STRATEGIC BEHAVIOUR AND CRISIS-DRIVEN CHANGE IN REGULATION AND GOVERNANCE OF THE EUROPEAN FINANCIAL AND ECONOMIC SYSTEM: FROM NETWORKS TO HYBRIDS

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Strategic Behaviour and Crisis-Driven Change in Regulation and Governance of the European Financial and Economic System: From Networks to Hybrids

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Abstract: A key challenge that European decision-makers struggle with today is regulating and governing the European financial and economic system in a way that is both effective and legitimate. To help address this challenge, this paper asks why regulatory gaps occurred and European governance has been weak, and how these gaps and weaknesses allowed risky behaviour. It then scrutinizes the regulatory governance structures that have emerged in response, particularly at the EU level, to coordinate the financial and economic system. Two illustrative cases are examined: self-regulation by and national supervision of banks and ‘decentred’ fiscal policy coordination by eurozone countries. We point to strategic behaviour as a key driver of the crisis. We also argue that changes in regulatory governance to curb such behaviour have entailed introduction of some form of hierarchy at the supranational level, yet still combined with strong network characteristics, thus creating or strengthening hybridity in regulatory governance.

Key Words: Agencies, coordination and decision-making processes, financial and economic system, governance, hierarchies, hybrids, networks, (self-)regulation, strategic behaviour
I. Introduction

The recent financial and economic crisis revealed serious gaps in regulation and weaknesses in governance at the European level. These allowed banks as well as countries to take enormous risks, to the detriment of the whole European Union (EU) (De Larosière Committee 2009; European Commission 2010a). While these gaps and weaknesses helped to make the crisis possible, ultimately it was these individual banks and eurozone countries that took the risks. Their behaviour bloated the financial markets with ‘toxic’ assets, resulting in the near-collapse of the European Monetary Union (EMU). Eventually, banks and eurozone countries had to be bailed out by ‘healthy’ financial institutions and governments, at the European taxpayers’ expense. If these banks and countries had gone bankrupt, they could have brought down the whole financial and economic system.

This raises the question of how such a situation, also known as ‘moral hazard’, could have occurred. That is, how did banks and countries come to expect they would receive assistance from others if their bets went bad, hence leading them to take more risks than they otherwise would? A superficial answer, in line with principal-agent models, is that lack of information hampered regulatory actors in their supervisory activities. Such ‘information asymmetry’ (Akerlof 1970) in the regulatory arrangements in place during the financial and economic crisis might have existed in at least two regulatory relationships: that between national central banks and financial institutions and that between the European Commission and eurozone member states.

Insufficient information, however, seems too simple an answer. National central banks will always operate with a lack of information and thus could never reliably police the activities of banks using a ‘command-and-control’ approach. For this reason, the banking sector was expected to regulate itself, for instance, through more or less voluntary codes of conduct and deposit insurance schemes. Likewise, Europe’s supranational institutions lack the necessary information to control the finances of eurozone countries via a centralized approach. Consequently, the authority to govern
national economies and budgets is left with member states, for instance, via national procedures with intergovernmental coordination. Through instruments aimed at mutual learning, such as steering by information and peer monitoring, banking and countries can supposedly avoid pitfalls related to information asymmetry. They have incentive to check up on one another because all suffer negative consequences if one of them takes too much risk.

However, these self-regulatory and decentralized strategies have not met expectations. Self-regulation by banks has not worked, and decentralized coordination among the eurozone countries has similarly failed. Despite the regulatory frameworks and governance structures in place before the crisis, banks and eurozone countries behaved irresponsibly, causing huge damage to the European economy and society. In the wake of the crisis, European decision-makers therefore face a dilemma: while a certain degree of centralization of regulation and governance may be necessary via legal rules and formal structures, a traditional command-and-control approach to regulation and fundamental shift to supranational governance are likely to be organizationally unfeasible and politically unacceptable. Thus, a key challenge that European decision-makers struggle with today is how to regulate and govern the European financial and economic system in a way that is both effective and legitimate.

In addressing this challenge, legal scholars have tended to look at rules, trying to get the legal framework right, while most economists have focused on incentives, seeking to get the market design right. This paper, by contrast, adopts a regulatory governance perspective. It examines ‘real’ actor behaviour and its effects in an increasingly complex European financial and economic system. Our aim is to advance understanding of coordination and decision-making processes, or modes of governance, in terms of both the arrangement (self-regulation versus public regulation) and the level of choice (national or supranational/EU), so as to ultimately get the (regulatory) governance right; that is, to render it effective as well as legitimate.

