Internationalized Banking, alternative banks and the Single Supervisory Mechanism'

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See appendix for tables and figure

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Abstract

This paper sets out to explain the preferences of the seven northern euro area member states on the Single Supervisory Mechanism (SSM) concerning the threshold set for direct European Central Bank control over bank supervision. Building on the concept of the 'financial trilemma', we argue that different bank internationalization patterns in the seven northern member states explain different preferences on the transfer of supervisory powers over less significant banks to the ECB. In particular, the reach of internationalization into a national banking system — notably the extent to which even smaller banks were exposed to foreign banking operations — is shown to be the core factor explaining different national preferences on threshold. In the five countries with a large number of small and parochial alternative (cooperative and savings) banks, it is necessary to examine the system-specific structures of these banks to explain better the reach of internationalization and national preferences on the threshold. Determined German opposition to ECB supervision of smaller alternative banks is juxtaposed with either less hostile or more positive support of at least four other countries despite the important presence of small alternative banks.

Keywords: Banking Union, Single Supervisory Mechanism, SSM, banking supervision, banking system, Economic and Monetary Union

Introduction

In June 2012, the European Council agreed to deepen Economic and Monetary Union (EMU) by creating 'Banking Union' (BU), which was to be based on four components: a single framework for banking supervision; a single framework for the managed resolution of banks and financial institutions; a common deposit guarantee scheme; and a common backstop for temporary financial support. The proposals for BU amounted to a radical initiative to rebuild financial market confidence in both banks and sovereigns — especially in the euro area periphery — to stabilise the national banking systems exposed directly to a vicious circle between the international financial crisis and the euro area's sovereign debt crisis (see Hall

2014; Hansen *et al.* 2014; Mourlon-Druol 2014) and to reverse the fragmentation of European financial markets. BU was also to bring about a significant transfer of powers from the national to the EU (to be precise, the BU) level.

The first key component of BU to be agreed was the Single Supervisory Mechanism (SSM), which was proposed by the Commission in September 2012 and approved by government leaders at the December 2012 European Council. The compromise reached foresaw that the ECB would be 'responsible for the overall effective functioning of the SSM' and would have 'direct oversight of the euro area banks' (European Council 2012a, p. 2; 2012b; 2012c). This supervision however would be 'differentiated' and the Bank would carry it out in 'close cooperation with national supervisory authorities'. Direct ECB supervision (through Joint Supervisory Teams (JSTs)) was to cover those banks which met the following four criteria: one of the country's three largest banks by assets; assets exceeding €30 billion; assets representing at least 20 per cent of their home country's annual GDP, except if the bank's assets amount to less than €5 billion; any other bank with a high level of cross-border exposure (although no precise figure was established).

This paper sets out to explain national preferences on the threshold set for direct ECB supervision of seven northern euro area member states.[1] Threshold is important because it concerns the degree of supranational bank supervision and thus the actual power of the ECB both in relation to national supervisors but also national governments. A very high bank size threshold (by bank assets and / or by assets as a percentage of national Gross Domestic Product (GDP)) would result in only the very largest banks being subject to direct ECB supervision. A cross-border threshold (notably, foreign held assets as a percentage of total bank assets) would lead to only banks with a certain level of cross-border activity being subject to ECB supervision. A combination of size and cross-border criteria would further limit the number of banks — depending on the precise levels set. Thus, threshold was about the reach of supranational supervision and the design of the SSM, namely the relative supervisory powers assigned to the ECB and to National Competent Authorities (NCAs).

National preferences on the reach of the ECB's direct control over bank supervision varied markedly. France, Luxembourg and the Netherlands supported direct ECB supervision over all euro area banks. Austria, Belgium and Finland preferred ECB supervision of only the largest systemically important banks. For officials from the latter three countries, preferences on threshold were driven — at least officially — by efficiency concerns: they argued that it was impractical to extend direct ECB supervision over thousands of smaller banks given staffing, travel and language concerns. Such concerns were however downplayed by French, Luxembourgish and Dutch negotiators who called for a gradual transfer. Crucially though, Austrian, Belgian and Finnish negotiators were willing to compromise on this point — the threshold was not a deal breaker for these three countries — and all accepted the possibility of ECB supervision for most if not all euro area banks.[2] The Austrian finance minister publicly

[1] The selection of these cases is explained below. Other papers in this special edition focus more specifically on the negotiations on the SSM (see notably Epstein and Rhodes, this volume). See also Howarth and Quaglia (2013).

[2] This claim has been confirmed in interviews with a large number of national ministry of finance and permanent representation officials from nine different member states. While less

criticised the German negotiators for their stubborn position on threshold and on sheltering small alternative (cooperative and savings) banks from direct ECB supervision, and called for compromise.[3] This German position aligns with longstanding government efforts to protect the country's cooperative and savings bank sector from EU Commission efforts to liberalise it (see Deeg 1999; Smith 2001). Given the important presence of smaller alternative banks in five of the seven banking systems examined in this article, a more uniform preference in favour of a high threshold for direct ECB supervision might have been expected. In particular, the juxtaposition of the German, French and Austrian positions on threshold merits further exploration: alternative banks held respectively 43, 43 and 50 per cent of assets in these three countries (central bank data). The bulk of these banks were very small institutions.

Why did some national finance ministries seek to extend direct ECB supervision to many if not all banks, including small parochial entities, while others maintained a policy in favour of covering only the biggest banks regardless the actual level of their cross-border activities? Building on the concept of the 'financial trilemma' (discussed in the following section) we demonstrate that neither the presence of large cross-border banks nor other aggregate internationalization measures that might be applied explain effectively national preferences on threshold. Rather, we argue that the 'reach' of internationalization into the banking system best explains national policy and that this 'reach' should be analysed in terms of the extent to which smaller banks held internationalized assets but also, more importantly, the extent to which smaller banks were exposed to larger banks which were internationalized — principally through central financial institutions in consolidated or semi-consolidated groups and joint liability schemes.

