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The Future of a Hybrid Mechanism – The Case of the Single Supervisory Mechanism

Master Thesis

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> “Today, the Council has given its final approval for the Single Supervisory Mechanism, the first pillar of the Banking Union. We have written regulatory history. This is a momentous step: the start of a new era for the supervision of Eurozone banks.”
>
> *- Michel Barnier, Commissioner responsible for Internal Market and Services (15 October 2013)*

Abstract

The *Single Supervisory Mechanism*, first component of the EU's Banking Union, represents an important step in revising the supervision system in the EU's financial sector and European integration. It aims to break the vicious circle that impacted the European economies heavily during the sovereign debt crisis. Interestingly, the Mechanism was created as a hybrid of supranational and national components and actors. Although supervisory powers were pooled at the ECB, the national competent authorities are also included. This set-up leaves room for questions looking at the future development of the Mechanism, either able to go beyond the will of the member states or effectively remain under national control. Derived from this general interest the primary research question asks “What is the relative power of the supranational and the national side within the Single Supervisory Mechanism?” (RQ1). The analysis is carried out as a Congruence Analysis within the theoretical framework of the two prominent European integration theories: Neo-Functionalism (NF) and Liberal Intergovernmentalism (LI). Both offer opposed views on integration: NF focuses on how the demand for integration is created and deems the supranational actors and underlying mechanisms responsible. LI highlights the role of the member states, supplying integration. The thesis has two objectives, on the one hand to explore the possibilities for the future development of the SSM, and providing evidence for the applicability of the theories and their relative potential to explain the evolving integration of the European financial sector, on the other. To enable conclusions to be drawn on RQ1 the sub-research question is “Which European Integration theory is better suited to explain the integration process in the European Union's financial supervision sector, and the establishment of the Single Supervisory Mechanism?“ (sRQ). The analysis of the negotiation process and the final output shows that Liberal Intergovernmentalism seems to be better suited to explain integration in the financial supervision sector. The influence of the supranational side was rather limited, as the national side remains influential even after the creation of the SSM influencing the scope and scale of the SSM's possible development. Still, to ensure a proper functioning and effective Mechanism, the ECB was equipped with rather strong competences. The relationship between the ECB, as the central actor of the SSM, and the NCAs will largely determine the future development and the success of the Mechanism. The ECB has to be careful to decide when to interfere at the national level of supervision.

List of Abbreviations

BU	Banking Union
CESR	Committee of European Securities Regulators
CEBS	Committee for European Banking Supervision
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
ESA	European Supervisory Authority
EBA	European Banking Authority
ECB	European Central Bank
EC	European Commission
ECJ	European Court of Justice
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervision
ESMA	European Security and Markets Authority
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
LI	Liberal Intergovernmentalism
NCA	National Competent Authority
NCB	National Central Banks
NF	Neo-Functionalism
PA	Principal-Agent (Theory)
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TEU	Treaty of the European Union

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1. Introduction

In the European Union's economy as a whole, as well as in the economic systems of the individual member states, banks play a vital role. One of the central tasks of these financial institutes is the provision of loans (Hartmann-Wendels et al 2007: 2). Through this mechanism, banks contribute to an economy's development, since it enables investment into the national economic system. In Europe's post-World War II environment, the eminent need for economic growth and financial investment led to strong links between the nation states and their respective national banks (Story & Walter 1997: 190). Unfortunately, particularly these strong ties between the states and the banking sector, created significant problems during the course of the financial crisis and the subsequent sovereign debt crisis.[1] Here, the high diversity of the 27 European national banking systems, and the fact that their supervision was largely based on the national level and not in supranational hands was contributing to the crisis' graveness. Historically, member states have been rather reluctant to further push integration in the sector of financial supervision, compared to other policy fields,[2] but the crisis has revealed a strong need for policy adjustments in this area. Leaving the concerns of national authorities regarding the loss of national control aside, the harmonization of financial regulation and a supranational governance regime responsible for effective micro-prudential supervision could be able to produce economic benefits, as it would aim to extinguish the negative effects of separated and divers supervision systems, especially since with the Euro a common currency exists. The introduction of a banking union (BU) was brought to the table in 2012, but the exact implementation of the different components has seen difficult discussions between the member states.

The *Single Supervisory Mechanism* (SSM), as the first component of the European Union's banking union, represents an important step in revising the supervision system in the EU's financial sector, and aims to provide remedy. As such, the Mechanism was not created as a completely supranational entity but as a hybrid mechanism of both supranational and national components, working together in this regime of supervision. This creates interesting ground for research, revolving around the question whether the SSM will be able to go beyond the will of the member states or effectively remain under national control? This thesis will explore the various dimensions of the present developments in the area of enhancing supervision of the financial sector in the EU, and aims to use the insights gained to establish expectations and produce conclusions regarding the possible future development and shape of the SSM.

1.1. Breaking the Vicious Circle: A Single Supervisor

As the events and impacts of the crisis have shown, adjustments in financial sector regulation, for example through the establishment of a single supervisor, could produce significant benefits for the overall (financial) stability. In order to understand why, and what the main tasks of such a single supervisor are, it is necessary to take a brief look at the progression of the sovereign debt crisis. The EU and its member states came under significant pressure, when the financial crisis evolved and turned into a sovereign debt crisis within the Union itself, triggered *inter alia* by the already

1 The global financial crisis originally developed as a private sub-prime debt crisis in the United States of America (approx. between 2005 – 2006) and spilled over to the European markets between 2007 and 2008, with its perceptible start commonly pinned down to the 15 September 2008, when the US American investment bank *Lehman Brothers* filed for bankruptcy.

2 Even though, through the growing interdependence in this sector it has become apparent that integration in this sector is necessary. Still, challenges in the integration of financial supervision are certain to arise (see e.g. Holopainen 2007).

mentioned close ties between the banking sector and the member states. The circumstances at that time aided and abetted so to speak, the development of a vicious circle (Donnelly 2011; European Commission 2012a: 8).

It is safe to state that, in consequence, the hesitancy or sometimes even the unwillingness of the member states to push integration in the area of financial supervision ultimately led to a situation where no transnational approach to answer the crisis was possible. The member states' governments were only responding to the crisis' impacts with state aid measures in order to stabilise their own economies first.[3] In this regard, it has been argued that the responsible national supervisors were acting with prejudice and first paid regard to national interests and only thereafter to European ones (Donnelly 2011; Goyal et al. 2013: 7).[4] This meant that the member states proceeded to rescue banks in trouble with public funds in order to avoid the risks they feared would arise from a possible bank failure impacting the whole financial system (European Commission 2012a: 8). These proceedings, put pressure on the sovereigns and added to their existing debt piles, since these state aid measures were mostly made in form of direct recapitalisations and guarantees. In addition, member states were confronted with decreasing tax revenues due to the general economic downturn in the wake of the financial crisis while state expenditures increased (European Commission 2012a: 9). As a result, through their attempts to rescue national banks, individual states increased their sovereign debt piles which, in some cases, were already of a significant (and dangerous) size. In doing so they reduced their own financial standing and ability to act. This situation negatively affected the standing of banks and other financial institutes, due to them holding government bonds which were losing value. In previous years, public debt from any Euro area country was broadly considered as good and in the best case "*could be used to get liquidity from the ECB or as collateral in wholesale markets[.]*" (European Commission 2012a: 8). In the way nations tried to cope with the crisis, the sovereign debt piles were significantly increased, this in turn affected the balance sheets of the European banks, due to losses in their portfolios containing sovereign assets thus completing the vicious circle. The second major factor that has to be mentioned in this context is the high cross-border activity of European banks, creating disadvantages due to different, highly complex supervisory jurisdictions.

Due to these circumstances, the dimensions of the sovereign debt crisis exceeded the ability of individual nation states to successfully cope with the crisis. This prompted a pull-down of the member states' economies, most prominently observable in Greece, Ireland, Spain and Portugal. The situation was grave and some observers went so far as to predict the end of the Euro as a single currency.[5] The EU realised that finding the appropriate responses to the crisis in the form of a sound revision of financial regulation and supervision were pressing matters to ensure financial stability in the Euro zone and the EU as a whole.

One adequate response was identified at the Euro Area Summit in June 2012, in the possibility to

3 In the *European Financial Stability and Integration Report 2011* (published in April 2012), the European Commission provides an overview of the state rescue measures between 2008 and 2011. During this period, state aid measures of € 4.5 trillion (representing approx. 36.7 % of the EU's total GDP) were approved. The Commission further notes, that the majority of the measures were issued in form of guarantees on bank liabilities (2012a: 63).

4 As Ferrarini and Chiarella argue, the home/host-country bias and the lack of cooperation did lead *inter alia* to the break up of the *Fortis Group* (in Belgium, the Netherlands and Luxembourg) and banks in Iceland (2013: 8).

5 See for example: The Economist (2011). The euro zone: Is this really the End? (published on 26 November 2011 in the print edition Leaders; Source: http://www.economist.com/node/21540255 – Date of Last Request: 17.02.2014); Müller, H. (2011). Uncommon Currency: A Possible Scenario for the End of the Euro. In: Spiegel Online. (Source: http://www.spiegel.de/international/europe/uncommon-currency-a-possible-scenario-for-the-end-of-the-euro-a-790352.html – Date of Last Request: 17.02.2014).

introduce a single supervisor for banks in the Euro zone. A main task of a single supervisor in the financial sector would be the coordination of the different national competent authorities (NCAs) responsible for banking supervision in the member states (Ferrarini & Chiarella 2013: 26). This is essential, due to the large amount of cross-border banking in the EU. Union-wide, cross-border supervision has so far relied on *voluntary* cooperation between the different national authorities (Ferrarini & Chiarella 2013: 8). This did not prove efficient, due to problems such as information asymmetries and other home/host-country biases. In addition, cross-border banks and their subsidiaries and branches are liable in different member states. While branches are subject to regulation of the home country, subsidiaries fall under the regulation of their state of incorporation (Ibid.). This clear division of supervisory power can and did lead to negative externalities in the event of a crisis (or in that of an actual bank insolvency) as argued above. Consequently, crisis management is the second main responsibility of a single supervisor.[6] A single supervisor would enhance the mechanisms of coordination, "*avoid[s] duplication of regulatory requirements and reduce[s] compliance and enforcement costs[.]*" (Ferrarini & Chiarella 2013: 24). The European Central Bank's (ECB) role within the SSM is essentially that of a single supervisor. Still, the NCAs also play a role in this set-up, therefore features of delegation can be detected. As this design leaves the room to examine the strength of the different sides, the following paragraphs will take a closer look at the Mechanism that stands in this thesis' spotlight.

1.2. Structural Adjustments: The SSM

The structure of financial supervision in the Euro area and the EU as a whole made it impossible to respond to the arising problems in an adequate manner. The separated regimes for banking regulation in the member states left coordination as the EU's only tool at hand to combat the crisis' impacts, which alone "*was not sufficient to respond to the financial sector crisis and its contagion to sovereigns[.]*" (European Commission 2012b: 1). Driven by the impacts of the crisis and the efforts to prevent similar events in the future, the European Union has undertaken several structural adjustments in this area to ensure financial stability now and in the future.

The first step taken was the introduction of the European System of Financial Supervision (ESFS) on 1 January 2011, as a measure to heap together supervisory powers at the European level. The ESFS includes the European Security and Risk Board (ESRB) and the three European Supervisory Authorities (ESAs). In this regard, the level-3 committees of the Lamfalussy process, CESR, CEBS and CEIOPS, were transformed into European Authorities: the EBA, the ESMA and the EIOPA.[7] Beforehand, the committees were only equipped, and therefore comparatively limited in their power, to issue non-binding guidelines and recommendations to foster European coordination and coherence. In contrast, the ESAs now possess a set of harder powers and can issue binding decisions (Spendzharova 2012: 2). The ESFS is responsible for macro- and micro-prudential oversight of financial markets and aims to improve the coordination between the different financial sectors and to "*promote harmonized and consistent supervision of financial institutions across the*

6 Since in the event of a crisis time is of the essence, Ferrarini and Chiarella argue that the single supervisor should be equipped with the necessary tools for early intervention and (bank) resolution (2013: 13). However, Art. 127(6) does not seem to provide the necessary legal grounds to equip the ECB with full powers in this regard. This point is still contested.

7 CESR: Committee of European Securities Regulators; CEBS: Committee for European Banking Supervision; CEIOPS: Committee of European Insurance and Occupational Pensions Supervisors. EBA: European Banking Authority (located in London); ESMA: European Securities and Markets Authority (located in Paris), EIOPA: European Insurance and Occupational Pensions Authority (located in Frankfurt am Main).

EU" (Spendzharova 2012: 12).[8]

The European Banking Union is the next building stone in this new supervision system. In the European context, it refers to a framework with three main components: the *Single Supervisory Mechanism* (SSM), the *Single Resolution Mechanism* (SRM) and a *Common Deposit Guarantee Scheme* (European Commission 2012c: 4). Sound regulation in the form of a banking union aims to decrease the fragmentation of the different banking systems significantly and, in addition, to reduce the risk for the EU as well as its member states to re-enter the vicious circle that is characterised by increasing sovereign and bank borrowing costs (see *inter alia* European Commission: 2012c).

The agreement on the Single Supervisory Mechanism was formally issued on 15 October 2013 with the publication of Council Regulation (EU) No. 1024/2013.[9] The regulation confers supervisory powers to the ECB based on Art. 127(6) of the Treaty of the European Union (TEU).[10] Within the SSM, all Euro zone banks will fall, either directly or indirectly (specified in Art. 5 of the Regulation), under supervision of the ECB.[11] Still, within this mechanism, the ECB will share competences with the NCAs and not supervise all of the approximately 6.000 banks in the Euro area directly (EU Observer 2012c). Banks will fall under *direct* supervision of the ECB if their assets' value exceeds € 30 billion, or respectively € 5 billion and 20% of the country's GDP where they are located. Additionally, if a bank is ranked among the three most significant banks of a member country, the institute has large cross-border activities or receives assistance from a Euro zone bailout fund it will also fall in this category. In 2013, the ECB issued a list containing 128 *significant* banks that it will be supervising directly.[12]

However, the Central Bank is authorised to take up direct supervision over a bank "*to ensure consistent application of high supervisory standards*" (Ferrarini & Chiarella 2013: 47) in a case where it comes to the conclusion that the responsible NCA performs insufficient oversight. Overall, the ECB is "*vested with [rather] broad powers to determine and oversee supervisory practices*" (Tröger 2013: 10). In fact, the ECB is even equipped with a sanctioning power, if an institution breaches acts of European Union law. However, the national side continues to play a role in this context. As Ferrarini and Chiarella note, "*[t]he SSM is largely grounded on delegation to national authorities and supervisory cooperation, despite strong powers conferred on the ECB[.]*" (2013: 54). The NCAs remain responsible for the larger amount of the Euro zone banks, and the ECB will be dependent on the commitment and input from the national side in its day-to-day work. Possible non-compliance with regard to the exchange of information might even be hard to deal with for the ECB.[13]

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8 The ECB is not an official element of the ESFS but is closely working with all of its institutions.

9 Council Regulation (EC) 1984/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L 287/63.

10 The SSM is legally based on Article 127 (6) of the Treaty of the European Union (TEU) which allows the Council to "*confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings[.]*".

11 Non-Euro zone countries can engage in a close cooperation with the ECB (see Art. 7 of Council Regulation (EC) 1984/2013). In this case, the individual member state can benefit from the advantages of the banking union and sets its banks under supervision by the ECB, within the SSM.