This paper first asks why, despite having self-regulatory and decentralized instruments supposedly in place, regulatory gaps occurred. Why was European governance weak, and how did this allow risk-taking by banks and countries? Second, the paper looks at
the new regulatory governance structures that have emerged in recent years for coordination of the European financial and economic system. After reviewing the theoretical notions guiding our research, two illustrative cases are presented: that of self-regulation and national supervision of banks in Europe and that of ‘decentred’ fiscal policy coordination by eurozone countries. We argue that attempts to curb strategic behaviour by banks and countries have entailed the introduction of some form of hierarchy at the supranational level, yet still in combination with strong network characteristics, thus creating or strengthening hybridity in regulatory governance.

II. Strategic Behaviour and Regulatory Governance in Europe

Information Asymmetry and Strategic Behaviour

To mitigate market failures and socio-economic risks, governments create public regulators and task them to enact and/or enforce rules. A key constraint of such a ‘traditional’ strategy of regulation is asymmetry of information between regulator (i.e., the principal) and regulatee (i.e., the agent) (Laffont and Tirole 1993). The regulator simply cannot monitor all behaviour of the regulatee. This becomes a problem, from the viewpoint of the regulator, if the regulatee has different or even conflicting interests and behaves strategically. ‘Strategic behaviour’ has been described as a “propensity to shirk, to be opportunistic, to maximise his or her self-interest, to act with guile and to behave in ways that constitute a moral hazard” (Donaldson 1990, p372). The essence of strategic behaviour is that it is intentional and aimed at narrow self-interest, while being unmindful of harm done to other private interests or to the public at large, thus having economic, social and regulatory costs (Jensen and Meckling 1976).

Ten Heuvelhof et al. (2009, p17-18) describe several characteristics of strategic behaviour. It is reflective in the sense that regulatees realise they have to camouflage their intentions, sometimes even by claiming virtuous motives, in order to pursue their own interest. This makes it difficult for outsiders to unmask regulatees’ true intentions (and for researchers to study strategic behaviour). Whether behaviour can be described as strategic is somewhat subjective and thus ambiguous. Strategic behaviour, finally, has a relational and temporal dimension: it requires involvement
of multiple actors in repeated interactions over time. This makes it difficult to anticipate outcomes and thus to devise regulatory arrangements or governance structures.

Strategic behaviour based on information asymmetry manifests itself in at least two forms (Laffont and Tirole 1993): ‘adverse selection’ and ‘moral hazard’. In the context of regulation, adverse selection refers to a process in which undesired results occur due to information asymmetry between regulator and regulatee during preparation of a regulatory arrangement. The regulatee has an information advantage over the principal and uses hidden information “to influence the design of the arrangement in his own favour, even if this prejudices the principal’s interest” (Ten Heuvelhof et al. 2009, p36). The consequences for the functioning of the regulatory arrangement are profound. Anticipating the strategic nondisclosure of information, other regulatees involved in negotiation of the arrangement also keep information hidden. This reduces the overall performance of regulation.

Moral hazard refers to a situation after negotiation of a regulatory agreement in which the regulatee evades the arrangement (Arrow 1965). The regulatee does not feel the costs that could incur as a result of this evasion, as these costs are borne by the principal, other regulatees and the public at large. The regulatee hides his actions from the principal, disclosing only behaviour that makes it appear that he is sticking to the prevailing rules and complying with the standards set. This form of strategic behaviour, too, has a significant impact on the effectiveness of regulatory arrangements. If multiple regulatees behave riskily, assuming that they will not have to take the full responsibility when things go wrong, this may trigger a domino effect, with government, regulators and citizens shouldering a too-heavy burden and may threaten system stability.

**Preventing Strategic Behaviour through Self-Regulation**

To address the limitations of a traditional strategy of regulation, several alternative strategies have been employed, including self-regulation by firms and the regulated industry or sector (Ayres and Braithwaite 1992; Coglianese and Mendelson 2010). Self-regulation supposedly solves two problems: the lack of information available to public regulators concerning not only enforcement but also standard-setting and,
closely related, the lack of motivation among regulatees to comply with the rules. The information asymmetry between regulator and regulatee makes a command-and-control strategy not only unfeasible but also undesirable. It is more advantageous to rely on non-hierarchical, self-regulatory processes (Lodge and Wegrich 2012).

The underlying theoretical assumption of self-regulation is that regulatees have more information about each other than regulators could ever have. So they are able to regulate each other. They are also willing, because they have an incentive to do so. If other regulatees fail to stick to the commonly agreed rules or meet the self-binding standards, this negatively affects the image of the entire regulated industry or sector. Moreover, if some regulatees run into trouble, this might undermine the viability of an entire regulated industry or sector. Other regulatees will then have to come to the rescue to avert trouble. As this is costly, regulatees often commit to a degree of peer monitoring and sometimes even self-enforcement.

