Capital Markets Union and the threat of regulatory competition

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FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
FONDATION EUROPÉENNE D'ÉTUDES PROGRESSISTES

FEPS STUDIES
September 2016

FUNDACIÓN alternativas

DIIS

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Abstract

STS regulation has been criticized by industry as overly complex and too ambiguous to incite a large scale revival of securitization. On the other hand, NGOs as well as academics have criticized the initiative for fixing the wrong problem (supply rather than demand of credit), and for reviving a trend towards financialisation, which is likely to lead to future asset-bubbles in sectors such as real estate. This contribution will take up a different historically comparative angle and focuses on the current governance mechanisms regarding the enforcement of STS criteria. Here, the remaining decentralization of enforcement of compliance, to be provided by national market supervisors is the starting point for critical analysis. This paper focuses on the Asset-Backed Commercial Paper market, a market which was a major conduit transferring the crisis from the US to Europe and argues that such governance architecture favours acts of national economic patriotism which will favour the most lenient interpretation of the criteria for STS in countries where securitization in general and ABCP financing in particular is an important element of bank profitability. In order to substantiate this argument, the study details similar dynamics, which occurred pre-crisis with respect to the regulation of the ABCP market, where prudential rules were set and enforced by national banking regulators rather than a single European regulator. This governance set-up introduced a dynamic, where regulators, concerned about the fate of their national champions favoured regulatory drift, the conscious decision by regulators to not regulate these activities. Regulatory decisions were influenced by the larger institutional context of European financial market integration, which aligned the interests of large domestic banks and national regulators. In countries where the establishment of pan-European banks was encumbered by small domestic retail markets, limited expansion abroad, and/or low profitability, regulators actively kept the regulatory burden for shadow banking at a minimum to support their banks' engagement. The conclusion by analogy is that the definition of STS regulation and its enforcement should be set at the European level, that is ESMA, and be accompanied by critical scrutiny of external observers such as the European Parliament in order to avoid lax interpretations of these standards. Only the latter will ensure that lax EU-wide regulation does not ensue.

Keywords: capital markets union; ECB; euro crisis; European monetary union; market-based finance; securitisation; shadow banking;

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Acknowledgements: I would like to thank Petra Bosshammer, Jan Friedrich, Daniela Gabor, Daniel Mertens, Max Nagel, Andreas Noelke and Suramya Shukla for their help in improving the manuscript.

Introduction

After the global financial crisis, which erupted in 2007/2008 and the ensuing Euro-Zone crisis, European governance of banking regulation has taken an important step forward with the Banking Union in 2012 (McPhilermy 2014). An important motivation for this quantum leap for European governance, which centralized supervision in the ECB and the EBA was to overcome protectionism and regulatory laxity by national regulators with respect to their national champions (Veron 2014). Following Banking Union, the European Commission is pursuing the Capital Markets Union, returning to the pre-crisis theme of financial market integration at the heart of the political agenda of the Commission (ibid). The initiative for the Capital Markets Union marks a retreat from command style regulation post-crisis and engenders a new form of "co-habitation" of private and public regulation (Dorn 2016), which diverges both from drastic reform measures considered post-crisis and the self-regulatory dynamics pre-crisis.

At the centre of this initiative is the revival of securitization as a technique for funding as well as capital relief for banks, a technique according to the European Commission as well as pertinent lobby groups that has been unduly stigmatized by a crisis that was caused by US securitization products (EC 2015, AFME 2015). Initiated in 2014, the components of the Capital Markets Union regarding the revival of securitization have run through the legislative process in the European Commission and European Council swiftly and are currently being debated in the European Parliament.[1] In order to demarcate "safe (European) securitizations" from the ones deemed complex and opaque, the current regulatory initiative proposes to implement a category of Simple, Transparent and Standardized Securitizations, allowing investors to process the characteristics of the securitization products sufficiently in order to overcome the information asymmetries which according to the reading of the European Commission underlay the crisis dynamics. Excluding the pre-crisis solution to information asymmetries that was provided by rating agencies, the new proposal seeks to remedy the problem by forcing buyers to undertake due diligence to evaluate the risk profile of securitizations. Furthermore, by holding originators of securitizations liable to the compliance with STS criteria, the problem of information asymmetries is supposed to be overcome. In the case of a declaration of compliance that post-factum turns out to be incorrect, the originators are liable for misstatement.

The STS regulation has been criticized by industry as overly complex and too ambiguous to incite a large scale revival of securitization (s. e.g. BDI letter 27th of November 2015). On the other hand, NGOs as well as academics have criticized the initiative for fixing the wrong problem (supply rather than demand of credit, SOMO 2015) and for reviving a trend towards financialization, which is likely to lead to future asset-bubbles in sectors such as real estate (Engelen 2015). This contribution will take up a different historically comparative angle and critically scrutinize the envisioned governance mechanisms regarding the enforcement of STS criteria. It does so focussing on the Asset-Backed Commercial Paper market, a market which was a major conduit transferring the crisis from the US to Europe in 2007 (Shin 2011) and which almost completely collapsed post-crisis (Moodys 2015). In the

[1] The final legislation for the initiative for Simple, Transparent and Standardized (STS) securitization, which was initially expected in November 2016 is now delayed by debates in the European Parliament. European Parliamentarians seem to agree to the goal to offer capital relief for STS, but at the same time request a 20% risk retention requirement for securitizations

legislative process for STS securitization, the Asset-Backed Commercial Paper market has been included in the initiative. Going beyond the work of the BCBS/ IOSCO on "Simple, Transparent and Comparable Securitization" finalized in December 2014, upon which the EU initiative bases itself (BCBS 2014), the European Commission argues that the ABCP market is an important refinancing market for SMEs, in particular regarding the refinancing of trade receivables and leasing obligations (European Commission November 2015, also BDI 2015).

An important weakness in the currently envisioned governance arrangement is the remaining decentralization of the enforcement of compliance. The fact that the post-factum enforcement resides with the responsible national market supervisor sets up the incentives for national economic patriotism (Clift and Woll 2012), which will favour the most lenient interpretation of the criteria for STS in countries where securitization in general and ABCP financing in particular is an important element of bank profitability. The plans for STS thus are at risk of repeating the mistakes in the set-up of the governance architecture for securitization pre-crisis, which were at least partly responsible for the large fall-out of the crisis in Europe. In order to substantiate this argument in the following, the study details such dynamics that occurred in the evolution of the ABCP market before the crisis, where prudential rules were set and enforced by national banking regulators rather than a single European regulator and regulatory laxity prevailed.

