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THE EVOLUTION OF THE EUROPEAN FINANCIAL SYSTEM AFTER THE CRISIS

Article published in the Quarterly Review 2016:1, pp. 96-115

THE EVOLUTION OF THE EUROPEAN FINANCIAL SYSTEM AFTER THE CRISIS[1]

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Abstract
The European Union (EU) probably faced its most severe test during its financial and sovereign debt crisis, which exposed a number of weaknesses and showed that Europe still had a long way to go before its regulations and mechanisms could effectively ensure a smooth and coordinated effort towards achieving the full benefits of integration. The crisis highlighted several threats and generated an urgent need to reshape the existing architecture in the financial, fiscal, economic and political domains by strengthening economic governance through stricter budgetary and economic policy surveillance and restoring confidence in the financial system, mostly by means of enhanced regulatory and supervisory measures.

This article provides an account of the various mechanisms put in place in recent years, thus making the European financial system, and particularly the Economic and Monetary Union (EMU) more capable at facing the challenges of financial integration and more resilient to possible future financial crises. It concludes by discussing possible caveats in the existing mechanisms with observations on the possible way ahead in the evolution of economic governance.

Introduction
The EU was established with the aim of fostering prosperity and stability across Europe by promoting economic, social and territorial cohesion and solidarity among Member States. While it was recognized that countries joining the EU had significant structural differences, the launch of the common currency was expected to create the conditions for further real convergence among member countries. The benefits of the single market were to be reinforced by growing trade and financial links, making economies more similar and subject to more common shocks over time. (Frankel and Rose, 1998).[3] From the onset, however, it became clear that the EU still had a long way to go before its regulations and mechanisms could effectively ensure a smooth and coordinated effort towards achieving the full benefits of European integration.

The EU faced its most severe test during its financial and sovereign debt crisis which commenced in 2009 and which exposed a number of weaknesses in the original framework, highlighting several threats and generating an urgent need to strengthen the existing architecture in the financial, fiscal, economic and political domains. The coupling of domestic fiscal and banking risks, together with extensive financial linkages across countries, turned country-specific shocks into systemic ones, with no existing mechanisms to deal with such events. At the same time, despite these setbacks, the EU demonstrated that there was enough political will to survive such calamities. This high level of cooperation was especially evident among the Member States within the EMU. As a result the single European currency was able to withstand the crisis.

[1] The cut-off date is April 2016.

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[3] Frankel J.A. and Rose A.K.: The Endogeneity of the Optimum Currency Area Criteria, NBER Working Paper, 1998.

The main challenge that the EMU faces is that national economic and financial policies cannot be decided in isolation since their effects could quickly propagate to the euro area as a whole. Therefore, such national policies must reflect the realities of being part of a monetary union by ensuring coordination and convergence, while maintaining high levels of competitiveness and sustainable growth, and reducing the prospects of instability.

Individual Member States need to act and coordinate their national policies according to common rules and regulations while ensuring that the appropriate fiscal, monetary and financial measures are triggered to prevent adverse scenarios which may impinge on their financial systems as well as those of other EMU members. Furthermore this coordination must ensure openness and transparency in order to function properly and the improvement and development of new tools with which financial stability can be safeguarded.

In light of this challenging scenario, at the June 2012 European Council, the President of the European Council was invited "*to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound map for the achievements of a genuine Economic and Monetary Union, which will include concrete proposals on preserving the unity and integrity of the Single Market.*"[4]

To this end, a number of reforms aimed at strengthening financial supervision, fiscal discipline and macroeconomic surveillance have been undertaken in order to make EMU more adept to face the challenges of financial integration while making it more resilient to shocks in the future.

This paper attempts to review the various mechanisms put in place in recent years, aimed at strengthening the financial architecture within the EU, in particular the euro area. Section 2 highlights the link between the financial crisis and the growing need to further improve economic governance in Europe. Section 3 presents the mechanisms put in place as a response to the crisis, categorised in four main blocks, these being targeted at improving: Budgetary Surveillance, Economic Policy Surveillance, Financial Regulation and Supervision and Crises Resolution Mechanism. It then concludes by discussing possible caveats in the existing mechanisms with observations on the possible way ahead in the evolution of economic governance.

The financial crisis called for an improved governance framework

The financial crisis was characterised by the sizeable fiscal cost of banking sector bail-out operations together with falling revenues resulting from lower levels of real and financial activity. This had an impact on government finances with public sector debt and deficits reaching unprecedented levels in a number of Member States. The average budget deficit, in proportion of gross domestic product (GDP), for the EU and for the euro area in 2010 reached 6.4% and 6.1%[5] respectively. The corresponding data for the public debt to GDP ratio were 78.2% and 83.7%.[6] These figures were substantially higher than the 60% limit identified in the Stability and Growth Pact (SGP). The lack of properly coordinated policy at the euro area level resulted in the emergence of imbalances and showed that the currency union was not well equipped to smooth out regional economic disturbances. In particular, the euro area's inability to uniformly enforce the SGP contributed to the Greek sovereign debt crisis.[7]

[4] European Council (EUCO 76/12 – 2012, June 29), "Conclusions of the European Council meeting 28/29 June 2012", Press release can be retrieved from: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131388.pdf

[5] Eurostat Tables: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00127&plugin=1

[6] Eurostat Tables: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde410&plugin=1 – Public debt to GDP ratios have since risen further to around 87% in the EU and 92% in the euro area.

[7] Public debt as a percentage of GDP reached 172.5% in 2015.

This led to the sovereign-debt crisis in the euro area which highlighted the urgent need to tackle the unresolved challenges of putting public finances on a sufficiently sound footing across all members of the EMU to limit the possibility of spillovers from the financial and economic crisis to public finances. These developments led to calls for improved mechanisms to instil fiscal discipline at the national level, particularly in times of economic boom. In a speech delivered in March 2011 Jean-Claude Trichet, then President of the European Central Bank (ECB), remarked that "*….a broader range of enforcement tools and more ambitious policy requirements are all urgently required at euro area level. But these will not be sufficient if they are not solidly anchored at national level."*[8] This approach was deemed necessary to build up sound fiscal positions, allow for fiscal buffers and reduce debt levels, while providing room for manoeuvre during adverse economic conditions in order to contain the effects of a financial market collapse and sustain economic activity. The financial crisis also exposed important failures in financial supervision, both with regard to individual institutions, as well as in relation to the financial system as a whole. Pre-crisis supervisory arrangements proved incapable of preventing, managing and resolving the situations which evolved, with nationally-based supervisory models being overwhelmed by the integrated and interconnectedness of European financial markets. The crisis also exposed serious shortcomings in the level of cooperation, coordination, consistency and trust that existed between national supervisors.

