Failing Forward Towards Reduced Instability?

Integration and Aggregation in EU Financial Regulation

Eirik Tegle Stenstad
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Abstract

The European Union (EU) institutional framework for financial stability has been redesigned three times since 2000. The financial crisis (2008-2009) and the European debt crisis (2009-) both triggered reforms. The first analytical task of this thesis is to gauge these processes of redesign, and for this purpose I establish three analytical dimensions to assess financial stability frameworks: the level of aggregation, the level of governance, and the functional scope.

The second equally important task is to expose why EU Member States tend to mostly agree on piecemeal institutional reforms that may result in crises, without ever addressing the root of the problems associated with financial stability. In order to make progress on this explanatory task I develop a revised ‘failing forward’ argument to uncover the decision-making logic resulting in these incomplete outcomes. It is based on Jones, Kelemen, and Meunier’s (2015) original argument that attempts to reconcile the grand theories of European integration – liberal intergovernmentalism and neofunctionalism. Intergovernmental bargaining drives the outcome towards the lowest common denominator as Member States have to compromise with the least forthcoming governments. Incomplete solutions lead to new crises, and a functional demand for more integration in a sequential cycle. However, in contrast to original argument, I argue that the decision-makers might not necessarily fully understand the risk of piecemeal reforms. Development of the institutional frameworks are based on learning from previous policies.

Based on process-tracing of the three reform processes, I find that social learning expands the policy options available for the decision-makers in each phase. The impact of the lowest common denominator bargaining dynamic increases as the policy options expand. Traces of learning are most clearly visible on issues and dimensions that are directly related to economic theory, such as determining the appropriate level to regulate, micro or macro. The Member States negotiate primarily over the level of governance. The evolution of the EU financial stability framework demonstrates that learning is problem- and crisis-driven, and that the pitfalls of intergovernmental bargains become more prominent on controversial issues. Theoretically, this thesis contributes to the integration theory field by revising the failing forward argument to fit a broader set of cases, in addition to the theoretical standard for financial stability frameworks. Politically, it pinpoints structural obstacles to financial stability.
Acknowledgements

My primary gratitude goes to Professor Bent Sofus Tranøy, who as supervisor has been more involved in my project than his role requires. Beside the eminent guidance to develop the theoretical framework, he has been attentive and generous, including invitations to stimulating dinners with your colleagues and helping me out with my grammatical shortcomings. I am grateful for the opportunity to get to know you also on a personal level.

Furthermore, I would like to thank ARENA Centre for European Studies for providing inspiring working environment and great facilities. It has been a great experience to be a part of your staff! Senior Lecturer Øivind Bratberg has given me valuable advices on process-tracing and research design. My friend Kristian Aaser provided decisive inspiration in the choice of topic in an early phase.

My fellow students have transformed this strenuous journey to a memorable adventure. The lunch breaks at “Kutt” with Bendik Karlsson, David Spetaas, Jens Wolther, Joachim Sandnes, Kristoffer Øygarden, and Mikkel Ersdal stand out. I will miss those absurd and humorous conversations with you. I am grateful for everything Grandfather Finn has taught me about hard work and devotion to learning. Finally, I will also thank my mother Dina and my father Dag for your unconditional support throughout my student days.

Any remaining errors and deficiencies are solely my own.
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<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>CEBS</td>
<td>Committee of European Banking Supervisors</td>
</tr>
<tr>
<td>CEIOPS</td>
<td>Committee of European Insurance and Occupational Pensions</td>
</tr>
<tr>
<td>CESR</td>
<td>Committee of European Securities Regulators</td>
</tr>
<tr>
<td>CRD</td>
<td>Capital Requirement Directive</td>
</tr>
<tr>
<td>EBA</td>
<td>European Banking Authority</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EFC</td>
<td>Economic and Financial Committee</td>
</tr>
<tr>
<td>EMU</td>
<td>Economic and Monetary Union</td>
</tr>
<tr>
<td>ESAs</td>
<td>European Supervisory Authorities</td>
</tr>
<tr>
<td>ESCB</td>
<td>European System of Central Banks</td>
</tr>
<tr>
<td>ESFS</td>
<td>European System of Financial Supervision</td>
</tr>
<tr>
<td>ESM</td>
<td>European Stability Mechanism</td>
</tr>
<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
</tr>
<tr>
<td>FSAP</td>
<td>Financial Services Action Plan</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>LTRo</td>
<td>Long-term refinancing operations</td>
</tr>
<tr>
<td>MoU</td>
<td>Memorandum of Understanding</td>
</tr>
<tr>
<td>SRB</td>
<td>Single Resolution Board</td>
</tr>
<tr>
<td>SRF</td>
<td>Single Resolution Fund</td>
</tr>
<tr>
<td>SRM</td>
<td>Single Resolution Mechanism</td>
</tr>
<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism</td>
</tr>
</tbody>
</table>
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1 Introduction

To be exact, our economic leadership does not seem to be aware that the normal functioning of our economy leads to financial trauma and crises, inflation, currency depreciations, unemployment, and poverty in the midst of what could be virtually universal affluence—in short, that financially complex capitalism is inherently flawed (Minsky, 1986: 320).

In the absence of a European government with a popular political base of its own, all possibilities of institutional transformation are entirely determined by the self-interests of national governments (Scharpf, 1988: 268).

The first 13 years of the new millennium saw the EU framework for financial stability undergo three major reform processes and two economic crises. The two crises— the financial crisis (2008-2009) and the European debt crisis (2009-), have caused substantial and ongoing economic damage in Europe, on a scale higher than that seen during the Great Depression as measured in public-debt-to-GDP ratio (Crafts, 2013). In little less than a year and a half, between 40 and 45 percent of the world’s wealth was destroyed (Davies & Siew, 2009). The European Union was at the centre of the financial crisis as by the end of 2009, 18 of the 23 countries experiencing it either directly, or as borderline cases suffering a systemic banking crisis, were members of the Single Market (Laeven & Valencia, 2010). The EU was vulnerable. Its largest 43 banks, out of a total 5000, held 77 percent of the total bank assets of the EU (House of Lords, 2009a). The EU failed to address systemic risk within the financial system. As the crisis unfolded, the Member States had to rescue overextended banks. The problems elucidated by the financial crisis went from being a crisis of financial institutions to a crisis of sovereign debt. The EU under provisioned the collective good of financial stability. The repeated reforms of the framework, though resulting in deeper integration, were insufficient.

What causes the EU to fail forward? Three decades ago, the economist Minsky (1986) and the political scientist Scharpf (1988) provided a commentary detailing the fundamental problems preventing a stable financial system in Europe. In the next section, I will set out my research question and the theoretical basis for my explanation. Finally, I will present the structure of this thesis and my findings.
1.1 The Research Question and the Theoretical Answers

This thesis is primarily a contribution to the study of the political foundations of financial stability. Its secondary aim is an attempt to challenge the traditional usage of integration theory. I will examine how the evolution of the framework for financial stability in the EU can be explained. However, this endeavour is not an attempt to understand the long historical lines leading up to today’s situation, but is rather a study of decision-making where the aim is to identify the structural obstacles to financial stability. The research questions is:

What characterizes the decision-making logic causing the evolution of the EU financial stability framework?

The theoretical basis for my explanation is Jones, Kelemen, and Meunier’s (2015) ‘failing forward’ argument. It attempts to reconcile the seemingly contradictory grand theories of European integration – liberal intergovernmentalism and neofunctionalism. They link the short-term outcome of intergovernmental bargaining with longer-term spillover effects. Over time, they connect and produce a failing forward pattern. Liberal intergovernmentalism provides an explanation of the reasons why functional demands remain unmet during interstate bargaining (in times of crisis), and neofunctionalism indicates the manners in which the reform processes are connected. Interstate bargains produce lowest common denominator outcomes, and over time, functional spillover connects the bargains. In contrast to Jones et al. (2015: 1018) claim, in their case on the governance architecture of the Economic and Monetary Union (EMU), that “leading policymakers recognized the shortcomings of Eurozone governance and understood that these shortcomings might provoke serious crises in the future”, I do not believe this assertion applies to my case. Along with Minsky (1986), I forward the argument that the economic and political leadership do not

Figure 1: The policy menu and the relation between the two causal mechanisms

Source: The author
necessarily fully understand the risk associated with an incomplete framework for financial stability. Thus, I have included a social learning perspective. According to Heclo (2010 [1974]) and Sacks (1980), changes in policy and policy thinking are based on learning from the previous policy. The two approaches together constitute my revised failing forward argument. From the revised failing forward argument, I identify two causal mechanisms that structure decision-making. The first is the belief system mechanism. In a reform process, social learning structures the kind of solutions that are proposed. The second is the lowest common denominator mechanism. In interstate bargaining based on intensity of preferences where there is need to compromise with the least forthcoming governments, the outcome tends towards the lowest common denominator. Together, the two causal mechanisms limit and constrain the options available to the decision-makers. To explain how the mechanisms structure the outcome, I use the notion of a policy menu, as illustrated in Figure 1. The belief system mechanism defines the content of the menu, while the lowest common denominator mechanism structures the selection of what the decision-makers can agree upon from the policy menu.

**Figure 2: The three dimensions of a comprehensive financial stability framework**

<table>
<thead>
<tr>
<th>Aggregation dimension</th>
<th>Macro</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td></td>
</tr>
<tr>
<td>Governance dimension</td>
<td></td>
</tr>
<tr>
<td>National</td>
<td></td>
</tr>
<tr>
<td>Supranational</td>
<td></td>
</tr>
<tr>
<td>Functional scope dimension</td>
<td>System-wide</td>
</tr>
<tr>
<td>Sectoral</td>
<td></td>
</tr>
</tbody>
</table>

Source: The author

The failing forward argument presupposes that a standard for comprehensive reform – one that satisfies the functional demands – exists. As mentioned, Jones et al. (2015: 1013) apply the accepted standard from the inception of the EMU when they compare “the actual pattern of policy response to the patterns expected from the alternative theoretical perspectives”. I will argue that no such ‘yardstick’ was in use as the thinking on financial stability frameworks has changed remarkably since the inception of its first version. Instead, I have deduced three dimensions from the theoretical perspectives that will be presented in chapter 4: level of aggregation, level of governance, and functional scope. The aggregation dimension denotes the systemic risk approach—macro or micro. The governance dimension indicates that the financial stability framework needs to match the level of integration. Level of integration is a political question. The functional scope dimension suggests that systemic risk needs to be addressed with a
system-wide not sector-wise perspective. A system-wide approach suggests that banking, securities, and insurance markets cannot be regulated separately. The dimensions are summarized in Figure 2. A development towards a comprehensive framework is an approximation to what Minsky (1977) termed a “good financial society”. A society “where the tendency by business and bankers to engage in speculative finance is constrained” (Ibid: 26).

1.2 Structure and Findings

This thesis comprises of five main sections. In chapter 2, I will introduce the concepts of the financial system, financial stability and supervision, and the structure of EU decision-making. The financial system is analogous to the ‘brain’ of the entire economic system, and hence a failure here would affect the economy as a whole. The system needs government intervention to preserve financial stability. Core financial stability policies are systemic supervision, crisis resolution, and recapitalization. Finally, integration of new economic and financial policy is subjected to an intergovernmental decision-making system. Financial regulation is a sensitive national matter.

In chapter 3, I present my theoretical argument, the three dimensions of a comprehensive financial stability framework, and the theories and perspectives it builds upon. I will introduce core concepts like constitutional asymmetry, the financial trilemma, the joint-decision trap, and positive and negative integration. I present a brief introduction to my revised failing forward argument and have structured my assertions and arguments around three theoretical expectations.

In chapter 4, I describe the research design and the methodology. I will make inferences on causal mechanisms based on a single-case, and I apply process-tracing as the procedure to identify the causal process leading to the outcome. The choice of research question has been a choice to know more about less, and the cost has been the (lowered) potential of generalization to a wider population. Finally, I will discuss validity and reliability.

In chapter 5, I introduce the institutional frameworks of the three phases, the steps of the reform process, and the context for reform. I have identified three phases in the evolution of the EU financial stability framework. Phase 1 (2000-2002) created the first institutional framework. The Lamfalussy Framework established coordinating institutions that did not addressed systemic risk. The legal competences were national. The framework replaced a pre-
framework period (extending up to 2000) governed by directives and regulations. Phase 2 (2009) came in the wake of the financial crisis. The de Larosière Framework transformed the committees into EU level supervisory authorities with some binding powers, though they still fell shy of addressing systemic risk. The financial stability instruments were national. Phase 3 is the current phase and supplemented the de Larosière Framework. The Banking Union came about as a consequence of the European debt crisis. It introduced financial stability instruments for the banking sector at the EU level. To describe the frameworks, I employ the three analytical dimensions. In Table 1, I summarize the evolution of the framework along the dimensions.

**Table 1: Evolution of EU financial stability framework along three dimensions**

<table>
<thead>
<tr>
<th>Phases and dimensions</th>
<th>Institutional reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of governance</td>
<td>National</td>
</tr>
<tr>
<td>Level of aggregation</td>
<td>Micro</td>
</tr>
<tr>
<td>Functional scope</td>
<td>Sectoral</td>
</tr>
</tbody>
</table>

*Source: The author*

In chapter 6, I analyse the different reform processes. The main tools are the two mechanisms presented in chapter 4, the belief system mechanism and the lowest common denominator mechanism. I find that the previous policies and their effects in each phase contributed to the evolution of new policy menus. New frameworks are built upon existing frameworks. Social learning along the aggregation dimension entailed a movement towards the Keynesian tradition. Gradually, from Phase 1 to Phase 3, the belief system mechanism expanded the policy menu, and opened for more comprehensive solutions. The lowest common denominator mechanism exerted an increasing significance on the incomplete outcomes from Phase 1 to Phase 3 as the policy menu got bigger. The Member States’ preferences converged along the aggregation and functional scope dimensions, and the lowest common denominator mechanism therefore contributed to the incomplete framework by affecting the governance dimension. I believe there are valid reasons to believe that the incomplete institutional frameworks have contributed to the crises and that the result of the social learning has been a functional spillover.
2 Background

This chapter introduces core concepts of the thesis related to the financial system and its stability, and EU decision-making. A financial system can be compared to a ‘brain’ while the economy can draw parallels to the body and a failure of the ‘brain’ can severely harm its ‘body’. Some behaviour within the financial system can reduce financial stability and increase systemic risk. This creates a vital role for governments to play. Financial stability is a collective good and demands collective action. However, supervision and crisis management have been sensitive, national matters. This has led to an intergovernmental decision-making system. In this chapter, I will explain the abovementioned concepts, provide background knowledge and start laying the theoretical foundation for the rest of my thesis. First, I present the financial system, and then I explain the concepts of financial stability and macroprudential supervision. Finally, I will describe the decision-making system of the EU.

2.1 The Financial System and the Economy

Financial markets and financial intermediaries together with their to-and-from flow of funds in the real economy, and the financial infrastructure, forms the financial system (De Haan, Oosterloo, & Schoenmaker, 2009: 5, 65). Figure 3 illustrates how the financial system works, according to the conventional view, with lenders to the left, and borrowers to the right. Securities are instruments representing financial value and are a promise of future payments. Securities are issued and traded in ‘financial markets’ by individuals. This is called ‘direct finance’, a way for sectors in need of funding borrowing from another. ‘Financial intermediaries’, such as banks, insurance companies, pension funds etc., obtain funds from savers and use them to provide loans to others, and can also be called ‘direct finance’. In this sub-section, I will present the role of the financial system in the economy.
The purpose of the financial system is to channel funds from sectors running a surplus to sectors with shortage of funds (De Haan et al., 2009: 5). According to Stiglitz (1993), financial markets allocate resources, and can thus be seen as ‘the brain’ of the entire economic system. Because these financial institutions are the centre for decision-making, a failure here will affect not only the financial sector, but the economy as a whole. Financial institutions are meant to direct resources to the activities with the highest return by selecting among projects and monitoring the use of funds. Quiggin (2011: 332) states that trade and markets have always been part of society, along with borrowing and lending, but the market for trade in financial obligations – like debts and future sales and purchases – are specific to capitalism. Stiglitz (1993: 20) holds that financial markets are distinctly different from other markets, and claims that market failures are likely to be more pervasive in them.

Not all activities and innovation in financial markets contributes to economic efficiency, and can decrease welfare (Stiglitz, 1993). Governments can intervene to make the financial system function more efficiently and thus improve the performance of the economy. How the financial markets are regulated is a matter of importance. In the era of capitalism, there has
always been tension between financial institutions and the state, and between financial capital, firms and households in the real economy (Quiggin, 2011). In the decades after World War II, the financial system had a subordinate role – it channelled savings into credit for investment and consumer credit – through tight regulation. Since the 1970s, financial markets have been liberalized and have taken an increasingly central role in the economy. Financial institutions deal with intertemporal bargaining, risk, and information, which are closely linked, and governments can influence these three elements.

2.2 Financial Stability and Macroprudential Supervision

Government intervention in markets is often needed to correct for sub-optimal outcomes produced when markets have been left to their own devices. According to Goodhart, Hartmann, Llewellyn, Rojas-Suárez, and Weisbrod (1998: 4), there are three main reasons for governments to intervene in the financial system: (i) to protect customers from monopolistic exploitation (market power), (ii) to provide smaller and less informed clients with protection (asymmetric information), and (iii) to ensure systemic stability (externalities). In this thesis, I will emphasize the third reason, relating to financial or systemic stability. The actions of individual financial institutions bring externalities, potentially affecting the stability of the system, though they do not incorporate such costs in their decision-making. To promote financial stability and contain the effects of systemic failure, governments conduct ‘systemic supervision’ (De Haan et al., 2009: 300-02). Systemic supervision is the monitoring of behaviour of financial institutions and enforcement of rules, while regulation is the legislation underlying the supervisory framework.¹ Figure 4 show the dynamics of financial stability. As described in the previous sub-section, the financial system is the brain of the economy, and can potentially create great harm in the real economy. Instability in the financial system can arise endogenously, or comes exogenously from outside the system (Houben, Kakes, & Schinasi, 2004: 19). In this sub-section, I will discuss the content of the policy box in the figure.

¹ However, there is a “widely used practice” of referring to these authorities interchangeably as supervisors and regulators (Schüler, 2003: 2).
Financial stability has no easy or universally accepted definition, but ECB (2006: 7) define it as a condition in which the financial system is “capable of withstanding shocks and the unravelling of financial imbalances”. It is closely related to systemic risk, which is the risk that “an event will trigger a loss of economic value or confidence in a substantial portion of the financial system. This disruption of the financial system is serious enough to have significant adverse effects on the real economy” (Schoenmaker, 2013: 24). It denotes the risk of a breakdown of the entire system, rather than a failure in individual parts and components (Kaufman & Scott, 2001: 2). The government intervention that addresses systemic risk is called ‘prudential supervision’, and can be executed at micro and macro level (Quaglia, 2013: 67). ‘Microprudential supervision’ concerns the stability of financial intermediaries, from the perspective of the users of the system, and addresses the first two reasons in the trichotomy of Goodhart et al. (1998). ‘Macroprudential supervision’ addresses the last of those three reasons and “operates at the level of the financial system and is concerned with the impact on the wider economy” (Schoenmaker, 2014: 2). According to the FSB, IMF, and BIS (2011b: 2), there are three defining elements: “the objective (limiting systemic or system-wide financial risk), the scope of analysis (the financial system as a whole and its interactions with the real economy), and a set of powers and instruments and their governance (prudential tools and those

Source: Houben et al. (2004: 19)
specifically assigned to macroprudential authorities). Macroprudential policy complements microprudential and macroeconomic policy, but cannot substitute them.

Table 2: Comparison of the two prudential perspectives

<table>
<thead>
<tr>
<th></th>
<th>Microprudential</th>
<th>Macroprudential</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objective</strong></td>
<td>limit distress of individual institutions</td>
<td>limit financial system-wide distress</td>
</tr>
<tr>
<td><strong>Model of risk</strong></td>
<td>exogenous</td>
<td>(in part) endogenous</td>
</tr>
<tr>
<td><strong>Correlations and common exposures across institutions</strong></td>
<td>irrelevant</td>
<td>important</td>
</tr>
<tr>
<td><strong>Calibration of prudential controls</strong></td>
<td>in terms of risks of individual institutions; bottom-up</td>
<td>in terms of system-wide distress; top-down</td>
</tr>
</tbody>
</table>

*Source: Borio (2003: 183)*

Financial stability is a collective good. When financial institutions do not internalize the externalities, financial stability will be underdelivered (Nieto & Schinasi, 2008: 10). The shared cost of a crisis will increase. Many policies influence financial stability and systemic risk, but not all are macroprudential (FSB et al., 2011b). Compared to monetary policy, there is little consensus on macroprudential policy (Galati & Moessner, 2013). Macroprudential instruments address the interface between prudential policy and macro economy, and aims to protect the financial system and the real economy from the cycles and risks of the financial system (Haldane, 2013: 1-2). In Table 3, I present a way of categorizing macroprudential tools.

Table 3: Macroprudential instruments

<table>
<thead>
<tr>
<th>Intermediate target</th>
<th>Countercyclicality</th>
<th>Structure (externalities)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sub-target</strong></td>
<td>Aggregate credit</td>
<td>Credit: Housing</td>
</tr>
<tr>
<td>Instruments</td>
<td>Countercyclical capital buffer</td>
<td>LTV ration</td>
</tr>
<tr>
<td><strong>Intermediate target</strong></td>
<td><strong>Countercyclicality</strong></td>
<td><strong>Structure (externalities)</strong></td>
</tr>
<tr>
<td><strong>Sub-target</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Instruments</td>
<td>Systemically important financial institutions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital surcharge</td>
<td></td>
</tr>
</tbody>
</table>

*Source: Schoenmaker and Wierts (2011: 13-14)*

The first part of the table contains time-varying or countercyclical instruments, intended to “tighten during the boom over asset (housing) prices and credit expansion, and to be relaxed, or even removed entirely, during the subsequent slump” (Goodhart, 2014: 13). The first sub-

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2 Public goods have to characteristics: (i) those who produce the good cannot control those who benefits from it (non-excludability), and (ii) the consumption of it by one actor does not affect the benefit of other (non-rivalrous consumption) (De Haan et al., 2009: 345).

