CHAPTER 3

THE EUROPEAN UNION FINANCIAL SYSTEM AFTER LEHMAN: POLICY AND REGULATORY RESPONSES

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1 INTRODUCTION

When addressing European matters we must remember that European construction is still a work in progress, with its peculiar architecture subject to a long-term evolutionary process. As normally happens with unfinished projects, the constituent, national, parts do not properly fit in the general design. This consistency gap persists, and may even widen as the system design itself evolves over time. Beyond the potential deficiencies of the projected architecture, its unfinished character may prove a serious threat when individual imbalances spill over into general fragilities. In other words, European construction is characterised by a largely unproven design, by its evolution over time, and by the 'traverse' problem coming from the adjustment of heterogeneous national conditions to the 'acquis communautaire'. Structural socio-political and economic changes induced by the integration process take time, with different adjustment rates in different member countries; enforcement may become feeble and moral hazard a recurring danger for the decision process. The evolution of the architecture is far from being the result of unanimous national approaches, with the necessary compromises leaving room to the persistence of ample degrees of national discretion and specificities.

In the past serious problems were often addressed through architectural reforms, sometimes leading, as in the case of Economic and Monetary Union, to the deepening of certain features of the unification process. The recent crisis could have led to a breakdown in European construction, especially in its later phase characterised by potential sovereign debt defaults. On the contrary,

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however, the response to the Lehman debacle was to reaffirm the acceleration in the convergence process sanctioned by the Lisbon Treaty. The lesson drawn from the crisis has been to re-draft the European institutional architecture, not just for the financial sphere. Common goals have been re-focused and the institutional set up redesigned, not secondarily aiming at more limited national discretion and increased enforcement of common rules. The reforms of the financial sector must then be analysed as part of the reshaping of the entire design.

For a full understanding of the European responses to the crisis, it will help to outline both the more salient characteristics of the European financial system (section 1) and the more recent stages in the process of regulatory harmonisation (section 2), delving into the management and resolution of cross-border crises, which is a particularly crucial problem for the European Union (EU) (section 3). A brief description of the crisis in Europe from the first phase of financial turmoil to the sovereign crises (section 4) brings light to bear on the policy and regulatory responses (sections 5, 6 and 7). An analysis of the process leading to the new overall design places those responses into the broader perspective of the consistency of the entire architecture (section 8). Some conclusions are finally offered on the relevance of the financial reforms for the viability of the entire European construction and on the dangers deriving from an approach to re-regulation that seems incapable of significantly reducing systemic fragilities.

2 BANKING AND FINANCIAL STRUCTURES BEFORE LEHMAN

In Europe the banks are the backbone of the financial system. For the period 2000-2007 the Euro area and United Kingdom (UK) present a level of bankarisation largely higher than the United States of America (USA) (table 1). The multiple of total assets over Gross Domestic Product (GDP) is, however, not uniform among the European countries (table 2): the level and growth of bankarisation is significantly higher in Ireland and UK.

Table 1

Bank assets and loans*

(In % of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
Euro area								
Total assets/GDP	247	252	254	260	267	282	294	313
Loans/GDP	89	91	92	93	94	98	104	109
UK								
Total assets/GDP	325	356	352	382	401	443	483	520
Loans/GDP	111	118	122	125	132	138	145	157
USA								
Total assets/GDP	59	61	62	65	65	67	69	73
Loans/GDP	35	35	34	35	36	39	41	43

* Loans exclude financial intermediaries and general government as counterparties. Stocks are annual averages.
Sources: Eurostat, European Central Bank (ECB), Federal Reserve, International Monetary Fund (IMF).

Table 2

Bank assets

(In % of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
Austria	251	259	259	257	265	280	295	310
Belgium	288	284	291	288	303	332	337	361
Denmark	245	247	262	286	284	314	327	365
Finland	94	109	121	124	138	152	156	162
France	259	266	268	271	281	300	328	361
Germany	286	296	294	297	297	305	303	304
Greece	143	139	133	128	130	137	144	156
Ireland	366	414	443	478	555	642	730	831
Italy	145	145	150	163	166	175	182	201
Netherlands	269	279	285	301	323	335	332	358
Portugal	210	212	219	239	235	226	235	246
Spain	171	179	184	189	198	220	239	262
Sweden	n.a.	184	187	184	195	215	233	249
United Kingdom	325	356	352	382	401	443	483	520

Source: ECB. Total assets are annual averages.

The European banks are mainly funded with non-deposit liabilities (short- and long-term bonds, covered bonds, money market and interbank market). US banks are, on the contrary, mainly funded with deposits (table 3). According to a study by the ECB (2009), European banks have, particularly as from 2003, experienced a sharp increase in maturity and currency mismatches, thus taking on increasing funding, counterparty and exchange risks.

Table 3

Bank market funding

(In % of total funding)

	2000	2001	2002	2003	2004	2005	2006	2007
Austria	61	54	57	55	57	58	58	58
Belgium	39	42	36	40	41	46	47	47
Denmark	60	63	64	64	62	63	65	64
Finland	55	62	58	54	68	60	62	61
France	67	62	62	63	60	63	62	64
Germany	52	50	50	49	49	49	48	47
Greece	25	29	29	26	20	28	28	32
Ireland	63	60	61	60	61	72	72	68
Italy	57	56	58	56	58	60	60	61
Netherlands	73	70	70	74	59	58	74	68
Portugal	64	59	64	62	67	47	67	59
Spain	34	31	31	33	35	41	42	42
Sweden	52	53	51	48	53	55	55	57
UK	49	50	54	55	60	62	62	58
USA	33	32	29	30	30	29	30	30

Source: For Europe BankScope, unconsolidated balance sheets; for the USA Federal Reserve, all commercial banks.

A third difference with the USA relates to leverage (table 4). The European banks are generally much more levered, with the countries showing higher levels and more vigorous growth of bankarisation also experiencing an increase of leverage (again Ireland and UK).

Table 4

Bank leverage*

	2000	2001	2002	2003	2004	2005	2006	2007
Austria	23	22	21	20	20	20	19	16
Belgium	28	28	24	27	29	34	32	23
Denmark	15	17	18	17	17	18	17	19
Finland	12	10	10	10	11	11	11	14
France	23	22	20	20	21	25	23	25
Germany	26	25	24	26	27	27	26	26
Greece	14	14	15	14	19	19	16	15
Ireland	18	17	18	21	26	31	33	33
Italy	14	14	13	13	13	12	12	10
Netherlands	15	16	17	19	23	20	18	17
Portugal	15	20	21	17	17	15	12	8
Spain	15	15	15	16	14	16	17	17
Sweden	30	25	27	25	21	22	23	25
UK	20	19	21	19	25	28	29	27
USA	12	11	11	11	10	10	10	10

* Leverage is computed as total assets/common equity.
Source: For Europe BankScope, unconsolidated balance sheets; for USA Federal Reserve, all commercial banks.

Finally, on the evidence of the 2000-2007 evolution bankarisation appears to be positively and significantly cross-country correlated with both market funding and leverage (table 5). Hence, the growth of bankarisation has usually been favoured by lower capitalisation and greater recourse to market funding.

Table 5

Cross countries correlations*

	2000	2001	2002	2003	2004	2005	2006	2007	2000-2007
Bankarisation versus Market funding	0.38	0.33	0.39	0.48	0.37	0.62	0.52	0.48	0.45
Bankarisation versus Leverage	0.63	0.46	0.44	0.53	0.67	0.72	0.73	0.72	0.65

* Present authors' calculations.

The increased weight of the European banks – especially the larger ones - is significantly accounted for by their market activities. Their presence increased substantially in the areas of investment banking (securities underwriting and loan syndication), securities trading and market making, especially subsequent to the introduction of the euro, which boosted the growth and integration of the European capital markets (European Commission, 2007b). “European banks are also the major managers of collective investment schemes, with a market share of over 80% in many countries.” (MÖRTTINEN et al, 2005, p. 11) Moreover, from 2000 to 2007 the volume of securitisation originated by banks increased tenfold, due mainly to mortgages (EUROPEAN COMMISSION, 2009a).

Starting from the 1980s the consolidation process in the banking sector gained impetus in all European countries, leading in many cases to an appreciable reduction in the number of banks and increase in their dimensions. While in the first phase the consolidation remained largely a national phenomenon, as from 2004-2005 mergers and acquisitions (M&A) operations acquired a cross-border dimension, with the birth of large pan-European banking and financial groups. For the year 2005 the ECB has identified 46 systemically important banking groups with activities covering more than the 60% of EU banking assets (ECB, 2006).

3 REGULATORY HARMONISATION AND THE CREATION OF A SINGLE FINANCIAL MARKET

The European institutional framework was built around the objective of unifying the rules within the common financial market while safeguarding national specificities.

As from the adoption of the Single European Act of February 1986[1], financial integration was pursued adopting a strategy of progressive interventions following the principles of subsidiarity and proportionality. The former principle recognises the prevalent competence of national authorities for the regulation and supervision of financial institutions, with the European legislator stepping in when the goals agreed on in EU treaties cannot be effectively pursued at the national level. Proportionality requires EU legislation not to exceed the strictly necessary to achieve the stated objectives. Matching the peculiarities of national legal systems with the principles of subsidiarity and

[1] The Single European Act committed Member States to achieving the single market of financial services by 1992. The Single European Act also intended to promote the liberalisation of capital movements as a precondition for the liberalisation of the EU financial services market.

proportionality leads automatically to legal diversity. This means that, instead of pursuing politically unfeasible full regulatory harmonisation, the single market has been built upon three key principles: minimum harmonisation, home country control and mutual recognition.[2] The mutual recognition of national regulation, on the basis of prior minimum harmonisation, adds prudential and accounting regulation to the traditional principle of home-country supervision. In this way, every financial institution acquires a single European passport, i.e. has the right to do business in the EU area under its home-country supervision and regulation. The Second Banking Directive (Directive 89/646/EEC, Annex 1[3]) extended mutual recognition from commercial banking to investment banking, thus attaching to the European passport the possibility of adopting the universal banking model.

