Fortressing on Markets

Financial Supervision in the Capital Markets Union

by

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Declaration

I, the undersigned Dominik Brenner, candidate for the degree of Doctor of Philosophy at the Central European University Doctoral School of Political Science, Public Policy and International Relations, declare herewith that the present thesis is exclusively my own work, based on my research and only such external information as properly credited in notes and bibliography. I declare that no unidentified and illegitimate use was made of work of others, and no part the thesis infringes on any person's or institution's copyright. I also declare that no part the thesis has been submitted in this form to any other institution of higher education for an academic degree.

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Dedicated to my mother, Mirjana.

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Acknowledgments

While focusing on supervisory developments in the post-crisis years, this dissertation itself is a product of crises. Shortly after the beginning of my PhD in Budapest, CEU became the target of government attention and, after a year of uncertainty, forcefully relocated to Vienna. Little did I know back then that the biggest crisis was yet to come. Halfway through a research stay at the European University Institute in Florence, COVID-19 hit the world. Indeed, the pandemic changed everything and forced me to re-conceptualize my project - both theoretically and empirically - at the very last stage.

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CEU is an outstanding place for a PhD researcher and I cannot overstate how lucky I was to have met a community of young scholars that strive for academic excel-

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Working on a PhD comes with joy and pain, enthusiasm and frustration. But, once the last words are written, it also opens up a new chapter in life. I vividly remember how, after the end of the first Italian lockdown in May 2020, a local newspaper in Florence celebrated that day with a famous quote from Dante's Vita Nova which stated that herewith "a new life is beginning". What would be more fitting than to end this project of mine with those very same words.... *incipit vita nova.*

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Abstract

The financial crisis became a true turning point in EU finance that moved the EU away from market liberalization towards financial stability. While the scope and depth of banking supervision after the financial crisis peaked in the creation of the Banking Union, the post-crisis emphasis on financial stability came at the cost of sluggish economic growth. Born out of the idea that the strengthening of non-bank finance can close this funding gap, the European Commission proposed a Capital Markets Union (CMU) which, in conjunct with the Banking Union, should create a true single market for capital based on market integration and increased supranational supervision. Yet while regulatory progress emerged, supervision remained de facto unchanged. This begs the question what can account for this status quo bias in non-bank financial supervision in the context of the CMU? The existing literature on the political economy of the CMU tends to either focus on member states preferences or takes a constructivist perspective on the CMU. This dissertation, in contrast, relies on a neofunctional perspective based on prior evidence from the Banking Union. The main argument is that in the context of low internationalization, or higher foreign competition relative to their own expansion, functional pressures for supranational supervision among non-bank finance are lacking and the status quo is sustained. In such a case, the financial industry is fortressing on their home markets to reap the potential benefits of national supervisory forbearance. The analysis is based on a novel dataset from public registers of the European Supervisory Authorities and maps the outward expansion and foreign penetration of non-bank finance in the EU27. The results show overall low levels of internationalization and a tendency for higher foreign competitive pressures for the main types of non-bank finance. Even in those non-bank segments where partial supervisory reform occurred, the outcome sustained an overall status quo bias through reform. These findings thereby contribute to the literature by demonstrating the strength of neofunctionalist explanations beyond mere spill-overs

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effect in the realm of non-bank financial integration and add to a better understanding of the drivers behind limited supervisory reform. Since the creation of a CMU is an ongoing project, future research should update the current findings with new empirical evidence and bridge the gap between the first CMU period (2015-2019) and ongoing efforts to finalize the Capital Markets Union in the years to come.

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1 Introduction

Financial markets are often portrayed as truly global with financial institutions that operate across borders and push national politics towards ever more financial liberalization. Yet, as a consequence of the financial crisis, and spurred by legislative deliberalization on the national level, much of EU finance refocused on national markets and increased national fragmentation in the EU. Like a pendulum, the crisis years led to a partial retreat of European finance to the national level. Even though the EU has encouraged cross-border capital mobility for decades, national regulatory and supervisory specificities continue to sustain fragmented national markets and shape the expansion of finance in Europe to this day.

This post-crisis momentum towards deliberalization in the EU emerged as consequence of the devastating effects of the financial and European sovereign debt crisis that showed vividly how unchecked financial liberalization can pose a severe risk for financial stability. At the same time, harmonizing capital market regulations, liberalizing investment choices and easing cross-border funding opportunities would come with various advantages. From an industry perspective, it enables economies of scale which provide a more efficient allocation of assets and resources, provides easier access to foreign markets, as well as a new client pool and higher profits. From a political perspective, the internationalization of finance increases funding opportunities for the real economy. Most importantly, such cross-border asset diversification should

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ultimately result in higher economic growth.

Half a decade after the beginning of the financial crisis, the EU still did not catch up to its pre-crisis productivity levels, despite conventional and unconventional monetary policy tools by the ECB and the creation of the Banking Union to stabilize and strengthen confidence in EU financial markets. Since EU finance is bank-based, market channels couldn't compensate for the lack of bank-to-real economy lending and a strengthening of alternative, non-bank channels seemed urgently needed. First introduced in 2014, the Capital Markets Union (CMU) was one of the flagship projects of the European Commission under Jean-Claude Juncker and should create a "true single market for capital" that provides barrier-free cross-border investment choices and funding opportunities for capital market actors. The CMU was envisioned as a transformative project to counterbalance the banking dominance and consisted of 16 legislative acts between 2017 and 2019 to strengthen market channels, ease market access for firms, and boost investment to the real economy. At the same time, creating a single market that removes national regulatory barriers for capital market participants requires a balance between financial integration and financial stability on the EU level. The European Commission therefore highlighted the need to accompany the CMU with a robust supervisory framework.

The reality diverged from these stated goals nonetheless. While the CMU liberalized national regulatory barriers, no robust supranational supervisory framework emerged. The reform of financial supervision led to mixed results that display a status quo bias rather than a decisive step toward increasing centralization. Consequently, calls for a 'reboot' of the CMU were increasingly articulated with the start of the Von der Leyen Commission in 2019 when it became clear that the CMU did not fully succeed in its ambitions and national resistance impeded the creation of a true Capital Markets Union (ECOFIN, 2019; Jenkins, 2019).

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1.1 Puzzle and Research Question

Together, the Banking Union and the Capital Markets Union should have advanced finance in the EU through a closely regulated and supervised banking sector, more efficient non-bank supervision, as well as a multitude of alternative funding opportunities for small and medium-sized enterprises. Since promoting investment and easier access to capital markets was at the heart of the project, the primary goal of the CMU was a deepening of financial integration; that is, national level de-regulation and harmonized supranational re-regulation. But the harmonization of rules also requires harmonized monitoring of these rules. There is an academic tendency to ignore the question of supervision when it comes to the CMU since the original proposal by the European Commission did not explicitly envision any further supervisory delegation to the supranational level (Darvas, Schoenmaker, & Veron, 2016; Allen, Faia, Haliassos, & Langenbucher, 2019). While this may hold for the very beginning of the project, questions of supervisory reforms soon entered the picture.

Even though the European Commission perceived the CMU first and foremost as a mean to improve financial integration in terms of further regulations of various capital markets sectors and products, supervision in the first CMU period (2016-2019) was permanently a latent question and indeed perceived as needed. The Capital Markets Union thereby included supervisory reform proposals for all major institutional investors through proposals for pan-European investment funds and a pan-European personal pension scheme that combined market-making with rule-policing. While the former tackled investment fund managers, the latter targeted pension funds and insurance companies. Together, the European Supervisory Authorities (ESAs) would have experienced a significant upgrading in terms of direct supervisory powers. Yet, while progress towards further market integration occurred, the intended supervisory

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reform for non-bank finance largely failed. Institutional investment - pension funds, insurance companies, and fund managers - remained de facto under national control and reform occurred only partially for investment firms, a subsegment of asset management, and central counter-parties (CCPs) as a main financial infrastructure. Looking at the historical trajectory of financial integration, that displays a continuous deepening both in terms of market making and rule-monitoring, it is puzzling why the CMU did not continue this trend in terms of supervision (Figure 1.1).

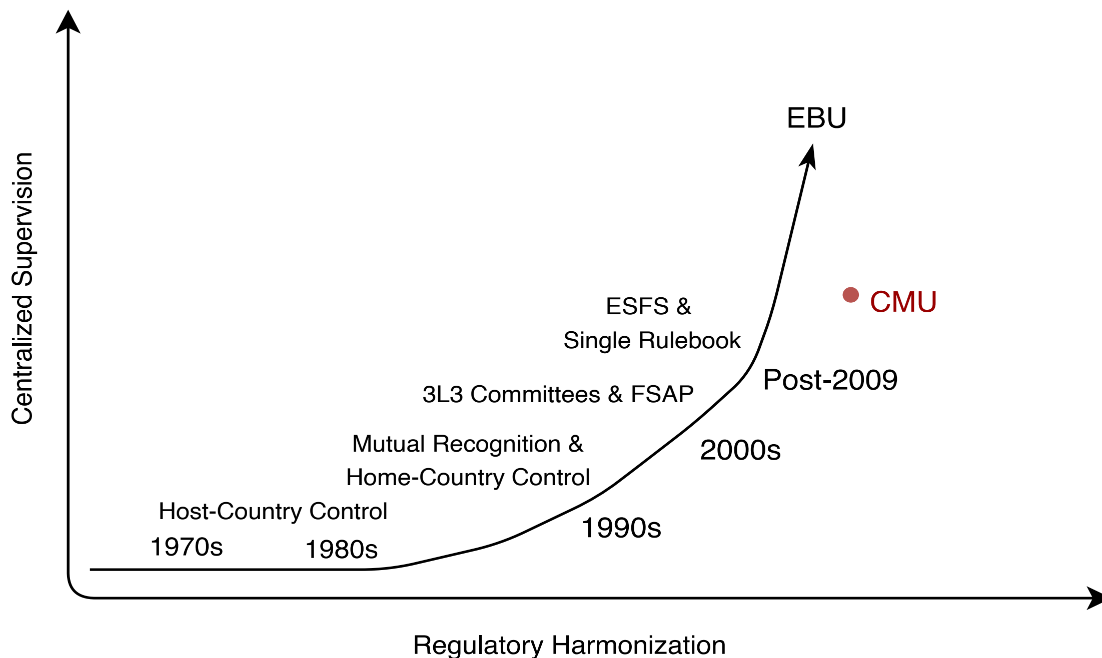

Figure 1.1: Puzzle

The first decades of the European Union were largely dominated by concerns over national sovereignty and financial supervision remained under full national control. At this earliest stage of European financial integration, national preferences were strongly shaped by the logic of national financial dominance and financial integration was seen as an efficient way to provide foreign market access for national firms. This should support and strengthen the market position of *national* finance in an ever more internationalized financial world. Yet, such integration was limited to a first attempt

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at regulatory integration and in particular the reduction of entry barriers across member states. If financial institutions entered foreign markets, they were still supervised by the host country's national competent authority. This host-country principle has the advantage that national supervisors remain in full control over foreign financial institutions in their national financial markets. While this can have some added value for national financial stability, it has negative effects on financial integration overall. If financial institutions have to comply with a variety of distinct national regulatory and supervisory regimes, the compliance costs may not justify the efficiency gains of easier foreign market access and cross-border financial activities remain limited.

As a consequence of this, the 'black box' of national supervision was slowly opened since the 1970s by moving from host-country control to the home-country principle in financial supervision which allows national supervisors to supervise their own national financial firms in foreign markets. From this point onwards, a deepening of regulatory financial integration was accompanied by some form of supervisory reforms. While such 'coupled' integration in rule-making and rule-monitoring progressed over time, the financial crisis accelerated the pace of that progress.

In the post-2009 period, it became clear that the existing approach to financial integration does not suffice to tackle financial instabilities. In terms of regulatory integration, the EU began to rely less on directives, that provide member states some leeway for the transposition into national law, and increasingly utilized regulations that need to be directly adopted by member states. As a consequence of this, the post-2009 period saw a significant move towards the development of a single rulebook. In terms of supervisory integration, the EU not only further institutionalized the existing system of national supervisory coordination on EU level through a new system of European financial supervision (ESFS) but also extended the focus beyond the micro-level to macro-prudential supervision. Born out of necessity, an increasing

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trend from coordination to centralization became apparent that peaked in the creation of the European Banking Union (EBU) based on a single banking rulebook as well as direct supervision.

It would not have been implausible for the CMU to follow the EBU. In terms of supervision, both the EBU and the CMU are - in theory - closely related. For the European Commission the European Banking Union did imply a Capital Markets Union. In order to have successful prudential supervision, capital markets need to be taken into account too. The CMU, just like EBU, should have therefore achieved a relocation of supervisory authority away from Member States to a supranational authority. Instead, the CMU displays a status quo bias in financial supervision. Such limited progress in supranational supervision is particularly puzzling in the context of this general integration trajectory and the post-crisis trend towards increased supranational supervision. The close ties between the Banking Union and a future Capital Markets Union should have created supervisory spill-over effects that ultimately failed to materialize.

As mentioned before, the CMU should overcome the fragmentation in non-bank finance and create a single market for capital. Removing national regulatory barriers would support the expansion of domestic financial institutions (outward internationalization) and increase foreign penetration into domestic markets (inward internationalization/foreign penetration). This begs the question whether national fragmentation is the very reason for the ultimate lack of supervisory reform. In other words:

Can the level of internationalization in non-bank finance account for the 'status quo bias' in supranational supervision?

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1.2 Literature Gap and Contribution

The political economy literature on the Capital Markets Union remains overall rather limited and tends to cluster around three main research foci. The first research takes a constructivist perspective on the CMU and/or focuses on the CMU as a tool towards increased financialization. Despite the merit in such research, most of the existing evidence focused on the first years of the CMU which does not support any general explanations about the status quo bias in supervisory reform over all.

A second research focus is on the role of national preferences in the design of the CMU. Such intergovernmental work on the CMU rests on a well established literature for both the Banking Union and the broader post-crisis integration trajectory and account for member states preferences on the EU level either based on power relations or the structure of domestic financial markets. In the latter case, varying levels of internationalization in national markets are increasingly used as an explanatory factor for state preferences. That is, countries with more internationalized markets should favor further market integration.

While no process can occur without the approval of national governments, this very fact does, in itself, not necessarily provide a sufficient explanation for the status quo bias with the Capital Markets Union. While the intergovernmental argument is attractive to explain final outcomes, earlier stages of the European policy making process are very much shaped by supranational institutions and organized industry interests. The European Commission, for example, started several public consultations in order to receive feedback from stakeholders on their proposals for a CMU. As such, the European Commission incorporated the expertise of stakeholders from the very beginning and a purely state-centric perspective on the status quo bias in supervision lacks insights at this crucial, earlier stage of the EU legislative process.

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Neofunctionalism highlights the functional role of supranational institutions and private, transnationally organized interests. Transnational interest groups recognize the benefits for deeper integration and supranational institutions, rather than national governments, are the main respondents of these demands that create incremental progress rather than one big integration leap. Within the neofunctional literature, spill-over effects dominate the explanatory framework of integration. The idea behind spill-over effects is that once integration in specific sectors occurred, the ever increasing complexity of problems requires integration to other sectors in order to find solutions for these problems (Niemann & Ioannou, 2015; Tranholm-Mikkelsen, 1991). Spill over effects require that actors see previous steps as imperfect (Scholten & Scholten, 2017). As such, functional dissonances emerge that push for further integration to overcome previous, imperfect integration steps.

So far, the application of neofunctional explanations for the post-crisis trajectory of supervisory reform remain limited. Among the notable exceptions is Rachel Epstein's work on the Banking and Capital Markets Union (Epstein, 2017; Epstein & Rhodes, 2018). In her book *Banking on Markets*, for example, Epstein argued that the persistence of state-bank ties (in Western Europe) enabled supervisory forbearance, protectionism and state guarantees for failing banks. This has intensified the consequences of the financial crisis for the banking sector through a bank-state doom loop. The combination of such bank-state ties with the increasing liberalization of the sector created a vicious cycle between banks and their sovereigns, enabled contagion across borders, compounded downturns and increased the likelihood of failed monetary policy transmission by the EBU (Epstein, 2017, p.15). As such, these state-ties created functional dissonances in the context of national control that required the delegation of regulatory and supervisory authority to the EU level. The Banking Union, through the Single Supervisory Mechanism, tackled these functional dissonances by delegating authority to the EU level and diminishing national control over banks

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(Epstein, 2017). Yet such functional dissonances are not solved by chance, in the case of the EBU, multinational banks joined the efforts of the European Commission to delegate supervisory control to the supranational level.

Both the European Commission and the ECB have repeatedly highlighted the close links between a EBU and CMU. Both projects should complement one another. A CMU supports the Banking Union, while a fully functioning Banking Union allows for more efficient capital allocation and a more effective Capital Markets Union. In order to create a true single market in capital, both bank and non-bank finance should rest on harmonized rules and robust regulatory framework with supranational supervision. From a neofunctionalist perspective, this raises the question why we observe a status quo bias rather than spill-over effects in terms of supranational supervision from the EBU to CMU. To the best of my knowledge, this question has so far remained unanswered in the literature.

This dissertation contributes to the literature in three ways. First, by taking a neo-functional perspective, this PhD project advances functional explanations that move away from national interests and/or purely constructivist accounts of financial integration. Second, existing neofunctional explanations tend to focus almost exclusively on the banking sector. Thus, by focusing on non-bank finance, this dissertation advances the literature on the CMU by testing whether existing neofunctional explanations can travel beyond the banking sector. Lastly, neofunctionalism still remains predominantly associated with the concept of spillovers, that is, functional dissonances from previous integration steps that lead to integration pressures and enable a 'falling forward'. While neofunctional explanations are often used for positive integration episodes, the CMU represents a status quo bias when it comes to supranational supervision. As such, this project provides a neofunctional account that goes beyond mere spill-over effects and puts forward an explanation for failed delegation.

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1.3 Main Argument

The main theoretical task is to find an explanation to the question of why national control did not give in to functional pressure in the CMU, when it did so in the EBU. I argue that this is due to the fact that the Commission-industry alliance that was present in the EBU broke down for the Capital Markets Union. The functional dissonances that were present ahead of the EBU and aligned the reform preferences of the European Commission with the interests of internationally-oriented banks were differently perceived by the Commission and non-bank finance in the case of the CMU.

To theorize the functional pressures for the European Commission, I will rely on the financial trilemma as a theoretical heuristic and adjust it to the Capital Markets Union (Schoenmaker, 2011).[1] The gist of his trilemma is that financial stability and financial integration cannot be secured through national-level supervision; one needs to go. Since both financial integration and financial stability are central objectives for the European Commission, the functional dissonance is linked to national control. While the Banking Union and the CMU differed in their primary goals - financial stability versus financial integration - the functional dissonance for the European Commission was in both cases the presence of national supervision. This, in turn, enabled policy proposals for the delegation of supervisory powers to the EU level. Thus, for the European Commission, the EBU and CMU should combine financial integration and financial stability for both bank and non-bank finance in a financial union by delegating national control to the EU level.

[1]The financial trilemma is often used a theoretical tool to explain national policy makers' policy choices towards EU banking integration but there is no theoretical justification within the trilemma that limits its application to national policy makers or the banking sector.

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In the case of the Banking Union, this functional dissonance overlapped with the preferences of large, internationally-oriented banks that enabled a Commission-industry alliance against national control in banking. Capital mobility and a common currency created tensions for finance-state ties that are only resolved for multinational banks through the delegation of national control to supranational authorities (Epstein, 2017). But non-bank finance is not necessarily exposed to the same level of cross-border capital mobility in the EU (or the Euro area). Ultimately, whether or not national control is seen as a functional dissonance for non-bank finance depends on the level of the internationalization. The level of internationalization, in turn, determines the presence or absence of a Commission-industry alliance.

This dissertation makes two main arguments. First, the reason for the delegation of supervision is not merely found in member state preferences but in the position of non-bank finance. Rather than being a natural ally of supranational institutions in their endeavor for more integration, finance can also support political settings that sustain the fragmentation of national markets. Whether or not supranational institutions gain the support of the financial industry shapes the delegation of supervision. The presence of a Commission-industry alliance can nudge member state preferences towards more supervisory delegation. In the case of a conflict between the position of the Commission and the industry, supervisory delegation becomes unlikely. A Commission-industry alliance is thereby a necessary but in itself insufficient condition. Even in the case of such an alliance, member states can still resist supervisory integration but in the absence of a Commission-industry alliance, supervisory delegation should fail.

Second, the driving factor behind the position of the financial industry is the level of outward internationalization and competitive pressures from foreign firms (inward internationalization) in those domestic markets with large enough non-bank financial

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sectors to influence politics - both on the national and supranational level. If national non-bank finance is highly outward oriented, supranational supervision becomes a supportive force in such outward expansion and a Commission-industry alliance is likely to emerge. Yet if outward internationalization remains low or if the number of foreign firms in the domestic market exceeds the number of domestic firms moving outwards, national control can gain traction for domestic non-bank finance in the conflict between competition and financial stability. In this case, the European Commission cannot count on financial industry support to move national preferences towards more supranationalism. In the worst case, the financial industry can actively lobby against a Commission proposal on the national level.

Low internationalization is a necessary condition for the absence of functional dissonances. High internationalization, in contrast, does not suffice in itself to trigger functional dissonances and a push for supranational control. If foreign penetration is higher than internationalization, the competitive disadvantages from a supranational supervisor are higher than the efficiency disadvantages that arise from capital mobility for internationally-oriented, domestic firms when they are controlled by national supervisors. Thus, with a high number of foreign competitors in domestic markets, the advantages of supervisory forbearance in national supervision are seen as an advantage and lead to the absence of functional dissonances despite increasing financial integration with the CMU. Only if foreign penetration is (on average) lower than internationalization, will non-bank finance perceive a functional dissonance between national control and the increasing integration of financial regulation via the CMU. In the context of competitive pressures, finance is 'fortressing on markets' by advocating for the status quo (i.e. national control); that is, they will discourage EU policy makers the move to supranational supervision since EU supervisors would emphasize a level-playing field and market competition.

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1.4 Operationalization and Case Selection

The main focus in this dissertation is on non-bank finance and will include insurance companies, pension funds, and asset managers (in particular investment fund managers and investment firms). Moreover financial infrastructures became a crucial actor since the financial crisis. Central counter-parties (CCPs), for example, are placing themselves in the middle of a capital market transaction by becoming the buyer to every seller and the seller to every buyer. They thereby reduce the risk exposure between buyers and sellers. Each of these types of non-bank finance was selected due to its exposure to supervisory reform proposals in the CMU. While the outcome of interest - supervisory delegation - varies to a certain extent, non-bank finance overall shows a status quo bias. Supervisory reform (partially) succeeded only for investment firms and CCPs. But, as I will argue later, even in these two cases, supervisory reform actually reinforced a status quo bias.

The empirical evidence for testing my neofunctional argument deploys a novel data set, based on the official registers of the European Supervisory Authorities (ESAs), on inward/outward internationalization in non-bank finance. ESA registers provide information about the number of financial institutions in a home country and the number of branches (together with the country of origin). Based on this information, the level of outward internationalization and foreign penetration can be calculated. Outward internationalization is thereby measured as the percentage of domestic non-bank financial institutions that operate branches in at least one other EU market, while foreign penetration is calculated as the percentage of foreign branches from the total number of branches in a market. The exact data collection procedures, together with the main datasets, are provided in detail in the appendices.[2] Other empirical

[2]The reliance on ESA registers is also due to the lack of adequate alternative data on the both the inward and outward internationalization by type of non-bank finance in the EU27.

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data is taken from secondary sources and referenced accordingly.

In order to lend further empirical evidence to my argument, I also focus on public consultation feedback on the CMU that contains stakeholder responses to the question of supranational supervision. Public consultations are thereby a decisive device for the European Commission to determine what policy proposals are likely to survive further scrutiny by member states and the European Parliament. Moreover, the European Commission relies on the wide range of stakeholders and their expertise in public consultations to strengthen their bargaining position vis-a-vis the Council and the Parliament (Bunea & Thomson, 2015). The European Commission's need to receive expert input on their proposals constantly increased the importance of consultations since the early 2000s. At the same time, this allows the financial industry to affect policies before a proposal reaches either the Council or the European Parliament (Klüver, 2011; Røed & Hansen, 2018; Quittkat, 2011).

Financial institutions can either use 'outsider' or 'insider' strategies to lobby legislation. The former refers to protest outside the legislative arena via media or protest, while the latter is linked to direct access to politicians via meetings, expert rounds, or public consultations (Dür & Mateo, 2016; Eising, 2017). While the legislative procedure in the European Union provides ample 'insider' opportunities for financial institutions and associations to influence the European Commission, public consultations are particularly well-suited to influence the design of legislation (Røed & Hansen, 2018; Bunea & Thomson, 2015; Binderkrantz, Blom-Hansen, & Senninger, 2021; Van Ballaert, 2017).Given the outcome of interest, supporting evidence should therefore be visible within these industry feedbacks to the European Commission.

In terms of case selection, this dissertation focuses on the pattern of internationalization and foreign penetration in the EU27. Including the EU27, rather than the Euro Area only, is due to the fact that the Capital Markets Union was, in contrast

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to the Banking Union, proposed by the European Commission to apply to the EU as a whole. Nonetheless, the main data will be subdivided for the Euro area which allows for a comparison of non-bank finance structures between the EU-27 and the Euro Area to ensure that the overall focus does not hide patterns that are unique for the Euro area only. Another consequence is that the main empirical analysis chapter excludes the United Kingdom. Since the UK vote to leave the EU occurred before supervisory proposals were voted on, supranational supervision affected mainly the EU27. Thus, intra-EU industry dynamics, rather than the influence of UK finance, as a third-country entity, should matter. I nonetheless account theoretically for the potential influence of the UK on EU non-bank finance in a later chapter. Of course, excluding the UK changes the pattern of internationalization and leads to a mismatch with the real levels of internationalization in overall non-bank finance. Yet, for my case, this should have no consequences; my main argument focuses on intra-EU competitive pressures and expansion patterns rather than the real levels for international finance.

Lastly, this dissertation ignores the role of US (and Chinese) finance in the EU. Of course, on a general level, non-EU finance plays a central role. Since most of EU finance retreated to domestic markets, global finance is by now almost synonymous with US financial institutions, while Chinese finance is gaining grounds. Nonetheless, this should have little effect on supervisory reform within the EU and my measures of outward/inward internationalization. While non-EU finance would benefit from a single supervisor, it is hard to imagine that the EU would account for the interests of third-country finance as long as EU non-bank finance objects supervisory reform. Thus, inward/outward internationalization of EU non-bank finance within the EU27 should be the decisive empirical test for the delegation of supervisory authority to the EU level.

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1.5 Structure of the Dissertation

Following up on this introduction, *Chapter 2* will outline the puzzle of this dissertation; that is, the status quo bias in supervisory reform within the CMU despite ever more centralization after the financial crisis that peaked with the Banking Union. The chapter presents a historical overview of financial integration in the EU to support the claim that regulatory and supervisory integration continuously deepened, albeit at different speeds and degrees. Regulatory integration always exceeded supervisory integration, but both deepened over time nonetheless. The main claim of this chapter is that such 'coupled deepening' discontinued with the CMU where we can observe progress in regulatory integration but limited reform in supervisory integration. The chapter ends with a detailed overview of the system of financial supervision for banks in the Banking Union and non-bank finance in the CMU.

In order to embed my work into the broader literature, *Chapter 3* provides a literature review of post-crisis financial integration and supervision with a focus on both intergovernmental and neofunctional explanations. I argue in this chapter that neofunctional explanations can provide a novel perspective on the outcome of the Capital Markets Union. By relying on neofunctionalism, the focus shifts from the national interests of governments to the role of supranational institutions and the financial industry in pushing integration forward. The chapter will conclude with a close reading of a recent neofunctional explanation for the Banking Union and adjust its main findings for non-bank finance to test the neofunctional argument on the Capital Markets Union.

Chapter 4 provides the main argument of this dissertation. In order to enable theory testing, this chapter will extend the neofunctional focus beyond banking to non-bank finance - in particular investment funds, insurance companies and pension funds. The

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first section will introduce the financial trilemma and the "optimal" choice for supranational institutions between financial integration, financial stability and national supervision. For the European Commission, the choice is clear. In order to create a true single market for capital, national control needs to give in. But previous neofunctionalist work highlighted the importance of a Commission-industry alliance and for non-bank finance, this 'optimal' choice is conditional on the level of internationalization. The main argument is that internationalization is a necessary conditions to explain the functional pressure towards supranational control in non-bank finance. While low levels of internationalization should lead to sustained national control over supranational supervision, high levels of internationalization only create functional dissonances if foreign penetration remains lower.

Chapter 5 tests this neofunctional argument for the main institutional investors: investment fund managers, pension funds and insurance companies. The first section focuses on investment funds and the European Commission's proposal for a pan-European investment funds scheme that should not only create a single investment fund market but also delegate direct supervisory authority to ESMA. The second section concentrates on pension funds and insurance companies by analyzing the European Commission's proposal for a pan-European personal pension scheme that should create a single market in private pensions. The chapter shows that the lack of reform in both cases fits the overall argument. While investment fund managers and pension funds show low levels of internationalization, insurance shows higher levels of foreign penetration than outward internationalization. Both patterns result in a lack of functional pressures for supranational supervision. Additional evidence from public consultations shows that industry preferences for all three types of institutional investment were in favor of the status quo. Together, the benefits of national control outweigh the benefits of supranational supervision for these actors, leading to a lack of functional pressures.

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Chapter 6 focuses on the two areas where supervisory reform partially succeed - large investment firms and third-country central counterparties. For investment funds, supervisory reform placed the largest, systemically relevant firms under ECB supervision, while providing a more lenient prudential framework for smaller investment firms that remain dominated by national supervision. For central counterparties, supervisory reform delegated direct supervisory powers to ESMA for the largest third-country CCPs. Thus, despite supervisory delegation, neither investment firms nor CCPs became fully supervised on the EU level. Given the dominance of the UK in both markets, this chapter takes a closer look at the effect of Brexit on this reform pattern. While existing research emphasizes the role of politics, the chapter argues that the level of internationalization in these industries can still account for the ultimate outcome of reform since both cases of supervisory reform sustained the status quo within the EU27.

The dissertation ends with the *Conclusion* that summarizes the main findings of this project, emphasizes the contribution and limitations, addresses open questions and takes a look at the road ahead.

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2 Financial Supervision in the EU

The crisis years between 2008 and 2013 turned out to be a true critical juncture in European financial integration, separating the liberalizing pre-crisis decades from the more prudent post-crisis years. While the Sovereign Debt Crisis brought the Euro area to the brink of collapse, it simultaneously created the ground for unprecedented levels of supranationalism. The EU experienced significant integration steps in the past - not least the creation of the single market - but it took an external shock in the magnitude of the financial and sovereign debt crisis to enable a significant delegation of regulatory and supervisory powers from the national to the EU level.

The European Banking Union (EBU) is an ideal example of this increasing supranationalism. Based on a single (banking) rulebook, centralized supervision, and a centralized banking resolution mechanism, the EBU stabilized European banking systems and weakened the vicious cycle between banks and sovereigns. At the same time, this new structure also highlighted the need to broaden the scope beyond banking. While the EBU, with all its supranational delegation, ensured the stability of EU banks, it could not tackle the issue of secular stagnation. In order to secure financial markets and tackle sluggish economic growth, alternative, non-bank funding channels are required. Yet for financial stability to work in conjunct with economic growth, a Financial Union is needed, combining both banking and non-bank finance.

The Capital Markets Union (CMU) was seen as the next logical step in this supra-

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national trajectory towards such a financial union. The CMU represents a set of financial legislation that should complement the Banking Union and constitute a decisive step towards a *true single market for capital* by 2019. First, harmonized capital markets regulations should enable deeper capital markets to strengthen alternative funding channels for the real economy and contribute to economic growth which failed to reach pre-crisis levels. Second, reforms of the European System of Financial Supervision (ESFS) should contribute to financial stability beyond the banking sector. Together, the Capital Markets Union and the Banking Union should have constituted a Financial Union based on a single rulebook and centralized supervision for both banks and non-bank financial institutions and infrastructures.

I argue in this chapter that despite the importance of the Capital Market Union for European financial integration and stability, the CMU interrupted the post-crisis integration trajectory of supranationalism. Instead of complementing the Banking Union and creating a true Financial Union, the CMU displayed a *status quo bias* towards national control. While the CMU progressed in terms of regulatory harmonization, reforms of capital markets supervision remained limited and national supervision sustained its dominant role in the European system of financial supervision. This puzzling discontinuity in the post-crisis integration pattern with the CMU requires an explanation.

The first section outlines the tensions between financial integration, stability and the delegation of control over finance to the EU levels by focusing on the historical trajectory of financial supervision. The second section will take a closer look at the relationship between the EBU and CMU in terms of financial supervision.

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2.1 Integration, Stability, and Control

While capital markets enable the direct allocation of funds from lenders to borrowers, in most cases, financial institutions serve as structural intermediaries between actors with a capital surplus to those in need of funding. Taking advantage of economies of scale, banks and non-bank financial institutions (i.e. institutional investors like investment funds, investment firms, insurance companies, and pension funds) can reduce information asymmetries and enable a more efficient allocation of such funds. Yet, each investment choice comes with risk in order to achieve profit. Risk is therefore an inherent feature of finance and can create unintended negative consequences for a society at large (Lupo-Pasini, 2017).

To ensure that financial risk does not transform into systemic risk and turn into a threat for the national financial system as a whole, politics can intervene through prudential regulations. Ideally, regulations create an optimal balance between the profit demands of finance and the protection needs of consumers and the society as a whole. But rules alone don't suffice; prudential regulations need to be complemented by appropriate control and enforcement mechanisms to ensure the compliance with these rules. In order to account for this, policymakers delegate the policing of national regulations to National Competent Authorities (NCAs) that can enforce these rules and ensure the stability of the national financial system overall (Lupo-Pasini & Buckley, 2015). Ultimately, it is on national supervisors to strike the right balance to ensure stability while allowing finance to profit.

In the context of European integration, such national control no longer suffices to ensure financial stability. The process of national de-regulation and European re-regulation resulted in increasing cross-border activities of financial firms, a trend towards concentration, and the presence of financial conglomerates that operate across

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different financial sectors. These dynamics can create negative externalities and risk beyond the national level. Such broader risks should be minimized by national prudential supervisors who consider the possibility of cross-country spill-over effects in their national supervision. Yet, constrained by their mandate to improve *national* welfare, national competent authorities tend to ignore broader risk implications beyond the national level (Lupo-Pasini, 2017). This tension between the legal responsibility towards national welfare and the economic responsiveness towards supranational financial stability has been present ever since the beginning of the financial integration process.

2.1.1 Pre-Crisis Trajectory of National Control

Financial integration is not a natural feature of finance. It is a strategic choice and the "result of constant attempts by firms and governments to rely on each other to increase efficiency and maximise returns" (Lupo-Pasini & Buckley, 2015, p.687). National finance was closely controlled during the Second World War and the first decades thereafter. During the first years of the European Community, financial integration remained de facto non-existent and financial firms were constrained by restrictive national regulations that bound them to their domestic markets (Goodhart, 2011, p.2-3). While the Bretton-Woods System further institutionalized this national insulation of finance, a global financial system slowly started to emerge in the 1960s with the creation of the Euro-currency market (Masciandaro & Quintyn, 2016, p.993). The fast rise of the Euro-currency market benefited financial firms by evading restrictive national regulations but it also constituted an unregulated international market. As such, it was prone to financial instabilities since national regulators at that time did not have the means to set and enforce prudential standards outside their national jurisprudence. Still, the rise of this market did not raise prudential concerns until

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first bank failures occurred that could be directly linked to high Euro-currency market exposures (Goodhart, 2011, p.4).

It was the failure of the German *Herstatt Bank* in 1974 that led to a first attempt of international prudential coordination with the creation of the *Groupe de Contact* as an informal meeting of national financial market regulators. The *Group the Contact* discussed international financial developments, shared national best practices and started to play an ever more important role in the formulation of national micro-prudential regulation across countries. While these meetings were politically independent, they had profound effects on financial integration later on. The *Group the Contact* served as a blueprint for the Basel Committee on Banking Supervision (BCBS) which, in turn, influenced the regulatory content of EU financial directives (Goodhart, 2011). While the BCBS, as an international prudential standard setters, influenced the regulatory content of EU directives, it focused less on the monitoring and enforcement of these standards and thus had limited impact on questions related to prudential supervision (Masciandaro & Quintyn, 2016, p.994).

The first phase of European financial integration started in the 1970s with directives that focused mainly on national deregulation and the reduction of entry barriers (Rakić & Dessimirova, 2019). The *1977 First Banking Directive*, for example, tackled the freedom of establishment and the freedom of providing financial services for banks and insurance firms. It introduced the principle of non-discrimination which allowed those financial institutions to enter foreign markets through branches or subsidiaries in order to offer their services to foreign consumers. The directive increased competition in national markets and reduced credit costs for consumers. It was also a first attempt to agree politically on prudential regulatory standards for banks through coordinated national rules on solvency, liquidity and internal control (Darvas et al., 2016; Lupo-Pasini & Buckley, 2015). While the principle of non-discrimination was a

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first attempt to liberalize finance, cooperation at this stage still meant the coordination of *national* rules that apply to *national* financial systems and are supervised by *national* authorities (De Haan, Osterloo, & Schoenmaker, 2015, p.98).

The default mode in prudential supervision during this first integration period was based on the *host-country principle* that limited all monitoring and enforcement responsibility to the national competent authority. This host-country principle comes with benefits and costs. On the one hand, national supervisors remain in full control over all financial institutions in their national system - foreign or not - which reduces potential societal costs based on negative externalities. On the other hand, the host-country principle sustained significant barriers to cross-border activities since banks, even if they were legally able to establish business in foreign markets, still faced different legal regimes, each one with their own supervisor, and distinct monitoring practices. Thus, while the period between 1977 and the mid-1980s shows first attempts at opening up national markets, national control remained de facto unchanged (Teixeira, 2019).

Since the 1980s, the EU experienced a further internationalization of national finance which increased regulatory pressures on national governments as internationally-active financial firms developed into financial conglomerates and preferred supra-national rule-making that mimics the US deregulation approach to capital markets (Mügge, 2013). Being constrained by restrictive national regulations reduced a firm's competitiveness vis-a-vis financial firms from less regulated national markets. Having a level playing field would mean that "no single country could tighten its own financial regulations unilaterally without finding that its own banks might lose their competitive edge vis--vis their international rivals, certainly abroad and even possibly at home"(Goodhart, 2011, 1-2). Based on the Commission's 1985 *White paper for the completion of the internal market*, the 1987 Single European Act included a section

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on financial services that should support the internationalization of finance by deregulating national financial systems and, at the same time, account for financial risk through micro-prudential re-regulation on the supranational level. The cornerstones of this approach were based on the principles of 'minimum harmonization', 'single passporting', 'mutual recognition' and 'home-country control' (Scott, 2009; Rakić & Dessimirova, 2019). These four principles effected both micro-prudential regulation and supervision in the EU.

'Minimum harmonization' and 'mutual recognition' introduced a set of minimum requirements for information disclosure by financial institutions that should reduce information asymmetries between market participants (Scott, 2009). The 'single passport' reduced entry barriers by removing the need to acquire new licenses to enter foreign financial markets if a financial institution has already been licensed in any one of the EU Member States. Lastly the 'home-country principle' delegated supervisory responsibilities to the national supervisor of the respective financial institution. The *1989 Second Banking Directive* introduced these principles for banks in order to strengthen cross border activities and lower regulatory barriers to open bank branches in other countries via a single banking license ("single banking passport"). These branches are then no longer supervised by the host supervisor of the foreign market in which the branch was opened (De Haan et al., 2015). The move from host- to home-country control reduced the regulatory burden on banks when they attempt to set up branches since it allowed a banks' domestic supervisor to extent its supervisory control to the bank's branches in a foreign market (Grossman & Leblond, 2012). This period was not only characterized by an increasing internationalization of finance but also by the blurring of financial sectors with the emergence of financial conglomerates and non-bank credit institutions (i.e. 'shadow banking'). Consequently, the *1993 Third Insurance Directive* and the *1993 Investment Services Directive (ISD)* extended these four regulatory principles to insurance firms and investment banks (De Haan et

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al., 2015; Schoenmaker & Oosterloo, 2005; Darvas et al., 2016).

