TOWARDS A EUROPEAN BANKING UNION:
Legal and Policy Implications

by

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INTRODUCTION

As a follower of Hyman P. Minsky I am humbled and honoured to be invited today by the institute that houses the living legacy of Minsky's ideas. The activities of the Levy Institute and the intellectual contributions of its associates, under the guidance of the most insightful President Dimitri Papadimitriou, constitute significant steps in my painful learning curve. Today I will share with you some personal thoughts on the forthcoming European Banking Union (EBU) as formed during my various professional lives in Brussels.

My presentation will thus revolve around the economic philosophy underpinning the creation of the Euro area (I). I will then focus on the EBU and its three main pillars (i.e., the Single Supervisory Mechanism (SSM) within the European Central Bank (ECB) (II); the Single Resolution Mechanism (SRM) for banks and investment firms (III); the Common Deposit Guarantee System (IV)). I will also discuss the necessity for an EU fiscal backstop to support the recapitalization of banks (V) and for structural reforms (VI). I will conclude by discussing the advantages and challenges of the EBU (VII) as well as the political dynamics that it sets in motion leading to the creation of the European Political Union and Federation (VIII). Throughout my presentation I will treat the recent Cypriot banking crisis as my "benevolent hypothesis" to demonstrate the value of promptly completing the EBU.

I. MAASTRICT'S vs MINSKY'S FINANCIAL INSTABILITY HYPOTHESIS

The current economic and financial crisis has shattered the premises of the post-war European and international financial system. It has challenged established theories, like the rational expectations theory and the financial equilibrium theory, as well as institutions, policies and actors and has found them gravely failing. At the same time, it has vindicated Hyman P. Minsky's financial instability hypothesis (arguing that the causes of instability are endogenous to the system) that now constitutes the steady beacon for the reform of the financial systems.[i]

Minsky's financial instability hypothesis professes the necessity of institutions as circuit breakers to avert and mitigate recurrent endogenous crises of the financial system. It stands for resilient and apt supervision and crisis management institutions.[ii] In sharp contrast, the Maastricht Treaty financial hypothesis holds, albeit indirectly, that the private sector behaves rationally and that threats stem mainly from the indebtedness of the public sector. Thus, it merely prohibits bail-outs but lacks supranational supervision and safety net institutions.

The Euro area institutional design as well as a great part of the responses to the crisis have been influenced by a version of the ordo-liberal dogma of "*putting the house in order*". According to this, it would be necessary and sufficient if every Member State individually were to discipline ("*order*") its public finances and banking system for the whole system to function efficiently based on market competition ("*liberal*").[iii] The crisis has proven this dogma rather unsustainable. In fact, what seems rational and necessary within national boundaries may prove damaging if extrapolated in an economically interdependent framework that ignores negative externalities.[iv] We now know that within a single currency zone of 17 Member States with a highly interconnected banking system not all partners will always behave rationally and responsibly.

The lack of adequate supervision and crisis management institutions has been one of the major causes of the protracted Euro area crisis. Against every historical experience some thought that the so-called "European Paradox", i.e. a single currency zone with different national banking supervisors, would be sustainable. However, a zone of advanced economic interdependence like the Euro area renders indispensable the creation of solid supranational institutional and political frameworks which will be able to deliver the "public goods" of financial stability and financial integration.

In addition, the Maastricht hypothesis up to recently ignored the perennial **financial trilemma.**[v] From the three policy objectives, i.e., financial integration, financial stability and national banking supervision, only two can be achieved at the same time. For example, during the Cypriot banks' crisis in order to maintain financial stability

through national supervision Cyprus had to compromise financial integration by imposing capital controls.

The financial and economic reality also supports the establishment of the EBU. In the EU banks provide up to 75% of the total financing in the European economy. In the last four years €4.5 trillion from taxpayers' money and state guarantees (37% of the EU GDP) have been committed to support and guarantee ailing banks in the EU. However, these individual national interventions have proven inadequate to avert the Euro area crisis and have rather exacerbated it. As the events in Ireland, Spain and most recently in Cyprus show, the Euro area crisis is fundamentally a crisis of the banking sector. At the same time the "Too Big To Fail" concern, though not as hotly debated in Europe yet as is in the US, is nonetheless even more relevant for the EU;[vi] the top ten European banks' balance sheets exceed by 50% the GDP of their home countries, while 5 of them have over 100% of their home countries' GDP.