The regulatory process shown in table 6 highlights how much the objective of creating a level-playing-field across member countries comes from translating into EU legislation the principles and prudential rules agreed upon by the Basel Committee. Apart from some marginal exceptions, in Europe this relates to both credit institutions (banks) and investment firms.

Chart 1

Prudential and accounting common rules for European financial institutions

Directives	Issue date	Implementation date (by)	Content
83/350/EEC	1983	1985	Supervision of credit institutions on a consolidated basis in line with the 1983 Basel Concordat
86/635/EEC	1986	1993	Annual and consolidated accounts of banks and other financial institutions
92/30/EEC	1992	1993	Supervision of credit institution on a consolidated basis in accordance with the 1988 Basel Capital Accord
89/299/EEC	1989	1993	Own funds of credit institutions in accordance with the 1988 Basel Capital Accord
89/647/EEC	1989	1993	Solvency ratio for credit institutions, in accordance with the 1988 Basel Capital Accord
92/121/EEC	1993	1994	Monitoring and control of large exposure of credit institutions

[2] These principles were endorsed by the Single European Act.
[3] All official documents of the EU are published in the Official Journal of the European Union (OJ), available at eur-lex.europa.eu/JOIndex.do

93/6/EEC (CAD)	1993	1996	Capital requirements for market risk resulting from trading in securities, derivatives and foreign exchanges
94/19/EC	1994	1995	Deposit guarantee schemes
95/26/EC	1995	1996	Reinforced supervision of financial institutions (post BCCI)
98/31/EC (CAD2)	1998	2000	Revision of the Capital Adequacy Directive 93/6/EEC in accordance with the amendment of the Basel Capital Accord to incorporate market risk, allowing for the use of internal models
2001/24/EC	2001	2004	Reorganisation and winding-up of credit institutions
2002/87/EC	2002	2004	Rules for supplementary supervision for credit institutions, investment firms and insurance companies pertaining to a financial conglomerate
EC 1606/2002 (Regulation) and 2003/51/EC	2002/2003	2005/6	Application of International Accounting Standards to annual and consolidated accounts of banks, financial institutions and insurance companies
2006/48/EC and 2006/49/EC (CRD)	2006	2007/8	Capital Requirements Directive implementing Basel II (credit institutions and investment firms)

The use of directives by the EU authorities is consistent with the minimum harmonisation approach. As stated by the Final Act and Declarations of the Single European Act (Article 100a) “In its proposals … the Commission shall give precedence to the use of the instrument of a directive if harmonisation involves the amendment of legislative provisions in one or more Member States”. A directive is binding for each member country in terms of the results to be achieved, but the national authorities are left free on the choice of forms and methods for achieving those results. Differently, in the EU jargon, regulation is the proper instrument when the objective is full or detailed harmonisation; a regulation is immediately binding for the member countries.

The Maastricht Treaty of 1992, leading to the creation of the euro and the European Central Bank, was part of a more general process aimed at transferring some national prerogatives to the European level. The deepening of financial integration, together with the expansion of cross-border activities expected from adoption of the common currency, made the inconsistency more evident between significant national specificities resulting from the minimum harmonisation approach and the single financial market. In this perspective, the EU launched in 1999 (European Commission 1999) a five-year Financial Services Action Plan (FSAP), whose objective was to single out the measures to update and harmonise financial regulation by 2005. This initiative made clear the intent to achieve a closer harmonisation of national rules. Recognising that the existing legal and regulatory framework was impeding the growth and competitiveness of the European securities markets, in July 2000 the Economic and Financial Affairs Council (ECOFIN) set up a Committee of Wise Men chaired by Alexander Lamfalussy. The Committee was asked

> to assess the current conditions for implementation of the regulation of the securities markets in the European Union; to assess how the mechanism for regulating the securities markets in the European Union can best respond to developments underway on securities markets……; and in order to eliminate barriers and obstacles, to propose as a result scenarios for adapting current practices in order to ensure greater convergence and cooperation in day to day implementation, taking into account new developments in the market (COMMITTEE OF WISE MEN, 2000, p. 1).

The final Report presented in 2001 (COMMITTEE OF WISE MEN, 2001) contained a range of measures based on a four-level approach that came to be known as the Lamfalussy process.[4] The key idea here was to distinguish between two stages of the legislative process. The first stage (Level 1) consists of basic political choices where, on proposal by the Commission, Parliament and Council jointly adopt under the "co-decision procedure" the framework legislation setting out the core principle and defining the implementing power. The second stage concerns technical implementation of the framework legislation and is formally adopted by the Commission at Level 2, after a vote of the competent regulatory Committee. Moreover, for technical preparation of the implementing measures the Commission is advised by Committees of national supervisors, referred to as "Level 3 Committees" (table 7). These Committees should contribute to consistent and convergent implementation of the EU directives, by securing more effective cooperation between national supervisors, and to convergence of the supervisory practices, by supplying (non-legally binding) guidance. Level 4 refers to the Commission enforcing timely and correct transposition of EU legislation into national laws.[5]

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[4] In March 2002, with the view to meeting deadlines for the implementation of the FSAP, the European Council approved application of the Lamfalussy process to legislation for the securities markets. In December 2002, the Council decided to extend the Lamfalussy process to the entire financial sector, thus embracing banking, insurance and occupational pensions and investment funds for transferable securities (UCITS).

[5] Infringement proceedings are the first step if a Member State fails to comply. More serious failures may be referred to the Court of Justice.

Chart 2

The Lamfalussy committees for financial regulation and supervision

	Banking	Insurance and Occupational Pensions	Securities (including UCITS*)
Regulatory Committees (Level 2)	European Banking Committee (EBC)	European Insurance and Occupational Pension Committee (EIOPC)	European Securities Committee (ESC)
Advisory Committees of National Supervisors (Level 3)	Committee of European Banking Supervisors (CEBS), London	Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), Frankfurt	Committee of European Securities Regulators (CESR), Paris

* UCITs are undertakings for collective investment in transferable securities.

The financial sphere, for which the Lamfalussy Committee was originally conceived, has been addressed by the Markets in Financial Instruments Directive (MiFID, 2004/39/EC), designed to enhance the process aiming at a single financial market, already set into motion by the 1993 Council Directive on investment services. The aim was to strengthen both competition, abolishing the concentration of trading in organised markets, and the level-playing-field among European investment firms. It was also meant to enhance protection of investors, governance of investment firms and market integrity. With adoption of the Level 2 Commission Directive (2006/73/EC) implementing the 2004 Directive, MiFID has applied since November 2007.

The Lamfalussy architecture was, de facto, a compromise solution between the required convergence of regulatory and supervisory practices and the maintenance of competences at the national level. According to this design, pursuit of effective harmonisation fell to the Level 3 committees, whose main task was to monitor the application of common non-binding guidelines and recommendations. At the beginning of the recent financial turmoil the European Commission presented an analysis of the of Level 3 committees' experience according to which

> [t]he Level 3 Committee are accountable to the Commission to the extent specified in their founding decisions. Their members are accountable to their own governments and/or Parliaments at national level. Many national supervisors do not have the capacity to perform their task at Level 3. If supervisors' obligations under their national law conflict with non-binding measures pursuant to Level 3, supervisors will let national obligation prevail (EUROPEAN COMMISSION, 2007a, p. 7).

The fact that the national statutes of the supervisory authorities lack explicit reference to attain financial stability at the European level constitutes a crucial limit for the Level 3 committees in pursuing effective regulatory and supervisory homogenisation. Thus, the Lamfalussy framework has not been able to eliminate financial institutions' regulatory arbitrages deriving from different national rules and supervisory practices.

Just to have an idea of the relevance of these divergences, the CEBS (2008) listed 152 options and national discretions in implementation of the capital requirement directive (CRD), many of which related to crucial profiles, such as the rules on inclusion of hybrid instruments and minority interests into own funds, the rules on consolidation, and interpretation of connectedness in the prudential treatment of large exposures. Divergences in prudential and accounting rules and supervisory practices leave room for lax interpretation by the national authorities of the banks' financial conditions (GARCIA and NIETO, 2005). The crisis of IKB[6] and Northern Rock revealed models and business strategies that would not have been accepted in countries with a more intrusive supervisory style, as for example that of the Italian authorities.[7]

4 CRISIS MANAGEMENT OF CROSS-BORDER INSTITUTIONS

It was already evident before the recent financial crisis that the diffusion of cross-border banks and financial groups would clash with home-country control and the European passport (ECONOMIC AND FINANCIAL COMMITTEE 2001; GOODHART and SCHOENMAKER, 2006).[8] The risk of

[6] IKB, the German bank that was the first in Europe to declare it had beene severely hit by the sub-prime crisis, had guaranteed its US conduit for 40% of its own assets. This is clearly a case of risk mismanagement by the bank, but also a patent violation of the European rules on large exposures permitted by its national supervisor (Lannoo, 2007; Brunnermeier 2009).

[7] Italy is the only major European country not hit by a systemic financial crisis and in which there was no public bail-out of banks. According to the Financial Stability Board (2011, p. 9) "The relatively mild initial impact of the crisis can be also attributed to a prudent regulatory and supervisory stance as well as more fundamental institutional factors. For example, the authorities point out that their approach to model validation may have discouraged banks from participating in complex securitization activities. In mortgage lending, the requirements for personal guarantees encourage conservative loan-to-value (LTV) ratios; banks are subject to credit product sales rules, including by third parties; and legislation against usury prevents riskier lending at high interest rates. Moreover, a 1999 law requires that special purpose vehicles be registered and periodically report their activities and data to the authorities. The Bank of Italy (BI) also subjected banks sponsoring structured investment vehicles to strict oversight and moral suasion, thereby avoiding some of the liquidity-related problems that impacted such institutions in other countries. Finally, the fact that the BI is also responsible for supervising non-bank financial intermediaries, and that such entities are required to register and (when above a size or complexity threshold) to comply with capital and governance requirements, may have reduced regulatory arbitrage possibilities."