While the idea behind the home-country principle was to increase efficiency and remove regulatory barriers, it also opened up the black box of national financial supervision. It required trust-based cooperation between national supervisors and can therefore be interpreted as the first manifestation of supervisory integration in the EU. After all, the idea behind the *home country control* is that member states give up control over foreign banks on their national territory by accepting the supervisory practices of a foreign regulatory regime. Even though the Single European Act further de-regulated national financial markets, it fell short of creating a single regulatory template and national resistance towards further integration still persisted. Re-regulation on the EU level was acknowledged as a necessity to overcome national financial fragmentation, but Member States were mainly concerned about how to best grant their national domestic firms access to other European national markets, while protecting their own institutional specificities in national finance (Mügge, 2013). As a consequence of the infamous "battle of the systems" (Story & Walter, 1997), EU directives displayed a sub-optimal compromise with enough regulatory loopholes to sustain national specificities (Kudrna, 2016; Mügge, 2013).

National financial fragmentation remained, while the interconnectedness of financial institutions further accelerated in the 1990s as a consequence of the single market program. This had prudential consequences: the home-country principle, for example, only applied to branches, while subsidiaries were still supervised by the host supervisor even though those subsidiaries did not operate independent of their parent bank. In order to assess the soundness of subsidiaries, host country supervisors were dependent on the cooperation with the respective home supervisor and their willingness to share information. Yet national supervisors have first and foremost a responsibility towards their own national financial system and this mandate tends to

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ignore possible spill-over effects of systemic risk to other countries. Such dominance of 'national' considerations creates coordination problems in supervision that only increased financial instabilities on the supranational level (Schoenmaker & Oosterloo, 2005; Masciandaro & Quintyn, 2016; Lupo-Pasini, 2017).

The 1990s were overall characterized by a 'reform fatigue' in financial market integration and by the end of the decade it became clear that more progress is needed towards a single financial market (Haentjens & Carabellese, 2020). A larger step in prudential integration thus occurred with the Financial Services Action Plan (FSAP) in 1999. Motivated by the common currency, the FSAP should once more overcome the still persistent fragmentation along national lines and foster "a genuine single financial market" (Kudrna, 2016, p.74). Based on 42 measures, it should reduce regulatory barriers, ease market access and create a level playing field by 2004 (Quaglia, 2010; Mügge, 2010). In addition, the European Commission set up the *Committee of Wise Men on the Regulation of European Securities Markets* that should support the FSAP in improving regulatory harmonization and supervisory coordination. The final report by the Committee of Wise Men led to the Lamfalussy process and resulted in the creation of a new four-level system of EU policy making (Darvas et al., 2016; Rakić & Dessimirova, 2019).

The first level determines the 'framework principles' that will be defined in directives or regulations and follow the EU's ordinary legislative procedure. The second level consists of more technical legislation that is adopted by the European Commission in cooperation with consultive bodies and it should improve the broader legislation of level 1. The third level describes the coordination of national supervisors in supranational committees in order to support the Commission in adapting level 1 and 2 legislation. This way, legislation should be adopted and enforced in a coherent and efficient way. Lastly, level four specifies that EU Commission needs to ensure the enforcement

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of legislation by member states (Haentjens & Carabellese, 2020). These three Level 3 Committees, or *3L3 Committees*, include the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) (Darvas et al., 2016, p.6). The 3L3 Committees thereby account for general financial trends since 1980s: increased direct interconnectedness between financial institutions, the development of of non-bank credit institutions and the emergence of financial conglomerates that blurred the lines between banking, insurance, and capital markets. Furthermore, finance also experienced an increasing sophistication of financial products and operations. These trends require a higher level of supervisory coordination than the bilateral approach of home-host regime based on the home-country principle. The 3L3 Committees ultimately institutionalized the exchange between national supervisors across all sectors on the EU level. This led to improved supervision by specifying technical details of prudential regulations, but these committees had no political mandate to create technical rules themselves. Their ultimate supervisory authority remained limited.

The Lamfalussy process attempted to regulate finance on the supranational level without delegating supervisory authority to the EU (Teixeira, 2019, p.137). As a consequence, the EU system of financial supervision strengthened coordination rather than direct supranational supervision and national authorities remained in control over financial supervision (Teixeira, 2019, p.138-139). Thus, despite advances in the harmonization of national financial regulation and improved coordination among national supervisors, ensuring financial stability remained by and large a national matter and the detriment of strong state-finance ties surfaced half a decade later with the financial and sovereign debt crisis.

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2.1.2 Post-Crisis Trajectory of National Control

The pre-crisis system of financial control should have mitigated financial instabilities through the coordination of supervisory activities among national supervisors. While this system sustained the primacy of national control over supranational centralization, the global financial crisis illustrated the limitations of such an approach. The use of ever more sophisticated financial products and techniques increased the common exposure of financial institutions to the same asset classes. Once assets with large common exposures drop in value, a chain reaction started that led to the default of various financial institutions across sectors, while cross-border interconnectedness transmitted these shocks across countries. The existing system of supervisory coordination within the 3L3 committees was unable to respond adequately and, as a consequence of the absence of supranational control, all burden was placed on individual member states. Those member states, in turn, started to 'renationalize' finance by splitting up financial institutions into their national parts (i.e. 'ring-fencing') and these various national units were then supported by their respective governments (Teixeira, 2019, p.138-139). The system of supervisory coordination on the EU level effectively failed to overcome national fragmentation and tackle financial instability.

As a response to this failure, the European Union established the De Larosière Committee in 2009 which suggested a reform of the 3L3 Committees, coupled with an increasing reliance on regulations rather than directives. The structural recommendations led to the creation of the *European System of Financial Supervision (ESFS)*. The ESFS advanced European supervisory integration in two ways. First, it updated the 3L3 Committees, renamed them as the the European Supervisory Authorities (ESAs), and provided them with a more effective political mandate. The ESAs now consist of the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pen-

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sions Authority (EIOPA). These regulatory agencies received further powers with the right to develop technical standards which should not only improve supervisory coordination and ensure that micro-prudential rules are similarly applied by all national supervisors but also support the development of a single rulebook that relies on regulations rather than directives. While directives provide member states the possibility to adjust European rules to their national specificities, they also help to sustain national financial fragmentation. Regulations, in contrast, need to be directly transposed into national law and provide little maneuver space for national adjustments. Secondly, the European System of Financial Supervision received a macro-prudential pillar, the *European Systemic Risk Board (ESRB)*, which monitors and evaluates potential macro-prudential sources of systemic risk. While the ESRB can make macro-prudential recommendation it nonetheless received no enforcement mechanisms (Darvas et al., 2016). The ESFS is therefore a prudential system based on an institutionalized combination of micro- and macro-prudential supervision. Yet, despite a new institutional set-up and progress towards a single rulebook (Kudrna, 2016), the ESFS lacked enforcement mechanisms and the dominance of national supervisors in this system of supranational coordination remained undisputed.

A supranational solution to this continued dominance of national control in financial supervision became an ever more pressing issue when a banking and a sovereign debt crisis within the Euro area emerged that exposed the vicious cycle between banks and states. The banking crisis required states to recapitalize national banks in order to avoid a collapse of national banking system. This, in turn, negatively effected sovereign default risk. Due to a strong home bias, banks were heavily exposed to sovereign debt, which, yet again, increased their own risk in case of sovereign default (Lastra, 2019). On July 26 2012, Mario Draghi famously stated that "within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough" (ECB, 2012). His speech marked the beginning of the end of the

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Sovereign Debt Crisis. While the massive intervention of the ECB via conventional and unconventional monetary policy tools stabilized market confidence, overcoming the bank-state vicious cycle, that brought the Eurozone to the brink of collapse, became a policy priority.

The presence of the infamous bank-state vicious cycle highlighted the need to replace the system of supranational coordination with a centralized approach based on monitoring and enforcement mechanisms on the EU level (Teixeira, 2019; Lastra, 2019). The resulting agreement on a European Banking Union (EBU) displays the current peak of supervisory integration. The EBU is based on a single banking rulebook and quasi-centralized, supranational banking supervision. The single rulebook consists of the Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR), that transposes Basel III into EU law and specifies the prudential regulation for banking and investment firms (Rakić & Dessimirova, 2019). Furthermore, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) delegate the supervision of the largest, systemically relevant banks to the European Central Bank. The ECB became the single licensing authority for all banks and the single prudential supervisor for the largest financial institutions. Moreover, the ECB also monitors the national prudential supervision of less significant credit institutions (Darvas et al., 2016, p.15).

With the creation of the European Banking Union, the fragility of EU finance was met with a robust institutional response - a single rulebook and a single supervisor - that put financial stability first. Yet, while escaping from the abyss, the EU moved from a crisis of stability to a crisis of productivity. Stabilizing the European banking system and implementing a Banking Union should have brought back confidence into financial markets and prompt investments into the real economy. But economic recovery remained limited. By the time the European Banking Union was established, the EU

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still failed to reach pre-2008 growth levels despite conventional and unconventional monetary policies by the ECB to encourage investment (Figure 2.1). Thus, with financial stability being regained through the Banking Union, concerns about sluggish economic growth steadily increased. More than half a decade after the beginning of the financial crisis in 2007/8, the EU remained stuck in a 'low growth trap' (Åslund & Djankov, 2017).

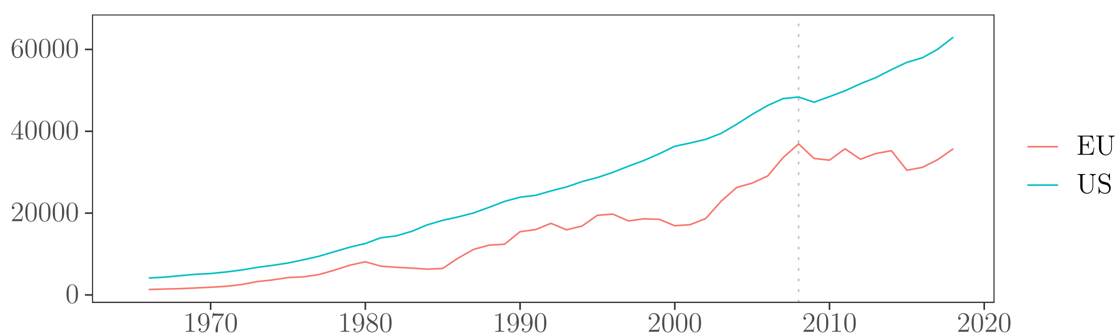

Figure 2.1: GDP per capita (current US $) in the EU and the US between 1960-2019 (Source: Worldbank).

Since the ECB used both conventional and unconventional monetary policies that failed to encourage bank-to-real economy lending, the focus among economist and European policy makers shifted towards the supply side and long-term structural reforms to boost investment in Europe (Åslund & Djankov, 2017). The dynamics of the crises sequence in the EU led to a re-evaluation of the claim that both bank-based and market-based system on their own create similar levels of economic growth (Allen & Gale, 1999). An over-reliance on banking can, in fact, have negative effects in times of financial distress and thus non-bank financial channels should be strengthened to overcome the negative effects of Europe's bank bias (Langfield & Pagano, 2016; Pagano et al., 2014; Valiante, 2016).

Figure 2.2 shows stock market capitalization as percent of GDP for the EU and for the US. Over the past decades, the US always had a stronger stock market than the

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EU but both generally followed the same trend. Since the financial crisis (black vertical line) this trend reversed. While stock market capitalization recovered relatively quickly in the US, it stagnated in the EU.

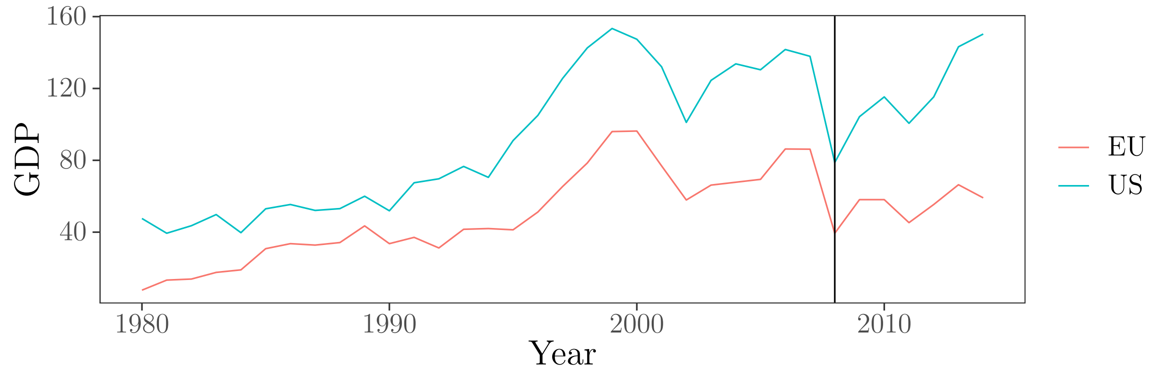

Figure 2.2: Stock market capitalization as % of GDP (1980-2014)

The Capital Markets Union is a response to this financial rethinking among policy makers. In 2014, the European Commission introduced the project and presented a variety of legislative proposals clustered around firms, banks, retail and institutional investors, as well as cross-border barriers and infrastructure which should combine financial liberalization with improved supervision (Commission, 2015a, 2017a). By 2019, most of the CMU proposals were officially adopted and Table 2.1 provides a summary of the legislation that constitutes the Capital Markets Union. Two points are worth highlighting. First, out of these 16 legislative acts, 12 have been adopted as regulation and only 4 as directives. Given that EU regulations need to be directly translated into national law, the CMU accelerates the general post-crisis trend towards increased regulatory harmonization. Secondly, several CMU proposals also envisioned a reform of European supervision. The CMU should therefore not only foster cross-border market-making but also strengthen financial supervision to keep up with the broader integration trajectory that led to the European Banking Union.

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Legislative Output	Objective / Aim	Year
Securitisation Regulation	Separates a new class of 'Simple, transparent and standardised (STS) securities' from 'opaque and complex' securitisation products	2017
PD3 Regulation	The reformed prospectus regulation (PD3) reduces market entry restrictions for SMEs, establishes more efficient prospectuses and ensures regulatory coverage for firms at every stage of the life-cycle.	2017
EuVECA / EuSEF	European Venture Capital Fund Regulation (EuVECA) and European Social Entrepreneurship Funds Regulation (EuSEF) expands number of firms that can apply to funds, allow larger fund managers to invest in it and reduces the marketing costs and barriers in registration processes.	2017
AML5 Directive	The 5th Anti-Money Laundering Directive strengthens the power of the EBA regarding anti-money laundering	2018
PEPP Regulation	Creates a Pan-European personal pension product (PEPP) as a voluntary personal pension scheme that can be offered throughout the EU by firms across all financial sectors	2019
Covered Bonds Directive	Harmonizes rules on securities issued by financial institutions and backed by assets (covered bonds) against the risk of issuer default	2019
Cross-Border Fund Distribution	Includes a regulation and directive that should reduce regulatory barriers to cross-border distribution of funds within the EU and simplify their marketing procedure	2019
Second Chance Directive	Reduces regulatory costs in national restructuring and insolvency rules. Implements a "rescue culture" to give entrepreneurs a second chance. This should also reduce non-performing loans on banks' balance sheets	2019
SME Growth Markets Regulation	The regulation amends several core financial market legislation and should reduce regulatory barriers for a SME growth markets	2019
Disclosure Regulation	Part of the Sustainable Finance Initiative. It requires, for example, that market actors consider sustainability risks in their decision-making process	2019
Low Carbon Benchmarks Regulation	Part of the Sustainable Finance Initiative. Supports transition towards 'greener' finance in the EU	2019
EMIR 2.2	Reforms ESFS supervision by strengthening the role of ESMA in the supervision of non-EU central counterparties (CCPs)	2019
IFR / IFD	The investment firm regulation (IFR) and directive (IFD) specifies a prudential framework and redefines ECB supervision for systemically-relevant investment firms	2019
Crowdfunding Regulation	Provide uniform standards for crowdfunding services with improved investor protection against financial losses.	2020

Table 2.1: Legislative set-up of the Capital Markets Union (by year)

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Within the European System of Financial Supervision (ESFS), the European Commission focused mainly on the ESAs and proposed the delegation of supervisory authority for a variety of non-bank financial sectors. Reform proposals were thereby envisioned for investment funds (related to EuVECA and EuSEF), personal pension funds providers (within PEPP), investment firms (IFR/IFD), as well as central counter-parties (EMIR 2.2). Ultimately, supervisory reform partially succeeded in only two subsegments of non-bank finance.[1] First, the new prudential framework for investment firms (IFR/IFD) amends the single banking rulebook. It provides stricter prudential rules for the largest investment firms which become re-categorized as credit institutions and thus fall under direct ECB supervision within the Euro area. Yet, at the same time, smaller investment firms received a more lenient prudential treatment under national supervision. Second, in terms of CCPs, EMIR 2.2 delegates direct supervisory powers to ESMA. But again, the delegation of powers is conditional on the size and the location of CCPs. Ultimately, only systemically-relevant third-country CCPs are directly supervised on the EU level.

The legislative set-up of the CMU displays progress when it comes to the harmonization of capital markets regulations across the EU, but non-bank financial supervision remained, overall, nationally dominated. No robust supranational supervisory framework emerged and national control continues to dominate. The minimization of financial instabilities in a truly single capital market requires the direct supervision of significant non-bank financial institutions. Especially compared to the achievements with the Banking Union, this overall status quo bias in supervisory reform is puzzling.

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[1] In the case of the Anti-Money Laundering Directive (AML5), the European Banking Authority (EBA) received merely additional technical powers with regards to money-laundering activities but the existing dominance of national supervision within the EBA remained intact.

2.2 Financial Supervision after the Crisis

When the common market was created, the regulatory architecture of the Euro area was based on three main assumptions: an independent central bank that focuses on price stability, the principle of coordination rather than centralization, and the primacy of national laws over EU regulations whenever possible (i.e. proportionality and subsidiarity) (De Haan et al., 2015, p.408). Strict enforcement mechanisms via a centralized supranational authority were not envisioned and voluntary rule-abiding behavior was assumed as given. One can argue that there was indeed no need to delegate national control to the EU level but the sequence of crises that the Euro Area experienced since 2008 shook these three pillars, and the underlying belief in rule-abiding behavior, to its core.

The creation of the Banking Union (EBU) was a direct response to this crisis sequence. The EBU began to take shape at the Euro summit meeting on 29 June 2012 where Euro area member states agreed to it in order "to break the vicious circle between banks and sovereigns". Supranational supervision was established through the Single Supervisory Mechanism (SSM) and the European Central Bank became the direct supervisor of significant credit institutions in the Euro Area. The categorization of credit institutions was thereby based on their size, their importance in the national or European economy, as well as their cross-border interconnectedness (Iglesias-Rodríguez, 2019). This distinction between significant and less significant banks was justified due to the importance of the proportionality principle in EU financial law. A uniform and over-regulated environment could disadvantage smaller firms that lack the economies of scale needed to comply with these rules. As a consequence, smaller credit institutions might be driven out of the market, leading to an even stronger dominance of significant credit institutions in the EU which could once

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again increase systemic risk (Joosen & Lehmann, 2019).

In order to create a truly single market for capital, supervision needs to be extended to non-bank financial institutions. Yet, instead of achieving a Financial Union, the CMU merely advances in the harmonization of financial market regulations, while supervisory reform failed for most of non-bank finance. Thus, while the EBU started to centralize supervision, the CMU displayed a 'status quo bias' in non-bank finance by discontinuing this trend and sustaining the primacy of national control over supranational centralization (Table 2.2).

Financial Institution	Supervisory Reform	Type of Delegation	Supervisor(s)
Investment Funds	Failed	Supervision remains on the national level. National supervisory coordination within ESMA	NCAs
Insurance Companies	Failed	Supervision remains on the national level. National supervisory coordination within EIOPA	NCAs
Pension Funds	Failed	Supervision remains on the national level. National supervisory coordination within EIOPA	NCAs
Investment Firms	Partially Successful	Largest investment firms redefined as credit institutions and directly supervised by ECB	ECB
Central Counterparties	Partially Successful	3rd country CCPs directly supervised by ESMA. EU CCPs remain supervised on the national level	ESMA

Table 2.2: Variety of Supervisory Reform in the EBU and CMU.

The implication of this variety in supervisory reforms between the EBU and the CMU is a fragmented supervisory architecture that includes the ECB, the European Supervisory Authorities and National Competent Authorities (NCAs). The remainder of this chapter will introduce the institutional design of the SSM (under the Banking Union) and ESFS (under the CMU) to show how these two integration projects incorporated national control into financial supervision.

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2.2.1 Supervision in the Banking Union

The Banking Union successfully centralized supervision in the ECB and tamed national control over credit institutions. While some argue that the delegation of supervisory tasks to the ECB "gained [supervision] an independent status largely equivalent to that of central banking" (Teixeira, 2019, p.146), the Single Supervisory Mechanism, in fact, tamed national control not by exclusion but by incorporating national competent authorities (NCAs) into this centralized system (Figure 2.3).

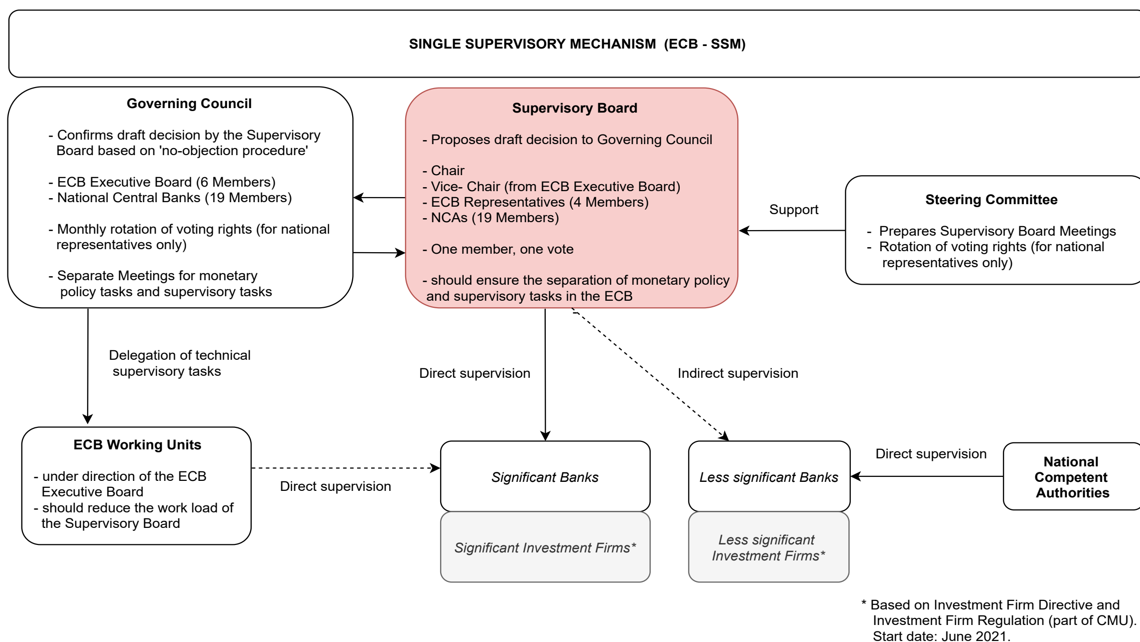

Figure 2.3: Institutional Set-Up of the Single Supervisory Mechanism

Any decision regarding the supervision of credit institutions needs to be formally adopted by the Governing Council, the main decision-making body of the ECB. Yet, the Governing Council is also responsible for the monetary policy task of the ECB (D'Ambrosio, 2019). In order to separate the monetary policy mandate from the supervisory task, a separate regulatory arm within the SSM, the Supervisory Board, was created which mirrors the composition of the Governing Council and, besides members from the ECB Executive Board, each Euro Area Member State is represented

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by one member from their National Competent Authorities (Türk, 2019).

The Governing Council only adopts supervisory decisions formally, while the acts themselves are drafted by the Supervisory Board and these drafts are de facto binding as long as there is no objection within 10 days from the Governing Council (Türk, 2019). This short objection period also limits the influence of the Governing Council since it does not allow for any deep analysis a priori and any objection need to be based purely on monetary policy concerns (D'Ambrosio, 2019). Additionally, it was assumed that the amount of supervisory decisions will not allow the Governing Council to cross-check every decision by the Supervisory Board and the latter's conclusion need to be trusted (Türk, 2019). This gives the Supervisory Board relatively large autonomy.

The relationship between supranational and national control in the SSM remains ambiguous. While the distinction between significant and less significant credit institutions should clearly demarcate the competences of the ECB and national competent authorities, various overlaps exist. The ECB formulates supervisory task for NCAs and can intervene if necessary. This right to directly supervise less significant banks can increase the flexibility of the supervisory system, especially in times of distress, but it can also increase uncertainty among banks. National competent authorities, on the other hand, conduct the day-to-day operation which requires a cooperative behavior by the ECB. The interplay between supranational and national control goes beyond the mere difference in bank size and NCAs are also involved when it comes to significant banks by assisting the ECB in to preparing and enforcing supervision on the ground. Thus, NCAs are led by the ECB without the ECB holding absolute control over them (Türk, 2019).

The establishment of the Supervisory Board also increased the influence of national supervisors within the SSM. While national supervisors have to comply with a rotating voting system in the Governing Council, no such rule exists for the Supervisory

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Board. The stronger role of NCAs in the Supervisory Board thereby counterbalances the power of supranational actors in the ECB. Yet then again, the Steering committee, that prepares the work for the Supervisory Board reduces this national influence again (Türk, 2019). Overall, supranational supervision dominates the SSM without denying NCAs the possibility to influence supervisory processes.

2.2.2 Supervision in the CMU

In the Capital Markets Union, national control is embedded within the European System of Financial Supervision (ESFS) and in particular the European Supervisory Authorities (ESAs) - the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). These ESAs constitute the micro-prudential pillar of the European System of Financial Supervision (ESFS) and are based on a sectoral supervisory model with a separate focus on banking, insurance and pensions, and securities markets. While these three ESAs are legally separated and mirror independent "silos", a Joint Committee was established to allow for an increase in supervisory coordination between the ESAs (Figure 2.4).

While the exact influence of national authorities in the SSM can be debated, national control is undisputed within the European System of Financial Supervision. The main authority in the ESFS remains with the national competent authorities (NCAs) and their structural power in this forum of institutionalized coordination is still based on the home-country principle (Moloney, 2015). As such, national competent authorities are gatekeepers between the EU level and national financial institutions, whereas only limited powers have been vested within the ESAs (Figure 2.4). Generally, the ESAs should ensure the unification of regulations and supervision as a mean to support the creation of single rulebook, ensure a common supervisory culture that minimizes

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the inconsistent application of rules across countries, facilitate the delegation of tasks among NCAs, and conduct peer-review of NCA to support supervisory consistency in outcomes. Furthermore, the ESAs should ensure the sufficient provision of information through close cooperation with the ESRB and monitoring of systemic risk via the assessment of market developments (Weismann, 2016).

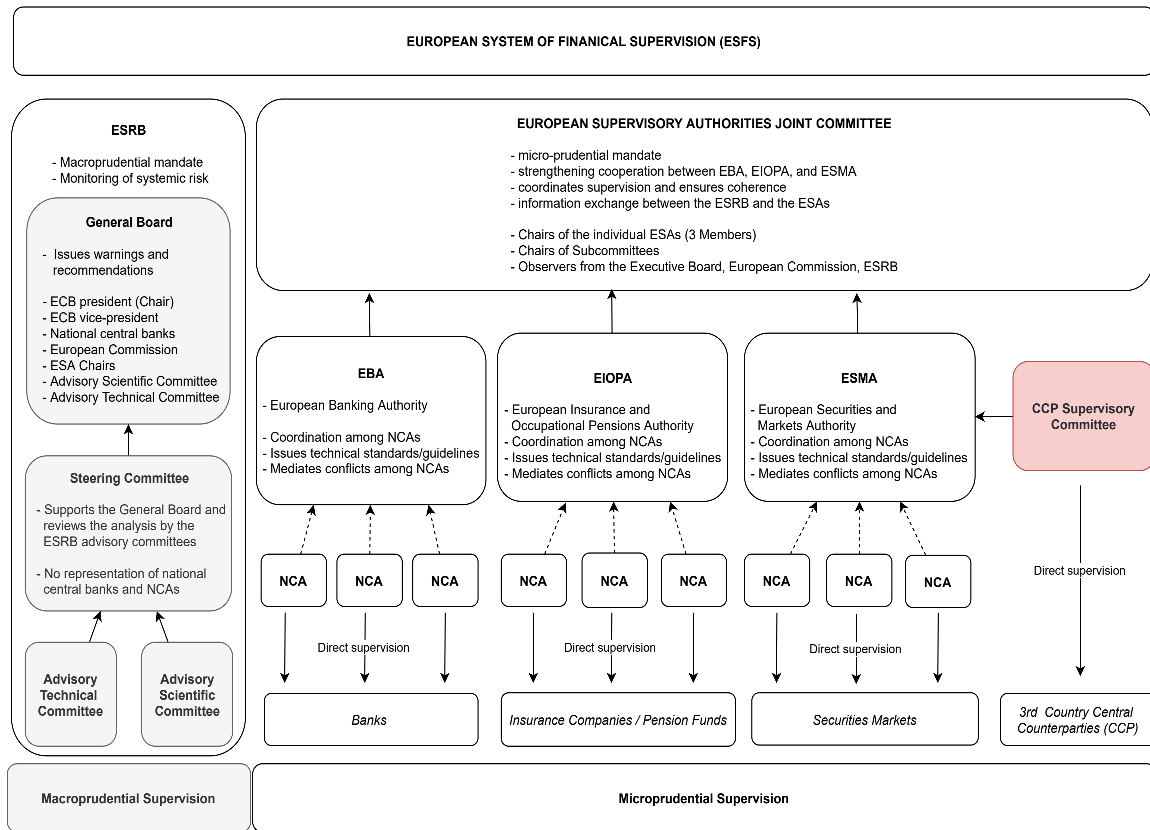

Figure 2.4: Institutional Set-up of CMU supervision.

The delegated tasks to the European Supervisory Authorities include the formulation of non-binding guidelines and recommendations, conducting peer reviews, promoting supervisory cooperation, the non-binding mediation in cases of dispute between supervisors, supporting the convergence of supervisory standards, facilitating the home/host relations between national supervisors, information gathering and maintaining of central databases, providing standard reporting formats, monitoring market developments and conditions generally, as well as providing opinions to the

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European Commission and other EU institutions (Ferran, 2012, p.138).

The ESAs have also received the authority to set regulatory technical standards (RTS). Yet those RTS need the approval of the European Commission. Moreover, RTS are technical and cannot include strategic choices. Nonetheless, while the Commission needs to adopt them, the ESAs are drafting these standards which provides them an important role in EU financial law making. Furthermore, the ESAs can also draft Implementing Technical Standards (ITS). The difference between ITS and RTS is that RTS "as quasi-legislative acts supplement or amend legislative acts, [while] ITS (as executive acts) shall 'determine the conditions of application' of legislative acts" (Weismann, 2016, p.128).

While the ability to develop guidelines may sound like a technicality, it can - potentially - turn into a tool of ESAs to overwrite national approaches to supervision. Nonetheless, such guidelines needs to be agreed upon by qualified majority voting from the board of supervisors which includes national authorities and ultimately an approval by the European Commission. After all, in order to turn ESA guidelines into binding law that is applicable throughout the EU, the European Commission needs to translate them into regulations. The reason for this is to be found in the constitutional law of the European Union that specifies that only EU institutions have the capacity to create binding regulations, while ESAs, as agencies, lack these capacities. To overcome this, the EU created a mechanism where the ESAs create technical details and the European Commissions then adopts them but only if these guidelines do "not involve policy choices or strategic decisions" (Ferran, 2012, p.140). This basically constitutes a protective measure against centralized supervision by EU agencies.

A second point, after the drafting of guidelines, is the potential enforcement of these guidelines. The ESAs have some sort of limited enforcement mechanisms. Limited

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because they require again the support of the European Commission. In theory, if a national regulator does not comply with technical guidelines, any of the ESAs can trigger an enforcement protocol. This protocol begins by investigating the degree of national non-compliance with ESA guidelines. Depending on the outcome of this investigation, the ESAs then draft a "compliance recommendation" to the respective national supervisors. In case of continuous non-compliance, the ESA evaluation is passed to the European Commission. The European Commission can formulate a formal opinion to the respective national competent authority stating that evaluation of non-compliance by the ESA is in conformity with the Commission's formal opinion (Ferran, 2012, p.140-148). It can be argued that this enforcement procedure displays some light form of supranational control over national supervisors.

The CMU was originally understood as a complement to the EBU. The full delegation of centralized supervisory powers to the supranational level is therefore not impossible to imagine. Indeed, while the CMU failed at a reform of the supervisory architectures of most institutional investors, the CMU did reform supervision for investment firms and CCPs. The case of ESMA's direct supervision of third-country CCPs with the CMU shows an example of this. Similarly, to the SSM, the direct supervision of CCPs is de facto outsourced to a new regulatory arm of ESMA, the CCP Supervisory Committee, that should ensure that ESMAs general tasks are not affected by their new mandate of CCP supervision. This makes the lack of supervisory reform for other non-bank financial institutions even more puzzling. After all, additional regulatory arms could be added to any of the other ESAs and the CCP example indicates that the lack of reform is due to political issues rather than legal or procedural difficulties.

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2.3 Summary and Discussion

To ensure financial stability in the context of financial integration, it is necessary to limit national control. European financial integration therefore requires both a single rulebook and robust supervision on the EU level. But the historical trajectory of European financial integration is paved with national resistance towards the delegation of supervisory authority. EU member states tend to protect their national finance, even at the expense of international financial stability.

Until the 1980s, the default mode in supervision was based on the host-country principle. Despite first initiatives, like the Groupe de Contact, supervisory powers were fully vested within national supervisors. A first attempt to break up the black box of national supervision occurred only in the early 1990s with the introduction of the home-country principle that allowed national supervisors to supervise branches of their internationally active banks in foreign markets. While the ultimate goal of this transition was to ease the amount of regulatory burden on national financial firms operating internationally, it simultaneously required foreign supervisors to give up some control over their own national markets. The home-country principle politically legitimized trust-based cooperation between national supervisors that paved the way for more institutionalized coordination later on. Such more institutionalized supranational coordination then materialized through the Lamfalussy process that set up three Level-3 Committees (3L3 Committees). Separated into banking, insurance, and securities markets, each of these committees constituted an institutionalized supranational forum in which national supervisors could discuss national best practices and coordinated the implementation of technical standards. As a consequence of the financial crisis in 2008/09, the 3L3 Committees were updated into the European Supervisory Authorities (ESAs) and equipped with political powers to set technical

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standards and guidelines. These ESAs, together with the macro-prudential European Systemic Risk Board (ESRB), constitute the European System of financial Supervisors (ESFS). The political mandate of the ESAs to set technical standards and the additional macro-prudential pillar via the ESRB displays a further deepening of European supervisory integration that reduced the importance of the home-country principle (Ferran, 2012; Moloney, 2015).

Even though financial integration made close supervision a necessity, national resistance never disappeared and progress towards a single market in capital occurred only in incremental steps until the recent financial crisis. The post-crisis years tilted the power of rule-making, monitoring and, to some degree, enforcement away from member states towards supranational authorities. As a direct consequence of the financial crisis, the right to initiate European financial legislation became the sole competence of the European Commission, national discretion in the implementation of EU financial law diminished, and the monitoring and enforcement of rules became increasingly centralized. Hence, the ordinary legislative procedure, the dominance of regulations over directives, and direct banking supervision by the ECB almost makes it seem as if the crisis experiences led national interests to succumb to the greater good of the common/supranational interest: deepened financial integration and strengthened financial stability.

Significant progress occurred with the European Banking Union which transformed the European Central Bank into a centralized supranational supervisors for the largest credit institutions in the Euro area. Based on a single banking rulebook, the ECB directly supervises these largest banks and monitors the national supervision of less significant credit institutions. This move towards a quasi-centralized banking supervisor is a significant leap in supervisory integration and should have been complemented by the Capital Markets Union. While some progress in centralized supervision occurred

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in terms of third-country central counter-parties, the CMU de facto strengthened the pre-EBU system based on the institutionalized cooperation of national competent authorities within the ESAs. While the Banking Union seem to have proven the necessity of supranational solutions, national control returned with the CMU. It is this tension between the financial integration, financial stability and the reluctance to delegate national control that resulted in incremental development of financial supervision in the EU. Thus, compared to the EBU, the CMU displays a status quo bias towards national control and this difference between the European Banking Union and the Capital Markets Union is at heart of my research question.

While the Banking Union managed to tame national control within the Single Supervisory Mechanism; the dominance of national supervision was sustained with the Capital Markets Union. One needs to wonder what can explain the significant leap in supranationalism and the subsequent status quo bias in non-bank finance. A first argument could be reform fatigue; after the hard political bargaining with EBU, national EU member states might not have been willing to fight the same battle for non-bank finance so close after the EBU. While this might be true, most of the reform attempts were cancelled by the European Commission before the proposal reached the Council. One might wonder if actors, other than states, therefore pressured in favor of the status quo. Second, one could argue that this status quo bias is due to legal limits. Since the ESAs are merely agencies, they cannot be provided with direct supervisory powers. Again, this could have been overcome by turning the ECB into a single supervisor. Lastly, one might argue it is too early to claim any status quo bias. Since the focus of this project is on the period 2015-2019, the CMU continues to be high on the EU agenda. Thus, supervisory reform might occur in the upcoming years. Even if this is the case, understanding the current status quo bias provides valuable insight into what needs to change for reforms to (possibly) accelerate in the near future.

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3 When Is National Control Delegated?

Times of crisis provide a window of opportunity for reform and the period after 2009 was no different. As a consequence of the financial crisis, the EU reformed its supervisory system with the set-up of the European System of Financial Supervision (ESFS), followed by an increasing reliance on regulations rather than directives, to the creation of the Banking Union as a consequence of close state-bank ties and the Eurozone crisis. Yet, as the previous chapter showed, the Capital Markets Union diverged from this trend and displayed a *status quo bias* towards national control rather than mirroring the depth of centralization in the Banking Union. With the exception of non-EU CCPs and the largest investment firms, direct supervision of non-bank finance remained, de facto, under the control of national competent authorities.

The aim of this chapter is to situate this status quo bias into the European financial integration literature in order to understand when national control is delegated. While a multitude of different theoretical angles emerged over the last decades, the dominant perspective in this literature review chapter is neofunctional. A central role is thereby dedicated to supranational institutions and financial actors based on the assumption that integration is a continuous process that advances due to unintended (negative) consequence of previous integration steps. Since policy areas tend to cluster together, progress in one area affects the behavior of actors in a neighboring area, creating demands for further integrations.

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So far, neofunctionalist explanations play a marginal role in the literature on post-crisis integration and existing studies focus predominantly on the potential conflict among EU member states. As I will show, there are good reasons to rely on a neofunctional account of the CMU to understand why we can overall observe a status quo bias rather than a 'big leap' in integration. While the question of supervision as such directly effects member states, the CMU was created through the ordinary legislative procedure that provides the European Commission the sole right to initiate legislative proposals. Moreover, (transnational) financial actors had a direct way of intervening in the law-making process and shaped proposals before they were forwarded and agreed upon (or rejected) by the European Council and the European Parliament. Given the complexity of law-making on the EU level, focusing purely on national interest articulation and intergovernmental bargaining provides an underdetermined account for our outcome of interest.

The first section of this chapter introduces the existing work on the Capital Markets which still remains scarce and heavily skewed towards the first years of the project. It then moves to the general neofunctional logic and possible alternative explanations, their explanatory power for the post-crisis period and the assumed drivers behind supervisory delegation. The second part takes a closer look at a neofunctional explanation for the European Banking Union and links them to the CMU. The main taking point from this chapter is that functional pressures lead to spill-over effects in integration, while in the absence of such functional demands, spill-over effects are replaced by a status quo bias.

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3.1 Supranational Dynamics or National Interest?

Despite its centrality to the Juncker Commission and its perceived role as a complement to the Banking Union, the political economy literature on the CMU remained relatively scarce and tackles predominantly a period of analysis when neither the current design nor the overall *status quo bias* in non-bank supervision was fully evident (Braun & Hübner, 2018; Quaglia & Howarth, 2018; Braun, Gabor, & Hübner, 2018; Quaglia, Howarth, & Liebe, 2016; Epstein & Rhodes, 2018).

As such, most of this political economy research on the Capital Markets Union tried to explain general drivers behind the launch of the CMU and possible broader consequences of the intended shift towards market-based financing in the EU. While Braun and Hübner (2018), for example, emphasized the common ideational overlap among major stakeholders regarding the empowerment of markets through the Capital Markets Union, Quaglia and Howarth (2018) showed that the European Commission used different CMU narratives depending on the targeted national audience in order to minimize CMU resistance among member states with different institutionalist preferences.