Thus, it is not by chance that the EU is dramatically reversing its ruling political and policy assumptions of subsidiarity (which traditionally allocated supervisory powers to Member States) and is building supranational institutions for countering the process of financial instability. Hence, one of the two fundamental components of Minsky's financial instability hypothesis, i.e. the need for a "system of interventions and regulations that are designed to keep the economy operating within reasonable bounds",[vii] is tested with the EBU.

My main argument is, first, that when completed the EBU will significantly contribute to the financial stability and efficiency of the European banking system. It will **break the vicious circle between banks and sovereigns**. It will reverse the fragmented single financial market and will reactivate the monetary transmission mechanism of the ECB thus allowing the financing of the real economy. The EBU will also create a shock - absorber mechanism protecting especially periphery Euro area Member States which suffer from asymmetric shocks. It will also force supervisory discipline upon large systemically significant banks in both periphery and center EU Member States. Second, the EBU constitutes an **indispensable part of the EU monetary union and a stepping stone towards the EU fiscal and political**

union. Third, the EBU through the stabilization of the European banking system will also contribute to the **global financial stability and open markets**.

II. THE NEW EUROPEAN SUPERVISORY ARCHITECTURE FOR BANKS : THE SINGLE SUPERVISORY MECHANISM (SSM)

- **A European Two-Tier Supervisory System**

The SSM Regulation, on which a political agreement was achieved on 19 March, establishes a two-tier supervisory system comprising at the first tier the ECB as the European Supervisor and at the second tier the National Supervisory Authorities. We should think of this new supervision system as a functional network of supranational and national supervisors (a "cooperative federalism") that creates synergies between them.[viii]

The EU's choice to designate the ECB as the European Banking Supervisor was heavily influenced by institutional and legal considerations. Article 127(6) TFEU provides that the Council may unanimously confer specific tasks upon the ECB concerning policies for the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. The setting up of an agency based on Article 114 TFEU would have been more complex as agencies cannot have discretionary powers according to the Court of Justice of the EU ("CJEU") case-law that are essential for supervision. As regards its scope, it is worth noting that the SSM does not currently extend to investment firms and depositories.

More importantly, by rendering the ECB the supervisor of large banks the EU brings within a single EU (supranational) institution the three fundamental functions of any Central Bank, i.e.: the monetary function, price stability; the financial stability (micro- and macro-prudential supervision); and payment systems. States which prior to the crisis removed supervisory tasks from their Central Banks paid a heavy toll and are now returning them back. Actually, up to the advent of the Euro in several Member States both these functions were exercised by the Central Banks.

Finally, the ECB is an independent EU institution whose credibility was enhanced during the crisis.

- **Tier I – ECB:**

Within the scope of the ECB's supervision will fall:

i) Large banks: The criteria for qualifying a bank as "large" are the following:
   1. the size of the bank;
   2. the importance of the bank for the EU economy or/and for the economy of the participating Member State;
   3. its cross-border activities, e.g. is how many subsidiaries it has in various Member States.

ii) The three biggest banks in each Member State;

iii) Any banks benefiting from the assistance of the European Stability Mechanism (ESM).

Furthermore, the ECB will also have the power to **bring under its supervision any bank at any moment** if, regardless of its size, it is considered as raising systemic threats. This open-ended clause becomes important in view of the systemic risks for a Member State's or the Euro area's stability that could potentially stem from domestic banks.

Thus, the ECB will become the supervisor of around 150 large, systemically important European banks whose assets will amount to 80% of the EU banking assets. It will be dealing primarily with the systemically important banking groups while national supervisors will have an important role to play under its control and guidance. The ultimate responsibility for banks and their systemic stability, regardless of their size and country of establishment, will rest with the ECB. The new supervisory system will have the ECB at its center which will ensure a working and efficient relationship with the National Supervisory Authorities.[ix]

ECB Supervisory Powers

The ECB will enjoy vast micro-prudential and macro-prudential supervisory powers including: the granting and withdrawal of authorization; the approval of acquisitions

and disposals of major shareholder participation (except resolution); and the supervision of financial conglomerates.

