

**Banking Union as Holy Grail:  
Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks and  
'Completing' Economic and Monetary Union.**

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In 2012, the European Commission celebrated the twentieth anniversary of the European Union 'Single Market'. In a climate of trepidation about the future of the European project, the Commission organised a series of events to remind Europeans of the great strides in market integration since the late 1980s. However, the year itself was marked by little progress on internal market legislation. In the context of the on-going sovereign debt crisis and instability in Europe's banking sector, the one exception to legislative inactivity was in the area of financial services. A series of major pieces of legislation have continued their slow progress through the EU's legislative process. Notably, the capital requirements directive and regulation were the topic of intense debate (Commission, 2010a&b; see Buckley, Howarth and Quaglia, 2012) and in 2012 the Member States failed to reach a final agreement on the package details.

The second half of 2012 was dominated by debates surrounding the construction of an EU Banking Union. In June 2012, the European Council and euro area summit agreed to deepen

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Economic and Monetary Union (EMU) creating ‘Banking Union’ (Euro area statement, 2012) which was to be based on five components: a single rulebook; a single framework for banking supervision; a common deposit guarantee scheme; a single framework for the managed resolution of banks and financial institutions; and a common backstop for temporary financial support. Indeed, the verb officially – and hyperbolically – used was ‘to complete’ EMU, suggesting that these elements – rarely discussed in European policy making circles prior to 2012 – were the *sine qua non* of ‘full’ EMU (European Council 2012). The Member States decided to make the creation of the Single Supervisory Mechanism (SSM) the precondition for possible direct recapitalization of banks by the European Stability Mechanism (ESM), the funding mechanism created to help tackle the sovereign debt crisis.

In September 2012, the Commission adopted a set of legislative proposals as first steps towards Banking Union: a regulation giving strong powers for the supervision of all banks in the euro area to the European Central Bank (ECB) (Commission, 2012a); a regulation with limited specific changes to the regulation setting up the European Banking Authority (EBA) to ensure a balance in its decision making structures between the euro area and non-euro area member states (Commission, 2012b); and a communication on a roadmap for completing the Banking Union over the coming years, covering the single rulebook, common deposit protection and a single bank resolution mechanism (Commission, 2012c). The Commission and the French government called for an end of year deadline to finalise the first element of Banking Union (the transfer of supervisory powers to the ECB). However, it became clear in the autumn that implementation would be delayed to the spring of 2014.

The proposals for Banking Union in several respects, amount to a radical initiative to stabilise the EU's national banking systems – exposed directly to the sovereign debt crisis – by breaking the dangerous link between the high and rising sovereign debt in the euro area peripheral Member States and domestic banks, which had come to hold an increasing amount of this debt. But Banking Union would also bring about a significant transfer of powers from the national to the EU level. While it is unlikely that some elements of the Banking Union proposals will be adopted in the near future, the December European Council decision to transfer significant supervisory responsibilities to the ECB amounts to a major development in European integration history and, more specifically, in the operation of the single market.

This article is organised as follows. Section 1 considers the fragmentation of the single market in financial services and the need for Banking Union to address this fragmentation. Section 2 outlines the key elements of Banking Union as well as the main outstanding issues on which Member States failed to reach an agreement at the December summit. Section 3 reviews the intergovernmental debate on Banking Union, focusing on the main euro area Member States and their priorities. Section 4 looks at the growing reality of a 'two-speed Europe' in addition to the priorities of the euro area outsiders and notably the United Kingdom. Section 5 discusses the stance of the ECB in this policy debate as well as the mostly likely changes that the euro area's central bank will have to undertake in the near future. This is followed by a discussion on democratic accountability of the new institutional set up, mainly focusing on the position of the European Parliament (EP).

## **1. The Fragmentation of the European Financial Market**

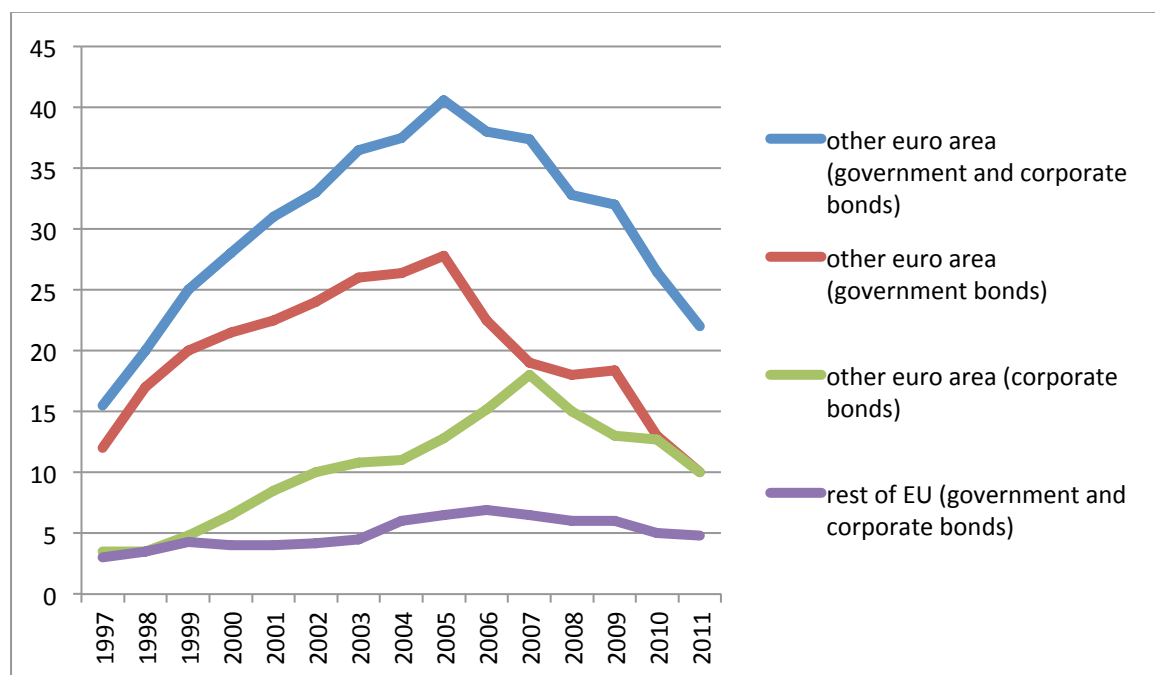
The impact of the international financial crisis and then the euro area sovereign debt crisis on the Single Market in Financial Services has been devastating. The fragmentation of the