This paper contributes to three main bodies of scholarly literature. First, it adds to a small but growing political economy literature on financial systems — starting with Zysman's (1983) pioneering work, followed by Allen and Gale (2000), Busch (2009), Deeg (2010), Hardie and Howarth (2013) and Hardie *et al*. (2013) which engage in a comparative analysis of financial (or specifically banking) systems. Second, the paper contributes to the (limited) comparative political economy literature on Varieties of Capitalism and the financial and sovereign debt crisis (Hall 2014) and specifically national banking systems and the recent crises (Hardie and Howarth 2013; Quaglia and Howarth 2013) by examining how the specific features of national banking systems can direct government preferences on both national and supranational financial regulation and supervisory frameworks. Third, this paper contributes to the emerging literature on the politics and political economy of Banking Union (Donnelly 2014; Howarth and Quaglia 2013, 2014; Schimmelfennig 2014; Salines *et al*. 2012, Spendzharova 2014) which feeds into the vast literature on EMU and European economic governance, more generally, and national preference formation on EMU, more specifically (for example, Dyson 2000; Dyson and Featherstone 1999; Verdun 2000; Walsh 2000).

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specific, several public statements by ministers and ministry officials of these three countries at the time of the negotiations also appear to confirm this point.

[3] 'Talks on European banking union end in failure', http://www.euronews.com/2012/12/04/talks-on-european-banking-union-end-in-failure/, 4 December 2012; accessed 12 December 2014.

The material is organised as follows. The next section outlines the theoretical framework and research design, explaining how the dynamics created by an intensified financial trilemma in the context of the European Union and specifically the euro area stimulated interest in the SSM and other elements of Banking Union. Section 3 explains how the different reach of internationalization in the seven national banking systems resulted in different positions on the threshold to determine ECB supervision.

2. Theoretical framework and research design

This paper takes as its starting point Dirk Schoenmaker's 'financial trilemma' (2013; Schoenmaker and Wagner 2011), an analytical tool created to examine the interplay of financial stability, international banking and national 'financial policies'. Schoenmaker postulates that the minimization of financial instability in the context of cross-border banking requires the transfer of 'financial policies' (regulation, supervision, financial support and resolution) to the supranational level. In other words, the optimal level of supervision and management for large cross-border banks is at the supranational level. Cooperation among national officials in international supervisory colleges for large cross-border banks is sub-optimal, especially given that control over supervision, bank bail-out and resolution remains at the national level. Schoenmaker focuses upon global bank governance but he dedicates a brief conclusion to the prospect of European Banking Union. While Schoenmaker presents an economic analysis to explain the existence of the trilemma, our paper applies a modified internationalization framework to explain national — specifically minister / ministry of finance — preference formation with regard to supranational bank supervision.

In the context of our analysis, the presence of large banks with a significant cross-border presence and, more generally, banking system internationalization increased national ministry of finance interest in supranational supervision. In the European Union, the financial trilemma should also be understood in terms of specific pressures and trends created by European market integration, reinforced by the creation of the euro. The bulk of internationalization for most EU member states was within the European Union — the United Kingdom, Netherlands and Cyprus were the three exceptions — and this is in particular the case for our other six country cases (at least 80 per cent and up to 99 per cent of internationalization was to and from other EU member states). Six of seven the countries considered here also had significant exposure to Central and Eastern European member states and / or euro periphery member states (Table 1, see appendix) which had suffered from significant instability because of the international financial crisis and then sovereign debt crisis. This exposure reinforced national policy maker awareness of and sensitivity to the problems created by cross-border banking involving unstable or potentially unstable banking systems and / or economies. Our understanding of pertinent internationalization is thus the 'EU internationalization' of national banking systems. In the EU (and especially euro area) context, the logic of the 'financial trilemma' encouraged support for supranational supervision at the European Union level rather than globally — the focus of Schoenmaker's work. We focus on EU rather than euro area exposure because, as confirmed in interviews, all seven member states sought the participation of *all* EU member states in Banking Union both because of single market concerns and because of the high level of cross-border banking throughout the EU and not just among euro area member states. The fragmentation of the EU financial markets — and notably the rapid drop in cross-border banking in the EU — in the context of the financial and sovereign debt crises undermined financial stability in all member states and in particular created instability in the EU / euro area periphery. Clearly, this fragmentation also ran contrary to market integration expectations.

We develop on Schoenmaker's understanding of cross-border banking in order to better understand national preference formation on supranational bank supervision. Schoenmaker seeks to explain the contribution to international financial instability that large cross-border banks can make. Supranational supervision has also been explained and justified in interviews and public statements by ministry of finance officials in all seven of our countries on the grounds that large cross-border banks escaped effective supervision.[4] All seven countries had large institutions with significant exposure to other EU member states (Table 2, see appendix). However, Schoenmaker's econometric analysis and his focus upon very large, globally important cross-border banks only provides a limited picture of the variable of internationalization that created interest in supranational supervision and fails to provide an effective guide to national preferences on the threshold for direct ECB supervision which concerns the potential supervision of smaller banks. There is no correlation between the presence of large cross-border banks and their relative presence in the national banking system and national preferences on the threshold for direct ECB supervision. Thus, the highly concentrated Finnish banking system with two systemically important banks with a moderately high cross-border presence sought a very high threshold, while the highly concentrated Dutch banking system with three very large banks with high cross-border presence and the less concentrated French banking system with five systemically important banks with significant cross-border operations advocated direct ECB supervision of all euro area banks.

We next consider the internationalization (exposure to other EU member states) of the entire banking system as an indicator of national preferences. It can be hypothesized that if overall internationalization levels are high than support for ECB supervision of more banks — beyond the largest — should be greater and, if internationalization levels are lower, the contrary. However, on a general internationalization index (Table 1, see appendix) there is no correlation with stated national preference on threshold. Thus, amongst the countries with lower levels of overall internationalization, France and the Netherlands supported the transfer of supervision of all banks to the ECB, while Austria and Germany sought a high threshold. Among the countries with a very high level of internationalization, two sought a high threshold — Belgium and Finland — but were willing to compromise, while Luxembourg sought full transfer to the ECB.