The ECB will also be entrusted with the **implementation of the Single Rulebook** which applies to the 27 Member States. The Single Rulebook will include, amongst others, EU Regulations (which are directly applicable upon their addressees) that cover 75% of all capital adequacy rules. However, the ECB as the supranational banking supervisor will have to apply the Single Rulebook even where the relevant rules are contained in EU Directives which need to be transposed by Member States and thus are not uniformly applied. For example, the CRD IV Directive comprises 25% of all capital requirements and grants Member States a number of options and discretions. This means that while the ECB could find itself implementing different national capital regimes depending on the Member State choices it will also be able to ensure through its own regulations a coordinated framework to diminish potential discrepancies.

Both the National Supervisory Authorities and the ECB will have **macro-prudential supervisory powers**. National authorities when implementing capital adequacy rules may apply higher macro-prudential capital requirements (capital buffers, countercyclical buffers) in addition to own funds requirements. In this case they should inform the ECB which may object. The ECB may also request higher requirements for capital buffers than those applied by national authorities and in addition to own fund requirements. The ECB will play an important role in that it will ensure coordination in this field by setting *ex ante* rules so that macro-prudential measures are not used by National Supervisory Authorities as a cover-up for protectionist reasons. This is important in view of this deleveraging period where national supervisors might be tempted to ring-fence capital and liquidity to direct finance to domestic needs. Finally, in case national rules are violated the ECB has the right to ask the national authorities to impose the sanctions provided by national law.

The ECB's relation with non-participating Member states is also linked to the operation of two bodies in which all 27 Member states participate. First, the European Banking Authority (EBA) which is composed by the banking supervisors of the 27

Member States and promotes the European Single Rulebook since it is entrusted with the preparation of regulatory standards. Second, the European Stability and Risk Board (ESRB) which, even though does not issue any legally binding instruments, contributes in the shaping of macro-prudential policy since it has the overview of the 27 economies and financial systems.

- **Tier II – National Supervisory Authorities Powers**

Under the new supervisory architecture national authorities will have supervisory powers over banks that will not come under the ECB supervision (e.g., smaller banks that do not raise systemic risks). Furthermore, they will maintain their powers relating to consumer protection, money laundering and will supervise branches of banks from third countries.

- **The Governance Structure of the European Banks' Supervisor**

The new supervisory governance structure will be hosted within the ECB and will comprise:

a) the ECB's **Governing Council,** which is provided by the Treaty and comprises the members of the Executive Board of the European Central Bank and the Governors of the national central banks of the Euro area Member States. The Governing Council is the only body which can adopt legally binding decisions; and

b) the **Supervisory Board** which is a new body created by the SSM Regulation and comprises: the Supervisors of banks of the participating Member States, i.e. of the 17 Euro area Member States; members of the ECB Executive Board; and banking Supervisors of any other Member State that opts in. The Supervisory Board cannot adopt legally binding decisions but will undertake all preparatory work and will submit draft decisions to the Governing Council.

This structure within the ECB raises some institutional, legal as well as functional issues:

First, the Treaty provides that the ECB should be independent in carrying out its monetary function. Thus, the SSM Regulation aims at averting potential conflicts of interest by ensuring the administrative and functional separation between the ECB's monetary policy and its prudential supervision tasks. This delicate institutional construction has given room to criticism suggesting the need for a Treaty revision. However, regardless of any merits that this separation may have, one should not disregard the important synergies that can be developed between monetary policy and prudential supervision, especially in the macro-prudential area, therefore enhancing financial stability.[x]

Second, non-Euro area participating Member States cannot take part in the Governing Council which adopts legally binding decisions. Therefore, the SSM introduces certain safeguards for these Member States , including:

- The right not to comply with a Governing Council Decision which contradicts the Supervisory Board proposal for decision; nevertheless, the Council may finally decide whether it will suspend or terminate the close cooperation with this non-euro participating Member State;
- The right to disagree with Supervisory Board draft decisions and exit the SSM for three years. However, I believe that in a well-established and functioning union decisions should in principle be taken by majority thus obliging even dissenting members to comply. Furthermore, some may argue that an exit of a non-Euro area participating Member State may have a negative impact on the SSM's credibility. However, I think that in practice a non-Euro area participating Member State will be hesitant to leave the SSM since this might have serious implications upon investors' and depositors' perception concerning their financial stability.[xi] In this respect, the independence of the Supervisory Board from any national and industry bias when performing its tasks will be of paramount importance for the credibility of the whole mechanism.

