The Eurozone Debt Crisis and the European Banking Union: Hard Choices, Intolerable Dilemmas, and the Question of Sovereignty

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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. This led to a threat of widespread bank failures in EU countries and near collapse of their financial systems. Today, in the wake of the Eurozone financial crisis and the recent Brexit vote, the EU is at a critical crossroads. It has to decide whether the road to recovery runs through closer integration of financial policies to follow recent centralization of bank supervision and resolution in the European Banking Union (EBU) 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 a key 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 EU leading up to the EBU without a discussion of the different forms of

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*** This article builds on the authors’ earlier framework of analysis on modalities and risks of financial integration initially presented in Emilios Avgouleas & Douglas Arner, The Broken Glass of European Integration: Origins and Remedies of the Eurozone Crisis and Implications for Global Markets, in INTERNATIONAL ECONOMIC LAW AFTER THE GLOBAL CRISIS: A TALE OF FRAGMENTED DISCIPLINES 72-106 (C. L. Lim & Bryan Mercurio eds., 2015) and Emilios Avgouleas & Douglas Arner, Ch. 10 Regional financial arrangements: lessons from the Eurozone crisis for East Asia, in GLOBAL SHOCK, RISKS, AND ASIAN FINANCIAL REFORM 377 (Iwan J. Azie & Song Shin eds., 2014). Though those earlier publications covered different ground we draw here on some (limited) text and references from this published work. The authors gratefully acknowledge the financial support provided by the Hong Kong Research Grants Council Project: Enhancing Hong Kong’s Future as a Leading International Financial Center.

integration and 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 obstacles to foreign direct investment (FDI). Monetary integration refers to formal currency alignments and interest rate cooperation between states supported through a variety of institutional mechanisms. It could take a stronger or a weaker form, depending on the nature of arrangements. The stronger form refers to an unequivocal decision between more than one jurisdiction to share a common currency and a single monetary and foreign exchange policy, as a result of a bilateral or multilateral agreement between interested states. It entails the establishment of a common central bank and shared responsibility for joint monetary policymaking. The weaker form of monetary integration essentially refers to exchange rate alignments, like the Bretton Woods system of fixed exchange rates, or even adoption of another country’s currency policy by means of currency board arrangements. In terms of sovereignty concessions the stronger form means abolition of the

2. For Röpke the free and reciprocal flow of trade between the various national economies is what defines economic integration. See Wilhelm Ropke, International Order and Economic Integration 72 (Gwen E. Trinks et al. trans. 1959) available at https://mises.org/system/idf/International%20Order%20and%20Economic%20Integration.pdf?file=1&type= document. Wilhelm Ropke was a “proponent of the Austrian School.” Shawn Ritenour, Biography of Wilhelm Röpke (1899-1966): Humane Economist, MISES INST. (Aug. 1, 2007), https://mises.org/library/biography-wilhelm-roepke-1899-1966-humane-economist. Thus, he was suspicious of other forms of integration such as political integration and attendant consolidation of political power. Id. He was one of the first economists to highlight “the connection between culture and economic systems,” and, uncharacteristically for an “Austrian,” he “explored the ethical foundations of a market-based social order.” Id. His ideas had significant influence over West German post-war economic development. See id.

3. “Monetary arrangements that supplement trade[es] relationships have existed for centuries.” Ellen E. Meade, Monetary Integration, HARVARD INT’L REV. (Mar. 21, 2009), http://hir.harvard.edu/rethinking-financemonetary-integration/. In the Eastern Roman Empire, “for example, the solidus coin—a money whose metallic content was stable—circulated widely” for more than seven hundred years. Id. Its predecessor, the denarius, was undermined by emperor Diocletian’s (284 – 305 AD) debasing of the metal content of the coin to cover the penury of the Roman treasury at the time due to continuous defensive wars. See Martin A. Armstrong, Diocletian – 284–305 AD, ARMSTRONG ECON.,https://www.armstrongeconomics.com/research/monetary-history-of-the-world/roman-empire/chronology-by-emperor/tetrachy/diocletian-284-305-ad/ (last visited Oct. 24, 2016). “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 the union did not establish a common monetary authority or currency.” Meade, supra note 3. Thus, they can hardly compare with the EMU. See id.


national currency and of member states’ ability to set interest rates. Yet weaker forms like currency boards also entail—in exchange of currency and economic credibility—loss of sovereignty over exchange rate setting and inflation targeting since the currency board country essentially imports the low or high inflation policies of the country of the reference currency.

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 and operation by financial intermediaries. It could extend to rights of establishment for foreign firms. 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 transact in financial instruments and/or provide financial services within a certain geographic area or region. Moreover, firms and consumers must have non-discriminatory access to such financial instruments and/or services. Regulatory oversight arrangements within integrated markets are non-discriminatory. Finally, political integration is equally important. It involves the voluntary sharing/pooling of sovereignty, whether in commercial and financial affairs, trade-policy cooperation/coordination, or in relation to justice and national security. Thus, given the sovereignty concessions, integrated markets require a lack of political integration that can hinder the flow of benefits emanating from monetary and financial integration.

A central idea of this article is that the design of institutions underpinning international financial integration has to be a step-by-step process. In the EU market integration took several decades, starting with the European Coal and Steel Community and the European Economic Community (EEC) and from there to the EU and ultimately to the European Economic and Monetary Union (EMU) and the introduction of the single currency.


8. The EU traces its origins to the European Coal and Steel Community (ECSC) and the European Economic Community (EEC). See Matthew J. Gabel, European Union (EU), ENCYCLOPEDIA BRITANNICA, https://www.britannica.com/topic/European-Union (last updated Oct. 17, 2016). 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.” See id. The ECSC was the first purely European organization in the postwar era to be based on the principles of supranationalism. See id.

9. The Maastricht Treaty established the European Union (EU) in 1993. See Gabel, supra note 8. The same Treaty introduced the charter of the European Monetary Union. See id. The
A key lesson EU financial integration offers is 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 was the case in the Eurozone before the advent of the European Banking Union (EBU). Namely, the end-point of any financial integration process is the establishment of common institutions to deal with financial sector supervision and crisis management. This, in turn, means the pooling of sovereignty. The United Kingdom’s decisions, first not to join the euro and second to exit the EU, reflect the likely unwillingness of nations to relinquish sovereignty to the extent necessary to achieve a fully integrated financial system.

This article 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, particularly in light of Brexit. It offers a critique of the process so far and discusses remaining gaps. Part V concludes with a discussion of potential implications of EU experiences for the future of international financial integration.

