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**The Eurozone Debt Crisis and the European Banking Union:  
A Cautionary Tale of Failure and Reform**

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October 2013

**Abstract:**

The 2008 global financial crisis spread to most of the developed economies, including those of the European Union. Unfortunately, despite decades of effort to build a Single Financial Market, almost all EU jurisdictions lacked proper crisis resolution mechanisms, especially with respect to the cross-border dimensions of a global crisis. This led to a threat of widespread bank failures in EU countries and near collapse of their financial systems. Today, in the context of the Eurozone financial crisis, the EU is at a critical crossroads. It has to decide whether the road to recovery runs through closer integration of financial policies and of bank supervision and resolution, or whether to take the path of fragmentation with a gradual return to controlled forms of protectionism in the pursuit of narrow national interest, although the latter is bound to endanger the single market. Therefore, the policy dilemmas facing the EU and contemporary institution building within the Eurozone provide an important window into the future of both global and regional financial integration.

The paper is in five parts. Following the present introduction, Part II provides an analytical overview of economic and institutional developments relating to the EU single market for financial services in the pre-crisis period. Part III discusses the evolution of the EU Single Financial Market and the causes of the Eurozone crisis. Part IV reviews the main tenets of the European Banking Union and considers how this new set of EU institutions will affect EU economic and political integration. Part V concludes with discussion of potential implications of EU experiences for the future of financial integration.

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## I. Introduction

The 2008 global financial crisis spread to most of the developed economies, including those of the European Union. Unfortunately, despite decades of effort to build a Single Financial Market, almost all EU jurisdictions lacked proper crisis resolution mechanisms, especially with respect to the cross-border dimensions of a global crisis.<sup>1</sup> This led to a threat of widespread bank failures in EU countries and near collapse of their financial systems. Today, in the context of the Eurozone financial crisis, the EU is at a critical crossroads. It has to decide whether the road to recovery runs through closer integration of financial policies and of bank supervision and resolution, or whether to take the path of fragmentation with a gradual return to controlled forms of protectionism in the pursuit of narrow national interest, although the latter is bound to endanger the single market. Therefore, the policy dilemmas facing the EU and contemporary institution building within the Eurozone provide an important window into the future of both global and regional financial integration.

The complexity of the financial integration process and its significance means that it is impossible to understand contemporary developments within the Eurozone without a discussion of the different forms of integration and of the history of financial integration in Europe. It is important to draw a distinction between economic, monetary and political forms of integration before looking at the specific properties of EU financial integration. Economic integration normally refers to integration of national commercial and economic policies and elimination of trade barriers and of obstacles to foreign direct investment (FDI).<sup>2</sup> Monetary integration<sup>3</sup> refers

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<sup>1</sup> See E. Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (CUP, 2012), ch. 6. See also Recine, F., & Teixeira, P. G. (November 2009). The New Financial Stability Architecture in the EU (November 2009). *Paolo Baffi Centre Research Paper No. 2009-62*. Available at SSRN: <http://ssrn.com/abstract=1509304> or <http://dx.doi.org/10.2139/ssrn.1509304>.

<sup>2</sup> For Ropke, the free and reciprocal flow of trade between national economies is what defines economic integration. See, Ropke, W. (1959). *International Order and Economic Integration*. Dordrecht, Holland: D. Reidel Publishing Company. Wilhelm Röpke was a proponent of the Austrian School, thus he was suspicious of other forms of integration, such as political integration and attendant consolidation of political power. He was one of the first economists to highlight the connection between culture and economic systems and uncharacteristically for a member of the 'Austrian' school he explored the ethical foundations of a market-based social order. His ideas had significant influence over West German post-war economic development.

to formal currency alignments and interest rate cooperation between states. On the other hand, financial sector integration refers to the elimination of restrictions to cross-border capital flows that may involve transactions concerning loans, debt and equity securities, and of barriers to cross-border market access by financial intermediaries, as well as to rights of foreign firm establishment. The market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics deal with a single set of rules, when they decide to transact in financial instruments and / or provide financial services, and firms and consumers have non-discriminatory access to such financial instruments and / or services. It must also provide non-discriminatory regulatory oversight arrangements.<sup>4</sup> Finally, political integration is equally important. It involves the voluntary sharing/pooling of sovereignty, whether in commercial and financial affairs, trade-policy cooperation/co-ordination, or in relation to justice and national security.<sup>5</sup> Thus, lack of political integration can hinder the flow of benefits emanating from monetary and financial integration.

A central idea of this paper is that the design of institutions underpinning financial integration has to be a step-by-step process, as in the EU over several decades, starting with the European Coal and Steel Community and the European Economic Community (EEC)<sup>6</sup> and from

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<sup>3</sup> Monetary arrangements that supplement trade relationships have existed for centuries. In the Eastern Roman Empire, for example, the solidus coin—a currency whose metallic content was stable—circulated widely for more than seven hundred years. Its predecessor the denarius was undermined by emperor Diocletian's (284-305AD) debasing of the metal content of the coin to cover the penury of the Roman treasury at the time due to continuous defensive wars. This type of monetary arrangement was not a true monetary union but rather a common-currency-standard area, because each country's monetary policy was separately rooted in a commodity—such as gold or silver—and they did not involve establishment of a common monetary authority or currency. Thus, they can hardly compare with the EMU. See, Meade, E. E. (March 21, 2009). Monetary Integration. *Rethinking Finance: Harvard International Review*. <http://hir.harvard.edu/rethinking-finance/monetary-integration>

<sup>4</sup> See, Baele, L., Ferrando, A., Hördahl, P., Krylova, E., & Monnet, C. (April 2004). Measuring Financial Integration in the Euro Area. *Occasional Paper Series No. 14: European Central Bank*. P.7

<sup>5</sup> On the main tenets of political integration in an intergovernmentalist rational bargaining framework see A. Moravcsik, "Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach," *Journal of Common Market Studies*, 34 (1993), 473-524.

<sup>6</sup> The EU traces its origins in the European Coal and Steel Community (ECSC) and the European Economic Community (EEC). The ECSC was established in 1951; it was a six-nation international organization serving to abolish trade barriers in the areas covered by the Treaty between the democratic nations of Western Europe, as the Cold War had divided the geographic area covered by European nations through the so-called 'iron curtain'. The ECSC was the first purely European organization in the postwar era to be based on the principles of supra-nationalism.

there to the EU and ultimately to the European Economic and Monetary Union (EMU) and the introduction of the single currency.<sup>7</sup> It is submitted that problems inevitably arise when a supra-national market exhibits a high degree of integration but the development of cross-border regulatory mechanisms lags significantly behind. This shortcoming has become acutely evident in the course of the current Eurozone crisis.

The paper is in five parts. Following the present introduction, Part II provides an analytical overview of economic and institutional developments relating to the EU single market for financial services in the pre-crisis period. Part III discusses the evolution of the EU Single Financial Market and the causes of the Eurozone crisis. Part IV reviews the main tenets of the European Banking Union and considers how this new set of EU institutions will affect EU economic and political integration. Part V concludes with discussion of potential implications of EU experiences for the future of financial integration.

## **II. Building Blocs of the EU Single Financial Market**

The European experience constitutes the most advanced global laboratory for regional economic, legal, and political integration.<sup>8</sup> Thus, it is worth examining the process of regional financial integration, as it developed in Europe, in order to discern inherent and artificial obstacles to efficient financial governance regimes for an integrated market. The establishment of pan-European banks has, of course, been the most potent integrative factor, in an environment marked, at least at the earlier stages, by absence of regulatory cohesion. At the same time, it was inevitable that the concurrent presence of pan-European banks and of incoherent regulatory structures would lead to financial instability across the single market and especially across the single currency area, in the event of serious market turbulence.

### **A. Challenges of European Financial Integration**

The establishment of a single currency area (the Eurozone) and the pan-European presence of a number of large banks with large cross-border operations lent urgency to questions about long-

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<sup>7</sup> The Maastricht Treaty established the European Union (EU) in 1993. The same Treaty introduced the charter of the European Monetary Union. The EU Treaty has undergone a series of amendments as its ambit and reach, both in terms of new members in terms of powers, became ever broader. The latest amendment of the EU treaty is the Treaty of Lisbon, 2009.

<sup>8</sup> Wouters, J., & Ramopoulos, T. (2012). The G20 and Global Economic Governance: Lessons from Multilevel European Governance? *Journal of International Economic Law*.

term protection of EU-wide financial stability in the absence of appropriate institutional arrangements.<sup>9</sup> The so-called financial stability trilemma,<sup>10</sup> which states that the (three) objectives of financial stability, financial integration, and national financial policies cannot be combined at the same time, has precisely described the acute policy tradeoff which holds that one of these objectives has to give in to safeguard the other two.<sup>11</sup> In spite assertions to the contrary,<sup>12</sup> the recent crisis has proven beyond doubt that a common currency area is not viable without building, at the same time, transnational supervisory structures in the field of fiscal monitoring and responsibility and bank supervision.

Arguably, an essential pre-requisite of financial market integration is importation of a harmonized set of core rules, which border on uniformity<sup>13</sup> and are binding in all jurisdictions comprising the single market. Absence of such uniformity can, in theory, seriously hinder market integration as it can give rise to regulatory arbitrage and hidden protectionism and harm efficient group approaches to capital allocation and risk management within cross-border banks.<sup>14</sup> There is no area where divergence of national rules and regulations is more important than cross-border

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<sup>9</sup> In 2005 Schoenmaker and Oosterloow conducted a statistical study spanning a four-year period (2000-03) on the potential emergence of pan-European banking groups. To this effect they gathered a new data set on cross-border penetration (as a proxy for cross-border externalities) of 30 large EU banking groups. They found a home country bias, but the data indicated that the number of groups having potential to pose significant cross-border externalities within the EU context was not only substantial but also increasing. Policymakers therefore had to face the challenge of designing European structures for financial supervision and stability to deal effectively with these emerging European banking groups. See for details, Schoenmaker, D., & Oosterloow, S. (2005). Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities. *International Finance*, 8(1), 1–27.

<sup>10</sup> See, Schoenmaker, D. (February, 2011). The Financial Trilemma. *Duisenberg School of Finance Amsterdam & Finance Department VU University Amsterdam; Tinbergen Institute Discussion Paper; Forthcoming in Economics Letters*, 7. See also, Thygesen, N. (2003). Comments on The Political Economy of Financial Harmonisation in Europe. In J. Kremer, D. Schoenmaker & P. Wierds (Eds.), *Financial Supervision in Europe*: Cheltenham: Edward Elgar.

<sup>11</sup> C.f. Lastra and Louis who (perhaps more accurately) describe the same trade off as an ‘inconsistent quartet’ of policy objectives: free trade, full capital mobility, pegged (or fixed) exchange rates and independent national monetary policies (Lastra, R. M., & Louis, J.-V. (2013). European Economic and Monetary Union: History, Trends, and Prospects. *Yearbook of European Law*.

<sup>12</sup> See Tommaso Padoa-Schioppa, *The Road to Monetary Union in Europe: The Emperor, the Kings and the Genies* (Oxford: Oxford University Press, 2000).

<sup>13</sup> Uniformity in this context only means the need to have coherence and compatible rules and regulations across jurisdictions.

<sup>14</sup> Larosiere, J. d. (February 2009). Report of the High Level Group on Financial Supervision in the EU. Brussels: European Union.

bank failures. Thus, protection of financial stability in an integrated financial market characterized by cross-border financial institutions becomes a very challenging task, especially when there are incongruent policy measures between national preferences and regional integration requirements. While, at the later stages of single market development the EU has moved very close to maximum harmonization in the field financial market regulation, the overall European regulatory edifice lacked strong uniformity/consistency both in terms of rule construction and rule enforcement in this area. In addition, there has been a marked absence of institutions that could provide binding guidance, in the event of difference of opinion between national regulators, as regards the application and enforcement of financial regulation, or could resolve eventual conflicts of national regulatory actions.

## **B. Early Stages of European Financial Integration**

Financial integration in Europe is a much earlier than late 20<sup>th</sup> century phenomenon, at least for the leading European markets. There is convincing evidence, which shows that by the mid-eighteenth century European equity markets were well integrated.<sup>15</sup> This was, in general, a period characterized by a transition from autarky to integrated world capital markets, and, thus, for many it constitutes the era of the first globalization. The term ‘financial integration’ however, was not used in this sense before the mid-1950s. German neoliberals during the 1950s advocated international integration through removal of trade barriers and the introduction of free convertibility. Machlup associated financial integration with capital mobility.<sup>16</sup> Ropke stated that multilateral trade and free convertibility was only ‘a different expression’ for international integration just as bilateralism and capital controls are another name for international disintegration of the economy. As this argument goes, the greater the degree of regional integration by multilateralism and convertibility, the larger are the advantages of economic

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<sup>15</sup> Neal, L. (1985). Integration of international capital markets: quantitative evidence from the eighteenth to twentieth centuries. *Journal of Economic History*, 45, 219-226. Also, Neal, L. (1990). *The rise of financial capitalism: international capital markets in the age of reason*. New York: Cambridge University Press. Neal, L. (1992). The disintegration and re-integration of international capital markets in the 19th century. *Business and Economic History*, 2, 84-96.

<sup>16</sup> See, Machlup, F. (1977). *A History of Thought on Economic Integration*. New York: Columbia University Press.



cooperation.<sup>17</sup> Yet evidence of the existence of a direct causal relationship between financial integration and economic growth remains inconclusive,<sup>18</sup> as any economic growth benefits deriving from financial integration depend upon a number of preconditions necessary to facilitate the integration process.<sup>19</sup>

When the six-state European Economic Community (EEC) was established, in 1957 (by the Treaty of Rome), furthering member states' growth was the apparent but not sole objective of the founders. Political integration was a stronger long-term objective. Namely, building a single market was seen as an essential pre-requisite to political integration and not a self-standing goal. The fact that political integration in the EU is still nowhere close to what was envisaged by the founding fathers can easily explain the lack of adequate institutions supervising the single financial market and securing financial stability. For example, even one of the EU fundamental freedoms, the free movement of capital, became effective only after the signing of the Maastricht Treaty in 1992, a full 35 years after the Treaty of Rome, as it was essential in building a European monetary union and national restrictions in the free flow of capital could no longer be retained.