Rather than discard internationalization as an explanatory variable, we next consider the 'reach' of internationalization into the banking system to explain varying national preferences on the threshold for supranational supervision. If internationalization is limited to a small

[4] All seven national finance ministers / ministries confirmed this logic publicly. On Wolfgang Schäuble's support for ECB supervision of the biggest cross-border banks see: 'ECB should only supervise big banks: Schaeuble', in Reuters.com, 3 September 2012; available at http://www.reuters.com/article/2012/09/03/us-eurozone-banks-schaeuble-idUSBRE88204U20120903. All our interlocutors in national financial ministries also confirmed this logic.

number of large institutions, while a large number of smaller banks are more domestically-focused, we would expect support for a higher threshold for supranational supervision. This leads then to the main hypothesis tested in this paper:

H: *The greater the reach of internationalization into the national banking system, the greater the support for direct ECB supervision of a larger number of smaller euro area banks.*

These smaller banks were both commercial and 'alternative' banks. In five of our seven countries, there were a large number of alternative (mostly cooperative and savings) banks.[5] These banks historically had an important social function and most continued to have a strong connection to a locality. This local connection had a clear political, if not politicised, dimension — most obviously in Germany, where local politicians continued to serve on the governing boards of savings banks (Ayadi *et al.* 2009; Bülbül *et al.* 2013; Simpson 2013) which continued to benefit from implicit guarantees of local government support. Most alternative banks, especially savings banks, continued to be the main lenders to Small and Medium Sized enterprises (SMEs) in these countries. We consider the extent to which small and parochial alternative banks were affected by internationalization in order to explain the willingness of some governments to allow them to be subject to direct ECB supervision. The relevant difference here owes to the structure of the alternative bank sector. In five of the seven countries which had a large number of small alternative banks, these banks operated joint liability schemes which meant that if one institution collapsed other banks would come to its rescue. The precise details of these schemes varied. In four of these five countries, small alternative banks (either cooperatives or savings banks or both) created central financial institutions in the context of partial or far-reaching consolidation in the 1980s and 1990s. These central financial institutions engaged in a larger range of commercial and investment banking activities than their much smaller associated banks, all engaged in significant international activities and, in a number of cases, were amongst the most internationalized of large EU banks. The structure of these part-consolidated banking groups and the internationalization of their central financial institutions is outlined in Table 3 (see appendix). Part consolidation meant that smaller banks would be subject to direct ECB supervision by virtue of their legal and financial relationship with the larger central financial institution, if the latter met the agreed threshold. Joint liability schemes created a financial commitment of a large number of very small and parochial banks to internationalized and systemically important institutions, the collapse of which would impose massive costs upon the smaller entities. A spectrum can be drawn between, on the one extreme, Luxembourg with only one

[5] The term 'alternative' banks is used because these entities — mostly cooperative and savings banks — normally did not issue equity and were not principally, or only, profit-oriented. Cooperative banks by definition are controlled by their depositors which became members with a single vote regardless their level of investment. Cooperatives pursue the interests of their members rather than profit-maximisation per se. The cooperative banking sector in all EU member states diversified over the past few decades and came to include a number of larger central financial institutions created to provide services to and for members of the smaller banks. Some of these larger institutions issued shares and operated similarly to commercial banks. Ayadi *et al*. (2009) discuss the challenge of defining a saving bank — created under public law, locally-rooted with a clear social function — which have also created central financial institutions.

relatively large savings bank and one medium sized cooperative bank and, on the other extreme, Germany with 1500 non-consolidated small alternative banks with a looser relationship with and financial commitment to central financial institutions. Belgium had no remaining cooperative and savings banks.

The potential counter-argument that the level of banking system concentration was a crucial variable directing national preferences on the ECB threshold can be challenged. It might be expected that countries with low levels of concentration (more smaller banks holding more assets) would opt for a higher threshold while those with a higher concentration would be less preoccupied by threshold or deliberately seek a lower or no threshold in order to ensure similar ECB supervision of the different national banking systems. In particular, French finance ministry officials and banks regularly and publicly raised the concern during the negotiations that the bulk of French bank assets would be covered by ECB supervision whereas the figure for Germany would be much lower (Moscovici 2012; FBF 2012). The compromise threshold finally agreed covered bank assets ranging from 18.5 per cent in Luxembourg and 45 per cent in Austria to 89 per cent in France and 91 per cent in Belgium (Table 4, see appendix). However, concentration levels only align well with the preferences of two of our seven countries: Germany and the Netherlands (see Figure 1, see appendix). Very low bank concentration in Austria and Luxembourg as well as Germany — 37, 33 and 33 per cent respectively at the end of 2012 (ECB 2013) — can be juxtaposed with very different national preferences on threshold. France, with only a moderate concentration level (44 per cent), sought no threshold while Finland and Belgium with comparatively high concentration levels sought a high threshold, which contradicts expectations derived from concentration levels.