3 See Bank of England (2011) for another way of categorizing.
target addresses debt financed growth as it could trigger defaults when the value of the asset drops below the level of debt (Schoenmaker & Wierts, 2011: 12). Countercyclical capital buffers are intended to “build resilience in the upswing” and “should help to maintain the supply of credit once losses from the boom crystallize” (Bank of England, 2011: 18). Loan to value (LTV) ratios increases the resilience of financial institutions by limiting “the extension of mortgage credit beyond a particular fraction of the value of housing collateral” (Ibid: 25). The last measure corrects the negative externalities caused by excessive reliance on short-term debt (Schoenmaker & Wierts, 2011). The second sub-target addresses the cross-sectional or structural instruments. Systemically important financial institutions can have tighter capital requirements imposed upon them to reduce the probability of distress or failure, and can limit the moral hazard related to their ‘too big to fail’ status (Bank of England, 2011: 36). Governments may recapitalize these institutions, either by direct capital injections or by purchasing troubled assets, when the cost of doing so is lower than the social benefits of preserving financial stability (De Haan et al., 2009: 351-52). Crisis resolution also reduces the concomitant moral hazard (Schoenmaker & Wierts, 2011: 14-15). As markets can transmit shocks via the price mechanism, a potential instrument brought into play is to adjust collateral demands. Most of the instruments of macroprudential supervision are shared with the microprudential approach (Clement, 2010: 65). Figure 5 sums up the components of macroprudential assessment and the policy actions needed to preserve financial stability. In the policy action area, there is a gradual change from a ‘passive’ prevention to ‘active’ resolution, with remedial actions like more intense supervision in the middle (Houben et al., 2004: 20). In the rest of the thesis, the discussion will be less concerned with the individual macroprudential instruments, and more focused on the broader categories of the financial stability policy action area spanning from crisis prevention to crisis management.
2.3 The EU Decision-Making Systems

Since the Maastricht Treaty of 1992, the EU has formalized, and later constitutionalized (Lisbon Treaty) two different decision-making regimes: one supranational and one intergovernmental (Fabbrini, 2013: 1004). Policies within the Single Market are managed through the decision-making interaction of the supranational institutions such as the European Commission and the European Parliament, and intergovernmental institutions such as the European Council and the Council of the European Union (hereafter ‘the Council’). However, the intergovernmental institutions have complete control over new economic and financial policies. The intergovernmental decision-making regime, illustrated in Figure 6, is comprised of economic and financial policies, as they are considered institutionally to fall within the sphere of the
European Council and the Council, and the arrangement has been built upon the constitutional logic of coordination amongst governments. In the construction of new supervisory frameworks, the decision-making regime is applied.

**Figure 6: The intergovernmental decision-making system of the EU**

The intergovernmental decision-making regime was a compromise between those who wanted integration of policy areas traditionally considered as sensitive to national sovereignty, and those who were reluctant to reduce the power of governments (Fabbrini, 2013: 1008-09). The outcome was the opening of these areas for integration, but on the premise that the integration was based on voluntary coordination among the Member States. National governments have an exclusive role, while supranational institutions play a minor one. In economic and financial policy, the European Commission has a technical role, but the decision-making is the territory of the Council. As I will discuss later, financial regulation is a sensitive national matter, and financial supervision and crisis management have traditionally been a national competence. According to Fabbrini (2013: 1010), the intergovernmental decision-making system “enjoyed the support of a powerful constellation of political leaders and public opinions” during the financial crisis and the European debt crisis. France and president Sarkozy had an intergovernmental vision where there were “no room for the [European Parliament] and the Commission in the decision-making process”, and the post-financial-crisis German government of Chancellor Merkel shared the vision. In the next chapter, I present my case study research design and process-tracing methods.
3 Theorizing Incomplete Integration

In this chapter, I will present my theoretical argument, the three dimensions of a comprehensive financial stability framework, and the theories and perspectives it builds upon. It consists of four sections: First, the concept of constitutional asymmetry and the financial trilemma provide the background for one of the three dimensions, namely, why governance integration needs to match market integration. Second, I present the idea of the joint-decision trap as the precursor of the failing forward argument. Scharpf (1988, 2006) explains why achieving integration of market-correcting positive integration is difficult compared to market-making negative integration. Third, the failing forward argument of Jones et al. (2015) reconciles the two contradictory grand theories – liberal intergovernmentalism and neofunctionalism – into a single argument. Liberal intergovernmentalism explains the short-term outcome of intergovernmental bargaining, while neo-functionalism can explain the longer-term spillover effects. Their argument forms the basis of my main argument and the lowest common denominator mechanism. Fourth, I set out my revised failing forward argument and the three dimensions by including the idea of social learning and politics of ideas. The second causal mechanism – the belief system mechanism – is formed by social learning and politics of ideas.

3.1 The Problem of Asymmetric Integration

If the policies intended to secure financial stability are fragmented, this collective good becomes underprovisioned. In a fragmented situation, Member States will not take into consideration the negative externalities inflicted upon other states. Financial stability demands that you either give up national policy or deep European integration. The Single Market created a situation where the financial system was Europeanized, but market-corrective policies (to tackle systemic risk) remained national. The result was a constitutional asymmetry, where market-making and market-correcting objectives could not be weighed against each other at the same level. The financial trilemma and constitutional asymmetry are overlapping ideas.

Financial stability is intimately connected to systemic risk, as mentioned in chapter 2.2. The absence of legally binding mechanisms that address risk at the systemic level poses a number of obstacles to the management of conflicts of national interest (De Haan et al., 2009: 322). National supervisors will only take into account the negative externalities from the activities of cross-border firms within their jurisdiction as they have national mandates
The same dynamic applies to improvised cooperation on recapitalization of cross-border firms, the contributions from each government will be insufficient, even in cases where it would be efficient for them as a community (Ibid: 30-31). There are some underlying, conflicting considerations here. This is what Schoenmaker (2008, 2013) calls the ‘financial trilemma’.

Figure 7: The trilemma of financial stability

The fundamental issue in the trilemma is the level at which the collective good of financial stability can be produced. An integrated and stable financial system on the one hand, and national stability policy on the other, are incompatible (Schoenmaker, 2008: 4). One of the objectives has to give. I have presented this trichotomy as three types of financial stability policy in Table 4. In an integrated financial system, national governments cannot incorporate cross-border externalities (Type 2) (Schoenmaker, 2013: 6). They are accountable to national parliaments. Moreover, as shown by the financial crisis, some financial institutions are too large for national supervision and resolution authorities to administer. The EU and its Member States must decide whether they want deep integration (Type 3) or national stability policy (Type 1) in their framework for stability.

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4 The American AIG had only about 40 percent domestic business in 2008 when they nearly failed (Ibid: 31). If the US government bailed out AIG, only 40 percent of the benefit would go to them. It was only saved because the Americans perceived the benefits for them to be large enough.

5 It builds on the Mundell-Fleming model of monetary policy.
Table 4: Types of financial stability policy

<table>
<thead>
<tr>
<th>Type 1</th>
<th>Type 2</th>
<th>Type 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Autonomy + Safety</strong></td>
<td><strong>Autonomy + Efficiency (intention)</strong></td>
<td><strong>Safety + Efficiency</strong></td>
</tr>
<tr>
<td>Prior to the Single Market</td>
<td>Since the launch of the Single Market</td>
<td>Partially from the Banking Union reforms</td>
</tr>
<tr>
<td>· Capital controls</td>
<td>· Partial harmonization of prudential standards and network of national supervisors (micro)</td>
<td>· Pan-European micro-prudential supervision</td>
</tr>
<tr>
<td>· National supervision and recapitalization</td>
<td>· Heterogeneous models for the supervision of banks and other financial institutions</td>
<td>· A Pan-European observatory of systemic risk</td>
</tr>
<tr>
<td>· Minimal coordination</td>
<td>· Bilateral episodic cooperation structured in Memoranda of Understanding</td>
<td>· The ECB as the recapitalization and resolution authority</td>
</tr>
</tbody>
</table>

Source: Aglietta (1999: 28)

European integration was initially symmetric (Menéndez, 2016: 391). That means that the scope of the economic (‘market-making’) and social protection (‘market-correcting’) communities were in constitutional parallel (Menéndez, 2009: 39-40; Scharpf, 2002: 549). Symmetric integration was slow, got stuck, and hindered supranational solutions (Menéndez, 2016: 392). The Single Market came as a response, and led to integration itself. The four freedoms unleashed pro-integration forces. The Single Market was ‘negative integration’: as such it rules out national regulation that may restrict the four freedoms or can be seen as discriminating against foreign business, and bringing about ‘regulatory competition’ (Scharpf, 1996: 142-43). The result was asymmetric integration. The area without economic borders became “a common space without a state” (Menéndez, 2016: 395). With the Single Market, the financial system became highly integrated; however, the infrastructure to support the system has not been integrated at the same rate (De Haan et al., 2009: 323). Such ‘positive integration’ happens through legal harmonization and re-regulation at EU level, and involves political action (Scharpf, 1996: 143). This fragmentation of systemic infrastructure and social protection spheres lead to underprovision of financial stability as a public good (costs are concentrated, benefits widely distributed) (Quaglia, 2013: 80).

The constitutional asymmetry undermined the legal and structural power of the Member States to realize socio-political goals, and there was no supranational community to mediate the

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6 The recession in early 1980s, caused by monetarist answers to the second oil-price crisis, opened a neo-liberal window of opportunity in the EU: it was explained as a symptom of ‘euro-sclerosis’, and the European Commission wanted to solve it with a Single Market (Scharpf, 2006: 853).
relation between the economic and the social protection communities (Menéndez, 2009: 50; Scharpf, 2002: 649). Accordingly, neither level of government can correct the distributive consequences of the market. Ultimately, this will affect the foundation of democratic government. At the same time, in such a situation, governments face “strong economic incentives to resort to just such strategies of competitive deregulation” to attract business (Ibid). The large variety of national social protection systems and their political salience impede a unified solution (Ibid: 652). In sum, the two societal interests can be balanced providing they are in political competition at the same constitutional level; but selective Europeanization constitutionally subjects social protection to “the ‘supremacy’ of all European rules of economic integration, liberalization and competition law” (Ibid: 665-66). In the next subsection, I introduce the decision-making logic that underpins this constitutional asymmetry. There are structural obstacles to positive integration.

3.2 The Joint-Decision Trap – The Root of Failing Forward

Almost 30 years ago, Scharpf (1988) wrote a seminal paper on why achieving positive integration in certain aspects of policy-making appears to be virtually impossible. It can be “systemically explained as the consequence of a characteristic pattern of policy choices under certain institutional conditions” (Ibid: 242). He describes a tendency to agree on “sub-optimal policy output” or “local optima”, compared to solutions of greater centralization or disintegration (Ibid: 239). This is the ‘joint-decision trap’. The “institutional condition” he refers to, is when the Member States represent national interests of citizens and firms, but also the institutional self-interests of their governments (Scharpf, 2006: 847). The agreement must be (nearly) unanimous (Scharpf, 1988: 254).

The joint decision trap results, on issues relating to institutional reform, from a situation where the Member States both represent the interests of their constituents, but also their own institutional self-interests, like autonomy and influence (Scharpf, 2006: 849). The Council represents territorial-based interests and not the ideological or class-based factions of parliaments (Ibid: 847). The central government of the EU cannot react freely or creatively on problems, decisions are filtered through the immediate self-interests of the Member States.

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7 Scharpf (2006) updated the analytical framework 20 years after.
(Scharpf, 1988: 255). It leads to a ‘bargaining’ style of decision-making, as opposed to a ‘problem-solving’ approach (Ibid: 239). Governments are reluctant to give up sovereignty, but may do it when autonomous policy choices are not effective, but will try to uphold as much influence as possible (Scharpf, 2006: 847). Hence, they will press for unanimity or qualified majority voting, despite the great risk of sub-optimal solutions. Thus, he describes the institutional conditions that make an “extreme variant of a multiple-veto player system” (Ibid: 847).

The trap manifests itself in two of the three different EU decision modes: the ‘intergovernmental’ and the ‘joint-decision’ modes (Scharpf, 2006: 847). They differ on the influence of the European Commission’s “potential role in reducing the transaction costs of consensual policy solutions through its monopoly of legislative initiative”, where the latter applies to the joint-decision mode (Ibid: 850-51). Its agenda-setting role can smooth the negotiations by making them less complex and reduce transaction costs. It is the most relevant mode for this paper. Later in this chapter, I will introduce another factor that affects this decision-making logic. Learning from policy problems can be a force that creates understanding for the need of more positive integration. It may alter the reform agenda. Other actors than the European Commission can also reducing the transaction costs, like committees that writes blueprint reports for the decision-makers, by providing subjects of negotiation. I will return to this in chapter 3.4.

The market-correcting, positive integration depends on political legislation, which is characterized by a consensual approach under circumstances of great heterogeneity of interests and preferences (Scharpf, 2006: 854-55). The underlying logic is that positive integration is likely when national interests converge, and is not likely when they diverge and it is a politically salient case. Financial stability might be a case where both the EU and the governments have high policy capacity, but heterogeneity and political salience of the preferences of the governments prevent an EU solution, and a national answer blocked as a result of the constraints stemming from successful negative integration (Ibid: 855-56; Scharpf, 1988: 258). Therefore, joint-decision systems are vulnerable to the consequences of non-agreement. It might produce

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8 It does not apply to the ‘supranational-hierarchical’ mode, where the political non-accountable EU institutions exercise policymaking functions alone (Ibid: 851-54). It had its strongest base through the Treaty-based Single Market, and it is not dependent on political policy choices.

9 See Scharpf (1999: 117) for a four-fold table where the dimensions are high and low capacity of respectively the EU and the Member States.
a systematic ‘problem-solving gap’. The capacity to solve problems diminishes and reduces the possibility of positive integration.

To sum up: positive integration is made difficult because of (i) the orientation of the participants, and (ii) the decision rule in joint-decision systems (Scharpf, 1988: 258). That involves a bargaining style combined with a unanimity rule. Non-agreement “would imply the self-defeating continuation of past policies in the face of a changing policy environment”, so the pressure is substantial (Ibid: 265). Bargaining is a less effective option than problem-solving style of decision-making. Joint-decision systems result in “either blockages or in inefficient lowest-denominator compromises” (Scharpf, 2006: 848). I believe the situation of “frustration without disintegration and resilience without progress” joint-decision systems relate closely to the failing forward argument of Jones et al. (2015) (Ibid). Jones et al. (2015) further develop the idea of a bargaining system that restrains the functional necessities, but connect it to the core theories of European integration: liberal intergovernmentalism and neofunctionalism. They believe the failure of intergovernmental joint-decision-making leads to crises that leads to a neo-functional spillover. This dynamic repeats itself continuously, and results in a crisis-driven development that spur new “local optima” through spillovers. In the next section, I will present how the contradictory European integration theories – liberal intergovernmentalism and neofunctionalism – fit together, and discuss their strengths as individual theories.

### 3.3 The Failing Forward Argument

In this section, I will introduce the failing forward argument of Jones et al. (2015), which is my theoretical basis for explaining the evolution of the financial stability framework of the EU. It attempts to reconcile what is perceived as contradictory ‘grand theories’ of European integration – liberal intergovernmentalism and neofunctionalism. I will present them in more detail later in the section. The liberal intergovernmentalism of Moravcsik (1993: 482; 1998) was a theoretical innovation that combined a liberal theory of national preference formation with an intergovernmentalist theory of interstate strategic action and institutional creation. By doing so, he linked the international demand for outcomes with the supply side, thus avoiding uni-causal explanations. The failing forward argument of Jones et al. (2015) develops this strategy further.
Both theories contain elements that are useful to explain the crisis-driven dynamics of the EU. Jones et al. (2015) link the short-term outcome of intergovernmental bargaining with longer-term spillover effects. The result is a particular tendency with the two different dynamics connecting over time and producing a failing forward pattern (Ibid: 1015). Liberal intergovernmentalism provides an explanation of why the functional demand cannot be fully satisfied in interstate bargaining (in times of crisis), and neofunctionalism indicates how the reform processes are connected. Liberal intergovernmentalism is less useful than neofunctionalism to explain gradual development over time, and vice versa for the individual negotiation process. In other words, the failing forward argument predicts that the outcome of intergovernmental negotiations will be the lowest common denominator – incremental and piecemeal reform – while the interstate reforms processes are connected over time through functional spillover.

The failing forward argument derives from two empirical and interwoven puzzles. The short-term puzzle is that “EU leaders have adopted piecemeal, incomplete reforms that only contain the crisis, rather than more comprehensive solutions that might resolve it definitively” (Jones et al., 2015: 1012). This stems from the fact that at any given decision-point, comprehensive solutions were available, but the leaders acknowledge the substantial risk that a piecemeal reform entails. Liberal intergovernmentalism provides the explanation. The intertwined longer-term puzzle is that “piecemeal responses forged by minimum winning coalitions in the heat of crisis consistently moved the EU in the direction of deeper integration over time, rather than toward a dismantling of shared governance institutions and market structures” (Ibid). What this implies is an “underlying dynamic connecting iterated intergovernmental bargains”, and thereby creates a pattern where the EU seems to “fail forward”: “again and again responding to the failures of incremental reforms by taking new steps to expand the scope and intensity of integration” (Ibid). The puzzles seen together seem like a paradox that EU leaders oppose comprehensive reform at the same time as they agree on incremental solutions that prepare the way for deeper integration later on.

To make sense of why European leaders accept the failing forward dynamics, Jones et al. (2015: 1016) argue that they see the survival of the EU as a whole as a vital interest economically and geo-strategically. The euro (in their case) or the Single Financial Market (in my case) are crucial means for them and they are not willing to let these elements of the EU break down. On the other side, the leaders are not willing to carry through unpopular
(necessary) elements associated with many comprehensive approaches. If we assume that the proximate objective of all political leaders is to retain office, according to Garrett and Lange (1995: 629-31), they will satisfy their core political constituents. Thus, the government cannot “ask what is good for society as a whole in the long run, lest they lose power in the interim” (Ibid). The political success of democratic leaders is determined in the short term, thus they discount long-term effects (Pierson, 1996: 135). The result is that distributional concerns take precedence over those of efficiency (functional demands), even if it has significant cost for macroeconomic performance (Garrett & Lange, 1995: 629-31). ‘In the economists' long run, “maladapted” government strategies invariably will change. But it is likely that political imperatives may diverge considerably from the path of economic efficiency and for extensive periods’ (Ibid).

The long-term effects, like new crisis reforms, are usually by-products of short-term political decisions (Pierson, 1996: 135-36). Bernhard and Leblang (2016) in their study of the struggle to preserve the euro during the European debt crisis, find that governments will not decide on unpopular reforms unless it is absolutely necessary to save the cooperation in that field. Jones et al. (2015: 1016-17) argue that leaders may acknowledge the insufficiency of piecemeal approaches, but postpone comprehensive reforms to future governments, thus not in principle opposed to cede sovereignty. In the long run, incomplete institutional frameworks can be costlier because they “stimulate further functional spillovers that perpetuate the cycle of crises” (Ibid). Those national governments that press for more comprehensive reforms will have to accept what the least forthcoming states can approve.

3.3.1 Unpacking the Argument

In this sub-section, I will unpack the two components of the failing forward argument by presenting what they predict. It will provide a more nuanced basis for the analysis. In the presentation of liberal intergovernmentalism, I will emphasize the three stages of intergovernmental bargaining. The key insight is that in negotiations based on intensity of preferences, the outcome drives towards the ‘lowest common denominator’ in situations where one needs to compromise with the least forthcoming government. In the neofunctionalism part, I will focus exclusively on the notion of a ‘spillover’, which is closely connected to incomplete integration.
Liberal Intergovernmentalism

Moravcsik (1998) is the most influential scholar of liberal intergovernmentalism. For him, European integration is the outcome of “a series of rational choices made by national leaders” pursuing economic interests (Ibid: 3). National preferences are the core determinants of integration and they must converge in order to integrate new policy areas (Saurugger, 2014: 54-68). The states – the political entrepreneurs – represent and defend the economic interest of its constituency, and act strategic to satisfy its objectives. Fundamentally, the interdependence between states is a result of externalities, which can be negative or positive. The EU is created to make the bargaining on the externalities more efficient. Governments decides the scope and intensity of integration. Liberal intergovernmentalism consists of a rationalist framework, with liberal assumptions and a theory of international bargaining, that disaggregates the intergovernmental bargaining into three stages. I will now introduce the three stages.

The formation of national preferences is the first stage of explaining the outcome of EU negotiations. National preferences are “ordered and weighted set of values” related to a future outcome – underlying national objectives – and reflect the objectives of domestic groups that affects the government, but can result from international political interaction (Moravcsik, 1998: 20-26). Liberal intergovernmentalism emphasizes on direct consequences of economic integration, both efficiency and distributional concerns (Ibid: 35-37). One important implication is that national positions depend on the competitiveness of their domestic producers (49-50). The political cleavage goes between the competitive and non-competitive firms. In the analysis, I am concerned with how the national preferences affects the outcome of the interstate bargaining, and not the formation itself.