### **C. The Role of the EU Treaties in European Integration: An Ever Closer Union?**

The European economic integration process and the establishment of the Euro as the common currency of (as of today) seventeen EU member states has been incremental with periods of strong progress and of painfully slow growth. In general, it has been the product of political expediencies as much as of economic efficiency rationales and it has witnessed major crises and setbacks.<sup>20</sup>

Western European economies have shown in the post-war era a marked preference for exchange rate stability. When the first set of European arrangements aiming at exchange rate

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<sup>17</sup> Ropke, W. (1950). *The social crisis of our time*. London: Hodge. See also, Dorn, J. A., & Xi, W. (Eds.). (1990). *Economic reform in China: problems and prospects*. Chicago: University of Chicago Press. P.120

<sup>18</sup> Liu, Q., Lejot, P., & Arner, D. A. (2013). Forthcoming (ch 12, page.513)

<sup>19</sup> Such integration pre-requisites include domestic institutional reforms, the maintenance of adequate and enforceable property rights, and adequate controls on money supply. See also, Dorn, J. A., & Xi, W. (Eds.). (1990). *Economic reform in China: problems and prospects*. Chicago: University of Chicago Press. P.121

<sup>20</sup> See P Pierson, "The Path to European Integration: A Historical Institutionalist Analysis," *Comparative Political Studies*, 29 (1996), 123-63 and J. Story and I. Walter, *Political Economy of Financial Integration in Europe: The Battle of the Systems* (Manchester University Press, 1997).

stability failed, following the collapse of the requisite Bretton Woods arrangements, and the post-war world entered the era of floating exchange rates, EEC members created the European Monetary System (EMS) in 1979,<sup>21</sup> in order to manage and control currency fluctuations among EMS members. EMS was viewed as the first step towards permanent exchange rate alignment and paved the way towards the establishment of EMU. Eventually, EMU member states irrevocably pegged the exchange rates of member country currencies, which were replaced by single European currency.

At this point it should be noted that the establishment of the single currency was itself a matter of politics as much as of economic necessity. Of course, through a currency union, EU members could answer the classic monetary trilemma, which is built on the Mundell-Fleming model of an open economy under capital mobility.<sup>22</sup> The monetary trilemma famously states that a fixed exchange rate, capital mobility, and national monetary policy cannot be achieved at the same time; one policy objective has to give. Therefore, under capital mobility and national monetary policy, fixed exchange rates will invariably break down.<sup>23</sup> However, as the EU has been very far from being an optimal currency area under the Mundell model,<sup>24</sup> and there was no fiscal integration or debt mutualization it was only a matter of time before the first strains would appear. It is, thus, arguable that the founders of the EMU just hoped that a single currency would pave the way for a fiscal and political union, something that has not yet happened. Moreover the desire for a political union might not have been the whole story.

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<sup>21</sup> See, Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters (1978) Bulletin of the European Communities. December, No 12, pp 9–13. Regulations Nos 380 and 381/78, 18 December 1978, OJEC, No L379, 30 December 1978 (and their modifications); Agreement of 13 March 1979 between the central banks of the Member States of the European Economic Community laid down the operating procedures for the European Monetary System. Available at [http://ec.europa.eu/economy\\_finance/emu\\_history/documentation/compendia/a791231en1771979compendiumcm\\_a.pdf](http://ec.europa.eu/economy_finance/emu_history/documentation/compendia/a791231en1771979compendiumcm_a.pdf) See for analysis, Giavazzi, F., & Giovannini, A. (1989). See also, Marcello De Cecco, A. G. (Ed.). (1989).

<sup>22</sup> See, Mundell, R. A. (1963). Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates. *Canadian Journal of Economics*, 29, 475-485 available at <http://jrxy.zjgsu.edu.cn/jrxy/jssc/2904.pdf>

<sup>23</sup> See, Obstfeld, M., Shambaugh, J. C., & Taylor, A. M. (2005). The Trilemma in History: Tradeoffs among Exchange Rates, Monetary Policies, and Capital Mobility. *Review of Economics and Statistics*, 87, 423-438.

<sup>24</sup> Mundell, R. A. (1961). A Theory of Optimum Currency Areas. *American Economic Review* 51 (4): 657–665

From a political economy viewpoint European financial and monetary integration was not just an inter-governmental goal, or merely dictated by the conditions of increasing market integration and capital mobility in the EU. The interests of professional intermediaries may have also been a strong force behind the push for further integration. For example, the Eurobond and the Eurocurrency interbank markets were the markets that emerged as a result of national, legal and regulatory impediments to capital flows.<sup>25</sup> Given an excess supply of petro-dollars in offshore markets, their scale began to rival national markets in banking and securities. This led to protracted negotiations in the early 1990s between industry representatives and regulators that brought off-shore activity back into national markets, while subsuming the many disparate local practices. In fact, the early Eurobond market might have played the role of an imperfect substitute to financial integration, given that capital mobility was only a secondary EU goal until the 1990s.<sup>26</sup> Conversely, The 1966 Segré report was both very cognizant of the growth potential attached to financial integration and of the potential for this objective to be confounded by commercial interests.<sup>27</sup>

#### 1. EMU membership criteria and realities

The path to monetary integration that was adopted by the Maastricht Treaty was based on a three-stage process and the fulfilment of convergence criteria. Only countries, which met the appropriate criteria, could gain Eurozone membership. The transitional framework under the treaty provided some flexibility in terms of the time required for the weaker candidate economies to converge with the strongest, especially as regards their macroeconomic outlooks and policies. However, such convergence proved in many cases no more than drawing board plans.

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<sup>25</sup> See European Commission, *The EU economy: 2003 review* (Brussels: Directorate-General for Economic and Financial Affairs, European Commission, (2003) No. 6 at 320, <[http://ec.europa.eu/economy\\_finance/publications/publication7694\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication7694_en.pdf)>.

<sup>26</sup> Robert Genillard, “The Eurobond Market” (1967) 23:2 *Financial Analysts J.* 144. The article concludes that the Eurobond market was a “fine example of the benefits of international collaboration by bankers in a fully competitive climate.” See also Kurt Richebacher, “The Problems and Prospects of Integrating European Capital Markets” (1969) 1:3 *J. Money, Credit & Banking* 337.

<sup>27</sup> See Claude Segré *et al.*, *The Development of a European Capital Market: Report of a Group of Experts appointed by the EEC Commission* (Brussels: European Economic Community, 1966). Segré argued for harmonization of non-retail national markets in ways later encouraged by the Eurobond market.

The Maastricht Treaty's convergence criteria included two basic conditions for euro membership: firstly, a three percent limit on general government annual deficit and a sixty percent limit on general government gross debt limit.<sup>28</sup> It also included three other important criteria, which were inflation, long-term interest rates, and exchange rate fluctuations. Inflation was to be kept within 1.5 percent margin over that of any of the three EU countries having the lowest inflation rate. Long-term interest rates were to stay within a 2 percent margin over that of the three states with the lowest borrowing rates in the European Union.

As regards exchange-rate fluctuations, there was a requirement of participation for two years in the Exchange Rate Mechanism II (ERM II), which provided for a narrow band of exchange-rate fluctuations. The reality was, however, in glaring contrast with the spirit of the Treaty, due to political pressures and the actual condition of the European economies, which even in the 1990s were mildly to grossly indebted states with considerable budget deficits. The Treaty itself had exceptions to provide political leverage in extending membership to certain countries while restricting it to others.<sup>29</sup> Italy, the third largest economy in continental Europe was running general government gross debt in 1998 at 114.9 percent of GDP (as against 60 percent required by the Treaty), Belgium's gross government debt (home to the EU capital, Brussels) was at 117.4 percent of GDP, and formation of a euro block was implausible without having both of these countries in the Eurozone. This makes visible a huge difference in the conditions of the European economies upon joining the Eurozone. In practice, these differences meant a much lesser degree of economic integration than had been envisaged in the earlier Werner (1970) and Delors reports (1989) respectively.<sup>30</sup> Moreover, the difference in the

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<sup>28</sup> See article 104c of *The Maastricht Treaty on European Union and the Treaties Establishing the European Communities Protocols*. (February 07, 1992). Maastricht: Retrieved from <http://www.eurotreaties.com/maastrichtprotocols.pdf>.

<sup>29</sup> Article 104c of the Maastricht Treaty stated that countries could exceed the 3 percent deficit target if 'the ratio has declined substantially and continuously and reached a level that comes close to the reference value' or 'excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value'. Euro area countries could similarly exceed the 60 percent gross debt target provided that 'the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.' See, *The Maastricht Treaty on European Union and the Treaties Establishing the European Communities Protocols*. (February 07, 1992).

<sup>30</sup> Under the Delors' report, economic union and monetary union form two integral and equally important parts of a single whole and would therefore have to be implemented in parallel (Point 21 of the report) available at [http://aei.pitt.edu/1007/1/monetary\\_delors.pdf](http://aei.pitt.edu/1007/1/monetary_delors.pdf) However, the Delors' report adopted a comparatively less centralized approach economic policy than the Werner report.

macroeconomic ‘initial conditions’ of the founding member states made it politically difficult to enforce the strict fiscal criteria laid down for EMU membership.

#### **D. EU harmonisation legislation 1985-2009: Market Impact, Gaps and Loopholes**

Completion of the legal and regulatory framework has always been regarded as an essential prerequisite in the EU financial integration process. The first step towards this direction was to develop a harmonized set of minimum regulatory standards based on consensus.<sup>31</sup> This seemed more aligned with the overall objective of achieving a single market without having to endure excessive concessions on idiosyncratic national policy designs and preferences, which might make the harmonisation process politically untenable.

##### 1. Harmonisation principles

The Delors Commission’s 1985 White Paper<sup>32</sup> preceded the enactment of the first amendment to the Treaty of Rome in 30 years, the so-called ‘Single European Act’.<sup>33</sup> The White Paper outlined the reforms required in the pre-existing EEC legal framework in order to build a truly single market in the EEC (as it then was) and pave the way to monetary integration.<sup>34</sup> The White Paper noted at the same time that: ‘the legislation adopted by the Council and the European Parliament is either too detailed, or insufficiently adapted to local conditions and experience; often in stark contrast to the original proposals.’<sup>35</sup> However, maximum harmonization proved impossible for many areas of activity in the single market and the European Commission adopted instead the principles of mutual recognition, minimum harmonisation, and home country control. The three principles were subsequently enshrined in harmonisation legislation in a number of areas, including financial services. The internal market was to be based on minimum harmonisation of

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<sup>31</sup> This has been defined by one of us as the first EU financial services consensus. See Avgouleas, E (2005). The New EC Financial Markets Legislation and the Emerging Regime for Capital Markets. *Yearbook of European Law*, 2004, 321 -61.

<sup>32</sup> European Commission, *Completing the Internal Market: White Paper from the European Commission to the European Council*, (1985) Com(85) 310 final.

<sup>33</sup> Single European Act [1987] O.J. L 169/1.

<sup>34</sup> The Delors’ report provided for the establishment of a new monetary institution that would be called a European System of Central Banks (ESCB) responsible to carry out monetary policy and the Community’s exchange rate policy vis-à-vis third currencies.

<sup>35</sup> Ibid.

national regulatory systems and mutual recognition<sup>36</sup> through which member states would recognise each other's laws, regulations, and authorities.<sup>37</sup> Use of minimum regional requirements was intended to limit competitive deregulation by state actors and regulatory arbitrage by commercial parties.<sup>38</sup> It was also a reflection of how political collaboration can encourage adoption of sound market principles and practices.<sup>39</sup>

The EU framework for financial services provided minimum standards for the establishment and operation of banks and other financial intermediaries, conduct of public offers on a national and pan-European basis, and extended to accounting, company law, and regulation of institutional investors, in the form of collective investments schemes. It also provided access to the single market unfettered by national borders or restrictions on activity, the so-called single passport facility.<sup>40</sup> Essentially, the purpose of the passport facility was to allow intermediaries to deliver products or services into any part of the internal market and promote cross-border competition.<sup>41</sup> As a result, the 'passport directives' in financial services defined the kind of financial intermediary to which they applied, its activities and the market segment, the conditions for initial and continuing authorizations, the division of regulatory responsibility between the home (domicile) state and the host state, and aspects of the regulatory treatment of non-EU member states.<sup>42</sup> Authorized financial intermediaries that came within the ambit of one of the 'passport directives' could, on the basis of the home country license, offer banking and investment services on a cross-border basis, without maintaining a permanent presence in the

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<sup>36</sup> Ibid.

<sup>37</sup> B. Steil, (1996). *The European Equity Markets: The State of the Union and an Agenda for the Millennium*. Brookings Institution Press.

<sup>38</sup> Arner, D. W., & Taylor, M. W. (2010). The Global Credit Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation? *University of New South Wales Law Journal*, 32, 488-513.

<sup>39</sup> Arner, D. W., Lejot, P., & Wang, W. (2009). Assessing East Asian Financial Cooperation and Integration. *Singapore Yearbook of International Law*, Vol. 12, pp. 1-42, 2009.

<sup>40</sup> EU financial services directives addressed issues relating to regulation of banks and banking markets, investment services firms, collective investment schemes, life and non-life insurance, and pension funds. See, Cranston, R (ed.), *The Single Market and the Law of Banking* (Lloyds of London Press, 2<sup>nd</sup> ed., 1995); Ferrarini, G (1998). *European Securities Markets: The Investment Services Directive and Beyond*, The Hague: Kluwer Law.