Research design

Our analysis focuses upon the preferences of the seven northern euro area member state ministers / ministries of finance: Austria, Belgium, Finland, Germany, France, Luxembourg and the Netherlands. We examine the positions of ministers / ministries of finance because they were the most involved in the SSM negotiations and largely — but not entirely — determined national positions. The selection of finance ministries (ministers) also allows us to discount bureaucratic turf battles that can take / have taken place on supervision. The selection of these seven countries stems from their most similar position. First, unlike the countries of the euro periphery, their need for a successful outcome in the SSM / Banking Union negotiations was not acute. They were not faced with the direct menace of sovereign and / or bank default created by the sovereign debt crisis, although the menace of contagion of default in and from the euro periphery was very real. They were policy 'makers' while euro periphery countries were policy 'takers': they were in a position whereby they were not willing to accept *any* supervisory solution in order to bolster confidence. The finance ministers of all seven countries also had explicit / publicly stated moral hazard concerns with regard to European funds to be created to support sovereigns and banks.[6] Such concerns

[6] For example, see 'Finnish Finance Minister opposes joint liability bank union', Reuters.com, http://uk.reuters.com/article/2012/06/13/finland-urpilainen-idUKH7E8FC02H20120613, 13 June 2012; accessed 4 January 2015.

demonstrate that they imposed clear limits on their support for Banking Union despite the menace of the sovereign debt crisis.

During the 2012 negotiations, all seven finance ministers accepted the need for the SSM — although the German finance minister did so with considerable reluctance. German insistence on treaty reform to create the SSM was widely interpreted as a delay tactic to push the project to a distant future (*Financial Times* 10 October 2012; *Financial Times*, 5 December 2012).[7] As substantiated in the empirical analysis below — notably with reference to bank position papers to the Commission's consultation on the SSM — the preferences of national finance ministries were aligned closely with the dominant preferences of their national banking sector. In all seven countries, the fit is very close. The ambivalence of the German position on the SSM reflects the divisions in the country's three-pillared banking system. However, despite a similarly differentiated banking sector in Austria, the positions of both Austrian alternative banks and the country's ministry of finance on the SSM was more positive. We will show how the structure of the Austrian alternative banks helps to explain Austrian willingness to negotiate on the SSM threshold.

Methodologically, this paper deploys a two-step political economy analysis. First, it examines the internationalization patterns of national banking systems. Second, this paper examines how these systemic features shaped policy maker preferences on the SSM. This is done through textual analysis of government policy documents and bank and banking association position papers, a systematic survey of press coverage and semi-structured elite interviews with policy makers across the EU, notably from the seven national ministries of finance, national supervisory bodies and national permanent representations to the EU in Brussels.

European banking systems and the reach of internationalization

Austria

In the two countries with a mixed system of both semi-consolidated alternative banks and small independent entities (Austria and Finland) a nuanced policy on threshold was adopted. Both supported a high threshold but expressed willingness to negotiate (on Austria see Ayadi *et al.* 2009; Bülbül *et al*. 2013; Fonteyne 2007). In Austria, where hundreds of semi-consolidated cooperatives and savings banks were built around and in a joint liability arrangement with two of the most internationalized banks in Europe (Volksbanken and Erste) with massive exposure to central, eastern and south-eastern European economies, there was clear interest in supranational banking supervision to gain greater control over the supervision of these groups (interview, Austrian Ministry of Finance official, 12 June 2015). The Austrian savings bank system was officially a federation where small members maintained considerable autonomy. However, with both assets and a range of activities concentrated in Erste bank — a savings bank hybrid partly owned by private investors — some authors have described it as closer to a group of companies (Ayadi *et al*. 2009). A significant number of smaller alternative banks also engaged in significant cross-border operations, notably through branches in areas bordering on Austria. Opposition to ECB supervision which was present in

[7] The expert officials in the other eight finance ministries and / or permanent representations interviewed for this paper interpreted the German position on necessary Treaty reform as a delay tactic designed to push the move to SSM to a long-term future.

both a range of cooperatives and savings banks was effectively sidelined within the federations (interviews with Erste bank officials, 16 June 2015). The ideal scenario for the Austrian finance ministry was that central and eastern European countries would join the SSM. However, even if they remained non-members, the assumption of Austrian authorities was that the ECB would have — as the dominant actor and lead supervisor in supervisory colleges — considerable influence over supervisors of subsidiaries of these big Austrian banks in neighbouring countries (interview, Austrian Ministry of Finance official, 12 June 2015). At the same time, a large number of small cooperative banks in Austria — about a third, holding about five per cent of total Austrian banks assets — remained independent of any semi-consolidated group and largely, if not entirely, parochial in their focus. Austrian opposition to direct ECB supervision of all banks stemmed from an interest in sheltering these institutions on the grounds that that national officials knew best how to supervise them and apply to them a complex regulatory framework that maintained distinct provisions for commercial, cooperative and savings banks (interview, Austrian Ministry of Finance official, 12 June 2015).

Belgium

The high internationalization figure for the Belgian banking system suggests interest in the SSM. Notably, the Belgium government had an interest in the effective supervision of the two largest banks in the country (BNP Fortis and ING), which were subsidiaries of very large French and Dutch banks, as well as of the only remaining large Belgian bank, KBC, which was heavily exposed to central and eastern European countries (interview, National Bank of Belgium officials, 3 June 2015). The devastation of the financial crisis and the difficult intergovernmental negotiations on the resolution of two of the country's largest banks loomed large for Belgian policy makers. There were no remaining cooperative or savings banks in Belgium — the cooperative banks collapsed in the 1990s and the savings banks had been taken over by private banks — and only one medium-sized commercial bank had a cooperative banking operation created to expand retail market share (Ayadi *et al*. 2009). At the same time, Belgium was also host to a large number of foreign bank subsidiaries and branches — many of which set up operations in Belgium specifically to take advantage of the low tax regime on savings accounts — which collectively held 65 per cent of the country's bank assets at the end of 2012 (ECB 2013). The Belgian ministry of finance pushed for a high threshold for direct ECB supervision for efficiency reasons. However, Belgian policy makers noted their flexibility on threshold (interviews, Belgian Federal Ministry of Finance, Central Bank and Permanent Representation to the EU, 2, 4 and 5 June 2015), especially given that a lower threshold could help to improve the control of the range of smaller subsidiaries of foreign banks operating in Belgium (interviews, National Bank of Belgium officials, 2 and 3 June 2015).