Following the establishment of the High Level Group on Financial Supervision,[9] chaired by Jacques de Larosière, a report[10] was published in February 2009 with the main aim of identifying proposals to strengthen European supervisory arrangements to better protect its citizens and rebuild trust in the financial system. This report concluded that the European system of regulation was in great need of "repairs" as it had not sufficiently addressed certain issues such as the relationship of financial stability with micro-financial regulation and supervision. This initiated the process of strengthening the financial architecture through a higher level of surveillance and cooperation, with the main aim of restoring public confidence in the financial system.

In its Communication "Driving European Recovery" of 4 March 2009 the European Commission welcomed these recommendations and set out an action plan for reforming the way financial markets are regulated and supervised. This was to ensure a *"long-term financial stability, as soon as economic conditions allow, in line with the revised Stability and Growth Pact"*.[11] Similarly, during the 19 and 20 March 2009[12] meeting the European Council agreed on the need to improve the regulation and supervision of financial institutions within the Union and to use the de Larosière Report as a basis for action. For the purpose of this paper, measures to improve the economic governance framework are divided in four main building blocks; budgetary surveillance, economic policy surveillance, financial regulation and supervision, and crisis resolution mechanisms. However, given the strong linkages between them they should all be considered as part of a mutually reinforcing comprehensive package aimed at strengthening the economic governance framework of the EU.

[8] Speech by Jean-Claude Trichet "Reforming EMU: time for bold decisions", speech during the conference of the Group of the Progressive Alliance of Socialists and Democrats in the European Parliament "What future for the euro?" Frankfurt, 18 March 2011. A transcript of the speech can be retrieved from: http://www.bis.org/review/r110322b.pdf

[9] This high level group was established to make recommendations to the Commission on strengthening European supervisory arrangements covering all financial sectors, with the objective of establishing a more efficient , integrated and sustainable European system of supervision and also of reinforcing cooperation between European supervisors and their international counterparts.

[10] The report published by the High Level Group on Financial Supervision in the EU can be retrieved from: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

[11] Commission Communication of 4 March 2009 to the Spring European Council, "Driving European Recovery" – COM(2009), http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009DC0114&from=EN

[12] Presidency Conclusions of 19-20 March 2009 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/106809.pdf

The strengthening of the financial architecture within the EU

Budgetary Surveillance

The Stability and Growth Pact

Since the inception of the euro it was clear that the increased interdependence of its Member States meant that sound budgetary and economic policies were of particular importance in order to avoid adverse spill-over effects from one country to another, and thus weakening the advantages of a common currency. In the absence of a common framework avoiding situations of moral hazard, Member States could have an incentive to conduct unsustainable fiscal policies especially if they could shift part of the costs of having fiscal deficits and debts to other Member States and the Eurosystem. This free riding problem was becoming increasingly important as the number of countries in the euro area increased (Bertoldi, 2005).

In view of this high level of interdependence, the SGP set down the rules governing the coordination of budgetary policies and foresaw action to be taken against Member States that did not comply with the rules, thus laying down the foundation of budgetary surveillance in EMU. This was eventually reinforced by various amendments and new regulations.

The original SGP, introduced in 1997, has always been the subject to controversy and has been extensively criticised by academics and opinion makers since it was insufficiently observed by Member States and lacked robust mechanisms to ensure sustainable public finances. The main issue surrounding the SGP stemmed from its overall mechanical interpretation reducing its flexibility and disregarding cyclical conditions. In fact, through the regulations that the SGP imposed (such as 3 percent of GDP reference value for the fiscal deficit which could only be breached in exceptional circumstances and for a limited period), it failed to take into account short-run cyclical developments when assessing fiscal policies for Member States.

The Preventive Arm[13] of the SGP requires Member States to establish medium-term budgetary objectives (MTOs) and an adjustment path to reach these objectives. Compliance with the preventive arm's provisions should ensure that the Treaty's limits (3% of GDP for the general government deficit and 60% of GDP for gross debt) are not breached over a normal economic cycle. Together with the strict economic convergence criteria,[14] the SGP was to create the fiscal and economic coordination needed for a currency union. However, this arrangement provided suboptimal outcomes, with countries easily achieving an unambitious deficit of 3% of GDP during favorable economic conditions, but then compelled to unduly tighten during downturns to meet that same target.

The 2005 reform of the SGP introduced more flexibility by recognizing that what constitutes a sustainable level of deficit or debt may differ across countries, particularly in view of the level of debt, growth potential and factors which affect implicit liabilities. As a result, the revised SGP allowed for country-specific MTOs to diverge from a close-to-balance or in-surplus requirement for individual

[13] European Commission – Economic and Financial Affairs, for further details see: http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm

[14] The convergence criteria for countries hoping to form part of the EMU includes four main points: (1) price stability (average inflation rate of no more than 2% above the three best-performing Member States), (2) low interest rates (no more than 2% above the three best-performing Member States), (3) minimal annual budgetary deficits (not exceeding 3% of GDP) and debts (not exceeding 60% of GDP), and (4) currency stability (with the narrow band of exchange rates, fluctuations of less than 2.5% around the central rate for at least two years with no competitive devaluations).

Member States. Therefore, while keeping the quantitative criteria, such as the 60% debt-to-GDP and the 3% deficit-to-GDP ratios, the revised SGP included provisos for qualitative aspects, such as a more efficient tax structure and public expenditure targeted at growth-enhancing areas, to ensure that sustainable public finances will in turn support economic growth.

Overall, the 2005 reform strengthened the SGP and reaffirmed its core role in the budgetary co-ordination process as an instrument which contributed to achieving a high degree of macroeconomic stability – an essential condition for sustained economic and employment growth. Moreover, the revised SGP helped in defining and organizing in a methodological way the transmission channels from deficit and debt to economic growth.

The Corrective Arm[15] of the SGP is a mechanism aimed at ensuring short-term fiscal sustainability as defined in terms of the Maastricht criteria on deficit and debt ratios. Governed by the Excessive Deficit Procedure (EDP), if a Member State reaches the 3% budget deficit target as described in the Treaty, the Council will issue recommendations as to how this fiscal excess should be addressed.

The revised SGP allowed a wider and more flexible interpretation of what constitutes an excessive deficit. A deficit will be considered excessive unless the ratio has declined substantially and continuously and reached a level that comes close to the reference value or alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.

