Chapter 20
Failing forward in financial stability regulation

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Abstract

This chapter asks three questions: To what degree has the European financial and debt crises spurred new policies and purposeful action towards improved financial stability regulation? Secondly, how can we theorize the processes that link crises and policy? And thirdly, we ask if what has been achieved is likely to be sufficient to avoid another crisis? We measure policy change along three dimensions: level of aggregation, level of governance and functional scope, and find significant change along the two first. This is explained by the "failing forward plus learning" framework that we develop. We do, however, find enough chinks in the EUs newly erected armour to predict that processes of failing forward will continue. Thus, we conclude that muddling through best describes the EU's post-crisis efforts in financial stability regulation.

Introduction

The overarching issues of the book will be translated into three questions about outputs, processes and outcomes. Firstly, to what degree has the European financial and debt crises spurred new policies and purposeful action towards improved financial stability regulation and thus more symmetry between market-making and market-correcting policies (output)? Secondly, given that Europe is still suffering in the aftermath of a systemic crisis that originated in the realm of finance, we ask if what has been achieved is likely to be sufficient (outcome)? And thirdly, how do we best theorize the processes that link crisis and policy?

Our answer to the third question draws on insights from liberal intergovermentalism, neofunctionalism and social constructivism (see Schimmelfennig, Niemann and Cross this volume). We build on the "failing forward" argument of Jones et al. (2015), an approach that is particularly suited to understand policy-making in times of crisis, since it takes recurrent crises as a key premise. It does so by combining the integration pessimism of intergovernmentalism with the dynamism of functionalism. Intergovernmentalism predicts that the outcome of inter-state negotiations will be the lowest common denominator, i.e. incremental, piecemeal and incomplete reform. While it is the very incompleteness of lowest common denominator reforms, which stimulates "functionalist processes": Incompleteness gives rise to functional problems – often in the shape of crisis – that have to be dealt with. Thus, Jones et al. (2015) can move from the old functionalist adage of "falling forward" to "failing forward." To this, we add theories of social learning: Decision makers are not only constrained by diverging interests within a framework where every state holds veto-power, but also by what we identify as epistemic deficits. We need to ask what ideas were available on the policy menu at any given point in time? The crude version of our answers to the first two questions about what has been achieved and if it is sufficient are “a lot”, and “maybe not” respectively. In order to gauge the progress made towards further regulatory integration within finance, we have investigated policy change along three dimensions. These are level of aggregation, functional scope and level of governance.

The aggregation dimension runs from a Chicago-school-inspired optimistic view of financial markets that considers micro-prudency as sufficient to ensure stability, to the more politically ambitious (and at heart Keynesian) concept of macro prudential regulation.[1] This dimension is fundamentally expert-driven and tends to evolve through a process of (re)learning. The functional scope dimension can also be seen in terms of Keynesianism versus Chicago-school economics. Keynesian thinking suggests that systemic risk needs to be addressed with a system-wide not sector-wise perspective. A system-wide approach means that banking, securities, and insurance markets should not be regulated separately. Finally, the governance dimension indicates to what degree the financial stability framework matches the current level of financial market integration. Level of integration is a fundamentally political question and tends to be decided by intergovernmental logic.

We proceed in three steps. The first step is to measure our answer to question number one (output), against the most optimistic scenario. We find that the crisis triggered more integration and clear new policy directions. In isolation, this strengthens the “heading forward” scenario. We do need, however, to modify this verdict in light of how we answer the two other questions. Firstly, we find the regulatory solutions chosen somewhat wanting, which pushes us towards the “muddling through” scenario. In turn this generates a forward-looking hypothesis of further failing forward-like decision-making activity, a process which clearly fits under the heading of “muddling through.”

