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ARTICLE

Banking on Stability: The Political Economy of New Capital Requirements in the European Union

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ABSTRACT The Basel III Accord on a ‘Global regulatory framework for more resilient banks and banking systems’ was issued in late 2010 as the cornerstone of the international regulatory response to the global financial crisis. Its adoption into European Union (EU) legislation has, however, been met with considerable member state reticence and intra-EU negotiations are ongoing. This paper investigates the political economy of new capital requirements in the EU, arguing that the institutional features of national banking sectors convincingly account for the divergence in EU member state preferences on capital rules.

KEY WORDS: Banking regulation, European Union, capital requirements, Basel III

Introduction

Since the global financial crisis delivered a major blow to the financial stability of much of the European Union (EU), financial regulation has moved to the centre stage of debates about the future of EU economic governance. Capital requirements for banks have traditionally been regarded as one of the main instruments to ensure the stability of the banking sector and hence financial stability *tout court*. Capital requirements are regulations limiting the amount of leverage that financial firms can take on.¹ As the US treasury minister Timothy Geithner put it in the wake of the financial crisis, ‘The top three things to get done are capital,

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capital and capital' (Leonhardt 2010). At the peak of the crisis the inter-bank markets froze, highlighting the importance of banks' holding of liquid assets² in order to meet short-term obligations. Hence, in addition to capital requirements, liquidity rules also made it into the *zeitgeist* of banking regulation.

In 1988, the Basel Committee on Banking Supervision (BCBS) issued the Basel I Accord on 'International convergence of capital measurement and capital standards', which was updated by the Basel II Accord in 2004 (revised in 2005). Over time, these 'soft' international rules have been incorporated into (legally binding) national legislation. In the EU this was done through the Capital Requirements Directives (CRD) (see Underhill 1997; Christopoulos and Quaglia 2009; Quaglia 2010). The Basel III accord (hereafter Basel III) was issued in late 2010 as the cornerstone of the international regulatory response to the global financial crisis (BCBS 2010a). Its adoption into EU law has, however, met with considerable member state and EU institutional reticence. The EU directive and regulation to be adopted (referred to collectively as CRDIV) will likely qualify the application of the Basel III capital requirements in the EU.

The EU is one of the largest financial jurisdictions worldwide and some scholars have indeed pointed out its 'market power' (Damro 2012; see also Dür 2011). In terms of total banking assets and liabilities, the EU's internal market is larger than that of the US. Hence, the implementation of Basel III into EU legislation will be consequential not only for its large internal market and the 6000 European banks therein, but also for the stability of the international financial system. Third jurisdictions, first and foremost the US, which is the main counterpart of the EU in international financial fora (Posner 2009; Posner and Véron 2010), are also concerned about potential regulatory arbitrage and competitive advantages accruing to European banks as a result of the 'distinctive' implementation of Basel rules in the EU.

In the making of the Basel III accord first and in the negotiations of the CRD IV later, the core of the controversy concerned the distributive implications of the regulatory changes proposed. The definition of capital (in particular the list of financial instruments that count as capital); the level of capital requirements; the definition of liquid assets and the amount of liquid assets affect different banks and national banking systems in different ways, imposing costs as well as benefits that are not equally distributed. Different banks have different sources of capital; some banks have capital instruments or liquid assets that other banks do not have; some banks are better positioned than others to meet higher capital requirements or liquidity coverage. Hence, banks and national banking systems face different adjustment costs to the proposed rules: it very much depends on the features of the national banking system and the domestic regulatory framework. It also depends on the link between the financial system and the real economy, in particular in terms of the major sources of funding for non-financial companies and the relative importance of bank credit. If companies mainly rely on credit from banks, rather than raising funds on

the stock market or issuing securities, higher capital and liquidity requirements are more likely to result in a credit crunch for the real economy.