The most recent global financial crisis had a surprisingly large, but varying impact on continental European banking systems. Political scientists and economists alike have pointed to considerable variation in shadow banking activities of European banks to explain the non-uniform impact of the financial crisis across Europe (Chang and Jones 2013; Hardie and Howarth 2009, 2013; Howarth 2013; Royo 2013; Gabor 2015; Shin 2011). But while the varying involvement of European banking systems in shadow banking activities is by now well established, the underlying drivers for these different exposures remain underspecified. Current explanations mostly point to banks as agents of change, and their choices about business activities as the decisive factors (Hardie and Howarth 2013: 51; Hardie et al. 2013b: 1; Bell and Hindmoor 2015), largely ignoring regulatory agency (but see Gabor 2015 for the case of the European Central Bank (ECB) and the European repo-market). However, shadow banking activities, such as securitization required favorable regulatory environments to flourish as they were very sensitive to regulatory costs. As shadow banking activities only generate very low margins (Claessens and Ratnovski 2014: 5) including them in costly banking regulation would thwart their growth. Regulatory agency was thus an important factor in constraining or facilitating these activities.

To overcome the bank-centric focus in current explanations regarding the shift to shadow banking activities, this paper examines regulatory agency and the institutional context of European financial integration that influenced it for the case of the Asset-Backed Commercial Paper (ABCP) market in the eight countries in the European Union (EU) whose banks sought an exposure to this market. The ABCP market was one of the main markets for pre-crisis shadow banking activities (Pozsar et al. 2010), which largely transmitted the crisis to Europe (Shin 2011). I find that the stringency of ABCP regulation correlates highly with exposure to the ABCP market. No country with stringent regulation has high exposure to the ABCP market, and four out of the six countries with lenient regulation have high exposure. I furthermore find that lenient regulation correlates highly with difficulties of national incumbent banks to establish themselves on the European level.

Based on this analysis, I argue that the regulatory agency of European banking regulators was influenced by the differential success of their large domestic banks to become large and profitable enough to remain independent in the new space of European banking competition; and associated regulatory concerns over the fate of "national champions"(for other factors influencing regulatory decision-making, s. Thiemann and Lepoutre forthcoming). EU financial market integration, which occurred stepwise from 1988 onwards, aligned the interests of national regulators and banks in the project of producing these national champions. In countries where this project ran into difficulties, I argue, there was particular pressure to allow banks to engage in shadow banking activities in wholesale markets in order to grow their fee income and make them more competitive.

The inquiry linking this different stringency in regulation to the competitive position of incumbent banks and the capacity of banking regulators to protect national incumbents is based on extensive analysis of statistics for European banking systems, using the Organisation for Economic Co-operation and Development (OECD), the ECB, the Bankers' Database, and Moody's Index Reports 1999–2010 for the ABCP market. I also draw upon 14 of 72 semi-structured expert interviews concerning the regulation of this market, held mainly with French, German, Dutch and Italian banking regulators, auditors, accountants, accounting standard setters, and financial analysts. All interviews were anonymized, and are referenced in the text with a coded number (for further information on interviewees cited, please see List of interviewees in the Online supplemental material). I first engage in a cross-case comparison, followed by within-case analyses of two typical and one crucial case that seek to substantiate the regulatory alignment hypothesis suggested by the cross-case comparison (Mahoney 2003).

The rest of the paper proceeds as follows: I first review the literature on the shift to shadow banking activities and its neglect of regulatory agency, proposing a more comprehensive framework of analysis that includes the agency of both the regulators and the regulated. I then lay out the argument that regulatory alignment led to less stringent regulation of shadow banking activities in certain banking systems, embedding such shadow banking activities into the creation of the common market for banking services in the European Union. I proceed by explicating the particulars of the ABCP sector and discussing the national regulatory decisions for this market in light of the competitive situation of the various national banking systems. I then provide qualitative evidence for the regulatory alignment hypothesis. The paper ends with a discussion of the implications of these findings for the larger literature on the institutional change of banking systems and the dangers inherent in increasing banking competition through market liberalization.

Regulatory agency: The missing component

Because shadow banking activities can only thrive in a favorable regulatory environment with minimal regulatory costs (Claessens and Ratnovski 2014), regulatory conditions played a major role in the shift to shadow banking. Research on the shift to shadow banking activities in European banking systems has acknowledged this structuring role.

As Hardie et al. put it:

Clearly, institutional factors shape bankers' business choices**: banking regulation and banking supervision … and protectionism in the banking sector**…. (2013a: 697, emphasis mine)

Researchers to date, however have emphasized the agency of bankers within these regulatory constraints (Acharya and Schnabel 2010; Hardie and Howarth 2013: 51; Hardie et al. 2013a: 697; Hardie et al. 2013b: 1), but have neglected regulators' agency that shaped these constraints[2] as well as the institutional constraints within which it itself evolved.[3] This is problematic as the shift to shadow banking was more than bankers "acting out institutional change" prepared by the (de-)regulatory efforts of rule-makers (O'Sullivan 2007). Instead, banks actively circumvented the rules, and a crucial question regarding the profitability of these activities was whether regulators updated regulation to include them or not.

This paper focuses on these regulatory decisions that hindered or facilitated these activities pre-crisis and places it in the context of European financial market integration, providing a more complete account for the differential exposure of national banking systems to shadow banking activities. The shift to shadow banking can then be analyzed as the endogenous outcome of the interaction of rule-takers and rule-makers (Streeck and Thelen 2005: 13–14) within a larger and changing institutional context, where rule-takers seek to circumvent regulation and rule-makers either do or do not expand regulation to capture these activities (Kane 1988). Fully grasping the stance that regulators had regarding these activities requires moving beyond the political economy literature's predominant explanations for pre-crisis regulatory (in-)action: regulatory and cognitive capture. These theories turn regulators into hapless victims, either of the financial might and political prowess of the financial industry (Johnson and Kwak 2010) or of an ideology proclaiming that the regulated possessed a superior intellectual capacity to control their risks (Baker 2010: 653–654; Engelen et al. 2011).