Overall, the revisions pointed towards a more softened Pact. For example, in situations of Excessive Deficit Procedure, it is very unlikely that this will lead to punishment as other relevant factors such as medium-term growth and the debt position can be invoked to postpone its start, particularly in cases where the required measures such as a minimal fiscal effort are undertaken. However, despite these escape clauses, the revised Pact included details on the adjustment measures required and the monitoring role of the Commission was strengthened considerably.

Nevertheless, the revised SGP was far from the ideal and sufficient mechanism ensuring sound fiscal policies. Lacking mechanisms that ensured a healthy and sustainable fiscal position, together with the lack of necessary rules to keep national fiscal policies and economic cycles from diverging, it reflected Member States' unwillingness to transfer the necessary degree of sovereignty over macro-fiscal objectives to the European level. Already in 2008, the Commission's EMU@10[16] report presented a range of possible changes to this setup, with the financial crisis increasing pressure to accelerate such need for change. In fact, the financial crisis and the significant deterioration in fiscal positions showed that the reformed SGP did not provide sufficient incentives for the correction of fiscal imbalances and therefore it became clear that economic policies needed better coordination as well as enhanced budgetary surveillance.

The Six-Pack Legislation

One of the main lessons learnt from the financial crisis was that despite a "healthy" fiscal policy, imbalances may still emerge in the private sector that could carry severe financial risk and impact competitiveness. Particularly, this was the case of Ireland and Spain[17] where the sovereign debt

[15] European Commission – Economic and Financial Affairs, for further details see: http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm

[16] EMU@10 – Success and Challenges after ten years of Economic and Monetary Union. For further details see: http://ec.europa.eu/economy_finance/publications/publication12682_en.pdf

[17] Both Spain and Ireland were run by fiscally prudent governments – they never violated the SGP and had budget surpluses on average.

crisis was attributable to severe imbalances in the housing market that left their banking sector highly vulnerable, which led to state aid. This highlighted the need to take into consideration both budgetary discipline and surveillance of the macroeconomic situation.

To further strengthen the reformed SGP, in December 2011, the European Commission submitted a package of six legislative proposals[18] aimed at reinforcing budgetary discipline in the EU and introducing a form of macroeconomic surveillance.[19] This new economic governance package consisted of two new amending regulations, three new regulations and one new directive. The amending regulations revised the existing regulations of the SGP while the new regulation provided for sanctions on euro area countries that do not comply with the rules of the SGP. The other two new regulations have created a new procedure to address harmful macroeconomic imbalances, with potential sanctions for euro area countries that do not comply with the rules. The new directive focuses on the minimum requirements for the EU Member States' budgetary frameworks.

The Treaty on Stability, Coordination and Governance

In March 2012, all EU Member States, with the exception of the United Kingdom and Czech Republic,[20] signed the Treaty on Stability, Coordination and Governance (TSCG) in the EMU (known as the European Fiscal Compact), thus complementing the legislation on fiscal and macroeconomic surveillance (the Six-Pack).[21] This Treaty ensured the full implementation of the provisions of the revised SGP by requiring the incorporation of its key concepts within national legislation. This Treaty requires Member States to respect convergence toward the country-specific medium-term objectives as defined by the SGP with a lower limit of structural deficit[22] of 0.5% GDP (1% of GDP if the debt-to-GDP ratio is significantly lower than 60%). This is known as "the Golden Rule".

The Two-Pack

Budgetary surveillance was further strengthened in May 2013 with the introduction of the Two-Pack[23] which is applicable only to euro area Member States and specifically designed to complement the preventive arm of the SGP by introducing a more comprehensive system for monitoring the way in which Member States deal with excessive deficits. Building on the Six-Pack reforms to the SGP and the European Semester this package comprises two regulations.[24] The first regulation focuses on strengthening the economic and budgetary surveillance of euro area countries already experiencing serious difficulties with regard to their financial stability. The second regulation focuses on the budget discipline in the EMU and requires euro area Member States to submit their draft budgets to the European Commission. The main aim of the Two-Pack was to step up surveillance of euro area national budgets and to exercise more oversight of the economic policy plans of those that are in financial difficulties.

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18 It was the Hungarian Presidency's task to conduct the debate about the package of six legislative proposals by aligning the legislative proposals of the Commission, the Ministerial task forces and the European Parliament.

19 The European Commission monitors a series of macroeconomic indicators including debt, investments, house prices and unemployment to determine whether there are actual or potential harmful economic imbalances in the member states. In cases where Member States breach the "alert threshold", the Commission will carry out in-depth studies to analyse whether the imbalances are harmfull and if necessary it will issue recommendations.

20 The UK did not agree with the Treaty while the Czech Republic has kept the option of participating at a later stage. Croatia was not yet an EU Member State and was not a signatory to the Treaty.

21 The Maltese Parliament authorised the ratification of the TSCG in June 2013 and it became effective on 1 July 2013. By April 2014, it had been ratified and brought into force by all 25 signatories.

22 The structural deficit refers to the total government deficit excluding cyclical effects and one-off measures.

23 For further details on the Two-Pack see: http://europa.eu/rapid/press-release_MEMO-13-457_en.htm

24 These two regulations originated from two reports, prepared by MEP Jean Paul Gauzés and MEP Elisa Ferreira. The Council adopted the recommendations of both the Gauzes and Ferreira reports on 21 February 2012, making only minor amendments. On 13 June the European Parliament supported the two-pack in a plenary vote, making significant amendments to the European Commission's original proposals in response to issues raised by a number of Member States.

Economic Policy Surveillance

The European Semester

In line with the aims delivered by the SGP and the Europe 2020 strategy, as from 2011, the European Semester[25] is another instrument for preventive surveillance of economic and fiscal policies of EU Member States with the main aim of enhancing economic policy coordination through appropriate sanctions and incentives and thus making the SGP more effective. By coordinating budgetary and economic policies, the European Semester helps in implementing more harmonised policy across all Member States by bringing policy-making in line with agreed country-specific recommendations. Given the close ties between European economies this reduces the possibility of contagion.

Following an in-depth analysis of EU Member States' plans for budgetary, macroeconomic and structural reforms, the Commission provides detailed recommendations for the following 12-18 months. These recommendations identify numerous weaknesses and reforms that need to be addressed in order to enhance growth and employment.