12 The ECB will resume (direct) supervision of banks formally in autumn 2014 (November 2014, approx. one year after the publication of Council Regulation (EU) No. 1024/2013). However, currently the ECB is conducting a comprehensive balance sheet assessment, an Asset Quality Review (AQR) (from November 2013 to October 2014). In this regard, the Central Bank has issued a list of 128 banks involved in this measure (23 October 2013). These banks also take part in a stress test. The issuing of this list can be seen as the list of banks that the ECB plans to supervise *directly* (see further chapter *4.2.3. The Comprehensive Assessment*).

13 Ferrarini and Chiarella note:"*While recourse to the European Court of Justice may be too slow for effective*

A more detailed description of the important components and aspects of the SSM will be provided in the course of this thesis' analysis (see chapter *4.2.1. The SSM: An Overview*).

1.3. Research Question and Goal of the Thesis

Council Regulation (EU) No. 1024/2013, or in other words the establishment of the SSM, marks an occasion of further integration in the financial supervision sector. As argued, integration in this area has so far been rather thin, *inter alia* due to concerns of the member states fearing the loss of control. As outlined above, the SSM has been created as a hybrid institutional mechanism formally located at the supranational level, with the ECB at its centre, incorporating both supranational and national elements and powers. The sticking point here is that although supervisory tasks and powers were brought together under the roof of the ECB, the NCAs remain the second important group of actors in this set-up.

This mixed design of the Mechanism is one of the driving considerations of this thesis' research; i.e. the manifestation of both national and supranational components and powers in the Mechanism sparks questions concerning the reasons behind it, the mechanisms and actors responsible and possible future development. How can the process of integration in the financial (supervision) sector and the reasons and driving factors for it be explained? And which direction will it take? European integration theory offers several explanatory approaches. This thesis will focus on the two prominent (competing) theories in this area of research: Neo-Functionalism (NF) and Liberal Intergovernmentalism (LI). Both theories differ in their central points of explanation (see chapter *2. Theory*). NF sees integration under a focus from the demand side, using spillovers in addition to the power of supranational actors, who may even be able to actively define and enlarge their own scope of competences (through fostering integration). Is this the case in the financial (supervision) sector as well? Is, for example, the ECB as the supranational institution within the SSM able to do so? Or are the member states in their role as "*gatekeepers*" (Johnston 1994), the sole actors directing integration and subsequently defining the responsibilities of the supranational actor, as suggested by LI? Can one expect more supranationalism or less of it? In each case, the SSM's future would be shaped in a different way, either as a powerful supranational mechanism or effectively still under the control of the member states.

Due to their different core points, the theories establish differing expectations and answers concerning the questions articulated above. This provides interesting ground for research, especially since up until now, literature about the current developments in financial supervision is mostly focusing on its design from different points of view calling for more or less supranationalism depending on the philosophy of the respective author, or on the issue of cross-border banks in the union.

The thesis aims to contribute to the research already conducted in the field of European integration, and provide first grounds to the question *if* and *how* the institutional development in European financial supervision, with special regard to the SSM, may evolve. Some supranational institutions, like the European Court of Justice (ECJ), were able to define and extend their own competences, others were kept under tighter control by the member states after their establishment. Within the SSM, supervisory powers over banks in the Euro zone are transferred to the ECB. However, as

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enforcement, the alternative of the ECB asking national supervisors to bring the relevant claims in national courts may encounter procedural difficulties, in addition to creating agency problems in the relationship between the central and the delegated supervisor[.]" (2013: 56).

outlined above, the SSM has been created as a hybrid institutional mechanism, although a significant amount of supervisory power has been pooled at the supranational level. But, beside the ECB, the NCAs and the EBA will play their parts in this system and certain powers will still remain at the national level. This hybrid set-up leaves room for different considerations regarding the future development of the SSM, based on the assumption that the composition of the SSM decision-making bodies and the competencies of their members will determine, or at least significantly influence the future development of the SSM. It sparks the question which side in the SSM is stronger equipped and therefore might be able to influence or even steer the direction the SSM's development might take. Based on these considerations, this thesis' main research question (*RQ1)* is:

> ***RQ1:*** *What is the relative power of the supranational and the national side within the Single Supervisory Mechanism?*

In order to be able to formulate sound and conclusive statements and prognosis regarding the possible development of the SSM, which remains the main interest of this thesis, it is necessary to expand the scope of the analysis and include additional considerations, e.g. by examining the reasons behind the SSM's establishment, as well as the role of the key actors, their interests and preferences, competences, degree of influence and decision-making mechanisms, but also functional requirements and processes and their effects. To come to adequate conclusions, the research on the main question will be carried out by taking into account the current institutional developments of the SSM under consideration of the theoretical framework of European integration theory. The results will serve as the basis to come to conclusions regarding this thesis' main research question and will facilitate reasonable considerations on the possible future development of the SSM and potential further (supranational) level integration in the European financial supervision sector. In order to base these conclusions and deliberations on solid scientific ground, it is necessary to build upon that integration theory that has the greatest explanatory power regarding European integration, including as regards the financial supervision sector. Consequently, the sub-research question (s*RQ*) is:

> ***sRQ:*** *Which European Integration theory is better suited to explain the integration process in the European Union's financial supervision sector, and the establishment of the Single Supervisory Mechanism?*

This thesis will provide an answer to the research questions above and in doing so contribute to the research already conducted in the field of European integration theory. The analysis regarding the *sRQ* will be carried out as research on the primary *RQ1*, thereby conducted through undertaking a Congruence Analysis (see chapter *3. Methodology*). The thesis will have two objectives on the one hand to explore the possibilities for the future development of the SSM, and providing evidence for the applicability of the European integration theories and their relative potential and suitability to explain, and establish prognoses for, the evolving integration of the European financial sector, on the other.

The structure of this thesis will be as follows: First, the two chosen theories will be presented and discussed. The thesis will then derive expectations, in form of hypotheses, from both theories with regard to the selected case. The analysis will then work to detect (mis-)matches and interferences between the expectations and the empirical and observational evidence found in reality. Here, the general point of interest of this thesis generates the necessity to look at two underlying parts. The first is related to the issue-complex of how the different actors were able to shape the current design of the SSM, in other words the policy translation of integration. Evidence of their respective strength provided here, promises to enable statements regarding the power of the two sides within the Mechanism as well as their influence on further development.

However, both theories provide the theoretical grounds to look further. For example, NF expects the outcome of the agreement to produce more supranationalism. The same goes with LI as the theory anticipates comparable effects only with the opposite outcome. The second underlying part of the question is therefore whether the agreed design of the SSM, and the strength of its different components, can generate either more or less supranationalism, in other words, a stronger supranational side able to shape further integration, or a national side able to limit supranational power. Both underlying aspects will be taken into account in the formulation of the hypotheses as well as in the subsequent analysis. It shall then be possible to formulate conclusions regarding the applicability and explanatory power of the chosen integration theories. Finally, through this research it shall be feasible to answer the question which side (either supranational or national) is more influential within the SSM.

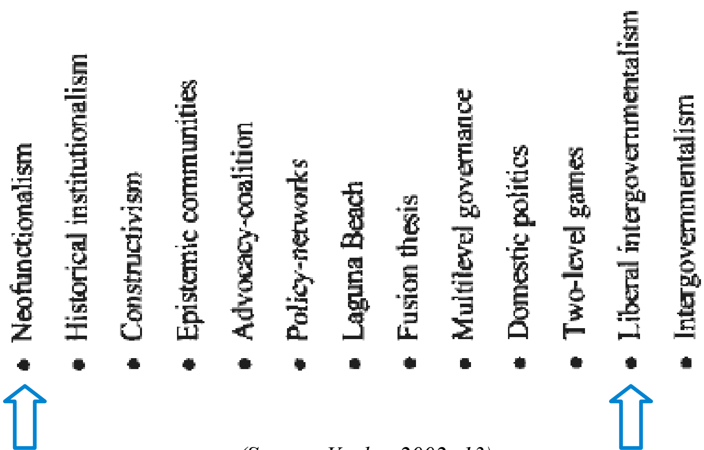
2. Theory

The field of European integration has been significantly influenced by the scientific struggle and the reciprocal critique between the rival theories of Neo-Functionalism (NF) and Liberal Intergovernmentalism (LI).[14] Both sides offer rather strongly opposed views on the issue of (European) integration. While NF sees integration as an incremental process sustained by the dynamics of supranational organisations and focuses on how the demand for integration is created (Haas 1958: 16; Rosamund 2005: 241), does LI set the spotlight pre-eminently on the role and interests of nations in supplying integration. This set-up provides the theoretical framework for this thesis' research. *Table 2* (on page 9) provides a short overview depicting and comparing the two explanatory approaches, which will be discussed in detail in the following chapter.

Over the years, several authors have worked to produce evidence for the applicability of the Neo-Functionalist and the Liberal Intergovernmentalist approach, or provide critique on their explanatory power and/or expectations. Besides Ernst B. Haas, Leon Lindberg (1963) is regarded as the second father of NF. Wayne Sandholtz and Alec Stone Sweet (1998; 2010), Ben Rosamund (2000; 2005) as well as Arne Niemann and Philippe C. Schmitter produced relevant works regarding the same theory. These authors will therefore *inter alia* be considered within the discussion of NF.[15] Some of the mentioned researchers will also be referred to when looking at LI. However, the examination of this theory will largely be based on Andrew Moravcsik (as he is the theory's creator) and Frank Schimmelfennig.

The two theories have been chosen because of their contrary views on how European integration is to be explained. As such they stand at the opposing ends of the spectrum of explanatory approaches concerning (European) integration (as shown in *Table 1*), and therefore allow for a clear comparison of their suitability to explain the reasons and drivers of integration with regard to the SSM.

Table 1: Spectrum of Integration Theory



(Source: Verdun 2002: 13)

14 The author is fully aware of the existence and significance of other theories and models constructed to answer the same set of issues (i.e. Social Constructivism, Historical Institutionalism, Multi-level governance, Networks etc.; see *Table 1*). However, it seems appropriate to use the selected theories, in view of the research design, the selected case regarding the supervision in the financial sector, as well as the ultimate goal of this thesis.

15 The chosen books and articles will be mentioned in the references section of this thesis.

In this chapter, the two theories will be presented with a particular focus on examining their essential conceptual elements and central points of explanations that are relevant to the case under consideration in this thesis. In the same vein, the respective actors and mechanisms each theory considers to be the driving factors of European integration shall be discussed. Subsequent to the summary description of the two integration theories, a number of expectations will be derived from both, with regard to the case analysed in this thesis. An overview of the hypotheses can be found at the end of this chapter. This part represents the first step in this thesis' congruence analysis, as the derived expectations will be assessed against the empirical findings (see chapter *4. Methodology*).

Table 2: Neo-Functionalism vs. Liberal Intergovernmentalism

Theory	Main Actors	Main Mechanism	Explanatory Approach
Neo-Functionalism	*The agents of integration*, i.e. the supranational actors	Underlying momentum (automaticity): *Functional*, *political* and *cultivated spillovers*	Integration as a process with an underlying momentum The supranational actors can direct the integration process
Liberal Intergovernmentalism	The member states, as *gatekeepers*	National interests and preferences, interstate bargaining at *grand bargains* (single events)	Integration supplied by the member states at individual points in time No automatic supply of integration

(Source: Author's version based on the theories)

2.2. Neo-Functionalism

Neo-Functionalism is a regional integration theory, rooting in the work of Ernst B. Haas. It was first introduced by Haas in 1958[16] and was enhanced and refined by several researchers. The theory aims to explain regional integration processes building on the European example. Although declared obsolete by Haas in the 1970s, the theory has been revived by several authors over the last years. NF perceives itself as a grand theory,[17] therefore claiming to hold all-embracing explanatory power regarding the field of integration. Building on functionalist beliefs, NF sets its focus on the mechanisms of technocratic decision-making, incremental change and learning processes (Niemann & Schmitter 2009).

The theory views (European) integration as a gradual process "*whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new centre, whose institutions posses or demand jurisdiction over the pre-existing national states[.]*", as defined by Haas (1958: 16), whereas LI highlights individual points in time to observe integration. The process is initiated with the creation of "*a high authority to promote the integration process*" - i.e. the European Commission (Rosamond 2000: 51). The main goals of said authority are the deepening of economic interdependence and to increase institutional capacities and power at the regional level or at least freeze the status quo (Ibid.). As Niemann & Schmitter note,

16 Haas, E. B. (1958). The Uniting of Europe: Political, Social and Economic Forces 1950 – 1957. Stanford: Stanford University Press.
17 As coined by Charles W. Mills in his work „*The Sociological Imagination*" (published in 1959).

the Commission’s influence is highest when its view's are shared by a powerful EU member state (2009).

The theory is based on five underlying assumptions. First, the actors are perceived to be rational and self-interested (Haas 1970: 627). Second, supranational institutions, once created, are believed to take up a life of their own and “*escape the control of their creators*” (Niemann & Schmitter 2009: 5); they benefit from the mechanism of unintended consequences. Third, the process of decision-making is assumed to be incremental, since most political decision-makers are not able to anticipate long-term consequences and act under a short-term horizon (Niemann & Schmitter 2009: 6). Fourth, the notion of zero-sum games/negotiations between actors is rejected and replaced by the assumption of positive-sum games (Ibid.). Finally, NF expects the increasing functional interdependence of economies and their productive sectors, as well as globalisation, to foster the integration process (Ibid.). European integration is fuelled by spillovers as its main mechanisms; they can be divided into three different subgroups: functional, political and cultivated spillovers.[18]

These mechanisms, pressures and unintended consequence can be brought together under the theory's expectation that the integration process is directed by an underlying momentum. This momentum can not be stopped (or reversed, as the supranational actors aim to keep the *status quo*) and as such will produce more integration over time.

Functional Spillovers

Functional spillovers are the consequence of the (increasing) interdependence of different policy areas. The need for supranational solutions and legislation is facilitated through technical, or functional pressure (Haas 1958: 383). In other words, integration in one policy sector can produce the need for integration measures in relating or adjacent policy fields to prevent problems arising from the initial integration (Haas 1958: xxxiii; Moravcsik 2005: 352), leading to deeper policy coordination (Moravcsik: 1993). In the European context, this would mean that the direction of the integration process is not influenced by the interests of the member states (as argued by LI), but rather by already existing institutional conditions and policies (i.e. functional pressure). The existing setting sets strong incentives for member states to support further integration. It is even possible to extend this argumentation to the global financial crisis and the subsequent sovereign debt crisis, arguing that they provided fertile ground for such mechanisms to promote integration. It could be argued that the creation of the ESFS could have produced functional pressure and would then lead to further regulation, taking the form of the BU. Still, in a similar fashion the crisis can be identified as the reason for integration which in turn can not be classified as functional pressure.
It is necessary to keep in mind that Verdun argues that functional spillovers only apply to issues related to “*low politics*”, concerned with technical matters, rather than with the so-called “*high politics*”, concerned with the politically sensitive areas of policy-making (2002a). If and how spillovers can be detected with regard to the creation of the SSM remains to be seen.

Political spillovers

Political spillovers originate from domestic elites, both political and non-official. Over time, these groups realise, that it is more favourable to turn from the national to the supranational level to find solutions for their policy issues (Haas 1958; Moravcsik 2005: 352). This gradual shift of their activity spectrum is described as a loyalty shift from the domestic to the supranational level

18 Although these are commonly regarded as the main mechanisms of NF, neither Haas nor Lindberg explicitly mentioned these three spillover types. Haas identified three mechanisms, (positive) spillover, the transfer of domestic allegiances and technocratic automaticity, which were later transformed into the three spillover categories.