Quaglia et al. (2016) focused more explicitly on such national institutionalist preferences in order to map the main beneficiaries and opposition in the creation of a CMU. Based on evidence from the first public consultations on the CMU, they found that member states with a larger non-bank financial sector and, to a lesser degree, states with a more open banking sector (and less banking nationalism), tend to be in favor of the CMU. Those member states include the UK, but also Ireland, the Netherlands, Sweden and Luxembourg (p. 10). In case of the financial industry, the authors show that institutional investors and international banks were the main supporters, while domestically oriented banks and financial infrastructure tend to oppose the

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CMU plans of the Commission. In both cases, the set of actors in favor of the CMU thereby overlaps with the assumed main beneficiaries of further market liberalization and national state preferences, in conjunct with national industry support, should determine the regulatory priorities in the making of the Capital Markets Union. The regulatory outcome is then based on intergovernmental bargaining and (financial) power relations (Quaglia, 2019).

Epstein and Rhodes (2018), in contrast, move beyond such state-centric explanations that rely on national financial market differences to account for the Capital Markets Union. Instead, they argue that supranational institutions are central drivers behind the CMU (and the EBU) and responded to functional pressures that emerged from a common currency in conjunct with post-crisis management flaws. This, in turn, paved the way for a 'dual shift' towards the further delegation of direct supervisory authority to the EU level and an increasing empowerment of market actors in the process. According to this view, functional pressures avoided intergovernmental stalemate and moved the CMU forward.

One of the main differences between such neofunctional and intergovernmental explanations is linked to the time-varying effects of integration. For Intergovernmentalism, each integration step tends to be insulated from previous progress and determined by national interests at that particular point in time. For Neofunctionalism, integration is path-dependent and previous integration outcomes determine current integration progress (Hooghe & Marks, 2019).

3.1.1 Functional Pressures and Spill-Over Effects

Neofunctionalism emphasizes supranational dynamics and assumes the relative independence of supranational institutions and (transnationally) organized private interests from national governments. This independent influence of these actors is based

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on the assumption that policy issues tend to cluster together and progress in one area creates unintended consequences for other areas that warrants further integration (Niemann, Lefkofridi, & Schmitter, 2019; Hooghe & Marks, 2019). The complexity of integration therefore leads to 'spill-overs' in order to find effective solutions for collective action problems (Haas, 1958, 1961, 1964; Lindberg, 1963; Scheingold, 1964; Lindberg & Scheingold, 1974). As Hooghe and Marks (2019) argues, the logic of neo-functionalism assumes that over time the scope of integration narrows and fewer options are available; with each step more cooperation possibilities emerge that make a reversal less likely. Thus, integration is a path-dependent but incremental process that takes previous experiences into account instead of a one-time game that restarts with every new initiative (Niemann & Ioannou, 2015). Neofunctionalism thereby builds upon and extends the logic of increasing returns by focusing on social actors rather than states (Sandholtz & Stone Sweet, 2012; Pierson, 2000).

While spillovers are functional in nature - that is, they derive from unintended consequence of previous integration that requires further cooperation - supranational institutions and interest groups need to be aware of them in order to push for action. When a functional dissonance is uncovered, interest groups will favor supranational delegation over national control to reap the benefits of an increasing level playing field. Once such transfer of competences to the supranational level occurs, it will trigger further integration demands by various interest groups but these stakeholders will no longer express their preferences to their respective national governments. Instead, they directly access the supranational level (Vilpišauskas, 2013; Saurugger, 2014). This triggers a virtuous integration cycle that increases the influence of supranational institutions at the expense of national governments (Saurugger, 2014). In order to limit national resistance, "transnational interest groups and supranational actors pursue incremental [...] reform along the line of least resistance" (Hooghe & Marks, 2009, p.4).

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The post-crisis trajectory that was outlined in the previous chapter can be seen as evidence for an incremental but continuous process towards integration via the increasing pooling of competences to the supranational level (Vilpišauskas, 2013). Since further delegation occurred in a sequential manner, neofunctionalism argues that each step made policy makers realize new forms of ’functional dissonances’ that require the spill-over of integration to ever more areas based on pressures from international financial markets (Niemann & Ioannou, 2015).

After the introduction of the common currency, for example, the prospect of increasing financial integration reduced the negative market perceptions of divergent competitiveness and productivity levels across Euro area members (Vilpišauskas, 2013). But a single monetary policy led to unintended negative consequences in the context of such divergent patterns of competitiveness. Fiscal imbalances and a lack of productivity in parts of the Euro area during the financial crisis laid the ground for the emergence of the Euro crisis (Niemann & Ioannou, 2015). The costs of sovereign borrowing diverged again and international financial markets ”indirectly push[ed] EU institutions and member states to look for measures on how to bring down the costs of borrowing for eurozone members in trouble” (Vilpišauskas, 2013, p.365). Financial markets ultimately served as a ’revealer’ of functional dissonances (Niemann & Ioannou, 2015).

Once revealed, the European Commission (and the ECB) became the prime respondents to increasing integration demands. While ad-hoc measures focused predominantly on fiscal monitoring and enforcement mechanism, the European Banking Union tackled the underlying functional dissonances in close state-bank ties. While national governments were eager to protect their national banks as a mean to enhance their international competitiveness, financial stability concerns took a secondary role. In the context of rising borrowing costs for peripheral Euro area countries, banks in

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these markets increased their sovereign debt home bias which resulted in a bank-state doom loop that began to spread financial fragility beyond individual national markets and increased systemic risk for the Euro area as a whole (Epstein & Rhodes, 2016; Epstein, 2017). In order to reduce such systemic risk, bank-state ties needed to be weakened by delegating control to the EU level (Bauer & Becker, 2014; Rynck, 2016; Torres, 2013; Epstein, 2017). Since the existing system of supervisory coordination within the ESAs failed to weaken these bank-state ties, the Single Supervisory Mechanism (partly) centralized supervision within the ECB.

Even though the Banking Union weakened bank-state ties and strengthened financial stability within the Euro area, it failed to strengthen cross-border bank-to-real-economy lending in the EU (Sapir, Veron, & Wolff, 2018; Hoffmann, Maslov, Sørensen, & Stewen, 2019). Sluggish economic growth became an unintended negative consequence of the strong post-crisis focus on prudential regulation. In July 2014, the then presidential candidate for the European Commission, Jean-Claude Juncker, outlined his political guidelines, emphasizing ten policy areas for jobs, growth, fairness and democratic change. Among these ten policy areas, the deepening of the internal market took a central role and the idea for a Capital Markets Union was introduced for the first time:

> My Commission will be active and vigilant in ensuring that we implement the new supervisory and resolution rules fully, making European banks more robust so that they can get back to lending to the real economy. Over time, I believe we should complement the new European rules for banks with a Capital Markets Union. To improve the financing of our economy, we should further develop and integrate capital markets (Juncker, 2014, p. 6-7).

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In January 2015, the project plan for a Capital Markets Union slowly began to take shape in a first orientation debate at the College of Commissioners where it was agreed to set the details of this flagship project in close cooperation with the industry. The readout from the College Meeting on 28 January 2015 by the then Vice-President of

the European Commission in charge of Jobs, Growth, Investment and Competitiveness, Jyrki Katainen, makes this even more evident:

> The next step is that we will launch the Green Paper Consultation on Capital Markets Union on 18th of February. It is very important kick off process because now it's a time for private sector, for industry itself, to speak loud and tell what they expect from us when creating Capital Markets Union [sic!]. So we have to get clear signals, clear feedback from the industry itself - what are the main issues which should be created or changed in order to create a Capital Markets Union?

What seems apparent from these two quotes ahead of the official start of the CMU is that, from the very beginning, the Capital Markets Union was an supranational integration project based on the understanding that a functional dissonance remained between the post-crisis focus on financial stability and the return to pre-crisis levels of economic growth. The persistence of sluggish economic growth required a reorientation towards alternative lending channels for the real economy and deeper integration of non-bank finance through a Capital Markets Union. These supranational dynamics towards the CMU therefore seem to justify a neofunctional perspective.

Moreover, the last quote already indicates a possible neofunctional explanation for the status quo bias in non-bank financial supervision. In order for functional pressures to create spill-over effects to the CMU, the two main neofunctional actors - supranational institutions and the financial industry - both need to place similar importance on them.[1] Without financial actors pushing for centralization, supranational institutions lose their main partner in limiting the effects of potential national resistance. A potential neofunctional explanation for the status quo bias is therefore the lack of financial industry support for the European Commission's supervisory proposals in the CMU.

[1] This mirrors the theoretical distinction between *political* and *cultivated* spillovers. The former refers to industry pressures for more integration, while the latter indicates pressures from EU institutions for increased authority delegation (Scholten & Scholten, 2017).

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3.1.2 Beyond Neofunctionalism

While Neofunctionalism assumes an emancipation of the integration process from the national level, the majority of accounts for the post-2009 period rely on intergovernmental explanations. On a very general level, intergovernmentalism assumes the primacy of state bargaining, national interests, and power relations as drivers behind specific integration outcomes. In contrast to the continuous logic of spill-over effects, an emphasis is placed on the insulation of integration episodes; each integration step is determined by national, issue-specific preferences of member states that do not necessarily depend on the experience of previous integration processes (Moravcsik & Schimmelfennig, 2019; Schimmelfennig, 2015).

Member states aggregate a multitude of domestic interests to a coherent set of 'state preferences'. Once these preferences are aggregated, states enter into intergovernmental bargaining to achieve institutionalized cooperation. Whether such cooperation succeed depends on the distance of national preference distributions. Countries that are least affected by new cooperation agreements are thereby in possession of the highest bargaining strength since they can threaten others with non-cooperation in order to get concessions toward their own interests while bearing fewest costs in case of actual cooperation failure (Moravcsik, 2018; Moravcsik & Schimmelfennig, 2019; Vilpišauskas, 2013). Depending on the type of intergovernmental argument, these national preferences are either driven by economic considerations and the institutional distinctiveness of national market economies or by sovereignty concerns and power relations (Fioretos, 2001; Spendzharova, 2012; Maris & Sklias, 2016). Since national interests can vary significantly within the EU, integration tends to result in the lowest common denominator by which each government sees its interests secured and supranational institutions mere serve as a mean to secure this fragile bargain outcome of national interest (Hooghe & Marks, 2019; Scharpf, 1988).

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A liberal reading of intergovernmentalism would argue that the post-crisis trajectory of European financial integration and the question of supervisory delegation is driven by the financial market structure of member states and the level of internationalization. The literature seems to point at a negative association between the level of internationalization of domestic banks and the level of openness of the domestic banking sectors when it comes to preferences regarding supervisory delegation and financial integration (Howarth & Quaglia, 2016c, 2016a). Countries with lower levels of foreign ownership and higher levels of domestic bank internationalization seem to be in favor of delegation in order to take advantage of the international level playing field. Countries with higher levels of foreign ownership and low internationalization of domestic banks, in contrast, refuse prudential delegation to protect their national regulatory autonomy (Spendzharova, 2014; Spendzharova & Bayram, 2016). Openness can therefore also have a negative effect. Research on EU member states in Central and Eastern Europe, all of which are characterized by high levels of foreign bank ownership, displayed a tendency towards prudential autonomy and banking nationalism. The higher foreign ownership in national financial system the less willing a country is to delegate powers to the EU level. While the level of internationalization seems to play a central role in intergovernmental accounts of the post-crisis period, sovereignty concerns might also intervene (Spendzharova, 2012, 2014).

A realist reading of intergovernmentalism focuses more explicitly on the question of sovereignty and power (Maris & Sklias, 2016; Donnelly, 2014; Howarth & Quaglia, 2016b; Lombardi & Moschella, 2016). An emphasis has thereby been put on the issue of moral hazard concerns among financial and/or economically powerful states and the dependency on international finance among weaker, crisis-hit countries. Member states in financial troubles favored supranational delegation in order to stabilize their financial systems, while economically more powerful countries remained concerned about moral hazard. The degree of delegation is then determined by the preferences of

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economically powerful states (Howarth & Quaglia, 2016c). These preferences, in turn, can be based on the above mentioned argument on financial market openness. The more open a country is to foreign financial institutions, the more it needs to attract and keep them during times of financial distress. This dependency is less pronounced for countries with less foreign financial presence. Countries that are financially most powerful and have relatively little foreign presence in national financial markets shape the ultimate outcome of prudential governance structures on the EU level (Donnelly, 2014; Maris & Sklias, 2016; Howarth & Quaglia, 2016c; Spendzharova & Bayram, 2016).

Another realist version overlaps with the literature on economic/financial nationalism (List, 1844; Johnson, 1965; Hieronymi, 1980; Levi-Faur, 1997b, 1997a; Helleiner & Pickel, 2005; Abdelal, 2001). States have an interest in the protection of economic or financial insiders at the cost of outsiders. Those insiders can be national sectors, firms, or individuals and the state uses a multitude of economic and financial policies by which they can discriminate such outsiders (Clift, 2013; Clift & Woll, 2012). Sustaining national supervision and resisting the delegation of authority then depends on the degree to which it would serve 'national champions' in the context of internationalization.

While arguments about the internationalization of financial markets seem to play a major role in determining the delegation of supervisory control to the EU level for both liberal and realist intergovernmentalism, the merits in focusing purely on power relations and intergovernmental bargaining are less obvious. There was a tendency to overemphasize the intergovernmental nature of EU policy making after the crisis. Partly due to various ad-hoc emergency measures, a theoretical consensus seem to have emerged that saw national governments as the determining factor for European integration. Even if authority was delegated to the EU levels, this happened via

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the creation of new supranational entities, rather than an updating of the European Commission, because those ”de-novo bodies” (like the Euro Group) remained fully vested within national control (Bickerton, Hodson, & Puetter, 2014, 2015; Puetter, 2012).

Despite this, it seems reasonable to assume that this ad-hoc activism after the financial crisis was an outlier rather than then the 'new standard' of integration and the same criticism that the intergovernmental argument received thirty years ago, still holds: most intergovernmental explanations fail to account for the complexity of EU policy making in 'normal times'. The Commission remains the agenda setter and governments cannot simply dictate their goals. After all, whenever a proposal is introduced according to the ordinary legislative procedure, a trilogue occurs and each EU institution needs to propose a solution that can be accepted by all three parties (Garrett & Tsebelis, 1996).

Another alternative explanations is based on a constructivist logic and focuses on ideas and shared beliefs between stakeholders and the use of common 'policy templates'. These connections based on shared ideas and understandings can be seen as some sort of 'epistemic communities' (Verdun, 2011). Such networks can exist between various types of non-state stakeholders or supranational bureaucrats and display an autonomous influence on policy making. The political agreement on the European Banking Union, for example, was assumed to result from the combined influence of the ECB and national central bankers. Together, they established an epistemic community through shared beliefs and influenced the ultimate political agreements via public and private debates, as well as formal recommendations and opinions (McPhilemy, 2016). Others have focused on the European Commission and non-state stakeholders as ideational networks and argued that such networks not only rely on their own beliefs but frequently borrow policy templates from their US coun-

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terparts. By mimicking existing structures, the European Commission can legitimize their own preferences and counter national resistance (Posner & Véron, 2010; Newman & Posner, 2016; Engelen & Glasmacher, 2018). Following this logic, the Capital Markets Union is then just the latest attempt to mimic the US approach to capital market governance (Braun et al., 2018).

Lastly, all of these explanations thus far tend to focus on elites and ignore the role of public perception. Some newer approaches therefore started to include party politics and public opinions as determinants behind the post-crisis period in EU integration (Webber, 2019; Hooghe & Marks, 2009). The issue is that such explanations require the presence of high issue salience among the public to provide any explanatory power. While the Banking Union was indeed a highly salient policy issue in many EU member states, the CMU so far remained in the realm of 'quiet politics' (Culpepper, 2010). In fact, this lack of (public) controversy was already argued to be one justification to apply neofunctional arguments to the CMU (Epstein & Rhodes, 2018).

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3.2 From the Banking Union to the CMU

Neofunctionalism assumes that supranational institutions and financial actors are the decisive actors behind the delegation of authority. Each integration episode - from the beginning of the home-country principle to the Banking Union - is then evidence for an incremental but continuous delegation process due to unintended (negative) consequences that create new integration demands either by supranational institutions, interest groups, or the combination of both.

Not only did the European Commission, together with the ECB, push for the CMU as an integration project, but they regularly emphasized the connection between the Banking Union and the Capital Markets Union. For EU institutions, the presence of the Banking Union created functional pressures that deemed a Capital Markets Union necessary. The essence of this neofunctionalist logic has been captured in a quote by the then vice-president of the ECB, Vitor Constancio, on the synergies between Banking Union and Capital Markets Union:

> [W]e should not treat banking union and capital markets union as two mutually exclusive projects but rather see them as mutually reinforcing initiatives that can bring the Single Market for financial services to the next level. [...] We are talking about two inseparable parts of the financial system. From a policy perspective, banking union and capital markets union are undoubtedly the two central catalysers of EU financial integration for the years to come (Constâncio, 2017).

This speech captures the very essence of functional progress in European financial integration. Constancio emphasized the close functional links between the Banking Union and the CMU at that time. The CMU thereby not only logically follows upon the Banking Union, but an established CMU, together with the EBU, enables further integration steps in the future. Moreover, he also highlights the contribution of the ECB in the promotion of the CMU. Together with the European Commission, the ECB's support for the CMU as a central pillar of financial integration highlights the

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central role of supranational actors. In his speech, Constancio also emphasized the importance of financial supervision in the CMU. His remarks show that the question of supervisory reform was indeed an important consideration for a Capital Markets Union:

> A Single Rulebook and an integrated supervisor for capital markets are key ingredients to support the integration of capital markets and would ultimately also allow banks to thrive from more stable capital markets. The establishment of ESMA has been a major step towards fostering convergence of national supervisory practices. But the supervision of securities markets remains at the national level, which fragments the application of EU legislation. ESMA could play a much larger role in ensuring consistent transposition and effective enforcement of rules agreed at EU level. In the longer term, capital markets union warrants a single European capital markets supervisor (Constâncio, 2017).

The importance of an integrated supervisor is shared by the European Commission and yet, the CMU displays a status quo bias in non-bank financial supervision. Reducing national control over national finance has been a daunting task ever since the start of the European financial integration process and it took a Sovereign Debt Crisis to delegate significant control over banks in the Banking Union. Given the synergies between the Banking Union and the Capital Markets Union, spill-over effects should have occurred from banking to capital markets, leading to supervisory reform and diminished national influence over finance. So why did national control not succumb to this integration pressure if it did so in the Banking Union?

It seems plausible that the functional mismatch that were present ahead of the EBU, might not have been too pressing in the CMU. I will therefore turn to these functional dynamics that led to the EBU in more detail. Rachel Epstein (2017) provided one of the most encompassing functional explanations for the Banking Union based on a detailed assessment of bank-state ties and their role as functional drivers for the creation of the EBU. As such, it is worth to summarize her argument in full before we can make any assumptions about lack of these functional pressures for the status quo bias in non-bank financial supervision.

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3.2.1 Banking On Markets

Epstein (2017) outlines in her work *Banking on Markets* a detailed, neofunctional explanation for the Banking Union that encompasses an account for the delegation of national control into the Single Supervisory Mechanism (SSM). Epstein's starting point are the traditionally strong state-bank ties in Europe that persisted throughout the European integration project (see also my own description in Chapter 2). Close state-bank ties play a central role for Epstein because they enabled states to employ national banks strategically for political goals. The political connection between banks and their sovereign are thereby the norm, rather than the exception. After all, both states and banks have benefited from such close ties.

For states, control over banks means a political tool to manage capital flows in their national financial systems. National control then minimizes the potential for capital flights (during times of crisis) and ensures the loyalty of a central creditor to the state. It allows for particularistic policy making by ensuring that a specific electoral clientele receives a better credit conditions and, more generally, enables the subsidiarization of industries (ibid., p. 20). In addition to these domestic benefits, close bank-state ties can also come with international competitiveness benefits, increased international state power and more flexibility to respond to negative external economic shocks. Ultimately, all these state benefits are linked to minimizing the potential for banks to 'cut and run', leaving countries exposed in times of crisis and in desperate need for capital (ibid., p. 47).

For banks, close bank-state ties come with supervisory forbearance and protectionism. As the sole licensing authority, national supervisors can restrict market access for foreign entities which provides domestic banks a competitive advantage in the home market and potential to growth. Once the domestic growth potential is saturated, national supervisors support the outward expansion of 'national champions' as a

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mean to increase a country's international prestige. Thus, national control offered supervisory forbearance and restrictive national market access that enabled domestic consolidation and outward expansion in return for a sovereign debt home bias and politically-induced credit allocations by banks.

The push for the EBU was based on four major underlying causes of the Euro crisis that could all be traced back to the close connection between banks and their home states: the downward spiral between the sovereign debt home basis of banks and the deterioration of states fiscal and debt position (i.e. the bank-state doom loop); a lack of banking internationalization that increased the severity of the bank-state doom loop; the potential of crisis contagion due to the lack of market confidence in more and more crisis countries that increased the risk of capital flights; and the reduced effectiveness of the ECB's monetary policy transmission due to the lack of internationalization in combination with the bank-state doom loop (ibid., p. 130).

These issues are all linked to close-state bank ties and created functional pressures that required the delegation of supervisory authority to the EU level in order to tackle systemic risk and increase financial stability. As a consequence of the Single Supervisory Mechanism, close state-bank ties became harder to sustain. Supervisory centralization on the EU level tied the hand of national supervisors and limited supervisory forbearance. Countering supervisory forbearance, in turn, reduces the incentives of banks to maintain a home bias that is politically induced. As such, the SSM also weakened the bank-state doom loop (ibid, p. 132). The EBU further provided the ECB with licensing rights that limited states' influence in restricting domestic competition and market access. After all, the protection of national markets against foreign entries was another central tool for state to maintain national control and support the growth and outward expansion of national banks. By ensuring a competitive level playing field and limiting restrictive licensing among national supervisors, the ECB not only

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supported the internationalization and consolidation of Euro area banks, but also improved the effectiveness of their monetary policy transmission. (ibid, p. 132).

While supranational institutions responded to these functional demands by pushing for supervisory centralization, financial actors shared these functional demands and became a decisive ally in the creation of the EBU. Since banks should benefit from national control and supervisory forbearance, Epstein points at the unintended long term consequences of bank-state ties as an explanation for bank support towards the EBU. National control enabled domestic growth and market consolidation and supported outward expansion of banks later on. Yet, at the same time, once banks became more internationalized, their main focus of operations moved from the domestic market to foreign markets, reducing banks' loyalties to the home markets. (ibid, p.150) As a consequence, it was mainly larger, internationally oriented banking institutions that supported the delegation of supervision, while smaller, domestically-rooted banks remained in favor of national control. Yet given the importance and size of internationally-oriented banks, they became a crucial neofunctional actor to limit national resistance and move the EBU forward.

In sum, the common exposure to systemic risk in combination with the functional pressures expressed by supranational institutions and large, internationally-oriented banks enabled the delegation of national control to the EU level. Internationalization is thereby the ultimate functional driver behind bank's support for the EBU (ibid., p. 152). The severe crisis experience in some EU member states, the potential for crisis contagion and the broader (fiscal) implications of systemic risk for the entire Euro area limited national resistance against the centralization of supervision (ibid, p.16).

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3.2.2 Status Quo Bias in the CMU

The most parsimonious interpretation of Epstein's account is that internationalization seems to drive the functional demands behind the EBU. As such, this neofunctional explanation shares the central determinant of most intergovernmental accounts, albeit with a focus on different actors. Then again, if capital mobility (in the Euro area) was the main functional driver behind the centralization of banking supervision and the EBU further empowered market actors, why do we not observe similar supervisory delegation in the CMU once we consider neofunctional explanations?

Rather than a continuous falling forward, the CMU seems to show a status quo bias. In order to understand the successful delegation of supervisory authority in the Banking Union's SSM and the failed reform in the supervisory set-up of the CMU, we need to take a closer look at the central role of functional dissonances. While spill-overs are often seen as the crucial hallmark of neofunctionalism, this can trigger false assumptions about a neofunctional determinism regarding the outcome of integration. Neofunctionalism is really a theory of the integration process rather than the integration outcome and as such, spill-overs are far from the only mechanism. Early accounts of the neofunctionalist framework indeed incorporated several possible integration outcomes beyond mere spill-overs (Schmitter, 1970).

Figure 3.1 presents six different modes of integration: status quo bias (zone of indifference), retrench, spill back, muddle through, spill-over, and spill-around. The vertical axis shows if more/less authority was delegated, while the horizontal one indicates if more areas are located to supranational institutions. *Spillover* refers to a situation in which both the scope and level of authority is simultaneously increased. As I have shown before, most neofunctional accounts indeed focus on such spill-overs. But other integration dynamics can be present, too. *Spill-around* refers to a situation were we can merely observe an increase in the scope of authority, without the further

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delegation of additional powers. *Retrench*, on the other hand, allows for improved co-ordinated deliberation but reduces the power of supranational institutions in a given area. Moreover, *muddle-through* enables supranational bureaucrats to be involved in ever more policy areas, without delegating any further enforcement powers.

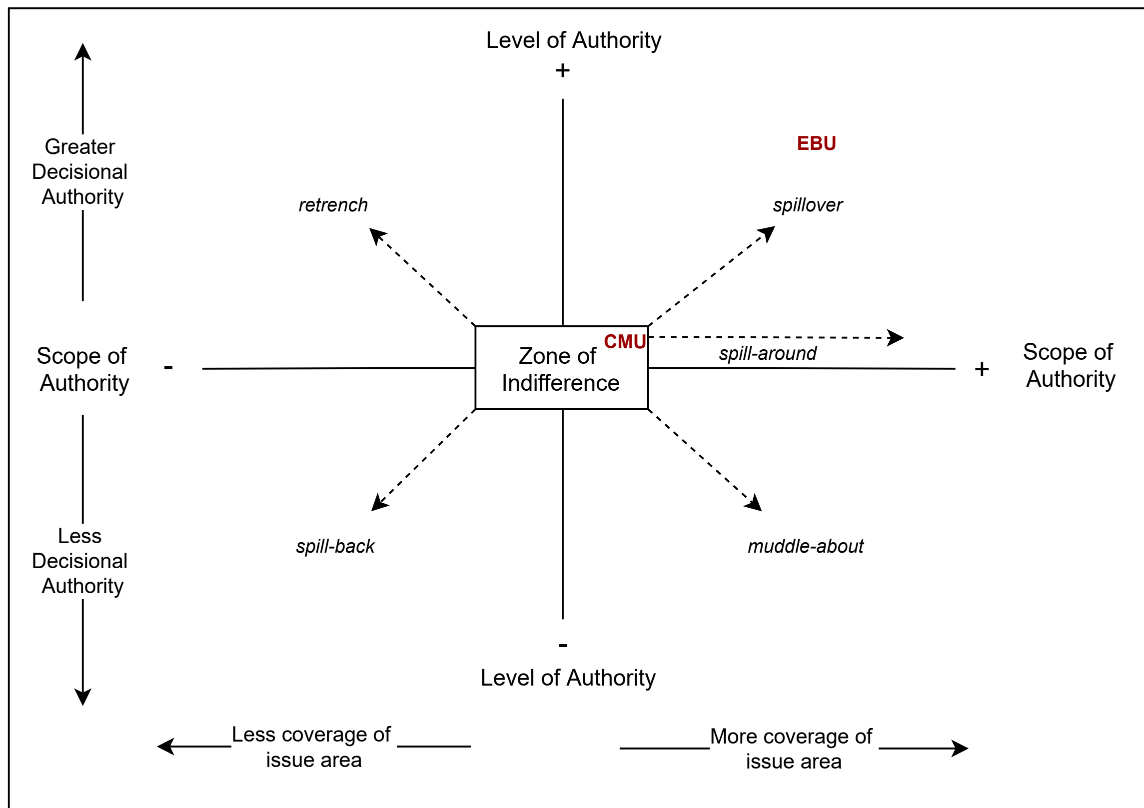

Figure 3.1: Variety of Integration Trajectories based on Schmitter (1970).

Most importantly for the CMU, a new integration cycle can also end up in, what Schmitter calls, *encapsulation*. In this case, actors "respond to crisis by marginal modifications within the zone of indifference" (Schmitter, 1970, p.846). Encapsulation represents a status quo bias. The difference between the EBU and CMU is ultimately the difference between a successful spill-over and a status quo bias (or encapsulation). In the case of the EBU, the level of authority increased by providing the ECB with direct supervisory powers and establishing a new regulatory arm within the ECB, while the scope of authority increased by providing this regulatory arm

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direct supervisory authority over the largest credit institutions in the Euro area, and indirect powers over the remaining banks. No such progress occurred in the CMU and integration progress remained in the *zone of indifference* that allowed for 'marginal modifications'.

Early neofunctional readings highlighted the importance of encapsulation as a mean to remain within the current level of integration and emphasized that spill-overs are rather the exception than the rule (Schmitter, 1996). Integration attempts within the zone of indifference remain uncontested by states since they don't lead to more costs. All other steps increase the costs of states, either in the form disintegration which leads to sunken costs, or in more integration which increases uncertainty and challenges the established compromise between vested interests (Schmitter, 1970). Only if encapsulation does not suffice, will other neofunctional processes emerge.

Because encapsulation is perceived as the default, neofunctionalists tend to emphasize the role of states for modifications within the zone of indifference (P. A. Busch, 1978; Schweiger, 2014; MacMillan, 2009). If encapsulation is present, then due to the fact that governments chose to adjust regulations within the zone to indifference; be it due to the choice of political elites, national industry lobbying or the institutional diversity of member states (Niemann, 2006; MacMillan, 2009). But there is no solid theoretical justification why a status quo bias cannot be an active choice by transnationally organized private interests. It is merely an assumption that the main neofunctional actors move together to account for functional dissonances by further integration demands.

While functional pressures are indeed mainly used in the literature to explain successful integration processes, they are equally well suited to account for a status quo bias. In that case, either functional dissonances are not strong enough for either supranational institutions and interest groups to push for further integration or a functional

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mismatch exists between these two central actors. That is, if supranational institutions, and the European Commission in particular, point at functional dissonances that require further integration progress but organized private interests fail to uncover a functional dissonance, the latter group will not share the urgency for reform and might even counter integration attempts by pushing for reform within the zone of indifference. This is even more likely, whenever different functional dissonances are perceived by the Commission and the industry.

The comparison with the European Banking Union is therefore crucial. Epstein argued that capital mobility in the context of a single currency lead to functional dissonances in the presence of bank-state ties that could only be solved by delegating authority to the supranational level. I argue that supervisory reform in the CMU affected mainly non-bank institutional investors (and CCPs as financial infrastructures) which have been exposed to the same factors - increasing liberalization and a single currency. In case of the EBU, these factors led to functional dissonances due to the openness of national banking sectors and the outward expansion of large, internationally-oriented banks. Thus, in case of the CMU, it seems plausible to argue that opposite dynamics might have been at play.

In the absence of internationalization, the profitability and growth potential of institutional investors should be linked to their home country. The continued presence of national control in terms of supervisory forbearance and market restrictions should therefore remain beneficial for non-bank financial institutions in the EU which, in turn, reduces the willingness of institutional investors to push for a supranational reform. In sum, functional dynamics do not require a 'falling forward'; encapsulation or even disintegration can also be the result and driven by a mismatch in the perception of functional dissonances between supranational institutions and transnationally organized private interests.

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3.3 Summary and Discussion

The delegation of authority to the supranational level is a complex process that involves a multitude of actors both on the EU and the national levels. Moreover, structural features of financial markets naturally intervene. The critical question is which level ultimately drives this delegation? Is it the European Commission that utilizes on its agenda-setting powers in the ordinary legislative procedure to respond to functional dissonances and enables spill-over effects or national member states that increasingly rely on ad-hoc agreements within various intergovernmental institutions to move European integration forward?

I argued in this chapter that neofunctionalist accounts might be better suited as a starting point for the status quo bias in non-bank supervisory reform. Neofunctional explanations emphasize day-to-day policy-making that is path dependent and rely on incremental progress rather than a big leap. This incremental process is thereby driven by (transnational) interest groups that recognize benefits for deeper integration and articulate this on the supranational level. Supranational institutions, especially the European Commission, are then the primary respondent of these demands (Vilpišauskas, 2013). Intergovernmentalism, in contrast, emphasizes state-centrism over the importance of supranational dynamics between the EU institutions and the financial industry. National preferences and the relative power of member states thereby determine integration and the delegation of authority to supranational institutions would merely be a mean to safeguard this fragile compromise over time.

Even though most accounts of the post-crisis developments were shaped by more state-centric explanations, there are various reasons to justify a neofunctional explanation. First, the strength of neofunctionalism lies in its explanatory power for 'day-to-day' policy-making, while intergovernmentalism fits better to ad-hoc decision making -

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oftentimes simply due to the time pressures inherent to such ad-hoc measures. Yet, in contrast to much of the crisis management, the CMU project was envisioned and initiated by the European Commission as a long-term transformative project that is based on the ordinary legislative procedure of the EU.

Second, neofunctionalism explicitly accounts for the influence of supranational institutions and (transnational) private actors as the primary drivers behind progress. Since the set of legislative CMU proposals followed the ordinary legislative procedure, the European Commission was vested with strong agenda-setting powers and(transnational) organized interests were given a direct way to intervene on the EU level before proposals are ultimately decided in the European Council and the European Parliament.

Lastly, neofunctionalism perceives integration as a continuous process in which each further integration step is a consequence of previous integration episodes and the CMU as been repeatedly justified in these terms by supranational actors. Since both the European Commission, and the ECB, repeatedly highlighted the synergies between a Banking and Capital Markets Union, neglecting neofunctional explanations would underdetermine the outcome of interest.

This chapter relied on the work of Epstein (2017) to provide a possible neofunctional argument to the status quo bias in the CMU. For Epstein, the crisis was ultimately driven by close bank-state ties that allowed for supervisory forbearance, while increasing the sovereign debt home bias of banks. Since these bank-state ties continued in the context of European financial integration, the presence of capital mobility and a single currency turned these close bank-state ties into a major source of risk that required the delegation of supervisory control to the EU level. The Single Supervisory Mechanism tied the hands of national supervisory by vesting the ECB with licensing, monitoring and enforcement powers, while it also weakened the loyalty of larger,

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internationally-oriented banks to their home country. After all, the ECB, as the sole supervisor of the largest Euro area banks, encouraged market competition and internal capital flexibility, both of which come at an advantage for parent banks and their branches (Epstein, 2017, p. 138-139).

The most parsimonious interpretation of Epstein's account is that internationalization drives the functional demands behind the EBU. As such, Epstein's neofunctional explanation shows important overlap with most intergovernmental accounts. Yet, if capital mobility (in the Euro area) was the main functional driver behind the centralization of banking supervision, then how can we account for the status quo bias in non-bank finance? After all, isn't non-bank finance the text book example of an international force?

The next chapter will tackle this question and provide the main theoretical argument of this project. My research thereby contributes to the literature on neofunctionalism by advancing the understanding of functional pressures beyond banking and mere spill-over effects.

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4 Internationalization and Status Quo Bias

Both the European Commission and the ECB repeatedly highlighted the close relationship between the European Banking Union and a Capital Markets Union. Both should not be seen as mere substitutes for each other but as jointly necessary to create a single market for capital. If the Banking Union and the CMU are indeed complementary projects, the successful delegation of supervisory authority in the Banking Union should have created spill-over effects, leading to supervisory delegation for non-bank finance within the Capital Markets Union.

In the midst of the crisis years, bank-state ties in the context of capital mobility became a functional dissonance that pushed the EU towards the Banking Union and the delegation of national control to the Single Supervisory Mechanism (Epstein, 2017). While Epstein's argument focuses on bank-state ties and the issue of such ties for states, she also emphasized the role of internationally-oriented banks whose outward orientation benefitted from a level playing field based on supranational supervision. Their importance for national member states provided them enough influence (i.e., lobbying power) to support supranational institutions and steer supervisory reform towards supranational centralization. If the Banking Union centralized supervision on the supranational level due to the combined efforts of European Commission and internationally-oriented financial institutions, then the status quo bias in the CMU might indicate the absence of these functional pressures among non-bank finance.

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I argue in this theory chapter that the status quo bias in financial supervision within the CMU is linked to the level of internationalization in non-bank finance. The lack of supervisory reform for pension funds, insurance companies and investment funds should be associated with the absence of functional dynamics that pushed for supranational delegation in banking. In other words, the status quo bias is linked to low levels of internationalization within non-bank finance that led to the absence of industry support for the European Commission's attempt of supervisory reform. In these cases, supervisory forbearance is more favorably perceived than in more internationalized financial segments where a level playing field encourages competition and further expansion.

In order to develop this argument, the first section will theorize supervisory delegation as a trade-off between financial integration, financial stability, and national control by introducing the financial trilemma and focusing on the functional dissonances for the European Commission. Since any functional pressure requires an urgent policy issue to be present, the financial trilemma highlights both the policy problem and the optimal choice to solve it from the perspective of the European Commission. Due to its parsimoniousness, the financial trilemma also allows us to move beyond banking and theorize this choice in the Capital Markets Union. The second section builds upon the financial trilemma and focuses on the functional dissonances within non-bank finance. I thereby introduce my main theoretical expectation that in sectors with low outward expansion via branches, or in the context of higher inward penetration of foreign branches than outward expansion, 'fortressing' on markets - that is, relying on the dominance of national supervisory authorities - is seen more beneficial than supranational supervision.

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4.1 Consequences of the Financial Trilemma

The internationalization of finance is at the core of financial integration and cross-border stability. While political choices determine the regulatory depth of financial integration, the actual degree of internationalization among banks and non-bank financial institutions determines the success of such political choices. Without outward expansion of financial institutions, national market fragmentation persists and the full benefit of capital mobility remains untapped.

The European Commission tends to place a significant emphasis on financial integration by boosting cross-border competition. Yet financial integration comes at the potential cost of financial instabilities if supervision remains rooted on the national level. National supervision should ensure that domestic financial institutions will internalize potential negative externalities of their investment choices and ensure that the sources of financial instability are minimized or, in case this is no longer possible, that a clear resolution mechanism is in place that allows financial institutions to fail without undue costs for a given society (Schoenmaker, 2013, p.2). As such, national supervision tends to be the preferred option by governments. Yet, as we have seen in the puzzle chapter, competitive pressures and the profit opportunities of financial institutions led to ever more integration demands that needed to be met politically through financial integration which encourages a level playing field and supports the outward expansion of finance.

Such internationalization in the context of national control can create havoc to financial stability. Internationalization and cross-border interconnectedness can spread financial risk across countries and national control then no longer suffices to safeguard financial stability. As long as national supervisors sustain their gatekeeping role in the ESFS, the respective home supervisor is mainly interested in ensuring that costs re-

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main limited to the home country, while ignoring potential negative effects in foreign markets. This could lead to significant costs on these foreign markets during times of financial duress. In order to safeguard financial stability across borders, in the context of financial integration, national control needs to be delegated to the supranational level. This would then minimize the potential costs of financial instabilities within a single market.

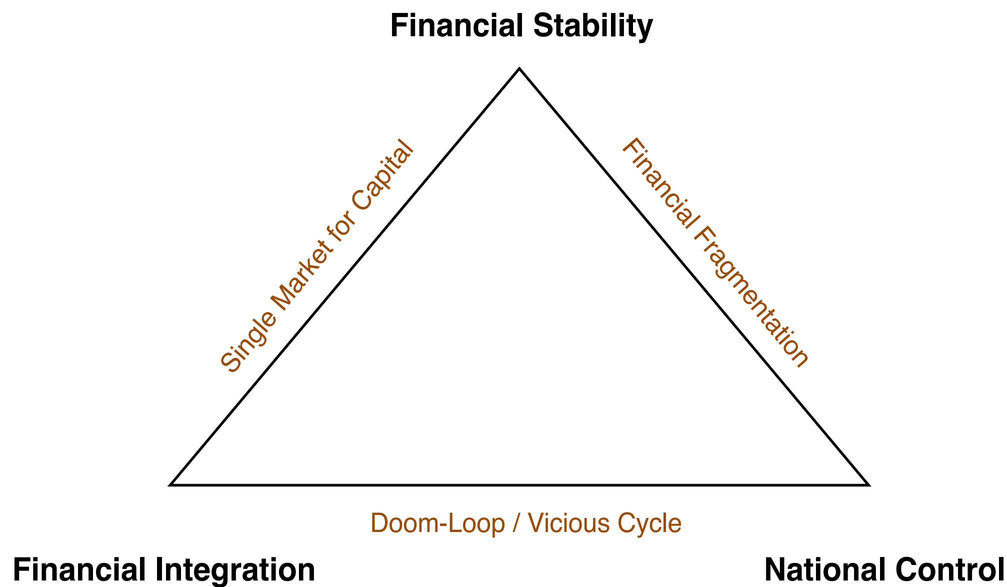

Figure 4.1: The Financial Trilemma and its Consequences

The financial trilemma theorizes the choice between financial integration, financial stability and national supervision (Schoenmaker, 2011, 2013). Borrowing from the classic Mundell-Fleming trilemma, the financial trilemma starts with the argument that it is not possible to have financial stability, financial integration, and national control at the same time; one of those needs to be given up (Figure 4.1). The question then is: which one has to go? The answer to this question depends on which side of the trilemma is perceived as an urgent policy problem.

