UNDERSTANDING THE POLITICS OF NEGOTIATION: EXPLORING THE SINGLE SUPERVISORY MECHANISM

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I, the undersigned ………..….Savithar Chiarapong……….hereby declare that I am the sole author of this thesis. To the best of my knowledge this thesis contains no material previously published by any other person except where proper acknowledgement has been made. This thesis contains no material which has been accepted as part of the requirements of any other academic degree or non-degree program, in English or in any other language.

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Abstract

The negotiation on the establishment of the Single Supervisory Mechanism (SSM) in the European Union (EU) was difficult and complex due to the involvement of multiple countries and issues. Each member state had its own particular preferences, which led to disagreement over some SSM issues in the negotiations. In the end, member states managed to reach an agreement in a timely manner. This thesis aims to examine the process and factor that made member states, which had diverse preferences, agree on the outcomes of the SSM negotiations. Based on the analysis, member states sought to find common ground on the controversial issues through a multilateral compromise. Bargaining power of member states played some roles, but not entirely, in shaping the negotiation outcomes. Combined with a smart tactic used by the European Commission (the Commission), the impacts of the financial crisis were seen as the driving forces behind pressuring member states to agree on the negotiation outcomes through a compromise.

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Introduction

The establishment of the SSM represents a major breakthrough for the EU integration. As the first pillar of the banking union, the SSM marks a significant shift of supervisory power from the national to the supranational level –a transfer of power that had previously received objections from member states. The SSM or the new centralized supervision aims to provide consistent supervision and ensure the financial integration and stability of the overall European banking system. The European Central Bank (ECB) is the main responsible actor, working in cooperation with the national supervisors.

Originated in the United States (U.S.), the recent global financial crisis has not only shattered market confidence, but also threatened financial stability in many countries around the globe, including the EU. Several EU member states were badly affected by the spread of the crisis. Amid the financial crisis, a number of EU financial institutions experienced hardship and unprecedented losses. However, banking crises in the EU quickly developed into sovereign debt crises, when some national governments spent large amounts of money on rescuing their domestic banks and almost bankrupted themselves. The shortcomings of the original design of the Economic and Monetary Union (EMU) were accused of making the EU vulnerable to the crisis. The design flaws gave rise to the negative bond between banks and sovereigns, and the inefficient and uneven practices of banking supervision. To solve the euro crisis and to impose structural reforms on the EMU, banking union is introduced, in which the setting up of the European banking supervision is the first step of banking union implementation.

At the time of the crisis outburst, the leaders of the Eurozone member states agreed on the establishment of the supranational supervision at the Euro area summit in mid-2012. The principle of the SSM was approved by the euro area heads of state and government, but its details must also be agreed by the Council of the European Union (the Council). Still, member states, particularly the Finance ministers, appeared to have different preferences on some issues of the SSM, raising heated debates in the EU intergovernmental negotiation. Most of the concerned issues on the new centralized supervision were raised by Germany, a leading participant in the SSM negotiations. Mostly disagreed with Berlin on the SSM issues, France, which is another primary actor, took the opposite position. Other member states and some supranational institutions, particularly the Commission, also actively participated in the negotiations in order to push national governments to agree on the supranational supervision.

In the end, the agreement on controversial issues had been reached by the end of 2012, and the SSM started its operation in November 2014. What puzzles me is how member states, particularly Germany and France hegemonies, which stood on opposite sides of negotiation and had different views on the SSM, managed to deal with and finally agreed on the concerning issues in this political negotiations. Thus, this thesis aims to answer the research questions: *How did and what made the EU member states with diverse preferences agree on the outcomes of the SSM negotiation?* The findings of this study could be used in an explanation for political negotiation concerning the establishment of other elements of the banking union – the Single Resolution Mechanism and a European Deposit Insurance Scheme –, which was (will be) implemented after the launch of SSM.

In terms of research design and methodology, preferences and bargaining power of some member states are assessed in this thesis. It is necessary to understand how preferences of countries on the SSM were formed as they indicated the positions of member states in the negotiations. The bargaining power of member states and some EU institutions is also taken into account to see if it was used to influence negotiation outcomes. Member states' preferences on the SSM were shaped by the unique structures of national banking sector (Howarth and

Quaglia 2015a), the conditions of domestic economy, the pressure from lobby group and public, and the institutional environment of where domestic regulators operate (Lombardi and Moschella 2016). Member states' bargaining power can be measured by the importance of their domestic economies and population size. This thesis discusses in more detail the overview of domestic economies and population as well as the structures of domestic banking system and the characteristics of domestic banking regulators of only key member states, namely Germany, France and Spain. Germany and France are chosen not only for their powerful positions in the Eurozone, but also for their leading roles in the negotiations and their hugely different stances on some issues of the European banking supervision. Given its direct involvement in one of the controversial issues of the SSM, Spain is also selected to demonstrate how other euro area member states, apart from Germany and France, reacted in the negotiation. Furthermore, only three controversial issues, which are the scope of the ECB's direct supervision, the speed of the implementation of the SSM and the potential conflicts of interest within the ECB, are emphasized to examine how member states reached an agreement over these issues.

This thesis however contains some limitations in two areas. Firstly, the thesis is unable to assess the country overview, the structures of national financial system and the features of domestic banking regulators of all member states. Although the SSM negotiations involved a number of member states, exploring all of them would be too ambitious and unnecessary since some countries had unnoticeable roles in this political negotiation. Secondly, other contentious issues such as on the relationship between non-euro area countries and the new supervisory mechanism (Howarth and Quaglia 2016) are not included in this thesis. Coupled with the inclusion of other controversial issues, an analysis on preferences of some other member states such as Italy and the United Kingdom should be carried out in future research concerning the political negotiation of the SSM. This would hence enable us to understand the political negotiations of the supranational supervision in a more complete view by taking into consideration of more issues and more countries, including non-eurozone.

This thesis is based on qualitative approach. The main sources of information are from academic journals, websites of the EU institutions (eg. the Commission and the ECB) and newspapers. Academic journals are essential sources as they crucially provide a vast literature on the political economy of the SSM. The websites of the EU institutions contain a set of legislation, regulations, minutes of meeting, and speeches of high-level officers concerning the establishment of the supranational banking supervision. Newspapers such as Financial Times and Euractiv gather all news reports about the SSM negotiations, including opinions and speeches of important officials directly involved in the negotiations.

The thesis is organized into three chapters. The first chapter starts with theoretical framework concerning political negotiations. Served as a literature review section, this chapter highlights key negotiation approaches, the sources of bargaining power, national/supranational preferences formation, and the key features of the EU negotiations. The second chapter explains how the global financial crisis led to the creation of the SSM in order to provide background information. This chapter begins with how the global financial crisis initially started. Then, it highlights how the global financial crisis spread to the EU and its disastrous impacts on member states' economies. Also, the second chapter discusses the main weaknesses of the original design of the EMU. These flaws are believed to be root causes of the financial crisis in the EU, leading to a strong need for the integrated supervision. The third chapter assesses the political negotiations of the SSM. At the beginning of this chapter, a general information about Germany, France and Spain is presented, along with information about their specific characteristics of domestic banking sector and banking regulators. Then, it is followed by the political negotiations among member states and the EU institutions on three contentious issues mentioned earlier and the outcomes of the negotiation. This chapter seeks to provide answers to the research questions. Finally, the thesis ends with the conclusion.

