapter focuses more on the underlying issue of cooperation and burden-sharing, on the assumption that when these issues are clarified, agreement on the specific legal form of resolution may be easier to achieve, despite the differences.

momentous economic consequences must be made within few hours or days.[91] Secondly, there is a high uncertainty about the overall costs and benefits of the bank resolution and their distribution across participating member states. Especially, in the context of broader financial crises it is nearly impossible to estimate the benefits of the bank resolution in terms of avoided costs of the systemic banking crisis for the given economy. Also the net fiscal costs of preserving the key functions of the cross-border systemic bank are highly uncertain for considerable period of up to several years before the guarantees are settled and assets worked out. Therefore, the resolution regime must enable national authorities to reach decisions very quickly and sustain them over time in a face of uncertainty. There is little room for ad hoc negotiations during the crisis, and ex post negotiations may be difficult due to conflicts over the distribution of losses. Thus, the credible commitment to multilateral cross-border cooperation requires ex ante agreements that can be adapted to specific circumstances of the crisis and maintained until all transactions are completed.

The gravity of decisions made in the heat of the crisis is demonstrated by the direct fiscal costs of systemic banking failures. Laeven and Valencia (2008:24) estimated that during the last three decades the direct fiscal costs of a banking crisis were approximately 13% of annual GDP on average, which is consistent with the EU experience so far. The nineteen EU member governments that introduced guarantees and recapitalizations, put at risk fiscal resources equivalent to 32% of EU-wide GDP, out of which banks used about 40% by mid 2010 (Commission 2010e).

[91] A typical window for bank resolution used to last 60 hours from the time the bank closed on Friday till it reopened on Monday, but with electronic banking crises no longer stop for the weekend.

Problems of national accountability, incompatible national tools, time-pressure and uncertainty over the magnitude and distribution of fiscal costs conspire against the commitment of national authorities to multilateral cooperation. However, the cross-border bank resolution regime that can deliver such commitment can create considerable economic and political benefits that justify the reform effort.

The multilateral resolution is likely to be the most cost-efficient solution of systemic bank failures, because it preserves the benefits of banks' internal integration, while also avoiding the costs and complexities of separating transnational banks into their national parts. Cross-border banks gained considerable efficiencies from integrating their internal functions across national boundaries. They tend to concentrate strategic decision-making, capital management, risk management and auditing at the headquarters, while other activities such as back-office, information technologies, liquidity management or asset and liabilities management also tend to be concentrated on the group-level, although not necessarily in the home-country (van den Siegel 2008, Commission 2009). Unilateral resolution inevitably destroys these benefits of integration.

The resolution framework also impacts the incentives of national supervisory authorities. If they expect multilateral cooperation during the crisis, then they are likely to focus on the financial stability of the whole banking group. However, if they expect unilateral resolution, then they are likely to focus narrowly on the part of the group within their jurisdiction. Host supervisors will insist on maximizing its capacity to withstand financial shocks, even if that may be at the expense of stability and efficiency of the rest of the group. Authorities may force local subsidiaries to increase the capital and liquidity buffers, even if they could be better utilized on the group level and provided to the subsidiary only when needed (Unicredit 2009). In short, absence of credible regime that leads to nationally-specific policy responses may re-fragment the single banking market.

An underestimated dimension of a well designed cross-border resolution regime is its capacity to prevent economic conflicts from escalating into political ones. Given the high fiscal stakes, absence of clear ex ante rules makes such conflicts very likely. This is amply demonstrated by the lasting dispute between Iceland and UK/Netherlands over the repayment of compensations to British and Dutch depositors of failed Icelandic banks (see Danielsson 2010). This drags for over two years and threatens to become an important hurdle on the Icelandic path to EU membership. Moreover, it was preceded by an unusually harsh decision of the British government to impose the freezing order based on the anti-terrorist law on all assets of an Icelandic bank in the UK, which effectively declared the bank bankrupt before the Icelandic authorities could do so (House of Commons 2009). The Fortis case analyzed below also highlights the intergovernmental conflict over the bank resolution, although in this case it was rather contained.

3.2 Fortis test of regulatory integration

The Fortis resolution provided the most direct test of the EU cross-border bank resolution regime during the crisis.[92] The Fortis Group had a systemic presence in the three Benelux countries and it was one of the banking groups with the most developed ex ante cooperation arrangements among its supervisors, including a specific Regional MoU signed by Belgium and Netherlands (Van den Spiegel 2008, Spouzas 2007, EFC 2001:9). Nevertheless, when the crisis tested these arrangements, they failed to sustain a multilateral cooperation on resolution.

Fortis was created by a merger of several Dutch and Belgian banks and insurance companies in 1990. It expanded rapidly and in 2007 participated in the consortia that acquired ABN AMRO in the largest-ever banking takeover. It became one of the major EU financial groups and its balance sheet exceeded the GDP of any of the Benelux countries. Fortis was headquartered in Brussels, and the Belgian financial authority was its home-country supervisor.

Following the turbulences in global financial markets, Fortis Bank — the entity controlling the banking subsidiaries of Fortis in Benelux countries and the retail operations of ABN AMRO — experienced difficulties in financing the 2007 acquisition. This led to a dramatic fall in its share price and several replacements of key banking

[92] Dexia was also the case of cross-border resolution, but it was partially owned by public entities so the national authorities could use not only the indirect resolution tools, but also the direct shareholder powers. Moreover, the proportions of shares owned by the institutional investors and public authorities of the three countries involved in Dexia resolution provided a convenient burden sharing formula (BIS 2009:11). The Icelandic banks were not subject to the 2008 MoU as Iceland (EEA member) signed it only in 2010. All other cases of EU bank instabilities were prevented from escalation across borders by home-country interventions.

officers. The situation escalated on Friday 26 September 2008, when bankruptcy rumors led institutional clients to withdraw deposits en masse (Fortis 2008:14). At the time, Fortis could no longer access the interbank market, and was relying on an emergency liquidity assistance provided by the central banks of Belgium and the Netherlands. The subsequent court investigation revealed that Fortis was solvent at the time (Cihak and Nier 2009:23), but public intervention seemed to be the only tool left to stop the run and prevent discontinuity of services (Fortis 2008: 15).

The Benelux governments approached the Fortis Group with an offer of capital increase of €11.2 bn that would partially nationalize Fortis banks. The Netherlands and Luxembourg would invest €4 bn and €2.5 bn in exchange for 49% of shares in Fortis Bank Nederland and Fortis Banque Luxembourg, respectively. The Belgian government was to invest €4.7 bn in exchange for 49% of Fortis Bank, which controlled all three Fortis banks in the Benelux countries. The Dutch government, however, later withdrew from this plan.

Even before it turned out that the plan would not be implemented, it became clear that it would be inadequate. The run on Fortis banks continued and consumed nearly €60 bn of the emergency liquidity from central banks (Fortis 2008:17). On 2 October 2008, the Dutch authorities announced their intention to impose forced administration on Fortis activities in the Netherlands, unless they are allowed to buy all Dutch assets, including financially stable insurance units. The Belgian authorities and Fortis directors eventually agreed to the sale. Luxembourg increased its share in Fortis Banque to 52%, and Belgium acquired the remaining domestic and international banking and insurance activities of Fortis (Cihak and Nier 2009:23). The government takeovers stabilized Fortis and the attention shifted towards consolidation and sales of the assets acquired by respective countries. This phase of the resolution was conducted primarily on national level without cross-border coordination.[93]

Before the critical week the Belgian authorities could have used the ‘early intervention tools’ to stabilize Fortis by a capital increase, loan or guarantee. Most such interventions in the EU were carried exclusively by home-countries without cross-border cooperation and, inevitably, their benefits spilled over to host-countries. However, in such cases host-country subsidiaries were stable and provided the home-country with some collateral assets limiting potential losses from the intervention. This balanced cross-border costs and benefits while also recognizing that the home-country had a higher responsibility for overseeing the group as a whole. In contrast, Fortis faced a parallel run on all its Benelux subsidiaries, including the ABN AMRO that was not its consolidated part (Fortis 2008:17). The risk of systemic failure was imminent in all three countries and stabilization thus required a joint action of home- and host-countries. The authorities of the Netherlands and Luxembourg recognized this when they offered their support for the stabilization effort orchestrated by the Belgian authorities.

Authorities faced the choice between multilateral and unilateral resolution that can be modeled as a prisoners’ dilemma game (Figure 1). The multilateral resolution (M, M outcome in Figure 1) was expected by the MoUs. The unilateral resolution (U,U) would

[93] In Belgium the government orchestrated sale of Fortis assets to BNP Paribas was challenged by the shareholders in the courts, which later escalated into a political crisis over allegations of ministerial interference into the judicial process, which in turn led to a collapse of the Yves Leterme's government in December 2008.

require splitting the banking group along national borders so that the national authorities could deal with each part separately. Given that all three governments were initially prepared to offer joint support to Fortis, multilateral resolution seemed to be the most viable option. Yet, the eventual resolution turned out to be unilateral. The answer to the puzzling outcome lies primarily in the failure of the pre-crisis regime to define clear rules and processes that authorities could follow in crisis in order to maintain their commitment to multilateral cooperation. Under pressure of an escalating crisis national authorities chose the unilateral resolution as a way to reduce uncertainty over the distribution of fiscal costs of the intervention.

Table 4.1: The prisoner's dilemma in cross-border bank resolution

		Netherlands	
		Multilateral (M)	Unilateral (U)
Belgium	Multilateral (M)	3, 3	1, 4
	Unilateral (U)	4, 1	2, 2*

Note: * Nash equilibrium. The higher the number in cell, the more preferred the outcome for given player. Preferences are expressed in terms of ranking of pay-offs; the highest payoff (4) is the most preferred solution of a given actor. The presentation of the Fortis case is simplified by focusing on the interaction between the Belgian and Dutch authorities. The Luxembourg authorities seemed prepared to adapt to outcomes of their negotiations.

The Dutch defection from multilateral resolution agreed on 28 September 2008 was indeed justified by the lower expected resolution costs. The Finance Minister argued that '[the Dutch side] had managed to buy the better part of Fortis, leaving the worse one to the Belgians' (Beck et al. 2010:73). The Fortis directors and Belgian authorities disputed such a view as banking subsidiaries in both countries were equally dependent on emergency credit from central banks (Fortis 2008:17). The Belgian side could refuse to approve the sale, but there was little time to renegotiate the Dutch ultimatum and without a quick solution the banking crisis could escalate out of control. Therefore, they negotiated a price increase from € 9 bn to €16.8 bn, accepted the Dutch buyout and focused on national resolution.

The Fortis resolution was not multilateral, but did it correspond to the unilateral Nash equilibrium (U,U)? There is also a possibility that one government emerged for the crisis better off then the other, corresponding to the (U,M) or (M,U) outcomes. This ultimately depends on whether the Dutch paid a fair price under the circumstances (implies U,U outcome) or overpaid, in which case they implicitly subsidized resolution costs in Belgium (U,M), or underpaid, in which case the implicit subsidy goes in the other direction (M,U). This will become clearer after the authorities dispose of assets acquired in the transaction and estimate the total costs of the Fortis resolution.[94]

Although the Fortis resolution was not multilateral, it stopped the run on Fortis banks and prevented the situation from escalating into a systemic crisis. This achievement was, however, predicated on several supportive factors that cannot be assumed in other cases. Firstly, the long tradition of cooperation among Benelux authorities was important to maintain a constructive approach after the Dutch decided not to follow through with the initial agreement and threatened to impose forced administration. The Belgian response was pragmatic and refrained from unhelpful retaliation. Instead, it focused on raising the initial offer that the Dutch were prepared to nearly double in

[94] Morgan Stanley, hired by the Fortis Group, valued the Dutch operations at € 22 bn (Fortis 2008: 18). Market participants speculated that the Dutch bought the Fortis assets at a discount of as much as €10 bn (FT Oct 4, 2008). These estimates would suggest (M,U) outcome, implying that Belgium bears disproportionately higher burden of the resolution.

order to prevent a collapse of the negotiations. Secondly, the cooperation among the Benelux authorities was not complicated by any of the asymmetries that may arise in other cases. For example, if a small bank from a large home country controls a systemic bank in a small member state, then national authorities may not be equally concerned and prepared for ad hoc intervention. Moreover, unlike Benelux countries certain EU members may not have the fiscal capacity necessary to support the unilateral resolution of a large bank, as happened in Iceland. Thirdly, the costs of the Fortis break-up were limited, because all important parts of the bank operated as subsidiaries rather than branches and ABN AMRO was not integrated into internal structures at all. The cooperative approach of Benelux authorities, sufficient fiscal capacity and limited break-up costs all aided to the relative success of the unilateral Fortis resolution in containing the acute crisis.

Nonetheless, the Fortis case was a failure of the pre-crisis bank resolution regime that, in its consequences, undermined the single banking market. The key lesson for national authorities is that they should not anticipate multilateral cooperation. General principles noted in MoUs, complex — but voluntary — governance arrangements and unspecified burden sharing rules were insufficient for sustaining the commitment to multilateral resolution even among Benelux authorities that were better prepared than others. The pre-crisis regime thus failed both during the simulations and in the case of Fortis. The lesson for national authorities is that in crisis the resolution will be 'every country to itself' thus they should focus primarily on enhancing the capacity of national subsidiaries to withstand shocks, regardless of the group level consequences. Only credible reforms may change this conclusion.

