**The Politics of Banking Union in the EU: Regulators, Resolution and Deposit Insurance**

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**Introduction**

Nearly 20 years ago Stanley Hoffmann (1997, 139) bemoaned the pessimism toward a more united Europe in a review essay in *Foreign Affairs* titled, “Back to Euro-Pessimism? A Jeremiad Too Fond of Gloom and Doom.” Since its inception as the European Coal and Steel Community (ECSC) in 1951, the European Union (EU) has struggled to unify its economic and monetary systems. Hoffmann’s point two decades ago is an important reminder that the history of European integration is characterized by periods of accomplishments and optimism followed by periods of stagnation and “Euro-pessimism.” The European shuffle is always two steps forward, one step back.

# Today Euro-pessimism is in resurgence (Yardley, 2015; Gordan, 2014). The continent continues to deal with a severe banking and sovereign debt problem (Jones, Kelemen, & Meunier, 2015). Growth rates among Europe’s national economies are uneven at best and anemic at worst. The real gross domestic product (GDP) of the 19 countries (out of 28 EU member states) that share the euro was less in 2014 than it was in 2007. In Spain and Greece jobless rates are north of 25 percent and even higher among young adults (Jolly 2014). Conflicts in the Middle East triggered a refugee crisis that taxes European governments’ capacity to govern and fuels extremist political parties (Polychroniou, 2015). The situation is so dire that countries like Greece and Britain are seriously considering the unthinkable: leaving the European Union ("Everyone Loses If Britain Exits the E.U.," 2016). Yet, there is one bright spot in an otherwise dreary outlook: banking union, the legislative effort by European policy makers to create a level playing field for their banking and finance sectors.

# The Great Recession and the sovereign debt crisis prompted European leaders to take “a radical initiative to stabilize the EU’s national banking systems” (Howarth and Quaglia 2013, 104; Münchau 2015). In spring 2012 IMF Managing Director Christine LaGarde ("IMF/CFP Policy Roundtable" 2012) and European Central Bank (ECB) president Mario Draghi (“Hearing at the Committee on Economic and Monetary Affairs” 2012) issued dire warnings about the health of the European Monetary Union (EMU) and called for “strengthening banking supervision and resolution at the European level.” The following summer the European Commission issued the “Roadmap towards a Banking Union” which stressed the importance of creating a banking union as a ‘mutual reinforcement’ for the single market (European Commission 2012, 4). The roadmap spelled out three pillars of banking union: 1) prudential requirements, including a single supervisor; 2) a common deposit guarantee scheme; and 3) an “integrated crisis management framework” or resolution plan (European Commission 2012, 6). In 2013, within a year of the Roadmap, the European Commission passed the Single Supervisory Mechanism (SSM), adopted a single regulatory playbook, and established the European Central Bank (ECB) as Europe’s singular banking supervisor. A year later, in 2014, Europe passed the Single Resolution Mechanism (SRM) which included a resolution fund designed to restructure or close insolvent banks and paid for through a tax on all existing European banks.

# European leaders managed in a short period of time (less than three years) to adopt two of the three pillars that constitute EU banking union (Donnelly, 2016; Howarth & Quaglia, 2013; Christie, 2014). Causes for the rapid integration of EU banking and finance include: the internationalization of transnational banks (Epstein 2014); intergovernmentalism (Schimmelfennig 2015; Niemann and Ioannou 2015); and the power of ideas (Schäfer 2015). No scholarly work, however, has addressed a particularly striking puzzle: Why did Europe succeed in adopting two pillars of banking union but fail to adopt a third - an EU-wide Deposit Insurance Scheme (EDIS)? The failure to accept all three pillars is curious on several counts. First, early in the process European leaders and banking experts emphasized that banking union consisted of three pillars that worked together to ensure a stable system and without which the entire system was vulnerable. Christine LaGarde, Mario Draghi, and **Vitor Constâncio (vice-president of the ECB) made this point during many public speeches.**[[1]](#footnote-1) Banking experts across the political spectrum stressed all three pillars as necessary for effective banking union (Verhelst 2012; Goyal et al., 2013; Veron and Wolff, 2013). In fact, experts often point to the United States’ Federal Deposit Insurance Corporation as an example of a banking union that is successful precisely because it connects resolution, deposit insurance and supervision.

# Equally puzzling is the fact that ideational, material interest, or intergovernmental factors that converged to pass the SSM and SRM would fall short in adopting an EDIS. All three pillars came on to the policy agenda at roughly the time and in the same context. Similar interest groups were involved in all three cases including member states, the European Commission, and banking interests, notably Germany’s powerful public and cooperative banks who opposed all three pillars (Schäfer 2015). The formal and informal institutions – the European Commission, the German parliament, the European parliament – that were in play in the development and implementation of SSM and SRM were also engaged in the development of EDIS. And finally, the ideational arguments made by David Schäfer and others to explain the passage of SSM and SRM apply equally to the passage of EDIS. Schäfer argues that SSM and SRM passed because they fit within Germany’s conception of ordo-liberalism. Material interests were trumped by Germany’s post-war economic ideology that made it difficult to oppose mechanisms that broke the “vicious cycle” or “deadly embrace” between sovereigns and banks (Schäfer 2015, 2; De Grauwe, 2013). Yet, an even stronger ordo-liberal case could be made to include deposit insurance since deposit guarantees are so closely linked to resolution. Indeed scholars note that the combination of deposit insurance AND resolution policies determines the level of moral hazard in the system. And it is moral hazard that, in turn, underscores the importance and challenge of banking supervision.

