

# **National State Aid within the Banking Union (BU) and the Hard Core: Periphery Financial Divide**

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## **Abstract**

Direct government intervention in the form of State Aid to the banking sector has emerged as a core theme in the recent crisis. The BU current structural design, leaving actual and potential government intervention largely unattached, may actually enhance moral hazard, negative cross-border externalities and financial fragmentation between the hard core and the periphery Member States. Borrowing costs (i.e. interest rates) would be influenced by a bank's location rather than by the ECB's monetary policy, eventually rendering the system unsustainable. The EDIS proposal highlights the issue of State Aid and the role of national involvement in the banking sector. Efficient supervision, elimination of national State Aid and effective backstops to the ERF and EDIS are the appropriate policies to eradicate hard core - periphery divide and preserve the integrity of the euro.

**JEL classification numbers:** G1, G2

**Keywords:** State Aid, Banking Union, Financial Fragmentation

## **1 Introduction**

State intervention in banking in the form of State Aid in the pre-crisis era was subject to constructive ambiguity as not proclaimed ex-ante to avoid any potential for moral hazard and entirely subject to national discretion. It, however, transformed to a sparkling issue, in the post crisis period, being explicitly portrayed in laws, challenging delicate balances between national and European authorities in its implementation and ultimately determining the completion of the BU. Since the crisis erupted, more than 22 EU governments intervened in the banking sector directly and massively in the form of provision of guarantees, asset relief and recapitalization. Around 30% of the European banking sector has been reorganized under EU State Aid

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rules.

The enormous amount of national State Aid gave rise to financial fragmentation and moral hazard of both banks and governments. Against this background the Banking Union (BU) project aims at promoting financial integration, eliminating the vicious circle between banks and sovereigns and ensuring a level playing field for all banking institutions. Are the instruments incorporated in BU legislation effective in attaining these objectives? What is required in the BU infrastructure to guarantee that the location of a bank (and not its assets) in the Eurozone does not influence either the public trust attached to it or its funding costs and that of the respective government? Does the potential of government intervention in the recapitalisation/resolution process contribute to competition on borrowing costs among member states?

The paper attempts at answering these questions.

## 2 The EU State Aid Rules and Implications

According to Article 107 of the Treaty on the Functioning of the European Union (TFEU)<sup>2</sup> State Aid is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities. To be State Aid, a measure needs to have the following features:

- the intervention carried out by the State or through State resources.
- the intervention provides to the recipient an advantage on a selective basis.
- competition has been or may be distorted, and
- the intervention may affect trade between Member States.

Despite the general prohibition of State Aid, the Treaty leaves room for a number of policy objectives for which State Aid can be considered compatible. Compatibility with the “Internal Market” framework is granted or may be granted in the case of:

- aid having a social character
- aid to recover the damage caused by natural disasters
- aid to support the economic development of economically depressed areas
- aid to support the implementation of project of common European interest
- aid to redress a serious shock in the economy of a Member State
- aid to assist culture and heritage conservation
- other categories of aid as may be specified by decision of the Council on a proposal from the Commission.

The European Commission is responsible for scrutinizing national State Aid to guarantee compliance with EU rules and particularly to guarantee that prevention is respected and exemptions are implemented evenly across the EU [1]. However, the EU institutional framework is lacking a precise definition and quantification methodology for State Aid. The “flexible” definition of exceptions allows great potential for

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<sup>2</sup>Consolidated Version of the Treaty on the Functioning of the European Union, 2012 O.J. C 326/1, [TFEU]

arbitrariness serving some important policy goals. Preserving certain degree of discretion in the issue of State Aid gives the power to the Commission to exert some control over national fiscal policies, which in principle is outside its field of competence. The vague definition of State Aid is fairly efficient and suitable for the EU Commission to exercise maximum leverage over Member States. The Member States, on the other hand, would enjoy a sufficient scope of ambiguity and discretion to pursue their goals. The lack of precision in the field of subsidies is an element of deliberate policy, basically providing the lowly common denominator on which all the parties involved could consent.

### 3 State Aid to the Financial Sector in the Crisis Context

The EU State Aid control in banking, an area with significant political interests, has always been frail and sluggish (European Commission's Press Release, 2002). Following the crisis, the EU State Aid control has loosened up. The unsubstantiated claim, made by any government, that lack of public support to a specific bank would impair financial stability could not be effectively challenged by the EU Commission. Financial stability considerations have considerably deprived the Commission control over national State Aid which has been used extensively. The Commission provided almost 500 authorizations in this respect on the grounds of redressing a serious shock in the national economies [2]. The major part of this aid involved guarantees on liabilities. More specifically between 2008 and 2014, the Commission authorized national State Aid in the form of:

- Guarantees on liabilities amounted to more than 3.8 trillion euro representing almost 30% of EU GDP in 2013.
- Recapitalisation measures amounted to more than 820 billion euro representing almost 6.3% of EU GDP in 2013.
- Direct short term liquidity support to banks in some Member States reaching almost to 400 billion euro representing approximately 3% of EU GDP in 2013.
- Asset relief measures reaching approximately 670 billion euro representing almost 5% of EU GDP in 2013.

