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# How the European Commission deepened financial market integration. The battle over the liberalization of public banks in Germany

Daniel Seikel

**ABSTRACT** In this article, I argue that the European financial market integration cannot be understood without the European Commission's gradual enforcement of supranational competition law for financial services. The conflict over the liberalization of public banks in Germany demonstrates how the Directorate General for Competition (DG COMP) deepened financial market integration through legal proceedings without the participation of the Council of Ministers. How could DG COMP prevail over the fierce resistance of Germany even though member states never intended for European law to have enough leverage to alter core elements of national financial systems? The article focuses on DG COMP's capacities for strategic action. DG COMP was able to enforce European competition rules for financial services, skilfully combining its legal competences with political strategies. The case illustrates that the regulatory integration of financial services in the EU is much more driven by supranational institutions than assumed by the bulk of the literature.

**KEY WORDS** European Commission; European competition law; European financial market integration; German public banks; liberalization policies

## INTRODUCTION

Studies about the European financial market integration usually focus on legislative acts of the European Union (EU), i.e. the positive integration of financial services. This has led to an understanding of the regulatory<sup>1</sup> integration of financial markets as a process that is mainly driven and controlled by member states. However, this perception largely ignores the incremental expansion of European competition law to financial services through the Commission, i.e. the negative integration of financial services. In response to the standard narration about financial market integration, this article refers to the fact that the Directorate General for Competition (DG COMP) imposed the competition rules on financial services in several highly contested state aid cases even though the positive integration of financial services was blocked by insurmountable politico-

economic differences between member states. Thus, in this article I ask how DG COMP could establish the primacy of European law even though member states never intended for European law to have enough leverage to alter core elements of national financial systems.

Although this article is primarily an empirical contribution to the literature on European financial market integration, the findings have theoretical implications. In European integration research, the institutional asymmetry between positive and negative integration is well established (Scharpf 1999; Schmidt 2008: 300). Positive integration covers politically settled decisions of the Council, the Commission and the European Parliament (EP), e.g. banking guidelines (see ‘The positive integration of financial markets: dissent and stagnation’) or broader policy frameworks like the Financial Services Action Plan (Bieling 2003) in the area of financial services. Since decisions in the Council require unanimity or a qualified majority, agreement is difficult to achieve. In contrast, negative integration consists of legal decisions of supranational institutions. In the area of financial services, such are judgments of the European Court of Justice (ECJ) on obstacles to the free movement of capital or, taking centre stage in this article, actions of DG COMP. Because no formal political approval is needed, negative integration is highly dynamic.

However, little attention has been paid to the question of how negative integration is activated when the regulatory competences of supranational institutions in a particular policy area are contested. In this regard, the incremental expansion of EU competition law to ever new areas, especially, needs further explanation. For this purpose, those processes through which previously exclusive national competences are ‘supranationalized’ by legal means are most insightful. The conflict over the liberalization of German public banks in 2001 (the WestLB case) is an example of this.

In analysing the WestLB case, I reveal the mechanisms that allowed DG COMP to circumvent the political blockade of the regulatory integration of financial services with legal means. That this was possible is not self-explanatory: member states originally restricted DG COMP’s ability to autonomously promote the regulatory integration of European financial markets. The analysis of the strategic interactions reveals that DG COMP systematically weakened the coalition of defenders. DG COMP not only shifted the default condition of the defenders, but also disunited their ranks. As a result, the previously united coalition of defenders collapsed.

The proceeding against German public banks connected the stagnant regulatory integration of financial markets to the dynamic development of state aid law. Grossmann (2006) and Smith (2001a, 2001b) have engaged with this case before, but both focus on the question of whether European integration transforms national models of capitalism. In this article, I do not address this question. Instead, the WestLB case serves to uncover a blind spot in the research on financial market integration. In expanding state aid discipline to banking, DG COMP – without ever having been empowered by the member states – furthered the regulatory integration of financial services.

The focus on a single case is justified by the inherent logic of negative integration. The evolution of EU law is driven by precedence and a path dependent development of legal principles (Schmidt 2012).<sup>2</sup> Thus, even apparently unimportant cases can mark decisive steps in the gradual evolution of European law. Legal principles established in these cases hence influence the subsequent jurisprudence. In this regard, the WestLB case was relevant in two ways: first, DG COMP had to enforce its regulatory authority over national financial systems for the first time; second, the legal principles that were developed during the state aid procedure were acknowledged by the ECJ afterwards (T-228/99, T-233/99). Building on the authority it had gained through the WestLB case, DG COMP succeeded in several follow up state aid conflicts in the area of banking (Crédit Lyonnais, Austrian savings banks, Crédit Mutuel, CDC, tax advantages for Italian banks). As Commission officials stated, '[t]he abolishment of state guarantees represents thus a fundamental contribution towards the *achievement of a single market for financial services in Europe* [...]’ (Moser *et al.* 2002: 3).