[8] For instance, the international expansion of the Nordea Banking Group has been a matter of concern for the Nordic supervisory authorities since 2003: *"…increased integration raises the question of how much responsibility home countries are willing to take for financial stability in other countries where a bank operates. For example, the Nordea Group is a Swedish bank that has its largest market share in Finland. Would the Swedish authorities be willing and able*

potential cross-border contagion was amplified by the increased size of international banks, the operations of whose subsidiaries or branches are often a multiple of the GDP of the country in which they are located, and by the development of the single interbank market in euro: a group of large European banks gradually becoming liquidity distributors by borrowing in the integrated interbank market in euro and then lending domestically (ECB, 2006).

The absence of efficient incentives and/or binding rules for collaboration between the countries involved highlight the contradiction between the tendency to foster cross-border financial activities and reliance on national supervisors, lender of last resort interventions, deposit guarantee schemes, and legislation on bank reorganisation and winding-up. The key problem is the mismatch between the extent of multinational banks' cross-border activities and the national scope of supervision and safety nets.

The allocation of supervisory responsibility for cross-border groups depends on whether the foreign activity refers to branches or subsidiaries. For branches the responsibility for stability supervision is up to the country where the parent company is incorporated, while the host country is responsible for liquidity management. For subsidiaries responsibility for its control pertains to the host-country, while the supervisory authority of the parent company bears responsibility for the stability of the entire group on a consolidated level. Collaboration between home and host authorities had generally been voluntary and discretionary, based on bilateral or multilateral Memorandums of Understanding (MoUs) on information sharing for on-going supervision.[9] Only starting from the Directive implementing Basel II (Directive 2006/48/EC, Articles

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to judge Nordea's impact on stability in Finland? And would the Finnish authority be prepared to transfer responsibility for a considerable part of its financial system to Sweden?" (Sveriges Riskbank 2003, pp. 75-76).

[9] The first multilateral MoU between the banking supervisory authorities and the central banks of the European Union is added in 2003 to the some existing bilateral MoUs. According to the press release (ECB 2003), this MoU, which is not made public, "*consists of a set of principles and procedures for cross-border co-operation in crisis management situations. These principles and procedures deal specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level."* A later not published MoU, between banking supervisors, central banks and finance ministries of the EU, was agreed in 2005. According to the press release (ECB 2005), this MoU "*consists of a set of principles and procedures for sharing information, views and assessments, in order to facilitate the pursuance by these authorities of their respective policy functions and preserve the overall stability of the financial system of individual Member States and of the EU as whole*". It is explicitly stated that "[A]n *MoU is non-legally binding instrument for setting forth practical arrangements aimed at promoting co-operation between authorities in crisis or potential crisis situations without overriding their respective institutional responsibilities or restricting their capacity for independent and timely decision-making in their respective fields of competence, notably with regard to the conduct of day-to-day central banking and supervisory tasks, as set out in national and Community legislation*." For an analysis of the incentive-inefficiencies deriving from the voluntary cooperation between home and host supervisory authorities see Enria and Vesala (2003).

129, 131, 132) has cooperation between home and host countries been made mandatory, even if only for certain Pillar 1 issues, such as the internal rating based approaches IRB . Coordination devolves upon the consolidating supervisor, who has the last word in case of dissent.

As shown in table 8, responsibility for supervision entails responsibility for deposit insurance and the reorganisation and winding-up of failing institutions.

Chart 3

Supervision, Deposit Insurance and Resolution Authorities' Jurisdiction in the EU

	Prudential Supervisor	Deposit Insurance Regulator	Reorganization and Winding-Up Authority
Banks legally incorporated			
Parent banks authorized in home country	Home country authorizing parent bank (consolidated supervision – solvency)	Home country	Home country
Subsidiaries of parent banks headquartered and authorized in another EU country	Home country authorizing parent bank (consolidated supervision –solvency) Host country authorizing the subsidiary (solo basis)	Host country	Host country
Subsidiaries of parent banks headquartered and authorized in a non-EU country	Host country authorizing the subsidiary	Host country	Host country
Branches			
Branches of banks headquartered and authorized in other EU country	Home country of head office (consolidated supervision –solvency) Host country (liquidity)	Home country (possibility to supplementing the guarantee by host country)	Home country
Branches of banks headquartered and authorized in a non –EU country	Host country	Host country, if cover provided by home country is not equivalent to that prescribed by the deposit guarantee scheme	Host country in case that the foreign bank has branches in more than one Member State.

Source: Garcia and Nieto (2005), p. 12.

To complete the picture, it must be remembered that, formally, the lender of last resort function is not attributed to the ECB, remaining in the sphere of each national central bank.

Lacking a common supervisory frame within the EU, neither the Deposit Guarantee Scheme Directive of 1994 (94/19/EC), nor the Directive on Reorganisation and Winding-up of credit institution of 2001 (2001/24/EC) could aspire to create a crisis management framework at the European level.

The aim of the Directive on Deposit Guarantee Schemes was to ensure only a minimum level of harmonisation of deposit guarantee arrangements within the Community, based on four guiding principles: compulsory participation of all European banks in a deposit guarantee scheme; the cost of financing such schemes to be borne, in principle, by the credit institutions themselves; deposit protection to be substantially assimilated of to the rules of prudential supervision; national deposit guarantee schemes not to be used as a means for generating unfair competition between national banks and EU bank branches. Moreover, the Directive specifies the basic compulsory features that the deposit insurance should have in all European countries: it should cover at least 20,000 euros per person per bank; it should exclude the coverage of inter-bank deposits and may exclude other liabilities at the discretion of national government. Because of the link which exists for a branch between its solvency supervision and its membership of a deposit guarantee scheme, the EU Directive adopted the principle of home country insurance, by virtue of which all the branches of a bank operating within the EU must be covered by the guarantee system reserved in the home country.

The minimum harmonisation approach adopted by the Directive resulted in significant differences in the pre-crisis coverage levels across the EU, ranging from the minimum of 20,000 euros (as in Austria, Belgium, Germany, Spain, Ireland and Netherland) to the maximum of 244,409 euros in Norway (EUROPEAN COMMISSION, 2010a). Different financing obligations on banks across Member States (ex-ante financing was not mandatory) and generally very low bank contributions rendered the EU deposit guarantee schemes ineffective to handle serious banking crises. “In relation to any of the 43 European LCFIs [large and complex financial institutions] ... no current scheme can be expected to have the capacity to make reimbursements without involving public funds." (DE LAROSIÈRE, 2009, p.34, note 7)

The European directive on crisis resolution concerns cross-border banks with branches in other member countries and follows international private law, whose scope is limited to identification of the competent jurisdiction and recognition of its decisions, while leaving issues of substance to be defined by home insolvency bank laws (NIEROP and STENSTRÖM, 2002). Consistently with the principles of the single licence, home-country control on solvency, and mutual recognition, the Winding-Up Directive establishes that resolution of cross-border bank crises must follow the principles of single entity and universality. The principle of single entity means that only one court, that of the home country, is competent to decide on the bankruptcy of a bank. The universality principle means that the national proceedings cover all foreign assets and liabilities of the insolvent firm, and equivalent groups of creditors are treated equally under a single set of priorities determined by the law governing the proceedings (LASTRA and WIHLBORG 2007). The principles of single entity (unity of proceedings) and universality "require the administrative or judicial authorities of the home Member State to have sole jurisdiction and their decisions to be recognised and to be capable of producing in all the other Member States, without any formality, the effects ascribed to them by the law of the home Member State" (Directive 2001/24/EC, (16)).

The lack of European harmonisation has several consequences. A common European definition of bank insolvency is still wanting. Different bankruptcy laws, general or specific to banks,[10] lead to different approaches to bank insolvency. The traditional definition of insolvency in commercial law – failure to pay obligations as they fall due or liabilities exceeding assets – is not so simply applicable to banks. In banking the demarcation line between illiquidity and insolvency is blurred. An economically insolvent bank is not always declared legally insolvent by the authorities responsible due the possible contagion for other banks. Moreover, the powers and obligations of resolution authorities may vary greatly across European countries. More importantly, intervention objectives may differ: some countries favour protection of the

[10] For an analysis of the resolution regimes across European countries, see Eisembeis and Kaufman (2007), Table 7 and Brierley (2009) for the recent reform in the UK.

institutions while others attach greater priority to protection of creditors. The priority of national interests is perfectly legitimate both for governments, which are accountable to their tax payers for the eventual fiscal costs of bail-outs, and for supervisors, who must preserve the stability of their national financial system. However, the failure of large cross-border groups renders inevitable the emergence of conflicts between home and host countries.

These conflicts may prove even more acute for cross-border banks with subsidiaries located in other EU countries. In principle, foreign subsidiaries might not be directly affected by the resolution proceeding of the parent bank. The management of a subsidiary should adopt ring-fencing practices in order to permit that its eventual resolution is made according with the legal and supervisory framework of the country in which it is incorporated. In reality, the financial interconnections among the various components of a group inevitably entail that the insolvency proceeding against the parent bank puts some stress on the national central bank and/or the fiscal authorities of the host country, especially if the subsidiary is locally systemic.

Depending on the nature of the troubled institution, crisis management may involve differently structured national supervisory agencies, national central banks with sharply differing scopes for emergency liquidity assistance, national treasuries (with restrictions deriving from the Stability and Growth Pact), and the ECB. In any case, crisis resolution is ultimately the responsibility of the national treasuries (PISANI-FERRY and SAPIR, 2009). The recent crisis has shown that the cross-border externalities and the negative spill-overs resulting from individual supervisory decisions are not given due consideration in the European institutional framework: "… it is questionable whether home country control for supervision and host country responsibility for financial stability are sustainable in an integrating European market" (SCHOENMAKER and OOSTERLOO, 2005, p.4).