Recent contributions (Major 2012; Thiemann 2014) have documented widespread regulatory awareness of rule circumvention in the ABCP market since the late 1990s and its potential impacts on financial stability. This awareness led to tighter regulations of the ABCP market in the Basel II Accord, ratified in 2004 and to be implemented latest by 2008. Cognitive capture, then, cannot exclusively explain regulatory inaction in Europe before the outbreak of the crisis in 2007, at least not from 2004 onwards.[4] Theories of regulatory capture on the other hand, the idea that regulators act in the interest of and on behalf of banks that focus on domestic relations between regulators and regulated, rely mainly on the idea of lobbying through campaign contributions and revolving doors between regulators and the regulated, which play only a limited role outside the U.S. and the U.K. (Baker 2010; Woll 2014). In particular, independent banking regulators with autonomous rule making powers are shielded from these mechanisms, but as I will show nevertheless engaged in regulatory forebearance (s. the case of Netherlands below). But if regulatory and cognitive capture cannot unanimously explain regulatory (in-)action, what does?

I argue that the regulatory stance of national regulators towards shadow banking activities was influenced on the one hand by the opportunities national incumbent banks had in gaining a European incumbent status, and on the other hand, by regulators' capacity to protect their national

[2] E.g. Hardie and Howarth's (2009) sole explanation as to why German banks were more involved in shadow banking pre-crisis than French banks is banks' differing expansion strategies (retail vs. investment banking, ibid, 1026), omitting the role regulatory decisions might have played in these developments.
[3] But see the contributions by Gabor (2015) and Gabor and Ban (2015), which show the active intervention by the European Central Bank for the case of the European Repo-market.
[4] Except for Austria, all of the European countries whose banks were engaged in the ABCP market were permanent members of the Basel Committee.

incumbents from foreign take-over attempts (for other factors influencing this stance, s. Thiemann and Lepoutre forthcoming). Regulatory inaction can be, at least from 2004 onwards, analyzed as a case of regulatory policy drift (Streeck and Thelen 2005): in order to improve the profitability of domestic banks, domestic legislative bodies and national banking regulators chose to not update their regulatory framework in a way that would capture the shadow banking activities before 2008. As regulators weighed the competing goals of guaranteeing financial stability and maintaining the competitiveness of the industry they regulated (Singer 2007), their decision was influenced by the process of European financial market integration and its concomitant threat of foreign takeovers of the largest national banks. [5]

This finding has important repercussions for the debate in financial economics on the impact of increasing banking competition on financial stability, where one side emphasizes the destabilizing impact of increasing competition on the risk-taking of banks (Allen and Gale 2000), whereas the other emphasizes the benign effect of competition upon stability (Edwards and Mishkin 1995; Carletti 2008: 473). The crucial assumption in this latter view is that regulators do adjust regulation to changing circumstances in order to mitigate the risk-taking of banks. This adjustment, I argue, is inhibited in those banking systems that fare badly in the process of the expansion of bank-system competition. In this situation, regulators favor the formation of national champions and covert protectionism (Clift and Woll 2012), and, as is argued in this paper, if these two are insufficient, lenient regulation of risk-taking to increase profitability.

The threat of European financial integration in the retail market and the national regulatory responses

The competitive situation for large national banks was transformed by the Second Banking Directive of 1989, which set Basel I as the minimum regulation for all European Union members and broke down the barriers for competition in Europe (Walter 1999). The impending European integration led many in the banking industry and national regulators (Smit 2009: 208–209; Walter 2004: 76–77; Barendregt and Visser 1997; Coleman 2001) to expect that only a few large pan-European conglomerates would dominate the future European banking system. To survive the ensuing consolidation, banks believed they would have to acquire a retail presence in several European markets and grow large enough in terms of market capitalization to prevent hostile takeovers (Walter 2004). The already high concentration of banking services in Europe meant that such outward growth could only be achieved by taking over existing retail networks, thereby making inefficient bigger banks attractive takeover targets (Koehler 2009: 62).

Fusing national banking systems into a larger European one meant winners and losers for the industry, but it also worried domestic banking regulators as well as politicians and ministries of finance that a large share of the domestic banking system would be subject to takeover (Story and Walter 1997). Domestic banks remain an important tool for industrial policies (Deeg 2012: 2; Macartney 2014), making a foreign-owned banking system highly undesirable to domestic governments and banking regulators alike. The prevalence of home country control in the EU starkly

[5] Other factors which influenced this stance include the legal capabilities of regulators and the form and content of regulatory dialogues in these countries, determining when the rule circumventing character of these activities was recognized (see Thiemann and Lepoutre forthcoming).

limits the power of the host country regulator to control foreign banks, which could abandon their hosts in times of crisis, exposing the domestic economy to external fluctuations (Epstein 2014). The distribution of home and host regulatory powers also threatened the status of domestic regulators as an institution, who without large national banks would face a devaluation of status, size, and importance and hence were prone to support their large banks to maintain their own institutional status.[6]

European financial integration thus aligned the interests of national governments, national regulators and large banks as it broke down barriers to competition in the European Union. Under the oversight of European competition law, however, which barred open protectionism, regulators' agency to promote their incumbents was confined to covert protectionism and the formation of national champions, which had manifested as the domestic consolidation of the national banking industry since the mid-1980s (for the cases of Netherlands, Germany, Belgium and Austria, see inter alia Barendregt and Visser 1997; Maes and Buyst 2009: 109–110; Slager 2004: 245–246). Sometimes these attempts were actively coordinated, as in the case of France (Coleman 2001) or Spain (Perez 1997). Whichever the case, European national banking systems were transformed to become more concentrated and populated by large national champions, albeit with limited foreign presence (Grossman and Leblond 2011: 421).