The dynamic of interstate bargaining – where the governments are the political entrepreneurs – is the second stage to explain the outcome of EU reforms (Saurugger, 2014: 70). Moravcsik (1998: 53) justifies the emphasis on governments by arguing that supranational actors are only necessary conditions, but not essential actors. They can propose tailored suggestions to national preferences and mediate between governments, but may often be redundant, posing neither binding constraints nor independent influence. The fundamental insight is that governments only have a clear incentive to cooperate when national policy creates negative externalities for one another, and unilateral adjustment is ineffective (Moravcsik, 1993: 486). The government preferences are rarely compatible, and in such a situation the bargaining has two dimensions: effectiveness, and distribution of gains
National preferences define the ‘bargaining space’ for potential agreements or equilibria outcomes (Moravcsik, 1998: 51). The ‘threat of non-agreement’ – veto or exiting – secures a solution within the bargaining space, and is the greatest source of bargaining power (Ibid: 63-65). Asymmetrical interdependence defines relative power. Governments with more intense preferences will have less bargaining power and will have to make greater concessions. The size of the state matters, where ‘big states’ carry more weight (Saurugger, 2014: 70). Generally, during negotiations based on intensity of preferences, the need to compromise with the “least forthcoming government” drives the cooperation towards the ‘lowest common denominator’ (Moravcsik, 1993: 500-01). That means that governments with the position closest to the status quo can limit the reform, but it is generally in their interest to compromise rather than veto, so the agreement will not precisely mirror their preferences. Comprehensive reforms demand convergence of national preferences.

The choice of institutional cooperation is the third analytical stage to interpret outcomes of reforms. Unanimity voting, pooling, and delegation are three different approaches placed on the continuum between efficiency of common decisions and the desire to reduce political risk by keeping the veto power (Moravcsik, 1998: 73-75). Sovereignty can be constrained in two ways: Pooling is voting procedures different from unanimity, and delegation means that supranational actors can take autonomous decisions (Ibid: 67). Unanimity voting tends to result in logrolling, lowest common denominator bargains or obstruction (Ibid: 75-76). Pooling and delegation are measures to reduce the bargaining power of potential opponents and arrange for compromises that are more ambitious. Governments are more likely to restrict sovereignty when joint gains are high and distributional conflicts are moderate. States that will benefit the most from common rules will also be the strongest advocates for pooling or delegating. In the next section, I will present the neofunctional term ‘spillover’. It indicates how issues are related, and contributes to explain what happens when the negative externalities of deep financial integration are not managed adequately. More generally, the failing forward argument is an attempt to describe how different reform processes are connected.

Neofunctionalism

Neofunctionalism – developed and refined between 1955 and 1975 by scholars like Haas – is the first grand theory of European integration, and sets to explain why states accept the idea of being part of such a supranational cooperation (Moravcsik, 1993: 474; Saurugger, 2014: 34). It
is based on a prediction that European economic integration is self-sustaining. The theoretical foundation for this prediction is the notion of ‘spillover’. The driving force for change is functional and technocratic needs (Jensen, 2013: 60-64). Spillover is

*the process whereby members of an integration scheme – agreed on some collective goals for a variety of motives but unequally satisfied with their attainment of these goals – attempt to resolve their dissatisfaction either by resorting to collaboration in another, related sector (expanding the scope of the mutual commitment) or by intensifying their commitment to the original sector (increasing the level of mutual commitment) or both* (Schmitter, 1969: 162).

As defined, spillover can expand integration within and across policy areas. Neofunctionalists assume that spillover is partly an outcome of unintended consequences – governments are trapped in a “web of unintended consequences spun by their own previous commitments” – and do not believe in a preconceived grand design (Jensen, 2013: 63; Moravcsik, 1993: 475; Saurugger, 2014: 37). In this thesis, I will emphasize a specific version, the ‘functional spillover’.

Functional spillover is connected to ‘incomplete integration’. When insufficient integration undermines the performance of existing policies, it increases the pressure for either widening or deepening integration (Moravcsik, 1993: 475). It is integration through economic interconnection where one step towards cooperation functionally leads to another (Jensen, 2013: 63; Saurugger, 2014: 39). According to Moravcsik (1993: 575), the term involves that “[any] ‘halfway house’ between sovereignty and integration is therefore unstable”. Thus, it is not ideology that spurs integration, but rather functional necessities (Saurugger, 2014: 36). However, spillover has less to say us on the character of the functional integration. It is an exogenous factor. The spillover hypothesis assumes that integration is “a linear, progressive phenomenon” that starts a dynamic that “would continue the momentum” (Ibid). After much criticism, Haas (1968) acknowledged that it is not necessarily automatic. According to Schmitter (1971; in Saurugger, 2014: 42), spillover is not automatic in joint-decision making because it involves costs, and the process to distribute it leads to politisation.
3.4 Politics of Ideas and a Revised Failing Forward Argument

In this section, I will present my own argument – the revised failing forward argument. The original failing forward argument forms the basis, but I will add a new dimension of politics of ideas and social learning. I will explain the development during the three phases with two causal mechanisms that affects the outcome in different ways: the lowest common denominator mechanism, which relates to liberal intergovernmentalism, and the belief system mechanism. First, I will introduce the idea of social learning and the two contrasting economic theories that are a core element of the belief system mechanism. Second, I define three dimensions to evaluate the comprehensiveness of the reforms. Finally, I consolidate the argument based on elements presented in this chapter.

3.4.1 The Role of Ideas in Shaping Outcomes

Three Orders of Policy Change – The Role of Ideas

Policymaking materializes within a context of a specific set of ideas (Hall, 1993: 289-92). This frame to make sense of the complexities of financial regulation will privilege some interest and some solutions and can act as a filter for policymaking (Ibid: 289). The actors’ different interests and the institutional arrangement for balancing them are not the only determinants of the outcome of reform processes, but it can also be structured by ideas. Hall (1993) used Kuhn’s (1970) concept of a paradigm to denote frameworks of policy ideas. A policy paradigm – or a belief system – is a defining character of the political discourse. In other words, the magnitude of policy change stemming from a reform process is shaped by the order of change in ideas that have occurred. That means that policy changes as a result of social learning. Hall (1993: 278) defines social learning as “a deliberate attempt to adjust the goals or techniques of policy in response to past experiences and new information. Learning is indicated when policy changes as the result of such a process” (Ibid). “The most important influence in this learning is previous policy itself” (Sacks, 1980: 356). Policy responds more directly to past policy than social and economic conditions (Hall, 1993: 277). Social learning opens the ‘black box’ of functional spillover, an explanation that neofunctionalism does not address. In this sub-section, I will present three kinds of changes in policy.
When the levels or settings of the basic policy instruments is changed, while the overall goals and instruments are unaltered, we can call it a first order change in policy (Hall, 1993: 278-80). Second order change is the result of a policy learning process where the policy instruments, but the overall goals persist. Relatively rarely, because of reflection of past experience, the overall goals change, a process of third order change. Such a paradigm shift is a result of a radical change in the policy discourse. It involves that much of what we take for granted and not scrutinize, is changed. First and second order change are associated with incrementalism and ‘normal policymaking’, but second order is more strategic. In the original framework of Hall (1993: 279), a third order change involves a simultaneous shift in all three components.

The Rational Expectations and the Efficient Market Traditions – Two Competing Belief Systems

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

As this famous quote from Keynes (2013 [1936]) illustrates, ideas structure politics. “[T]he deliberation of public policy takes place within realm of discourse […] policies are made within some system of ideas and standards which is comprehensible and plausible to the actors” (Anderson, 1978: 23). Policymaking happens within a framework of ideas that specifies the nature of the problem, and defines the goals and instruments (Hall, 1993: 279). Those ideas privilege some social interests over others, and dictates what policies are to be used (Ibid: 292). Policymaking is therefore highly influenced by the wider societal currents. In the field of financial stability, there are two main strands of approaches: the macroprudential and the efficient market. They represent two different belief systems, the Keynesian and the ‘rational expectations’. The ‘efficient market hypothesis’, with its micro approach, dominated before the financial crisis, while the macroprudential has gained important influence after the crisis. Fundamentally, they differ on how they perceive the market or the financial system – as stable and self-equilibrating or as volatile and inherently unstable. In this sub-section, I will introduce the two belief systems.
Table 5: Comparison of the two main belief systems of finance

<table>
<thead>
<tr>
<th></th>
<th>Rational expectations tradition</th>
<th>Keynesian tradition</th>
</tr>
</thead>
<tbody>
<tr>
<td>View on markets</td>
<td>largely efficient, prone to short term disruptions. Markets require better and more timely information, but should be left to their own devices as far as possible</td>
<td>financial system is inherently procyclical and prone to herding. Financial innovation and increasing complexity can make the system prone to shocks and less stable.</td>
</tr>
<tr>
<td>Instruments</td>
<td>market discipline</td>
<td>leverage limits</td>
</tr>
<tr>
<td></td>
<td>enhanced transparency</td>
<td>countercyclical capital buffers</td>
</tr>
<tr>
<td></td>
<td>private risk management (VaR models)</td>
<td>modularity/prohibition</td>
</tr>
<tr>
<td>Regulation in action</td>
<td>regulators ask banks and financial institutions what they do</td>
<td>regulators define limits for banks and financial institutions, what they must and must not do</td>
</tr>
<tr>
<td></td>
<td>VaR models and microprudential regulation the route to stability</td>
<td>VaR models insufficient and can hardwire procyclicality</td>
</tr>
<tr>
<td></td>
<td>shadow banking and financial innovation increases resilience and risk management capacity of the system</td>
<td>excessive complexity and financial innovation increases instability and may need to be rolled back</td>
</tr>
</tbody>
</table>

Source: Baker (2013b: 117)

The efficient market hypothesis was the “dominant conventional wisdom” of financial regulation until the financial crisis (Turner, 2010: 1318). From this perspective, markets are seen as rational and self-equilibrating, market completion would ensure efficiency and stability, and financial innovation and increased trade activity are thus advantageous. When markets process all available information, the price of a security will be a good estimate of its intrinsic value. From this worldview, there is no role for discretionary stabilization, but rather clearly communicated rules. Deregulation and financial innovation will complete the markets and create better incentives. Speculation leads to better price discovery. Additionally, a complex and active financial system will improve the system’s stability. According to the former chair of the UK Financial Services Authority (FSA) and now Chairman of the Institute for New Economic Thinking, Lord Turner (2010), those practical men that Keynes was talking about are actually policymakers in central banks, regulator agencies, and governments, and in risk management departments of banks. They know of their intellectual influences, but “tend to gravitate to simplified versions of the dominant beliefs of economists who are not yet defunct but still very much alive” (Ibid: 1320). “[I]n the translation of ideas from academia to public policy, a dominant, over-simplified and dangerous conventional wisdom developed” and this belief system became part of “the institutional DNA” (Turner, 2011: 26-29). The efficient market hypothesis became the orthodoxy because it provided
a set of ideas complex and internally consistent enough to have intellectual credibility, but simple enough to provide a workable basis for day to day decision-making. Complex human institutions—such as those which together form the policymaking and regulatory system—are difficult to manage without guiding philosophies—and guiding philosophies are most compelling when they provide clear answers (Turner, 2010: 1321-22).

Tranøy (2017: 41-42) presents seven premises of this belief system. (i) They see the financial system as an epiphenomenon, as something that mirrors, not drives the real economy. (ii) Thus, financial markets are treated as a neutral channel for funding between savers and borrowers. (iii) The financial system is self-stabilizing and therefore fundamentally stable. (iv) Because the system is perceived as stable and neutral, it is not necessary to understand its workings in detail. (v) More specifically, studying the development of level of indebtedness of different sectors in private sector is of less importance. Due to this optimistic inclination (vi) the financial system should be as liquid as possible – the more transactions the better – (price discovery) and (vii) the more financial instruments and innovations the better to complete the market. The premises of the belief system has been translated into the financial institutions through use of “Value at Risk” (VaR) models and techniques (Baker, 2013a: 4). They are based on assumptions that future market prices can be inferred from observation over the recent past, and that rational interaction between actors can be mathematically modelled. VaR guided the risk management and investment strategies of large banks. Supervisors trusted this model to the extent that they became the centre of regulatory practice.

Macroprudential thinking is based on Keynesian ideas, and the financial instability hypothesis of Minsky (1977) is a core inspiration (Baker, 2013b: 116-18). It disputes the analytical foundation of the efficient market hypothesis, and views the financial system as volatile and inherently unstable. Minsky (2015 [1982]: xii) believed instability was a normal result of the economic process, and “[o]nce instability is understood as a theoretical possibility, then we are well positioned to design appropriate interventions to constrain it”. There are four constituent macroprudential concepts: (i) Fallacy of composition, a Keynesian notion, tells that the individual incentives and behaviour do not automatically lead to beneficial aggregate or systemic outcomes (Baker, 2013a: 4; 2013b: 115). (ii) Procyclicality is the result of calculation of risk that follows prices, then credit is most abundant when asset prices rise and is restricted when falling. (iii) Herding describes the phenomenon where individuals “adopt behaviors close to the overall mean, deferring to the judgement of others, behaving in a non-rational or short-term fashion” (Ibid: 4). (iv) Network externalities and complex systems describe the fact that “small events can generate systemic dislocations because of the complex and unintended
interactions that ensue in complex systems” (Ibid). This conception of the financial system, perceives financial instability as endemic and endogenous, and prescribes a new and more powerful role of public authorities to intervene and limit (Baker, 2013b: 113-18). In the next sub-section, I will present how ‘social learning’ plays a key role in policymaking, and explain what a shift from the rational expectations to the Keynesian tradition involves in terms of policymaking.

### 3.4.2 The Pattern of Comprehensive Financial Stability Reforms

I will compare the reform outcomes to what the alternative theoretical perspective prescribes, following Jones et al. (2015: 1013) mutatis mutandis, as the failing forward argument presupposes a standard for a comprehensive reform. Figure 8 shows the model for comprehensive financial stability framework that I will employ to analyse the outcomes in the three phases. I have deduced three dimensions from theoretical perspectives of this chapter: level of aggregation, level of governance, and functional scope. Together, from a Keynesian and macroprudential perspective, they make up an ‘ideal menu’.

(i) **The level of aggregation** (aggregation dimension) is based on the macroprudential perspective and indicates that you need a top-down approach to financial stability. To cope with systemic risk, you need a macro approach. As described in chapter 2.2, financial stability instruments, spanning from crisis prevention to crisis management, can broadly be categorized as macroprudential supervision, recapitalization, and resolution. (ii) **The level of governance** dimension (the governance dimension) is based on the financial trilemma, the notion of asymmetric integration, and on the Keynesian notion of fallacy of composition. What is beneficial for the individual country is not necessarily advantageous for the EU. The choice along the continuum with national or supranational governance on either side, should be determined by the level of financial integration. As presented in chapter 3.3.1, national sovereignty can be limited by pooling or delegating power. Delegation is equal to supranational governance, while pooling corresponds to an intergovernmental level of governance. If the systemic risk is domestically delimited, then the governance framework should correspond. Level of integration is a political question, and the EU has chosen deep financial integration through the Single Market. Thus, the level of governance should be European.

(iii) **The functional scope** dimension build on the macroprudential notion of network externalities and complex systems and indicates that you cannot supervise only one part of the
financial system. The different parts are interconnected and are sensitive to the same systemic risk. The financial crisis is a good example: The shadow banking system was the key provider of liquidity to the financial institutions, market makers, and the core funding markets (Moe, 2014: 8-15). Securitization concentrated risks in the banking sector. The American investment bank Lehman Brothers failed in 2008 and the American multinational insurance corporation AIG had to be rescued soon after. A financial stability framework needs a system-wide approach.

The three dimensions are necessary, but not sufficient conditions for coping with systemic risks. They provide the general framework, while the policy instruments and their calibration determine the efficiency. I will employ the three dimensions to structure the description of the outcomes of the reform processes. In the next sub-section, I will present a revised and tailored failing forward argument wherein I combine the different theoretical perspectives previously presented.

Figure 8: Three dimensions of a comprehensive financial stability framework

![Diagram showing three dimensions of a comprehensive financial stability framework]

Source: The author
3.4.3 The Revised Failing Forward Argument

My revised failing forward argument combines theoretical insights from the social learning approach of Heclo (2010 [1974]), Sacks (1980) and Hall (1993) with an extended version of Jones et al.’s (2015) argument. In the latter article, I identify a mechanism that conditions outcomes of EU reform processes, the *lowest common denominator mechanism*. The main insight is that inter-state bargaining based on intensity of preferences, where you need to compromise with the least forthcoming governments (unanimity decision-making), tends towards lowest common denominator outcomes. In the former approach, I single out the *belief system mechanism*. In a reform process, social learning structures the kind of solutions that are proposed. Together, they define what outcome is possible.

I use the notion of a policy menu to explain how they affect the outcome. The belief system mechanism establishes the content of the policy menu, while the lowest common denominator mechanism defines the limit for which “dishes on the menu” that can be agreed. The relative strength and relation between the two mechanisms differs from reform process to reform process. However, the relation is not a zero-sum game. The mechanisms are always active. The belief system mechanism may reduce or expand the menu. When it reduces the policy menu – creating an epistemic deficit – the effect of the lowest common denominator mechanism can be trivial. In reform processes where the belief system mechanism expands the menu, the impact of the lowest common denominator mechanism may increase, as there are more elements on the menu to disagree. Now, I will explain my argument, and the theoretical expectations (TE) I derive.\(^{10}\)

The belief system mechanism is closely connected to social learning. The original failing forward argument of Jones et al. (2015) does not include social learning. Policy-making is inherently a historical process where ‘policy’ is a reaction to previous efforts to solve the same problem (Weir & Skocpol, 1985: 199). You cannot “read off” the policies from the current structural conditions, but rather look at the reactions to previous policies. According to Heclo (2010 [1974]: 315), “policy invariably builds on policy, either in moving forward with what has been inherited, or amending it, or repudiating it”. As Sacks (1980) summarized, policy changes are based on the previous policy. I expect the ‘size of the policy menu’ to be a

\(^{10}\) H2-H3 is based on the “observable implications” of Jones et al. (2015: 1017).
consequence of learning from the effects of antecedent framework. The functional spillover can occur along all three dimensions.

**TEI:** The policy menu will evolve in reaction to previous policy choices and their effects.

Along the aggregation dimension, social learning on the three orders of policy determines the development of the policy menu. I draw on the ideas of Hall (1993). The reform process occurs within a policy paradigm. When the comprehensive solution is to be found within another paradigm, you need a ‘paradigmatic’ third order change. According to Hall (1993), this shift will be a result of social learning. Even though alternative and parallel belief systems with stable solution exist, they have limited influence as long as policymakers relate to the prevailing paradigm. Anomalies which the prevailing paradigm is unable to explain with ad hoc efforts by stretching the terms to cover them will undermine the paradigm’s intellectual consistency and accuracy (Hall, 1993: 280). According to Hall (1993), the efforts may involve experiments to adjust the policies. If experiments do not solve the problems, policy failures will gradually erode the paradigm. The social learning process will gradually impair the prevailing belief system and slide towards an alternative system. Thus, experimentation with new forms of policy starts.

Hall (1993) believed that a paradigm shift presupposes a change in all three orders of policy. However, as Baker (2013a: 7) finds in the case of macroprudential policy, there was no previous experimentation of lower order that led to the third order change in the aftermath of the financial crisis. Such policies were still in the process of being fully developed. Thus, it was a more ‘contingent ideational shift’, with the possibility of a subsequent shift in first and/or second order policies, rather than a paradigm shift. According to Moschella and Tsingou (2013: 5), we can expect an incremental expansion of the policy menu when the technical knowledge is “not well developed” and when the organization capacity is “poor or absent”. Radical policy change is discouraged as creating new capacities requires great expenditure of resources and time, all the more so in a situation of economic emergency where quick results are important (Weir & Skocpol, 1985: 121). I depict the change as a continuum with the incumbent and the main challenger belief system on either side.

**TEI-1:** Given the hegemonic position of rational expectations tradition/efficient market hypothesis at the outset of the process under study here, social learning will entail a movement from one end of an economic theory continuum towards a more Keynesian-
oriented/macroprudential stance. The more the social learning is parallel in all three orders of policy, the more movement across the continuum.

**Figure 9: The policy menu and the relation between the two causal mechanisms**

The lowest common denominator mechanism relates to a particular mode of decision-making where decisions are filtered through territorial-based interests of domestic politics. As governments are reluctant to cede power over collective policy choices, they adhere to (near-) unanimity. The result is a ‘bargaining’ mode, rather than a problem-solving mode of decision-making. Governments threatening with non-agreement have greater bargaining power, while governments with intense preferences for a specific solution have less. Due to the domestic distributional implications, there is limited room for concessions that diverge greatly from the nationally defined bargaining space. As politicians tend to emphasize political cost in the short term, large concessions in the bargaining process are less likely. The long-term benefits that can be associated with substantive concession are given less weight. Naturally, the size of the country will also affect bargaining leverage. By reducing the complexity of the negotiations and through its legislative initiatives, the European Commission has a facilitating role. In joint-decision-making, where there is a need to compromise with the least forthcoming governments, the outcome tends to be that of the lowest common denominator. The result is a Scharpfian joint-decision trap that creates incomplete institutional frameworks.

*TE2: The EU will introduce incomplete institutional frameworks as a result of lowest common denominator choices from belief system mechanism-generated policy menus.*
The last theoretical expectation explains how the decision-making dynamics of individual reform processes create incomplete outcomes, and becomes an iterated phenomenon connected through crises. When policymakers learn the effects of the prevailing institutional framework and see that it undermines collective goals, it increases the pressure to deepen integration. The underlying assumption is that bad market-correcting policy is connected to bad market outcomes, and that well-crafted market-correcting policy will lead to more stable and well-functioning markets. Crises generate functional spillover because severe anomalies lead to a learning process where the experts and politicians acknowledge that the functional necessities are not being satisfied. Therefore, in my explanation, the direction of the functional spillover is endogenous given. Pooling and delegation makes for more efficiency and problem solving. This dynamic will prevail until the functional demand is satisfied. However, the dynamic is not deterministic because the distributional costs lead to politicization.

*TE3:* The incomplete institutional frameworks help spark future crises and should generate social learning and ultimately functional spillovers.

In Figure 10, I have synthesized theoretical expectations and presented the revised failing forward argument as a cycle that drives the evolution of the institutional framework. In the next chapter, I present my case study research design and process-tracing method.
4 Research Design and Method

In this chapter, I will detail my proposal on how to utilise evidence to make inferences – that is, the methods by which that evidence is collected and analysed (King, Keohane, & Verba, 1994: 9,118). I will make inferences on causal mechanisms based on a single case-study, and will use process-tracing as the procedure to identify the causal process leading to the outcome. The evolution of the EU framework for financial stability does not lend itself to quantitative analysis. Causality is unobservable, so the inferences generated are provisional and the conclusions drawn are associated with significant uncertainty. To compensate for these fundamental problems, I will explain the procedure for examination of the evolution of EU financial stability framework in detail in this chapter. First, I will present the research design (case study). Second, I will discuss the methodology used (process-tracing). Third, I will declare the sources of data employed, and lastly I will discuss issues related to validity and reliability.