II. Building Blocks of the EU Single Financial Market

The EU constitutes the most advanced global laboratory for regional economic, legal, and political integration. At the same time, the advent of a banking crisis and a sovereign debt crisis—the two normally have a causal relationship—provides a key ground to test again the fundamentals of financial integration in the dual context of cost-benefit analysis and institution building. The establishment of pan-European banks has, of course, been the most potent integrative factor, in an environment marked, at least in 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-term protection of EU-wide financial stability in the absence of appropriate institutional arrangements.\footnote{For example, in 2005, Schoenmaker and Oosterloo conducted a statistical study spanning a four-year period (2000-2003) on the potential emergence of pan-European banking groups. See generally Dirk Schoenmaker & Sander Oosterloo, Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities, 8 INT’L FIN. 1 (2005), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.584.2073&rep=rep1&type=pdf. To this effect, they gathered “[a] new data set on cross-border penetration (as a proxy for cross-border externalities) of thirty large EU banking groups.” Id. They found a home country bias, but “the data indicated that the number of groups that have the potential to pose significant cross-border externalities within the EU context” was not only substantial, but also increasing. Id. 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.” Id. at 1-2.}

The so-called financial stability trilemma,\footnote{See generally Dirk Schoenmaker, The financial trilemma, 111 ECON. LETTERS 57 (Apr. 2011), http://personal.vu.nl/dschoenmaker/Financial_Trilemma.pdf. See also FINANCIAL SUPERVISION IN EUROPE 142-50 (Jeroen J.M. Kremers, Dirk Schoenmaker & Peter J. Wierts eds., 2003).} 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.\footnote{See Schoenmaker, supra note 12, at 57. Compare Lasta 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.” Rosa M. Lastra & Jean-Victor Louis, European Economic and Monetary Union: History, Trends and Prospects, 32 Y.B. OF EUR. L. 143 (2013), http://yel.oxfordjournals.org/content/32/1/143.full.pdf.} In spite of assertions to the contrary,\footnote{See TOMMASO PADOA-SCHIOPPA, THE ROAD TO MONETARY UNION IN EUROPE: THE EMPEROR, THE KINGS, AND THE GENIES (2000).} the Eurozone debt crisis has proven beyond doubt that a common currency area is not viable without building, at the same time, transnational supervisory structures in the fields of fiscal monitoring and responsibility and bank supervision and resolution. The loss of sovereignty essential in building a fully integrated economy can of course be intolerable and the recent Brexit plebiscite in the United Kingdom highlights the difficulty facing national polities to accept such loss of sovereignty in a multitude of fronts including the financial sector.

Arguably, an essential pre-requisite of financial market integration is imposition of a harmonized set of core rules, which gradually gravitate towards uniformity\footnote{See JACQUES DE LAROSIÈRE, THE HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU REPORT 27 (Feb. 25, 2009), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf. Uniformity in this context only means the need to have coherence and compatible rules and regulations across jurisdictions. See id.} and are binding on all jurisdictions comprising the single market. The absence of such uniformity can, in theory, seriously hinder market integration as it can give rise to regulatory arbitrage and hidden protectionism. On the other hand, while protectionism harms efficient group approaches to capital allocation and risk management within
cross-border banks, regulatory arbitrage may have the opposite effect. So, the key rationale behind maximum harmonization is not allocative efficiency in an integrated market but building trust between the players. Certainty that all players are being bound by the same detailed rules—even more so when application is uniform (by means of centralized supervision structures)—offers comfort to market competitors and supervisors that the risk of rule-gaming and racing to the bottom—that would essentially amount to free riding—becomes negligible.

There is no area where divergence of national rules and regulations is more important than cross-border 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 of 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 was 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 began much earlier than the late twentieth century, 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. This was, in general, a period characterized by a transition from autarky to integrated world capital markets, and, thus, for many it constitutes the first era of 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. Röpke stated that multilateral trade and free convertibility were 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 means of multilateralism and currency convertibility, the larger the advantages of economic cooperation. Yet evidence of the existence of a direct causal relationship between financial integration and economic growth remains inconclusive, as any economic growth benefits deriving from financial integration depend upon a number of preconditions necessary to facilitate the integration process.

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 prerequisite 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, one of the EU fundamental freedoms for building an internal market, the free movement of capital, became effective only after the signing of the Maastricht Treaty in 1992, a full thirty-five years after the Treaty of Rome, and then because it was essential in building a European monetary union and national restrictions in the free flow of capital could no longer be retained.

C. An Ever Closer Union?

1. The Political Economy of Market Integration in the EU

The European economic integration process and the establishment of the Euro as the common currency of (as of today) nineteen EU Member States has been incremental with periods of strong progress alternating with interludes of painfully slow growth. It has, also, been the product of political expediencies as much as economic efficiency rationales. Thus, it has witnessed major crises and setbacks.


22. Such integration prerequisites include domestic institutional reforms, the maintenance of adequate and enforceable property rights, and adequate controls on money supply. See generally Economic Reform in China, supra note 20, at 121.

Continental 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 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, 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, the establishment of the single currency was itself a matter of politics as much as 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. 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. But, as the euro-area has been very far from being an optimal currency area under the Mundell model and there was no fiscal integration or debt mutualization, it was only a matter of time before differences in the competitiveness of national economies gave rise to some serious strains. Arguably, 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. At the same time, the political element of the EMU, as well as a divergent economic and housing market cycle that had no realistic chance of converging with continental economies was central to the United Kingdom’s decision not to participate in EMU.

Nonetheless, the desire for a political union might not have been the whole story behind EU financial integration. 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 emerged as a result of national, legal, and regulatory impediments to capital flows.28 Given an excess supply of petrodollars in offshore markets, their scale began to rival national markets in banking and securities in the 1970s. This led to protracted negotiations in the early 1990s between industry representatives and regulators that brought offshore 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.29 Conversely, the 1966 Segre report was both very cognizant of the growth potential attached to financial integration and the potential for this objective to be confounded by commercial interests.30 In this way, the United Kingdom—as the leading center of the Eurobond and Eurocurrency markets—had a keen interest in participating in the process of financial market integration, while at the same time—from a political standpoint—maintaining its own economic and political sovereignty. This was a balance that has eventually proven impossible to hold.

2. 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 fulfillment of convergence criteria. Only countries that 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. But, such convergence proved in many cases no more than drawing board plans.

The Maastricht Treaty’s convergence criteria included two basic conditions for euro membership: firstly, a 3 percent limit on general government annual deficit and a 6 percent limit on general government

gross debt limit. 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. 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. Moreover, the difference in the macroeconomic “initial conditions” of the founding Member States made it


32. 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.” See Treaty on European Union, supra note 31, at 27. Provisions Amending the Treaty Establishing the European Economic Community with a View to Establishing the European Community, art. 104c(2)(a). 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 id. art. 104c(2)(b).