A key characteristic of self-regulation is its ‘decentredness’. The capacity to gather information and enforce compliance is typically distributed across regulatees. That means any attempt at hierarchical control is likely to be ineffective, because it evokes irresponsible behaviour among regulatees. “Therefore, delegating regulatory responsibility to regulated entities (in various ways) enhances expertise and flexibility in dealing with diagnosed problems” (Lodge and Wegrich 2012, p115). It also enhances the legitimacy of regulatory arrangements among regulatees, because they are not prescribed by a regulator but are set by a group of the regulatees themselves. The expectation is that through informal mechanisms of control, such as peer pressure, compliance can be induced from the members of such groups (Gunningham 1995).

From Regulation at the National Level to Regulation at the EU Level

The argument in favour of decentralized, self-regulatory strategies is very similar to that in favour of regulation at the national level, rather than at the international or, in our case, European level. National regulation is generally said to be closer to the regulatory problem. As a result, problem-solving can be more effective and embedded in national structures of accountability, which may make interventions more legitimate to both regulatees and the public at large. In fact, information asymmetries
are exacerbated when regulatory tasks are delegated to EU-level bodies, which increases the potential for strategic behaviour. After all, supranational institutions are unlikely to build up the capacity required to survey the entire EU territory, while member states are unlikely to allow such institutions to act upon abuses of rules or standards in their jurisdictions without prior agreement, especially not in highly salient policy areas.

Nevertheless, countries have increasingly engaged in cooperative regulatory efforts at the EU level, even pooling a degree of sovereignty (Majone 1994). Some regulatory problems (risks, crises) cross the boundaries of national jurisdictions, particularly as trade barriers have been removed and internal frontiers abolished in order to realise a single European market. These problems challenge the effectiveness and legitimacy of national regulatory frameworks and require – technocratic – solutions at the European level, to the benefit of all member states. The establishment of an internal market, and the need to police it properly, has thus led to a surge of regulatory activity at the EU level, for instance, to prevent abuse of market power and to mitigate financial and economic risks.

**Decentredness and Strategic Behaviour**

Like command-and-control types of regulation, decentred types of regulation, such as self-regulation and national regulation, are subject to strategic behaviour. Adverse selection occurs when ‘lower-quality’ regulatees seek to participate in self-regulatory schemes (Lenox and Nash 2002). Without adequate information gathering on the behaviour of these regulatees and in the absence of enforcement of such regulatees’ compliance, poorly performing regulatees will try to become members so as to improve their reputation and benefit from the assistance offered by other members, without actually undertaking the required effort. If higher-quality regulatees do not check up on the behaviour of newly entering regulatees and many poorly performing regulatees join, the difference between membership and non-membership disappears and the self-regulatory programme no longer serves its societally valuable purpose.

In the EU, selection is often deliberately adverse. Newly entering countries must meet certain minimum requirements to become a member of, for instance, Schengen or the eurozone; but their membership also serves an important political goal in that –
through cooperation with existing members – their performance is expected to improve. This becomes problematic, however, when new member states do not meet the minimum requirements for cooperation. That is a real risk, as newly entering countries have an incentive to not disclose information about their poor performance, because they want to reap the benefits of the cooperative regulatory arrangement. While this in the short term may help them to improve their reputation, in the long term it may endanger the value of the arrangement.

Moral hazard occurs when regulatees participating in a self-regulatory scheme manage to evade mechanisms for measuring and enforcing compliance with the scheme’s objectives. If compliance is not monitored in some way and if non-compliant members are not expelled from the scheme, members have an incentive to behave in a risky way, diminishing the effectiveness of self-regulatory schemes. Because self-regulatory schemes usually require regulatees to impose their own rules and standards and the consequences thereof upon themselves, monitoring and sanctioning are not always effective and sometimes completely lacking. In the domestic context, self-regulatory strategies are therefore frequently implemented following general instructions and broad guidance from outside regulators, also referred to as ‘meta-regulation’ (Coglianese and Mendelson 2010). These are often backed by the threat of state intervention, the so-called ‘shadow of hierarchy’, should self-compliance not be forthcoming (Newman and Bach 2004).