# In short, standard theories of comparative political economy are insufficient to explain the incompleteness of the EU’s banking union. Based on ideational, interest, or institutional theories one would expect all three policies to either pass together or fail to pass together. Yet we don’t see this. Why not?

# Two literatures, one commonly used in the study of public policy and a second used in the study of international relations, offer a clue. The first literature argues that the politics surrounding an issue – the nature of the conflict over the development or adoption of a policy -- is a function of the type of policy being proposed (Lowi 1964; Wilson 1995; Gormley 1986). We argue William Gormley’s salience-complexity typology is a useful heuristic to understand banking union. In particular, we suggest that what distinguishes the three pillars of banking union is the level of salience. All three pillars are equally complex. However, deposit insurance is far more salient than the other two. It is this heightened level of salience that triggers a different, more contentious political dynamic.

# A second literature common in economics and IR theory, argues that policy choices are influenced not only by the potential net gains from a policy but also the expected losses (Tversky & Kahneman, 1992; Jervis 1992; Mercer 2005). Prospect theory argues that when a policy is perceived as leading to loss, individuals and groups will be more likely to oppose it than if the policy is perceived as a gain, even when the net outcome is neutral or even positive. Or to put more simply: “We hate to lose more than we love to win.” (Mercer 2005, 17). We argue that the psychological differences in expected losses contributed to the banking union outcome. Both theoretical literatures are discussed below as alternatives to standard accounts of banking union, and then applied to the political process involved in the policy development and adoption of the three pillars of EU banking union.

 The paper presents the argument in three sections. The first section provides background on the three pillars of EU banking union, their function, and why they are important to the larger European integration project. The two theoretical explanations we explore are described in a second section. A third section applies the policy theories by examining empirically the political dynamics involved in the adoption of each of the pillars.

The empirical section draws on several data sources. First, using LexisNexis Academic we conducted a search of all English-speaking media outlets during the two-week period preceding the attempted passage of each pillar of banking union. The search terms used for the three pillars were, respectively, “single supervisory mechanism” and “single supervisory authority”; “single resolution mechanism” and “single resolution authority”; “European deposit insurance” and “European deposit guarantee”. As the debate over deposit insurance is ongoing, more current documents were used to demonstrate that arguments had not changed much in the several years since EU-wide deposit insurance was first recommended. The search also included English language versions of Der Spiegel Online International and Frankfurter Allgemeine Zeitung (FAZ). We also conducted a search of press releases and public statements by European Union institutions and banking shareholders, especially the German Savings Bank Association (DSGV) using the same search terms. In addition, one of the authors conducted 16 semi-structured interviews[[2]](#footnote-2) with three groups: 1) former members or staff from the supervisory boards savings banks; 2) top regulators in the *Bundesbank* and *Bundesanstalt für Finanzdienstleistungsaufsicht* (*BaFin*) specifically charged with overseeing *Landesbanken*; and 3) experts on savings banks including representatives from associations representing savings banks,academics with expertise in the field of deposit insurance, banking, and journalists.

**Background: Three Pillars of the EU’s Banking Union**

 European banking union is a coordinated system of banking between 19 EU member states that share a single currency. Figure 1 describes the three pillars of the EU banking system and the general purpose of each pillar.



Figure 1: A Diagram of EU Banking Union’s Three Pillars (Source: Oesterreichischenationalbank https://www.oenb.at/en/Financial

**Supervision and Regulation.**

Before the financial crisis, each member-state’s supervisory body operated independently. Capital requirements, risk assessments, and other systemic factors were guided by international bodies such as the Basel Committee but legislative solutions were left to national discretion. Supervision was based on the “home rule” principle, by which member-states are primarily responsible for the stability of their own banks and less concerned with spillover effects that are frequent in an integrated banking sector (Pisani-Ferry and Sapir 2010, 344). National supervisors maintained a minimal level of cooperation amongst themselves, although this often involved little more than information sharing. When banks functioned properly, this laxity did not pose a problem (Pisani-Ferry and Sapir 2010, 346). However, between 2003 and 2012, the period in which the global economy fell into recession, the ECB issued a series of Memoranda of Understanding (MoU) designed to establish EU-wide standards and regulations (Kudrna 2012, 287; European Central Bank 2003, 2005, 2008).

 Despite these voluntary efforts vis-à-vis MoUs, member states, the Commission and the ECB remained concerned in 2012 about the fragmented regulatory landscape in Europe. This led the European Commission to propose the “Single Supervisory Mechanism” (SSM) in 2012 and formally accept it in 2013 (European Commission 2012). Under the SSM the ECB assigns day-to-day supervision of smaller EU banks to their respective national authorities, while directly overseeing approximately 120 of the biggest banks (RTT News 2014).[[3]](#footnote-3) The ECB assumed official responsibility for supervision, effective November 2014 (Fox 2014).