Chapter 1: Literature Review- The Politics of Negotiation in the EU

Negotiations are crucial to the functioning of the EU. Practically, the process of negotiation involves all EU activities, starting from making day-to-day decisions to modifying the institutional framework for decision-making (Dur et al. 2010). The policy-making procedure for adopting new legislatives and setting up new supranational authorities in the EU, including the SSM, must pass through a process of negotiation.

Political negotiations in the EU could be difficult, bothersome and long, especially when dealing with a large number of actors. Given the differences in preferences and interests, conflicts may arise. Member states negotiate or bargain with each other in order to achieve their desired outcomes on particular issues. Some may exert their bargaining power in order to influence outcomes that align with their preferences. Disagreement in negotiations among member states is common. To resolve conflicts and reach an agreement in a timely manner, suitable bargaining strategies must be used to deliver satisfied outcomes for all parties. The literatures on bargaining strategies, bargaining power, the formation of preferences and characteristics of the EU negotiation would serve as crucial guidelines for the assessment of the SSM negotiations

This chapter is divided into two parts. Part one highlights the main bargaining strategies and the sources of bargaining power. Part two presents the preferences formation and the key characteristics of the EU negotiations.

1.1 Bargaining Strategies and the Sources of Bargaining Power

Several bargaining approaches are available for negotiators. Yet, each approach conveys different outcomes. This part discusses the key approaches and their advantages and/or disadvantages. Also, it explores bargaining power resources that enable negotiators to influence negotiation outcomes.

1.1.1 Bargaining Strategies

A negotiation can be defined as 'a process in which parties with differing interests seek a mutually agreeable set of terms that each would prefer to non-settlement' (Lowenthal 1982). It is also considered as a vehicle of communication (Alfredson and Cungu 2008) and a form of social interaction not only to accomplish goals of negotiators, but also to find solutions to conflicts (Thompson 1990). Conflicts generally arise from different preferences of actors. As a result, each negotiating party seeks to achieve its ultimate interests by adopting competitive strategies in order to win the negotiations (Lowenthal 1982).

Many scholars identified and analysed various bargaining approaches. For example, Alfredson and Cungu (2008) presented an overview of several bargaining strategies such as structural, strategic and integrative approaches; Da Conceição-Heldt (2006) examined two key bargaining situations, namely integrative and distributive bargaining, used in the EU negotiations; and Elgström and Jönsson (2000) provided an explanation on distinction between bargaining and a problem-solving approach, in which are commonly known as distributive and integrative negotiations, respectively. Apart from the previously mentioned bargaining approaches, another well-known bargaining method is the game theory. There are many types of game available. In a particular game, outcomes are different in relation to strategies the players use.

This thesis focuses on key bargaining approaches, notably distributive and integrative approaches, and a famous type of game-theoretical model called Prisoner's Dilemma.

In general, a distributive approach is always used in comparison with an integrative model when analysing the outcomes of negotiation. As defined by Thompson et al. (2010), a distributive aspect of negotiation refers to a situation when 'negotiators are mainly concerned about their own economic outcomes and not the joint outcomes of all negotiating parties'. In other words, this approach is based on competitive behaviours of negotiators in dividing scarce resources (Da Conceição-Heldt 2006; Dür and Mateo 2010) in order to secure the biggest portion of desired benefits while leaving the other side with the smallest (Alfredson and Cungu 2008). This one's gain-one's loss bargaining approach is known as 'win-lose' or 'zero-sum' negotiations.

In contrast to a distributive approach, an integrative method creates 'win-win' outcomes, in which neither negotiating party is going to lose. As Thompson et al. (2010) put it, an integrative approach is the situation when both parties satisfy with negotiating results and that 'all creative opportunities are leveraged and no resources are left on the table', resulting in Pareto efficiency. Under an integrative method, negotiating actors cooperate, work together, share information and make joint decisions. This allows them to reach a common-interest agreement. Hence, an integrative approach is sometimes called a 'cooperative' or 'non-zero sum' or 'win-win' or 'problem-solving' type of negotiation.

The application of game theory is prevalent in many areas of negotiations. One of the classic game-theoretical models is the Prisoner's Dilemma. Two prisoners are left to decide whether to confess to their crimes or not. There are three possible consequences that could occur from their decisions (Figure 1) -1) if one prisoner confesses while his partner does not, the prisoner who confesses is released but his partner must serve a prison for 5 years; 2) if both prisoners confess, both of them get 3-year sentence; and 3) if none of prisoner confesses, both go to jail for 1 year.

Figure 1: Prisoner's Dilemma

		PRISONER 2	
		Do not Confess	Confess
PRISONER 1	Do not Confess	(-1,-1)	(-5,0)
	Confess	(0, -5)	(-3,-3)

The game of Prisoner’s Dilemma, if play repeatedly, demonstrates that if both prisoners rely on cooperative strategy (both of them are not going to confess based on a trust they have on each other), they could be able to reach mutually beneficial outcome (Brams 1975) or yield more satisfying results than choosing other alternatives (Keohane 1986). When applying the Prisoner’s Dilemma to real-world negotiations, participants are more likely to be better-off when they choose to cooperate with each other.

Based on the literature presented earlier, it would make more sense for the EU member states to choose an integrative or cooperative strategy rather than a distributive approach when participating in negotiations. While a distributive approach only concerns about the maximization of individual surplus and could create difficulties for negotiators in reaching conclusion (Stoshikj 2014), a cooperative strategy provides more desired results as it creates a win-win situation for all parties.

1.1.2 The Sources of Bargaining Power

The main objective of negotiating actors is to achieve possible desired outcomes. It is not surprising to see participants use bargaining power to influence the negotiation outcomes, making them align with their preferences. The EU negotiation is no different from other common negotiations. Generally, member states with stronger bargaining power are in better negotiating positions to shape the outcomes of agreement than those with constrained power. Hence, it is vital to examine power resources that assist the EU member states in achieving negotiation success. Few studies discuss key factors that contribute to the success of member states in reaching goals in, for example, the Council (Bailer 2010; Cross 2013) and the European Council (Tallberg 2008) negotiations. Based on the study of Tallberg (2008), I distinguish bargaining sources of power into two dimensions, which are the state and individual.

State's Source of Power

A country's power can be determined by its structural characteristics such as the number of population, the size of economy and the capacity and stability of the political system (Tallberg 2008). Coupled with greater political capacity and stability, member states with higher number of population and bigger size of economy tend to be larger states and are more powerful than those with the opposite. In an attempt to analyze EU negotiation activities, several scholars assumed that larger member states are equipped with sufficient resources and capacity, including financial, economic and political sources of power, which are advantageous to them and would thus enable them to influence negotiations (e.g. Tallberg 2008; Dur and Mateo 2010).

The importance of other structural characteristics of member states, notably economic size and political stability, cannot be overlooked. Both economic strength and political stability and capacity can be transformed into power resources of member states. We have witnessed that economies of member states, especially the Eurozone, are highly interdependent upon each other. This makes member states with large home market to be more influential in economic negotiation (Tallberg 2008) as they stand in significant positions in international economic networks and have the power to block trade (Bailer 2010). Likewise, member states with a high level of domestic political stability and capacity are likely to have more political influence in the negotiations than those with instability and less capacity in politics. An example would be the case of Italy before the unification. Despite the same level of economic strength and the same size of population as France, Germany and UK, the country's political influence in the negotiation, however, was hindered by the weakness of its political instability (Tallberg 2008).