(Lindberg 1963: 5). This is due to the aforementioned political elites' socialisation on the European level with other domestic representatives, which results in the willingness to make compromises and, thus, achieve effective solutions. Non-governmental interest groups or elites become aware of this movement and see it as necessary to follow this trend and refocus their work to the supranational level as well. As a result, the European institutions become the centre of their efforts and expectations.

Cultivated Spillovers

In the case of cultivated spillovers (Tranholm-Mikkelsen 1991) the "*agents of integration*" (Haas 1958: 29) are often referred to as the actors that cultivate the spillover's effects and thereby direct the process of integration. The European Commission is the actor most commonly referred to in this context (see *inter alia* Wiener & Diez 2009). Its special position, at the heart of the European Union, as well as its scope of authority and set of competences, enables the supranational institution to act in this regard (Lindberg 1963: 71). In this set-up, the Commission is able to ultimately use the different international actors, both with political and non-governmental background, through the cultivation of contacts to attain European goals (Niemann & Schmitter 2009: 8). The support for further integration is very much in the Commission's interest, since more integration would mean more capacities for the supranational institutions.

Neo-Functionalism and the Goal of this Thesis

As the first step for the analysis of this thesis, it is now necessary to derive expectations from theory in order to later be able to detect concordance between the hypotheses and the empirical data. It is therefore required to take away several important conceptual points form the theory to be able to formulate conclusive statements regarding the applicability of the two theories and their explanatory power. As regards NF-theory, keeping in mind that once the integration process is started an underlying momentum directs its course leading to further integration, supranational institution are the main actors in this process and they intend to foster supranational competences and create more supranationalism.

A first important point connected to the above mentioned notion stressed by NF is the power of the supranational actors. From the NFist point of view, these actors, once created, are able to influence the process of integration and shape the design of the SSM accordingly. They would therefore be able to significantly influence the member states and therefore the outcome regarding for example the distribution of competences in the SSM. The underlying momentum of integration and the mechanisms described above decrease the possibility for member states to direct and regulate integration outcomes. The main actors directing the integration process are these agents of integration (Sandholtz & Stone Sweet 1998). An empirical example supporting these assumptions could be the notion that the ECB was able to extent the number of banks that she will be supervising directly. In early 2013, Vítor Constâncio, Vice-President of the ECB, mentioned the possibility for the institution to supervise 20 to 30 banks directly. In October 2013, the ECB was able to issue a list with all banks that will be supervised directly; on this list the bank was able to increase the number to 128. This factor could support the view that the agents of integration are able to promote the process, create more supranationalism and extent their own scope of competences.

H(NF) 1: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, the output (i.e. design of the SSM) would reflect the set of preferences of the supranational institutions to a significant extent.*

The second main element, NF is advocating is the proposition that the European integration process has an underlying momentum directing its course. This momentum is expressed in the three mechanisms driving integration, the spillovers.

H(NF) 2: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, then the integration process is expected to be driven by an underlying momentum (i.e. spillovers would pressure the member states to responses in form or regulation).*

Another general point of interest of this thesis is to determine whether the SSM will create more power on the supranational level or, in contrast, less supranationalism (a weaker supranational actor, the ECB, or components) and stronger national components. As argued, NF strongly suggests the development of further supranationalisation and stronger actors and powers located at this level.

H(NF) 3: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, this will lead to a higher degree of supranationalism and this would then be reflected in the design of the Mechanism.*

The question regarding the possible development consists of two parts. On the one hand, it is necessary to look at the stage of creation (of the Mechanism) and determine the supranational influence on its establishment. On the other hand, it concerns the possible development after that stage of law and treaty making where the competences have been assigned, and the question arises how these would direct its further development. Integration theory looks at the first point in particular. However, the NF-theory provides the scientific ground to also take a second point into account, where the supranational actors (i.e. the ECB) might claim more power in the SSM over the other actors, enabling it to steer the process, than was actually intended at the stage of creation. In short, integration leaves the supranational actors with the possibility to increase the degree of supranationalism themselves.

H(NF) 4: *If Neo-Functionalism is applicable, then the supranational actors are able to claim more power in the SSM.*

2.2. Liberal Intergovernmentalism

The second European integration theory that will be tested in the context of this thesis is Liberal Intergovernmentalism. In his article *Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach* published in 1993 as a critique on NF,[19] Andrew Moravcsik notes that the European Community (now European Union) is "*the most successful example of institutionalized international policy co-ordination in the modern world, yet there is little agreement about the power of explanation for this evolution[.]*" (1993: 473). Further on, Moravcsik challenges the Neo-Functionalist view of the power of "*unintended consequences of previous decisions and the capacity of supranational officials to provide leadership[.]*" (Ibid.) and offers a different approach to explain European integration.
This chapter will not put too much emphasis on Moravcsik's critique of NF, but rather present LI's view on the European integration process in a similar fashion as NF was presented above.[20] Broadly speaking, Liberal Intergovernmentalism's central issue, or point of critique so to speak with regard to Neo-Functionalism, is the theory's perceived underestimation of the EU's member states' role in the integration process (Moravcsik 1998: 18).

In order to explain integration in the EU, LI combines two components, namely a liberal theory concerned with the link between economic interdependence and its influence on the process of national interest formation on the one hand, and an "*intergovernmentalist theory of international negotiation*" (Moravcsik 1993: 474) on the other . Moravcsik sought to build on and enhance intergovernmental institutionalism, adding national preference formation to its existing component of "*interstate bargaining and institutional compliance*" (1993: 480). Consequently, the member states are considered to be the actors responsible for the supply of integration, after the first stage of national interest and preference formation. In this manner, the member states in their role as members of the Council of the European Union, act as "*gatekeepers*" (Johnston 1994) allowing integration to happen at key events in the EU's development, referred to as "*grand bargains*" (Pierson in Sandholtz & Stone Sweet 1998: 33). As a consequence, Liberal Intergovernmentalists tend to play down the influence of supranational actors and dynamic mechanisms engaged between these events.

The existence of strong supranational entities does not stand in contrast to the view of LI, since such institutions can increase efficiency in the bargaining process (Moravcsik 1993). Here, LI incorporates (elements of) *Principal-Agent theory* (PA) to explain the creation of supranational institutions as well as their course of action (Moravcsik 1993: 507). The *principal* (the member states) creates the *agent* (the supranational institutions) since this form of cooperation can produce benefits or decrease negative externalities. Where the supranational institutions contribute to the process, they are implementing the wishes of the member states.[21] Institutions such as the Commission are "*deliberate instruments to improve the efficiency of bargaining between states"* (Ibid.; Kassim & Mennon 2003: 127) and are seen as an "*international regime for policy coordination*" (Moravcsik 1993: 480; Moravcsik & Schimmelfennig 2009: 68).
PA notes the possibility that the agent might pursue its own interests, facilitated by information asymmetries between the two sides. As mentioned by Kassim and Mennon,[22] the possibility that the

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19 The Article was published in the Journal of Common Market Studies Volume 31, No. 4 in December 1993.

20 Annex 1 provides an overview of the "*Liberal Intergovernmentalist Framework of Analysis*".

21 This is a point of critique stressed by Sandholtz and Stone Sweet (2010). They argue that at this point, Liberal Intergovernmentalism becomes "*non-falsible*" (2010: 31). In every case, either when they contribute or when they do not, the work of the supranational entities fits LI's point of view.

22 Kassim & Menon offer critique on the way LI uses PA-theory and looks at the relationship between member states

"*Commission may draw on its own resources to pursue its own policy agenda, or that the Court may evolve into a more powerful institution than the original contract envisages is not contemplated[.]*" (2003: 127). However, due to the asymmetries agents might very well pursue this course. The principal will then strive to stop this action. In the following, both the national preference formation stage as well as the step of interstate bargaining shall now be examined in more detail.

National Preference Formation

Due to the theory's liberal character, LI explains the formation of national preferences as follows: The state is seen as a rational actor, with politicians, or national governments as the actors responsible to formulate national preferences and determining policies (Ibid.). They are located in an environment consisting of different societal groups, "*[g]roups [that] articulate preferences*" and "*governments [that] aggregate them[.]*" (Moravcsik 1993: 483). It is necessary to keep in mind that the process of national preference formation does not always start with these groups expressing their interests. Rather governments or politicians are interested to actively form coalitions to pursue one of their primary goals: *office seeking* (Moravcsik 1993: 484).
Although domestic non-governmental actors do play a role in this equation, LI points out that these actors and their activities have no direct effect on the policy output at the supranational level. The government is granted with a scope of discretion depending on the strength of the groups and issues (Ibid.). As already mentioned above, the interactions of the societal groups and the government take place on a domestic level and produce the national interests as a result. The government than (inter-)acts on the supranational level, based on these interests created in national discourse.
At this point, it is necessary to make a clear distinction between the two terms *set(s) of preferences* (as used in the analysis of this thesis) and *national preferences* (as coined by Moravcsik 1997: 519). Moravcsik defines these national preferences as greater values and not as strategies to get there (i.e. policy output) (Ibid.). The term sets of preferences of all the relevant actors (national as well as supranational) is characterised by the main aspects, components and themes regarding the design of the SSM and the distribution of competences, focused on by the actor(s) in question.

Interstate Bargaining

The second pillar of LI is Intergovernmentalist theory, which aims to explain the European Union "*as the result of strategies pursued by rational governments acting on the basis of their preferences and power[.]*" (Moravcsik 1993: 496). The incentives for the member states to favour cooperation over a national solution originate from the possibility to increase benefits and prevent negative policy externalities that arise when one country's policy produces cost to another country, and the "*control over domestic outcomes[.]*" (Moravcsik 1993: 485). This marks the second stage of LI's explanation for the integration process: interstate bargaining, which is assumed to be non-coercive, embedded in an information-rich environment and connected to low transaction costs, although this exact shaping is not always found in reality (Moravcsik 1993: 497 – 498). Based on this, Moravcsik formulated three determinants of interstate bargaining power: "*(1) unilateral policy alternatives ('threats of non-agreement'); (2) alternative coalitions ('threats of exclusion'); and (3) the potential for compromise and linkage[.]*" (1993: 498).
The first determinant, the unilateral policy alternative, strengthens the position and the bargaining power of one national government in the interstate bargaining process to a significant extent. In a case where, besides cooperation, a government possesses a good alternative that does not incorporate international cooperation, this exerts pressure on other (rational) governments to get

and supranational institutions. However, in the context of this thesis this shall be excluded due to the scope of this work.

closer to the position of the government in possession of such an alternative (Moravcsik 1993: 499). Here, it is more likely that other governments give in to minimize the "*threat of non agreement*" (Moravcsik 1993: 499 – 500).

In situations where a unilateral option is not the best alternative to international agreement, the second determinant may gain traction: alternative coalitions (Moravcsik 1993: 502). In this case, a government must weigh the advantages of forming a coalition against those of going in alone (Ibid.). The bargaining power increases due to the possibility to threaten other governments with exclusion, and the fear of members to be left behind and be placed in a "*'two track' or 'multi-speed' Europe*" (Moravcsik 1993: 503).

In both situations referred to with respect to the previous two determinants, all options at hand represent solutions with significant advantages compared to the *status quo*. Is this the case, governments that "*place a greater value on concession at the margin will gain more from negotiations*" (Moravcsik 1993: 505). In addition, the linkage of different issues can be an advantage to multiple actors, if every actor has a distinct issue that is of value to each of them. Then, the willingness to compromise on an issue that is of less importance to one government increases, if at the same time this government gains the support of other governments on an issue of great importance. This interaction between states can create a favourable outcome. When an agreement has been reached, the member states "*create (or adjust) institutions to secure that outcome*" (Moravcsik & Schimmelfennig 2009: 68 – 69).

Liberal Intergovernmentalism and the Goal of this Thesis

The case that shall be analysed in this thesis shows evidence for a Liberal Intergovernmentalist perspective, based on the assumption that the EU's member states are the sole driving actors able to shape integration (i.e. the policy output referring to the design of the SSM). It is possible to derive several expectations from the central points of LI, suited, if tested, to answer this thesis' research question(s). These will be presented in the following paragraphs, in a similar fashion as it was done in the previous sub-chapter concerning NF.

According to LI theory, the outcome is the result of interstate bargaining after a first stage of national preference formation. In this set-up, the member states' governments are the sole important actors directing and influencing integration. Evidence of their finger prints on the final result (i.e. the regulation establishing the SSM) would support a LIist point of view.

H(LI) 1: *If Liberal Intergovernmentalism is applicable, then the output (i.e. design of the SSM) significantly reflects the set of preferences of the member states and the preferences of the supranational actors are minimised.*

Moravcsik and Schimmelfennig argue that some policy areas are more likely to remain national than others (2009: 76). For example, agricultural as well as trade policy, where the sets of national preferences are stable, certain and well defined, are expected to enter the process of integration depending on whether cooperation and the creation of supranational institutions create benefits for the member states. On the other hand, defence and monetary policy are areas that are "*more uncertain and the distribution of costs and benefits more diffuse[.]*" (Moravcsik & Schimmelfennig 2009: 77). As a consequence, these are more likely to remain under national control at the domestic level, an important fact to keep in mind with regard to the case examined within the context of this thesis. In other words, member states will only agree to integrate in this field if this produces benefits to them. This supports the LI's claim that only the member states are responsible for further integration and not an underlying momentum or functional or technical pressure.

_H(LI) 2:_ *If Liberal Intergovernmentalism is applicable, policy areas concerned with monetary and financial issues are expected to remain on the national level as long as member states support this idea.*

As supranational institutions are created by the member states to minimise transaction costs and to carry out functions transferred to them by the national governments in order to implement their wishes, LI is likely to expect an outcome showing less supranational influence than NF would suggest. As the SSM is a mixture of supranational and national actors and elements, LI would expect the national components to develop stronger compared to the strength of the supranational actors and powers, as long as these measures suit the set of preferences of the national governments. However, at this point it is important to keep in mind that some member states might support more supranationalism, if this provides certain benefits: in a case where a country has moved capital to financial institutions in other member states, this country would rather support supranational institution to safeguard its own investments. So there could be evidence for the willingness to support supervision at the supranational level and/or the reluctance to let it go too far. A look at the set of preferences of the member states is therefore necessary in the analysis.

_H(LI) 3:_ *If Liberal Intergovernmentalism is applicable, the SSM would incorporate stronger national components than supranational as long as this matches the member states' set of preferences.*

In the paragraphs concerning the expectations derived from NF, the two parts of the question concerning the development where mentioned. In a case where more supranational power has been created (the agent), LI-theory expects the national actors to be determined to take back control/limit the supranational power through different channels. In this case, this could happen through the EBA or any other arena where the member states can protect and promote their interests. Here, Principal-Agent theory provides the framework for such activities in the context of the LI-theory.

_H(LI) 4:_ *If Liberal Intergovernmentalism is applicable, then there would be evidence that the national side (principal) is willing to limit supranational power (agent).*

2.3. Summary Comparison

Within this chapter, two sets of hypotheses have been formulated, derived from the core messages, findings and propositions of both NF and LI, with regard to the research question(s) (see below: *Table 3*). As research on the main research question the current institutional development under the SSM shall be examined, analysed and used to formulate conclusions regarding the future possible development of the Mechanism. The second part of the thesis will therefore undertake a Congruence Analysis based on this set of hypotheses.