4. Post-crisis reforms: endogenous change only

The financial crisis in general and the Fortis experience in particular generated a severe exogenous shock to the gradual evolution of the cross-border bank resolution regime in the EU. It has highlighted the regulatory gap between the degree of financial integration manifested in the presence of large cross-border banks, on one hand, and limited regulatory integration exemplified by the country-based bank resolution regimes on the other. Hence, the first question is whether the post-crisis reforms still constituted endogenous institutional changes or whether the crisis was seized for more radical reforms that would have been implausible during the preceding period of stability (see Rodrik 1996:27, Drazen and Grilli 1993:598 on shocks and policy reforms).

In the EU, reforms are put on the policy agenda by the Commission. In this section, we outline the policy alternatives for regulatory integration of the cross-border bank resolution regime, check whether the Commission considered any more radical reform alternative and then evaluate the effects of delegation on integration. The section identifies two principal policy alternatives, shows that the Commission considered but postponed the more radical option and therefore any progress in regulatory integration was left to the supervisory colleges and cross-border stability groups. We conclude that the one stability group established in 2010 moved the regulatory integration forward, albeit marginally.

There are two principled ways of closing the gap between transnational banks and national resolution regimes. One possibility is to shift the resolution regime up to the EU level that provides the largest possible jurisdiction matching the operations of large European banking groups. Alternatively, resolution could be shifted back to the national level, which would, however, require the cross-border banks to reorganize as a string of operationally independent national subsidiaries. These options resolve the conflicting incentives of national authorities either by shifting the decisions to the EU level entity, or by reducing the need for cross-border cooperation through re-embedding of banks in national resolution regimes.

The idea of re-embedding cross-border banks in national resolution regime — dubbed subsidiarization — was voiced by the UK's Financial Services Authority at the onset of the post-crisis debate (FSA 2009). However, it was immediately countered by large banks (IIF 2009: 73-82) as well as the Commission that viewed it as a protectionist measure inconsistent with single market (Speech 10/122, 19 March 2010, Commission 2009:39). Some of the technical substance of the idea lingers on in reform proposals on EU (Commission 2010c) and global levels (FSB 2010), which presume compulsory introduction of recovery and resolution plans for all cross-border banks that may limit the internal integration of some banking groups in order to make them 'resolvable' on national basis. Nonetheless, return to the pre-single market banking regulation never received serious consideration. The debate quickly focused on either deepening of the pre-crisis regime or developing a new integrated regime on EU level.

4.1 Integrated EU level resolution regime

Designs of an integrated EU level resolution regime were discussed in a specialized literature before the crisis (see Dermine 2000, Vives 2001, Goodhard and Schoenmakker 2006, Veron 2007, for example) and entered the mainstream policy debate during the crisis (see IMF 2010, FSB 2010, Commission 2009, Cihak and Decressin 2007). Their distinguishing characteristic is the separation of the decision-making on the most efficient resolution strategy of the ailing banking group from the direct distributive consequences for the member states involved. It shifts the decision from domestically accountable national authorities to the EU level agency with a mandate to minimize overall costs of resolution. The fiscal backing for the resolution strategy is to be provided by a 'fungible' financing mechanism based on the joint guarantees of all member states, whereas the net fiscal costs would be subsequently distributed among the affected member states according to some ex ante burden sharing principles. Such a regime would be credible in committing national authorities to multilateral resolution strategies as it limits a scope to unilateral defections.

The proposals for a single European regulatory agency predate the crisis, but they were turned down due to the absence of a clear Treaty base (Angeloni 2008:25). Treaty confers a limited financial stability mandate on the Banking Supervision Committee of the ESCB, but this can be expanded neither to non-banking financial services nor to non-euro zone countries. Moreover, both Eurozone members and the UK opposed expansion of the ECB role into financial supervision (Posner and Veron 2010: 409), which led the Schoenmaker and Oosterloo (2008:343) to argue that the post-crisis reforms can aspire only to gradual process of closer cooperation resembling the institutionalization of the ECB.

However, the IMF challenged the gradualist assumption and argued for more radical reforms that do not avoid institutional changes (IMF 2010). It made a proposal for introduction of the 28th legal regime for pan-European banks, that would include an EU level resolution regime (see Table 4.1). The idea is based on the European Banking Charter, inspired by the Societas Europaea company statute (IMF 2010:60, Cihak and Decressin 2007). The large cross-border banks would be given the option to comply with a complete legislative package defined in a single Regulation that would cover all aspects of banking licensing, regulation, supervision and resolution (IMF 2010:55, Commission 2009). The resolution decisions for banks in the 28th legal regime would be taken by the European Resolution Agency with "adequate powers, clear mandates to pursue the common good based on ex-ante agreed common principles and objectives, robust legal and accountability frameworks, and appropriate safeguards" (IMF 2010:58). Given that banking crises are rare events the IMF team envisions ERA as a shell agency with small staff capable of quick mobilization of trained experts or as a body attached to the European Banking Authority (IMF 2010:58).

Table 4.2: Post-crisis reform alternatives

Component	Coordinated regime	Integrated regime
Rules of communication and coordination	Basics in CRD and FCD; bank-specific agreements based on 2008 MoU template (VSCA)	28^{th} legal regime for systemic cross-border banks that includes a Regulation on bank resolution
Governance arrangements	Bank-specific colleges of supervisors and cross-border stability groups with binding mediation by EBA	European Resolution Agency (ERA) makes binding decisions by qualified majority
Financing and burden-sharing	Ex ante, bank-specific burden-sharing agreements based on VSCA	'Fungible funding' through ERA and burden-sharing according to ex ante formula

With regard to financing, the proposals for integrated EU regime stress the effects of parallel reforms that aim to increase the capital buffers of the systemically important banks. The Basel III rules will to require more capital from larger financial institutions (Lannoo 2011). Requirements for contingent capital and 'bail-in' clauses on unsecured creditors — proposed by the Financial Stability Board (FSB) on behalf of G20 — would add another layer of capital buffer (FSB 2010). The next line of defense may arise from the capital surcharge on systemically important financial institutions that would pre-finance a bank resolution funds also suggested by FSB and turned in to a proposal by the Commission in May 2010 (Commission 2010b).[95] Yet another source of financing could come from the more flexible use of the deposit guarantee schemes that would allow the use of these resources for bank resolution in some cases (IMF 2010:59, Unicredit 2009:19). All these measures cumulatively reduce the likelihood that fiscal financing may be necessary, but they cannot exclude it completely.

[95] The proposal suggests introducing a network of national funds rather than a single European fund that was deemed politically infeasible (Commission 2010b). This reintroduces the conflicting incentives into the decision-making as national authorities strive to limit the costs to the domestic resolution fund.

The policy ideas for the ultimate fiscal backdrop for the bank resolution regime range from using the European Investment Bank to raise such funds (Goodhart and Schoenmaker 2009: 149) to enlargement the EU budget, to providing a joint and several liability of EU member states for ERA related debt and guarantees (IMF 2010:63). Nonetheless, the most plausible alternative may arise from institutionalization of the European Financial Stability Facility/Mechanism that was created in response to the Greek debt problems.[96] This scheme is designed to provide emergency lending to countries without access to private financing, but could pave the way towards joint fiscal guarantees or even Euro-bonds needed for initial funding of bank resolutions. However, whatever the funding arrangement, each and every one of them requires an ex ante agreement on sharing the net fiscal costs across member states. As the Fortis experience revealed, clear burden sharing criteria are a cornerstone of the credibility of any cross-border resolution regime, including the integrated one.

There is no shortage of burden sharing criteria suggested in the post-crisis policy proposals, but choosing one approach and committing to it proves difficult. The 2008 MoUs specified a burden sharing formula based on the expected economic impact of the cross-border bank failure on the member states concerned and the allocation of home and host supervisory responsibilities. The de Laroisiere report (2009) suggested to expand the list of principles that guide the burden sharing by additional criteria (see section 1.3). The IMF (2010) proposal called for fixed ex ante rules on burden sharing, combined with the power of ERA to adjust their distribution to specific circumstances, where the adjustment should be based on a ratio between avoided damage to bank

[96] The extraordinary summit on 21 July 2011 essentially approved use of these financial stabilization facilities for bank stabilization.

creditors and broader economy on the one hand and net resolution costs incurred by the national authorities on the other. Although all these burden-sharing criteria are plausible, they imply different technical calculations and thus different distribution of costs. Hence, the policy choice needs to be made, before any of them can be adopted.

The early signs of crisis in summer 2007 led the Council to outline the 'roadmap' for financial reforms during the October 2007 and March 2008 meetings. The roadmap included the new principles codified in the 2008 MoU and called for further changes in the Capital Requirement Directive. Hence, the crisis provided the Commission with an opportunity to put the integrated EU level resolution regime on the legislative agenda and reduce the intergovernmental nature of the cross-border bank resolution for the first time since the Brouwer reports in 2001. The Commission prepared the first revision of the Capital Requirement Directive, which inter alia required national supervisors to adapt their mandates to 'have regard to financial stability concerns in all Member States concerned' (Consultation document SEC(2008) 2532: 23). These proposals were prepared before the peak of the crisis — published on 1 October 2008 — and did not indicate any discontinuous shift towards an integrated resolution regime and clear burden sharing criteria.

However, the chain of bank collapses culminating with the Fortis case in autumn 2008, made the inadequacy of non-binding MoUs clear and invited more ambitious proposals from the Commission. This is observable in the October 2009 Communication on an EU Framework for Cross-border Crisis Management in the Banking Sector (COM(2009) 561/4) and, especially, in its accompanying working document (SEC(2009) 1407) and impact assessment (SEC(2009) 1389). There the Commission staff concluded that the EU bank resolution framework would have overall positive effect on all stakeholders (SEC(2009) 1389:40) and that the integrated approach was best suited for the 'branch-like' subsidiaries of EU cross-border banks (SEC(2009) 1407:50). This was also reflected in the consultation questions that asked for comments on desirability of the 28th regime, to which the IMF responded with the most ambitions EU level proposal to date summarized above. At that point, Commission seemed ready to put an integrated regime on the EU legislative agenda.

The October 2009 Communication was, however, the high point for the integrated resolution regime proposals. Negotiations with the Council and European Parliament regarding the power of European Banking Authority to impose binding obligations on national authorities during the crisis (see section below) revealed political limits of post-crisis reforms. Member governments were not prepared to consider shifting any resolution powers that may have fiscal implications to the European level, which led the Commission to revert back to the gradualist strategy based on delegation of some powers to committees. The Communication on EU framework for crisis management in the financial sector from October 2010 (COM(2010) 579) reiterated that the "integrated framework for resolution of cross border entities by a single European body would deliver a rapid, decisive and equitable resolution process for European financial groups, and better reflect the pan EU nature of banking markets". However, it concluded that such a regime was not achievable in the absence of a harmonized insolvency regime and of a Single European Supervisory authority (Commission 2010c:12). The Commission plans to reassess the framework in 2014, after some of the complementary reforms are concluded. Hence, two years after the crisis the reform strategy was back to the pre-crisis endogenous mode of regulatory integration.

4.2 Coordinated resolution regime

The favorite response of the EU to the financial sector challenges is to ask a committee of wise men to suggest the blueprint for reform. In February 2009, the de Larosiere group of bankers delivered such a report that recommended a creation of the European Systemic Risk Board (ESRB) to address macro-stability risks and the European System of Financial Supervisors (ESFS) overseeing stability of financial institutions across the EU. At the core of the ESFS proposal was the transformation of the existing Lamfalussy committees into European Supervisory Authorities, so that the Committee of European Banking Supervisors became European Banking Authority (EBA). The EBA received independent chairperson, staff, legal status and EU funding and — importantly for the resolution regime — the power of arbitration that allows it to impose binding obligations on national authorities in cases: (i) when arbitrating a disagreement among national authorities supervising a cross-border group; (ii) when national authorities implement incorrectly directly applicable EU Regulations; and (iii) in emergency situations declared by the Council of Ministers. The EBA's decision-making body, which comprises its chairperson and heads of national supervisory authorities, can adopt the arbitration decisions by qualified majority (Gros 2009).

Binding arbitration powers decided by the qualified majority could in principle impose obligations on the national authorities and thus turn the voluntary specific binding agreements prepared by the cross-border stability groups into binding EU rules. The EBA could intervene into a dispute among national authorities and prevent any one of them from defecting to unilateral resolution strategies not envisaged in the ex ante agreements among them. However, such powers proved controversial in the Council. The UK refused to accept any EU level rule that could result in binding fiscal commitments (EurActiv Dec 3, 2009), hence the Council introduced a fiscal clause declaring that EBA's decisions may not in any way impinge on the fiscal sovereignty of member states. The UK has also insisted on additional "triple-lock" safeguards that can suspend EBA's decisions by giving any member state the right to appeal to the Council, where a simple majority of member states can overturn EBA's arbitration decision. Any member state also has the right to appeal to the European Council. The European Parliament opposed safeguards that undermine EBA's ability to resolve disagreements and — after nine months of negotiations — managed to insert a 'safeguard on the safeguard' clause that bans abuse of the fiscal veto if it does not have "a significant or material fiscal impact" (EP 2010: 13).