In order to explain the politics of the CRD IV, that is member states and industry preferences in the negotiations on the new capital and liquidity rules, this article builds on and develops further the literature that examines the specific features of national banking systems (Allen and Gale 2000; Deeg 2010; Hardie and Howarth 2013) and links these features to member states and industry preferences concerning EU financial regulation (Busch 2004; Fioretos 2001, 2010; Macartney 2010; Zimmerman 2010; for a somewhat different version of this argument see Mügge 2010). Adopting a comparative political economy analysis, this article sees member state and industry preferences determined by a combination of political economy factors and, notably, the institutional features of the national banking sector. This analysis involves digging into the balance sheets of banks in the main EU countries, their assets and liabilities (i.e., how banks are funded). The impact of state intervention during the recent financial crisis on banks' capital position is also considered.

The paper proceeds as follows. The second section provides an overview of the negotiations and the content of the new capital rules in the EU. The third section investigates the political economy of these rules in the main European countries. It is argued that the divergence in EU member state preferences on Basel III / CRDIV—rooted in differences in national banking systems—explains the incomplete nature of European economic governance in the area of financial regulation and accounts for the intergovernmental character of many EU negotiations in this policy field.

The Content and Negotiations of the New EU Capital Legislation

The Basel III accord was signed by the BCBS in December 2010 (BCBS 2010a). The new rules: provide a more restrictive definition of what counts as bank capital; increase the risk weight of several assets in the banking book and introduce capital buffers; set up a recommended and potentially obligatory leverage ratio; and outline international rules on liquidity management. All in all, the new rules increase the proportion of capital that must be of proven loss absorbing capacity (going concern)—i.e., core tier one (equity) capital—over Basel II requirements, and will be phased in gradually from January 2013 until 2019. The Basel III accord is an agreement between national regulators gathered in the BCBS; hence it has to be implemented into national (and/or EU) legislation in order to become legally binding.

In July 2011, after extensive consultations conducted in parallel with the work of the BCBS, the EU Commission adopted the CRDIV legislative package designed to replace the CRDII with a directive that governs the access to deposit-taking activities (Commission 2011a) and a regulation that establishes prudential requirements for credit institutions (Commission 2011b). After its approval, the proposed directive (Commission 2011a) will have to be transposed by the member states in a way suitable to their own national environment. It contains rules concerning the taking up and pursuit of the business of banks, the conditions for the freedom of establishment and the freedom to provide services, the supervisory review

process and the definition of competent authorities. The directive also incorporates two elements of the Basel III accord, namely the introduction of two capital buffers in addition to the minimum capital requirements: the capital conservation buffer identical for all banks in the EU and the countercyclical capital buffer to be determined at national level. The proposed EU regulation (Commission 2011b) contains prudential requirements for credit institutions and investment firms. The proposed regulation covers the definition of capital, increasing the amount of own funds that banks need to hold as well as the quality of those funds; it introduces the Liquidity Coverage Ratio (LCR)—the exact composition and calibration of which will be determined after an observation and review period in 2015; and the need to consider a leverage ratio, subject to supervisory review.

The Commission's CRDIV draft, which would implement Basel III into EU law, is the most substantial of all the post-financial crisis regulatory measures entertained to date at the EU-level but its draft also involved watering down or modifying the Basel III guidelines in ways to meet EU member state demands (IMF 2011a). Indeed, the CRDIV draft was criticised by many regulators and by the IMF for significantly watering down key Basel III elements. Speaking at a meeting of EU Economic and Finance ministers held to discuss the CRD IV, the British Treasury minister complained that: 'We are not implementing the Basel agreement, as anyone who will look at this text will be able to tell you' (Barker and Masters 2012).

The Commission 'softened' its definition of core tier 1 capital relative to the Basel III recommendations in some areas. Notably, the Commission draft allows 'silent participations', that is, state loans that make up a significant part of the capital of many EU banks, including the publicly owned German Landesbanken. The Commission's draft also limits the role of the leverage ratio designed to limit risk-taking at banks. The almost unique reliance on Basel III's risk-weighted core tier 1 ratio in the Commission's draft CRDIV was criticised for inadequately representing the health of the European banking sector (Lanoo 2010).³ On liquidity, the Commission adopts the less prescriptive definition of liquid assets: for the LCR to include 'transferable assets that are of extremely high liquidity and credit quality' and 'transferable assets that are of high liquidity and credit quality'. The Commission's draft lacks a firm commitment to implement the Net Stable Funding Ratio by 2018 called for in Basel III. The Commission's proposed regulation also sets higher capital requirements for Over the Counter derivatives that are not cleared through Central Counterparties.