<sup>41</sup> Ibid

<sup>42</sup> Ibid

target market, or through a foreign branch.<sup>43</sup> The home state would generally be responsible for the licensing and supervision of financial intermediaries, for their foreign branches, and for the fitness and propriety of managers and major shareholders. The host state would be responsible for conduct within their jurisdiction or in the course of offering services cross-border to clients residing within their jurisdiction.

The Maastricht Treaty, which established the European Union as a successor to the EEC, provided an impetus for states to implement prior financial services directives and led to members other than Ireland and the United Kingdom adopting legislation that was often foreign to their traditional market practices. One important influence in the success of the harmonization mechanisms adopted at this stage of EU integration process was the role played by the rulings of the European Court of Justice (ECJ). Being part of the EU obligated its member states to adopt and implement EU legislation, as national governments could be held liable in damages for failing to comply with EU-level decisions.<sup>44</sup>

## 2. The gradual shift to ‘maximum’ harmonisation

The ‘passport directives’ have clearly enhanced financial integration in the EU, although areas of marked divergence, such as retail financial services, remained.<sup>45</sup> But, minimum harmonization left the EU with an incomplete regulatory framework, since, in many cases, it merely augmented rather than replaced pre-existing national laws.<sup>46</sup> Thus, the drive towards harmonization intensified in the early 2000s, following the introduction of the Euro and the publication of the Commission’s Financial Services Action Plan (FSAP) in 1999.<sup>47</sup> Arguably, the most important integrative instrument of that era (which can be viewed as the second EU financial services

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<sup>43</sup> A good discussion of the ambit of the provisions for investment firms may be found in Moloney, N. (2008). *EC Securities Regulation* (Oxford, 2<sup>nd</sup> edition, 2008), pp.379-460.

<sup>44</sup> Judgment of the Court of 19 November 1991. - Andrea Francovich and Danila Bonifaci and others v Italian Republic. - References for a preliminary ruling: Pretura di Vicenza and Pretura di Bassano del Grappa - Italy. - Failure to implement a directive - Liability of the Member State. - Joined cases C-6/90 and C-9/90. *European Court reports 1991 Page I-05357*. Available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61990J0006:EN:HTML>

<sup>45</sup> E. Grossman and P. Leblond, “European Financial Integration: Finally the Great Leap Forward?,” *Journal of Common Market Studies*, 49 (2011), 413-35.

<sup>46</sup> See for a discussion of this issue and the gaps left behind by minimum harmonization Avgouleas, E (2000). *The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection*. *European Law Journal*, Vol. 6, pp. 72-92.

<sup>47</sup> Commission Communication, *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM(1999)232.

consensus)<sup>48</sup> was the Directive on Markets in Financial Instruments (MiFID), which established a detailed pan-European regime with respect to conditions of establishment and operation of financial markets and investment intermediaries and the conduct of cross-border financial activities.<sup>49</sup> National implementation of MiFID from 2007 onwards represented the third stage of single market development.<sup>50</sup>

To answer a number of challenges pertaining mostly to enactment and consistent implementation of financial services legislation, the EU adopted the so-called Lamfalussy process in 2001. It consisted of four levels that started with the adoption of the framework legislation (Level 1) and more detailed implementing measures (Level 2). For the technical preparation of the implementing measures, the Commission was to be advised by the committees made up of representatives of national supervisory bodies from three sectors: banking, insurance and occupational pensions, and the securities markets. These committees were CEBS,<sup>51</sup> CEIOPS<sup>52</sup> and CESR<sup>53</sup>. The level 3 committees would then contribute to the consistent

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<sup>48</sup> On this and for a critical discussion of FSAP legislation see Avgouleas, E (2005). Evaluation of the New EC Financial Market Regulation: Peaks and Troughs in the Road Ahead. *Transnational Lawyer* Vol. 18, pp. 179-228.

<sup>49</sup> EC, Directive 2004/39/EC 2004 of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, [2007] O.J. L 145/1. For a discussion of the contours of MiFID see Avgouleas, E (ed.), *The Regulation of Investment Services in Europe under MiFiD: Implementation and Practice* (Tottel, 2008).

<sup>50</sup> Mads Andenas, Douglas Arner & Mei-wah Leung, "The Future of the European Single Market for Financial Services" AIIFL Working Paper No. 8, online: <http://www.aiifl.com>.

<sup>51</sup> The Committee of European Banking Supervisors (CEBS) as an independent advisory group on banking supervision in the European Union was established by the European Commission in 2004 by Decision 2004/5/EC (the Commission's decision dated November 2003 is available at [http://europa.eu/legislation\\_summaries/internal\\_market/single\\_market\\_services/financial\\_services\\_banking/l22025\\_en.htm](http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l22025_en.htm)) On 1 January 2011, this committee was replaced by the European Banking Authority (EBA), which took over all existing and ongoing tasks and responsibilities of the Committee of European Banking Supervisors (CEBS). The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 available at: <http://www.esrb.europa.eu/shared/pdf/EBA-en.pdf?79016e649558f0a9a741da6c169b806b>

<sup>52</sup> CEIOPS (2003-2010) was established under the European Commission's Decision 2004/6/EC of 5 November 2003. In January 2011 CEIOPS was replaced by EIOPA under the Decision 2009/79/EC in accordance with the new European financial supervision framework.

<sup>53</sup> The Committee of European Securities Regulators (CESR) was an independent committee of European Securities regulators established by European Commission on June 6 of 2001. On 1 January 2011, CESR was replaced by the European Securities and Markets Authority (ESMA) in accordance with the new



implementation of Community directives in the Member States, ensuring effective cooperation between the supervisory authorities and convergence of their practices (Level 3) and finally, the Commission was to enforce timely and correct transposition of EU legislation into national laws (Level 4).<sup>54</sup>

In the aftermath of the global financial crisis, the EU has introduced a number of pan-European bodies with regulatory competences, the most important of which is the development of a common rulebook.<sup>55</sup> The new institutions that the EU has built since 2009 are discussed in the following sections.

### III. The Global Financial Crisis and the Eurozone Debt Crisis

As mentioned earlier, it was not until the 2008 crisis and in earnest after the outbreak of the Eurozone debt crisis in 2010 that the vexed issue of preservation of financial stability in an integrated market came to the forefront of EU policy-makers' attention. Both crises have emphasized the need to revisit existing models of financial market integration with a view of enriching them with institutions and structures that underpin financial stability as well as economic growth. It should be noted here that the Maastricht Treaty (1992) did not include 'financial stability' as a key objective of the ECB, although, article 127(5) of TFEU underscores the 'financial stability' as a classic central banking good. Thus, financial stability has not been designed as one of the four basic tasks to be carried through the ESCB (article 127(2) of TFEU) and has rather been clustered with prudential supervision under the 'non-binding tasks' of the ECB.

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European financial supervision framework. See more at <http://www.esma.europa.eu/index.php?page=cesrinshort&mac=0&id=>

<sup>54</sup> See, Lamfalussy, A. (2001). Final Report of the Committee of Wise Men on the Regulation of European Securities Markets Brussels, 15 February 2001, available at [http://ec.europa.eu/internal\\_market/securities/docs/lamfalussy/wisemen/final-report-wise-men\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf).

For a review on the process recommendations, see also, Ferran, E. (2010). Understanding the New Institutional Architecture of EU Financial Market Supervision. In G.Ferrarini, K.J.Hopt & E.Wymeersch (Eds.), *Rethinking Financial Regulation and Supervision in Times of Crisis* (OUP, 2012), Ch. 5, where Ferran examines the recent EU institutional reforms on financial market supervision to assess their significance. See also, Schaub, A. (2004). The Lamfalussy process four years on. *Journal of Financial Regulation and Compliance*, 13(2), 110 - 120.

<sup>55</sup> See 'Report of the High Level Group on Financial Supervision in the EU', February 2009 (the de Larosière report), available at [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf)

## A. Background

Until the onset of the GFC in 2008, the ‘common passport facility’ was at the heart of the EU single market. The EU legislative framework based on harmonized standards for financial markets sought equivalence among disparate regulatory and legal systems, so that regional initiatives could recognise national legal and regulatory regimes.<sup>56</sup> But a multi-level governance system involves far more complexities than a regime based on minimum harmonisation can foresee. These mainly arise out of the conflicting and sometimes misunderstood national priorities and transnational requirements. Even before the current crisis, the European Union was viewed by some as a ‘too intrusive’ and ‘remote’ institution in need of a more coherent set of policies within existing treaties.<sup>57</sup>

Political considerations also undermined the credibility of rule-based frameworks for coordination of national fiscal policies in the euro area.<sup>58</sup> For example, the Stability and Growth Pact (SGP) was originally designed to safeguard sound public finances and to thwart individual Eurozone members from adopting fiscal policies leading to unsustainable debt levels by enforcing budgetary discipline. Nonetheless, France and Germany, faced with a breach of the 3 percent deficit limit in 2002-04, pushed through a watering down of the SGP rules by March 2005. Arguably, the Maastricht Treaty itself allowed sufficient flexibility to the interpretation of SGP and its enforcement as to allow it to become part of the political bargaining process in the EU at the expense of objective economic criteria.<sup>59</sup> As a result, during the period that the debt crisis was building up, the Eurozone was deeply marked by economic and financial imbalances and the Union itself lacked a central fiscal authority, which would have afforded it a credible mechanism to enforce budget discipline. In addition, trade imbalances due to accelerating competitiveness imbalances and lack of exchange rate flexibility meant that there were no

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<sup>56</sup> See, B Steil, *The European Equity Markets: The State of the Union and an Agenda for the Millennium* (Brookings Institution Press, 1996), 113

<sup>57</sup> COM. (2001). *European Governance - A White Paper*. Brussels: Commission of the European Communities. P12

<sup>58</sup> See, Bergsten, C. F., & Kirkegaard, J. F. (2012). *The coming resolution of the European crisis [electronic resource]* Peterson Institute for International Economics, Washington, D.C Retrieved from [http://www.ciaonet.org/pbei/ie/0024277/f\\_0024277\\_19801.pdf](http://www.ciaonet.org/pbei/ie/0024277/f_0024277_19801.pdf)

<sup>59</sup> *European Council Presidency Conclusions, Council of the European Union*. (March 22-23, 2005). Brussels: [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/84335.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf).

realistic prospects for fiscal convergence.<sup>60</sup> Yet, preserving, in the long-term, any currency union, including the EMU, requires a sufficient level of economic convergence, together with a properly functioning internal market, and an effective system for economic and budgetary policy surveillance and coordination.

Accordingly, when the GFC broke out with force, European financial stability was hampered by a number of pre-existing problems which had simply been ignored for far too long. These included colossal pre-crisis public and private debt piles, a flawed macroeconomic framework, and absence of institutions capable of handling effectively a cross-border banking crisis. The incomplete institutional design was the true mark of an ‘imbalanced’ and disjointed monetary union, also characterized by the absence of effective fiscal convergence mechanisms. Namely, during the first decade of its life, the EMU was premised on a weak institutional framework that was more suitable to a ‘fair weather currency’,<sup>61</sup> rather than a monetary union with asymmetrical member economies, which were about to experience massive macroeconomic shocks. It assumed that any macroeconomic or banking system stability shocks could be dealt with at the national level without requiring any transfers from the strongest to the weaker members of the Eurozone, due to the no bailout clause in the EMU Treaty.<sup>62</sup> Consequently, the outbreak of the sovereign debt crisis in the Eurozone in 2010 meant that the EU had to enter into the most transformative phase of its history.

While the 2008 crisis intensified reform efforts to a great extent, the true big bang for the mooted pan-European supervisory and bank resolution structures has been the ensuing Eurozone debt crisis, which has shaken to its foundations the banking system of the eurozone. The EU had to devise mechanisms, in the midst of crisis, firstly, to prevent an immediate meltdown of its banking sector and ensuing chain of sovereign bankruptcies and, secondly, to reform its flawed institutions, in order to prevent the Eurozone architecture from collapsing. Namely, Eurozone members had to build both a crisis-fighting capacity and support bailout funding mechanisms. This has led to the establishment of a European Financial Stability Facility (EFSF), which will be superseded by the European Stability Mechanism (ESM). At the same time, serious steps have been taken to build a European Banking Union based on structures safeguarding centralization of

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<sup>60</sup> See P. de Grawe (2012). *Economics of Monetary Union*. Oxford University Press, 9<sup>th</sup> ed., part 2.

<sup>61</sup> Bergsten, C. F., & Kirkegaard, J. F. (2012). *Ibid*

<sup>62</sup> See Art. 101 TEU (now enshrined in Art. 125 of the Treaty on the Functioning of the European Union, 2008).

bank supervision and uniform deposit insurance arrangements, as well as centralization of crisis-resolution.

## **B. Problems of Integration – Cross-border banking**

The premise of home-country control and the principle of minimum harmonization were bound to undermine at some point the stability of the EU banking system. The integration process continued in an increasingly de-regulated market following the intensification of liberalization efforts in the last quarter of the 20<sup>th</sup> century, but the regulatory standards and supervisory principles were not adjusted to new realities. The Eurozone crisis has brought home with devastating force the potential risks of financial market integration, which inevitably leads financial institutions operating in the single market to develop very tight links of interconnectedness, allowing thus shocks appearing in one part of the market to be transmitted widely and quickly across all other parts. Examples of such rapid transmission of shocks include the failure of Icelandic banks, the botched rescue of Fortis bank, the threat of collapse of the financial systems of Ireland and Spain, and the possibility of a sovereign default (e.g., Greece), or of a chain of sovereign defaults. Each of those crises brought serious tremors to European markets and exposed their fragility and the dearth of policy options available to Eurozone decision-makers. Naturally, the rapid amplification of those crises and their grave consequences has raised serious questions regarding the survival of Eurozone.