Over the years the process has been continuously improved, to capitalise on its strengths and to address its weaknesses. In particular, the Commission has made a number of changes to the running of the 2015 European Semester, designed to focus on the top priority areas for action in each Member State, to promote greater implementation of the recommendations and to increase ownership at national level and with social partners and stakeholders. The changes included:

- more focus on the priorities in the Annual Growth Survey;
- the publication of the Commission's country-specific and euro area analysis three months earlier than in previous years in order to enable discussion of the key issues in advance of the conclusions to be drawn from the analysis;
- a more intensive outreach at political level and deeper discussion between members of the Commission, national authorities and social partners on the implementation of past recommendations and potential areas for future recommendations.

Macroeconomic Imbalance Procedure

The Macroeconomic Imbalance Procedure[26] (MIP), which was established in December 2011 and implemented for the first time in 2012, is a surveillance mechanism with the aim of detecting, preventing and correcting macroeconomic imbalances. Based on scorecards of indicators, this mechanism identifies countries and issues that need further analysis. The preventive arm of the MIP will focus on the avoidance of the build-up of imbalances by making country-specific recommendations put forward in the European Semester. On the other hand, the corrective arm operates through the Excessive Imbalance Procedure,[27] whereby sanctions can be imposed on Member States.

Financial Regulation and Supervision

Apart from highlighting the importance of having close cooperation between monetary, fiscal and supervisory authorities, the financial crisis revealed that, while certain credit institutions remained resilient and able to absorb market shocks, others, albeit with similar capital levels, were unable

[25] For further details on the European Semester see: http://europa.eu/rapid/press-release_MEMO-11-14_en.htm

[26] For further details on the Macroeconomic Imbalance Procedure see: http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm

[27] The Member State concerned will have to submit a corrective action plan with a clear roadmap and deadlines for implementing corrective action. Surveillance will be stepped up by the Commission on the basis of regular progress reports submitted by the Member State concerned.

to protect themselves. This was largely due to differences in the quality, structure and availability of the capital base, liquidity management practices and internal and corporate governance. In order to ensure that all financial institutions adopt uniform and resilient criteria which are able to withstand highly adverse market conditions various mechanisms were put in place with the aim of ensuring financial stability in the EMU.

The Capital Requirements Directive

On 20 July 2011, the European Commission published proposals to implement the international standards on bank capital requirements recommended by the Basel Committee on Banking Supervision, commonly known as the Basel III. The Commission's proposals divide the current Capital Requirements Directive (CRD) into two legislative instruments: the Capital Requirements Regulation (CRR) and the CRD IV Directive. The CRR contains provisions relating to the "single rule book", including the majority of the provisions relating to the Basel III prudential reforms while the CRD IV Directive introduces provisions concerning remuneration, enhanced governance and transparency and the introduction of buffers. The new CRD IV package entered into force on 17 July 2013.

This was a significant step forward in the completion of the single rulebook for financial institutions with the main aim of providing a single set of harmonised prudential rules which institutions throughout the EU must respect, thus ensuring the uniform application of Basel III requirements across all Member States.

European Supervisory Authorities and the European Systemic Risk Board

Starting in January 2011, the European System of Financial Supervision (ESFS) was created as a result of the 2009 de Larosière Report and was aimed at strengthening European supervisory arrangements in order to better protect citizens and rebuild trust in the financial system. The ESFS consists of three European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

The EBA[28] aims to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector by ensuring effective and consistent prudential regulation and supervision across the European banking sector. The main task of the EBA, as an independent EU authority, is to contribute through the adoption of Binding Technical Standards (BTS) and Guidelines, as well as to the creation of the European Single Rulebook in banking. The EBA is also responsible for promoting convergence of supervisory practices ensuring a harmonised application of prudential rules while assessing risk and vulnerabilities in the EU banking sector through regular risk assessment reports and pan-European stress tests.[29]

The main responsibilities of EIOPA[30] are to support the stability of the financial system, transparency of markets and financial products as well as the protection of policyholders, pension scheme members and beneficiaries. EIOPA, as an independent advisory body to the European Parliament, the Council of the European Union and the European Commission is governed by its Board of Supervisors, which integrates the relevant national authorities in the fields of insurance and occupational pensions in each Member State.

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28 For further information on the EBA see: https://www.esrb.europa.eu/shared/pdf/EBA-en.pdf?3559e43b40d256628be935349679018b

29 As from 2014 this role is being shared with the Single Supervisory Mechanism of the ECB.

30 For further information on the European Insurance and Occupational Pensions Authority (EIOPA) see: https://www.esrb.europa.eu/shared/pdf/EIOPA-en.pdf?bb683bdc0fdfe3f7299143ed5e682f94

ESMA[31] is another independent EU authority that contributes to safeguarding the stability of European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other ESAs competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA).

The financial crisis challenged the notion that if institutions were sufficiently healthy individually the entire system would be equally healthy. The systemic shock that started in August 2007 led to the creation of a new platform in the supervisory structure aimed at identifying, mitigating and avoiding systemic risk. Thus, the European Systemic Risk Board (ESRB) was created in December 2010 with the main aim of monitoring developments that may put in danger the overall stability of the European financial system, closely liaising with national stability boards, central banks and supervisory authorities that monitor the banking, insurance and securities markets in the EU.

The Single Supervisory Mechanism

The recent financial crisis compounded itself as a result of bank bailout operations which a number of national governments were compelled to undertake. In some cases this proved unsustainable with the consequence that Ireland, Portugal, Greece and Cyprus had to be bailed out under specific IMF and EU programmes. Moreover, Cyprus enforced bail-in measures on its banks in 2013, with financial consequences on depositors. In order to avoid such situations, the European Council had agreed in June 2012,[32] to create a Banking Union, thus completing the EMU, and allowing for the centralised application of rules for banks in the euro area. One of the main pillars of the Banking Union is the Single Supervisory Mechanism (SSM).

Together with the objective of achieving a high level of quality in banking supervision, the SSM seeks to ensure a level playing field among participating Member States. This is defined in Article 1 of the SSM Framework Regulation as:

"…contributing to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State, with full regard and duty of care for the unity and integrity of the internal market based on equal treatment of credit institutions…"

In September 2012, the ECB was entrusted with the supervisory role to monitor the soundness of banks based in EU Member States.[33] This enhances supervision of Europe's banking sector through an integrated architecture combining both a supranational authority (the ECB) and national supervisory authorities,[34] to directly oversee all "significant"[35] banks in participating Member States.[36] The ECB is also responsible for the supervision of the "less significant institutions",

[31] For further information on the European Securities and Markets Authority (ESMA) see: https://www.esrb.europa.eu/shared/pdf/ESMA-en.pdf?eac52cbc088bedfb2214fa2bf20bcae8

[32] European Council (EUCO 76/12 – 2012, June 29), "Conclusions of the European Council meeting 28/29 June 2012", Press release can be retrieved from: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131388.pdf

[33] Other EU countries that do not yet have the euro as their currency can choose to participate. To do so, their national supervisors enter into "close cooperation" with the ECB.