The use of a regulation, which once approved is directly applicable without the need for national transposition, is designed to ensure the creation of a single rulebook in the EU. The regulation will eliminate a key source of national divergence. In the CRD III, more than one hundred national discretions (differences in national legislation transposing the EU directive) remained. Yet, the Commission's draft regulation also proposes a maximum capital ratio which was opposed by many who argued in

favour of EU standards that exceed the Basel minimum because of prevailing balance sheet uncertainties in the EU, the lack of EU-wide resolution arrangements and a fully unified fiscal backstop. The analysis below will demonstrate that most of these modifications to Basel III in CRDIV owe to French and German government demands.

Following the agreement on Basel III and during the intra-EU negotiations on CRDIV, some of the compromises reached in the BCBS unravelled. Several EU member states, the European Parliament (EP) and even the Commission itself called for the taking into account of ‘European specificities’ in incorporating the Basel III rules into the CRD IV, reopening some of the issues that had caused friction within the BCBS. Basel III applied to internationally active banks, whereas EU legislation was to apply to all banks, making some Basel III provisions—notably the calculation of tier 1—impossible to apply in EU member states without a massive shift in the structure of a large range of banks and banking systems. The Commission has justified its decision to apply Basel III rules, as with Basel I and Basel II, to all EU banks on both stability grounds and reasons linked to the application of EU Competition Policy (Paulis 2012). Both the Commission and the EP have also expressed concern as to the international competitiveness of European banks and the need to ensure an ‘international level playing field.’ Of particular concern has been the fact that in the US, the Basel III accord would be applied only to financial institutions with over US\$50bn in assets (EP 2010, 2011).

The Political Economy of New EU Capital Rules

This section engages in a political economy analysis of national preferences on EU capital requirements. These preferences reflect three factors: the capital, and thus competitive, position of national banks; national banking and financial system structure; and related macro-economic considerations, that is the impact of Basel III on the wider economy.

Capital Position

The first explanation focuses specifically on the capital position of banks and relates to the likely impact of recapitalization upon their market share and competitiveness. Basel III/CRDIV will force banks to hold 6 per cent tier 1 and 8 per cent tier 1 and tier 2 capital by 2015 and four years later—with the capital conservation buffer of 2.5 per cent to be phased in by 2019—8.5 per cent and 10.5 per cent respectively. The obligation to raise a bank’s tier 1 capital ratio can have one or both of two effects. To meet those requirements the banks either need to reduce their assets (including lending) (i.e., decrease the Risk Weighted Assets (RWA) denominator) or retain earnings (i.e., increase the capital base numerator). If the former is undertaken then profits will be lower; if the latter then discretionary payments such as dividends on equity will decrease. *Ceteris paribus*, both developments make the bank less attractive to investors. However — it should also be noted — that many investors are also

focused upon the long-term stability of banks, especially in the difficult market conditions of the early 2010s, which provides an incentive to banks to recapitalise.

While the capital position of different banks within a national economy varies considerably, systemic patterns can be detected. The studies and impact assessment of the BCBS of new Basel III rules were conducted at the aggregate level. Nonetheless, even the BCBS warned about differentiated effects across countries, without identifying those with banking systems most affected (BCBS 2010). A perusal of the equity and tier 1 capital for systemically important British, French and German banks shows why the German government in particular had good reasons to oppose the rigid tightening of capital requirements. The German government also favoured a maximum harmonization rule in order to prevent better capitalized banks from gaining competitive advantage and expanding market share at the expense of undercapitalized (German) banks (see Table 1 and 2). Faced with adverse capital conditions, the two large German commercial banks would only narrowly respect the Basel III target for 2015. The data also show that most of the main British banks would have limited difficulties in meeting the Basel III standards. The data help to explain why the British government was most in favour of tighter capital rules and most opposed to a maximum harmonization rule. The data on French banks suggest their strong position but the double counting of insurance subsidiaries — which Basel III recommends banning — inflates the tier 1 capital ratio significantly in most cases.