Basically, the root of these difficulties lies in a fundamental contradiction. The European passport and the Single European Act require the existence of an effective single market, i.e. of maximum harmonisation, and the absence of fiscal externalities across fiscally independent countries. The realities are, however, rather different, for the latter condition does not hold and the EU financial market remains fragmented by national regulators and supervisors, national emergency liquidity assistance and strictly national resolution laws.

5 THE TWO PHASES OF THE EUROPEAN CRISIS

The first phase of the European crisis (August 2007-September 2008) appeared to be limited to the financial turmoil caused by the US sub-prime crisis. In the summer of 2007 the collapse of the US derivatives market based on sub-prime mortgages provoked a sharp and generalised increase in evaluation of the counterparty risk in the interbank market due to uncertainty about potential heavy losses on those products. The fear was prompted by the demise of IKB as a consequence of the failure of its US vehicle, and the decision of BNP Paribas to suspend redemption of three investment funds due to its inability to value their portfolio of structured products. Short-term interest rates in the interbank market shot up, while the supply of longer-term contracts practically disappeared. At the beginning of August the ECB offered unlimited liquidity for overnight operations. In the following months several other EU banks, particularly exposed to the mortgage sector and/or to wholesale funding, showed serious sign of distress, being often bailed out through public intervention. Apart from the single serious cases of write-down and recapitalisation, the liquidity problem was much more general due to the above-mentioned funding structure of the European banks.[11] Up to the first half of 2008 policy makers perceived the crisis as mainly concerning liquidity, which is why the ECB was mainly preoccupied with the rising inflation and continued to raise its key reference rates up to July 2008. This period saw no easing up in the stance on monetary policy, as is also witnessed by the moderate increase in the monetary base. The liquidity needed to smooth the functioning of the interbank market was guaranteed by reverse swap operations and liquidity policies of frontloading and fine tuning within the reserve maintenance period (ECB 2010).

The second phase of the EU crisis opens with the Lehman failure (September 2008). This phase is characterised by the realisation of the systemic nature of bank failures in many EU countries, the widespread although

[11] For a more detailed analysis of distress episodes and national rescue measures see Petrovic and Tutsch (2009), European Commission (2009b), Banque de France (2010).

not uniform negative effects on real growth (with backward consequences on bank losses) and, later, by the appearance of sovereign debt crises within the euro area.

A series of factors account for the differences in the extent to which the crisis hit the EU countries. Some factors were exogenous, such as exposure to foreign financial markets (USA and emerging countries of Central-Eastern Europe) and the fall in international trade. Others were country specific, such as the size of the financial sector in relation to GDP, the magnitude of the housing bubble, the relative exposure to market risk, first, and then to credit risk, the degree of international competitiveness, and, last but not least, the laxity of supervisory practices.

A more detailed analysis of the varying degree of crisis impact on national financial systems is presented in the next section. As shown in table 9, the interaction between the above exogenous and endogenous factors produced its major real effects in 2009.

Table 6

Annual GDP growth – constant 2000 price

(In %)

	2006	2007	2008	2009
European Union (27 countries)	3.2	3.0	0.5	-4.2
Austria	3.6	3.7	2.2	-3.9
Belgium	2.7	2.9	1.0	-2.8
Denmark	3.4	1.6	-1.1	-5.2
Finland	4.4	5.3	0.9	-8.2
France	2.2	2.4	0.2	-2.6
Germany	3.4	2.7	1.0	-4.7
Greece	5.2	4.3	1.0	-2.0
Ireland	5.3	5.6	-3.5	-7.6
Italy	2.0	1.5	-1.3	-5.0
Netherlands	3.4	3.9	1.9	-3.9
Portugal	1.4	2.4	0.0	-2.5
Spain	4.0	3.6	0.9	-3.7
Sweden	4.3	3.3	-0.6	-5.3
United Kingdom	2.8	2.7	-0.1	-4.9
United States	2.7	1.9	0.0	-2.6

Source: Eurostat - The statistics database of European Comission. Available at: (http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home)

Table 10 visualises how those fragility factors differently characterised some EU countries, finally causing several systemic crises.

Table 7

Systemic vulnerabilities of EU banks and countries

	Hit by systemic financial crises (1)	Housing bubbles (2)	Large exposure to US toxic assets (2)	Large exposure to weak European emerging countries (2)	Large banks' size/GDP (3)	Low external competitiveness (4)
Austria	√			√		
Belgium	√			√	√	
Denmark	√	√			√	
Finland				√		
France					√	
Germany	√		√			
Greece				√		√
Ireland	√	√			√	√
Italy						√
Netherlands	√			√	√	
Portugal						√
Spain	√	√				√
Sweden				√		
United Kingdom	√	√	√		√	√

(1) According to Laeven and Valencia (2010). Spain has been added to update the authors' list.
(2) European Commission (2010b).
(3) See above, table 2.
(4) Present authors' calculations based on the recent evolution of balance of payment current account balances and real effective exchange rates.

Save Austria, the EU countries in the above table are open economies, much more so than the USA. Even if all countries suffered from a slow-down of international trade, the worst hit were those showing a low and deteriorating degree of competitiveness.

Regulatory distortions and lax national supervisory practices lie behind many of the vulnerabilities of Table 10. Having allowed a general undervaluation of risks and their concentration, the financing of housing and market bubbles and the oversizing of individual banks and indeed of the whole sector, the official authorities bear a major responsibility if not for the origin of the crisis, quite certainly for its severity.

To a certain extent the evidence of Tables 9 and 10 does not fully account for the different impact of the crisis across the EU countries. A point to bear in mind is that the full force of the crisis was mitigated in some countries by counter-cyclical fiscal stimuli (EUROPEAN COMMISSION, 2009c). Countries with a high public debt, such as Greece and Italy, substantially counted only on automatic stabilizers. Furthermore, as pointed out in the following section, many national financial systems were saved from more serious disruptions by specific state aid. Finally, starting from the second half of 2008, the ECB eased monetary policy by sharply reducing its reference interest rates, injecting large amounts of liquidity mainly by extending the collateral eligibility for open market operations to lower grade assets, and lengthening the terms of refinancing. Moreover, the national central banks launched emergency liquidity assistance operations using quite different collateral and haircut requirements. As a result of this price and quantitative easing the funding costs of banks saw general and sharp decrease in 2009 (ECB, Statistical Data Warehouse), representing a crucial lifeboat for several of them and with varying effects across member countries.

Although the ECB (2010, p. 70) states that "[i]n the course of 2009 financial markets increasingly showed signs of stabilisation", the underlying problems were far from being solved. In particular, banks and markets continued to count on extraordinary abundant central bank liquidity and low funding costs. The attempts by the ECB to abandon its non-standard operations were substantially halted by the explosion of the sovereign debt crisis in the early months of 2010, starting in Greece, then spreading to Ireland and more recently to Portugal.

Due to the combined effect of counter-cyclical policies, the bail-outs of financial intermediaries and the reduction of public revenues due to the "great recession", the overall public deficit of the EU countries has tripled in recent years, up to 6.8% of GDP in 2009 (6.3% in the Euro area). The ratio of debt to GDP was driven to 73.6% (78.7% in the Euro area), expected to rise to 84% in 2011 (EUROPEAN COMMISSION, 2010). In 2009 market attention was shifting from the financial sector to the leveraging of the public sector, sharply increasing the spreads on sovereign debt among the Euro countries. In some cases, like that of Greece, the sovereign debt crisis erupted independently of the crisis, although it was aggravated by it; in other cases, like that of Ireland, it was crisis-specific. Countries showing similar problems, low growth and competitiveness for Portugal and Italy, or bank bail-outs and low competitiveness for Spain, began to come under closer scrutiny. Since most of the EU banks have their prevalent activity in their home country, the downgrading of sovereign debt comes to be increasingly reflected in higher funding costs. The danger of a negative spiral, with cross-border losses increasing the contagion and leading to a more general deterioration of public finances, has alerted all the EU authorities.

6 GOVERNMENT INTERVENTIONS TO SUPPORT FINANCIAL SYSTEMS

Immediately after the Lehman bankruptcy (15 September 2008), several EU countries realised the risk of a wave of bank failures and rushed, each in its own way, to rescue their ailing financial institutions. Bail-out packages were adopted for Bradford & Bingley (UK), Hypo Real Estate (DE), Fortis (BE/NL/LU), and Dexia (BE/FR/LU). Many governments also issued guarantees on bank deposits and other liabilities. Although justified by the urgency to act, these measures constituted a patent violation of the rules of the single financial market, posing the danger of large flows of funds directed towards the countries offering the highest level of protection. Actually, a process of this type started after the Irish government introduced a guarantee scheme restricted to Irish majority-owned banks; funds began to migrate to the latter both from non-Irish institutions operating in Ireland and from abroad.

The first EU response came from the ECOFIN meeting of 7 October, which recognised the necessity to support systemic financial institutions with all the necessary measures, recapitalisation included. At the same time it stated the common principles that governments should have respected: interventions should be timely and the support should in principle be temporary; taxpayers' interests should be protected; existing shareholders should bear the due consequences of the intervention; the government should bring about a change of management; the management should not retain undue benefits;

governments should intervene on remuneration; the legitimate interests of competitors should be protected, in particular applying the rules on state aid; negative spillover effects should be avoided. At the same time the Council underlined the importance of coordination of national intervention, which should take into account the potential cross-border effects of national decisions (ECOFIN, 2008).