The rest of the chapter is structured as follows. First, we flesh out the framework we use when conceptualizing the output variable. Then we revisit aspects of integration theory and present our expanded failing forward argument. The next section offers a descriptive analysis. It tracks changes to the regulatory regime along the three dimensions. After that we apply our version of the failing forward argument to the process behind the observed changes, while the concluding section returns to the “is it sufficient” question in the shape of closing reflections.

Theoretical dimensions of financial stability regulation

We investigate policy change along three analytically distinct, but empirically overlapping dimensions: level of aggregation, functional scope and level of governance. In order to clarify what we mean by level of aggregation and functional scope; we need to take

[1] Here we will have a note outlining extremely briefly what micro and macroprudential regulation is.

a step back and introduce the mutually exclusive assumptions that differing positions on these two dimensions reflect. Thereafter we will provide a theoretical justification for the third dimension, level of governance. Finally, we operationalize the three dimensions.

The economics of level of aggregation and functional scope

In the field of financial stability, we can distinguish between two main belief systems. According to the former chair of the UK Financial Services Authority (FSA) Lord Turner (2010: 1318), the rational expectations/Chicago-school perspective, (with its micro-oriented efficient market hypothesis), was the "conventional wisdom" of financial regulation until the financial crisis. From this vantage point there is no role for discretionary stabilization, only clearly communicated rules of micro-prudential regulation. The alternative belief system is Keynesian. The core figure Minsky (2015 [1982]: xii) believed instability was inherent to 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." In the years leading up to 2008 Keynesianism had been banished to the margins of the discipline and out of the regulatory discourse, but it re-emerged in the guise of macro-prudential regulation after the crisis. Fundamentally, the two perspectives differ on how they perceive the market in general and the financial system in particular – as self-equilibrating or inherently unstable. Baker (2013b) summarizes the two belief systems succinctly.

Table 20.1: Comparison of the two main belief systems of finance

	Rational expectations tradition	Keynesian tradition
View on markets	-largely efficient, prone to short term disruptions, but should be left to their own devices as far as possible	-inherently pro-cyclical and prone to herding. -financial innovation and increasing complexity can make the system prone to shocks and less stable.
Instruments	-market discipline -enhanced transparency -private risk management (VaR models)	-leverage limits -countercyclical capital buffers modularity/prohibition
Regulation in action	-regulators ask banks and financial institutions what they do	-regulators define limits for banks and financial institutions, what they must and must not do

Based on Baker (2013b: 117)

Thinking about the level of governance

The issue of macro-prudential regulation brings policy content into focus. But for financial stability policy to be effective it also needs sufficient geographical reach. Initially, European integration was symmetric (Menéndez 2016: 391). 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 and easily stuck, thus it hindered supranational solutions (Menéndez 2016: 392). The Single Market came as a response, and the four freedoms unleashed pro-integration forces. The Single Market was a clear case of 'negative integration'; it ruled out national regulation that restricted the four freedoms or could be seen as discriminating against foreign business (Scharpf 1996: 142-43). The result was asymmetric integration. With the Single Market, the financial system became highly integrated; however, the infrastructure to support the system was not integrated at the same rate (De Haan et al. 2009: 323).

This state of affairs has led to what Schoenmaker (2008, 2013) labelled the financial trilemma. This holds that it is not possible for the EU to achieve the goals of a *stable* financial system which is *integrated* across borders, while financial stability policy is provided at the *national* level. One of the three must yield. The absence of legally binding mechanisms that address risk at the EU-level poses a number of obstacles to the management of conflicts of national interest (De Haan et al. 2009: 322). The single market stimulated cross border finance. Cross border firms will sometimes generate negative externalities. National supervisors, however, will only address negative externalities to the degree that they appear in their jurisdiction, as they only had national mandates (Schoenmaker 2013: 24).[2]

The three dimensions operationalized

The *level of aggregation* (aggregation dimension) indicates that one needs a top-down approach to financial stability. To cope with systemic risk,one needs a macro approach. Financial stability instruments, spanning from crisis prevention to crisis management, can broadly be categorized as macroprudential supervision, recapitalization, and resolution respectively.