Table 3: Hypotheses

Neo-Functionalism	Liberal Intergovernmentalism
H(NF) 1: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, the output (i.e. design of the SSM) would reflect the set of preferences of the supranational institutions to a significant extent.*	***H(LI) 1:*** *If Liberal Intergovernmentalism is applicable, then the output (i.e. design of the SSM) significantly reflects the set of preferences of the member states and the preferences of the supranational actors are minimized.*
H(NF) 2: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, then the integration process is expected to be driven by an underlying momentum (i.e. spillovers would pressure the member states to responses in form or regulation).*	***H(LI) 2:*** *If Liberal Intergovernmentalism is applicable, policy areas concerned with monetary and financial issues are expected to remain on the national level as long as member states support this idea.*
H(NF) 3: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, this will lead to a higher degree of supranationalism and this would then be reflected in the design of the Mechanism.*	***H(LI) 3:*** *If Liberal Intergovernmentalism is applicable, the SSM would incorporate stronger national components than supranational ones as long as this matches the member states' set of preferences.*
H(NF) 4: *If Neo-Functionalism is applicable, then the supranational actors are able to claim more power in the SSM.*	***H(LI) 4:*** *If Liberal Intergovernmentalism is applicable, then there would be evidence that the national side (principal) is willing to limit supranational power (agent).*

(Source: Author's version)

3. Methodology

The design of the SSM is an interesting field of study due to the distribution of competences on the supranational and national level, the goal to break the vicious circle between banks and sovereigns and to ensure financial stability in the EU. The hybrid design, which differs from the design of other comparable entities, makes it favourable to conduct a single case study of the newly established hybrid financial supervisory mechanism. The second half of the thesis will consist of an analysis of the current developments concerning the setting up and the design of the SSM, and aims to answer the sub-research question (*sRQ*) first. The analysis will thereby make use of the Congruence Analysis approach, which is a suited instrument to evaluate the explanatory power of the two theories. These proceedings are deemed appropriate to test the hypotheses formulated beforehand and will ultimately serve as the basis to answer the main research question (*RQ1*) of this thesis in a subsequent step. This chapter will present the chosen design and methods that will be applied within the analysis.

Limitations of the chosen approach are that the general point of interest is largely a development of the future. The conclusions drawn in this thesis are based on the presently available data. However, observational evidence based on actor's actions in the future could impact the results. To increase the validity and reliability of the conclusions at this point, data triangulation will be applied, i.e. multiple sources will be considered to paint a more complete picture of reality. A second limitation is that one cannot derive general statements from a single case study, as it only deals with one specific case. Therefore only statements and conclusions for the case in question can be generated.

3.1. Congruence Analysis

The competition between Neo-Functionalism and Liberal Intergovernmentalism is omnipresent in the research field of European studies and more specifically European integration. Both aim to provide answers concerning the *why* and *how* of the European integration process. Due to these circumstances it is favourable to embed the two theories into a *Congruence Analysis* of competing theories, in order to provide adequate evidence. Blatter and Haverland provide a sufficiently articulated definition for this approach:

> *"A congruence analysis approach (CON) is a small-N research design in which the researcher uses case studies to provide empirical evidence for the explanatory relevance or relative strength of one theoretical approach in comparison to other theoretical approaches[.]" (2012: 144).*

Blatter argues that a "*co-variational orthodoxy [...] dominated the literature on case study methodology in Political Science since the 1970s*" (2012: 2). He challenges this procedure with the introduction of the Congruence Analysis. In their book, Blatter and Haverland note that this design has two distinct advantages. First, "*it broadens the available tools for drawing causal inferences in small-N research*" (Ibid.), and enables the researcher to identify connections between empirical observation and abstract concepts, or theories and put them into context (Blatter & Haverland 2012: 144). Second, Blatter is of the opinion, that "*it allows to make each approach internally more coherent[.]*" (2012: 2). This research design makes it possible to combine and/or compare different theories in a specific field of scientific research and therefore promises sufficient results that can contribute to the scientific discussion (Blatter & Haverland 2012: 144). In the following, an overview of the components of a Congruence Analysis will be provided.

When undertaking an analysis, it is important to first identify the goal one wishes to achieve with the undertaken research. One of the two goals, formulated in the introduction to this thesis, will be to provide a contribution to the scholarly discourse on the relevance, relative importance and applicability of the two chosen theories, used in the analysis, in this research field of European integration. A Congruence Analysis of competing theories has been identified as the appropriate approach to attain this goal. In deploying this approach, it might be possible to strengthen the position of a specific theory compared to the competing prominent theories in the area of research. Two preconditions are necessary to proceed in this direction. First, the existence of diverse and fully developed coherent theories, and second, the sufficient and likewise diverse number of possible observations. As it can be observed in the discussion of the two theories in chapter *2. Theory,* both theories fulfil these preconditions, since they differ in their core elements regarding the origin of integration in the EU, and especially differ in their explanation of the process and responsible actors and mechanisms behind it.

The Congruence Analysis provides the tools to pin down (mis-)matches between "*specific propositions and observable implications [deduced] from abstract theories*" (Blatter & Haverland 2012: 144; see also Blatter & Blume 2008: 319) on the one hand, and empirical findings on the other. It supplies the means to identify the different degrees of congruence between the assumptions made on the basis of the theories used and the empirical evidence.[23] In doing so, it is then possible to formulate conclusions regarding the (relative) strength of the theories and to explain the developments with regard to the distribution of competences within the (Blatter & Blume 2008: 319). In other words it is then possible to determine which of the theories possesses more explanatory power. This can be achieved through the usage of two different sub-types of this approach (Blatter & Haverland 2012: 145). Either, it is possible to make use of the *complementary* theories approach, which is based on two (or more) theories in one specific field of research that complement each other.

Similarly, it is feasible to use a *competing* theories approach which includes the most prominent rival theories of the research field in question.[24] It assumes the existence of several divergent theoretical approaches, producing different expectations competing for the interpretative authority concerning their specific research field (Blatter & Haverland 2012: 145). This thesis will make use of this approach. In this regard, Blatter and Haverland note that it is possible to only use one theory. However, they argue that this is "*less compelling*" and take the view that "*good theory-oriented social science is a 'three-cornered fight' involving empirical information and (at least) two different theories[!]*" (2012: 146). This approach does not promise sufficient results in the context of this thesis, since it should be regarded as a design that aims to initiate a paradigm shift regarding the use of different theories in a research field (Blatter & Haverland 2012: 147).

This chapter did provide an overview of the research design and established the Congruence Analysis' second subtype as the favourable design to achieve the goal of this thesis. The analysis will therefore be conducted as follows: the empirical results acquired (observation points) will be compared with the expected results deduced from the core elements of *theory a* (here Neo-Functionalism) and *theory b* (Liberal Intergovernmentalism). In a second step, it is then possible to

23 The approach makes it possible to "*use empirical information to judge the explanatory power of a theory in relative terms by comparing these actual observations with expectations that are deduced from this theory and with the expectations that we deduced from another theory[.]*" (Blatter 2012: 12).

24 At this point it is necessary to clearly point out, that the goal of this thesis' analysis is certainly not to actually verify or falsify a certain theory but to determine their explanatory power with regard to the context of financial regulation and supervision in the European Union.

determine the relative explanatory power of the different European integration theories used and formulate final conclusions regarding the thesis' research question.

3.2. Data Triangulation

The analysis will incorporate qualitative data analysis rather than quantitative, meaning the material used will be qualitative in the sense explained e.g. by Babbie, i.e. the data will be analysed without transforming it into numerical data (2007: 378). As noted by Yeasmin and Rahman, the "*objective of science is to discover, describe and explain the fact, whereas in case of social science it is to observe, verify and conclude[.]*" (2012: 155). A central point here is the validity and the reliability of the conclusions made. Validation through the replication of the same exact scientific results, as it is done in natural science, is not possible to undertake in social science research (Ibid.). Subsequently, the thorough collection and the evaluation of the empirical data is of particular importance for the soundness of scientific work. The chosen method to acquire the data is therefore important. In the analysis, the triangulation approach shall therefore be applied. This technique to acquire and evaluate data allows one to pool the advantages of using different (methods and/or) sources in order to ensure validity and reliability of the results appropriately. In qualitative research, triangulation approach is a useful method "*to check and establish validity in [...] studies by analyzing a research question from multiple perspectives*" (Guion, Diehl & McDonald 2011: 1), in addition, "*[t]riangulation can be used to deepen the researchers' understanding of the issues and maximize their confidence in the findings[.]*" (Guion, Diehl & McDonald 2011: 3).

Denzin identified and distinguished four different types of triangulation, the first of which is *Data Triangulation* (1970),[25] arguably, the most common type of triangulation used in social science. It refers to making use of a number of different sources in order to increase validity and reliability. In this case, it refers to documents regarding the positions of the different actors in order to come to conclusions regarding the research question(s) of this thesis: i.e. position papers, proposal for the design of the SSM or components, press releases, news paper articles and interviews or other statements of the actors. In other words, "*different accounts from [different] perspectives*" (Pierce 2007: 90) will be used. Incorporating and combining such different sources allows the creation of a more complete picture of the necessary information with regard to the SSM, as well as a thorough evaluation of the evidence presented. Here, data triangulation means that these different sources or different points of view on the same issue will be used to ensure that the situation is grasped in full and not argued for based on a single source and its point of understanding. This approach further ensures that another researcher would come to the same conclusions using the same approach, as the overlapping of the different sources would paint the same picture without giving rise to a certain opinion but a neutral and fact-based view on the issue.

The data that will be used has been defined above, already. The actors that will be considered important within the analysis are those included in the process of establishment of the SSM. As such the European Commission, the Parliament and the ECB will be considered from the supranational side and the Council, and the two most important member states, Germany and France, will serve as the second group.

25 The second type is investigator triangulation working by incorporating multiple observers able to acquire data to increase the data pool. Third, theoretical triangulation makes use of more than one theoretical view on the issue in question, and fourth, methodological triangulation combines multiple methods and techniques to collect data (Denzin 1970).

3.3. Operationalisation & Variables

As the first step in the operationalisation, the term "relative strength" found within *RQ1* has to be defined. The relative strength of the two sides is thereby characterized by their influence within the creation process of the SSM as well as in the final set-up of the Mechanism. Second, the applicability of the theories (formulated within *sRQ*) will be measured by searching for evidence of the existence of concepts of the two integration theories in reality. These concepts have been included in the formulated expectations derived from the respective theory. The Congruence Analysis will thereby work to detect (mis-)matches between theoretical expectations and reality. The existence of concepts, such as e.g. the influence of different actors in the creation process, would then speak for the applicability of one theory over the other.

The thesis deploys an *Y*-centered approach. The explanandum within the analysis will be the applicability of the theories (NF and LI). This will be the *dependent variable Y*. Consequently, the *independent variable X* will be concepts or shaping of the two theories. Within the formulated hypotheses different attributes of *X* are expressed and will now be operationalised.

Regarding the hypotheses *H(NF) 1* and *H(LI) 1,* the attribute of the independent variable is the preference of the actors deemed influential in the process of integration: the supranational actors preferences (X_{1a}) or that of the member states (X_{1b}). The extent to which a set of preferences can be found within the design of the SSM, would highlight the dominance of the respective actor and the theory that deemed that actor important. The same method will be applied with regard to the other attributes of the variable (see below). For example, the Commission's position was to ensure a timely establishment of the SSM as well as the inclusion of all credit institutions, while the national side (particularly Germany) aimed to slow down the process and to exclude smaller institutes. Evidence that the former position succeeded in the negotiations would support the applicability of NF while evidence for the latter would speak in favour of LI.

The second group of hypotheses (*H(NF) 2* and *H(LI) 2*) possess the attribute looking at the mechanisms driving integration. Here, the variable's attribute has the following characteristics: the existence of an underlying momentum (X_{2a}) or national control (X_{2b}). At this stage evidence of functional pressures or automaticity would speak for the former, evidence for national control, i.e. deciding at what point in time integration will take place, over the process for the latter.

The last attribute of the variable *X* refers to the power potential of the actors within the Mechanism. This will be measured through determining the strength of the SSM's components and actors. Focus will be set on which competences have been assigned to which side, how the decisions-making bodies are composed and which side is the stronger actor in the relationship between ECB and NCAs. This enables statements about the degree of supranationalism as well as the potential scope of acting for the different actors. Here, the attributes are: stronger supranational actors (X_{3a}) and stronger national actors (X_{3b}) within the component. This relates to the last four hypotheses (*H(NF)3/4* and *H(LI) 3/4*).

4. Analysis

This analysis aims to research on the thesis' *sRQ* within the framework of a Congruence Analysis (as described in the previous chapter), to produce scientific evidence to come to conclusions regarding the primary *RQ1*. As previously shown, when looking at the explanatory power and applicability of the two chosen integration theories, two aspects have to be considered in this analysis. Both aspects are reflected in the formulated hypotheses (see chapter *2. Theory*).
In the following, the analysis will examine empirical evidence, of the factual role of both national and supranational actors and components in the development of the SSM, and, in doing so, test the hypotheses derived from theory in order to detect (mis-)matches between the expectations formulated therein and reality. First, it is necessary to look at the stage of the SSM's creation, in other words the process of integration, and determine the supranational and national influence on this outcome. Second, the potential for development after that stage of law and treaty making, where the competences have been assigned, based on the strength of the supranational and national components must be analysed. Through this approach, the thesis will contribute to the two key points of interest, namely the applicability of integration theory in the field of financial supervision and the drawing of conclusions regarding the future of the Single Supervisory Mechanism.

4.1. The Creation of the SSM: Preferences and Influence

The following paragraphs will identify and discuss the key actors' set of preferences regarding the design of the Mechanism and their influence in the process of establishing the European BU and the SSM respectively. Through determining which actors (or mechanisms) are responsible for integration in the sector of financial supervision and most influential in designing the components of the SSM, it shall be possible to formulate initial conclusions regarding their influence on the future development of the hybrid mechanism based on the observed strength in this first stage. The choice of actors was explained in the prior chapter.

The possibility to set up a Banking Union at the European level was first articulated by Hermann Van Rompuy, President of the European Council.[26] Following his report, the Heads of Government of the Euro zone acknowledged the adverse link between the banking sector and the sovereign debt piles,[27] a vicious circle that ought to be broken by the SSM as noted by ECB President Mario Draghi (EU Observer 2012b). The Euro area summit on 28/29 June 2012 instructed the European Commission to present a proposal for a Common Supervisory Mechanism (Euro Area Summit 2012).

4.1.1. The Supranational Actors: The EC, the ECB and the EP

European Commission

At the Euro area summit 2012, where "*EU leaders agreed to deepen economic and monetary union as one of the remedies of the current crisis*" (European Commission 2012b), the European Commission (EC) was tasked to formulate a proposal for *inter alia* a Common Supervisory Mechanism. On 12 September 2012, the EC published its proposal for a banking union and a mechanism responsible for the micro-prudential supervision of Euro zone banks. This was done in the form of a Communication to the Council and the European Parliament (*A Roadmap towards a*

26 Van Rompuy, H. (2012). EUCO 120/12: Towards a Genuine Economic and Monetary Union: Report by the President of the European Council. Brussels.

27 As explained in chapter *1. Introduction*.

Banking Union).[28] Since the proposal has been directly developed and published by the Commission, it can be regarded as the first official formulation of the Commission's preferences for the design of the SSM. The analysis will show whether this set of preferences can be found in the actual result and to which extent. The Commission is strongly in favour of a transnational banking union, since it sees it as a measure to restore and financial stability in the Euro zone (European Commission 2014: 1). Its proposal is structured accordingly:

> "*The ECB will become responsible for tasks such as authorizing credit institutions; compliance with capital, leverage and liquidity requirements; and conducting supervision of financial conglomerates. The ECB will be able to carry out early intervention measures when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action.*" (European Commission 2012c: 2).