In the October Paris summit, the Heads of State and Governments of the Euro area issued the so-called Declaration of Paris (Declaration on a concerted European action plan of the Euro area countries, Paris, 12 October 2008), backing the ECOFIN conclusions. They agreed that governments could provide state guarantees to facilitate medium term bank funding, and additional capital resources to sustain the economy, as well as recapitalising distressed banks. At the same time they invited the ECB to ease the eligibility criteria for assets that qualify as collaterals.[12]

Between the end of 2008 and the beginning of 2009 the Commission issued four Communications regarding the coordinating principles for the rescue and restructuring of EU banks. These Communications, although not legally-binding, pragmatically state the rules for the main forms of public support to banks: guarantees on bank liabilities, recapitalisation of sound banks, rescue of distressed banks, and treatment of impaired assets. Their rationale was to ensure that rescue measures could attain the objectives of financial stability and maintenance of credit flows while ensuring a level playing-field between banks located in different Member States as well as between banks receiving or not receiving public support. A harmful subsidy race and moral hazard should have been avoided. Each communication states that any state aid measure can only be justified as an emergency response to extraordinary stress conditions, and only as long these exceptional circumstances prevail (see the box below).

[12] The European Council Meeting of 15-16 October 2008 endorsed the principles of the Paris Declaration.

Box 1

Summary of principles issued by european commission on state aid to the financial sector

The Banking Communication issued by the European Commission on 13 October 2008 (2008/C 270/02) provided the conditions for national guarantee schemes for bank liabilities. They must be open to all banks, without discriminating against the subsidiaries of foreign banks, can cover liabilities longer than 3 months, up to five years, and must follow a common pricing formula. Subordinated debt is explicitly excluded from eligible liabilities. For maturities up to 1 year the fee is flat at 50 basis points; for maturities from 1 year up to 5 years the fee is based on the credit default swap spread of the bank plus 50 bp. The schemes have limited temporal scope, with the obligation to obtain new Commission approval every six months on the basis of continued justification and the potential for adjustment.

The Recapitalisation Communication of 5 December 2008 (2009/C 10/03) provided the design for the recapitalisation of banks by Member States. The main principles limiting the distortion of competition by these structural interventions relate to: the price that the beneficiary has to pay for capital injections, having to depend on the risk profile of the bank and the seniority of the instrument used; and the follow-up, which can go from the exit strategy from the reliance on State capital to in-depth restructuring or liquidation for distressed banks. The recapitalisation packages are envisaged, in principle, not primarily for rescuing banks, but as a precautionary measure to sustain lending to the real economy. Rescue recapitalisation of unsound banks should be subject to stricter requirements. Until redemption of State aid, they should include: restrictive policies on dividends; limits to executive remuneration and distribution of bonuses; the obligation to restore and maintain an increased level of solvency ratio compatible with the objective of financial stability; a timetable for redemption of State participation. In cases of recapitalisation with preferred shares, the rules require fixing the level of pricing, including step-up clauses in order to incentivise banks to redeem State capital when market conditions permit.

On 25 February 2009, the Commission issued the Impaired Assets Communication (2009/C 72/01), providing guidance on how Member States can create state aid schemes for impaired assets and the rules that must be respected to gain state aid approval. The design of the asset relief measures can take the form of bad bank schemes, insurance schemes for indemnifying asset losses, asset swaps or hybrids of such arrangements. Irrespective of the form, the rules require full transparency and disclosures by beneficiary banks, adequate burden sharing between the State and the beneficiary, and prudent valuation of impaired assets based on their real economic value. Finally, the Communication requires that all beneficiary financial institutions must be subjected to a restructuring plan.

The Restructuring Communication of 19 August 2009 *(*2009/C 195/04) prescribes that a government willing to give state aid to a financial institution up to the end of 2010 must submit a viability plan (in the case of aid received by a fundamentally sound bank) or a restructuring plan (in the case of aid received by a distressed bank). The above distinction is defined on the basis of the relative size of aid measures received in the form of recapitalisation or asset relief: an amount of more than 2% of the bank's risk weighted assets is considered as the threshold between fundamentally sound and distressed banks. The viability plan should demonstrate how the bank will restore its long-term viability without reliance on state support. The plan should include comparison with alternative options, including break-up or absorption by another bank, in order to allow the Commission to assess whether more market oriented, less costly or less distortive solutions are available. In the eventuality that the bank cannot be restored to viability, the restructuring plan should indicate how it can be wound up in an orderly fashion. Restructuring should not last more than five years to be effective. The principle of burden sharing should be followed: the costs associated with the restructuring should be borne not only by the state but also by shareholders and adequate remuneration should be paid for State intervention. To limit distortions of competition, and to enable entry or expansion of competitors, benefiting banks may be required to divest subsidiaries or branches, portfolios or business units, in particular when the amount of aid is truly considerable, the extent of the beneficiary's own contribution and burden sharing having been modest, and the bank benefiting from a large market share. State aid must not be used for the acquisition of competing businesses; this condition should apply for at least three years. Due to the new financial vulnerabilities linked to the tensions in sovereign debt markets, a later Communication of 7 December 2010 (2010/C/ 329/07) extended throughout 2011 this support framework, but introducing the obligation to submit a restructuring plan also for sound banks benefiting from aid measures.

In the period between 1 October 2008 and 1 October 2010 the Commission took more than 200 decisions authorising, amending or prolonging 41 national bank support schemes and addressing the situation of more than 40 financial institutions on the basis of individual decisions (EUROPEAN COMMISSION, 2010b). The approved maximum volume of measures including general schemes and ad-hoc interventions amounts to € 4588.90 billion or 39% of EU-27 GDP for 2009 (Table 11). The total volume approved for the schemes (€ 3478.96 billion) was considerably higher than for individual financial institutions (€ 1109.94 billion). The larger amount approved for scheme support can be accounted for with the fact that two Member States (Denmark and Ireland) adopted blanket guarantees covering all of their bank debt. Member States mainly relied on guarantee measures whose stabilising effect would not weight heavily on public finances, as would have done more interventionist instruments such as recapitalisation or the cleaning up of impaired assets. It is worth noting is that almost 70% of approved aid relates to just 5 Member States, the United Kingdom, Ireland, Denmark, Germany and France. In 2009, the amount (nominal amount) of state aid actually used for the financial sector was € 1106.54 billion or 9.3% of the EU-27 2009 GDP, slightly more than half of the approved maximum.

Table 8

State aid granted to the financial sector: type of interventions (2008-2009)

	Approved amounts 2008-2010 (€ billion)	Approved amounts as a % of EU-27 2009 GDP	Actual use i.e. nominal amount 2009 (€ billion)	Total actual used as a % of EU-27 2009 GDP
Schemes	3478.96	29.48%	727.38	6.16%
• for guarantees	3026.28	25.64%	612.59	5.19%
• for recapitalisation measures	348.64	2.95%	95.15	0.81%
• for asset relief interventions	62.17	0.53%	1.4	0.01%
• for liquidity measures other than guarantee schemes	41.87	0.35%	18.23	0.15%
Ad hoc interventions in favour of individual financial institutions	1109.94	9.40%	379.16	3.21%
• for guarantees	458.97	3.89%	214.3	1.82%
• recapitalisation measures	197.44	1.67%	46.36	0.39%
• for asset relief interventions	339.63	2.88%	108.38	0.92%
• for liquidity measures other than guarantees	113.9	0.97%	11.11	0.09%
TOTAL	**4588.90**	**38.88%**	**1106.54**	**9.38%**

Source: European Commission, Directorate General for Competition. Available at: http://ec.europa.eu/competition/state_aid/studies_reports/expenditure.html

Table 12 shows that the sums involved in the support programmes vary considerably across Member States. These differences reflect a range of factors, including the relative size of banking sectors (Belgium, Netherland, United Kingdom, Ireland, Luxembourg), exposure to impaired assets originated in the United States (United Kingdom, Germany), exposure to collapse of local real estate markets (United Kingdom, Ireland, Spain, Denmark) and exposure to emerging economies in Central and Eastern Europe (Sweden, Finland, Austria, Greece, Belgium, Netherlands).

Table 9

State aid granted to the financial sector in 2008 and 2009 (per member states)

Country	Approved amounts 2008-2010	Approved Amounts as a % of national 2009 GDP	Actual use 2009	Actual used amounts as a % of national 2009 GDP	No. of financial institutions
Austria	91.70	33.1%	30.94	11.2%	8
Belgium	328.59	97.4%	120.43	35.7%	6
Denmark	599.66	269.0%	14.44	6.5%	59
Finland	54.00	31.6%	0.00	Not used	-
France	351.10	18.4%	129.48	6.8%	8
Germany	592.23	24.6%	262.68	10.9%	13
Greece	78.00	32.8%	25.12	10.6%	9
Ireland	723.31	442.3%	11.29	6.9%	6
Italy	20.00	1.3%	4.05	0.3%	4
Luxembourg	11.59	30.7%	2.72	7.2%	4
Netherlands	323.60	56.8%	75.00	13.2%	14
Portugal	20.45	12.2%	0.65	0.4%	7
Spain	334.27	31.8%	60.31	5.7%	2
Sweden	161.56	55.2%	79.39	27.1%	n.a.
United Kingdom	850.30	54.3%	282.41	18.0%	18

Sources: European Commission, Directorate General for Competition. For the number of banks: R&S (2010).

The different weight of national public support for banks clearly shows the greater fragility of some banking sectors.

> “Was this related to differences in national supervision? It could be that some banks' supervisors had a more "prudent" approach than others (see for example the Spanish approach to off-balance sheet transactions which was the most rigorous and also their requirement for dynamic provisioning which provided cushions to the banks when the crisis erupted).” (DE LAROSIÈRE, 2009, p. 42, note 9).

7 THE NEW EU INSTITUTIONAL REGULATORY AND SUPERVISORY ARCHITECTURE

At the pinnacle of the new architecture (Table 13) is the European Systemic Risk Board (ESRB) composed of the President and Vice-President of the European Central Bank, the Governors of National Central Banks, the

Chairs of the new three European Supervisory Authorities for Banking, Insurance and Securities, the European Commission, and, as non-voting members, one representative of the competent national supervisors per Member State plus the President of the Economic and Financial Committee. The new three independent Authorities, and their joint committee, are liaised with the national supervisors in what is defined as the European System of Financial Supervisors.

