Power to the European Supervisory Authorities:

Explaining the Incremental Evolution of European Financial Regulation

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Abstract: What explains the incremental evolution of European financial regulation after the 2008 financial crisis despite the unequalled opportunity for bold institutional redesign? This article probes two accounts of the observed outcome. The first account focuses on historical institutionalist mechanisms such as path dependence, policy feedback effects, and institutional layering. The second explanation draws on rational choice institutionalism and emphasizes preference convergence in pursuit of collective action. The empirical investigation demonstrates that the two accounts are complementary. The novelty of this article is showing that incremental reform is also consistent with a rational choice institutionalist framework of analysis.

The 2008 global financial crisis has led to a severe economic downturn in advanced industrialized economies. It presented an unparalleled opportunity for a bold redesign of financial sector supervision, considering the public outcry against the shortcomings of the financial industry and regulators. The central puzzle in this article is why European decision-makers have responded by incremental regulatory reform.

I argue that preference convergence among the main legislative actors in the European Union (EU) – the European Commission, Parliament, and Council of Ministers – helps to understand the observed incremental institutional redesign. Historical institutionalist mechanisms such as path dependence, feedback effects, and layering explain well the build-up of pressures for institutional reform. However, these mechanisms do not explain how to resolve disagreements among key decision-makers about the need for greater regulatory harmonization in the Union. Thus I turn to rational choice institutionalism as a complementary theoretical framework to analyze the negotiations of financial sector reforms in the EU.

This article shows that the de Larosière regulatory framework, developed in the EU after the 2008 financial crisis, incrementally upgrades the preceding Lamfalussy framework. Let me sketch the main aspects of institutional reform. Level 3 Lamfalussy committees – CEBS (banking), CESR (securities), and CEIOPS (insurance) – were set up to spur regulatory convergence across member states and sectors. As early as 2007, the Economic and Financial Affairs Council of Ministers (ECOFIN) suggested that level 3 committees strengthen the national application of their guidelines, standards, and recommendations (Council, 2007). However, it did not recommend upgrading the non-binding status of their recommendations in order to give them 'more teeth'.

Two years later, the de Larosière reforms enhanced the institutional powers of the three committees. They became European supervisory authorities (ESAs) – the European Banking Authority (EBA), the European Securities and Market Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). Elliot Posner and Nicolas Véron (2010) have shown that the European Commission played a central role in initiating the de Larosière report and, subsequently, developing the blueprint for more centralized European supervisory authorities. However, they also observed significant intergovernmental and inter-institutional constraints on how far centralization could go (Posner and Véron, 2010). Fully operational since January 2011, the ESAs have been developing and enforcing common supervision rule books in their respective sector, and are able to issue *binding* decisions to ensure greater regulatory coherence. This is a clear institutional upgrade of the Lamfalussy framework which, at least in theory, enables the ESAs to make decisions with direct effect on market participants and national supervisory organizations.

At the same time, the institutional redesign of level 3 Lamfalussy committees was less ambitious than the bold proposals for institutional reform circulated in the EU legislative triangle such as merging sectoral supervision into a single European financial supervision authority (Financial Services Authority, 2009, p.103; Hungarian Financial Supervisory Authority, 2009; Luxembourg Bankers' Association, 2009; see also Buckley and Howarth, 2010). This is one important reason why I consider the recent European financial architecture reforms to be incremental rather than radical.

This article is organized as follows: First, I present the evolution of European financial regulation from the Lamfalussy to the de Larosière framework in greater detail. Then I consider whether incrementalism, drawing on the work of Charles Lindblom, provides useful insights to understand the evolution of financial regulation in the EU. In the empirical part I probe the relevance of two theoretical frameworks – historical institutionalism and rational choice institutionalism. Incrementalism has been used mostly in historical institutionalist analyses of EU decision-making. This article contributes to the literature by showing that a rational choice institutionalist account, focusing on the preferences of the main policy actors and bargaining, can also explain incremental institutional redesign. In this context, incrementalism results from the pursuit of collective action in a complex institutional environment where preference heterogeneity is high. The conclusion summarizes the main findings.

The incremental evolution of EU financial sector regulation: From Lamfalussy to de Larosière

To begin with, the following brief overview of EU financial regulation milestones provides background for understanding the policy debates about empowering the European supervisory authorities. The first overarching policy at the EU level in the realm of financial markets and services was the Financial Services Action Plan (FSAP) covering the period 1999-2005. Due to its slow implementation, in 2000, the ECOFIN Council of Ministers appointed an expert committee, chaired by Alexandre Lamfalussy, to speed up EU-wide convergence in regulating securities markets. The committee developed the four-level regulatory approach shown here in Appendix I. The so-called Lamfalussy framework was adopted in 2002 after lengthy negotiations between the European Commission, Council, and Parliament, and the principles outlined in the Lamfalussy report for the securities sector were extended to banking and insurance (Lannoo, 2002; Quaglia, 2007). In 2004, the European Commission reviewed the Lamfalussy process and engaged in extensive consultations to fine-tune its implementation. The Commission's White Paper on Financial Services 2005-2010 succeeded the FSAP in providing a vision for developing the single market in financial services (European Commission, 2005; see also Masciandaro *et al.*, 2009; Grossman and Leblond, 2011).