Governments and regulators also encouraged their banks to pursue foreign acquisitions (Barendregt and Visser 1997; Coleman 2001), but these attempts were repeatedly obstructed by other national regulators seeking to protect their own domestic banks through nontransparent merger review processes (Berger 2007; European Commission 2005; Koehler 2009). The continuous expansion of European competition law in the 2000s put this strategy under increasing strain, however, threatening the capacity of domestic governments to protect their national financial systems (Seikel 2014; Deeg 2012: 35). Paradigmatic of these events is the case of the Bank of Italy in 2005: when its obstruction of merger attempts by foreign banks became public, the European Commission filed charges, and the powers of the Italian regulator to interfere in the process were removed by late 2005 (Koehler 2007).

In the 2000s, then, the possibility to create national champions through domestic consolidation exhausted itself as, did protection from foreign takeovers, two prominent tactics of economic patriotism in open economies (Clift and Woll 2012). As the capacities of national regulators to protect their incumbents from foreign takeovers diminished, regulatory leniency became an attractive third option to foster national banks' expansion and increase their competitiveness. Financial regulation and supervision impose "a set of 'taxes' and 'subsidies' on the operations of financial firms" (Story and Walter 1997: 129), so a low "net regulatory burden" could revive banks' and thus national banking system's competitiveness. This holds especially in wholesale banking activities which were particularly sensitive to regulatory requirements (Hellwig 2010). Such regulatory leniency, however, could only be applied to banking activities that fell outside the scope of the first Basel Accord.

The European implementation of Basel I had been part of a particular political compromise: having failed to delegate the rule-making and supervision functions of regulation to the European level, the EU countries instead agreed on minimum standards: the mutual recognition of national regulation,

[6] In the words of Philip Selznick, they were engaging in institutional self-maintenance (Selznick 1957).

predominance of home country regulation, and harmonization according to the Basel framework (Story and Walter 1997: 17). This compromise largely facilitated the negotiations between European countries (Muegge 2006: 1006), but it also meant that additional regulations had to be taken on the national level, opening up the opportunity for deliberate regulatory inaction. The European Commission installed this opportunity for regulatory competition right at the heart of the European financial integration, hoping (mistakenly) for an optimal regulatory burden to emerge (Jabko 2006: 79).

Regulatory arbitrage in shadow banking and the bank-government alignment

One area in which national regulators could act leniently was the engagement of their banks in wholesale finance, in particular those practices by banks used to evade the core capital requirements in the Basel Accord (Jackson et al. 1999). These financial innovations allowed banks to increase their income without having to raise their equity, thereby improving their reported return on equity, an important element in stock market valuations (Bell and Hindmoore 2015). A paradigmatic example of such an innovation is the ABCP market, a main component of pre-crisis shadow banking system (Pozsar et al. 2010). Banks used this market to refinance long-term credits and asset-backed securities with short-term papers and make money off the yield spreads.

Because the short-term papers were issued by weakly capitalized special-purpose entities (SPEs), the transactions stayed off the balance sheets of the banks. But the SPEs were sponsored by the banks, which provided liquidity lines and credit guarantees (Fligstein and Habinek 2014), ensuring that the ABCPs were indeed risk-free for investors and earning the banks fee income (Gorton and Souleles 2007). This sector was particularly attractive for banks with below-average profitability (Arteta et al. 2013: 54), but its very weak margins also made it especially sensitive to regulation, since regulatory costs could wipe out any of its gains (Hellwig 2010: 27). Figure 1 below shows banks' involvement in the ABCP market for all countries from the European Union where banks had such an exposure (Arteta et al. 2013), showing that exposure was by no means uniform.

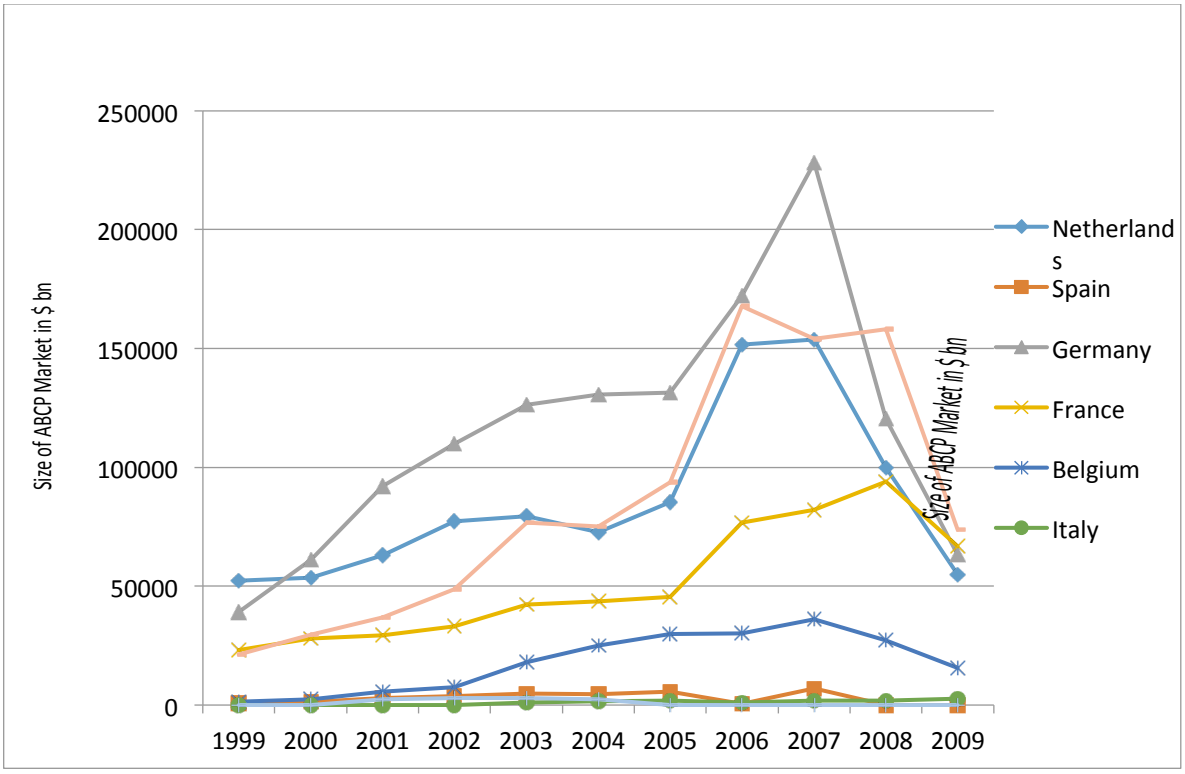

Figure 1: Differential Exposure of EU countries to the ABCP market

German banks had the largest exposure to the market in June 2007 ($228 billion), with Dutch and British banks closely following ($154 billion). French banks were a distant fourth ($82 billion dollars) and Belgian banks fifth ($36 billion). Spanish ($7 billion), Italian ($3 billion), and Austrian banks ($2.5 billion) had such negligible ABCP exposure that they barely appear on the graph.