**Resolution**

 A second pillar of the European financial safety net is the “Single Resolution Mechanism” (SRM), which complements the SSM. Resolution, like supervision generally, was largely left up the discretion of the member states. Unfortunately, when the financial crisis struck Europe, few member states had resolution strategies in place. Resolving a bank involves recapitalizing to avoid closure or managing winding down a bank with minimal damage. Without clear guidelines, this was difficult for both domestic and cross-border banks. As a result, the harmonization of resolution tools was added to the banking union agenda.

 The major impetus for developing resolution schemes came from the infamous rescues of the Fortis and Dexia banks in September of 2008 (Pisani-Ferry and Sapir 2010, 354). Fortis, a Belgo-Dutch cross-national institution, was the first systemic bank rescue in the EU (Pisani-Ferry and Sapir 2010, 354). The three Benelux countries contribute billions of euros each and, together, they partly nationalized the bank’s branches, a deal coordinated by the ECB (BBC 2008). The ECB took a special interest in this case because Fortis was considered “too big to fail.” The ECB was obligated to rescue the bank from collapse, which was likely in the face of the decentralized resolution and liquidity assistance programs of the Benelux countries (Pisani-Ferry and Sapir 2010, 352). Days later, the safety of the EU banking system was again put at risk by the instability of Dexia. After facing the need to enforce and oversee cooperation between banking authorities of both the home and host countries of these large cross-national banks, EU leaders realized they also needed a harmonized approach to resolution (Pisani-Ferry and Sapir 2010, 356). The crisis management system “based on supervisory authorities within individual countries and ad-hoc, discretionary cooperation” was insufficient in the face of system-wide bank issues (Pisani-Ferry and Sapir 2010, 342).

 In 2009 the European Commission issued a report to the European Parliament and Council of Ministers calling for “an EU framework for cross-border crisis management in the banking sector” (European Commission 2009, 1). The Commission called for a harmonized EU framework for bank resolution to correct the “[e]xisting EU measures aimed at resolving a failing bank [which] are minimal in scope and substance” (European Commission 2009, 7). These measures, set at the national level, were incapable of efficiently and effectively resolving crises of large, cross-border bank branches that have increasingly become major players in the European banking environment (European Commission 2014).

 This Commission communication, and a similar call from the European Parliament provided motivation for further action towards a more comprehensive, EU-wide strategy for resolution. The first legal step in this direction was taken on May 9, 2010, with the regulation establishing the European Financial Stabilization Mechanism (EFSM). This short-lived program was financed through the issuance of bonds in exchange for financial assistance to troubled bank systems. Ireland, Portugal, and Greece took advantage of this system, before it was replaced by the European Security Mechanism (ESM) in 2012 (EFSF 2014). The ESM was created to be the “permanent crisis resolution mechanism for the countries of the euro area” (European Security Mechanism 2016). All Eurozone states ratified the ESM. These states were required to contribute to the ESM in order to have the potential benefit from its emergency financial services. Thus far, only Greece, Spain, Ireland, and Cyprus have benefited from the fund (Ewing 2014).

 Despite the large size of the ESM’s lending capacity (500 billion euros) EU leaders called for further crisis management mechanisms for banks (Kment and Lindner 2014, 17). In response, the Commission proposed the creation of a Single Resolution Mechanism (SRM) as an efficient tool for the comprehensive resolution of cross-border banks (European Commission 2012, 9). The SRM was approved by the Council of Ministers in July 2014, creating a mechanism that would exist in conjunction with the SSM, in order to quickly address individual banks’ need for resolution. This matched the 2009 *de Larosière* report, which called for the creation of bodies whose purpose would be to monitor systemic risks, conduct financial supervision, and oversee crisis management (European Commission 2009, 1). Further, the SRM program would be determined by the mechanism’s board and funded through a common EU fund with a target level of 55 billion euros (Regulation 806/2014). The members of the SRM, all EU countries except the UK and Sweden, are required to contribute to a national fund an amount that is proportional to their assets (STRATFOR 2014). Gradually, these national funds must be transferred to the common EU fund, the Single Resolution Fund (SRF), with an ultimate deadline of January 2016.

 These contributions were the main source of controversy behind the conception of the SRF, as there was much disagreement over how the funds should be calculated and how soon the national funds should merge into the EU fund. The size of the contributions was soon determined, as well, requiring French and German banks to contribute the largest amount to the fund, as contributions are calculated based on total assets and risk (Dendrinou 2014). Small banks, on the other hand, pay a comparatively low flat rate. As a result, the largest banks contribute 90% of the SRF’s 55 billion euros, although they only represent 85% of total banking assets (STRATFOR 2014). French and German banks contribute the most to the SRF, roughly 15 billion euros (Le Guernigou et. al. 2014).

 There were also concessions made *for* Germany. Germany wished to protect the interests of its many smaller banks by ensuring that their contributions to the SRF would be minimal (Spiegel, Barker, and Ross 2014). The compromise reached favors states with large numbers of smaller banks, such as Germany and Spain, and disadvantages states like France, which have larger banks. Germany also agreed to drop its opposition to the SRM on the provision that the European Central Bank would be the official authority for the SSM.