The political goal of EU membership is at odds with impartially measuring and enforcing compliance by countries themselves. Even if monitoring takes place, sanctioning is likely to be rare because countries adhere to the norm of reciprocity, which reduces the effectiveness of cooperative efforts. Moreover, considerable fragmentation remains in the political realm, as member states have not only common but also divergent interests, and they lack the level of mutual trust required to cooperate in an effective manner. In such ‘co-competitive’ relationships, strategic behaviour thrives (Dixit and Nalebuff 1993). To prevent strategic behaviour, EU member states may decide to ‘tie their hands’ and delegate regulatory power to supranational EU-level bodies, such as the European Commission or European regulatory agencies. Such bodies, invested with a degree of discretion, may then implement regulatory policies on the member states’ behalf to keep member states
from defecting on their commitments vis-à-vis each other when this would be in their (or their home companies’) interest (Majone 2001).

**Network Governance, Crisis-Driven Change and Hybridization**

In the absence of the resources and political will necessary to centralize regulatory power in EU-level bodies, recent decades have instead seen a move towards ‘network-type’ regulatory regimes (Kohler-Koch and Eising 1999). In many sectors (informal and formal) European networks of national regulators, aimed at information sharing, coordination and cooperation, have served as an alternative to a single EU regulator with hierarchical steering capacity (Eberlein and Grande 2005). However, coordination through European networks in the past has not necessarily led to the level of supervisory convergence required to regulate increasingly interdependent markets (Coen and Thatcher 2008; Kelemen and Tarrant 2011). National regulators are usually not compelled to follow the advice and opinions rendered in the context of European networks; and common positions and peer reviews generally remain without binding effect, the result being that member states continue to implement EU rules in various manners. The network model, thus, has clear limitations (Jordan and Schout 2006).

Since the 1990s, EU agencies, independent from the EU institutions and member states, have proliferated in various policy domains. Although they increasingly have regulatory tasks, EU agencies still seldom can enact rules and have only limited possibilities for enforcement. Usually, their role is restricted to creating networks and coordinating the activities of member-state regulators. Through these networks, involvement of stakeholders and exchange of information and best practices are encouraged (Eberlein and Kerwer 2004; Sabel and Zeitlin 2010). In fact, EU agencies are said to add most value when they serve as platforms for discussion and debate among European and national stakeholders and in stimulating peer review and mutual learning processes among national regulatory authorities (Groenleer, Kaeding and Versluis 2010). In that sense, the contribution of agencies to EU regulatory governance is little different from that of European networks.

While networks or network-type regimes remain the regulatory tool of choice in the EU, a gradual – yet sometimes accelerated – transfer of powers from the member
states to EU-level bodies is observable. In particular, crisis pressures in a variety of sectors have led to the build-up of capacities at the EU level and the emergence of a hybrid form of EU governance, combining network characteristics with some form of hierarchy through ‘centralized nodes’ or ‘hubs’ (Boin et al. 2013). These hubs, while lacking full-fledged hierarchical authority, can impose a minimal level of control on network elements – countries as well as companies – to enhance coherence of the system and maintain its stability, especially in view of risks or crises. Regulatory gaps and weaknesses in transnational governance have thus spurred a hybridization process in which ‘agencified networks’ or ‘networked agencies’ are granted ever more significant powers to coordinate national regulators and, under certain conditions, to even directly supervise firms (Groenleer 2011; Levi-Faur 2011). This development, the institutionalization of the EU’s regulatory space, is particularly clear in the financial and economic sectors, as illustrated by the following, highly related, yet analytically distinct case studies.

III. Case Study 1: Regulation of the European Banking Sector and the Change towards More Europe

The Limits of Self-Regulation and Nationally-Oriented Regulation

Due to different national histories and political choices, the banking sector in Europe has long faced divergent regulatory regimes in different countries, with varying degrees of public regulation and regulation by the sector itself (Begg 2009). From 2004 onwards, these different national regulatory regimes were supplemented at the European level by a network of national supervisory authorities, called the Committee of European Banking Supervisors (CEBS).

The financial crisis exposed the gaps in these regimes and the failure to adequately regulate the European banking sector (De Larosière Committee 2009; Financial Services Authority 2009). Firstly, the CEBS, despite being tasked to facilitate the exchange of information on national implementation of European banking legislation, was unsuccessful in achieving the required level of coordination. Its agreements were voluntary, the setting was informal, and the rules were complex (Kudrna 2012). Often, discussions were dominated by national interests, in particular, the competitiveness of countries’ own financial markets (Begg 2009), while trust between
national supervisors was absent. EU law was therefore not always consistently applied, member states taking advantage of the ample room for national discretion that EU directives allowed (Quaglia, Eastwood and Holmes 2009).