[34] SSM framework regulation: http://www.ecb.europa.eu/ecb/legal/pdf/en_reg_ecb_2014_17_f_sign.pdf

[35] "Significant" banks are defined as banks which have assets of more than €30 billion or which account for at least 20% of their home country's GDP. There are around 120 such banks in the euro area, representing 82% (by asset) of its total banking assets. For all other 3,500 banks the ECB will also set and monitor the supervisory standards and work closely with the national competent authorities in the supervision of these banks.

[36] Non euro area countries can also adopt the SSM on a voluntary basis.

where supervision is carried out by national supervisory authorities, but has the power to directly supervise any bank in SSM Member States to ensure high standards of supervision.

In the preparatory phase, the ECB analysed banks' soundness by undertaking a "comprehensive assessment",[37] including reviews of banks' balance-sheets, especially with regard to asset quality, and "stress tests", which were designed to test whether banks are sufficiently capitalised and able to withstand shocks. In cooperation with national supervisory authorities, the ECB also has the power to grant or withdraw bank licences and to sanction banks in cases of non-compliance.

Following 28 months[38] of preparation between the ECB and national authorities on 4 November 2014 the SSM assumed its duties as banking supervisor for 18 European countries.

Other initiatives

Over the years various other initiatives were taken to establish new rules for the European and the global financial system. In many cases, these were in response to European G20 commitments. These initiatives include the Directive on Alternative Investment Funds Managers (AIFMD), which ensures that hedge funds and private equity will no longer operate in a regulatory void outside the scope of supervisors, while introducing greater transparency and security to the way these funds are managed and operated. This Directive, which entered into force in July 2013, addresses the lack of financial regulation in an area which was deemed to have contributed to the severity of the global financial crisis.

Another important development was the introduction of the European Market Infrastructure Regulation (EMIR) which was designed to increase the stability of the over-the-counter (OTC) derivative markets throughout the EU Member States. This Regulation entered into force in August 2012.

The global financial crisis indicated that credit rating agencies needed to be more transparent and accountable when rating sovereign states. In this regard, the EU Regulation on Credit Rating Agencies (CRAs) was enacted in 2009,[39] and subsequently amended in May 2011, to attribute ESMA with supervisory powers over the credit rating agencies. As from June 2013, CRAs were obliged to follow stricter rules to improve the quality of the rating process and reduce possible conflicts of interest. The new rules are also aimed at reducing over-reliance on credit rating agencies, while at the same time increasing competition in the rating market.

Crisis resolution mechanism

While the financial regulation and supervision mechanisms focus on crisis prevention and aim at detecting and preventing serious problems from emerging in the financial sector, the crisis resolution[40] mechanisms tackle legacy problems in order to reduce the potential impact of failures, should they occur.

[37] These reviews by the ECB were carried out in cooperation with the EBA where appropriate.

[38] The preparatory cycle that spanned 28 months was marked with several milestones: starting with the announcement by EU leaders on 29 June 2012, the adoption of the draft SSM Regulation by the EU Council (13 December 2012); the launch of the comprehensive assessment of the banks (23 October 2013); and the entry into force of the SSM Regulation (4 November 2014). During 2015, the SSM identified around 120 "options and national discretions" in Union law which can be exercised by a supervisor, for which a single approach has been agreed upon. Despite exceeding all expectations during the first year in operation, work is still underway to bring the single supervisor of the euro area to ever higher standards.

[39] Regulation on Credit Rating Agencies: http://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=uriserv:OJ.L_.2009.302.01.0001.01.ENG

[40] Resolution means the restructuring of a bank by a resolution authority, through the use of resolution tools, to ensure the continuity of its critical functions, preservation of financial stability and restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings.

At the Pittsburgh Summit held in September 2009, the G20 committed to act together to "*…create more powerful tools to hold large global firms to account for the risks they take*" and, more specifically, to "*develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future*."

At a European level, resolution tools enable the national authorities to intervene at a sufficiently early stage with a view to minimising the externalities of a crisis while ensuring a high level of harmonisation between Member States. In the wake of the sovereign debt crisis in Greece, an urgency arose to design mechanisms aimed at crisis prevention, management and resolution. The May 2010 ECOFIN Council meeting stressed that such mechanisms should be aimed at:

- developing an enhanced EU policy coordination framework;
- enhancing the EU regulatory framework;
- improving the design of mechanisms to ensure that systemic risk is mitigated and that the financial sector bears the net costs of financial crisis.

The European Financial Stability Facility, the European Financial Stabilisation Mechanism, and the European Stability Mechanism

The Greek deficit and debt figures for 2009 were both well above the convergence criteria set by the Maastricht Treaty,[41] at 12.7% and 113% respectively. Following a failure to comply with the excessive deficit procedure,[42] at the February 2010 ECOFIN Council meeting,[43] it was decided to:

- set out plans for reducing its government deficit below 3% of GDP by 2012;
- give notice to Greece to remedy its excessive deficit by 2012;
- recommend to Greece to bring its economic policies in line with the Union's broad economic policy guidelines and remove the risk of jeopardising the proper functioning of EMU.

Heads of State or Government of EU Member States supported the Greek government efforts[44] with euro area Member States, reaffirming their willingness to take determined and coordinated action to safeguard financial stability in the euro area by making available a package involving coordinated bilateral loans[45] and IMF financing.[46]

In May 2010, during an ECOFIN Extraordinary Council meeting[47] discussing the delicate situation of Greece, it was decided to adopt a comprehensive package of measures, including two additional sources of financial assistance to complement the ad hoc loan facility agreed with Greece. These two new sources of financial aid were the European Financial Stability Facility (EFSF), which is only available to euro area Member States and the European Financial Stabilisation Mechanism (EFSM) which is also available to non-euro area Member States. These two mechanisms were set up to safeguard EU financial stability amid severe tensions in euro area sovereign debt markets.