4.1 Case Study as Research Design

The point of departure for my thesis and research design from the convention is that of using individual case-study as evidence. As Beach and Pedersen (2016: 6) put it in a sports analogy, I analyse a single game closely, and from it generalize only to games played in causally very similar contexts. This differs from a variance-based research design wherein one would have opted for a larger population of potentially causally dissimilar games. I will gain within-case evidence on how the causal process played out in EU financial stability institution building, with sensitivity to its context. Consequently, it can be very difficult to generalize to other relevant cases. Causal explanations of an event is all about explaining why it happened (T. Kuhn, 1977: 23), and history ”provides the groundwork” (Moses & Knutsen, 2012: 119).

A case is a “spatially delimited phenomenon (a unit) observed at a single point in time or over some period of time” and “comprises the type of phenomenon that an inference attempts to explain” (Gerring, 2007: 19). In other words, a case is “the unit in which a given causal relationship plays out, from the occurrence of the cause to the theorized outcome” (Beach & Pedersen, 2016: 5). There are many definitions of what a case is, but at the root of all of them is that case studies address ‘cases of something’ (Moses & Knutsen, 2012: 113). That ‘something’ makes the case worth studying. My case is the evolution of the EU financial
stability framework, and I observe the case from its inception until 2013, delineated as three phases (and one pre-framework phase). The quest to explain why the framework has been incomplete and crisis-driven has an idiographic foundation. That means that I aim to explain a particular historical case, whilst being guided by theory. In the typology of Levy (2008), it is a ‘theory-guided case study research design’. Thus, the aim is not primarily to generalize beyond data. I will explicitly structure the case in a “well-developed conceptual framework that focuses attention on some theoretically specified aspects of reality and neglects others” (Ibid: 4-5). The study will probably be relevant for other cases of European integration in other policy fields, and hopefully the extended failing forward argument can nuance the original version of Jones et al. (2015).

Naturalist social science is divided on the utility of case study research design (Moses & Knutsen, 2012: 141). Critics are sceptical to generalizations based on a single case. King et al. (1994: 221) believed “the single observation is not a useful technique for testing hypothesis or theories”. Other naturalists appreciate such knowledge and its connection to historical approaches (Moses & Knutsen, 2012: 133-42). Within case study research design, process-tracing and within-case methods can bridge the methodological gap between naturalist and constructivist approaches.

Research design can be divided into four components: the research question, the theory, the data, and the use of data (King et al., 1994: 13). My theoretical framework comes prior to the empirical analysis, but has undergone further development. George and Bennett (2005: 94) recommend that the writer must indicate the initial expectations and if they were changed during the course of the study. In the initial phase of the project, I expected that the pattern of financial stability regulation fitted with the failing forward argument. After digging deeper into the data for two months, I came to believe that the lowest common denominator mechanism was not sufficient. The problem was not only contained to diverging national positions, but also a crucial lack of understanding and acknowledgement of systemic risk among core political actors and their gatekeepers. It led me to revise the theoretical foundation, and I started deliberating on how to adjust the failing forward argument. As it lacked an epistemic component or mechanism, I included politics of ideas and social learning in the failing forward argument.

It is challenging to strike a balance between a “detailed historical description of the case and development of a theoretically focused explanation of it” (George & Bennett, 2005: 94). As my research topic is rather technical and unfamiliar to most readers, it seemed prudent to
provide a historical account, but also provide clear-cut theoretically focused introductions to each phase so that the central piece of evidence is clearly highlighted for the reader. The three dimensions are the main organizing device in the chronological presentation of the phases. In chapter 5, I have separated the process and the framework. In chapter 6, where I explain the decision-making logic in each of the phases, I organize the analysis around the two causal mechanisms. In the end, I discuss the findings in light of the theoretical expectations of the revised failing forward argument.

Case explanations have a provisional character (George & Bennett, 2005: 90-91). The conclusions of this thesis could be challenged on grounds of omitted sources or variables. The plausibility of a causal explanation increases if it is consistent with available data – in such, a process-oriented case study is analogous to detective work leaning upon the weight of available evidence. A too-narrow set of historical accounts may “overstate performance of favoured hypotheses” (Ibid: 95). In my historical examination, I have strived to use broad material from different sources to increase the plausibility of my findings. Primary sources like official policy documents are by themselves insufficient as sources, they are designed to serve someone’s purpose (Ibid: 97-100). To include the public context, I have used contemporary public sources such as newspapers, supplements, and other publications that are informed by contemporary information or interviews with well-informed experts. Much of the important data from negotiation talks and creation of preferences is not available for perusal, and this increases the uncertainty of my inferences and conclusions. The analysis is quite complex due to the fact that the policymakers “seek multiple payoffs from any decision they take” (Ibid: 98). This means that several explanations might be correct, and that my theoretical expectations are not mutually exclusive from competing explanations.

Like in all research, I have to make the choice between “knowing more about less, or less about more” (Gerring, 2007: 49). By choosing a case study of the evolution of EU financial stability framework, I have chosen to know more about less. Hence, though I can say much about my specific phenomenon, it comes at the cost of generalization. Variance-based research on the other hand, provides breadth, but “decontextualizes the realm of social behaviour by employing abstract variables that seem to bear slight relationship to the phenomena of interest” as a result. Gerring sees research designs as a ‘trade-off’. I will discuss these trade-offs in further detail in sub-section 4.4. In the next section, I will explain the methodology employed to answer
the research question. Process-tracing is one of the most central and widespread approaches to causal case study research (Beach & Pedersen, 2016: 3).

4.2 Process-tracing as the Method

Process-tracing can, as indicated above, be compared to detective work (Gerring, 2007: 173). The detective collects testimonies and evidence of the context and what happened prior to the event, and each fact is relevant to the central claim. Covering different angles and perspectives, they are not directly comparable. The different pieces cannot be “reduced to standard dataset observations” (Ibid). Instead, the pieces of evidence is used to identify the causal chain and causal mechanisms that links causes to an outcome (Beach & Pedersen, 2016: 10; George & Bennett, 2005: 206-07). Tracing of causal mechanism can be seen as the core of process-tracing (Beach & Pedersen, 2016: 302-04). Causal mechanisms are a theoretical system to provide strong mechanistic evidence on causal relations and processes that agents with “causal capacities operate, but only in specific contexts” (Bennett & Checkel, 2014: 11-12). Causality is not something we can observe, but something that we infer. Nevertheless, hypothesis about causal mechanisms can generate testable implications. Because there will always be fine grained aspects that cannot be observed – newspaper articles, interviews, and policy documents cannot replace actual recordings of the bargaining – the inferences generated will be provisional.

Process-tracing is “a procedure for identifying steps in a causal process leading to the outcome of a given dependent variable of a particular case in a particular historical context” (George & Bennett, 2005: 176). In this thesis, I will trace the process that has led to incomplete, crisis-driven reforms to “narrow the list of potential causes” (Ibid: 207). This will of course not eliminate all other potential rival explanations, but the equifinality of my case – multiple paths towards an outcome – forces me to take into account an additional mechanism, namely, knowledge and ideas. Process-tracing has the additional advantage that it can identify single or different paths to an outcome (Ibid: 217).

There are two general approaches to process-tracing: theory-centric and case-centric (Beach & Pedersen, 2016: 305). In theory-centric work, the goal is to improve a wider theoretical debate to generalize to small, bounded populations. It can take the form of building or testing theories, or theoretical revision. In this thesis, I follow the case-centric approach. It
aims to better understand a specific phenomenon, and is less concerned with generalizations to a broader population. I will use what Beach and Pedersen (2016: 308) call ‘explaining outcome process-tracing’. The combination of systematic and case-specific mechanisms allows for a comprehensive account of the “big and important” elements of my case (Ibid: 307). The findings will primarily be case-specific, but the goal is also to nuance the failing forward argument of Jones et al. (2015) to fit other contexts.

Case selection in explaining outcome process-tracing is based on interest focused on a specific phenomenon, and is a single-outcome study (Ibid: 309-10). The evolution of EU financial stability framework as a case is unique in itself (and not necessary relevant for a theoretically defined population, like integration bargaining processes). The case-specific combination of mechanisms makes my explanation case-specific as well, but those mechanisms can be systematic individually (relevant to other cases). Whether it is possible to generalize the case depends on the status of the mechanisms as being systematic. That means that some of my findings are unique to my case, and other can potentially be generalized. “Underlying causes, no matter how numerous or deep-seated, do not make an event inevitable” (Lebow, 2007: 85). That means that the context of the mechanisms plays a significant role. A mechanism cannot be more sufficient than the cause that triggered it (Beach & Pedersen, 2016: 308-10). Explaining outcome process-tracing is different from the historical research methods because it is guided by theory and has ambitions to generalize findings.

Explaining outcome process-tracing is an iterative method (Beach & Pedersen, 2016: 311). There are two possible points of departure- theory or the data. I started with the theory-first path, where I tested the traditional failing forward argument on the data. I found that while it could account for why they weakened the menu of policies in Phase 1 and Phase 2, it could not explain why the menu was deficient. As discussed in 4.1, the lowest common denominator mechanism was not sufficient, so I used the empirical data to guide me towards new theoretical perspectives to explain the element that could not be accounted for with only the lowest common denominator mechanism. Politics of ideas account for the epistemic deficit in the Phase 1 and Phase 2, where the efficient market hypothesis was dominant and blocked a macro approach to systemic risk. The detection of the least common denominator mechanism was a top-down analysis, while the belief system mechanism was a product of a bottom-up approach. As Beach and Pedersen (2016: 312) note, a theory cannot be confirmed a 100 percent as one stops at the first explanation that accounts for the most important aspects of the outcome. The
revised failing forward argument incorporates elements from different approaches to European integration and policy change. The two mechanisms constitute a parsimonious line of reasoning, which is a core criterion for good causal arguments (Gerring, 2005). In the analysis chapter, I will present them together in a non-iterative manner.

4.3 The Sources of Data

Data are “systematically collected elements of information about the world” (King et al., 1994: 23). To reveal the causal mechanisms at work, I have made use of primary and secondary sources. EU policy documents including Presidency Conclusions, Summit Statements, and reports such as the de Larosière and Lamfalussy reports are my primary sources. The primary sources provide a frame to understand the timeline of the process. They give an indication of what was proposed and what the actors agreed on, but are sensitive to how the actors want to present themselves. Therefore, I have supplemented with secondary sources, like newspaper and journal articles, to account for the paucity of content in primary sources. Most of the newspaper articles come from the Financial Times’ or the Factiva databases. In general, the journal articles have primarily given insight the reform processes of the phases or in the development of macroprudential thinking. As George and Bennett (2005: 90) warn, there is always a danger that the authors underestimate the complexity and the myriad of interests.

In the preparation to this project, I have had two background conversations, one with a researcher from the Norwegian central bank about financial stability, and one about the failing forward argument with one of the writers of the original argument. The background discussions were important in an early stage to locate data and to refine my theoretical argument. Elite interviews could be an important supplement to the written data, but it was not attainable to locate the interviewees with the right information for this thesis. The background conversations were also part of the scan for possible interviewees at EU level as both were familiar with financial actors at EU level. In the next section, I discuss validity and reliability issues.
4.4 Validity and Reliability

Causal Inference

An inference is “the process of using facts we know to learn something about facts we do not know” (King et al., 1994: 119). As there are no time-machines, we cannot make causal inferences for certain, but we can reduce the uncertainty (Gerring, 2007: 151-52). True experiments are the closest we get to a time machine, but case studies have quasi-experimental qualities; one can compare the case before and after a decision has been taken. As I study a single case, it would be pointless to estimate causal effects across the population, but I can make inferences about the causal mechanisms in place (Ibid: 44). The research design determines what inferences you can make (Lund, 2002: 89). Causal effects are grounded in cross-case evidence, while case studies “may allow one to peer into the box of causality to locate the intermediate factors lying between some structural cause and its purported effect” (Gerring, 2007: 45). There is a trade-off between analysing causality through effects and via mechanisms (Ibid: 48). By tracing decision-making logic, I can make causal inferences about the forces that create the failing forward dynamic.

Inferencing is an inexact process; it is not possible to reach ‘certain’ conclusions from uncertain data (King et al., 1994: 8-10). In addition, complexity makes for more uncertain inferences. The sources of error differ in qualitative and quantitative research (Ibid: 31). In complex cases, the tendency to attach more significance to evidence that conforms to the theoretical expectations increases its uncertainty (George & Bennett, 2005: 99). I started out with clear theoretical expectations that may have led to such a bias, but by being open to inductive insight – including a new mechanism at a later point – made me rethink my initial expectations (Bennett & Checkel, 2014: 29-30). Such revisions of the theoretical argument may have increased the certainty of the inferences. On the other side, ex ante theoretically specified mechanisms are also a safeguard against storytelling (Schimmelfennig, 2014: 105). Process-tracing is much about “soaking and poking”, that is, take in a significant amount of data that may or may not be part of the final explanation – and demands “enormous amounts of information” (Bennett & Checkel, 2014: 18; George & Bennett, 2005: 223). We only have a “strong basis for causal inference” if we can “establish an uninterrupted causal path”. Considering that the status of our conclusions is only provisional, and that the data can always be more fine-grained, it is not always possible to form an unbroken causal chain (Ibid: 222).
Theories do not provide clear expectations regarding all steps in the causal process for complex phenomenon. The data I provide could potentially be more fine-grained, there is a plethora of other data, and the theoretical predictions can be regarded as somewhat indeterminate. As a result, the uncertainty of my causal inferences increases and can at times be substantial.

**Reliability and the Potential for Generalizations**

Case studies have generally strong internal validity and weaker external validity, and Gerring (2007: 43) presents the relation as a trade-off that is intrinsic to the choice of research design.\(^{11}\) Process-tracing maximizes the internal validity of causal inferences, but does not produce external validity per se (Bennett & Checkel, 2014: 102). My case study is only one case and will naturally have problems with representativeness. I do not have ambitions to generalize the case to a greater universe, but through process-tracing I can clarify whether a hypothesis about the mechanisms is generalizable and systematic (Gerring, 2007: 13). This presupposes a clear theory of the workings of the mechanisms. In the chapter 6, I find that the mechanisms are systematic and suggest that the observed causal trajectory can be prevalent in other similar cases. The findings can possibly be transferable to other cases of EU integration processes.

Reliability means that “applying the same procedure in the same way will always produce the same measure” (King et al., 1994: 25-26). In process-tracing based on public written material, the problem of reliability is reduced. All my sources can be verified and are listed in my references. The Financial Times articles are sometimes behind a pay wall. I have tried to indicate the page number in all my source references to increase the reliability. The reliability is better than if I had based my inferences mostly on observations or interviews. Still, selection bias is a great challenge in the production of “determinate and reliable results” (King et al., 1994: 128). The quotes I have chosen from the sources that I have included are all guided by my interpretation and might favour my theoretical expectations. Such subconscious biases may have affected the selection of observation. Other people might not have necessarily arrived at the same conclusions. The most important measure to increase reliability is the detailed documentation of references.

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\(^{11}\) Internal validity refers to the correctness of a hypothesis regarding to the case in focus, while external validity is concerned with the correctness towards the cases not studied (Ibid: 217).
5 The Evolution of the EU Financial Stability Framework

The governance of the EU financial system began to evolve 16 years ago (Kudrna, 2016: 71). It started out as a policy area governed by the ‘community method’ with generic comitology, but a “quick succession of innovative reforms” has dramatically transformed it (Ibid). I have identified three phases of EU financial stability framework. Table 6 sums up the framework in each phase along the three dimensions. The parenthesis denote the presence of other elements, but is not the main tendency.

First, the initial Lamfalussy reform created sectoral, coordinating committees for microprudential authorities. Supervisory authority continued to be national, and macroprudential issues were not included in the framework. Second, the de Larosière reforms in the aftermath of the financial crisis (2008-2009) transformed the committees into EU level microprudential supervisory authorities with some binding powers, and introduced a board for systemic risk oversight, without any instruments for enforcement. Crisis management remained a national responsibility. Third, the European debt crisis led to the Banking Union reforms. Micro- and macroprudential supervision, crisis resolution, and recapitalization became intergovernmental responsibility, under the aegis of the ECB. The Banking Union supplements the de Larosière Framework and did not replace it.

Table 6: Evolution of EU financial stability framework along three dimensions

<table>
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<th>Phases and dimensions</th>
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*Source: The author*
5.1 The Pre-Framework Phase (-2000): The Introduction of Common Core Principles

The pre-framework phase is characterized by a lack of an EU-level institutional framework, and a microprudential approach to supervision. Member States were responsible for supervision and crisis management. During this phase, the primary concerns shifted from national autonomy and financial stability to national autonomy and financial efficiency. Gradually, less importance was given to the question of stability. In this section, I will present some historical background and the foundational principles of the EU framework.

5.1.1 From the Treaty of Rome to the Eurozone

Integration of financial supervision moved slowly until the very end of the 1990s (Quaglia, 2010b: 24). This phase consisted of three stages: (i) The Treaty of Rome of 1957 to the mid-1980s – a period of slow integration of the financial systems, ending with the launch of the Single Market program. (ii) From the agreement of the Single European Act to the date of completion of the Single Market in 1992 – a period marked by the increased pace of financial market integration, deregulation and re-regulation. (iii) The run-up to the Economic and Monetary Union (EMU) quickened integration of the financial systems. The Treaty and ESCB Statute do not prescribe prudential supervision as one of the basic tasks of the ESCB, but that they shall contribute to “the stability of the financial system” (OJ, 2012: Article 105 (5-6)). However, the Council may confer “specific tasks upon the [ECB] concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings” (Ibid). The Maastricht Treaty is explicit on decentralization and allocation of supervisory power to national central banks. Only in special circumstances, and when the European Council is unanimous, is the ECB allowed to supervise financial institutions (De Haan et al., 2009: 47). The pre-framework phase ended with the launch of the Financial Services Action Plan (FSAP) in 1999.

5.1.2 The Three Initial Core Principles of EU Financial System

In the second and third stage, the three core principles of the EU financial system were introduced: ‘mutual recognition’ and ‘minimum harmonization’, ‘home-country control’, and non-binding international rules. (i) National regulation was combined with ‘mutual recognition’
and ‘minimum harmonization’ of national rules through EU rules (Quaglia, 2010b: 33-34). Mutual recognition involves a single banking license (Second Banking Directive) where financial institutions authorized in one Member State may establish branches or supply financial services in any other Member State on the basis of rules set by the home country. This has significantly stimulated cross-border banking (De Haan et al., 2009: 48-50). This is the notion of the ‘passport’, and it implies that “financial services are similar in character to the other goods and services for which the single market program sought to create a level playing field” (Begg, 2009: 1113). The license does not extend to subsidiaries in host Member States (De Haan et al., 2009: 48-50). Minimum harmonization is a common minimum requirement for all the Member States, but they can move beyond it. Similar developments have taken place in the fields of insurance (Third Insurance Directives) and securities (Investment Services Directive).

(ii) Supervision was a national concern with bilateral cooperation by memoranda of understanding (MoU), or multilaterally in technical committees, e.g. the Groupe de Contact (Quaglia, 2010b: 34). The principle of ‘home-country control’ (Second Banking Directive) means that the home country of a financial institution is responsible for supervision of the bank’s solvency, as well as that of its foreign branches (De Haan et al., 2009: 48-49). The host country may only intervene in order to protect the ‘public interest’, and in emergency situations to protect depositors and investors. There was no single template for supervision and sanctions were not defined at the EU level, so the financial institutions were subject to substantially different supervisory regimes (Lamfalussy, 2000). (iii) There were non-binding rules at the international level, such as the standards set by Basel Committee on Banking Supervision (Quaglia, 2010b: 34). In the pre-framework phase, no serious EU coordination took place among supervisors; therefore EU did not have any micro background for proper handling of macroprudential issues (Aglietta, 1999: 24). In the next sub-section, I will present the first phase of EU financial stability framework. Phase 1 retained the national approach to supervision and introduced some arrangements for microprudential coordination. The financial crisis occurred under this framework.
5.2 Phase 1: The Lamfalussy Reform (2000-2002) – Soft Microprudential Coordination

The Lamfalussy Reform created a framework with sectoral, coordinating institutions for microprudential supervisors (aggregation dimension and functional scope), but supervision remained a national responsibility (governance dimension). The new institutions did not execute prudential supervision, and especially not handling any macro issues. Crisis management was not a part of the reform. The framework provided for forums for supervisory convergence and information exchange. In short, the process towards a framework started with a committee that the Council mandated to find ways to improve the implementation of the FSAP within the securities market. The European Council approved the approach. Then, a negotiation started on what to do with the two other sectors of the financial system. The national leaders decided to extend the approach. In this section, I will first present the setting for the reform, then the template-based process, before I set out the agreed framework.

5.2.1 The Financial Services Action Plan – A Prelude to Reform

The Cardiff European Council in June 1998 laid the foundation for a new phase of governance of the financial system. The Single Market and the EMU had triggered the formation of large-scale financial institutions and challenged the traditional mode of regulation and supervision, while the Single Currency and the enlargement of the EU set off further restructuring of the banking system (Quaglia, 2007: 279). Following the introduction of the euro, the European Council (1998) emphasized that deeper financial integration was needed to achieve full economic potential. The euro was a “convenient vehicle for re-establishing completion of the single financial market on the agenda” (Mügge, 2006: 1013). The British presidency had this priority high on its agenda, and the Council asked the Commission to produce what was to become the Financial Services Action Plan (FSAP). The FSAP (1999-2005) was the first overarching policy at EU level for the financial system (Spendzharova, 2012: 316). The purpose was to remove the remaining regulatory and market barriers that limited cross-border provision of financial services and free flow of capital, and create a “level playing field” (De Haan et al., 2009: 36). According to Mügge (2006: 1013-14), the most ardent advocates were large firms.