Finland

Internationalization in Finland came principally in the form of the dominant presence of the Swedish bank Nordea which held approximately two-thirds of Finnish bank assets. For the IMF (2014) there was a clear logic for Finnish authorities to accept Banking Union — ideally with Sweden in but also with it out — to ensure better control over the consolidated group and decrease the chance of Nordea activities that could be detrimental to the Finnish economy (notably potential ring-fencing of capital). Nordea had also outsourced nearly all of its derivatives activities to its Finnish subsidiary. The Finnish banking sector was thus excessively reliant on a subsidiary of a single foreign bank which held a disproportionately high level of higher risk-weighted assets. The international presence of the second largest bank (Op Pohjola) was significant (18 per cent of assets in the EU) but principally in other Nordic countries. As the main supervisor for a number of Nordea subsidiaries in SSM participating countries, the ECB was set to have a significant presence in the bank's supervisory college. This ECB presence was seen as inherently desirable to Finnish authorities (IMF 2014; interviews) even if this meant an end to a formal Finnish presence in the Nordea supervisory college. Given, the very heavy concentration of the Finnish banking sector, Finnish support for ECB supervision of only the very largest Finnish entities — and in fact *only* Nordea — made sense. However, the Finns accepted compromise on threshold, notably the inclusion of the three bank minimum. The threshold agreed would cover the Dansk bank subsidiary which, although less than a tenth the size of Nordea, had a massive international presence of over 60 per cent of assets (principally back to Denmark). However, the threshold agreed would also result in covering the country's second largest bank, the semi-consolidated group of cooperative banks (Op Pohjola).

As in Austria, there was a major division in the Finnish cooperative bank sector. About two-thirds of all cooperatives, holding roughly 20 per cent of the country's bank assets, were in a centralized semi-consolidated arrangement with joint liability with a large commercial bank created by the cooperatives in the 1990s (OP Pohjola) with significant international activities as noted above (see also Fonteyne 2007). As in Austria, there remained a significant number of independent cooperatives (about a third) with a purely local focus. Finnish Ministry of Finance officials saw ECB supervision of these smaller and locally-focused entities as problematic (interviews with Finnish authorities, 7 and 18 June, 2015) and preferred not to assign full supervisory powers to the ECB in order to shelter this sector from ECB supervision. The differential treatment of national cooperatives was also a cause for concern, particularly for Op Pohjola (interviews, Op Pohjola official, 11 June, 2015; Finnish authorities, 7 June 2015). The small savings bank group was organised similarly to Op Pohjola, with a joint liability scheme among small regional and local banks and also with a central financial institution (the SB Central Bank), that was, at the end of 2012, very small and with minimal international exposure. The ministry of finance hoped to shelter these small savings banks from direct ECB supervision (interview, Finnish Ministry of Finance official, 17 June 2015).

France

In accordance with the financial trilemma, French interest in supranational supervision was sparked by the internationalization of the five largest French banks which all held a significant percentage of the assets in other EU member states and in the euro periphery specifically (Howarth 2013). However, the low aggregate internationalization and moderate concentration figures for the French banking system appear to contradict French ministry of finance preference on the transfer of all bank supervision to the ECB (Table 1; Figure 1, see appendix). French preferences can be explained in terms of the semi-consolidated nature of French cooperative banks which meant that even with a relatively high threshold, a very high percentage of French bank assets would likely be subject to direct ECB supervision.

All French cooperatives were in one of three large centralized semi-consolidated groups, in which small banks advertised as distinct entities at the local and regional level but had very limited autonomy from the mother bank. The central institutions and, in the case of the part-listed Crédit Agricole and Banques Populaires et Caisses d'Epargne (BPCE), specially created investment banks (Crédit Agricole Corporate and Investment Banks (CACIB) and Natixis), were highly internationalised. The international financial crisis resulted in significant losses from derivatives trading by both these investment banks and the central institutions (Howarth 2013). The one partial exception was Crédit Mutuel which nonetheless still held a significant percentage of its assets (14 per cent) outside of France.

The French ministry of finance, the main peak banking association and a number of individual French banks expressed concern over the unequal treatment of member states given the size of the five largest French institutions which would all likely end up being directly supervised by the ECB (*Financial Times*, 14 November 2012; FBF 2012; Crédit Agricole 2014). In addition to 'fairness' concerns, the French government and banks also argued that the division into larger and smaller banks made little economic sense, given that banking crises often originated with smaller, fast-expanding banks (FBF 2012). French opposition to differential treatment also reflects French government insistence of a lack of a 'too big to fail' problem facing the large French banks given their 'mixed business' model and a longstanding strategy of constructing national champions engaged in a range of banking activities (Howarth 2013). The three largest alternative banking groups in France — Crédit Mutuel and BPCE (a federation of cooperative and former savings banks) and Crédit Agricole — also expressed concerns about direct ECB supervision, given their funding structure, but not outright opposition (Crédit Agricole 2014). Overall though, French government preference in favour of direct ECB supervision of all euro area banks was flexible. France was one of the main member state drivers behind Banking Union and the SSM and President François Holland placed great emphasis on the rapid construction of the SSM (see Donnelly 2014, Howarth and Quaglia 2013; Moscovici 2012; interviews with German policy makers 30 October 2014, interviews with Commission officials 13-14 November 2014).[8]

Germany

Unlike France, the German position on the threshold for direct ECB supervision corresponded closely to both aggregate figures on internationalization and concentration (Table 1; Figure 1, see appendix). The German financial ministry consistently supported ECB direct supervision of the country's two largest commercial banks, both with a very high international presence — Deutsche Bank and Commerzbank (*Financial Times* 5 December 2012; interviews BaFin official, Berlin, 30 October 2014). These two banks were also themselves strongly in favour of their direct supervision by the ECB which would also simplify the supervision of their numerous subsidiaries in the euro area (Deutsche Bank 2012 & 2013; Bloomberg 2012). Ministry of Finance opposition to lowering the supervision threshold also aligned with the position of associations representing the publicly owned Landesbanks and savings banks (the VOB) and Cooperatives (the BVR) which were clear in their opposition to the extension of direct ECB supervision to smaller German banks (BVR/VÖB/DSGV 2012; *Financial Times*, 9 September 2012; *Financial Times* 2 December 2012). In the meantime, Deutsche Bank and Commerzbank actively supported direct ECB supervision of all euro area banks in order to

[8] See 'Europe nears deal to make ECB chief bank watchdog', Reuters.com; available at: http://www.reuters.com/article/2012/12/12/us-eu-banking- idUSBRE8BB00820121212; accessed on 2 December 2014.

avoid the differential treatment of bank supervision (Deutsche Bank 2012 & 2013; Bloomberg 2012).