Table 1. Bank equity as percentage of total assets (core tier 1) and leverage ratio in parentheses

Recall: core tier 1 ratio of 4.5%/or 7% with the 'capital conservation buffer' from 2019	UK	France	Germany
2008	3.7 (27)	3.8 (26.3)	2.93 (34.1)
2009	4.87 (20.5)	4.91 (20.4)	3.76 (26.6)
2010	5.37 (18.6)	5.07 (19.7)	3.88 (25.8)

Source: ECB statistical data warehouse. Domestic banking group and stand alone banks only.

Table 2. Tier 1 capital (as a percentage of total assets) main British, German and French systematically important banks (non-weighted average)*

Recall: Basel III target of 6% / or 8.5% with the 'capital conservation buffer' from 2019.	2012 baseline scenario	2012 adverse	2011 baseline scenario	2011 adverse
UK	10.4	7.45	9.75	7.95
France	9	7.4	8.5	7.7
Germany	8.8	6.4	7.85	6.75

Source: EBA *results of the stress test based on the full static balance sheet assumption without any mitigating actions, mandatory restructuring or capital raisings post 31 December 2010/11 (all government support measures fully paid in before 31 December 2010/11 are included). Figures cover the largest four banks in UK and France and largest two in Germany.

The implications of the new capital rules were potentially greatest for the many non-listed public sector and mutual banks (a much more significant element of the German and French banking systems than in the UK) which did not use equity, relying on other capital to meet capital requirements in the past including hybrids — that is, capital which has some features of both debt and equity and notably ‘silent participations’ (government loans) (Bowles 2010). Basel III menaced a significant overhaul of the capital structure and legal status of internationally active publicly-owned banks and mutuals — although exceptions could have been allowed which did not apply to commercial banks with listed equity. Proportionately, the ban on hybrids would hit the German banking system the most and in particular the Landesbanken which explains the Commission’s CRDIV draft provision to continue to allow only the one form of hybrid on which they rely to meet the core tier 1 ratio: ‘silent participations’. The ban on all other hybrids was incorporated into the European Banking Authority’s late 2011 stress-tests of systemically important banks, resulting in the withdrawal of one German LB, Helaba (the Hessen-Thüringen LB) in order to avoid public failure (Wilson 2011). The Basel III ban on hybrids has also already hit the two large German commercial banks despite the qualification of the ban in the CRDIV draft. In early 2012, Commerzbank moved to boost investor confidence by replacing its hybrid capital (‘silent participations’) with equity in order to improve its core tier 1 position (Wilson 2012).

The IMF estimated that a ban on double counting of capital in banks’ insurance subsidiaries would result in French banks losing a total of 28.9 per cent of their tier 1 capital, preventing several from meeting the 6 per cent threshold and all from meeting the 8.5 per cent threshold (with the capital conservation buffer to be in place from 2019) (IMF, 2011b). It is not surprising then that the French government (and to a less extent the German) lobbied to lift the restrictions in Basel III on double counting. A ban would hit the three large French commercial banks particularly hard because of the longstanding feature the French banking system of *bancassurance*, in which insurance companies (often subsidiaries of banks) make use of banks to market their products. The system predominates in certain other EU member states, including Spain and Austria. However, the lifting of the Basel III restriction also benefited the part-state owned Lloyds-TSB, which is one of Britain’s largest insurance providers.

Basel II guidelines and CRDII rules on bank capital allow banks to amass assets with high credit ratings without setting capital aside to cover potential losses. This allowed many banks in Europe to become highly leveraged despite meeting international rules on capital cushions. European Central Bank (ECB) and several other central bank officials pushed for a leverage ratio as a simple mechanism to curb excessive risk-taking (Masters 2012). The French, German and a range of other EU member states governments opposed the adoption of a leverage ratio to determine the quantity of capital to be held by banks, which explains why the specific Basel III provision (3 per cent or an assets to tier 1 capital ratio of approximately 33) was made more flexible in the Commission’s CRDIV draft.