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4.1.1 The Quest for Stability in the EBU

In order for the financial trilemma to occur, policy-makers must perceive one of the three sides of the trilemma as an urgent policy issue that requires a solution. As I have outlined in earlier chapters, the ad-hoc measures after the financial crisis were perceived insufficient to calm financial markets and the EU was faced with a banking and sovereign debt crisis that was ultimately rooted in close bank-state ties. The bank-state doom loop thereby refers to the negative effects of a mutual dependency between banks and their sovereign that derived from strong banking exposure to sovereign debt. Ultimately, this bank-state nexus is sustained by the tendency of national governments to apply 'moral suasion'; that is, by pressuring national banks to increase their sovereign debt holdings (Battistini, Pagano, & Simonelli, 2013).

As a consequence of this state-bank nexus, sovereign debt yields spiked (especially in the periphery of the Euro Area), bank interest rates differed and the home bias among European banks increased - all of which are indicators of reduced financial integration since the financial crisis (Battistini et al., 2013). The exposure of banks to their home countries increased after the sovereign debt crisis, especially in peripheral countries, which can be partly explained by "Euro area national governments' attempts to create a captive domestic investor base on the sovereign bonds market in response to fiscal stress episodes" (Cornand, Gandré, & Gimet, 2016). Such 'moral suasion' either occurred through political pressure or political control which can explain why in particular politically-controlled banks have increased their sovereign debt holding in the crisis (De Marco & Macchiavelli, 2016).

The sovereign debt crisis - and its inherent bank-state ties - pushed the Eurozone to the brink of collapse. To re-establish financial stability, policy makers had the choice of either retreating from financial integration or deepening integration and delegating supervisory authority to the supranational level. In the case of the Banking Union,

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the bank-state doom loop turned the quest for financial stability into a salient and urgent policy issue which could only be solved by either retreating from financial integration or by delegating national control to the EU level.

Developed at the height of the Euro crisis, the financial trilemma argues that once national financial institutions turn multinational, the costs of failure can exceed the capability of any single state to cover the losses on society. Thus, national financial policies need to force financial firms to internalize parts of the costs either by increasing capital requirements or by establishing a resolution mechanism that allows banks to fail without creating too much costs for a given society (Schoenmaker, 2013, p.92). Yet not all financial institutions can be saved. While financial stability is a public good and it is assumed that the recapitalization of financial institutions provides social benefits if such recapitalization reduces systemic risk, national authorities have nonetheless only a finite amount of capital with which banks could be recapitalized in times of distress (ibid, 24-25). The public choice for recapitalization thus becomes a pure cost-benefit analysis. Within the national context, such public intervention occur if such cost-benefit considerations indicate that the societal benefits of a bank rescue outweigh potential societal costs; otherwise the full costs need to be covered by the private sector and if the private sector is unwilling to do so, troubled banks will be forced to fail.

Whether or not the benefits of a public rescue justifies the costs is thereby determined by the relevance of a financial institution for the stability of the national financial system (i.e. their size and internationalization). Banks that are not systemically relevant should ideally simply be forced to fail as long as the private sector does not intent to rescue them (ibid, 25). Schoenmaker emphasizes that this logic only holds as long as finance remains nationally constrained; it becomes problematic once finance is internationalized. While national financial policies - regulation and supervision -

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tackle negative externalities and consider the costs on the overall welfare of a national society, these national policies tend to ignore cross-border spill-over effects of such costs (ibid, 2).

As a consequence of the financial trilemma, policy makers need to choose between the re-nationalization of finance or the de-nationalization of financial policies. The continuous progress of financial integration, that I have sketched out in the second chapter, made re-nationalization an unlikely option. The gist of this trilemma is therefore that financial stability, in a time when finance is internationalized, can no longer co-exist with national control and policy makers do not really have a choice: national control needs to be delegated to the supranational level. The most effective way to overcome the trilemma and internalize cross-border externalities is thereby through supranational centralization (ibid, 91). Since his trilemma was developed before the Banking Union and focuses on the national level, Schoenmaker argues that such delegation rarely occurs even though it would support financial stability.

This original interpretation of the financial trilemma emphasizes the importance of government choice in determining the outcome and the internationalization of banks are merely assumed to be the drivers behind governmental choices. The last chapter has shown that neofunctional explanations might be a better fit to explain the choice for supranational supervision as a way out of this trilemma. As such, the financial trilemma can also explain functional dissonances among supranational institutions. Indeed, Vítor Constâncio, the then Vice-President of the ECB, explicitly mentioned the importance of the financial trilemma for the supervision of banks and non-bank finance more generally:

> [M]onetary union implies increasing integration between financial institutions and markets, be it through internationally active banking groups, bilateral trading exposures, or presence in the same market segments. We saw this process unfold in the euro area over its first decade. But such financial integration also creates what Dirk Schoenmaker has termed a financial trilemma: it is impossible to maintain the level of integration required for monetary union while

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> practicing national supervision, without putting European financial stability at risk (Constâncio, 2013).

Thus, while the original interpretation focused on government choices in banking, the inherent logic of the trilemma is not limited to national decision-makers. In line with the quote above, I argue that the choice depends on which side of the trilemma is perceived as an urgent policy problem by *supranational institutions* and whether the European Commission and financial actors agree on the solution implied by the trilemma. In a neofunctional reading of the trilemma, internationalized financial institutions take a more prominent position in solving this trilemma. As Epstein (2017) has argued, even though the European Commission was pushing for a Banking Union, large internationalized banks soon became decisive coalition partners that eased the ultimate resistance of national governments towards the EBU. Once banks are internationalized, harmonized rules and a single supervisor benefit those financial institutions more than a protective national supervisor in their outward expansion. Capital mobility and the common currency thereby created functional pressures that ultimately forced Euro area member states to solve this financial trilemma by replacing national control with a supranational framework based on a single rulebook and supranational supervision. Even if internationalized banks pushed for the EBU due to profit considerations, they posed a decisive influence. This ultimately allowed the EBU to increase financial stability at a time when financial integration collided with the consequences of close bank-state ties due to sustained national control over these banks. Yet the trilemma can also be applied to account for financial fragmentation in non-bank finance which became a central functional dissonance for the Commission after the financial crisis.

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4.1.2 Financial Fragmentation and the CMU

The peak in supranational supervision with the Banking Union coincided with a general trend on the national level towards de-liberalization and countries returned to inward looking policy approaches as a mean to safeguard themselves against international financial turmoil. Figure 4.2 displays the strength of financial liberalization and de-liberalization in national policy-making in the European Union based on data from Armingeon et al. (2019). The dataset consists of national political reforms that pursuit either liberalization, de-liberalization, or maintained current levels. For financial reforms, they considered capital account restrictions, credit controls and reserve requirements, entry barriers, financial products, interest rate controls, ownership, securities market, as well as supervision and regulation (Armingeon et al., 2019, p.9).

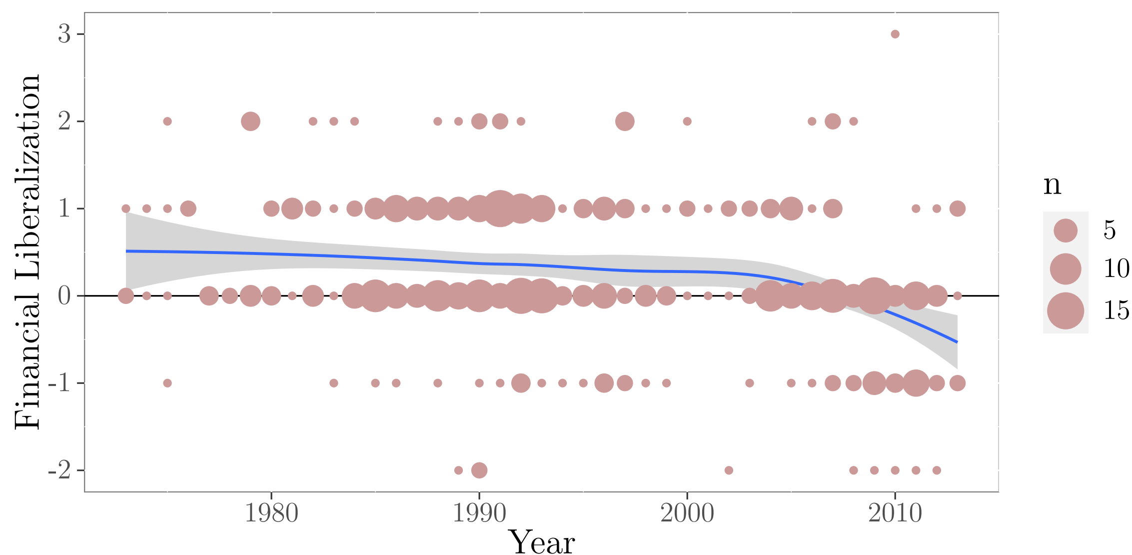

Figure 4.2: Strength of National Financial Liberalization in the EU (1973-2013)

The horizontal axis displays the year in which a new financial market regulation was adopted, ranging from 1973 to 2013. The vertical axis displays the liberalization/de-liberalization index and shows the degree to which a new regulation supported finan-

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cial liberalization or de-liberalization. The maximum value of 3 indicates the highest level of liberalization, while a minimum of -3 is the highest level of de-liberalization. The zero point indicates laws that have not led to changes in either direction. Each dot thereby denotes national-level financial regulations. The larger the dot, the more regulations are present at given year on a given index value. N thus denotes the number of laws in a given year at a given point of the liberalization-deliberalization axis.

Ever since the 1970s, EU member states passed financial regulations that either maintained the current levels or supported further financial liberalization. As we have seen in the second chapter, this was often due to pressures from the financial industry. Overall, this led to a positive trend towards liberalization that resulted in the increasing internationalization of finance. This trend only reversed with the great financial crisis. In fact, the presence of close bank-state ties due to national control in the context of such liberalization fueled the very sovereign debt crisis that led to the Banking Union. The political reaction after 2009 shows a regulatory trend towards de-liberalization based on an increasing number of financial regulations on the national level that are linked to the introduction of free market restrictions and entry barriers.

Since financial liberalization became increasingly constrained by national policies and EU financial markets are heavily bank-based, the European Commission shifted its focus towards non-bank finance as an alternative channel for financial integration. The advantage of increasing financial integration is that it allows for a more efficient risk sharing and increases the possibility to diversify investments across borders which reduces the exposure to idiosyncratic shocks (Baele, Ferrando, Hördahl, Krylova, & Monnet, 2004). Up until the financial crisis, it was generally assumed that financial integration - either in terms of banking *or* capital markets - can improve such risk-

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sharing and this ultimately cemented the dominance of banks in the EU (Langfield & Pagano, 2016). The idea was that banking integration suffices to improve private risk sharing as long as banks increase their cross-border asset holding. Such cross-border asset holding would then lead to investment diversification and disperse idiosyncratic risk more efficiently (Valiante, 2016, p.46).

The financial crisis and the subsequent banking and sovereign debt crisis showed that this does not necessarily hold. Banks increasingly entered capital markets over the last 40 years and blurred the line between bank-based and capital-market based finance (Hardie & Howarth, 2013). As a consequence of the crisis, interbank lending collapsed, while cross-border lending to the real economy remained at very low levels. As long as the positive effects of financial integration are mainly linked to an increase in the level of bank-to-bank lending, the real economy remains dependent on local bank funding. Yet, since those local banks increasingly receive capital from the interbank market - that broke down during the crisis - the real economy had no alternative ways to compensate for this loss of lending options (Kalemli-Ozcan & Martin, 2019; Hoffmann et al., 2019). While the creation of the EBU increased financial stability, it did not alter the levels of direct cross-border lending to the real economy. Inter-temporal risk sharing requires banks to increase their cross-border activities, cross-border banking penetration remains limited even after the creation of the EBU. Less than one-third of those banks that are surveilled in the context of the Single Supervisory Mechanism established branches or subsidiaries outside their home country (Valiante, 2016, p. 56).

The presence of fully developed and integrated capital markets would strengthen non-bank finance and create an alternative mechanism to boost private investment into the real economy. The Capital Markets Union was therefore proposed as a mean to strengthen inter-sectoral private risk-sharing as a complement to the existing temporal

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risk-sharing channel by banks. The CMU should lead to a level playing field, ease market access for financial intermediaries, increase competition, reduce funding costs for non-financial companies and improve funding opportunities for SMEs. The Capital Markets Union therefore differed in its main target compared to the Banking Union. Instead of financial stability, the CMU should, first and foremost, reduce capital market fragmentation and support economic growth. The timing of the CMU was ideal. As a consequence of ever restrictive banking regulations after the financial crisis, non-bank finance started to increase their relevance in the EU and slowly shifted the importance of financial intermediation away from banks.

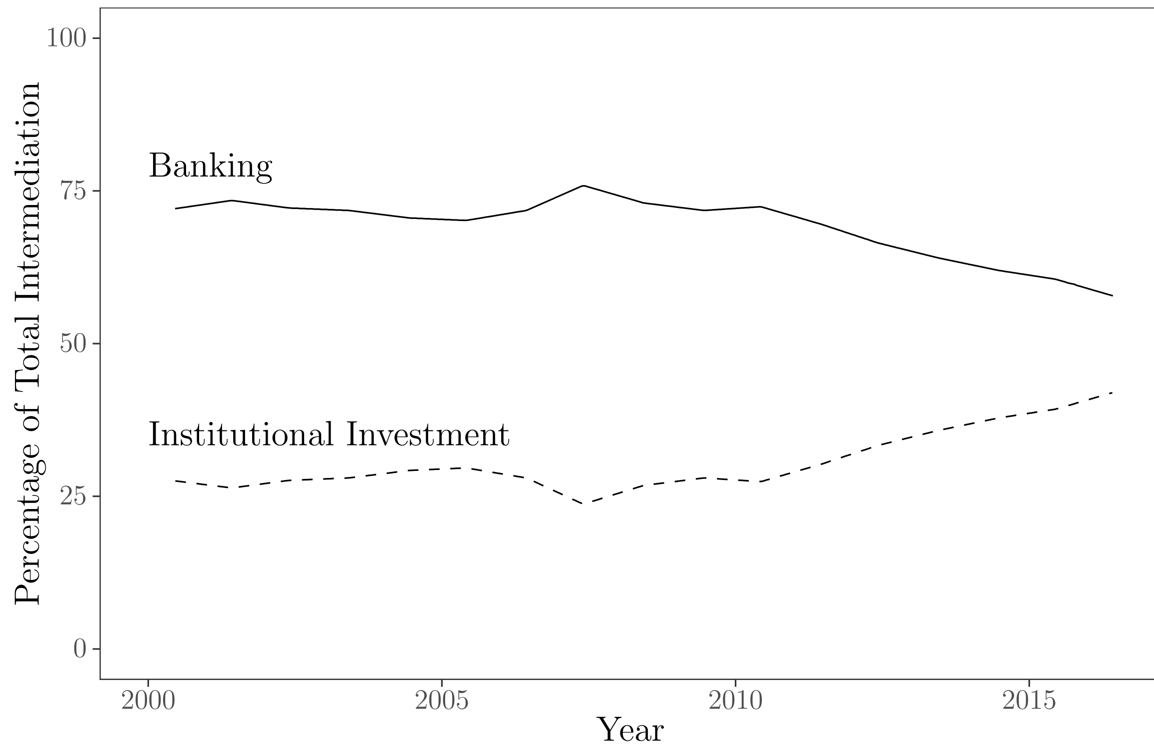

Figure 4.3: Financial Intermediation by type (Source: De Haan et al 2020)

Figure 4.3 shows that the relevance of banks as intermediator on capital markets is decreasing since 2007/08, while institutional investors (pension funds, insurance companies, and investment funds) play an increasingly important role for financial

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intermediation in the European Union. Non-bank finance thereby increases its relevance for the real economy by allowing for better funding opportunities and risk sharing mechanisms which should support economic growth. Moreover, not only the relative importance of institutional investment relative to banks increased but also the size of different institutional investors (De Haan, Schoenmaker, & Wierts, 2020, p.34). The decrease in banking intermediation thereby seems to be mainly driven by investment funds that rose significantly after the crisis. Pension funds and insurance companies also experienced an increase in size, albeit to a more limit extent (Figure 4.4).

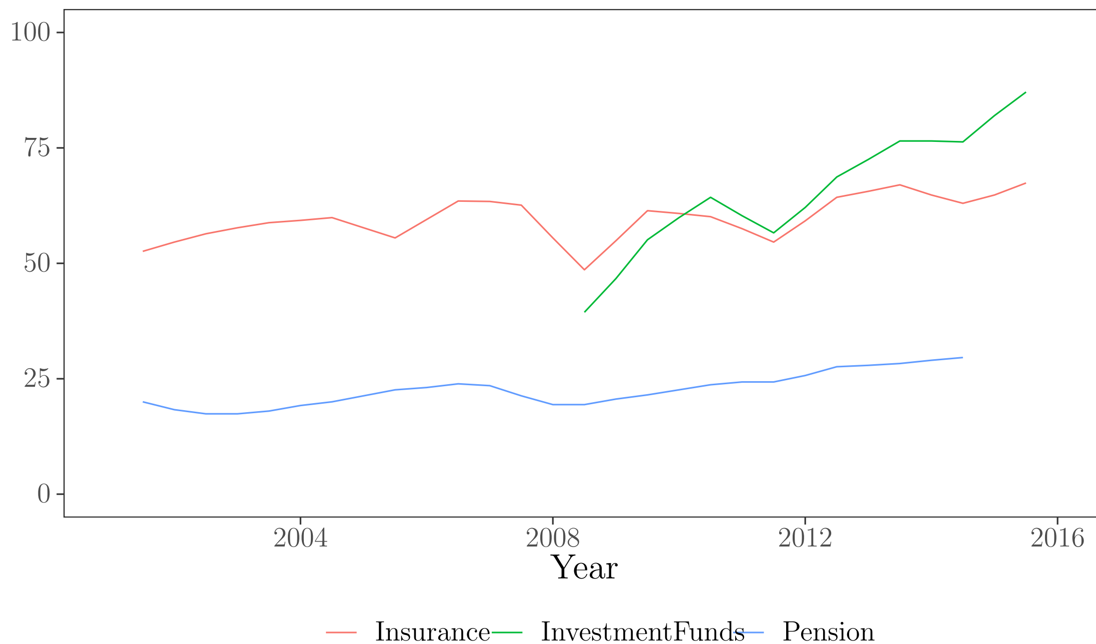

Figure 4.4: Asset managed by institutional investors as % of EU GDP between 2001-2016 (Source: Schoenmaker & Darvas 2017)

This rise, that should be amplified with the CMU, strengthens financial competition which should increase funding opportunities and reduce funding costs for European non-financial companies and thereby contribute to economic growth. At the same time, non-bank finance lacks access to central banks. While banks could rely on the

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central bank role as lender-of-last-resort, non-bank finance increasingly take up the role of banks without having the safety net provided to banks by central banks (Pires, 2019). Even if the CMU was first and foremost a project to reduce capital markets fragmentation, this slowly emerging change from bank to non-bank intermediation brings the question of financial stability back into the picture. Financial integration in non-bank finance increases the potential for cross-border contagion because economic shocks are easier transmitted across borders the more integrated markets are. The causal link is thereby that increased integration leads to increased interconnectedness, which increases contagion risk (De Haan et al., 2020, p.196-198).

Therefore, despite the focus on financial integration, the CMU is exposed to the same trade-off between integration, financial stability and national control that was already present in the Banking Union. In order to reduce financial integration, either financial stability or national control needs to go. Giving up financial stability could create the same vicious cycle that we observed between banks and their sovereigns, while giving up national control could ensure a true single market for capital at the cost of national sovereignty and supervisory forbearance. From the perspective of the European Commission, as the initiator behind the CMU, the optimal choice is financial integration coupled with supranational supervision in order to safeguard stability and create a true single market for capital. Yet, the ultimate outcome is of this trilemma is known: ideas for a reform of the ESFS failed to gain traction and created a status quo bias. National supervision remained unchanged for pension funds, insurance companies and investment funds (i.e. institutional investors), while it was only for investment firms and third-country CCPs that we can observe some centralization on the EU level. So why did the functional pressures from the Banking Union fail to spill-over to the CMU?

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4.2 A Theory of the Status Quo Bias

Based on the financial trilemma, the optimal choice to ensure a single market for capital is the deepening of financial integration in conjunct with the delegation of national control to the EU level (Figure 4.1). Since the CMU was envisioned to overcome financial fragmentation, the only way not to jeopardize financial stability is to give up on national supervision. And yet, supervisory powers remained predominantly vested within national authorities, overall displaying a status quo bias.

Neofunctionalism, as an integration theory, tends to conceptualize lack of progress merely as the absence of functional dissonances among supranational institutions and/or organized private interests. But the status quo bias is a well-known feature in the behavior of individuals, firms, and of policy-making (Samuelson & Zeckhauser, 1988; Fernandez & Rodrik, 1991; Kahneman, Knetsch, & Thaler, 1991). It broadly refers to a situation "when subjects overvalue the status quo relative to some new possibility, even when the expected value of the new option is the same as or even greater than the status quo value" (McKay, 2012, p.121). Sticking with the status quo is thereby not an outcome by mistake but the consequence of a variety of possible reasons, ranging from risk aversion to transition costs and sunk costs (Samuelson & Zeckhauser, 1988). Ultimately, uncertainty about efficiency and costs tends to hinder support for change.

The absence of functional pressures is thus rooted in the fact that some actors overvalue the benefits of national supervision over the optimal choice for financial stability. We therefore first need to establish which actors are driving the status quo bias. Since the CMU was initiated by the European Commission and included proposals for the reform of the European System of Financial Supervision, we know that the European Commission was aware of these functional dissonances and would have chosen finan-

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cial stability over national supervision. But for legislative progress on the EU level to occur, it does not suffice that the European Commission proposes change. After all, the success of the Banking Union required the joint actions of the European Commission and multinational banks to ease national resistance and enable supervisory delegation to the EU level. Since the European Commission initiated the CMU, the status quo bias seems to be rooted within another central neofunctional actor relevant for the CMU: non-bank finance.

This argument is further supported by the law making process of the European Union. The CMU was created through the *ordinary legislative procedure* that provides the European Commission the sole right to initiate policy proposals. But since these proposals require the approval of the European Parliament and the European Council, the Commission needs to ensure that their initiatives will eventually pass both the European Parliament and the Council. In order to increase their chances of legislative success, the Commission uses a wide array of tools to anticipate the level of support for their legislative ideas (Klüver, 2013). Expert groups, forums, conferences, and public online consultations are all means by which the Commission anticipates potential contestation (Røed & Hansen, 2018; Bunea & Thomson, 2015; Binderkrantz et al., 2021; Van Ballaert, 2017). At the same time, these channels provide financial institutions a mean to influence EU policy making.

If an issue is contested between the European Commission and financial interest groups but non-salient in the broader public - as is the case with the CMU - financial institutions and associations tend to use their lobbying powers early on, while legislation is still being formulated (Bunea, 2014). Moreover, existing evidence shows that negative lobbying against a proposal has more influence on the outcome than policy support, due to the fact that such negative lobbying indicates possible broader discontent, rather than mere interest articulation (McKay, 2012). To rephrase McKay's

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point for the CMU, negative lobbying against the CMU that is not addressed by the European Commission will move to the national level and ensure that national resistance remains high and the Commission proposal will potentially fail in the Council. Broad opposition against - or support in favor - of a given legislative initiative can indicate resistance or support in the European Council and the European Parliament later on (Klüver, 2013, 2011; Røed & Hansen, 2018). The Commission then has a choice of either retracting a proposal beforehand or risk defeat later on.

While the ordinary legislative procedure provides the mean for non-bank finance to interact with the European Commission and influence the outcome of the CMU, this project is really interested in the underlying structural drivers behind the status quo; instead of the *how*, we need to understand the *why*. Since existing studies point at the level of internationalization as a driving force behind change (Epstein, 2017; Schoenmaker, 2013; Spendzharova, 2014), I argue that the status quo bias should be partially explained by a lack thereof within non-bank finance.

I will concentrate on two perspectives to account for the internationalization of non-bank finance. The first focuses on portfolio allocation of institutional investors and links internationalization to varying levels of debt home bias. The second perspective concentrates on the outward expansion via branches. The main argument that follows is that the home bias and branch internationalization matters differently for the status quo bias. While relatively high levels of sovereign debt home bias over time point at the persistence of state-finance ties, they do not per se indicate a preference for the status quo bias among non-bank finance. What matters instead is the level of outward expansion of domestic non-bank finance relative to the level of inward penetration by foreign entities.

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4.2.1 Home Bias in Non-Bank Finance

The portfolio home bias can be used as one indicator of the strength of internationalization. Institutional investors should ideally invest according to the logic of international diversification and, as such, the optimal portfolio strategy is based on geographical diversification that will increase returns and decrease overall investment risks (De Haan et al., 2020, p.282-285). Yet in reality this is not always the case and institutional investors tend to display a *home bias*; that is, an overemphasis of domestic investments in their portfolio choices.

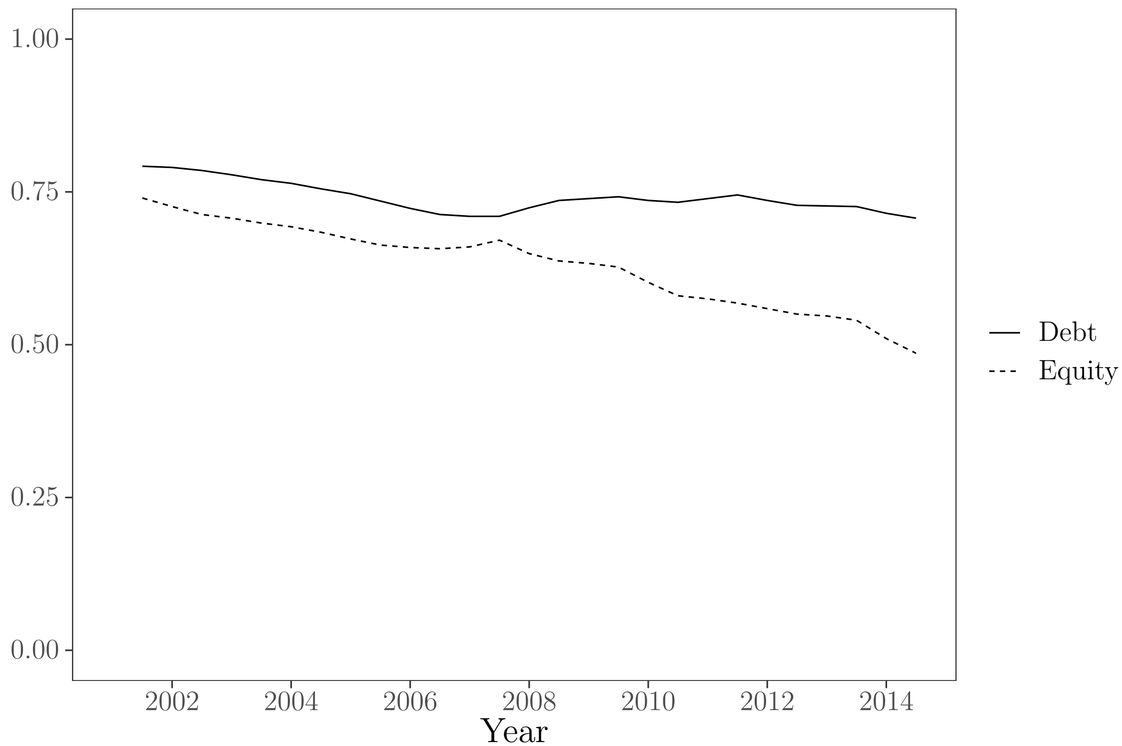

Figure 4.5: Home Bias in Equity and Debt within the Euro area (Source: Schoenmaker & Darvas 2017)

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Figure 4.5 shows the development of the investor home bias in the Euro Area both for debt and equity markets since the introduction of the Euro based on the home bias index by Schoenmaker and Darvas (2017). A value of 1 thereby denotes a portfolio

choice that fully depends on domestic investments. While the index relies on country-level data, rather than actual percentage values of domestic assets in the portfolio of institutional investors, a few interesting patterns can be observed that require further elaboration. First, from the introduction of the common currency until the financial crisis, both the debt and equity home bias continuously declined. Non-bank finance thus diversified their portfolios and became ever more internationalized in their investment choices. This very much overlaps with the picture of finance as an international force that breaks with national coordination mechanisms and patient capital provision (Hall & Soskice, 2001).

Second, while the home bias in equity kept decreasing after the financial crisis, this general trend reversed for debt. Non-bank finance became, at least partially, less internationalized in their portfolio choices. Arguably, this reversal should be mainly linked to sovereign bonds, rather than corporate bonds. Moreover, this trend accelerated in recent years and national central banks emerged as significant holders of domestic debt due to the ECB's QE and public sector purchase programme (PSPP) (ECB, 2017). This raises three important questions: first, is this constant debt home bias after the crisis really driven by institutional investors. Second, if so, does the home bias differ among different types of institutional investors and thirdly, can these constant levels of debt home bias since the financial crisis be associated with a sovereign debt home bias or do they manifest a broader home orientation that includes both corporate and sovereign bonds?

In order to get more insight into these questions, I will move away from the home bias index of Schoenmaker and Darvas (2017) that relies on country data and focus instead on aggregate portfolio data for three types of institutional investors (see Table A.1 and Table A.2 in the appendix for the data). I first focus on the total debt home bias that remained constant according to Schoenmaker and Darvas' index in the Euro

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area and separate it by type of institutional investor. Figure 4.6 thus shows the total debt home bias among European pension funds, insurance companies, and investment funds between 2005 and 2019.

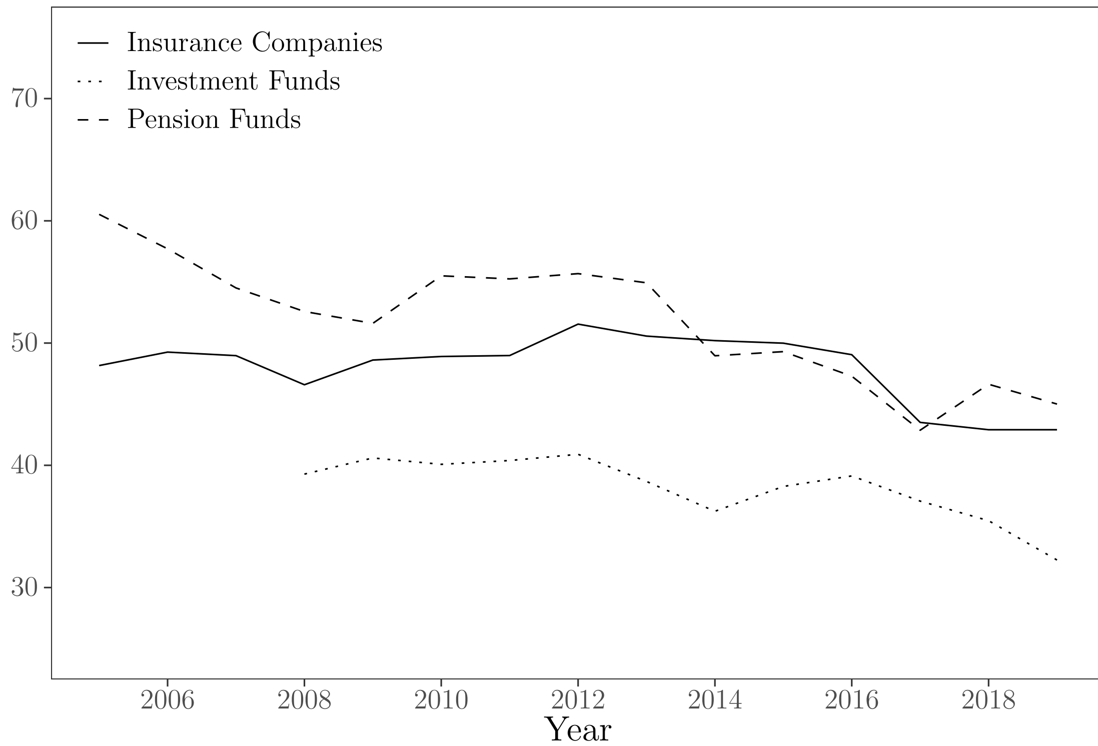

Figure 4.6: Total debt home bias among institutional investors in the EU between 2005 and 2019.

Interestingly, all three non-bank financial sectors reduce their total debt home bias over time, albeit at a stronger rate among pension and investment funds. Based on the total debt home bias, one cannot conclude that institutional investors became significantly re-nationalized after the financial crisis; at least not beyond the first crisis years. Unsurprisingly, investment funds, in particular, seem to be heavily diversifying their portfolio. Nonetheless, as I have argued above, this picture might differ if we focus on sovereign debt rather than total debt. Figure 4.7 moves away from the total debt home bias and focuses on the sovereign debt home bias as a percentage of total debt home bias. Focusing exclusively on domestic sovereign debt, the investment

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pattern among institutional investors changes. Rather than diversifying across all their assets, insurance companies and pension funds show rising levels of investment orientation towards domestic sovereign debt which points at the potential presence of state-finance ties in the context of increased financial diversification in corporate debt and equity. Investment funds, in contrast, have roughly constant levels of sovereign debt with a small increase until 2014 and a slight decrease thereafter.

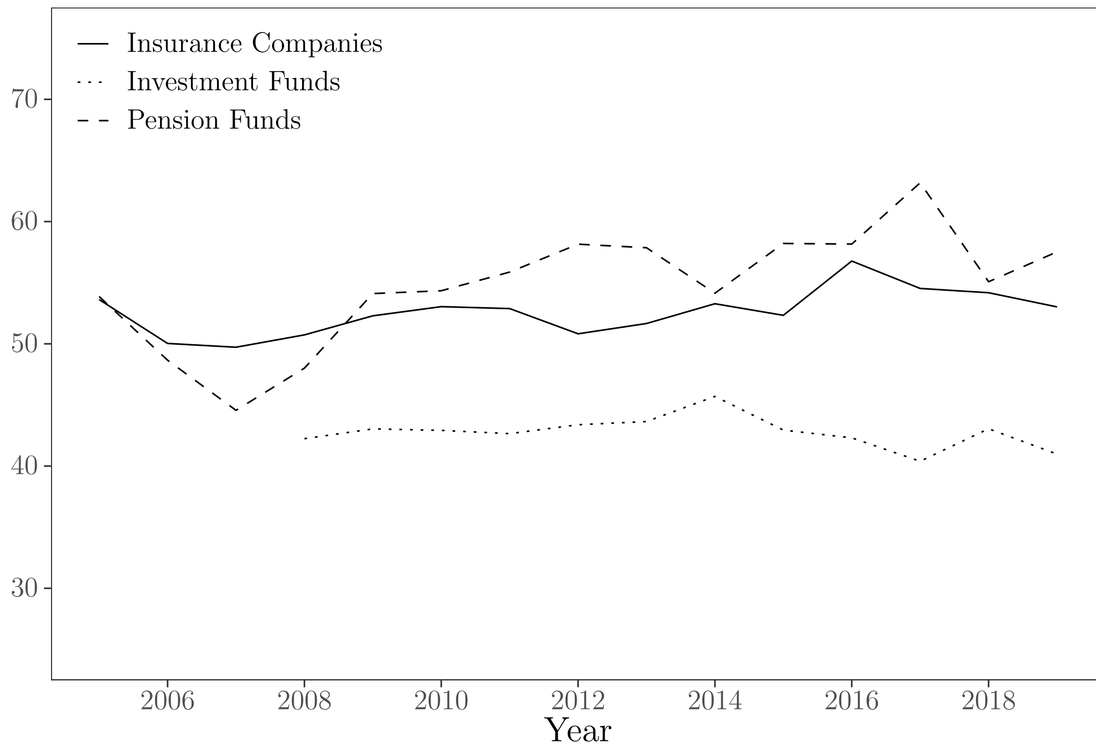

Figure 4.7: Sovereign Debt home bias as a percentage of total debt home bias among institutional investors in the EU.

Within the Euro area, the introduction of the common currency and increasing regulatory harmonization reduced the home bias both in equity and debt markets (Baele et al., 2004). This decreasing home bias over time within the Euro area is thereby partially explained by the removal of exchange rate risk as well as the reduction of information asymmetry through increasing regulatory harmonization and supervisory coordination (Balli, Basher, & Ozer-Balli, 2010). Yet as we have seen, the finan-

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cial crisis and the subsequent sovereign debt crisis reversed this trend and increased the sovereign debt home bias. According to Andritzky (2012), foreign investors held sovereign bonds, especially in the Euro area, because of the increasing harmonization of financial regulation that reduced transaction costs and the assumption that sovereign credit risk is homogenous inside a monetary union, both of which served as a justification to use sovereign debt as a mean for portfolio diversification. This increasing debt home bias can therefore be partly explained by the fact that foreign investors seem to be attracted by lower bond yields which signal good macroeconomic performance. Since this was no longer the case after the great financial crisis, foreign investors reduced their exposure, while domestic finance increasingly reemerged as central holders of government debt (Andritzky, 2012).

But Andritzky (2012) argues that domestic banks and central banks are largely accountable for this increasing sovereign debt home bias in the first crisis years. His explanation does neither account for the continuity of this trend beyond the crisis years, nor for the existing of a sovereign debt home bias among non-bank finance. While one could argue that this is simply due to a lacking depth in financial integration, the reduction in total debt home bias and the constant levels in sovereign debt home bias seems to indicate something else. One possible explanation is thereby the existence of close state-finance ties among institutional investors. Non-bank finance might after all be less internationalized as often assumed and state-finance ties exist beyond the banking sector. Still, even if this sovereign home bias is evidence of state-finance ties among institutional investors, it seems unlikely that it can fully account for the status quo bias in supervisory reform during that period. As we have seen from the Banking Union, banks also increased their home bias after the financial crisis and yet, especially internationalized banks supported the Banking Union. In other words, a home bias might be a supporting factor, but the status quo bias is ultimately driven by something else.

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4.2.2 Fortressing Through National Supervision

State-finance ties are characterized by a mutual dependence that is reinforcing as long as both sides benefit (Monnet, Pagliari, & Vallée, 2019). But the Banking Union has shown that such ties are not unbreakable. If the level of internationalization is large enough, financial actors value the centralization of supervision across countries higher than the potential benefits of national supervisory protection and shift their loyalties away from their home countries towards the supranational level. The special role of finance in a national economy provides financial institutions enough structural power (i.e. lobbying) to nudge political choices in their favor, especially when their position is shared by supranational institutions. Yet financial actors need to perceive the necessity of creating a level playing field via supranational supervision.

In the case of the Banking Union, the level of internationalization was indeed sufficient. Multinational banks shared with the European Commission a sense of functional dissonance between a financial integration, financial stability, and national supervision that created spill-over effects and allowed for supranational supervision in the EBU. Since the status quo bias does not occur by mistake, I argue that supervisory reform in the CMU is driven by the very same forces and the level of internationalization within non-bank finance can be linked to the lack of supervisory reform for the main types of institutional investment (i.e., pension funds, insurance companies, and investment funds). While the European Commission perceived a strong functional dissonance between the Banking Union and fragmented capital markets, I argue that (transnationally-organized) industry associations in these three non-bank financial segments failed to share the urgency to tackle these functional dissonances. Non-bank finance thereby lacked the sense of urgency for supranational supervision due to perceived benefits in sustaining state-finance ties. While the sovereign debt home bias merely points at a presence of state-finance ties, the actual expansion of non-bank

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finance via branches provide an explanation for the role of internationalization and its relationship to the status quo bias.

Just like banks, non-bank finance can expand outwards via branches and/or subsidiaries which enables them to reap efficiency benefits due to economies of scale and better diversification options (see also Chapter 2). This creates lower intermediation costs and a better allocation of funds (Fiechter et al., 2011, p.3-5).[1] Yet these two means of outward expansion display important differences in terms of capital mobility. Subsidiaries are relatively independent from their parent institution insofar as their capitalization needs to be independent from the parent's funding base and supervision occurs through the host market supervisor. Branches, in contrast, rely on the funding base of the parent institutions, while remaining under home market supervision (Epstein, 2017, p.48). As we have seen from the financial trilemma on the Banking Union, the political environment is more open to foreign market access via subsidiaries than branches since this increases national control and financial stability in the respective national financial market (Epstein, 2017; Fiechter et al., 2011; Schoenmaker, 2013). But non-bank financial institutions have an independent preference in this decision between branching and subsidiarization which is oftentimes driven by efficiency and profit concerns (Fiechter et al., 2011).