Determined German ministry of finance opposition to extending ECB direct supervision beyond the largest banks also reflects the limited reach of internationalization into the German banking system.[9] Despite waves of consolidation that had more than halved their total number since the 1950s, by the end of 2012 there were still 1104 very small to small cooperative banks and 423 saving banks in Germany (Bülbül *et al*. 2013). Collectively, the smaller cooperative and savings banks (excluding central institutions) held 22 per cent of total assets. In late 2012, the largest saving bank had a balance sheet of approximately €40bn — about one-fiftieth that of Deutsche Bank — and more than 100 had less than a billion euros in assets (Bundesbank statistics; *Financial Times*, 2 December 2012). Cooperatives were even smaller on average. However, their role in the German economy was far greater than their balance sheet size would suggest. Small cooperative and savings banks provided, respectively, 13 and 21 per cent of loans to non financial companies in Germany and held, respectively, 16 and 24 per cent of the country's bank deposits (Bundesbank, end 2012 figures). With associated institutions, German alternative banks held 40 per cent of total assets and provided 51 per cent of lending to non financial companies.

The cooperative banks included two central financial institutions — DZ-Bank and WGZ-Bank and a number of specialized service providers — for example, a large building society (Bausparkasse Schwäbisch-Hall) and an asset management company (Union Investment) — operating nationwide. DZ-Bank, the fourth largest bank in Germany at the end of 2012, also operated as a commercial bank and had a significant international presence (21 per cent in the EU and a total of 27 per cent internationally). It was very likely to be covered by direct ECB supervision. However, the cooperatives' joint liability scheme did not cover these larger institutions and, with the exception of DZ-Bank, their focus was overwhelmingly domestic. The absence of a joint liability scheme that included these much larger entities stands in marked distinction to the Austrian cooperative banks and their highly internationalized mother institution (Fonteyne 2007).

Savings banks maintained joint liability schemes but only with other small, locally focused entities. Importantly, they had a reputation for being financially stable banks — none had to

[9] The German government's willingness to compromise on the inclusion of the DZ-Bank (the central financial institution to the cooperative banks) and the Landesbanks in the remit of direct ECB supervision is beyond the remit of this paper and involved a range of considerations. However, the decision to lower the threshold sufficiently to include these banks confirms the internationalization argument presented in this paper in that DZ-Bank and the Landesbanks all held a significant percentage of their assets in other EU member states. The damage caused to some Landesbanks during the financial crisis, large government bail-outs, Commission-imposed restructuring and stagnant lending placed them in a politically weakened position (Deeg and Donnelly, this volume). German federal governments and the Bundesbank have long called for the consolidation of banks in this sector (Hardie and Howarth 2009; 2013; *Financial Times* 14 September 2010). Clearly, the German preference to extend ECB direct supervision to the unstable Spanish cajas also encouraged compromise.

be bailed out by governments since the 1950s. The savings banks in certain regions had ties to regional Landesbanks, some of which had a strong international presence, notably LB Baden-Württemberg. However, as with the cooperatives, there were no joint liability schemes that bound the savings banks to Landesbanks. Rather many savings banks contributed to Landesbank funding and benefitted from some of their services. Alone in Europe, German cooperatives and savings banks formally maintained the regional principle, which blocked competition among cooperatives and savings banks respectively and maintained local fiefdoms (Ayadi *et al*. 2009; Bülbül *et al*. 2013). German savings banks had a vested interest in the local economy and a strong presence in local community life. Local politicians sat on bank boards. Savings bank directors appeared to be unanimous in their view that home regulators and supervisors better understood their characteristics and way of doing business (Simpson 2013; *Financial Times*, 2 December 2012). The close connections between the savings bank and local and other German politicians encouraged federal government support for the protection of existing practices and the policy of extending direct ECB supervision to only systemically important banks.

Luxembourg

Luxembourg was, by a significant margin, the most internationalized of the seven banking systems both in and out and it was also the country where the reach of internationalization was the greatest. The very large majority of the more than 140 banks in the country — all but three of which were subsidiaries or branches of foreign headquartered banks — had significant international presence. At the same time, many of these subsidiaries were not very large which explains why Luxembourg authorities pushed actively for a low threshold and, ideally, the transfer to the ECB of supervisory powers over all banks. Ironically, Luxembourg finished up as the country with the lowest percentage of bank assets covered by the agreed ECB threshold. Luxembourg's largest home-headquartered bank was a savings bank — the *Banque et Caisse d'Epargne de l'Etat* (BCEE) — owned by the Luxembourg state. The single cooperative bank (Raiffeisen), was of moderate size (assets of approximately €6 billion in 2012) and had negligible international assets. The BCEE was, however, an unusual savings bank — more similar to Erste bank in Austria — in that it also had a very high presence of 34 per cent of its assets in other EU member states. For Luxembourg ministry of finance officials, the significant reach of internationalisation into the national banking system demonstrated clearly that ECB direct supervision of all these entities 'could significantly improve their supervision' (interviews 24 February 2014). For EU-headquartered banks, the ECB would lead and dominate their supervisory colleges.