Individual's Source of Power

Negotiations require the actions of individuals to perform. The outcomes of negotiation are derived from what negotiators prepare for the discussion beforehand and how they do, say or interact during the negotiations. Whether the outcomes of negotiation are successful and align with preferences of negotiators or not depend on bargaining skills and experience of individuals, who conduct negotiations.

A number of literature gauge a relationship between personal skills and outcomes of negotiations (eg. Thompson 1990; Tallberg 2008; Bailer 2010; Thompson et al. 2010; Stoshikj 2014). Among these studies, some literatures found that the individuals' skills have influence on the success of negotiation outcomes. For example, Tallberg (2008) considered individual personality traits, experience, authority and expertise as important bargaining sources of power for participants in shaping negotiation outcomes in the European Council; Stoshikj (2014) investigated negotiation behavior in general negotiations, and her findings showed that negotiation outcomes not only depend on bargaining skills of involved actors, but also their chosen behavior and strategies used in negotiation.

As mentioned earlier, a negotiation is viewed as a form of social interaction (Thompson 1990). The behavior of negotiators can thus be explained by social psychology through intrapersonal and interpersonal system such as perceptions and inner experience of negotiating actors, how they interact with opponents in negotiation, and what strategies or medium of negotiation they use (Thompson et al. 2010). Undoubtedly, experienced actors, who are able to wisely and effectively use their negotiation skills and abilities, could expect to reach desired outcomes in negotiation. Great bargaining skills and experience could therefore strengthen the power of individuals in shaping the negotiation outcomes.

1.2 Preferences and the Characteristics of the EU Negotiations

The positions of member states in the political negotiations vary. This is mainly due to the differences in preferences of member states .Therefore, it is important to understand the theory of preferences that could shape bargaining behaviour. This section highlights how preferences are formed and how they shape the negotiation behaviours. Also, the primary characteristics of the EU negotiations are briefly discussed. This provides an overview of what we might expect to see in the SSM negotiations.

1.2.1 Preferences

A number of studies explain the nature of national preferences and their formation; many of which focus on issues related to the EU context, particularly the European integration (eg.

Moravcsik 1993 and 1998; Aspinwall 2002 and 2007; Copsey and Haughton 2009). Since the member states' positions in the EU political negotiations are reflected by national preferences, it is therefore necessary to understand how those preferences are formed and how they can affect the choices member states made in the negotiations.

National preferences are defined as 'an ordered and weighted set of values placed on future substantive outcomes...that might result from international political interaction' (Moravcsik 1998). The explanation on the intergovernmental bargains in the European Community is mainly derived from the analysis of national preference formation and interstate bargaining, in which the combination of these two theories is known as liberal intergovernmentalism (Moravcsik 1993).

Many academics found that social demands could lead to the formation of national preferences. For example, Aspinwall (2002) explained that national governments would take social demands into consideration before negotiating with other member states in order to attain maximum possible outcomes that are consistent with goals set at the national level. Similarly, Moravcsik (1998) elucidated that preferences of the nations are formed by demands of domestic political groups, which exert power, pressure and influence over the politicians or states. One explainable reason for national governments to take preferences of influential supporters (eg. domestic voters and interest groups) into account is to satisfy their supporters in order to gain voting from them in the next election (Moravcsik 1993).

To give a clearer picture of how social demands or influential domestic groups could influence the preferences of member states, an example is showed as follows. Given that its economy is largely depended on steel market, the national government opposes to the idea of trade liberalization on steel products in interstate negotiations due to a strong protest from its domestic steel industry, which holds the fears of losing profits to efficient international competitors that could freely enter domestic market after liberalization. Thus, we could expect that the preferences or interests of some domestic groups, which are considered important to the countries, can shape national preferences and subsequently the choice the member states make in intergovernmental negotiations.

It is important to note that there is a variation in preferences. Preferences of countries and groups may vary across time, place and issue-area (Moravcsik 1993; Hosli 1996). More importantly, differences in the structure of domestic economies, politics and financial systems could also lead to different formations of member states' preferences. The previous example has demonstrated that the national government's preference is not only influenced by domestic political pressure, but also the structure of domestic economy that is highly depended on steel market. In fact, the preferences of member states on the SSM issues are mainly dictated by the unique features of national banking system (Howarth and Quaglia 2015a), the conditions of domestic economy, and the particular institutional environment where banking regulators operate (Lombardi and Moschella 2016), in which we would explore about this in more detail in Chapter 3.

What we discuss above concerns only the preferences of states. Still, the preferences of supranational organizations should also be taken into consideration when analysing EU negotiations. This is due to the fact that some supranational entities such as the Commission are playing essential roles in the political economy throughout the history of the EU, including in the intergovernmental negotiations on the SSM. A number of existing literatures investigate the influence and preferences of the supranational bodies in the EU. For instance, Pollack (1998) sought to explore how and to what extent supranational organizations can drive integration process; and Howarth and Roos (2017) examined the roles of the EU supranational institutions in the EU integration and policymaking through the concept of activism. Supranational entities may interest in seeking to expand their institutional powers and roles, increasing their competences, supporting for the European integration or moving forward to 'more Europe', and taking actions to fulfilling the inadequacy of existing policy (Pollack 1998; Howarth and Roos 2017). Several studies give examples of supranational bodies' preferences over particular issues. For instance, the work of Vilpisauskas (2013) pointed out a strong desire of the Commission in supporting for economic governance in the EU. Nonetheless, it should be noted that preferences of supranational institutions might not align with those of member states. This could result in conflicting preferences between these two groups.

1.2.2 The Characteristics of the EU Negotiations

Prior to the SSM negotiations, the EU has gone through a number of negotiations, including on the EU enlargement, trade agreement and the EMU. This section briefly explores the key characteristics of the EU negotiations, in order to gain insights into the dynamics we may expect to see in the SSM negotiations. In particular, existing literatures demonstrate that the EU negotiations tend to be multilateral, multi-issue and complex.

Firstly, EU negotiations are multilateral negotiations. In other words, there is a large number of parties involved in the EU negotiations (Elgstrom and Smith 2000; Dur et al. 2010). The negotiation on the EU enlargement is an exemplary example. Accession negotiations, which take place in intergovernmental conferences, involve the candidate country and a group of ministers and ambassadors of the existing EU member states (European Commission 2016). Moreover, the process of accession negotiations essentially involves some supranational institutions, particularly the Commission, which needs to provide a recommendation to existing member states on whether accession negotiations of candidate country should be open directly or not. Besides, the EU negotiations might involve participants from the institutions, NGOs and quasi-governmental agencies (Elgstrom and Smith 2000). Secondly, the EU negotiations are multi-issue negotiations. There are multiple issues to be discussed in the negotiations at the same time (Dur et al. 2010). Again, the negotiation on the EU enlargement underlines this fact as participants need to negotiate on more than 30 different policy fields. Lastly, the EU negotiations are complex. The EU negotiations are complex not only due to an involvement of multiple players at different level (Elgstrom and Smith 2000), but also the complex nature of negotiating issues. For example, the Commission admitted that the fisheries issue was 'one of the more difficult and complex subjects' in the accession negotiations with Norway (European Commission 2017).