In the US the response to the crisis was rapid and came in the form of state purchase of distressed bank assets so-called Troubled Asset Relief Programme (TARP), innovative intervention schemes by the Federal Reserve, and (complex) re-regulation of the financial sector. In the EU however, the diversity of member state economies and issues arising out of inherent contradictions between national policy priorities meant a much lower degree of responsiveness to the crisis. This became evident as soon as some of the EMU states, which experienced a more severe crisis than other members had to adopt policies based on their own national needs and interests – which may not be necessarily have been in conformity with single market policies. For example, lack of common deposit insurance in a well-integrated banking market at a time of cross-border crisis led to several conflicting policy choices and responses in an effort by the states to protect their own citizens.

## 1. The Icelandic banking crisis

The collapse of the Icelandic banks - Glitnir, Kaupthing and Landsbanki<sup>63</sup> – which operated branches in EU member states on the basis of the single passport presents a classic case of home country control failure and of the disastrous consequences of lack of centralized supervision and resolution mechanisms in the EU. The single passport, also afforded to European Economic Area countries (such as Iceland, which is not an EU member), gave Icelandic banks the ability to expand their assets and deposit base through branches and through internet-based operations offering cross-border banking services. As European depositors were lured by the high interest rates offered by Icelandic banks, gradually Icelandic banks built a large depositor base in certain European countries.

However, by 2008 both the country's economy and even more its banks were in serious trouble. While trouble was brewing over several months Icelandic bank operations within the EU were supervised by the home country authorities, which were unwilling to take any radical restructuring or rescue measures, thus, nothing was done to prevent the ensuing panic. So when Icelandic banks faced difficulties in refinancing their short-term debt, a run on the Icelandic bank's deposits in the Netherlands and the United Kingdom became inevitable, as domestic depositors were not covered by the deposit protection scheme of their home countries. While both the Netherlands and the UK, were, in the beginning unwilling to extend protection to Icelandic bank depositors, at the same time, Iceland could provide no comfort to foreign depositors, because it was already in the middle of a deep financial crisis, and its government did not want to pay for the mistakes made by private banks with the assistance of politicians and of 'home' supervisory authorities. Harsh responses followed both from the UK and Netherlands authorities,<sup>64</sup> which, though entirely necessary, annulled the single passport principle. In order to

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<sup>63</sup> The collapse followed from difficulties in refinancing their short-term debt and a run on deposits in the Netherlands and the United Kingdom.

<sup>64</sup> The UK used provisions in sections 4 and 14 and Schedule 3 of the Anti-terrorism, Crime and Security Act 2001 to issue a freezing order over Landsbanki assets. The Landsbanki Freezing Order 2008 was passed at 10 am on 8 October 2008 and came into force ten minutes later. Under the order the UK Treasury froze the assets of Landsbanki within the UK, to prevent the sale or movement of Landsbanki assets within the UK, even if held by the Central Bank of Iceland or the Government of Iceland. [http://en.wikipedia.org/wiki/2008%E2%80%932012\\_Icelandic\\_financial\\_crisis](http://en.wikipedia.org/wiki/2008%E2%80%932012_Icelandic_financial_crisis) - cite\_note-55 See, Anti-terrorism, Crime and Security Act 2001, retrieved, November 24, 2012 <http://www.legislation.gov.uk/ukpga/2001/24/contents>.

prevent the crisis spreading to the British banking system the UK Prime Minister, Gordon Brown extended protection to British depositors, which essentially meant that the British deposit protection scheme would cover the loss. Thus, the UK Treasury proceeded with the unprecedented step of issuing a compulsory freezing order of Icelandic bank assets and deposits under the Anti-terrorism, Crime and Security Act 2001, which, of course, antagonized relationships with Iceland. In addition, the UK government announced that it would launch legal action against Iceland over any losses connected to the compensation of an estimated 300,000 UK savers.<sup>65</sup> Icelandic authorities later reached an agreement separately with both the UK and the government of the Netherlands. Thus, Iceland will be paying the UK and Netherlands a percentage of GDP from 2019-23 to compensate for the deposit protection made available by these two countries to their own consumers holding deposits in Icelandic banks.

The collapse of Icelandic banks led to economic crisis and the mishandling of the crisis brought down the political machinery of the government. The Icelandic banking crisis and the more recent Cyprus banking crisis hold serious lessons as they underscore the risks arising from the ‘nurturing’ of over-grown financial sectors which much outstrip a country’s GDP, although this irrefutable does place smaller country industries into a disadvantageous competitive position.<sup>66</sup>

## 2. The fractious rescue of Fortis Bank

When the collapse of Lehman Brothers hit global markets, Fortis -- a big European bank with strong cross-border presence in France, the Netherlands, Belgium and Luxembourg -- came very close to collapse.<sup>67</sup> In Belgium, Fortis was the country's biggest private sector employer and more than 1.5 million households -- about half the country -- banked with the group. In 2007, Fortis had acquired parts of ABN AMRO through a consortium with Royal Bank of Scotland and

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<sup>65</sup> Marshall, Chris; Martin, Iain (October 08, 2008). “UK government launching legal action against Iceland.”<http://www.citywire.co.uk/money/update-uk-govt-launching-legal-action-against-iceland/a316803>, retrieved on November 24, 2011

<sup>66</sup> Another lesson that the Icelandic banks crisis might hold is that default in the face of mounting and unreasonable debt might not be such a bad thing. By mid-2012 Iceland is regarded as one of Europe's recovery success stories. It has had two years of economic growth. Unemployment is down to 6.3% and Iceland is attracting immigrants to fill jobs.

<sup>67</sup> Basel Committee on Banking Supervision (BCBS), ‘Report and Recommendations of the Cross-border Bank Resolution Group’, Basel, September 2009, p. 10.

Santander. In 2008, Fortis had difficulties realising its plans to strengthen its financial position. Over the summer of 2008, its share price deteriorated and liquidity became a serious concern. Insolvency fears saw Fortis' shares to fall to their lowest level in more than a decade and its shares gradually lost more than three-quarters of their value.

Fortis was deemed to be systemically relevant in the three countries. Thus, the ECB and ministers from the Netherlands, Belgium and Luxembourg agreed to put 11.2bn euros (\$16.1bn; £8.9bn) into Fortis to save the bank. As part of the weekend deal to rescue Fortis, the bank would have to sell its stake in the Dutch bank ABN Amro, which it had partially taken over the previous year. The Fortis deal would have seen Belgium contribute 4.7bn euros, the Netherlands 4bn euros and Luxembourg 2.5bn euros. However, European bank shares fell sharply on worries that other banks could have problems, and on concerns over the 700bn dollars bailout plan in the United States (TARP). One of the biggest casualties was Fortis' rival Dexia, which French and Belgian governments also promised to step in to support. Eventually the joint rescue of Fortis broke down along national lines and each of the three countries (Belgium, the Netherlands, Luxembourg) concentrated only on the part of the group that was most important for their market,<sup>68</sup> in defiance of single market principles/ideals.

### **C. The Eurozone Debt Crisis**

In Europe, the banking and liquidity crisis soon transformed into a complex and multilayered crisis. As soon as a series of public bailouts took the issue of the continuing solvency of UK, US,

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<sup>68</sup> (Emphasis added). The Dutch government purchased Fortis Bank Netherlands, Fortis Insurance Netherlands, Fortis Corporate Insurance and the Fortis share in ABN AMRO. The Belgian government raised its holding in Fortis Bank Belgium up to 99%. 'The Belgian government also agreed to sell a 75% interest to BNP Paribas (BNP) in return for new BNP shares, keeping a blocking minority of 25% of the capital of Fortis Bank Belgium. BNP also bought the Belgian insurance activities of Fortis and took a majority stake in Fortis Bank Luxembourg. A portfolio of structured products was transferred to a financial structure owned by the Belgian State, BNP and Fortis Group.' BCBS, Report and Recommendations, p. 10. On 12 December 2008, the Court of Appeal of Brussels suspended the sale to BNP, which was not yet finalised, and decided that the finalised sales to the Dutch State and to the Belgian State as well as the subsequent sale to BNP had to be submitted for approval by the shareholders of Fortis Holding in order for these three sales to be valid under Belgian Law. After initial rejection by the shareholders, certain transactions were renegotiated and financing of the portfolio of structured products was modified. The renegotiated transaction with the Belgian State and BNP was approved at the second general meeting of shareholders and the latter transaction was finalised on 12 May 2009. Ibid.

and major European banks out of the limelight, the state of Irish and Spanish banks and the possibility of a Greek default brought the lurking woes of the Eurozone into sharp focus. Ireland and Greece have essentially triggered the second and more lethal wave of the crisis of confidence that has hit most of Europe since 2010 - although Italy and Spain might in the end prove much bigger threats to Eurozone's survival than Greece, Portugal and Ireland, which represent only a very small fraction of Eurozone GDP. The Eurozone crisis should be seen as a sequence of four interlocking crises resulting from imbalanced monetary integration. This resulted in a competitiveness crisis that transformed into a marked loss of fiscal revenues and widening fiscal deficits which led to debt accumulations (particularly in Greece, Italy, Portugal, and Spain) that were financed by the surpluses of the northern countries, reflecting, in turn, to massive payment imbalances within the Eurozone (in particular, Germany, the Netherlands, and Finland vis-à-vis the European South). As said surpluses had to be re-invested, they found their way to investments in the bonds of deficit countries (Greece, Italy) or to the banking systems of the Eurozone periphery (Ireland, Spain) and financed gigantic real estate bubbles in Ireland and Spain. Thus, they led to accumulation of unsustainable levels of public or private debt or both.<sup>69</sup>

The Eurozone crisis has signaled a fundamental shift in the political dynamics underpinning the EU. While the exact remedies of the crisis, austerity, more integration, mutualization of Eurozone members' debt and other measures remain the topic of heated discussion, one remedy is viewed as uncontroversial. Namely, it is quite beyond dispute that the Eurozone crisis would have been much less severe, if Eurozone members could find a way to break up the link between bank debt and sovereign indebtedness, which, of course, created a vicious circle of ever more bank bailouts and ever-higher levels of national debt. The fact that many EU banks had invested in EU members' bonds and are also adversely affected by the continuous recession ravaging the periphery of the Eurozone has only made things worse. However, the EMU, although it had interest rate setting competence through the European Central Bank, has until recently been devoid of any binding mechanism to effectively enforce fiscal and banking stability, both areas of serious national interest where pooling of sovereignty was regarded, until recently, as intolerable. Namely, since its establishment the EMU lacked

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<sup>69</sup> Avgouleas, E. (July 2012). Eurozone Crisis and Sovereign Debt restructuring: Intellectual Fallacies and New Lines of Research. Paper presented at the Society of International Economic Law (SIEL), 3rd Biennial Global Conference, Centre for International Law (CIL) and Faculty of Law, at National University of Singapore.



these crucial supporting institutions that could have helped it to restore financial stability during times of acute uncertainty and market volatility.<sup>70</sup> More specifically, the EMU lacked suitable institutions that could absorb liquidity shocks, due to a collapse of confidence in the prospects of a member state's economy, and cross-border supervisory and resolution structures that could effectively deal with the cross-border spillover effects of a bank collapse.

In order to break the vicious circle between bank bailouts and levels of sovereign indebtedness, the Eurozone members have established a funding facility, the European Stability Mechanism (ESM), which, subject to a strict conditionality, will be employed to directly recapitalize Eurozone banks. The use of ESM funds for such recapitalisations would put a stop to further increases of the indebtedness of the sovereign concerned due to bank bailouts. The inevitable transfer of payments from the richer to the weaker Eurozone members through the ESM, which enjoys the guarantee of all Eurozone members, and the need to tighten the framework for bank regulation, supervision, and resolution have meant that the countries in the core of the Eurozone have promoted the centralization of bank supervision and resolution functions in the EMU. These demands have given birth to a new set of bank authorization, supervision and resolution arrangements: the European Banking Union. However, the European Banking Union, plausible and necessary as it may be, has also reinforced rather than calmed the centrifugal forces within the EU and has the potential to lead to a serious split of the internal market.<sup>71</sup> Important members of the EU, chiefly the UK, have resolutely remained outside important European Banking Union arrangements. It is, thus, reasonable to infer that political expediency, and not economic necessities, will, in the end seal the fate of the single currency.

### **III. EU Financial Regulation Infrastructure in the post-2009 period: Phase I – From the Lamfalussy Process to the ESFS**

#### **A. The Larosiere Reforms**

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<sup>70</sup> Bergsten, C. F., & Kirkegaard, J. F. (2012). *The coming resolution of the European crisis [electronic resource]* Peterson Institute for International Economics, Washington, D.C Retrieved from [http://www.ciaonet.org/pbei/ie/0024277/f\\_0024277\\_19801.pdf](http://www.ciaonet.org/pbei/ie/0024277/f_0024277_19801.pdf)

<sup>71</sup> Lastra, R. (2013). Banking Union and Single Market: Conflict or Companionship?, *Fordham International Law Journal*, Vol. 36, forthcoming.

In November 2008 the Commission appointed a High Level Group (chaired by Jacques de Larosiere) to study the Lamfalussy framework in light of the GFC and the threats to cross-border banking and the internal market that the GFC uncovered, and to make recommendations for a new EU regulatory set up.<sup>72</sup> The proposals advanced by the de Larosiere report were instrumental to subsequent developments. In order to implement the recommendations of the de Larosiere committee the EU established (through a series of Regulations, normally referred to as the ESAs founding Regulations) an integrated European System of Financial Supervision (ESFS), which came into effect in December 2010.<sup>73</sup> It comprises the European Systemic Risk Board<sup>74</sup> and a decentralized network comprising existing national supervisors (who would continue to carry out day-to-day supervision) and three new European Supervisory Authorities (ESAs): the European Banking Authority (EBA),<sup>75</sup> the European Insurance and Occupational Pension Authority (EIOPA), and the European Securities Markets Authority (ESMA), which respectively replaced the corresponding Lamfalussy Level 3 Committees: CEBS,<sup>76</sup> CEIOPS<sup>77</sup>

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<sup>72</sup> Larosiere, J. d. (February 2009). Report of the High Level Group on Financial Supervision in the EU. Brussels: European Union.