The binding arbitration powers, albeit limited by the safeguards clauses, enhance the credibility of the commitment to multilateral resolution at least for cases with limited fiscal impacts, but preserves the status quo ante for cases as was the Fortis. Although, the total net fiscal costs of Fortis resolution may not be known for some time, they are certain to be substantial, thus either Dutch or Belgian side could invoke the fiscal sovereignty clause to avoid EBA arbitration. Moreover, even if they asked for EBA involvement, it is unlikely that the decision could be reached and processed through the safeguards sufficiently fast to matter for that case. Hence, the reform of EBA's powers essentially leaves national authorities free to defect to unilateral resolution any time they see it fit. The cross-border bank resolution regime remains voluntary and any progress in regulatory integration depends on the effort of supervisory colleges and stability groups.

4.3 Cross-border stability groups and regulatory integration

The EBA reforms and the one cross-border stability group that was formally established achieved some progress on regulatory integration on the most contested issues of information and burden sharing. Since these are rather recent developments they cannot yet be evaluated from the implementation angle as there were neither simulation exercises nor crises under the latest arrangements. Nonetheless, there is evidence that delegation was instrumental for adoption of these new rules.

The information sharing was fully delegated to EBA, which was charged with developing an EU-wide database of the micro-prudential information in order to ensure that the information can be shared within the colleges of supervisors. The access is also necessary for the work of the European Systemic Risk Board and the EBA itself that could hardly provide binding mediation without access to such information. Indeed, the maintenance of this database is the single largest item on EBA's estimated budget. The institutional innovation contained in the proposal is that the information would be collected directly from the financial groups, thus turning the national authorities from monopoly suppliers of this information to its consumers (SEC (2009) 1234: 29, Strohbach et al. 2011).

The development of the unified micro-prudential database was delegated to EBA by the CRD III amendment adopted in December 2010.[97] The EBA inherited the CEBS mandate of increasing the comparability of financial information reported to different supervisors within the EU, increasing the cost-effectiveness of supervision across the EU by reducing reporting burden on cross-border credit institutions, and removing a potential obstacle to financial market integration. This mandate was realized by the 'Guidelines on FINREP and COREP' issued by CEBS in 2005 and 2006 respectively, that are being fully harmonized before the 2012 deadline.

Shifting the responsibility for the database compilation to the EU level provides a definitive solution to the problem of cross-border sharing of quantitative information. The CRD III amendment was adopted unanimously by the Council as member states accepted that it is not plausible to withhold sensitive information from each other. At the same time, the legislation sidesteps the issue of access rights to all details contained in the databases. This has been left for the EBA to decide as a part of its work on the technical specification of the IT system[98], which underlines the extent to which the legislators grew accustomed to shifting potentially contested issues to the lower levels of policy-making. The common EU micro-prudential database will provide the relevant national authorities access to the most sensitive information, which is likely to make

[97] Article 74 of Directive 2006/48: For the communication of those calculations by credit institutions, competent authorities shall apply, from 31 December 2012, uniform formats, frequencies and dates of reporting. To facilitate this, the Committee of European Banking Supervisors shall elaborate guidelines to introduce, within the Community, a uniform reporting format before 1 January 2012. The reporting formats shall be proportionate to the nature, scale and complexity of the credit institutions' activities.
[98] The technical challenge is enormous in its own right as IT, accounting and supervision experts need to design the unified EU format and link up tables that reconcile the EU and national legal and regulatory concepts.

national forbearance based on asymmetric access to information more difficult. The (non)assessment by host or home country authorities can be challenged by other authorities, thus making the earlier detection of potential problems more likely.

The burden sharing rules still represent greater challenge than the information sharing. For once, they can never be reduced to a mere technical problem as the amount of public resources potentially necessary requires clear political backing and supervision. As the Fortis case also demonstrated, when a systemically important bank is in troubles, the key decisions are made by prime ministers, ministers of finance and heads of central banks, not any low level technocrats. Nonetheless, such decisions are made more predictable, if they are based on the ex ante rules that the technocrats agree upon in committees.

When the general burden sharing problem is reduced to the level of individual cross-border banking groups, then it is the balancing of home and host country interests that poses the greatest challenge. The 2008 MoU only defines two principles that burden sharing should be proportionate to distribution of banking group assets in affected countries and that home countries that bear greater responsibility for supervision should bear greater share of potential losses. However, the agreements within cross-border stability groups need to operationalize the formula on case-by-case basis that balances the interests of home and host countries. At the same time, the stability groups also need to balance the trade off between the predictability derived from fixed ex ante rules and flexibility needed for adaptation to the specific circumstances of the case as pointed out by the early Brouwer reports (EFC 2000, 2001). Hence, any operationalization of the burden sharing formula beyond the declaration of the two principles in 2008 MoU represents a progress towards more regulatory integration, albeit only on very micro level of individual banking group.

The implementation process of the 2008 MoU resulted only in one concluded agreement so far — the Baltic-Nordic VSCA signed in August 2010. This VSCA developed the common MoU template to introduce a burden sharing model based on asset share of the relevant financial groups in a given country and the supervisory responsibilities. The model gives equal weight to asset shares and supervisory responsibility and also introduces exacerbating and mitigating factors that can change share of the given country providing that other countries within the cross-border stability group agree to it. The mitigating factors include early alerting and thus create incentives not to forbear on potentially destabilizing problems (see Table 4.3).

Table 4.3: The Baltic-Nordic VSCA introduced a burden sharing model

When a multilateral resolution is jointly decided upon, then the costs of the following can be shared:

- direct support provided from the government budget, for instance, in form of capital injection;
- direct support provided by any special vehicle mandated by the government;
- guarantees and other risks accepted by the government or such a vehicle;
- asset relief measures or transfers of assets from an institution implemented by the government;
- less eventual repayments and recoveries as well as payments for guarantees and risks eventually transferred to the government.

- The cost sharing model is based on two factors:
- the relative importance of the Relevant Financial Group (either parent, subsidiary or branch) in the countries as measured by asset shares (summing to 100%), and
- the supervisory responsibilities for the same institution in the same countries (summing to 100%). A Home country status, with full and exclusive powers to act and influence Host (branch) country activities is given a full 100% weight in the Model. If a college structure is in operation (subsidiary), the relative Home country weight will be less than 100%. The NBSG will regularly review the extent of

supervisory cooperation – on the basis of number of college meetings and/or tasks delegated - and from that derive the possible need to change weighting shares.

These two factors are given an equal weight, the sum of these shares providing each country with a cost reference weight. Costs are distributed among countries according to the relative size of these reference weights.

Qualitative exacerbating and mitigating factors, which may change with time, will be assessed by the Parties and may be used to amend the mechanical outcome from the Model calculation:

Exacerbating qualitative factors, which increase the share of costs to be carried by a country, are:

- the systemic importance of the institution in the country describe, for instance, by market shares or importance in payment systems;
- the share of problem assets of the institution associated with the country;

Mitigating qualitative factors, which reduce the share of costs to be carried by a country, are:

- superior general crisis preparedness in the country concerned;
- proven early detection and communication of emerging problems by the country's authorities;
- proven efforts to explicitly prevent problems from becoming cross-border;
- the proven role of different parties in adequately preventing the emerging crisis; and
- exceptional consequences for government fiscal balances and credibility.

Source: Baltic-Nordic VSCA

The Baltic-Nordic burden sharing rules recognize the need to combine algebraic formula with some weighting factors that allow for adaptation to the specifics of each case. The real innovation that makes this VSCA the most advanced burden sharing agreement to date is the specification of the three weighting factors. First, is the amount of assets in the countries concerned, which are risk weighted and calculated using 12 months old financial data to prevent gaming with this parameter during a crisis when asset valuations are uncertain. Second input, is pre-negotiated weight capturing the extent of supervisory responsibility for given banking group allocated to the given country. This weight is decided and adapted regularly by the stability group. The third parameter of the burden sharing model — the mitigating and exacerbating factors — is the unique contribution of the Baltic - Nordic VSCA. Although, these factors are listed ex ante, they would be specified only ex post and thus allow for adaptation of the burden sharing weights. The mitigating factors are set so to incentivize national authorities — especially the host country ones — to report the problem early, but also recognize that the burden might have to be reduced, if the country's sovereign fiscal capacity is insufficient as it proved to be the case in Iceland in 2008.

In any case, the Baltic-Nordic VSCA prepared by supervisors, central bankers and ministries of the eight countries represents the most specific burden sharing formula to date. It is more developed than any other policy proposals, including the IMF (2010, 2011) blueprints for the cross-border bank resolution regime in the EU. It creates a set of harmonized rules for burden sharing that covers 8 out of 30 EEA countries and all major banks in the Baltic-Nordic region. At the same time, these rules remain to be tested either by simulation or a real crisis. Since they remain voluntary and non-binding it is an open question whether they can prevent a break down of multilateral resolution that was witnessed in the Fortis case.

5. Conclusion

This chapter confirms that delegation of regulatory powers over the most contested aspects of financial regulation is a trend that extends outside of the Lamfalussy procedure. The relative novelty of the cross-border banking combined with high political sensitivity of the burden-sharing that potentially impinges on fiscal sovereignty, keeps the cross-border bank resolution regime outside of the standard EU legislative process. The Council kept adoption and implementation of the resolution rules firmly in the intergovernmental domain and all delegated powers were strictly non-binding. Nonetheless, some aspects of the resolution regime, such as the information sharing and arbitration of disagreements between national authorities — at least those without material fiscal consequences — were already delegated to the Lamfalussy committee.

The information sharing is on a verge of full harmonization planned for the end of 2011. In this case, the CRD amendment gave EBA a full mandate to develop an EU-wide database of micro-prudential information based on the unified format. The EU banking groups will report directly to EBA and all relevant national supervisors will have access to the same data. Hence, the problem with reluctance of some national authorities to share some factual information necessary for crisis management and resolution is likely to be resolved.

However, the burden sharing remains firmly in the domain of non-binding soft law produced by the technocratic committees. The Commission attempts to introduce integrated EU level resolution regime during the immediate post-crisis period were put on hold, thus the regulatory integration within this domain continues its endogenous path. The supervisory colleges were set up for 45 important EU banking groups (CEBS 2010:20) and some of them progress towards setting up the cross-border stability groups that also include relevant representatives of central banks and ministries of finance. However, only one voluntary specific cooperation agreement based on the 2008 MoU template has been signed. Nonetheless, it confirms the capacity of the lower level actors in cross-border committees to adopt more complex policy compromises that are possible on the legislative level.

The cross-border resolution regime is more contested than the policy issues in previous two chapters, because the disagreement extends to the basic question whether there should be any common EU rules at all. When the Council adopted the three successive memoranda of understanding between 2003 and 2008, there was never any suggestion that the Commission should go ahead and submit a proposal for EU level legislation, despite quite some prodding from the European Parliament (Hertig and Lee 2003, EP 2010). Although over time the information exchange and coordination pertinent to the cross border resolution were included in the EU directives, the burden sharing remains out of legislative bounds.

The negotiations over the EBA arbitration powers revealed that at least some member governments are willing to shift decision making powers to the EU level. Without the UK insistence on the political safeguards the power to impose binding obligation on national authorities through the EBA arbitration could have been granted. When national authorities establish more stability groups, it will be interesting to observe what specific burden sharing formula they opt for. If they use the same approach as the Baltic-Nordic group, then it is plausible that this approach may become a de facto EU wide approach that could be subsequently adopted into a directive. In any case, the delegation of the burden sharing formula to stability groups provides the EU with an experimental mechanism that may over time generate a consensual solution, providing that there is no return to complacency over the crisis management rules that characterized the pre-crisis period.

Concluding chapter:

Regulatory integration and transaction cost efficiency

This thesis scrutinized how the delegation of powers to committees affects regulatory integration of the most contested aspects of EU financial regulation. More broadly, it probed the question of how the EU adopts and implements politically contested rules, informed by four strands of EU literature (see Chapter 1). First, it drew upon policy literature on regulatory integration of EU financial markets that stresses the need for more harmonization and more consistent implementation of the EU regulations. Second, it employed political economy literature on the integration of European financial markets that points out that structural differences among national financial sectors divide policy preferences of member states and lead to the 'battle of the systems'. Third, the thesis considered the literature on the EU policy-making purporting that divided policy preferences in combination with supermajoritarian decision requirements are likely to result in policy stalemates. Finally, the EU implementation research suggesting that contested rules are often difficult to implement consistently due to either their fuzziness or misfit was also taken into account. The combination of these four strands of literature brings to light an interesting paradox motivating this research: while the policy literature insists that regulatory integration is necessary, the three other strands of the related literature suggest that it is all but impossible.

The EU is no newcomer to difficult, but necessary integration problems. Its approach to the harmonization of rules that underpin the single market has evolved over time. It began with cumbersome attempts at full harmonization in the early decades of the EU, abandoned in favour of a new approach combining minimal harmonization with mutual recognition. The latter largely succeeded in regulatory integration of markets for goods, but struggled to harmonize the regulatory framework for services, including financial services. Faced with these problems, the EU again innovated its approach; it delegated regulatory powers to expert committees striving for maximum harmonization, in order to resolve differences in implementation that fragmented the single market in financial services.

The delegation of powers to committees is not an entirely new approach, as the expert groups have always played at least some advisory role in EU policy-making. The delegation is a mere reshuffling of competences within the multi-level system of EU governance, and therefore it is not *a priori* obvious why it should enhance regulatory integration, given the challenges of divided policy preferences, supermajoritarian rules, and national control over implementation. The delegation strategy thus creates two related puzzles: the empirical puzzle is if it works at all; does an increased delegation of power to committees result in more regulatory integration? The theoretical puzzle is how it works; what are the causal mechanisms that enable committees to enhance regulatory integration of contested aspects of EU financial market rules beyond what previously seemed possible? In short, we have asked if and why more delegation leads to the adoption of more harmonized rules that are consistently implemented in all EU member states.