The *functional scope* dimension also builds on notions of network externalities and complex systems and indicates that one cannot supervise the financial system in a piecemeal fashion (Baker 2013a: 5; 2013b: 116). The different parts are interconnected and 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). The American investment bank Lehman Brothers failed in 2008 and the American multinational *insurance* corporation AIG had to be rescued soon after. Therefore, it has become a tenant of macroprudential thinking that financial stability frameworks need a system-wide approach.

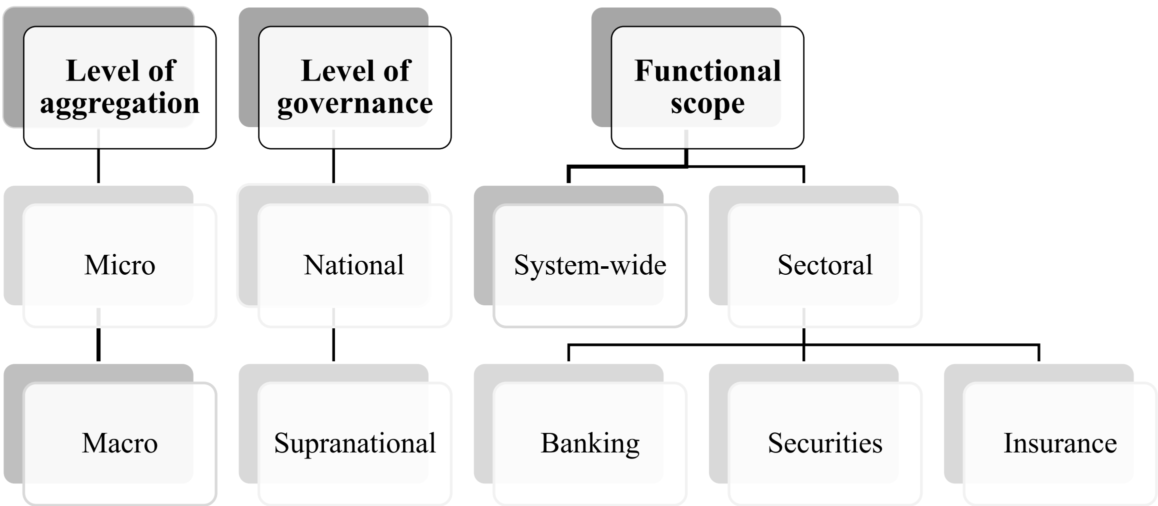
The *governance* dimension can be deduced from the financial trilemma and the notion of asymmetric integration. What is beneficial for an individual country is not necessarily advantageous in an EU context. The choice along the continuum with national or supranational governance on either side, should be determined by the level of financial

[2] 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.

integration. Level of integration is a political question, and the EU has chosen deep financial integration through the Single Market. Thus, the appropriate level of governance is European.

Awareness of the three dimensions is a necessary, but not sufficient condition for coping with systemic risk. They provide the general framework, while the policy instruments and their calibration determine the efficiency. We can stylize the three dimensions, with their respective endpoints, graphically.

Figure 20.1: Three dimensions of a comprehensive financial stability framework



Source: Stenstad (2017:31).

Theorizing processes and decisions

We build on liberal intergovernmentalism, neo-functionalism and social learning when we theorize the processes that link crisis and policy. The fundamental insight from liberal intergovernmentalism's analysis of interstate bargaining 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). 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). This 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, thus the agreement will not precisely mirror their preferences. Comprehensive reforms demand convergence of national preferences.