In the above sections, we have seen that an extensive body of literature exists on the politics of negotiation. Within this literature, contributions have sought to explore various types of bargaining approach, bargaining power resources, formation of national/supranational preferences and the characteristics of the EU negotiations. The literature highlights that different preferences of member states could lead to disagreement in the intergovernmental negotiations, whereby the states might exert their bargaining power in order to shape negotiation outcomes to align with their preferences. Reaching an agreement in the EU negotiations is not an easy task due to the complexity related to the involvement of multiple actors and issues. Still, the literature has suggested that the use of cooperative approach would provide the optimum results for all participants and allow them to reach an agreement. Through this study as a whole, I engage with this body of scholarship by demonstrating that, in the case of SSM negotiations, outcomes have been shaped through the interplay of state power and multilateral compromise. By using a cooperative approach, member states were able to reach a compromise and an agreement in the SSM negotiations.

Chapter 2: The Global Financial Crisis and the Need for the Reform in the EU Banking Supervision

The year 2007 marked an unprecedented financial crisis that badly hit a number of countries across the globe. The U.S. was the origin of global financial crisis, and its real economy has been in recession for many years from the impact of the crisis. The European countries are no exception. Several European banks faced financial distress from severe liquidity problems during the financial crisis. To avoid bank failures, national governments responded to the situation by spending huge amounts of money to save ailing banks. Still, the EU banking crisis was developed into sovereign debt crisis, when the cost of bailing out banks in trouble turned out to be extremely high for national governments, almost triggering sovereign debt defaults in some vulnerable Eurozone countries such as the case in Ireland and Greece (Eichler 2012). The design faults of the EMU received much of the blame for causing the euro area to be vulnerable to economic shock. The original EMU design allowed for the creation of the doom loop between banks and sovereigns and caused inefficient and uneven practices in the EU banking supervision. To solve financial crisis in the EU and tackle the EMU design problems, banking union is introduced with the centralized supervision as its first step of implementation.

This chapter is divided into three parts. Part one examines how the global financial crisis started in the U.S. Part two explores how the EU was affected by the spread of the global financial crisis. Part three investigates two key weaknesses of the EMU architecture, and discusses the need for the reform in the EU banking supervision.

2.1 The Origin of the Global Financial Crisis

The U.S. mortgage market was the main catalyst of the recent financial crisis. Prior to 2007, the U.S. housing market grew rapidly, causing home prices to rise substantially and forming housing bubble. However, once the home prices began to fall in 2007, the housing bubble burst, causing significant losses not only to home lenders, but also to investment banks and foreign investors, who heavily invested in the U.S mortgage market. Indeed, many U.S. investment banks experienced tremendous losses and later filed for bankruptcy. The worst economic nightmare in the U.S. history was the collapse of Lehman Brothers, the fourth largest U.S. investment banks, which triggered economic turmoil in the global financial markets.

There are three root causes that contributed to accelerated growth in mortgage market in the U.S. – 1) low interest rates, 2) risky banking practices, and 3) failure of regulatory authorities. Starting with low interest rates, before the eruption of financial crisis, the interest rates were set at a relatively low level in order to boost the U.S. economy when it entered into recession in 2001. Low interest rates imply low cost of borrowing. This proved to be a great opportunity for home buyers due to low principal and interest payment in relation to low interest rates. An increasing demand for housing was apparent, thus fueling a credit boom in mortgage market and a bubble in the U.S. home prices. However, the low interest rates were not the only cause to blame for the financial crisis. The financial institutions, particularly investment banks, were also at fault for building the crisis. Risky banking practices made the second source of financial crisis. A low interest rate environment encouraged lending institutions to offer not only low interest rates loans to prime borrowers, but also affordable interest rates loans to subprime customers. Indeed, subprime lending accounted for 20% of the total mortgage loans by 2005 (Buckley 2011; Schoen 2016). A high percentage of risky loans or assets in the portfolio made banks greatly exposed to credit loss. Still, another significant risky banking practice that had been widely conducted among banks prior to 2007 was securitization, in which financial institutions, especially investment banks sold their bundled debts to the third parties. Securitization process occurs when a number of loans, which combine good and bad credit loans, were packed together and sold to others as a package. Mortgaged back securities and collateralized debt obligations are examples of securitization products. Although securitization products were aimed to diversify risk in case debtors fail to meet loan repayment (Hodson and Puetter 2013), they were found to be extremely risky and complex. As securitization process had become exceedingly complex, bad loans were passed to investors, who did not fully understand the risk underlying the securities they were taking from when buying those products (Schoen 2016). The last cause was due to the failure of regulatory authorities to address 'the dangers that had been building in the global financial system' (Helleiner 2011). The complexity of securitization products made it difficult for regulators or supervisors to monitor risk. Most important, investment banks were part of the shadow banking system that was not subject to strict regulations and supervision before the outburst financial crisis. Consequently, these investment banks were more prone to a higher risk from conducting risky businesses and suffered severe collapses once the crisis hit.

2.2 The Spread of Financial Crisis to the EU

The financial crisis was originated in the U.S., but it did not ended within the country where it started. It did not take a long time for the financial crisis to spread to several countries around the world, including the EU. During February and March 2007, the sign of economic catastrophe in the U.S. started to become apparent when several providers of subprime mortgage announced losses; among them was the New Century Financial, which was the biggest U.S. subprime lender, filing for bankruptcy at the beginning of April. Few months later, the crisis reached the EU. BNP Paribas, one of the European's largest banks, made an announcement to freeze three of its money market funds exposed to the U.S subprime mortgage in August 2007. Indeed, within the same month, the ECB and other central banks in the EU injected funds to improve liquidity of banks. The reasons that cross-border transactions were rapidly transmitted from the U.S. to the EU were mainly due to ‘tight connections within the financial system’ and ‘strongly integrated supply chains in global product markets’ (European Commission 2009).

The case of BNP Paribas was however just the starter of traumatic events coming up within the EU. Panic broke as fears of European banking system entering into crisis arose among investors and depositors following the news of several U.S investment banks on the verge of collapse. Norther Rock, the UK's fifth-largest mortgage lender, suffered the first bank run in Britain since 1866 (The Economist 2007). Fortis, a Belgian-Dutch bank, also fell a victim of financial crisis, requiring a bank rescue package from the Benelux governments. Even German banks faced difficulties in obtaining finance on the interbank and capital markets after the collapse of Lehman Brothers (Bundesbank 2015). In fact, on the onset of the EU banking crisis, the Eurozone countries were more vulnerable than those of non-euro area member states, particularly Spain, Ireland and Portugal, which were badly affected by housing price bubble. A number of Spanish small saving banks known as Cajas (34 out of 45 Cajas) were forced to enter the merging and restructuring process due to substantial losses from heavy investment in real estate market during the boom times (Royo 2013).

2.3 The EMU Design Flaws and the Need for the Reform in Banking Supervision

A number of scholars have accused the initial design weaknesses of the EMU of being root causes of the crisis (See eg. De Grauwe 2013 and 2015; Copelovitch et al. 2016; Howarth and

Quaglia 2016). Two fundamental flaws[1] of the EMU architecture are discussed in this thesis - 1) the negative link between banks and sovereigns, and 2) the inefficient and uneven practices in banking supervision.