The duties of the ESRB include macro-prudential supervision and issuing of warnings and recommendations to the relevant EU and national authorities. The decisions of the Board are taken with the simple majority of the present members with voting rights; the votes are not weighted. The Board will monitor compliance with its warnings and recommendations for remedial action. In the case of inaction, the parties concerned should provide adequate justification (act or explain mechanism).

Chart 4

Changes in the European supervisory framework

New supervisory authorities	European Parliament and the Council: Regulations (EU) No 1092, 1093, 1094, 1095 Directive 2010/78/EU 24 November 2010	▪ Macro-prudential framework: creation of the European Systemic Risk Board (ESRB), chaired for the next 5 years by the ECB President ▪ Micro-prudential EU framework: adoption of the European System of Financial Supervisors (ESFS). The existing III Level Committee will be replaced by the new European Supervisory Authorities (ESAs): European Banking Authority (EBA), European Insurance and Occupational Pension Authority (EIOPA), European Security Authority (ESA).
Colleges of Supervisors	Directive 2009/111/EC 16 September 2009 (CRD II)	▪ The amended Capital Requirement Directive requires consolidating supervisors to create colleges of supervisors for each cross-border financial institutions. The colleges also include supervisors from Member States where a subsidiary is located or host significant branches of financial institutions.

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The two most Europe-specific novelties of the micro-prudential architecture are as follows. First, there is the power attributed to the three new authorities to settle disagreements among national supervisors and propose rule-books, to be approved by the Commission, aimed at creating a narrower corridor for national discretion. Consequently more legislation will come in the form of regulations rather than directives. Second comes the formalisation of the colleges of supervisors, one for each cross-border financial institution, to enhance cooperation on day-to-day supervision and emergency situations; this could also help smooth out national differences in supervisory practices.

8 TOWARDS A NEW EU REGULATORY FRAMEWORK

The Financial Stability Board (FSB), designed by the G20 as coordinator of the new proposals advanced by the international standard setters, and itself an originator in certain fields, thus summarizes the areas on which reforms have already been implemented or are being discussed (FSB, 2010):

1. Building high quality capital and liquidity standards and mitigating pro-cyclicality
2. Addressing systemically important financial institutions and cross-border resolutions
3. Improving the OTC derivatives markets
4. Strengthening accounting standards
5. Strengthening adherence to international supervisory and regulatory standards
6. Reforming compensation practices to support financial stability
7. Developing macro-prudential frameworks and tools
8. Expanding and refining the regulatory perimeter (hedge funds, Credit Rating Agencies (CRAs), supervisory colleges, securitisation)

In the following pages the attention will focus on the areas in which Europe has made significant steps, either approving new legislation or advancing proposals. Table 14 shows the main initiatives taken by the EU on regulation and supervision of the financial sector subsequent to the crisis, singling out the features that characterise the European framework.

Chart 5

Main reformsand proposals on financial regulation and supervision after the crisis

	Content
Initiatives taken	
Agreement ECFIN/CEFCPE(2008) 1 June 2008 (Memorandum of Understanding)	Extension of the 2005 MoU. In order to limit the economic impact of cross-border systemic financial crises, the agreement sets out common principles, procedures and practical arrangements concerning cooperation among the authorities responsible for preserving financial stability (financial supervisory authorities, central banks and finance ministries).
Directive 2009/14/2009 11 March 2009 (Deposit Guarantee Schemes)	Amending Directive 94/19/EC on deposit guarantee schemes as regards the coverage level (increased to € 50,000 and to € 100,000 from June 2010) and pay-out delay (reduced to a period of 20 working days). Abolishes coinsurance option.
Directive 2009/111/EC 16 September 2009 (Capital Requirement Directive II)	▪ Removal of some national options and discretions as regards prudential regimes for large exposures, inter-bank exposures, connected clients. ▪ Harmonization of eligibility criteria of hybrid capital instruments and limits to inclusion in Tier I. ▪ Retention by originator or sponsor of an “economic interest” no less than 5% of the nominal value of the securitised exposures.
Regulation (EC) No. 1060/2009 16 September 2009 (Credit Rating Agencies)	A credit rating agency applies to the Committee of European Securities Regulators (CESR) for registration in the EU as a condition for being recognised as an ECAI in accordance with the 2006 CRD. A credit rating agency established and registered in the EU may endorse a credit rating issued in a third country only if it fulfils requirements at least as stringent as the EU requirements. Rules to guarantee independence and avoidance of conflicts of interest. Disclosure requirements and supervision by CESR (now ESMA).
Directive 2010/43/EU 1 July 2010 (Uundertakings for Collective Investment in Transferable Securities	Rules for the conduct of UCITS (undertakings for collective investment in transferable securities) management companies, aligned with organisational requirements and rules of conduct of the MIFID Directive. These rules also cover prevention, management and disclosure of conflict of interest. The directive obliges UCITS managers to employ robust and effective procedures and techniques to manage adequately the different types of risk they might face.
Directive 2010/76/EU 24 November 2010 (Capital Requirement Directive III)	Linked to FSB principles and the Basel Process. ▪ General principles applicable to remuneration policy in the financial services sector. Remuneration policies should aim at aligning the personal objectives of staff members with the long-term interests of the financial undertaking concerned. The assessment of performance-based components of remuneration should be based on long-term performance and take into account outstanding risks, making those policies consistent with effective risk management. ▪ Amendments of CRD as regards capital requirements for trading book and for re-securitisations. For the trading book it adds an additional capital buffer based on stress scenario VAR to the ordinary VAR. The change is expected roughly to double the current trading book capital requirement. Higher capital charges are required for re-securitisation positions to reflect adequately the risk of unexpected impairment losses.
Initiatives proposed	

Directive proposal by the European Commission COM(2009) 207 30 April 2009 (Alternative Investment Fund Managers)	Harmonised requirements for entities engaged in the management and administration of alternative investment funds (all funds that are not regulated under the UCITS: hedge funds, private equity, real estate funds, commodity funds, infrastructure funds and other type of institutional funds). The proposal introduces a legally binding authorisation and supervisory regime for all AIFM operating in the EU. The prudential regulation includes disclosure on the investment strategy and objectives, and the possibility to impose leverage limits for systemic stability purposes. A European passport is given to an AIFM authorised in one Member State. AIFMs are allowed to market AIF located in third countries provided that the regulatory framework and supervisory arrangements are equivalent to those of the proposed directive, and only if their country of domicile has entered into an agreement based on OECD Tax Convention with the Member State on whose territory the AIF shall be marketed.
Directive proposal by European Commission COM(2010) 368 12 July 2010 (Deposit Guarantee Schemes)	This is the first measure that introduces maximum harmonisation. Deposit guarantee schemes for all EU countries must now cover a given amount, must be financed ex ante, with contributions determined on the basis of each bank risk profile. The ratio of coverage of the schemes must be at least 1.5% of eligible deposits. Deposits by public authorities and of financial institutions of any kind are excluded.
Regulation proposal by European Commission COM(2010) 482 15 September 2010 (Short-selling and CDS)	The attempt is to harmonise national decisions on short selling and credit default swaps, giving regulators more and harmonised powers to limit related risks if they can affect the whole financial system. ESMA should have the task to coordinate these emergency powers.
Regulation proposal by European Commission COM(2010) 484 15 September 2010 (Over The Counter)	This concerns OTC derivatives, central counterparties and trade repositories. It increases the transparency of the OTC derivatives market for regulators, market participants and the public. It reduces the counterparty credit risk and operational risk associated with OTC derivatives. The operational objectives are: to obtain complete and comprehensive information on OTC derivative positions; increase the standardisation of OTC derivatives contracts and processes; increase the use of CCP clearing; improve bilateral clearing practices; subject CCP clearings and trade repositories to strict prudential regulation.
Future initiatives	
By European Commission Directive proposal February 2010 (Capital Requirement Directive IV)	This follows the Basel process (Basel III) for possible changes in the Basel II framework. The innovations relate to liquidity standards, the definition of capital, leverage ratio, counterparty credit risk, countercyclical measures, and systematically important financial institutions. The specific EU objective is to produce a single rule book in banking, eliminating the proliferation of national options and discretions.
By European Commission Communication COM(2010) 254 26 May 2010 (Resolution funds)	This concerns the establishment of a network of *ex ante* national resolution funds, funded by a levy on banks. It should facilitate the resolution of failing banks in ways which avoid contagion, and allow banks to be wound down in an orderly manner and in a timeframe which avoids the “fire sale” of assets. It should minimize future reliance on taxpayer funds to bail-out banks. At the moment the only clear rules concern the *ex ante* nature of the funds, their separation from DGSs, their use only for the resolution of banks, irrespective of their size and interconnectedness.

By European Commission Communication 20 October 2010 (Crisis management and resolution)	This applies to all banks and to systemic investment firms. It allows them to fail without costs for taxpayers or disruption of markets. The goal is not full harmonisation; each country should possess procedures for the management and resolution of crises broadly based on common principles. ▪ Prevention: these institutions should prepare Recovery plans, on how the firm would face stressed scenarios for liquidity and solvency problems, which must be approved by the supervisory authority. Resolution plans, on how to permit the transference or wind down of the institution's activities in an orderly way in the event of its failure, are prepared by the resolution authorities and supervisors in close cooperation with the firm. ▪ Management: Implementation of the recovery plans, with a standard conservatorship regime. ▪ Resolution: Implementation of the resolution plans, with national receivership regimes which should possibly be based on ad hoc bank resolution legislation. Resolution colleges should look after cross-border institutions with burden-sharing agreements.
By European Commission Public consultation on a Review of Markets in Financial Instruments Directive 8 December 2010	This extends to every type of organised trading facility the legal treatment of investment services, i.e. submission to the single passport. It aligns the organisational requirements for relevant Multilateral Trading Facilities with those applicable to organised markets. It extends the MiFiD as regards the organisation, transparency and oversight of previously neglected market segments, especially for instruments traded mostly over the counter. It proposes to increase convergence in terms of sanctions. It proposes to minimise, where appropriate, discretions available to Member States across EU financial services directives, thus establishing a single rulebook for EU financial markets.