Lowest common denominator bargaining and functional spillover are the two key mechanisms of the failing forward model. Our main gripe with this argument is that the existence of adequate policy options is taken for granted, and furthermore, that policy makers are aware of these options, a bold assumption that is explicit in Jones et al. (2015: 1018). This might be true in some cases, but it is unreasonable to hold it as a general assumption. Thus, we introduce the notions of *belief systems* that in turn delimit *policy menus*. This flows from an assumption that all policymaking materializes within a context of a specific set of ideas (Hall 1993: 289-92). 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”. Hall distinguishes between three types of change 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 are changed, but the overall goals persist. When these overall goals are replaced, we can speak of a process of *third order change*.

We use the notion of a policy menu to explain how learning (or lack thereof) affects outcomes. 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” can be agreed upon. The relation is not a zero-sum game. Both 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 (Stenstad 2017).

From Lamfalussy to the Banking Union

Integration of financial supervision moved slowly until the end of the 1990s (Quaglia 2010: 24). The internal market for capital was institutionalized in 1992, but eight years passed before the EU made its first feeble attempts at positive integration. The Lamfalussy Framework institutionalized cooperation on regulatory micro-matters (aggregation dimension), and a sectoral approach (functional scope dimension) while it preserved supervision as a national competence (governance dimension). The Lamfalussy Framework thus deviated considerably from what our definition of comprehensive financial stability entails. The new committees did not execute prudential supervision, and macro issues were explicitly kept off the table. Crisis management was not part of the reform. It consolidated a framework where national autonomy and belief in the efficiency of financial markets were the main principles. The main goal was the creation of “a level playing field”. The result was under-provision of the collective good of financial stability.

The financial crisis – financial stability back on the agenda (the Larosière Framework)

The de Larosière Framework, or the European System of Financial Supervisors (ESFS), was a result of the financial crisis. This round of reforms introduced financial stability as an element of the institutional structures at the EU level through a new macroprudential body. Financial stability policies remained a national competence, but EU conducted macroprudential oversight on the systemic level. Despite the macroprudential and systemic element, the framework underprovided the collective good of financial stability for two main reasons. Firstly, even though this period is marked by a burst of positive integration, market correcting policies did not catch up with the negative integration/market making that had gone on before. At the micro level this stage saw a piecemeal upgrading of the institutional framework (Quaglia 2013: 79; Spendzharova 2012: 318).

The ESFS framework consisted of two components: three micro-level European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB). The three ESAs are responsible for supervising banking (EBA), insurance and occupational pension schemes (EIOPA) and securities (ESMA). Functional scope remained sectoral. ESRB on the other hand, pushed the framework somewhat towards macro *level of aggregation*. It was set up as an independent body tasked with macroprudential oversight over the entire financial system. The ESRB issued warnings and recommendations but were given no financial stability policy instruments apart from an 'act or explain' mechanism: If the addressees did not act, they had to justify it. The *functional scope* of the ESRB is in and of itself system-wide, but the ESRB has no financial stability instruments apart from its right to issue warnings and recommendations.

The *level of governance* of financial stability policy on the micro side took a step towards the supranational level by transforming what had previously been committees into agencies but regulation was still exercised at the national level, with a lot of room for discretion. Hence, the de Larosière reforms did not fully address the constitutional asymmetry between negative and positive integration. Regarding the macro side, the ESRB had no binding powers over Member States, it was a 'reputational' body: Its most powerful measure was its moral authority (European Commission 2009: 5). The ECB and the central banks dominate the ESRB, but supervisors are also involved (OJ 2010). The ESRB relies on the goodwill of the different national micro prudential bodies to get the information it needs.

The Banking Union Reforms of 2012-2013

The Banking Union reforms had many components, but the main developments were a move towards macro on the aggregation dimension, a consolidation of a banking-centred regime on the functional scope dimension and a move towards a much stronger supranational hue on the governance dimension. The move towards macro can be seen firstly from the introduction of macroprudential instruments, the most obvious of which are countercyclical capital buffers and regulations that allow for restricting risk-taking by banks, particularly in the mortgage sector. The two most important of these regulations are loan-to-value ratios (LTVs) and debt-service-to-income (DSTI) (ESRB 2019). Furthermore, two new decision-making pillars were introduced. The Single Supervision Mechanism (SSM) and the Single Resolution Mechanism (SRM), both resting on the Single Rulebook for regulating, supervising and governing the financial sector in all EU-countries. These pillars have mandates that cover both macro and micro-level issues. At the micro level the SSM represents a further harmonization and standardization of practices, while the macro level responsibility of the SSM and the introduction of the SRM represent more radical innovations.