The differing exposures of these eight European national banking systems can be better appreciated once one makes the size of the ABCP conduits sponsored by national banks proportional to the size of the banking system, as in figure 2 below. This graph documents the pronounced exposure of Dutch and Belgian banks, with the former's exposure by far the largest and the latter's exposure relatively equivalent to Germany's.

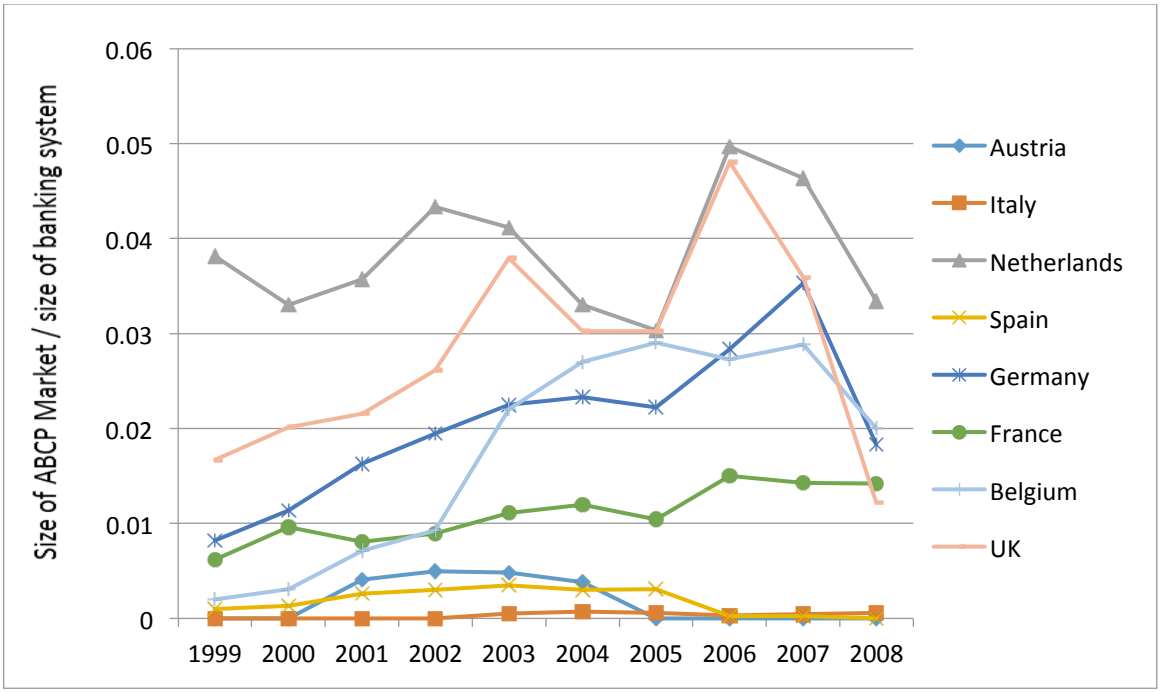

Figure 2: Conduits by European nation / size of banking system

Given the sensitivity of this market to regulation, this non-uniform exposure points to different national regulatory stances towards the engagement of domestic banks in this transnational market. Regulators could increase the costs for their banks to participate in this market either by forcing banks to account for the risks of the assets of the SPEs they de facto controlled, or by putting extra capital charges on liquidity lines, thus making market participation less likely (Acharya and Schnabl 2010; Thiemann 2012). Only Spain and France did so, by applying core capital charges to consolidated conduits and by introducing core capital charges in 2002/2003 for liquidity lines below one year (Acharya and Schnabl 2010 for Spain; Thiemann 2012 for France). The other six countries decided to wait on introducing a core capital charge on liquidity lines until 2008, when the new Basel II regulations adopted in 2004 entered into force. These six countries also exempted the conduits from core capital charges if they were consolidated into banks' balance sheets following the introduction of the International Financial Reporting Standards in Europe in 2005.

I will now examine the structure of the national banking systems of these eight countries and the position of incumbents in the emerging European space to show that these regulatory decisions correlate highly with the capacity of the respective national champions to establish themselves on the European level and of the regulator to protect them from foreign take-over.

Structural reasons for the differential regulation of the ABCP market

In light of the theory laid out above, one would expect regulatory alignment to lead to regulatory inaction anywhere national incumbent banks faced problems to become large enough to fend off foreign take-overs; that is where banks had difficulty gaining a second large retail market; where

price-to-book (P/B) ratios were low, indicating inefficiencies that made banks likely takeover targets for foreign banks; and/or where banking regulators had limited capacity to block foreign acquisitions. Regulatory alignment should be less likely to lead to regulatory drift in countries where banking regulators are highly capable of protecting their incumbents; profitability is high; and/or banks are large in size, making them unlikely takeover targets. This finding should hold independent of whether regulators are independent from the ministry of finance or not.

Table 1 below seeks to capture these variables, depicting average return on assets, size of the home market, concentration in the domestic market, the establishment of a second large retail market by domestic incumbents (defined as the largest three banks), independence of the banking regulator and the 2004 capacity of the regulator/finance ministry to interfere in the competition review process regarding mergers and acquisitions. The size of the home market and concentration in the banking system influence how large domestic banks can become through domestic growth, showing the degree to which regulators can still favor this form of economic patriotism. The profitability, stock-market valuation, and P/B ratios of domestic banks indicate their relative attractiveness as takeover targets and the difficulty of acquiring them. The protective capacity of regulators is an important intervening variable for such acquisitions.