- **The European Banks' Supervisor and the Cypriot Banks**

Had the SSM been in place earlier, **the Cypriot crisis would have either been prevented or its effects would have been significantly minimized**.

The ECB would have been the supervisor of at least the three biggest Cypriot banks. As an independent and impartial supervisor it would have been able to take early intervention measures (in cooperation with the national recovery and resolution authorities). More specifically:

a) The ECB would have not allowed the paradoxical liability structure of the Cypriot banking system whereby deposits constituted a dangerously disproportionate part while bondholders and shareholders were an insignificant part of the liabilities.
b) The ECB would have spotted the main dysfunctions of the banking system, e.g. the excessive high rates offered to induce depositors, and could have imposed caps on rates for time deposits.
c) The ECB would have spotted the bubble and would have asked for additional macro-prudential capital buffers.
d) The ECB would have intervened to curtail the Cypriot banks' excessive investments in Greek bonds between 2009 – 2010 as well as the over concentration of large loans to the same few clients.
e) Finally, the ECB could have requested the imposition of sanctions by the national authorities.

III. EUROPE'S STRATEGY FOR THE RESOLUTION OF BANKS: THE SINGLE RESOLUTION MECHANISM (SRM)

While the Lehman Brothers failure was a sharp awakening for the need of global and European resolution arrangements, the recent Cypriot banking crisis and the initial decision of the Eurogroup of 16 March 2013 to bail-in uninsured depositors of two Cypriot banks highlighted the importance of establishing a stable legal framework for the resolution of banks. The Single Resolution Mechanism (SRM), as proposed by

the EU leaders, in combination with the SSM will be vital in breaking the vicious circle between banks and their sovereigns.

Last spring the Commission published a proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms ("**BRR Directive**") which aims at setting up resolution authorities and resolution funds in every Member State. These resolution funds will be financed by the banking industry. Thus, ailing banks would undergo a resolution process rapidly and with minimal costs while maintaining their critical "utility functions" (i.e., payment systems, deposits, etc.). The fundamental principle is that banks should be saved without having recourse to taxpayers' money ("bail-out"). For the resolution of cross-border banks the BRR Directive sets up a network of national resolution authorities and funds which should closely cooperate. The EBA should also have sufficient powers to facilitate the resolution process in cross-border cases. The proposed directive is in line with global policy initiatives like the "Key Attributes of Effective Resolution Regimes for Financial Institutions" of the Financial Stability Board, which was endorsed by the G20 Leaders in November 2011, and draws inspiration from national laws like the UK Banking Act of 2009.[xii]

Furthermore, the BRR Directive provides a number of **resolution tools**, including the **bail-in procedure** whereby first are called in shareholders and then unsecured bondholders ranking *pari passu* with uninsured depositors. This means that when a bank's losses exceed its capital (equity, capital tier I and II) there should be a pro rata sharing between uninsured depositors and unsecured bondholders. Secured bondholders (including covered bonds) and covered depositors are excluded.

The ECB and some Member States that have a different system of ranking of claims argue that given the crucial importance of deposits for banks' finance and for the stability of the system there should be a "**depositors' preference**", i.e. uninsured depositors should incur losses only after unsecured bondholders have taken a loss (have been "wiped out"). This would reinforce banks' loss absorption capacity and would avert a potential depositors' run on the banks. In addition, this approach is thought to incite bondholders to exert stricter control on the way banks conduct their business. Depositors' preference is already known in the US as well as in several

G20 countries. Members disagreeing with this concept argue along the lines of the traditional insolvency law principles that there is no reason to distinguish between creditors, be it bondholders or depositors, as this would increase banks' financing costs. Other ideas for enhancing banks' loss absorption capacity and minimising the losses of depositors advance that banks' capital structure should include sufficient designated bail-in instruments with clear pre-specified contractual terms (preventing other banks from holding them) which will be attractive to investors and which can be written down during the resolution process. Regardless which view will finally prevail, it should be consistent with the principle of level playing field which could be seriously hampered in case of diverging national solutions.