French and German opposition reflected the much higher leverage ratios of most large banks in France and Germany (compared to the UK), the difficult situation facing German Landesbanken and French mutual banks having to respect a new leverage ratio and the fear of the need to force through a rapid de-leveraging of banks. While the leverage ratio of British banks increased dramatically in the two years prior to the outbreak of the financial crisis, this had been historically amongst the lowest in the EU and it dropped quickly in 2009 and 2010. The figures for French banks appear similarly low. However, the Basel III ban on double counting the capital of insurance subsidiaries — if adopted in EU legislation — would hit the leverage ratios for the three biggest French commercial banks considerably.

The British government has been the most in favour of the big three for closely aligning CRDIV and Basel III (IMF 2011a). The British Conservative–Liberal Democrat government (joined by several other member state governments including the Swedish) criticised the Commission’s CRDIV draft on the grounds that it did not go far enough (see for example, Djankov 2011). In particular, the British opposed the move under CRDIV to embrace a leverage ratio for guidance purposes only and sought to keep open the possibility of imposing capital requirements higher than those eventually set by EU legislation, which the Commission’s CRDIV draft explicitly blocked by imposing a cap. Many British policy-makers, including the Governor of the Bank of England, were critical of the Commission’s position on a maximum capital ratio, arguing that the new level of required capital should have been many times higher than the levels set out in Basel III (Robinson, 2010). The British Independent Commission on Banking recommended that large retail banks be required to have a minimum core tier 1 ratio of 10 per cent of risk-weighted assets which would significantly exceed the Basel III minimum of 7 per cent (core tier 1 at 4.5 per cent plus the 2.5 per cent capital conservation buffer and the proposed surcharge for global systemically important banks — possibly up to 2.5 per cent). Other (mainly continental) policy-makers, such as the former Governor of the Bank of France, Jacques de Larosière, argued that ‘Basel rules risk punishing the wrong banks’, that is the ‘diversified’ and ‘safer’ continental European banks, rather the Anglo-Saxon banks which, he claimed, engaged in riskier investment banking activities (de Larosière 2010).

The Structure of Banking and Financial Systems

The second political economy explanation focuses on the structure of banking and financial systems and how these structures shape the activities of banks (Allen and Gale 2000; Hardie and Howarth 2009, 2013). This explanation reminds us that British and French commercial banks are better capitalised because, on average, they rely more on equity finance in relative terms than banks in most continental European countries (see Table 1 above). As noted above, many banks on the continent, such as the publicly owned German Landesbanken, cooperative and savings banks and most French mutuals, do not have equity finance. Indeed, this aspect

proved problematic in the incorporation of the Basel III accord into EU legislation, which contains specific provisions for the cooperative and mutual banks. Basel III was written having in mind banks funded by equity finance (hence the emphasis on common equities in core tier 1 capital), whereas many banks in the EU rely upon on other sources of funding.

The overall equity position of banks in all three countries improved following the financial crisis (with increases of 45 per cent in the UK; 45 per cent in France; and most in Germany at 67 per cent although from a lower position). This improvement was due in part to significant government interventions in the banking system which involved share purchases. For the UK, government intervention came far more, in comparative terms, in the form of share purchase (6.3 per cent of GDP versus only 1.2 per cent in Germany, where the government opted more to purchase toxic assets, and 1.1 per cent of GDP in France — at end 2009) (National Central Bank figures). No other national share purchase programme came close to reaching the British level, in either real terms or in terms relative to GDP.

There are other, less obvious, features of national banking systems which explain positioning on CRDIV. French and German bank and government opposition to the use of a simple leverage rule, as opposed to risk-weighted assets, owes in large part to the relative importance of trade financing in their operations. Trade financing is high in terms of overall assets but low in terms of risk-weighted assets. Similarly, different levels of bank and banking system exposure to short-term funding on wholesale markets directed national preferences on CRDIV liquidity rules.