As Fiechter et al. (2011) shows, branches are closely interconnected with the parent company which allows the parent unit to move assets between different branches and the risk management of all branches is centrally organized within the parent company. Thus, through a branch model of outward expansion, financial institutions can accumulate capital through their branches in countries with the lowest price and move

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[1] It is important to note that the role of branches differs significantly between banks and non-bank finance. In contrast to banks, non-bank finance is not really involved in the deposit-taking business and therefore direct client contact via branches is less relevant. Still, in order to enjoy passporting rights, many national regulations require non-bank finance to set up physical presence in a foreign market. Such legal requirements for a physical presence ensures that branches can still serve as a measurement of internationalization.

it to branches and clients in need of funding which becomes most beneficial in the context of country-specific risks. Subsidiaries, in contrast, are independent from the parent both in operations and risk management. Since they are also supervised by different national authorities, they might be exposed to different regulatory requirements, which lowers overall efficiency and increases costs relative to branches (ibid, p. 7,9). In case of financial turmoil, the outward expansion via branches faces the risk that a branch structure, through its interconnectedness risks contagion effects that might affect the parent firm. In this context, subsidiaries can be beneficial. If they fail, their lack of interconnectedness is less likely to affect the parent, besides potential reputational losses (Fiechter et al., 2011).

Branches provide a more cost efficient path towards outward expansion. Such cost benefits are thereby largest when financial institutions first enter into a foreign market since they can ideally use this to lower service costs to attract more foreign clients which provides further support for outward expansion (IAIS, 2013). But these two expansion strategy have different benefits based on the client base it should attract. For wholesale services and corporate clients, a branch structure and its inherent capital mobility becomes an advantage, while the independence and local embeddedness of subsidiaries is beneficial for retail clients. This is especially valuable in the European financial ecosystem where non-bank financial intermediation still remains below bank intermediation and is only slowly approaching. If capital markets are not fully developed, subsidiaries might not find enough funding source and thus outward expansion is better with branches. But even if markets are developed, branch expansion can be a benefit. While subsidiaries have an easier time finding funding, branches can collect capital in fully developed markets and move it around to other branches that have been established in less developed capital markets (Fiechter et al., 2011, p.10). For the more established bank-based system the creation of costly subsidiaries can pay off since banks tend to be already established in foreign markets and it then it provides

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closer access to the local (retail) client base. And yet, even among banks that have established subsidiaries in foreign markets, there is a trend to transform them into branches to reap capital mobility efficiencies (Epstein, 2017).

Since internationalization via branches seems most efficient for non-bank finance, I argue that differences in branch expansion should have implication for the status quo bias in non-bank supervision. Higher levels of outward expansion in a given non-bank financial sector should point at a saturation in the home market and the need to find profit and clients elsewhere. In turn, low levels of outward expansion indicates a need to consolidate market power domestically. After all, the change from banking to institutional investment has only started after the financial crisis and most of European non-bank finance still needs to fully take advantage of this shift in financial intermediation. While any financial firm is driven by profit and therefore prefers as little regulatory involvement as possible, it is only banking that has direct central banks access and thus a safety net in case of failure. The safety net for non-bark finance needs to come through size and market dominance. In the absence of supranational supervision, non-bank finance remains at the mercy of national authorities to save them in times of turmoil. Yet, as Schoenmaker's financial trilemma has shown, only if institutions rise to systemic relevance in their own markets (and ideally, foreign markets, too), will governments be inclined to support them.

Internationalization and the development into a national champion are means to ensure that, in the case of distress, governments step in either because they'll be too big to fail or, more likely, due to reputational concerns. According to Schoenmaker, internationalization beyond 20-30% appears to be the decisive threshold (Schoenmaker, 2013, p.91). Yet, for this they first need to dominate domestic market and only then expand outward. After all, a lack of domestic dominance means that home supervisor has no incentive to protect them.

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The outward expansion via branches or high foreign penetration into the domestic market, in contrast, directly effects the growth potential and market position of non-bank financial institutions. This effect should hold under two conditions. First, in the context of low levels of outward internationalization via branches, non-bank finance perceives the benefits of national control to outweigh the need to ensure financial stability in the EU. Low levels of branch internationalization points at an underdevelopment of a given financial sector in a given national market. As such, growth potentials have to be realized on the domestic market first. In order to shield themselves from potential market competition, non-bank financial actors in sectors with low levels of internationalization therefore overvalue the benefits of national supervision relative to the stability and efficiency gains through supranational supervision. Thus, those non-bank finance sectors that remain nationally supervised should display low levels of outward expansion via branches and the level of internationalization should remain below 25%. If this is constant across member states (or at least core states), it should lead to industry pressures that influenced the European Commission and shaped the outcome of supervisory reform in the CMU.

Second, even if outward expansion via branches is beyond 25%, this in itself is not sufficient to create functional dissonances. The effect of higher levels of internationalization on supervision are conditional on the levels of inward penetration. As foreign penetration dominates a non-bank financial sector, competitive pressures need to be accounted for and national supervision is preferred over supranational centralization in order to keep the possibility of supervisory protection. Since regulations are increasingly harmonized on the EU level, supervisory protection remains the only tool to keep (or grow) domestic dominance. Thus, secondly, only if outward penetration exceeds the level of inward penetration, should we observe supervisory reform.

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4.3 Summary and Discussion

This chapter provided the main theoretical argument for the status quo bias in non-bank supervision during the first CMU period (2016-2019). In line with a neofunctional logic, the Capital Markets Union has been repeatedly portrayed by supranational institutions as a complement to the Banking Union and a necessary next step for the creation of a true single market for capital. Yet no such single market occurred. The difference between the Banking Union and the CMU appears most striking in supranational supervision; while the EBU succeeded to delegate supervision, the CMU displayed a status quo bias. Supervisory authority was delegated for investment firms and third-country CCPs but reform attempts failed for the most dominant institutional investors - pension funds, insurance companies, and investment funds.

For change to occur, both supranational and financial actors need to share the urgency for reform. In neofunctional terms, the strength of functional pressures depends on the salience of a policy objective among both supranational institutions and financial interests, the closeness between policy areas to enable spill-over effects and a shared agreement on the policy solution to these functional pressures (Niemann & Ioannou, 2015, p.15). Both the Banking Union and the Capital Markets Union are thereby exposed to a trade-off between financial integration, financial stability, and national control. This trade-off is known as the financial trilemma and can serve as a model to understand the relationship between this political choice and the underlying pressure of finance (and international institutions) to nudge government actions.

The trilemma states that it is not possible to have financial integration, financial stability, and national supervision at the same time; one of these three needs to be given up. In times of financial distress, the main goal is to ensure financial stability by giving up either national control or financial integration and thus the EBU solved

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this trilemma by delegating national control to the EU level. While the EBU solved the trilemma to overcome the bank-state doom loop and ensure financial stability, the prudential focus of national governments during the crisis years still led to an overall trend of de-liberalization and financial re-nationalization. The resulting fragmentation in EU finance was seen as a main factor of sluggish economic growth and deepened financial integration became a central goal, justifying the CMU as a complementary project to foster alternative, non-bank funding channels for the real economy. But deepening non-bank financial integration across borders, while maintaining national control, could yet again fuel financial instabilities.

According to the financial trilemma, the optimal choice to create a true single market for capital is the delegation of supervisory authority to the EU levels. Instead, the CMU displayed a status quo bias towards national supervision and mere coordination on the EU level. Such a status quo bias, I argued, is not an outcome by mistake but the intended choice of actors who overvalue the benefits of national supervision against the optimal choice of delegation in an interconnected single market. At the most parsimonious level, both neofunctional and intergovernmental accounts share internationalization as a decisive explanatory factor. I argue that this effected the EBU and the CMU differently, leading to centralized supervision in the EBU and a status quo bias in the CMU.

In order to theorize this for the CMU, I relied on two measures of internationalization: portfolio home bias and branch internationalization. Non-bank finance is often assumed to be the textbook example of an international force and we should therefore observe a relatively internationalized sector with high portfolio diversification across countries. But for EU finance, this assumption seems conditional on the type of investment. Only corporate debt and equity investments are diversified, while non-bank finance displays no decrease in the sovereign debt home bias since the financial

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crisis. High levels of sovereign debt home bias might thus indicate the presence of state-finance ties.

One could make the argument that such high sovereign debt exposure are merely a consequence of the zero risk weight of sovereign bonds and the regulatory limits regarding speculative investment targets - especially the prudent person rule for insurance companies and pension funds - but these points apply to all sovereign bonds. Still, portfolio choices could be due to the possible intervening role of EU regulations. I therefore proposed branch expansion in non-bank finance as an alternative measure of internationalization.

In short, I argued that the status quo bias is linked to those non-bank financial sectors where we observe low levels of branch internationalization (below 25%) or were inward penetration by foreign branches exceeds outward expansion of domestic non-bank finance. *Fortressing* on domestic markets via national supervision should be seen in both cases as an advantage for non-bank finance since it is allows for a potential protective environment in the context of domestic growth and market dominance. The next chapters will test these theoretical expectations for the main types of institutional investment; that is, for investment funds, insurance companies and (occupational) pension funds.

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5 Reform Resistance in Non-Bank Finance

The last chapter has theorized the role of supervisory delegation in the CMU and argued that the EU is exposed to a trilemma between financial stability, financial integration and national supervision. For supranational institutions, the optimal choice is the delegation of national control to the EU level but - despite reform proposals by the European Commission - the CMU ultimately ended up with a status quo bias. I argued that such a status quo bias is not an outcome by mistake. From a neofunctionalist perspective, both supranational institutions *and* the financial industry need to be aware of functional dissonances to push integration forward. If these two actors differ in the extent to which they perceive such dissonances, spill-overs will fail. In other words, a mismatch in functional perception between the main actors creates reform resistance and sustains the status quo in the supervision of institutional investors. Since the European Commission initiated the Capital Market Union and repeatedly highlighted the need for supervisory reform, any mismatch in the functional pressures towards supervisory reform should be linked to the financial industry.

The main argument is that reform resistance towards supranational supervision is linked to the lack of industry support that can be associated with low level of internationalization, or higher levels of foreign penetration. In the context of low internationalization or when foreign penetration exceeds domestic internationalization, national supervision should be perceived more beneficial than supervisory delegation.

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This pattern should hold especially in more developed national markets. Non-bank finance in those markets should have a larger influence on the position of transnational industry associations and industry preference articulation on the EU level. This chapter will test these theoretical expectations by focusing on the status quo bias for the main institutional investors; that is, investment funds, insurance companies and pension funds. For all three types of non-bank finance, the European Commission proposed supervisory reform but, ultimately, the status quo was retained.

The empirical evidence in this chapter supports my theoretical expectation. The main finding is that all three types of institutional investors show internationalization patterns that align with my theoretical expectations. In the case of investment funds and pension funds, we observe low level of outward internationalization which reduces the benefits of direct supranational supervision. In the case of insurance companies, we observe somewhat higher levels of outward internationalization yet the levels of foreign penetration by far exceeds domestic internationalization. In a context, where foreign penetration into domestic markets exceeds outward expansion, national supervision is, again, seen more beneficial than supranational supervision.

Additional evidence for my arguments comes from public feedback of (transnational) industry associations. Associations from all three types of institutional investment expressed decisive resistance towards the expansion of ESA powers in the context of the CMU. Due to this, neither the investment funds industry, nor the pension and insurance industries shared the European Commission's urgency for reform and the proposed reforms of ESMA (for investment funds) and EIOPA (for insurance and pension funds) failed. This mismatch in the perception of functional dissonances between supranational institutions and industry associations made any Commission-industry alliance unlikely to materialize and nudge government position towards supranational reform.

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5.1 Supervisory Reform for Investment Funds

In order to tackle sluggish economic growth, the Capital Markets Union should strengthen alternative market channels. While more than half of all financial intermediation in the EU is still conducted via banks, institutional investors are rapidly catching up and this rise has mainly been fueled by investment funds (see chapter 4). Part of the reason for their steep growth in recent years is the ability of investment funds to reduce investment risk and lower transaction costs (EFAMA, 2020, p. 7). At a very general level, investment funds - in particular hedge funds and private equity funds - receive cash from both individual and other institutional investors which is then pooled and invested based on the investment strategy of a given fund. The investment fund, in return, issues shares in the investment fund to the contributing investors (Haentjens & Carabellese, 2020, p. 160). As such, investment funds provide an effective way to transfer savings into capital markets, diversify the portfolio of retail and institutional investors, and increase the funding opportunities for non-bank financial corporations (EFAMA, 2020).

Despite the importance of investment funds in closing the gap between bank and non-bank financial intermediation in the EU, fund managers are still confronted with market fragmentation despite integration attempts since the 1980s. This fragmentation in investment funds market has been detected by the European Commission as a functional dissonance for a single market for investment funds early on in its attempt to create a true single market for capital (Commission, 2015b). Sustained national regulatory barriers dragged the creation of a pan-European investment funds markets in the past and the European Commission placed a particular emphasis on the removal of regulatory barriers and a reform of ESMA, the main European supervisory authority for investment funds.

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5.1.1 Functional Dissonances in Investment Fund Integration

The first attempt of integrating investment funds in the EU started with the *1985 Collective Investment of Transferable Securities Directive* (or UCITS) that extended the passport regime - which then already existed for banks - to investment funds. But instead of a robust investment fund regime, UCITS was merely a 'voluntary passport mechanism' which enabled investment fund providers to decide whether they want to reap the benefits of the single passport and market their funds across border.[1] In a sense, UCITS was seen as quality label that allowed investment funds to differentiate themselves from their competitors in the hope of attracting clients in foreign markets (Gargantini, Di Noia, & Dimitropoulos, 2018, p.414). As a 'quality label', UCITS came with transparency, marketing and investment rules in order to minimize financial risk related to the cross-border distribution of funds. Once defined as a UCITS, investment funds are required to invest in transferable and liquid assets, diversify investment to spread risks and raise capital from the public - especially the risk-spreading principle thereby becomes an attractive feature for institutional investors (Haentjens & Carabellese, 2020, p.163). The directive also sets clear investment boundaries when it comes to asset classes and the size of investment.

Nonetheless, the regulation provides national competent authorities some leeway in the strictness of these rules. NCAs can, for example increase these asset investment limitations for transferable securities from 5% to 10% if the total value invested in assets of one issuing body does not exceed 40% of UCITS total values (UCITS V, Art 52,2). Member states can also raise these investment limits for asset managers from 5% to 25% if the bonds they invest into are issued by credit institutions from another EU member state and UCITS do not apply the upper limit of 40% asset exposure in

[1]The UCITS directive was repeatedly amended over time with UCITS V being currently in place.

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one institution if it comes to sovereign bonds and bank bonds (UCITS V Art 52,5). Especially, the last point could strengthen state-finance ties and increase the home bias of investment funds.

Until the financial crisis, the only choice for investment fund providers to market their funds across the EU was to opt into UCITS (Gargantini et al., 2018). As a consequence, various investment funds remained unregulated and, far from creating a single investment fund market, this opt-in choice left large parts of the rising investment funds sector unregulated. Since then, investment funds that are not labelled as a UCITS became regulated as alternative investment funds (AIF). The 2010 Alternative Investment Management Directive (AIFMD) was a consequence of the financial crisis and the worries about the lack of supervision and regulation of alternative investment funds, like hedge funds and their managers, and the provision of a passporting regime in the EU (Athanassiou, 2010).

The regulatory goal of the AIFM directive was to establish a common regulatory and supervisory structure for investment funds that are not authorized by UCITS and that collect capital from various investors to re-invest that capital based on a pre-defined investment. Such alternative investment funds are mainly hedge funds but also private equity funds (Seretakis, 2012). In conjunct with the UCITS directive, the AIFMD should improve the transparency of hedge funds and private equity, increase investor protection and control for their financial risk implications based on minimum capital requirements and a variety of disclosure and transparency rules (Seretakis, 2012; Fagetan, 2021).

While the investment funds sector is now broadly divided into UCITS and non-UCTS/alternative investment funds, both frameworks did not create a single market for investment funds in the EU. Since the goal of the CMU was to create a true single market in capital, the European Commission tackled this issue early on. The

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European Commission thereby detected political barriers as a central cause of the lack of integration progress in UCITS and AIFMD. As a mean to overcome national resistance, the CMU limited the proposed scope of reform to a subcategory of alternative investment funds that focus exclusively on those funds with a pan-European perspective. The European Commission proposed amendments to the European venture capital funds (EuVECA) regulation, the European social entrepreneurship funds (EuSEF) regulation, and the European long-term investment funds (ELTIF) regulation. All three AIF subcategories tend to prioritize fund allocations to those areas that would also support the broader CMU goal of better funding opportunities for firms. EuVECA-defined funds have an investment focus on start-ups and other companies in their early stages that are in need of venture capital to foster innovation. EuSEF-defined funds have an even narrower investment focus and invest their capital into firms with 'social objectives', while ELTIFs tend to provide long-term investments into infrastructures and SMEs. Moreover, all three investment fund types are based on EU regulations rather than directives which would ease the creation of a single market for pan-European investment schemes.

By removing national regulatory barriers and delegating supervisory tasks to the EU level, the CMU would support the cross-border operations of investment funds, enable easier foreign market access and increase competition (Commission, 2015b, p.17). As the Commission highlighted, in order to increase investments, a focus needs to be placed on competition, while ensuring the stability of the sector (European Commission, 2016, p.9). The European Commission considered the provision of additional direct supervisory powers for ESMA. The Commission thereby explicitly mentioned these pan-European funds as a reason for it:

> Several EU laws provide for standardized fund rules whose success across the EU depends on their consistent use. Stakeholder confirmed that the understanding and supervision of such funds is very different among NCAs, which ultimately limits the uptake of these funds. In order to reap the full benefits of the Single

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> Market, the role of ESMA could be further strengthened, in particular in the area of these funds.

For the European Commission, the cross-border integration of investments funds and the delegation of supervisory powers to ESMA are effective tools to tackle these functional dissonances because "[i]f funds can do business more easily cross border, they can grow and compete within national markets to deliver better value and greater innovation for consumers" (European Commission, 2016, p.3). In line with the neo-functional expectation, the targeted investment funds segments for reform point at incremental reform attempts to lower national resistance and enable integration progress. At the same time this quote shows the potential source of functional tensions between the Commission and the financial industry. While increased competition is positively framed by the Commission, it can be negatively viewed by the industry in case of low internationalization or high foreign penetration. Especially when these patterns of internationalization are present in otherwise large national investment funds markets.

Figure 5.1 is based on the institutional investment data in the appendix table C.2 and provides an overview of the size of national investment funds in the EU27 in 2017 with a demarkation line at 50 % of GDP for large national markets. The figure shows a relative mixed picture of the EU investment funds landscape. Luxembourg - and to a lesser extent Ireland, are significant outliers. Due to a beneficial tax regime, both of these national markets exceed all other markets by far. Beyond these two extreme cases, investments funds markets are larger in Western EU member states, irrespective of Euro Area membership. In the majority of EU member states, investment funds asset remain below 50 % of GDP and the smallest market tend to be clustered around new EU member states as well as Greece.

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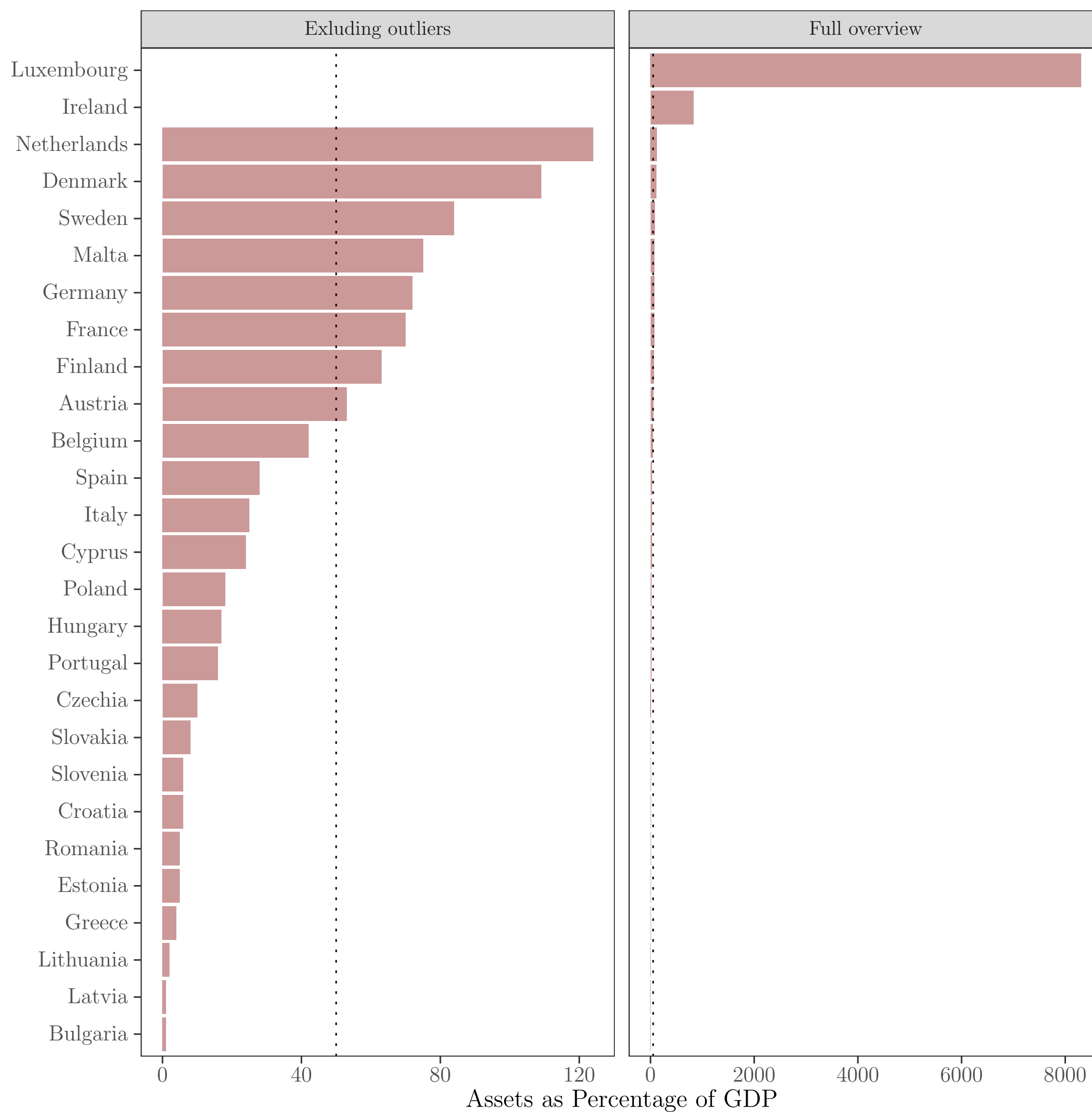

Figure 5.1: Size of national investment funds markets in the EU27 in 2017

Since investment funds from larger national markets are assumed to be more influential in shaping the position of transnational industry associations and nudging the preferences of their national governments, the possibility of a Commission-industry alliance should be determined by the level of internationalization and foreign penetration in these larger markets. In order to understand the lack of supervisory reform in the investment fund sector, the empirical analysis will focus on the internationalization of investment funds in the EU and the lack of a Commission-industry alliance

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that led to the status quo rather than spill-over effects of functional dissonances. For the neofunctionalist argument to hold, the level of internationalization should either be low (expectation 1) or, in the case of higher internationalization, the level of foreign penetration should exceed the level of internationalization (expectation 2).

5.1.2 Limited Expansion and Industry Resistance

Figure 5.2 shows the clustering of national markets for investment funds - both UCITS management companies as well as alternative investment funds managers - in the EU27 and the Euro area. The heat map thereby visualizes an overlap of national markets at the same value by darker colors. Thus, the darker the color, the more national investment fund markets cluster at one point.

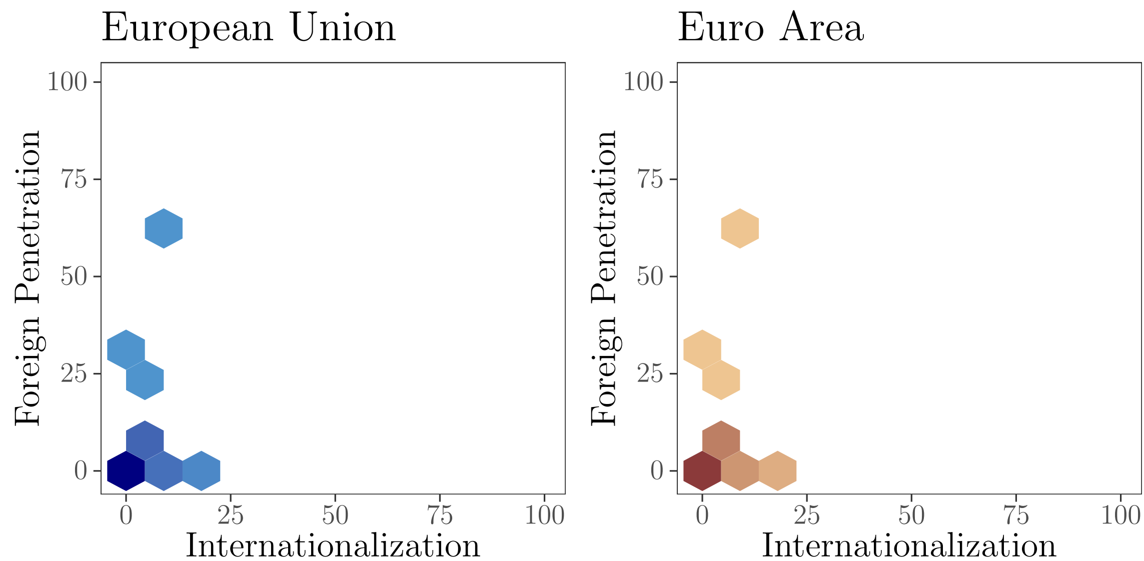

Figure 5.2: Clustering of EU investment fund markets as percentage of foreign penetration into domestic market and domestic investment fund manager's internationalization (Author's calculations, see appendix B).

What we can see from the graphs is that, overall, the investment fund industry in the EU is lacking internationalization. All national markets show internationalization

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levels below 25 percent. Moreover, subsetting the data for the Euro area does not alter the overall picture. Both in the EU, as well as in the Euro Area, investment fund industries display a more or less similar pictures. As such, the internal market for investment funds seems to be too fragmented to create robust support for the delegation of supervisory authority to the supranational level.

Additional evidence to support this claim can be found in the response of European investment fund associations to the European Commission's public consultation on the operations of the ESAs (Commission, 2017c). One of the most direct questions regarding ESMA supervision and its reform was whether ESMA should receive direct supervisory powers to "reap the full benefits of a CMU" and the areas in which this should occur. While the relatively low number of responses from national industry associations cannot provide a representative picture of each EU member state, the largest European investment fund associations as well as national associations from several core EU countries with developed industry markets did reply. As such, the overall preference of the industry towards supranational supervision becomes clearer.

Invest Europe, the leading European industry associations for private equity and long-term investments, which would be directly affect by supervisory delegation for pan-European investment funds, encouraged the further liberalization of the investment fund market by removing cross-border barriers but overall supports the status quo of national control. As *Invest Europe* wrote:

> Where a fund operates mainly on the domestic market or on a limited geographical market (e.g. the Nordic region) the particulars of that market should be taken into account, and often the national authority would be the best placed to do so. Existing relationships between fund managers and their authorities generally work well and allow for useful discussion. There is also a risk that direct supervisory powers would restrict fund managers from having a direct and low-barrier access to the supervisor. Communication with the local supervisor is important as it allows for a more tailored discussion for small-scale local operators. A more distant and less accessible European supervisor could create additional administrative burdens for these smaller players and have a notable impact on their operations.

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Invest Europe clearly points at a loss of industry ties with national authorities as the main disadvantage of supervisory reform. Overall, this seems to further strengthen my first theoretical expectation. Similar concerns have also been raised by *EFAMA*, the representative association for the European investment management industry. They "agree with the European Commission that stronger supervision can help overcome market fragmentation and is a natural step towards achieving a successful Capital Markets Union." However, in terms of investment funds, *EFAMA* "believe[s] that the current architecture of European investment funds works well, whereby funds are distributed in the EU through passport mechanism with the home NCA agreeing and supervising and the host NCA receiving a notification and being able to ask for complementary information." EFAMA then outlines in detail the reason for the inappropriateness of direct supervision for both UCITS and AIF providers all of which boil down to the fact that the lack of an internal market and the continuous presence of national leeway in the supervision of investment funds is a reason for rejecting the delegation of supervisory powers rather than supporting it. While this might sound paradoxical, since the European Commission tends to highlight national supervisory differences as a reasons to delegate authority, it fits my overall argument. As long as the investment fund sector does not display relative high levels of internationalization, national supervisory control comes with advantages for the industry.

In order to provide a more granular picture, Figure 5.3 maps internationalization and foreign penetration by country inside the EU. The picture from the heat map becomes even clearer. No single national market in the EU shows levels of outside expansion (i.e internationalization) beyond 25%. Especially in core EU member states, that have deeper capital markets, low levels of internationalization should sustain a status quo bias rather than a preference in favor of delegating direct supervisory authority to the supranational level. Moreover, foreign penetration is overall low as well even though Belgium, Italy, and Austria display somewhat higher values than the rest. In such a

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scenario, the benefits of national control should be higher than the advantages from supranational centralization.

Outward Expansion

Foreign Penetration

Figure 5.3: Internationalization in national investment fund industries in the EU. Left pane shows domestic expansion. Right pane shows foreign penetration (Author's calculations).

As such, it should not come at a surprise that the preferences from national industry associations mirror those from transnationally-organized non-bank finance (Commission, 2017c). *ALFI*, the national association of investment funds in Luxembourg, the largest investment fund sector in terms of assets to GDP in the EU, clearly rejected the delegation of any further supervisory powers. They thereby provide a variety of justifications for keeping supervisory powers vested within national competent authorities. First, they reject the delegation of powers due to a lack of political mandate. They wonder "whether an extension of ESMAs direct supervisory powers is compatible with the Treaty of the European Union and the principle

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of separation of powers". Since this would "give an EU agency cumulative powers as well as direct supervisory competence via the supervision or even the authorization of investment funds." Another justification is the proximity between supervisor and supervisee since such "[p]roximity to the local market ensures that the supervisory authority has profound knowledge and understanding of the local legislation applicable to the market participants". Lastly, for *ALFI*, the Commission's focus on pan-European investment funds is a further reasons not add any additional powers:

> The text of the consultation also seems to suggest that only pan-European funds would be subject to such supervision. This would introduce an un-level playing field between the various fund industries in Europe and would not be acceptable. It could also lead to a fragmentation of the European fund industry in purely domestic funds vs. cross-border funds.

Overall, *ALFI* emphasizes the importance of the subsidiarity principle and seems to be worried about potential competitive pressures between pan-EU and national investment funds. A similar picture comes from associations from the Baltic states. The *Swedish Investment Fund Association* acknowledged coordination issues between NCAs but this in itself was not enough to support the delegation of additional powers to ESMA. As they wrote in the consultation:

> As regards investment funds we fear that moving supervision from the NCA to ESMA would further distance the supervision from the entities that are supervised. The contacts between the supervised entities and the supervisor would be more complicated and there would inevitably be a lack of understanding of the specific markets where the supervised entities operate

The *Federation of Finnish Financial Services* points at bureaucratic issues with the delegation of supervisory authority to ESMA and sees the lack of liberalization as a bigger issue than centralized supervision. Other national industry associations from core EU member states share these preferences. *BVI*, the German investment funds association, and *AFTI*, the French association of securities traders, share this overall reluctance towards the direct supervision of investment funds in the EU. The most

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explicit preference in favor of 'fortressing on markets' came from the French *Association Francaise Des Societes Financiers* which not only rejected the delegation of supervisory authority to the EU level but suggested that overall member state powers should be increased in the control of the ESAs. Countries with larger financial markets should thereby receive more vote weights than smaller markets. Both of which directly point at fortressing on domestic markets by strengthening national supervisors.

Looking at national association in the public consultation, the investment fund industry had a clear opinion on that matter and all respondents from the EU rejected the delegation of additional powers to ESMA. Positive responses towards the centralization of direct supervisory authority in ESMA came exclusively from UK-based or global associations. For these third-country actors, a single supervisor eases market access to the EU by reducing the number of supervisory access points to one. Yet, within the EU, the investment funds industry shows clear resistance against the delegation of supervisory powers to ESMA. The benefits of 'fortressing on markets', in the context of low internationalization, thereby outweighs the support for the European Commission's attempt to delegate direct powers to ESMA.

5.2 Private Pensions and EIOPA Reform

But ESMA has not been the only supervisory target of the European Commission in its endeavor to create a true single market for capital. In the case of the European Insurance and Occupational Pensions Authority (EIOPA), the attempt was linked to the creation of a single market in private pensions. The CMU should tackle better funding opportunity and improved cross-border integration of institutional investors as a mean to achieve economic growth. The diversification of funding opportunity and more efficient markets basically means improved competition and the removal

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of national regulatory and supervisory barrier (Commission, 2015b, p.5). National regulatory obstacles towards pension portability and the lack of private pensions as investment products were thereby seen by the European Commission as yet another functional dissonances to tackle these challenges.

Pensions are at the core of national welfare regimes and national pension systems tend to rely on pay-as-you-go (PAYG) which is a generational contract between the current labour force and the current retirees (De Haan et al., 2020). While PAYG is based on public pension provisions (first pillar pensions), most European countries also provide access to alternative private pension options that are either based on occupational (second pillar) or personal schemes (third pillar). Moreover, recent years showed a decline in first-pillar, public pensions and a move toward private pensions, be it occupational or personal (Hassel, Naczyk, & Wiß, 2019). In such a '3-tier system', pensions are either ensured by the state, the employer, or individually and the main providers of private pensions are pension funds and insurance companies (Gelepithis, 2019; Van Meerten, 2013). While both non-bank financial sectors can offer occupational and personal pension schemes, pension funds tend to dominate occupational pensions (second pillar), while insurance companies play an important role for personal pensions (third pillars).

This rise in private pensions is the consequence of political choice to tackle two pressing issues. First, it should reduce the fiscal burden of public pensions in the context of changing demographics within the EU and, second, it should support economic growth by strengthening institutional investors (Hassel et al., 2019). Both pension funds and insurance companies can turn into decisive domestic institutional investors depending on their size in the national economy. Yet, just like in the case of investment funds, no single pension market emerged in the EU and the European Commission perceived the lack of a single market in private pensions as a functional dissonance

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that hampers the goals of a true single market for capital.

In order to tackle these functional dissonances, the European Commission proposed the Pan-European Pension Product (PEPP) and based it around a narrative that focuses on PEPP as a financial product without effects on national social, labour, and tax laws in order to smooth government resistance against the reform of EIOPA. The Commission proposed a dual supervisory structure that leaves prudential supervision on the national level while providing EIOPA with authorization powers regarding future PEPP providers. Despite this incremental reform proposal, the delegation of authorization powers to EIOPA failed and PEPP emerged as a cross-border pension product without any new supervisory arrangements. National supervision was sustained and the European Insurance and Occupational Pensions Authority (EIOPA) continues to provide mainly a coordination function for national competent authorities on the supranational level.

5.2.1 Functional Dissonances in Private Pensions

The EU has long encouraged a single market in supplementary pensions due to the same reasons that led to the rise in private pensions on the national level - demographic change and economic growth. A single pension market would support cross-border labor mobility which should positively affect productivity and provide higher economic growth across the EU (Guardiancich, 2011, 2015). Even though fragmented national pension markets are an obstacle for a supranational solution to these issues, private pension integration has been slow. In order to support labour mobility, ensuring the pay-out of public pension across the EU is insufficient without the integration of private pension schemes. As long as occupational pensions are not portable, workers will be less likely to take advantage of the internal market and free movement in order not to jeopardize pension benefits (Hennessy, 2011, p.577). Moreover,

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the efficient functioning of the internal market is reduced when internationally-active firms have to establish independent occupational pension schemes in each operating member states (Haverland, 2007, p.888).

The European Commission attempted to integrate occupational pensions since the 1990s. Yet it was only a decade later, with the *2003 Institutions for Occupational Retirement Provision (IORP) Directive*, that provided the first harmonization of second-pillar pension in the EU. The IORP directive enabled occupational pension providers to offer their services across member states which, in turn, supported the internal market. It established a "framework for prudential regulation of occupational pension schemes that operate on a funded basis and are outside the scope of social security schemes" (Van Meerten, 2013, p.414-415). The IORP directive regulates the cross-border provision of occupational pensions and was the first attempt on the EU level to create a single market in pensions through the logic of minimum harmonization and mutual recognition (Guardiancich, 2011; Van Meerten, 2013). As such, it mirrored the approach in banking (and insurance) since the late 1980s (see chapter 2).

The IORP directive was thereby already the second attempt to integrate occupational pensions after a first failed attempt in 1991 (Hennessy, 2008). One of the reasons for this second attempt towards occupational pension integration to succeed was that the European Commission strategically utilized its agenda-setting powers (Hennessy, 2011). In order to lower national resistance, the Commission changed the overall narrative of the proposal from a welfare issue to an issue of liberalization. A few years before, in 1999, the Financial Services Action Plan (FSAP) was introduced and the narrative around the IORP directive should therefore place pensions as one part of the broader Financial Services Action Plan (FSAP). As such, this IORP directive should merely provide pensions the same rights that the FSAP already provided to banks and insurance companies (Haverland, 2007; Hennessy, 2008). In addition, the Commission

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relied on public stakeholder consultations and a close financial industry alliance to lower national resistance (Hennessy, 2011; Haverland, 2007). The pension sector was in favor of the European Commission's proposal because the FSAP provided single passporting rights to other financial industries which placed occupational pension funds at a competitive disadvantage (Hennessy, 2008, p.115). The success of the IORP directive is thereby an example of how a Commission-industry alliance based on a shared understanding of the urgency of functional pressures, together with the right narrative, can overcome national resistance.

While the IORP directive tackles second-pillar pensions (occupational schemes), it still excluded personal, third-pillar pensions from the scope of the directive. But personal pensions are by now linked to more than 27 % of European workers which shows the growth potential for private pension markets in the EU (Bernardino, 2019, p.131). As such, the integration of private pensions would not only provide an alternative, cross-border pension options for citizens but also strengthen the cross-border integration of private pension providers - mainly pension funds and insurance companies. The deepened integration of these two institutional investors would directly affect the main goal of the CMU; that is, providing alternative investment choices for the real economy. Thus, in 2016, the European Commission proposed *PEPP*, a pan-European pension product, which was envisioned as a third pillar, private pension scheme that should create a single European market in personal pensions (Belko & Allroggen, 2019). A PEPP is basically a 'regulatory template' that enables a product to be offered across borders, similar to the IORP directive for second pillar pensions (Caldas, 2019, p.200, 212). The idea behind PEPP is "to set out common standards for a scheme with a European 'kitemark' that would be acceptable in all member states and fully transferable across border" (Schelkle, 2019, p.607). Such a personal pension scheme should complement occupational pensions in reducing pressures on public finances. PEPP was therefore also designed as a financial product to increase

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the availability of more patient capital and, ultimately, yet another tool to support economic growth through non-bank finance. Since sluggish economic growth was the root cause for the Capital Markets Union, it is only consequential that the European Commission initiated the pan-European pension product (PEPP) as part of its overall CMU project.

The arguments for the integration of third-pillar pensions (via a pan-European pension product PEPP) mirrored the argument that have been used for the integration of second-pillar pensions (via the IORP directive) in the past. The European Commission created a narrative around the PEPP that emphasized its role as a financial product to tackle demographic change and support economic growth by deepening capital markets (Belko & Allroggen, 2019). PEPPs should be offered as a choice between four different products for savers that would allow both cross-border occupational pension funds and insurance companies (and other investors) to offer such a product across the EU (Lannoo, 2019).

Since PEPP was envisioned as a financial product, insurance companies, as a dominant provider of personal pensions, are naturally involved as well. Yet insurance companies are exposed to additional regulatory scrutiny with higher prudential requirements than pension funds. The first insurance directive (Solvency I) included prudential considerations based on solvency margins - that is "the amount of capital that an insurance undertaking is required to hold against unforeseen events" (Quaglia, 2011, p.104). Such prudential regulations were missing for pension funds. At the same time, Solvency I limited the scope of supervisory delegation by relying on minimum harmonization and the home country principle in supervision. In the context home country control, these margins allowed for national discretion. Later on, the EU established the Solvency II directive as "a risk-based, principle -based approach to the prudential regulation of insurance companies" (Quaglia, 2011, p.101). Solvency II

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thereby reduces the potential for national discretion.