Table 1: The Structure of Domestic Banking Systems and the Protective Capacity of the Banking Regulator

	France	Spain	Italy	Netherlands	Austria	Germany	Belgium	UK
Return on average Assets (1999-2007), EU 15 average: 0.62%*	0.489%, -below EU-15 average	0.776%, above EU-15 average	0.649%, -above EU-15 average	0.476%, -below EU-15 average	0.49%, -below EU-15 average	0.176%, -below EU-15 average	0.447%, -below EU-15 average	0.699% (above EU 15)
Banking regulator subordinated to central bank or finance ministry (Regulatory Independence 1-100, source Quentyn et al 2007)	Commission Bancaire, subordinated to Central Bank/independent (N/A)	Central Bank/ independent N/A	Central Bank/ independent N/A	Central Bank (76)	Since 2002, independent from CB and MoF (79)	Subordinated to MoF (47)	Independent agency, since 2004 linked toCB (92)	Officially independent: MoF appoints board members (82)
Size of Home market 2004 (bn of Euro)	3642.8	1551.3	2330.9	2198.4	308.13	5604.4 (but limited :three pillar system)	930.6	6609 bn Euro
Asset share of foreign Credit Inst. as percent of total 2004 (1997)	11,4 (10.4)	11,5 (12.5)	7.7 (7.0)	12,1 (7.2)	19.4 (3.4)	6,3 (4.3)	23.2 (30.4)	51.3 (52.2)
concentration of 5 largest banks in 2004 (ECB data)	49,2	41,9	26,8	84,5	44.4	21,6	84	34.5%
Second large Retail Market in Europe in 2004**	No	No (but Latin America)	No	Yes, Belgium	Yes, Central and Eastern Europe	No	No	No
Average Market Value of 3 largest banks 2004**	High (37.39bn Euro)	High (50.5 bn Euro)	Medium (20,85)	High (41 bn Euro)	Low (9,486)	Low (18,66 bn Euro, outlier Deutsche Bank)	Medium (20,98 bn Euro)	Large (98 bn Euro)
Price to Book ratio***	Medium (1,85)	High (2,7025)	Medium (1,63)	Medium (1,99)	High (2,83)	Low (1,18)	Medium (1,78)	2,35 (high)
Capacity of regulator/ministry of finance to protect banks in Merger Review Process 2004 ****	Medium (0.60)	High (0.9)	High (0.92)	Low (0.12)	Low (0.12)	Low (0.12)	Not computable*****, no role for banking regulator	Not computable*****, no role for banking regulator
Regulation above Basel I for ABCP Market	Yes	Yes	No	No	No	No	No	No

Source: OECD Database on banking profitability, Carletti et al 200 6, p. 8, Slager 2004, EC 2005, p. 13, ECB Statistical Data Warehouse, Quintyn et al 2007, Schoenmaker and van Laecke 2006, p. 27f, V-Lab Beta, authors' calculation

* Return on average assets, rather than return on equity is employed for two reasons. First, return on average assets shows the underlying profitability, excluding leverage. Second, as the hypothesis of the paper is that banks and regulators were colluding to produce high RoE, RoE cannot be used to measure the regulator-regulated alignment.

**The top three banks by market value were used to calculate size and exposure to foreign retail markets. These include for the UK RBS; HSBC and Barclays; for France BNP Paribas, Societe Generale and Credit Agricole; for Belgium Fortis, Dexia and KBC; for Italy Unicredit, Intesa and Sanpaolo, for the Netherlands: ING, ABN Amro, Rabobank; for Spain Santander, BBVA, Caja Ahorra Barcelona; for Germany Deutsche Bank, Hypovereinsbank and Commerzbank and for Austria Erste Bank and Raiffeisenbank. Caluclating the market value, for the case of Spain, the third largest bank was excluded as it was a local savings bank (Caja Ahorra Barcelona),in Austria, the second largest bank was excluded, as it was a cooperative bank that was not listed (Raiffeisen). In the Netherlands, the third largest bank was also excluded, as it was a not listed cooperative bank (Rabobank) Data from The Banker and Annual Reports, authors' calculations.

*** In the case of France, the Price to Book Ratio for Credit Agricole is excluded from the calculation, as it is distorted by the specific shareholding structure of this cooperative bank, with 56,25% of shares controlled by the regional savings banks of Credit Agricole. This fact and the core capital of €46.48 bn make it invulnerable to take-over attempts.

****authors' own calculation, using data from Köhler 2007 and Carletti et al 2007. Aggregate Approval Requirements Index (Koehler 2007, p. 31) is multiplied by the status of the competition enforcer (=1 if antitrust-authority, 0 if no competition control, s. Carletti et al 2006, 8). Final result is computed by 1- (computation).
****Koehler does not provide data on Aggregate Approval Requirements Index. However, in Belgium and the UK only the anti-trust authority is involved in the competition review, indicating a weak position of the banking regulator to influence the process.

The protective capacity is calculated using data from Carletti et al. (2006) and Koehler (2007: 31), who document the role of banking regulators and finance ministries in the merger review process and the aggregated approval requirements. These authors rate the capacity of regulators and finance ministries to protect incumbents as high if they are directly involved in the competition review process and have high approval requirements, and as low if the competition review process is undertaken by an independent competition enforcement authority with limited approval requirements. The quantitative findings match qualitative data describing the protectionist stance and capacity of the French (Jabko and Massoc 2012), Italian (Berger 2007), and Spanish authorities as high (Perez and Westrup 2010: 1179). On the other hand, Dutch and British authorities (Macartney 2014; Smit 2009: 334) are hindered engaging in protective measures due to their embrace of liberal traditions. Lastly, German interventions are limited by a strong independent competition review process (Carletti and Hartmann 2002: 15).

Looking at these variables describing the banking systems and the regulation of the ABCP market, one can see that in countries where the capacity to expand in domestic markets was rather exhausted and/or markets were rather small, profitability was below average, and/or regulators' protective capacity was low, regulation of the ABCP market was lenient. This holds for the Netherlands, Austria, Belgium, and Germany (because of the three-pillar system, which limited expansion for commercial banks; Hackethal 2004). The incumbents in Germany, Belgium, and Austria reached only limited size, with the Netherlands an exception. Importantly, three of these four regulators are rated as highly independent by the International Monetary Fund (IMF) (Quintyn et al. 2007).