Basel III liquidity rules effectively discourage reliance on short term funding (less than a year) on wholesale markets. Clearly British bank reliance on short-term funding was the highest of the three countries in 2007, and much of this was short term funding of less than three months. The boom in British bank lending over the decade preceding the crisis owed in part to this short-term funding. But by 2010 this reliance had dropped dramatically, moving from above 60 per cent of GDP to 30 per cent (own calculations on the basis of central bank data), contributing to the credit crunch in the British economy (see below). UK banks have gone the furthest, and by a significant margin, to reduce their reliance on short-term funding and increase the resilience of their funding positions and thus they and the British authorities are most comfortable with the liquidity rules and ambitious phase-in dates. This improved position owed in large part to the early introduction in 2009 of restrictive liquidity rules in the UK, on which the Basel III and CRDIV rules were largely modelled. British banks thus had a head start on liquidity.

The German government was less preoccupied about Basel III liquidity rules given that German bank debt was issued principally in the form of longer maturity covered bonds — *pfandbrief* — itself a reflection of the ‘patient capital’ that characterises the German financial system. For German banks, reliance on short term funding was low, dropping from slightly above 10 per cent in 2007 to slightly below 10 per cent of GDP in

2010. However, in the case of French banks, reliance on short term funding was far greater and dropped only marginally from a high of 45 per cent of GDP in 2007 to 40 per cent by 2010. The comparatively high reliance of French banks — and bank lending — on short-term debt largely explains the French government's push to make CRDIV liquidity rules less prescriptive (Masters 2012). Basel III includes a prolonged phase-in period for the Liquidity Coverage Ratio (2015) and the Net Stable Funding Ratio (2018), while the Commission's CRDIV draft waters down the first ratio and fails to impose the second. This preference for gradualism and flexibility can be explained by concerns about the potential impact of these liquidity measures on bank lending.

Differences in national financial systems — and notably, differences in the funding of non-financial companies — also shaped government policy. Small and medium-sized companies in the three countries were most exposed to potential de-leveraging given their limited access to other funding sources. However, overall non-financial company reliance on bank credit, as opposed to equity and securities, varied markedly. Reliance was particularly high in Germany, where bank credit comprised about 50 per cent of non-financial company external funding in 2011. In France, bank credit amounted to only 30 per cent of non-financial company external funding in 2011, while in the UK, the figure reached only 27 per cent (ECB statistics data warehouse, national central bank data). The comparison with non-financial company external funding in the United States — only 13 per cent from bank credit — indicates even more clearly the comparatively heavy reliance in Germany and its underdeveloped equity markets (Federal Reserve Flow of Funds, December 2011 release).

Differing Macro-economic Concerns

The heavy reliance of non-financial companies in most European countries on bank credit finance, the comparatively limited role of equity and corporate debt markets in many countries and the strong bank–industry link (*hausbank*/relational banking in Germany) further explains the preoccupation of many European governments as to the impact of Basel III on bank lending and the real economy. This leads us to the third, macroeconomic, factor that explains differing national positions on Basel III/CRDIV. The BCBS accepted the negative implications of pushing too hard and too fast with capital rules — especially in the aftermath of a deep post-crisis recession in many European countries (see BCBS a,b 2010).

These concerns were particularly acute in some countries. The United Kingdom was not one of them. From the outbreak of the financial crisis, bank lending in the UK shrunk dramatically (Table 3). This is part of a more general story about the early deleveraging of British banks and the collapse of lending, which had previously relied on securitisation and short term bank funding on wholesale markets (Hardie and Howarth 2013). The British Treasury Minister George Osborne spoke repeatedly of the 'British dilemma' — namely the desire to retain Britain's world leading position in financial services but to avoid placing the British government

Table 3. Monetary financial institution lending to non-financial companies (national currencies)

	UK to NFCs (domestic only)	France to NFCs (euro area)	Germany to NFCs (euro area)
2007	691.3	764.7	859.4
2008	606.1	845.6	947.5
2009	588.7	827.6	901.7
2010	561.5	838.8	893.8
2011	536.2	877.5	906.8

Source: National central bank data.