The BRR Directive, cognizant of the significance of global arrangements, provides a framework for **cooperation with third country authorities**. Under the proposal, EU authorities will support third country resolution actions concerning a failed third country bank with activities in the EU by allowing the transfer of its assets and liabilities that are located in or governed by the law of any EU Member State. However, such support will only be provided if the foreign action ensures fair and equal treatment for EU depositors and creditors and does not jeopardize financial stability in any EU Member State.

Rationale for a European Resolution Mechanism

In spite of the steps taken for the harmonization of the national resolution regimes of the 27 EU Member States I believe that there are compelling reasons for the adoption of the SRM in the near future.

First, the European Council in December 2012 undertook the political commitment to establish the SRM as a corollary to the SSM. The SRM will comprise a Single Resolution Authority and a European Resolution Fund.

Second, under the SSM the ECB will have the power to definitely withdraw the authorization of any bank and this will necessitate the intervention of national resolution authorities and their resolution funds as established under the BRR

Directive. In case national authorities do not agree with the ECB's decision and proposal, e.g. for bail-in, but rather prefer bail–out the failing institution, this could delay the necessary actions and increase costs, especially in case of large and cross-border banks. As the Cypriot crisis revealed, the ECB can act as a de facto resolution authority by threatening to cut liquidity to ailing banks. This confers to it disproportional (and probably unsolicited) resolution powers for which it would not be fully accountable to the EU's political authorities.

Third, it is doubtful whether the resolution of systemically important cross-border banking groups will be dealt with through the cooperation of national authorities as in these instances decisions must be taken rapidly while limiting costs and systemic implications.

Finally, National Resolution Funds may not be able to cover the relevant resolution costs in which case they should be able to resort to a European Resolution Fund.

- **Legal issues concerning the establishment of the SRM**

Some politicians have voiced their concerns over an allegedly thin legal basis for the establishment of the SRM. They fear that this could open the door for legal challenges in the national constitutional or/and the European courts which would lead to economic and political uncertainty. To overcome this obstacle they suggest revising the Treaties which, however, is a lengthy procedure entailing ratification by Member States' parliaments or through referenda. Notwithstanding these concerns, the Commission has declared already that its proposal can be launched within the existing Treaty powers.

As the cooperation of national authorities cannot always warrant adequate solution to cross-border resolution, a single European body endowed with important decision-making powers should be established. Pending the Commission's proposal which should be delivered before this summer, it is still unclear **which authority could act as the Single Resolution Authority**.

In academic articles there is an *in abstracto* debate for optimal authorities based on general economic considerations. Nevertheless, apart from these any choice must primarily respect the existing EU legal order. This means that the Single Resolution Authority will either be housed **within current institutions** which have the power to adopt legally binding decisions (i.e., the Commission and the ECB) or **within a new body** (e.g., an agency/authority). Some have even proposed assigning these tasks to the **EBA**; however, while the EBA stands for the 27 Member States and will have some powers concerning mediation in cross-border resolution under the BRR Directive, agencies cannot have discretionary powers according to EU law and CJEU case-law when adopting decisions. In addition, it is often argued that agencies are not sufficiently politically accountable. Others advance the **ESM** which, however, serves different purposes and has a rather burdensome requiring unanimity for decision-making procedure and endorsement by some national parliaments . Finally, a **revision of the Treaties** aimed at the creation of a Resolution Authority is also proposed; despite its mid-term merits, this is not absolutely necessary and goes against the urgency of the whole undertaking.

As far as the SRM scope is concerned, it would be necessary that the same Member States covered by the SSM also fall within the SRM's scope. Thus, it would be important for the credibility of the EBU if both structures were to come into force at the same time. This would reassure also some Member States that while supervision decisions will be taken at the ECB level they would not be left alone when one of their banks has to undergo the resolution process.

- **The EU Framework for Resolution and the Cypriot Banks**

Had the BRR Directive and the SRM been in place, the **Cypriot banks' problems** could have been contained because a framework for the orderly resolution of banks would exist. More specifically:

a) A sound legal framework is needed to dispel the false impression that the choice of method for bank restructuring and resolution depends on the solvency of the sovereign. In other terms this *à la carte* approach would mean

that if the sovereign is weak then it would bail-in investors and bondholders whereas if the sovereign is strong then it could opt for a bail-out.

b) Cyprus would have been equipped with a national resolution authority and fund. In addition, the resolution rules, including bail-in, would have been previously known to investors, creditors and depositors.

c) In case the resources of the National Resolution Fund would not suffice the European Resolution Fund would come in support and the ESM could directly recapitalize the banks.