[41] According to article 104c of the Maastricht Treaty, the annual government deficit measured as government deficit to GDP must not exceed 3% at the end of the preceding fiscal year. The Treaty also indicated that the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding fiscal year.
[42] See Article 1 of the Council Decision of 27 April 2009 on the existence of an excessive deficit in Greece (2009/415/EC).
[43] See ECOFIN Press Release 6477/10, 16 February 2010.
[44] Statement of the Heads of State or Government of the EU, 11 February 2010.
[45] Each country in the euro area has limits on what it will guarantee to another country that applies for an EFSF loan. For instance Greece would only guarantee 2.82% of the loan, while Germany would guarantee 27.13 % of the loan – but the total from all the euro area countries would add up to a 100 percent guarantee.
[46] Statement of the Heads of State or Government of the Euro Area, 25 March 2010.
[47] Council of the European Union, Extraordinary Council Meeting, 9-10 May 2010.

The EFSF is a public limited company with the main aim to facilitate or provide financing[48] in the form of loans up to €440 billion. The maximum available assistance facility under the EFSF was also complemented by the EFSM financial assistance of up to €60 billion and IMF financial assistance of up to €250 billion, thus creating a safety net of a maximum of €750 billion.

The conditions to qualify for this aid are:

- the currency of the Member State must be the euro;
- the recipient Member State must be in financial difficulties;
- the recipient Member State must have already entered a Memorandum of Understanding (MoU) with the European Commission (EC) – acting on behalf of the other euro area Member States regarding budget discipline and policy conditionality.

Eligible Member States can only apply if they are unable to borrow money from the international debt markets. Loans are granted following the activation of an adjustment programme agreed with the Commission and in liaison with the ECB.

The EFSM is a part of a wider safety net, providing financial assistance of up to €60 billion with terms and conditions similar to those imposed for the EFSF. Financial assistance provided by EFSM is either in the form of loan or of a credit line granted to the Member State in distress, with the ECB acting as a fiscal agent with respect to the administration of the loans between the EC and the central bank of the beneficiary Member State.[49]

As from October 2012 the EFSF began to operate concurrently with a more permanent mechanism – the European Stability Mechanism (ESM), which similarly to the EFSF, provides financial assistance to euro area Member States experiencing or threatened by financing difficulties. The ESM assumes the tasks which were previously fulfilled by the EFSF and the EFSM, with the main purpose to:

"…*mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States. For this purpose, the ESM shall be entitled to raise funds by issuing financial instruments or by entering into financial or other agreements or arrangements with ESM Members, financial institutions or other third parties."*[50]

Building on the Stability and Growth Pact and the macroeconomic imbalances framework, the ESM is seen as an extraordinary mechanism to safeguard the financial stability of the euro area as a whole. While reinforcing economic surveillance, the ESM aims to focus on prevention, and thus reducing the probability of a crisis emerging in the future.

Since July 2013, the EFSF has not entered into any new financial assistance programmes but continued with operations relating to the management and repayment of any outstanding debt. The ESM therefore remained the sole and permanent mechanism for responding to new requests

[48] The EFSF has provided financial assistance to Ireland, Portugal and Greece.
[49] See Article 2 of EU Council Regulation No. 407/2010 (OJ L 118/1).
[50] Treaty establishing the European Stability Mechanism, European Council (2012). More information could be retrieved from: http://europa.eu/rapid/press-release_DOC-12-3_en.htm

for financial assistance from euro area Member States. It has an authorised capital stock of €700 billion divided into paid-in (€80 billion) and callable shares (€620 billion).

Since its inception the ESM has been involved in financial assistance programmes for the recapitalisation of Spanish banks and for the Cypriot state to cope with budgetary financing, the redemption of medium and long-term debt, and the recapitalisation of financial institutions. The importance of the ESM gained further significance in 2015 when it had to be resorted in order to avoid a potentially catastrophic Greek default following a severe macroeconomic deterioration and the near collapse of the banking sector as a result of massive capital outflows.

By June 2015 Greece was unable to honour its IMF loan commitments and, on 8 July 2015, Greece made an official request to the ESM, for support. Following an assessment[51] by the European Commission, in liaison with the ECB and according to the ESM treaty, it was decided that *"there are substantial financial stability risks in Greece which are caused by the uncertainty on the economic and financial policies of the Greek authorities".*[52] It was concluded that support to Greece should be granted to eliminate the possibility of a default which could have serious consequences on the euro area as a whole. This support was granted conditional to a far-reaching and credible reform programme to ensure that Greece would eventually regain competitiveness and sustainable economic growth.

As a result, following approval by the ESM Board of Governors, in August, the European Commission signed a Memorandum of Understanding (MoU) with Greece, enabling the disbursement of up to €86 billion in loans over a period of three years, subject to the implementation of reforms by the Greek authorities, aimed at addressing fundamental economic and social challenges as specified in the MoU.

The Single Resolution Mechanism

As highlighted during the December 2012[53] and June 2013[54] European Council meetings, in order to eliminate the tensions that could arise between the supervisor (ECB) and the national resolution authorities when dealing with ailing banks, a *"single resolution mechanism will be required, with the necessary powers to ensure that any bank in participating Member States can be resolved with the appropriate tools"* (December 2012 European Council Meeting).

The financial crisis in Cyprus showed that bank resolution at the national level could lead to uncertainty and contagion in the euro area. In this regard, the EU Commission proposed the Single Resolution Mechanism (SRM) on 10 July 2013,[55] which introduced the concept of bail-in in bank resolution rather than taxpayers having to foot the bill through a bank bail-out. This had the aim of helping to restore confidence in the banking sector and ensure the proper functioning of EMU.

The SRM is the second pillar of the Banking Union underpinning financial stability by creating a common fund for the resolution of banks, built by the banking industry itself. Following the introduction of the SSM in November 2014, the SRM is intended to complement the supervision by providing

51 The assessment was mainly based on establishing the level of risk to financial stability, analysing sustainability of public debt and assessing the actual or potential financing need of Greece.