Netherlands

The highly consolidated nature of the Dutch banking system and the high internationalization of the three largest banks created a very strong interest in supranational supervision. Netherlands was home to two of the world's 30 largest banks (by asset size) (ING and Rabobank) and a third very large bank that had previously been one of the world's largest (ABN). All the small and locally focused Dutch cooperative banks (Raiffeisen) formed part of a semi-consolidated group and participated in a joint liability scheme with a 'mother bank' (Rabobank) with a very strong international presence. Dutch savings banks had merged decades earlier and operated as a standard commercial retail bank. The Dutch finance ministry supported direct ECB supervision of all euro area banks which was presented, as in France, as the best way to even out ECB supervisory control among the different member states (Netherlands Government 2012; Dutch ministry of finance interview, 22 June 2015).

Conclusions

This article has examined the manner in which internationalization patterns shaped national preferences on the threshold of ECB direct supervision. Controlling the principal providers of credit to the real economy was an important policy making power of national competent authorities. The transfer of this power to the supranational level could only ever have been achieved in exceptional circumstances — which the sovereign debt crisis created. For economists, the logic behind a move to supranational supervision was that national control of large ('systemically important') cross-border banks was bound to be sub-optimal. This paper demonstrates that this economic logic fails to explain most national preferences on the transfer of supervisory powers to the ECB and the actual transfer that took place — which covered a large number of banks with minimal international presence, including some very small parochial institutions, including alternative banks, focused entirely on traditional banking activities and the local economy. It is necessary then to consider the internationalization of the entire banking system both out — the international exposure of national banks — and in — the foreign bank presence in the banking system. We focus specifically on exposure to and from other EU member states on the grounds that it dominated the internationalization of the seven national banking systems that we consider and because this is the internationalization which the SSM was created better to manage. There were significant differences in the internationalization patterns of the seven countries studied in our paper. Four of the countries — Austria, France, Germany and the Netherlands — were dominated overwhelmingly (more than 80 per cent) by national banks but these banks also had a very a large presence through subsidiaries in other EU member states. Belgium, Finland and Luxembourg had banking systems with a major foreign (mostly other EU) bank presence but these foreign-owned subsidiaries (and the biggest national banks) also had a significant presence in other EU member states. The largest foreign bank subsidiaries in all three countries would be (if they met the threshold) subject to direct ECB supervision.

However, aggregate internationalization figures provide only limited guidance as to national preferences. In six of our seven case study countries is necessary to consider the reach of internationalization and the extent to which even small institutions were exposed to international banking. In the case of Luxembourg, the large number of small but internationalised institutions explained national support for a low threshold for direct ECB supervision or none at all. In the case of the five countries with a large alternative banking sector — where the large majority of small banks were cooperatives and / or savings banks, where many or most of these banks were in consolidated or semi-consolidated groups with joint-liability schemes that exposed them directly to much larger internationalized institutions — the logic of sheltering smaller banks from supranational supervision was eliminated. Although German alternative banks were in a similar structure, with large central financial institutions, attached entities and tied Landesbanks engaged in a range of international banking activities, Germany was the only country where joint liability schemes covered only smaller institutions. These institutions were thus sheltered from international operations and the econometric logic of supranational supervision did not apply. Independent cooperative banks in Austria and Finland were similarly sheltered but in both countries they formed a minority of cooperative banks. In terms of the position of the banks themselves, larger institutions in all seven countries supported the transfer to the ECB of supervisory powers over all banks in participating countries. The largest banks in all seven countries uniformly opposed uneven supervision. They feared that they would be subject to a stricter ECB control while smaller institutions continued to benefit from a national supervision that was potentially more favourable and informed by specific local concerns and, thus, benefit potentially from supervisory forbearance.

The reluctance of smaller alternative banks in Austria, Finland, France and the Netherlands to accept the potential extension of direct ECB supervision to even the smaller entities of semi-consolidated banks, was sidelined by the support from much larger mother banks (central financial institutions) with a stronger international presence. Only in Germany did the representative associations for the cooperatives and savings banks succeed in presenting a strong opposition to the extension of ECB supervision to all banks — a line also presented by the independent Finnish and Austrian cooperative and savings banks. This paper has argued that national ministries of finance largely followed a structural logic in the determination of their national preferences on the SSM: ranging from stubborn German opposition to the extension of direction ECB supervision to any but the largest banks, to softer Austrian, Finnish and Belgian support for a high threshold, and French, Dutch and Luxembourgish support for a complete transfer of supervisory powers.

This political economy analysis contributes to the academic literature in two ways. It complements academic accounts that focus on the political negotiations on BU, at the EU level or domestically, by explaining why national finance ministries and different parts of the financial industry had the preferences they had. It outlines the different internationalization patterns of seven national banking systems in the EU in order to explain preferences on the SSM and BU. Despite more than sixty years of financial integration in the EU and significant strides forward in the single financial market in recent years, national banking systems remained very distinct, complicating the negotiations on the SSM and ensuring the persistence of national variation in supervisory practice.

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Appendix: Tables and Figure

Table 1: European Union exposure of national banking systems (assets as a percentage of total bank assets) (end 2012)

	EU in	**EU out**	**EU Total (in + out)**	**EU Periphery out (Southern Europe and + CEEC)**	**Exposure to At-Risk countries (euro periphery) as per cent of bank risk-weighted assets***
Austria	16.4	15	**32.4**	13.2	10
Belgium	50	23	**73**	14.6	36.4
Finland	66.2	1.8	**68**	2.3	5.6
France	10.1	14.7	**24.8**	8.2	21.9
Germany	11.8	7.2	**19**	7.4	25.9
Luxembourg	78.2	71.2	**149.4**	16.3	28.5
Netherlands	9.9	10.3	**20.2**	4.8	13.6

Sources for EU in: national central bank data bases. Sources for EU Consolidated foreign claims of reporting banks - immediate borrower basis: Bank for International Settlements (BIS), ECB statistical warehouse, European Banking Authority, EU Capital Exercise. The euro periphery includes Italy, Spain, Greece, Portugal and Ireland. Consolidated foreign claims of reporting banks - immediate borrower basis EU in from *EU banking structures* 2013. EU out includes assets held in the EU of all banks (including subsidiaries of foreign banks).