The most important concession to macro-thinking within the SSM is the notion that there are 'systemically important institutions' (SIIs), that are now regulated by ECB in cooperation with national supervisors. Previously the implicit assumption had been that each bank could be supervised and regulated "on its own" by authorities in their respective home countries. This, the crises demonstrated, was highly problematic, it underestimated the complexity of the financial system the internal market had created. In particular, how network externalities arising from trouble in a single bank with cross border activities could unbalance the whole system. The establishment of a single resolution mechanism also reflects the post-crisis realization in regulatory circles that complex financial systems give rise to network externalities. Banks' fortunes are linked through various ties; from asset prices and confidence (one bank's losses can impact the value of another bank's assets) to their direct exposure to each other. This makes controlled troubleshooting, on a spectrum from recapitalization to orderly winding down procedures, crucial for systemic stability.

On the functional scope dimension, the system is still sectoral. The three separate ESAs (for banking, insurance and securities) uphold their division of labour which, arguably, reflects the nature of micro-regulation. If one is concerned with one institution at the time, why not leave regulation to specialized agencies? Not so at the macro level where the ESRB's monitoring responsibility is towards the system as such. Furthermore, the ESRB's recommendations and warnings assumed increased significance with the new macroprudential tools given to the ECB (which in turn is the dominant voice in the governance of the ESRB) as part of the Banking Union. On the other hand, if one goes through the ECB's (2018) list of systemically important institutions, only banks and holding companies owned by banks are to be found.

When it comes to the governance dimension, the system took important steps towards supranationality. Firstly, the Single Rulebook moved micro level governance from intergovernmental harmonization towards supranational standardization, reducing the leeway for national discretion. Secondly, at the macro level, the granting of significant powers to the ECB, and thus indirectly also to the ESRB, marks a clear step towards supranational governance.

Discussion

Output: Heading forward

This book revolves around three scenarios, *change* in shape of "breaking down", *continuity* via "muddling through" and *change* as in "heading forward" towards further integration. We argue that the regulatory efforts of the EU in terms of *output* immediately after the global financial crisis qualifies as muddling through, that is path-dependent and incremental responses that built on pre-existing institutional architectures. As the European debt crisis wore on however, new institutions were given new powers which altered the landscape of European financial regulation fundamentally. We are now in a situation that qualifies as heading forward. Confirming to the expectation that "crises may trigger more integration to address common challenges, leading to policy changes and the delegation of new powers to EU institutions" (se chapter 1).

In terms of level of aggregation EU financial regulation is markedly different to what it was before the global financial and European debt crises. Macroprudential regulation has in less than ten years gone from being non-existent to a fundamental part of the EU's regulatory set-up. This is, however, mainly limited to banking. The ESRB is mandated to monitor systemic stability as such, which by definition includes insurance and securities (capital markets) as well as banking, but among the institutions defined as systemically important we find only banks. As regards level of governance, the supervision of these institutions who between them account for around 80 percent of the assets in the banking market in Europe, is performed by Joint Supervisory Teams heavily influenced, and probably dominated by, actors at the European level (the ECB and the ESRB). At the micro level the introduction of the Single Rulebook and the creation of three new agencies represent significant steps towards more integration. The standard-setting efforts of these micro level agencies are more geared towards creating a level playing field when regulating and supervising individual institutions, than financial stability at the systemic level, and we therefore deem them less important for our analysis.