financial services market in turn affects the ability of the European Central Bank to operate effective monetary policy. The ECB thus, not surprisingly, dedicates a sizable part (almost half) of the 2012 annual report on *Financial Integration in Europe* to the benefits of financial integration and the deleterious effects of disintegration on Monetary Union and the effectiveness of monetary policy. Several measures demonstrate the increasing fragmentation of the EU's financial market (ECB, 2012a): a significant increase in the differentiation of average unsecured interbank lending rates across the euro area Member States; the divergence of euro area Member State lending rates; a decline in unsecured transactions undertaken with non-domestic counterparties in the euro area since 2007, both in real terms and relative secured transactions; the increased dispersion in credit default swap premiums across the euro area Member States for sovereign, bank and telecommunications debt (which multiplied from five to nine times from the end of 2009 to early 2012) (ECB, 2012a: 23). Banking markets had also become less integrated since 2008 on a range of measures. The establishment and activity (measured in assets) of foreign branches and subsidiaries has dropped marginally since 2008 (ECB, 2012a: 27). The cross-border merger and acquisition (M&A) activity of banks – another indicator of market integration – declined sharply from 2008 and remained low in 2012. The share of loans granted to monetary financial institutions (MFIs) by MFIs of other euro area countries stabilized for two years after a drop from 2008 but then began to decline again in 2011. Although the level of cross-border interbank loans in the EU remained relatively high (at around 35 per cent of the total at the end of 2011) this was nonetheless a significant decline from the 45 per cent peak in 2007. The dispersion of bank interest rates applied to new loans to non financial companies (NFCs) rose considerably from the low of 2007 (ECB, 2012a: 29). One glimmer of hope in financial integration concerned cross-border lending (euro area and EU more generally) to NFCs and households, which was close to peak levels at the end of 2011, albeit at a tiny percentage of the total (5.1

and 2.8 per cent respectively) (ECB, 2012a: 28) with domestic lending only one percentage point above its lowest level in 2008. On the other hand, two additional sets of figures further indicate the fragmentation in euro area/EU financial markets. The cross-border bond holdings of euro area MFIs (as a percentage of the total) declined markedly from the middle of the 2000s with no indication of stabilization prior to 2012 (see Figure 1). In 2005, of the government and corporate bonds held by MFIs, over 40 per cent were cross-border. By 2011 this figure had dropped to 23 per cent. Similarly, the share of cross-border collateral used by euro area MFIs had dropped from over 50 per cent of the total to approximately 33 per cent (see Figure 2). The euro area periphery (Italy, Portugal, Spain, Greece and Ireland) was most affected by this retreat to domestic debt, given the declining confidence of non-periphery banks in the value of sovereign and corporate debt issued in the periphery.

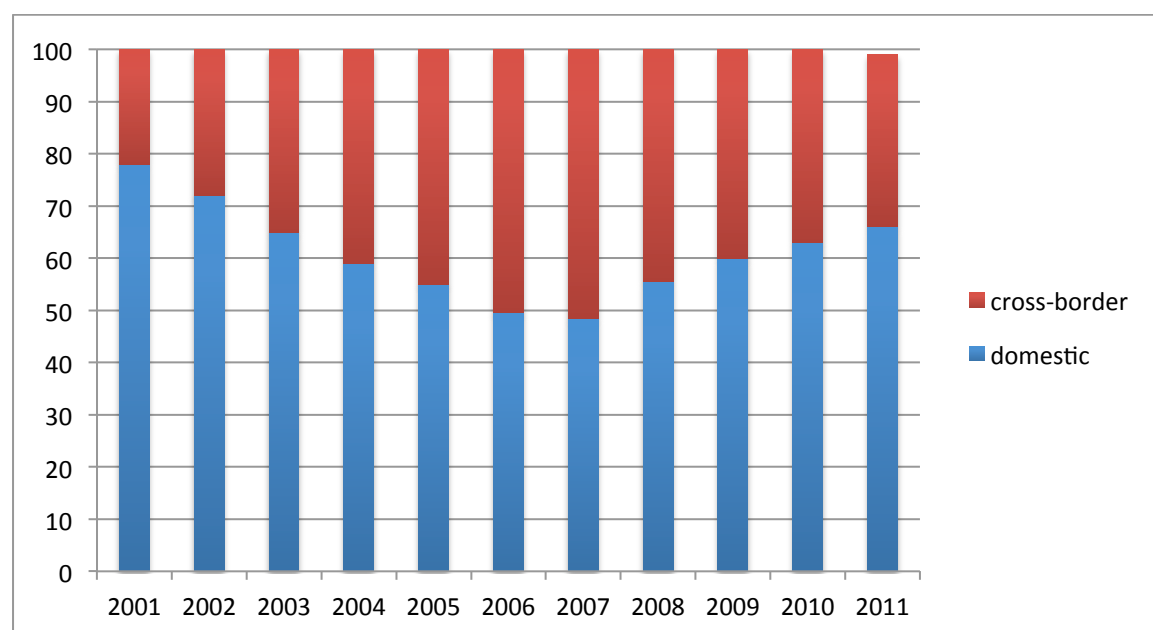
<Insert Figures 1, 2 & 3 about here>

**Figure 1: Cross-border bond holdings of European financial institutions (*% of total*) (end June figures)**



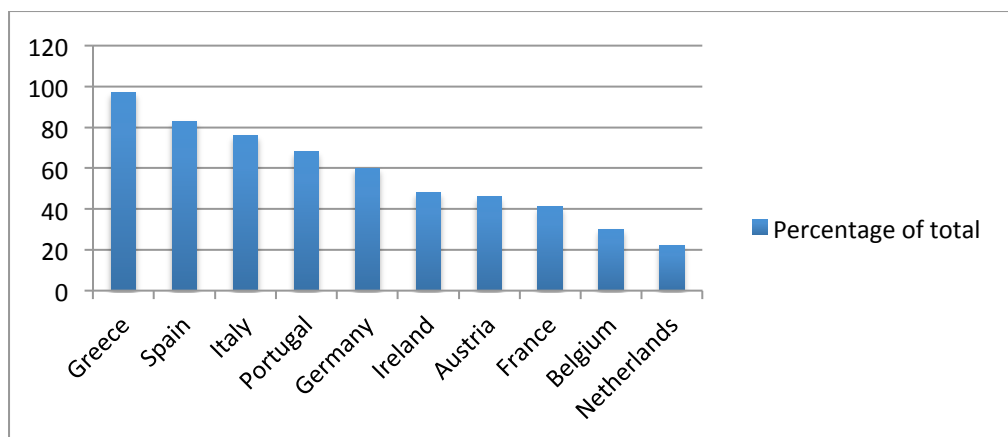
Source: ECB (2012a: 22)

**Figure 2: Share of domestic and cross-border collateral used in Eurosystem operations (percentages)**



Source: ECB (2012a: S10)

**Figure 3: Share of domestic government debt in banks' total government debt portfolios, selected euro area Member States, June 2010.**