**Deposit Insurance**

Deposit insurance is a guarantee scheme in which bank deposits below a certain threshold are guaranteed in the event of a bank failure. The purpose of deposit insurance is three-fold. First, it protects depositors who lack the ability to monitor the riskiness of a bank’s activities (Demirguc-Kunt, Kane, and Laeven 2006). In this sense, deposit insurance is another component of the social safety net that reduces citizen uncertainty in the wake of economic turmoil. Deposit insurance also prevents bank runs when depositors feel that their money is unsafe in a bank (Demirguc-Kunt, Kane, Laeven 2006). Finally, deposit insurance is a tool of economic development. The more generous the deposit insurance scheme, the more a bank can attract capital to invest in regional businesses and investors. Generosity varies based on level of coverage, type of funding, and management of the scheme and its funds.

In 1986, the EU (then known as the European Economic Community) passed its first directive on deposit insurance (Recommendation 87/63/EEC). The requirements were minimal and vague and the directive encouraged rather than mandated the establishment of deposit guarantee schemes. Member states set up insurance schemes with different levels of generosity that affected the competitiveness of banks. Recognizing this, EU legislators followed up the 1986 recommendations with the 1994 Deposit Guarantee Scheme Directive (Directive 94/19/EC). This was the first legal step towards harmonizing deposit insurance schemes, undertaken to prevent undue competition between European banks.

This directive was also a response to the 1991 failure of the Bank of Credit and Commerce International (BCCI) (Zimmerman 2013). This bank failure, attributed to severe bank fraud and irresponsibility, is often cited as the “biggest bank fraud scandal in history” (Fritz and Bates 1991, n.p.) Upon the closure of BCCI, hundreds of thousands of depositors and other creditors experienced the loss of an estimated $15 billion, with roughly half of those victims being individual depositors (Fritz and Bates 1991, n.p.; Osborne 2013, n.p.). The uneven availability of deposit protection in the states in which BCCI operated spelled disaster for many depositors, who were forced to endure over a decade of legal proceedings to receive incomplete compensation for the BCCI insolvency.

European leaders learned a valuable lesson from the BCCI case, leading to the 1994 Deposit Guarantee Scheme Directive. This directive *required* every member-state to create a deposit guarantee scheme and every credit institution to belong to one (Directive 94/19/EC, 2). Prior to this, most schemes were *implicit*. The Directive mandated the creation of an *explicit* deposit insurance scheme, or a formal body within each member state, to coordinate provision of compensation to depositors in the event of a bank failure (Directive 94/19/EC, 2). The 1994 Directive set insurance at 20,000 European currency units (ECU) per account. The move was controversial because several states at that time had deposit guarantees that covered 100 percent of deposits. The passage of the 1994 Directive meant they had to lower coverage to comply with the law, as well as ensure competitiveness of other banks in the system. Some states had formerly taken advantage of the low or non-existent levels of deposit insurance in neighboring states by advertising their higher coverage in order to attract depositors (Engineer, Schure, and Gillis 2010; European Parliament 2014). This system was inconsistent with the idea that EMU and EU decision-makers set out to eliminate such “unequal conditions of competition” (Directive 94/19/EC, 2).

 Directive 94/19/EC sought to ensure the stability of the banking system by increasing public confidence in banks and eliminating harmful inter-state competition (Directive 94/19/EC). The 2007 bank run on Northern Rock Bank in Ireland showed that the 1994 Directive was insufficient (Bosly and Verhaegen 2014). The 2007-2008 financial crisis further demonstrated the need for more to be done leading to the 2009 amendment to the Deposit Guarantee Scheme Directive (Directive 2009/14/EC).

 The 2009 Directive increased depositors’ coverage from 20,000 to 50,000 euros and decreased the payout period from three months to twenty days (Directive 2009/14/EC). The Directive also stipulated that all schemes should aim to insure deposits up to 100,000 euros by 2010 (Directive 2009/14/EC). Further, the Directive eliminated the former practice of “co-insurance,” which placed some of the financial burden for bank losses on the shoulders of depositors (European Union 2008, n.p.). EU legislators recognized, however, that these immediate responses would be insufficient and almost simultaneously with the passing of 2009/14/EC they initiated a review of the existing deposit insurance legislation and of how to enhance protection (European Commission 2015).

 The review led to the 2014 Directive on Deposit Guarantee Schemes (Directive 2014/49/EU). This most recent iteration of European deposit insurance contributed “to the completion of the internal market” in the required uniformity of depositor protection for all banks operating within the EU (Directive 2014/49/EU). Under this law, banks must belong to a deposit insurance scheme if they wish to accept deposits. The coverage level is equal to 100,000 euros per depositor, excluding public authorities. The repayment period is reduced to seven business days. More importantly, the 2014 Directive addresses, for the first time, the question of funding for the deposit insurance schemes. This law stipulates that deposit insurance schemes should maintain adequate *ex-ante* funds, with banks’ contributions determined by both the amount of deposits they hold and their levels of risk (Directive 2014/49/EC).