<sup>73</sup> Article 2, ESA founding Regulations, see, Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC. (2010) (pp. 84-119): Official Journal of the European Union, available at [http://www.esma.europa.eu/system/files/Reg\\_716\\_2010\\_ESMA.pdf](http://www.esma.europa.eu/system/files/Reg_716_2010_ESMA.pdf).

<sup>74</sup> The European Systemic Risk Board (ESRB), established on 16 December 2010 in response to the ongoing financial crisis. It has been tasked with the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union. It was established under the EU Regulation No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (the 'ESRB Regulation'). The Regulation is available at <http://www.esrb.europa.eu/shared/pdf/ESRB-en.pdf?efba86ec695eea33d6b673acc62578d9>

<sup>75</sup> The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 available at: <http://www.esrb.europa.eu/shared/pdf/EBA-en.pdf?79016e649558f0a9a741da6c169b806b>

<sup>76</sup> The Committee of European Banking Supervisors (CEBS) as an independent advisory group on banking supervision in the European Union was established by the European Commission in 2004 by Decision 2004/5/EC (the Commission's decision dated November 2003 is available at [http://europa.eu/legislation\\_summaries/internal\\_market/single\\_market\\_services/financial\\_services\\_banking/l22025\\_en.htm](http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l22025_en.htm)) On 1 January 2011, this committee was succeeded by the European Banking Authority (EBA), which took over all existing and ongoing tasks and responsibilities of the Committee of European Banking Supervisors (CEBS).

and CESR.<sup>78</sup> Furthermore, colleges of supervisors<sup>79</sup> were to be put in place for all major cross-border institutions because supervision of strategic decisions at the consolidated level requires a college of supervisors to understand the global effects and externalities of those decisions.<sup>80</sup> Last but not least, a Joint Committee was formed by the European Supervisory Authorities to coordinate their actions on cross-sectoral rule-making and supervisory matters.

ESAs' work with the newly established European Systemic Risk Board (ESRB) to ensure financial stability and to strengthen and enhance the EU supervisory framework. Apart from issuing guidance and recommendations to national supervisors,<sup>81</sup> ESAs also seek to formulate a single EU rulebook and harmonise technical standards on the basis of powers conferred by the

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<sup>77</sup> CEIOPS (2003-2010) was established under the European Commission's Decision 2004/6/EC of 5 November 2003, which has been replaced by EIOPA.

<sup>78</sup> The Committee of European Securities Regulators (CESR) was an independent committee of European Securities regulators established by European Commission on June 6 of 2001. On 1 January 2011, CESR was replaced by the ESMA.

<sup>79</sup> The colleges are a mechanism for the exchange of information between home and host authorities, for the planning and performance of key supervisory tasks in a coordinated manner or jointly, including all aspects of ongoing supervision, and also for the preparation for and the handling of emergency situations.. These are permanent, although flexible, structures for cooperation and coordination among the EU authorities responsible for and involved in the supervision of the different components of cross-border groups, specifically large groups. See for the operating principles of the colleges <http://www.eba.europa.eu/Supervisory-Colleges/Introduction.aspx> and, Colleges of Supervisors – 10 Common Principles. (January 27, 2009) (Vol. CEIOPS-SEC-54/08, CEBS 2008 124, IWCFC 08 32): <http://eba.europa.eu/getdoc/aecaf1a-81b5-476a-95dd-599c5e967697/Clean-V3-formatted-CEBS-2008-124-CEIOPS-SEC-08-54-.aspx>.

<sup>80</sup> In a sense this followed similar propositions as to how regulation of cross-border banking in the EU had to be structured. See, Lamanda, C. (March 2009). Cross-Border Banking in Europe: what regulation and supervision? *Unicredit Group Forum on Financial Cross-border Groups, Discussion paper No 01*, available at [https://www.unicreditgroup.eu/content/dam/unicreditgroup/documents/inc/press-and-media/cross\\_border\\_banking\\_discussion\\_paper.pdf](https://www.unicreditgroup.eu/content/dam/unicreditgroup/documents/inc/press-and-media/cross_border_banking_discussion_paper.pdf). Lamanda's Report had suggested that the supervision of cross-border banks had to be based on three tiers: day-to-day supervision to continue with national supervisors as it requires supervisors to be close to a business; strategic decisions, affecting the entire group to be supervised by colleges of supervisors, with enhanced, legally binding supervisory powers for each cross-border institution; and, a European Banking Authority (EBA), whose independence, governance and mechanisms follow the proposal of the de Larosiere Group. For banks within the Eurozone it is expected that the colleges will become largely redundant once bank supervision is centralized under the Single supervisory Mechanism the first pillar of the European Banking Union to come into effect in 2014.

<sup>81</sup> Article 8, defining tasks and powers of the Authority; See also, Article 10-17, ESA founding Regulations.

EU commission,<sup>82</sup> which subsequently will be adopted by the European Commission to become formal/binding EU law.<sup>83</sup> To safeguard consistent application of harmonized legislation, if the ESAs find a national supervisory authority failing to apply EU law, they have the power to investigate infractions, with the relevant Authority having the power to directly issue recommendations to national supervisors to remedy potential infractions, followed by a formal opinion from the Commission (if the recommendation is not acted upon). If the supervisor does not comply with the Commission's formal opinion, the ESA may then take decisions directly binding on firms or market participants concerned to ensure that they comply with EU law. In adverse situations, ESAs have wider-ranging powers.<sup>84</sup> In a crisis, the ESAs will provide EU-wide coordination.<sup>85</sup> If an emergency is declared, the ESAs may make decisions that are binding on national supervisors and on firms. The ESAs will mediate in certain situations where national supervisory authorities disagree. If necessary, they will be able to resolve disputes by making a decision that is binding on both of the parties to ensure compliance with EU law.<sup>86</sup> They have a role in EU supervisory colleges to ensure that they function efficiently and that consistent approaches and practices are followed.<sup>87</sup> The ESAs will conduct regular peer reviews of national supervisory authorities across the EU.<sup>88</sup> They will be able to collect information from national supervisors to allow them to fulfill their role.<sup>89</sup> This information will be used for analyzing market developments, coordinating EU-wide stress tests and the macro prudential analysis undertaken by the ESRB.<sup>90</sup> They also have a remit to consider consumer protection issues.<sup>91</sup> In

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<sup>82</sup> Article 11, exercise of delegation, ESA founding Regulations.

<sup>83</sup> Article 10, Regulatory Technical Standards, ESA founding Regulation.

<sup>84</sup> Article 18, Action in emergency situations, ESA founding Regulations.

<sup>85</sup> Article 31, Coordination function, ESA founding Regulations.

<sup>86</sup> Article 19, Settlement of disagreements between competent authorities in cross-border situations, and also, Article 20, Settlement of disagreements between competent authorities across sectors; Article 21, Colleges of supervisors, ESA founding regulations.

<sup>87</sup> Article 29, Common supervisory culture; Article 27, European system of resolution and funding arrangements, ESA founding Regulations.

<sup>88</sup> Article 30, Peer reviews of competent authorities, ESA founding Regulations.

<sup>89</sup> Article 36, Relationship with the ESRB, ESA founding Regulations.

<sup>90</sup> Article 36, Relationship with the ESRB, and, Article 23 Identification and measurement of systemic risk, ESA founding Regulations. See also Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board. (2010) *Official Journal of the European Union*

the ensuing paragraphs we provided a more analytical overview of the competences discharged by the ESRB and the ESAs.

#### 1. The European Systemic Risk Board (ESRB)

One of the recommendations of the de Larosiere report was to take stock of systemic risk factors that have been affecting the stability of the EU financial system as a whole. This made necessary the establishment of an EU-level body tasked with macro-prudential risk assessment. On 16 December 2010, Regulation (EU) No 1092/2010 established a European Systemic Risk Board (the ESRB Regulation) as an independent body with no legal personality and with no legally binding powers, hosted by the ECB, which directs its work and chairs the meetings.

The ESRB aims at detection of excessive risk accumulation, improving surveillance and supervision. Thus, its principal task is to conduct operations consisting of prediction, assessment management, and prevention and control of systemic risk and to collect and analyze all the relevant and necessary information, identify and prioritize systemic risks,<sup>92</sup> issue warnings where such systemic risks are deemed to be significant,<sup>93</sup> and, issue recommendations for remedial action and, where appropriate, making those recommendations public.<sup>94</sup> The ESRB can determine an emergency situation where it may issue a confidential warning addressed to the European Council. This should provide the Council with an assessment of the situation<sup>95</sup> in order to enable the Council to adopt a decision addressed to the European Supervisory Authorities (ESAs) determining the existence of an emergency situation.<sup>96</sup> It is for the Council – and not for the ESRB, which serves only the advisory function- to make decisions on such emergencies. The ESRB works in close cooperation with several other parties to the European System of Financial Supervision (ESFS),<sup>97</sup> including the EU Commission and EU Economic and Financial

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(Vol. L331/1): available at <http://www.esrb.europa.eu/shared/pdf/ESRB-en.pdf?49c9d3be4e6566e3eb2c1f0b210d4980>. [Hereinafter ESRB Regulation].

<sup>91</sup> Article 9, Tasks related to consumer protection and financial activities; Article 26, European system of national Investor Compensation Schemes, ESA founding Regulations.

<sup>92</sup> Article 3, ESRB Regulation.

<sup>93</sup> Article 3, and Article 16, ESRB Regulation.

<sup>94</sup> Article 3 and Article 16, ESRB Regulation.

<sup>95</sup> Article 3, ESRB Regulation.

<sup>96</sup> Recital 22, ESRB Regulation

<sup>97</sup> Article 16, ESRB Regulation.

Committee (EFC) for surveillance.<sup>98</sup> Jointly with the European Council it performs a collective oversight for systemic stability policies and it co-operates with the IMF, BIS, and FSB to identify and assess SIFIs in the EU.<sup>99</sup> Moreover, in collaboration with the ESAs, it maintains a common set of quantitative and qualitative indicators (risk dashboard) to identify and measure systemic risk.<sup>100</sup>

Naturally, there are ambiguities surrounding the ESRB's role. First, ESRB's very low visibility almost two years after it 'opened for business', shows that, in practice, it is not the paramount macro-prudential regulator in the EU. Secondly, since it is a soft law body with informal status, it is very much dependent for information collection on national supervisory and regulatory authorities. The ESRB's dependence on other bodies to carry out some of its tasks and above all its mandate also implies that it may easily become involved in national and European level political struggles and reputation damaging litigation. Secondly, because of the ESRB's closeness with the ECB, which is the effective lender of last resort in the Eurozone, its credibility and independence may further be compromised by the ECB's policy priorities.<sup>101</sup> It should be noted here that the ECB – unlike traditional central banks who are endowed with powers to employ both monetary policy and LoLR instruments in response to financial crisis – though it has a clear role with respect to monetary policy (Article 127(2) TFEU, and Article 18 of the ESCB Statute), it has a very limited mandate vis-à-vis the discharge of LoLR powers. Also, until the ESM moves into full action, only fiscal authorities can effect bailouts using taxpayers' money.<sup>102</sup> The absence of fiscal union/ powers in the Eurozone therefore, poses an additional constraint to the ECB apart from the restrictions that the Treaty itself provides to deliver effectively as LoLR in Eurozone crisis.

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<sup>98</sup> See, Dierick, F., Lennartsdotter, P., & Favero, P. D. (2012). The ESRB at work—its role, organization and functioning. Macro-prudential Commentaries, ESRB(1), available at [http://www.esrb.europa.eu/pub/pdf/commentaries/ESRB\\_commentary\\_1202.pdf](http://www.esrb.europa.eu/pub/pdf/commentaries/ESRB_commentary_1202.pdf)

<sup>99</sup> Article 3, ESRB Regulation.

<sup>100</sup> Article 3, ESRB Regulation.

<sup>101</sup> Avgouleas, E. (2012). Another perspective is raised by Goodhart and Franklin Allen et.al., who argue that the ECB might not necessarily be a 'tougher supervisor' than national authorities. See Goodhart, C. and Allen, F. in Beck, T. (2012). *Banking Union for Europe Risks and Challenges*, [electronic resource], Centre for Economic Policy Research (CEPR). Retrieved from [http://www.dsf.nl/assets/cms/File/Events/Thorsten%20Beck\\_Banking\\_Union.pdf](http://www.dsf.nl/assets/cms/File/Events/Thorsten%20Beck_Banking_Union.pdf) Pp 105-119

<sup>102</sup> See, Goodhart, C. (2003). The Political Economy of Financial Harmonisation in Europe. In J. Kremer, D. Schoemaker & P. Wierts (Eds.), *Financial Supervision in Europe*: Cheltenham: Edward Elgar.

## 2. European Banking Authority (EBA)

The European Banking Authority was established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010<sup>103</sup> and has officially started operations as of 1 January 2011. Having taken over the tasks and responsibilities of the Committee of European Banking Supervisors (CEBS), EBA acts as a hub and support network of EU and member state national bodies, safeguarding the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors.