Secondly, the pre-crisis regulatory regimes were primarily oriented towards the national level, which proved inconsistent with the internationally expanding activities of banks and the interdependent character of markets. National regulatory agencies focused their efforts on individual financial institutions (i.e., conducting micro-prudential oversight), paying little attention to the financial system as such (i.e., undertaking macro-prudential regulation). More specifically, while the so-called ‘European Passport’ permitted financial institutions to do business in other countries, regulation in the EU was guided by the ‘home country control’ principle (Begg 2009): only the regulator of the home country of a bank was entitled to conduct supervision, also in respect of a subsidiary in another country. This made it difficult for the regulator of the host country to exert control, for instance, over a ‘lower-quality’ subsidiary bank, as became clear in Fortis case (Quaglia, Eastwood and Holmes 2009; Dabrowski 2010; Kudrna 2012).

Thirdly, self-regulation by banks turned out to be dysfunctional, failing not only at the organizational level but also at the individual level. Bank management lacked detailed information on the behaviour of its employees, and supervisory boards were unable to oversee what exactly took place within the banks they were supposed to control (De Larosière Committee 2009). As a result, bank employees could behave irresponsibly, knowing they would likely escape sanctions or, oftentimes, not considering their behaviour as risky at all.

**National and Cross-Border Risk-Taking Activities**

To be sure, the highly competitive banking environment produced strong incentives for banks and their employees to take ever more risks, even apart from the gaps in regulatory supervision. Financial innovation, in particular ‘securitization’, made it possible to sell questionable loans to investors in the international financial market. As a result, banks no longer had to deal directly with the consequences of their behaviour and became less cautious. Most financial institutions also had systems in place to incentivize their employees, rewarding short-term profits rather than long-
term stability (Dabrowski 2010). Overconfident about the potential profits, banks and their employees underestimated the possibility of failure. Rather than strictly monitoring banks’ risk-taking behaviour, shareholders actually encouraged such behaviour by demanding more and more return on their investments (De Larosière Committee 2009). Moreover, the ability of banks to move activities to countries with different regulatory arrangements created an environment for a ‘race to the bottom’, with EU countries competing with one another on behalf of their financial markets and enforcing regulations laxly in order to attract foreign banks to their territories.

Example: The Fortis debacle

The Fortis debacle is illustrative of the gaps in European regulatory regimes and strategic behaviour on the part of banks. When ABN AMRO Bank was purchased in October 2007 by a consortium of Royal Bank of Scotland, Fortis and Banco Santander, it was widely understood that the purchase was expensive, but could ultimately be profitable, under a steadily growing economy and market. A large part of the takeover price consisted of goodwill, however, which had to be written off during the financial crisis (De Wit Committee 2012). In addition, Fortis was seriously exposed to American subprime debt, resulting in uncertainty about the bank’s liquidity and solvency. This led investors to sell their Fortis shares and prompted deposit-holders to empty their bank accounts (Pisany-Ferry and Sapir 2010).

The purchase of ABN AMRO was financed by the Belgium part of Fortis, which was supervised by the Belgian regulator. The financial troubles of the Dutch subsidiary of Fortis were discovered by the Dutch regulator only when it was too late for intervention. Uncertainty surfaced about Fortis, and the quickly diminishing confidence in the bank required a swift reaction from the Dutch and Belgian regulators. But the regulators, at least partly driven by their national interests, disagreed on how to tackle the problems and communicated in different ways about their proposed solutions, fuelling mutual distrust and hampering effective cooperation. Eventually, the Dutch government nationalized Fortis Bank Netherlands, ABN AMRO Netherlands, and the Dutch insurance activities of Fortis in October 2008, in order to stabilize the Dutch banking sector – a temporary move that still continues today.
More Europe, but Not Necessarily through Centralization

Changes introduced since 2009 signify a move towards ‘more Europe’, via expansion of the regulatory regimes at the EU level (Moloney 2010). Following the recommendations of the De Larosière Committee (2009), the European Commission introduced a completely new European Systemic Risk Board (ESRB), responsible for assessing threats to the financial system at a macro-prudential level. It also proposed increased EU coordination through the European System of Financial Supervision (ESFS) (Begg 2009; Dabrowski 2010). The ESFS entails, among other things, the transformation of the CEBS into a European Banking Authority (EBA), established as from January 2011. Compared to the CEBS, the EBA has much more regulatory power. Rather than voluntary agreements, its decisions are binding upon member states, and the EBA has authority to bypass national regulation in certain cases.

Furthermore, the European Central Bank (ECB) has been invested with tasks related to the prudential supervision of European banks, as part of the progress towards a Banking Union and the creation of the so-called Single Supervisory Mechanism (SSM), which at the same time, integrates the work of national supervisors. Centralization tendencies are also observable in the design of the Single Resolution Board, a corollary to the SSM, and still under negotiation at the time of writing. In this board, decision-making competences will formally lie with the European Commission. National supervisors and ECB officials will have only an advisory and executive role concerning the resolution of a bank.