From the above table it emerges clearly that the EU legislation follows the general principles laid down by the G20, FSB and international standard-setting bodies, on whose decisions many European countries participate. However, the transposition of those principles into a European legislative framework necessarily leads to incorporating features specific to the EU context of unity in diversity. The EU initiatives confirm the trend towards increasing harmonisation and cooperation, setting up institutional arrangements which should be capable of pressing national representatives to adopt an EU wide perspective. Cooperation is increasingly made mandatory and the minimum harmonisation threshold is raised. The new initiatives potentially allow for more intrusive actions by EU supervisory authorities, including the various colleges of supervisors. There are not sufficient grounds at the moment to enter into discussion of the specific features of many initiatives in the absence of implementation legislation, much as in the USA, where the relevant supervisory authorities are still discussing how to transform many parts of the Dodd-Frank Act into specific rules.

9 THE NEW OVERALL DESIGN

The recent crisis has severely stressed European construction. The propagation of fire within the single market proved just how unprepared the overall European institutional framework was to manage systemic crisis situations. In this the EU was not alone; peculiar to its construction are, however, the potential disruptive effects on the single financial market of *ad hoc* national policy responses.

Bank bail-outs were largely national, with some extemporary cross-border solutions, calling for ex-post interventions by the EU Commission to contain the threats posed by national state aids to the single financial market. The same applies to the fiscal counter-crisis policies, whose national bent often had to be allowed as a temporary exception. When private de-leveraging produced some unsustainable public leveraging in the Euro area, two funds were hastily created in order to limit the spread of panic to a wider set of Economic and Monetary Union countries. The European Financial Stabilisation Mechanism (EFSM), a € 60 billion fund contributed to by all the EU countries, and the European Financial Stability Facility (EFSF), a special-purpose vehicle owned by the Euro area countries with resources up to € 440 billion and expiring in 2013, were created in May 2010 to help member countries in difficulty (the ESFS for Euro area countries), subject to strict conditionality. The IMF participates in financing arrangements and providing an extra line amounting to half the EU contribution.

Even the ECB, considered the only real European authority and lauded for its prompt interventions, showed the limits of a construction where the national central banks were allowed to grant emergency liquidity assistance to their financial sector following widely diverse rules on guarantees and haircuts. Furthermore, ECB decisions to intervene on the secondary markets of sovereign debt were not unanimous, being seen as hardly accounted for by the need to guarantee the orderly transmission of monetary policy.

The latitude given to national supervisors is considered, also at the EU level, as one of the main causes leading some countries to develop fragile financial systems endogenously. The previous sections have shown how the changes introduced in the regulatory and supervisory institutional architecture are leading to increased centralisation, aiming at narrowing national discretions. Coupled with the on-going process of drawing up stricter rulebooks, a more resilient overall financial system is expected to follow. Much attention is now also being paid both to pre-emptive actions by the new EU authorities, at both the micro and macro level, and to the functioning of the colleges of supervisors to homogenise supervisory practices and ease EU cross-border crises management.

In the early 1990s the overall European design was deepened with adoption of the Maastricht Treaty, with which the Member States resolved, *inter alia*, to "achieve the strengthening and the convergence of their economies and to establish an economic and monetary union including … a single and stable currency." (EU, 1992. p. 1) Despite two opt-out cases (the UK and Denmark) and derogations for countries in the process of adopting the common currency (presently eight countries), it is important to note that the Treaty is framed in terms of a monetary union (the Euro area) which should include all countries pertaining to the Union. All EU countries are represented in the European System of Central Banks[13] and the fiscal discipline imposed on the countries adopting the euro is extended, although in a milder form, to non-Euro EU countries. Along the single market and the single currency the European architecture is, in fact, crucially based on a third leg, namely the fiscal leg first embodied in the Stability and Growth Pact (SGP) (Council of the European Union. 1997 and 2005) prompted by the Maastricht Treaty.

According to the criteria laid down for adoption of the euro, each Member State should have a debt to GDP ratio lower than 60% and pursue the objective of a balanced or surplus budget. Deficits up to 3% of GDP are allowed for normal cyclical fluctuations (1% for Euro countries); larger deficits are permitted in exceptional circumstances, but then require annual adjustments not lower than 0.5% of the GDP, and an agreed timeframe. Offending countries are sanctioned and may be fined, and are ultimately referred to the European Court of Justice. Despite numerous violations and feeble enforcement, which led to the 2005 revision, the Council of the European Union affirmed that:

[13] Obviously, non-euro countries have no voting rights on ECB monetary policy.

> The Stability and Growth Pact has proven its usefulness in anchoring fiscal discipline, thereby contributing to a high degree of macroeconomic stability with low inflation and low interest rates, which is necessary to induce sustainable growth and employment creation (COUNCIL OF THE EUROPEAN UNION, 2005, p.1)

In other words, fiscal discipline was considered a necessary condition to prevent fiscal imbalances from creating difficulties for the ECB in targeting inflation, and indeed to avoid the crowding-out of private investments.

The SGP was increasingly seen as at most a necessary but not sufficient condition for achieving higher growth and employment. In 2000 the Lisbon Strategy added a wider perspective. The Lisbon declaration starts from recognising that Europe had fallen behind the US and the more dynamic emerging countries, and implicitly admits the limits of EU level policies in fostering competitiveness and growth. The necessary structural reforms had to be thought out and promoted at the national level. Some 'flagship' EU initiatives, coordination of national plans and their assessment by the Commission should have served as sufficient incentives for their implementation. Putting aside grandiloquent enunciations on the knowledge society, flawed procedures and the absence of significant results, the Strategy represents a shift from the purely quantitative fiscal parameters of the SGP towards structural reforms which require changes in national legislation and modifications in the structure of national public budgets. Albeit with significant differences, the EU countries have long since reached what Minsky termed Big Government, i.e. public expenditure taking a large share of GDP. As Minsky (1982) suggested, and the Lisbon Strategy recognises, long-term growth requires re-orienting public budgets towards policies capable of enhancing system-wide efficiency.

The crisis represented the exceptional circumstance that forced most EU countries to run up deficits well beyond the 3% ceiling. In some countries public debts ballooned, causing sovereign debt crises. The danger of contagion to other EU countries and of a second and more disruptive wave of financial crisis prompted the fiscal and monetary 'unorthodox' interventions discussed above. The contagion has for the moment been halted, but the underlying problems remain, posing serious threats to the Euro construction and with it to the whole EU project. The seriousness of these problems, coming on top of the difficulties that had already prompted the Lisbon Strategy, together with the deep recession and sluggish recovery then convinced the EU authorities that a Japanese-type of 'lost decade' could result. A general consensus has been reached on the need for a strong institutional reform. The previous sections have discussed the new institutional architecture for financial regulation and supervision. A full understanding of the future efficacy of such regulation and supervision requires considering the reform of the entire architecture.

Even if pressed by poor past results and suggestions like "let the [Lisbon] strategy die a peaceful death" (WYPLOSZ, 2010), the European Council (2010) has put forward the proposal for a new plan called Europe 2020 Strategy, which should be coordinated with a revised SGP and a new plan for the prevention and correction of macroeconomic imbalances. The necessity for strengthened governance will be met by the "European Semester".

> The "European Semester" is a time-window in the first half of each year in which Member States reporting under the Stability and Growth Pact and reporting under the Europe 2020 Strategy are aligned and policy guidance and recommendations are given to Member States before national budgets are finalised. This will strengthen the ex ante dimension of economic policy coordination and surveillance in the EU, making it possible to combine the benefits of a common agenda at EU level and of tailor-made action at national level. In this way, the EU can draw timely lessons from national developments and Member States can incorporate the European perspective and guidance into their national policies for the following year (EUROPEAN COMMISSION, 2011, p. 2-3).

Europe 2020 refocuses the Lisbon goals, with a slimmer set of verifiable parameters and the call for a stronger "political ownership" of national reform plans, i.e. the "involvement of political actors (national parliaments, regional and local authorities) as well as social partners and other stakeholders in the preparations." (EUROPEAN COMMISSION, 2011. p.11). Although making allowances for the on-going difficulties created by the crisis, in the same Report the Commission laments the scant attention that the most countries' programmes continue to pay to structural reforms.

The reformulation of the SGP adds the principle of 'prudent fiscal policy-making' to the medium-term objective of a balanced or surplus budget and the annual adjustment not lower than 5% of GDP. According to this principle, the annual growth of public expenditure should not exceed a prudent evaluation of the medium-term rate of GDP growth. The rationale behind this principle is to ensure that eventual revenue windfalls are not spent, but are instead allocated to debt reduction. Its enforcement for the Euro area countries would take the form of an interest-bearing deposit, amounting to 0.2% of the GDP. Furthermore, these same countries would be subject to financial sanctions in case of excessive deficit, initially with a non-interest-bearing deposit amounting to 0.2% of the GDP, which would be transformed into a fine should the deficit not be corrected within a required timeframe. The new SGP also refocuses on debt. Member countries whose debt is higher than 60% of the GDP should produce evidence of having reduced it in the last three years at an annual rate of not less than 5% of the difference between the average debt in the last three years and the 60% ceiling. Failing this adjustment, the country would be submitted to the procedure for excessive debt unless some specified relevant factors had impeded reduction of the debt.

Finally, “Member States should avoid unsustainable macroeconomic imbalances, arising notably from developments in current accounts, asset markets and the balance sheets of the household and corporate sectors.” (COUNCIL OF THE EUROPEAN UNION, 2010. p. 3) On the basis of an alert mechanism, made up of a, yet to be defined, scoreboard backed by judgmental analysis, the Commission will decide if the imbalances are serious enough to start an ‘excessive imbalances procedure’ (EIP). For the Euro area the enforcement mechanism envisages a fine of 0.1% of the GDP if the country persists in failing to take corrective measures. It is worth noting that the Commission will take into account early warnings and recommendations coming from the European Systemic Risk Board, thus adding to the Board's policy instruments.