Sources: EBA data

A destabilizing sovereign debt-domestic bank loop was created in the euro periphery (BIS, 2011). Higher periphery government spending and rising debt burden increased sovereign risk (Merler and Pisani-Ferry, 2012) and threatened to disrupt the collateral function of sovereign debt, with a resultant damaging effect on bank funding conditions (BIS, 2011). From 2008, the percentage of euro periphery sovereign debt held by domestic banks increased markedly as foreign investors – fearing unsustainable euro periphery debt burdens – became less willing to purchase this debt or keen to discard it (see Figure 3). Thus, increasingly at risk domestic banks came to hold growing amounts downgrading sovereign debt, while the ability of sovereigns to bail-out or wind-down domestic banks in an orderly manner (to avoid a systemic crisis) diminished as public debt loads rose. There was thus a downward spiral in the euro periphery of a rising public debt burden, rising yields and credit rating downgrades on sovereign debt, a retreat of foreign investors and an increased holding of sovereign debt by domestic banks. In Spain, for example, the bursting of a large real estate bubble hit both the economy and government revenues hard, while bringing about the collapse of a number of regional lenders (*cajas*) (Royo 2013). EU institutions and Member State governments looked to ways to cut the sovereign debt-domestic bank loop. From the outbreak of the international financial crisis in 2008, the quantitative easing (massive

sovereign debt purchase) by the Bank of England reduced the dangers of a sovereign debt-domestic bank link. However, the ECB provided more limited forms of support to the euro periphery – performing a reluctant and officially denied ‘lender of last resort’ role. Banking Union was presented as necessary step to stabilize euro periphery banking systems and save EMU.

## **2. The main elements of the Banking Union**

‘Banking Union’, as proposed by the European Council in its June conclusions and the Commission in its September legislative proposals and communication, has five main elements: a single EU rulebook for financial services (and specifically banks); a SSM for banks; a single framework on bank resolution; a common deposit guarantee scheme; and a common fiscal backstop for struggling banks. A range of scholars and institutions argue that all five of these elements should be adopted to ensure that Banking Union creates more stability than existing national supervisory systems (Schoenmaker 2012; Ionnidou 2012; IMF 2013). Senior Commission officials have argued that Banking Union must consist of at least four of the five elements, accepting delays to the construction of a common deposit guarantee scheme given the political difficulties associated with modifying national schemes (Merlin 2013). A single rule book, which has been advocated by the EU in the aftermath of the global financial crisis, means a set of fully harmonized EU rules applied consistently across the Member States. EU financial legislation is mainly comprised of directives, which need to be adopted by the Member States in order to be implemented. Some of these directives contain several national discretions, that is they leave open the possibility of national options or ‘specificities’ in the implementation of EU rules. For example, the Capital Requirements Directive III (CRD III) (2006) contained more than 100 national discretions (Quaglia, 2010). Partly for this reason, the proposed Capital Requirement IV legislation comprises a directive



(Commission 2011a); and a regulation, which imposes a maximum harmonization directly applicable in the Member States, therefore leaving little room for manoeuvre in national transposition (Commission, 2011b) (see also Buckley, Howarth and Quaglia, 2012; Howarth and Quaglia, 2013).

The principal logic behind the establishment of deposit guarantee schemes – which reimburse part of the amount of deposits to clients of banks that have failed – is to prevent a ‘bank run’, that is panic withdrawals by customers of their banks deposits because of fear of collapse. There exists longstanding EU legislation on deposit guarantee schemes to decrease the distorting effect to the Single Market created by different national schemes. The Deposit Guarantee Scheme Directive of 1994 set the minimum level of deposit protection schemes in the EU at €20,000 per depositor (Commission, 1994). However, as the 1994 directive was based on minimum harmonization, national deposit guarantee schemes continued to differ in several important respects, such as the definition of eligible deposits, the level of cover, the types of funding mechanism, and the calculation of bank contributions.

The global financial crisis that accelerated in late 2008 with the collapse of the American investment bank Lehman Brothers brought into the spotlight the inadequacy of the 1994 directive (Ayadi and Lastra, 2010; Quaglia *et al.* 2009). To begin with, the minimum level (€20,000) was too low to placate fears of a bank run. Moreover, the depositor protection coverage varied markedly across the EU, ranging from €20,000 in most of the new Member States and the UK to more than €100,000 in Italy and France. Furthermore, uncoordinated decisions on deposit guarantees taken by some Member States at the height of the crisis in late 2008 (notably in Ireland and Germany) worsened the crisis (Quaglia *et al.* 2009). It became evident that different national schemes across the EU potentially distorted level-

playing field competition and created the potential for ‘bank runs’ because, in the event of financial crises, customers in some Member States were prone to shift deposits to a bank headquartered in those Member State with more generous guarantee schemes.

At the peak of the international financial crisis in late 2008, the Commission proposed legislative changes to the Deposit Guarantee Scheme Directive. These changes – agreed hurriedly in 2009 – represented an emergency measure designed to restore depositors’ confidence by raising the minimum level of coverage for deposits from €20,000 to €50,000 and subsequently to €100,000. The need for swift action meant that several controversial issues were not tackled and hence the directive contained a clause providing for a broad review of all aspects of deposit guarantee schemes. By 2010, the deposit guarantee schemes continued to vary markedly across the Member States and only 16 out of 27 applied the coverage level of €100 000, or had legislation in place to do so (Commission, 2010).

When the sovereign debt crisis broke out in the euro area in late 2009, the issue of a common Deposit Guarantee Scheme came back onto the agenda. In July 2010, the Commission put forward a legislative proposal to amend the Deposit Guarantee Scheme Directive with a view to promoting the ‘harmonization and simplification of protected deposits, a faster pay-out, and an improved financing of schemes’ (Commission 2010, p. 5). The proposal aimed to establish a network of guarantee schemes as a first step towards a ‘pan-European deposit guarantee scheme’ to cover all European Union-based banks (*ibid.*, p. 5). Such a pan-European scheme however presupposed full harmonization of national schemes and could only enter into force after a minimum fund of 1.5 per cent of eligible bank deposits had been reached in all the Member States.

One of the most contentious provisions in the Commission's proposed 2010 directive was the establishment of a mandatory mutual borrowing facility, whereby if a national deposit guarantee scheme is depleted, it can borrow from another national fund. Several Member States tried to remove this provision during negotiations the directive in the Council (interviews with Commission and Permanent Representation officials, Brussels, July 2012). The mutual borrowing facility could be the first step towards a pan-EU deposit guarantee scheme, which was even more controversial. Indeed, during the preparation of the directive in 2010, the Commission considered the establishment of a single pan-European scheme. However, it soon realised that there were complicated legal issues that needed to be examined (Commission, 2010) and therefore the idea of a pan-European scheme was shelved for the time being. Ultimately though, the problem was political. The creation of a pan-European Deposit Guarantee Scheme would have implied pooling national sovereignty to an extent not acceptable to the Member States at that time (i.e., in 2010). The main line of division was between the countries that fear that they would become net contributors to the scheme, such as Germany, and the countries experiencing banking problems (for example, Spain and Ireland) and which were likely to resort to the scheme. Effectively, the German government balked at the prospect of German taxpayers underwriting depositors in other Member States with unstable banking systems.<sup>2</sup>

The issue of deposit guarantee schemes is interlinked with the discussion on a resolution framework for banks and financial institutions. 'Bank resolution' is the organization of an orderly failure, which involves the continuity of banking service. It is an alternative or complementary mechanism to the Deposit Guarantee Scheme in the event of bank failure. In June 2012, the Commission adopted a legislative proposal for bank recovery and resolution

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<sup>2</sup> *Financial Times*, 13 September 2012.