 The 2014 legislation that harmonized the deposit guarantee schemes came after a brief, failed attempt in 2012 by EU leaders to create a common European deposit insurance scheme (Barker 2012). This singular deposit insurance mechanism was meant to be one of three essential components to true banking union, along with a common European bank supervisor and resolution authority. Political battles, to be discussed later in this paper, prevented any proposals on the common deposit insurer to reach the floor, and discussion on the topic was, for all intents and purposes, put to an end. EU members settled for two and a half legs of the tripod, with only further harmonized deposit insurance requirements instead of a single deposit insurance mechanism.

**Theoretical Explanations for why EU Deposit Insurance failed**

 As we note above, standard accounts are insufficient to explain why a single deposit insurance scheme (EDIS) failed even as a single regulator (SSM) and resolution mechanism (SRM) succeeded. Banking union negotiations across all three pillars involved two coalitions: a German-led coalition that included Germany, Finland, the Netherlands and some northern European states; and a French-led coalition that included France, Spain, Italy, and other economically-weak Eurozone states. The French-led coalition – which called for the adoption of all three pillars – was supported by the European Commission, European Parliament, and European Central Bank. The German-led coalition led the opposition to all three pillars of banking union (Schäfer 2015; Howarth and Quaglia 2014). Scholarly and journalistic accounts of the negotiations focus mainly on the power and influence of Germany’s 400 public savings banks (*Sparkassen*) and 1,200 cooperatives.

Deeg’s (1999) seminal study of Germany’s banking system described how savings banks, because of their close relationship with local and regional governments, enjoy unusual influence over German politicians across political parties or ideology. Savings banks are the main source of capital for small and medium-sized enterprises (SMEs) in German. And when combined they make up about a third of all banking assets in Germany, more than the largest private banks (Howarth and Quaglia 2014; Hardie and Howarth 2013). So when “the loudest objections to EU banking comes from Germany, and particularly from its savings banks,” scholars point to *Sparkassen* as the main driver of banking union (Wilson, Wiesmann, and Barker 2012; Barker 2012; Howarth and Quaglia 2014). Others echo this sentiment, stating that the *Sparkassen* used their political influence to block several EU rules, including a single deposit insurer, in order to protect their small, retail industry from EU rules designed for “big financial conglomerates” (Steinhauser and Stevens 2013).

 While it may be appealing to hold Germany’s public banks responsible for stifling EU banking union, such accounts are at best incomplete since public banks and co-ops were equally opposed to the SSM and SRM and yet these initiatives succeeded. In addition, German leaders’ objections to a common deposit insurance scheme centered around moral hazard and the mutualization of risk: the concern that weak Greek, Italian, Spanish and Cyprian banks would take advantage of the common insurance scheme precisely because German banks and German citizens provide a financial backstop that insures depositors. As one German state official put it, “To now start a discussion of further mutualization of banks risks through a common deposit insurance is unacceptable” (Financial Times 2015). Yet, the SRM and its accompanying common resolution fund, is no less a risk-sharing agreement than deposit insurance. While it is true that German leaders initially opposed the SRM, they did not use veto power on the issue and have supported the mechanism since its legal creation. Arguably, any concession that was made to Germany in exchange for its acceptance of resolution could have been negotiated in the realm of deposit insurance as well. Yet, a 2015 German finance ministry “non-paper” even acknowledged that an effective resolution mechanism is *needed* to prevent bank risks from becoming sovereign risks (Financial Times 2015). Why, then, did Europeans agree to a common resolution fund while rejecting a common deposit insurance scheme? The fields of public policy and psychology offer an answer.

**Gormley’s Complexity-Salience Typology**

One possible reason for the difference in outcomes across the three pillars is the level of salience; that is the number of people affected by the three policies. In the 1980s, William Gormley developed a policy typology that, like other typologies (Lowi 1972; Wilson 1989), suggests one can understand the politics behind a policy with reference to the characteristics of the policy itself. Politics is a function of the policy rather than the other way around. For Gormley the political process surrounding regulatory policies differs depending upon the salience and technical complexity of the policy. Salience refers to the size of the population affected and complexity refers to the level of expertise needed to understand an issue. Salience and complexity are important because they generate different incentives for political actors to participate in the policymaking process. Moreover, the mix of complexity and salience creates different opportunities for involvement and, by extension, different levels and types of conflict among actors. Figure 2 illustrates Gormley’s salience-complexity typology.

|  |  |
| --- | --- |
|  | **Salience** |
| **Complexity** | **High** | **Low** |
| **High** | Operating room politics | Board room politics |
| **Low** | Hearing room politics | Street level politics |

 Figure 2. Gormley’s Salience-Complexity Policy Typology

The first category “operating room politics” describes policies that are highly salient and highly complex such as environmental regulation or financial regulation. The public cares a great deal about the issue yet lacks the expertise to fully understand it. Because of the level of salience, politicians from all sides have a strong incentive to exercise political leadership and public posturing. Operating Room Politics is typically highly contentious. Gormley notes that while Operating Room Politics garners much attention in the form of legislative hearings, the result is often a set of procedural rather than substantive solutions.