Therefore, the resolution of the Cypriot banks would not have any systemic implications, and would not have made headlines internationally but would rather be like the resolution of hundreds of US banks by the FDIC which has not affected investors' and depositors' confidence.[xiii]

IV. BANKS RECAPITALISATION: ESM AND THE EU FISCAL BACKSTOP

The Cypriot banks' crisis has also brought to light the role that the **ESM could play in the recapitalization of banks undergoing resolution**. Currently, it is still not clear which would be the relationship between the EU and national resolution funds and which entity could undertake the role of the fiscal backstop, i.e. the body that would provide finance as a means of last resort. Until a decision is reached upon which body will be the EU fiscal backstop for ailing banks part of its tasks can be assumed by the already established ESM, provided that its rules are properly amended.

The political agreement of last June (European Council of 29 June 2012) stipulated that Euro area banks supervised by the ECB can **benefit directly from ESM financing** for their recapitalization under certain conditions, i.e.: a) after the establishment of the SSM; b) subject to conditionality; and c) in compliance with State aids rules. The decision of the European Council on 18/19 October 2012 reconfirmed the possibility of banks' direct recapitalization by the ESM following the adoption of the SSM.

An important issue under negotiation is whether the recapitalization of ailing banks by the ESM will cover **banks' "legacy loans"** or only loan losses incurred after the establishment of the SSM. On this there are two rather diverging positions:

On the one hand, some Member States argue that the ESM should not cover "legacy loans".[xiv] As a consequence, Member States "at fault" should bear the cost of restructuring. This view is rather reflected in the recent Ecofin decision on Cyprus which implies that investors and uninsured depositors of ailing banks as well as their States should bear the losses first and only then could the ESM provide its support.

On the other hand, it is advanced that up to the setting up of the European Resolution Fund, the ESM should be directly financing banks' legacy loans as there is a shared responsibility and liability amongst Euro area Member States. This is so since the so-called "creditor" states' banks and their supervisors are also responsible and liable for allowing the profligate over-lending to debtor states and to their banks. If not, debtor State' budgets would be called to bear alone a disproportionate burden for supporting their ailing banks, thus increasing their debt and perpetrating the vicious circle between banks and sovereigns.

Though not officially a pillar of the EBU, the existence of a credible EU fiscal backstop for the European banking sector is of fundamental importance.[xv] National Resolution Funds would be first responsible to provide the necessary financial support to banks subject to resolution and, in case their resources were not sufficient, the European Resolution Fund would intervene. However, until the European Resolution Fund is established and sufficiently funded, the ESM could be the backstop for banks' direct recapitalization. Of significance for the EBU as well as for the integrity of the single financial market is the possibility of providing this financial back-stop also to non-Euro area participating Member States whose banks may have to undergo the resolution process.

V. EUROPEAN DEPOSIT GUARANTEE SYSTEM

The crises in Greece and Cyprus made clear that depositors' confidence in banks is proportional to the solvency of their State. Absence of such confidence leads to a massive exodus of deposits from periphery banks to banks of the center. In addition, the Cypriot case underlined the important link between the resolution bail-in procedures and security of deposits. In the EU the Deposit Guarantee Directive ensures protection of deposits of up to €100,000. There is currently an on-going negotiation for its revision aiming to secure *ex ante* financing for the national deposit guarantee systems and speedy reimbursement procedures. However, it is unclear whether this Directive explicitly obliges Member States to support their depleted deposit guarantee systems, as shown from the Icelandic *Icesave* case. In that case the EFTA Court held that the Directive does not impose such an obligation upon States since deposit guarantee systems are not in place to backstop systemic crises. Nonetheless, the European Court of Justice (CJEU) has not examined this issue yet.

The political sequence of events leading to the completion of the EBU implies that the adoption of the SRM and ESM are preconditions for introducing the Common Deposit Guarantee System at a later stage. A Common Deposit Guarantee System as a backstop to national deposit guarantee systems would ensure that insured depositors enjoy the same level of protection, regardless of the sovereign supporting them. In other terms, a full banking union will exist not only when banks are subject to supervision at the EU level but also when mechanisms for the resolution of banks and deposits' protection (both implying a risk sharing) are established at the same (EU) level.