(Commission, 2012d), with the same scope of application as the CRD (hence, credit institutions and certain investment firms). The aim of the directive was to create an EU-wide framework on bank resolution.

The proposal distinguished between powers of ‘prevention’, ‘early intervention’ and ‘resolution’. In the case of prevention, banks would be required to draw up recovery plans and resolution authorities would be required to prepare resolution plans both at group level and for the individual institutions within the group. Authorities could require a bank to change its legal or operational structures to ensure that it could be resolved with the available tools. Financial groups may enter into intra-group support agreements in the form of loans, or the provision of guarantees. The framework envisages early supervisory intervention whereby the authorities could require banks to implement measures set out in the recovery plan and would have the power to appoint a special manager at a bank for a limited period (Commission, 2012d).

The harmonised resolution tools and powers outlined in the proposed directive were designed to ensure that national authorities in all Member States had a common toolkit and roadmap to manage the failure of banks. Amongst the tools considered, there is the bail-in tool, whereby banks would be recapitalised with shareholders wiped out or diluted, and creditors would have their claims reduced or converted to shares. ‘Resolution colleges’ would be established under the leadership of a clearly identified resolution authority and with the participation of the EBA, which would act as binding mediator if necessary (Commission, 2012d, p. 15).

The legislation envisaged the creation of resolution funding, which would raise contributions from banks proportionate to their liabilities and risk profiles and would not be used to bail out

a bank. There was a link between this piece of legislation and the Deposit Guarantee Scheme Directive, which was to provide funding for the protection of retail depositors. Member States would be allowed to merge these two funds, provided that the scheme remained able to repay depositors in case of failure (Commission, 2012d). The Commission noted that ideally, a single pan-European fund should be established with a pan-European resolution authority to manage its disbursement, but the absence of a single European banking supervisor and insolvency regime would make this unworkable (Commission, 2012d). As in the case of the Deposit Guarantee Scheme Directive, the obstacles to these far reaching changes were ultimately political, with the main line of division running between potential net contributors and net beneficiaries. The EU legislative activity on bank recovery and resolution regimes was in line with international regulatory initiatives in this field undertaken by the Financial Stability Board (FSB, 2011) and the Basel Committee on Banking Supervision (BCBS, 2010) which mainly focused on global systemically important cross border financial institutions.

On the SSM, the Commission proposed that the ECB would be empowered with specific supervisory tasks over euro area banks in order to help to strengthen confidence in prudential supervision and financial stability. Non-euro Member States would be able to participate in the SSM on a voluntary basis (Commission, 2012a). The main issues and political negotiations concerning the SSM are discussed in Section 3.

As for the common fiscal backstop, a link was established between Banking Union and the European Stability Mechanism (ESM) in the event that temporary financial support was needed. The ESM is a new EU agency which was to replace the temporary European Financial Stability Facility (EFSF). It was established in September 2012 and was to have a full lending capacity of €500 billion by 2014. The Member States of the ESM could apply for

an ESM bailout if they were in financial difficulty or their financial sector was a stability threat in need of recapitalization. However, the ESM bailouts were to be based on strong conditionality and Member States were required to sign the ‘Memorandum of Understanding’ which would highlight which reforms needed to be undertaken or fiscal consolidation to be implemented in order to restore financial stability. The Commission proposed that the ESM be used to support failing banks directly.

There were several open (and potentially sensitive) issues concerning Banking Union (see Comporti and Cosimo, 2012; Elliott, 2012; Pisani-Ferry *et al.*, 2012; Veron, 2013). Even on the elements agreed in 2012, and notably the SSM, several issues remained. First, both the Commission’s September proposals and the December agreement sidestepped the operational details of the SSM, and notably the relationship between the ECB and national prudential supervision and the responsibilities and powers of the European Central Bank (ECB) and the European Banking Authority (EBA) and the relationship between these two bodies. Second, many questions remained about the future organization of national supervisory authorities given the loss of potential powers. Furthermore, the relationship among national prudential authorities in the operation of Banking Union was unclear as was the relationship between these authorities and prudential authorities in EU Member States outside the Banking Union and those outside the EU.

Perhaps most importantly, the absence of a central EU body responsible for financial crisis management and the lack of a common resolution and deposit insurance scheme cast doubt over the ability of the euro area to deal effectively with crisis management and resolution. The supervisory power of the ECB still needed to be complemented by a single framework for resolving banks. At the end of 2012, crisis management and resolution remained a

national competence. A crisis management body had not yet been proposed at the EU level. Its creation would inevitably be controversial, as it would have to be assigned decision-making powers with fiscal implications.

### **3. The (euro area) intergovernmental debate on Banking Union**

The debate on Banking Union was characterised by intense intergovernmental negotiations. As in many episodes of EU institution-building, the main players were France and Germany, as discussed in this section. However, non-euro area Member States, first and foremost the UK, were also active in the debate (Section 4), which extended to the ECB and the EP (Section 5 and Section 6, respectively). The French, Italian and Spanish governments were the main supporters of Banking Union and the need to move quickly.<sup>3</sup> The German government was more guarded: it raised several objections in the run up to the European Council meeting in December and repeatedly pointed out that the need to get the right institutional arrangements in place was more important than to proceed speedily.<sup>4</sup> At the October European Council, German Chancellor Angela Merkel scuppered President François Hollande's ambitious deadline for an agreement on Banking Union by the end of the year and the meeting of euro area Finance Ministers at the start of December failed to overcome major on-going obstacles.

Effectively, the Franco-German debate on Banking Union paralleled longstanding debates on euro area governance and solutions to the euro area's sovereign debt crisis. The French sought support mechanisms; the Germans reinforced fiscal policy commitments (sustainable

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<sup>3</sup> *Financial Times*, 5 December 2012.

<sup>4</sup> *Financial Times*, 6 December 2012.

Member State budgets). French efforts stemmed from their limited success in convincing the Germans to agree to other measures to tackle the crisis. The French had pushed for the construction of massive support mechanisms – what David Cameron called the ‘Big Bazooka’ – able to purchase debt directly from euro area Member State governments and engage in bank recapitalisation.<sup>5</sup> The temporary EFSF and the permanent ESM in operation from late September were endowed with far less firepower than the French would have wanted and more restricted mandates – only the purchase of sovereign debt on secondary markets.<sup>6</sup>

President Hollande for his part insisted that Banking Union and ‘Social Union’ come before Political Union – meaning reinforced control over national fiscal and macroeconomic policies – sought by the Germans.<sup>7</sup> President Hollande called for further discussions on Political Union only after the European Parliament elections in 2014. Officially, the French supported Banking Union because they sought reinforced banking supervision, a euro area wide deposit guarantee and a bank resolution fund – that would relieve market worries over unstable banks in the euro area periphery holding huge quantities of their government’s sovereign debt. French interest in Banking Union also stemmed from a desire to establish a kind of fiscal backstop to the euro area – via a lender of last resort style support for banks rather than governments per se. Banking Union should thus be seen as old wine in a new bottle. The French argued that cutting the sovereign debt–domestic bank loop was crucial in order to rebuild international confidence in the value of sovereign debt of the euro area periphery. In

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<sup>5</sup> *Financial Times*, 10 October 2011.