In the case of Spain and France, where regulation was stringent, incumbents reached large size and the power of banking regulators or the finance ministry to intervene in the merger review process was medium to high. The French domestic market is large, and Spanish banks managed to grow their retail presence beyond Spain, opening up lucrative retail markets in Latin America and the U.K. (Guillen and Tschoegl 2008). In Spain, furthermore, profitability before the crisis is above average. These features correlate with a regulatory stance that refused to grant regulatory exemption and regulatory interventions to apply core capital charges to the exposure of French and Spanish banks to the ABCP market, e.g., when Spanish banks requested more favorable regulatory capital treatment for their ABCP conduits in 2004 (Thiemann 2012).

The two cases in the table above that do not conform to this pattern are the U.K. and Italy, where regulatory leniency coincides on the one hand with large banks (U.K.) or strong domestic protective capacity (Italy). However, a closer look at these two cases reveals that these two are in line with the general argument of the paper. British banks are large and profitable, and the home market is large. However, regulators' capacity to limit mergers is very limited through competition law, and the foreign presence of banks very large (51.3%). While the concentration of the five largest banks is

rather low, the competition enforcement in the U.K. has repeatedly interdicted domestic mergers out of competitiveness concerns (Carletti and Vives 2009: 273; Slager 2004: 281), with important consequences for the presence of foreign banks in the U.K.: e.g. when the merger of Abbey and Lloyd was banned in 2004, it created an opportunity for the foreign group Santander to buy Abbey. Attempts by British banks to expand into retail markets abroad also failed (Slager 2004: 304). This left facilitating growth in wholesale markets as one of the few regulatory opportunities for economic patriotism.

In Italy, on the other hand, regulators' capacity to intervene in merger review processes was very high in 2004, profitability was above average, and while banks only reached medium size, the possibilities for domestic mergers had not yet been fully exhausted. While formal regulation here was lenient in order to support the growth of securitization in general (Deacon 2004: 316ff), the Bank of Italy employed moral suasion to keep banks out of the ABCP market (#56). Furthermore, it had the legal discretion to apply core capital charges to ABCP transactions of Italian banks, if it came to the assessment that the risks of the ABCP remained with the bank (#65), a discretion it repeatedly used (e-mail former member Bank of Italy, 26th of February 2015). Furthermore, the Italian banking law did not recognize synthetic structures of ABCP conduits and no regulatory accommodation of this fact was undertaken (#69).

Within-Case Analysis

I will now seek to substantiate these findings from the cross-case comparison that indicate a correlation between the position of national banking champions in the process of European financial integration and the regulation of shadow banking activities through within-case analysis. I will do so first for two typical cases, one that enacted early re-regulation (France, with large national champions and an independent regulator), and one that chose not to (Germany with a regulator subordinated to the Ministry of Finance and rather small national champions). These two cases can be explained with the regulatory alignment hypothesis but could also be explained by the simple presence/absence of regulatory capture. The Netherlands with large banking conglomerates and an independent regulator endowed with large discretion and ranked as highly independent (Quintyn et al. 2007) function as a crucial case (Seawright and Gerring 2008), where regulatory independence suggests the absence of regulatory capture. However, my within-case analysis shows regulatory policy-drift as an outcome of the concerns by the regulator regarding the competitiveness of its national champions.

France

Following a comprehensive and anticipatory strategy (Coleman 1996: 14), the overall merger activity coordinated by the French government during and after the 1991 re-privatization of banks resulted in an oligopolistic structure and good profitability in a home market large enough to sustain pan-European banks (#6, #10). The unification and privatization of mutual banks into two large players in 1988 (Credit Agricole and Credit Mutuel) is paradigmatic for this change. The government also had a clear protectionist stance, as was demonstrated during the 1998 sale of CIC to Credit Mutuel rather than to the Dutch ABN Amro, the breakup of Credit Lyonnais in 1999, and the crisis of Société Générale in 2008 (Jabko and Massoc 2012; Koehler 2009: 40, Woll 2014). These facts put the independence of large French banks beyond doubt and eased regulators' concerns about the

competitive disadvantages French banks might face in the shadow banking sector. The French banking regulator, independent from the ministry of finance since 1993 (Coleman 2001) tightened regulation of the ABCP market in 1999, 2000, 2002 and 2003, despite industry complaints of competitive disadvantages in the ABCP market (#19; #28) and despite the ministry of finance at some point siding with industry (#33). In this case, competitiveness concerns in shadow banking did not carry sufficient weight for regulators to inhibit action, as incumbents were well protected and profitable.

Germany

During the 2000s, the German banking system generated consistently lower profitability than the European average. Large German banks were smaller than their European peers because of the fragmentation of the German banking system into three pillars of private, public, and local credit associations (Hackethal 2004). Attempts in the 2000s to form a national champion by combining at least two of the three large private banks failed (Slager 2004), despite support at the highest political levels (Hakenes and Schnabel 2006). The low profitability of German banks was a main preoccupation at the ministry of finance (#50), which saw fee income from securitization business as one means to improve the situation (Asmussen 2006). The comparative weakness of German banks dissuaded the finance ministry from raising the regulatory burden for securitization beyond general European requirements. A regulatory advisor explained this stance: "It was always important; it was a unitary market in Europe … equal rules should apply, and the German ones should definitely not be stricter than the others" (#46, also #41). As a consequence of this stance and the fact that the ministry of finance controls the decisions of the financial regulator (the Bundesanstalt für Finanzdienstleistungsaufsicht, see Quintyn 2007), regulatory measures that increased the costs for ABCP business were delayed to the latest possible moment (2008, #50).