Regulation, oversight, and consumer Protection are the core functions of the EBA as laid down in the EBA Regulation. The fundamental objective of EBA is to develop a single European supervisory and recovery and resolution rulebook, in order to achieve a level playing field for financial institutions and raise the quality of financial regulation and the overall functioning of the Single Market. EBA's oversight activities focus on identifying, analyzing and addressing key risks in the EU banking sector to strengthen European supervision of cross-border banking groups. EBA is also committed to enhance consumer protection and promote transparency, simplicity and fairness for consumers of financial products and services across the Single Market.<sup>104</sup>

## 3. Evaluation

The ECB together with the Central Banks of the EU Member States (NCBs) comprises the European System of Central Banks (ESCB). This configuration produces in itself structural complexity,<sup>105</sup> which has its roots in the dual role performed by the NCBs. The NCBs are national agencies while performing non-ESCB functions and at the same time, NCBs constitute an important part of the ESCB and play a role in the conduct of EMU monetary policy. This functional complexity has deeper roots that relate to their constitutive laws. Whereas the ECB

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<sup>103</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC. (Vol. 331/12): Official Journal of the European Union, available at <http://www.esrb.europa.eu/shared/pdf/EBA-en.pdf?79016e649558f0a9a741da6c169b806b>.

<sup>104</sup> See, EBA Work Program 2013. (28 September 2012) (Vol. EBA BS 2012 163 FINAL): The European Banking Authority, available at <http://www.eba.europa.eu/cebs/media/aboutus/Work%20Programme/EBA-BS-2012-163-FINAL--EBA-work-programme-for-2013-.pdf>.

<sup>105</sup> Lastra, R. M., & Louis, J.-V. (2013).

operates solely under the EC law, while the status of the NCBs is governed by both the EC law and national legislation. In addition, no provision was made, until the advent of the EBU, for the ECB to have any regulatory oversight over cross-border banks. The ESFS did not remedy the ‘mismatch’ between the geographic scope of European bank activities and the regulatory remit of the authorities supervising them. On the contrary, the ESFS might be accused of just providing yet another layer of complexity in the EU structures. Therefore, even after the implementation of the de Larosiere reforms, cross-border supervision and bank resolution at the EU level remained decentralized and in want of further clarifications as to how ESAs would be able to control and manage their complicated tasks when parties involved would include non-EU countries.

Finally, the structures developed under the ESFS for cross-border bank supervision remain complex and involve too many levels of over-lapping competences that may lead to critical delays during a crisis.<sup>106</sup> And then, if any major European bank or a financial institution fails, it would certainly have repercussions outside EU,<sup>107</sup> though no provision is made for formalized cooperation structures with third country regulators beyond those provided in the (informal) context of the G20 and the Financial Stability Board. The most important international co-operation issue is of course the need to draw up clear fiscal burden sharing arrangements.<sup>108</sup>

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<sup>106</sup> E.g., Jamie Dimon has raised a very pertinent question with respect to the effectiveness of regulatory reforms: “has anyone bothered to study the cumulative effect of these regulatory and market fixes?” on June 07, 2011. Ben Bernanke, the Fed Chairman issues a statement, as reproduced by Barth, “the central bank doesn’t have the quantitative tools to study the net impact of all the regulatory and market changes over the last three years...It’s too complicated” to study the new regulations’ effect. Reproduced in Barth, J. R., & Prabha, A. P. (December 03, 2012). Moreover, James Barth contends that not everyone is convinced of the new regulations in place (in case of the US, the Dodd-Frank Act) has solved the too-big-to-fail problem, yet, the biggest banks have not been downsized despite the presence of a general consensus from various stake-holders. He quotes from Sheila Bair (Former FDIC Chair, Fortune, February 06, 2012), Richard Fischer & Harvey Rosenblum (FRB of Dallas, Wall Street Journal, April 4, 2012), and, Simon Johnson (Professor at MIT, Bloomberg, October 10, 2011). See, Barth, J. R., & Prabha, A. P. (December 03, 2012). *Breaking (Banks) Up is Hard to Do: New Perspectives on Too Big to fail*. Financial Institutions Centre. Retrieved from <http://fic.wharton.upenn.edu/fic/papers/12/12-16.pdf>

<sup>107</sup> See, Beck, T. (25 October 2011). *The Future of Banking, A VoxEU.org eBook* Retrieved from [http://www.voxeu.org/sites/default/files/file/the\\_future\\_of\\_banking.pdf](http://www.voxeu.org/sites/default/files/file/the_future_of_banking.pdf)

<sup>108</sup> Goodhart and Schoenmaker have proposed binding burden-sharing arrangement among national governments. If a cross-border bank faces difficulties, the governments would share the costs according to some predetermined key – for example, according to the distribution of the troubled bank’s assets over the respective countries. Under such a burden sharing approach, a common solution can be found upfront.



Moreover, even under the EFSF extensive reliance is being placed on the judgment and decisions of the home supervisor.<sup>109</sup> A binding mediation mechanism is required to deal with such cross-border supervisory problems. Without such an effective and binding mechanism, some Member States might in the future try to limit the branching activities of any firm regulated only by a home supervisor, who is judged to have failed to meet the required standards of supervisory practice. Such fragmentation would represent a major step backwards for the Single Market.<sup>110</sup>

## **B. Phase II: From the ESFS to the European Banking Union**

The nature of the regulatory architecture itself may not be an important cause of a financial crisis. Yet the ‘institutional design’ can be very important for the prevention and resolution of a major financial crisis. Prevention is dealt with through a framework of systemic risk control and robust prudential regulations. Crisis management and resolution, on the other hand, require established supervisory and resolution structures, which in an integrated market, must have a cross-border remit, in order to override or subsume the principle of home country control.<sup>111</sup> For a very long time and until the different pillars of the European Banking Union come into place, the regulatory structures of the EU have been characterized by three principles: decentralization,

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By pre-committing to burden sharing, governments would give up some of their sovereignty, but in return, the single market in banking serving Europe’s businesses and consumers would be saved. Goodhart, C. A. E., & Schoenmaker, D. (2006). Burden Sharing in a Banking Crisis in Europe. *Sveriges Riksbank Economic Review*, 2, 34-57. This proposal was refined and suggested to become an integral part of group level recovery and resolution plans for cross-border banks in Avgouleas, E, Goodhart, C. & Schoenmaker, D. (2013). Bank Resolution Plans as a Catalyst for Global Financial Reform. *Journal of Financial Stability*, 9, in press.

<sup>109</sup> See, Larosiere, J. d. (February 2009). Report of the High Level Group on Financial Supervision in the EU. European Union, Brussels, available at [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf).

<sup>110</sup> EU. (June 22, 2012). Country-specific recommendations on economic and fiscal policies: The European Semester, 2012. Luxembourg: Council of the European Union, available at [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ecofin/131135.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/131135.pdf).

<sup>111</sup> Garicano, L., & Lastra, R. M. (2010). Towards a New Architecture for Financial Stability: Seven Principles. *Journal of International Economic Law*, 13(3), 597-621. See also, The new supervisory framework in the EU, see Arroyo, H. T. (2011). The EU’s Fiscal Crisis and Policy Response: reforming economic governance in the EU Directorate General for Economic and Financial Affairs, European Commission, available at <http://www.oecd.org/gov/budgetingandpublicexpenditures/48871475.pdf>

lack of coordination and segmentation. A careful look at the developmental phase of European institution-building reveals this has been a process of experimentation rather than design.<sup>112</sup> The preceding analysis of the crisis and of the responses to it has shown that the inadequacies of the EU financial and institutional framework have played an important role in undermining the stability of the Eurozone financial sector during the crisis.

The EU Treaties did not establish clear institutional borders as a prerequisite for the efficient functioning of ‘multilevel European governance’. This flaw was most evident in the Eurozone sovereign debt crisis. European responses to this crisis highlighted the current role of and power balance among EU institutions and Member States where the Union continues only to react to, and very rarely foresees, urgent needs and international developments which call for a speedy reaction. ‘Who does what’ in Europe has been occupying policy-makers for many years.<sup>113</sup> A ‘competence catalogue’ was included in the Lisbon Treaty, in force since 1 December 2009. This distinguishes between EU and the member state powers/competences on the basis of the principle of conferral and recognition. Essentially, for the first time in EU’s history it has been explicitly enshrined in the Treaties that competences not conferred upon the Union remain with the Member States.<sup>114</sup>

The EU, as a whole, has embarked on to a number of initiatives to build an integrated surveillance framework with respect to: (1) the implementation of fiscal policies under the Stability and Growth Pact to strengthen economic governance and to ensure budgetary discipline, and, (2) the implementation of structural reforms. As a first step, Eurozone Heads of State adopted the intergovernmental Euro Plus Pact, to strengthen the economic pillar of EMU and achieve a new quality of economic policy coordination, with the objective of improving competitiveness and thereby leading to a higher degree of convergence. As this remains outside the existing institutional framework a constitutional amendment to the EMU will be required to

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<sup>112</sup> Schoemaker, D. (19 December 2009). The financial crisis: Financial trilemma in Europe VOX: Research-based policy analysis and commentary from leading economists. <http://www.voxeu.org/article/financial-crisis-and-europe-s-financial-trilemma>

<sup>113</sup> COM. (2001). *European Governance - A White Paper*. Brussels: Commission of the European Communities.

<sup>114</sup> Wouters, J., & Ramopoulos, T. (2012).

implement it.<sup>115</sup> In addition, the European Parliament and the Council adopted a ‘six-pack’ set of new legislative acts, aimed at strengthening the Eurozone’s economic governance by reduction of deficits through tighter control of national finances.<sup>116</sup> The reforms represented the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the EMU almost 20 years ago. This legislative package aims at concrete and decisive steps towards ensuring fiscal discipline to stabilize the EU economy and to avert new crisis in future.

Moreover, the EMU is currently in the process of adopting a number of radical institutional reforms with a view of addressing the existential challenges it is facing. Radical measures have been adopted, which aim at stabilizing market conditions and containing the impact of the Eurozone debt crisis on the banking system and vice versa, containing negative feedback loops between banks and sovereigns.<sup>117</sup> Breaking up the vicious circle of bank debt piling up on sovereign debt is a matter of utmost importance for the survival of the Eurozone. EU

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<sup>115</sup> Conclusions of the European Council, 24–25 March 2011, EUCO 10/1/10 REV 1, and subsequently revised conclusions, EU. (January 25, 2012). Conclusions of the European Council, December 09, 2011 (Vol. EUCO 139/1/11 REV 1).

<sup>116</sup> The legislative ‘six-pack’ set of European economic governance architecture reforms comprised five regulations and one directive, proposed by the European Commission to come into force on 13 December 2011. See, Regulation (EU) No 1173/2011 of the European Parliament and of the Council of November 16, 2011 on the effective enforcement of budgetary surveillance in the euro area, OJ 2011, L 306/1; Regulation (EU) No 1174/2011 of the European Parliament and of the Council of November 16, 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, OJ 2011, L 306/8; Regulation (EU) No 1175/ 2011 of the European Parliament and of the Council of November 16, 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ 2011 L 306/12; Regulation (EU) No 1176/2011 of the European Parliament and of the Council of November 16, 2011 on the prevention and correction of macroeconomic imbalances, OJ 2011 L 306/25; Council Regulation (EU) No 1177/2011 of November 08, 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ 2011 L 306/25; Council Directive 2011/85/EU of November 08, 2011 on requirements for budgetary frameworks of the Member States, OJ 2011 L 306/41. Available at [http://ec.europa.eu/economy\\_finance/economic\\_governance/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/index_en.htm) See also Regulation (EU) No 1175/2011 of the European Parliament and of the Council of October 04, 2011 amending Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ 2011 L 306/12, at 15–16.

<sup>117</sup> See also, Ferran, E. (2010). Understanding the New Institutional Architecture of EU Financial Market Supervision. In G.Ferrarini, K.J.Hopt & E.Wymeersch (Eds.), *Rethinking Financial Regulation and Supervision in Times of Crisis* (OUP, 2012).

members need to complete the adjustment of internal and external imbalances, to repair financial sectors and to achieve sustainable public finances.<sup>118</sup> The economic and financial crisis has exacerbated pressure on the public finances of EU Member States where 23 out of the 27 Member States fall in the so-called ‘excessive deficit procedure’ (EDP). EDP is a mechanism established by the EU Treaties obliging countries to keep their budget deficits below 3% of GDP and government debts below 60 percent of GDP. Accordingly, the Member States running any excess deficit must comply with the recommendations and deadlines as decided by the EU Council to correct their excessive deficit.<sup>119</sup> Piling up debt in their effort to bail out Europe’s ailing banks only makes things worse. In addition, it raises the cost of borrowing for Eurozone members to unsustainable levels, necessitating continuous bailouts by the wealthier members of the Eurozone in an effort to keep the EMU from breaking up. However, such sovereign bailouts are not only very expensive they are also highly unpopular with the citizens of lender countries.

The most important of forthcoming reforms is the decision to move towards a banking union reflected by the legislative proposal for a single supervisory mechanism (SSM) for the euro area, the entry into force of the European Stability Mechanism (ESM), and the ECB decision to undertake Outright Monetary Transactions (OMTs) in secondary markets for the bonds of Eurozone countries. Conditional on measures implemented at the national level, these policy initiatives will also support fiscal consolidation and private sector deleveraging.<sup>120</sup> The Liikanen report<sup>121</sup> has proposed solutions to separate deposit-taking banking from riskier banking activities. However, a comprehensive EU mandate on structural reform of the EU

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<sup>118</sup> EU. (Spring 2012). European Economic Forecast (Vol. European Economy: 1|2012). European Commission: Directorate-General for Economic and Financial Affairs, available at [http://ec.europa.eu/economy\\_finance/publications/european\\_economy/2012/pdf/ee-2012-1\\_en.pdf](http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf)

<sup>119</sup> There is however, mounting criticism of the conditionality of deficit reduction by pursuing austerity measures and tighter control of national expenses, especially on the member states facing financial stresses. See for example, Bellofiore, R. (2013) who perceives a way out of crisis requires not only monetary reforms and expansionary coordinated fiscal measures, but also a wholesale change of economic model built upon a new ‘engine’ of demand and growth that requires a monetary finance of ‘good’ deficits. Bellofiore, R. (2013). ‘Two or three things I know about her’: Europe in the global crisis and heterodox economics. *Cambridge Journal of Economics*.