The enquiry is based on 22 semi-structured expert interviews with public and private banks, the European Commission and German governmental departments. The balanced distribution of interview partners across the conflicting parties prevents a bias towards one position. In order to compensate for methodological problems of interviews – such as subjectivity or *ex-post* rationalization – information has been triangulated with other interviewees’ accounts, secondary literature, official documents and news coverage.

The remainder is organized as follows: the next section reviews the literature on financial market integration. The third section recapitulates the development of financial market integration and state aid law in the EU. In the fourth section, I reconstruct the conflict about the liberalization of German public banks and analyse the effects of DG COMP’s strategies. Finally, I discuss the findings in the fifth section.

## PERSPECTIVES ON EUROPEAN FINANCIAL MARKET INTEGRATION

The literature on European financial market integration focuses mainly on the positive integration of financial services. Financial services integration is understood as an outcome of political deliberations. Most of the authors see financial regulation as ‘a policy area that is still jealously guarded by the member states’ (Quaglia 2012: 3). State centred explanations prevail; the role of supranational institutions as agents of negative integration is widely disregarded.

The literature can be divided according to the degree of influence ascribed either to governments, economic actors or supranational institutions.

McKeen-Edwards *et al.* (2004) and Grossman (2004) highlight the primacy of national governments over supranational and private actors. Governments initiated all relevant regulative and legislative measures in this area (McKeen-Edwards *et al.* 2004). According to Grossman (2004), financial integration

cannot be explained by the interests of economic actors. Economic interest groups are unable to act in a utility-maximizing way because the complexity of the multilevel political system in the EU confronts them with uncertainty that impedes rational calculations. This group can be characterized as ‘realists’.

The bulk of the literature recognizes the economic interests of private firms as an influential factor for the formation of national preferences. Authors belonging to this field also assume that the process is essentially controlled by member states. This strand splits up to two subgroups.

‘Structuralists’ trace the moderate integration record in the area of financial services up to the 1990s back to institutional and politico-economic differences between the member states. Story and Walter (1997) depict financial integration as a contended process in which member states sought to shape EU rules according to their domestic institutional arrangements in order to defend comparative advantages of their financial systems. Likewise, Underhill (1997) sees the process as being determined by member states with the biggest financial industries: the United Kingdom, France and Germany.

‘Materialists’ identify private financial firms as the main drivers. From this perspective, large transnational firms do not pursue their goals at the EU level. Rather, they try to influence the preference formation of their governments (Quaglia 2008). In negotiations at the EU level, governments defend these interests.

Quaglia (2010) amends the ‘materialist’ approach by integrating ideas into the framework. In the process of financial market integration, competing advocacy coalitions are organized around two belief systems: a market shaping or a market friendly approach. This perspective remains ‘materialist’ in that the affiliation of member states with one of the advocacy coalitions is determined by the national institutional setting and the economic interest of financial firms.

Another group of ‘materialists’ recognizes the transnational dimension of the process. Bieling (2003) and Van Apeldoorn (2002) understand financial market integration as a result of the direct exercise of influence of transnational finance capital on European institutions. Dorn (2012) describes the dynamic of financial market integration since the mid-2000s as ‘private–public’. Regulatory bodies like the Committee of European Securities Regulators adopt and defend the interest of large firms and financial institutions. According to Mügge (2006), liberalization of capital markets is a result of firm struggles over access to markets. Mügge agrees that in the beginning the integration of European securities markets was driven by national interests. Then, private transnational actors took the lead in agenda setting. The Commission became ‘the natural ally of the pro-integrationist lobby’ (Mügge 2006: 1013) and used the private input to strengthen its position *vis-à-vis* reluctant governments. Despite these concessions to the transnational character of the process, these accounts share the assumption that all activities of supranational institutions are ultimately in line with the preferences of the member states. Only because member states had empowered the Commission before, it was able to take a leading role (Grahl and Teague 2005: 1018).

Opposed to the first two camps, a third group emphasizes the informal supranational leadership by the Commission. According to this perspective, the Commission acted as a political entrepreneur, making use of its agenda setting powers, and as discourse framer. From a constructivist perspective, Jabko (2006) argues that the Commission used an ‘idea-based political strategy’ to compensate for its lack of formal power resources and to form a winning coalition in favour of capital market liberalization. Weber and Posner (2000: 531) show that EU institutions were crucial driving forces in the creation of a pan-European equity market. Posner (2005) traces back the dynamic to the political skills, motivations and actions of low level officials of the Commission. Day to day bureaucratic actions accumulated over time and led to institutional change. Thereby, the Commission officials were motivated by their own political preferences. Neither did they act on the will of governments nor was the Commission a vessel through which economic actors tried to achieve their goals. Note that this camp still focuses on political deliberations and does not pay attention to the negative integration of financial services.