The FSAP replaced the Investment Service Directive, even though the directive was not implemented in many countries at the time, and continued to support the two-pronged approach
of combining directives with national law (Jackson, 2010: 6-7; Mügge, 2006: 1013). The 42 articles were intended to meet three objectives: a single wholesale market, an open and secure retail market, and state-of-the-art rules and supervision. The cornerstone of the FSAP is the Markets in Financial Instruments Directive that introduced the concept of ‘maximum harmonization’. It sets the maximum allowable standard for national legislation. The action field of the passport principle was extended. The Capital Requirement Directive (CRD) laid down new capital-adequacy rules for banks and was based on the 2004 Basel II Capital Accord. The aim was to ensure financial soundness by allowing the financial institutions to use their internal risk management models to calculate their own capital requirement. In the next subsection, I present how the framework came about. The blueprint for reform was a report on the securities market by an expert committee with a distinct mandate.

5.2.2 The Process Towards a Framework – It Started With the Securities Market

When the Action Plan was approved, the pressure to overhaul governance mounted (Mügge, 2006: 1014). Due to slow implementation of the FSAP – it was argued that it was not possible to implement within 2005 – the French presidency arranged for the Council to appoint a ‘Committee of Wise Men’ to discuss the securities market (Ibid; Quaglia, 2010b: 35; Spendzharova, 2012: 316). Alexandre Lamfalussy, former President of the European Monetary Institute (precursor of the ECB), was its chair, and it discussed the best ways and measures to adopt the FSAP, and adapt EU regulation to a changing financial marketplace. The mandate given to the Council in July 2000 limited the discussion to “practical implementation of the directives by the competent national authorities” in the securities market, and underscored specifically that the Committee “will not […] deal with the prudential supervision” (Lamfalussy, 2000: 29-30).

The final report on the securities market was published in February 2001. The European Council endorsed the approach the same year (De Haan et al., 2009: 54). The Lamfalussy Report on the securities market was a real trigger for the debate on financial supervision (Quaglia, 2010b: 37-39). In April 2002, Hans Eichel and Gordon Brown, the finance ministers of Germany and Britain, launched a joint banking initiative to create a modern and effective supervisory structure at the EU level – a European Stability Forum – where the final responsibility would lay at the national level. This was criticized heavily, especially by central
bankers who stood to lose influence. There were negotiations throughout 2002, and in December the Council adopted a proposal from Economic and Financial Committee (EFC; 2002) to extend the securities market framework of Lamfalussy to the banking and securities sector, and included the involvement of the ECB. It was set in place in 2003 and 2004. In the next sub-section, I will describe the institutional set-up of Phase 1. The cooperation on supervision happened in three Level 3 Committees, but they merely performed an advisory role at the micro level.

5.2.3 The Lamfalussy Framework (2000-2002)

The Lamfalussy Framework deviated considerably from what a comprehensive financial stability demands. It consolidated a Type 2 financial stability framework, where national autonomy and financial efficiency were the main principles (see Table 4). In this sub-section, I will present the framework by linking it with the three analytical dimensions, presented in chapter 3.4.2. In short, the Lamfalussy Framework institutionalized cooperation on regulatory micro matters (aggregation dimension), preserved supervision as a national competence (governance dimension), and institutionalized a sectoral approach (functional scope dimension).

The level of aggregation of the Lamfalussy Framework was barely micro. It brought above all a change in how to make and implement rules and coordinate supervision, away from the traditional, limited directive of the pre-framework phase (Quaglia, 2010b: 35). Lamfalussy reorganized the financial market governance from a minimal set of rules with ‘thin’ institutional arrangements into institutional framework, with four levels following the policy circle (Kudrna, 2016: 74; Lamfalussy, 2001; Quaglia, 2007: 269).12 The most consequential governance innovation – and most relevant for this thesis – was the three micro Level 3 Committees: the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) (Kudrna, 2016: 74). CEBS replaced the informal Groupe de Contact.

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12 The first two levels regarded creation of regulation, while the last two levels concerned consistent implementation (House of Lords, 2009a: 12). Financial regulation was now definitely an EU level matter, while financial supervision remained essentially a responsibility for the Member States and with little EU competence. At the political Level 1, legislative acts – the principles – was made under co-decision procedure (Ibid; Lamfalussy, 2001: 19). The technocratic Level 2 Committees, led by the Commission, created “a second tier of more detailed regulation” and fulfilled “a quasi rule-making power” (House of Lords, 2009b: Q622). Level 4 concerned the enforcement of Community rules; the European Commission checked the accurate transposition into national law (Lamfalussy, 2001: 40).
They were provided with an explicit mandate, a binding work program, a budget, and assigned independent expertise. They advised the European Commission in the draft to Level 2 legislation. The Level 3 Committees consisted of the authorities of the Member States, each with the right to vote (Quaglia, 2007: 272). The European Commission had observer status, while the national central banks and the ECB took part without a vote. The Level 3 Committees had no role in prudential supervision.

**Figure 11: The Lamfalussy Framework**

The level of governance continued to be national, even though the financial system was integrated through the Single Market. The Level 3 Committees were not in charge of day-to-day microprudential supervision, which was a national competence. They brought together supervisors and were forums for information exchange, supervisory convergence, and development of best practices (House of Lords, 2009a: 13-14). They could only issue non-binding guidance, and had a purely advisory role (Lannoo, 2008: 29). Lamfalussy (2001: 37) described it as a “cooperative network” for consistent transposition and implementation of Level 1 and 2 legislation by national supervisors, but, as The Swedish Central Bank Governor
Ingves (2007: 294) underscored, they did not have “any legal powers”. The mandate was essentially regulatory, and did not include supervisory matters or rights to sanction (Lannoo, 2008: 29). They acted as “an informal mediator, often coming up with the broadest possible consensus to come to an agreement between the member states” (Ibid). The functional scope was sectoral.

The Lamfalussy Framework was genuinely nationally and consensually oriented. The Member States neither pooled nor delegated supervisory powers. The framework cemented ‘a common space without a state’ through constitutional asymmetry between negative and positive integration. With only micro level of aggregation, the level of governance and the functional scope become less decisive from a financial stability perspective. The result of the fragmentation between negative and positive financial integration and the micro approach of the Lamfalussy Framework is an underprovision of the collective good of financial stability. In the next section, I will present the reform process and the framework resulting from the financial crisis.

5.3 Phase 2: The de Larosière Reform (2009) – “We Are All Macroprudentialists Now”

The financial crisis compelled reforms and forced new thinking. These reforms brought an innovation: a macroprudential institution. However, it did not come with any binding powers, and macroprudential supervision and crisis management remained a national matter. Compared to the Lamfalussy Framework, the de Larosière Framework entailed an incremental movement along the aggregation and functional scope dimension, but not along the governance dimension. Phase 2 was an ‘in-between phase’, before the more far-reaching Banking Union reforms. The structure of this section reflects the reform process. First, I present the backdrop, then the process, starting with a ‘report’ as the prototype for the negotiations. Last, I present the agreed framework.

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13 The main mean of the Council to strengthen microprudential supervision was through supervisory colleges, chaired by the home supervisor, which functioned ad hoc and were established in case of cross-border financial institutions (Lannoo, 2008: 30-34). A basic problem is that the home country is supposed to have the full picture and it was questionable if they work in times of crises. The bilateral MoUs were the legal basis, and were not binding. MoUs were also used as a framework to share information and coordinate various authorities to contribute to financial instability and crisis management. Thus, multilateral coordination was very weak (Aglietta, 1999: 23).
5.3.1 The Financial Crisis and the Need for Reform

There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient. [...] The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently, the commercial banks, a core segment of the financial system, may be less vulnerable today to credit or economic shocks (International Monetary Fund, 2006: 51).

Prior to the financial crisis, much of the attention was directed towards microprudential supervision, such as this IFM report illustrates, but the crisis changed the perceptions of self-correcting markets (Quaglia, 2013: 82).14 These perceptions were mirrored in the Lamfalussy Framework. The financial crisis revealed serious weaknesses. The EU supervisory convergence had been “insufficient” (Spendzharova, 2012: 316). In fact, “systemic risk is THE risk financial regulation failed to capture” (Noyer, 2009: II). At the time of the crisis, the largest 43 cross-border banks in the EU held 77 percent of the total EU bank assets (House of Lords, 2009a).15 Financial supervisors had focused on microprudential approaches and “not sufficiently” on macrosystemic risk (De Larosière et al., 2009: 11). “Micro-level prudential regulation is not a substitute for a macroprudential policy” (Noyer, 2009: II). Around a quarter of Europe’s GDP was given as aid to financial institutions (De Larosière et al., 2009: 8-9).

It created a political momentum for an institutional reform, but had the costs “not been that high, ‘business as usual’ would have continued” (Caravelis, 2010: 1; House of Lords, 2009a: 27). The European Council (2009: 1) “took a number of decisions intended to lead to the creation of a new financial supervisory architecture with the aim of protecting the European financial system from future risks and ensuring that the mistakes of the past can never be repeated”. How to agree on the structure and powers of a new macroprudential body was “a subject of much controversy” (House of Lords, 2009a: 27). In the next sub-section, I present how the framework came about. The blueprint for reform this time as well was a report, and prudential supervision, crisis management, and systemic risk oversight was all part of the mandate of the group.

14 The Turner Review presents five core assumptions of the pre-financial crisis intellectual mindset that previous regulations have been built on. The theory of efficient and rational markets is central (FSA, 2009: 39).
15 There are 5,000 banks in Europe, so the great majority are small and medium-sized domestic or regional institutions (De Larosière et al., 2009: 10).
5.3.2 A Crisis-Driven Reform Process

After three decades with policies where the financial institutions had been conferred ever increasing autonomy to oversee themselves, the course was overturned in little over six months (Baker, 2013a: 6). In October 2008, the European Commission mandated Jacques de Larosière to chair a expert group to produce a report with advice on the future financial regulation and supervision in the EU (De Larosière et al., 2009: 1; Quaglia, 2013: 79). He was the former governor of Bank of France and the former managing director of IMF. The group was mandated this time to look at how to organize prudential supervision, strengthen cooperation on financial stability oversight, early warning mechanisms, and crisis management (De Larosi ère et al., 2009: 69-70). De Larosi ère et al. (2009: 35) anticipated political problems related to pooling of EU taxpayer money (the national deposit guarantee funds) and therefore rejected it.

The report was published in February 2009 (De Larosière et al., 2009). The report built on a simple, inductive premise: ‘‘learn from the real and important supervisory failures’; then device a new architecture of supervision’ (Caravelis, 2010: 2). The report became the blueprint for the new framework. It was built on the Lamfalussy Framework with some important innovations (Kudrna, 2016: 77). Macroprudential oversight was suggested to be executed by a European Systemic Risk Council (De Larosière et al., 2009: 44). The group proposed that it should be composed of members of the General Council of the ECB/ESCB,16 the chairs of new supervisory agencies, and one representative of the European Commission. They recommended that the President of the ECB should chair it, with support by an ECB-led secretariat.

In May 2009, the European Commission (2009a) approved the recommendations, but made some suggestions related to the configuration, voting rights and addressee warning of this new body through a package of five draft legislative acts (Caravelis, 2010: 1). In June, the Council endorsed the Communication and agreed that a European Systemic Risk Board (ESRB) should be established, “without legal personality” (Council, 2009: 8). The Council added a Steering Committee, and stressed that decisions under the new mechanisms “should not impinge on the fiscal responsibilities of the Member States” (Ibid: 11). In June, the European Council (2009: 7) agreed to the new framework, and decided that the members of the General

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16 The General Council members: The President and the Vice-President of the ECB, and the Governors of the 27 central banks.
Council will elect the chair. In the next sub-section, I will describe the institutional set-up of Phase 2. The macroprudential ESRB was the core innovation.

### 5.3.3 The de Larosière Framework (2009)

The de Larosière Framework introduced financial stability as an element of the institutional structures at the EU level. However, it did not alter the nature of the framework as an efficiency- and autonomy-focused Type 2 system, rather than a stability-based Type 1 or Type 3 system. The de Larosière Framework, or the European System of Financial Supervisors (ESFS), was more or less an piecemeal upgrading of the Lamfalussy Framework, but with one major institutional innovation, a macroprudential body (Quaglia, 2013: 79; Spendzharova, 2012: 318). The framework has two components: three European Supervisory Authorities (ESAs) and the ESRB. The ESFS is, in the words of the Council (2009: 11), “an operational European network with shared and mutually reinforcing responsibilities”. In this sub-section, I will apply the three analytical dimensions on the framework. The de Larosière Framework preserved financial stability policies as a national competence, but introduced macroprudential oversight on the systemic level.

The creation of the ESRB entailed an incremental movement towards macro level of aggregation. The systemic risk perspective became a part of the institutional framework. The task of the ESRB is to mitigate systemic risk in normal times (OJ, 2010a). It conducts macroprudential oversight over the entire financial system and is an independent body. The ESRB issues warnings and recommendations, public or confidential, and monitors the compliance by the so-called ‘act or explain’ mechanism. If the addressees do not act, they have to justify it. No new financial stability instruments were added to the framework.
The level of governance of financial stability policy continued to be exercised at the national level, and did not address the constitutional asymmetry between negative and positive integration. The ESRB has no binding powers upon the Member States, and can be seen as a ‘reputational’ body where its most powerful measure is its moral authority (European Commission, 2009b: 5). It has a “very narrow mandate”, and less power than the ESAs (Caravelis, 2010: 6-8). The ECB and the central banks dominate, but supervisors are also involved (OJ, 2010a). The ESRB has a General Board, taking decisions, and a Steering Committee that prepares the board meetings. The European Commission and the Council extended members with voting rights at General Board with three leaders from the Advisory Scientific Committee and the Advisory Technical Committee of the ESRB, compared to the suggestion by de Larosière. The supervisors and the president of the EFC can participate, but not vote. The General Board meets at least four times a year. The ESRB relies on the goodwill
of the different national microprudential bodies to get the information it needs. According to Spendzharova (2012: 317), the body has been “fairly uncontroversial”. The functional scope of the ESRB is system-wide.

The ESFS transformed the three Lamfalussy Committees into microprudential ESAs: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). The day-to-day supervision was still a national responsibility, hence the supervision at EU level became intervention-based (Chiu, 2015: 72). The ESAs are still responsible for supervisory convergence, but now have the power to settle disagreements between national agencies and issue supervisory guidelines with binding effect, and if necessary, they can address the decision directly to the financial institutions (OJ, 2010b, 2010c, 2010d). The ESAs coordinate in a Joint Committee.

Despite the new macroprudential and systemic emphasis, the new framework underprovides the collective good of financial stability as long as there is asymmetry between negative and positive integration and lack of macro instruments. The institutional competence to addressing financial stability continued to be national, while the systemic risk was European. In the next section, I will present the framework and the reform process resulting from the European debt crisis.

5.4 Phase 3: The Banking Union Reforms (2012-2013) – New Instruments for the Banking Sector

In this section, I will introduce the current phase and identify the status of the Banking Union along the three dimensions. The Banking Union reforms had many components, but the main developments was new financial stability instruments for systemic supervision, crisis resolution, and recapitalization (aggregation dimension), and that the ECB shared the responsibility for the use of macroprudential instruments with national authorities (governance dimension). The reforms only concerned banks (functional scope dimension). The Banking Union supplemented the de Larosière Framework. In this section, I will first present how the financial crisis evolved to a sovereign debt crisis, before I introduce the different stages of the reform process. Finally, I set out the new financial stability framework of the Banking Union.
5.4.1 The European Debt Crisis and the Need for Further Reform

The financial crisis forced many Member States to rescue overextended banks (Boin, Ekengren, & Rhinard, 2013: 126). The European Commission (2008) stressed that it was only the Member States that had the legal power and funds of taxpayer money for “rescue plans” and direct intervention in financial institution. The crisis led to a greater segmentation and disintegration of the financial system, where cross-border banks pulled back to their domestic markets (Epstein & Rhodes, 2016: 416). The ECB had an increasingly important role during the crisis to counteract this effect; it had to replace private funding with central bank liquidity. In an early stage, it cut the base rate historically low, provided cheap, unlimited liquidity to banks, and executed quantitative easing (Boin et al., 2013: 127). Later, the ECB supported the banks’ investment in national debt in disproportionate volumes, and thereby strengthened the ties and the linked vulnerabilities between states and banks (Epstein & Rhodes, 2016: 416). The result is a “doom loop” – a vicious circle (Gros, 2013: 93). Thus, the risk became concentrated in the Eurozone during the crisis (Epstein & Rhodes, 2016: 417). According to Financial Times’ columnist Wolf (2012), the Eurozone had “no effective way” to sustain the banking system or finance troubled countries, and it paved way for improvisation where “the eurozone’s aircraft is being redesigned while crashing”. The de Larosière reform was not seen at the time as a preliminary framework, but the European policymakers left many of the identified fundamental flaws of the financial governance intact (Chiu, 2015: 72; Jones, 2015a: 52).

The development from a crisis of financial institutions to a sovereign debt crisis added a distributive element (Hennessy, 2014: 159). The breakup of the Eurozone was a possible outcome. The prevailing “soft coordination approach” did not seem effective, and the proposal of a binding banking union actualized (Ibid: 161). The intention behind the Banking Union was to delink the destinies of banks from the fate of states (Gros, 2013: 93). It was the first time different pieces of a comprehensive framework were “brought together in a consistent manner” (Jones, 2015a: 61). In the next sub-section, I will introduce the different elements of the new macroprudential framework.
5.4.2 The Financial Stability Framework of the Banking Union (2012-2013)

The Banking Union Framework strengthens the EU financial stability framework. It drives the EU towards a Type 3 system, where financial stability is a great concern and the national autonomy forgoes. The outcome of the reform process was several new institutions with financial stability purposes: a single banking supervisor, a single banking resolution authority, and a mechanism for direct recapitalization of banks. The reform institutionalized the macro approach to the financial stability with effective tools at the systemic level, but it was precisely delimited to only one of the financial sectors and has an intergovernmental character. In other words, the Banking Union has a macro level of aggregation, intergovernmental level of governance, and a banking functional scope. In this sub-section, I will describe the framework by using the analytical dimensions.

The level of aggregation is now macro. Beside its role in monetary policy, the ECB performs two essential functions: (i) Microprudential supervision through the Single Supervision Mechanism (SSM), and (ii) macroprudential supervision through the ESRB at EU level and its Banking Union macroprudential powers (European Parliament, 2016: 4). Hence, the new system of banking supervision in the EU, the SSM, complements the Phase 2 institution ESRB. The Single Resolution Mechanism (SRM) is another institution intended “to ensure an orderly resolution of failing banks with minimal costs to taxpayers and to the real economy” (European Central Bank, 2017b). The European Stability Mechanism (ESM, 2017), the permanent bailout fund, complements the SSM and the SRM through its ‘direct recapitalization instrument’. The new EU level financial stability instruments, with systemic supervision, crisis resolution, and recapitalization, can directly address systemic risk and preserve stability (see chapter 2.2 and 3.4.2). However, functional scope is severely limited with only banking being included in the Banking Union reform. The ESRB executes system-wide macroprudential analyses, but the national authorities still execute the policy instruments and supervise the financial institutions of securities and insurance.
The level of governance is now ‘intergovernmental’. The ECB has a renewed and more comprehensive role in macroprudential supervision; it shares power with national authorities in the use of macroprudential instruments to mitigate the systemic risks (McPhilemy, 2016: 526). The ECB/SSM can only impose stricter requirements than those at the national level (European Parliament, 2016: 4; OJ, 2013: Article 5). It can only use instruments harmonized under EU law. The national macroprudential authorities, predominantly central banks, have preserved the power to calibrate the macroprudential tools (McPhilemy, 2016: 534-37). The instruments can be exercised by the ECB at the level of individual countries, groups of countries, or all Banking Union Member States (McPhilemy, 2016: 537). The ECB macroprudential powers are less comprehensive than its microprudential powers.

The intergovernmental character derives from the decision-making structure of the two pillars of the Banking Union, the SSM and the SRB. The SSM supervises 126 ‘significant banks’ that hold 82 percent of the banking assets in the euro area (European Central Bank, 2017c). Each significant bank, defined by certain criteria, has its own Joint Supervisory Team – comprised by the ECB and national supervisors – that conduct the supervision. It also instructs and guides the national authorities on how to supervise the other 6,000 ‘less significant banks’ (OJ, 2013: Article 4, 6). Decision-making on microprudential issues are executed by the new intergovernmental SSM Supervisory Board consisting of mainly national supervisors, while in macroprudential matters the intergovernmental Governing Council of the ECB takes the final decision (European Central Bank, 2014).

The other pillar is the SRM, and it has two components: The Single Resolution Board (SRB) and the Single Resolution Fund (SRF) (European Central Bank, 2017b). The SRB is the main decision-making body, and it determines resolution schemes for failing banks (the operation of resolution instruments and the service of the SRF), is responsible for all SRF

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At both levels, the ESCB dominates: 28 of 38 voting members of the ESRB is central bankers, and 21 of 28 Member States has delegated domestic macroprudential policy to the central banks (McPhilemy, 2016: 526-27).
resolution cases (regardless of the size of the bank), has the final responsibility for all the banks, and can choose to apply its powers at any time. The SRF is a supranational fund to resolve failing banks when other options have been unsuccessful, and is financed by banking sector contributions. When the SRB takes decisions about measures, it takes into account the warnings and recommendations of the ESRB due to the potential systemic risk of all institutions (OJ, 2014: recital 46-47). The Council (2013b) can, acting by simple majority, object or call for changes, on proposal from the European Commission. Decisions with significant implications for the SRF needs a two-thirds majority of the SRB, representing 50 percent of the contributions (Howarth & Quaglia, 2014: 134). The SSM supervisory board, SRM executive board and plenary council, the Council, and the European Commission needs to approve the ‘close down’ of a bank.