<sup>120</sup> EU. (Autumn 2012). European Economic Forecast (Vol. European Economy: 7|2012). European Commission: Directorate-General for Economic and Financial Affairs, Retrieved from [http://ec.europa.eu/economy\\_finance/publications/european\\_economy/2012/pdf/ee-2012-1\\_en.pdf](http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf).

<sup>121</sup> Liikanen, E. (October 02, 2012). High-level Expert Group on reforming the structure of the EU banking sector. Brussels; available at [http://ec.europa.eu/internal\\_market/bank/docs/high-level\\_expert\\_group/report\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf).

banking sector may take some time as the EU faces so many existential problems on numerous fronts.

Finally, irrespective of the progress already achieved on the policy side, the experience of the past two years reflects that reversal of sentiment in financial markets and widening of interest rate spreads can happen very rapidly if the implementation of radical measures falters or the measures do not seem radical enough to meet the requisite challenges. The next few paragraphs will provide an analytical account of the reforms that are developed to strengthen the EU's financial and monetary stability with particular focus on the forthcoming Single Supervisory Mechanism (SSM) and the mooted pan-European resolution and deposit insurance arrangements.

#### **IV. The European Banking Union**

Responding to the ever growing pressure for more bank and sovereign bailouts the European Commission initiated the establishment of institutions that would support the ESM<sup>122</sup> and lead to the establishment of a more integrated banking union in the EMU.<sup>123</sup> This has, in principle, three pillars: a unified supervision mechanism (the SSM), operated by the European Central Bank, a future pan-European deposit guarantee scheme (DGS), and a future single bank resolution mechanism with common backstops.

It should be noted here that new structures adopted by the leadership of the Eurozone to put off the burning flames of the continuous banking and sovereign debt crisis are not without their detractors. Authoritative voices argue that European-level crisis management action (including bank recapitalizations by the ESM) which is so far contingent on the establishment of a permanent institutional infrastructure (i.e., an effective SSM) has been perceived as 'a delaying tactic' and in denial of the urgency of the present situation.<sup>124</sup> Another sensitive question pertains to whether the doors of a new integrated financial supervisory mechanism are to be closed on non-EU countries.

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<sup>122</sup> See, Article 81 of the Regulation (EU) No 1093/2010; Regulation No 1094/2010; and Regulation (EU) No 1095/2010

<sup>123</sup> See, speech of the President of the EU Commission Manuel Barroso, available at [http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2012/06/20120626\\_speeches\\_2\\_en.htm](http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/06/20120626_speeches_2_en.htm)

<sup>124</sup> Véron, N. (October 17, 2012 ). The First Step in Europe's Banking Union: Difficult but Achievable. RealTime Economic Issues Watch; the Peterson Institute for International Economics. Available at <http://www.piie.com/blogs/realtime/?p=3174>.

## **A. The Single Supervisory Mechanism (SSM)**

As mentioned earlier, the EU's reliance on national supervisory structures for the single market proved to be flawed. The failure of the rudimentary crisis management coordination mechanisms that were in place, through the Lamfalussy level 3 committees, lacked both the competence and the resources to cope with a cross-border banking crisis that endangered taxpayers' money. Lack of appropriate co-ordination structures was nowhere more evident than bank recovery and resolution. Similarly the complete absence of a centralized EU structure dealing with systemic risk monitoring was incomprehensible. The most important of those gaps in the Eurozone institutional edifice is about to be remedied through the establishment of the first and most significant pillar of the proposed European Banking Union, the Single Supervisory Mechanism (SSM).

On 12 September 2012 the Commission proposed a single supervisory mechanism for Eurozone banks, which will be run by the European Central Bank (ECB), in order to strengthen the Economic and Monetary Union. The SSM is the first step towards an integrated 'banking union' which includes further components such as a single rulebook, common deposit protection and single bank resolution mechanisms. The Commission called on the Council and the European Parliament to adopt proposed regulations by the end of 2012, together with the other three components of an integrated 'banking union' – the single rulebook in the form of capital requirements (IP/11/915), harmonized deposit protection schemes (IP/10/918), and a single European recovery and resolution framework (IP/12/570). In the words of the president of the European Commission José-Manuel Barroso:

This new system, with the European Central Bank at the core and involving national supervisors, will restore confidence in the supervision of all banks in the euro area... We should make it a top priority to get the European supervisor in place by the start of next year. This will also pave the way for any decisions to use European backstops to recapitalize banks.

Barroso has also explained with authority the main purpose of these arrangements: ‘We want to break the vicious link between sovereigns and their banks. In future, bankers' losses should no longer become people's debt, bringing into doubt the financial stability of whole countries.’

The desirable ambit of the ECB’s supervisory powers has been the subject of considerable debate. Several member states have wanted the SSM to be restricted to ‘systemically important’ banks. For example, there is a controversy on whether German savings and cooperative banks should come under the remit of the SSM, as these banks consider themselves as local regional banks with passive assets and low risk exposures hence, subject to different policy regime from commercial banks. However, small or medium-size banks can also endanger the stability of EU financial system as well, e.g., the failures of banks like Northern Rock or the Spanish Caixas. Thus, a single supervisory mechanism is probably a more effective option. Furthermore, the existence of two supervisory mechanisms for banks, operating in the same market, would inevitably create conflicts of jurisdiction and competence (‘turf wars’) undermining the banking union. Early indications say that the ECB will be empowered to take over the supervision of any bank in the Eurozone if it so decides, in particular if the bank is receiving public support. Namely, the ECB will set the rules and be able to assume directly all relevant supervisory tasks, whenever it considers it appropriate, for each one of these 6,000 Eurozone banks. However, in principle, the ECB will focus its direct supervision only on those banks, which can generate significant prudential risks through their size or risk profile.

Thus, within the unified supervisory system, the ECB have direct responsibility for around 150 banks with assets of more than 30 billion Euros, or those with assets representing more than 20 percent of a Member State’s GDP. National supervisors within the same unified supervisory system will primarily supervise the remaining banks. Finally, while the ECB will have the power to step in to assume direct supervision at any moment, if need be, national supervisors will remain in charge of tasks like consumer protection, money laundering and branches of third country banks. ECB supervision will be phased in automatically on 1 July 2013 for the most significant European systemically important banks, and on 1 January 2014 for all other banks.

The ECB will be vested with the necessary investigatory and supervisory powers to perform its task and will apply single rulebook across the single financial market to carry out following functions:

- i. Licensing/authorizing credit institutions;
- ii. Monitoring compliance with capital, leverage and liquidity requirements;
- iii. Conducting supervision of financial conglomerates; and,
- iv. Early intervention measures (Prompt Corrective Action) when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action.

The reforms roadmap bequeaths ECB the status of a mother institution for the SSM. The June 2012 statement<sup>125</sup> identifies article 127(6) of the European Union's Lisbon Treaty<sup>126</sup> as the legal basis for the SSM, which means the new supervisor will be part of the ECB. Yet the roadmap does not hand over the management of the European Stability Mechanism (ESM) to the ECB until the new supervisory structures prove their effectiveness.

The legislative proposals<sup>127</sup> published by the Commission establishing the SSM have still to work out appropriate solutions for some outstanding issues. Firstly, as regards the geographical reach of the membership, that is, who to include and who to exclude from the EU members into the EBU. Beck has argued that the need for a banking union is stronger within a currency union because as it is here where the close link between monetary and financial stability plays out strongest and where the link between government and banking fragility is exacerbated as national governments lack policy tools that countries with an independent monetary policy have available.<sup>128</sup> But some non-euro area member states, including in Central Europe and Scandinavia, may want to join, and they have a veto over decisions under article 127(6). However, as far as the UK is concerned, it has been made categorically obvious that it would not join the SSM. Thus, while, the Commission maintains that the banking union and the

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<sup>125</sup> Euro Area Summit Statement. (June 29, 2012). Brussels, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131359.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf).

<sup>126</sup> Treaty of Lisbon was signed on 13 December 2007 in Lisbon, entered into force on 1 December 2009. Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union. (30 March 2010). Official Journal of the European Union: C 83/01, Volume 53.

<sup>127</sup> Issued on September 12, 2012, see EC. (September 12, 2012). Commission proposes new ECB powers for banking supervision as part of a banking union *Press Release*. Brussels/Strasbourg: European Commission. And also, Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union. (September 12, 2012) (Vol. COM(2012) 510 final). European Commission, available at [http://ec.europa.eu/internal\\_market/finances/docs/committees/reform/20120912-com-2012-510](http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510).

<sup>128</sup> Beck, T. (2012). Banking Union as a Crisis Management Tool, in Banking Union for Europe Risks and Challenges, [electronic resource], Centre for Economic Policy Research (CEPR). Retrieved from [http://www.dsf.nl/assets/cms/File/Events/Thorsten%20Beck\\_Banking\\_Union.pdf](http://www.dsf.nl/assets/cms/File/Events/Thorsten%20Beck_Banking_Union.pdf)



single market are mutually reinforcing processes and that the establishment of banking union is inseparable from the completion of substantive regulatory reforms, which are already underway for the single market under the ‘single rulebook’, the geopolitical reality might be that the EMU and non-EMU members (Member States with a derogation) within the EU are pulling much further apart than ever before.<sup>129</sup>

Secondly, there is a legitimate concern that adding supervision - a politically charged task - to the ECB’s responsibilities, may compromise its impartiality and independence. Therefore, the supervisory function needs to be kept discrete and independent from the rest of the ECB structures to preserve its institutional autonomy. This is a very important distinction since banking and monetary policy, though inter-linked, are not identical. However, there are contrasting views as regards the extent and form of separation between the two functions.<sup>130</sup>

## **B. The New EU Resolution Framework: Plans for Integrated Resolution Funds and Deposit Guarantee Schemes**

To provide for common mechanisms to resolve banks and guarantee customer deposits, the Commission has proposed instituting a single resolution mechanism, which would govern the resolution of banks and coordinate in particular the application of ‘resolution tools’ to banks within the EU. The resolution mechanism is aimed at safeguarding the continuity of essential banking operations, to protect depositors, client assets and public funds, and to minimize risks to financial stability. This mechanism would be more efficient than a network of national resolution authorities particularly in the case of cross-border failures, given the need for speed and credibility in addressing the issues in the midst of a crisis.<sup>131</sup> The decisions have to be taken in line with the principles of resolution as set out in the single rulebook consistent with

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<sup>129</sup> Member States who have not adopted the euro are not members of the Governing Council of the ECB.

<sup>130</sup> E.g., there is overlap of representatives between the supervisory board and the Governing Council. Therefore, as Beck and Gros conclude that raising Chinese walls between the two highly overlapping bodies would make no sense. See, Beck, T., & Gros, D. (March 2013). Monetary Policy and Banking Supervision: Coordination instead of Separation. *European Banking Center Discussion Paper No. 2013-003; published as CEPS Policy Brief.*

<sup>131</sup> See also, Beck, T. (2012). *Banking Union for Europe Risks and Challenges*, [electronic resource], Centre for Economic Policy Research (CEPR). Retrieved from [http://www.dsf.nl/assets/cms/File/Events/Thorsten%20Beck\\_Banking\\_Union.pdf](http://www.dsf.nl/assets/cms/File/Events/Thorsten%20Beck_Banking_Union.pdf) and Schinasi, G. (November 05, 2012) also distinguishes between immediate crisis resolution and intermediate to long-term measures.

international best practices and in full compliance with Union state aid rules, in particular that, shareholders and creditors should bear the cost of resolution before any external funding is granted.<sup>132</sup>

The main resolution tools, as detailed in the Commission's proposal directive for crisis management and resolution, are the following:

- (1) the sale of business tool whereby the authorities would sell all or part of the failing bank to another bank, without the consent of shareholders);
- (2) the bridge bank tool, which consists of identifying the good assets or essential functions of the bank and separates them into a new bank (bridge bank). The bridge bank will later be sold to another entity, in order to preserve these essential banking functions or facilitate the continuous access to deposits. The old bank with the bad or non-essential functions would then be liquidated under normal insolvency proceedings;
- (3) the asset separation tool, whereby the bad assets of the bank are put into an asset management vehicle. This tool relieves the balance sheet of a bank from bad or 'toxic' assets. In order to prevent this tool from being used solely as a state aid measure, the framework prescribes that it may be used only in conjunction with another tool (bridge bank, sale of business or write-down). This ensures that while the bank receives support, it also undergoes restructuring; and,
- (4) the bail-in tool, whereby the bank would be recapitalized with shareholders wiped out or diluted, and creditors would have their claims reduced or converted to shares.

Therefore, an institution for which a private buyer cannot be found, or which cannot split up without destroying franchise value and other intra-firm synergies, could thus continue to provide essential services without the need for bail-out by public funds, and authorities would have time to reorganize it or wind down parts of its business in an orderly manner. To this end, banks would be required to have a minimum percentage of their total liabilities in the shape of instruments eligible for bail-in. If triggered, they would be written down in a pre-defined order in terms of seniority of claims in order for the institution to regain viability. The choice of tools will depend on the specific circumstances of each case and build on options laid out in the resolution plan prepared for the bank.

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<sup>132</sup> EC. (Sep 09, 2012). Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union (Vol. COM (2012) 510 final). Brussels.

A bank would become subject to resolution when: (a) it has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe, (b) all other intervention measures above have been exhausted, and (c) winding up the institution under normal insolvency proceedings would risk prolonged uncertainty or financial instability. Thus, entry into resolution will always occur at a point close to insolvency.

The Commission has also proposed the harmonization and simplification of protected deposit regimes, faster pay-outs and improved financing of schemes, notably through ex-ante funding of deposit guarantee schemes and a mandatory mutual borrowing facility between the national schemes. Therefore, if a national deposit guarantee scheme finds itself depleted, it can borrow from another national fund. The mutual borrowing facility would be the first step towards a pan-EU deposit guarantee scheme, and would be a natural complement to the establishment of a single supervisory mechanism. The single rulebook could include rules on the structure of the banking sector.