Process: Failing forward

In general, the process towards a more ambitious and hopefully more adequate financial stability regulation, confirms to expectations generated by the failing forward plus social learning perspective. The belief system that surrounded regulators underwent a dramatic shift in the immediate aftermath of the financial crisis. The efficient market hypothesis was the pre-crises 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).

The financial crisis was an immense anomaly that the rational expectations tradition, in the guise of the efficient market hypothesis, could not explain. Thus, the hegemonic belief system was severely weakened. 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 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 Paul 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).

For decision-makers, the de Larosière Report translated this broader social learning into a policy menu. To fully understand the development of the policy menu, we need to assess change along the aggregation dimension. The de Larosière Group found a lack of supervisory focus on 'macrosystemic risk'. As Baker (2013a) argues, it was not a paradigm shift that led to a change in all three orders, but rather a contingent ideational shift, paradoxically enough, without corresponding changes of a second and first order nature. De Larosière delivered a new view of how financial markets work and a clear focus on systemic risks, without recommending new tough instruments that corresponded to this ideational shift. Consequently, the financial crisis did not extend the policy menu beyond oversight and the 'act or explain' mechanism. De Larosière et al. (2009: 58) explained the reasoning for rejecting a broader and more centralized option to a lack of "irrefutable arguments".

In the words of De Vries (2009):

> 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. [...] As national interests prevail in a crisis, the advice is likely not heeded when it is most needed.

This damning judgement raises the question of why de Larosière did not go further? One reason is that the new "paradigm", at least not in the eyes of mainstream economists, had not been fleshed out yet. A joint report from the FSB, IMF, and BIS (2011: 3) put it this way: "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". A second reason is related to the experts' judgment of what was politically feasible, an anticipation of what the intergovernmentalism literature speaks of as the lowest common denominator mechanism. In the words of de Larosière et al. (2009: 58), a further reason for limiting the policy menu was "doubts of it being implemented at this juncture."

The group's perception of political realities was most likely correct, because at this point in time the three core states, France, Germany and the UK had diverging interests. France continued its longstanding support for more comprehensive solutions (Jabko 2012: 103-04). As France has a small, but consolidated financial sector, she preferred more integration as it could gain from a more ambitious, European solution (Buckley & Howarth 2010: 125-28).

Germany was more ambivalent as its financial sector was divided on the reform. Consequently, at least initially, Germany "dragged [its] feet" along with Britain (Jabko 2012: 103-04). As the proposed framework split the industry between the strong private banks who could see several advantages in a common European regulatory framework and the smaller saving banks, co-operatives, and semi-public banks that wanted to remain under the auspices of national agencies, 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).

Britain on the other hand, was a vocal supporter of preserving national autonomy. With a large financial sector, Britain has less to gain from centralization of supervision (Rixen 2013: 441). They wanted the systemic risk board to be an 'informing agency' that reported to the Council, totally independent of the ECB, a less binding arrangement along the governance dimension (Ibid; House of Lords 2009: Q610-21). Despite the lack of EU level crisis management arrangement, Britain did not support EU supervisory powers that could overrule national governments. 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 its bargaining space. This position gave her substantial bargaining power.

Britain underlined 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). 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. Thus, we see that the lowest common denominator mechanism determined the choices made 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.

If de Larosière was a child of the financial crisis, the Euro crisis facilitated accelerated social learning, which in turn paved the way for Banking Union. The widespread sovereign debt crisis led to "successive waves of emergency policy action, both at the ECB and in the Council" (Jones 2015: 58). The urgency of the situation(s) sped up learning to such a degree that there was no time for blueprints. The most important lesson emerged from the ECBs support of the banks' investment in national debt (in disproportionate volumes), thereby strengthening the ties and the linked vulnerabilities between states and banks (Epstein & Rhodes 2016: 416). The result was a "doom loop" – a vicious circle – where declining state finances increased the vulnerability of the banks and vice versa (Gros 2013: 93). Thus, risk was increasingly concentrated in a set of individual debt-ridden Eurozone countries as the crisis progressed (Epstein & Rhodes 2016: 417). Financial stability became connected to the fate of the states themselves, and not only of the financial institutions.