*December 2011 figures.

Table 2: Internationalization of large banks*, end 2012 (per cent of total bank assets; rounded figures)

	European Union	**Rest of World**
Austria		
Erste	56	3
Volksbank	48	4
Raiffeisenlandesbank	16	0
Bank of Austria (UniCredit)	50	1.8
Belgium		
KBC Group	21	15
BNP Fortis	16	4
ING Bel.	23	9
Finland		
Nordea Fin.	9	1
Dansk Fin.	43	4
OP Pohjala	18	3
France		
BNP Paribas	34	17
Société Générale	12	9
Crédit Agricole	11	8
CACIB	30	41
BPCE	14	15
Natixis	21	22
Crédit Mutuel	10	4

Germany		
Deutsche Bank	32	34
Commerzbank	17	32
Landesbank BW	20	8
Landesbank Bayerische	12	11
DZ Bank	21	6
Luxembourg		
BCEE	34	1
BNP-BGL	63	4
Netherlands		
Ing	22	38
ABN	12	8
Rabobank	9	17

*Those linked to alternative banks in bold.

Table 3: The institutional position of alternative banks and the internationalization of their central financial institutions

Country	Alternative bank assets as a percentage of total bank assets (end 2011)	Institutional position	EU exposure of central financial institution and linked investment banks	National preference on ECB supervision
Austria	51	Federation with bank autonomy but increasingly centralized and subject to joint liability schemes. Only a third of cooperatives remained independent entities (with a joint liability scheme in place).	Very high. Erste: 56 per cent. Volksbanken: 57 per cent of assets.	Only largest (including large alternative banks).
Belgium	N/A	No remaining savings banks and cooperatives.	N/A	Only largest.
Finland	21	Two-thirds in a centralized semi-consolidated relationship with a large mother bank. A third of cooperatives remained independent entities (non-consolidated) with no joint-liability scheme. Very small savings bank network.	Moderate. Op Pohjola: 18 per cent exposure to EU.	Only Nordea (largest) ideally; willing to include Op Pohjola.
France	43	Consolidated, very limited autonomy of members. Savings	Moderate to moderately high. Crédit Mutuel 10 per	All.

		banks and cooperative banks federated into large entities. Very few independent alternative banks.	cent. Crédit Agricole 11 per cent. BPCE high 14 per cent (29 per cent international). CACIB 30 per cent (71 per cent international). Natixis 21 per cent (43 international).	
Germany	43	Autonomous entities in joint liability and supervisory schemes. Central financial institutions created but without joint liability with smaller entities.	DZ Bank at 21 per cent (but no joint liability with cooperatives). Landesbanks range from 8 to 20 per cent (but no joint liability with savings banks).	Largest only. Very reluctant to compromise.
Luxembourg	15	No smaller alternative banks (measured by assets as a percentage of total assets). One single large savings bank and a single medium sized Raiffeisen (agricultural cooperative).	BCEE very high at 35 per cent.	All.
Netherlands	31	Centralized and Semi-Consolidated. 129 small Cooperative Rabobank banks (at end 2012) under a Central Rabobank with joint liability.	Coöperatieve Centrale Raiffeisen-Boerenleenbank **(**Rabobank) high at 18 per cent (38 per cent international).	All.

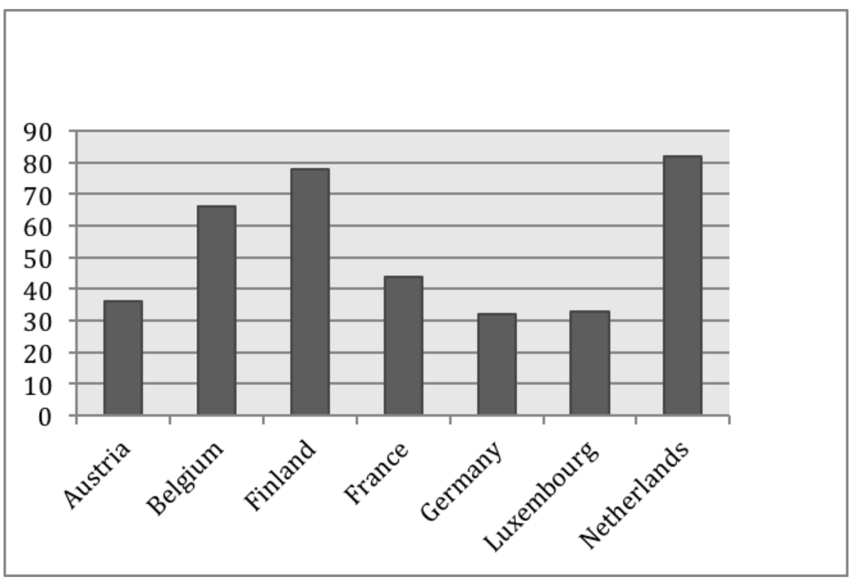
This list of alternative banks includes only cooperatives and savings banks; it does not include a range of public and semi-public banks or banks (e.g. Post office and municipal banks).

Table 4: Banks subject to direct ECB supervision (end 2012 figures)

	All banks	Banks directly supervised by the ECB*	Banks directly supervised by the ECB (percentage of total bank assets)
Austria	678	8	45.3
Belgium	16	7	91.1
Finland	193	3	79.5
France	18	10	89.1
Germany	1682	21	68.9
Luxembourg	146	5	18.5
Netherlands	91	7	88.5

Source: European Parliament (2014). *2014 decision based on end 2013 data.

Figure 1: Banking system concentration* (end 2012)



Source: ECB (2013) *Banking Structures Report;* *Share of the largest five banking institutions as a percentage of total assets.