The Commission planned to shift "*specific supervisory tasks […] to the European level in the Euro area, notably those that are key to preserving financial stability and detecting viability risks of banks[.]*" (Ibid.). The two main preference points that need to be mentioned in this regard are concerned with the time frame in which to set up the SSM, and the scope of the ECB's authority within the Mechanism. The Commission included the national competent authorities (NCAs) and planned for them to assist the ECB to cope with the huge amount of work in day-to-day supervision of Euro zone banks (European Commission 2012a). But, the institution envisioned the ECB to be responsible for *all* credit institutions in the Euro area in order to avoid further fragmentation, and there was no indication made in the EC's proposal on a possible distinction between type or size of the institutions to be supervised. The "*ECB [would] be able to decide to assume full supervisory responsibility over any credit institution*" (European Commission 2012c: 2). In addition, the EC planned to have the SSM able to take up its work by 1 January 2013. Both issues were met with resistance from the national side, particularly by Germany, and are not reflected in the final design of the SSM in the fashion preferred by the EC (see below). The Commission's preferences were not met although they were, to an extent, shared by a powerful member state, i.e. France (see below), a prerequisite for a situation where the Commission's influence would be at its highest (Niemann & Schmitter 2009).

European Central Bank

Generally, the ECB itself has always expressed its support for the establishment of a European BU and a common supervisory mechanism. In addition, the Central Bank has shown the willingness to take up the necessary supervisory responsibilities over banks and stated that "*the ECB stands ready to perform the new tasks relating to the prudential supervision of credit institutions provided for in the proposed SSM regulation[.]*" (ECB 2012a: 2). The ECB considers these arrangements as the only way to "*break the adverse link between banks and sovereigns in some euro area Member States and to reverse the current process of financial market fragmentation in the euro area[.]*" (Ibid.).

Central points in the ECB's set of preferences were generally congruent with those of the EC: the swift establishment of the SSM, as a prerequisite for the implementation of the other components of the BU,[29] as well as the supervisory scope, incorporating "*the inclusion of all credit institutions*"

28 European Commission (2012a). COM(2012) 510 final: Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union. Brussels.

29 Initially, and in line with the Commission's preferences regarding the time frame, the ECB called for an "*entry into force of the proposed SSM regulation on 1 January 2013*" (ECB 2012: 7).

(Ibid.) in order to prevent further fragmentation in this sector. Similar to the standpoints of the EC, the ECB's set of preferences regarding scope and timely implementation was met with resistance by the national leaders and subsequently to a significant extent not reflected in the final design of the SSM.

European Parliament

The European Parliament (EP) made it clear that it would make its approval for the amendments of the European Banking Authority, regarding new voting arrangements, dependent on the Council's concession to include the EP in the process concerning the SSM regulation (Bundesministerium der Finanzen 2013). An agreement on nearly all aspects of the SSM was reached in the Trialogue[30] in March 2013 (EU Observer 2013a). A final vote in the EP however was postponed until September 2013 due to disagreements between the EP and the ECB on the degree of democratic control the EP sought to achieve. The Parliament did then approve the establishment of the SSM in the Euro zone in its plenary session on 12 September 2013 with a "*sweeping majority*" (Vogel 2013).

The European Parliament's preferences contained one central point: the democratic accountability of the ECB as the main actor in the SSM. This was the primary issue between the Parliament and the Central Bank, as the EP was "*uncomfortable with the ECB's high degree of political independence*" (Gilmore 2013). The Parliament demanded access to minutes of the ECB's Supervisory Board, while the Central Bank feared that sensitive information could reach the public and was originally only willing to disclose a summary of the board's proceedings. As noted by commentators, the "*compromise agreement allows for a 'comprehensive and meaningful record' of the meetings*" (Gilmore 2013). The following points have been included in the final agreement: together with the Council, the EP has a joint role in the appointment of the Chair and Vice Chair of the Supervisory Board and in initiating their dismissal. The ECB originally opposed the possibility that the EP would gain a veto in the appointment and dismissal of the Chair and Vice-chair of the Supervisory Board (Bowker 2013; EU Observer 2013c). Commentators noted that the "*power to initiate the dismissal of the vice-chair is [...] seen as a key power by lawmakers, since the ECB has previously intimated that real power will lie with the vice-chair[.]*" (Bowker 2013). The ECB is now required to regularly report to the EP regarding supervision and has to answer written questions. The members of the EP (MEPs) are content with the results; the green MEP Sven Giegold, responsible for the negotiations together with Marianne Thyssen, noted that "*the European Parliament has obtained "strong control mechanisms, beyond what national parliaments usually have."*" (EU Observer 2013c). Since the preference of the Parliament mainly concerned democratic control of the ECB's activities in the framework of the SSM, but not a direct influential role in the development of the latter, in the context of this analysis, this does not weigh as heavy as others observations when determining the actors' relative influence.

4.1.2. The National Side: The Council and Selected Member States

In the given context, i.e. the development of the negotiations concerning the establishment of the SSM, the Council can be seen as the forum where the member states articulated and aggregated their set(s) of preferences regarding the design of the SSM.[31] On 12/13 December 2012, the Council, or more precisely the European Finance Ministers in the ECOFIN Council, announced that an agreement was reached regarding the design of the SSM (Council 2012: 2).When examining the Councils position as the national side's set of preferences, it is necessary to take a closer look at

30 Referring to the negotiation process between the European Commission, the European Parliament and the Council.

31 As mentioned earlier, the term "*set(s) of preferences*" is distinguished from Moravcsik's term "*national preferences*".

important member states to understand how the position was formed and how it differs from the supranational institutions' sets of preferences.

To this end, the positions of Germany and France will be examined in more detail to better understand the final agreement of the Council. Both countries, and their Heads of State and Government, played a leading role in the course of the crisis and in the proceedings to respond to its impacts. Both represented two different schools of thought on how to manage the crisis. And both represented two groups of member states in the debates on the SSM; France 'led' a coalition of Southern European nations; Germany a Northern one. As a consequence, it appears that the sets of preferences and respectively the compromises achieved between these two nations significantly shaped the outcome of the Council's negotiations.

France (and the Southern Coalition)

As the first of the two key actors within the Council, France represented the group of countries that suffered under the impacts of the sovereign debt crisis more severely. These countries are geographically primarily located in the Southern European hemisphere, like Spain, Italy, Portugal, Greece and Cyprus. The approach taken by France and the Southern member states was driven by the idea that direct recapitalisation of banks, without new pressure on sovereign debts, but through the European Stability Mechanism (ESM) should be possible.[32]

The Heads of Government of Italy and Spain did bring Angela Merkel to a concession regarding the recapitalisation issue; However, she made it conditional on the prior establishment of the SSM, as "*a key element of the banking union, which also foresees a common resolution authority and a common deposit guarantee scheme[.]*" (Council 2012: 7). A speedy implementation of the SSM was therefore favoured by France, which needed to protect significant financial investments in Southern European banks. Based on the proposition of the Commission, France and the Southern member states favoured the SSM to take up its work on 1 January 2013 (EU Observer 2012a). In December 2012 it was clear that this would not be the case, "*a blow for member states keen for the ECB to start work immediately[.]*" (Ibid.). The German Chancellor had traded her agreement on direct recapitalisation against the prior and thorough establishment of the SSM and as such slowed down the process significantly.

The second important point for France concerning the design of the SSM was the inclusion of all banks regardless of their size under the supervisory umbrella of the ECB to avoid further fragmentation, a point Germany was not prepared to agree to.

Germany (and the Northern Coalition)

Germany represented the other pole, so to speak, within the Council's negotiations. The biggest European member state thereby largely represented the views of those states comparably lightly impacted by the financial crisis, such as Austria, Estonia, Finland and the Netherlands. The German preferences were threefold, primarily concerning the time frame, the division of monetary policy and supervisory responsibilities within the ECB and the scope of the SSM. The preferences of the Northern states stem from the need to assure their population that they (e.g. the tax payer) would not have to pay to recapitalise a foreign bank in crisis.

Germany was persistent to follow a slow and careful approach to designing the BU and its components. At the Euro area June 2012 summit, Angela Merkel agreed to the Southern calls to enable direct recapitalisation of Euro zone banks via the ESM. However, the German Chancellor traded her consent in this regard against the affirmation to first set up the necessary supervision (as

32 The ESM is holding € 500 billion.

already noted above) (EU Observer 2012a). The plans of the EC, the ECB and the Southern countries to establish the BU quickly were met with sometimes rather harsh resistance.[33] Consequently, the SSM is now taking up its work in autumn 2014 and not in January 2013 as envisioned in the Commission's proposal.

The second German point of preference was the strict separation of monetary policy and supervisory responsibilities within the ECB. The German side feared that otherwise this would negatively affect the ECB's independence (Deutscher Bundestag 2012). Following this demur, the Supervisory Board will now oversee the separation of monetary and supervisory policy (EU Observer 2012a). A mediation body will be tasked to settle differences between national supervisors and the ECB.

Germany and Austria strictly refused letting smaller and medium-sized banks, like the German *Sparkassen* and *Genossenschaftsbanken*,[34] fall under supervision of a supranational institution as they did not cause the financial crisis as noted by German Minister of Finance Wolfgang Schäuble (Kaess 2012). The countries (and the institutes) feared that this would lead to financial pressure, e.g. through financing a possible resolution fund, which the smaller credit institutions would not be able to withstand.

With these considerations in mind, it is safe to say that the Council's agreement on the design of the SSM constitutes a compromise between the two sides with a surplus on the end of Germany's camp. The speed of implementation was slowed down and France agreed to leave supervision of smaller banks at the national level, a point the majority of the member states supported in the end (EuropeanVoice 2012), but connected to the requirement that the ECB would have the final say. Hence, the ECB will only execute *direct* supervision over "*banks that pose a systemic risk or that receive bail-outs*" (Ibid.) as called for by Germany. In addition, the Council agreed to confer indirect supervisory powers to the ECB, working in close cooperation with the NCAs, which will be responsible for "*consumer protection, money laundering, payment services, and branches of third country banks*" (Ibid.). The non-Euro zone countries supported the slow approach. They were concerned that the EBA would be dominated by the SSM-countries and pressed for amendments of the voting rights. These preferences were met with the agreement on a regulation amending the EBA (see chapter *4.2.5. The EBA: Voting Arrangements*).

4.1.3. The Underlying Momentum vs. National Control

Besides the influential role of the supranational actors in the integration process, NF would expect an underlying momentum in the integration of financial supervision, exerting functional pressure on the actors, leaving integration measures as the only tool to respond adequately (Haas 1958).[35] In other words, NF expects spillovers to drive and steer the integration process. LI-theory neglects this

33 In this regard, Angela Merkel coined the phrase "*quality comes before speed*" ("*Allerdings sage ich an dieser Stelle: Qualität muss vor Schnelligkeit gehen;*" (Bundesregierung 2012)).

34 In 2012, the President of the German Sparkassen Georg Fahrenschon, the President of the Genossenschaftsbanken Uwe Fröhlich, and Christian Brand, President of the Verband öffentlicher Banken published a letter to Angela Merkel asking her to stand for the exclusion of the Sparkassen and Genossenschaftsbanken from the SSM (Süddeutsche.de 2012).

35 The author is aware that NF incorporates the irreversability of integration into the notion of the underlying momentum. However, the thesis seeks to establish which mechanism is strong enough and directing integration. (Irreversable) Integration in this field alone would therefore not provide the grounds to confirm the expectations, since it is of value whether the national or the supranational actors and mechanism's were responsible.

influence and deems only the member states' decisions at specific points in time important for further integration. Looking at the European financial sector, it becomes apparent that there are clear differences in how far the financial sector has been brought onto the European level (introduction of the Euro) and how its micro-prudential supervision remained on the national. Liberal Intergovernmentalists argue that the member states favour policy fields where the national preferences are uncertain and prone to change to remain on the national level (Moravcsik & Schimmelfennig 2009: 76). The willingness to cooperate only arises when the member states believe to gain benefits through common policy and terminate negative externalities of national policy. These aspects will now be examined in more detail.

An underlying momentum, if existent, would trigger a consequential, quasi automatic response to functional pressures (Haas 1958). The main goal to be achieved through the establishment of the SSM (and the BU) is the prevention of the vicious circle created through the links between member states and banks. During the sovereign debt crisis, member states started to bail out banks in crisis which in turn where holding government bonds that were undergoing devaluation. The shared currency in the Euro zone and, thus, the shared risks in terms of financial stability should have produced the functional pressure to integrate in financial supervision. In other words, integration in the financial sector through the introduction of the Euro, would lead to integration in financial supervision. The view that this is pro-actively driving the integration process must, however, be contested. Admittedly, the crisis has shown that this connection exists; the functional pressure resulting from the risks and the need to integrate can be detected. But, the time gap between the introduction of the Euro and the establishment of the SSM provides evidence that this functional demand was not strong enough and did not produce or initiate automaticity. Still, Verdun argues that functional spillovers only apply to issues relate to technical matters i.e. “*low politics*”, rather than with the so-called “*high politics*”, concerned with the politically sensitive areas of policy-making (2002).

But it is rather safe to say that without the crisis, Europe would not see the establishment of the SSM today. The developments over the last years create a different picture than it would be expected by NF-theory. The member states were always reluctant to integrate in financial supervision. This reluctance was not overcome by the functional demand alone, let alone due to automaticity. On the contrary, it can be argued that the member states have been in control of the integration process, and it is possible to go so far as to conclude that it was only the effects of the crisis that led to integration measures in the area of financial supervision, as the member states would still consider it as an area of national interest. The fact that the Council significantly slowed down the whole process further underlines these assumptions.

The Council's role in the establishment of the SSM is visible. The strength of individual member states can also be observed when looking at the past years and the fashion in which these actors have chosen to respond to the sovereign debt crisis. This provides evidence supporting the claim that the policy field of financial supervision only experiences integration if desired by the member states. Moravcsik and Schimmelfennig argued that integration in uncertain policy fields, such as financial policy, will remain at the national level until such time when the member states decide that benefits resulting from integration exceed those from keeping the policy issue on the previous level (2009: 76 – 77). It can be stated, that this seems to be the case here, integration in financial supervision was largely neglected by the member states before the crisis as it represents an area where national interests are very important.

When looking at the distribution of powers between the supranational institutions and the member states in the decision-making process leading to the SSM, the developments of the past few years suggest a surplus for the member states. Here, particularly the role of the German Chancellor Angela Merkel and the former French President Nicolas Sarkozy catch one's eye, for example in the Greek crisis. Donnelly noted that "*[i]n [the financial] crisis, national governments became more important than Europe for saving the financial system*" (2011: 390), a point already argued for in chapter *1. Introduction*. State intervention in the process of saving the member states' economies dominated the picture.
Intergovernmental bargaining and the influence of nations on the process can be observed at the June 2012 summit, after long negotiations, the Italian Prime Minister Monti and his Spanish counterpart Rajoy achieved the concessions of the German Chancellor on easier access to the ESM via the European Commission (under compliance to budgetary rules established by this institution) (Volkery 2012). As mentioned earlier in this chapter, Merkel tied her consent to the point that this would only be the case after the establishment of the SSM (Ibid.).[36] Reflecting on these considerations, regulatory decision-making power concerning measures to combat the impacts of a crisis, such as the establishment of supranational supervision in the financial sector seem to be subject of the member states' will, as "*Europe only gets and only keeps the rules and institutions that its member states agree on[.]*" (Donnelly 2011: 384). The member states themselves kick-started the establishment of the European BU. Liberal Intergovernmentalists refer to such points in time like the Euro area summit in June 2012 or the ECOFIN Council meeting in December of the same year as "*grand bargains*" (Pierson in Sandholtz & Stone Sweet 1998: 33), where the European countries agree on integration measures among themselves. In fact, the move towards the BU and the introduction and design of its components is strongly debated between the member states possessing very different opinions. The member states slowed down the pace desired by the Commission.