More recently, on 11 March 2011 the Heads of State or Government of the Euro area decided to launch the "Pact for the Euro"[14], open to voluntary participation by non-Euro Member States. The Pact "establishes stronger economic policy coordination for competitiveness and convergence" within the reformed framework discussed above. An agreement was also reached on the

[14] The Pact follows the lines of a document by the President of the Commission and the President of the European Council, compromising between the tougher and automatic rules proposed by the German and French Governments and strong objections by most of the other Euro area governments.

creation of a permanent European Stability Mechanism (ESM) to deal with sovereign debt problems.

The goals of the proposed Pact are: to foster competitiveness and employment, contribute further to the sustainability of public finances and reinforce financial stability. Since these are areas that fall under national competence, the new commitments will be included in the National Reform and Stability Programmes to be evaluated during the European Semester. The salient measures outlined in the document refer to: wage setting arrangements, so as to render unit labour costs consistent with competitiveness; further opening up of sheltered sectors (professional services and retail sector); labour market reforms to secure "flexicurity" (flexibility with security); sustainability of pensions, health care and social benefits; transformation of the fiscal rules contained in the new SGP into binding national legislation (constitutional or framework law); and the introduction of specific national legislation for banking resolution procedures. The document also calls for discussion on tax policy coordination, in particular on a common corporate tax base, upon which a legislative proposal by the Commission is expected.

The stricter discipline for Euro countries was what some of them required to allow for transformation of the EFSF into a permanent institution, the European Stability Mechanism (ESM). Starting from 2013, the fund will have a € 500 billion effective lending capacity, intervening on request of a member country and when the Eurogroup Ministers unanimously decide on its indispensability to safeguard the stability of the Euro area as a whole. The scheme retains the strict conditionality and the pricing (funding cost plus an adequate mark up for risk) of the ESFS, with its loans junior only to IMF loans. The most significant innovation is a honing of the concept of debt sustainability, distinguishing between solvent and insolvent member countries. The latter will have to restructure their debt with private creditors; if the result leads to debt sustainability the ESM will provide liquidity assistance. This debt restructuring scheme requires that all Euro-area countries issue bonds with collective action clauses by 2013. Note that this is the first attempt to formalise agreed procedures for sovereign debt restructuring.

The new general design is not reshaping the fundamentals of the Union. Almost every new EU document stresses that the enhanced institutional and governance architecture does not come at the expense of national sovereignty as expressed by the Treaties. In other words, the goal of the reform is not maximum homogenisation, but an attempt to raise the floor of the minimum homogenisation set in the past. This means a more precise statement of the Union's objectives, their translation into stricter rulebooks, and making the institutional framework better geared to exerting stricter control over whether each country is pursuing them effectively. The choice of the specific policies that are consistent with its own social, legal and political conditions is left to each country. European construction remains anchored to the bottom-up approach, much like the Basel approach on banking regulation. After stating some general principles and a few rules, it is left to each jurisdiction to convert them into effective practices. What differs from Basel, and experience shows it to be a crucial point, is the need for enforcement mechanisms; the current effort is to make them more stringent than in the past, especially for Euro area countries. Although technical bodies, like the EU supervisory agencies, have gained in scope, the effective enforcement power will continue to remain with more politically oriented institutions, like the Commission and the Council. From a 'constitutional' point of view this is a sound solution. The problem rests with the many judgmental criteria that remain relevant for a final decision. If the past is any guide, specific-country interests will continue to limit the top-down efficacy of the new architecture.

Discussion on the European institutional construction must be cleared of the long-lasting and recently renewed debate on the Euro area not being an optimal currency area (OCA). What Mundell in fact showed in his seminal paper (MUNDELL, 1961), was that no actual nation corresponds to an OCA and that for flexible exchanges to work effectively and efficiently a series of restrictive conditions must hold that are very far from being present in the actual world. Unfeasible as it is to rearrange political boundaries into OCA regions, Mundell also argued in favour of the efficiency gains deriving from a common currency. The starting point for Europe is the creation of an area possessing a truly single market for goods and services. As the long history of economic international relations shows, such a construction is inconsistent with the beggar-thy-neighbour policies allowed by flexible (managed) exchanges. Hence the crucial construction for Europe is not just the euro, but the single market. If the latter remains an irrevocable goal, the anomaly lies not in the monetary union, but in the UK and Denmark (to which Sweden may possibly be added) being allowed opt-out from the euro while benefiting from free access to the European market.

The crucial point is what type of constitutional and institutional architecture is needed to make way for a common market and a common currency producing net gains for all, while retaining fair margins of national sovereignty - and not only a fiscal sovereignty – within the area. Proposing arrangements which imply moving on from Union to Federation is, and will remain for many decades, a dangerous exercise. As the previous analysis sought to show, this does not dispense with the need to converge on a set of common values, principles and rules, required to enhance the net gains deriving from the Union. This crucially means strengthening the enforcement mechanisms. Well before the crisis, an ambitious and difficult process was started with the Lisbon Strategy, designed to extend convergence over a wider set of objectives. The poor results reached before 2007 are mainly to be ascribed to the absence of an institutional framework capable of driving the national authorities towards the agreed goals. In the financial sphere, the crisis has shown both the serious shortcomings of the regulatory approach and how these shortcomings were amplified by national discretions. Rightly, the institutional response of the EU to both has been to start strengthening enforcement mechanisms and common rulebooks. The debate is still open as to whether the steps already taken will suffice to ward off a repetition of the past.

10 Concluding remarks

For centuries Europe fought intestine wars aiming at asserting the prevalence of a part over the rest, and certainly not at unification under common values. The sense of belonging to a broad European community declined sharply, especially with the rise of 19^{th} century nationalism. After the Second World War the opposite process was laboriously set into motion aiming at agreement on basic common values and identifying unifying goals, creating an institutional framework that would ease advance in the process. It is this complex design that must be considered when analysing the general framework and specific parts of the architecture, like the part relating to the financial sector. Abstract theoretical models, notorious for their disregard of institutional constructions, are of very limited help and may distort discussion on how to improve the overall design. Given the relevance of historical, social and cultural elements, there is no unique design for constitutional and institutional architectures, even when based on a similar set of values. What it is necessary, in any case, is a sufficient degree of coherence in its constituent parts.

The EU design derives its strong peculiarities from the cohabitation of Member State sovereignty with the goal of a single market. Enhancement of harmonisation and convergence necessarily requires a complex political process, with Member States willing to pass on some parts of their sovereignty to collegial decisions, increasingly taken without veto powers. The wisdom of the EU decision process lies in seeking unanimity or large convergences wherever possible. Compromise solutions are, then, a necessary trait of the EU construction. In normal times it is easier for each Member State to be satisfied with the balance of its own benefits, although distribution within the Union may not be uniform. Analogously to the Minsky process, it is in normal times that the fragility of the construction may increase. Not driven by apparent threats, the enforcement mechanisms may significantly lag behind in the desirable advance towards harmonisation, thus leaving room for the accumulation of various sorts of imbalances. When a shock hits the Union or part of it, those fragilities may radically change the perceived national balances of costs and benefits and their distribution within the EU. Heightened national interest may produce serious damage to the whole EU edifice. The recent crisis represented such a shock, laying the cumulated fragilities bare.

The entire EU construction rests, then, on keeping economic, monetary and financial imbalances within socially and politically acceptable limits and preparing smooth resolution procedures when they occur. The three institutional legs - the broad fiscal one under the umbrella of the European Semester, the ECB and the financial regulatory and supervisory authorities - represent the result of compromises among national 'egoisms'. As the recent crisis has shown, the efficacy of enforcement, from which their credibility derives, rests on serious shocks not seriously disturbing this fragile equilibrium. It has also made clear how the increased interconnections between member countries have entailed further individual weaknesses throughout the whole area. Light touch supervision in some countries has directly or indirectly generated cross-border negative externalities, while economic negative and positive imbalances have contributed to weakening the edifice. The present paper has repeatedly argued in favour of attempts to increase convergence primarily homogenising procedures and strengthening enforcement.

The EU financial regulatory and supervisory construction requires particularly strong measures to prevent the financial sector from generating such heavy negative externalities as to disrupt the delicate equilibriums on which the European monetary and fiscal constructions rest. Although the reforms in the institutional architecture are going in the right direction, doubts can be raised as to whether, following the international approach to financial re-regulation, the European financial systems will gain the extra resilience required by the peculiar European construction.

The international agenda on financial reforms does not, in fact, imply radical changes to the previous architecture. It explicitly follows the same prudential approach, seeking to reinforce its mechanisms. The point is that the increases in capital requirements are widely judged insufficient and continue to be based on discredited methodologies; the financial institutions will continue to be too big to fail and to be resolved; since the non-banking sector will continue to be regulated with a light-touch approach, leaving connectedness and contagion untouched, the focus on banks will give way to new forms of regulatory arbitrage; the ample discretion attributed to supervisors, with the problem of their capture left unsolved, adds to their regulatory status and to regulatory uncertainty. The present authors have already argued that the current reforms, with their extra costs, will not tangibly reduce financial systemic fragility and that a radical change in the regulatory approach is badly needed (TONVERONACHI and MONTANARO, 2010).

Given the dependence of the European financial systems on banking, these reforms will certainly increase their regulatory costs, probably more than in other contexts characterised by a less systemic role of the banking sector. The European banking industry is already pressing for a softer approach, pointing out the disproportionate impact of stricter requirements on Europe's already sluggish growth. It is certainly impracticable for Europe to extra-toughen requirements for banks, as it is highly improbable that it will implement non-bank international standards with stricter rules. The financial sector will continue to pose serious threats in all countries. For Europe it might jeopardise its entire construction.

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