The negative link between banks and sovereigns

Being a member of the EMU gave some member states opportunities to borrow at lower-interest rates and easier access to credit (Obstfeld 2013) than being a non-member. The Eurozone member states are entitled to a single monetary policy or a single interest rate set by the ECB. The rate set prior to the crisis however appeared to be low in the eyes of economic boom countries such as Spain and Ireland. Besides, there were substantial capital flows moved from core Eurozone member states like Germany to these economic boom countries (Howarth and Quaglia 2016). Coupled with a low interest rate, an easy access to credit drove some euro area countries to borrow extensively to invest in real estate sector, a booming industry before the eruption of the crisis. Housing sector in these countries grew rapidly, causing a substantial increase in asset prices and fueling asset bubbles. Unfortunately, the asset prices collapsed when the crisis started. This put banking sectors in vulnerable positions due to a decline in the value of collateral financial institutions hold (Vila 2000), and a deteriorated credit quality from housing loans giving out to borrowers, who faced repayment difficulties during the crisis. Therefore, this led to banking crises in some member states, where their domestic banks suffered from acute liquidity problems.

To prevent bank failures, huge amounts of financial assistance were pumped into ailing banks by national governments. Due to heavy losses from real estate crash, Bankia, the Spain's fourth-largest bank, requested a state rescue of €19bn and ended up being nationalized by the

[1] Based on my Essay 'Eurozone reforms since 2010 have addressed the key problems of EMU' summited for European Public Policy (2016/2017) at the University of York

Spanish government in May 2012 (Telegraph 2012). In response to the crisis, Ireland spent extremely large amounts of money, around 230% of its Gross Domestic Product (GDP), to save banks in trouble, causing the banking crisis to develop into sovereign debt crisis (Grossman and Woll 2014) and almost bankrupting the Irish government. When weak banks dragging down governments, this interlinkage is known as 'vicious circle' or 'doom loop' (Bloomberg 2012). The design flaws of the EMU hence gave rise to the negative link between banks and sovereigns, in which the EU is taking an important step to sever these ties with the implementation of the SSM.

Inefficient and Uneven Practices in Banking Supervision

Before the introduction of the supranational supervision, banking supervision was undertaken by national governments. Following the introduction of the EMU, financial and banking markets of member states are becoming more cross-border integrated and interdependent. The initial design of banking supervision was prove inefficient and insufficient for such highly integrated markets. In the absence of cross-border supervision, supervisory entities failed not only to anticipate the crisis, but also to understand and handle the impact of the crisis in a timely fashion (Papantoniou 2011). The inefficiencies in both micro and macro-prudential supervision were apparent during the pre-crisis period. According to Lamandini (2010), micro-prudential inefficiencies stemmed from lax supervision and regulatory fragmentation, while macro-prudential inefficiencies were a result of an inability of regulators to pool and gather data on cross-border activities of large banks.

Some countries adopted lax supervision to promote their national industry in order to attract financial industry from neighboring countries (Lamandini 2010). As the Maastricht treaty leaves financial supervision at the discretion of the member states (Papantoniou 2011), this caused diverging national interpretation on regulations, resulting in regulatory fragmentation (Lamandini 2010). Given different economic approaches, banking supervisory styles of member states varied, thus causing uneven supervisory practices in the EU (Papantoniou 2011). As global financial markets are more interconnected and there is an increased volume of cross-border activities of financial institutions, regulators' failure to pool and gather necessary information could threaten overall banking system once facing external shocks.

The crisis revealed the design flaws of the EMU, in which has put the EU in vulnerability. To move towards a stronger EMU architecture in order to ensure economic welfare and prevent future occurrence of the crisis, former President of the European Council Herman Van Rompuy introduced an integrated financial framework or the banking union, which is built on four essential elements of 1) a single European banking supervision, 2) a European deposit insurance scheme, 3) a European resolution scheme, and 4) the single rulebook, on June 26, 2012. As the first step of banking union, the creation of the centralized supervision had been endorsed by heads of state or government of the euro area countries on June 29, 2012, with the main objective to 'break the vicious circle between banks and sovereigns.' (Euro area summit 2012) and to ensure 'enhanced supervision of Europe's banking sector' (Consilium 2017).

The idea of creating a single European regulator has indeed been floating in the EU political arena for almost two decades. But, such idea had always received negative responses from member states during the pre-2008 crisis period. Starting with the Lamfalussy report that has been introduced in 2001, the Committee of Wise Men chaired by Baron Alexander Lamfalussy came up with the proposal for the reform of the EU regulatory and supervision in order to achieve greater supervisory convergence and cooperation (European Commission 2007). The report mentioned about the creation of the Single European Regulatory Authority, but concluded that there is ‘clear opposition’ from member states to the establishment of such body in the time being (Committee of Wise Men 2001: 104) due to a long period of intergovernmental negotiations and the diversity of national regulations that could hinder such body (Howarth and Quaglia 2015a). Another possible reason behind member states’ resistance was due to fears of losing national political power over banks from the entry of foreign banks with less support for national political objectives into the euro area banking markets (Epstein and Rhodes 2016a). It was not until the latest financial crisis that made the EU member states agree on the transfer of supervisory power from the national level to the supranational level, specifically the ECB. This confirms one of the hypotheses concerning the new intergovernmentalism, a framework invented by Bickerton et al. (2015): where delegation occurs, it involves the empowerment of de nova institutions. In the case of SSM, supervisory tasks are delegated to the ECB or the de nova body, thus empowering the institution with new tasks.

The creation of the SSM was difficult as it concerned several controversial issues that must be agreed by national governments, which had diverse preferences. The next chapter explores about the SSM negotiations in more detail.

Chapter 3: The Negotiation on the Establishment of the SSM

This chapter seeks to find answers to the research questions of how did and what made member states agree on the SSM negotiation outcomes. This chapter is organised into three parts. Part one provides a country overview of Germany, France and Spain in terms of their population size, economy, banking system and the characteristics of institutional environment, where banking regulators operate. The countries overview allows us to see how national preferences on the SSM are shaped. Also, information about the size of population and economy reflects bargaining power of member states. Part two explores the SSM negotiations on controversial issues in more detail. This part highlights and explains the positions of member states in the negotiations with respect to their preferences. Part three presents the outcomes of negotiations and summarizes major findings in relation to the research questions.

3.1 Countries Overview

3.1.1 Germany

Germany has the highest number of population in the EU, accounting for almost 16% of the total EU population as of 2015. The country is also the largest national economy (with GDP of 3.03 trillion euro in 2015) in the EU with extremely strong fundamentals, compared with other large and economically advanced member states (Bulmer 2014). As the strongest state economically with the biggest size of population, Germany becomes the most powerful EU member state with the strongest bargaining power. The German economy is mainly driven by small and medium-sized enterprises (SMEs) or what is known as 'Mittelstand'. In fact, the Mittelstand is not only responsible for 75% of employment in Germany, but also behind the success of technological innovation and in placing the country as a 'highly industrialized' member state (Faltermeier 2013). Therefore, SMEs are considered the backbone of the German economy. In regards to the German banking model, it is known for its predominant characteristic of being a universal banking system with three pillar structure consisting of private commercial banks, publicly-owned banks (saving banks or Sparkassen and Landesbanken) and cooperative banks. There are few big private commercial banks, but a large number of saving banks (more than 400 banks) and cooperative banks (more than 1,000 banks). Still, the nature of German banking sector is highly fragmented, with public sector banks, notably Landesbanken, have strong influence (Hüfner 2010). Despite holding approximately the same share of the total assets of the German banking system of 30%, saving banks are key lenders that fuel the activities of SMEs and are local champions (Howarth and Quaglia 2016) that have strong presence in local and rural areas. This makes saving banks very important to local and to the real economy. Indeed, Landesbanken enjoyed not only the liquidity support from state and local municipalities in case they become insolvent (Hüfner 2010), but also a low cost of capital funded by regional governments prior to the crisis (Howarth and Quaglia 2016). In terms of banking supervision, the supervisory responsibilities are shared between the Bundesbank (central bank) and the Federal Financial Supervisory Authority (BaFin). While the Bundesbank has a key role in monitoring credit institutions and overall financial stability, the BaFin is in charge with operational tasks related to micro-prudential supervision and has all regulatory decision-making powers in securing solvency of banks.