The presented considerations and findings show that although it was possible to detect functional demands and pressures, these were not strong enough to push integration. Rather, the empirical and observational evidence suggests that is was the progression and impacts of the financial and sovereign debt crisis that brought the member states to the conclusion, that the establishment of such measures as the SSM would produce economic benefits. The way the member states came to agreements among themselves underlines this view.

4.1.4. Reflection I

In the first part of this analysis, the preferences of the relevant actors regarding the establishment and the design of the SSM have been presented and discussed. It is possible to register the following important findings: Although the Commission was tasked to produce a proposal for a European BU and a common supervisory mechanism, the influence of the supranational side in the decision-making process has turned out to be rather limited. It has become apparent that the national side has dominated the process, with particularly strong influence from Germany and France. The member states' fingerprints can be found all over the final design of the SSM. The proposal of the Commission was altered in several important points such as the time frame and the scope of supervision, as small and medium-sized banks will only be indirectly supervised by the ECB. The SSM should therefore be regarded as a compromise achieved between the member states themselves with a little surplus on the side of Germany and the Northern Coalition.

36 In this regard, Herman Gröhe (at that time Secretary General of the German party CDU) coined the phrase "*no liability without oversight*" (Volkery 2012).

It was possible to detect functional demands, but their influence has to be evaluated as relatively low as they were not significant enough to initiate the integration process on their own and at an earlier point in time. Hence, automaticity as a driving force could not be proven. Only the crisis, but not the original integration in the financial sector through the introduction of the Euro, led the member states to favour the introduction of a BU. Member states are the entities dominating the integration process through their decisions. This becomes apparent when looking at how e.g. Germany was able to influence and notably slow down the process of establishing the SSM. The member states wanted to terminate any possible negative externalities that would be an incentive not to cooperate on the supranational level (Moravcsik 1993: 485), only if such externalities do not exist are the member states willing to integrate in a certain policy field. Consequently, components of the BU only see an agreement after in-depth discussions between the member states.[37]

These observations make it possible to draw conclusions regarding some of the hypotheses listed in chapter two. *H(NF) 1* cannot be confirmed as the member states have to be seen as the major actors in the process of integration in financial supervision since the outcome clearly shows their finger prints. Consequently *H(LI) 1* can be confirmed. Although functional pressures to create the BU, and the SSM respectively, were found, they are not deemed strong enough to drive the integration process. *H(NF) 2* can therefore not be confirmed to the full extent. *H(LI) 2,* expecting that the member states decide about the policy fields where integration takes place, can be confirmed. *Table* 4 provides an overview over the status of the first four hypotheses.

Table 4: Reflection I

Hypotheses	**Status**
H(NF) 1: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, the output (i.e. design of the SSM) would reflect the set of preferences of the supranational institutions to a significant extent.*	Not Confirmed
H(LI) 1: *If Liberal Intergovernmentalism is applicable, then the output (i.e. design of the SSM) significantly reflects the set of preferences of the member states and the preferences of the supranational actors are minimized.*	Confirmed
H(NF) 2: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, then the integration process is expected to be driven by an underlying momentum (i.e. spillovers would pressure the member states to responses in form or regulation).*	Not Confirmed
H(LI) 2: *If Liberal Intergovernmentalism is applicable, policy areas concerned with monetary and financial issues are expected to remain on the national level as long as member states support this idea.*	Confirmed

37 At the point of writing, the Single Resolution Mechanism has now also seen an agreement, after negotiations between the member states. The only component left is the *Common Deposit Gurantee Scheme*.

4.2. Components of the Single Supervisory Mechanism

After having addressed the first stage, i.e. the creation of the Mechanism, this thesis will now look at the SSM and its components in more depth. First, a descriptive overview of the Mechanism will be provided, before turning to the most important aspect, such as e.g. decision-making in the SSM and the relationship between the ECB and the NCAs, in more detail. As noted by Ferrarini and Chiarella, the SSM can be described as a single supervisor with elements of cooperation and delegation (2013: 62), incorporating the ECB at the supranational level and the NCAs at the member states level. As the first part of this analysis has provided evidence for the strong influence of the member states in the process of creation of the SSM, it will now be interesting how this influence impacts the SSM's components and possible future development of the Mechanism.

4.2.1. The SSM: An Overview

The SSM's specifications and the key points of its design, which have to be taken into account in the context of the analysis, are laid down in Council Regulation (EU) No. 1024/2013. The SSM is legally based on Article 127(6) of the TEU which allows the Council to "*confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings[.]*". Furthermore, the SSM is located under the roof of the ECB which receives direct and indirect supervisory powers over banks located in the Euro zone (and non-Euro zone countries participating in the SSM).

Scope

As already outlined, the ECB will principally be in charge of supervising all banks in the Euro zone (approximately 6.000) and non-Euro zone member states participating in the SSM in the future. Of these banks, it will be *directly* supervising 128 banks (or credit institutions) deemed *significant*. A bank is significant if one or more of the following criteria are met: a bank's assets' value exceeds € 30 billion, or respectively € 5 billion and 20% of the country's GDP where the financial institute is located. If a bank is ranked among the three most significant banks of said country, the institute has large cross-border activities or it receives assistance from a Euro zone bailout fund it will also fall in this category (Art. 6 of the Regulation).[38] These criteria were chosen as they consider both the country's importance where the bank is located as well as the bank's significance itself (Verhelst 2013: 19).

Supervisory Powers

The ECB and NCAs are subjected to **exchange all the information** necessary to perform their supervisory duties. The NCAs' tasks include the responsibility to acquire "*information reported on a regular basis by any supervised entity, and [...] require[d] to check the integrity and quality of the data and make it available to the ECB[.]*" (ECB 2014: 15).

The Central Bank can decide to conduct a general **investigation** and on-site inspections. The investigatory powers include: requiring credit institutions and other legal or natural persons to provide information, conducting investigations of any relevant person and even the right to conduct all necessary on-site inspections. The ECB may also deem a bank significant that has a large amount of cross-border activities, even if the bank does not meet the other criteria. The ECB will

38 The last criterion will only apply if the bank receives direct aid through the ESM or the EFSF, if the stream however goes via a member state first, i.e. indirect aid, this does not apply (Verhelst 2013: 19).

appoint the head of the investigation team which will consist of both ECB and NCA staff. The NCAs are also authorised to launch their own investigations and on-site inspections in relation to less significant supervised banks.

The ECB has the **exclusive competence to grant or withdraw authorisations** (i.e. allow an institute to take up business). Applicants will have to submit their application to their respective NCA. The NCA will then send a draft decision to the ECB. Finally, the ECB can decide whether or not an authorisation is granted.[39] A withdrawal of an authorisation may be requested under EU or national law.

Under Art. 8 of the Regulation, the ECB and the NCAs must cooperate very closely. In this relationship with the NCAs, the ECB may require those authorities (through instructions) to make use of their supervisory power if the ECB is not able to do so.

Participation

Participation in the SSM for member states of the Euro zone is mandatory. Article 2(1) of the Regulation defines a participating country as a "*Member State whose currency is the euro or a Member State whose currency is not the euro which has established a close cooperation in accordance with Article 7 [of this regulation]*".

Non-Euro zone member states are not required to participate, as they do not possess the Euro as a single currency, and are not represented in the ECB's Governing Council. Decisions made by the ECB do therefore not apply within their borders. Non-Euro zone countries may, however, choose to establish a close cooperation agreement with the ECB to participate in the SSM. This creates the basis for the ECB to engage in close cooperation with that member states' responsible competent authority (Article 7(2)). The course of the cooperation between ECB and the respective NCA will be based on and explained in a Memorandum of Understanding. This would *inter alia* contain specifications regarding "*the consultation relating to decisions of the ECB having effect on subsidiaries or branches established in the non-participating Member State*"(see SSM Regulation paragraph (14)), proceedings in emergency situations as well as the establishment of early warning mechanisms. The respective countries will have to ensure "*that their national competent authorities will abide by and adopt any measure in relation to credit institutions requested by the ECB*" (Ibid. (42)). The close cooperation can be terminated by both sides, however, it should only be ended under exceptional circumstances. On the one hand, the ECB may suspend or terminate the cooperation in a case where the NCA of a country does not act in accordance with its obligations (Article 7(5)). Here, the ECB may issue a warning beforehand (Ibid.). Equally, a member state can request the ECB to terminate the cooperation, three years after the publication in the *Official Journal of the European Union* (Article 7(6)). The ECB then has three months to carry out this action.

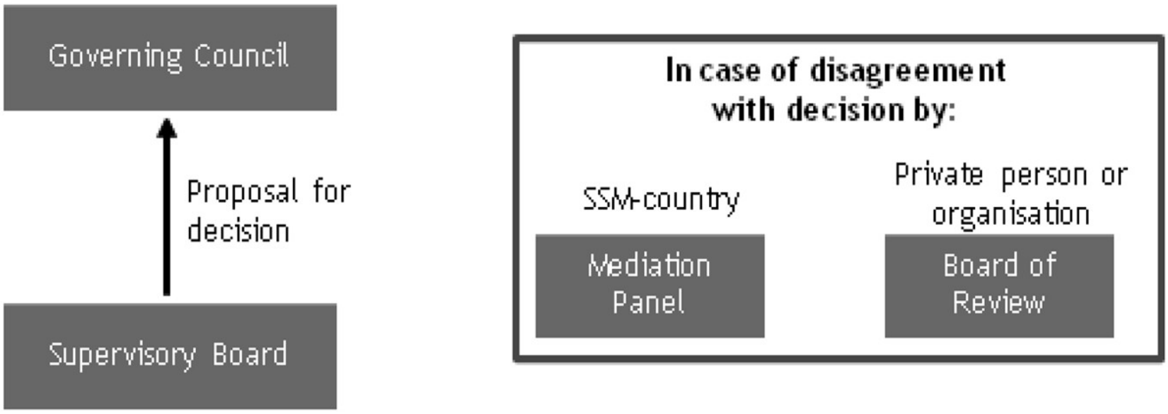
In light of the contents of the Regulation and the design of the SSM it can be concluded that the ECB has been vested with rather strong powers in order to ensure an effective functioning of the Mechanism.

39 It carries out a first assessment of the application on the basis of the conditions laid down under national law. If it considers that the application complies with those conditions, it prepares a draft decision and sends it to the ECB. On the basis of relevant Union law, the ECB performs an independent assessment of the application based on the NCA's draft decision. The ECB may agree or object to the (positive) draft decision of the NCA: it takes a final decision to adopt or to reject the draft decision, i.e. whether to grant the authorisation or not. The ECB decision is notified to the applicant by the NCA.

4.2.2. Decision-making in the SSM

Decisions in the SSM are taken in two forums. These bodies are the Supervisory Board of the SSM and the Governing Council of the ECB. Besides these two, the Mediation Panel will mediate in case of disagreements between the Supervisory Board and the Governing Council; its decisions, however will not be binding. In addition, the Board of Review will look at decisions if contested by a private body; again its verdict will not be binding in any form. *Table 5* provides a depiction of the relevant bodies in the SSM.

Table 5: Decision-making in the SSM



(Verhelst 2013: 22)

The **Supervisory Board** is responsible for the formulation of supervisory policy and for their initial adoption. A draft is deemed adopted unless the Governing Council blocks the decision within ten working days. It is composed of the Chair and the Vice-Chair,[40] both proposed by the ECB and approved by the EP and the Council, four ECB representatives appointed by the Central Bank's Governing Council and a representative of every NCA of the member states taking part in the SSM.[41] The Chair will be a full-time position, the Vice-Chair, however, selected from the Executive Board of the ECB. Within the SSM, this board has to be seen as the decision-making body (Verhelst 2013: 21). In general, the Supervisory Board will make decisions through simple majority vote. The exceptions are "*ECB regulations that are adopted to apply Union law*" (Verhelst 2013: 23). These regulations are quite important as they "*will play an important role in streamlining supervisory practices[.]*" (Ibid.). Here, qualified majority voting applies.

The **Governing Council** is the second decision-making body formally adopting the regulations produced in the Supervisory Board. It has the power to block a decision that was taken by the Supervisory Board beforehand. However, it is expected that the body will do this only in exceptional cases (Ibid.), due to political and market confidence reasons. The Governing Council is composed of the heads of the national central banks and the six member of the ECB's Executive Board, which are appointed by the Heads of State and Government of the Euro zone member states. At any given time only 15 heads of the central banks will have voting rights within the Governing

40 On 20 November 2013, the ECB nominated Danièle Nouy for Chair of the Supervisory Board. She took the position on 1 January 2014. She is the former Secretary General of the *Autorité de contrôle prudentiel et de résolution* and of the Basel Committee.

41 In a case where the national central bank is not the supervisor, the Central Bank may attend the meetings. The two national representatives will then vote as one member (Verhelst 2013: 23).

Council. In a case where the Euro zone has more than 18 members the voting arrangements will alter. In such a situation not all countries that are represented in the Council will be in a position to vote, a situation which will then turn to favour the bigger member states as they will have the right to vote more often.

Notably, the first committee (the Supervisory Board) consists to the largest amount of representatives of the member states who will play a strong role in drafting and adopting the decisions in this body. Since the Governing Council of the ECB also consist of the heads of the central banks and the ECB's Executive Board, which are appointed by the member states, the member states influence on supervisory decisions within the SSM should therefore be regarded as rather strong.

4.2.3. The Comprehensive Assessment

Prior to picking up its full supervisory task, the ECB is currently undertaking a *Comprehensive Assessment* (from November 2013 to October 2014) of the significant Euro zone banks and their balance sheets, falling under direct supervision of the Central Bank. This assessment is composed of three parts: first, the identification of portfolios which need scrutiny;[42] second, an asset quality review (AQR); and third, a stress test conducted in close cooperation with the EBA (Verma 2013: 1; Brennan & Markova 2013).[43] The assessment is primarily designed to achieve transparency, and rebuild confidence in the Euro zone banks. The ECB wants to make sure that the supervised banks are working on solid basis once it takes up its supervisory work (Ibid.). In this regard, the Central Bank has issued a list of 128 banks in October 2013, representing approximately 85% of the Euro zone's banking assets. The publication of the banks' names represents a list of financial institutes that the ECB deemed significant and therefore plans to supervise directly.

In the past, the EBA has already conducted two stress tests in 2010 and 2011 respectively, to boost market confidence. When reviewing the *Bank of Cyprus* and the *Laiki Bank*, the EBA came to the conclusion that the then high portion of Greek government bonds in their portfolios did not pose any risk. Consequently, both banks passed the stress test with flying colours. Only a week after the publication of the stress test results, the European leaders agreed on a new rescue package for Greece, incorporating depreciation and losses on Greek government bonds. Both banks were then in urgent need of fast recapitalisation. This incident did decrease the credibility of the EBA as it failed to restore market confidence. The ECB is committed to avoid a comparable situation with a similar unfavourable outcome, as this would weaken its position as the primary supervisory body even before the official start of the SSM. The Central Bank is therefore conducting the AQR of the significant Euro zone banks beforehand (The Economist 2013; Brennan & Markova 2013).