Yet, expansion of the regulatory regimes at the EU level does not necessarily involve centralization. A proposal for a new centralized, integrated European regulatory agency was not backed, as such centralization of powers was perceived as encroaching upon national sovereignty (Kudrna 2012; Bauer, Becker and Kern forthcoming). Instead, the chairs of the national regulatory agencies will still make up the board of the EBA, and thereby remain powerful. In addition, the EBA can bypass member states only if they have failed to act. So, what has emerged from the negotiations between the Commission, the Council and the European Parliament, is a body with the characteristic features of a network, but centralized elements.
A similar hybrid arrangement characterizes the expansion of the ECB’s role. The ECB will not simply take over prudential supervision of banks. Rather, the degree of direct, day-to-day supervision by the ECB will depend on the size of banks, with smaller banks still monitored by national supervisors. Even for tasks assigned to the ECB, most of the actual supervisory work will be done by national bank supervisors, given that they “are in many cases best placed to carry out such activities, due to their knowledge of national, regional and local banking markets, their significant existing resources and to locational and language considerations” (European Commission 2013b, p4).

What is more, the De Larosière Committee (2009) stressed the importance of self-regulation by banks, in addition to regulation at the EU level. In order to create the conditions for effective self-regulation, the EU imposed legislation on individual banks with regard to the complexity of products. By forcing banks to be more transparent about their products, the information asymmetries between bank management and employees and between bank management and supervisory board should be reduced. Self-regulation and nationally-oriented regulation thus remains the basis for micro-prudential regulation.

IV. Case study 2: Eurozone countries and the partial centralization of economic coordination

The Failure of Peer Monitoring

It is commonly understood that though the eurozone crisis was set in motion by the global financial crisis, it was exacerbated by the institutional set-up of the European Monetary Union (see, e.g., Gianviti Krueger et al. 2010). While member states had agreed to coordinate monetary policy centrally via the European Central Bank (ECB), they sought to regulate fiscal policy at a decentralized level via the Stability and Growth Pact (SGP), adopted in 1997 (Heipertz and Verdun 2010). According to the SGP, member states evaluate each other’s financial sustainability based on agreed norms, namely a maximum 3 per cent deficit-to-GDP ratio and 60 per cent debt-to-GDP ratio (or, in any case, debt declining from year to year at a satisfactorily pace).

The introduction of a common currency, the euro, reduced the means of national central banks to discipline the fiscal behaviour of governments and meant that
borrowing by one government also affected other eurozone countries (Morris, Ogena and Schuknecht 2006). Member states decided to discipline each other when in breach of SGP norms by rules that separated fiscal and monetary policy and prohibited bailouts of member states. A peer-monitoring system was put in place, allowing fiscal regulation at a European level (as favoured by some) as well as national control over budgetary decisions (as favoured by most, if not all, countries).

Soon after adoption of the SGP, violations of the agreed norms turned out to be frequent, and not all member states were always willing to enforce the pact (De Grauwe 2003; Strauch, Hallerberg and Von Hagen 2004). Member states considered the norms too rigid, straightjacketing them in economically hard times, or they considered the SGP unenforceable, due to the ambiguity of the norms and the resulting differences in interpretation. To address these criticisms, the SGP was relaxed in 2005 (Amtenbrink and De Haan 2006; Schwarzer 2007). Immediately afterwards, many member states reported decreasing deficits, but when the financial crisis hit, the deficits of most member states rose again. By 2010, at a time when member states were more interdependent than ever, they put their economic and budgetary surveillance of each other on a low. The peer-monitoring system supposedly in place was essentially broken, and there was no easy fix.

Irresponsible Conduct by Eurozone Countries

A number of weaknesses in the fiscal governance of Europe through the SGP allowed member states to pursue their short-term national interests, notwithstanding their long-term collective interest in a sustainable and financially sound Europe (Heipertz and Verdun 2010). Firstly, the SGP offered only one strict sanction: a fiscal penalty. However, to allow member states enough time to adjust their fiscal policy, this sanction could only be considered after several years of non-compliance (European Commission 2013a). Not only was the fiscal penalty difficult to impose, the crisis showed that it made no sense to punish an already financially troubled member state, making the fiscal penalty essentially unenforceable. Secondly, information on governmental debt and deficits was sometimes incorrect (Morris, Ogena and Schuknecht 2006). This occurred not only during and after negotiation of the SGP in 1997, but also when new members joined. In fact, Greece had been providing inaccurate fiscal data even before it entered the eurozone in 2001 (European...
Commission 2010b; Featherstone 2011). Thirdly, it was not just countries with a history of excessive debts and deficits that ran into trouble, but also countries that had never exceeded the norms (Giavanti Krueger et al. 2010). It appeared that additional factors, such as the development of the housing market, the size of the banking system and the competitiveness of the economy, also played a substantial role. Information gathered under the SGP thus only partially covered the financial risk exposure of a member state. Fourthly, when several member states were not in compliance with the norms, they could form coalitions to influence decision-making. The best known example is the 25 November 2003 ECOFIN decision not to act on Commission recommendations to sanction France and Germany.