3.1.2 France

Another powerful EU country is France, which has the second-highest number of population, accounting for 13% of the total EU population at the end of 2015. The country is the third-largest EU economy with GDP of €2.18 trillion in the same period. During the pre-crisis period, its economy grew considerably and was primarily driven by domestic demand, particularly from resilient private consumption (Casaux and Ecochard 2011). Indeed, the French credit institutions hugely contributed to the domestic economy, in which the majority of its total outstanding loans (almost 60%) was used in financing consumer and mortgage loans as of half-year 2007 (Federation Bancaire Francaise 2008). This made domestic retail banking activities became a ‘comparative strength’ of the French banking system (Hardie and Howarth 2009). Unlike the German system, banking system in France is highly concentrated in the EU. By 2012, there were four French banks in the top 10 European banks by asset size -BNP Paribas, Crédit Agricole, Société Générale and Banque Populaire CdE, whereas there was just only one German bank, Deutsche Bank. The assets of these four French banks represented almost 25% of the total assets of all European banks in 2012, thus making them the ‘major systemic banks’ on the G20 list in 2013 (Creel et al. 2014). In fact, the exposure of French banks to euro area was substantially high and was considered ‘the highest in the world’ for the exposure to euro periphery (Howarth and Quaglia 2016). Besides, the French banking system is not only concentrated in the EU level, but also in domestic level. Its banking sector is dominated by five largest banks (adding CIC-Crédit Mutuel to the lists of four largest French banks mentioned earlier), accounting for almost 80% of the total French banking system at the end of 2012. Created in 2010, the Autorité de contrôle prudentiel et de résolution (ACPR) is responsible for banking supervision in France. The ACPR is an independent authority operated under the auspices of Banque de France, which holds responsibilities on ensuring the overall financial stability.

3.1.3 Spain

Spain is among the top five most populous EU countries, accounting for 9.1% of the total EU population in 2015. The country is ranked the fifth largest EU economy with GDP of €1.08 trillion in 2015. During the pre-crisis period, the Spanish economy was running towards expansionary direction. Rapid growth in real estate sector was the primary factor that fueled the economy. Coupled with low real interest rate environment, the Spanish banking system was also seen as another crucial element for making the country prone to speculative activities in the real estate market during boom times (Jimeno and Santos 2014). In regards to the Spanish financial sector, only the two biggest commercial banks and a number of Cajas are considered main players in credit markets (Royo 2013; Santo 2014). With international expansion strategies, Santander and BBVA were (are) the biggest Spanish banks with reasonably high level of internationalization. The OECD figures showed that both institutions were among the top 30 European banks by asset size from 2007 to 2012 (Schoenmaker and Peek 2014). Another equally important credit institutions in Spain are the Cajas, which constitute half of the financial sector's assets and are said to be an epicentre of the crisis due to their high exposure to the real estate market. Apart from being private entities, the Cajas are similar to the German Landesbanken in terms of their regional base and political ties with local governments. They appear to have strong presence in the regions they operate and are influenced by local governments, which are granted sufficient powers to control them. According to Santo (2014), the Cajas were used by local government officials as powerful tools to fund politically motivated projects, particularly those concerning real estates, in order to secure their seats in the next re-election. The Bank of Spain play a central role in banking supervision. Still, its competences and supervisory power over the Cajas are shared with autonomous governments.

3.2 Controversial Issues of the SSM Negotiation

Three controversial issues on the SSM are examined in this part -1) the scope of ECB's direct supervision, 2) the speed of the SSM implementation, and 3) potential conflicts of interest in the ECB. Overall, the evidences show that national preferences on the SSM were shaped by the particular characteristics of national banking system, the conditions of domestic economy, the pressure from lobby group and public, and the institutional environment of where domestic regulators operate.

3.2.1 Scope of ECB's Direct Supervision

In the wake of the financial crisis, the Commission called for the establishment of the supranational supervision in the Euro area summit on June 2012. The vision was endorsed by the Presidents of the European Council, the Commission, the Eurogroup and the ECB in the summit. In September 2012, the Commission submitted the SSM proposal to the Council to consider and adopt. One of the main controversial issues on this proposal was about the assignment of 'ultimate responsibility for specific supervisory tasks' of all euro area banks to the ECB. This implies that all 6,000 eurozone banks must fall under the ECB's direct supervision. However, some member states opposed to this issue due to a concern about 'the degree of supranational bank supervision' and 'the actual power of the ECB' (Howarth and Quaglia 2016). Voices in the negotiations were split into two sides: one that agreed with the Commission's proposal, led by France, and one that against the proposal, led by Germany.

Germany took a strong position against granting monitoring power of all euro area banks to the ECB. Although the German Chancellor Angela Merkel agreed upon the principle of the SSM involving the ECB in the Euro area summit, her administration disagreed with the idea of ECB's direct supervision. Wolfgang Schäuble, German finance minister contended that it is 'common sense' for the ECB to hold supervisory power only on large banks (Financial Times 2012a), and it would be 'very difficult to get an approval from the German parliament' to agree on any deal that forced all German banks to fall under the European banking supervision (Financial Times 2012b). Besides, he expressed a strong disbelief in the capabilities of the ECB in taking charge of over thousands of financial institutions. "Nobody believes that any

European institution would be capable of supervising 6,000 banks in Europe – maybe not in this decade, to be very frank", said Mr. Schäuble (Financial Times 2012b). To be more specific, Berlin wished to create a two-tier system of supervision (Gren et al. 2015)– the supranational supervision for large systematically significant banks and the national supervision for small local banks.

On the contrary, France seemed to disagree with Germany on the plan to put the ECB in charge of banking supervision. Pierre Moscovici, France's former finance minister, made a clear statement backing the Commission's proposal that 'In the end it must be the ECB that has the responsibility on the whole. Otherwise, there is no real system of banking supervision' (EU Observer 2012a). More importantly, the Paris government worried that the existence of a two-tier supervisory system would result in unequal treatment of member states (Howarth and Quaglia 2015a, 2015b and 2016) and would leave 'open the risk that problems identified in such a local bank could create market panic' (Euractiv 2012a). Similar concerns were raised by the Commission, which argued that a two-tier system would introduce 'significant asymmetries within the same country' and increase volatility risks, leading to instability (European Commission 2012). As the central actor in the negotiation drama, the ECB president Mario Draghi also fought back against Germany, stressing that an agreement on the centralized supervision was a 'crucial move' for European banking system integration and underlining that the ECB should take charge of all 6,000 euro area banks (Financial Times 2012c).