In theoretical terms, regulatory integration is the problem of institutional change. It's a change from the status quo, where each member state implements its own financial regulations, to where all member states consistently implement the common EU regulations necessary for a seamlessly integrated market in financial services. The three dominant institutionalist theories relied upon in EU studies — historical, sociological and rationalist institutionalism — all formulate different explanations of such changes. They propose alternative hypotheses about causal effects of delegation on regulatory integration (see Introductory Chapter). The historical institutionalist model of change — calibrated for the characteristics of the EU legislative and implementation processes — predicts regulatory integration through drifting. It hypothesizes that even if formal change is impossible, the shifts in financial markets would provide expert committees with opportunities to reinterpret existing rules in more harmonized manner. For the sociological hypothesis, committee deliberation resulting in a professional consensus on the most feasible common policy is emphasized as a likely effect. Finally, rationalist institutionalism posits that committees may have an independent effect on regulatory integration, because they can propose more complex package deals due to their informational and cognitive advantages that lower the transaction costs of policy-making.

This thesis evaluated the hypotheses against the observable characteristics of the three sets of the EU financial market regulations: the Own Fund Directive defining the composition of bank capital (Chapter 2), the Investment Services Directive stipulating the EU rules for securities trading (Chapter 3) and the cross-border bank resolution regime that specifies non-binding rules for crisis management and resolution of systemically important transnational banking groups (Chapter 4). In each empirical chapter some effect of empowered committees on regulatory integration is identified. In each case, expert committees enhanced regulatory integration of at least one of the most contested aspects of the given set of financial regulations. In case of bank capital, CEBS marshaled a complex technical compromise that accommodated competing approaches to loss absorbency of hybrid capital instruments by distinguishing between going and gone concern situations. In investment services CESR reconciled competing proposals on business conduct and transparency rules by differentiating among three types of clients and 22 different thresholds for post-trading reporting, respectively. In cross-border bank resolution, the Baltic-Nordic Cross-Border Stability Group reconciled the concerns of home and host supervisors by a combination of qualitative and quantitative weights for burden sharing calculation, rewarding proactive behavior of national authorities. These improvements refute the Null Hypothesis that predicted no effect of delegation on regulatory integration (see Table 5.1 for schematic summary). They demonstrate that more delegation was associated with progress in integration of some of the most contested aspects.

The concluding chapter is structured as follows. The next section compares evidence on the structure of policy compromises that enabled progress in regulatory integration with the predictions of the three hypotheses and concludes that the predictions of Bargaining Hypothesis provide the closest match. The subsequent section summarizes mechanisms through which delegation reduces transaction costs of policy-making and the third section reviews broader effects of reduced transaction costs on the EU legislative process. The fourth section briefly highlights some contributions to empirical debates that motivated this research. The final section adds several observations about further research based on the findings of this thesis.

Table 5.1: Contested aspects, policy coalitions and structured compromises

Policy domain	Contested aspect	Policy coalitions	Structured compromise enabling regulatory integration
Bank capital	Loss absorbency of eligible hybrid capital instruments	'Anglo-Saxon' vs. 'Continental European'	CEBS accommodated competing approaches to loss absorbency by distinguishing between going and gone concern situations
Investment services	Conduct of business rules and concentration/transparency rules	'Northern' vs. 'Southern'	CESR introduced 22 different categories for post-trading transparency and differentiated conduct of business rules
Bank resolution	Ex ante fiscal burden sharing rules	Home vs. host countries	The Baltic-Nordic Cross-Border Stability Group reconciled concerns of home and host supervisors by a combination of qualitative and quantitative weights for burden sharing that encourage proactivity

1. Evaluation of causal hypotheses

The progress in regulatory integration of the most contested aspects was achieved in all three cases by complex policy compromises that accommodated preferences of contending policy coalitions. The regulatory integration was facilitated by bargaining over structured compromises (Bargaining Hypothesis), rather than informal reinterpretation of existing rules (Drifting Hypothesis) or consensus on common standards (Deliberative Hypothesis). This is not to say that deliberations or reinterpretations are not part of the operational toolbox of the EU committees. They certainly are, but when it comes to integrating the most contested aspects of the regulation, the formal agreements proved necessary and in all three cases they clearly bore the sign of structured compromises accommodating the preferences of the contending policy coalitions that were predicted by the Bargaining Hypothesis.

The Drifting Hypothesis, derived from historical-institutionalist model of change, asserts that supermajoritarian decision-rules combined with national discretion over implementation would result in policy stalemate. Under these circumstances, it predicted that endogenous institutional change could be generated only by shifting market conditions that would allow expert committees to reinterpret existing rules in novel ways. The three case studies generate plenty of evidence that suboptimal policy solutions can prevail for a long time, even though their drawbacks are well known, thus providing ample time for reinterpretation. The definition of bank capital is the prime example. The 1988 policy compromise will be in place till 2013, exactly 25 years, without substantial reform, despite the evidence of its distorting effects on capital of banks within the single market (see Chapter 2). The deficient provisions on conduct of business and regulated markets stipulated in the Investment Services Directive lasted for a decade (see Chapter 3), and the clearly inadequate non-binding rules on cross-border bank resolution were enacted in 2003 and will not be reformed until 2014 (see Chapter 4). However, the case studies did not uncover any evidence of successful reinterpretation of existing rules in a way that would increase the degree of regulatory integration. To the contrary, the bank capital rules on "other items" were reinterpreted by authorities of some member states to allow for very liberal inclusion of hybrid capital instruments, which seriously increased regulatory fragmentation and reduced quality of bank capital in some EU countries. Similarly, when the Commission tried to provide consistent interpretation of the contested aspects of investment services regulation, it had to acknowledge that ISD rules do not prevent differing national interpretations, and that further regulatory integration would require a recasting of the directive. Finally, there was no way to reinterpret the burden sharing rules in a more binding fashion, as the Memoranda explicitly stated their non-binding character. In short, there is no support for the Drifting Hypothesis in the three empirical chapters. When the EU rules on contested aspects of financial regulation were vague or fuzzy in order to paper-over the policy conflict, they remained so until they were formally replaced with the next generation of rules.

The Deliberative Hypothesis based on sociological institutionalism suggests that regulatory integration of the most contested aspects can be achieved through expert deliberation in EU committees that leads to a convergence of national preferences on the common standards. Although delegating powers is conducive to deliberations among experts from within an epistemic community of financial market professionals, the micro-level policy outcomes bear little evidence of convergence on common rules. In all three cases the competing policy positions are clearly traceable in the compromises that advanced the degree of regulatory integration. Although the longitudinal case studies cover one or two decades of the policy evolution, they uncovered no instance of persuasion where one side of the policy divide would accept the competing proposal on any of the most contested aspects. Instead, committees continued to bargain over ever more complex compromises that reconcile competing proposals on ever-deeper technical level.

In the case of the bank capital composition, the one contested issue where there was any traceable progress in integration was the set of rules defining the hybrid capital instruments eligible as original own funds. The EU legislators delegated the rule-making powers to the Committee of European Banking Supervisors, which proposed micro-level rules specifying the loss-absorbency criteria that divided national authorities for more than a decade. However, the resulting rules were a compromise between the two dominant approaches to loss absorbency. It applied the 'Anglo-Saxon' approach to loss absorbency in cases when the ailing bank remains a going concern by avoiding insolvency. However, when the bank becomes a gone concern by entering into liquidation, the loss absorbency of hybrid capital is assured by its subordination to all asset classes except equity, which comes close to the write-down of the face value of the hybrid instrument advocated by the more stringent 'Continental' approach (see Chapter 2).

Similarly, the MiFID implementation measures stipulating post-trade transparency and conduct of business rules show the sign of a structured compromise between the approaches advocated by the 'Southern' and 'Northern' policy coalitions. In case of transparency rules, the question of how long the publication of share price data can be delayed was the bone of contention between the stock exchanges and investment banks that mapped on the policy conflict between the two advocacy coalitions in the Council. Investment banks preferred long delays, whereas stock exchanges argued for no or short delays. The resulting compromise prepared by the Committee of European Securities Regulators and adopted by the European Securities Committee included 22 different delays between 60 minutes and 3 days depending on the average daily turnover of given assets and the size of the transaction (see Chapter 3, Table 3.7). The conflict concerning the stringency of conduct of business rules was also resolved by a structured compromise. The MiFID introduced three client classifications to which different conduct of business rules apply. The most stringent rules encompass retail clients, reflecting the policy preferences of the 'Southern' advocacy coalition for protection. The rules for professional investors and eligible counterparties are less demanding, reflecting the 'Northern' preference for flexibility and competition (see Chapter 3, section 3).

The most contested aspect of the cross-border bank resolution regime is the fiscal burden-sharing formula, which is a necessary precondition for multilateral resolution of a failing bank by more than one member state. Although, the crisis opened an opportunity for discontinuous change, the conflicting preferences over the bindingness of EU rules and their impact on fiscal sovereignty prevented radical reforms. Instead, the EU continues on the path of endogenous change of the cross-border bank resolution rules. The technocrats in the cross-border stability groups were charged with devising resolution agreements for each individual banking group, which however remain in the domain of non-binding soft law. The most advanced agreement of cross-border cooperation signed till the end of 2010 — the Nordic-Baltic agreement on cross-border financial stability, crisis management and resolution — developed a burden sharing formula that combines the quantitative and qualitative factors, and reconciles the interests of the home and host country supervisors (see Chapter 4).

The empirical evidence matches the predictions of the Bargaining Hypothesis better than the two competing hypotheses. A summary of the key characteristics of the reformed rules that advanced regulatory integration confirms the predicted pattern of complex technical compromises. The preferences of the 'Anglo Saxon' and 'Continental' or 'Southern' and 'Northern' or home and host countries are recognizable in the policy proposals generated by the committees in all three cases (see Table 5.1). This leads to the conclusion that — at least in these three cases — the delegation of regulatory powers to committees enhanced regulatory integration through reduced transaction costs of bargaining rather than through persuasion and preference convergence on common standards or reinterpretation of existing rules. The complex rules were introduced not so much in response to functional demands of financial markets, as to accommodate divergent policy preferences of member states. Hence, the observed technical complexities cannot be understood as a result of a professional compromise that arose from committee deliberation. Instead, they resulted from continued bargaining.

The rational institutionalist prediction of effects of delegation on regulatory integration relies on the transaction-cost argument. It asserts that technocratic experts are capable of striking more complex policy compromises than legislators due to better information and better understanding of the technical aspects of the given policy. They can exploit preference asymmetries on micro-level of technical regulations and propose more complex, yet more harmonized package deals. These are more likely to be adopted by legislators due to extensive prior consultations with stakeholders and are more likely be implemented consistently due to the enhanced monitoring by committees. Hence, it is not delegation *per se* that increases the likelihood of regulatory integration. The success of delegation is predicated on the increased transaction cost efficiency. Regulatory powers need to be delegated in such a way that genuinely reduces these costs arising from informational asymmetries and bounded rationality.[99] At the same time, the delegation does not reduce transaction costs of EU policy making only because committees generate more information and better understanding of regulatory differences (see section 2); it induces additional changes in the EU policy-making process that also affect regulatory integration (see section 3).

2. Sources of transaction cost efficiency

The Bargaining Hypothesis essentially claims that regulatory integration of contested issues can be achieved by reducing the transaction costs of EU policy-making accomplished by delegating regulatory powers to expert committees. The causal chain connecting delegation and regulatory integration starts, however, with the accountability that induces committees to develop operational capacity, which in turn allows them to reduce transaction costs of policy-making by generating superior information and understanding of problems hindering regulatory integration.

The superior capacity to analyze regulatory integration, combined with strong accountability imposed by open consultations, enable committees to formulate harmonizing proposals that evade fuzzy provisions on contested aspects. Consultations compel committees to reconcile diverse interests and functional requirements of

[99] See Introductory chapter, section 1.3 for definition of transaction costs.

financial regulation, while superior information and understanding make them uniquely capable of orchestrating complex but harmonized package deals. Committees are better equipped to formulate such proposals than actors on legislative level that lack comparable insight into regulatory integration. At the same time, if committee proposals pass through the open consultation process, they are more likely to gather unanimous support or at least sufficient qualified majority on legislative level. In short, they are more likely to be adopted despite supermajoritarian decision requirements. They are also more likely to be implemented consistently, because the rules are harmonized and the same committees monitor their transposition and interpretation. Ultimately, consistently implemented harmonized rules translate to higher degree of regulatory integration. The empirical evidence from case studies confirms the expected increase in transaction cost efficiency caused by delegation. The process tracing and interviews revealed that committees produce unprecedented amount of high quality information on financial market regulation across the EU. The complex nature of policy compromises on contested aspects then attests committees' comparative advantages in formulation of micro-level technical deals that accommodate competing interests.