To sum up, the literature depicts European financial market integration as a story of *politically* settled delegations of competences to the European level. The present study draws a different picture. To a substantial part, the regulatory integration of financial services is the result of the *legally* enforced expansion of DG COMP’s discretionary competences by DG COMP itself. I demonstrate below that DG COMP shaped the process of integrating financial services regulation independently from the will of the member states. Hence, analyses of financial market integration that do not pay systematic attention to the autonomous activities of the Commission as a supranational competition authority remain incomplete.

## **TWO DYNAMICS OF INTEGRATION: FINANCIAL MARKET INTEGRATION AND STATE AID LAW**

The following sections show that the positive integration of financial markets was blocked by conflicting interests between member states. In contrast, the development of EU state aid law was driven by supranational institutions. The proceedings against German public banks connected both fields. In the end, DG COMP was able to circumvent the political blockade against the liberalization of financial markets with the means of competition law.

### **The positive integration of financial markets: dissent and stagnation**

European financial market integration consists of two processes: the liberalization of cross-border capital movements and the creation of a European Single Market (ESM) for financial services. The former was completed in the course of the ESM programme (Story and Walter 1997: 17). On the other hand, the regulatory integration of financial services was excluded from the agenda.

The white paper 'Completing the Internal Market' (1985) contained only a few paragraphs on the regulatory integration of financial markets. Behind this reservation 'lurked the specter of three decades of almost no action in this area' (Jabko 2006: 57). Since the free movement of capital did not have a direct effect before 1992, further integration depended on political agreement between the member states (Blauberger *et al.* 2012: 51). Yet the member states eagerly defended their control over areas of such politico-economic importance as banking, insurances, securities trading and corporate governance. Due to substantial institutional differences between the national financial systems, governments feared that common European regulation would disadvantage their domestic finance industry (Story and Walter 1997). As a result, financial services formed a policy sector in which the ESM was still incomplete in 1993 (De Visscher *et al.* 2008: 19).

The difficulty of creating the ESM for financial services is reflected by the relatively low progress in the harmonization of banking regulation. The Commission's attempts to establish the principle of mutual recognition failed (Story and Walter 1997: 17; Underhill 1997: 107). Instead, for the opening of branches of foreign banks, host country authorities had to give permission first. The Commission's plans to expand its competition competences to banking were equally unsuccessful. Banking was defined as an area of general interest that justified its exemption from the competition rules. The negotiations over the harmonization of minimum standards were accompanied by severe disputes between member states. The main dividing line ran between Germany and the United Kingdom. Fundamental institutional differences led to 'battles between different financial systems for hegemony in Europe' (Story and Walter 1997: 253–54, 306). From the perspective of the Commission, the banking sector remained a fallow field (Van Miert 2000: 105).

In the areas of insurances, securities trading and investment banking member states limited the power of the Commission even more. Negotiations were a 'bitter row' (Jabko 2006: 84). Governments restricted the Commission's right of initiative and hence cut down its agenda setting power. For securities trading and investment banking, the Commission's formal privileges were axed to consultation rights (Story and Walter 1997: 21–23, 254).

In the end, the negotiations over common standards for financial services did not lead to truly European regulations and the member states kept loopholes for protective measures (Mügge 2006: 1004–05). European financial markets 'remained relatively closed, domestic regulatory systems were largely left in place and nation-level institutions asserted their control on regulation' (Mügge 2006: 992).

In sum, the Commission was not able to create a political consensus in order to activate negative integration for financial services. The ESM led to liberalized capital markets but not to a regulatory integration of financial services (Bieling 2003: 209–10).

### State aid law: Commission and ECJ as ‘strategic tandem’

European competition rules rest on four pillars: the control of restrictive practices or cartels (Article 101 TFEU), monopolies (Article 102 TFEU), public enterprises (Article 106 TFEU) and state aid (Articles 107-109 TFEU). A subsidy qualifies as illegal state aid if it grants a company an unjustified competitive advantage and therefore potentially affects the trade between member states (Blauberger 2009). The enforcement of state aid rules is an exclusive Commission’s competence. DG COMP, in charge of the control of subsidies, can judge autonomously whether a subsidy is illegal or not. This grants DG COMP exceptional discretion.

The enforcement of state aid rules is often heavily contested and highly politicized. Hence, it is no wonder that an effective state aid control could not be established for decades, even though the legal basis was already laid down in the Treaty of Rome. Since member states refused the Commission’s request to define state aid provisions and procedures, in the 1970s DG COMP began successively to close this regulative gap with ‘soft’ law instruments like guidelines, frameworks, communications, codes and letters. Originally, those instruments were not binding and served DG COMP to clarify its treatment of legal issues. Member states do not participate in the formulation of ‘soft’ law (Cini 2001: 196–99). Subsequently, DG COMP gradually developed state aid policy on a case by case basis. Nevertheless, facing the unwillingness of governments to comply with state aid provisions, the number of negative state aid decisions remained low (Lavdas and Mendrinou 1999: 29–32). But despite its weakness to control state aids effectively, DG COMP, closely interacting with the ECJ, extended the legal boundaries of state aid control step by step. In the end, the absence of a fixed procedural framework opened DG COMP considerable room for interpreting the Treaty. The creation of a comprehensive system of state aid rules was more the result of independently developed categories by DG COMP than of a narrow interpretation of the Treaty (Blauberger 2009: 63).