A disagreement between two camps of powerful member states, Germany and France, on the scope of the ECB's direct supervision reflected preferences of each country, in which were dictated by a strong will to protect domestic banking system and the pressure from lobby group. The preferences of the German government were to shield small German banks, particularly Sparkassen and Landesbanken, which have strong impact on local community and economy, from full supervisory oversight of the ECB. As explained by small German banks' supporters, the ECB-led supervision is believed to be unnecessary and increase burden to small German banks that posed no systemic risk during the financial crisis and are indeed behind the economic success and stability of Germany (Financial Times 2012d). Coupled with Sparkassen's intensive lobbying and their close connections with local and other German politicians (Howarth and Quaglia 2015a), there is no doubt that the German government's position was leaning forward to say 'no' over the ECB's full supervision in the SSM negotiation. In contrast, the preferences of the Paris government were opposite to those of Germany due to a high level of concentration in its banking system. Since the French banking system is dominated by five enormous banks with significant cross-border activities, these financial institutions are large enough and would likely be entitled to the ECB's direct supervision despite setting a high threshold for classifying large banks (Howarth and Quaglia 2016). Hence, by considering the characteristic of the French banking system, it is not surprising to see the Paris government stood beside the Commission and the ECB during the SSM negotiation in pushing for the proposed idea of having the ECB supervise all eurozone banks.

3.2.2 The Speed of the SSM Implementation

Serious disagreement over particular issues could lead to several rounds of negotiation, which probably take a long time for all negotiating parties to reach a final agreement. However, the establishment of the SSM cannot be delayed. In fact, it was considered 'a matter of urgency', requiring the Council to agree on the SSM proposal by the end of 2012 (Euro area summit) for the new mechanism to be implemented at the beginning of 2013. The reason for a rapid decision on the SSM proposal was somehow related to the use of European Stability Mechanism (ESM) funds to directly recapitalize fragile banks. The SSM was served as a precondition for the ESM, which could not start its operation unless the supranational supervision is setting up and its effectiveness has been determined. Some countries, particularly Spain, were desperately in need of money channelled via the ESM to restore stability in the banking system, and therefore expected the centralized supervision to be successfully implemented as soon as possible. However, disputes about the start of the SSM broke between two politically powerful countries- Germany and France. Germany and its allies - the Netherlands, Sweden and Poland – insisted on having a 'realistic' negotiating timetable for the SSM (Financial Times 2012e). As Chancellor Merkel stressed it, 'quality must come before speed' and that the ECB 'will not take up the practical task' of supervision in January (2013), but instead will be assigned to work out the operational details 'over the course of 2013' (MNI News 2012). The view of the French government on the SSM timetable however was dissimilar. France and its Southern coalitions, including Spain and Italy urged the EU to move speedily towards establishing the centralized supervisory system. Mr. Moscovici insisted that the discussion should go fast and be completed by the end of 2012, following the direction agreed by European leaders in the Euro area summit, and stressed that 'wasting time would be a mistake' because the crisis is 'affecting everybody, including Germany' (Financial Times 2012e). Spain also joined force with France in pushing for a swift implementation of the SSM. In a joint statement with Mr. Moscovici, the Spanish Minister of Economy Luis De Guindos urged the European banking supervision to be put in place by the end of 2012 (Reuters 2012a). The Commission was also calling for accelerated adoption of the European supervision. As appeared in the Commission's proposal on the SSM, the ECB should start its operation in mid-2013.

The issue on the speed of the new supranational supervision implementation reflects preferences of involved actors, in which most likely concerned with the conditions of domestic economy, a will to protect domestic financial sector, and the pressure from domestic group. The Spanish banking sector experienced severe losses from the collapse of its real estate sector and could not afford to borrow money from the market to aid its troubled banks. Thus, the country was left with no option but to seek financial assistance from the EU. During the onset of the crisis, Spain initially estimated that the amount of financial assistance for the bailout could reach €300 billion (Euractiv 2012b), though in the end the country only needed around €40 billion. The ESM was therefore the solution. Undoubtedly, Spain preferred the supranational supervision to be set up as early as possible. The earlier the implementation of the SSM, the sooner the ESM could start its operation and lend money to Spain. As jointly stated by De Guindos and Moscovici, the new centralized banking supervision will 'open the way for direct recapitalizations with appropriate conditionality' (Reuters 2012a). Apart from the reasons of national solvency (Epstein and Rhodes 2016b) and impending decline in France's credit rating (Donnelly 2014), a concern over high exposure of French banks to periphery countries (Howarth and Quaglia 2016), including Spain, was another motive for the French government to go for a rapid move to the centralized supervision. If the Spanish banking sector was unable to receive a rescue package in a timely manner and ended up with extremely serious losses, the French banking sector would inevitably have been affected. On the other hand, the preferences of Berlin for a 'go-slow' approach were not only due to an intention to ensure a regulator of high quality (Reuters 2012b), but also negative attitudes of German towards bailing out ailing periphery countries with the ESM as 'Germany is the biggest contributor of the ESM, which is funded by taxpayer's money (Euractiv 2012c). Hence, this was the reason why Berlin rejected a hastily implementation of the SSM that was related to the kick off of the ESM.

3.2.3 Potential Conflicts of Interest in the ECB

The final issue dealt with a giving out of supervisory power to the ECB due to a concern over possible conflicts of interest in the supranational central bank. Prior to the establishment of the SSM, the ECB's primary task is to ensure price stability through the monetary policy decision-making. The ECB Governing Council is the main decision-making body, responsible for decisions on monetary policy. After the announcement of the new integrated supervision, some countries, particularly Germany casted doubt on the idea, worrying that conflicts of interest between the goals of monetary policy and banking supervision could arise and would threaten the independence of the ECB.

In particular, the Bundesbank and the BaFin strongly opposed to placing the supranational supervision under the auspices of the ECB. Jens Weidmann, the President of the Bundesbank, expressed his deep concern over this issue when he gave a speech in 2013. As he put it, 'The Bundesbank is unhappy with this arrangement, as it gives rise to potential conflicts of interest between monetary policy and supervision on the Governing Council… However, I very much hope that this solution is not the final stage of development and that, in the medium term at least, the EU treaties will be amended to ensure a clear separation of monetary policy and supervisory responsibilities' (Weidmann 2013). Former head of BaFin, Elke König, also shared similar view with the President of the Bundesbank, stating that 'The ECB has conflicting objectives when it comes to monetary policy and oversight' (Spiegel 2012). Likewise, Mr. Schäuble also insisted on building 'a Chinese wall between banking supervision and monetary policy' (Reuters 2012c). The concern about this issue, however, was dismissed by Italian regulators, who viewed the ECB's dual responsibilities as complementarities and overall benefits (Lombardi and Moschella 2016). As the governor of the Bank of Italy Ignazio Visco put it, '[t]he complementarities that exist between macroeconomic stability and financial stability … suggest that the central bank may contribute to the pursuit to both objectives' (cite in Lombardi and Moschella 2016).

The German preferences on this issue is clear –the ECB should not hold both roles as a banking watchdog and a guardian of price stability. Indeed, Berlin feared that monetary policy decision could be distorted by the fragility of banking system (vice versa). In other words, it feared that the ECB might set low interest rate in order to help weak banks (vice versa). However, the Italian government did not concern about this issue. The explanation for different preferences is most likely due to the institutional environment of where domestic regulators operate (Lombardi and Moschella 2016). In Germany, there is a distinct separation of duties between the task of monetary policy (Bundesbank) and that of banking supervision (BaFin). On the contrary, the Bank of Italy holds dual responsibilities as a banking supervisor and a monetary policy decision maker. The characteristics of domestic regulators were therefore likely to dictate the preferences of each member state (Lombardi and Moschella 2016).

3.3 The Outcomes of Negotiations

Despite heated debates on controversial issues of the SSM, member states managed to find common ground and reached an agreement in the end (Table 1).