<sup>6</sup> For an analysis of France’s EU policies and stances in light of Hollande’s election see Lequesne’s contribution to this volume

<sup>7</sup> *Euractiv.com*, 18 October 2012.



late November, European Council president, Herman Van Rompuy, published his paper ‘Towards a genuine economic and monetary union’ which largely aligned with French policy preferences (Van Rompuy, 2012). The Van Rompuy paper called for the adoption of a legal framework by early 2013 to enable the ESM to begin direct bank recapitalizations by the early Spring. The French also supported the Van Rompuy paper proposal to create a euro area wide ‘shock absorption’ fund, effectively an insurance scheme to which all 17 euro area countries would contribute.

The underlying German and Northern European concern remained the fiscal backstop and being forced into a situation of having to contribute more funds to the ESM in order to bail out banks in other countries.<sup>8</sup> Already, by late-September, the German, Dutch and Finnish governments made it clear that they opposed any agreement to allow the ESM to recapitalise banks, without prior agreement on an adequate regulatory and supervisory framework and reinforced fiscal policy rules (Finnish Ministry of Finance, 2012). These three governments also insisted that the banks in difficulty in those Member States with fragile banking systems – notably Spain and Ireland – remained primarily the responsibility of the governments of those Member States. The ESM was only to be used to help banks facing difficulties in the future, arising under the supervision of the ECB in the new Banking Union.<sup>9</sup>

The Germans expressed interest in the Van Rompuy paper proposal on a ‘shock absorption fund’ provided that funds used to help countries absorb shocks in EMU were limited.<sup>10</sup> They insisted that any financing come with thick strings attached – effectively contracts signed –

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<sup>8</sup> *Financial Times*, 12 December 2012.

<sup>9</sup> *Financial Times* 18 October 2012.

<sup>10</sup> *EUObserver* 14 December 2012.

requiring budget discipline and reinforced Commission monitoring – similar to the conditions imposed by the ECB upon countries whose debt it purchases. There was however no agreement on the special euro area fund at the December European Council.

The German and other northern euro area Member State governments were also concerned as to the scope of the Banking Union, in particular whether the ECB should directly supervise all banks in the euro area or only the main (cross-border) banks. The Germans opposed ECB supervision of the country's public Landesbanks and savings banks.<sup>11</sup> These banks were seen as having a 'public' function in Germany with strong ties to local and regional governments and traditionally reliant on them for financial backing – in terms of credit guarantees for the Landesbanks (banned since 2007) and long-term covered bond holdings. For these reasons German policy-makers preferred them to be subject to national supervision. The Commission and the French government pushed for Banking Union to cover all euro area banks. Many argued that the division into larger and smaller banks made little economic sense, given that banking crises often originated with smaller, fast-expanding banks (such as Spanish *cajas*) (Garicano 2012). The French government expressed concern over unequal treatment of Member States given that its banking system was dominated by five very large institutions which would all end up being directly supervised by the ECB.<sup>12</sup>

Some questioned the ability of the ECB to handle the supervision of all 6000 euro area banks – as suggested in the European Commission's September draft of Banking Union – without a massive transfer of resources.<sup>13</sup> The French and ECB responded that the ECB would only

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<sup>11</sup> *Financial Times*, 5 December 2012.

<sup>12</sup> *Financial Times*, 14 November 2012.

<sup>13</sup> *Financial Times*, 5 December 2012.

have direct responsibility for the supervision of systemically important banks, leaving the rest to national supervisors working according to EU rules. The Germans were also seeking real investigation and auditing powers to be assigned to the ECB – but only over the biggest banks – while the French preferred a ‘licensing’ system that would enable national supervisors to act on behalf of the ECB.

Despite entrenched Franco-German differences on pre-conditions for bank recapitalization, in early June, euro area finance ministers agreed up to €100 billion for the recapitalization of Spanish banks from the euro area’s bailout funds, without an accompanying austerity programme.<sup>14</sup> The Germans subsequently appeared to backtrack on this commitment in their position on support only to banks with future difficulties under the ECB’s watch. The Spanish government feared that the credit line to Spanish banks would count as public debt thus reinforcing the sovereign debt-bank link and increasing the likelihood of default.<sup>15</sup> However, in early December, the German government announced that it was willing to accept the immediate, and exceptional, recapitalization of four nationalized Spanish banks. The EU leaders agreed on a bailout plan for Spanish banks using Spain's ‘Fund for Orderly Bank Restructuring’ permitting the transfer of €39.5 billion from the ESM to the Fund. This transfer was accompanied by a pledge by Spain to restructure its financial sector. Nonetheless, Wolfgang Schäuble, the German Finance Minister, insisted that the ESM would not be used for other bank recapitalizations until the Banking Union was in full operation.<sup>16</sup>

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<sup>14</sup> *EUObserver* 9 June 2012

<sup>15</sup> *Reuters*, 25 September 2012

<sup>16</sup> *EUObserver*, 3 December 2012.

At the June European Council, which took place during a period when Spanish and Italian sovereign bond yields reached dangerously high levels and the situation of many Spanish banks looked particularly fragile, the French secured a commitment of euro area leaders to reach an agreement on Banking Union prior to the end of the year. The largest holders of Spanish sovereign debt, Spanish banks, looked fragile. However, in late July, the ECB President Mario Draghi announced that the bank was ‘ready to do whatever it takes’ to save the single currency and would make ‘unlimited’ purchases of sovereign debt of any euro area Member State government which agreed to introduce the kinds of austerity reforms introduced in the three bailed out, so-called ‘programme’, countries – Greece, Ireland and Portugal.<sup>17</sup> This helped to bring down bond yields. However, it also reduced pressure on euro area Member State governments to agree far-reaching reforms on Banking Union.

In the end, the agreement reached at the December European Council foresaw that the ECB would be ‘responsible for the overall effective functioning of the SSM’ and would have ‘direct oversight of the euro area banks’ (Council 2012, p. 2). This supervision however would be ‘differentiated’ and the Bank would carry it out in ‘close cooperation with national supervisory authorities’. Direct ECB supervision was to cover those banks with assets exceeding €30 billion or those whose assets represent at least 20 per cent of their home country's annual GDP.<sup>18</sup> This direct supervision would concern approximately 200 euro area banks. However, the agreement also permits the ECB to step in, if necessary, and supervise any of the 6000 banks in the euro area to bring about the eventual restructuring or closure of banks that found themselves in difficulties. The European Council agreed that the SSM would allow the ESM to recapitalize banks in difficulties directly, subject to ‘double

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<sup>17</sup> *Financial Times*, 26 July 2012. See Hodson’s contribution in this volume.