Level 3 committees (CEBS, CESR, and CEIOPS) were the most innovative institutional feature of the Lamfalussy framework. They were set up to foster the exchange of best practices across member states and sectors, and facilitate regulatory convergence (European Central Bank 2007; Grossman and Leblond, 2011). However, they were only authorized to issue *non-binding* recommendations. In November 2005, the three committees signed a joint protocol on cooperation to ensure greater coherence and consistency. They pledged to share information more effectively, exchange experience, reduce duplication of reporting, and issue joint reports and strategies for future development (European Central Bank, 2007).

In the aftermath of the 2008 global financial crisis, the European Commission launched a new initiative to redesign the European financial architecture following the recommendations of another high-level expert group, chaired by Jacques de Larosière (see Hodson and Quaglia, 2009; Quaglia, 2010). These reforms envisaged the creation of a European Systemic Risk Board (ESRB) that would be in charge of macro-prudential supervision – monitoring and assessing systemic risk in European financial markets (European Commission, 2009b). A second institution – the European System of Financial Supervisors (ESFS) – would complement the ESRB in the area of micro-prudential supervision. The ESFS includes the three new European supervisory authorities in banking, securities, and insurance (European Commission, 2009c; Amtenbrink, 2011). This new EU regulatory framework is shown here in Appendix II.

The first new institution, the European Systemic Risk Board, is fairly uncontroversial. It monitors risks to financial stability in the EU-27. It is comprised of the 27 national central bank governors of the EU member states, the two top European Central Bank officials, as well as representatives of the Commission and the three newly-created European supervisory authorities. The second institution, the European System of Financial Supervisors, has caused significant debate. The de Larosière reforms empowered the ESAs to issue decisions with *binding* power. While member states in favour of greater centralization and harmonization of financial regulation as well as the European Commission and Parliament welcomed the enhancement of the ESAs' powers, other member states voiced concerns about possible fiscal burden and loss of sovereignty (Buckley and Howarth, 2010; Spendzharova, 2012). The negotiations also gave rise to debates about the lack of an adequate common European deposit guarantees and bank resolution regime (Kudrna, 2012; Schoenmaker and Gros, 2012). Next, let us consider the relevance of incrementalism for understanding the recent EU financial regulation reforms.

Incrementalism

Incrementalism gained prominence in response to what a number of public policy scholars saw as the unrealistic assumptions of the rational choice paradigm. For rational choice theorists in the 1950s and 60s, policy-making followed a linear sequence of identifying all relevant alternatives, doing cost-benefit analysis, and picking the most optimal policy. As Charles Londblom (1959, p.80) stated, 'the hallmarks of these procedures…are clarity of objective, explicitness of evaluation, a high degree of comprehensiveness of overview, and, whenever possible, quantification of values for mathematical analysis'. By contrast, Lindblom argued that in complex decision-making, the number of politically feasible alternatives is considerably smaller to begin with. In his view, rational decision-making was only possible in small-scale problems where all alternatives were known and only a few variables could impact the outcome. Public policy scholars such as Aaron Wildavsky (1987; see also Padgett, 1980) have provided further evidence in support of Lindblom's critique.

The alternative decision-making method proposed by Lindblom for complex problems is that of *successive limited comparisons*, better known as incrementalism. He used the metaphor of the branch method to describe his approach, 'continually building out from the current situation, step-by-step and by small degrees', rather than starting from scratch every time decision-makers encounter a problem (Lindblom, 1959, p.81). Lindblom's analytical framework is particularly relevant for policy environments where decision-makers are faced with conflicting priorities and disagree about the most appropriate course of action. Such constraints become all the more evident and important in fragmented multi-layer systems of decision-making such as the European Union (Seifert, 2011). Simple rank ordering of policy alternatives is not feasible, and policy actors often neglect important possible outcomes and alternative policies. In the end, policy adjustment tends to occur in the margins because decision-makers 'simultaneously choose a policy to attain certain objectives and choose the objectives themselves' (Lindblom, 1959, p.82).

In complex decision-making involving many actors, the 'best' policy emerges not out of a comparison against an abstract ideal, but out of a pragmatic agreement on a policy that is acceptable for all parties (Lindblom, 1959, p.82). The goal of discussion becomes to find focal points of agreement. This aspect of Lindblom's work is especially relevant for understanding collective action. He has described the evolution of US policies as a process of *partisan mutual adjustment* between diverse groups such as political parties, organized interest groups and labor, federal and local administrators, and government agencies (Lindblom, 1959, p.85). While Lindblom's incremental partisan mutual adjustment model is derived from a pluralist system of interest representation, it applies well to the current multi-level system of EU decision-making, where supranational, national, and subnational interests, as well as organized business and labor shape policy together.

Historical institutionalist analyses of the EU policy process have drawn heavily on Lindblom's insights about the limited time-horizons of decision-makers. Policy feedback effects and path dependence emerge because decision-makers consider only a small set of policy alternatives and often opt to support the status quo (Hall and Taylor, 1996; Hall, 2010). However, in addition to those aspects of incrementalism, Lindblom has emphasized a cognitive component. Decision-makers focus on a few policy alternatives only marginally different from the status quo, because this approach makes the most of existing knowledge and their ability to anticipate the future consequences of their most preferred policy. Otherwise, when there are too many moving pieces, one cannot credibly predict the actual impact of policy change. The literature on bounded rationality has developed this insight further. Decision-makers often have to generate the possible policy alternatives themselves and define them according to their understanding of the problem at hand (Simon, 1979; 1996). More recently, public policy scholars have shown that actors tend to have ready policy solutions which they put forward when a window of opportunity opens up (Cohen *et al*., 1972; Kingdon, 1996). In response to the powerful critique from the incrementalism and bounded rationality literatures, recent work in rational choice institutionalism has developed a more nuanced understanding of rationality, taking into consideration the cognitive constraints of decision-makers (see Bates *et al.,* 1998).