The initiative for the pan-European pension product was part of the overall Capital Markets Union project and personal pensions should not only evolve into a single market but the supervision of this market was at least partially envisioned on the supranational level. Since national resistance has hampered pension integration in the past, the European Commission utilized its agenda-setting power to frame the PEPP proposal in a way that can overcome the most contested issues among member states. First, the issue of national fragmented social, labor, and tax laws - that has been an obstacle to pension integration in the past - was solved in the PEPP by creating 'national compartments' within each pan-European pension product. The logic behind these compartments is that for each member state a person moves to (in the EU), a separate compartment is opened in his pension product that follows the specific national laws (Rodrigues, 2019, p.181-183). Thus, while PEPP does not harmonize national laws, it provides an elegant solution against member state resistance that accounts for national specifies while enabling the the portability of this pension product. As such, the PEPP is first and foremost an investment product to support economic growth, rather than a tool to secure old age security (Schelkle, 2019). Second, EIOPA - as a supranational supervisor - should receive direct powers in the context of PEPP by granting it authorization rights rather than full monitoring and enforcement powers.

Yet different regulatory and supervisory standards between IORP I/II and Solvency II complicated the creation of PEPP and resulted in a lack of further supervisory powers to EIOPA. On the one hand, it would be reasonable to assume that the financial industry supports the further liberalization of private pensions in order to tap economies of scale and new markets, especially for those pension funds and insurance companies that are already internationally oriented. On the other hand, even though

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IORP I/II and Solvency II already set prudential standards, they both differ in the strictness of the rules and the delegation of supervision for PEPP to EIOPA would further increase market competition among pension providers from both sectors. A fully integrated PEPP, with a reform of EIOPA, would have increased competition in private pensions and reduced the ability of national supervisors for supervisory forbearance. Based on my theoretical expectations, especially in the context of varying levels of internationalization, both the pension fund and insurance industry should have an interest in resisting supervisory delegation if their level of internationalization remains low or if foreign penetration overall exceeds outwards integration - especially in larger national pension and insurance markets. Based on my theoretical expectations, we should either observe low levels of outward internationalization (expectation 1), or larger foreign penetration, relative to outward internationalization (expectation 2) for both (occupational) pension funds and insurance industry.

5.2.2 Domestic Orientation and Foreign Penetration

The new pan-European pension product would have meant increased competition for occupational pension funds. IORP providers are supervised by their home supervisor both in terms of every-day prudential supervision as well as authorization. Moving the authorization of PEPP providers to the EU level would lead to increased supervisory scrutiny and benefit IORPs only if they can utilize economies of scale as a mean for outward expansion. Without high levels of internationalization, or low levels of foreign penetration, even the partial centralization of supervisory authority to EIOPA would come at a cost for occupational pension providers. Following my argument, we should observe either limited internationalization or high foreign penetration given the lack of supervisory reform for EIOPA.

Based on the same methodology as before, Figure 5.4 shows that the pattern for

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occupational pension funds in the EU follows my overall argument. National pension markets show low level of internationalization and this holds, again, both within the Euro area as well as the EU27. Thus, overall, my first theoretical expectation holds. The vast majority of national (occupational) pension markets show low levels of outward internationalization - far below 25% that makes the delegation of monitoring powers to EU less beneficial compared to the advantages linked to national supervision. As such, the pension funds industry should not perceive any functional dissonances in the current structure of pension supervision that would require the delegation of additional powers to EIOPA.

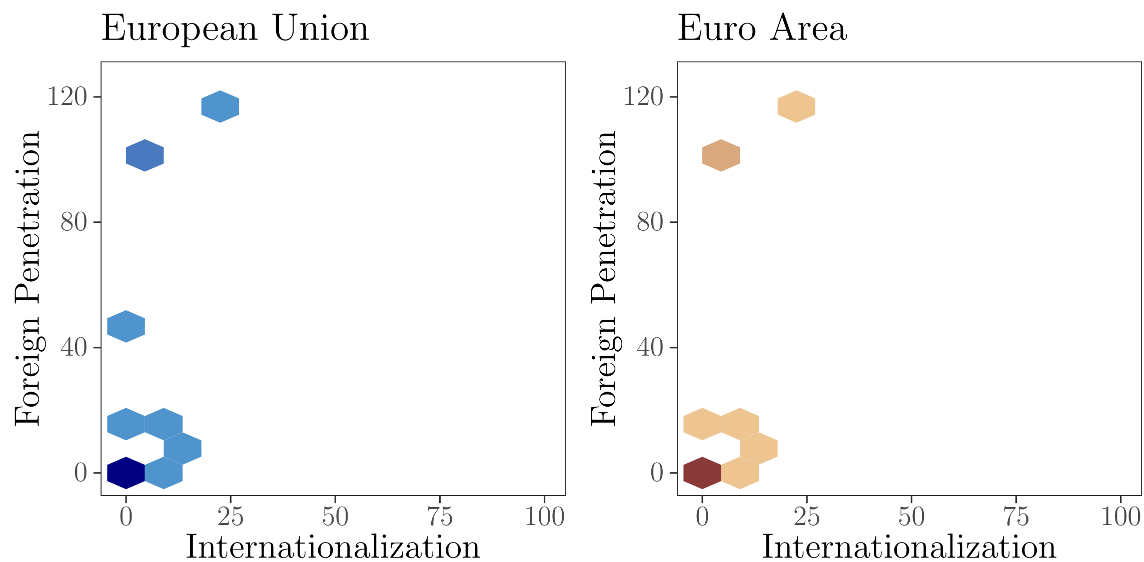

Figure 5.4: Heat Map of national IORP (pension) markets in the European Union and Euro Area (Author's calculations, see appendix B).

As for investment funds before, we can also map these values across the EU to provide more insight into the patterns of outward internationalization and foreign penetration (Figure 5.5). The left pane shows the internationalization of pension funds (outward expansion) measured as the percentage of domestic IORPs that are active across borders of the total IORPs in a country. The right pane shows foreign penetration, measures as the percentage of foreign IORPs relative to the total number of IORPs

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in a country.

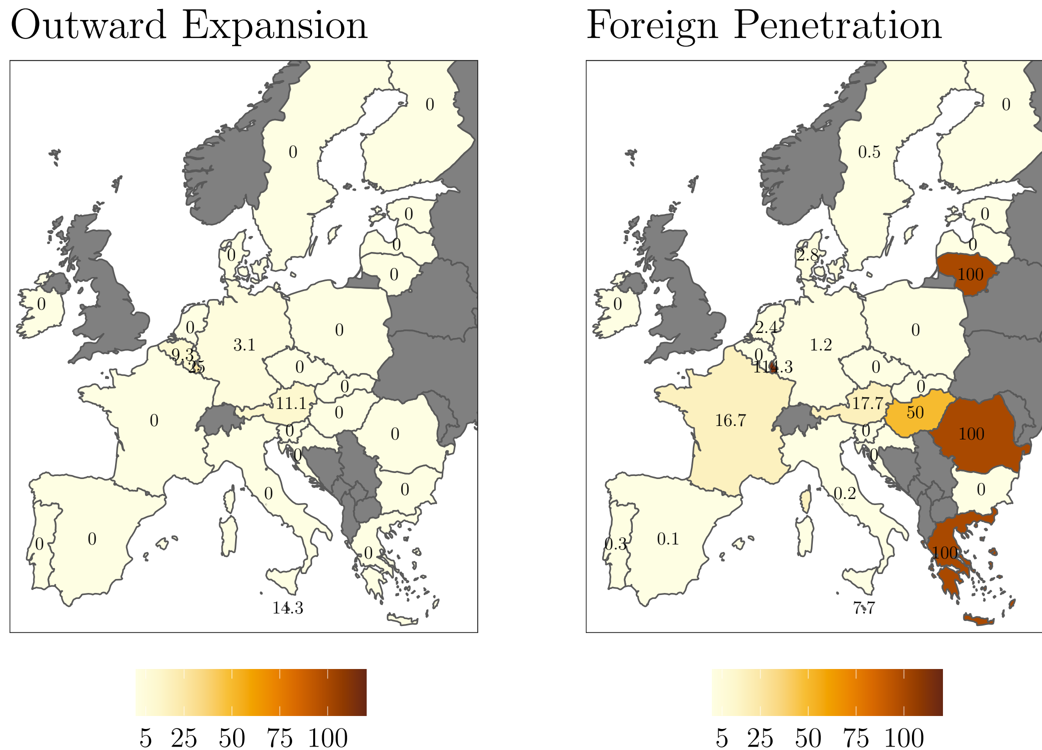

Figure 5.5: Domestic expansion and foreign penetration in IORP markets (Author's calculations).

No EU country has large levels of internationalization even in those core EU member states with a large pension fund sector in terms of assets to GDP (see also Table C.2 in the appendix). In terms of foreign penetration, several national pension markets shows high levels yet mainly in the new member states. Moreover, the level of internationalization remains almost non-existent in those EU markets that show pension markets with relative high levels of pension fund assets to GDP. Since there is little capital mobility in the market, industry support for supervisory reform is unlikely. In this case of low IORP internationalization, creating an international third-pillar market only increases competitive pressures and the advantages of national supervision (e.g. supervisory forbearance and limited foreign competition) outweighs the benefits of delegating supervisory authority to the EU level.

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We should therefore see coordinated attempts by the industry via transnationally-organized associations to resist the delegation of any further authority to EIOPA. Focusing on industry feedback on "EIOPA's advice on the development of an EU Single Market for personal pension products (PPP)" there is indeed some evidence that the industry resisted the delegation of any further authority to EIOPA. *PensionsEurope*, the European pension association that represents national associations of pension funds and similar institutions for workplace and other funded pensions, displayed opposing views on the delegation of supervisory authority to EIOPA:

> We consider that further supervisory powers are not necessary. As mentioned, we are in favor of EIOPA's opinion that only providers falling under relevant EU legislation are eligible to provide PEPPs. In our view the authorization requirements for providers as laid down in existing EU legislation are largely sufficient. We are not convinced that a stand-alone regime for the authorisation of PEPP providers is desirable. We fear that a regulatory gap in favour of providers not yet authorised under other EU financial service legislation might be created. This might result in an unlevel playing field vis--vis EU regulated providers and IORPs providing occupational pension schemes. Moreover, we question the perspectives on adequate supervision in practice on providers which are not yet authorised under other EU financial service legislation (PensionsEurope, 2016, p.4-5)

Overall, given the role of *PensionsEurope* as a central transnational association of EU pension providers, this resistance against supranational supervision seems to point at the lack of a Commission - industry alliance which should be a necessary condition of supervisory reform in the CMU to succeed. Yet, since PEPP was proposed as a personal pension scheme and insurance companies are dominant providers thereof, the insurance sector would be equally affected by the Commission's push for EIOPA reform (Gutiérrez Curos, Herr, Quevedo, Valadzija, & Yeh, 2020). Figure 5.6 therefore extends the analysis towards insurance and displays the level of outward internationalization and foreign penetration in national insurance markets.

We can see again that the overall pattern does not diverge too much between the EU-27 and the Euro area. But overall, insurance markets in the EU are much more inter-

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nationalized that IORP markets. While IORP providers are almost fully domestically-oriented, this pattern is more mixed in the case of national insurance markets. While many national markets still cluster below 25%, several national markets exceed the 25% threshold which indicates relative high levels of outward internationalization.

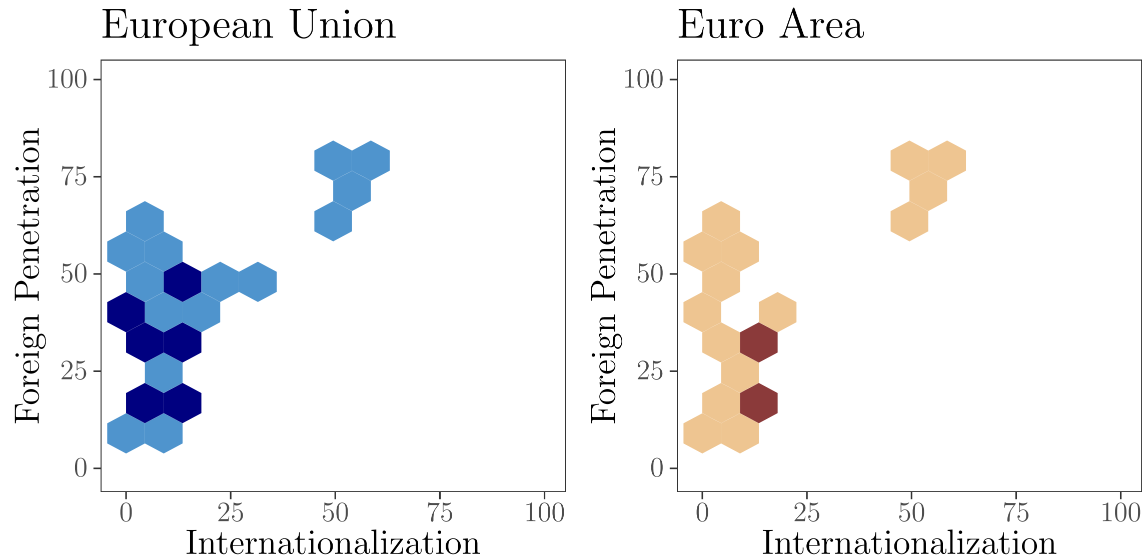

Figure 5.6: Heat Map of national insurance markets in the European Union and Euro Area (Author's calculations, see appendix B).

In itself, this would contradict my main expectation but when we consider these relative high levels of outward internationalization in conjunct with the respective levels of foreign penetration (inward internationalization), my second expectation holds. For each national insurance market that exceeds 25% of outward internationalization, the level of inward internationalization remains even higher. With higher levels of foreign penetration, competitive pressures remain and this should reduce support for supranational supervision and encourage preferences in favor of sustaining the status quo in supervision based on the dominance of national competent authorities within EIOPA on the EU level.

We can see this pattern even clearer by mapping the data across the EU (Figure 5.7). The pattern of outward internationalization in national insurance markets mirrors the

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previous patterns among investment funds and IORP markets. Especially in markets were the insurance sector is large enough to influence politics on both the national and supranational level (see Table C.3), outward internationalization remains low. Larger levels of outward expansion can rather be observed in new EU member states that overall have smaller insurance markets. Moreover, foreign penetration exceeds outward expansion for almost every EU member states.

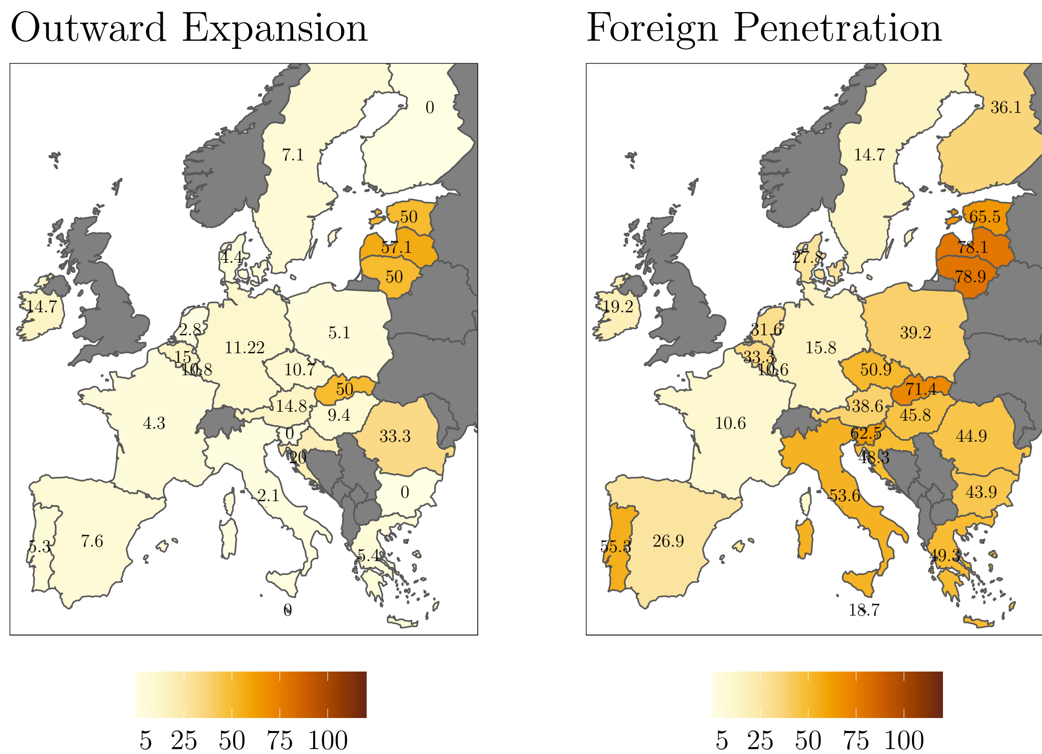

Figure 5.7: Domestic expansion (left pane) and foreign penetration (right pane) in national insurance markets in the EU (Author's calculations).

Unfortunately, insurance preferences on the provision of additional powers to EIOPA can only be gathered indirectly. *Insurance Europe*, the European insurance and reinsurance federation, did not respond directly to the issue of authorization powers. Instead, *Insurance Europe* emphasized that PEPP - and all its future providers - should follow the principles of Solvency II, the current regulatory and supervisory framework for insurance companies (Insurance Europe, 2016, p.6). This would mean

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that supervisory powers should not only remain on the national level but that national supervision should be based on stricter rules. This issue was already present before PEPP and directly linked to differences in the prudential oversight of pension providers and its effect on competitive pressures. Pension funds, according to IORP II, must invest "in such way that they can accomplish the two primary objectives of 'security' and 'profitability'" (Pino & Yermo, 2010, p.9). To ensure this dual objective, supervision is based on the prudent person rule that limits the investment scope of pension funds by requiring investments into 'safe' asset types (e.g. sovereign bonds) and geographical diversification. In terms of supervision, IORP I/II follows the home country principle that defined the pre-crisis trajectory of national control (see Chapter 2). That is, cross-border IORPs are supervised (and authorized) by their home supervisor whenever they enter foreign markets via branches (Guardiancich, 2011; Van Meerten, 2013, p.17).

But the prudential person rule also allows for supervisory discretion. As long as supervision remains on the national level, the interpretation of this rule can vary significantly. Ireland, for example, interprets these prudential rules rather vaguely, while other countries rely on defined quantitative restrictions (Haverland, 2007, p.891). Solvency II provides much stricter, capital-based rules for the insurance sector and thus, the industry used the PEPP proposal to push, once more, for stricter rules to other competitors. Giving EIOPA further direct powers in a context where different PEPP providers would fall under differently strict regulations, would have increased competitive pressures for the insurance sector, especially in the context of already large foreign penetration within the insurance industry. Fortressing on markets in the context of PEPP thereby offers the insurance industry a way to tame the un-level playing field between pension funds and insurance companies.

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5.3 Summary and Discussion

This chapter empirically tested my theoretical expectations on the status quo bias in supranational supervision for non-bank finance. Since the CMU should foster the cross-border integration of non-bank finance, the focus has been on investment funds as well as insurance companies and (occupational) pension funds as the main institutional investors in the European Union. From a neofunctional perspective, a necessary condition for supervisory reform is the presence of a Commission-industry alliance based on a shared understanding of functional dissonances that require the delegation of supervisory authority to the EU level. For the European Commission, this functional dissonance is linked to market fragmentation and sluggish economic growth that not only requires the removal of regulatory barriers but also the delegation of supervisory authority to create a true single market for capital. Since neither the investment funds industry, nor the pension and insurance industry shared the same urgency for supervisory reform, this mismatch in functional dissonances between supranational institutions and the financial industry paved the way for the status quo bias.

Investment funds providers are required by both UCITS and AIFM regulations to create physical presence for cross-border operations. I therefore looked at branch internationalization based on ESMA data and found low levels of both outward and inward internationalization of investment funds across the EU. Additional evidence from the investment fund industry thereby supported my theoretical expectation that in the context of such low levels of internationalization, a Commission-industry alliance is unlikely to materialize. For pension funds, the focus was placed on occupational pension funds that are categorized as IORPs. The IORP framework enabled pension funds to operate across borders which allows us to map both domestic inter-

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nationalization, as well as foreign penetration across the EU. The data showed that national IORP markets display low levels of internationalization below 25 % as well as limited foreign penetration throughout the EU. As we would expect from this pattern of domestic orientation, the pension industry showed limited support for the delegation of supervisory authority to the EU level. In the case of insurance companies, this chapter focused on the expansion of the insurance sector via branch internationalization. While insurance companies tended to expand via subsidiaries, the consequence of Solvency II, the current regulatory framework for the insurance industry, expansion patterns shifted from subsidiaries to branches. As such, a focus on branches provided a more dynamic picture of insurance internationalization. The analysis showed that the insurance industry displays overall higher levels of internationalization, compared to the pension industry. Yet, those levels of outward internationalization are exceeded by even higher levels of inward internationalization. In the context of higher levels of foreign penetration, fortressing on market once more becomes an advantage. As we would expect, the insurance industry seems to oppose the delegation of supervisory authority to the EU level.

One could, of course, argue that the focus should really be on the preferences of the banking sector as the decisive neofunctional ally of the Commission. Not only did the European Commission repeatedly highlight the complementary nature of the Banking Union and the CMU but the structural power of banks exceeds the lobbying strength of non-bank finance by far. Yet, looking at the responses of banks regarding, for example, ESMA supervision (which does not apply to them), we see no coherent position of the banking industry (Commission, 2017c). The Austrian Federal Economic Chamber, Division Bank and Insurance, for example, explicitly advocated for the direct supervision of investment funds on the EU level and argued that "[t]he role of ESMA could be further extended with a direct supervisory function for funds (UCITS, AIF, ELTIF, EUVECA and EUSEF) including the licensing and passport-

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ing. [...] The current regime is fragmented and inefficient." Other national banking associations, opposed such delegation. This stands in stark contrast with the unanimity of the investment funds industry where neither European nor national associations supported the delegation of further authority over investment funds to ESMA. If the position of the banking industry would have been the decisive element, the withdrawal of the ESMA proposals for pan-European investment funds schemes becomes, at least, puzzling. Moreover, the data for investment funds as well as insurance companies and pension funds mirrors by theoretical expectations on the status quo bias.

One could also argue that the neglect for the United Kingdom in this chapter skews the findings towards my theoretical expectations. With regards to Brexit, two objections could be raised. First, ignoring the UK empirically distorts the real level of internationalization and foreign penetration in non-bank finance. This is likely correct but since the goal is to understand these levels in regards to supervisory preferences, it matters little. The decision to keep the status quo occurred after the vote for Brexit and thus UK finance counts as a third-country entity with different supervisory arrangements. Second, one could argue that the real functional dissonance was the exit of the United Kingdom as the largest financial center in the EU. Instead, I have argued that this functional dissonance, at least for the European Commission, is linked to market fragmentation and sluggish economic growth that not only requires the removal of regulatory barriers but also the delegation of supervisory authority to create a true single market for capital. In order to adequately answer this question, the next chapter will focus explicitly on the role of Brexit for the CMU and analyses investment firms and third-country CCPs as the two cases of (partially) successful supervisory reform in the CMU.

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6 Supervisory Reform after Brexit

Despite proposals by the European Commission to combine regulatory integration with supervisory reform, direct supervisory powers were neither delegated for investment funds, nor insurance companies and pension funds. Based on a neofunctional perspective, the last chapter focused on reform preferences among non-bank finance and showed that an explanation for the absence of functional dissonances within non-bank finance can be found in low levels of internationalization or higher foreign penetration. In both contexts, institutional investors prefer the status quo as a mean to 'fortress on markets'; that is, to rely on the potential benefits of national control (e.g. supervisory forbearance). In the context of lagging outward expansion or the competitive pressures from foreign penetration, the role of national competent authorities as gatekeepers in the European System of Financial Supervision (ESFS) can potentially become more beneficial for non-bank finance compared to the competitive-oriented perspective of supranational supervision. Reform resistance within non-bank finance and the lack of a Commission-industry alliance seem to be associated with a lack of supervisory reform for the main types of institutional investment in the CMU.

These findings are nonetheless conditional on two factors that have not yet been accounted for. First, despite the lack of reform for the main types of institutional investment, supervisory reform was not fully absent from the CMU. The direct supervision of the largest investment firms is conducted by the ECB and has been specified in

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the CMU with the Investment Fund Regulation and the Investment Fund Directive (IFR/IFD), while third-country CCPs are now directly supervised by ESMA as specified by EMIR 2.2. In both cases, direct supervision occurs through the creation of a regulatory arm that should separate direct supervisory tasks from the everyday tasks of the ECB and ESMA. Second, the previous analysis focused on the EU27 as the main target of supranational supervision and excluded the UK and the effects of Brexit on supervisory reform. Brexit could indeed be seen as an exogenous shock that required prompt legislative action to reduce its disruptive potential for European finance - even more so because the UK entities dominate in both markets. Supervisory reform for investment firms and CCPs could therefore merely be a political response of EU member states to limit the access option of the United Kingdom and increase the financial position of national financial markets in the EU. If so, political considerations rather than functional dissonances would account for supranational supervision.

The aim of this chapter is to test if my theoretical explanations can travel beyond the main types of institutional investment in the EU27 and account for successful supervisory reform after Brexit. I will show that the logic of 'fortressing on markets' can still offer an alternative but mutually non-exclusive explanation for supervisory reform compared to more intergovernmental explanations. With Brexit, low levels of internationalization for investment firms and CCPs created functional pressures within both segments of non-bank finance which, together with a political interest to tame the influence of the UK, enabled the emergence of a Commission-industry alliance. Brexit, as an exogenous shock, therefore amplified functional pressures since the UK is the single most dominant market for both investment firms and CCPs.

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6.1 Brexit as an Exogenous Shock

While the CMU lacked supervisory progress overall, financial supervision in two subsegments of non-bank finance became reformed during the CMU. That is, investment firms and central counterparties. In the case of investment firms, the European Commission proposed amendments to the main legislative body for investment firms (MiFIR and MiFID) which resulted in the Investment Firm Regulation and Directive (IFR/IFD). The IFR/IFD reformed the prudential standards for investment firms but the effects in terms of supranational supervision are somewhat mixed and provide different supervisory arrangement based on the systemic importance of investment firms. One the one hand, the IFR/IFD defines the largest investment firms as credit institutions which places them under the single banking rule book and thus under direct ECB supervision. On the other hand, the IFR/IFD lowers the prudential standards for smaller investment firms and thereby sustained the status quo bias of national supervision. Overall, this approach basically mirrors the supervisory distinction in the Banking Union.

In the case of central counterparties, the reform process has remained focused on the question of non-EU CCPs and the existing legislation EMIR was amended by EMIR 2. EMIR 2 led to the partial delegation of supervisory authority and vested ESMA with the authority to supervise (only) systemically-important, third-country CCPs. Similarly to the Banking Union, this direct supervision was achieved by adding a new regulatory arm to the set-up of ESMA that focuses exclusively on the supervisory tasks related of third-country entities. Despite existing differences, both supervisory arrangements show similarities to the solution found for banks in the Banking Union. It is therefore worth testing my theoretical argument on these two partially successful cases, especially since they overlap with a truly exogenous shock to supervisory reform

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in the Capital Markets Union.

On June 23, 2016 the United Kingdom held a referendum in accordance with Article 50 of the TEU that enabled the UK to leave the European Union. Once Article 50 is triggered, the European Union negotiates a withdrawal agreement on the terms of the United Kingdom's exit from the EU (Armstrong, 2018). At this point, the UK receives the status of a 'third-country' which requires a new agreement on the future (financial) relationship between these two markets.

While the EU negotiated third-country relations across the globe and has experienced contentious negotiations before (e.g. with Switzerland), the UK differs from other third-countries not only due to the fact that it was previously a member of the EU but the UK, and the City of London in particular, was - and still is - at the center of European finance.

The United Kingdom was, by far, the dominant financial hub in EU finance in terms of population and employment size. The City of London hosts most credit institutions, has most foreign-registered and domestically-registered financial institutions, has the largest amount of total banking assets - split equally between wholesale and retail - and has the largest derivatives market (Batsaikhan, Kalcik, & Schoenmaker, 2017, p.3). Moreover, the United Kingdom has traditionally been the main access point for third-country entities into the European market. Especially the City of London has been the central node connecting European and global finance. Given this financial importance of the United Kingdom, the role of Brexit for these two successful cases of supervisory reform in the CMU needs to be considered.

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6.1.1 Investment Firms, CCPs, and Brexit

Within EU finance, the United Kingdom's position before Brexit has been particularly pronounced in the two subsegments of non-bank finance that received supervisory updating with the CMU. First, in terms of investment firms, the UK was the leading market, outperforming all other EU member states by far. Figure 6.1 is based on data from the industry association EFAMA and shows that the UK indeed dominated the investment firm sector in terms of asset under management as percentage of GDP (EFAMA, 2019, p.12).

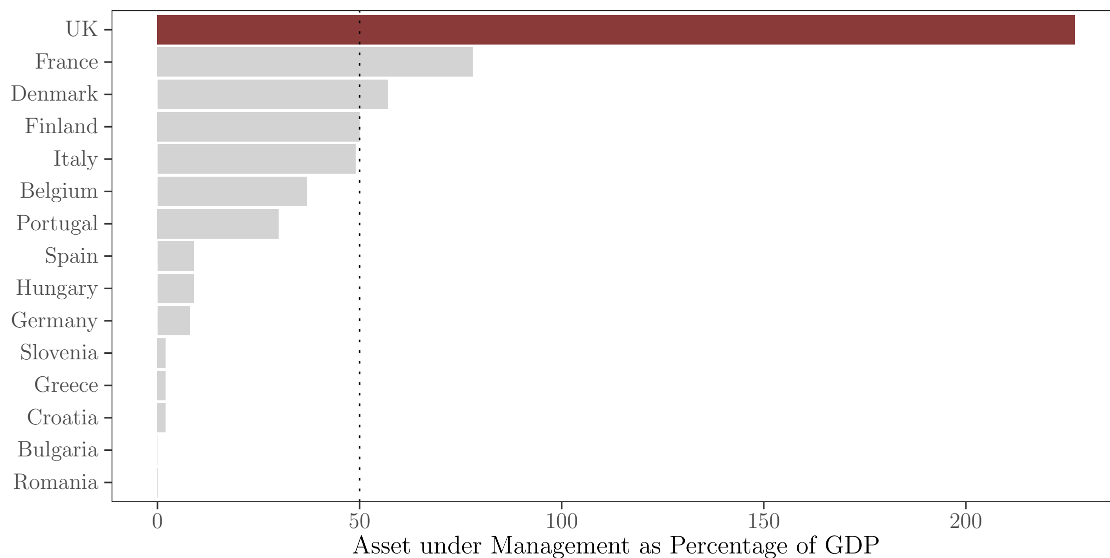

Figure 6.1: Size of investment firm sectors in 2017 measured in terms of asset under management as percentage of GDP (Data: EFAMA).

Investment firms are often equated with investment fund managers but there are important distinctions between these two types of asset management. While both investment firms and investment fund managers invest the capital of their clients, investment funds (e.g. hedge funds or private equity funds) tend to be offered to a larger client pool (both retail clients and institutional investors) and tend to follow a predefined investment strategy. Investment firms, in contrast, tend to be tailor-made

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to the needs of specific clients. Such a 'discretionary mandate' reduces the client pool mainly to institutional investors (e.g. pension funds and insurance companies) given the costs involved (EFAMA, 2014, 2019). The reasons for the dominant role of the UK is partly due to the higher specialization and professionalization needs for investment firm and their discretionary mandates and that expertise tends be clustered in the City of London.

Interestingly, the UK dominates in no other type of institutional investment as clearly as is does for investment firms. While I have so far excluded the UK from the empirical analysis in the previous chapter, Tables C.1 to C.3 in Appendix C shows the position of the UK over time for investment funds, insurance companies as well as pension funds. The striking finding from these tables is that even if we exclude outliers like Luxembourg and Ireland, due to their favorable tax regimes, at least one other EU member state still exceeds the UK in terms of market size relative to GDP for all three main types of institutional investment. This difference between the three main types of institutional investment and the investment firm sector warrants a closer look at the role of the UK for the successful reform of investment firm supervision in the CMU.

A similar picture emerges for financial infrastructures where the United Kingdom dominates the market for central counterparties. Since the financial crisis, central counterparties (or CCPs) took up a central role in reducing risk in the financial system. CCPs serve as a 'middle men' between buyers and sellers to ensure the smooth operation of a financial transaction. Since CCPs place themselves between sellers and buyers of financial instruments, these two parties no longer become exposed to the risk of the other side (counterparty risk). Instead, a CCP takes up the risk and both parties only expose themselves to the risk of the CCP (Wendt, 2015). Part of the need to include CCPs to serve as a buyer to every seller, and a seller to every buyer

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is that modern financial trading occurred increasingly outside of stock exchanges and other regulated markets and, instead, moved towards opaque over-the-counter (OTC) markets where two buyers agree on a bilateral trading. Since OTC markets are less transparent than trades on stock exchanges, the two parties in a financial transaction can find it hard to realistically evaluate the risk of the other side which, in turn, can negatively affect confidence among market participants. CCPs standardize the interaction between two counterparties, bundle risk in a single institution and reduce overall risk exposure (Armakolla & Bianchi, 2017; Braithwaite & Murphy, 2016). Thus, CCPs are nothing less than a protective shield against system risk since counterparty default could potentially lead to contagion and turn into systemic risk for the European and global financial system.

A CCP covers for the default risk of counterparties through a three-layered process ("default waterfall") based on initial margins, a default fund, and their own funding ('skin-in-the-game'). The initial margin is the collateral provided by the seller and buyer that use a CCP to cover for credit risk. The default fund is the contribution of all CCP members that should ensure that a CCP can cover for credit risk even if the initial margins are insufficient and lastly, a CCP also has its own funding that can be used if all other funds remain insufficient (Alfranseder, Fiedor, Lapschies, Orszaghova, & Sobolewski, 2018; Braithwaite & Murphy, 2016; Domanski, Gambacorta, & Picillo, 2015).

UK central counter-parties are the biggest CCPs in Europe, both in absolute terms and when it comes to euro-dominated clearing (Moloney, 2017). By 2015, the EU had 11 CCPs authorized out of which four are based in the UK. Most of euro-dominated clearing occurs with LCH Clearnet, a UK CCP that is owned by the London Stock exchange. The EU has no single CCP that is comparable in size and scope to LCH Clearnet. Most EU-based CCPs tend to be more constrained and limit their clearing

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to particular classes. EuroCCP, for example, only clears securities, while LCH SA France only clears euro-dominated products. Eurex Clearing is a bit more extensive in their offers but it remains much smaller than LCH Clearnet (Batsaikhan et al., 2017).

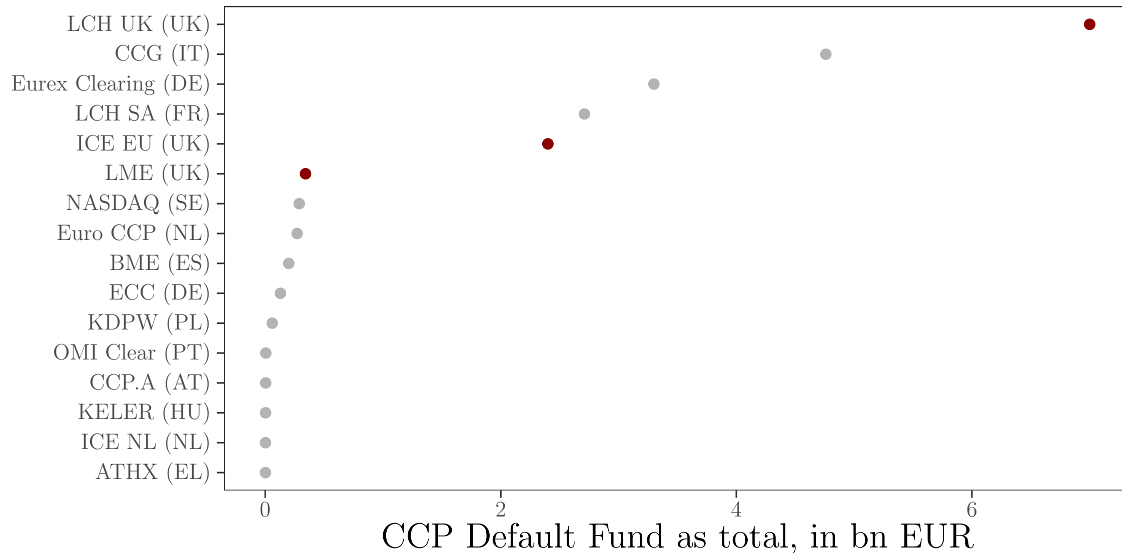

Figure 6.2: Size of CCPs operating in the EU measured in terms of the total size of a CCPs default fund in bn Euro. UK CCPs highlighted in red (Data: ESMA)

Thus, the UK dominated the EU in the two areas of the Capital Markets Union where supervisory reform succeeded. Yet, with Brexit, the UK is becoming a third-country and access to the single market becomes more restrictive. While UK finance can still operate branches in national markets (pending the approval of national competent authorities), passporting rights depend on the EU's equivalence regime to allow non-EU finance to operate branches across borders within the single market. Equivalence requires that the regulatory and supervisory framework of a third-country is 'equivalent' to that of the European Union. It does not require that laws are identical ex-ante but rather that the ex-post goal and outcome of regulations is similar. Equivalence decision are taken by the European Commission and once it perceive the supervisory standards of a third-country to be equivalent to that of the EU, foreign entities need

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to be granted the same access as EU firms (Pennesi, 2020; Moloney, 2017). Following a thorough analysis of each single entity that requests equivalence, the European Commission can unilaterally withdraw decisions ex-post if a respective third-country entity fails to comply with EU laws. This equivalence process thereby includes a power dimension, since equivalence is granted, denied, or withdrawn unilaterally by the EU (Deslandes, Dias, & Magnus, 2019).

A second access option for UK finance is via the establishment of subsidiaries in an EU member state. Such subsidiaries are relatively independent from the parent entity and fall fully under EU law. Once a subsidiary is established, the respective EU host country becomes the main supervisor and the subsidiary, in return, receives passporting rights, allowing cross-border activities across the single market. But subsidiarization comes with higher operation and management costs for the third-country entity. In a sense, Post-Brexit equivalence should dis-encourage foreign (and in particular British) access into the single market by entities that cannot be supervised by competent authorities inside the EU and encourage relocation through subsidiaries, instead. This push for subsidiarization should ensure proper financial supervision and increase the attractiveness of EU financial centers that competed so far relatively unsuccessfully with the City of London (Howarth & Quaglia, 2018).

The supervisory reform pattern for investment firms and CCPs - direct supervision of the largest intra-EU investment firms for the former and direct supervision for the largest third-country entities in the latter case - thereby seem to overlap with the most likely access path into the single market. Investment firms are indeed assumed to rely on subsidiaries, especially established in Luxembourg and Ireland, to enter the single market (Moloney, 2018b, p.82). CCPs, in contrast, will rely more extensively on the EU's equivalence regime as a mean to conduct business in the EU. The London Stock Exchange, for example, operates the largest CCP - LCH UK - and has a subsidiary in

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France (LCH SA). Yet, most reports indicate that clearing clients from LCH UK will most likely move to Eurex in Germany in the case of non-equivalence. Equivalence, rather than subsidiarization, thus provides UK CCPs a better post-Brexit option for EU market access.

The fact that direct supervision of the largest EU investment firms and third-country CCPs overlaps with the two main access options for UK finance could be seen as an indication that political choice - to control UK finance and increase the financial power of EU markets vis-a-vis the UK - matter for supervisory reform, rather than functional pressures from the industry that led to spill-over effects from previous supervisory reform episodes.

6.1.2 The Politics of Third-Country Access

Indeed, a small but growing body of political economy literature is focusing on the role of Brexit and the political effect on third-country access. Existing research thereby takes mainly a state-centric perspective that perceives the developments after Brexit as a consequence of battles of (financial) systems among the EU27. As such, these explanations are variants of intergovernmental explanations (see chapter 3). Most of these explanations thereby focus on the EU's equivalence regime as the main point of access for third-country finance.

The politics of third-country access has been a political battle ground for decades and pitched between member states with a more liberal approach to market access against more protectionist states. As Howarth and Quaglia (2017) argued, the EU is traditionally exposed to two different ideological coalitions. The first group of countries, that include the United Kingdom, Ireland, Luxembourg, Sweden, and the Netherlands, insist on the equivalence as a market-making mechanism. These countries have highly developed and internationally competitive capital markets. For member states

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that favor market-making, equivalence provisions should be a tool to ease market access and regulatory burdens and thereby increase the attractiveness of the EU for global finance. Since the UK is the main access point to the single market, a more lenient equivalence disproportionally benefitted the City of London. The second group of (continental) countries, including France, Italy, and Germany, insist on the equivalence as a market-shaping mechanism. For market-shaping proponents, equivalence is a mean against the import of instability from third countries by strengthening prudential regulation and oversight rather than liberalizing market access.