In the 1980s, several crucial steps were taken. Commission and ECJ formed a ‘strategic tandem’. Whereas DG COMP – ‘sitting in front’ – determined the direction of the development, the ECJ – ‘sitting at the rear’ – dictated the pace of the process. Against the resistance of member states, DG COMP enforced its right to enact directives for public enterprises independently from the Council and the EP. The ECJ affirmed this practice (C-142/87, 1990). Moreover, again with the help of the Court, DG COMP pushed through that illegal state aids had to be reimbursed (C-305/89, 1991). From the *Intermills* judgement (C-323/82, 1984), DG COMP derived the principle of non-discrimination of different types of state aid. From then on, DG COMP regarded all sorts of subsidies from public authorities as illegal state aids. In 1986, the ECJ allowed DG COMP to judge on available information if member states do not deliver all relevant information (C-234/84, 1986) (Blauberger 2009: 82–85).

One example of the skill of DG COMP to pursue its policy goals is the guideline for the automobile industry in 1988. After Germany had refused to accept the new – legally non-binding – guideline, DG COMP contested state aid schemes for German car producers. State aid proceedings usually test if a measure is compatible with EU law. In this case, DG COMP used a legally binding state aid decision to force member states to accept a guideline, the enactment of which would have otherwise depended on member states' voluntary compliance. This was a precedent that marked a new policy of DG COMP: the use of legal competences to impose non-binding 'soft' law instruments against recalcitrant governments (Cini 2001: 201–02).

This strategic use of state aid cases to 'harden' 'soft' law finally cumulated in the establishment of an effective state aid regime in the 1990s. A series of state aid conflicts (Alstrom, France Télécom, WestLB) led to the expansion of state aid rules to formerly protected sectors like transport, energy, telecommunications and banking (Hansen *et al.* 2004: 202; Lavdas and Mendrinou 1999: 34–35). For the subordination of national financial systems under the supranational competition regime, the WestLB case was crucial. Until then, regulatory financial market integration and the development of state aid law were unconnected processes. The WestLB case tied them together. Now, DG COMP was able to pursue the stagnant political integration of financial services with the help of its sharpened legal instruments.

### THE BATTLE OVER PUBLIC BANKS IN GERMANY

Compared to other countries, German public banks play an exceptionally important role. They account for more than 30 per cent of the German banking business. The public banking sector consists of Landesbanken (owned by the Länder) and savings banks. While savings banks are elements of the communal public service, supplying private consumers and small and medium sized enterprises with banking accounts and loans, politicians have used the Landesbanken primarily as instruments for regional structural policy (Deeg 1999).

Landesbanken were protected by state guarantees: '*Gewährträgerhaftung*' was a liability of the owners of public banks for all debts those banks owed to third parties. In addition, '*Anstaltslast*' guaranteed that public authorities secured the economic existence of public banks. In consequence, Landesbanken shared the excellent rating of their owners, the Länder, usually AAA or AA +, enabling the Landesbanken to refinance loans cheaply on the capital market (Smith 2001a: 529).

Because of their ubiquitous presence, savings banks hold a large market share of the retail banking segment. Politicians, seeking to counterbalance the economic and political power of major private banks, fostered the Landesbanken to the point where these could compete directly with the dominant private banks. Thus, public banks have always been a thorn in the side of the private banks. Private banks could neither increase their shares in retail business nor

compete against the low interest rates that the Landesbanken could offer to corporate customers.

In the past, conflicts arose regularly, but never resulted in a liberalization of the German banking system. Until the 1990s, political power networks across the main political parties, Länder and municipalities sheltered public banks effectively against all attacks (Deeg 1999; Grossman 2006), until DG COMP sided with the private banks.

### Europeanization of the conflict (1990–1997)

In 1992, North-Rhine-Westphalia (NRW) transcribed its public housing institute *Wfa*, with a value of four billion Deutsche Mark (DM), to WestLB, the then third biggest German bank and most ambitious rival of the major private banks. This capital injection allowed WestLB to acquire additional commercial activities amounting to 31 billion DM.

The association of German private banks (BdB) appealed, at first unofficially, to DG COMP. High ranking Commission officials saw the WestLB case as an opportunity to pursue a greater political aim: The enforcement of European competition law for financial services should serve as a vehicle for furthering the regulatory integration of financial markets. The subordination of the German banking sector under DG COMP's authority would mark an important step. It would demonstrate that DG COMP was legitimized – and able – to enforce state aid rules for financial services that, up to then, were subordinated to member states' authority. But DG COMP wanted to avoid its action against WestLB being seen as a political initiative. Therefore, DG COMP pushed the private banks to lodge a formal complaint, making it clear that it would not start an enquiry on its own initiative but would react to an official complaint (Grossman 2006: 337). Eventually, DG COMP succeeded in convincing the private banks.<sup>3</sup>