The AQR examines the most problematic balance sheets in terms of transparency and risk. The NCAs proposed the portfolios that are to be included, and the ECB made the final pick (Brennan & Markova 2013). The bulk of the work is undertaken by the NCAs and private-sector advisors,[44] however, the ECB thoroughly monitors the execution (Ibid.). On 23 October 2013, the ECB has announced the necessary capital requirements in the AQR (8%) against which the banks will be judged. The requirements are based upon the Capital Requirements Directive IV (CRD IV)

42 The first step of the comprehensive assessment, the supervisory risk assessment, is designed to analyse the risk profile of the banks in question and their vulnerability to exogenous factors (Brennan & Markova 2013).

43 The results of the ECB's *Comprehensive Assessment* are not available at the time of writing.

44 The consultancy firm Oliver Wyman, which infamously misjudged the state of the Anglo Irish Bank. The choice did lead to mixed feedbacks from commentators (EU Observer 2013b).

definitions and are composed of a core capital ratio of 4,5% (Common Equity Tier 1), an additional buffer of 2,5% and a charge of 1% relating to the systemic relevance of the banks tested in the comprehensive assessment.

The review itself and the way the ECB is approaching its supervisory task is seen by commentators as a first battle between the institution and the national supervisors over the scope and strength of the ECB as the primary supervisor in the SSM (The Economist 2013). Particularly the French and, to a smaller extent, the German supervisors, are trying to push back the ECB's efforts (Ibid.). Before, the Basel Committee and the EBA have found “*wide and unjustifiable variations in the way banks risk-weight their assets, even when asked to do so for identical hypothetical portfolios[.]*” (Ibid.). The ECB insists that stronger standards will have to be met by the banks. This would mean that French and German banks may be required to raise their capital. The national supervisors seem to fear “*the ECB to find evidence of “regulatory forbearance”*” (Ibid.) stemming from the practice that national supervisors turned a blind eye and allowed banks to “*fudge the level of non-performing loans on their books, restructuring loans and easing repayment terms instead of taking write-downs*” (Ibid.) in order to boost market confidence.

The results of the review will most likely not lead to the announcement of major holes in the banks' balance sheets. Capital shortfalls, which can not be made up for, would be problematic but are not likely to happen. This is due to two reasons, first, as the example of the Italian bank *UniCredit* has shown, banks anticipated the situation and were trying to meet the targets early.[45] Second, the ECB faces a logistical challenge when “*conducting all these complex investigations, in such a short period of time[.]*” (Verma 2013). Although hiring, it has simply not enough expert personnel to cope with the huge workload at this time. Therefore only 58 % of risk-weighted portfolios are probed by the ECB.

In addition to that, exemptions regarding the revaluation of loans are made in some cases (Ross 2014). As noted, a “*number of German banks including Commerzbank and HSH Nordbank will not face scrutiny of their residential mortgage loan books[.]*” (Ibid.). However, the ECB assured that not all banks could avoid scrutiny (Ibid.). Still, these exemptions prompted critique on the AQR, arguing that the ECB “*design[ed] a bank asset quality review that was just tough enough to gain credibility, but not too tough, for fear of scaring the horses*” (Beecroft 2013). The AQR includes “sovereign exposure”, i.e. the already mentioned effects of the vicious circle, in the risk assessment, but a detailed assessment in this regard has been postponed due to the high amount of logistics necessary (Verma 2013), a point regarded as the main goal for the implementation of the BU. The AQR could therefore be regarded as only “*just enough*” (Beecroft 2013), but as helpful to strengthen the position of the ECB.

As the ECB is setting foot on grounds previously controlled by the national supervisors, the comprehensive risk assessment in general, and the AQR in particular, have to be regarded as the first battlefield where the ECB is willing to extent its scope of competences by pushing for stricter standards. The process can be seen as the start of a more “*aggressive era of banking supervision*” (Ross 2014; Taylor 2014). The whole process and the fashion in which the ECB is structuring and conducting the comprehensive assessment can be seen as accelerating the pace and as an argument speaking for the strength and determination of the Central Bank. If the outcome of the comprehensive assessment is regarded as a success (i.e. increasing transparency of assets and

45 In 2013, *UniCredit* did post a surprising loss of € 14 billion, after write-downs and provisions. This loss did arise because the bank was committed to meet the requirements (Ross 2014; Taylor 2014).

boosting market confidence), which it most likely will be, then the ECB will make a big step in the direction of ensuring its authority as the primary financial supervisor in the Euro zone and within the SSM. This situation currently seems to provide evidence that the supranational institution is able to stand against the national side.

4.2.4. The Relationship of the ECB and the NCAs

The availability and quality of data is essential for the effective functioning of a construct like the Single Supervisory Mechanism. Therefore the relationship and cooperation between the ECB and the NCAs, which are responsible to provide the Central Bank with all the necessary information is a very important aspect of the SSM. The hybrid mechanism thereby largely shows delegation features rather than centralisation (Ferrarini & Chiarella 2013: 61). These arrangements are necessary because of the SSM's reach, the available supervisory resources and the proximity of the NCAs to the banks (Ibid.). As noted above, both the ECB and the NCAs are subjected to exchange all the necessary information to enable the ECB to perform the supervisory duties. In this regard, delegation can produce difficulties between both sides, such as information asymmetries.

Although the ECB will initially only be supervising 128 (out of 6.000) (EU Observer 2012c) banks in the Euro zone directly the Central Bank needs to be able to take up direct supervision over any of the smaller and medium-sized banks in cases where the financial standing of such a financial institute is deteriorating. It was determined that the Central Bank should be able to do so in any such situation at any point in time. Due to the size of the whole construct, cooperation between the ECB and the NCA is inevitable from an organisational and management point of view. As such, the ECB will have to acquire and analyse different large streams of information for example from the NCAs and the EBA. As Verhelst notes, a "*good working relationship between the national supervisors and the ECB*" is essential and the ECB will consequently have to "*determine when and to what extent it interferes with national supervision*" (2013: 20). The ECB is dependent on the NCAs which are responsible for the day-to-day supervision of the smaller institutes and providing the ECB with the necessary data (Art. 5(2) and (3) of the SSM Regulation). This decentralisation should however not work against the ECB, as it needs to ensure that its role at the centre of the SSM is not weakened (Ferrarini & Chiarella 2013: 62).

Although both sides are subject to a duty of cooperation and the exchange of information, this cooperation can certainly develop information asymmetries, for example in a case of a crisis. The SSM is created to prevent a situation where the national side could take actions with prejudice i.e. favour actions that first benefit their own banks. Still, the "*delegated authority [could] exploit its informational advantage*" (Ferrarini & Chiarella 2013: 62), particularly to when withholding information. It is not clear how the ECB can ensure that such an offence would be dealt with adequately. The way in which the ECB will handle this situation will determine the effectiveness and soundness of the whole mechanism.

4.2.5. The EBA: Voting Arrangements

When created in 2010, the EBA replaced one of the level-3 committees of the Lamfalussy process (see chapter *1. Introduction*). The pan-EU body now consists of the national supervisory bodies of all EU member states (Verhelst 2013: 32). The EBA's tasks are the development of a single rule book with harmonised rules and technical standards for credit institutions (i.e. banks) and mediation between national supervisors in disagreements about the rules and the preparation for crisis situations (Verhelst 2013: 33). With its creation the EBA was no longer subject of the consensus approach and predominately used simple majority voting arrangements. Along with the regulation creating the SSM, a regulation was published impacting the EBA and particularly the voting rights within this institution. This was necessary as the EBA was created without considering the possibility of "*cross-Member State supervisory integration*" (Ibid.). Due to this fact, it is necessary to examine the EBA in the context of this thesis.

With the creation of the SSM, the EBA was concerned with governance issues, since "*the introduction of the SSM is raising the contentious issue of voting mechanisms in the Board of Supervisors of the EBA*" (EBA 2012: 6). Since not all EU member states take part in the SSM, non-participating member states such as the United Kingdom share the concern that the other member states would vote as a single unit, steered by the ECB and consequently undermine the other member states in the decision-making process. Due to their number (i.e. representing a simple majority) these SSM-countries would control normal decision-making in the EBA (Ibid.). Under qualified majority they would possess a blocking minority. The arrangements concerned with the latter will change in November 2014. Then, the SSM-member states would possess a qualified majority, too (Verhelst 2013: 34). Therefore the double majority has been introduced under which an EBA decision needs "*both a majority of SSM-countries and a majority of non-SSM countries[.]*" (Ibid.).

Some commentators consider the British concern to be, for the most part, unsubstantial. Voting within the EBA is done by national supervisors, and the ECB as such does not possess or receive any voting rights. In addition, the idea brought to the table by the Commission, that "*the SSM-countries should coordinate their voting in the EBA, [...] has been dropped in the final text*" (Ibid.). This clearly carries the fingerprints of the member states. Nevertheless, the ECB might be able to extent its influence in the EBA. In a critical situation where the ECB stand for a certain point of view, the SSM-countries can be considered to vote accordingly. However, it might similarly be the case that the NCAs and therefore the member states use the EBA as a forum to take paths not favoured by the ECB. It is difficult to predict the outcomes of such situations, and in reality, this is a point that remains to be answered in the future.
The new arrangements fit until a situation arises where only a very small amount of member states does not participate in the SSM. These would then be in a position to hamper and block progress and decision-making in the EBA. With these considerations in mind, it can be stated that the situation in the EBA still seems to be complicated.

4.2.6. Reflection II

The second half of this analysis has examined the design of the SSM in more detail. As such, it aimed to explore the strength of the different supranational and national components and the possibility of the Mechanism and these components to either produce more supranationalism or limit the supranational power through a stronger national influence.

When looking at the SSM, it can be stated that the ECB is vested with rather broad powers within the Mechanism. Although the actual number of banks the ECB directly supervises is comparably small to the number that it only indirectly controls, but after all these 128 banks stand for approx. 85% of all the banks' assets in the Euro zone. In addition, the ECB can at any time it sees fit decide to resume direct supervision over one or more credit institutions. This element is strengthening the credibility of the SSM as a whole, as its absence would otherwise weaken the position of the ECB

(Verhelst 2013: 19). Stronger powers conferred to the supranational entity could consequently translate into more supranationalism, as the ECB would be able to gain ground vis-à-vis the national supervisors and the member states when it comes to supervisory issues. The ECB insists that stronger standards will have to be met, despite French and German reservations. The design of the comprehensive assessment and the approach the ECB has chosen to conduct it in, is currently regarded as a profitable action for the Central Bank, as the common perception connects a successful comprehensive assessment and AQR to a central bank that is positioning itself as a strong primary actor in the SSM. However, it is necessary to keep in mind that the powers conferred to the ECB were indeed agreed between the member states to ensure a functioning SSM. It remains to be seen whether the ECB is able to maintain and further extend its competences.

The concern of some of the non-Euro zone member states that the ECB would gain more control within the EBA seems to be largely unsubstantial. In reality, the ECB does not possess voting rights in the EBA and the voting arrangements have been adjusted as called for by e.g. the UK and Sweden. In the end, decisions in the EBA are made by the heads of the NCBs. The final text of the regulation even dropped the phrase calling for the SSM-countries to vote as a single faction and in addition calls for unanimity among all countries in the EBA.

Within the Supervisory Board and the General Council, ergo the decision-making bodies in the ECB/SSM, the bulk of the voting rights rests with the representatives of the member states' NCAs and/or national central banks. This could mean strong influence in drafting and adopting of supervisory decisions.
The relationship with the NCAs could be an area where negative effects and subsequently disadvantages for the ECB reveal themselves. As argued, the ECB depends on the national supervisors to cooperate and provide information on those financial institutes it is only indirectly supervising. It is unclear how the ECB could handle a situation where a NCA acts with prejudice or withholds information. Much of the future development and the credibility and effectiveness of the SSM depends on the way the ECB is handling the relationship with the NCAs. Although it should be careful, it also should "*dare to use its powers to claw back the delegation of supervision when it has doubts regarding a national supervisor's actions*" (Verhelst 2013: 19). As noted earlier, the ECB will subsequently have to "*determine when and to what extent it interferes with national supervision*" (Verhelst 2013: 20).

This reflection will now again take a look at the hypotheses: The expectation formulated in *H(NF) 3* can as such not be confirmed to the required extent. True, the establishment of the SSM and the incorporation of a strong ECB do provide an increase of power on the supranational level. In addition, the ECB is now working on grounds formerly controlled by the member states' authorities and aims to further strengthen its position. The SSM constitutes a point of no return. The other components of the BU will also have to be implemented. However, when looking at the expectation derived from NF-theory this fact does not acquire full support. The design of the Mechanism was negotiated between the member states. The scope of power the member states decided to equip the ECB with is based on their preferences and the interest to produce a functional mechanism. In addition, the competences seem not to allow for an independent development to more supranationalism through the supranational actors. Consequently, *H(LI) 3* should at this point be confirmed. Although the national side cannot be deemed stronger, as the real strength of both sides within the Mechanism cannot be determined in full at this stage, this set-up was favoured by the member states. The EU has seen a lot of cross-border banking, a situation where supranational supervision is rather favourable. In other words, the supranational approach does provide more benefits than a national solution. The circumstances therefore match the member states' sets of preferences to support some a certain degree of integration.

Based on the above made observations, *H(NF) 4* cannot be rejected, but cannot be confirmed in full either, as evidence of the ECB being successful in extending its power without the support of the member states remains a development of the future. The ECB is currently positioning itself as the strong actor within the SSM, as the AQR is commonly expected to be a success. As the Central Bank has been vested with rather broad and strong powers, it could still be possible for the ECB to further substantiate its claim in the future. Subsequently, the hypothesis *H(LI) 4* again cannot be rejected or confirmed to the extent necessary. The member states remain influential within the SSM, but at this point in time it cannot be sufficiently argued that the member states will be constantly limit or hinder the ECB in the decision-making process. *Table 6* provides an overview over the status of the second set of hypotheses.

Table 6: Reflection II

Hypotheses	**Status**
H(NF) 3: *If Neo-Functionalism is suited to explain the process of integration in financial supervision, this will lead to a higher degree of supranationalism and this would then be reflected in the design of the Mechanism.*	Not Confirmed
H(LI) 3: *If Liberal Intergovernmentalism is applicable, the SSM would incorporate stronger national components than supranational ones as long as this matches the member states' set of preferences.*	Confirmed
H(NF) 4: *If Neo-Functionalism is applicable, then the supranational actors are able to claim more power in the SSM.*	NC / NR
H(LI) 4: *If Liberal Intergovernmentalism is applicable, then there would be evidence that the national side (principal) is willing to limit supranational power (agent).*	NC / NR

4.3. Conclusion on sub-Research Question *sRQ*

The analysis has aimed to provide the basis to answer the main research question *RQ1* as well as the sub-research question *sRQ* of this thesis. The next paragraphs will provide conclusions regarding the latter of these questions before turning to the primary *RQ1* and the main point of interest of this thesis in the next chapter.

sRQ: *Which European Integration theory is better suited to explain the integration process in the European Union's financial supervision sector, and the establishment of the Single Supervisory Mechanism?*

In order to answer the *sRQ*, the analysis has been divided into two stages. The first tried to determine the relative strength and influence of the actors on the creation of the SSM and its design. As it can be observed in chapter *4.1.4. Reflection I,* the Council and the member states were identified as the decisive actors in this regard. The SSM and its design have to be described as a compromise achieved among the member states within the Council. Both the Commission and the ECB favoured a faster and broader approach, as the supranational institutions aimed for a starting date as of 1 January 2013 and no exclusions, referring for example to the German *Sparkassen*. Both targets were not met. Only the Parliament was able to secure a say in the appointment of the Chair and Vice-chair of the Supervisory Board. Still, this only improves the Mechanism's democratic accountability. The influence of the member states becomes even more apparent when searching for an underlying momentum. This notion was dismissed above, as solely the member states negotiated the establishment of the BU and SSM among themselves. The time gap between integration in the financial sector and integration in the financial supervision sector supports this claim.