52 More information about the assessment on the Greek economy could be retrieved from: http://ec.europa.eu/economy_finance/assistance_eu_ms/documents/2015-07-10_greece_art__13_eligibility_assessment_esm_en.pdf

53 European Council Meeting – December 2012: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134353.pdf

54 European Council Meeting – June 2013: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/137634.pdf

55 European Commission Meeting – 10 July 2013. More information could be retrieved from: http://europa.eu/rapid/press-release_IP-13-674_en.htm

an efficient cross-jurisdictional process, ensuring that failing banks can be resolved sufficiently with minimal costs to taxpayers. This mechanism does not eliminate risk of future bank failures but *"with the Single Resolution Mechanism and the Resolution Fund it should be banks themselves – and not European taxpayers – who should shoulder the burden of losses in the future."*[56]

The ECB, as the banking supervisor, would indicate when a bank in the euro area or established in a Member State participating in the Banking Union is in severe financial difficulties and is failing or likely to fail, and therefore in need of resolution. Subsequently, on the basis of the Single Resolution Board's (SRB) recommendation, the EU Commission will determine the application of resolution tools and the use of the Single Resolution Fund (SRF). The role of the Commission would be limited to the decision to trigger the resolution of a bank and the decision on the resolution framework, thereby ensuring its consistency with EU rules on state aid. On the basis of the Board's recommendation, national authorities, supervised by the SRB, will then be in charge of the execution of the resolution plan.

The SRM applies to those countries and institutions which are already part of the first pillar of the Banking Union – the SSM. However, unlike the SSM, the SRM does not draw a distinction between the "significant" institutions, which are directly supervised by the ECB, and other "less significant" institutions, whose day-to-day supervision has been delegated to national supervisory authorities.

The preparatory work for the SRM, including the operation of the Board and the preparation of resolution plans and resolvability assessments, began as from 1 January 2015. By 30 November 2015, a sufficient number of Member States[57] had ratified an Intergovernmental Agreement (IGA) on the transfer and mutualisation of contributions to the SRF. The Fund[58] which will be built up over eight years (2016-23) will reach an estimated €55 billion, with a target level of at least 1% of the amount of covered bank deposits in all the participating Member States.

The SRB took over full responsibility for bank resolution on 1 January 2016.

The Bank Recovery and Resolution Directive

The Bank Recovery and Resolution Directive[59] (BRRD) is a common framework across all 28 Member States of the EU, setting guidelines on how to deal with failing banks at national level, as well as cooperation arrangements to tackle cross-border banking failures. For euro area countries, the BRRD will be implemented through the SRM. This Directive sets rules to act as guidelines as to how and when authorities should intervene, encompassing precautionary, early intervention and measures designed to prevent bank failures. Where failure is unavoidable, the BRRD aims to ensure orderly resolution, even for banks operating across national borders.

During the financial crisis, banks which were considered as "too big to fail" were bailed out with public funds. Although this practice was necessary to prevent further widespread disruption to

[56] European Commission Meeting – 10 July 2013.

[57] Participating Member States representing not less than 90% of the aggregate of the weighted votes had ratified and deposited the ratification instrument by 30 November 2015.

[58] Contributions by banks raised at national level will be transferred to the SRF. These will be gradually merged over the eight-year transitional phase. This mutualisation of paid-in funds will be front-loaded, starting with 40% in the first year and a further 20% in the second year, and continuously increasing by equal amounts over the subsequent six years until the SRF is fully mutualised.

[59] The BRRD entered into force on 2 July 2014, but started being implemented on 1 January 2015.

the financial markets, it is not deemed desirable for taxpayers' money to be used in this way, and create fiscal pressure on the sovereign.

As a result, this Directive aims shifting the cost of bank failures from the taxpayer to the shareholders and creditors of the failing banks by harmonising the approach to protecting retail depositors among EU Member States and establishing the principle that banks must shoulder the costs and be responsible for poor management before EU countries and their taxpayers are called in for financial support.

Both the BRRD and the SRM are complementary to each other in the context of the Banking Union. While the BRRD provides uniform rules for the whole EU single market and thus addressing moral hazard through increasing market discipline over banks' activities, the SRM sets out the institutional and funding architecture for applying these rules in Member States participating in the Banking Union.

Harmonised Deposit Guarantee Scheme
The third pillar of the Banking Union is the Deposit Guarantee Scheme (DGS) which guarantees, up to a certain amount, the repayment of deposits from account holders in the event of a failure of one of their members. Along with the BRRD, this Directive aims at protecting the deposits of EU citizens and therefore enhancing the trust and confidence that any banking system requires to be efficient. Moreover, this Directive should also reduce the burden on taxpayers in case of a bank failure.

The DGS was first introduced in 1994, and remained virtually unchanged for about 15 years, despite significant financial market developments during the period. Given that in the original DGS the financing of schemes was left entirely to Member States, this resulted in heterogeneity in the implementation of such a mechanism. As a result, following a decision by the Council in March 2009, the level of deposit protection was increased first, to at least €50,000, and then, to a uniform level of €100,000 by the end of 2010.

Following this increase in deposit protection, the Commission adopted a comprehensive review of the DGS Directive[60] targeted at improving further the protection of deposits,[61] maintain depositor confidence and strengthen the safety nets. Efforts are now underway to create the third pillar of a banking union with the attempt of establishing a European Deposit Insurance Scheme (EDIS), characterised by a common fund for participating Member States.

Concluding remarks and the way forward towards improved economic governance

The EU and, in particular, the EMU were established with the aim of achieving economic growth and high employment through appropriate economic and monetary policy-making framework. Such framework seeks to achieve closer integration of national policies through coordinated actions while ensuring that fiscal, monetary and financial measures would not result in adverse scenarios which may quickly propagate to other Member States.

The financial crisis revealed several weaknesses in the original framework and generated an urgent need to strengthen the existing architecture by tackling existing problems while identifying

[60] The DGS Directive, adopted in July 2010, can be retrieved from: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010PC0368&from=EN
[61] In case of default, repayment deadlines will be gradually reduced from 20 to 7 working days by 1 January 2024.

and preventing possible future threats. New mechanisms were developed to strengthen economic governance through sustainable budgetary and economic policy surveillance and the restoration of public confidence in the financial system. Nevertheless, a number of challenges still remain. Mechanisms need to be regularly reviewed to ensure that they are in tune with current realities and that they are truly attaining the targets for which they were established, while being applied uniformly across all Member States to ensure a level playing field.

Cooperation and coordination between all Member States is vital to avoid situations of moral hazard which could hinder the process of restoring and maintaining confidence in the markets. This is an essential prerequisite to establish effective market discipline and thus protect the integrity of the EU single market. A high level of transparency and comparability of information, for example, minimises the possibility that national imprudent fiscal policies will result in widespread spillovers affecting adversely other Member States.