The Lamfalussy reform delegated powers to expert committees, but also made them accountable to the Commission, Council and European Parliament as well as the financial industry and other stakeholders. The accountability of CESR and CEBS to EU legislators is ensured through their work program, regular reporting as well as through the 'regulatory committee with scrutiny' procedure (see Chapter 1, section 5).[100] This

[100] The increased accountability is not limited to Lamfalussy committees. The EU memoranda on bank resolution also broadened the composition of the supervisory colleges. The colleges were enlarged to include representatives of central bank, economic ministries and the banking group in question (i.e. to

provides the legislative bodies with a considerable degree of control over the committee policy decisions and ensures regular review of accomplishments. Even more important accountability mechanism is the open and transparent consultation process that exposes committee proposals to scrutiny of all stakeholders (see Chapter 2, section 3.3). These consultations mean that complex compromises proposed by the committees need to be defended vis-à-vis external critics, which keeps committees accountable to wide spectrum of stakeholders.

The accountability mechanisms and tasks delegated to committees are defined by formal mandates. The mandate requires the committee to develop sufficient administrative and analytical capacity to advise the Commission, contribute to consistent implementation, and promote convergence of supervisory practices, and provides them with necessary resources (see Chapter 2, section 3.3). Their administrative and analytical capacity is regularly tested by the busy agenda delegated to them by the Commission, Council, and European Parliament that are relying on committees inputs to the policy-making process. The Lamfalussy committees have been working at full capacity since their inception and proved their ability to diagnose obstacles in regulatory integration and propose possible improvements. Compared to pre-delegation comitology arrangements, the new committees operate on an ongoing basis and nurture much more frequent interactions among national authorities. They also operate with independent resources and analytical capacities, allowing them to take a 'European', rather than specifically national view on any contested rule. The evidence in empirical chapters confirms that Level 3 committees develop the required

form a cross-border stability group) before the power to prepare non-binding resolution agreements was delegated to them.

capacities and their role is expanding even to cross-border bank resolution regime, where their mandate is very limited (see Chapter 4, section 4).

The effect of the increased capacity of committees on the commitment to regulatory integration was observable in the case studies. The case of bank capital composition revealed the increased capacity of the Committee of European Banking Supervisors to steer the consultation process relentlessly towards complex compromise. This allowed it to prevent repeated non-decision on the contested definition of loss absorbency requirement for hybrid capital instruments (see Chapter 2, section 3.3). Similarly, in case of investment services, the work of the Committee of European Securities Regulators generated complex agreements on the conduct of business and transparency rules, despite continued policy conflicts (see Chapter 3, sections 3 and 5). Analogously, the most advanced burden sharing formula emanated from the work of the Nordic-Baltic stability group, which had the capacity to specify the EU level recommendations (see Chapter 4, section 3). These examples demonstrate that delegation can induce capacity-building that makes a difference in the process of regulatory integration.

The capacity of committees to monitor and analyze national implementation of EU financial regulation generated an unprecedented amount of publicly accessible information. Open and transparent consultations greatly enhanced the quality of this information, because any stakeholder could comment and dispute the committee findings and many actively did. As a result, inconsistent implementation is much easier to identify than ever before. At the same time, the open debate about adoption and implementation of EU financial regulation improved supervisors' understanding of the sources of inconsistencies that fragment the regulatory framework along national lines. This increases the likelihood that committees pinpoint technical compromise that can accommodate competing policy preferences to gather unanimous support or at least respective majorities in the Council and European Parliament.

The higher 'adoptability' of committee proposals in the Council was clearly observable in the MiFID case, when 5 member states voted against the directive in the Council, but accepted unanimously the complex compromises on implementation measures that were proposed by CESR (see Chapter 3, sections 2 and 3). Similarly, the CEBS definition of loss absorbency was accepted by all member states, despite their refusal to even consider adopting such rules few years earlier (see Chapter 2, section 4.2). Analogous effect was also observable in regard to the cross-border resolution agreements. When no EU level rules on burden sharing seemed possible, the delegation enabled at least the eight countries involved in the Nordic-Baltic stability group to agree on acceptable formula (see Chapter 4, section 3).

Reduced transaction costs also explain why the same expert committees had a much lower effect on regulatory integration, when they played mere advisory role. They had no mandate to approach stakeholders and draw them into an extensive consultation process. Instead, they merely supplied their opinion for the consideration of the EU legislators. They were not accountable for the formulation of policy compromises that would be both adoptable and implementable. They were also not even formally obliged to deliver their recommendations and even less to defend them in open and transparent consultations. Hence, they did not develop the administrative and analytical capacity that reduces the transaction costs of policy-making, and were much less likely to propose adoptable solutions to contested regulatory issues.

The enhanced capacity and accountability of regulatory committees also affected implementation. Committees regularly monitor the implementation of contested aspects. Either they are obliged to do so by the mandatory review clause or they evaluate the implementation during the consultation process on related financial regulation. Lamfalussy committees can also initiate their own inquiries on the basis of their mandate to contribute to the consistent implementation of EU legislation and when they prepare harmonized guidelines or recommendations (see Chapter 2, section 3.3). Their monitoring capacity makes persistently inconsistent implementation less likely, which improves the prospects of regulatory integration. The case study evidence on implementation is conclusive only for the investment services regulation, where the monitoring role of CESR contributed to the consistent implementation of MiFID, so that the problems with fragmented implementation of ISD did not reappear (see Chapter 3, section 3). In the other two cases, the implementation record points in the expected direction, but remains too short for conclusive evaluation. Hence, a natural extension of this thesis would be to evaluate the evidence on implementation of the complex policy compromises and the capacity of committees to monitor them (see section 5).

Overall, committees made it easier to adopt and implement contested financial market regulations. Their mandate and accountability forced them to establish considerable analytical capacity that enhanced their understanding of the obstacles to regulatory integration, and allowed them to negotiate complex, but harmonized policy proposals. More harmonized rules and more implementation supported by committees lead to a higher degree of regulatory integration. Nonetheless, the effects of the reduced transaction costs extend beyond the bargaining and subsequent monitoring. Higher transaction costs efficiency changes important aspects of the legislative process as is summarized in the next section.

3. Effects of transaction cost efficiency on legislative bargaining

The increasing use of delegation to committees indicates perceived usefulness of the new governance arrangements by EU legislators. Initially, the delegation of implementation powers was limited to the four 'Lamfalussy directives' (see Chapter 1, section 5), but its use has gradually expanded to other fundamental pieces of financial market legislation such as the Capital Requirements Directive (see Chapter 2, section 1.3). The expanding scope of delegation indicates that the Commission, Council and European Parliament have confidence in the policy-making capacity of committees as well as their accountability. This is an important observation given the initial concerns over their legitimacy and oversight; it seems that the regulatory procedure with scrutiny provided a satisfactory solution (see Chapter 1, section 5).

The delegation of implementation powers to committees reduced political stakes in legislative bargaining. It is no longer necessary to settle all technical provisions on the legislative level, which was difficult, time consuming, and often run against the deadlines of legislative process (see Chapter 3 for the example of ISD). In contrast, the committee bargaining on implementation measures may continue beyond the self-imposed deadlines such as those stipulated in Financial Services Action Plan. Moreover, the Level 2 or 3 legislation can be adapted promptly by committee decision, without the reopening of political agreements on Level 1. This is a distinct advantage for regulations that needs to be adapted to market developments or in cases when new rules generate unexpected or unintended consequences. This flexibility also makes experimentation with novel regulatory approaches more acceptable (see Posner 2010).

The increased use of mandatory review clauses suggests that EU legislators took notice of reduced transaction costs of policy-making in the financial market domain. Review clauses are included in directives in 'recognition of the fact that the agreed legislation is as far as the negotiating parties could go at the time' (Bulmer 1998:367). They commit the Commission — and thus the expert committees — to evaluate progress of regulatory integration and propose harmonizing amendments by a set date. They were used in past, but their number in recent amendments of key banking directives quadrupled (see Chapter 2, Table 2.12). This testifies to legislators' confidence that committees would be able to cope with the increased demand for policy evaluations and harmonizing proposals. In turn, the demonstrated capacity of committees to supply such proposals makes the review clause commitments to further harmonization more credible as it is less likely that the deadline set in the directive would pass unheeded as it happened with the Own Funds Directive review clause (see Chapter 3, section 5.1). Moreover, the open consultation process makes it more difficult to block harmonization through behind the scene agreements of member governments. If there are unsolvable policy conflicts that prevent agreements on further harmonization, then they need to be acknowledged and justified publicly.

The option to delegate some powers to committees also adds a new parameter into EU negotiations of the common rules. The delegation can become a bargaining chip of its own. Member states or other stakeholders marginally opposing some measure may be prepared to accept it, if it is delegated to the Level 2 or subjected to a review clause. Hence, delegation of implementation powers or agreement on mandatory review becomes a way of luring the pivotal votes for or against some legislative proposals.

An additional effect of delegation on regulatory integration may arise from a shift from positive to negative harmonization. The Chapter 2 (section 4.2.2) documents such an example. The negative harmonization requires agreements only on those rules that need to be suppressed, and is generally easier to adopt than positive harmonization, which requires a formulation of a common standard. However, because it relies on less prescriptive rules, the negative harmonization requires greater monitoring capacity to ensure that distorting national rules are identified and suppressed. Since the Lamfalussy committee can provide such monitoring capacity, negative harmonization provides a plausible policy option.

Increasing reliance on flexible multi-level regulation, frequent use of mandatory review clauses and occasional shift to negative harmonization all attest that reduced transaction costs of policy making affect the way financial regulations are adopted and implemented. The delegation strategy provided the EU policy-making process with coping mechanisms that reduce the likelihood of a policy stalemate due to divided policy preferences, supermajoritarian decision rules or national control over implementation. It enables adoption and implementation of more harmonized regulations. At the same time, the thesis also indicates some limits to delegation.

Reduced transaction costs enable progress of regulatory integration by facilitating punishingly complex package deals. The delegation strategy reduces contested issues to their micro-level technical aspects in order to propose harmonized rules. However, this strategy works only at the margin of the EU regulatory framework. The delegation is not an answer to some fundamental regulatory issues that need to be decided on the political level. For example, committees may help to harmonize rules on hybrid capital, but they cannot be expected to decide whether hybrid instruments should be allowed at all or whether heretofore unregulated issues should be covered by new rules. Had there been some support for Deliberative Hypothesis, the committees could aspire to more important role on the basis of clear professional consensus on the most appropriate common standards. However, if experts cannot produce consensus without extensive micro-level accommodation of competing interests — as in the three cases analyzed here — their views are not likely to gather political support necessary for fundamental reforms. Hence, the role of expert committees seems to remain limited to bargaining over complex compromises that further regulatory integration on micro-level one step at a time.

4. Empirical contributions to policy debates

The primary contribution of this thesis is the evaluation of the three causal hypotheses and identifying sources and effects of reduced transaction costs on regulatory integration and EU policy-making. These were summarized in the previous sections. However, the thesis also adds several notable observations to related debates on EU policy-making.

Financial market regulation is rarely analyzed in comparison with such staples of EU research as environmental, social or agricultural policies (as noted by review articles of Toshkov 2010 and Treib 2008). The thesis reduces this gap in the literature in a novel way with its emphasis on the long-term evolution that avoids exclusive focus on the most recent developments. The EU policies on hybrid capital (Chapter 2) and cross-border bank resolution (Chapter 4) are of particular interest, as they have not received prior attention in scholarly literature.

The thesis generates several observations relevant for the four strands of the EU policy-making literature that motivated the research question (see Chapter 1). It supports the assertion of the policy literature that harmonization of regulatory framework is a necessary precondition for single market in financial services. In each case, the differences in regulation generated adverse effects such as reducing quality and comparability of bank capital (Chapter 2, section 2), limiting competition and consumer protection in investment services (Chapter 3, section 3) or undermining incentives for multilateral cooperation in cross-border bank resolution (Chapter 4, section 2). The findings also support the assertion of the literature on political economy of EU financial market regulation that the battle of the systems still provides apt characterization of policy preferences on many regulatory issues, including the three cases analyzed here (see Table 5.1 and discussion in Chapter 1, section 2).

The thesis demonstrated that the EU developed coping mechanisms preventing the traps, stalemates, deadlocks, or gridlocks highlighted by the EU decision-making literature (see Chapter 1, section 2). In this context, the delegation of regulatory powers to technocratic committees can be characterized as arena shifting (Falkner 2011a) or, more generally, venue shopping (Baumgartner and Jones 2009). Arena shifting is typically motivated by the expectation that different actors may have different capacity to resolve disagreements. The conclusion here pointed out that these differences are attributable to differences in transaction cost efficiency of alternative governance arrangements.

4. Research outlook

The generalizability of the findings of this thesis is limited by the chosen research method. The three longitudinal case studies of on the adoption and implementation of the most contested aspects of EU financial rules can hardly aspire to general validity within the domain of financial market regulation and beyond. However, the primary contribution of the case studies comes from uncovering causal mechanisms that can be subjected to further testing on a larger number of cases. This thesis generated several such ideas and also provided evidence that can be used for further research.

The conclusion of this thesis supports the claim that governance matters for institutional outcomes. It provides a causal explanation based on the extended application of the transaction cost analysis to the study of EU policy-making (see Introductory Chapter, section 1.3 for brief review of previous applications). The novel use of this analytical framework stems from qualitative comparison of the transaction cost efficiency of governance arrangements before and after delegation of regulatory powers. It demonstrates that higher transaction costs efficiency exerts independent causal effect on regulatory integration and that this effect can be evaluated ex ante. Hence, this application of the transaction cost analysis could be utilized in debates on reforms of EU governance.