Example: The Greek debt crisis

The Greek debt crisis is illustrative of how a member state could behave irresponsibly due to weaknesses in EU governance. Greece always was one of the more frequent violators of the SGP, along with Germany, France and Portugal, but by feigning compliance it had managed to fend off a fiscal penalty. However, during the crisis, it became known that Greece had constantly been in violation of the SGP and, in fact, had not even met the criteria to enter into the EMU (Eurostat 2013). Creative and sloppy accounting had allowed Greece to share inaccurate financial data for years. Eurostat, the EU statistical office responsible for aggregating SGP data, was well aware of inaccuracies in data provided by national statistics agencies, but it was not in the position to do anything about it (Schout 1999).

Moreover, the problems behind the high deficit and debt ratio of Greece appeared to have much to do with its economic position (Katsimi and Moutos 2010), which had been deteriorating since the country joined the euro. This suggests that other economic factors would have given a better picture of Greece’s financial sustainability than merely deficit and debt indicators (Giavanti Krueger et al. 2010). The same is true for Spain and Ireland, where government finances proved unsustainable, despite these countries’ past compliance with the SGP. Initially, member states tried to pressure Greece into implementing reform and austerity measures, as a fiscal penalty was deemed ineffective, if not counterproductive. Eventually, the country was bailed out under strict preconditions.
A Shift of Power to ‘Brussels’?

In response to the pending crisis, changes were made to strengthen the EU’s fiscal governance structure. Because the SGP had not prevented irresponsible behaviour in the past, the ‘Six Pack’ and the ‘Two Pack’ were introduced, enacting important modifications to the pact, yet without delegating ultimate decision-making authority to the supranational level (see, e.g., Salines, Glöckler and Truchlewski 2012; Schwarzer 2012; Puetter 2013). Instead, self-regulation by member states was enhanced with implementation of the ‘European Semester’, an early peer-review system for national budgets, even before they are sent to parliament for approval. Member states also agreed to enforce the 60 per cent debt-to-GDP norm and to allow benchmarks on additional economic factors to facilitate self-regulation (European Commission 2013a).

While the crisis has resulted in an increase of power for ‘Brussels’, notably the European Commission (Bauer Becker and Kern forthcoming), this does not signify a fundamental shift away from national responsibility to a centralized model (Salines, Glöckler and Truchlewski 2012). Under the new arrangements, the Council can still overwrite financial penalties imposed by the Commission on member states with excessive deficits or debts, albeit by a reversed qualified majority vote. If excessive imbalances in a country’s economy are not corrected, the Commission can impose sanctions. Yet again, these can be rejected by the Council with a qualified majority vote (European Commission 2013a). Finally, Eurostat received the power of enquiry, making it easier to gather public finance data, even on-site in member countries. It does not supplant national statistics agencies, however, which still allows national governments to influence the data-collection process. The Commission and Eurostat have thus been invested with powers that were solely in the hands of member states before the crisis, but not without the possibility for the member states to overrule or influence supranational governance.

V. Discussion and Conclusion

A key challenge that European decision-makers continue to struggle with in the wake of the crisis is how to regulate and govern the European financial and economic system in a way that is both effective and legitimate. This paper sought to help
address this challenge of getting the regulation and governance of the European financial and economic system ‘right’. We asked why – despite the self-regulatory and ‘decentred’ instruments supposedly in place – regulatory gaps remained and European governance was weak. How did this play into risk-taking by banks and by eurozone countries? We then scrutinized the new regulatory governance structures that have emerged in recent years to oversee the European financial and economic system, in response to a crisis that largely resulted from such risk-taking.

**Self-Regulation, Decentred Coordination and Strategic Behaviour in the EU**

Our case studies of the (self-)regulation of European banks and decentred fiscal policy coordination by eurozone countries clearly illustrate that strategic behaviour is common in the European Union. Such behaviour, implying self-interestedness of banks or countries, does not always mix well with shared interests, such as European financial and economic integration. We briefly re-examine our cases here in light of the theoretical notions introduced at the start of this paper.