 A second category, “Hearing Room Politics”, consists of high salience, low complexity policies. Morality policies such as gun control or civil rights policies fit this category. The public is concerned and affected by an issue and is capable of understanding the issue. Citizens and politicians share a strong incentive to devote resources and attention to the adoption. Bureaucrats, on the other hand, are less likely to play a role.

 A third category, “Board Room Politics” are policies that are typically low in salience and high in complexity. Jacob Hacker characterizes such policies as “subterranean politics.” They include issues such as privatizing social welfare or passing tax expenditures, which, while important, do not typically garner much public awareness. These are often policies that would not pass if they saw the light of day. Because they are complex and lack public awareness or interest, substantive outcomes do occur and the political process is typically dominated by special interest groups and bureaucrats.

 Finally, policies with low public interest and low levels of complexity are often made on an *ad-hoc* basis by street-level bureaucrats. How a police officer handles a traffic stop or how a building inspector addresses a code violation are neither complex questions nor do they affect a large number of people. There’s little incentive for politicians or interest groups to get involved.

 Applying Gormley’s salience-complexity typology is a heuristic tool to better understand the politics behind a policy. All three pillars of banking union are highly complex policies that even financial experts struggle to understand. Yet, if they vary in terms of salience, then one can expect a different type of political battle (and result) even though the institutional-, interest- and ideational-context are largely the same.

**Prospect Theory**

 A second theoretical literature that makes sense of the EU banking union outcomes is known as “prospect theory” – a descriptive theory of decision-making under risk (Mercer 2005, 1). Of course, no one likes to lose. But prospect theory, developed by economists Kahneman and Tversky (1979), argues that when issues are framed as a loss we are more likely to engage in risky behavior to avoid that outcome than if the identical issue is framed as a gain. By framing something as a gain or a loss – discussing an inheritance tax as a “death tax” or as source of revenue to improve equity or fairness – people will change their preferences (Luntz 2007). Moreover, because they accept frames as a given, people are particularly vulnerable to manipulation (Mercer 2005, 3).

 At its core, Prospect Theory argues that perceptions matter more than empirical reality. To understand the politics behind a policy requires understanding how the policy is portrayed by elites and understood by the population. Moreover, Tversky and Kahneman (1974) suggest that we use mental short-cuts such as analogies or heuristics to simplify a domain and determine whether it represents a loss or gain. The probability of something occurring is based on how closely it resembles an event that’s already occurred. We ignore the differences in the two situations and are drawn to the similarities. Another heuristic is to assess probability based on how easily an object comes to mind. The more salient or visible an event, the more likely we are to overestimate its frequency (Mercer 2005, 8). A final heuristic is to rely on a first impressions and assessment, regardless of how arbitrary it might be. So we use the initial assessment to anchor all subsequent judgments; using new information not to revise but to further substantiate our original assessment.

 In short, Prospect Theory suggests that fear of loss rather than hope for gain is what drives our actions. Furthermore, perceptions of loss or gain are a function of framing by elites and the heuristics individuals use to make sense of information they receive. Prospect Theory thus complements Gormley’s complexity/salience typology for making sense of Europe’s banking union.

A straightforward hypothesis emerges from Prospect Theory: Policies perceived by the public and elites as a loss are less likely to be adopted and more likely to be avoided. And the more something is understood as a loss the less likely it is to occur. Or to put in the context of the puzzle at the center of this research: Is there evidence that an EU-wide deposit insurance scheme was framed by elites or understood differently by the public from the SSM and SRM? And, was EDIS framed and understood as a loss in comparison to the other two pillars? The following section turns the question of whether there is empirical support for Gormley’s complexity/salience hypothesis and Kahneman and Tversky’s Prospect Theory.

**Revisiting the three pillars of EU banking**

From a distance it is not obvious why European member states would adopt only two out of the three pillars of banking union, particularly when banking experts and EU political leaders like Mario Draghi and Christine Lagarde argued (and continue to make the case) that the entire package was necessary to ensure a stable banking system. Even today the website of the European Commission’s Banking Union Page lists all three pillars as necessary (European Commission 2016). The proposals occurred at roughly the same moment. The institutions, interests, and ideas that helped pass SSM and SRM were also in play in the debates over EDIS. Work by comparative political economists on public policy in Europe suggests that all three pieces of legislation should either fail together or succeed together. Yet, that did not occur. So the question is: What’s unique about deposit insurance?

**Salience Higher for Depository Insurance**

One factor that distinguishes deposit insurance is salience. In reviewing documents leading to the attempted passage of each of the three pillars we find that deposit insurance is a far more salient issue than SRM and SSM for several reasons. First, although resolution mechanisms and deposit insurance both protect from the fallout of a failed bank, the latter is designed to protect individual account holders while the former is designed to help creditors and bondholders. And while resolution and supervision arguably affect large numbers of people indirectly, the number of people directly affected by deposit insurance is significantly higher. In European countries, in particular, nearly every adult has a bank account insured by some type of deposit scheme. In Germany, for example, 99 percent of adults over the age of 15 have a bank account (World Bank 2014).