The thesis pointed out that the choice of governance arrangements in the domain of financial market regulation continues to expand. The EU policy-makers regularly engage in intense disputes about the most appropriate governance mechanism as they are well aware that it is not only the content of the rules but also the underpinning governance arrangement that determine policy impact (see Chapter 2, section 3.2 for 1980s example of such dispute). Since the comitology was established during the 1960s, the choice of formal governance arrangements was limited to the three types of procedures — advisory, management and regulatory committees (see Pollack 2003a). The Lamfalussy reform added the regulatory committee with scrutiny procedure and the Level 2 and Level 3 committees (see Chapter 1). There are additional cross-sectoral committees dealing with accounting, auditing and regulations of conglomerates that can be also involved (see Quaglia 2010b for comprehensive review). Furthermore, previously informal arrangements, such as supervisory colleges and cross-border stability groups, are also assigned formal regulatory powers by EU legislation or soft law. This expanding list of committees can be variously combined and recombined to form governance arrangements that support the adoption and implementation of specific sets of financial rules, which leads to the question of what arrangement might be most appropriate. Different arrangements are likely to differ with regard to their capacity to support adoption and implementation of contested rules, which can be fruitfully analyzed and compared in terms of transaction cost efficiency. Hence, the transaction cost analysis offers one way of deciding what governance arrangement to adopt.

The thesis highlighted the increasing use of the mandatory review clauses in order to stimulate regulatory integration on contested issues. Chapter 2 revealed that the choice of governance arrangements — including the question of which powers are delegated to committees and which remain under exclusive control of legislators — may have important consequences for the credibility of EU's commitment to further harmonization stipulated by the mandatory review clauses attached to the contested aspects of financial market directives. The thesis offers a hypothesis that the more transaction cost efficient governance arrangements make the commitment to regulatory integration more credible. The committee accountability and capacity to process technical complexities should increase the likelihood that the EU would agree upon and implement more harmonized rules despite hindrances such as divided policy preferences, supermajoritarian decision rules and national control over implementation. It is easily observable whether the Commission submitted reports and harmonizing amendments by the deadlines set by the review clauses, hence this hypothesis, formulated on the basis of qualitative case studies, is suitable for systematic statistical testing. Table 2.12 demonstrates that the use of mandatory review clauses in banking directives quadrupled recently; hence capacity of committees to honor these commitments may be crucial for the success of the post-crisis re-regulation of financial markets.

The empirical chapters of this thesis provide rather conclusive evidence of the effects of delegation on the adoption of contested EU regulations. However, only the case study of investment services regulation provided a sufficiently long implementation record to conclude that the more complex compromises can be successfully enforced so that inconsistent implementation does not resurface (see Chapter 3, section 3). In the other two cases, the implementation record points in the expected direction, but remains too short for conclusive evaluation. Hence, a natural extension of this thesis would be to evaluate the evidence on the implementation of the complex policy compromises and the capacity of committees to monitor them. The committee reports induced by mandatory review clauses are likely to provide the empirical evidence for such analysis.

One of the consequences of delegation is the increasing number of the levels of EU legislation, which potentially creates new challenges for regulatory harmonization. There may be up to four levels of rules jointly defining some specific regulatory provision. The essential rules may be defined in a directive on Level 1 of the Lamfalussy process. The technical aspects may be defined in the implementation directive on Level 2, and further clarified by the guidelines on Level 3 (see Table 3.3, for example). Finally, there may be further voluntary agreements originating from supervisory colleges or cross-border stability groups. This multi-level legal structure creates ample opportunity for inconsistencies and even contradictory provisions that may undermine progress in regulatory integration that was achieved by the delegation strategy (see also Commission 2005b:5). This invites follow-up research on capacity of EU committees to prevent and resolve inconsistencies of multi-level regulations, which will ultimately determine the long-term success of delegation as an effective strategy of EU regulatory integration.

Bibliography

Allen, F. & Gale, D., (2000) Comparing financial systems, MIT Press, Cambridge.

Angeloni, I., (2008) Testing times for global financial governance, Bruegel essay and Lecture series, 3.

Armingeon, K. (2000) Swiss federalism in comparative perspective, In U Wachendorfer-Schmidt (ed), Federalism and Political Performance, Routledge, London and New York, pp. 112-29.

Aspinwall, M. & Schneider, G. (2001) Institutional research on the European Union: mapping the field, In M Aspinwall & G Schneider (eds), The rules of integration: institutionalist approaches to the study of Europe, Manchester University Press, Manchester.

BAC, (2001) Revision of the EU legislation on the Own Funds of Credit Institutions and its implementation in the member states (MARKT/1005/01), Banking Advisory Committee: Interim report by the Own Funds Directive Working Group , Brussels.

Banting, K.G. (2008) The three federalisms: Social policy and intergovernmental decision-making, In H Bakvis & G Skogstad (eds), Canadian Federalism: Performance, Effectiveness, and Legitimacy, Oxford University Press, .

Bates, R.H., Greif, A., Levi, M., Rosenthal, J.L. & Weingast, B.R., (1998) Analytic narratives, Princeton University Press, Princeton, N.J.

Baumgartner, F.R. & Jones, B.D., (2009) Agendas and instability in American politics, 2, illustrated ed. University of Chicago Press, Chicago.

BBA, (2008) BBA/LIBA response to CEBS Hybrids consultation paper, British Bankers' Association, London.

BCBS, (1983) Report on International Developments in Banking Supervision, Basel Committee on Banking Supervision, Basel.

BCBS, (1999a) Capital Requirements and Bank Behaviour: The Impact of the Basle Accord, Basel Committee on Banking Supervision, Basel.

BCBS, (1999b) A new capital adequacy framework: Consultative paper, Basel Committee on Banking Supervision, Basel.

BCBS, (2009) Strengthening the resilience of the banking sector, Basel Committee on Banking Supervision, Basel.

BCBS, (2010) Basel III: A global regulatory framework for more resilient banks and banking systems, Basel Committee on Banking Supervision, Basel.

Beck, T., Demirgüç-Kunt, A. & Levine, R., (2008) A new database on financial development and structure, World Bank Economic Review.

Benz, F.W. (2011) Escaping Joint-Decision Traps: National and supranational experiences compared, In G Falkner (ed), The EU's Decision Traps: Comparing Policies, Oxford University Press, Oxford.

Bergström, C.F., (2005) Comitology, Oxford University Press, Oxford and New York.

BIS, (2009) Report and Recommendations of the Cross-border Bank Resolution Group, Basel Committee on Banking Supervision, Bank for International Settlements.

Blom-Hansen, J., (1999) Avoiding the joint-decision trap: Lessons from intergovernmental relations in Scandinavia, European Journal of Political Research, 35(1), pp. 35-67.

Blom-Hansen, J., (2011) The EU comitology system: taking stock before the new Lisbon regime, Journal of European Public Policy, 18(4), pp. 607-17.
Blom-Hansen, J. & Brandsma, G.J., (2009) The EU comitology system: intergovernmental bargaining and deliberative supranationalism? JCMS: Journal of Common Market Studies, 47(4), pp. 719-40.
Bowles, S., (2010) MiFID: Speech by Sharon Bowles MEP Chair Economic and Monetary Affairs Committee, DG Internal Market website, Brussels.
Börzel, T. & Panke, D. (2010) Europeanization, In M Cini & N Pérez-Solórzano Borragán (eds), European Union Politics, Oxford University Press, Oxford and New York, pp. 104-22.
Börzel, T.A. (2003) Guarding the Treaty: The Compliance Strategies of the European Commission, In TA Börzel & RA Cichowski (eds), The State of the European Union, Oxford University Press, Oxford.
Bradley, K.S.C., (2008) Halfway house: the 2006 comitology reforms and the European Parliament, West European Politics, 31(4), pp. 837-54.
Brandsma, G.J. (2010) Accountable comitology? In M Bovens, D Curtin & P Hart (eds), The real world of EU accountability: what deficit? Oxford University Press, Oxford and New York, p. 221.
Buehler, K., Samandari, H. & Mazingo, C., (2009) Capital ratios and financial distress: lessons from the crisis, McKinsey working papers on risk.
Bulmer, S.J., (1998) New institutionalism and the governance of the Single European Market, Journal of European Public Policy, 5(3), pp. 365-86.
Casey, J.P. & Lannoo, K., (2006) The MiFID implementing measures: Excessive detail or level playing field, ECMI Policy Brief, Brussels.
CEBS, (2005) Annual Report for 2004, Committee of European Banking Supervisors, London.
CEBS, (2006a) Analysis of the capital instruments recently created by the industry, Committee of European Banking Supervisors, London.
CEBS, (2006b) Survey of the implementation of the current rules on own funds across Member States, Committee of European Banking Supervisors, London.
CEBS, (2007a) Annual Report for 2006, Committee of European Banking Supervisors, London.
CEBS, (2007b) Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area, Committee of European Banking Supervisors, London.
CEBS, (2009a) Annual Report for 2008, Committee of European Banking Supervisors, London.
CEBS, (2009b) Implementation Guidelines for Hybrid Capital Instruments, Committee of European Banking Supervisors, Brussels.
CEBS, (2010) CEBS guidelines for the operational functioning of colleges, Committee of European Banking Supervisors, London.
CESR, (2009) Annual Report for 2008, Committee of European Securities Regulators, Paris.
CESR/CEBS/CEIOPS, (2010) 3L3 cross-sector seminar on MiFID: Presentations, Committee of European Banking Supervisors, London.
Checkel, J.T., (1999) Social construction and integration, Journal of European Public Policy, 6(4), pp. 545-60.

Checkel, J.T., (2003) "Going Native" In Europe?: Theorizing Social Interaction in European Institutions, Comparative Political Studies, 36(1-2), p. 209.

Checkel, J.T., (2005) International institutions and socialization in Europe: Introduction and framework, International Organization, pp. 801-26.

Christiansen, T. & Vaccari, B., (2006) The 2006 Reform of Comitology: Problem Solved or Dispute Postponed, EIPASCOPE, 1(3), pp. 9-17.

Christiansen, T., Jørgensen, A. & Wiener, A., (1999) The Social Construction of Europe special issue, Journal of European Public Policy, 6, pp. 528-44.

Cihak, M. & Decressin, J., (2007) The case for a European Banking charter, International Monetary Fund Working Paper 07/173.

Cihak, M. & Nier, E., (2009) The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union, International Monetary Fund working paper 09/200.

Cini, M. & Pérez-Solórzano Borragán, N., (2010) European Union politics, 3, illustrated ed. Oxford University Press, Oxford and New York.

Coleman, W. & Underhill, G. (1998) Globalism, regionalism and the emergence of international securities markets: the case of IOSCO and EU financial integration, In W Coleman & G Underhill (eds), Regionalism and the global economic integration: Europe, Asia, and the Americas, Routledge, London, pp. 223-48.

Commission, (1985) Completing the Internal Market: white paper COM(85) 310 final, Commission of the European Communities, Brussels.

Commission, (1989a) A common market for services: Completing the internal market, Commission of the European Communities, Brussels.

Commission, (1989b) The European financial common market, Office for official publications of the European Communities.

Commission, (1989c) Reexamined proposal for a council directive on the own funds of credit institutions (COM (89) 208 final), Commission of the European Communities, Brussels.

Commission, (1999) Financial services: Implementing the framework for financial markets - action plan, Commission of the European Communities, Brussels.

Commission, (2000a) First Commission Report to the European Parliament and the Council on the Implementation of the Own Funds Directive (COM (2000) 74 final), Commission of the European Communities, Brussels.

Commission, (2000b) Institutional Arrangements for the Regulation and Supervision of the Financial Sector, Commission of the European Communities, DG MARKT., Brussels.

Commission, (2000c) Upgrading the Investment Services Directive (ISD) – frequently asked questions. (MEMO/00/81), European Commission, Brussels .

Commission, (2002a) The Internal Market – Ten Years without Frontiers, Commission of the European Communities, Brussels.

Commission, (2002b) Proposal for a directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council directives 85/611/EEC and European Parliament and Council directive 2000/12/EC, European Commission, Brussels.