VI. STRUCTURAL BANK REFORMS: Does Europe needs a Volcker Rule?

According to Minsky **the structure of the financial system determines financial stability.** While the US has been at the forefront of this regulatory reform with the adoption of the rule named after the legendary Central Banker Chairman Paul Volcker, in Europe the relevant discussion has only recently started. For quite some time now the Second Banking Directive allowed universal banks to provide the full

spectrum of their services on a cross-border basis.[xvi] Large EU banks are mainly universal banks. Reform of the banking sector's structure is not only a means of containing systemic risks ("Too Big To Fail") by avoiding cross-subsidies, regulatory arbitrage and facilitating resolution. It is also a matter of vital importance for the functioning of the single financial market. During this period several Member States, including the UK, Germany and France have undertaken structural reforms of their banking systems. Thus, unless the EU adopts a harmonized approach, diverging national measures will inevitably hamper the functioning of the single market. This, for instance, would be the case if branches of banks from Member States that allow universal banking provide the same range of services in other Member States that have imposed upon their own banks the separation of their commercial and investment activities.

In October 2012 **the Liikanen Group** report explored the need for structural separation of the banks in Europe.[xvii] It proposed that proprietary trading and market making be placed in a separate legal entity which should be away from the deposit taking part of the same banking group. The separation could be completed by individual capitalization per entity and is thought to facilitate recovery and resolution. Economically and politically such reform should take into consideration several fundamental issues, including: the preservation of European banks' competitiveness; its impact on the financing of the economy; the risk of regulatory arbitrage and development of the shadow banking sector; the need to reduce the likelihood of future financial crises; the degree of protection of depositors and taxpayers; and, the risk inherent in the absence of coordinated reform at European level. The Commission will submit relevant proposals soon.

VII. ADVANTAGES AND CHALLENGES OF THE EBU

The completion of the EBU is necessary and urgent in order to reverse the financial fragmentation of the Euro area and of the single financial market, to de-freeze the monetary transmission mechanism and enhance the provision of bank financing on a cross-border basis. This will reinforce financial stability and financial integration by addressing the Euro area's nexus problem between banks and sovereigns. It will speed

up the restructuring of the banking sector of all Member States which is a real challenge for "putting the banking home in order". It will mainly allow the **rebalancing of the asymmetric access to finance between Northern and Southern Member States** thus enabling the latter to have access to cheap finance, attain their growth and job creation objectives and exit the crisis.

During the process of completing the EBU several dangers loom ahead. Given the important stability concerns but also lack of robust EU institutions, **national supervisors tend to ring-fence foreign banks' assets** and liquidity within national boundaries. Some of them even force foreign banks' branches to capitalize, thus turning them into de facto subsidiaries. In some cases they also unjustifiably require additional capital buffers for foreign subsidiaries, even though they are part of cross-border groups and thus their assets and liabilities should be matched on a group rather than on a national level. Should this trend gain momentum and take a structural shape (i.e. banks revise their structures according to these national protectionist policies) there is a serious risk of fragmenting and renationalizing the single financial market and depriving the European economy of the much needed finance for growth.[xviii]

It is even questionable whether ring-fencing can actually ensure financial stability for the host Member States since assets and liquidity can be transferred from the subsidiary to the parent bank with a push of the button overnight. The ring-fencing of national markets via subsidiarization will hamper the efficiency gains of the single market and will limit the regional strategies of European banks. **Subsidiarization, de *facto or de lege*, could prima facie violate EU law** (e.g., right of establishment) since it obstructs the free passporting of banks' branches throughout the EU which is the quintessence of the single financial market. The advent of the EBU and its prompt implementation will address the problems raised by the home/host allocation of supervision powers, at least for participating Member States, and will significantly reduce the incentives for supervisory protectionism.

The same challenges fall upon the global financial system which nonetheless lacks the institutional infrastructure of the EU, i.e. legally binding rules, sound institutions, as well as enforcement mechanisms and adjudicating procedures. G20 is an important

response to the global economic and financial crisis. Its effectiveness depends, amongst others, on the contribution of its major partners like the US and the EU that bear a heavy responsibility to ensure financial stability and open global markets.