33. As a result of sluggish growth and loss of competitiveness due to inability to depreciate Italian national debt stands today at 142 percent, one of the highest in the developed world. National Debt of Italy, NATIONALDEBTCLOCKS.ORG, http://www.nationaldebtclocks.org/debtclock/Italy (last visited Dec. 1, 2016).

34. Under the Delors’ report, “[e]conomic union and monetary union form two integral” and equally important “parts of a single whole and would therefore have to be implemented in parallel.” COMMITTEE FOR THE STUDY OF ECON. AND MONETARY UNION, REPORT ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY 14 (Apr. 17, 1989), http://azi.pitt.edu/1007/1/monetary_delors.pdf. But the Delors’ report adopted a comparatively less centralized approach to economic policy than the Werner report. See id. at 14-15.
politically difficult to enforce the strict fiscal criteria laid down for EMU membership.


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. 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 harmonization process politically untenable. This was a process in which the United Kingdom was a very active, even leading, participant as well as beneficiary.

1. Harmonization Principles

The Delors Commission’s 1985 White Paper preceded the enactment of the first amendment to the Treaty of Rome in thirty years, the so-called “Single European Act.” 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. 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.” But, 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 harmonization, and home country control—a system with minimal political integration but maximum market integration—the balance always preferred by the United Kingdom. The three principles were subsequently enshrined in harmonization legislation in a number of areas, including financial services. The internal market was to be based on minimum harmonization

35. This has been defined by one of the authors as the First EU financial services consensus. See Emilios E. Avgouleas, The New EU Financial Markets Legislation and the Emerging Regime for Capital Markets, 23 Y.B. of Eur. L. 321 (Apr. 2005).


of national regulatory systems and mutual recognition through which Member States would recognize each other’s laws, regulations, and authorities. Use of minimum regional requirements was intended to limit competitive deregulation by state actors and regulatory arbitrage by commercial parties. It was also a reflection of how political collaboration can encourage adoption of sound market principles and practices.

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. 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. 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. 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 target market or through a foreign branch. 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.

40. Id.
41. See Benn Steil et al., The European Equity Markets: The State of the Union and an Agenda for the Millennium (Benn Steil ed., Feb. 1, 1996).
44. 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 generally The Single Market and The Law of Banking (Ross Cranston ed., 2d ed. 1995); European Securities Markets: The Investment Services Directive and Beyond (Guido Ferrarini ed., 1998).
45. See The Single Market and The Law of Banking, supra note 44; European Securities Markets, supra note 44.
46. Id.
47. For a good discussion of the ambit of provisions for investment firms, see Niamh Moloney, EC Sec. Regulation 379–460 (2d ed. 2008).
The Maastricht Treaty, which established the European Union as a successor to the EEC, provided an impetus for states to implement key 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, now the Court of Justice of the European Union (CJEU)). 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. 48

2. The Gradual Shift To “Maximum” Harmonization

The “passport directives” clearly enhanced financial integration in the EU, although areas of marked divergence, such as retail financial services, remained prior to 2008 and continue to remain today. 49 But minimum harmonization left the EU with an incomplete regulatory framework, because, in many cases, it merely augmented rather than replaced pre-existing national laws. 50 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. 51 Arguably, the most important integrative instrument of that era (which can be viewed as the second EU financial services consensus) 52 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. 53

National implementation of MiFID from 2007 onwards represented the third stage of single market development.\textsuperscript{54}

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 One) and more detailed implementing measures (Level Two). 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,\textsuperscript{55} CEIOPS,\textsuperscript{56} and CESR.\textsuperscript{57} The Level Three committees contributed to the consistent implementation of Community directives in the Member States, ensuring effective cooperation between the supervisory authorities and convergence of their practices (Level Three) and finally, the Commission was to enforce timely and correct transposition of EU legislation into national laws (Level Four).\textsuperscript{58}


In the aftermath of the 2008 global financial crisis, the EU has introduced a number of pan-European bodies with regulatory and supervisory competence and developed a common rulebook.59 The new institutions that the EU has built since 2009 are discussed in the ensuing 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 “financial stability” as a classic central banking good. Thus, financial stability was not designed as one of the four basic tasks to be carried through the European System of Central Banks (article 127(2) of TFEU) and rather was clustered with prudential supervision under the “non-binding tasks” of the ECB. This is, of course, in marked contrast to all post-2009 EU financial services legislation, which has financial stability either as core or chief auxiliary objective.

A. BACKGROUND

Until the onset of the Global Financial Crisis (GFC) in 2008, the common passport facility was at the heart of the EU market integration effort. The EU legislative framework based on harmonized standards for financial markets sought equivalence among disparate national regulatory and legal systems, so that regional initiatives could recognize the idiosyncrasies of national legal and regulatory regimes.60 But a multi-level governance system involves far more complexity than a regime based on minimum harmonization can foresee. These mainly arise out of the conflicting and sometimes misunderstood national implementation and enforcement priorities and interpretation of harmonization legislation.

But where the EU moved faster to offer direct regulation and or maximum harmonization of national standards this move was not welcomed by the polities of several member states, due to so-called “democratic deficit,”61 giving rise to what was subsequently dubbed “Euro scepticism.” In

60. See STEIL ET AL., supra note 41, at 113.
61. This broadly meant that the EU Commission officials that produced the core of European regulations were not elected. In a way this was a rhetoric scheme, especially, from the viewpoint of democratic legitimacy formalities (though, perhaps, accurate, in terms of substance), since most EU legislation was co-produced with the Council which comprises
fact, the European Union was viewed even prior to 2008 as “too intrusive” and “remote” an institution in need of a more coherent set of policies within existing treaties.\footnote{See Comm’n White Paper on European Governance, at 12, COM (2001) 428 final (July 25, 2001).} As this view gathered pace across the EU but especially in the United Kingdom it eventually culminated the in “leave” outcome (so-called Brexit) of the British 2016 EU Referendum.