Commission, (2004) The application of the Lamfalussy process to EU securities markets legislation: A preliminary assessment by the Commission services (SEC (2004) 1459), Commission of the European Communities, Brussels.
Commission, (2005a) Call For Technical Advice (No.4) from the Committee of European Banking Supervisors (CEBS), Commission of the European Communities, Brussels.
Commission, (2005b) White Paper on Financial Services Policy (2005 – 2010), European Commission, Brussels.
Commission, (2008) Impact assessment accompanying the proposal for an amendment of the capital requirement directive (SEC(2008) 2523), Commission of the European Communities, Brussels.
Commission, (2009) Impact assessment Accompanying Communiation on an EU Framework for cross-border crisis management in the banking sector, Commission of the European Communities, Brussels.
Commission, (2010a) Commission sets out vision for bank resolution funds, Commission of the European Communities, Brussels.
Commission, (2010b) Communication on an EU framework for crisis management in the financial sector (COM (579) 2010 final), Commission of the European Communities, Brussels.
Commission, (2010c) Possible further changes to the Capital Requirements Directive, Brussels.
Commission, (2010d) Review of the Markets in financial instruments directive (MiFID): Public consultation, Brussels.
Commission, (2010e) State aid: Latest scorecard shows reduced use of crisis support to banks, Commission of the European Communities, Brussels.
Crombez, C., Steunenberg, B. & Corbett, R., (2000) Understanding the EU Legislative Process: Political Scientists' and Practitioners' Perspectives, European Union Politics, 1(3), p. 363.
Csaba, L., (2005) Poetry and Reality about the Future of the Union: Reflections on the Dimensions and Nature of the Re-launch of the Lisbon Strategy, Intereconomics, 40(2), pp. 61-5.
Csaba, L., (2009) Crisis in economics? Studies in European political economy, Akademiai kiado, Budapest.
Danielsson, J., (2010) The saga of Icesave, Centre for Economic Policy Research: Policy insight(44).
Davies, H. & Green, D., (2008) Global financial regulation: the essential guide, Polity Press.
Deeg, R. & Lütz, (2000) Internationalization and financial federalism: the United States and Germany at the crossroads? Comparative Political Studies, 33(3), pp. 374-405.
Dehousse, R., (2003) Comitology: who watches the watchmen? Journal of European Public Policy, 10(5), pp. 798-813.
Dehousse, R., (2009) The governance turn revisited, Paper prepared for a seminar at the Academy of Sciences in Vienna, October 12.
Demirguc-Kunt, A. & Levine, R., (2008) Finance, financial sector policies, and long-run growth, World Bank Policy Research Working Paper No. 4469.

Demirguc-Kunt, A., Detragiache, E. & Merrouche, O., (2010) Bank Capital: Lessons from the Financial Crisis, IMF Working Papers, 10(286), pp. 1-35.

Department of Finance, (2010) Government statement: Announcement of Joint EU-IMF programme for Ireland, Department of Finance, Dublin.

Dermine, J., (2000) Bank mergers in Europe, the public policy issues, Journal of Common Market Studies, 38(3), pp. 409-25.

Dixit, A.K., (1996) The making of economic policy: A transaction-cost politics perspective, MIT press.

Drazen, A. & Grilli, V., (1993) The Benefit of Crises for Economic Reforms, The American Economic Review, 83(3), pp. 598-607.

EBC, (2006) Own funds: Commission Services propose a possible way forward for hybrid capital instruments, EU newsletter for the European Banking Committee, 1(3).

ECB, (2003) Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations, European Central Bank, Frankfurt.

ECB, (2005) Memorandum of Understanding on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations, European Central Bank, Frankfurt.

ECB, (2007) Review of the Lamfalussy framework: Eurosystem contribution, European Central Bank, Frankfurt.

EFC, (2000) Report on financial stability (first Brouwer reports), Economic and Financial Committee, Brussels.

EFC, (2001) Report on financial crisis management (second Brouwer reports), Economic and Financial Committee, Brussels.

EFC, (2009) Lessons from the financial crisis for European financial stability arrangements, Economic and Financial Committee, Brussels.

EP, (2001) European Parliament resolution on the evaluation of Directive 89/299/EEC on the own funds of banks (2000/2207(INI)), European Parliament, Brussels.

EP, (2003) European Parliament: position (COD/2002/0269, 1st reading), European Parliament, Strasbourg.

EP, (2004) European Parliament: position (COD/2002/0269, 2nd reading), European Parliament, Strasbourg.

EP, (2010) Regulation of the European Parliament and of the Council establishing a European Supervisory Authority (European Banking Authority)(A7-0166/2010), European Parliament, Brussels.

ESC, (2003) Summary reports of the European Securities Committee meeting 45, European Securities Committee, Paris.

Falkner, G. (2011a) The EU's Decision Traps and their Exits: Comparative Perspectives, In G Falkner (ed), The EU's Decision Traps: Comparing Policies, Oxford University Press, Oxford.

Falkner, G., (2011b) Fines and Second ECJ Judgments as Modes of EU Governance, Paper presented at ECPR General Conference in Reykjavik.

Ferran, E., (2004) Building an EU securities market, Cambridge University Press, Cambridge.

FESE, (2006) Share ownership structure in Europe, Federation of European Stock Exchanges, Brussels.

Fortis, (2008) Fortis: Shareholder Circular of November 19, 2008, Fortis Group, Brussels.
Franchino, F., (2000) The Commission's executive discretion, information and comitology, Journal of Theoretical Politics, 12(2), p. 155.
Franchino, F., (2007) The powers of the Union : delegation in the EU, Cambridge University Press, Cambridge.
FSA, (2009) A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact, Turner Review Conference Discussion Paper, Financial Services Authority, London.
FSB, (2010) Reducing the moral hazard posed by systemically important financial institutions: Interim report to G20 Leaders, Financial stability board.
G20, (2009) The G20 communique from Pittsburg Summit, Group of 20.
Genschel, P. (2011) One trap, many exits, but no free lunch: How the Joint-Decision Trap shapes EU tax policy, In G Falkner (ed), The EU's Decision Traps: Comparing Policies, Oxford University Press, Oxford.
Gomber, P. & Pierron, A., (2010) MiFID: Spirit and Reality of a European Financial Markets Directive, European Federation of Stock Exchanges.
Goodhart, C. & Schoenmaker, D., (2009) Fiscal burden sharing in cross-border banking crises, International Journal of Central Banking(5).
Grande, E., (1996) The state and interest groups in a framework of multi-level decision-making: the case of the European Union, Journal of European Public Policy, 3(3), pp. 318-38.
Groenleer, M., Kaeding, M. & Versluis, E., (2010) Regulatory governance through agencies of the European Union? The role of the European agencies for maritime and aviation safety in the implementation of European transport legislation, Journal of European Public Policy, 17(8), pp. 1212-30.
Gros, D., (2009) Institution-Building in Action, Center for European Policy Studies, Brussels.
Grossman, E. & Leblond, P., (2011) European Financial Integration: Finally the Great Leap Forward? JCMS: Journal of Common Market Studies, 49(2), pp. 413-35.
Haas, E.B., (1990) When knowledge is power: three models of change in international organizations, University of California Press.
Hacker, J.S. (2005) Policy drift: Hidden politics of US welfare state retrenchment, In W Streeck & K Thelen (eds), Beyond Continuity, Oxford University Press, Oxford and New York.
Hall, P.A. (2010) Historical institutionalism in rationalist and sociological perspective, In J Mahoney & KA Thelen (eds), Explaining institutional change: ambiguity, agency, and power, Cambridge University Press, Cambridge and New York.
Hall, P.A. & Soskice, D.W., (2001) Varieties of capitalism: The institutional foundations of comparative advantage, Oxford University Press, USA.
Hall, P.A. & Taylor, R.C.R., (1996) Political Science and the Three New Institutionalisms, Political studies, 44(5), pp. 936-57.
Hartmann, P., Maddaloni, A. & Manganelli, S., (2003) The Euro-area financial system: structure, integration, and policy initiatives, ECB working paper 230.
Hayes-Renshaw, F. & Wallace, H.S., (1997) The Council of Ministers, Palgrave Macmillan.

Hayes-Renshaw, F., Van Aken, W. & Wallace, H., (2006) When and why the EU Council of Ministers votes explicitly, Journal of Common Market Studies, 44(1), p. 161.

Heritier, A., (1999) Policy-making and diversity in Europe: Escape from Deadlock, Cambridge University Press.

Hertig, G. & Lee, R., (2003) Four predictions about the future of EU securities regulation, Journal of Corporate Law Studies, 3, p. 359.

Héritier, A., (1997) Policy-making by subterfuge: interest accommodation, innovation and substitute democratic legitimation in Europe-perspectives from distinctive policy areas, Journal of European Public Policy, 4(2), pp. 171-89.

Hix, H., (2008) What's Wrong with the European Union and How to Fix it, Polity Press.

Hix, S., (2005) The Political System of the European Union, 2nd ed. Palgrave MacMillan.

House of Commons, (2009) Banking Crisis: The impact of the failure of the Icelandic banks, Treasury Committee Publications, London.

IIF, (2009) Restoring confidence, creating resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability, Institute of International Finance, Washington.

IIMG, (2003) First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe, Inter-Institutional Monitoring Group, Commission of the European Communities.

IMF, (2009) An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency, International Monetary Fund, Washington.

IMF, (2010) Crisis management and resolution for a European banking system, International Monetary Fund, Washington.

Jachtenfuchs, M., (2002) The governance approach to European integration, JCMS: Journal of Common Market Studies, 39(2), pp. 245-64.

Jennings, M., (2007) MiFID: Market transparency, Deloitte Czech Republic, Prague.

Joerges, C. & Neyer, J., (1997) Transforming strategic interaction into deliberative problem-solving: European comitology in the foodstuffs sector, Journal of European Public Policy, 4(4), pp. 609-25.

Jupille, J. & Caporaso, J.A., (1999) Institutionalism and the European Union: Beyond international relations and comparative politics, Annual review of political science, 2(1), pp. 429-44.

Jupille, J., Caporaso, J. & Checkel, J., (2003) Integrating Institutions: Rationalism, Constructivism, and the Study of the European Union, Comparative Political Studies, 36(1-2), pp. 7-40.

Kapstein, E.B., (1989) Resolving the regulator's dilemma: international coordination of banking regulations, International Organization, 43(02), pp. 323-47.

Kapstein, E.B., (1991) Supervising International Banks: Origins and Implications of the Basle Accord, Essays in international finance(185).

Kapstein, E.B., (1994) Governing the global economy : international finance and the state, Harvard University Press, Cambridge, Mass.

Kudrna, Z., (2009) The EU Financial Market Policy: Evolution, Innovation and Research Outlook, EIF working paper 4.

Kudrna, Z. (2011) Financial Market Regulation: A 'Lamfalussy exit' from the joint-decision trap, In G Falkner (ed), The EU's Decision Traps: Comparing Policies, Oxford University Press, Oxford.

Laeven, L.A. & Valencia, F.V., (2008) Systemic Banking Crises: A New Database, International Monetary Fund Working Paper 08/224.

Lamfalussy, A., (2000) Reflection on the regulation of European securities markets. Annual SUERF lecture, Société Universitaire Européenne de Recherches Financières, Vienna.

Lamfalussy, A., (2001) Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, Commission of the European Communities, Brussels.

Lannoo, (2011) CEPS commentary, Center for European Policy Studies, Brussels.

Lannoo, K., (2001) EU securities market regulation: Adapting to the needs of a single capital market, Centre for European Policy Studies, Brussels.

Lannoo, K. (2005) The transformation of financial regulation and supervision in the EU, In D Masciandaro (ed), Handbook of central banking and financial authorities in Europe : new architectures in the supervision of financial markets, Edward Elgar Publishing, Cheltenham, UK ; Northhampton, MA, p. 566.

Lannoo, K. & Levin, M., (2004) Securities Market Regulation in the EU, CEPS Research Report in Finance and Banking.

Lannoo, K., Casey, J.-P. & Sutton, A., (2005) EU financial regulation and supervision beyond 2005, Center for European Policy Studies, Brussels.

de Larosiere, J., (2009) Report of the high-level group on cross-border financial supervision, European Union, Brussels.

Lewis, J., (2003) Institutional Environments and Everyday EU Decision Making: Rationalist or Constructivist? Comparative Political Studies, 36(1-2), p. 97.

Lewis, J., (2005) The Janus face of Brussels: socialization and everyday decision making in the European Union, International Organization, 59(04), pp. 937-71.

Linklaters, (2010) The MiFID review: European Commission consultation, Linklaters Stop Press, London.

Mahoney, J. & Thelen, K.A. (2010) A theory of gradual instituional change, In J Mahoney & KA Thelen (eds), Explaining institutional change: ambiguity, agency, and power, Cambridge University Press, Cambridge and New York, p. 236.

Majone, G., (1996) Regulating Europe, Routledge, London and New York.

Majone, G., (1997) From the positive to the regulatory state: causes and consequences of changes in the mode of governance, Journal of Public Policy, 17(02), pp. 139-67.

March, J.G. & Olsen, J.P., (1989) Rediscovering institutions: The organizational basis of politics, Free Press.

Masciandaro, D., Nieto, M. & Quintyn, M., (2009) Financial supervision in the EU: is there convergence in the national architectures? Journal of Financial Regulation and Compliance, 17(2), pp. 86-92.

Mishkin, F.S., (2001) Prudential supervision: what works and what doesn't, University of Chicago Press.