Taken together, the blueprint-less 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 and thus fulfils the scenario, "heading forward" (?). The European debt crisis complemented the previously stand-alone third order change that followed the financial crisis, with macroprudential instruments, i.e. 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. 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 desire to combat the doom-loop spawned three major initiatives. The SSM, the SRM and the ESM. Since there are space-constraints and the European Stability Mechanism (ESM) is not formally a part of the banking union, nor the regulatory framework as such, we will not afford it further attention here.

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).[3] The juxtaposition of divergent interests and therefore the dynamics of the negotiations resembled those over the ESRB, with one notable exception. The Banking Union was established within the Eurozone, which meant that the UK did not have formal role in the negotiations.

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 resulted in a compromise. The threshold ended up at €30 billion. National supervisors were to assume responsibility for the day-to-day supervision of those below this threshold, but ultimate power rested at the ECB. The ECB now directly supervise the 114 most significant banks, representing 82 percent of the Eurozone banking assets (ECB 2019). In addition, Germany won concessions through the creation of a supervisory board of ECB and national supervisory representatives to better secure separation of the monetary policy functions from the new micro-prudential banking tasks of the ECB, and in the shape of a mediation panel for conflicts between Supervisory Board and the ECB. The lowest common denominator mechanism was less influential in this round compared to the de Larosière negotiations. After all, the least forthcoming government could not stop what was a major transfer of sovereignty, but Germany did water down the ambition of France and the European Commission.

[3] The last conflict is not relevant for the three dimensions. However, non-Eurozone countries were allowed to opt in (Howarth & Quaglia, 2013: 114-15).

The Single Resolution Mechanism – A Very Complex Compromise

Banking resolution can have great distributional consequences. Also, in times of a crisis, decisiveness will normally be essential to avoid self-fulfilling prophesies spinning out of control. In this case, level of governance was directly tied to fiscal risk, which only made matters more complicated. Echoing positions taken all the way back to Maastricht, Germany was concerned with the risk of moral hazard, that member states would be more permissive towards their banks when EU funds were available (Howarth & Quaglia 2014: 126-34). Therefore, Germany wanted 'bail-in' rules (initial losses on private sector bonds and shareholders), and that EU funding could only be released after a complex intergovernmental process. France, Italy and Spain were opposed to bail-in clauses and wanted simpler and faster decision-making. Echoing positions taken all the way back to Maastricht, Germany was concerned with the risk of moral hazard, that Member States would be more permissive towards their banks when EU funds were available (Howarth & Quaglia 2014: 126-34). Therefore, Germany wanted 'bail-in' rules (initial losses on private sector bonds and shareholders), and that EU funding could only be released after a complex intergovernmental process. France, Italy and Spain were opposed to bail-in clauses and wanted simpler and faster decision-making. SRM bargaining circled around what Germany did and did not want. Germany had considerable bargaining power, and as it would become a net contributor, had little to gain and preferred a solution close to the status quo. It was the least forthcoming government, and largely defined the terms to integration for 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 Single Resolution Fund (SRF). To close a bank, there are considerable checks and balances. The decision-making authority, the Single Resolution Board (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.

Closing reflections on possible outcomes: Is this sufficient?

In our introduction, we listed three levels at which we wanted to discuss the financial stability regulation regime of the EU: outputs, processes and outcomes. In short, there has been at last a lot of output produced through the kind of failing forward-like processes that our theory predicted. This leaves us with our final questions. Is the outcome satisfactory, is this enough?

