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Regulatory cascading: Limitations of policy design in European banking structural reforms

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Abstract

This article examines banking structural reforms introduced in the European Union (EU), placed in an international context. The concept of 'regulatory cascading' is put forward to investigate how European policy-makers tackle complex multi-faceted problems, such as that of banks which are 'too big to fail'. The article shows that partial solutions to the problem introduced in other areas of banking regulation, coupled with strategic activism at the domestic level by key EU member states have constrained the opportunities to design a coherent EU framework regulating bank structures. In response to the Commission's proposal for harmonised European banking structural reforms, the Council has stressed in its position two approaches that closely correspond to the measures adopted in France and Germany, on the one hand, and the UK, on the other hand.
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1. Introduction

The 2008 crisis revealed that financial globalisation and de-regulation, especially in states with large financial centres such as the United States (US) and United Kingdom (UK), threatened financial stability (Germain, 2012). The long-term viability of the global financial system depends not only on launching innovative products but also on introducing robust risk management practices. Hence, scholars, policy-makers, and stakeholders have called for more rigorous financial sector oversight (Ferran, Moloney, Hill, & Coffee, 2012; Moloney, 2011; Vickers et al., 2011; Wymeersch, 2012).

In the European Union (EU), policy-makers engaged in protracted negotiations to further centralise authority in banking supervision and harmonise regulatory practices across the member states. They conferred greater monitoring and rule-making powers to the three European financial sector agencies, adopted stricter capital adequacy requirements in line with the Basel III international standards, and moved forward with establishing a European Banking Union (EBU) (Ferran et al., 2012; Howarth & Quaglia, 2016a; Lastra, 2003; Masciandaro & Eijffinger, 2011; Moloney, 2011; Quaglia, 2010; Spendzharova, 2014).

At the same time, regulators, financial industry firms, and stakeholders have struggled to keep abreast of the rapid sequence of policy and institutional reforms adopted at the European and international level. The most recent rounds of

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EU banking sector reforms coincided with the launch of the new 'Better Regulation' programme, designed to 'ensure that European Union (EU) laws and policies are prepared, implemented, and reviewed in an open and transparent manner, informed by the best available evidence, and responsive to stakeholder input' (European Commission, 2015: 4–5; see also Meuwese, Scheltema, & van der Velden, 2015; Radaelli, 2007; Smismans, 2015). As part of the EU's commitment to designing effective and coherent policies, the European Commission has conducted extensive stakeholder consultations and regulatory impact assessments before proposing new legislation (Alemanno, 2015; De Francesco, Radaelli, & Troeger, 2012; Dunlop, Maggetti, Radaelli, & Russel, 2012).

Bakir and Woo (2016) refer to policy design as 'deliberate governmental efforts at attaining desired policy objectives'. One of the core aims of policy design is to produce policy tools and instruments facilitating the attainment of policy goals (see also Howlett & Lejano, 2013; Howlett, 2011; Woo et al. (in this volume)). Furthermore, Woo et al. (in this volume) highlight the importance of regime coherence at the domestic and international level in order to achieve optimal policy design. However, in practice, mismatches in coherence occur frequently. For example, highly coherent domestic regimes may intersect with incoherent international regimes. Woo et al. (in this volume) point out that this scenario may produce regulatory capture. This article adds first insights into another limitation of policy design, which I refer to as 'regulatory cascading'.

In line with one of the central goals of this special issue – to provide a clearer and deeper understanding of the underlying processes shaping financial regulation reform – this article focuses on the interests of the public and private sector actors seeking to shape banking sector reforms in the EU (see also Howarth & Quaglia, this volume; Mérő & Piroska, this volume). In particular, I investigate banking structural reforms introduced in the European Union (EU), placed in an international context. One of the main aims of banking structural reforms at all governance levels is to streamline and simplify bank structures, thus facilitating the resolution of large internationalised banks in times of crisis.

Analysing EU banking structural reforms provides us with a better understanding of how governments and the financial industry are managing the cumulative impact of rapid institutional and regulatory reforms (see also Quaglia, 2008; Pagliari & Young, 2014; Young, 2014). This investigation is especially relevant in a multi-level polity such as the EU because it allows us to capture the interplay of international, (macro-)regional, and domestic banking sector reforms initiated after 2008 (see also Quaglia, 2014a, 2014b; Mügge, 2014).

In Section 3, the concept of 'regulatory cascading' is put forward to examine how European policy-makers tackle complex multi-faceted problems, such as 'too big to fail'. Partial solutions to the problem introduced in a rapid sequence of reforms in capital adequacy rules, bank supervision, and bank resolution regimes have constrained the opportunities to design a coherent EU framework regulating bank structures. Furthermore, the article investigates the repercussions of regulatory cascading for the coherence and effectiveness of the new policies. I argue that the quick accumulation of new regulatory standards and policy instruments poses significant challenges for policy-makers and stakeholders. By necessity, the policy evaluation tools used by the European institutions operate on a slower time scale than the widely-used stakeholder consultation tools. So far, policy evaluation, including *ex ante* economic impact assessment, has not captured fully the interactions between different strands of reform and unintended consequences of regulatory cascading.

What issues stand out in European banking structural reforms and which stakeholders will be affected the most? The European Commission's (2014a: 7) legislative proposal contains two main elements: 'a ban on proprietary trading' and 'mandatory separation of some trading activities from the deposit-taking entity.' Existing EU legislation, such as the Capital Requirements Directive IV (CRD IV) and the Single Supervisory Mechanism (SSM) Regulation, was desirable from the point of view of regulators and the financial industry, as it guaranteed a European level playing field, created a single supervisory contact point, and a single rulebook in banking. By contrast, analysts have pointed out that the proposed EU banking structural reforms will generate high compliance costs and require a substantial redesign of banks' business models. The high adjustment costs are expected to have especially adverse effects on universal banks in Europe, which rely on both deposit-taking and market-making activities (Deloitte, 2015; Hardie & Macartney, 2016; Spendzharova, Versluis, Flöthe, & Radulova, 2016).

In the following sections, I first take stock of banking structural reforms placed in an international context. Next, I outline the concept of 'regulatory cascading' in EU banking structural reforms. After that, I examine the reforms adopted in individual EU member states and analyse the positions of the European Parliament and Council on the legislation proposed by the European Commission. Lastly, the conclusion summarises the main findings.

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