Moran, M., (1991) The politics of the financial services revolution: The USA, UK and Japan, Macmillan, Basingstoke.
Moravcsik, A., (1993) Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach, JCMS: Journal of Common Market Studies, 31(4), pp. 473-524.
Moravcsik, A., (1998) The choice for Europe : social purpose and state power from Messina to Maastricht Cornell studies in political economy, Cornell University Press, Ithaca, N.Y.
Moravcsik, A., (1999) A new statecraft? Supranational entrepreneurs and international cooperation, International Organization, 53(02), pp. 267-306.
MoU, (2008) Memorandum Of Understanding On Cooperation Between The Financial Supervisory Authorities, Central Banks And Finance Ministries Of The European Union On Cross-Border Financial Stability (ECFIN/CEFCPE(2008)REP/53106), ECOFIN Council, Brussels.
Mügge, D., (2010) Widen the market, narrow the competition: banker interests and the making of a European capital market, European Consortium for Political Research, Colchester.
Norton, J.J., (1992) Recent developments in the regulation and supervision of US financial institutions The evolution of capital adequacy standards and the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Institute of European Finance, Bankor.
Norton Rose, (2010) Overview: Commission consultation on MiFID review, Norton Rose, London.
Nyberg, P. (2007) Getting the end-game expectations right, In O Castren, G Caviglia & PG Teixeira (eds), Simulating financial instability, European Central Bank, Frankfurt.
Palier, B. (2005) Ambiguous agreement, cumulative change: French social policy in the 1990s, In W Streeck & K Thelen (eds), Beyond Continuity, Oxford University Press, Oxford and New York.
Pelkmans, J., (1987) The new approach to technical harmonization and standardization, JCMS: Journal of Common Market Studies, 25(3), pp. 249-69.
Peters, B.G., (1997) Escaping the joint-decision trap: repetition and sectoral politics in the European Union, West European Politics, 20, pp. 22-36.
Peterson, J., (1995) Decision-making in the European Union: towards a framework for analysis, Journal of European Public Policy, 2(1), pp. 69-93.
Pisani-Ferry, J. & Sapir, A., (2010) Banking crisis management in the EU: an early assessment, Economic Policy, 25(62), pp. 341-73.
Pollack, M.A., (1997) Delegation, agency, and agenda setting in the European Community, International Organization, 51(01), pp. 99-134.
Pollack, M.A., (2002) International relations theory and European integration, JCMS: Journal of Common Market Studies, 39(2), pp. 221-44.
Pollack, M.A., (2003a) Control Mechanism or Deliberative Democracy?: Two Images of Comitology, Comparative Political Studies, 36(1-2), p. 125.
Pollack, M.A., (2003b) The engines of European integration: delegation, agency, and agenda setting in the EU, Oxford University Press, Oxford and New York.

Pollack, M.A. (2005) Theorizing EU policy-making, In H Wallace, W Wallace & MA Pollack (eds), Policy-Making in the European Union, Oxford University Press, Oxford.
Pollack, M.A. (2010) Theorizing EU policy-making, In H Wallace, MA Pollack & AR Young (eds), Policy-Making in the European Union, Oxford University Press, Oxford and New York, pp. 107-32.
Posner, E. (2007) Financial transformation in the European Union, In U Meunier & K McNamara (eds), Making history: European Integration and institutional change at fifty, Oxford University Press, Oxford.
Posner, E. (2010) The Lamfalussy process: New forms of financial rulemaking in the EU, In CF Sabel & J Zeitlin (eds), Experimentalist Governance in the European Union: Towards a New Architecture, Oxford University Press, Oxford and New York.
Posner, E. & Veron, N., (2010) The EU and financial regulation: power without purpose? Journal of European Public Policy, 17(3), pp. 400-15.
Puetter, U., (2011) Organising the EU's responses to the global economic and financial crisis-the role of the European Council and the Council, Paper prepared for the EUSA Conference, March, Boston.
Quaglia, L., (2008) Financial Sector Committee Governance in the European Union, Journal of European Integration, 30(4), pp. 563-78.
Quaglia, L., (2009) Completing the Single Market in financial services: the politics of competing advocacy coalitions, Paper prepared for the EUSA Conference, Los Angeles.
Quaglia, L., (2010a) Completing the single market in financial services: the politics of competing advocacy coalitions, Journal of European Public Policy, 17(7), pp. 1007-23.
Quaglia, L., (2010b) Governing Financial Services in the European Union: Banking, Securities and Post-trading, Routledge.
Quaglia, L., (2011) The European Union in regulating global finance, Paper prepared for the EUSA Conference, March, Boston.
Quillin, B., (2008) International Financial Co-operation: Political economics of compliance with the 1988 Basel Accord, Routledge, London and New York.
Reinicke, W.H., (1995) Banking, politics, and global finance: American commercial banks and regulatory change, 1980-1990, Edward Elgar, Aldershot.
Resti, A. & Sironi, A., (2010) Regulation of the financial sector: What future for Basel II? CES info DICE, 8(1), pp. 3-7.
Richardson, J.J., (2001) European Union: power and policy-making, Routledge, London and New York.
Risse, T., (2000) Let's argue!: Communicative action in world politics, International Organization, 54(01), pp. 1-39.
Rodrik, D., (1996) Understanding economic policy reform, Journal of Economic Literature, 34(1), pp. 9-41.
Rosamond, B., (2000) Theories of European integration, Macmillan Press, London.
Rosamond, B. (2010) New theories of European integration, In M Cini & N Pérez-Solórzano Borragán (eds), European Union Politics, Oxford University Press, Oxford and New York, pp. 104-22.

Sabatier, P.A., (1998) The advocacy coalition framework: revisions and relevance for Europe, Journal of European Public Policy, 5(1), pp. 98-130.

Sandholz, W. & Stone Sweet, A. (1998) In W Sandholtz & A Stone Sweet (eds), European Integration and Supranational Governance, Oxford University Press, Oxford and New York.

Scharpf, F.W., (1988) The joint-decision trap: lessons from German federalism and European integration, Public administration, 66(3), pp. 239-78.

Scharpf, F.W. (1996) Negative and positive integration in the political economy of European welfare states, In G Marks, FW Scharpf, PC Schmitter & W Streeck (eds), Governance in the European Union, SAGE Publications, London, pp. 15-39.

Scharpf, F.W., (1997) Games Real Actors Play. Actor-Centered Institutionalism in Policy Research. Boulder, Colo, Westview Press.

Scharpf, F.W., (2000) Institutions in comparative policy research, Comparative Political Studies, 33(6/7), pp. 762-90.

Scharpf, F.W., (2006) The joint-decision trap revisited, Journal of Common Market Studies, 44(4), p. 845.

Scharpf, F.W. (2011) The Joint-Decision Trap Model: Context and Extensions, In G Falkner (ed), The EU's Decision Traps: Comparing Policies, Oxford University Press, Oxford.

Schickler, E., (2001) Disjointed pluralism: institutional innovation and the development of the U.S. Congress, Princeton University Press, Princeton.

Schoenmaker, D. & Oosterloo, S. (2008) Financial Supervision in Europe: A Proposal for a New Architecture, In M Watson & L Jonung (eds), Building the Financial Foundations of the Euro-Experiences and Challenges, Routledge, London, pp. 337-54.

Schusterschitz, G. & Kotz, S., (2007) The Comitology Reform of 2006 Increasing the Powers of the European Parliament Without Changing the Treaties, European Constitutional Law Review, 3(01), pp. 68-90.

Selck, T.J., (2005) Explaining the Absence of Inertia in European Union Legislative Decision-Making, Journal of Common Market Studies, 43(5), pp. 1055-70.

Speyer & Walter, (2009) Why Europe must create a strong financial watchdog, Europe's World.

Story, J. (1997) Globalisation, the European Union and German financial reform: The political economy of Finanzplatz Deutschland, In GRD Underhill (ed), The new world order in international finance, Macmillan Press, London, pp. 245-73.

Story, J. & Walter, I., (1997) Political economy of financial integration in Europe: The battle of the systems, The MIT Press.

Strohbach, W., Schmehl, K. & Boixo, I., (2011) European Banking Autority: Workplan 2011-2013, European Banking Authority, London.

Strouzas, P. (2007a) EU Financial Crisis Management Arrangements from a Central Banking Perspective and the Eurosystem Financial Crisis Simulation Exercise, In O Castren, G Caviglia & PG Teixeira (eds), Simulating Financial Instability, European Central Bank, Frankfurt.

Strouzas, P., (2007b) Eurosystem's financial crisis simulation exercises, European Central Bank, Frankfurt.

Sun, J.M. & Pelkmans, J., (1995) Regulatory Competition in the Single Market, JCMS: Journal of Common Market Studies, 33(67).

Tallberg, J., (2002a) Delegation to Supranational Institutions: Why, How, and with What Consequences? West European Politics, 25(23).

Tallberg, J., (2002b) Paths to compliance: Enforcement, management, and the European Union, International Organization, 56(03), pp. 609-43.

Tarullo, D.K., (2008) Banking on Basel: The future of international financial regulation, Peterson Institute for International Economics, Washington.

Thelen, K.A., (2004) How institutions evolve: the political economy of skills in Germany, Britain, the United States, and Japan, Cambridge University Press, Cambridge and New York.

Thelen, T.A. (2003) How institutions evolve: insights from comparative historical analysis, In J Mahoney & D Rueschemeyer (eds), Comparative historical analysis in the social sciences, Cambridge University Press, Cambridge, U.K. ; New York.

Thomson, R. & Hosli, M., (2006) Who Has Power in the EU? The Commission, Council and Parliament in Legislative Decision-making, JCMS: Journal of Common Market Studies, 44(2), pp. 391-417.

Tison, M., (1999) The Investment Services Directive and its Implementation in the EU Member States, Financial Law Institute working paper, Universiteit Gent, 17.

Toshkov, D., (2010) Taking stock: a review of quantitative studies of transposition and implementation of EU law, EIF working paper 10.

Treib, O., (2003) EU governance, misfit and the partisan logic of domestic adaptation: An actor-centered perspective on the transposition of EU directives, Paper prepared for the EUSA Conference, Nashville.

Treib, O., (2008) Implementing and complying with EU governance outputs, Living reviews in European governance, 3(5).

Tsebelis, G., (1994) The power of the European Parliament as a conditional agenda setter, American Political Science Review, 88(1), pp. 128-42.

Tsebelis, G., (2002) Veto players: How Political Institutions Work, Princeton University Press.

Tsebelis, G. & Garrett, G., (2001) The institutional foundations of intergovernmentalism and supranationalism in the European Union, International organization, 55(2), pp. 357-90.

Tsebelis, G. & Yataganas, X., (2002) Veto Players and Decision-making in the EU After Nice, JCMS: Journal of Common Market Studies, 40(2), pp. 283-307.

Underhill, G. (1997) The making of the European financial area: global market integration and the EU single market for financial service, In G Underhill (ed), The New World Order in International Finance, Macmillan, London.

Unicredit, (2009) Cross-border banking in Europe: what regulation and supervision? Forum on financia cross-border groups.

Van den Spiegel, F., (2008) Presentation at the Roundtable on the Review of the Financial Conglomerates Directive, September 8, 2008, Brussels.

Versluis, E., van Keulen, M. & Stephenson, P., (2010) Analyzing the European Union policy process, Palgrave Macmillan, Basingstoke.

Véron, N., (2007) Is Europe ready for a major banking crisis, Bruegel Policy Brief, 3.

de Vischer, C. & Varone, F., (2006) Governance of the EU securities sector: impacts of Lamfalussy reforms, NewGov policy brief number 1.
de Visscher, C., Maiscocq, O. & Varone, F., (2007) The Lamfalussy Reform in the EU Securities Markets: Fiduciary Relationships, Policy Effectiveness and Balance of Power, Journal of Public Policy, 28(1), pp. 19-47.
Vives, X., (2001) Restructuring financial regulation in the European Monetary Union, Journal of Financial Services Research, 19(1), pp. 57-82.
Wallace, H. (2005) An Institutional Anatomy and Five Policy Modes, In H Wallace, W Wallace & MA Pollack (eds), Policy-Making in the European Union, Oxford University Press, Oxford.
Wallace, H. (2010) An Institutional Anatomy and Five Policy Modes, In H Wallace, MA Pollack & AR Young (eds), Policy-Making in the European Union, Oxford University Press, Oxford and New York.
Wallace, H., Wallace, W. & Pollack, M.A., (2005) Policy-Making in the European Union, 5th ed. Oxford University Press.
Walter, N. & Bergheim, S., (2008) ECB Objectives and Tasks: Price Stability vs. Lender of Last Resort, Deutsche Bank Research, Frankfurt.
Williamson, O.E., (2000) The new institutional economics: taking stock, looking ahead, Journal of economic literature, 38(3), pp. 595-613.
Williamson, O.E., (2010) Transaction Cost Economics: The Natural Progression, The American Economic Review, 100(3), pp. 673-90.
Wood, D., (2005) Governing global banking: the Basel Committee and the politics of financial globalisation, Ashgate Publishing, Aldershot.
Woolcock, S. (2001) Competition among rules in the single European market, In AI Ogus (ed), Edward Elgar, Cheltenham.
Young, A.R. (2005) The Single Market: A New Approach to Policy, In H Wallace, W Wallace & MA Pollack (eds), Policy-Making in the European Union, Oxford University Press, Oxford.
Young, A.R. (2010) The European policy process in comparative perspective, In H Wallace, MA Pollack & AR Young (eds), Policy-Making in the European Union, Oxford University Press, Oxford and New York, pp. 107-32.
Young, A.R., Pollack, M.A. & Wallace , H., (2010) Policy-Making in the European Union, 6th ed. Oxford University Press, Oxford and New York.

List of interviews

No.	Date	Affiliation/background
1	25 May 2011	Austrian National Bank, Level 2 Committee
2	30 May 2011	Austrian Financial Authority, Level 2 Committee
3	15 October 2009	European Commission official
4	23 October 2009	Bundesbank, Member of Level 2 Committee
5	15 October 2009	European Commission official
6	17 October 2009	Independent industry expert, Brussels
7	5 October 2009	Ministry of Finance, Czech Republic, ECOFIN Council
8	6 October 2009	Ministry of Finance, Czech Republic
9	23 October 2009	National Bank of Slovakia, Member of Level 2 Committee
10	22 October 2009	Czech National Bank, Financial Stability Unit
11	5 March 2011	Independent industry expert, London
12	17 October 2009	European Parliament official