For banks, the SRM is the front-line measure, while the ESM (2017) is only an instrument of last resort. The ESM is intergovernmental – requires unanimity among its member states – and does not mutualize debt at the EU level (Gocaj & Meunier, 2013: 250). The foundation of the Banking Union is the Single Rulebook that contains rules on capital requirements, recovery and resolution processes, and a system of harmonized national Deposit Guarantee Schemes (European Central Bank, 2017a). This package applies to all EU Member States. In the next sub-section, I describe how the reform process evolved. It proceeded in a less uniform manner than the previous reform processes.

5.4.3 An Extensive Process

In October 2009, the true extent of the Greek government’s financial problems was revealed (Hennessy, 2014: 160). The ECB disarmed a crisis in the financial markets in 2010 when the Greek, Irish and Portuguese debt defaults were an impending danger (Epstein & Rhodes, 2016: 420; Jones & Fuller, 2015: 343-44). The Eurozone hastily created the European Financial Stability Facility and the European Financial Stability Mechanism, which were only temporary measurement without any treaty basis. The ECB continued to prevent a Europe-wide banking crisis in 2011 and 2012 through its long-term refinancing operations (LTROs). During these

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18 The SRB consists of an executive director, four appointed members and the national resolution authorities (Howarth & Quaglia, 2014: 134). The ECB and the European Commission are only observers.
19 After eight years of merging of ‘national compartments’, it is supposed to reach around 1 percent of the amount of covered deposits.
20 The ESM replaced them later.
tumultuous circumstances, EU policy-makers started a fundamental reconstruction of the banking sector, and it culminated in the launch of the SSM, the basis of a banking union, in November 2014 (McPhilemy, 2016: 526-34). The process towards a deeper reform of the prudential framework achieved in Phase 3 was less consolidated and linear, and the focal point was almost exclusively on the banks.

In spring of 2012, the President of the European Commission (2012) introduced the concept of a banking union that the European Council (2012) formally accepted the Banking Union during the fall, and to establish a single supervision mechanism. They advanced the idea of a single rulebook, and acknowledged the European Commission proposal of a single resolution mechanism. The Council (2012) agreed that the ECB would “be responsible for the overall functioning of the SSM”, and have “direct oversight of eurozone banks, although in a differentiated way and in close cooperation with national supervisory authorities”. The Council (2013a) adopted the SSM legislation during the fall of 2013. The design of the SRM, formally proposed by European Commission (2013a) during the summer of 2013, was highly controversial and incurred much debate both before and after the proposal. The European Commission had placed itself as the ultimate decision-maker of resolution (Howarth & Quaglia, 2015: 157-59). Later that year, the Council made a compromise. First, the SRB got the decision-making power for cross-border banks (Howarth & Quaglia, 2015: 157-59). Second, bank levies were going to finance the SRF. Third, the opposition accepted bail-in rules (initial losses on private sector bonds and shareholders). The European Council (2013a, 2013b) confirmed during the spring of 2013 the framework for direct recapitalization by the ESM following the establishment of the SSM. In the next chapter, I will analyse this crisis-driven evolution of the financial stability framework.
6 The Unfolding of the Failing Forward Dynamic

From the pre-framework phase through to the three phases that I identified in the previous chapter, the financial stability framework has evolved significantly. As Table 7 shows, it has developed from a framework without macroprudential institutions to a structure with a systemic risk oversight board, and highly developed financial stability architecture for the banking sector. In this chapter, I will attempt to explain the evolution of the financial stability framework. The two mechanisms presented in chapter 4, the belief system mechanism and the lowest common denominator mechanism, are the main tools. I will structure the analysis around them. In the last sub-section, I present the findings through a discussion of the three theoretical expectations generated from the revised failing forward argument. I find that the belief system mechanism – affecting primarily the level of aggregation dimension – was increased the policy menu from Phase 1 to Phase 3. Due to the epistemic deficit along the level of aggregation dimension, the lowest common denominator mechanism was less decisive in the two first phases. However, it came to play an important role in Phase 3, where Germany watered down the governance structures.

<table>
<thead>
<tr>
<th>Phases and dimensions</th>
<th>Institutional reforms</th>
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<td>Level of governance</td>
<td>National</td>
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<td>Level of aggregation</td>
<td>Micro</td>
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<td>Functional scope</td>
<td>Sectoral</td>
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Source: The author
6.1 Phase 1: Introduction of the First Framework, but Not the Last …

In chapter 5.2.3, I described the first EU supervisory framework. The Lamfalussy Framework included a national level of governance and a micro level of aggregation. In this section, I will analyse how the two mechanisms affected this outcome. The Financial Services Action Plan (FSAP) highlighted the lack of governance capabilities in the pre-framework phase to implement the new directives. This experience led to social learning along the governance dimension, and thereby extended the policy menu. As there was no learning on financial stability, the policy menu did not develop along the aggregation or functional scope dimensions. The rational expectations tradition proved dominant, while the belief system mechanism limited the policy menu decisively. Bargaining concentrated on the level of governance. The preferences along the aggregation dimension converged, and the decision-makers accepted these elements from the policy menu. The sectoral approach continued; a system-wide approach was not on the table. The lowest common denominator mechanism limited the choices the from already small belief system mechanism-generated policy menu. The compromises proposed were close to the preferences of the two least forthcoming governments – Germany and Britain. First, I analyse the effect of the belief system mechanism on the creation of the policy menu, and then present the analysis of the effect of the lowest common denominator mechanism on the choice deriving from it.

6.1.1 Creation of the Policy Menu – Learning Along the Governance Dimension

In this sub-section, I will analyse how social learning and the prevailing belief system prepared for a framework with a micro level of aggregation, national the level of governance, with a sectional functional scope. First, I will describe the societal currents dominating at the time, before I analyse how it materialized in the policy menu through the Lamfalussy Report. I find that social learning did not extend the policy menu along the functional scope and aggregation dimensions, but slightly along the governance dimension. The prevailing paradigm was in the rational expectations tradition.

The content of the policy menu of financial regulation prior to the Lamfalussy process was minimum harmonization which sets the ‘floor’ standard of regulation, and increased access
for financial institutions to operate across borders through an extended passport principle. In addition, the first Capital Requirement Directive (CRD) arranged for financial institutions to use their internal risk models to calculate their own prudential capital requirement. All these measures were introduced in the FSAP, and lay safely within the rational expectations tradition. As Baker (2013a) writes, supervisors assessed the internal risk models and concentrated on IT capacity, and not on results and risks. Development of the policy menu is a result of social learning. The background for the Lamfalussy reform process was an experience of inefficient implementation of the FSAP directives along the governance dimension, and not policy failure of supervision or financial stability. The hegemonic ‘light touch’ approach to supervision was not challenged, and so no social learning on financial stability policy followed from it. The aggregation and functional scope dimension of the policy menu remained unaltered. Along the aggregation dimension, the thinking at the time seemed to be that as long as the national supervisors adopted and implemented the EU regulation of the FSAP, the national orientation of financial supervision did not provide any reason to worry.

The Lamfalussy Report, a blueprint for reform of the securities market, filtered the broader policy menu and translated it into concrete policy proposals. However, the Council narrowed the mandate, and confined it within the prevailing policy paradigm. Within the rational expectations tradition, the delimitation along the aggregation dimension from the Council was self-evident; there was no need to discuss European prudential supervision. Still, national preferences may have influenced this part of the mandate, as will be briefly discussed in the next sub-section. The policy menu of the Lamfalussy Committee provided new instruments to exchange information and develop best practices in a non-binding cooperative network. The overall understanding of the financial system as rational and self-equilibrating persisted. Due to the mandate, it only contained micro level of aggregation. The idea of an efficient market where firms secure their own resilience delimited the size of the policy menu.

Along the governance dimension, the policy menu only offered coordination among national microprudential supervisors. The Committee stated that there was “no serious alternative available” and “strongly believes that the approach recommended in this report is the only way forward” (Lamfalussy, 2001: 8). Other options, like a single European regulatory authority of the securities market, were “impractical” (Ibid). The belief system mechanism, which is a product of social learning, reduced the content of the policy menu substantially. I traced the social learning from the FSAP implementation in the development along the
governance dimension. It was only social learning along the governance dimension, thus the menu did not develop on other dimensions. The policy menu, filtered through the belief system mechanism, is the point of departure for the decision-makers. In the next sub-section, I will analyse how the decision-makers make their choices from the policy menu.

6.1.2 The Choice from the Policy Menu – The Struggle Along the Governance Dimension

In the previous sub-section, I found that social learning did not extend the policy menu along the functional scope and aggregation dimensions, though it did exert some influence along the governance dimension. The rational expectations tradition was the hegemonic paradigm. In this sub-section, I will explain the decision-makers’ selection from the policy menu.

The negotiations on the selection from the policy menu are concentrated along the governance dimension. As the preferences along the aggregation dimension converged, the policy makers accepted those elements from the policy menu. The Council sealed the aggregation dimension through the mandate to the Lamfalussy Committee, as explained in the previous sub-section and in chapter 5.2.2. It was mainly a result of the dominant rational expectations tradition – the belief system mechanism – but can also have been political insofar as some Member States operated outside the rational expectation tradition. Though my data does not give such indications, the joint initiative of Germany and France on a non-committal European Stability Forum directed some attention on systemic issues. However, it attracted some opposition from supranational actors. The European Parliament (2000, 2002) wanted more emphasis on financial stability in the FSAP and underscored it later in a resolution on prudential supervision rules in 2002. The ECB tried in 2001 to reshape the agenda for reform of prudential supervision as a response to the proposed extension of the Lamfalussy Framework of the securities market to the banking and insurance sectors (European Central Bank, 2001; Lannoo, 2008: 35; Quaglia, 2007: 281). It attempted to enlarge its powers into prudential supervision through the central banks’ responsibility for systemic stability.\textsuperscript{21} The move led to

\textsuperscript{21} It is worth noting that among the central bankers of the ESCB, many downplayed the danger of systemic risk (aggregation dimension) and believed that the nation-based approach (governance dimension) would be sufficient. According to Aglietta (1999: 24), some central bankers did not believe in the possibility of systemic risk or they believed it could be kept under control even without suitable information at the right time. Padoa-Schioppa (1999: 305-06) believed the probability of a systemic risk was “quite small”, and if such an event actually occurs, “the euro area authorities would have the necessary capacity to act” and “[i]n these circumstances the various national arrangements would continue to apply”. He was the member of the ECB’s executive board dealing with banking, and former president of the Basel Committee on Banking Supervision.
a “fierce reaction” from the Council in 2002 (Lannoo, 2008: 36). When the Lamfalussy model – institutional architecture with four levels following the policy circle – gathered support, the ECB worked to be present in the committees (Quaglia, 2010b: 39). It corresponds with what Quaglia (2010b: 38-41) finds; national governments dominated the decision-making, while supranational actors influenced mostly on agenda-setting. As all Member States acknowledged the need for reform, it was a matter of how (Quaglia, 2007: 283-87). In the following text, I will discuss the areas in which the decision-makers shaped the outcome. National preferences diverged to some degree along the governance and functional scope dimensions.

In the run-up to the decision on the mandate for the Lamfalussy Committee on the securities market in 2000, the French Treasury Minister Fabius proposed to create a Paris-based EU super-regulator called the European Securities and Exchange Commission (Crooks & Norman, 2000a). The European Parliament (2000) also expressed openness to “enhance cooperation and coordination among European supervisors (banking, capital markets and insurance), extending beyond sectorial disciplines to cover all types of financial services”. Under pressure from Germany and Britain, France retreated from the proposal, and underlined that the Committee “would not be concerned with making institutional changes to Europe's financial architecture” (Crooks & Norman, 2000b). In this context, we find the political disagreement over the mandate of the Lamfalussy Committee. France wanted the mandate to be “as open as possible” (Crooks, 2000). Britain and Germany wanted to tighten the mandate to avoid any “secret French agenda” to use the Committee to create the Paris-based super-regulator happen (L. Barber, 2000). In Britain, it was described as a “French plot” (Jabko, 2012: 103). The Council narrowed the mandate to “propose adaptations of current practice” (Dickinson, 2000).

The lowest common denominator mechanism had a limited scope of influence while the belief system mechanism exerted a decisive impact through its creation of a severely restricted menu. The impact of the belief system mechanism was most consequential along the aggregation dimension, while the lowest common denominator mechanism influenced the outcome along the governance dimension. Among the three ‘core player’ governments, only France had aspirations for some form of centralized authority at EU level at some stage of the reform process. Britain and Germany were the least forthcoming governments with preferences closest to the status quo, and opposed the initiative forcing France to pull back. The disagreement greatly influenced the mandate of the Lamfalussy Committee. France wanted an
open mandate, while Britain and Germany wanted a narrow mandate that did not deviate from the current division of competences. France, with the most intense preferences had to concede and accept a mandate that did not alter the status quo along the governance dimension.

The Member States accepted the Lamfalussy Framework for the securities market. The joint banking proposal from Britain and Germany was a move to “head off” any increased role of supranational governance from the ECB (T. Barber, 2002). Their proposed Forum should only be a “watchdog” for coordination, and they emphasized in a joint statement that they were “firmly convinced that the appropriate level for supervision is at national level” (Market News International, 2002). It lacked support. As the Member States with the biggest financial sector, Germany and Britain were now the main proponents of extending the Lamfalussy Framework to the other two sectors of the financial system (Quaglia, 2007: 270-87). Italy was obliging, and France approved. In December 2002, the Council decided to extend the framework of Lamfalussy to the banking and insurance sectors, and included a role for the ECB. Lanno (2005) claims that the reason behind the extension of the framework to banking and insurance could be seen as an attempt by financial public authorities, primarily in Britain and Germany, to curb enlarged powers to the ECB, or a pan-European agency (Quaglia, 2010b: 41-42). Extension of the framework was a logical solution (Quaglia, 2007: 283-87). Level 3 Committees were nationally oriented, and broad consensuses structured their guidance. The outcome was located within the ‘Pareto frontier’ of the Member States, which indicates that it did not challenge the bargaining space of the main players, the British and the German government (Quaglia, 2007: 270). Again, Germany and Britain were the least forthcoming governments and wanted to preserve the status quo, and the compromise was close to their position. The lowest common denominator mechanism watered down any substantial change along the governance dimension. Along the functional scope dimension, neither government wanted a system-wide solution, but rather preferred to organize the new framework along sectoral lines. The risk stemming from the interplay between the sectors was not acknowledged.
6.2 Phase 2: Never Let a Good Financial Crisis Go to Waste!

In chapter 5.3.3, I described a new framework that seems like an incremental extension of the Lamfalussy Framework. The de Larosière Framework preserved the national level of governance and the micro level of aggregation. However, the functional scope became system-wide for the systemic oversight, but the overall tendency of the framework was a sectional approach. In the previous section, I found that the social learning extended the policy menu somewhat along the governance dimension, but not along the aggregation or functional scope dimensions. The belief system mechanism limited the policy menu decisively. The lowest common denominator mechanism affected mostly the level of governance. It resulted in an even lower level of governance. In this section, I will analyse how the two mechanisms affected the outcome in Phase 2. Though I find a radical change of perceptions, the policy menu was only incrementally extended along the three dimensions. Along the aggregation dimension, the learning improved only at third order policy, and not along the first and second order. Along the governance dimension, limited social learning took place. The financial crisis did not extend the policy menu beyond oversight and the ‘act or explain’ mechanism. The lowest common denominator mechanism influenced mostly the governance part of the menu, and preserved the national orientation of the governance. The preferences along the aggregation dimension converged, and they accepted those elements from the policy menu. First, I will explain the creation of the menu, and then I will analyse the mechanism behind the selection of the menu.

6.2.1 Creation of the Policy Menu – Piecemeal Development Along the Dimensions

In this sub-section, I will analyse how the belief system mechanism affected the new framework. Generally, the belief system mechanism extended the policy menu incrementally along all three dimensions. I will describe the societal currents dominating at the time, before I analyse how it materialized in a policy menu through the de Larosière Report. I found that the financial crisis only brought modest social learning.

The financial crisis triggered social learning and a subsequent evolution of the policy menu. The incremental nature of the change along the aggregation dimension is striking. A
contingent ideational shift, with only a third order policy change, took place. The financial crisis showed

[...] how surprisingly optimistic the EU was when constructing the internal market for financial services. Regulatory ‘black holes’ that reveal a systematic underestimation of the risks associated with creating a dynamic cross-border market in financial services have emerged from the wreckage (Tranøy, 2011: 281).

The Governor of Bank of France, Noyer (2009) also stressed that the decisive, systematic underestimated black hole of the framework was systemic risk. The financial crisis was an immense anomaly that the rational expectations tradition that the efficient market hypothesis could not explain, and the hegemonic belief system was undermined. Before the crisis, the attitude was that securitization and “slicing and dicing [of] risk” made the system safer, but instead such a diversified system emboldened the financial institution to increase their risk-taking (Borio, 2009: 34). The American professor Eichengreen (2009: 102) emphasized that “[l]ight-touch Anglo-Saxon style regulation failed its crucial test” and a new consensus was being built around a more “heavy-handed approach”. The understanding in the European Commission that “all can be arranged by tailor-made regulation” disappeared (Caravelis, 2010: 7). Deputy Governor for financial stability at the Bank of England Tucker (2011: 2) encouraged a “Gestalt flip to thinking of markets as inefficient, riddled with preferred habitats, imperfect arbitrage, regulatory arbitrage, herding, and inhabited by agents with less than idealized rationality”. The cognitive filter of policymakers “switched”, and resulted in macroprudential reports like the Turner Review, the de Larosière Report, the UN Stiglitz Commission etc., that became the blueprints for reforms (Baker, 2013a: 5-8). Technocratic judgments constituted an ‘interpretive frame’, or what I label a ‘policy menu’, for politicians in an altered policy landscape (Baker, 2013a: 8). For the decision-makers post-financial-crisis, the de Larosière Report transposed the broader social learning into a tangible policy menu. The whole premise of the de Larosière Group, according to Caravelis (2010), was to develop a new policy menu based on learning from previous choices and their effects. This time, the mandate indicated the dimension along which the learning occurred, namely, prudential supervision and financial stability.

The de Larosière Group found a lack of supervisory focus on ‘macrosystemic risk’. To understand the development of the policy menu, we need to assess the order of change along the aggregation dimension. As Baker (2013a) found, it was not a paradigm shift that demanded a change in all three orders, but rather a contingent ideational shift. The quote in the title of chapter 5.3, “we are all macroprudentialists now”, is a paraphrasing of Milton Friedman by the
Head of Research and Policy Analysis in BIS Borio (2009: 32), and denotes a radical change of perceptions. Given that the de Larosière Report represented the social learning from the financial crisis, the trusted experts of the EU policymakers made no substantial learning on second order. However, when the technical knowledge is “not well developed” and the organization capacity is “poor or absent”, as Moschella and Tsingou (2013) found, we can expect an incremental expansion of the policy menu. The FSB, IMF, and BIS (2011a: 3) provide evidence for this expectation: “the identification of systemic risk is a nascent field. No common paradigms yet exist. Further fundamental and applied research is needed, not least to better inform the collection and analysis of data underway”. Naturally, the policy menu created by the de Larosière Group included only the new institution called the ESRB. As they did not propose any new macroprudential instruments, the ESRB mirrors the third order policy change at the time. No second order policies or no binding powers accompanied it, but after all, it addressed the new emphasis on systemic risk. Consequentially, the essence of the new framework could not deviate substantially from the rational expectations tradition.

Along the governance dimension, minimal social learning took place. The trembling experience of the financial crisis did not extend the policy menu beyond oversight and the ‘act or explain’ mechanism (see chapter 5.3.3) at EU level. De Larosière et al. (2009: 58) explained the reasoning for rejecting a broader and more centralized option due to the lack of “irrefutable arguments”. They limited the policy menu because of “doubts of it being implemented at this juncture” (Ibid). The de Larosière Report was written as crisis was going on, thus they may not have recognised the severity. At least, they perceived the rational expectations tradition to be able to explain the financial crisis anomalies. Incremental learning occurred also along the functional scope dimension, as the system-wide ESRB did not alter the sectoral fundament of the framework. In sum, the financial crisis incrementally extended the policy menu. The menu does not address the fundamental shortcomings of the Lamfalussy Framework. The policy menu was largely a continuation of the Lamfalussy Framework. Taken together, De Vries (2009, in Caravelis, 2010: 7) illustrated the piecemeal change along the aggregation and governance dimensions precisely:

So what should be the role of a Systemic Risk Board if it has no clear goal, no instrument and may only give advice? This is like an ECB that cannot set the interest rate, but has to advise national central banks on the interest rate they should set. Pretty much a return to the days of the [European Monetary System] it looks like. At the time local central banks were well advised to follow the lead of the Buba [slang for the Deutsche Bundesbank, my clarification], but often acted otherwise. As national interests prevail in a crisis, the advice is likely not heeded when it is most needed.
6.2.2 The Choice from the Policy Menu – It’s the Governance Dimension, Stupid!

In the previous sub-section, I found that social learning extended the policy menu incrementally along the dimensions. The rational expectations tradition lost its hegemonic position, but still, a paradigm shift did not occur. The menu did not provide financial stability instruments. The Member States believed financial stability could be ensured through national governance. The framework, as described in chapter 5.3.3, was an incremental development from that of Phase 1. No instruments addressed systemic risk, power rested at the national level. The functional scope was only system-wide for the systemic risk oversight. In this sub-section, I will explain the selection from the policy menu by the decision-makers.