The pre-crisis period was very much dominated by the liberal, market-making coalition and the role of equivalence was to strengthen financial liberalization and ensure that third-countries provide the same levels of liberalization (and investor protection) to EU clients (Pennesi, 2020; Wymeersch, 2018; Howarth & Quaglia, 2017). Broader financial stability concerns that would require stricter supervisory standards took a secondary role and merely resulting in a push for multilateralism and compliance with international standards (Quaglia, 2015). The United Kingdom played a decisive role in shaping European financial legislation during that time. It was the market-making influence of the UK that pushed the EU towards for a more industry-friendly approach, both in terms of the pre-crisis legislative set-up of the single market, as well as the EU's relationship with third countries (Howarth & Quaglia, 2017).

After the financial crisis, the market-shaping logic gained traction, started to dominate EU financial legislation (see also Chapter 2) and began to extend a more restrictive stance to the EU's relationship with third-countries in equivalence provisions. European financial legislation became more focused on financial stability with the UK becoming a "foot-dragger', fearing economic inefficiencies, competitive losses, and a reduced attractiveness of European financial centers in global comparison (Howarth & Quaglia, 2017; Quaglia, 2015). With Brexit, the market-shaping logic that started

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to shape post-crisis regulatory and supervisory integration fully dominates the EU. As such, one could argue that supervisory reform for investment funds and CCPs is merely a sign of this shifting ideological landscape within the European Union since restrictive supervision was traditionally associated with the market-shaping logic.

Moreover, not only member states but also financial centers are seen as a driver behind the regulatory set-up after Brexit and thus CMU supervisory reform post-2016 (Lavery, McDaniel, & Schmid, 2019). Howarth and Quaglia (2018), for example, argued that the regulatory consequences of Brexit is based on an increased competition between the main remaining financial markets inside the EU to gain attraction for UK business to relocate in order to gain single market access. In the case of CCPs, this push is based on a long standing conflict regarding the location of clearing outside the Euro area. In the past, the UK successfully repelled a first attempt by the European Commission to relocate these euro-dominated CCPs into the Euro area. After the Brexit vote, renewed pressures from member states with large financial centers that would benefit from stricter supervisory rule for 3rd country CCPs, in particular Germany and France, resurged the question of 'location policy' and, arguably, pushed for stricter equivalence provisions in order to force the relocation of third-country entities to Frankfurt and Paris (James & Quaglia, 2021).

As a consequence of this intergovernmental argument, little agency is given to the financial industry. If an industry perspective is taken then as a case to show how transnational industry associations have lost their structural power as a consequence of Brexit and therefore cannot account for the regulatory outcome after Brexit. Transnational industry organizations are often seen as being unsuccessful but the focus is mainly placed on the lack of success of UK finance (see Kalaitzake (2021) for a different interpretation). This literature assumes that transnationally-organized industry interests should be unitary and in line with integration demands. As such,

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transnational industry associations are driven by the largest industries, that is, UK, French and German finance, in support of open markets access and competitions (Howarth & Quaglia, 2018). Moreover, in the case of Brexit, the UK industry was expected to convince other associations of its position and lobby for a soft Brexit. Yet Howarth and Quaglia (2018) found that no unity within UK finance existed and even those parts of finance that opposed Brexit were ultimately looking for alternative routes to enter the EU market which increased competitive pressures in Germany and France to limit third-country access (ibid, p.1123-1124). National industry associations failed to create an alliance between finance in the EU27 and the UK and focused on domestic state preferences instead (ibid, 1128). I argue that the main issue with such a perspective is that no independent role is given to organized finance within the EU27 which might indeed act against the interests of UK finance in order to 'fortress on markets'.

Given the political salience of Brexit, member state preferences clearly matter for understanding EU policies after 2016. Yet, ignoring the role of transnationally-organized non-bank finance merely because UK finance failed to influence the outcome of Brexit, seems to underdetermine the role of European financial interests ex the UK industry. Based on my theoretical framework, I offer an alternative explanation to the existing literature that can complement the state-centric approach and provide a more encompassing picture of supranational reform in the context of Brexit.

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6.2 Status Quo Bias Through Reform

Following the main argument of this thesis, supervisory reform - even in the context of Brexit - emphasizes the central role of supranational institutions, that is, the European Commission in particular, and (transnationally) organized financial interests that target the supranational level directly. I argued that a shared urgency for reform, based on functional pressures among both the European Commission and non-bank finance, is a necessary condition for the delegation of supervisory authority to the EU level. If both of these central actors perceive functional dissonances in the existing level of integration, a Commission-industry alliance will enable progress and create spill-over effects in terms of supranational supervision.

Importantly, the sources of functional dissonances do not have to be identical for the European Commission and the industry. Indeed, as I theorized before, in the case of the European Commission, functional dissonances emerge from the financial trilemma which states that in the context of increasing financial integration, national control needs to be delegated in order to sustain financial stability. In the case of the non-bank finance, in contrast, functional dissonances emerge from the level of internationalization and/or foreign penetration. The status quo bias for the main types of institutional investment is therefore a consequence of a lack of Commission-industry alliance due to a mismatch in the functional pressures among the European Commission and non-bank finance. In the case of investment fund managers, insurance companies and pension funds, the lack of functional pressures was linked to low levels of internationalization, or higher levels of foreign penetration, that encourages the status quo as a mean to fortress on markets.

If my general argument holds, we should see some variant of this argument in the case of investment firms and CCPs. From the perspective of the European Commission,

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functional dissonances should derive from the link between financial stability and financial integration. Since the largest, systemically relevant investment firms and CCPs are indeed from the UK, the consequence of Brexit in terms of market access for third-country entities, led to functional dissonances to push the European Commission towards reform. In the case of the investment firm and CCP industries, functional dissonances should be based on the level of internationalization. The issue in case of investment firms and CCPs is that supervision has been partially delegated and direct supervision, arguably, affected predominantly UK investment firms and CCPs. As such, these two cases of supranational supervision with the CMU led to little supervisory change within the EU27 and therefore seem to display a status quo bias through reform. Following my argument, we should see limited internationalization and higher levels of foreign penetration in the EU27 for both investment firms and CCPs.

6.2.1 Supervisory Reform for Investment Firms

Looking at the case of investment firms, we can see that the European Commission has emphasized the importance to ensure financial stability in the investment firm sector as a consequence of Brexit. Investment firms were exposed to a distinct legislative framework, compared to investment fund management companies. While the latter are regulated and supervised as collective asset management and fall under UCITS and AIFMD, investment firms are regulated as individual asset management and exposed to a different regulatory regime (Jutzi & Feuz, 2016, p.15). Investment firms became strongly regulated after the financial crisis through the Market in Financial Instruments Directive and the Markets in Financial Instruments Regulation (MIFID II/MiFIR). In 2015, around 6000 investment firms were authorized under MiFID II/MiFIR which also provided a passporting regime for these firms (Pafili,

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2019; Lannoo, 2018). Under this directive, investment firms are further subject to the prudential rules of the single banking rulebook, that is, the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) (Kelly, 2019). Moreover the CRD IV/CRR framework distinguished investment firms into 11 categories based on their service provision, complexity, and systemic relevance. Depending on the category, some investment firms then had to comply fully with CRD IV/CRR provisions, while others received lower prudential requirements (Pafili, 2019). Nonetheless, the regulatory framework was developed for credit institutions and thus displays a misfit for the majority of investment firms that follow a different business model than banks. While some large investment firms can share similar risk profile as banks and are central nodes in the financial system, most investment firms show minimal interconnectedness to other financial institutions, have no central role in the financial system and can easily be replaced by other firms. The moral hazard considerations that underlie the single banking rule book does therefore not apply to this large group of small, less interconnected investment firms (Ross, 2019).

After the Brexit vote, the European Commission proposed amendments to MiFID II / MiFIR in order to account for systemically-relevant investment firms. The result was the Investment Fund Directive and Regulation (IFD/IFR) that places more emphasis on stability than liberal market access. The aim was to deregulate and increase the competitiveness of smaller investment firms, while treating large, systemically relevant investment firms as credit institutions under the same prudential framework as banks (Pafili, 2019). The IFR/IFD reduces the existing complexity and creates a single rulebook for investment firms by establishing a 3-tiered regime in which the most important investment firms that are systemically relevant are now defined as credit institutions (i.e banks) and thereby fall fully under the CRD IV/CRR, including direct supervision by the ECB (Ross, 2019; Lannoo, 2018; Moloney, 2018a). As such, the IFD/IFR legislative package creates a single rulebook for investment firms based

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on their risk profile and systemic relevance. Direct ECB supervision for the largest firms is coupled with national supervision for the remaining investment funds. The advantage of this set up is that the IFR/IFR package "could restore a competitive environment for non-bank investment firms, certainly in the EU-27, where it will be needed following the departure of the most developed capital market in the EU" (Lannoo, 2018, p.3).

In contrast to the main types of institutional investors, the European Commission succeeded with their supervisory proposal for investment firms and the ECB received direct supervisory authority over the largest investment firms in the EU. Following the logic of the Banking Union, the IFD/IFR established a clear framework based on a single rulebook and strengthened supervision within the ECB (Moloney, 2018a). Yet this framework affects only the largest investment firms that are predominantly based in the UK, while IFD/IFR sustains the status quo bias for most investment firms in the EU27. Based on my expectations, this lack of progress for the EU27 should be visible in the level of internationalization and foreign penetration.

Figure 6.3 follows the same logic as in Chapter 5 and shows a heat map of national markets in terms of the percentage of domestic firms' with a presence in other EU member states and the percentage of foreign investment firms of the total number of investment firms in the domestic market. Investment firms are, on average, relatively nationally oriented. Most clustering occurs below 25% of internationalization. Yet, while most national markets cluster at lower levels on both axes, we do see some higher levels of internationalization, compared to previous analyses on investment funds, insurance companies, and pension funds. Two national investment firm markets occur at around 25% which indicates some internationalization in those countries.

Thus, in the first case of partially successful supervisory reform in the CMU, we can observe somewhat higher levels of internationalization compared to the results from

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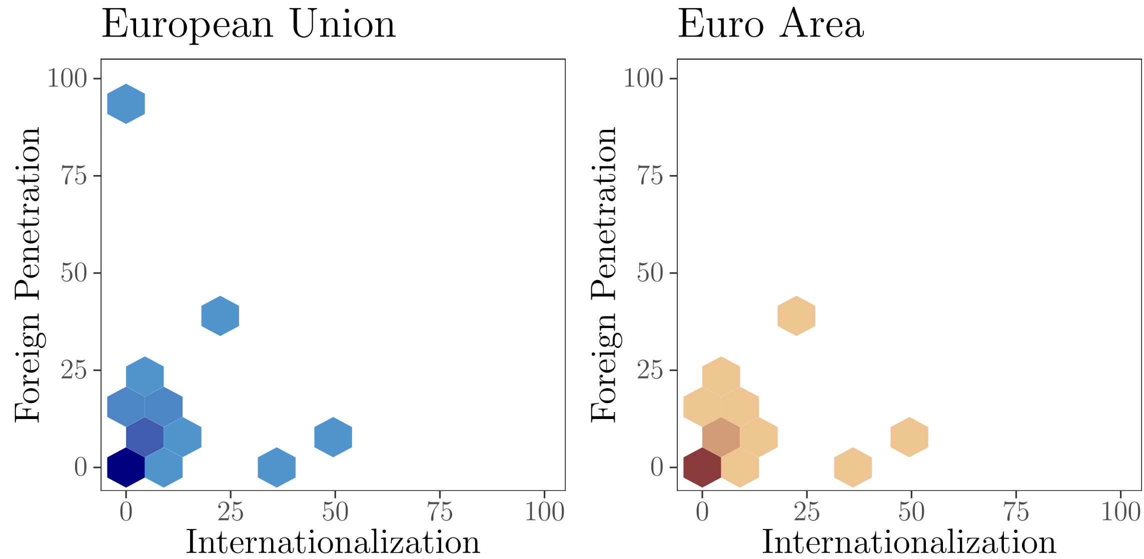

Figure 6.3: Heat Map of National Investment Firm Markets in the EU27 and the Euro area (Author's calculation, see appendix B.2

the previous chapter. Ultimately, these higher levels are linked to only two national markets and thus a closer look at them is warranted. Figure 6.4 maps these values across the EU for internationalization and foreign penetration separately, following the same approach as in the last chapter.

We can see that these higher levels of internationalization are linked to Luxembourg and Slovakia. Arguably, in the case of Slovakia, this is linked to the local proximity with the Czech Republic which shows high foreign penetration - especially since both countries only have a small number of investment firms which skews these percentage values. Luxembourg, in contrast, is a central country for investment firms due to its tax laws. In most other national markets, including Germany and France, less than 10 % of all national investment firms have expanded outwards. Moreover, in various core member states, foreign penetration is relatively high compared to the level of outward expansion. Based on the ESMA register, almost 20 % of all investment firms in France are foreign branches. Other countries with higher levels of foreign penetration relative to outward internationalization include Italy, Portugal, Spain, and Sweden.

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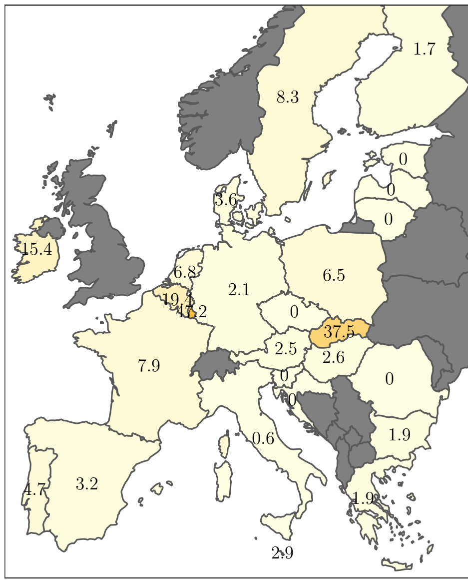
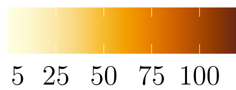
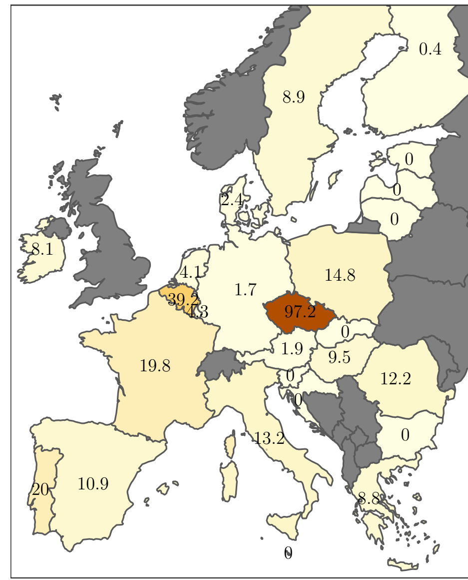
Outward Expansion





Foreign Penetration



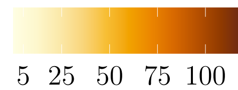


Figure 6.4: Domestic expansion and foreign penetration in national investment firm markets in the EU (Author's calculations).

With Brexit, most UK investment firms will set up subsidiaries in Luxembourg which will skew this pattern of foreign penetration even further in the other EU member states. Thus, it seems plausible that EU investment firms supported a reformed supervisory regime that targets mainly UK investment firms while keeping smaller entities under national control. By delegating the supervisory authority to only the largest investment firms, i.e. mainly UK firms, these actors can benefit for a single supervisor while reducing supervisory burdens on smaller investment firms allows less internationalized national markets in the EU27 to enjoy the potential benefits of national supervisory dominance, especially against new market competition from relocating UK investment firms.

Thus, even in the case of partially successful supervisory reform in the CMU, the overall argument should still hold. When the average level of internationalization

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in an industry is lower than the level of foreign penetration, the advantage of national control still outperforms the advantages of supranational supervision in terms of competition and supervisory forbearance. Without Brexit, this should have led to the absence of functional dissonances. Yet due to this exogenous shock, a Commission-industry alliance should have enabled supervisory reform as long as the status quo is remained for the EU27 overall. In other words, in the case of investment firms, we could have seen a status quo bias through reform.

6.2.2 Supervisory Reform for Third-Country CCPs

Looking at the case of supervisory reform for CCPs and the delegation of direct ESMA supervision for third-country CCPs, the literature tends to emphasize 'location politics' as a central driving force behind reform that should encourage the location of UK business into the EU, rather than relying on the EU's equivalence regime. Yet, as Kalaitzake (2021) has argued, the Commission prepared contingency plans for UK CCPs' market access in the case of a hard Brexit based on a more lenient equivalence position. This should ensure UK access to the single market and mirrors the traditional market-making logic rather than the principle of market-shaping that is claimed to dominate according the intergovernmental explanation.

This decision to provide uninterrupted market access to UK CCPs for up to a year after Brexit is at odds with the location policy argument. Of course, this limited time period can also be interpreted as an incentive to use this time to relocate into the EU but there are signs that the European Commission is willing to extent this period (McGuinness, 2021). In any case, the purely state-centric perspective cannot fully account for this. An alternative reading would argue that this location policies stance by the Commission followed financial stability concerns rather than competition pressures that dominate among member states. As such, Brexit, as an exogenous shock,

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created functional pressures for the European Commission to revaluate the role of CCPs to safeguard the overall stability of EU finance since equivalence provisions are likely to be granted.

As mentioned earlier, CCPs standardize and centralize the trading between market participants by pooling all risks into one institution that is backed by a default fund. While this structure allows CCPs to become a crucial node in the prudential architecture of post-crisis finance, this interconnected set-up, at the same time, increases the systemic risk threats of CCPs. Thus, CCPs became heavily regulated after the crisis to ensure sound supervision and their internal resilience against external shocks (Braithwaite & Murphy, 2016). The 2012 European Market Infrastructure Regulation (EMIR) was the first regulation that tackled CCPs and regulated their prudential architecture. Ultimately, EMIR institutionalized the use of CCPs by requiring that most bilateral trading transactions in OTC markets need to be cleared centrally by CCPs (Braithwaite & Murphy, 2016). EMIR also regulated the default waterfall of CCPs as a three layered defense mechanism against counterparty default risks based on initial margins, a default fund and CCPs own capital ('skin-in-the-game') as well as the sequence by which each of these three items needs to be utilized in case of the default of a clearing member (Domanski et al., 2015; Alfranseder et al., 2018). In such a scenario, EMIR requires CCPs to first use 'initial margins' to cover for any losses to the non-defaulting side. 'Initial margin' are cash or securities collateral provided by CCP members to the CCP to cover for counterparty credit risk. If these 'initial margins' by the two counterparties do not suffice, CCPs need to tap their 'default funds' which are based on the contribution of all clearing members of a CCP and not only the two parties in a given financial transaction. Lastly, if neither of these two pools suffice to cover for losses, CCPs need to utilize their own fundings - their 'skin-in-the-game' (Braithwaite & Murphy, 2016; Alfranseder et al., 2018). EMIR further requires that the default fund and CCPs own skin-in-the-game need to be sufficiently

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large to cover for the default of two clearing members with the highest CCP exposure "under extreme but plausible conditions" (Priem & Girard, 2019, p.10).

In terms of supervision, EMIR follows the same structure as the legislative framework of institutional investors (last chapter). While supervisory colleges exist for the cross-border activities of CCPs, supervision ultimately remains dominated by national competent authorities and EMIR advises ESMA as the main standard setter and supranational coordination body to "assess the resilience of CCPs to adverse market developments, [...] identify any potential shortcomings in the CCPs' resilience, [and] [...] issue recommendations as appropriate" (ESMA, 2018, p.9). EMIR was amended after the vote of the UK to leave the European Union by two regulations (EMIR REFIT and EMIR 2.2). While EMIR Refit streamlines the regulatory framework and removes some red tapes to the operation of CCPs, EMIR 2.2 was true transformative regulation since it provides ESMA direct supervisory powers for systemically relevant, third-country CCPs through the creation of a new regulatory arm, similarly to the added regulatory arm in the ECB for direct bank supervision.

Yet, while the Commission is driven by stability concerns, I argued that this in itself should not be sufficient to account for supervisory reform. Transnationally-organized industry associations need to share the functional need for reform to enable spillover effects. These pressures, I argue, derive from the level of internationalization. Since reform only targeted third-country CCPs, rather than EU CCPs, we should see overall low levels of internationalization that justify a fortressing on markets to keep the negative competitive consequence of Brexit at bay.

Indeed, the European Commission, in their consultation paper on the Operations of ESAs in 2016, explicitly targeted supervisory reform for CCPs from both the EU and the UK. As the Commission stated:

> Given the cross-border nature of their activities and their systemic importance [..], consideration could be given on how to strengthen their collective supervi-

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sion through a transfer of appropriate powers to the pan-European level, also consistent with the ideas set out in the De Larosiere report. In this respect it should also be taken into account that currently CCPs established in the United Kingdom have a large share of the EU clearing market and therefore an important part of the supervisory capacity of that market is in the United Kingdom (Commission, 2017b)

Given my argument, the ultimate result of partial reform should be linked to a lack of Commission-industry alliance based on their level of internationalization and foreign penetration. Yet, due to the very concentrated CCP market in the EU and the structure of CCPs as a financial infrastructure, data on CCPs is harder to compile and we cannot rely on our usual measurement of internationalization and foreign penetration based on ESA registers. Instead, I rely on data collected by the Viennese Stock Exchange on the CCP links to European stock exchanges and multilateral trading facility (MTF) as the two main venues for CCPs to operate(Wiener Börse, 2018, p.9). Based on this, Figure 6.5 shows the various links between CCP (left) and their operative locations (right).

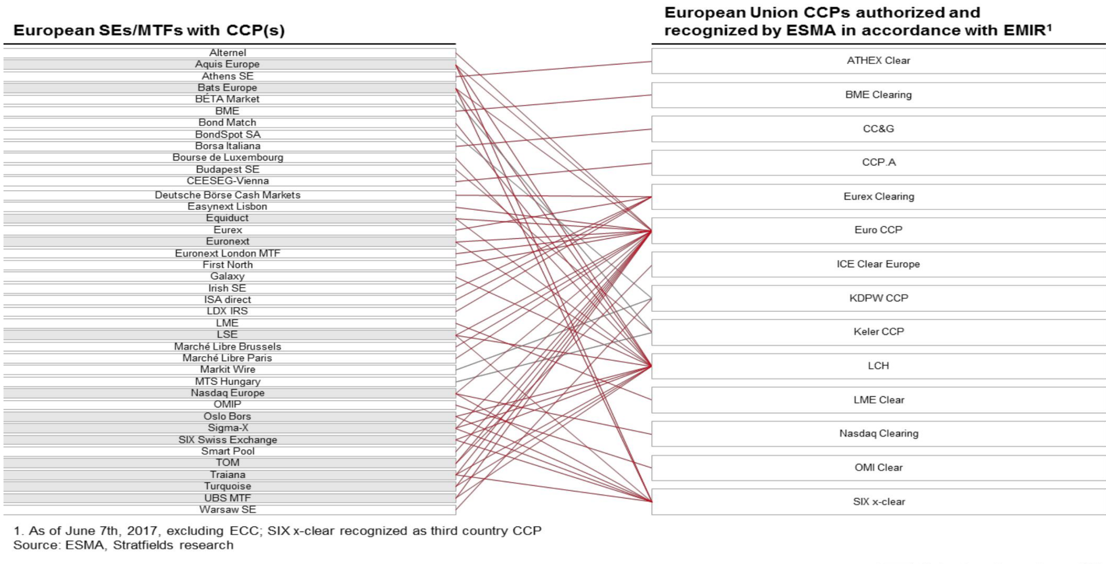

Figure 6.5: CCP links to Stock Exchanges and MTFs (Source: Wiener Boerse)

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A few interesting patterns can be observed. First, few CCPs have links to multiple stock exchanges and trading facilities with the majority of CCPs being linked to its domestic location only. Second, among those CCPs with several operative locations, the UK-registered LCH as well as the Dutch-registered EuroCPP clearly dominate. Yet, as we have seen before, in terms of default fund size, EuroCCP is rather small. Thus, financial stability concerns in the context of Brexit are indeed mainly linked to LCH as a third-country CCP.

As a caveat, Figure 6.5 includes both EU CCPs as well as third-country CCPs from the UK and beyond and the actual level of domestic and foreign operative locations of these CCPs is hard to distinguish. Figure 6.6 relies on the same data but tries to separate domestic and foreign location *within the EU27* based on a CCPs country of registration as a proxy for the level of internationalization. In other words, I excluded links to UK stock exchanges and MTFs as well as other third-country locations from Figure 6.5. This should allow for some insight into the level of intra-EU internationalization and the consequence of competitive pressures as a result of Brexit.

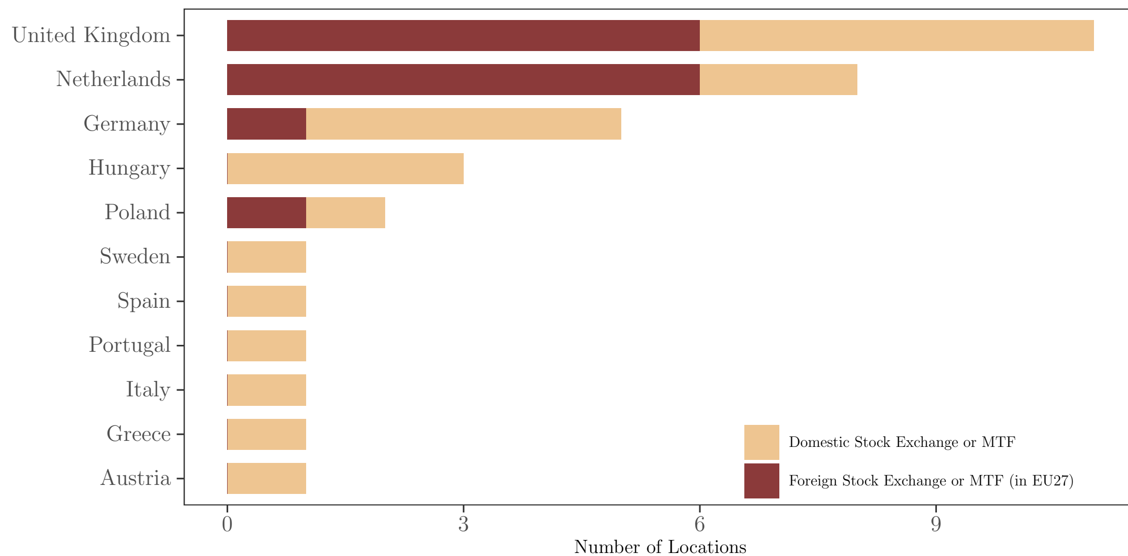

Figure 6.6: Internationalization of CCP based on the number of domestic and foreign operative locations in the EU27

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First, as we could already see from the previous figure, UK CCPs have the largest number of operative location, followed by the Netherlands where EuroCCP is registered. Second, in terms of foreign locations, the majority of CCPs remain domestically rooted. Thirdly, among those EU CCPs with foreign locations - the Netherlands, Germany, and Poland, only the German CCP, Eurex Clearing, is somewhat larger in size yet still not comparable to the UK. Thus, the delegation of direct supervisory powers for third-country CCPs to ESMA targets the UK and allows the remaining CCPs to counter their market dominance via the potential benefits of national supervisory forbearance.

The public consultation response to the European Commission's proposal for CCP supervision by EACH, the European Association of CCP Clearing Houses, seems to confirm this (Commission, 2017c):

> Based on the experience of EACH members, we do not have any reason to believe that the current system of supervision set out under EMIR is fundamentally flawed. [...] The potential benefits of providing ESMA with direct supervisory powers over CCPs, either full or partial, are unclear to us, and some form of local supervision or intervention of local authorities would in any case likely remain necessary. [...] While all CCPs have in common the goal of providing safer and more efficient financial markets through the provision of CCP clearing services, European CCPs offer different products and serve a different client structures. Local supervisors are best placed to understand business models of CCPs in their jurisdictions which have a basis in a local business and regulatory environment. EACH members believe that it would be very challenging for a single CCP supervisory structure at EU level to represent all the different interests of CCP stakeholders the way colleges currently do. We therefore agree that a combination of national competent authorities and colleges is the most appropriate supervisory structure for CCPs in the EU.

The quote clearly shows a lack of industry support for supranational reform in the EU27. As such, it seems likely that the partially successful case of supervisory reform for third-country CCPs was the consequence of intergovernmental bargainings, while the lack of reform for the remaining EU CCPs can be linked to a lack of industry support. Just like for investment firms, the result is a status quo bias through reform.

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6.3 Summary and Discussion

The Capital Markets Union has overall lacked supervisory reform and the delegation of monitoring authority to the EU level. As the last chapter has shown, despite proposals by the European Commission for supranational supervision, investment funds managers, insurance companies and pension funds failed to share the urgency for reform. As such, functional dissonances were only expressed by supranational institutions, not transnational and national industry associations, which made any transnational Commission-industry alliance unlikely to emerge. Instead, the CMU showed a status quo bias for these main types of institutional investors which, as I argued, can be linked to low levels of internationalization and/or high foreign penetration. Sustaining the status quo thereby enables non-bank finance to fortress on markets since a reliance on national supervisory forbearance remained more attractive than supervisory centralization.

Yet for two subsegments of non-bank finance, supervisory reform occurred. In the case of investment firms, the IFR/IFD separates the largest, systemically relevant investment firms and redefines them as credit institutions which places them under direct ECB supervision (inside the Euro Area). EMIR 2.2 delegates direct supervisory authority to ESMA in the case of third-country CCPs. Given that both reforms occurred after the vote of the United Kingdom to leave the European Union, one could conclude that instead of functional dissonances, Brexit, as an exogenous shock, led to intergovernmental reaction that enabled supervisory reform as a mean to restrict the UK access and encourage the relocation of UK firms into the EU. Given the EU legislative process, member states preferences obviously matter but such an intergovernmental perspective seems in itself insufficient to fully explain the outcome of interest.

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I argued in this chapter that a neofunctional focus can offer an alternative view on this pattern of supervisory reform. The level of internationalization and foreign penetration, conditional on Brexit, should thereby account for the partial delegation of supervision to the EU level. Brexit as an exogenous shock did not remove the functional pressures among non-bank finance that derived from internationalization and foreign penetration. Instead, the exit of the UK amplified these pressures towards supervisory reform as a mean to sustain the status quo bias inside the EU27, while taming the potential competitive pressures form the UK as a third-country

Ultimately, functional pressures - whether they derive from previous integration steps or due to an exogenous shock - can provide one explanation for supervisory reform or a lack thereof. In the case of supranational institutions such pressures derive from the financial trilemma, while the industry is claimed to be influenced by varied levels of outward expansion and foreign penetration. Ultimately, a shared interest for supervisory reform by supranational institutions and the financial industry seems to be necessary condition for reform - be it to sustain the status quo or for spill-over effects. Future research should take this insight as a starting point and test it in future cases of successful spill-over effects. Moreover, a closer look at the interaction between non-bank finance and the European institutions throughout the ordinary legislative procedure is warranted to fully uncover the mechanisms of functional pressures towards supervisory reform.

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7 Conclusion

This research focused on the question of financial supervision within the broader structure of European non-bank finance. European institutional investors, in particular, are still less interconnected across borders than often assumed. While it has been widely acknowledged that 'internationalization' is one of the main driving forces behind the support or resistance towards supranational supervision, this project made a more detailed theoretical argument about the direction of internationalization in order to determine industry preferences towards the delegation of supervisory authority to the EU level.

The main argument in this thesis is that supervisory preferences of non-bank finance - that is, institutional investors and market infrastructures - play an important role to understand the outcome of supervisory reform in the CMU. These preferences, in turn, are determined by the level and direction of internationalization. Depending on the relation between the level of outward internationalization to foreign markets and the level of foreign penetration into domestic markets, non-bank finance either pushes for supranational supervision or advocates for the status quo (i.e. national dominance within the European System of Financial Supervision). Low levels of outward internationalization, or higher levels of inward internationalization (foreign penetration) relative to outward internationalization, seem to be linked with resistance towards supranational supervision. Thus, the dominance of foreign branches in domestic mar-

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kets, controlled mainly by foreign supervisors (even in the context of the ESFS or supervisory colleges), seems to reduce the preference for a common supervisor. This research argued that such 'fortressing' on national markets provides one explanation for the resistance of supranational supervision.

The concluding chapter will start with a summary of the main argument and findings, outline the contribution, point at existing limitations and potential future research. The chapter will then engage with two open questions regarding the political legitimacy of the post-crisis trend towards increasing supranationalism and the limits of supranational policies in the absence of broad national consensus. The conclusion ends with an outlook on the road ahead: the importance of a Capital Markets Union for Europe's post-pandemic recovery and the transformative effects of climate change.

7.1 Argument and Findings

The financial crisis of 2008/09 became a critical juncture for the logic of financial supervision in the EU and the main regulatory focus after the crisis moved from financial liberalization to financial stability based on strict prudential requirements and a more restrictive approach towards supervision. The peak of post-crisis supervisory integration was reached with the establishment of the European Banking Union (EBU) that equipped the European Central Bank with direct supervisory authority for the largest credit institutions in the Euro area based on a single banking rulebook. The EBU represents a move to quasi-centralized supervision and a significant leap in supervisory integration. Yet, while the EBU further strengthened the resilience of EU financial systems, the post-crisis period continued to experienced sluggish economic growth.

The central goal of the CMU was to increase economic growth in the EU by reducing

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Europe's bank dependency and strengthening alternative, non-bank funding channels for the real economy. Non-bank finance in the EU remained nationally fragmented and a CMU was therefore first and foremost an integration project for institutional investment. But strengthening the cross-border integration of institutional investment should come with supranational supervision in order to minimize negative externalities and potential financial risk implications in a Capital Markets Union. Despite various proposals and ideas to strengthen direct supervisory powers at the EU level, overall supervision in the CMU sustained the status quo for investment funds, pension funds and insurance companies, while the partial delegation of supervisory authority succeeded for investment firms and central counterparties. Yet, even in these latter cases, the effect of supervisory reform overall lead to marginal changes within the EU27. The main goal of this dissertation was to understand what drives this status quo bias in supervisory reform within the Capital Markets Union?

While the post-crisis literature tends to overemphasize intergovernmental accounts that advocate for a state-centric perspective on integration, the European Commission was the driving force behind proposals for a CMU and repeatedly highlighted the close connection between the Banking Union and a Capital Markets Union. I therefore argued that neofunctionalism can offer a unique insight into my central research question. Neofunctionalism is based on the primacy of supranational institutions and transnationally-organized private interests (e.g. European industry associations) over states. These actors are assumed to move the integration process forward by uncovering unintended consequences from previous integration processes (functional dissonances) that require further integration progress (spill-overs).

While most neofunctional accounts emphasize the importance of spill-overs, neofunctionalism can also account for the lack of progress (i.e. status quo bias). Successful spill-over episodes in the CMU should require that both the European Commission

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and non-bank finance perceives a functional dissonance in the current system of EU supervision - especially after the Banking Union - that requires the further delegation of supervisory authority to the EU level. If one of these central actors fails to share the urgency for reform, we should observe a status quo bias rather than the delegation of further powers to the EU level.

For the European Commission, the functional dissonances that emerge can be conceptualized through the financial trilemma. The trilemma states that it is not possible to have financial stability, financial integration and national supervision at the same time, one has to go. Since the central goal of the CMU, for the Commission, was deepened financial integration, the only way not to jeopardize financial stability in the long run, is to give up national supervision. For non-bank finance, functional dissonances should emerge from the level and direction of internationalization. The general pattern of outward internationalization and foreign penetration should thereby shape industry preferences and determine the presence or absence of a Commission-industry alliance in favor of supranational supervision.

Overall, low levels of outward internationalization should create a preference in favor of the status quo based on national supervision to support nascent levels of internationalization and tame competitive pressures from foreign entries. This should produce a mismatch with the functional dissonances uncovered by the European Commission and sustain the status quo bias. But high levels of internationalization should not suffice to push for reform. If the level of foreign penetration remains higher than the level of internationalization, the status quo should be preferred as a mean to tame competitive pressures from foreign entries. In all other cases, supranational supervision, with its focus on competition and market access, should be perceived more beneficial than national forbearance. Figure 7.1 summarizes the main findings for national non-bank finance in the EU27 and the Euro Area.

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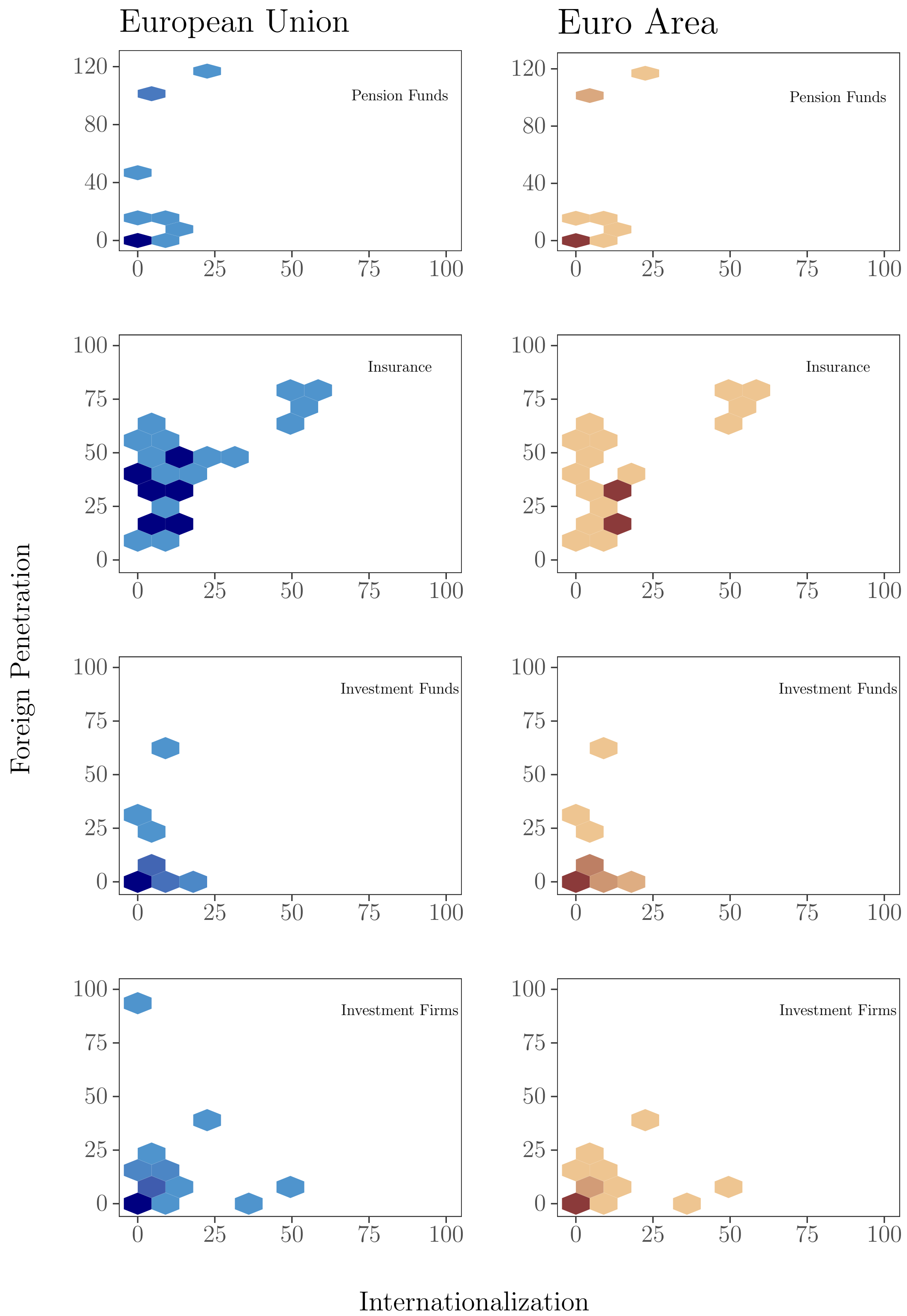

Figure 7.1: Overview of Results

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Starting with occupational pension markets (first row), we can observe the lowest levels of internationalization compared to any non-bank finance type. Moreover, foreign penetration exceeds outwards internationalization in various national markets. Similar to the pension fund sector, investment fund managers show low levels of internationalization with somewhat higher levels of foreign penetration. In the case of insurance companies (second row), we see relatively high level of internationalization albeit with even higher levels of foreign penetration. Thus, fitting to my main argument, supervision was not delegated to the EU level. The picture changes slightly for investment firms (fourth row) with higher levels of internationalization compared to the level of foreign penetration. But high outward internationalization is limited to two national markets, one of which has been identified as Luxembourg, a central point for UK firms to set up subsidiarization. Most other markets cluster at low levels of internationalization.