VIII. FROM THE BANKING UNION TO A EUROPEAN FEDERATION

"How many borders do we have to cross before we reach home?" T. Angelopoulos , Ulysses' Gaze,1995

The advent of the EBU is a fundamental game-changer because it reverses the dominant during the last three decades political and institutional assumptions on subsidiarity which allocated banking supervision powers to national authorities. Since the Maastricht Treaty it is the most important conferral of Member States' powers to EU institutions. At the same time it sets in motion a broader reinforcement of European supranational structures:

First, with respect to its **geographic scope**, it is expected that the overwhelming majority of the non-Euro-area Member States will participate in the EBU in order to benefit from its financial stability mechanisms and enjoy the benefits of the single financial market. Even if some Member States remain outside, all the necessary steps should be taken to avoid any divides in the single banking market.

Second, during this period of deleveraging and restructuring of European banks the **ECB supervisory powers will inevitably expand** to cover smaller ailing banks presenting systemic risks or benefiting from EU financial assistance. This will tilt the balance towards the supranational tier of the system which will be a clear gain for financial stability and ensuring a level playing field.

Third, given the market developments there could be a need to complement the ECB banking supervisory structures with parallel **supranational supervisory structures for investment firms and insurance companies**. This would be necessary due to the cross-sector interconnectedness between banks and other financial institutions which raises systemic risks as well as the need to avoid regulatory arbitrage risks.

Fourth, the EBU renders necessary the establishment of a **Fiscal Union.** Dealing only with the ailing banking sector is not sufficient to break the vicious circle between banks and sovereigns; it is also essential to address sovereigns' public finance problems. This highlights the need for Eurobonds which should also be seen as a crucial component of a deep European capital market, able to provide competitive financing to the European economy.[xix] As the EU backstops (e.g. the ESM) will be using public money for risk sharing in support of Member States and/or the banking sector, such decisions must be made by genuine EU political institutions.

Minsky's main finding for exiting a crisis of monumental dimensions like the one of the 1930's is that a "Big Bank" (lender of last resort) and a "Big State" (significant fiscal power) are required. The EU has the first but lacks the second, i.e. a Treasury. This finding however presupposes a unitary state or a complete federal union like the US endowed with federal supervisory and crisis management institutions. Europe's challenge is to realize Minsky's proposal in a short period by rebalancing the dangerously asymmetric relation between markets and politics and by building institutions through the conferral of sovereign powers to the supranational level. In addition, the EU has to advance through "differentiated integration" (multi-level and multi-speed) as not all Member States are participating at the same time in these new structures.

Only through the building of strong and accountable supranational institutions can certain vital "public goods", including financial stability, be ensured. These institutions should be embedded within a Federation guaranteeing the dispersal of power, active citizen participation and proper judicial review. Above all this calls for political leadership grasping the challenges of interdependence and globalization while putting aside the relics of the Westphalian era that keeps Europe hostage from turning into a dynamic global player.

In the apex of the Euro area crisis the late great European visionary and Central Banker Tommaso Padoa – Schioppa captured marvelously the fundamental political challenge of Europe: "*in our era, the dynamics of history consist precisely of the search – largely unguided, often painful but inexorable – for an optimal distribution*

of power along the scale of ever-wider human aggregations, which are tied by common interests more than by tribal identity. The optimality can be gauged with a simple criterion: the consistency between the span of government and the "common good" entrusted to it, be this a public garden in the city, the administration of justice in the state, or climate change on the planet. ***Seen in this light, the advent of the euro is just an episode – a most significant one – in the building of a post-Westphalian order.***"[xx]

While I do not believe in the historical inevitability of things I do believe that Europe is undergoing a unique transformation, where political authority is trying to regain the ground lost to the markets, albeit on the supranational level. A European political union presupposes, among others, equal citizens and States and that cannot be based on metaphysical distinctions between "sinner" and "virtuous" or on mercantilist concepts of "creditors and debtors" which perpetrate the supremacy of economic jargon over the liberal political discourse. In essence, Europe cannot afford a new geopolitical and geoeconomic schism which would relegate it to the league of laggards of international competition.

Never before has European integration faced so acutely the litmus test of democratic legitimacy. The bold question is how much risk European societies and their citizens will want to take for supporting their ailing banks with their taxpayers' money while maintaining outdated national supervisory structures and stagnate economies. By the end of the day, the response should not be given only by central bankers but primarily by Europe's citizens and their political leaderships that for the time being seem rather hesitant.

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