DG COMP immediately had to fight against fierce headwinds. Even Chancellor Kohl intervened. The chairman of WestLB Neuber was confident that his political networks would repel this attack, like they used to do in the past. Neuber was firmly integrated into the power structures of the Social Democratic Party, which at that time was holding an almost hegemonic position in NRW. His political networking brought him the bynames 'red baron' and 'red godfather'. The public banks assumed that the German government would be strong enough to stop DG COMP.<sup>4</sup>

In 1995, DG COMP identified state guarantees for public banks in a so-called non-paper as illegal state aid. This added a new dimension to the conflict. Now a structural core element of the public banking sector was at stake. The camp of public banks feared that DG COMP could tear down the whole public banking system.<sup>5</sup>

For the Landesbanken the situation was extremely threatening: Without guarantees the Landesbanken could not sustain their rating and would lose their competitive advantage.<sup>6</sup> Furthermore, now the savings banks were directly

threatened by an intervention of DG COMP, too. They defended the Landesbanken even more rigorously.<sup>7</sup> The conflict had become a defensive battle of the whole public banking sector.

The German Federal Association of Savings Banks (DSGV) announced that it would not support the introduction of the Euro if DG COMP would take action against the guarantees. The threat caused a stir and increased the pressure on DG COMP. Once more Kohl intervened. He urged Competition Commissioner Van Miert not to contest the guarantees until the Euro had been introduced. Otherwise, Kohl would not be able to guarantee German support for the Economic and Monetary Union (EMU). The threat was effective: Van Miert put the issue on the back burner.<sup>8</sup> Thus the German side had gained time to prepare its next step.

### **The failure of intergovernmental counter measures: the European Council of Amsterdam (1997)**

The announcement to take action against WestLB had created turmoil in Germany. In February 1997 the Länder called on the federal government to introduce an article into the Treaty of Amsterdam that should exempt German public banks from European competition law. The defenders were optimistic that Kohl's political influence would suffice to dissuade DG COMP from penalizing public banks.<sup>11</sup>

Kohl tightened the screws on the President of the Commission Santer. Santer finally promised to present a solution. But DG COMP did not want to be stopped by a Treaty revision. Officials of DG COMP activated personal contacts to Dutch, British and Spanish private banks to inform them about the German plan. The national banking associations lobbied their governments not to support the Germans. Internally, van Miert cut Santer down to size. Under no condition was he ready to accept a limitation of his competences.<sup>11</sup> To the infuriation of Kohl, Santer had to draw back his promise. At the Council meeting, the other governments refused to support a special clause for German public banks. In the end, Germany achieved only a general, legally non-binding declaration.

In October 1997 DG COMP started to officially enquire the transfer of *Wfa* to WestLB. At the same time, it indicated that the guarantees might be tolerable if the trade between member states would not be affected; a signal that smaller savings banks not engaged in cross border activities possibly could be kept out of the conflict (Smith 2001b: 20–21). This was the wedge that DG COMP sought to drive between Landesbanken and savings banks. The endgame of the Landesbanken had just begun.

### **The endgame of the Landesbanken (1997–2004)**

In the *Wfa* case, a decision was imminent. The German government pulled all levers to divide DG COMP, almost successfully. In July 1999, DG COMP

could win the controversial poll in the college of Commissioners only by a close vote. The transfer of *Wfa* to WestLB was an illegal state aid that had to be reimbursed. After Van Miert had not followed up on the issue of guarantees, it gained momentum under his successor Monti. Once the member states had agreed on introducing a common currency, all fears vanished that a conflict with Germany could endanger the Euro.<sup>11</sup> In December 1999, the European Banking Federation lodged a complaint against state guarantees for German public banks.

During the following struggle, DG COMP applied strong economic and legal pressure. DG COMP calculated that the economic benefit of the guarantees amounted to one billion Euro *per year* since the Treaty of Rome came into effect in 1957 (Moser *et al.* 2002). Since state aids have to be reimbursed immediately and for the whole period of their existence, public banks were in acute danger of collapsing. This would have posed overwhelming financial difficulties on their liable owners, municipalities and Länder.

Among the defenders there existed tensions: between Länder, which contested the competence of DG COMP, and the federal government, which sought to contain the conflict; and between the Länder, which depended to different degrees on their Landesbanken. Especially Länder with a small or without a Landesbank were afraid to be dominated economically by Länder with strong ones. DG COMP, being aware of these tensions, combined economic and legal pressure with strategies that aimed at these differences within the coalition of defenders. The ranks between the Länder were no longer closed. In March 2000 Monti offered that, under certain conditions, a distinction between Landesbanken and savings banks, restricted to regional business, would be possible.<sup>12</sup> This offer was DG COMP's gambit. Since Landesbanken were to be separated from the political power networks of the savings banks, some Länder had no reason to defend Landesbanken in order to protect the savings banks. The offer created an exit option for savings banks, their communal owners and some of the Länder. Slowly, the offer unfolded its disintegrative effects. It sowed the seed for the idea that a differentiation between Landesbanken and savings banks was possible; an idea that soon fell on fertile grounds.