First a caveat: It is in the nature of the beast that it is difficult not only to predict, but also to prevent financial crises within systems that let credit and capital move freely. If it were not the case, crises would have been fewer and farther between. What we can do, however, is gauge the output produced against our model of a fully integrated regulatory regime. Europe's internal market for capital (or finance) has been highly integrated since the establishment of the internal market in 1992 and for practical purposes fully integrated since the inception of the euro around the turn of the millennium. Our story is therefore, basically, a story about stability regulation catching up: The EU gradually realizing that it needed to overcome its Scharpfian joint-decision trap and re-establish symmetry between financial markets and their regulatory framework. The big picture that emerges is that the EU is getting there, but is not quite there. Substantial progress has been made along all three dimensions. Governance is now in the main located at the supranational level, macroprudential regulation has been institutionalized and the functional scope of regulation is somewhat increased. Upon closer inspection, however, several chinks in the armour come into view.

The most obvious evidence for “heading forward” (?) is to be found in the degree to which regulation now has a broad enough functional scope. The ESRB is tasked with monitoring the system as such, but when one looks at the institutions actually covered by the instruments of ECB, a bank-centric pattern is revealed. This is both interesting and problematic. It is theoretically interesting because it reflects the nature of what we termed the blueprint-less learning that took place during the European debt crisis. The doom loop that emerged between banks and their domestic governments became the major conundrum. Thus, banks were at the centre of regulatory attention when the Eurozone sought to fix its broken system. The bank-centric pattern is problematic because “the next” financial crisis never crops up exactly the same place as where the last one broke out. Financial markets are dynamic and the borders between institutional spheres like credit, capital, insurance and brokerage are constantly challenged by actors seeking to find new ways to make a profit, often in direct response to the last round of regulation. This means that innovative business models and the “new” risks associated with them are highly likely to surface outside of the sphere that is usually referred to, and regulated as, banking.

When it comes to the level of governance issue, we believe that the most important weakness is to be found in the cumbersome routine established for releasing funds from the resolution mechanism (SRM). Here German fiscal concerns clearly trumped the functional demand for speedy resolution, in effect threatening to undermine the logic behind establishing a resolution mechanism in the first place. One lesson (relearned) in the crisis of 2008 and the subsequent European debt crisis is that when crises hits there is never enough time. If resolution drags out, then panic spreads and the system as such, or large parts of it, gets dragged down. Therefore, regulatory efforts towards facilitating orderly resolution of banks in crisis through resolution funds and “living wills” have been on the agenda in all regulatory agencies since 2008, but with limited progress made on either (Hjertaker and Tranøy 2017).

Finally, the most important potential weakness with the new macroprudential regime is associated with the underlying worldviews and ontology upon which it rests. As we shall see political economists have criticised the macroprudential efforts of both the Bank for International Settlements (BIS) and the EU for trying to add macroprudential regulation to a regulatory structure that is based on ontological priors that are incompatible with the intellectual underpinnings of the Minsky-Keynes tradition. As a consequence, the regulation –

or policy menu from which this is chosen – does not go far enough. The key issues are an insistence on continued quantification of risk (at the cost of thinking more in terms of fundamental uncertainty), the notion that risk resides in institutions rather than in the network and more fundamentally that macroprudential regulation as it stands now does not to a sufficient degree problematize the relationship between finance and the societies which finance notionally serves (Kranke and Yarrow 2018). In short, the predatory, value extracting, and socially useless aspects of modern finance is never addressed.

According to Baker (2018: 293), who has followed the macroprudential process outside and inside the EU since the first macro-murmurs appeared in 2010, the macroprudential regulation which has been produced so far falls short because "[…] a variety of epistemological, professional, institutional and political barriers have impeded relevant expert groups and political actors' willingness and ability to actively translate macroprudential ontology into a systemic vision, or sense of social purpose […]".Taken together these three weaknesses along our three dimensions lead us to conclude that there is a good chance that further progress in financial stability regulation will follow the now established pattern of "failing forward". A more radical interpretation is that the EU is selling muddling through as "heading forward" thereby risking a more severe breakdown further down the line.

20.7 References

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