Drawing on the cognitive aspect of partisan mutual adjustment, Lindblom's work on incrementalism can be used to shed light on how decision-makers overcome collective action problems in the EU. Committed to the overarching project of completing the single market in financial services, most EU member states would find a common set of financial regulation rules to be more optimal than the persistence of a myriad of national regulations. Yet what kind of harmonized policy could satisfy the member states and the EU institutions involved in negotiating new legislation? Incrementalism highlights how preference convergence among EU decision-makers could take place. As we will see in the following sections, upgrading level 3 Lamfalussy committees emerged as a key focal point of discussion.

Incrementalism does entail policy adjustments in the margins. At the same time, Lindblom has stressed in his later work that ‘incrementalism in politics is not, in principle, slow moving...not necessarily, therefore, a tactic of conservatism’ (Lindblom, 1979, p.520). He even suggested that a fast-moving sequence of small changes could bring about a substantial change of the status quo. This may very well be what we are currently observing in European financial regulation. In 2010, the EU institutions adopted the ground-breaking Directive 2010/78/EU, also known as the Omnibus directive, which spelled out the new supervisory framework and main powers of the ESAs. The following year, they passed another directive, Omnibus II, that empowered the ESAs even further. The next section presents two explanations of the observed incremental institutional empowerment of the ESAs: the first one focuses on historical institutionalism, while the second one probes the explanatory power of rational choice institutionalism.

Explaining the incremental institutional upgrading of the European supervisory authorities

As the three European supervisory authorities are de facto European agencies, it is important to relate the argument developed here to general explanations of agency formation. Groenleer (2011) presents three powerful accounts of agency creation in the literature – functional, political, and transnational policy diffusion. According to functional explanations, regulatory divergence across the Union and growing pressures on the Commission’s resources lead to setting up independent agencies. Agencies bring together independent expertise at the EU level, increase the transparency and visibility of EU policymaking, and reduce transaction costs for national governments (Groenleer, 2011; see also Dehousse, 1997; Majone, 1996). According to political explanations, agencies demonstrate decision-makers’ credible commitment to optimize collective action arrangements and improve the regulatory environment, especially in the wake of a crisis (Kelemen, 2002; Shapiro, 1997). Lastly, policy diffusion explanations emphasize that in the past two decades governments have set up a large number of independent regulators at the domestic level. This institutional design has been emulated at the European level. In this context, European agencies are complementary to the national regulatory authorities and act as a hub for regulatory cooperation (Groenleer, 2011; see also Dehousse, 1997; Chiti, 2000). In a similar vein, Yesilkagit and Christensen (2010) have tested two main explanations of the institutional design and formal autonomy of national regulatory agencies in Sweden, the Netherlands, and Denmark – historical-cultural and political ones.

Groenleer (2011) notes that, overall, ‘most [European] agencies have a limited mandate...and only a few agencies have been granted decision-making tasks’. Against this backdrop, this article sheds light on the factors that made possible the empowerment of the European supervisory authorities in the financial sector with far-reaching competences. I take an institutionalist approach to analyzing the development of the ESAs. The historical institutionalist account tested here resonates with functional explanations of agency formation, while the rational choice one – with political explanations.

Functional pressures for greater powers of the ESAs: The case for historical institutionalism

A historical institutionalist application of incrementalism focuses on the path dependence induced by earlier policy choices, policy feedback effects, and institutional layering (see Hall and Taylor, 1996; Thelen, 1999; Pierson, 2004; Mahoney and Thelen, 2010). For example, in their recent analysis of the incremental evolution of the European Monetary Union, Salines *et al.* (2012) observe significant path dependence and institutional stickiness effects in European economic governance, induced by the institutional architecture set out in the Maastricht treaty. While, path dependence and policy feedback effects are well established in the literature, layering has been developed more recently to account for 'gradual institutional change' (Mahoney and Thelen, 2010). Several contributions have shown that it is particularly suited to understanding institutional change in the EU (Salines *et al*., 2012; Chou, 2012).

Below I probe whether the three mechanisms can explain the incremental empowerment of the European supervisory authorities. In order to trace the process of institutional reform, I draw on official reports evaluating the Lamfalussy framework, triangulated with interviews with policy-makers. Several expert committee assessments of the Lamfalussy financial regulation framework as well as ECOFIN Council conclusions show the build-up of functional pressures, especially in the mid-2000s, to enhance the powers of level 3 committees and pursue greater regulatory coherence across the Union. Let us examine the conclusions and recommendations of those reports more closely.

The first comprehensive review of the Lamfalussy framework in 2004 resulted in a positive assessment by ECOFIN and the extension of the general approach from securities to all financial services sectors. We can glean experts' reasoning from the regular reports of the Inter-institutional Monitoring Group (IIMG) which was responsible for assessing the implementation of the Lamfalussy process and identifying bottlenecks. Convened in 2003, the IIMG was reconstituted in 2005, following the extension of the Lamfalussy process to all financial services. The IIMG highlighted that European financial markets had changed considerably and new issues needed to be addressed (IIMG, 2007, p.6). For example, regulators increasingly had to oversee the activities of large cross-border European financial groups. These market developments called for stronger coordination between the national supervisory authorities and more consistent application of EU rules across the member states to realize the full benefits of the single market (IIMG, 2007, p.13).