Regulatory regimes in the banking sector have combined a traditional strategy of public regulation with alternative strategies of self-regulation. Yet, relationships within banks – between management and employees and between supervisory boards and management – and those among banks have been characterized by considerable information asymmetries. Despite having rules and norms in place before the crisis, banks behaved recklessly, encouraged by innovation in financial products and the enormous profits to be gained. Thus, banks took ever more risks, while self-regulation functioned less and less effectively.

Banks’ risk-taking behaviour could, at least partly, have been curtailed if oversight had not been led, for reasons of stimulating competition, by the ‘home country control’ principle, restricting national supervisors’ field of vision with regard to the activities of subsidiary banks. Such a narrow view, similarly exhibited in national regulators’ inconsistent implementation of EU laws, proved at odds with the ‘European passport’, which allowed banks to set up shop in another country and to strategically move activities between countries. In view of the significant economic interests involved, regulatory competition appeared to prevail over regulatory coordination.
Among the eurozone countries, peer monitoring through the SGP was largely ineffective. Some countries withheld essential information at the time of (re-)negotiating or joining the pact, resulting in adverse selection, and they behaved similarly strategic during the pact’s application. When rules and norms were in place, enforcement remained essentially lacking, partly because of its counterproductive effects. This further incentivized irresponsible behaviour, which manifested in countries’ non-implementation of structural reforms, putting the stability of the system at risk. Individual eurozone countries seemingly never believed that failure was even a possibility, and that rescue would thus be necessary. In fact, bailouts were explicitly prohibited in order to avoid moral hazard.

The irresponsible behaviour of eurozone countries could, at least to some extent, have been curbed if the peer-monitoring system put in place through the SGP had been backed by the necessary means for supranational intervention. But both EU-level bodies and eurozone peers lacked the competences and capacities required to credibly discipline misbehaving eurozone countries.

**Towards Hybrid, Multi-Level Regulation and Governance**

Our cases display a shift away from self-regulation and decentred coordination as the arrangement of choice to control the banking sector and coordinate economic policy. This shift is not as radical as one would perhaps expect (Mayntz 2012), given the enormous economic and social costs of the crisis. While new, stricter rules have been enacted, the key change lies in enforcement of these rules, which was essentially lacking before and during the crisis. Voluntary agreements have become binding, and bureaucratic agencies and regulatory bodies have been invested with increased formal authority to monitor behaviour and apply sanctions in cases of non-compliance.

Public regulation through independent authorities has become more acceptable, but it certainly is not an adequate substitute for self-regulatory arrangements – if only because its limitations remain. In fact, rather than a resort to hierarchy, the shift away from self-regulation as the arrangement of choice represents a further hybridization of EU financial and economic governance. Mixing elements of the network model with hierarchical features – such as the threat of intervention by the EBA, the new, but still circumscribed tasks of the ECB and reversed qualified majority voting – hybrid
governance is supposed to incentivize banks as well as countries to refrain from strategic behaviour (cf. Ten Heuvelhof et al. 2009).

We observe a similar incremental change regarding the chosen level at which to organize regulation of the banking sector and the governance of economic policy (Ferran et al. 2012; see also Tosun, Wetzel, and Zapryanova forthcoming). Whereas crisis pressures clearly led to significant modifications of the EU’s regulatory governance structures, member states have not simply transferred power to Brussels. Supranational governance, like public regulation, has become more acceptable as a result of the crisis, but it is still far from the dominant mode of governance. European structures, some of them new, while being invested with substantial competences, still build and rely on the capacities of member-state authorities, which are legitimized in the national political setting.

So if anything can be said at this stage about the effects of the crisis in terms of governance, it is that the crisis has contributed to the further intermingling of levels of governance in the EU, often complexifying (and certainly not always clarifying) institutional arrangements. Such an effect is not uncommon. Indeed, in many policy areas (consider food safety and irregular immigration) crises have led to additional authority being invested in the EU’s regulatory apparatus, without necessarily encroaching on member states’ sovereignty (Boin et al. 2013).

Limitations of Our Study and Ways Ahead

This paper constitutes a first, exploratory attempt to study EU regulation and governance and changes thereof in response to the financial and economic crisis by focusing on information asymmetry and strategic behaviour. Follow-up research could adopt a more explanatory approach, while attempting to substantiate our analysis using further empirical evidence, for instance, drawn from interviews with key players. Strategic behaviour remains difficult to prove, however, especially after the fact. To get more grip on such behaviour as a social and political phenomenon occurring in reality, future studies might make use of process-tracing techniques and real-time observation. Indeed, only when the behaviour of actors in European coordination and decision-making processes is understood, will it be possible to get the regulatory governance structures ‘right’.
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