<sup>18</sup> *Financial Times*, 13 December 2012.

majority' voting by both the ECB and the EBA. The SSM was to begin operation on 1 March 2014 or twelve months following the entry into force of the legislation, whichever is later, subject to operational arrangements (Council, 2012).

The EU leaders called upon EU co-legislators to adopt a directive on a Common European Resolution Fund (to be financed by banks) and the Deposit Guarantee Scheme Directive by June 2013, with implementation 'by the Member States as a matter of priority' (European Council, 2012, p.3). The Member State governments failed to agree how these bank contributions should be calculated (for example, on a proportional basis of bank capital). The December European Summit was never likely to agree on a pan-European deposit guarantee scheme which would allow savings to be protected anywhere in the Union or a Union-wide resolution fund to which banks would have to contribute. The German government made clear its opposition to the mutualisation of debt, hidden transfer payments and the liability of German taxpayers for foreign bank resolution or for deposit guarantees in other EU Member State banks.<sup>19</sup> The goal of full Banking Union by 2014 appeared increasingly unrealistic.

#### **4. Banking Union and non-euro area Member States: The reinforcement of a 'two-speed' EU**

The euro-outsiders interested in participating in the SSM were opposed to the European Commission's proposed regulation of September which placed the ECB at the centre of the mechanism. The wording of the draft suggested that non-euro Member States would be excluded from decision-making as they lacked a vote on the ECB's Governing Council. The

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<sup>19</sup> *Financial Times* 12 December 2012.

Commission's draft also appeared explicitly to limit membership by defining 'participating Member State' as a 'Member State whose currency is the euro' (Commission, 2012a). The euro-outsiders were supported by the EP's Economic and Monetary Affairs Committee which formed its own position on the status of the ten EU Member States not in the euro area, deciding that 'opt-in' countries should be able to sit on a new ECB supervisory board with equal voting powers but not on the decision-making Governing Council.<sup>20</sup> The December Council agreement on the SSM satisfied some euro-outsider concerns. The revised regulation changed the definition of 'participating Member State' to 'a Member State whose currency is the euro or a Member State whose currency is not the euro which has established a close cooperation', defined as adopting the necessary legal framework and cooperating with the ECB along the lines codified in the draft regulation. Opening the SSM to non-euro Member States made good sense in that more Member States sharing common supervisory frameworks, rules and mechanisms would further strengthen stability.<sup>21</sup> Not including them would potentially create a more difficult situation in case of (financial) problems and the necessity of extra financial assistance. Furthermore, if different rules were to apply in these Member States, the Banking Union might find itself confronted with regulatory and supervisory arbitrage on its doorstep.

At the time of writing (April 2013) most non-euro Member State governments have yet to take a definitive position on participation in Banking Union and they are weighing up the pros and cons of membership (see also, Darvas and Wolff, 2013). Amongst the reasons provided to support membership, participation in the SSM was seen in terms of improving the credibility of national prudential arrangements, overseen by the ECB. The ECB would

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<sup>20</sup> *EUObserver* 29 November 2012.

<sup>21</sup> *Ibid.*.

possess information about the banks' headquarters and subsidiaries, allowing more effective supervision and decision-making. Furthermore, the banking systems of the Central and Eastern European Member States were dominated by foreign institutions: non-participation in Banking Union might have a devastating effect on domestic banks as depositors shifted their accounts to banks headquartered in Banking Union Member States. There were also several reasons not to participate in Banking Union. Non-euro Member States were worried about their second-class status, with limited decision-making power as compared to euro area members. The ECB might be less prone to focus on the risks building in non-euro and smaller Member States. The as yet undetermined implications of full Banking Union also encouraged some non-euro Member States to adopt a cautious position on the SSM.

The majority of non-euro Member States either sought to enter Banking Union or adopted a 'wait and see' policy. This included Denmark, which had a formal opt-out on EMU. By the December European Council, it was clear that the United Kingdom, Sweden and the Czech Republic would opt not to participate in the SSM. The British position is discussed below. The Swedish government's decision not to participate in Banking Union owed largely to the fact that no major banks in the country were owned by banking groups headquartered in another EU Member State (Darvas and Wolff, 2013). The Swedish government also expressed concern as to the second-class position of non-euro Member States in the SSM.<sup>22</sup> Finland and Estonia – with banking systems dominated by Swedish-owned institutions, such as the Hansabank subsidiary of Swedbank – had a strong vested interest in reaching a compromise to ensure Swedish participation. Latvia and Lithuania, also dominated by subsidiaries of Swedish banks, had less interest in joining Banking Union given Swedish non-membership, although Latvia's intention to enter the euro area in 2014 pushed its

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<sup>22</sup> *Financial Times*, 11 December 2012.

government to support the form of membership on offer.

The main priority of the British government – which had no intention of joining the SSM – was to avoid a potential euro area block within the single financial market. The British, supported by seven other non-euro Member State governments, threatened to block Banking Union if there were insufficient safeguards put in place for the ‘euro-outsiders’.<sup>23</sup> Crucially, the British feared the adoption of subsequent financial legislation that would be detrimental to the British financial sector. However, the broader issue of concern was the satisfactory co-existence of a more integrated euro area core and the non-core Member States. Banking Union became a kind of test case for Britain's role in a two-speed Europe.<sup>24</sup> In the European Banking Authority (EBA) – the supervisory body responsible for EU-wide bank stress tests – the British feared a euro area majority able to impose its rules on non-euro area members. Hence, as early as the summer of 2012, the British demanded an EBA voting reform: that any decision by the Authority should be approved by a minimum number of Member States outside the Banking Union and thus effectively by a ‘double majority’ of Member States inside and outside the Banking Union.

Germany, the Netherlands and Austria all broadly accepted British-led requests for so-called ‘double majority’ voting. However, most euro area Member States expressed concern that in the event that the number of non-Banking Union Member States dwindled, the United Kingdom would enjoy effective veto powers.<sup>25</sup> The European Commission opposed EBA reform because it would result in the creation of two forums for decision-making: those

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<sup>23</sup> *Financial Times*, 8 November 2012.

<sup>24</sup> *Financial Times*, 13 December 2012.

<sup>25</sup> *Financial Times*, 8 November 2012.



inside and outside the euro area.<sup>26</sup> The outcome was a compromise involving the creation of a double majority system until the number of non-Banking Union Member States dwindled to less than four. The European Parliament retained amendment and veto powers on the EBA regulation which was to be adopted in 2013.