Path dependence

The expert committee assessment reports provide evidence of a path-dependent increase in the powers of the three Lamfalussy supervisory committees. The initial focus of the committees' work was on their advisory tasks. Those were essential in the preparation of urgent sectoral legislation such as the CRD, MiFID, and Solvency II EU directives. Later on, as member states started the implementation process, the convergence tasks of level 3 committees came to the foreground, and so did the issue of their powers (FSC, 2007, p.6). Level 3 committees faced mounting challenges due to the increased speed of market integration and growing prominence of financial conglomerates. In this new environment, the committees acquired new tasks and their supervisory discretion grew over time. After all, level 3 committees were the only supranational institutions that had both the staff and prior experience to handle the new regulatory pressures (FSC, 2007, p.8). The sunk costs of establishing and funding the committees as well as increasing returns of promoting supervisory convergence served as a constraint on any alternative options for institutional redesign. In sum, we do observe some enhancement in the supervisory discretion of level 3 Lamfalussy committees due to path dependence. Yet this occurred *without* changing the committees' legal basis, and within the framework of issuing *non-binding* decisions.

Positive feedback effects

The initial reviews of the Lamfalussy process also show that a positive feedback effect supported the institutional development of level 3 committees. They were largely seen to perform their tasks well and live up to the expectations of both the member states and EU institutions. The IIMG applauded their important advisory work and stressed that they had fully met their original mandate (IIMG, 2007, p.15). Based on its positive assessment of the committees' performance, the IIMG recommended 'a considerable uplift in their resources...which may require changes to the level 3 committees' legal base or status within the EU system' (IIMG, 2007, p.18-19). However, the IIMG also stressed that its members were divided about the need for such further empowerment. Thus despite the presence of a positive feedback effect supporting further transfer of powers to level 3 Lamfalussy committees, important EU policy actors were not convinced that this step was necessary.

Layering

Layering occurs when new rules are put in place, but they mainly supplement existing ones. The new rules usually 'involve amendments, revisions or additions' (Mahoney and Thelen, 2010, p.16). Over time, the new institutional rules can change the established logic and performance of the original institutions. European financial regulation reforms fit well with the institutional context where layering is most likely to occur according to Mahoney and Thelen's conceptualization (2010, p.19). The redesign of European financial regulation unfolded in a political environment where discretion in enforcement is relatively low and the policy process is dominated by strong veto players – each of the EU's legislative institutions can thwart the reform process.

The outcome of the de Larosière institutional redesign supports the layering conjecture. The European supervisory authorities are an upgrade of level 3 committees, and we observe a very close correspondence in terms of their core mandate, staff, and location. The main difference is that the ESAs have more binding powers and tasks, shown here in Appendix III, than their predecessors despite opposition from some member states. Mahoney and Thelen (2010, p.17) discuss an important limit to what defenders of the status quo can achieve: 'While [they] may be able to preserve the original rules, they are unable to prevent the introduction of amendments and modifications.' This insight is pertinent to European policy-making, especially when decision-makers are under pressure to seek compromise and produce tangible results. Yet the tension between proponents of reform and defenders of the status quo needs to be unpacked further. How can the diverging preferences of key policy actors be reconciled?

Preference heterogeneity in EU financial regulation

We find the greatest preference heterogeneity regarding the new European financial supervision architecture in the Council of Ministers. The European Commission and Parliament clearly favoured a further transfer of powers to the European supervisory authorities in order to enhance regulatory convergence in the Union and ensure stronger sanctions in case of failure to comply (EurActive, 2009b; Financial Times, 2009; EurActive 2010; Tait, 2010). By contrast, member states' preferences about this issue diverged (see also Buckley and Howarth, 2010; Grossman and Leblond, 2011).

Public stakeholder consultations provide clear evidence of these disagreements. In January 2007, the Inter-institutional Monitoring Group invited all interested parties to comment on its second interim report on the Lamfalussy process. It received 34 reactions from the main stakeholders such as national and EU level industry associations, member states' central banks, financial regulation agencies and finance ministries, banks and financial companies. The consultation revealed that a number of stakeholders saw a problem in the existing incentives for the members of level 3 committees to follow predominantly national interests. To correct this perceived shortcoming, they proposed that level 3 committees should be able to make binding decisions based on a majority vote. This, in turn, would encourage supervisors to take a pan-European view rather than a national one (IIMG, 2007, p. 26).

At the same time, a strong constituency disagreed that level 3 committees should be empowered to make binding decisions and preferred the status quo instead. The opponents of empowerment suggested an alternative mechanism: level 3 committees should report to the Council of Ministers and European Parliament on why consensus could not be reached; the EU institutions would then take any necessary action (IIMG, 2007, p.26). According to one of the more critical contributions, a system where 'the home country supervisor has the ultimate decision-making power and where the host country's supervisor is only appropriately informed' would lead to unclear political and financial accountability (IIMG, 2007, p.17). Stakeholders were concerned that decisions taken by the home country authority might cause systemic risks for the financial system of the host country. Without having any significant say in supervising a financial institution, the host country could be forced to intervene as a lender-of-last resort (IIMG, 2007, p.17).

A full account of EU financial regulation reforms needs to explain how these actors could reach an agreement on mutually acceptable institutional changes. The evidence presented so far suggests that despite considerable functional pressures to enhance the powers of the three Lamfalussy supervisory committees, in 2007 and 2008, the ECOFIN Council of Ministers still preferred to maintain the system of *non-binding* powers. In its December 2007 review of the Lamfalussy process, ECOFIN invited the committees to strengthen the national application of their guidelines, recommendations, and technical standards yet *without* changing their legally non-binding nature (Council, 2007, p.5). When discussing the convergence of supervisory practices in 2008, ECOFIN reached an agreement on common EU-wide reporting formats to become operational by 2012. However, the Council again highlighted that this should happen "without changing the current institutional framework" (Council, 2008a, p.2).