Political considerations also undermined the credibility of rule-based frameworks for coordination of national fiscal policies in the Eurozone.\footnote{See Comm’n White Paper on European Governance, at 12, COM (2001) 428 final (July 25, 2001).} 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 and enforcement as to allow it to become part of the political bargaining process in the EU at the expense of objective economic criteria.\footnote{See Presidency Conclusions, Brussels European Council paras. 3, 7 (Mar. 23, 2005), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf.}

In the first decade of its life, the EMU was premised on a weak institutional framework that was more suitable to a “fair weather currency,” rather than a monetary union with asymmetrical member economies, which were about to experience massive macro-economic shocks. 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 realistic prospects for fiscal convergence.\footnote{See Paul de Grauwe, Economics of Monetary Union pt. 2 (9th ed. 2012).} 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. In addition, it seems unlikely that a strong form Monetary Union can survive without balanced trade flows and some elected member state politicians and the EU Parliament, whose members are elected by means of pan-European elections. See House of Commons, The European Union: A democratic institution?, Research Paper 14/25 (Apr. 29, 2014). Of course, the irony is that the parties and individuals who complained about EU’s democratic deficit, and rightly so to some extent, are members of the same coalition that asks the UK to leave the European Convention of Human Rights.

form of fiscal burden sharing. But the EMU—which presents neither of those two characteristics—has confounded expectations so far.

When the GFC broke out with force, European financial stability was hampered by a number of pre-existing problems that had simply been ignored for far too long. These included colossal pre-crisis public and private debt loads, 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, which, as explained above, also lacked an effective fiscal convergence mechanism. Essentially, it was 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, based on the no bailout clause in the EMU Treaty. 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. This phase would, in the end, bind euro-area members closer together at the expense of further alienation of reluctant members of the club like the United Kingdom.

While the 2008 crisis intensified reform efforts to a great extent, the true catalyst for the emergence of 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), 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 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, at some point, to undermine the stability of the EU banking system. The integration process had continued apace in an increasingly de-regulated market following the intensification of liberalization efforts in the last quarter of the twentieth century, but the regulatory standards and supervisory principles were not adjusted to new realities. The Eurozone crisis brought home with devastating force the potential risks of financial market integration reflecting the main findings of

the aforementioned financial stability trilemma. Financial integration had led 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 included 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.

In contrast, in the United States, following the initial shock from the collapse of Lehman Brothers, the response to the crisis was rapid and came in the form of state purchases of distressed bank assets so-called Troubled Asset Relief Program (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 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.

C. The Eurozone Debt Crisis

In Europe, the global banking and liquidity crisis soon transformed into a complex and multilayered regional crisis. As soon as a series of public bailouts took the issue of the continuing solvency of banks in the United Kingdom, United States, and Western Europe 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 triggered the second and more lethal wave of the crisis of confidence that hit most of Europe since 2010—although Italy and Spain might in the end prove much bigger threats to the Eurozone’s survival than Greece, Portugal and Ireland, which represent only a very small faction of Eurozone GDP.

The Eurozone crisis should be seen as a sequence of four interlocking crises resulting from imbalanced monetary integration. This sequence resulted in a competitiveness crisis that transformed into a marked loss of fiscal revenues and widening fiscal deficits which led to debt accumulations.

69. Id.
(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 led to accumulation of unsustainable levels of public or private debt or both. Essentially, surpluses found their way to the public and private debt markets 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.70

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 EU 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 Member State bonds and were also adversely affected by the continuous recession ravaging the periphery of the Eurozone only made things worse. As mentioned above, the EMU, although it had interest rate setting competence through the ECB, had until recently been devoid of any binding mechanism to effectively enforce fiscal and banking stability. Both are areas of serious national interest where pooling of sovereignty was regarded, until recently, as intolerable. Moreover, since its establishment, the EMU lacked these crucial supporting institutions that could have helped it to restore financial stability during times of acute uncertainty and market volatility.71

In the beginning it was thought that EMU Member States could break the vicious circle between bank bailouts and levels of sovereign indebtedness, by means of establishing a funding facility the ESM, which, subject to a strict conditionality, could be employed to directly recapitalize Eurozone banks. Fears of burden sharing between the richer and 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 put a stop to direct (through the ESM) bank recapitalizations and just promoted the centralization of bank supervision and resolution functions in the EMU. Said centralization has given birth to a new set of bank authorization, supervision, and resolution arrangements, which together comprise the so-called European Banking Union. As the United Kingdom did not participate in the EMU and was not part of the Banking Union, its exit from the EU could provide further glue to Banking Union

71. BERGSTEN & KIRKEGAARD, supra note 63, at 2.
arrangements but for German opposition to any kind of burden sharing for cross-border bank failures, including its continuous opposition to a single deposit guarantee scheme for Europe (discussed in section III.C below).

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

A. The Larosière Reforms

In November 2008, the Commission appointed a High Level Group (chaired by Jacques de Larosière) 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.72 The proposals advanced by the de Larosière report were instrumental to subsequent developments. In order to implement the recommendations of the de Larosière 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 2010.73 It comprises the European Systemic Risk Board (ESRB)74 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),75 the European Insurance and Occupational Pension Authority (EIOPA), and the European Securities Markets Authority (ESMA), which respectively replaced the corresponding Lamfalussy Level Three Committees: CEBS, CEIOPS and CESR. Furthermore, colleges of supervisors76 were to be put in place for all major

74. The European Systemic Risk Board (ESRB) was established on December 16, 2010, in response to the ongoing financial crisis. Regulation No. 1092/2010 of the European Parliament and of the Council of 24 Nov. 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, 2010 O.J. (L 331) 1. It has been tasked with the macro-prudential oversight of the financial system of the financial system within the EU in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU. See id.
75. The Committee of European Banking Supervisors (CEBS) as an independent advisory group on banking supervision in the EU was establish by the European Commission in 2004. Commission Decision of 3 Nov. 2003 establishing the Committee of European Banking Supervisors, 2004 O.J. (L 3) 28. On January 1, 2011, this committee was succeeded by the European Banking Authority (EBA), which took over all existing and ongoing tasks and responsibilities of the CEBS. See Regulation No. 1092/2010, supra note 74.
76. The Colleges of Supervisors are mechanisms for the exchange of information between home and host authorities and for the planning and performance of key supervisory tasks in a coordinated or joint manner, including all aspects of ongoing supervision. See generally Comm. of Eur. Banking Supervisors document on CEBS’ Guidelines for the Operational Functioning of
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.77 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.78

ESAs work with the ESRB to ensure financial stability and to strengthen and enhance the EU supervisory framework. Apart from issuing guidance and recommendations to national supervisors,79 ESAs also seek to formulate a single EU rulebook and harmonize technical standards on the basis of powers conferred by the EU commission,80 which subsequently will be adopted by the European Commission to become formal/binding EU law.81 In order 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.82 In a crisis, they will provide EU-wide coordination.83 If an emergency is declared, the ESAs

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77. In a sense, this followed similar proposals as to how regulations of cross-border banking in the EU had to be structured. See, e.g., FORUM ON FINANCIAL CROSS-BORDER GROUPS, UNICREDIT GROUP, DISCUSSION PAPER No. 1, CROSS-BORDER BANKING IN EUROPE: WHAT REGULATION AND SUPERVISION? 5, 16-17 (Mar. 2009), https://www.unicreditgroup.eu/content/dam/unicreditgroup/documents/inc/press-and-media/cross_border_banking_discussion_paper.pdf. The paper suggests that the supervision of cross-border banks had to be based on three tiers: day-to-day supervision remaining with national supervisors, as these supervisors would be close to the business, while supervisory decisions affecting an entire cross-border group would be made by the Colleges of Supervisors (with legally binding authority), and a European Banking Authority (EBA) based on the de Larosiere Group recommendations would facilitate information sharing and coordination among supervisors. See id.