French policy makers tended to be the least forthcoming towards British requests. French support for Banking Union was bolstered by a direct interest to redirect euro trading business and other financial services away from the United Kingdom. In January 2009, then-Finance Minister Christine Lagarde referred to the need for ‘euro area clearing’.<sup>27</sup> In February 2009, a 26 page confidential memo by the Bank of France was leaked.<sup>28</sup> The memo advocated the creation of a Paris-based clearing house for credit default swaps (CDS) with the explicit aim of preventing London from dominating the business. Christian Noyer, the Governor of the Bank of France, publicly confirmed the longstanding French position in a 2 December 2012 interview with the *Financial Times*: ‘Most of the euro business should be done inside the euro area. It’s linked to the capacity of the central bank to provide liquidity and ensure oversight of its own currency.’ Other euro area Member States likely agreed on the desirability of redirecting financial transactions from London to the euro area but most were less overt in expressing this preference.

The French position also reflected longstanding ECB preference on the location of euro-derivatives clearing, stated as early as 2001 (ECB, 2011c). The ECB recommended legislating on this preference for the first time in a July 2011 policy paper (ECB, 2011a)

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<sup>26</sup> *Financial Times*, 13 December 2012.

<sup>27</sup> *Financial Times*, 19 February 2009.

<sup>28</sup> *Ibid.*

which called for legislation requiring clearing houses to be based in the euro area if they handled ‘sizeable amounts’ of (i.e., more than 5 per cent of the clearer’s business was in) a euro-denominated financial product. This recommendation came in the context of a long-standing debate over the control and authorization of clearinghouses in the European Markets Infrastructure Regulation (EMIR) on which the British government later won an important concession, prohibiting the discrimination against any Member State as a venue for clearing services. In September 2011, the British government launched its first lawsuit against the ECB through the European Court of Justice on the grounds that the ECB’s policy recommendation would restrict the free movement of capital and infringe upon the right of establishment. The rule would disadvantage financial services in the United Kingdom and could force one of the world’s largest clearing houses – LCH.Clearnet, which far exceeded the 5 per cent threshold – to move its euro operations to the euro area.<sup>29</sup> At the end of 2012, over 40 per cent of euro-denominated transactions took place in London, more than the entire euro area combined. Further, the British government remained concerned that the ECB would push for new regulation that would contradict British preferences. The ECB responded by a clarification of its clearinghouse location policy in a November 2011 document (ECB, 2011c) against which, in February 2012, the British government launched a second ‘technical’ legal challenge.

## **5. The European Central Bank and Banking Union**

Prior to the debate on Banking Union, some senior ECB officials (for example, Tommaso Padoa-Schioppa) expressed support for the ECB to take over supervisory functions (Howarth and Loedel, 2005). However, this was not an official ECB policy. Nonetheless, the ECB endorsed the initial Commission’s proposal of allocating all supervisory competences to the

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<sup>29</sup> *Financial Times*, 14 September 2011.

ECB, regardless of the size of banks. President Mario Draghi made clear that being a decisive supervisor included oversight of all 6,000 banks to ensure a level playing field.<sup>30</sup> But in several speeches he also reiterated that day-to-day tasks would remain with national supervisors (see for example, ECB, 2012c.). He argued that the ECB should be in a position to carry out its new functions ‘in a decisive, firm, complete and strong manner without any reputational risks’ and ‘new tasks should not be mixed with [the central bank’s] monetary policy tasks – delivering price stability in the medium term – which for [the central bank] remains the primary task’ (ECB, 2012c). The ECB welcomed the 13 December agreement on the SSM.

The impact of Banking Union upon the size and organization of the ECB remained far from clear. In December, senior ECB figures reported the likely need for approximately 500 new staff members hired from national supervisory bodies but this was almost certainly an underestimate.<sup>31</sup> President Draghi commissioned a private consultancy firm to prepare a report (published in January 2013) on the necessary steps to prepare the ECB for Banking Union. The firm recommended that the ECB should more than double its staff, with an expansion of almost two thousand, to be allocated to the operation of the SSM, by 2017 – the date by which the ECB would be supervising up to 200 banks directly.<sup>32</sup> By comparison, there were approximately 1500 officials working in prudential supervision in Germany (in the Bundesbank and BaFin, the Federal Financial Supervisory Authority).

The consultancy also noted the dangers of power struggles with national authorities (some of

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<sup>30</sup> *Financial Times*, 8 November 2012.

<sup>31</sup> *Financial Times* 4 February 2013.

<sup>32</sup> *Ibid.*.

which are not central banks) over prudential supervision.<sup>33</sup> The consultancy firm proposed that national representatives on supervisory boards should abstain on issues relating directly to their national banks, so as to ensure that decisions are objective and pan-European. It was also uncertain where power over supervision would rest in the ECB, although all were agreed that safeguards were needed to ensure a clear separation of the banks' monetary policy and supervisory policy. However, there were on-going concerns about the operation of the European Systemic Risk Board (ESRB) – the body established in 2011 to monitor trends in European financial markets – which was chaired by the ECB president and supported by the analytical, statistical, administrative and logistical assistance of the ECB. Critics claimed that the close ECB-ESRB ties already gave the central bank a role in macro-economic supervision that could compromise its monetary policy functions.<sup>34</sup>

The December agreement involved the creation of a planned mediation committee between the banking supervisory board and the ECB Governing Council. This was a last-minute compromise introduced to satisfy the German government which was opposed to assigning automatic responsibility to the ECB for mishaps it could not directly supervise.<sup>35</sup> It was agreed that the mediation committee would intervene when the banking supervisory board (which would likely include both euro area members and non-members) disagreed with the ECB's Governing Council on the supervision of a specific bank. The consultancy hired by the ECB proposed that the administrative head of the supervisory arm should be a member of the central bank's Executive Board who would also serve as a vice-chair of the supervisory board. This powerful figure would likely come from one of the larger Member States, with

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<sup>33</sup> *Op. Cit.*. See also Howarth (2012).

<sup>34</sup> *EUObserver*, 1 February 2012.

<sup>35</sup> *Financial Times*, 17 December 2012.

Danièle Nouy, a senior official from the Bank of France a likely candidate.<sup>36</sup>

On the Common Deposit Guarantee Scheme, the ECB supported the development of common support tools to manage the failure of financial institutions (ECB, 2012b). It argued that a common deposit guarantee scheme could help to maintain financial stability by discouraging speculation against individual member states or institutions of the euro area. The ECB ‘fully supports the development of a recovery and resolution framework’ (ECB, 2012b, p. 1). In this respect it called for a rapid establishment of an Independent European Resolution Mechanism (ECB, 2012b, p. 2). ECB President Draghi declared himself confident that the resolution mechanism would be in place when the SSM enters into force.<sup>37</sup> However, Draghi claimed that even if this mechanism was not in place, a negative assessment by the SSM of the viability of a bank, ‘would likely’ force national governments to undertake corrective measures<sup>38</sup>. The ECB adopted a positive position on the use of ESM funds to support banks, whilst its general position had always been that financial assistance should be conditioned by fiscal and macroeconomic reforms (as in the case of Greece, Ireland and Portugal).<sup>39</sup>

The Bundesbank maintained its reputation for rigorous critique on the euro crisis and mooted reforms by issuing an opinion that the December deal on the ECB’s role in supervision lacked ‘a long-term solid legal basis’ and that the mediation committee operating between the

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<sup>36</sup> *Financial Times*, 4 February 2012.