The negotiations among the Member States primarily concerned the governance dimension. As the core dilemma was how to weight supranational demands against the desire for national autonomy, the divergence along the two other dimensions was insignificant (Buckley & Howarth, 2010: 120; Schammo, 2012: 777; Spendzharova, 2012: 318). My data does not indicate that any government wanted to introduce new financial stability instruments, as expected as the policy menu did not provide any. Along the governance dimension, neither of the three main governments of the Council, France, Germany, and Britain, wanted change that could significantly impact domestic financial sectors or domestic supervisory frameworks (Buckley & Howarth, 2010: 137). Financial integration generally, and supervision specifically, has always been a sensitive matter for the Member States (Quaglia, 2007: 269). Since the creation of the Single Market, financial sector has always lagged behind. Financial regulation has been an EU matter, while supervision has been national. According to Scharpf (1996), the negative integration of the Single Market arranges for regulatory or jurisdictional competition. Rixen (2013: 441) argues that competition makes governments more receptive of business interests. Governments want to attract financial activity, and lower standards can enhance competitive ability. The British, French and German governments also had the largest financial sectors (Quaglia, 2010a: 1017). The three core states did not wish to inhibit their banks in order to bring about stability, and they resisted any transfer of matters with fiscal implications (Buckley & Howarth, 2010: 127-37). The nature of the integrated, business-oriented, competitive, and nationally sensitive financial system reduced the ambitions for a substantial transfer along the governance dimension from the outset of the bargaining. Consequentially, the divergence of national preferences took place at a low level along the governance
dimension. Fundamentally, all agreed to preserve the day-to-day supervision at the national level (Ibid: 125).

The national preferences of the three core Member States were still mixed (Buckley & Howarth, 2010: 125). In the dilemma, Britain was a vocal supporter of preserving national autonomy. According to Lord Myners, the Financial Services Secretary to the Treasury, Britain has consistently opposed a single EU supervisor and been sceptical to an increased role for the ECB (House of Lords, 2009a: 32; 2009b: Q54). With a large financial sector, Britain has less to gain from centralization of supervision (Rixen, 2013: 441). Consequently, any substantial divergence from status quo was not acceptable. The British government acknowledged the need for an systemic risk board that could provide macroprudential analysis, and emphasized that it needed to be totally independent of the ECB, because supervision should still be a national matter (Ibid; House of Lords, 2009b: Q610-21). They wanted the systemic risk board to be an ‘informing agency’ that reports to the Council, a less binding arrangement along the governance dimension. Despite the lack of EU level crisis management arrangement, Britain did not support EU supervisory powers that could overrule national governments in matters of national taxpayer money. For Britain, movement towards supranational governance was unacceptable, and the British government preferred a less binding choice from the policy menu than the de Larosière Report suggested.

France and Germany had relatively smaller financial sectors than Britain, and hence they were relatively more positive to integration (Rixen, 2013: 449). France continued its longstanding support for more comprehensive solutions (Jabko, 2012: 103-04). As France has a small, but consolidated financial sector, they preferred more integration as they would relatively gain from a more ambitious, European solution (Buckley & Howarth, 2010: 125-28). For all that, the choice of the Frenchman de Larosière to form the blueprint for reform increased French influence, and they appeared as the group’s greatest promoter. Germany was more ambivalent as its financial sector was divided on the reform. The strong private banks stood to gain from a more centralized supervision and therefore preferred it. Many wanted a system modelled on the ESCB or a single supervisor, and feared a lack of economic and supervisory action from the ESRB (Association of German Banks, 2009; Banziger, 2009: 28; BVR, DSGV, VÖB, & VDP, 2009; House of Lords, 2009a: 32).

On the other hand, the influential but smaller saving banks, co-operatives, and semi-public banks only extended qualified support for a systemic risk board and opposed the new
microprudential authorities as they benefited from the ‘protected’ status quo (Buckley & Howarth, 2010: 126-29). Consequently, at least initially, Germany “dragged [its] feet” along with Britain (Jabko, 2012: 103-04). As the proposed framework split the industry between those who would gain and those who would not, the government did not voice strong opinions on the proposed framework of the de Larosière Report, but chose to back the French position during the negotiations (Buckley & Howarth, 2010: 126-28; Hennessy, 2014: 157). In the end, Chancellor Merkel finally embraced the ESRB at the time of the European Council Summit. However, Germany could also potentially veto any profound deviation from the status quo (Buckley & Howarth, 2010: 125-28). In sum, Germany was a moderate force for change along the lines of the de Larosière Report.

In the negotiations, Britain was the least forthcoming government and had national preferences closest to status quo, and could threaten to block or veto proposals outside the bargaining space. This position gave them substantial bargaining power. France, on the other side, with the highest (or at least higher) ambitions, consequently had less. Italy, Portugal and the Netherlands supported the French position (Spendzharova, 2012: 318). When the Council agreed on intricate voting rules and procedures for appeals in December 2009 – in effect, it strengthened the bargaining power of the least forthcoming governments – the British government eased its resistance towards the ESRB and the ESAs (Hennessy, 2014: 158). Britain underlined also that the non-euro countries had to have equal representation at the board and for the participation of national supervisors, and won concessions there (Buckley & Howarth, 2010: 127). The fact that the European Council changed the procedure for election of the ESRB chair was also a concession to the British and other non-euro countries (Begg, 2009: 1120). The President of the ECB no longer had monopoly on the position. In addition, the Council stated explicitly, to accommodate the British government, that the establishment of the ESRB was without legal personality, and that the new framework excluded any fiscal responsibilities for the Member States. The independence of the ESRB from the ECB was a main issue for Britain. Spain, the Czech Republic and a number of new Member States backed the British position (Spendzharova, 2012: 318). The outcome did not correspond to the traditional centralizing ambitions of France, but, according to Hennessy (2014: 157), the ESRB and the ESAs were “hailed as a symbolic French victory over the excesses of Anglo-Saxon capitalism”.

The lowest common denominator mechanism continued to the choices from the already restricted policy menu. The negotiations focused on the governance dimension, as this was the
most controversial part of the policy menu for the Member States. Along the functional scope dimension, my data indicates that the system-wide approach to systemic oversight did not challenge any bargaining spaces. The financial stability instruments were still national, while the financial system was European. Autonomy and efficiency was still a higher priority than safety (Type 2 system). As the European Parliament (2010) stated, “[a] number of Member States, particularly those with large financial centres favoured the limited reform approach. This led to a significant reduction in the scope of proposals of the Commission, and was itself considered by the EP as not going far enough”. As the belief system mechanism limited the policy menu severely – it did not challenge the epistemic deficit – the impact of the lowest common denominator mechanism became less decisive.

6.3 Phase 3: A Paradigm Shift, But Not a Revolution

In chapter 5.4.2, I described a new framework that differed substantially from the de Larosière Framework. The Banking Union had a macro level of governance and an intergovernmental level of governance. However, the functional scope was limited to the banking sector. In the previous section, I found that social learning extended the policy menu slightly along the three dimensions. The belief system mechanism limited the policy menu decisively. However, a system-wide approach to systemic risk oversight developed. The lowest common denominator mechanism affected mostly the governance dimension. It resulted in an even lower level of governance. Phase 2 appears as a ‘fumble phase’ where the response does not correspond to the character of the crisis. In this section, I will analyse how the two mechanisms affected the outcome in Phase 3. I find that the belief system mechanism radically extended the policy menu along the governance dimension, but especially along the aggregation dimension. No social learning occurred along the functional scope dimension. The lowest common denominator mechanism influenced mostly the governance part of the menu, and reduced the governance from supranational to intergovernmental. First, I will explain the creation of the menu, before I analyse the mechanism behind the selection of the menu.

6.3.1 Creation of the Policy Menu – A Radical Extension

In this sub-section, I will analyse how social learning and the prevailing belief system prepared for a reform resulting in macro level of aggregation and intergovernmental level of governance. The functional scope was limited to banking. First, I will explain how the European debt crisis
induced social learning, and then I try to explain how it translated into a new policy menu. I find that social learning radically extended the policy menu along the governance and aggregation dimensions, but not along the functional scope dimension. The Keynesian tradition now dominated. Thus, the menu provided financial stability instruments.

The experience of the European debt crisis induced social learning. The crisis substantially extended the policy menu along the aggregation dimension, but also on level of governance. More precisely, it generated learning on second order policy, and on the problem of asymmetrical integration. The ‘doom loop’ between banks and their sovereign, the different Member States, challenged the choice of policy instruments available at the systemic level. The dominating rational expectations tradition could not address this anomaly, and it undermined its credibility. Member States had to rescue overextended banks following the financial crisis. Banks also invested in national debt but with support from the ECB. The link became very strong. It was primarily a Eurozone problem, but the Eurozone had no instruments to solve the problem collectively. The weaknesses of the de Larosière Framework became strikingly evident. Only the Member States had the legal power, the tools, and funds to rescue and intervene, and that made them vulnerable. The problems, revealed through the financial crisis, went from a crisis of financial institutions to a crisis of sovereign debt, and the distributional consequences became prominent. Financial stability became connected to the fate of the states themselves, and not only of the financial institutions.

The social learning started as response to the shortcomings of the de Larosière Framework. Alternatively, in Jones’ (2015a: 52-55) words, “European policymakers left many of the mechanisms that de Larosière identified at the core of the crisis intact”. Greece, and later Ireland and Portugal, experienced debt problems due to the “death spiral” relationship with their banks. The Eurozone went through a sequence of improvisations. The EU financial system connected the bailouts of the three troubled Member States, both among them and to the rest of the EU. The failure of EU policymakers to deal with this situation caused increased risk for everyone else as well. It affected the conduct and risk assessment of the financial actors. The consequence was a fully developed sovereign debt crisis. Italy and Spain were the next Member States getting into difficulties. Two countries that were too big to fail. The widespread sovereign debt crisis led to “successive waves of emergency policy action, both at the ECB and in the Council” (Jones, 2015a: 58). The measures represented “a fundamental departure” from the “evolution in pre-existing institutions and practices” (Ibid). As described in chapter 5.4.3, it
involved long-term refinancing operations (LTROs). The purpose was to offer unlimited ECB liquidity at low cost, and it would give the banks the opportunity to profit on the difference between this liquidity and the high yields on distressed sovereign debt. Next, the sovereign debt could be used to act as collateral for more ECB loans, and then purchase more sovereign debt (Ibid: 59-60). The effect was short-term, as it would ease the strains on banks, but not on Member States. Thus, the LTROs were not effective. The LTROs reinforced the link between the national banking system and sovereign finances. These ad-hoc efforts could not restore the intellectual consistency of the dominating belief system of rational expectations.

Unlike Phase 1 and 2, there was no blueprint policy menu in Phase 3. There is no report that I can cite in support of social learning and the policy menu of bargains. The promise of the European Council and Euro Area summits in the summer of 2012 indicates social learning. The national leaders promised fundamental reform to secure financial stability (Jones, 2015a: 59-61). The governments wanted to cut the doom loop, and not have to borrow money to bail out their own banks. It was a part of a wider agenda to create a Banking Union. According to Jones (2015a: 61), the single resolution element was more “aspirational” than “real”. It indicates that the leaders acknowledged the need for new financial stability instruments, and that they could not be restricted at the national level of governance. With the Banking Union, single supervision and resolution, and direct recapitalization became available on the menu. To delink the “death spiral”, intergovernmental or supranational governance is a necessary consequence. My data gives no indications that the second order policy learning extended beyond the banking sector.

Taken together, the blueprint-free actions of the EU leaders in this phase can be interpreted as a radical extension of the policy menu, and implicitly a radical evolution of the belief system. The European debt crisis complemented the contingent third order change of the financial crisis, embodied by the systemic risk board, with macroprudential second order policy. The Keynesian tradition with its macroprudential thinking dominated as the three orders of policy now coincided. The new policy menu contained instruments that addressed financial stability proactively (crisis prevention) and reactively (crisis management): macroprudential supervision, recapitalization, and resolution (see chapter 2.2 and 3.4.2). Supranational governance was available on the menu. It was now possible to address the constitutional asymmetry and systemic risk. However, the belief system mechanism did not extend the second order policy beyond banking. The crisis of the Member States itself seemed to have given rise to decisive social learning.
6.3.2 The Choice from the Policy Menu – From Supranational to Intergovernmental Governance

In the previous sub-section, I found that social learning radically extended the policy menu along the governance and aggregation dimensions, but not along the functional scope dimension. The Keynesian tradition became dominant. The menu provided financial stability instruments. The Member States understood that national level of governance was inadequate. The framework described in chapter 5.4.2 was substantially different from that of Phase 2. The new instruments can directly address systemic risk. However, the power is not supranational, but rather intergovernmental. Now, the governments take decisions either unanimously or through pooling of sovereignty. The functional scope became limited to the banking sector for the new financial stability instruments. In this sub-section, I will explain how the new configuration of national preferences translated into a relatively moderate selection along the governance dimension.

Howarth and Quaglia (2013: 111) characterized the process towards the Banking Union as “intense intergovernmental”, where France and Germany were the dominating. The French contended that the Banking Union and ‘social union’ should be prior to the political union (fiscal and macroeconomic policies) urged by Germany (Howarth & Quaglia, 2013: 111). They wanted to construct massive support mechanisms for banks directly rather than indirectly through governments, where the Germans emphasized sustainable Member State budgets. They were disagreements on the fundamental principles of the reform, mainly along the governance dimension like the scope of powers of the ECB and decision-making rules within the ECB (Barker & Spiegel, 2012). The governments of Spain, Italy, Greece and Portugal supported the French stance (Epstein & Rhodes, 2016: 419; Howarth & Quaglia, 2013: 111). These Member States were strongly in favour due to national solvency concerns and wanted an EU bank rescue fund. Consequently, they accepted a transfer of sovereignty. They allied with the European Commission. Germany, along with Denmark, the Netherlands and Finland, opposed EU level supervision and resolution. The reform process was not as coherent and concerted as in Phase 1 and 2, as described in chapter 5.4.3. Therefore, I will present the different elements of the Banking Union reform separated. The scope and interests differ from negotiation to negotiation. The reform consists of three elements: the ESM, the SSM, and the SRM.
The European Stability Mechanism – Bailouts Introduced, But German Status Quo Compromise on Governance

In the aftermath of the financial crisis, neither of the core countries wanted any substantial transfer along the governance dimension, but the European debt crisis changed their national preferences, albeit for different reasons and at different paces (Epstein & Rhodes, 2016: 419). The position of France changed when the great exposure of French banks to Spanish and Italian bank debt become clear in early 2012. Also, as the crisis intensified, the German vision of the Eurozone as ‘no bailout and no debt sharing’ entity crumbled, and was replaced by a new view that “shared burdens came with centralized control” (Spiegel, 2014). Crisis management and resolution was a nationally responsibility. Initially, the Germans, in the words of the finance minister Schäuble, did not want to give an “implicit guarantee” for foreign struggling banks on behalf of its taxpayers (Barker & Spiegel, 2012). The German commitment to the Eurozone has been credible, thus the survival of the Eurozone is a vital interest. Consequentially, they were willing accept a European solution to bailout, but only on German terms.

Germany wanted to trade concessions, pool control over economic policies and steps towards a fiscal union before pooling debt liabilities (Hennessy, 2014: 161). France became the leader of a southern coalition. They, and especially Spain, pushed for direct European recapitalization of banks (Hennessy, 2014: 161; Schimmelfennig, 2015: 183). The intensity of southern preferences was greater, and that gave Germany more bargaining power. According to Schimmelfennig (2015: 187), Germany shaped the terms for integration at each step of the decision-making as a payback for its debt sharing concessions. Financial assistance to failing banks become linked to strict austerity – the ‘fiscal compact’ – and Europeanization of oversight and liquidation (Ibid; Spiegel, 2014). The President of ECB Draghi supported the German position.

Germany, as the least forthcoming government, accepted the ESM to save the Eurozone as it was not in their interest to veto. However, the desire to reduce political risk trumped efficiency concerns of the common decisions. The ESM decisions requires unanimity of the Eurozone, and the debt will not be mutualized at EU level. Germany determined the choice of institutional cooperation, and the consequence was that sovereignty was not constrained. The compromise was a lowest common denominator outcome close to status quo preferences of Germany, and an intergovernmental level of governance instead of one that was supranational. The belief system mechanism made direct recapitalization at EU level available at the decision-
makers’ policy menu, while the lowest common denominator mechanism watered down the outcome along the governance dimension.

**The Single Supervision Mechanism – The Least Forthcoming Government was Less Decisive**

The negotiation over the SSM was not a matter of a micro or macro level of aggregation, but rather on the level of governance. The Member States accepted the need for single supervision as part of the new Banking Union. There were two points of disagreement: the scope of ECB powers – all banks or only cross-border banks, and definition of ‘significant’ and ‘less significant’ banks – and the relationship to non-Eurozone countries (Howarth & Quaglia, 2015: 155). Along the governance dimension, the competitiveness of domestic producers structured national preferences. France was worried of unequal treatment of its five ‘significant banks’ that dominate the French financial system, and advocated that the Banking Union should encompass all Eurozone banks (Barker & Spiegel, 2012; Howarth & Quaglia, 2013: 112; 2015: 155). In other words, they advocated for supranational governance. Germany opposed ECB supervision of their regional Landesbanks and local Sparkassen saving banks (Wilson, Wiesmann, & Barker, 2012). Almost all German banks, beside the two big commercial banks Deutsche Bank and Commerzbank, were nationally focused, thus they had little interest in EU funds, and it would not have had problems bailing out its own banks (Howarth & Quaglia, 2014: 131). Thus, Germany opposed supranational governance. Supranational governance would have benefitted the French industry, as they would have lost the effect of national supervision nonetheless. Compared to Germany, the risk of a collapse in banking liquidity was considerably greater (Howarth & Quaglia, 2014: 131). The Spanish case showed also that a systemic crisis can affect a lot of small institutions, and not necessarily the big ones (Garicano, 2012: 84). The ECB supported the initial SSM proposal of the European Commission, where it was supposed to supervise all banks, in order to secure a ‘level playing field’ (Howarth & Quaglia, 2015: 155). The German practice to regard loans between branches of Landesbanks and between Sparkassen banks as ‘risk free’ benefitted them. They did not need any collateral. These banks exerted significant influence on the German

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22 The last conflict is not relevant for the three dimensions. However, non-Eurozone countries were allowed to opt in (Howarth & Quaglia, 2013: 114-15).
preferences. The Germans accepted the need for the SSM, but Schäuble announced that his government still did not accept full ECB supervision (Epstein & Rhodes, 2016: 422-24).

Again, France had the most ambitious preferences – ECB supervision of all 6,000 banks – while the German government had a position close to status quo – only ECB supervision of the few, major cross-border banks. Germany wanted a €50 billion threshold for direct ECB supervision to ensure that most of its domestic financial industry remained under German control (Epstein & Rhodes, 2016: 422-24). The bargaining ended up in a compromise. The threshold ended up at 60 percent of the German preferences at €30 billion. National supervisors became responsible for the day-to-day supervision of those below them, but the ultimate power rested at the ECB. The ECB now directly supervised the 120 most significant banks, representing 82 percent of the Eurozone banking sector. The Germans won concessions in the establishment of a mediation panel for conflicts between national authorities and the ECB, and through the creation of a supervisory board to secure the independence of the ECB. However, the lowest common denominator mechanism was less influential this time. After all, the least forthcoming government could not stop what was a major shift in sovereignty, but still, Germany watered down the ambition of France, the European Commission, and the ECB to encompass the SSM on all banks. Germany deprived the ECBs direct supervisory power for all but 120 significant banks.

The Single Resolution Mechanism – A Very Complex Compromise

Banking resolution affects core sovereign powers and has great domestic, distributional consequences. In times of a crisis, speed in decision-making is decisive, thus the balance between national autonomy and functional demands is of great importance. The SRM delayed the Banking Union in 2013 because of disagreements along the governance dimension between France, the EU institutions, Italy and the peripheral Eurozone countries on the ambitious side, and Germany and a few Northern Member States on the other (Howarth & Quaglia, 2014: 126-30). The Germans, due to their size and economy, would be a net contributor, and had considerable leverage. According to The Guardian analyst Traynor (2013), the negotiation was a matter of “what chancellor [Merkel] wants, what she does not want, and what she might get in the end”. Germany was concerned with the risk of moral hazard, that Member States would be more permissive towards their banks when EU funds could be used to resolve the banks (Howarth & Quaglia, 2014: 126-34). A core condition of Germany was ‘bail-in’ rules (initial
losses on private sector bonds and shareholders), and that EU funding would only be the result of a long and complex process. France, Italy and Spain resisted bail-in measures and wanted effective decision-making.

The ECB, the European Commission, France and southern governments supported a solution where bank levies funded the Single Resolution Fund (SRF) (Howarth & Quaglia, 2014: 133-35). Germany opposed it, as then a treaty change would be necessary. Rather, they wanted a network of national funds. They feared and expected to be the main contributor to the SRF and that the European Commission decisions would have fiscal implications for the Member States. If the SRF did not have enough resources, it should be national governments and their taxpayers who would step in. France and other Southern Member States argued that the ESM should be the resolution authority of last resort. The German preference was closest to status quo and they could threaten with non-agreement. As Germany had adequate fiscal resources and less to benefit from the SRM, it had more bargaining power than those with fewer resources and had much to gain from a severed relationship to domestic banks. The least forthcoming government Germany managed to exclude the most sensitive element from the regulation – the transfer and pooling of the Member State compartments into a single mutualized fund – and instead it was put in a strictly intergovernmental side agreement where subsequent intergovernmental agreements would determine the activation of the mutualization of the compartments. The SRM could not borrow from the ESM when the national resolution funds are fully merged. The Germans also won a concession of Southern Member States by the inclusion of bail-in rules.

When it comes to centralization of decision-making power, the Germans opposed the initial European Commission proposal where it assigned the ultimate decision-making authority to the European Commission itself, and argued that this would warrant a treaty change (Howarth & Quaglia, 2014: 133-35). The Germans had a much greater interest in reducing political risk by keeping the veto power than to increase the efficiency prerequisite of crisis management. Thus, the commitment was less credible. Pooling or delegation would have reduced the influence of opponents like Germany, and would arrange for solutions that are more ambitious. Instead, Germany required unanimity in voting in the European Council where each Member State can veto. The final agreement was close to the German position on this point, as well on the composition of the Single Resolution Board (SRB) (see chapter 5.4.2). Germany also wanted to reduce the coverage so that the SRM did not include the smaller banks and the
Sparkassen. They preferred a compromise where the scope and decision-making followed that of the SSM. Again, the least forthcoming state Germany managed to weaken the outcome.