The increasing pressure from Brussels put the public credit institutions in distress. After the election of a new president in 1998, the DSGV started an internal discussion process. The savings banks realized that the guarantees were lost. The DSGV was ready to give up the strict opposition to achieve a compromise that provided legal certainty for the savings banks. DG COMP's success in the *Wfa* case and the German failure at the Council of Amsterdam had demonstrated DG COMP's assertiveness, whereas the German government proved not to be strong enough to stop DG COMP.<sup>13</sup>

Four major points led to the strategic reorientation of DSGV. First, DG COMP gradually limited the leeway of savings banks with communications and new provisions for public enterprises. The commercial activities of savings banks exceeded DG COMP's understanding of 'services of general economic interest', which would have justified an exemption of savings banks from

the competition rules. DG COMP announced that normal banking business could not be regarded as a public service. Secondly, whereas DG COMP can decide independently whether a subsidy is illegal or not, judicial procedures against this decision have no suspensive effect. The menace of a backdated and immediate reimbursement of state aid would have resulted in the collapse of public banks, no matter if the ECJ annulled DG COMP's decision afterwards. According to a DSGVO representative, DG COMP skilfully tightened the noose step by step. The more the savings banks floundered, the quicker it tightened.<sup>14</sup> Thirdly, the savings banks re-evaluated the utility of the guarantees. In contrast to the Landesbanken, the business model of the savings banks did not rely on the guarantees. The vast majority of savings banks refinanced themselves with the account deposits of their private customers. Fourthly, the savings banks feared that DG COMP would abolish their public law status if no compromise could be found.

Thus, the DSGVO pushed for a compromise that granted the savings banks legal certainty. In return, the savings banks were ready to cede to DG COMP and give up the guarantees; in other words to sacrifice the Landesbanken. Finally, the DSGVO succeeded in convincing all political levels. In January 2001, the camp of the public banks offered to cede to DG COMP in all relevant claims. The guarantees should be abolished. In return, the Landesbanken expected to get a transition period so that they could prepare for the change. DG COMP accepted the proposition.<sup>15</sup>

When Germany abandoned its fundamental opposition in order to actively influence a compromise rather than be overruled by DG COMP, the German government finally conceded the competence to DG COMP to regulate the German banking system. DG COMP had achieved its goals. Now, DG COMP searched for a possibility to clear the way for a political solution. It assigned the Legal Service with the task of finding a legally waterproof justification to circumvent a formal proceeding.<sup>15</sup>

I remember we had a hard time in finding out a system, a legal device, a legal motivation that would be solid enough to allow us not to order the reimbursement because these guarantees had been in place for, I don't know, hundred years or many decades. So you can imagine what would have happened if as a consequence of our decision the Landesbanken had been forced to pay back the guarantee. It would have been totally unmanageable. [...] So this is a good illustration of how the principles of law were implemented, particularly in a sensitive market, have to be implemented with a grain of salt. So, paradoxically we made great efforts of imagination in order to become less tough than we might have been but that would have been the nuclear weapon as you can understand. So this was also one advantage coming to a solid, strong, tough, but agreed upon solution. (Interview, DG COMP, 18 November 2010)

In May 2001, DG COMP announced that the guarantees were illegal state aids that had to be abolished. But it judged the guarantees separately.

*Gewährträgerhaftung* had been introduced after the Treaty of Rome came into force. Thus, it was a new state aid, the abolishment of which DG COMP could order. This was the ‘stick’: if an agreement failed, any economic benefit that public banks gained from the guarantee would have to be reimbursed immediately. On the other hand, DG COMP judged that *Anstaltslast* was an existing state aid. It dated back to Prussian law and therefore was in force long before the EU was founded (Moser *et al.* 2002). In this case, DG COMP cannot abolish the state aid directly but has to co-operate with the member state to develop appropriate measures. This was the ‘carrot’: Both state aids could be coupled and abolished with one agreed upon settlement. A backdated reimbursement would be obsolete and a transition period was possible.

In July 2001, Germany and DG COMP agreed on abolishing the guarantees. In return, DG COMP granted a transition period of four years before the guarantees expired.

### The effects of DG COMP’s strategies

What made the liberalization of German public banks possible? Today’s *de facto* primacy of European law is not sufficient to explain the process. The legal basis for subjecting public enterprises to state aid rules ‘dozed’ in the European Treaties since the foundation of the Community, but was not applied for decades until the 1990s.