78. Regulation No. 1095/2010, supra note 73, arts. 54-56 (establishing the Joint Committee).

79. Id. art. 8 (defining tasks and powers of the Authority); see also id. arts. 10-17.

80. Id. art. 11 (power to adopt regulatory technical standards).

81. Id. art. 10 (definition of and process for adoption of regulatory technical standards).

82. Id. art. 18 (action in emergency situations).

may make decisions that are binding on national supervisors and on firms, and 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.84 They have a role in EU supervisory colleges to ensure that they function efficiently and that consistent approaches and practices are followed.85 ESAs conduct regular peer reviews of national supervisory authorities across the EU,86 and they can collect information from national supervisors to allow them to fulfill their role.87 This information is used for analyzing market developments, coordinating EU-wide stress tests, and for the macroprudential analysis undertaken by the ESRB.88 They also have the competence to consider consumer protection issues.89

The ESFS did not remedy the “mismatch” between the geographic scope of European bank activities and the regulatory remit of the authorities supervising them. Therefore, even after the implementation of the de Larosière reforms, cross-border supervision and bank resolution at the EU level remained decentralized and, in want of further clarification as to how ESAs would be able to control and manage their complicated tasks when parties involved, would include non-EU countries.90 And then, if any major European bank or financial institution failed, it would certainly have repercussions outside the EU, though no provision was made for formalized cooperation structures with third country regulators beyond those provided in the (informal) context of the G20 and the Financial Stability Board.91

A binding mediation mechanism would be required, in any case, to deal with 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

84. Id. arts. 19-21, at 28, 29.
85. Id. arts. 27, 29, at 31.
86. Id. art. 30, at 32.
87. Id., art. 36, at 34.
90. 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 7, 2011. Ben Bernanke, the Fed Chairman issued 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. Moreover, James Barth contends that not everyone is convinced of the new regulations in place (in case of the U.S., the Dodd-Frank Act) have 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. See James R. Barth and Apanard Prabha, Breaking (Banks) Up is Hard to Do: New Perspective on Too Big To Fail, MILKEN INST. (Dec. 3, 2012), http://fic.wharton.upenn.edu/fic/papers/12/12-16.pdf.
practice. Such fragmentation would represent a major step backwards for the single market.92

In some ways, this structure was a necessity of the United Kingdom’s refusal to participate in EMU and to countenance the necessary pooling of sovereignty to make it work in the aftermath of the crisis. Given London’s position as the predominant financial center within the EU, this was a major stumbling bloc.

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. A framework of systemic risk controls and robust micro-prudential regulations deals with prevention. 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.93 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, 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.94 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.95 A “competence catalogue” was included in the Lisbon Treaty, which has been in force since

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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 the EU’s history, it has been explicitly enshrined in the treaties that are not conferred upon the Union and, instead, remains with the Member States.

Since 2011, the EU as a whole has embarked on 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 implement it. In addition, the European Parliament and the Council adopted a “six-pack” set of legislative acts, aimed at strengthening the Eurozone’s economic governance by reduction of deficits through tighter control of national finances. The reforms represented the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the EMU almost twenty years ago. This legislative package aims to employ concrete and decisive steps towards ensuring fiscal discipline in order to stabilize the EU economy and to avert new crisis in future.

But the most important development has been the implementation of the Banking Union. Also, the implementation of mandatory bail-ins aims at containing the impact of the banking crisis on the sovereign by making bailouts nearly impossible, a measure that has not inspired universal enthusiasm.

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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 members need to complete the adjustment of internal and external imbalances to repair financial sectors and to achieve sustainable public finances. The economic and financial crisis has exacerbated pressure on the public finances of EU Member States where twenty-three out of the twenty-seven 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 percent 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. 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 wealthier members of the Eurozone in an effort to keep the EMU from breaking up. But such sovereign bailouts are not only very expensive; they are also highly unpopular with the citizens of lender countries.

The Liikanen report has proposed solutions to separate deposit-taking banking from riskier banking activities. But a comprehensive EU mandate on structural reform of the EU banking sector may take some time as the EU faces so many existential problems on numerous fronts. Perhaps as important in stabilizing euro-markets, but impossible to be long-lived, has been ECB activism through its Quantitative Easing program and the still unused so-called Outright Monetary Transactions have stabilized market conditions in sovereign debt markets. Like the establishment and operation of the ESM, these measures just passed the test of legality under the TFEU Treaty and, arguably, the CJEU was very accommodative of the need to adopt practical measures to avert a Eurozone meltdown.

103. 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, e.g., Riccardo Bellofiore, “Two or Three Things I Know About Her”: Europe in the Global Crisis and Heterodox Economics, 37 CAMBRIDGE J. ECON. 497 (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 monetary financing of “good” deficits).
106. Thomas Pringle v Gov’t of Ireland, Ireland and The Attorney General, Nov. 27, 2012, CJEU Case C-370/12.
Finally, irrespective of the progress already achieved on the policy side, the experience of the past eight years reflects that reversal of sentiment in financial markets and the 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. This is a very important qualification as the high levels of bank non-performing loans (NPLs) in the periphery of the Eurozone are a very important time-bomb, not only as regards the financial health of member states’ banks, but also vis-à-vis resolution of the looming debt overhang, supply of new loans, and negative impact on GDP growth. Arguably, the slow level of NPL resolution (e.g., Italy, Greece, Cyprus and Portugal) and of bank recapitalization (e.g., Deutsche Bank) raises questions about the wisdom of not using the ESM as a possible Eurozone bad bank of last resort.

V. The European Banking Union

The EBU has, in principle, three pillars: a unified supervision mechanism (the SSM), operated by the ECB, a single resolution mechanism with no fiscal backstops (the SRM), and a future pan-European deposit guarantee scheme (DGS).