<sup>37</sup> *Financial Times* 14 December 2012.

<sup>38</sup> *Financial Times*, 14 December 2012.

<sup>39</sup> *EurActiv.com*, 4 December; *Der Spiegel*, 6 June 2012.

bank supervisor and the Governing Council could be attacked in the courts.<sup>40</sup> The Bundesbank President, Jens Weidmann, also challenged the logic of transforming the ECB into a prudential supervisor and expressed concern that the ECB's new supervisory role would not be sufficiently separate from its monetary policy role (and the goal of price stability) to ensure independence.<sup>41</sup> Many other observers and policy makers, including the EP's Economic and Monetary Affairs Committee expressed similar concerns.<sup>42</sup> Weidmann, however, argued that at best the ECB should operate as a transitional supervisor, while another entirely independent body was set up. Weidmann was also opposed to the creation of a 'resolution' authority able to use taxpayer money to shut down banks, until a fund based on bank contributions was established, on the grounds that this would spread risks to taxpayers yet without adequate democratic controls.

## **5. Banking Union and (the lack of) democratic oversight**

Members of the European Parliament from the two main party groups were broadly supportive of Banking Union and called for adoption of the legal framework by the end of 2012 and for implementation to start in 2013.<sup>43</sup> However, MEPs also expressed the concern that the EP had been side-lined in the design of the Banking Union proposals and that democracy would suffer as a consequence.<sup>44</sup> The EP only possessed consultative power over the SSM regulation and other potential legislation to reinforce the powers of the ECB – although the EP held equal legislative power with the Council on the directive amending the

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<sup>40</sup> *Financial Times*, 17 December 2012.

<sup>41</sup> *Financial Times*, 27 September 2012; *WirtschaftsWoche*, 22 December 2012.

<sup>42</sup> *Financial Times*, 29/30 November 2012.

<sup>43</sup> *EUObserver*, 29 November 2012.

<sup>44</sup> *EUObserver* 29 November 2012.

powers of the EBA in the context of Banking Union. MEPs thus pushed to maintain an important role in negotiations and for Member States to treat the two pieces of legislation (SSM and EBA powers) equally. MEPs referred to the negotiations in 2011 on the ‘Six Pack’ reforms to economic governance as a precedent on which the EP enjoyed de facto co-decision even though Consultation procedures applied to the reforms.<sup>45</sup> MEPs demanded transparency both in the negotiations on Banking Union and in the future operation of ECB supervisory powers and threatened to block new rules for the EBA if the Council (Member States) refused to negotiate on its SSM demands.<sup>46</sup>

On 29 November, the EP’s Economic and Monetary Affairs Committee adopted its amendments of the European Commission’s September legislative package (EP, 2012) focusing in large part upon improving the democratic accountability of the SSM. The Committee demanded a veto over the nominee for chair of the SSM’s board (to be located within the ECB), and that MEPs should have greater say over the SSM’s budget and full investigative powers over the new board and its operations. At present the EP has no confirmation power over the appointment of ECB Executive Board members, which MEPs have compared unfavourably with the power of Congress over the confirmation of nominees to the US Federal Reserve Board (Howarth and Loedel, 2005; Jabko, 2003). The new supervisory board would be required to report to the EP and national parliaments. MEPs also forwarded specific positions on a range of matters. MEPs demanded that the SSM regulation include conflict of interest provisions which could prevent members of the SSM's board from also having a mandate as a national regulator and blocking supervisory officials from entering (or returning) to banking jobs (thus avoiding the ‘revolving door’ phenomenon).

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<sup>45</sup> *EUObserver*, 29 November 2012.

<sup>46</sup> *EUObserver*, 1 February 2013.

MEPs also recommended that the EBA be assigned more powers to carry out stress tests and investigations and that it be relocated to Frankfurt – in order to tighten the Authority’s links with the ECB and avoid institutional overlap.

## **Conclusion**

Banking Union – if adopted in its entirety as proposed by the European Commission – would be the most important step in European integration since the launch of Economic and Monetary Union. The adoption of the SSM is, in itself, one of the most significant leaps forward since 1999. Banking Union can be seen as a necessary response to the ‘asymmetric’ design of EMU (a Monetary Union with a limited form of EU) and to the fragmentation of the single financial market. Banking Union can be seen as a crisis-driven attempt to address several important issues that were side-stepped or papered over during the negotiations leading to the Maastricht Treaty, principally the allocation of supervisory responsibilities to the ECB and the creation of a fiscal backstop in the euro area. Other issues, notably the need for a single rule book and the harmonization of deposit guarantee schemes, stemmed from the incomplete nature of the single financial market – despite its heralded re-launch in the early 2000s. The limited integration of financial services markets (and notably banking markets) even after 13 years of EMU is a major weakness in the Single Market. Finally, other issues, such as the need for a common deposit guarantee and a resolution fund/authority for the euro area, were highlighted by the global financial crisis and the sovereign debt crisis. The further disintegration of financial markets since 2007 is the most significant on-going impact of these crises upon the Single Market. The Banking Union proposals are a direct response to this disintegration and thus should be seen as much in terms of reinforcing the Single Market as stabilising banks and EMU.



In the summer of 2012, the International Monetary Fund (IMF) came out as a vocal champion of Banking Union as an essential step to resolve the sovereign debt crisis (Goyal *et al.*, 2013; IMF, 2012; IMF, 2013). Like the Bundesbank, the IMF expressed its concern over a ‘half-finished’ project, arguing that the SSM, the single resolution mechanism with common fiscal backstops (mutualisation), a single authority with the power to shut down banks and common safety nets were *all* required to ensure a successful Banking Union. The creation of an SSM prior to the creation of a credible fiscal backstop would leave the former at risk, resulting in ‘an architecture that is inferior to the current national one’ (Goyal *et al.*, 2013, p. 22).

The sudden push on Banking Union by the European Commission and certain Member State governments, and notably the French, reflects the limited success of EU-level fiscal policy reinforcement and support mechanism construction in terms of building confidence in the stability of EMU. The half-hearted nature of reform to date owes to fundamental disagreements between France and Germany on how to tackle the crisis. Banking Union has thus been embraced by many as an alternative route to stability: a European Holy Grail. Yet the Banking Union to be agreed in 2013 was as likely to be an uncomfortable compromise as previous reforms adopted to resolve the sovereign debt crisis. German opposition to the mutualisation of financial support for banks would be difficult to overcome. While a major step forward in European economic integration, the reforms adopted would likely fall short of the silver bullet hoped by many to bring the sovereign debt crisis to an end.

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