DG COMP’s strategic capacities played a decisive role. The strategies had two effects. First, both the ineffectiveness of the political counterstrategies and the legal and economic pressure resulted in a re-evaluation of the situation. The guarantees were less important for savings banks than for Landesbanken. Above all, savings banks were interested in preserving their public law status. Therefore, they were ready to make concessions. DG COMP managed to foster diverging interests between Landesbanken and savings banks and between Länder and the federal government. In the beginning, the utility of maintaining the coalition was valued higher than the costs caused by diverging interests. Later, though, the costs of a negative Commission’s decision were perceived as being higher than the utility of preserving the coalition. The coalition cracked and Germany yielded to DG COMP. In addition, DG COMP’s offer of special treatment for savings banks (SB) created an exit option for some members of the coalition of defenders. The diverging interests between Länder with strong Landesbanken (L), particularly NRW, Bavaria and Baden-Württemberg, and Länder without or only with a small Landesbank (L’) became relevant. Länder that did not benefit from the guarantees had no reason to defend Landesbanken in the place of savings banks. This effect can be described as ‘divide and conquer’ logic (cf. Schmidt 2000): DG COMP’s gambit changed the preference of some of the actors on the German side, the camp of defenders split up so that DG COMP no longer faced a united opposition. DG COMP’s preference for political compromise is a result of the political calculus of DG COMP. It prefers an agreement over a decision because a

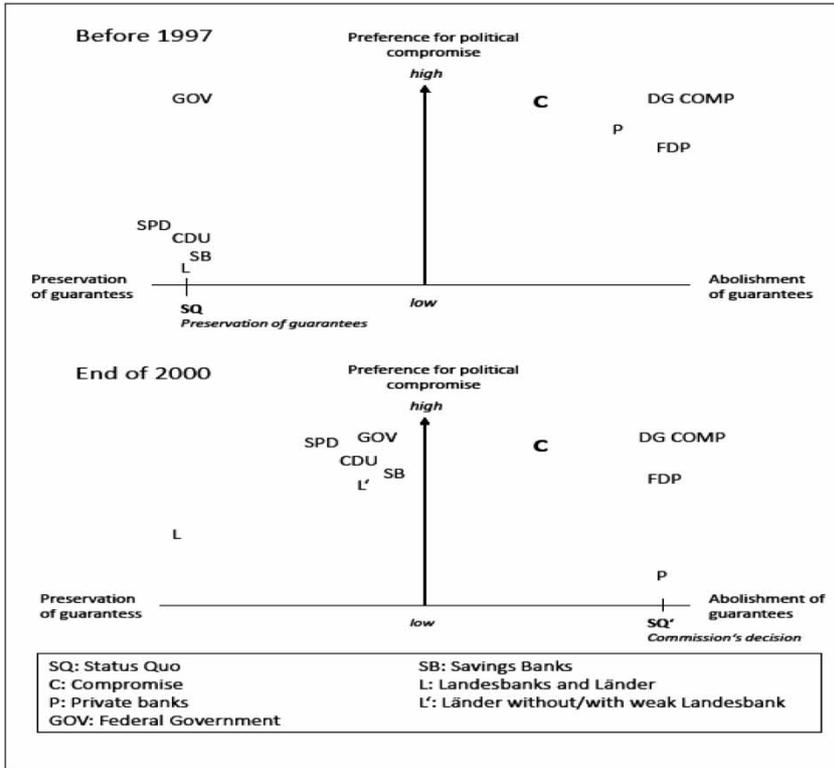


Figure 1 Changes of preferences and shift of the default condition

compromise accepted by both sides prevents a longer conflict with a member state on whose political support DG COMP depends for future policies. Furthermore, potentially contested polls in the Commission and following lawsuits offer member states new opportunities to influence the procedure. A compromise allows DG COMP to prevent these uncertainties.

Second, by demonstrating its assertiveness during the first WestLB case, DG COMP shifted the default condition of the German actors. The status quo (SQ, preservation of the guarantees) was no longer the default condition in case of no decision. The new default condition was a decision of the Commission (SQ'), with devastating consequences for public banks: an immediate and backdated reimbursement of state aid. The savings banks decided to choose the 'lesser evil' (cf. Schmidt 2000) since a compromise (C) was closer to their own preferences than the new default condition (SQ').

## CONCLUSIONS

Literature on European financial market integration focuses on politically settled compromises (i.e. positive integration). This has consequences for the

conclusions drawn by students of financial services integration: First, the bulk of the literature identifies member states' or firms' preferences as the main driving forces. In general, most of the studies do not expect supranational influence in areas of high political contention like finance, where member states are eager to protect national regulatory sovereignty (Posner 2005: 7). Second, not even the advocates of a stronger influence of the Commission grasp the full impact of European institutions. They focus solely on the political leadership of the Commission, acting as political entrepreneur and discourse framer. Even Posner (2005: 21) concludes that the Commission lacked formal power and therefore had to rely on its political skills. However, this is not true for negative integration: in the area of competition policy DG COM commands over powerful means.