Table 1: Outcomes of the SSM Negotiations

Issues	Position of Germany	Position of countries against Germany's preferences[1]	Outcomes of the negotiation
1. Scope of ECB supervision	Only significant banks covered by SSM	All Eurozone banks covered by SSM	The ECB directly supervises significant banks[2], and indirectly supervises less significant banks
2. Speed of SSM implementation	No firm deadline	Start in mid-2013[3]	November 4, 2014
3. Potential conflicts of interest in ECB	Against giving out supervisory power to the ECB	Support giving out supervisory power to the ECB	The establishment of Supervisory Board within the ECB

Remark: [1] France was the leading opposing country on the first and second issues, while Italy was the main opposition to the third issue

[2] Significance criteria: 1) Size (assets > €30 billion), 2) Economic importance, 3) Cross-border activities (assets > €5 billion & ratio of cross-border activities > 20%), and 4) Direct public financial assistance

[3] According to 'A roadmap towards a banking union' (12 September 2012), the ECB supervision would start on July 1, 2013 for the most significant European systemically important banks, and on January 1, 2014 for all other banks

Starting with the issue on scope of ECB direct supervision, member states finally agreed to assign the ECB the authority to directly supervise only big banks with assets exceeding €30 billion, the threshold. Financial institutions with assets below the threshold were subject to national supervisors, who work in cooperation with the ECB. Although this sounds like the Berlin government won negotiation over this issue as the outcome of negotiations was likely aligned with the German preferences, it was seen as a compromise between Berlin and Paris. In fact, the German government requested for a higher threshold of bank assets of €50 billion, which would have excluded most Landesbanken from direct ECB supervision. In the end, the final threshold was set at minimum of €30 billion of assets, which is lower than what Germany initially called for. Besides, the ECB also retains the power to decide whether to directly supervise any bank that is considered small or 'less significant' banks to ensure that those banks comply with high supervisory standards. Technically, this means that all Eurozone banks fall under the ECB's monitoring although some are indirectly supervised. The negotiation outcome was indeed satisfactory (at least for Paris's side) in the sense that both hegemonies -Germany and France- were able to bridge different preferences and reached an agreement on this issue. As expressed by Mr. Moscovici, he called the agreement as a "good working balance" (Financial Times 2012f).

For the issue on the speed of the SSM implementation, it seemed that the German government won concessions on the issue as there was no fixed deadline set on when the centralized banking supervision would be started (Financial Times 2012f). Moreover, the official starting date for the new supranational supervision was at the end of 2014, delaying from the expected period in mid-2013 initially set by the Commission. The outcome unquestionably aligned with the preferences of Germany and its Northern coalitions, which were against a fast-implementation approach and managed to exert their pressures to postpone supervisory role of the ECB until 2014 (Epstein and Rhodes 2016b). Nevertheless, hailing Berlin as a winner of this issue is a bit overstated when taking the disbursement of the ESM loans to Spain at the end of 2012 into account. It appears that member states, including Germany, agreed to provide the ESM loans to Spain before the SSM was actually established. The main reason for German objection to rapid implementation of the new banking watchdog was a reluctance of German over the use of ESM funds to recapitalize failing banks in periphery countries. Hence, allotting this issue as a victory of Germany is not entirely true when the real purpose, which concerned with the ESM, was not achieved.

In regards to the issue on the possible conflicts of interests, member states agreed on the establishment of the new governance structure within the ECB called the Supervisory Board, a separated body from the Governing Council, in order to ease German concerns (EU Observer, 2012b; Epstein and Rhodes 2016a and 2016b). Again, the negotiation outcome most likely reflected compromise positions of member states, especially Germany. Despite a separation of tasks and processes between supervisory and monetary policy responsibilities, the Supervisory Board has to submit the draft decisions concerning banking supervision to the Governing Council for approval. If disagree, the Governing Council could object and send back the draft decisions to the Supervisory Board for submission of new draft decisions. This implies that the Governing Council is the ultimate decision-making authority in the ECB (De Rynck 2016). Realized about this fact, Germany yet agreed reluctantly on the creation of the Supervisory Board, thus supporting the claim that the agreement on this issue was reached with a compromise.

Based on the above analysis, outcomes of the SSM negotiations were likely shaped by preferences of powerful member states, particularly Germany. Member states reached an agreement on controversial issues with a compromise. It is notable that bargaining power of some member states like Germany dictated the negotiation outcomes to some extent but not completely. In other words, the bargaining power of even the most powerful EU country like Germany did not guarantee that the end results of negotiation would entirely align with German preferences. Some scholars (Schäfer 2016; Epstein and Rhodes 2016a) even claimed that the deal on the scope of ECB's direct supervision was seen as a significant depart from Berlin's original position of excluding all small banks from the ECB's supervision, including the indirect monitoring. Still, member states agreed reluctantly and reached a compromise on contentious issues. What seems to weaken member states' will to resist, diminish their bargaining power and push them towards a compromise in the political negotiation was the pressure of financial crisis and its devastating economic effects (Epstein and Rhodes 2016a). Affected by the crisis, Spain and France were among the group that agreed on the Commission's original proposal on the supranational supervision and hoped to reach an agreement as soon as possible. Despite raising many concerns on the SSM issues, Germany was unable to drag its feet on negotiation. As the EU economy is highly interconnected and interdependent, especially the Eurozone, severe economic problems in one country could easily spread to others and throw the whole bloc into chaos. This might be an explanation for a compromise of Germany on the scope of ECB's direct supervision, potential conflicts of interest and the early disbursement of ESM funds to Spain before the launch of SSM. Apart from the financial crisis, the Commission is also believed to be a driving force for pressuring member states to agree on the SSM, by using a series of tactics the institution accumulated from its negotiation experience (Epstein and Rhodes 2016a). One of its smart strategies was to gain a broad approval and commitment on the SSM from the heads of state or government in the Euro area summit before seeking an agreement from the Finance ministers. The Commission knew that it would be awkward for the ministers even for Germany to strongly oppose to what their heads of state or government had already approved. As Schäfer (2016) put it, the German government conceded (in the SSM negotiation) because it was 'rhetorically entrapped' by a joint commitment made in the Euro area summit.

Conclusions

The SSM negotiation was difficult and complex as it had to deal with a number of parties and multiple issues at the same time. Each member state had its own unique preferences on the SSM, in which were shaped by the distinctive characteristics of domestic financial system (Howarth and Quaglia 2015a), the conditions of domestic economy, the pressure from lobby group or public and the structure of domestic banking supervision (Lombardi and Moschella 2016). A diversity in member states' preferences led to a disagreement over some issues concerning the new centralized supervision. Still, member states sought to find common ground and agreed on outcomes of negotiation through a multilateral compromise. Despite playing a role in dictating negotiation outcomes, the bargaining power of member states, especially Germany, the most powerful country in Europe, did not have a complete influence on the outcomes of SSM negotiation. The impacts of financial crisis had indeed weakened the power of member states in political negotiation. Combined with a clever move by the Commission in securing a commitment on the SSM from the euro area heads of state or government, the pressure of crisis was seen as a driving force pushing member states to reach a compromise and an agreement in the negotiation in a timely manner. A tight connection within the financial system and high economic interdependence made the EU member states aware of the importance of a supranational banking watchdog. A nationally based supervision alone was insufficient to deal with increasingly integrated global markets and opened door to external risks that could threaten the stability of the entire EU banking system. Hence, the agreement on the transfer of supervisory power to the EU level did not only reflect an intention of member states to tackle the financial crisis, but also a desire to make a stronger and more united Europe.

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