These observations suggest stronger explanatory power of Liberal Intergovernmentalism over Neo-Functionalism regarding the first stage. Expectations derived from NF-theory could not be confirmed.

The analysis' second part produced a more complex picture. Although the member states were in the past reluctant to agree to integration in the field of financial supervision, the SSM marks such an occasion. Both national and supranational actors and components have been included in this set-up, both equipped with powers. NF expects more supranational power, and this was produced with the creation of the SSM. However, the design includes only powers agreed upon by the member states. It seems to be the case that within the SSM the relationship between both sides could provide more evidence, unfortunately cannot be backed up by hard evidence. It has to be acknowledged that the ECB is equipped to position itself as the strong actor within the Mechanism. These observations, however, still do not provide clear evidence for the explanatory power of one theory over the other. There is more supranationalism but the member states decided to implement it and retain strong influence. The establishment of such powers have rather to be seen as ensuring a functional SSM. Also, the Mechanism addresses supervision of banks, but not the rest of the financial sector, such as insurance agencies. Finally, some elements of bank supervision, e.g consumer protection, remain a national responsibility.

Liberal Intergovernmentalism has been identified as best suited to explain the creation of the SSM. However, the expectations derived from both NF and LI could not be fully rejected or confirmed when looking at the second stage. That stage largely concerns problem-complexes and developments that lie in the future of the SSM and can therefore not backed up or rejected with bulletproof evidence. All in all, however, Liberal Intergovernmentalism can be regarded as better suited to explaining European integration in the area of financial supervision at this point. The financial crisis might be seen as having created a paradox: it has led to more supranational control in the European financial sector and at the same time strengthened the role of national governments and the intergovernmental cooperation as opposed to supranational integration.

5. The Single Supervisory Mechanism – Summary

The establishment of the Single Supervisory Mechanism can be regarded as quite "*a momentous step*" (as formulated by Michel Barnier, Commissioner responsible for the Internal Market and Services, on 15 October 2013). It was mostly met with a positive resonance, as it marks the important first step on the way to the emerging European Banking Union to foster and ensure, along with its other components, the Single Resolution Mechanism and a Common Deposit Guarantee Scheme, the financial stability in the Euro zone and the EU as a whole – thereby breaking the vicious circle that impacted sovereigns and banks heavily during the crisis (see chapter *1. Introduction*). Furthermore, the SSM introduces an integrative element into the European financial sector and, thus, in a policy area that has seen few such measures. In the past, integration in the European financial sector happened *inter alia* through the introduction of the Euro as a common currency. However, the area of financial supervision did not follow up on this development and remained under the control of domestic institutions on the national level. The financial and the sovereign debt crisis, however, exposed the weaknesses of the existing system as the crisis' effects significantly affected financial stability. Therefore, a mechanism was to be found to overcome the limitations and shortcomings of national based approaches, to be able to manage the wider impacts of the sovereign debt crisis and to respond timely and effectively to possible future ones affecting Europe's financial stability and economic welfare.

Given the importance member states attach to their (national) financial sector and the proper functioning and financial solvency of their banks and financial institutes as key supporters of their economies and, on the other hand, in view of the political sensitivities related to national sovereignty connected to the financial sector, the establishment of the SSM at the European level is a significant development with potentially far-reaching consequences. From a scientific perspective, it immediately suggests examining whether it represents a new tool for nations to get better control of the interconnected financial sector or whether it carries the potential of giving supranational integration in the European financial sector a push towards a self-sustaining integration process.

5.1. Conclusion on Research Question *RQ1*

With the above in mind, this thesis' chief interest lays in the question of whether or not the SSM could become a strong, supranational entity of its own, or if it will remain under strong control of the member states. From this guiding interest the following primary research question was derived:

RQ1: *What is the relative power of the supranational and the national side within the Single Supervisory Mechanism?*

The relative strength of the two sides – supranational vs. national – was characterised by their influence in the creation process of the SSM as well as within the final set-up of the Mechanism (see chapter *3.3. Operationalisation & Variables*). As the analysis has shown, Liberal Intergovernmentalism all in all seems to be better suited to explain integration in the area of financial supervision. The theory attaches more power and influence to the member states and the national side. Expectations derived form that theoretical framework could be matched accordingly with the observational evidence, and were broadly confirmed in the analysis, although not all hypotheses derived from Neo-Functionalism were falsified in full. The analysis has also shown that both the supranational side and the national side are equipped with considerable powers and different possibilities resulting from the SSM's set-up. As the relative strength of the ECB can be explained by the notion that the goal was to establish a functioning SSM, and the member states remain influential in the creation process, through the inclusion of the NCAs as well as the composition of the decision-making bodies and other competences, a small preponderance on the national side can be detected influencing the scope and scale of the SSM's possible development. Yet, the supranational side is still not to be seen as weak.

5.2. Implications for the Future of the SSM

With regard to the thesis' guiding interest on the implications of the establishment of the SSM for possible future supranational integration in the financial sector, it has been shown that the member states remain influential also after the creation of the SSM. Still, as the analysis has demonstrated, the establishment of the SSM and the strong role of the ECB aim to reduce the negative externalities of separated national financial supervision. The member states are therefore not likely to continuously limit the ECB's sphere of influence as the main actor within the framework of the Mechanism. Rather, discussions and consensus-orientated solutions should be the action of choice.

Although the member states were most influential in designing the SSM, it is necessary to keep two observations in mind which underline the role of the supranational side. First, the ECB was equipped with rather broad powers within its role as the main supervisory body in the SSM. Second, and probably even more remarkable, the member states "*withstood the temptation of creating a partial SSM that would have covered only the largest banks[.]*" (Verhelst 2013: 51). The notion that the ECB will supervise the majority of the banks only indirectly, is made up for by the fact that the banks which the Central Bank will be covering directly stand for approx. 85% of assets in the Euro zone. In addition, the ECB will be able to take up direct supervision over any credit institution, if it sees the necessity to do so. The ECB will always have the final say.

With the establishment of the SSM, the EU has produced a greater level of supranationalism and removed several problems highlighted by the financial crisis. Although, the SSM is probably unlikely to become as independent a body as, for example, the European Commission or the ECJ, this does not stand in contrast to a strong primary actor, the ECB, and an effective Mechanism.

The relationship between the ECB, as the central actor of the SSM, and the NCAs will determine the future development and the success of the Mechanism, still it "*will be quite a task for the ECB to take up its supervisory role, as it needs to quickly develop supervisory competences[.]*" (Verhelst 2013: 51). But similarly the ECB has to be careful to decide when to interfere at the national level of supervision. The latter is an essential point when looking at that relationship. Here, there are risks associated with possibly arising information asymmetries, rooting form a NCA decree over the information the ECB may be in need of. A strong but thoughtful approach to the situation is most favourable.

As Verhelst notes, more important than the establishment of the SSM itself is the point that this "*represents a point of no return towards a European Banking Union. As a consequence of the SSM, the EU will have to put in place the other essential pillars of the Banking Union*" (2013: 52). In fact at the point of writing an agreement was reached over the SRM. Even though the SSM will most likely not develop as some supranational institutions, it heralds the start of a new era of financial supervision and promises, if effective, sound supervision to prevent banks in Europe, those with significant cross-border activities in particular, from conducting hazardous financial operations. The groundwork for an effective SSM is laid and the potential for successful development is there.

6. Summary Conclusion and Outlook

This thesis' research question was to identify the relative strength of national and supranational actors and components within the European Single Supervisory Mechanism (*RQ1*). The SSM, established with the publication of Council Regulation (EU) No. 1024/2013, was created as a hybrid of both national and supranational components, most distinctly reflected in the inclusion of both the ECB as well as the NCAs. This configuration provided fruitful and interesting ground for research revolving around one general point of interest on how the Mechanism might develop in the future, either as a strong supranational entity able to pursue its own goals or effectively remain under the control of the member states.

The appropriate theoretical framework was established through the application of two of the prominent European integration theories: Neo-Functionalism and Liberal Intergovernmentalism. Both theories differ in their central points of explanation regarding the reasons, actors and mechanisms driving and directing European integration. To enable conclusions to be drawn on the main research interest and question, a sub-research question was established (s*RQ*) looking at the explanatory power of these theories within the area of European financial supervision. The analysis proceeded to detect matches and divergences between expectations, derived from theory, and observational reality within the framework of a Congruence Analysis. Besides the main research interest in the functioning and the possible future development of the SSM, the thesis therefore had a second objective: the provision of evidence for the applicability and suitability of the two European integration theories.

When examining the issue in question the need to analyse two specific stages arose. First, the development and establishment phase of the Mechanism and, in the course of this, the relative influence of the relevant actors. The analysis of the negotiation process and its comparison with the final policy output has shown that the influence of the supranational side was rather limited. Evidently, the member states, i.e. the national side, took a dominating role in the process, as they decided the scope of this supervisory regime as well as the pace of its implementation. Forced policy response due to technical or functional pressures strong enough to initiate the process on their own could not be proven as such. Rather, the final design of the SSM must be seen as a compromise achieved mainly within the Council. The scope of national influence suggests that the member states saw the SSM as the means to produce benefits and decrease negative externalities that have shown themselves during the sovereign debt crisis. The question that remained was whether the SSM's design provided for development with or without control of the member states.
The second phase was therefore the subsequent step of the analysis. Theory laid the grounds to look at how the design of the SSM, and the allocated strength of the different national and supranational components can either generate more supranational- or strengthen national control. Here, the analysis has shown that both sides are influential and the ECB has been equipped with strong powers, but the SSM will not be able to act as independent as other supranational organisations. Consequently, Liberal Intergovernmentalism's explanatory approach was deemed more suitable to explain integration in the area of financial supervision.

These findings made it possible to draw conclusions on the possible future development of the SSM. The member states remain influential even after its creation, but in order to ensure a proper functioning and effective Mechanism the ECB was equipped with rather strong competences. Also, it is unlikely that they will limit or try to steer the ECB’s activities at every turn, as this would undermine the effectiveness of the Mechanism (along with the other elements of the European Banking Union) and would therefore stand in contrast to the goal the member states want to achieve, i.e. effective management of risks associated with the operations of European banks as well as regaining and maintaining financial stability in the European financial sector. Similarly, the member states "*withstood the temptation of creating a partial SSM that would have covered only the largest banks[.]*" (Verhelst 2013: 51). The relationship between the supranational side (the ECB) and the national side (NCAs) within the SSM and how this will be handled by the ECB will influence the SSM's future development and its success. the Central Bank has to be careful in deciding when to interfere at the national level of supervision.

Future research could further shed light upon the development of the hybrid mechanism. As such it is promising to look for evidence when the SSM is fully operational and took up its work. Additionally, the functioning of the SSM could be explored once the other components of the BU have seen an agreement and the BU is finally established. This shows the limitations of this research as many answers and developments are still in the future and can therefore not be included. It is only possible to evaluate the available data and draw conclusions based on the findings. Although these limitations exist, the impact on validity and reliability could be decreased due to the chosen approach.

Finally, one could examine a related question, namely whether the key governing consideration to describe and explain the SSM should be the antagonism of supranational integration versus national control and intergovernmental cooperation respectively or whether the SSM rather reflects the sheer necessity of the member states and governments of the Euro zone creating a means, through which they collectively can ensure sufficient control of the banks in the Euro zone. Since the latter are interconnected and act at trans-national level, an appropriate mechanism to supervise them had to be established at European level, too – irrespective of whether or not this may favour supranational integration. In the light of this, the SSM (and the BU at large) could perhaps be considered not so much through the lens of an integrative supranational entity but as a collective instrument of the Euro zone's national governments to get control of the banking system in Europe, with a view to preventing another trans-national financial crisis. This considerations leads to questions of whether it may be some sorts of hybrid mechanism that may increasingly determine the European Union's further development also in other policy areas, or if this remains a subject of "uncertain" policy fields (in the sense of Moravcsik) such as financial supervision.

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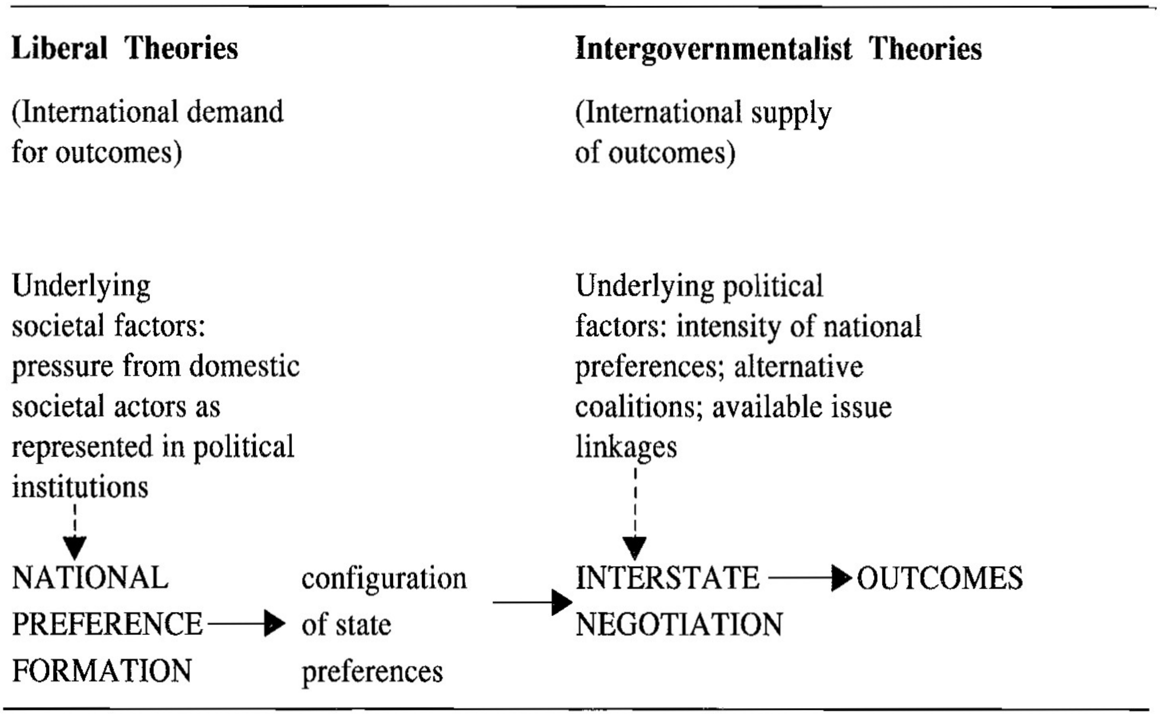
8. Annex

Annex I (p. 13)

Figure 1: The Liberal Intergovernmentalist Framework of Analysis



<u>Source:</u> Moravcsik, A. (1993). Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach. Journal of Common Market Studies, 31:4, p. 482.