The EBA should develop a single supervisory handbook to complement the single rulebook. In order to avoid any divergence between the Euro Area and the rest of the EU, the single rulebook should be underpinned by uniform supervisory practices. Different supervisory handbooks and supervisory approaches between the Member States participating in the single supervisory mechanism and the other Member States pose a risk of fragmentation of the single market, as banks could exploit the differences to pursue regulatory arbitrage.

### **C. Evaluation of EU Regulatory Reforms**

Weaknesses in the institutional framework have affected EU financial integration in two ways: firstly, the incomplete or partial harmonization of the pre-crisis supervisory and regulatory framework prevented the benefits of full integration from being reaped and created fragilities in the financial sector to build up in a way that became threatening over time and, secondly, the crisis revealed the vulnerabilities and gaps in the national and EU-wide crisis management frameworks. These weaknesses have resulted in partial disintegration of the internal market and have caused splits along national lines of some segments of the single EU market for capital and financial services.<sup>133</sup> Thus, for the EU, progression to a framework of tighter financial integration

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<sup>133</sup> ECB. (April 2012). Financial Integration in Europe: European Central Bank. P.87

and risk controls for the banking system – together with improved governance standards in the monetary and fiscal spheres and centralization of responsibility for financial stability – has become a one-way road.

Current EU reforms promise to create a stronger financial and institutional framework in order to strengthen the resilience of the single market and mitigate the risk of vicious circles of market instability and fragmentation observed during the GFC and the on-going Eurozone debt crisis.<sup>134</sup> Nonetheless, current integration efforts are high risk, as their core only extends to the seventeen EMU members and, thus, it might create irreparable fractures for the internal market that remains incomplete at this stage.<sup>135</sup> Moreover, the new arrangements under the SSM need to become ‘first-best’<sup>136</sup> framework in order to stabilize the euro-area sovereign debt crisis and financial instability. Effective supervision, however, will challenge the fiscal sovereignty of Eurozone members,<sup>137</sup> especially, as the SSM will be able to activate the permanent EU rescue fund in order to directly recapitalize struggling Eurozone banks, such as those in Spain. This initiative, which essentially centralizes control over Eurozone finances by reducing the power of national governments, has attracted criticism from different quarters with respect to the role of the ECB, which will end up mustering an enormous amount of power without having a democratic mandate. At the same time, the legal basis for the new arrangements must be robust and must include a mechanism for judicial review, and gives rise to criticism as to whether this is best feasible under Article 127(6) of TFEU or other Treaty provisions.

Finally, the establishment of the SSM is only a big first step on a much longer path towards building crisis management and resolution institutions for the EU banking union. There remain several essential components such as a European banking charter, a fully-fledged single rulebook, a single resolution authority and a common deposit insurance scheme whose detailed arrangements are still to be worked out.

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<sup>134</sup> ECB. (April 2012). *Financial Integration in Europe*: European Central Bank. P.12

<sup>135</sup> Lastra, R. (2013). *Banking Union and Single Market: Conflict or Companionship?*, *Fordham International Law Journal*, Vol. 36, forthcoming.

<sup>136</sup> Schinasi elaborates on ‘first-best’ mechanism in the EU context comprising of single supervisor, uniform deposit insurance, and European resolution mechanism.

<sup>137</sup> Schinasi, G. (November 05, 2012). *European Banking Union: Pros and Cons - A View from Across the Atlantic*. Power point presentation, Available at [http://www.dsf.nl/assets/cms/File/Events/Garry%20Schinasi\\_European%20Banking%20Union%20.pdf](http://www.dsf.nl/assets/cms/File/Events/Garry%20Schinasi_European%20Banking%20Union%20.pdf).

## **V. Conclusion: Fragmentation or a More Complete Union?**

The reform of the EU integration mechanisms in the aftermath of the GFC and in the context of Eurozone debt crisis marks an important milestone in the integration process and regionalism drive, especially because it has exposed the failure of various institutional mechanisms supposed to ensure financial market stability. The EU crisis response bears significant implications in the development and functioning of single market operations and has emphasized the need to improve international and regional coordination on fiscal, monetary and financial policies affecting other states.

Over a period of several decades, the progressive development of an integrated single financial market in the EU combined with a single currency among 17 of its members led to the imbalances that became visible when the GFC erupted in 2008.<sup>138</sup> Unfortunately, despite the vast amount of effort expended in developing both the EU single financial market and EMU, important design features necessary to support financial stability had not been put in place or were not sufficiently robust, particularly in relation to burden sharing, resolution of cross-border financial institutions, deposit guarantee arrangements, regulation and supervision, and fiscal arrangements and affairs.

It is not controversial, even though it does challenge orthodox thinking, to argue that financial integration is not always beneficial. Despite the increased importance of enhanced regionalism and integration, policy formulation must take a balanced view. The European crisis provides a deep insight to the risks of integration and identifies mistakes not to be repeated in following integration plans elsewhere.

This balanced view of integration offers further perspectives: Firstly, that the soundness and credibility of domestic policies are not substitutes for regional commitments even though, at times when domestic policies are ‘stuck’, regional commitments can help to ‘tie hands’ and exert external pressure. Secondly, rather than imposition of strict benchmarks and milestones to meet the idiosyncrasies of individual economies, the integration framework should facilitate and encourage the growth of regional economies while allowing the market to work freely. Thirdly, it

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<sup>138</sup> Stark, J. (2012). Crisis and Recovery in Emerging Europe: The Policy Response in Retrospect and Challenges Ahead. In T. Bracke & R. Martin (Eds.), *From Crisis to Recovery: Old and New Challenges in Emerging Europe* [electronic resource]: Palgrave Macmillan.

doesn't matter how much integration or liberalization has been achieved in the region, but what matters is that regional approaches and small steps of cooperation result in increased integration which can bring more growth, development and stability while lowering associated contagion-driven risks.

Risks flowing from cross-border financial crises tend to intensify within integrated markets. The more integrated is a regional market the higher the propensity for cross-border contagion. The cascading effects of the on-going Eurozone crisis are a vivid reminder of the contagion risk in a highly integrated system.<sup>139</sup> The EU crisis is a powerful reassertion of the same reality that reflects on the vulnerability of economically integrated markets in times of crisis when national responses prove insufficient to deal with the common issues in an economically integrated area.

Given this context, the European example constitutes a major significant precedent and as a laboratory of economic, legal, and political integration transcending national borders.

The Eurozone debt crisis has clearly exposed the weaknesses of regulatory structures divided along national lines when these have to deal with integrated cross-border financial markets. It has also highlighted the limited range of policy choices available from within the EU / EMU system as it existed prior to 2008. As a result, the EU faces a number of hard choices extending to the intractable trade off between national sovereignty and collective financial stability. The plans to establish a European banking union within the boundaries of the Eurozone, which will include a single supervisor and, in the future, a single resolution authority and a pan-European deposit guarantee scheme, have clearly tilted the balance towards further centralization and pooling of sovereignty.

From the EU regulatory reforms discussed above, three initiatives stand out. First, plans to centralize supervision for Eurozone banks through the SSM, which will come into force in 2014. This will mean that the ECB<sup>140</sup> is poised to take over as the prudential supervisor of the Eurozone banking sector. Second, EU plans for the harmonization of member state resolution laws and introduction of integrated resolution structures are in the process of implementation.

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<sup>139</sup> ADB. (July 2012). Asian Economic Integration Monitor: Asian Development Bank. [http://www.aric.adb.org/pdf/aeim/AEIM\\_2012July\\_FullReport.pdf](http://www.aric.adb.org/pdf/aeim/AEIM_2012July_FullReport.pdf).

<sup>140</sup> It should also be noted that the ECB had never had a 'treaty-based' mandate to act as shock-absorber in the Euro area sovereign debt markets. Absence of this mandate will continue to represent a missing link in the EU reform process.

Third, the development of common EU rulebooks for the single market by the European Supervisory Authorities is proceeding rapidly. Another area of particular importance is the adoption by the EU, through the ESM (and the European Banking Union), of measures, which aim at breaking the link between levels of sovereign indebtedness and bank bail outs. A very important lesson is how the EU has recently apportioned the costs of the Cyprus rescue to private stakeholders, such as shareholders, bondholders and large depositors, treating essentially the latter as investors.<sup>141</sup>

EU Member States have set up, in the course of the last 60 years, institutions in order to manage the challenges of a multi-faceted integration process and provide acceptable structures for political and democratic accountability. EU institutions have also been used by the Union in order to accumulate knowledge and expertise that may be useful in responding to new challenges. But we should be careful in arguing that the EU institution-building experience, or for that matter the EU integration process, given the specific characteristic of internal market,<sup>142</sup> can be used as the only reform template, although they can indeed provide model lessons to the rest of the world.<sup>143</sup>

The impact of institutions dealing with financial markets has mostly been ignored, probably because economists regarded such impact as ‘unimportant’<sup>144</sup> in a free market environment. So while the EU is obliged to take drastic steps to cover gigantic gaps in its policy and regulatory framework to prevent irrevocable fractures in financial integration, it still needs to proceed with caution, as all this is untested territory. This caveat puts the usefulness of lessons drawn on EU institution-building experience in the right context.<sup>145</sup> Moreover, it should be noted that the ECB had never had a ‘treaty-based’ mandate to act as shock-absorber in the Euro area sovereign debt markets. Absence of this mandate will continue to represent a missing link in the

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<sup>141</sup> For a complete analysis of the Cyprus bailout plan and of its implications see Financial Times, In depth, ‘Cyprus bailout’, available at <http://www.ft.com/in-depth/cyprus-bailout>

<sup>142</sup> For example, the EU has a rather well developed banking sector that eventually became a threat to the fiscal position of certain member states. The size of Eurozone’s banking system as a share of overall economy stood at over 300 percent in the pre-crisis period, whereas by a comparison, the banking system forms only 100 percent of the overall economy for the US. This implies that the largest euro area banks are a much larger part of any individual national economy within the EU zone.

<sup>143</sup> Wouters, J., & Ramopoulos, T. (2012).

<sup>144</sup> Allen, F. (2001). Do Financial Institutions Matter? *Journal of Finance*, 56, 1165-1175.

<sup>145</sup> Allen, F., & Carletti, E. (2011). New Theories to Underpin Financial Reform. *Journal of Financial Stability*. doi: 10.1016/j.jfs.2011.07.001

EU reform process. Finally, the European Banking Union may not be seen as an entirely irreversible development. Taxpayers and governments from both the core and the periphery of the Eurozone may, in the end, decide that the wider and abstract good of further European integration and of the stability of the single market is not worth the loss of sovereignty, and perennial austerity and sacrifice of national interest that they seem to entail. Accordingly, East Asian economies, must find which parts of the European project are successful and suitable to them to adopt and which parts are either of dubious success or would lead to an intolerable loss of sovereignty in a region that is not accustomed to any considerable degree of political integration.

Where, however, the EU experience is invaluable is in supplying policy-makers with irrefutable evidence about the axiom that, although financial markets may be established anywhere, provided that certain property rights are recognized by local law, in the absence of restrictions on cross-border flows, their stability may only be guaranteed through appropriate institutions and not by reliance on market forces' rationality and co-ordination. Therefore, arrangements to safeguard the stability of the cross-border market cannot be delayed until formal integration efforts reach a peak, whether in the form of establishment of a single currency area, or otherwise.

The complexities involved in harmonizing common practices, standards, and specifically the legal rules for such diverse economies mean that European Banking Union type institutions are not feasible in the foreseeable future. Yet this does not mean that the leadership of those countries should not think about the challenges to financial stability created by increasing market integration and financial interconnectedness in the region. It only means that for the time being, other less strongly integrative measures, such as subsidiarisation, are probably more suitable and effective in the East Asian context than the EU's plans for centralization of cross-border bank supervision and resolution. In addition, while establishment of a single regulator with power to intervene and discipline banks is probably not feasible at present, building a macro-supervisory umbrella is essential. In such a case, the function of macro-prudential oversight ought to be discharged by an independent body in order to secure credibility and authority, even if it is a soft law body.

Arguably, in an increasingly globalised world, formal international cooperation in the field of financial stability and cross-border bank supervision and resolution, might in the long



run come to be seen as a necessary ingredient of national prosperity in an environment where national financial markets are closely integrated.<sup>146</sup> This would become especially the case if ongoing national and regional reforms prove to be less successful than expected.<sup>147</sup> Building multilevel financial governance in a region as economically and politically integrated as the EU is infinitely less complicated than a similar attempt at the global scale. The same might apply to replication of EU plans in another region. Of course, in the end prove, institution building may prove more a challenge to be overcome rather than an insurmountable stumbling bloc. Either way policy-makers should not assume that they have ample time to deliberate before another major crisis breaks out. They should urgently start with the business of augmenting the global and regional financial stability mechanisms in order to safeguard future economic prosperity and the lessons drawn on the Eurozone crisis may prove very useful in this process.

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<sup>146</sup> For an example of such a model for the governance of global financial markets see Avgouleas, E (2012).

<sup>147</sup> E.g., James Barth contends that not everyone is convinced of the new regulations in place (in case of the US, the Dodd-Frank Act) has solved the too-big-to-fail problem, yet, the biggest banks have not been downsized despite the presence of a general consensus from various stake-holders. He quotes from Sheila Bair (Former FDIC Chair, Fortune, February 06, 2012), Richard Fischer & Harvey Rosenblum (FRB of Dallas, Wall Street Journal, April 4, 2012), and, Simon Johnson (Professor at MIT, Bloomberg, October 10, 2011). See, Barth, J. R., & Prabha, A. P. (December 03, 2012). *Breaking (Banks) Up is Hard to Do: New Perspectives on Too Big to fail*. Financial Institutions Centre. Retrieved from <http://fic.wharton.upenn.edu/fic/papers/12/12-16.pdf>