A. The Single Supervisory Mechanism (SSM)

1. Overview

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-three committees, lacked both the competence and the resources to cope with a cross-border banking crisis that endangered taxpayers’ money. Lack of appropriate coordination structures was most evident regarding 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 SSM.


On September 12, 2012, the Commission proposed a single supervisory mechanism for Eurozone banks, run by the ECB, in order to strengthen the EMU. 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 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 about 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, and hence, subject to different policy regime from commercial banks. But small or medium-sized banks can also endanger the stability of the 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. Eventually, the ECB would focus its direct supervision only on those banks, which can generate significant prudential risks through their size or risk profile.

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 because banking and monetary policy, though inter-linked, are not identical. But there are contrasting views with regards to the extent and form of separation between the two functions.110 This concern is less theoretical than it sounds and in many corners of the euro-area banking sector voices are raised about the deleterious effect that QE and very low interest rates have on bank profitability and overall financial health.111

2. The Scope of SSM Powers

Under the SSM Regulation of October 2013, the ECB is vested with the necessary investigatory and supervisory powers to perform its tasks and will carry out the following functions:

- Licensing/authorization of EMU based financial institutions (in cooperation with the National Competent Authorities (NCAs) (Arts 4 & 14 of the SSM Regulation);

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111. David Folkerts-Landau, The ECB must change course, DEUTSCHE BANK RESEARCH, June 8, 2016.
Monitoring compliance with capital, leverage and liquidity requirements (Arts 4 & 16 of the SSM Regulation);

Conducting supervision of financial conglomerates (Art. 4(1)(h) and Rec. 26);

Early intervention measures (Prompt Corrective Action) when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action (Art. 4(1)(i) and Rec. 27). 112

The ECB is directly responsible only for the authorization and supervision of “significant” institutions, a term that encompasses individual entities, significant groups, and holding companies. The SSM Regulation and the SSM Framework Regulation contain several criteria according to which credit institutions are classified as either significant or less significant. Accordingly, significance is assessed based on the following criteria: “(a) size; (b) importance for the economy of the Union or of any participating Member State; (c) significance of cross-border activities.” 113 A credit institution, financial holding company, or mixed financial holding company shall not be considered less significant, unless justified by particular circumstances, if any of the following conditions are met:

(a) the total value of its assets exceeds EUR 30 billion;

(b) the ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20 [percent], unless the total value of its assets is below EUR 5 billion;

(c) the total value of its assets exceeds €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20 [percent].

(d) it is one of the three most significant credit institutions established in a Member State;

(e) it is a recipient of direct assistance from the European Stability Mechanism. 114

Following a notification by a national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, the ECB makes a decision confirming such significance following a comprehensive assessment, including a balance-sheet assessment of that credit institution. Notwithstanding the fulfillment of the above criteria, the ECB may also, on its own initiative, consider an institution to be of significant relevance where it has established banking subsidiaries in more than one participating Member State and its cross-border assets or liabilities

113. Id. art. 6, at 75.
114. Id.
represent a significant part of its total assets or liabilities subject to the conditions laid down in the methodology.115

Determination of whether or not a credit institution is significant is made on an on-going basis and the SSM conducts a regular review: all credit institutions authorized within the participating Member States are assessed to determine whether they fulfill the criteria for significance. If a group or a credit institution that is considered less significant meets any of the relevant criteria for the first time, it is declared significant and the NCA hands over responsibility for its direct supervision to the ECB. Conversely, a credit institution may no longer be significant, in which case, the supervisory responsibility for it returns to the relevant NCA(s). In both cases, the ECB and the NCA(s) involved carefully review and discuss the issue and, unless particular circumstances exist, plan and implement the transfer of supervisory responsibilities so as to allow for a continued and effective supervision.116

The ECB has exclusive competence to grant and withdraw the authorization of any credit institution,117 acting as the home regulator for firms from the Eurozone who use the EU passport to carry out cross-border business or establish a branch in a non-Eurozone Member State,118 and to assess the acquisition of holdings in credit institutions in the euro area.119 The ECB’s Authorization Division carries out these tasks.120 Notwithstanding the ECB’s exclusive competence in carrying out these tasks the ECB acts jointly with the National Competent Authorities (NCAs).

Both the ECB and the NCAs of participating Member States, where an institution is established, have the right to propose the withdrawal of a banking license. NCAs can propose a withdrawal upon the request of the credit institution concerned or, in other cases, on its own initiative in accordance with national legislation.121 The ECB can initiate a withdrawal in cases set out in the relevant EU laws.122 Either way, the final decision rests with the ECB.123 The institution concerned has the right to be heard under Article 31 of the SSM Framework Regulation. The ECB Guide to Banking Supervision provides that the ECB and the relevant NCAs consult on any proposals for the withdrawal of a license.124

Critically, given the fact that such withdrawal, if not voluntary, will inevitably relate to a bank entering resolution due to failing to meet the

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115. Id.
116. Id. at 75, 77.
118. Id. at 74.
121. Id. art. 80, at 37.
122. Id. art. 82, at 38.
123. Id. arts. 81, 83.
124. Id. at 29 n.121.
capital and liquidity thresholds provided in the CRD IV, these consultations, according to the ECB Guide, are also used to lawfully buy time, as they “are intended to ensure that, before a decision is taken, the relevant bodies (i.e. NCAs, national resolution authorities and the ECB) have sufficient time to analyze and comment on the proposal, raise potential objections and take the necessary steps and decisions to preserve the going concern or resolve the institution, if deemed appropriate.”

B. The New EU Resolution Framework

By providing common mechanisms to resolve banks, the Eurozone has established, by means of Regulation (EU) No 806/2014 (SRM Regulation), a single resolution mechanism (SRM), which would govern the resolution of banks in the Eurozone and coordinate the application of resolution tools to banks. 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. The core body within the SRM is the Single Resolution Board (SRB), which is the resolution authority within the Banking Union. Together, with the National Resolution Authorities (NRAs), it forms the SRM. The Single Resolution Board (SRB) has been operational as an independent European Union (EU) Agency since January 2015. The mission of the SRB is to ensure an orderly resolution of failing banks with minimum impact on the real economy and the public finances of the participating Member States of the Banking Union.

The decisions have to be taken in line with the principles of resolution as set out in the single resolution rulebook comprising the EU Bank Recovery and Resolution Directive (BRRD) and associated legislation. The main resolution tools, as detailed in the BRRD (Art. 37) 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 (Art. 38-38 BRRD);

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) (Art. 40-41 BRRD). 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;

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125. Id.
(3) the asset separation tool, whereby the bad assets of the bank are put into an asset management vehicle (Arts 37(3), 42 BRRD). 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 (Section 5 BRRD).127

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 a 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 eligible for bail-in Art. 48 BRRD).128 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 (Art. 46 BRRD).129 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.