An issue that needs to be addressed concerns the exposure of EU banks and other financial institutions to debt issued by the domestic sovereign. Although the banking sector is an important source of funding for the sovereign, the recent crises have shown that sovereign debt is not without its risks. For this reason the ESRB has been following sovereign debt exposure in Europe very closely. Given the importance of sovereign debt in banks' balance sheets, it is essential, from a financial stability point-of-view, that any initiatives to address this situation are introduced gradually and in a manner which takes into consideration the specific circumstances of individual Member States because of their small size. Lower levels of fiscal deficits and public debt should also contribute towards a healthier sovereign debt environment by ensuring sustainability and minimising risk.

The growth in recent years of shadow banking, involving entities and activities outside the regulated banking system, presents a significant challenge for the management of financial stability in Europe. As lending from the banking sector contracted in recent years, shadow banking entities have become an increasingly important source of credit. In view of the risk of contagion spreading to other areas of the financial sector in times of stress, further initiatives are needed to monitor and assess the risks and vulnerabilities which prevail in the shadow banking sector. A sustained effort is necessary to enhance the oversight and the supervision of this area, as well as to institute the necessary structures for preventing and handling situations of crisis which may evolve.

Since various institutions engage in Securities Financing Transactions (SFTs) in order to secure funding, invest cash or borrow specific securities or, for market-making purposes, the use of SFTs poses various macro-prudential implications as these may foster contagion or propagate shocks, apart from increasing leverage in the system, thus introducing additional sources of risk. In August 2013 the Financial Stability Board (FSB) issued a report that included policy recommendations for "*enhanced transparency and regulation of securities financing.*" [62]

On its part, the European Commission in September 2013, following consultations on a Green Paper, adopted a Communication[63] setting out its roadmap to limit the emergence of risks in the

[62] Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Report – FSB August 2013: http://www.financialstabilityboard.org/wp-content/uploads/r_130829b.pdf?page_moved=1
[63] Communication from the Commission to the Council and the European Parliament - Shadow banking – addressing new sources of risk in the financial sector: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013DC0614

unregulated or less regulated financial system, in particular risks of systemic nature, such as those which may arise through the shadow banking sector's interconnectedness with the banking system. At the same time the Commission also proposed new rules on money market funds.[64] Subsequently, in January 2014, the Commission adopted a proposal for a regulation aimed at increasing transparency of SFTs.[65]

A major challenge for the immediate future is the structural reform of the EU banking sector – in particular the isolation of the trading and deposit taking functions in banking institutions. Although, in January 2014, the European Commission adopted a legislative proposal[66] to introduce a ban on banks' proprietary trading activities, it should be kept in mind that such market-making activities are important for financial stability, the transmission of monetary policy measures and the financing of the economy. In fact, the ECB maintains that deposit-taking banks should be allowed to pursue such activities within certain parameters. In June 2015, the Council agreed its negotiating stance on structural measures to improve the resilience of EU credit institutions aimed at strengthening financial stability by protecting the deposit-taking business of the largest and most complex EU banks from potentially risky trading activities. This draft regulation is intended to reduce excessive risk taking and prevent rapid balance sheet growth as a result of trading activities.

An issue which must also be taken into consideration is the exposure to some emerging economies to financial stability risks. Banks can no longer be treated as purely national institutions and if such risks materialise, this could lead to negative repercussions for all euro area banks with sizeable exposures to those economies. Euro area banks account for almost 45% of global exposures to emerging markets[67] thus highlighting the importance for these banks to have sufficient capital buffers in place.

Finally, it is important to align micro- and macro-prudential policies in order to ensure an optimum level of financial stability. In the absence of such alignment, tensions may arise if micro-prudential supervision does not internalise any potential adverse effects that it may have from a macroeconomic perspective.

In June 2015, the President of the European Commission, together with the President of the Euro Summit, the President of the Eurogroup, the President of the ECB and the President of the European Parliament presented a report on an ambitious yet pragmatic roadmap for completing the EMU.[68] In particular it calls for work to continue to "*develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity"* and *"to prepare next steps on better economic governance in the euro area".*

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64 Proposal for a Regulation of the European Parliament and of the Council on money market funds: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52013PC0615

65 Proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions – European Commission January 2014: http://eur-lex.europa.eu/resource.html?uri=cellar:b2522602-8f15-11e3-b19c-01aa75ed71a1.0025.03/DOC_1&format=PDF

66 Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions – European Commission January 2014: http://ec.europa.eu/transparency/regdoc/rep/1/2014/EN/1-2014-43-EN-F1-1.Pdf

67 ECB Financial Stability Review – May 2014: https://www.ecb.europa.eu/pub/fsr/shared/pdf/sfdfinancialstabilityreview201405en.pdf??bb5545e9afe88927d9401142282b581b

68 Completing Europe's Economic and Monetary Union. (The Five President's Report): http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en.pdf

This report noted that for a full integration of the EMU, progress should be aimed at achieving:

- Economic Union that ensures that each economy has the structural features to prosper within the Monetary Union;
- Financial Union that guarantees the integrity of the currency across the Monetary Union by limiting risk to financial stability and increasing risk-sharing with the private sector;
- Fiscal Union that delivers both fiscal sustainability and fiscal stabilisation;
- Political Union that provides the foundation for all the above through genuine democratic accountability, legitimacy and institutional strengthening.

The achievement of an Economic, Financial, Fiscal and Political Union[69] would equip the EMU with the necessary framework to combat more easily any possible crisis in the future. However, this can only be achieved by sacrificing some national sovereignty. Member States would have less flexibility to adjust to local shocks – which may, in turn, result in the development of highly adverse scenarios that can later be difficult to manage. Given the heterogeneity among Member States a "one-size-fits-all" approach may therefore not necessarily be the optimal solution. Rather than focusing on implementing the same policies across all Member States, the focus should be on the results that different policies are achieving. In particular, these should be aimed at building resilience to rebound quickly from short-term shocks, exploiting comparative advantages within the Single Market and attracting investment, thereby sustaining high levels of growth and employment across the euro area.

In recent years, a lot of effort was placed on strengthening the fiscal and financial architecture of the EU and of the EMU with the aim of fostering more co-operation and integration. Restoring confidence in the financial sector and preventing new imbalances is leading to a fundamental transformation of policymaking at both the national and the euro area level.

Achieving the right balance between an Economic, Financial, Fiscal and Political Union and allowing the necessary flexibility for governments to deal with country-specific situations remains a challenge. However, finding the right balance could reduce the frequency, severity and vulnerability to systemic spillovers. It is therefore essential that the momentum for further integration is maintained in order to address current outstanding and future challenges for EMU and build higher levels of resilience to possible future financial crises.

[69] All four elements depend on each other and must develop in parallel for each Member State.

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