In sum, functional pressures alone cannot explain why the Council would go along with the push from the European Commission and Parliament to upgrade the powers of the European supervisory committees. For this reason, I turn to the complementary theoretical framework of rational choice institutionalism. This theoretical account provides an important supplementary causal mechanism to explain how to overcome the unwillingness of some member states to grant more powers to the European supervisory authorities.

Preference convergence in the evolution of European financial regulation: The case for rational choice institutionalism

The practical steps toward empowering the European Supervision Authorities occurred only after the 2008 global financial crisis and a cumbersome negotiation process. This section shows that a preference convergence mechanism can help to explain the incremental reforms of European financial regulation. I draw on a rational choice institutionalist account of policy-making that focuses on the preferences of the key actors during the unfolding bargaining process (see Tallberg, 2006). The argument presented here also resonates with liberal intergovernmentalist accounts of decision-making, emphasizing that EU policies have been shaped by the convergence of national preferences in the face of economic change (Moravcsik, 1998). I use Jon Elster's (1989) conceptualization of rational action as geared toward achieving the outcome that the actor prefers the most, or the next most highly ranked feasible alternative. I also draw on Peter Hall's (2010) work on complementarities between historical and rational choice institutionalism. Hall has shown that institutional change often depends on a favourable coalition of actors mobilized to overcome collective action problems. At the same time, actors' preferences cannot be taken for granted and are frequently shaped by their beliefs, 'the relevant outcome…is driven largely by considerations of material interest, [but] issues of identity can be important determinants of the result' (Hall, 2010). While earlier rational choice explanations have been criticized for imputing preferences to actors, I avoid this pitfall by focusing on actors' revealed preferences in ECOFIN Council conclusions, public stakeholder consultations, and personal interviews with decision-makers.

Preference convergence

I argue that undertaking collective action at the European level was more optimal for all parties in the negotiations, and the incremental empowerment of the ESAs emerged as a mutually acceptable compromise. Below I show how this preference convergence took place. As discussed earlier, the Council of Ministers was the locus of the greatest preference heterogeneity regarding the new European financial supervision architecture. Most member states recognized the importance of the colleges of supervisors in cross-border groups and urged national supervisors to share information (Council, 2008a, p. 4-5). However, they could not reach an agreement on granting the ESAs more binding powers. The Commission was also well aware of the diversity of preferences among the member states. From the very launch of its policy proposals, it dismissed any approaches that would radically redraw the Lamfalussy framework as unfeasible because they would not find sufficient support from the member states (European Commission 2009a, p. 12). Under such conditions, the veto players literature would also predict, at best, a modest departure from the status quo due to the high number of veto players in the EU institutional reform process and high preference heterogeneity (Tsebelis, 2002; see also Dimitrova and Steunenberg, 2000).

Two policy issues capture very clearly the tensions among member states about giving more powers to the European supervisory authorities – home-host supervision and voting rules in the ESAs. For the sake of focus and concreteness, I will examine how preference convergence took place in these two highly divisive areas. Regardless of the functional pressures for deeper integration in financial regulation, level 3 Lamfalussy committees would not gain significant new powers unless the EU member states and institutions could find a mutually acceptable compromise.

There have been frequent disagreements among member states about the appropriate allocation of tasks between home and host supervisors during the preparation of legislation in all three financial sectors – banking, securities, and insurance. The issue was discussed extensively in 1999, in the context of negotiating the Capital Requirements Directive (CRD). The disagreements were even more noticeable during the preparation of the Solvency II Directive when the new EU member states from Central and Easter Europe fully participated in the negotiations (Personal Interview, 2011). The Lamfalussy process gave priority to home regulators which took the leading role in supervising large cross-border financial groups such as UniCredit, Société Générale, and Deutsche Bank. Elliot Posner (2007) observed similar dynamics of preference convergence between France and Germany dating back to the formulation of the Financial Services Action Plan in the 1990s.

Countries with large financial sectors such as France, Germany, and the Netherlands were under pressure from the financial industry to pursue a common European rule book and greater supervisory convergence across the EU (Mügge, 2010). This would allow financial conglomerates to maximize their gains from economies of scale. Large financial companies also preferred home supervisors to take the lead in overseeing their operations abroad (European Banking Federation, 2009, p.4; European Financial Services Round Table, 2009, p.3). They lobbied not only the member states in which they were based but also the European Commission (Posner 2007). The influence of large financial sector firms on policy outcomes has important normative repercussions, but those are beyond the scope of my analysis here. For example, Daniel Mügge (2011) has shown that the excessive influence of the financial industry has seriously compromised the legitimacy of financial sector governance.

While home countries preferred greater lead powers for home supervisory institutions, host countries were adamant to receive more safeguards and defend the national regulatory autonomy of host supervisory organizations (Personal Interview, 2011). We need to note here that states with very diversified financial sectors such as the UK and the Netherlands can be considered both home and host countries – they are home to powerful international financial groups, but also host branches and subsidiaries of foreign financial institutions. The home-host fault line re-emerged during the negotiations of the de Larosière reform package in 2009.