(and tax payer) in a position in which it was forced bail the banks out again. Despite, the raft of measures adopted to encourage and facilitate bank lending (e.g., Project Merlin), the British government has effectively accepted the lending and economic growth implications of restricting bank activities and specifically decreasing the bank lending that relied directly on shorter-term unstable funding.

Euro area lending by German and French banks remained comparatively strong in the five years following the outbreak of the financial crisis, and was limited principally by growth in the broader economy rather than the deleveraging efforts of banks. Forcing French and, more significantly, German banks to deleverage during a recessionary period could result in a credit crunch if banks reduced their lending (cut their risk-weighted assets denominator) instead of boosting their capital (lifting their equity numerator). One IMF study from 2011 on the differential impact of Basel III rules on national banking systems echoes the findings in a range of other studies: to demonstrate a particularly significant impact upon bank lending in Germany (with a decline of upwards of 7.73 per cent) and a smaller but still significant drop in the UK, with France somewhere in between (Cosimano and Hakura 2011).

The two largest German commercial banks engaged in a significant de-leveraging from 2008 and shrunk their loan book, while Landesbanken lending was largely stagnant. Stable bank lending levels in Germany since the outbreak of the financial crisis thus owed to a rise in lending from smaller Cooperative and Savings Banks, the backbone of German small and medium-sized companies (the *Mittelstand*) (Bundesbank figures). Thus, imposing significantly higher capital requirements on these smaller banks would have a devastating impact upon the German economy. It is the largest French commercial banks — comparatively more engaged in retail banking than their large German competitors — and the French economy as a result that were most exposed to deleveraging because of higher capital requirements. Indeed, this fact explains why the French led the charge for the addition of a maximum harmonisation rule in CRDIV — also supported by the Germans — fearing that the British and Swedish push to move beyond Basel requirements would force French banks to be just as capitalised because of investor expectations (Peston 2011). The French government thus sought to use EU rules to try and limit the fall-out from

market pressures for greater capital: it did not matter if the markets wanted banks to increase their capital, EU rules would not allow it.

Conclusion: The ‘Battle of the Systems’ in EU Economic Governance

More than fifteen years ago, Story and Walter (1997) argued that ‘the battle of the systems’ impinged upon financial integration and regulation in the EU. Despite the progress made following the introduction of the single currency and the re-launch of financial market integration in the early 2000s (Mügge 2010), the financial systems of EU member states retain distinctive features. These features largely explain national positions on CRDIV and the intergovernmental character of the negotiations in this field. Despite the ‘new era in financial regulation’ (Helleiner and Pagliari 2010) heralded by some authors in the wake of the crisis, the ‘new’ politics of EU financial regulation is rather similar to the ‘old’ one (Quaglia 2012), at least in certain respects, and notably with the core issue of banking regulation.

In countries, such as Germany, with less developed equity markets and greater non-financial company reliance on bank credit, governments were more opposed to high capital requirements that would restrict lending. Clearly, British banks were concerned about the implications of higher capital requirements and struggled to raise capital. However, they were in a better position — on average — than most of their French and German competitors and the British government was less preoccupied with the impact of Basel III rules upon the British economy because of earlier deleveraging.

The implementation of the Basel III rules on capital requirements is politically controversial in the EU and the negotiations on the new EU legislation are — as of mid-February 2013 2012 — ongoing. The intergovernmental politics of the CRDIV provides a useful case study of the importance of political economy explanations that undermine EU-level efforts to construct financial regulation that effectively stabilises the EU banking system. A conclusion of this article of relevance to this special issue is that the construction of EU economic governance is bound to be less effective than sought because of the diverging implications of EU-level rules for national economies. This core economic fact casts doubt on the ability of the EU to satisfy both markets, by facilitating cross border financial integration, and politics, through the provision of the public good of financial stability.

Notes

1. Capital represents the portion of a bank’s assets which have no associated contractual commitment for repayment. It is, therefore, available as a cushion in case the value of the bank’s assets declines or its liabilities rise.
2. Liquid assets are cash or any other negotiable assets that can be quickly converted into cash.
3. There are wider questions being asked about the whole foundation on which the Basel agreement is built — i.e., risk weighted assets — hence the desire for the leverage ratio which looks at overall assets.

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