Deposit insurance is particularly salient in Germany because it affects not just account holders but also peer institutions (Beck 2001, 1; DSGV 2015a). In Germany deposit insurance is 1) funded and managed privately and 2) excludes interbank deposits from insurance. The scheme thus fulfills its public function of insuring depositors but outside public regulation and supervision. Instead, in keeping with Germany’s corporatist system of “private sector governance” German deposit insurance relies primarily on peers monitoring banks rather than depositors. Thus, both German depositor holders and peer institutions are directly affected by shift in sovereignty from member states to Europe.

Finally, in Germany, history plays a role in raising EDIS’ level of salience. The financial collapse in the 1920s, characterized by hyperinflation, high unemployment, and a collapsed banking sector in the lead-up to WWII, remains deeply embedded in the German psyche (Conradt 1978). It explain German attitudes toward inflation but also risk taking and financial security more generally. More recently during the Great Recession of 2007-2008 Germany’s retail savings banks and cooperative banks suffered very few losses. Interviews with leaders of several of Germany’s savings banks or *Sparkassen* revealed that they take a great deal of pride in their depository insurance schemes. Indeed, several savings bank leaders described their institutions in terms of their depository insurance scheme. When asked what kept savings banks from making the same mistakes as Deutsche Bank or some of the *Landesbanken*, several savings bank executives pointed to the peer-monitoring system connected to their depository insurance scheme. The anecdotal evidence is supported by systematic analysis of bank risks. In his analysis of 12 OECD countries including the US, Laeven (2000) found that German banks take by far the lowest risk.

 So while all three pillars of EU banking union are complex, in Germany EDIS is far more salient than SRM and SSM in terms of the number of people/voters affected by the policy. Gormley’s typology suggests that EDIS is characterized as “operating politics” - a high level of participation of politicians and interest groups, greater levels of conflict, and ultimately, a lower likelihood of a solution. Salience is part of the reason German cooperatives and local savings banks fought so hard against the passage of a mutual European deposit insurance scheme (Zimmerman 2013, 276).

**EDIS Framed Effectively as a Loss**

A review of statements by elites in the lead-up to the vote on SRM, SSM, and EDIS reveals themes common across all three pillars of banking union and several differences. The first common theme articulated by elites is the need to prevent further financial crises. Elites spoke of the need to break the “doom loop” or the “vicious cycle” between bank debt and sovereign debt (Coy 2012; Schäuble 2013).

Another common theme particularly across the SRM and EDIS, is the fear of mutualization of debt or the “pooling of debt” debt held by banks and sovereigns particularly in southern Europe. The framework articulated by elites of the German-led coalition is that mutualization will weaken fiscal discipline in southern European countries, create significant moral hazard, and force the wealthiest EU countries to subsidize the debt of poorer states and their banking sectors (Economist 2014). In discussing deposit insurance and a resolution mechanism, elites in the German-led coalition frame the issue the same: a single resolution mechanism or deposit insurance fund would lead taxpayer money to be used irresponsibly (Traynor 2013; Wilson 2012a; Heller and Strupczewski 2015). At the same time, elites discussed deposit insurance differently than resolution and regulation.

 Leaders of the German-led coalition framed deposit insurance as a loss. Leaders argued that deposit insurance was a threat to taxpayers’ savings, “economically wrong and counterproductive” “legalized pickpocketing,” and “a big betrayal” (Erlanger and Castle 2012; Financial Times 2015; Münchau 2015). The German banking association which represents cooperative and savings banks professed the fear that banking union would force “them having to pool deposit insurance schemes on a cross-border basis, potentially using German savings to bail out bank customers in other countries” (Wilson 2012a; DSGV 2014; DSGV 2015b). Ludger Schuknecht, chief economist of the German Federal Ministry of Finance, used a heuristic to make the case against EDIS stating:

It’s no coincidence that investors fled from Greece when, in the first half of 2015, the government undermined the banking system which had been newly recapitalised with €40bn (20% of GDP). EDIS would mean that other countries would soon be liable for the consequences of misguided domestic policies, without those countries being able to influence such behavior (Schuknecht, 2016).

Schuknecht argues: first, moral hazard created the Greek crisis; second, that the Greeks are largely to blame; and third, that an EDIS would create the same moral hazard problem for other European countries. The frame is clearly one of loss with a healthy dose of fear and xenophobia; fear that their German taxpayers would essentially pay for the bad behavior of southern European politicians and their banks (Brunsden 2015a; Brunsden 2015b).

A related theme used by elites to frame deposit insurance as a loss was to focus on the loss of exiting depository insurance schemes. In Germany there are at least six different deposit insurance schemes. In debates over EDIS, German elites emphasized the success of their well-functioning deposit guarantees during the post-war period in German and during the recent financial crisis (Wilson 2012b; Steinhauser and Stevens 2013). EDIS represented a loss of control over what many Germans, Dutch and Finns argue were highly successful programs. Schuknecht (2016) articulates the point:

The Commission wants to introduce a new levy for the banking sector, ignoring the existing guarantee systems in certain countries and forcibly creating indirect liability risks across national borders. This represents a massive intervention in property rights and freedom of contract, which doesn’t exactly enhance expectations about legal certainty and protection of property in Germany and Europe.