A bank would become subject to resolution when:130 (a) the institution is failing or is likely to fail having breached objective capital and liquidity indicators,131 (b) having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures, or supervisory action, including early intervention measures or the write

127. Id. art. 37.
128. Id. art. 48.
129. Id. art. 46.
130. Id. art. 32.
131. “[A]n institution shall be deemed to be failing or likely to fail in one or more of the following circumstances: (a) the institution infringes or there are objective elements to support a determination that the institution will, in the near future, infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority including but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds; (b) the assets of the institution are or there are objective elements to support a determination that the assets of the institution will, in the near future, be less than its liabilities; (c) the institution is or there are objective elements to support a determination that the institution will, in the near future, be unable to pay its debts or other liabilities as they fall due; (d) extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes any of the following forms: (i) a State guarantee to bank liquidity facilities provided by central banks according to the central banks' conditions; (ii) a State guarantee of newly issued liabilities; or (iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution.” Id.
down or conversion of relevant capital instruments would prevent the failure of the institution within a reasonable timeframe, (c) a resolution action is necessary in the public interest and to achieve the resolution objectives of financial stability, protection of public money and depositors’ money and continuous provision of critical services.132 As explained above, it is deemed that entry into resolution will always occur at a point close to insolvency.

C. THE NEW DEPOSIT GUARANTEE SCHEME

The European Union started the process of harmonization of DGSs in 1994 with the EU Directive on Deposit Guarantee Schemes,133 According to the Commission, the minimum harmonization approach of the 1994 Directive resulted in significant differences among DGSs as to the level of coverage, the scope of covered depositors, and products and the payout delay. Prior to Autumn 2008, when the financial crisis hit, the mechanics of the financing of schemes was left entirely to Member States. This turned out to be disruptive for financial stability and the proper functioning of the internal market. The DGS Directive was significantly amended following the failure of Lehman Brothers,134 and in 2010, the Commission proposed a comprehensive reform of DGS in the European Union. The harmonization process was primarily guided by the principle of creating a level playing field with a focus on coverage limits and preference for ex ante funding. It was rightly thought that without common rules and consistent protection for consumers, the single market for deposits cannot operate effectively. The Eurozone banking and sovereign debt crisis subsequently became the catalyst, as countries which seemed to be in trouble—especially Greece, but also Italy and Spain—experienced a deposit drain.135 Accordingly, a pan-European deposit guarantee scheme implemented via a redrawn DGS directive136 was mooted as the third pillar of the European Banking Union.137 Yet, it has been the pillar that Member States have found the most difficult to agree on, as doing so would essentially lead to mutualization of bank debt in the Eurozone.

134. Directive 2009/14/EC of the European Parliament and of the Council of 11 Mar. 2009 amending Directive 94/19/EC as regards the coverage level and the payout delay, 2009 O.J. (L 68) 3. The Directive of March 2009 required Member States to increase coverage of their DGS - first, to at least 50,000, and then, to a uniform level of 100,000 by the end of 2010.
136. European Commission Memoranda, MEMO/12/656, Towards a Banking Union (Sept. 10, 2012), “This would be the first step towards a pan-EU deposit guarantee scheme.” Id.
The widespread consultation culminated in the 2014 EU DGS Directive,\(^\text{138}\) which had a very short implementation period up to July 2015. Proposals for a pan-European deposit insurance scheme were not adopted, but the Commission has pushed for them\(^\text{139}\) and German opposition continues.\(^\text{140}\) Thus, deposit protection continues to be provided by national DGSs, which extend coverage nationally to both financial institutions and their EU-based foreign branches.\(^\text{141}\) For example, under the 2015 Treasury Regulation, the United Kingdom’s Financial Services Compensation Scheme (FSCS) covers both United Kingdom regulated banks, building societies, and credit unions and their branches in other Member States.\(^\text{142}\)

Harmonization of coverage levels under the 2014 DGS Directive is limited to statutory DGSs. Outside the scope of the Directive are Member State protection schemes in Member States (e.g., on a voluntary or contractual basis) that offer additional deposit protection (except for some requirements on the information that needs to be given to depositors about the actual protection offered to them under the alternative scheme). The protection limit for deposits remains at €100,000 or its local currency equivalent.\(^\text{143}\) The Directive imposes a standard of a seven (working) day pay-out following a transition period,\(^\text{144}\) and has a generous implementation lead-time of nine years. Under the 2014 Directive, deposit protection is now extended to trade transactions, as it covers “temporary high balances.”\(^\text{145}\) For consumers, this means they will have some additional protection for exceptional and short-lived deposits resulting from major life events, like the sale of a home. The Directive extends DGS to all businesses and not just SMEs, as was previously the case.\(^\text{146}\)

The 2014 Directive imposes a minimum target funding level of 0.8 percent of covered deposits; Member States, however, can set a higher target level for their DGS.\(^\text{147}\) Currently, schemes in about half of Member States


\(^{142}\) The Deposit Guarantee Scheme Regulations 2015, SI 2015/486, art. 3 (UK).

\(^{143}\) Parliament and Council Directive on Deposit Guarantee Schemes, supra note 133, art. 6, recs. 21, 23.

\(^{144}\) Id. art. 8.

\(^{145}\) Id. art. 2.

\(^{146}\) Id.

\(^{147}\) Id. art. 10(2). The level of coverage is a costly and thus contentious issue. For this reason the Directive provides that 5 years after its entry into force, the Commission, supported by the European Banking Authority (EBA) will submit to the European Parliament and to the Council a report on, inter alia, the target level on the basis of covered deposits, with an assessment of the
have already reached the above target level or are relatively close to it. In one-third of Member States, DGS funds are above 1 percent of covered deposits, and in a few of them, they are even beyond 2 percent or 3 percent. Nonetheless, the Directive stipulates that Member States, upon approval of the Commission, may set a target level lower than the above, but not lower than 0.5 percent of covered deposits.

In principle, the composition of funds available to the DGS should include cash, deposits, and low-risk assets, which can be liquidated within a short period of time. But, DGS funds may also consist of so-called “payment commitments.” Payment commitments are commitments of a bank towards a DGS, which are fully collateralized, provided that the collateral consists of low risk assets, and the collateral is unencumbered by third party rights. The total share of payment commitments shall not exceed 30 percent of the total amount of available financial means of the DGS. In order to ensure consistent application of the Directive in Member States, the European Banking Authority will issue guidelines on the irrevocable payment commitments. Moreover, in order to fulfill their obligations of reaching the required target funding level, Member States may regard bank levies as equivalent to ex ante funds. The available financial means of DGS must be invested in a low-risk and sufficiently diversified manner.