The analysis shows that the main functionalist argument holds. Low internationalization equals limited capital mobility for domestic non-bank finance. As such, low internationalization is a necessary condition for the absence of functional dissonances. High internationalization, in contrast, does not suffice in itself to trigger functional dissonances and a push for supranational control. If foreign penetration is higher than the internationalization of domestic firms, the advantages from a supranational supervisor (e.g. focus on a level-playing field) are lower than the potential benefits from national supervision for internationally-oriented, domestic firms. Thus, with a high number of foreign competitors in domestic markets, the advantages of supervisory forbearance in national supervision are seen as an advantage and lead to the absence of functional dissonances despite high capital mobility and increasing financial integration with the CMU. Only if foreign penetration is (on average) lower than internationalization, while internationalization is high, will non-bank finance perceive a functional dissonance between national control and the increasing integration of

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financial regulation via the CMU. In the context of competitive pressures, finance is basically 'fortressing' on markets by advocating for the status quo; that is, they will discourage EU policy makers to move to supranational supervision since EU supervisors would emphasize a level-playing field and market competition to tackle economic growth - the very reason for initiating the CMU in the first place. The two successful cases of supervisory reform were thereby a consequence of Brexit that amplified functional dissonances and created a dual supervisory system in which UK entities are mainly exposed to direct supervision, while most EU firms with remain under the current system. Thus, in a sense, Brexit sustained the status quo bias through supervisory reform.

7.2 Contribution and Limitations

Despite the versatility of neofunctionalism to explain integration *processes*, most accounts of the Capital Markets Union and post-crisis supervision remain heavily state-centric. This dissertation, in contrast, relies on previous neofunctional work on the European Banking Union (Epstein, 2017), and extend it - in a slightly modified form - to the Capital Markets Union. By strengthening a neofunctional perspective, this project contributes to the political economy literature on the Capital Markets Union and offers an alternative explanation that can be tested in future research on supervisory reform. Moreover, most neofunctional explanations still tend to rely on the concept of spill-overs and successful integration. This project, in contrast, theorized lack of progress based on the status quo bias (or, in neofunctional terms, *encapsulation*) which results either in a lack of progress or in minimal reform that does not affect the overall scope and depth of current supervision in the EU. Lastly, in order to test for the lack of reform, I compiled a novel dataset on the level and direction of internationalization in non-bank finance in the EU27 based on registers by the Euro-

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pean Supervisory Authorities. This dataset has been made available in the appendix of this dissertation and can therefore be used for future research.

Notwithstanding these contributions, various limitations remain. First, the empirical analysis would benefit from a more extensive data collection process on the structure of non-bank finance in the EU27. While the public registers of the ESAs should serve as a sufficient starting point, future research would benefit strongly from more in-depth data on institutional investment. Especially ownership data in non-bank finance within the Euro area and across the European Union would increase the comparability with previous findings on the Banking Union and European financial supervision more broadly.

Second, and related to the issue of data collection, future work should focus in more detail on the mechanisms of a Commission-finance alliance in favor or against supervisory reform and the influence of transnational industry associations on the policy making process in the Capital Markets Union. While existing work already incorporated public consultations to question related to the Capital Markets Union, public consultations on the CMU continue to be published which would allow a more quantitative approach (e.g. by relying on text-as-data). Otherwise, a more qualitative approach based on interviews with the main European non-bank industry associations could provide additional insight into the status quo.

Third, this research excluded international finance from the analysis, due to the assumption that - in the context of the CMU - intra-EU27 finance remained the main target. But future research could focus more explicitly on the role of international finance in shaping the outcome of EU supervisory integration. Especially the rise of Chinese equity and debt markets after 2012-13 (De Haan et al., 2020, p.149), could, in the medium run, raise new questions about the supervision of third-country finance in the EU's equivalence regime.

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Lastly, the Capital Markets Union remains a work-in-progress which renders any finding preliminary. While this limits the generalizability of my results, it provides an opportunity for future research to engage with the findings of this dissertation in the years to come.

7.3 A Question of Legitimacy

The initial idea of the Capital Markets Union in 2015 envisioned a single capital market in the EU by 2019 but the set of policy measures that were introduced by the Juncker Commission between 2015 and 2019 ended up far from creating such a true single capital market. In terms of financial supervision, this research project provided one possible answer for this lack of progress. Still, the underlying rationale for a true Capital Markets Union did not vanish; the over-reliance on bank funding, low levels of market access for SMEs, and, ultimately, sluggish economic growth persisted. It is therefore not a surprise that the current European Commission keeps the Capital Markets Union high on the agenda. Following up on the final Report of the High Level Forum on the Capital Markets Union, a new European Commission action plan was adopted in 2020 which - yet again - advocated for the creation of a true level playing field and the delegation of direct supervisory powers.

Whenever the EU intends to establish a *true* union - be it a Fiscal Union and Banking Union (FBU) or a Capital Markets Union - the target goal is supranational centralization. Yet, any integration measure on the EU level is constrained by the treaty of the European Union that can create contestations between the desirable and the legitimate level of integration (Csaba, 2018). When the single currency was established, the regulatory architecture of the Euro area was based on three main assumptions: an independent central bank that focuses on price stability, the principle of (fiscal)

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coordination rather than supranational delegation, and the primacy of national economic and financial policy making over supranational centralization (De Haan et al., 2015, p.408). While the legal architecture of the EU remains based on intergovernmentalism, the sequence of EU crisis management increasingly shifted the momentum towards ever more supranationalism (Csaba, 2016).

The European Commission institutionalized its national reach via various fiscal measures after the financial crisis in response to a lack of fiscal discipline and rising public debt levels. But it was the ECB that transformed to a degree that was unimaginable two decades ago. On the one hand, the European Banking Union turned the ECB into the direct supervisor of the largest European banks. The Capital Markets Union extended this scope of direct supervision to investment firms. On the other hand, the transformation of the ECB moved beyond mere supervision. The ECB started to intervene directly into financial markets in order to reduce the burden of member states that struggled to enter financial markets and raise funding due to a loss of market confidence. It bought up government debt via several bond purchase programs to support Euro area members and implemented long-term refinancing operations to support European banks (Győrffy, 2018). The main controversy is thereby the ECB's position towards its narrow mandate to ensure price stability. This narrow mandate guarantees a relative high level of independence. Any action outside the mandate exposes the ECB to increasingly political decision-making and potentially decreases their political independence. Furthermore, the increasingly active role of the ECB ever since the crisis occurred outside of European Union law which poses questions about its democratic legitimacy (Csaba, 2018; Reichlin & Pill, 2016; Bellamy, 2013).

Since this project focused on financial supervision, it is worth highlighting a few issues when it comes to the ECB's role as a direct supervisor for the largest credit institutions in the EU. First, the ECB could suffer from reputational losses if they fail to maintain

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financial stability. This would not only effect the reputation as a prudential supervisor but may also create negative spill-over effects to its monetary objectives (Abrams & Taylor, 2000). Second, a potential conflict of interest could emerge between monetary responsibilities and supervisory requirements ((Masciandaro & Quintyn, 2016). Empirical evidence shows that central banks that are involved in micro-prudential supervision tend to be less inflation-averse (Chortareas, Logothetis, Magkonis, & Zekente, 2016). A case at hand is the ECB's *strategy review* from July 8, 2021 - the first strategy review since 2003 - where the ECB officially announced the adjustment of its inflation target to 2 percent with "negative and positive deviations from the target [being] equally undesirable" (ECB 2021). The previous target specified an inflation of close to but under 2 percent. Thirdly, delegating supervisory tasks to the ECB may also increase its exposure to vested interests. Given the ECB's dominant position in EU finance, it could be exposed to more political pressures and attempts to increase political control which would also diminish its monetary policy independence (Briault, 1999). Lastly, ever more tasks might be assigned to the ECB in the future that are only remotely connected to its main objective ("Christmas-tree effect") (Abrams & Taylor, 2000). This can then led to difficulties in finding the right balance between various objectives.

While both the European Commission, via fiscal surveillance measures, and the ECB, via the EBU and its monetary policy, gained unprecedented levels of powers, a fully developed, future CMU might add another entity to this list: ESMA. So far, no single capital markets supervisor emerged but calls for it are getting louder - not least due to the controversy about the increasingly active role of the ECB. Some have therefore argued that a CMU should establish centralized supervision through ESMA, the European Securities and Markets Authority (D. Busch, 2018). Centralizing capital markets supervision within ESMA can indeed be an advantage. First, it could account for the increasing integration of EU financial markets in the Capital Markets Union

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and the increasingly blurring sectoral distinction in finance. ESMA, as a single capital markets supervisor, would be more efficient in creating a level playing field, reducing supervisory transaction costs, as well as avoiding regulatory overlap and arbitrage (Alexander, 2010; Montanaro, 2016; Ringe, Morais, & Muñoz, 2019). Second, such a single CMU supervisor could take advantage of economies of scale, monitor direct interconnectedness across sectors more efficiently, and is better situated to disentangle financial ties that derives from common exposure of financial firms to the same asset classes (Taylor, 1995; Abrams & Taylor, 2000; Llewellyn, 2006). At the very least, being the sole authority responsible for the financial sector as a whole removes the possibility to ditch supervisory responsibilities, while multiple supervisors with their specialized objectives may even try to "pass the buck" to the other supervisors when it comes to the supervision of financial conglomerates or new financial products that are used across sectors (Abrams & Taylor, 2000; Čihák & Podpiera, 2006). Lastly, there is also an argument that a unified supervisor displays more regulatory flexibility, a more efficient transposition of international standards to the national setting and a higher consistency in applying these standards over time (Abrams & Taylor, 2000; Čihák & Podpiera, 2006; Arnone & Gambini, 2007).

Yet, then again, centralizing supervisory powers for non-bank finance in a single supranational entity ultimately represents a monopoly. Besides the inefficiencies that are typically associated with monopoly structures, a single supervisor can lead to bureaucratic overpower (Masciandaro & Quintyn, 2009). The current structure of sectoral supervision, based on coordination within the ESAs, allows for some degree of inter-agency competition and counters, at least to some extent, such bureaucratic overpower. A single supervisor, in contrast, prevents any competition between supervisory methods and may tend to over-regulate which could negatively affect the potential for financial innovations and risk-taking (Goodhart, 2000; De Luna Martinez & Rose, 2003). Lastly, just as in the case of the ECB, adding more powers to

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ESMA would ultimately require treaty changes in order to give ESMA - that is so far merely a regulatory agency - discretionary powers. This would not only lead to political contestation among vested interests but may also raise accountability issues (Lannoo, 2001, 2002; Montanaro, 2016). The question of political accountability and democratic legitimacy looms over any move towards more centralized supervision on the EU level.

An easier mid-term solution would be a stepwise updating of the current structure rather than sudden 'big bang' towards a single CMU supervisor. After all, any new supervisory design, especially one in which supervisory powers are centralized, would create regulatory competition between the various stakeholders, be it between supra-national agencies and national supervisors, or between member states (Ringe et al., 2019). Updating the current structure would mirror the supervisory developments in the ECB and ESMA. In both cases, direct supervisory tasks were added through the introduction of new 'regulatory arms'. Adding further regulatory arms to the ESAs would allow for a continued involvement of national competent authorities even if direct supervision would, de jure, move to the EU level.

Finally, the dominant position of the ECB in European financial markets might indicate yet another reason for a stepwise updating of the current sector structure, rather than supervisory unification within ESMA. Masciandaro (2007) shows that the historical position of central banks in financial supervision determines supervisory reforms towards a unified model. He argues that a historically strong central bank is linked to supervisory reforms that do not move towards unification. His theoretical explanation for these empirical findings are based on a power argument: If central banks were not assigned any role in the existing supervisory framework, then politicians do not want to assign them such a role in a reformed set-up either. If the central bank already had a role in supervision, than politician still do not want to assign new powers to the

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central banks due to the same reasons (moral hazard and bureaucratic overpower) but the move towards a single supervisory authority would be hard to justify given the previous strong role of the central bank in supervision and its reputational advantage compared to a newly established single supervisory authority. Hence no reform towards unification will occur. This "central bank fragmentation effect" means that "the prior choice of the policymaker regarding 'who' should be delegated supervisory policy seems to have consequences on the choice of 'how many' institutions to delegate" (Masciandaro, 2007, p.306-307). Any future CMU will therefore, most likely, be based on the current sectoral supervisory model with ever more 'regulatory arms' linked to the three ESAs.

7.4 The Limits of Supranationalism

The full reach of supranationalism was always constrained by the intergovernmental nature of the EU. Even if, as in the case of the CMU, a policy initiative comes from the supranational level, the resulting legislative proposals need to be approved by the European Council and the European Parliament. While this project focused on the role of non-bank financial market actors in shaping the policy outcome, the national level cannot be ignored. Ever more powers were delegated to the EU level since the financial crisis but never uncontested. The Capital Markets Union does not exist in a vacuum but operates within the broader financial structure of the EU and the EMU.

The EMU has received ample criticism in the past, ranging from arguments that call the entire institutional construct of the EMU a failure, to the more distributional criticism that a single currency with a single interest rate increases the disparity between northern surplus countries and southern deficit countries. Csaba (2018) reminds us that such critical perspectives are unfounded. If we acknowledge that price stability

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was - and still is - the main benchmark against which we should consider the success of the EMU, then this structure should be seen, by and large, as a successful example of supranationalism. Neither should the EMU be seen as a straight-jacket that fully ties the hand of national governments, nor did the presence of strict supranational rules and conditionalities prevent the national deviation from these rules. This indicates that the "inter-governmental nature of the EU [...] puts severe limits on any supra-national practice that would directly interfere with the economic practices of the member-states" (Csaba, 2018, p.6). In order for a supranational integration process to succeeded, national consensus and a bottom-up institutional design towards supranationalism is required in which national reforms align with supranational institutional developments (Csaba, 2018).

It remains to be seen whether a broad national consensus towards a true Capital Markets Union, based on a regulatory level playing field and centralized supervision, exists. Following the findings in this project, two diametrically opposite predictions could be made. First, a broad national consensus is possible over the medium run. The lack of supervisory reform for institutional investment was linked to low levels of outward internationalization or higher levels of foreign penetration relative to outward internationalization. In both cases, national control provides non-bank financial sectors competitive advantages (e.g. due to supervisory forbearance). But this also means that once the level of internationalization increases, the advantages of national control diminish. While no true CMU exists, financial integration did advance and various regulations have been implemented that should foster increasing internationalization in the future. Thus the current regulatory proposals have the potential to strengthen the cross-border activities of non-bank financial actors in the medium run and this will then, with some time lag, lead to functional pressures towards a true CMU which would also effect national consensus.

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Second, one could argue that a broad national consensus is unlikely over the medium run. Even if non-bank finance in the EU becomes highly internationalized in the short run, this quick outward expansion might encourage even closer state-finance ties to support non-bank financial 'national champions'. In such a case, supranational supervision, which prefers competition and consolidation over national 'champions', might continue to be seen by some EU member states as an undesirable interference for the creation of such new non-bank national financial champions. In that case, a broad consensus is unlikely to emerge.

An example for this more pessimistic view is the recent Wirecard scandal in Germany (McCrum, 2020; Storbeck, 2020, 2021b). On June 25th 2020, the German Fintech firm *Wirecard* announced their plans to file for insolvency after the company declared €1.9bn as 'missing' from their accounts. *Wirecard*, until then a 'rising star' of German finance and one of the few European examples of innovation in financial technology, entered the Frankfurt Stock Exchange (TecDAX) in 2006, generated extraordinary growth rates for years and overtook Deutsche Bank as Germany's most valuable financial services provider in mid-2018. The company specialized in payment system for online and smartphone transactions and benefited from investor expectations about the increasing relevance of cashless payment. At the end of 2018, Wirecard became listed on the German blue chip stock market (DAX), replacing Commerzbank, the second largest German universal bank, which was seen by many as the symbolic victory of Fintech over more traditional finance. Wirecard provided the electronic infrastructure for online and smartphone payment transactions, processed payments for online retailers, and, as an intermediary, covered the risk involved in return for a small service fee. Since the profitability of this fee-based business model depends decisively on the size of the customer base, Wirecard started to buy-up customer accounts from other financial institutions and aggressively expanded into various Asian countries in which cashless payments were more common than in Europe.

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Despite the occurrence of various accusations of fraudulent behavior over the years, the *Wirecard scandal* ultimately started to unfold in 2019 after the Financial Times published an article accusing the company of an accounting scam in their Asian operations. In order to sway these allegations, Wirecard decided to set-up a special audit by KPMG to double check their books, after years of accounting clearances by Ernst&Young. After months of auditing, KPMG was unable to account for the money in Wirecard's Asian operation which forced the company to announce €1.9bn as 'missing' - a third of all Wirecard assets - and additional €3bn of creditor obligations seem lost as a consequence of the scandal. While the *Wirecard scandal* is mainly about accounting fraud, obscure conducts of business and a potential money laundering scheme, it had the potential to develop broader systemic risk implications on the EU level. After the firm overtook Deutsche Bank in terms of market valuation and the accusations started to pile up, Wirecard's CEO began to initiate plans for a hostile takeover of Deutsche Bank in order to hide the missing money in the massive balance sheets of Deutsche Bank. If this plan would have indeed succeeded, the envisioned 'Wirebank' would have immediately turned into a systemically-relevant credit institutions and potentially a central node for systemic risk in the EU overall.

The aftermath of the scandal revealed that close state-finance ties seem to have played a decisive role in the scandal (O'Donnell & Kraemer, 2021). As "Europe's PayPal", the German government had a national interest in the success of Wirecard to signal and support Germany as a centre of financial innovation ("Finanzplatz Deutschland"). The German government advocated for Wirecard abroad and Chancellor Merkel, after repeated lobbying efforts by the former German Federal Minister for Economic Affairs, Karl-Theodor zu Guttenberg, referenced the company on her state visit to China in order to reduce market access and licensing burdens, at a time when accusations against Wirecard were already piling up. Moreover, the company received the status of a 'technology company' rather than a bank, which places it, to a large extent,

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outside the scope of the German Federal Financial Supervisory Authority (BaFin). Thus, it seems as if the German government protected Wirecard at all costs to reap the reputational benefits for the German financial system.

The potential to turn Wirecard into a future 'national champion' played a decisive role in this story and it is questionable whether a CMU supervisor would have been powerful enough to intervene. The history of the EMU showed that rule-abiding behavior is not a given even in the context of institutionalized, supranational surveillance and enforcement mechanisms. While the Wirecard scandal is an extreme example, the potential that a single CMU supervisor might be able to successfully enforce supervision and fine a 'national non-bank financial champion' seems unlikely at the moment.

But the Wirecard scandal can also serve as an example for a more fundamental issue about the findings in this dissertation. Neither protectionism nor functional pressures might be central drivers behind the lack of supranational supervision but regulatory capture on the national level. In 2021, a BaFin employee was accused of insider trading with Wirecard shares between 2018 and 2020 - a day before Wirecard announced €1.9bn as 'missing' (Storbeck, 2021a; O'Donnell, 2021). Thus, if the Wirecard scandal provides any insight, we should not exclude the possibility that national-level regulators might have an interests in sustaining the status quo that is independent of potential lobbying efforts by non-bank finance. Still, such a claim about regulatory capture as a central mechanism and my own argument on fortressing on markets are mutually non-exclusive. Regulatory capture might reinforce an already existing preference of non-bank finance to fortress on markets.

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7.5 CMU and the Road Ahead

While a set of financial regulations have been adopted between 2015 and 2019, the CMU project fell short of a true single European market for capital. Yet the European Union requires much more integrated capital markets - both to complement the European Banking Union and to face the challenges that lie ahead. These last pages will touch upon two major challenges: Europe's economic recovery after Covid-19 and the structural consequences of climate change. While legitimacy concern and the requirement of a broad national consensus are potential obstacles towards any future Capital Markets Union, a fully developed CMU is crucial for post-pandemic recovery and for tackling climate change.

The consequences of the Covid-19 pandemic can be compared to those of the 2008/09 financial crisis. Most countries in the EU implemented strict lockdown measures which stopped economic life and led to a 6.6% drop in GDP within the Euro area. As a consequence of the pandemic, the profitability of firms shrank and credit losses increased (De Guindos, 2020a, 2021). National governments responded with a mix of fiscal and monetary policies, which, in turn, increased budgetary deficits and pushed public debt levels further up. Given these rising public debt levels, pandemic support measures cannot continue indefinitely. Yet, if they end too abruptly, the shock to the real economy would, most likely, lead to significant increase in insolvencies while, if they end too late, public debt accumulation will become unsustainable. Thus, public spending won't suffice to finance the post-pandemic recovery in the EU. A potential solution is bank funding. After all, the banking sector was able to absorb the crisis effects relatively smoothly due to the existing post-crisis prudential framework; "tighter regulation and higher capital ratios have been key factors enabling banks to act as shock absorbers rather than shock amplifiers during the coronavirus (COVID-19) pandemic"

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(Schnabel, 2020). Yet the banking sector has struggled in the pandemic, too. Banks in the Euro area saw a decline in their returns and they will have to reduce their costs in the near future, which will reduce the availability for bank funding to the real economy (De Guindos, 2020a). Given rising budget deficits and public debt constrains, together with the predicted decline in bank financing over the next years, the post-pandemic recovery cannot create sustainable growth levels without a stronger reliance on private funding via non-bank finance (De Guindos, 2020a, 2020b). The deepening of financial integration through a true capital markets union would deepen such market funding for non-financial firms and boost post-pandemic recovery in the EU (De Guindos, 2020b).

The preconditions for a true Capital Markets Union are ideal to advance financial integration and ensure financial stability through supranational supervision. During the pandemic, the share of investment funds in financial intermediation continued to rise and non-bank market funding to firms doubled, compared to the pre-pandemic period (Schnabel, 2020; De Guindos, 2020a). A fully developed CMU would, on the one hand, support this trend by allowing for the further diversification of funding opportunity. This would reduce the bank dependency and supporting economic growth. Moreover, increase cross-border and cross-sectoral risk sharing would increase the resilience towards local, asymmetric shocks (De Guindos, 2020a, 2020b). On the other hand, there was also greater risk taking in non-bank finance in 'search for yields' (De Guindos, 2020a). Thus, while a CMU would further encourage these positive traits of increasing non-bank finance and support their cross-border activities, these negative side effects point at the need to couple the CMU with stricter prudential regulations (Schnabel, 2020). Ultimately, a fully developed CMU based on a single rulebook and centralized supervision could ensure a smooth post-pandemic recovery without neglecting financial stability concerns.

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The Covid-19 pandemic had highly disruptive effects on the EU but the biggest challenge to sustainable economic growth in the EU remains climate change. Currently, fiscal and monetary measures on the EU level are employed to limit the future negative effects of climate change. Nonetheless, both channels remain highly contested. The ECB's recent strategy review emphasized the increasing importance of climate change considerations for its monetary policy strategy. In the future, such climate change considerations will be expanded to the ECB's macroeconomic modelling and will be included in its monetary policy operations; be it in risk assessment or corporate sector asset purchase operations, among others. Yet, as long as no treaty change occurs, climate change related actions have to be justified on the basis of the ECB's mandate. The ECB itself argues, that the two main mandates cover this expansion towards climate change considerations. Schnabel (2021), for example, makes the point that climate change can be seen as a precondition for price stability and therefore legitimize monetary policy operations that tackle climate change. Furthermore, Schnabel highlights that the ECB's second main objective requires an alignment of its monetary policy tools with the European Commission's general economic policies, given that this alignment will not affect price stability. Again, this can be interpreted in favor of a more active role of the ECB towards climate change.. As Schnabel emphasizes: "if purchases of two bond portfolios are deemed to provide a similar degree of monetary accommodation, but one of them has a lower carbon footprint, then the ECB should purchase the portfolio with the lower footprint" (Schnabel, 2021). Nonetheless, the recent change towards a symmetric inflation target of 2 percent, rather than the traditional 'close to but under 2 percent" could be seen as the consequence of the extended scope of the ECB. In this case, the ECB's ability to fulfill price stability objective is directly affected by other considerations.

Even if we agree with such a broad interpretation of the ECB's mandate, monetary policy means might not be sufficient to tackle the effects of climate change. A recent

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study by the ECB and the ESRB predicted that the consequence of climate change will be unevenly distributed across countries and regions, as well as sectors and firms in the EU (ECB & ESRB, 2021). While northern countries, for example, are more likely to be exposed to flooding, southern member states will more likely experience ever more heat waves and droughts. As such, climate change-related shocks can lead to asymmetric shocks which, in turn, cannot be tackled by monetary policies only (De Guindos, 2020b).

The sooner the EU moves to a carbon-neutral economy, the less likely it is that such change-related asymmetric shocks will create long-lasting disruptive effects. A Capital Markets Union would support this transformation since "analysis suggests that an economy's carbon footprint shrinks faster when it receives a higher proportion of its funding from equity investors than from banks or through corporate bonds" (De Guindos, 2020b). Furthermore, as a consequence of the Covid-19 crisis, the "Next generation" recovery funds were set up and provide a unique 'window of opportunity' for this transition. The NGEU issues high-quality euro-dominated sovereign bonds that can support and foster deeper capital markets. 30% of the funds have to be raised by issuing green bonds (Panetta, 2021). Such green bonds are more likely to be held cross-border and they can thereby contribute to further financial integration (De Guindos, 2020b). The EU is already the largest hub for green bond issuance in the world and half of all global green bonds in 2020 were issued in Euro. Thus, in an ideal scenario, the NGEU advances green finance and the CMU simultaneously, leading to a *Green Capital Markets Union* (Lagarde, 2021). As Lagarde emphasized, such a Green Capital Markets Union comes with a variety of benefits. First, it would make the EMU more resilient against cyclical shocks. Second, it would support the transformation towards greener and more sustainable economies. Lastly, a fully developed CMU allows for more diversified debt and equity investments with lower home bias.

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Despite all the political obstacles towards a Capital Markets Union, the ever more prominent role of climate change in financial regulation and the need for private funding might just turn the current pandemic recovery phase into a 'critical juncture' for non-bank finance that opens the path for a true single capital market in the years to come.

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A Home Bias Data in Non-Bank Finance

The home bias among institutional investors was used as one central measurement of state-finance ties in the EU in chapter 4. This appendix provides information about the data collection process and the data. Table A.1 provides the data for total home bias among institutional investors in the EU, while Table A.2 provides the data on sovereign debt home bias. All data points are percentage values. The data for both tables was derived from the OECD Institutional Investors Statistics that can be accessed at https://stats.oecd.org/Index.aspx?DataSetCode=QASA_7II. I followed the approach given by Schoenmaker and Darvas (2017) who relied on the same dataset by selecting *Sector: Investment Funds; Transaction: Financial assets; Measure: $, current prices, current exchange rates, end of period*. The same was then applied for pensions funds and insurance companies by simply changing the sector value. I then saved - for each available EU member state - the value points for *debt securities*, *debt securities issued by residents*, *debt securities issued by residents general government*, and *debt securities issued by non residents* for the period 2005 to 2019. As a second step, I divided *debt securities issued by residents* by *debt securities* to get the overall debt home bias in a given country and divided *debt securities issued by residents general government* by *debt securities issued by residents* to get the sovereign debt home bias. Lastly, I took the mean across all available EU member states in a given year for the period between 2005 and 2019. Whenever a value was missing, the respective country was excluded from the overall mean calculation.

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Year	Pension Funds	Insurance Companies	Investment Funds
2005	60.53	48.16	na
2006	57.71	49.26	na
2007	54.51	48.97	na
2008	52.58	46.59	39.28
2009	51.61	48.61	40.6
2010	55.5	48.9	40.08
2011	55.25	48.98	40.39
2012	55.68	51.55	40.9
2013	54.93	50.57	38.68
2014	48.96	50.2	36.24
2015	49.3	49.99	38.27
2016	47.29	49.05	39.13
2017	42.87	43.51	37.07
2018	46.63	42.91	35.47
2019	45.01	42.91	32.25

Table A.1: Total debt home bias among institutional investors in the EU (2005-2019).

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Year	Pension Funds	Insurance Companies	Investment Funds
2005	53.87	53.62	na
2006	48.66	50.03	na
2007	44.56	49.72	na
2008	48.01	50.73	42.24
2009	54.11	52.29	43.04
2010	54.34	53.04	42.92
2011	55.87	52.88	42.65
2012	58.15	50.82	43.38
2013	57.86	51.66	43.64
2014	54.14	53.28	45.7
2015	58.21	52.33	42.94
2016	58.16	56.77	42.31
2017	63.17	54.53	40.39
2018	55.08	54.18	43.05
2019	57.52	53.02	40.98

Table A.2: Sovereign debt home bias as percentage of total debt home bias among institutional investors in the EU (2005-2019).

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B Internationalization and Foreign Penetration Data

The level of internationalization and foreign penetration is the core empirical evidence for my argument in the analysis chapters 5 and 6. This appendix provides information about the data collection process and the dataset for (outward) internationalization and foreign penetration (or inward internationalization) in non-bank finance in the EU. The data is based on the public registers of ESMA and EIOPA. All data points are percentage values.

For (occupational) pension funds and insurance companies, I relied on the public register provided by EIOPA that can be accessed at www.eiopa.europa.eu/tools-and-data/registers_en. In the case of insurance companies, I selected *insurance undertakings*, then *register of insurance undertakings* and *active undertakings*. Then, for each EU member state, I collected the number of *domestic undertakings*, *EEA branch* (but excluding non-EU countries), and *3rd country branch*. For outward internationalization, I divided the number of EEA branches of a given country (in at least one other EU member state) by the number of total domestic undertakings in that country. For foreign penetration, I first collected the number of foreign EEA branches in a country and then divided the number of foreign branches in a country by the total sum of all domestic undertakings and foreign branches in that country. In the case of

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pension funds, I selected *institutions for occupational retirement provision*, followed by *register of institutions for occupational retirement provision*. Then, for each EU member state (i.e, home country), I collected data on *IORP with cross-border operations* and the country where the entity operates as well as *IORP without cross-border operations*. Outward internationalization is then calculated by dividing IORP with cross-border operations by the sum of IORP with cross-border operations and IORP without cross-border operations. For foreign penetration, I calculated the number of foreign IORPs in a given country and divided by the sum of all domestic IORPs.

For investment funds and investment firms, I relied on the public register provided by ESMA on MiFID/UCITS/AIFMD/TICOU entities that can be accessed at [here]. In the case of investment funds, I first selected the *entity type: UCITS management company* and *office type: head office*. This provided the number of domestic investment funds in a given EU member states. For the number of foreign branches in a country, I selected *office type: branch* and counted the number of foreign investment firms (from another EU country) in each EU host member state. Lastly, I counted the number of countries an investment firms of a home country expanded into by selecting *office type: branch* and *home member state*. As a second step, I elected for each EU home member state the *entity type: AIFM* and conducted the same data collection progress. Lastly, I added it to the information from UCITS investment funds. To create the data for outward internationalization for investment funds (UCITS + AIFM), I divided the number of domestic investment funds with a branch (in at least one other EU member state) by the number of total domestic investment funds. For inward internationalization (or foreign penetration), I divided the number of foreign branches in a country by the total sum of all domestic investment funds and foreign branches. The same steps were also followed for investment firms (the only difference was that that I selected *entity type: investment firm* at the first step of the data collection process).

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Country	Euro	Insurance Companies		Pension Funds		Invest. Firms		Invest. Funds	
		Outward	Inward	Out.	In.	Out.	In.	Out.	In.
Austria	Y	14.8	38.6	11.1	17.7	2.5	1.9	2.8	23.4
Belgium	Y	15	33.3	9.3	0	19.4	39.2	8.3	61.3
Bulgaria	N	0	43.9	0	0	1.9	0	0	2
Croatia	N	20	48.3	0	0	0	0	0	0
Cyprus	Y	11.1	35.7	0	100	8.5	0	0	0
Czechia	N	10.7	50.9	0	0	0	97.2	0	0
Denmark	N	4.4	27.8	0	2.8	3.6	2.4	4.7	0
Estonia	Y	50	65.5	0	0	0	0	22.2	0
Finland	Y	0	36.1	0	0	1.7	0.4	7	1.7
France	Y	4.3	10.6	0	16.7	7.9	19.8	4.6	3.8
Germany	Y	11.22	15.8	3.1	1.2	2.1	1.7	4	9.3
Greece	Y	5.4	49.3	0	100	1.9	8.8	0	0
Hungary	N	9.4	45.8	0	50	2.6	9.5	0	0
Ireland	Y	14.7	19.2	0	0	15.4	8.1	8.5	7.8
Italy	Y	2.1	53.6	0	0.2	0.6	13.2	3.4	30.8
Latvia	Y	57.1	78.1	0	0	0	0	0	0
Lithuania	Y	50	78.9	0	100	0	0	0	0
Luxembourg	Y	10.8	10.6	25	114.3	47.2	4.3	18	4
Malta	Y	0	18.7	14.3	7.7	2.9	0	8.8	0
Netherlands	Y	2.8	31.6	0	2.4	6.8	4.1	5.6	0
Poland	N	5.1	39.2	0	0	6.5	14.8	0	0
Portugal	Y	5.3	55.3	0	0.3	4.7	20	0	0
Romania	N	33.3	44.9	0	100	0	12.2	0	0
Slovakia	Y	50	71.4	0	0	37.5	0	0	0
Slovenia	Y	0	62.5	0	0	0	0	0	0
Spain	Y	7.6	26.9	0	0.1	3.2	10.9	0.5	8.3
Sweden	N	7.1	14.7	0	0.5	8.3	8.9	1.5	8.2

Table B.2: Internationalisation and foreign penetration for insurance, pensions, and asset management in the EU. Outward internationalisation calculates the % of domestic non-bank financial institutions that operate branches in at least one other EU market. Inward internationalisation (i.e. foreign penetration) calculates the % of foreign branches from the total number of branches and pension funds in a market.

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C Institutional Investment Data in the EU

Besides the level of internalization and foreign penetration, both Chapter 5 and 6 refer to the size of national institutional investment markets. In order to see their development over time, appendix C provides information on the data collection process and the dataset for the size of national institutional investment markets for the period between 2001 and 2017. In contrast to the figures in the main body of this dissertation, these tables also include data on the United Kingdom to enable a broader comparison within the EU27 as well as between the EU27 and the United Kingdom. Table C.1 includes the data of national investment funds markets, Table C.2 shows the data for national pension funds markets, and Table C.3 provides the data for national insurance markets. All data points refer to assets as percentage of GDP in a given country.

In order to create this data, I combine two datasets to extend the time period across all types of institutional investment. The data points in 2001, 2007, 2012, and 2017 were taken from De Haan et al. (2020), while all other data points were collected from the European Capital Markets Institute's *ECMI data on capital markets*. Access to the ECMI dataset was granted during my research stay at the European University Institute in February 2020. Since De Haan et al. (2020) rounded the percentage values in their tables, I did the same for the ECMI data.

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Country	2001	2003	2004	2006	2007	2010	2011	2012	2013	2014	2017
Austria	45	41	53	65	59	52	46	49	48	49	53
Belgium	34	30	34	40	35	27	23	23	25	28	42
Bulgaria	na	na	na	na	2	1	1	1	1	1	1
Croatia	na	na	na	na	na	na	na	na	na	5	6
Cyprus	na	na	na	na	8	na	na	12	na	na	24
Czechia	4	4	4	5	3	3	3	5	3	4	10
Denmark	21	38	39	56	60	57	58	91	75	90	109
Estonia	1	na	na	na	8	na	na	3	na	na	5
Finland	9	16	20	37	27	34	29	35	39	42	63
France	43	64	67	83	63	72	69	53	74	74	70
Germany	38	38	39	44	43	45	43	51	51	54	72
Greece	13	18	18	12	6	4	3	3	4	4	4
Hungary	5	5	5	10	9	14	9	8	16	17	17
Ireland	155	257	290	404	272	609	649	622	819	896	826
Italy	32	29	28	26	19	15	12	14	13	15	25
Latvia	0	na	na	na	1	na	na	1	na	na	1
Lithunania	0	na	na	na	1	na	na	1	na	na	2
Luxembourg	3779	3692	4031	5440	5156	5595	5074	5675	5751	6590	8307
Malta	12	na	na	na	22	na	122	210	130	122	75
Netherlands	25	20	18	19	18	13	11	98	12	12	124
Poland	2	4	5	10	12	8	7	10	12	12	18
Portugal	20	19	21	24	23	15	13	17	15	13	16
Romania	na	na	na	na	3	2	3	5	3	4	5
Slovakia	na	na	5	7	4	6	5	5	6	7	8
Slovenia	11	na	na	na	12	6	5	5	5	6	6
Spain	23	26	28	29	28	16	15	14	18	22	28
Sweden	35	25	28	44	46	48	39	49	48	59	84
UK	23	25	26	39	33	46	46	49	59	60	62

Table C.1: Size of national investment funds in the EU27 (+UK) between 2001 and 2017 as percentage of GDP (rounded).

CEU eTD Collection

Country	2001	2003	2004	2006	2007	2010	2011	2012	2013	2017
Austria	4	4	4	5	5	5	5	5	6	6
Belgium	6	5	4	4	4	4	4	5	5	8
Bulgaria	na	1	2	3	4	6	6	7	9	14
Croatia	na	2	4	6	na	12	13	na	19	28
Cyprus	na	na	na	na	na	na	na	24	na	14
Czechia	3	3	4	5	5	6	6	7	7	9
Denmark	23	28	31	33	27	49	50	76	43	80
Estonia	0	1	2	4	5	7	7	9	10	18
Finland	0	54	62	72	71	83	44	47	51	4
France	0	na	na	0	0	0	0	0	0	0
Germany	4	4	4	4	5	5	6	6	6	7
Greece	0	na	na	na	0	0	0	0	1	1
Hungary	4	5	7	10	11	15	3	4	4	5
Ireland	44	39	42	49	46	48	45	49	56	48
Italy	1	2	3	3	2	5	5	2	6	5
Latvia	0	na	1	2	0	1	1	1	1	2
Lithunania	0	na	na	na	2	na	na	4	na	8
Luxembourg	na	na	0	1	1	2	2	3	2	4
Malta	0	na	na	na	0	na	1	0	17	0
Netherlands	101	101	108	124	134	130	136	168	166	211
Poland	3	5	8	11	13	16	14	17	19	10
Portugal	11	11	10	13	13	11	8	9	9	10
Romania	na	na	na	na	0	1	1	2	2	5
Slovakia	na	0	na	3	4	7	8	10	10	12
Slovenia	1	0	1	2	3	3	3	5	4	7
Spain	7	6	7	8	8	8	8	11	9	13
Sweden	24	7	7	9	8	10	9	9	9	9
UK	74	61	64	82	72	87	97	102	102	110

Table C.2: Size of national pension funds in the EU27 (+UK) between 2001 and 2017 as percentage of GDP (rounded).

CEU eTD Collection

Country	2001	2003	2004	2006	2007	2010	2011	2012	2013	2017
Austria	27	25	26	27	32	29	28	35	27	40
Belgium	45	47	52	61	65	65	64	69	70	78
Bulgaria	na	na	na	2	4	3	3	7	3	8
Croatia	na	na	na	na	na	na	na	na	na	11
Cyprus	18	12	12	14	na	12	10	23	10	20
Czechia	8	2	9	8	9	9	8	11	8	10
Denmark	54	77	81	88	72	109	100	100	99	119
Estonia	3	2	3	4	5	9	8	5	7	6
Finland	23	56	59	65	30	69	63	29	68	37
France	56	64	68	78	72	87	83	102	94	128
Germany	45	49	50	52	46	54	54	44	57	52
Greece	9	4	4	5	9	5	5	8	6	10
Hungary	6	6	6	7	8	8	7	8	7	8
Ireland	48	39	44	51	86	52	49	141	56	111
Italy	25	27	29	32	35	33	32	36	36	58
Latvia	2	2	1	1	2	2	2	2	2	2
Lithuania	1	2	2	3	3	4	3	3	3	5
Luxembourg	127	118	130	160	161	246	243	312	281	340
Malta	12	13	15	32	25	51	53	29	59	36
Netherlands	66	56	59	62	64	61	64	78	67	68
Poland	6	7	9	10	10	9	8	9	9	9
Portugal	21	20	22	28	31	34	30	32	32	33
Romania	na	0	1	na	1	1	na	3	na	3
Slovakia	6	na	5	6	9	10	9	10	9	9
Slovenia	6	14	15	14	12	14	12	18	13	20
Spain	22	17	17	18	23	21	21	26	25	28
Sweden	0	82	87	90	82	96	86	87	95	104
UK	109	84	80	95	102	91	92	100	94	97

Table C.3: Size of national insurance companies in the EU27 (+UK) between 2001 and 2017 as percentage of GDP (rounded).

CEU eTD Collection