Preference convergence on giving more powers to the European supervisory authorities occurred when the two groups realized that their most preferred policy option was not feasible, but empowering the ESAs presented a second-best alternative. Home countries endorsed a supranational solution, including more powers for the European supervisory authorities. Some of the lead powers of home supervisors would be taken up by the ESAs, but the system of supervisory colleges would be preserved and home supervisors would maintain a central role in cross-border supervision. Likewise, host countries realized that they could not extract any more concessions and safeguards for host supervisory organizations. As one policy-maker involved in the negotiations summed up, ‘the host countries realized that they couldn’t win in the long run, and having the same [home-host supervision] argument every time when a new directive or an amendment came up would be costly and counterproductive’ (Personal Interview, 2011).

As the incrementalism and bounded rationality literatures would anticipate, EU decision-makers did not have a comprehensive list of policy alternatives from the very beginning. At the same time, rational choice institutionalism is still an applicable theoretical lens to analyze this process, because actors had clear preferences about what they wanted to achieve. During the negotiations, decision-makers sought to devise a policy solution that could accommodate the heterogeneous preferences of member states in the Council as well as those of the European Commission and Parliament. Among the main three European legislative institutions, the Council was the most cautious about giving the European supervisory authorities greater regulatory powers. Thus the compromise reached among the member states in the Council was crucial in determining the scope of institutional redesign.

Returning to Lindblom’s emphasis on the cognitive aspect of partisan mutual adjustment, we see that negotiating how to reform the European financial regulation framework clearly entailed a consideration of a small number of policy alternatives. Decision-makers were aware that a coordinated European financial regulation framework would be more optimal than the persistence of a myriad of national sectoral regulations. Further delegation of powers to the ESAs turned out to be the most viable option that would ensure collective action, even though both home and host countries considered giving more powers to the ESAs a second-best option, less desirable than their most preferred choice (Personal Interview, 2011).

The turning point toward giving the European supervisory authorities greater regulatory powers occurred in 2009. In the June 2009 ECOFIN Council of Ministers meeting, member states agreed to give the ESAs powers to take binding decisions in order to promote harmonized and consistent supervision of financial institutions across the EU (Council, 2009a, p. 4-6). They also put in place the so-called ‘triple-lock’ safeguard mechanism which gives member states multiple appeal mechanisms to contest decisions taken by the ESAs. As a first option, a member state can appeal a decision at the ECOFIN Council of Ministers. A simple majority of at least 14 member states can then overturn that decision. The next level of appeal is at the European Court of Justice. As a last resort, a country can also appeal a decision at the European Council (EurActive, 2009a; EurActive, 2009c). The October 2009 ECOFIN Council conclusions built up on the June 2009 decision and provided a detailed roadmap for the EU regulatory framework (Council, 2009b).

The European Commission launched its proposal for a directive specifying the powers of the three European supervisory authorities (2009/0161 COD) on 26th October 2009, which was then discussed in the Council on 13th July 2010 and passed first reading in the European

Parliament on 22th September 2010. The Parliament's amendments further bolstered the European mandate of the ESAs, especially when it comes to overseeing cross-border financial institutions and imposing legally-binding mediation on national supervisory bodies or colleges of supervisors. Furthermore, MEPs gave the ESAs a stronger consumer protection profile – the ESAs gained powers to investigate specific financial institutions if they posed a significant risk to the European financial market. The Parliament also achieved its priority to have veto power over the appointment of the ESA chairpersons (EurActive, 2010; European Parliament, 2010). Overall, the amendments introduced by the European Parliament increased further the powers of the European supervisory authorities and their supranational profile. Within a month, the Council approved the Parliament's amendments. That, in turn, paved the way for the official adoption of the three European Union Regulations (1093/2010, 1094/2010, 1095/2010) that set up the European supervisory authorities and European Union Directive 2010/78/EU that specified their powers in November 2010.

As mentioned in the beginning of this section, the voting rule which the ESAs would use to adopt decisions was another contentious item in the policy discussions. Host countries and smaller member states preferred the so-called 'one person – one vote' formula, where everyone's vote would count equally and a simple majority would be necessary to adopt a decision. By contrast, host countries preferred a QMV-based formula that somewhat favours larger member states, and would also favour member states that are home to large financial institutions (Personal Interview, 2010). As a compromise solution to satisfy both groups, the EU Regulations stipulate that the ESA board of supervisors should take decisions by simple majority, where each member has one vote. At the same time, QMV voting will be used for acts of a general nature, including regulatory and implementing technical standards, guidelines and recommendations, and budgetary matters (see Article 53 of EU Regulation 1093/2010).

Furthermore, cases concerning the settlement of disagreements between national supervisory authorities will be examined by a restricted panel, composed of members who are neutral in the conflict situation. The composition of the panel should be balanced, and its decision should be approved by the ESA board of supervisors by simple majority according to the 'one person – one vote' rule. However, regarding decisions taken by the consolidating (home) supervisor, the decision proposed by the panel could still be rejected by members representing a blocking minority of the votes under QMV rules (see Article 53 of EU Regulation 1093/2010).

Overall, while Lindblom's incremental partisan mutual adjustment model is derived from a pluralist system of interest representation, I have argued in this section that it applies well to the current multi-level EU system of decision-making characterized by a high degree of preference heterogeneity. In my analysis, preference convergence complements historical institutionalist mechanisms such as path dependence, policy feedback effects, and layering in explaining the incremental institutional redesign of European financial regulation.