Funding arrangements will also change under the new scheme. For example, levies on the industry to fund deposit protection will be “risk-based,” meaning that firms' liability to meet levies will no longer be based solely on their share of deposits, but will take account of the risk they pose to the deposit insurer. The risk-based approach has been adopted in order to counter moral hazard; namely, in order to provide banks incentives to operate “under a less risky business model.” Risk will be measured on the basis of a mix of obligatory indicators developed by the European Banking Authority (75 percent weight) and other indicators developed by the DGS and the national authorities (25 percent weight). In addition,
contributions will have a counter-cyclical element. This provision makes very good sense, as it adjusts bank contributions to the macroeconomic cycle and requisite fluctuations of bank profitability.

Finally, the 2014 Directive allows national DGSs to voluntarily borrow funds from each other in the event that they face a shortfall, provided that the total amount lent does not exceed 0.5 percent of covered deposits of the borrowing DGS. But the borrowing DGS must repay the loan within five years, and the contributions levied by the borrowing DGS must be sufficient to reimburse the amount borrowed and to reestablish the target level as soon as possible.

D. Evaluation of EU Regulatory Reforms

Centralization of bank supervision and resolution within a single currency zone is an essential condition for a functional monetary union, but it is no panacea. The continuing NPL crisis in the Eurozone periphery as well as concerns about the financial health of Deutsche Bank are a very strong argument in favor of this view. The EU crisis management and resolution framework does not contain a fiscal backstop, as the ESM was not, as originally envisaged, as it turned into a direct bank recapitalization tool. On the contrary, the job of breaking up the doom loop has been entrusted to the creation of a minimum requirement of own funds and eligible liabilities to be bailed-in and the mandatory use of creditor bail-ins up to an 8 percent minimum of total liabilities and own funds to cover bank losses. At the heart of these loopholes is the Treaty prohibition of fiscal transfers in the Eurozone and fears that a fiscal union in the Eurozone will undermine fiscal discipline.

A number of coordination challenges remain within the SSM. The ECB, together with the Central Banks of the EU Member States (NCBs), comprises the European System of Central Banks (ESCB). Because of the dual roles the NCBs play, this configuration produces significant structural complexity. The NCBs, on the one hand, are national agencies that perform non-ESCB functions; and on the other, the NCBs constitute an important part of the ESCB helping to shape the conduct of EMU monetary policy. Moreover, this functional complexity is rooted deeper still in their
constitutive laws. Whereas, the ECB operates solely under the EC law while the status of the NCBs is governed by both the EC law and national legislation.

Moreover, in spite of the existence of common rulebooks, tensions between the EBU bodies and non EBU European supervisors may not be ruled out, especially when it comes to early intervention measures concerning branches. In spite of the existence of EU-wide supervision colleges, the lack of complete centralization in terms of supervision creates the same conflicting incentives between home and host (and room for regulatory forbearance) as in any other context. In response to this concern, non-EBU EU members increasingly move toward further de facto localization/subsidiarization, negating the spirit of the EU single-market project.

On the other hand, developments surrounding the result of the United Kingdom’s EU Referendum of June 2016 may reverse this trend, especially if United Kingdom negotiators do not safeguard the passport for the country’s financial services firms. In that case, while the United Kingdom may proceed on the basis of equivalence provisions to obliterate the prudential carve out offered in GATS, the rest of the EU regulatory regimes remaining outside the EBU will probably subject themselves to the “suzerainty” of the larger jurisdiction (the EBU), leading to a possible reversal of subsidiarization.

VI. 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 the 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 most of its members, led to the imbalances that became

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visible when the GFC erupted in 2008.\textsuperscript{165} 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 resolution of cross-border financial institutions, deposit guarantee arrangements, regulation and supervision and fiscal arrangements and affairs.

Arguably, the financial stability risks are magnified within integrated cross-border markets, especially contagion risks. Thus, 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 the adoption of integration plans elsewhere, chiefly in the context of East Asia.

This balanced view of integration offers further perspectives. First, 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. Second, 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. Third, it does not matter how much integration or liberalization has been achieved in the region. 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 a regional market, the higher the propensity for cross-border contagion. The cascading effects of the ongoing Eurozone crisis are a vivid reminder of the contagion risk in a highly integrated system.\textsuperscript{166} 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.

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-offs between national sovereignty and


collective financial stability. The establishment of a European banking union within the boundaries of the Eurozone, which includes a single supervisor, a single resolution authority and, in the future, a pan-European deposit guarantee scheme, have clearly tilted the balance towards further centralization and pooling of sovereignty. This development, however, highlights the level of sovereignty concessions that are necessary to support an effective single market, and even more so when the single market is underpinned by currency arrangements. In that case, a fiscal union to smooth out trade imbalances and to contain shocks in the financial sector seems inevitable. This level of sacrifice, though, is beyond the capacity of most national polities. This has been clearly demonstrated by Brexit, highlighting the very probable sui generis situation of Continental Western Europe in the process of full economic, monetary, and financial integration.

From the EU regulatory reforms discussed above, three initiatives stand out. First, centralization of supervision for Eurozone banks through the SSM means that the ECB is now 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. 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 European Banking Union and the common resolution framework, of measures, which aim at breaking the link between bank rescues and public money/indebtedness.

EU Member States have set up, in the course of the last sixty 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 characteristics of internal market, can be used as the only reform template, although they can indeed provide model lessons to the rest of the world.

In past decades, the importance of institutions dealing with financial markets has mostly been ignored, probably because economists thought of them as an unnecessary cost imposed on efficient and self-correcting markets. So, the EU experience is invaluable 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 coordination. 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 strong integrative measures, such as subsidiarization, are probably more suitable and effective in other contexts 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 in other regions, 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 globalized 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.169 This would especially be the case if on-going national and regional reforms prove to be less successful than expected. 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 other regions. Of course, these may in the end serve more as challenges to be overcome rather than insurmountable stumbling blocks. 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 global and regional financial stability mechanisms in order to safeguard future economic prosperity.

169. For an example of such a model for the governance of global financial markets, see EMILIOS AYGOULEAS, GOVERNANCE OF GLOBAL FINANCIAL MARKETS: THE LAW, THE ECONOMICS, THE POLITICS, 213-58, 429-59 (Cambridge Univ. Press 2012).