For Schuknecht and other elites who oppose EDIS, the shift in sovereignty represented by the policy is akin to taking away property rights and the freedom to enter into contracts. EDIS, in other words, represents a major loss and step into great uncertainty.

 In contrast to EDIS, the SRM was framed differently. The SRM was marketed as a way to ensure that banks were “bailed in” using investor and shareholder funds, rather than taxpayers’ money. Through this mechanism, bondholders and other investors in banks would be charged with contributing to bank resolutions before individual citizens, compared to the former bail-out system in which government funds were used to resolve failing banks (Traynor 2013; Kumar 2015). Moreover, although the SRM creates a common Resolution Fund (SRF), resolutions themselves are left to member-states until they build up the appropriate reserves to contribute to the SRF (Traynor 2013).

 And although similar moral hazard arguments were leveled against the SRM, elites could not make the case that the SRM replaced well-functioning existing resolution systems. As noted above, European countries lacked any type of systematized resolution systems. Resolution in the post-war history of bank failures was done ad-hoc. Actions to recapitalize or resolve failing institution like Herstatt Bank in Germany in 1974 or Nordbanken Sweden in the early 1990s were idiosyncratic and dependent on the political and economic context in the country at that moment. Elites opposed to SRM could therefore not make the case the policy meant losing an existing policy.

 In sum, although the three pillars of EU banking union are interconnected, because of its salience and how it was perceived, EDIS created a very different type of politics; one that generated obstacles to passage that were not faced by the SRM or SSM.

**Conclusion: Future of european deposit insurance schemes**

 The debates over a European-wide depository insurance scheme are likely to continue despite setbacks. In February 2016, the European Banking Authority (EBA) published guidelines on cooperation agreements between existing deposit insurance schemes. The Deposit Guarantee Schemes Directive (DGSD) falls far short of a single European-wide Deposit Insurance Scheme. The aim of the new directives, however, is three-fold: 1) insure minimum deposit insurance requirements are met by all members of the EMU; 2) establish a multilateral framework for creating and implementing cooperation agreements across the EU system of depository institutions in the hopes of converging on a single system; and 3) insure depositors in EU branches of institutions headquartered in other member states are treated similarly to depositors in the home member state. There are currently 750 branches of EU credit institutions located in member states other than the member states in which their headquarters are located. Therefore, the question of how accounts handle cross-border transactions is acute. The hope is that such rules enable countries to retain depository insurance as an economic development tool, reduce the likelihood of bank runs, and create the conditions for convergence on a single scheme. But the new directives keep the responsibility of implementing and running deposit insurance schemes firmly in the hands of domestic institutions. Whether countries are able to fulfill their commitments remains an open question. The difficult nature of depository insurance, and resolution mechanisms for that matter, is that at the very moment financial institutions (and states) must fulfill commitment they are often the least able to financially or politically. Yet the recent guidelines are a step closer.

 Comparative political economists point to interests, ideas and institutions in shaping cross-national and supra-national public policies. We argue that salience and psychology are factors that also contribute to the nature EU banking union today. Whether deposit insurance schemes across Europe actually converge will largely depend on the degree to which the citizens within member states perceive change as a loss or a gain particularly in the major economies such as Germany and France.

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Appendix 1

Interviewees were promised anonymity. Interviews were conducted in German, transcribed and translated into English. Listed are the titles of those interviewed.

1. Executive Director, Banking SupervisionBAK and BaFin
2. Regional banking regulator, Deutsche Bank
3. Regional banking regulator, Deutsche Bank
4. President of the Deutsche Bank Regional Office
5. Former *Landesbank* Supervisory Board Member
6. Former *Landesbank* Supervisory Board Member
7. Former management director, *Landesbank*
8. Financial journalist at major German newspaper who covered the *Landesbanken* collapse
9. Former managing director *Landesbank*
10. Chairman of management committee , Landesbausparkasse
11. Manager, Deutsche Sparkassen- und Giroverband
12. Economics professor and expert on *Landesbanken*
13. Political science professor and expert on public banks in Germany
14. Member of Supervisory Board of a medium-size *Sparkasse*
15. Chairman of the Supervisory Board of a medium size *Sparkasse.*
16. Director, *Bundesverband Öffentlicher Banken Deutschlands* (Federal Association of Public Banks in Germany)

1. **Constâncio stated before the British House of Lords’ hearing, “**Of course, the concept of banking union is something for which different people can have different definitions. Nevertheless it is now more or less official, because it is already stated in documents that it comprises three main elements: first, supervision, then resolution of financial institutions and then deposit insurance.” [↑](#footnote-ref-1)
2. A list of interviewees is presented in Appendix 1. The recorded interviews were primarily conducted in German, transcribed, and then translated into English. [↑](#footnote-ref-2)
3. The banks chosen for direct supervision by ECB included those banks whose assets comprised upwards from 20% of their respective member state’s gross domestic product (GDP), as well as those institutions that received financial assistance from the temporary crisis resolution mechanism, the European Financial Stability Facility (RTT News 2014). [↑](#footnote-ref-3)