The gradual deepening of regulatory integration achieved by DG COMP through the application of its formal competences (i.e. negative integration) is widely disregarded. The WestLB case demonstrates that DG COMP was able to deepen regulatory integration of financial services *without* ever being politically empowered by the member states. To find out how it was possible to activate negative integration in the area of banking, I conducted an in depth analysis of the conflict over the liberalization of German public banks. I showed how DG COMP was able to impose European competition rules on financial services: DG COMP shifted the default condition and divided the opposition of Landesbanken, savings banks and Länder. DG COMP saw the Landesbanken case as a possibility to enforce the competition rules for the financial sector in order to accelerate the regulatory integration of financial services. As indicated in the Introduction, DG COMP continued to use competition law to remove state aids for French, Italian and Austrian banks. The Austrian case illustrates the importance of the WestLB conflict as precedent. In 2003, DG COMP and Austria agreed to abolish state guarantees for Austrian savings banks. DG COMP could build on the toolkit refined and corroborated during the dispute about German Landesbanken (cf. Schorner 2008: 123).<sup>16</sup> After the WestLB case, the authority of DG COMP was no longer contested; the state aid procedure against Austrian public banks did not have the character of a fundamental conflict of competence.

Thus, looking at negative integration of financial services adds a new facet to the picture. Financial services integration is not only a process exclusively instituted by national governments. In fact, supranational institutions are among the key drivers of the process. Europe's financial market integration is much more strongly influenced by the Commission than most observers recognize.

My argument was that regulatory financial market integration cannot be fully explained without taking into consideration the Commission's discretionary use of its autonomous competences as European competition authority. This does not suggest that the literature on financial market integration is wrong. I do not question its account of the positive integration of financial services. The role of German private banks illustrates that the 'materialist' perspective is instructive even for negative integration. Firms cannot only pursue their interests

by influencing genuine political processes, e.g. through lobbying, but also by activating the European legal system. Moreover, the fact that the German government failed to convince the other governments to support a Treaty revision shows that the action of the Commission against Landesbanken was consistent with the preferences of at least some, if not a majority of, member states. At first glance, this confirms the interpretation of most of the authors. But the reluctance to grant German public banks a special status should not to be confused with an explicit empowerment of the Commission by the member states to extend its competences to financial services. Rather, the lack of support can be explained by a ‘*Constrain thy neighbour*’ effect (Callaghan 2011): since the benefits of a Treaty revision would have been distributed asymmetrically, securing the competitive advantage of German Landesbanken, other governments refused to agree.

In contrast to positive integration, in the case of legally enforced integration, the convergence of member states’ preferences is not the prerequisite for further integration, but for its prevention. Heterogeneous interests of member states suffice to open room for manoeuvre for the Commission to pursue its own goals (Tsebelis and Garret 2001). The WestLB example illustrates that, against all odds, through the skilful combination of legal competences and well directed political strategies, DG COMP was able to influence the regulatory integration of financial services in the EU according to its political preferences.

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## NOTES

- 1 Grossman and Leblond (2011: 414–16) distinguish between *de jure* liberalization – regulatory integration – and *de facto* economic integration. The former covers legislative and regulatory measures at the EU level, the latter the increase of cross border economic transactions at the market level. In this article, I focus on the regulatory integration of financial services.
- 2 In the area of competition policy, the Commission has an autonomous law making competence.

- 3 Interviews, DG COMP, 18 December 2009 and 24 March 2010; Legal Service of the Commission, 10 March 2010; BdB, 4 April 2010; Commerzbank, 21 July 2010.
- 4 Interview, Rheinischer Sparkassen- und Giroverband (RSGV), 5 October 2009.
- 5 Interview, Federal Chancellery, 7 July 2010.
- 6 The credit worthiness of the Landesbanken without the guarantees was calculated below an investment grade. If the credit worthiness would have dropped below this level, the Landesbanken would have become insolvent.
- 7 Interview, WestLB, 16 March 2010.
- 8 Interviews, RSGV, 5 October 2009; DSGV, 24 February 2010; DG COMP, 5 May 2010; Federal Ministry of Finance, 17 June 2010; Federal Chancellery, 29 June 2010.
- 9 Interviews, RSGV, 2 February 2009, EU Commission, 11 November 2009; WestLB and Landesbank Schleswig-Holstein (LSH), 1 January 2010; Federal Ministry of Finance, 17 June 2010; Federal Chancellery, 7 July 2010.
- 10 Interviews, DG COMP, 18 December 2009 and 5 May 2010.
- 11 Interview, DG COMP, 5 May 2010.
- 12 Interviews, RSGV, 26 February 2009; DG COMP, 18 November 2010.
- 13 Interviews, DSGV, 9, 24 and 26 February 2010.
- 14 Interviews, WestLB, 16 March 2010; LSH, 26 January 2010; DSGV, 9 February 2010; DG COMP, November 2010; Ministry of Finance of Hessen and Ministry of Finance of NRW, 4 March 2010.
- 15 Interviews, Legal Service of the Commission, 10 March 2010; DG COMP, 24 March 2010.
- 16 For the importance of the methodology developed during the WestLB case, see Hansen *et al.* (2004): DG COMP enhanced the 'private market investor test', the basic tool for assessing whether a measure is a distortion of competition.

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