The December 2013 agreement of the Member States gave the SRB direct responsibility for only the banks under direct supervision by the ECB and the national authorities for the rest (but the SRM still covered them) (Howarth & Quaglia, 2014: 133-35). The national authorities also got the responsibility to execute the resolution plans of the SRB under control by the SRM. The decision-making power of the SRM became largely decentralized. The SRM “could not require Member States to provide extraordinary public support to any entity under resolution” (European Commission, 2013b). The ECB, the European Parliament and the European Commission together opposed the December deal (Howarth & Quaglia, 2014: 136). The European Parliament adopted a regulation in January 2014 that differed greatly, and that called for a much more effective, depoliticized and centralized solution (Howarth & Quaglia, 2014: 136-37). They strongly opposed the intergovernmental side-agreement. In the 2014 compromise, the European Parliament won limited concessions.

As I wrote in the first paragraph, the SRM bargaining circled around what Germany wanted and not wanted. Germany had considerable bargaining power, and as they would become a net contributor, had little to gain and they preferred a solution close to the status quo. It was the least forthcoming government, and largely defined the terms for integration of the new instrument. The original proposal was supranational, while the final agreement was highly intergovernmental. A minority of the Council has veto power on the use of SRF. To close a bank, there are considerable checks and balances. The decision-making authority, the SRB, is intergovernmental, and the Member States control the mutualization of the SRF. The outcome tended towards the lowest common denominator. Thus, the lowest common denominator mechanism limited the selection from the policy menu along the governance dimension.

6.4 Theoretical Expectations: Findings

During the phases, I have identified two causal mechanisms that can explain why the EU fails forward in the pursuit of financial stability. The belief system mechanism explains the content of the policy menu. The prevailing policy paradigm structures what policy solutions are available. The lowest common denominator mechanism predicts that in bargaining on intensity of preferences, compromises with the least forthcoming government will drive the outcome
towards the lowest common denominator when the governments adhere to (near) unanimity. The mechanism leads to selective choices from the policy menu. Together, they drive the EU towards a failing forward dynamics. In this sub-section, I will sum up the findings of the analysis structured by the theoretical expectations.

Table 8: Summary of the theoretical expectations

<table>
<thead>
<tr>
<th>#</th>
<th>Theoretical expectations</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>The policy menu will evolve in reaction to previous policy choices and their effects.</td>
</tr>
<tr>
<td>1-1</td>
<td>Given the hegemonic position of rational expectations tradition/efficient market hypothesis at the outset of the process under study here, social learning will entail a movement from one end of an economic theory continuum towards a more Keynesian-oriented/macroprudential stance. The more the social learning is parallel in all three orders of policy, the more movement across the continuum.</td>
</tr>
<tr>
<td>2</td>
<td>The EU will introduce incomplete institutional frameworks as a result of lowest common denominator choices from belief system mechanism-generated policy menus.</td>
</tr>
<tr>
<td>3</td>
<td>The incomplete institutional frameworks help spark future crises and should generate social learning and ultimately functional spillovers.</td>
</tr>
</tbody>
</table>

Source: The author

6.4.1 TE1+TE1-1: The Belief System Mechanism

The analysis of the three phases indicates that the reform processes were a result of social learning from previous policy choices. Theoretically, the policy menu is a representation of the prevailing belief system, and the development of the menu depends on social learning.

In Phase 1, there was no learning on financial stability along the aggregation or functional scope dimensions, with some learning along the governance dimension. The rational expectations tradition dominated – no movement along the economic theory continuum – combined with a sectoral approach to supervision. Thus, I find incremental expansion of the policy menu. The belief system mechanism limited the menu considerably.

In Phase 2, the financial crisis induced piecemeal social learning along the three dimensions. Consequently, the policy menu broadened incrementally. Along the aggregation dimension, third order policy learning occurred, but did not come with second order financial stability policy instruments. A contingent ideational shift took place, but the instruments were within the rational expectations tradition. The de Larosière Group did not find ‘irrefutable
arguments’ for deviating from the rational expectations’ range of instruments. Thus, a small movement occurred along the economic theory continuum. Only incremental extension of the policy menu took place along the functional scope dimension. The system-wide approach to the systemic risk oversight did not change the sectoral application of the policy instruments. This social learning marginally extended the level of governance, as the ESRB did not challenge the constitutional asymmetry. The belief system mechanism limited the policy menu decisively, and as no new policy instruments were available, the constitutional asymmetry and sectoral approach continued.

In Phase 3, the European debt crisis substantially extended the policy menu, as the third order learning of Phase 2 was complemented by second order change and the national governance ended. The result of the social learning was a Keynesian-inspired macroprudential belief system. In the social learning process, national level of governance was abandoned. It had created a doom death spiral. However, beside the important extension of the aggregation and governance dimension, no social learning took place along the functional scope, as only the banking sector was on the table. The belief system mechanism extended the policy menu with elements to address systemic risk and constitutional asymmetry within the banking sector.

In sum, the previous policies and their effects in each phase contributed to the evolution of new policy menus. New frameworks are based on earlier frameworks. Social learning along the aggregation dimension entailed a movement towards the Keynesian tradition. We can see that the belief system mechanism had a declining negative effect on the reform outcomes. Gradually, the mechanism expanded the policy menu and reduced the epistemic deficit. The menu was substantially extended from Phase 1 to Phase 3, where Phase 2 was an in-between phase.

6.4.2 TE2: The Lowest Common Denominator Mechanism

In my empirical analysis, I find a tendency where the lowest common denominator affects the selection from the policy menu primarily along the governance dimension. In theoretical terms, bargaining outcomes based on intensity of preferences under (near) unanimity compromises will tend towards the position of the least forthcoming government. The governance dimension was the most controversial dimension. In all phases, the outcome corresponds largely with the status quo positions. The importance of the lowest common denominator mechanism in shaping
the incomplete frameworks increases from Phase 1 to Phase 3, as the belief system mechanism expands the policy menu.

In Phase 1, the decision-makers discussed primarily the level of governance, more than the level of aggregation or functional scope. As the belief system mechanism did not offer any macro level of aggregation or system-wide functional scope on the menu, such solutions were not available for national leaders in the negotiations. The belief system mechanism probably contributed to the limited mandate on prudential matters by the Council, but this explanation is not uni-causal. The mechanism may have reinforced the limited policy menu. The national preferences converged along the aggregation and functional scope dimensions. Along the governance dimension, there were diverging national preferences. France wanted a broad mandate of the securities market blueprint report, and proposed an EU level regulator. However, Britain and Germany, the two least forthcoming governments, opposed the initiative, and the mandate became close to their position of a narrow mandate. This lowest common denominator compromise designed the mandate of the Lamfalussy Committee not to challenge any bargaining spaces of the Member States. The governance of the new framework became close to the status quo preferences of Germany and Britain. Due to the lowest common denominator mechanism, together with the belief system mechanism, the EU introduced incomplete governance. On the two other dimensions, the preferences converged. As the negative impact of the belief system mechanism on the policy menu was pervasive, the effect of the lowest common denominator mechanism on the framework was of less importance. The belief system mechanism was more decisive.

In Phase 2, the policy menu was also small, thanks to the strong impact of the belief system mechanism, but allowed for more scattered national preferences. The latitude of the lowest common denominator mechanism was somewhat greater. The governance dimension was the most controversial bargaining theme. Consequently, the disagreement on governance was a matter of details along the continuum. The work of de Larosière Group reduced the complexity of bargaining, and the conspicuous disagreement was therefore missing, but the least forthcoming government Britain managed to water down the choices from the policy menu. The status quo position gave them more bargaining power than the more ambitious Frenchmen. The lowest common denominator mechanism had impact on the governance dimension – the Member States prioritized national autonomy over supranational efficiency demands – but, again, the negative influence of the belief system mechanism was considerably
more decisive. The lowest common denominator mechanism contributed to the incremental extension of the incomplete EU framework.

In Phase 3, the social learning from the financial crisis considerably extended the policy menu. The importance of the lowest common denominator increased as the policy menu was more extensive. The social learning reconfigured the national preferences. The preferences converged at a macro level of aggregation and a banking sector functional scope, while along the governance dimension they diverged. Hence, it was here that the lowest common denominator mechanism exerted the most influence. The French wanted supranational governance of the ESM, the SSM, and the SRM, while the least forthcoming government Germany opposed it, and wanted intergovernmental governance. The outcome corresponded to a large degree with the German status quo position along the governance dimension. The lowest common denominator mechanism largely structured the incomplete outcome.

The lowest common denominator mechanism had an increasing influence on the incomplete outcomes from Phase 1 to Phase 3, as the policy menu was bigger. When the national leaders select from the policy menu – the lowest common denominator mechanism – they apply the menu defined by the belief system mechanism. In Phase 3, the latitude of the lowest common denominator mechanism to define the outcome was significant as the belief system mechanism had extended the policy menu considerably. The Member States’ preferences converged along the aggregation and functional scope dimensions, and the lowest common denominator mechanism therefore contributed to the incomplete framework by affecting the governance dimension. We can find this pattern in Phase 1 and Phase 2 as well, but less pronounced. In all phases, France had the most intense preferences along the governance dimension, while Britain and Germany wanted to preserve the status quo distribution of governance competences. The tendency is clear, that the latter stance gave significant bargaining powers. As these reforms hinge upon unanimity – neither Britain, Germany, nor France are never overruled in these bargains – the compromises tended towards the preferences of the least forthcoming governments. In every case, France had to give in. The other Member States were positioning themselves behind one of the two stances. The bargaining mode that stems from territorially organized interests locks the Member States into a Scharpfian joint-decision trap. The result is more incomplete frameworks.
6.4.3 TE3: Incompleteness, Crises, Social Learning, and Functional Spillover

The incomplete financial stability frameworks, measured along the three dimensions, have been filtered through the two causal mechanisms discussed in the two previous sub-sections. During the three phases, two major crises took place. The financial crisis took place within the Lamfalussy Framework, and the European debt crisis happened within the de Larosière Framework. The two frameworks seem to spark off crises and functional spillovers. However, is it a causal relationship?

The financial crisis uncovered the incompleteness of the Lamfalussy Framework. It did not address systemic risk, as I described earlier in chapter 5.3.1 and earlier in this chapter. The causal relationship was established by the de Larosière Report, the EU itself, and other heavyweight financial actors. The Lamfalussy Framework did not address systemic risk. The acknowledgement of the incompleteness of the framework set off a functional spillover to direct the financial stability concern. The outcome was the de Larosière Framework. The incrementally extended framework did not address the fundamental shortcomings uncovered by the financial crisis. The European debt crisis illuminated that it did not satisfy the collective goal of financial stability. The incomplete framework did not have financial stability instruments to hinder the sovereign debt crisis. Again, as I explain in chapter 5.4.1 and earlier in this chapter, the financial stability framework did not address fundamental shortcomings. The de Larosière Framework did not delink the ‘death spiraling’ connection between banks and their sovereigns. It set off a learning process with extensive experimentation within the rational expectations tradition. In the end, the learning generated a functional spillover that resulted in the foundation of the financial stability-based Banking Union. There seem to be good reasons to believe that the incomplete institutional frameworks have contributed to crises and that the result of the social learning has been a functional spillover. Functional spillovers take the institutional framework one step closer to meet the demands of the collective goal of financial stability.

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23 In Phase 1, there was no financial stability policy failure, but rather a lack of efficient implementation of the FSAP directives. As there was no previous institutional framework at EU level, the functional spillover from market integration to governance integration was not a result of a crisis.
7 Conclusion

In this thesis, I have been process-tracing the dynamics behind the reforms of the framework for financial stability. The research question was, ‘what characterizes the decision-making logic causing the evolution of the EU financial stability framework?’ The point of departure was an observation of a framework that “produced”, or at least failed to prevent, two major economic and societal disruptions, the financial crisis and the European debt crisis. I aim to identify structural causes, causes beyond the agency of purposeful actors, in order to identify the reasons why the decision-makers constructed incomplete frameworks in the three phases. In other words, identifying the structure the actors must define their strategic choices within (Giddens, 1984). I found two causal mechanisms, one institutional and one epistemic, that together appear to explain the crisis-driven evolution of a financial stability framework that generated deeper integration.

Jones et al. (2015) applied their failing forward argument to the EMU and the euro, and crafted an innovative explanation of why the EU produces incremental and piecemeal reforms that over time lead to deeper integration through functional spillover. Applied to my case study, the failing forward argument is insufficient. Their interwoven puzzles – the leaders being aware of the comprehensive solutions, but rejecting them as a calculated risk due to the short-term political costs even though the leaders oppose the long-term consequences of deeper integration – has less explanatory power in a field with substantial ideational and technical development. To account for the changes in the prevailing paradigm, I have included perspectives on social learning, especially within economic thinking. Heclo (2010 [1974]) and Sacks (1980) assert that changes in policy and policy thinking are based on learning from the previous policy itself.

I employed the procedure of tracing causal mechanisms to identify the steps in the causal process that led to the incomplete outcome. I have generated two mechanisms from the two theoretical approaches. Based on the social learning perspective, the belief system mechanism structures what solutions are available for the decision-makers in the bargaining stage of the process. The lowest common denominator mechanism, based on liberal intergovernmentalism, forms the outcome through specific decision-making logic. In intergovernmental negotiations, where intensity of preferences and unanimity structure bargaining power, the outcome leans towards the lowest common denominator. Together, these two mechanisms define the comprehensiveness of a reform. I use the notion of a policy menu to explain how the two
mechanisms affect the outcome, illustrated in Figure 9. The belief system mechanism is prior in the causal chain, and it defines the policy menu that is available for the national decision-makers. The lowest common denominator mechanism structures the selection from the policy menu by the agents with “causal capacities”.

The advantage of process-tracing is that it can identify different paths to the outcome, and I find that the significance of the two mechanisms differs from one reform to another, but follows a pattern. To summarize, I identify two distinct findings on the decision-making logic that has forged the different frameworks of EU financial stability. The first relates to the relative strength of the mechanisms, and the second relates to the dimension upon which the mechanisms exert influence. The more the belief system mechanism limits the policy menu, the less is the influence of the lowest common denominator mechanism. Conversely, the more the belief system mechanism expands the policy menu, the more is the influence of the lowest common denominator mechanism. The historical reconstruction shows that the belief system mechanism expanded the policy menu considerably from Phase 1 to Phase 3. Consequentially, the impact of the lowest common denominator mechanism was more decisive in Phase 3, as the policy menu was relatively more comprehensive, than in Phase 1.

The analysis revealed a tendency where the belief system mechanism primarily affected the aggregation dimension, and the lowest common denominator mechanism influenced the governance dimension. In all three phases, the governance dimension divided the national preferences the most. The belief system mechanism depends on social learning, and in Phase 2 and Phase 3 the crises challenged intellectual appeal and consistency of the rational expectations. Phase 2 was an in-between phase with minimal social learning before the seriousness of the shortcomings stroke in with the sovereign debt crisis. The Keynesian approach gradually took its place. In Phase 1, the social learning from the pre-framework phase was limited to the governance dimension. The findings illustrate the manner in which mechanisms interact with context. The two mechanisms linked the specific causes of the three phases to the different financial stability frameworks.

In a study such as this, there is always the possibility of fine-tuning the data further or gaining access to data that is currently unavailable. Thus, the inferences I have made from my dataset are provisional. Studies with more fine-grained data including interviews or internal documents of the actors, can potentially uncover other patterns. However, it may be more decisive if I aimed to find agency-driven explanation, rather than structural explanation. As I
explained in chapter 3.2, tracing the decision-making logic behind the evolution of the EU financial stability framework is detective work, and lack of evidence would undermine ‘the case’. Consequently, the findings are associated with uncertainty. The greatest drivers of uncertainty in this thesis are the complexity of context and selection bias. The theory-guided design may have increased the significance of certain evidence, but may have also reduced the risk of outright storytelling. Given the complexity of the evolution of the framework over almost 15 years, there will be other relevant mechanisms present. I emphasize that my findings do not eliminate other explanations. Though the process-tracing method has maximized the internal validity of the causal inferences I have made, it comes at the cost of knowing “more about less”. The single-outcome case by itself is not necessarily representative for the greater universe, but is a useful starting point for other intergovernmental reform processes as both the mechanisms are systematic, and relevant for other cases.

What insight does the revised failing forward argument provide beyond these tendencies in the data? I derive two fundamental, almost elementary, observations from the findings. First, social learning is crisis-driven. My case study shows that evolution of policy happens as a consequence of previous (unsuccessful) efforts to solve the same problem. The Lamfalussy Framework came because the Member States understood that a framework for governance of the market-integrating project FSAP was necessary. Along the aggregation dimension, no substantial movement occurred preceding the financial crisis. New information is required before policy can be adjusted. In apparently stable periods, the status quo is taken for granted. The European debt crisis brought about new experiences and threw light on blind spots. The incremental adjustment within the rational expectations paradigm was insufficient, and the doom loop between banks and Member States need to be delinked. Second, the pitfalls of intergovernmental decision-making system – the joint-decision trap – became more prominent over disputed issues. On such matters, where the national preferences diverge markedly, the outcome invariably drifts towards the status quo. One important implication is that as the policy menu increases in the quest to bring about change, there is a corresponding increase in the opposition to that change. In sum, there are strong forces – decision-making logics – that counter comprehensive reforms.

The failing forward argument invites a degree of speculation about future development. Do the Banking Union reforms represent the end of the failing forward dynamic? This is a question of how successfully the EU as a decision-making system responds to functional
demands. The original failing forward argument and the revised version to an even lesser extent, do not envision the EU under the current system to manage the necessities, and expect it to continue to underprovision financial stability. So far, the failing forward argument has fitted the data. Political science is not a predictive science, but to my best judgement, given the three dimensions that indicates the functional demands of financial stability, the failing forward dynamic is likely to continue. The Banking Union meet the demands along the aggregation dimension to a relatively high degree. However, it is underdeveloped along the governance and functional scope dimensions. The financial stability framework neither covers the entirety of the system nor eliminates the constitutional asymmetry. A functional satisfying framework needs to overcome the two “mechanistic” filters, the belief system and lowest common denominator tendency.\textsuperscript{24} As the relevance of the belief system mechanism is declining, the effect of the joint-decision trap, or the intergovernmental decision-making system, becomes more prevalent. Politically, the latter is easier to address. According to Scharpf (1988), the bargaining orientation of the decision-makers and the unanimity decision rule impedes such positive integration. Consequentially, the EU and its Member States seem unable to choose a stable financial system in the financial trilemma. It cannot move from a Type 2 system (autonomy and efficiency) to a Type 1 (autonomy and safety) or a Type 3 (safety and efficiency).

\textit{Capitalism is essentially a financial system, and the peculiar behavioral attributes of a capitalist economy center around the impact of finance upon system behavior.}

How we regulate the financial system is of utmost importance and was unequivocally proved by the financial and European debt crises, and as the economist Minsky (1967: 33) foresightedly acknowledged here. As democratic societies, we are free to choose the version of capitalism we want. In an era where the logic of finance extends ever deeper into ever more areas of our lives, the level of systemic risk is a concern for democracy (Tranøy, 2017). According to Scharpf (2006: 861), the joint-decision trap has a negative effect on democracy. Figure 14 shows Rodrik’s (2011) political trilemma, and it corresponds to the financial trilemma. To preserve both financial stability and democratic politics we need to choose between deep financial integration and powerful nation states. It implies that we need to choose

\textsuperscript{24} However, systemic risk would not vanish. The calibration of the macroprudential instruments may be flawed, or financial innovation creates a regulatory “black hole”. The risk averseness of the society will also affect the level.
along the governance dimension to preserve democracy and the stability of the financial system: Europe’s politicians must choose either to accept a renationalization of finance or they must embrace reforms necessary to stabilize international financial market integration” (Jones, 2015b: 817). At present, the lowest common denominator mechanism, through the intergovernmental joint-decision trap prevents such a decision, keeping in mind that the potential for change according to democratic preferences is inversely related to the number of veto players in the decision-making system (Tsebelis, 1995). The Financial Times’ European economy commentator, Münchau (2017) asserted that “The past 10 years taught us that financial regulation is primarily a political, not a technical issue”. Thus, Europe needs to eliminate the structural barriers compromising the functioning of democratic government in order for the people to control the level of systemic risk in the financial system.

The three dimensions of a comprehensive framework for financial stability has been the yardstick for the failing forward argument. The two mechanisms have affected the dimensions in different magnitudes. In this thesis, I have examined the manner of interaction of the mechanisms, and the tendencies of the relationship between each of the mechanisms and the dimensions. Future research should refine my revised failing forward argument by further examining how social learning affects the functional scope and governance dimensions, as theoretical expectations on social learning along the aggregation dimension are more precise. More generally, both mechanisms have less explanatory power in explaining the outcome along the functional scope dimension. Other causes should be explored. The structural, macro level approach may underestimate the importance of agency or the causal capacity of the actors, or what Falkner (2011, 2012) calls ‘individual micro-level processes’, acting within the constraints of the belief system and the intergovernmental decision-making system. More fine-grained data could illuminate how policy entrepreneurs, among scholars or within supranational institutions of the EU, affect the social learning and bargaining situation.
In this thesis, I have identified two causal mechanisms that define the decision-making logic behind the evolution of the EU financial stability framework. The belief system mechanism and the lowest common denominator mechanism together structure the causal path towards incomplete frameworks unleashing crisis-driven functional spillovers and a failing forward dynamic. Theoretically, this thesis contributes to the integration theory field by revising the fruitful failing forward argument of Jones et al. (2015) to fit into a broader set of cases, and suggests a theoretical standard for financial stability frameworks. Politically, the revised argument pinpoints structural obstacles via the failing forward dynamics that the EU and the Member States need to manage in order to achieve the collective goal of financial stability. However, it might be that once Europe achieves the ‘Minskian’ “good financial society”, as introduced in the first chapter, it may have already sown the seeds of the next financial crisis. Economic stability breeds instability (Minsky, 1992).
References


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