Conclusion

The central puzzle in this article is why the European financial regulatory reforms after the 2008 financial crisis turned out to be quite incremental despite the unequalled opportunity for bold institutional redesign. I have shown that historical institutionalist mechanisms such as path dependence, policy feedback effects, and layering explain the build-up of functional pressures to give more powers to the European supervisory authorities. However, those functional pressures ran up against the unwillingness of some EU member states to delegate more binding powers to the supranational level. I have argued that, complementary to historical institutionalist mechanisms, the rational choice institutionalist mechanism of preference convergence helps to explain how EU member states were able to overcome their disagreements. I have shown that the observed incremental policy outcome is consistent with a rational choice institutionalist framework, which differs from the typical use of incrementalism in the literature.

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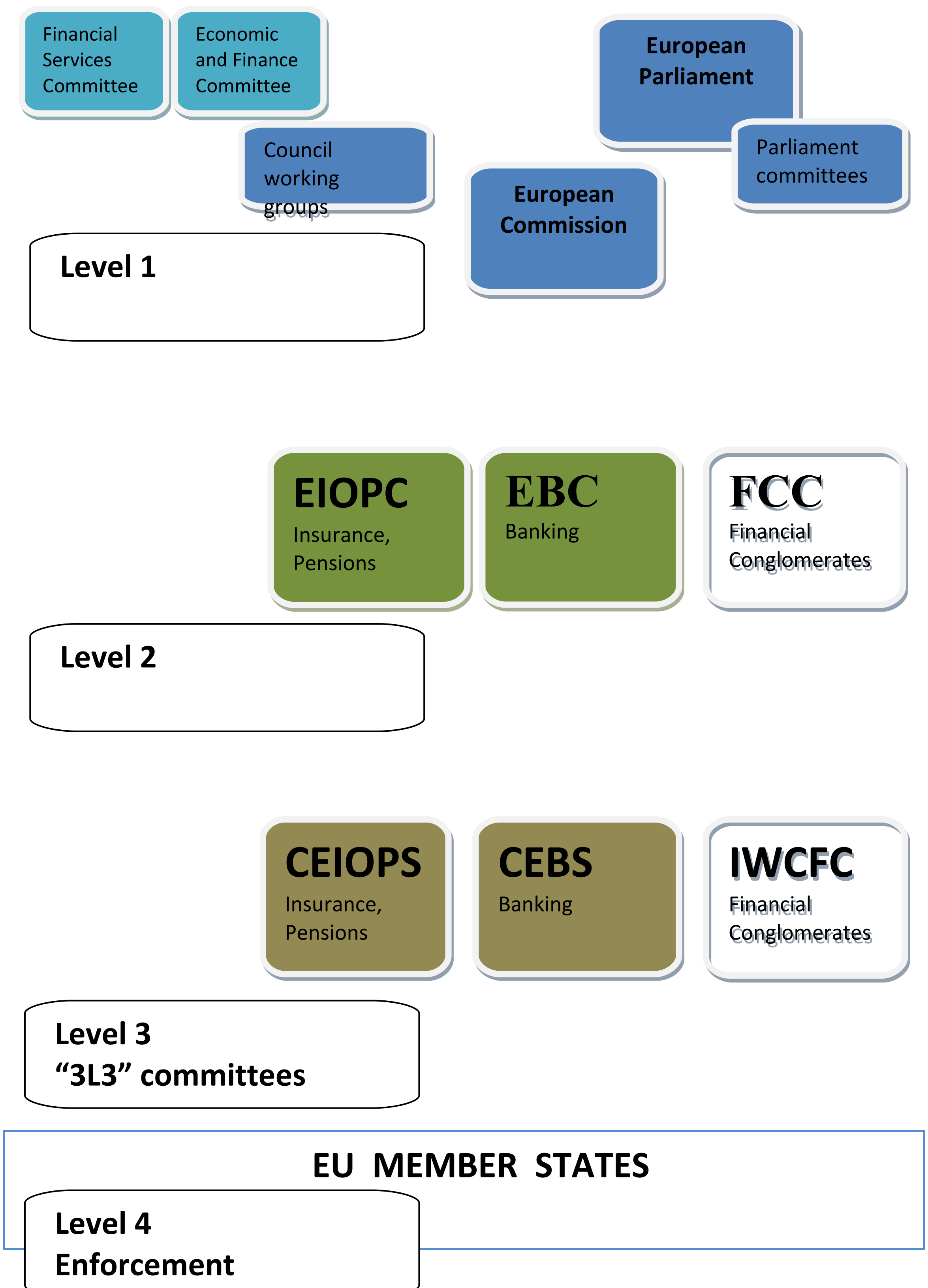
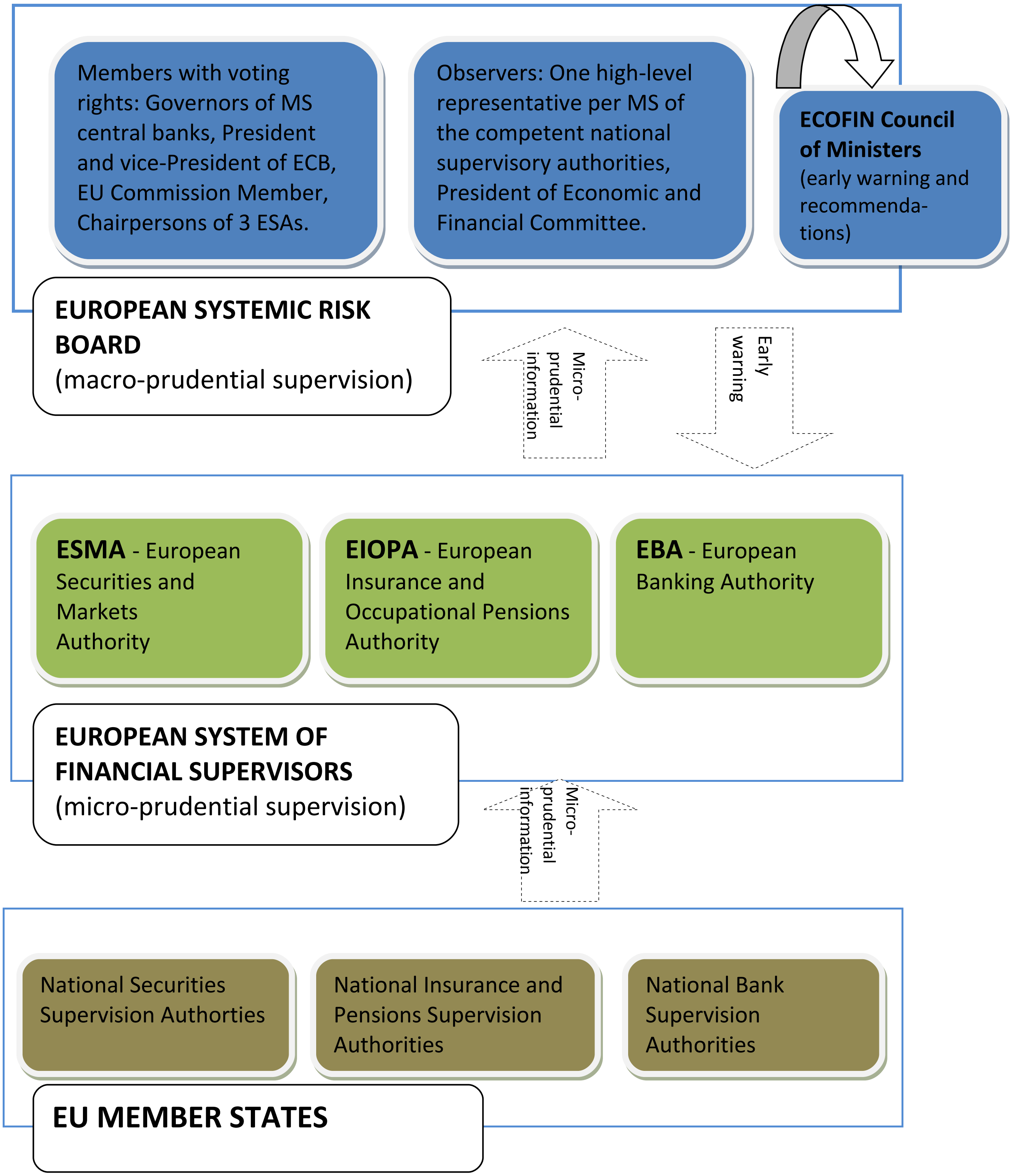
Appendix I: Lamfalussy Regulatory Framework