The Netherlands

Like their Belgian counterparts, Dutch conglomerates in the 2000s were facing low interest margins in their domestic markets and were having difficulties expanding into Western Europe. Characterized as having truly European ambitions (Boot 1999), the conglomerates were looking for a second home retail market large enough to sustain them as large pan-European banks; it was clear to both Chief Executive Officers (CEOs) and banking regulators that without expansion, they would be taken over. Despite pressure from the Dutch National Bank (DNB) on the Bank of Italy and others to allow takeover bids from Dutch banks (Smit 2009: 251, 340), interference by foreign domestic regulators blocked Dutch banks' European expansion. This led these banks to direct their attention to the wholesale market. The CEO of ABN Amro explained to a professional journal in the summer of 2000:

Germany and France are locked up … the merger process is making little progress in those countries … where it is that foreign banks are not really welcome. That's why we've stopped saying that we want to create a second domestic market … … the expansion will come from global wholesale banking. (Smit 2009: 168f)

From the 1990s onwards, the DNB was supportive of Dutch banks' plans to establish themselves in wholesale finance and the ABCP market (#65, Aalbers et al 2011). By 2007, with no extra regulatory charges, and lenient regulation, Dutch banks had become major players in the ABCP market. Indeed, ABN Amro, the largest Dutch bank by asset size, was the largest sponsor of ABCP conduits in the world ($75 billion, ING $38 billion, Rabobank $35 billion, Moody's Index Program). The increased fee

income from this market gave an important competitiveness boost to ABN Amro, which in the mid-2000s, had a mid-sized market capitalization and underperformed its peers in most of its activities. It suffered from comparatively high cost-to-income ratios (Slager 2004: 205), putting its independence into question (Smit 2009: 208–209, 288). In this conjuncture, in 2004, the DNB considered imposing additional capital charges on liquidity lines for ABCP conduits (DNB 2005). It could have tightened measures even without legislative approval (#71), but abstained due to its focus on the level playing field for its banks with respect to European competitors (DNB manager e-mail 14th of April 2015). Instead, reacting to the threat to the independence of one of its large national champions, the DNB in 2006 sought to facilitate a merger between the largest banks, ING and ABN Amro, but failed (Smit 2009: 322ff). Finally, ABN Amro was taken over in 2007 by a consortium led by the Royal Bank of Scotland.

Discussion and Conclusion

Current explanations for European banking systems' shift to shadow banking activities have mostly focused on bankers' agency (Hardie and Howarth 2009, 2013), ignoring regulatory agency and the context within which it evolved (but see Gabor 2015; Gabor and Ban 2015). But this shift was not just bankers "acting out institutional change" prepared by the regulatory efforts of rule-makers (O'Sullivan 2007) as it involved rule circumvention by the banks. The crucial question in this shift was whether domestic regulators would update regulation to rein in additional risk-taking by their banks. These decisions, as this paper has shown for the ABCP market, were influenced by regulators' concerns over the competitiveness of their national champions in the context of European financial integration.

European financial integration aligned the interests of large banks and their regulators, leading all regulators to favor the formation of national champions and covert protectionism. When these two measures of "economic patriotism" were insufficient to establish their national champions at the European level, regulators could choose to not update regulation to support their champions' growth and profitability. Their decisions then were partially an endogenous response to the shifting institutional context, within which banks as well as regulators sought to ensure banks' growth and survival through strategic action. These findings challenge the common economic approach of considering the effects of competition upon banks independent of their effects on regulators. They show that the process of increasing competition between banks of different nations should be better analyzed as a competition between national banking systems, including the banking regulators, with its attending negative consequences for financial stability.

It is noticeable that Spain, France, and to a lesser extent Italy, countries often categorized as forms of "state-enhanced capitalism," (Schmidt 2003) opposed this regulatory drift. This reflects their capacity to "adapt traditional aims, notably the promotion of … international champions, to new conditions" in the European Union (Thatcher 2007: 1028), when state intervention was facilitating the formation of banks competitive at the European level before full liberalization exposed them to their competitors (Deeg 2012). The capacity of these governments to protect their incumbents from foreign takeovers and restructure their banking systems to establish them at the European level allowed them to ignore questions of competitiveness in the field of shadow banking.

This study then is a cautionary tale about liberalizing and integrating markets when regulatory powers remain fragmented. While the supranational level of European financial regulatory architecture received a significant boost after the Eurozone crisis (Quaglia and Howarth 2013), the transfer of regulatory powers was not complete (McPhilermy 2014). But even such a complete transfer could not resolve the problem of economic patriotism, as it shifts to the next-higher level. Today, banks from the US, the EU and Switzerland are competing in a quasi-single market, within a legal framework that limits acts of overt protectionism, a fact that will even become more pronounced if the Transatlantic Trade and Investment Partnership (TTIP) is enacted. Economic patriotism in the form of regulatory drift thus remains a possible policy option in systems with problems adapting to the changing competitive landscape, which would favor further shifts to shadow banking activities of banks. This constellation endangers financial stability, regardless of regulatory or cognitive capture of regulators.

For the case of the STS initiative as parts of the Capital Markets Union initiative, these findings have important implications. Leaving post-factum enforcement of STS criteria for ABCP to national domestic regulators re-installs the incentives for economic patriotism at a different entry point. As shown in this paper, regulatory conditions are very important for the thriving of the ABCP market (s. also Acharya and Schnabl 2010). As such, any regulator concerned about its evolution will seek to lower the regulatory burden where seemingly appropriate, a tendency reinforced by the fact that banks from all European nations compete for ABCP transactions based on domestic interpretations of European regulations. Given the argument in the paragraph above, however, it is clear that simply transferring post-factum enforcement to ESMA will not do the trick. Besides needing an expansion in manpower and financing in order to do this job, the regulatory agency will also need external oversight in order to prevent regulatory leniency at the European level.

Here, the post-factum level of enforcement can be an advantage, as enforcement activities occur less regularly but with a larger signaling effect. Hence, first transferring the enforcement decision to ESMA in order to achieve a unique interpretation to avoid regulatory competition and second, supervising these decisions by an external third party could help to overcome the deficiencies in the currently envisioned governance architecture. As regulatory leniency and the related over-expansion of credit pose dangers to financial stability, one possible candidate for such oversight is the European Systemic Risk Board, which has the task to supervise developments in the Euro-Zone with respect to systemic risks. Another option is to regularly review the decisions by ESMA in the European parliament, which due to the limited amount of enforcement to be expected could be feasible. Such oversight also needs to include an analysis of communications by ESMA to market participants concerning STS and the expectations thus formed, in order to avoid the build-up of securitizations based upon the expectations of lenient enforcement. Any national enforcement decisions would make such analysis much more complicated, requiring legal analysis in each and every jurisdiction it occurs.

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