Appendix II: De Larosière Regulatory Framework



Appendix III: Increased Powers of the European Supervisory Authorities

Tasks and Powers of the ESAs after the 2009 EU Regulatory Reforms

Sources: European Union Regulations 1093/2010; 1094/2010; 1095/2010; European Union Directive 2010/78; ECOFIN Council Conclusions 2009.

1. Ensuring that a single set of harmonised rules and consistent supervisory practices is applied by national supervisors, by two means:

   - Developing *binding* harmonised technical standards in the areas to be specified in Community legislation.
   - Drawing up non-binding standards, recommendations and interpretative guidelines, which the competent national authorities would apply in taking individual decisions.

2. Ensuring a common supervisory culture and consistent supervisory practices, and ensuring uniform procedures and consistent approaches across financial groups by:

   - Issuing guidelines on practical supervisory issues with a view to a common framework for supervision.
   - Coordinating ex ante the supervisory analyses of the risks and behaviours of financial institutions and groups.
   - Conducting peer analysis across financial institutions and groups, to ensure consistency in supervisory outcomes.
   - Participating as appropriate as observers in supervisory colleges, so as to identify and address possible inconsistencies.
   - Collecting practical issues emerging in the implementation of Community legislation and ESAs' standards and ensuring that there is consistent interpretation across the Single Market.
   - Developing on a much broader scale common training for supervisors and staff exchanges.
   - Coordinating international issues, including technical arrangements and preparation of equivalence assessments.

3. Collecting micro-prudential information:

   - The ESAs should be responsible for the definition, collection and aggregation of all relevant micro-prudential information emanating from national supervisors.
   - A central European database should be established and managed by the ESAs. The information would be available for the relevant authorities in colleges of

supervisors and should be shared with the ESRB subject to specific confidentiality agreements.

4. Ensuring consistent application of EU rules, in cases to be further clearly specified in Community legislation such as:

   - Manifest breach of EU law or ESAs' standards.
   - Disagreement between national supervisors or within a college of supervisors.

   In the case of diverging opinions between national supervisory authorities over the proper enforcement of EU legislation, or in the case of diverging opinions between national supervisory authorities within a college of supervisors, the ESAs should facilitate a dialogue and assist the supervisors in reaching a joint agreement. If, after a phase of conciliation, national supervisors or colleges of supervisors have not been able to reach an agreement, the ESAs should, through a *binding decision*, settle the matter.

5. Using full supervisory powers over some specific pan-European entities such as credit rating agencies and EU central counterparty clearing houses. These full supervisory powers do not cover financial conglomerates, banks, insurance companies or investment firms and other financial institutions whose failure could result in fiscal burden for Member States.

6. Ensuring a coordinated response in crisis situations.