Table 1 presents data on authorized State Aid amounts in selected Member States. This Table clearly reveals that State Aid was provided far more extensively in the Eurozone than in non-Eurozone countries. State Aid to some extent might have been used as a substitute to macroeconomic policy instruments (e.g. interest rate, exchange rate), eliminated by the introduction of the euro, and as a device to pursue national interests and goals. This issue requires further research.

Table 1: Financial Aid Approved by the EU Commission in Selected EU Countries, 2008 -1/10/2014

	2008 - 30/09/2014							
	Recapitalisation measures		Guarantees		Asset relief interventions		Liquidity measures other than guarantees	
	in € billion	as % of 2013 GDP	in € billion	as % of 2013 GDP	in € billion	as % of 2013 GDP	in € billion	as % of 2013 GDP
Belgium	23,32	6,1%	325,42	85%	28,22	7,4%	20,50	5,4%
Finland	4,00	2,1%	50,00	28%	0,00	0%	0,00	0%
France	29,24	1,4%	382,66	19%	4,70	0,2%	6,65	0%
Germany	114,61	4,2%	455,86	17%	82,78	3%	9,50	0%
Italy	22,00	1,4%	110,00	7%	0,00	0%	0,00	0%
Luxembourg	2,50	5,5%	7,05	16%	0,00	0%	0,32	0%
Netherlands	39,84	6,6%	200,00	33%	30,61	5,1%	54,00	0,2%
Ireland	111,39	87,9%	554,18	338%	122,28	74,5%	40,73	0%
Cyprus	1,80	10,9%	9,00	55%	0,00	0%	0,00	0%
Greece	48,97	26,9%	85,00	47%	0,00	0%	15,74	4,0%
Portugal	32,25	19,5%	44,27	27%	4,00	2,4%	6,08	0%
Spain	174,52	17,1%	321,05	31%	139,92	13,7%	32,65	0,08%
Czech Republic	0,00	0,0%	0,00	0%	0,00	0%	0,00	0%
Hungary	1,07	1,1%	5,35	5%	0,04	0%	3,87	0%
Poland	34,72	8,9%	33,89	9%	0,00	0%	0,00	0%
Romania	0,00	0,0%	0,00	0%	0,00	0%	0,00	0%
Sweden	5,03	1,2%	158,00	37%	0,00	0%	0,52	0%
United Kingdom	114,62	8,0%	458,75	24%	248,05	13,1%	51,93	0%
<b>TOTAL EU-27</b>	<b>821,13</b>	<b>6,3%</b>	<b>3892,57</b>	<b>29,8%</b>	<b>669,13</b>	<b>5,12%</b>	<b>379,91</b>	<b>2,9%</b>

Source: EU Commission 2014

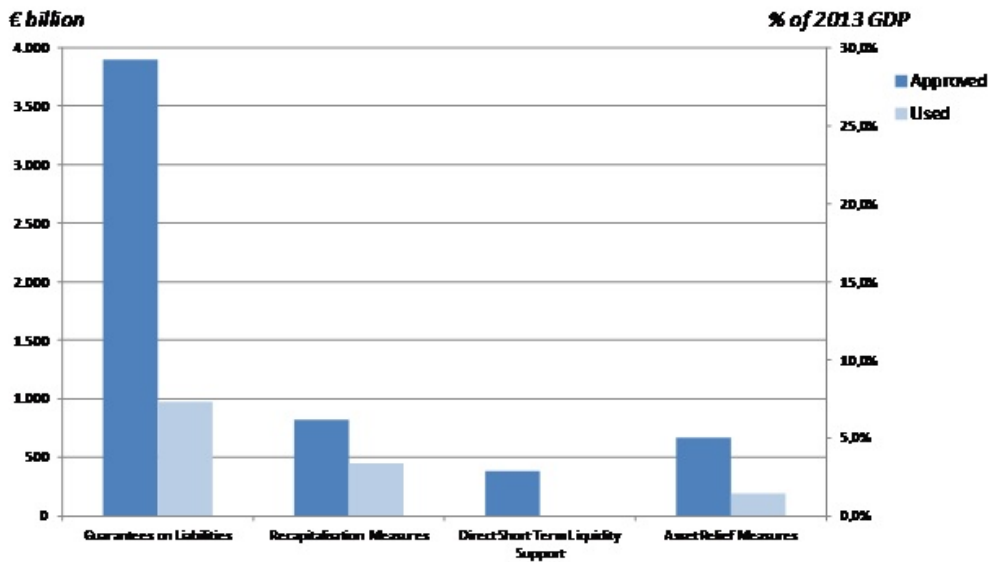


Figure 1: State Aid Interventions 2008-2014

## **4 Assessing national state aids to the financial sector within the eurozone**

### **4.1 The Eurozone Framework**

The Eurozone has some unique elements:

- Unrestricted capital flows due to common currency and payment infrastructure: absence of economic and legal barriers associated with different currencies.
- National fiscal policies and backstops.
- National resolution policies and instruments.
- Absence of a Central Bank backstop in case of exhausted government funds.
- Tight banks' political connections – links between banking and policy makers. In general, governments consider banks as institutions that should serve to finance their policies and interventions or even the government itself [3].

Within this framework governments have powerful incentives to:

- Act strategically and intervene to contain instability in their banking sectors which would lead to capital flights towards more secure jurisdictions and thus raising funding costs.
- Refrain from inflicting domestic bank losses upon creditors and governments debt holders which could contribute to fear of defaults, divestments, capital out flows, liquidity squeeze and severe repercussions on funding costs. In the absence of a flexible exchange rate to prevent capital outflows and a Central Bank to act as a lender of last resort, fear of defaults transformed into a liquidity crisis, with borrowers (including banks and sovereigns) unable to roll over their debt at acceptable interest rates. The Lehman crisis and the post-Lehman bailouts lead to strong tensions against any creditor liability [4]. Imposing ailing banks losses on creditors is considered as imminent systemic risks from potential domino effects, since, either such creditors are unable to meet their liabilities, or realization of creditors liabilities impairs the financing conditions of the entire banking system (contagion risk) with severe repercussions for the real economy. The Cypriot crisis is an exception which confirms the rule: the losses were imposed on non-European creditors with limited contagious effects for the European banking sectors and systemic damage [5]. Given the uncertainties about funding and preservation of systemically important functions, most governments would be reluctant to impose tough resolution procedures.
- Delay the necessary adjustment of the domestic banking system postponing the appropriate management of losses derived from non-performing loans –the so called “legacy” assets. Since banks are politically connected, governments would refrain from engaging in appropriate interventions that would compel banks to realize their losses and retrench their activities.
- Avoid equity dilution by erecting or maintaining legal and fiscal obstacles to equity market integration. The low market capitalization of several banks observed during the crisis did not generate any significant increase in cross-border equity ownership.

Within this framework, national State Aid has largely been successful in restoring confidence and stability in the financial sectors. Nevertheless it has contributed significantly to two market deficiencies:

- financial fragmentation with uneven level playing field,
- increased moral hazard obstructing the restructuring of the banking sectors.

These two are considered in turn:

## **4.2 Financial Disintegration in the Eurozone**

The emerging financial landscape after the crisis in the Eurozone is characterized by substantial fragmentation of the banking system with savings transfers to countries endowed with greater fiscal capacity. Financial fragmentation is probably the most serious setback for the eurozone due to the lack of a fiscal system to accommodate any asymmetric or external shocks [6].

The birth of euro provided an apt payment infrastructure that allowed unrestricted capital flows to flourish and respectively restricted the governments' capacity to borrow funds when risk aversion increases. Following the crisis, financial integration in the euro area reversed. The financial crisis and the consequent adverse market conditions generated risk aversion which contributed to a retreat of capital flows (home bias). Furthermore regulatory provisions and administrative practices (regulatory capital requirements, resolution procedures, and payment systems) have divided the euro area financial system back into national boundaries. The lack of harmonized national resolution procedures backed by credible resolution funds has generated uncertainty over the burden sharing and contributed to banks' risk aversion and thus liquidity ring-fencing at the national level.

Financial stress has declined since 2013, yet the funding patterns have been distorted with cross-border financial flows diminished and international diversification of balance sheets altered across all sectors [7]. Fragmentation remains sizeable and integration is well below pre-crisis levels [8]. It is apparent that certain markets (in particular sovereign bond markets and interbank credit) had been haunted by distortions in credit risk pricing. The level and intensity of state guarantees to the national banking sectors generated significant distortions in credit risk pricing and consequently lead to credit market fragmentation at national level.

Eurozone governments have a powerful incentive to support their national banks with enormous amounts of State Aid mainly in the form of explicit or implicit state guarantees. It is extremely important to stress that not all guarantees are equally effective. Their effectiveness depends on the financial status of the provider that is the respective State. Thus, the fiscal capacity of a Eurozone member state, which is its ability to provide State Aid and credible guarantees in the banking sector, has emerged as a major determinant of its borrowing cost –i.e. its interest rate. This condition maintains an uneven playing field among national banks according to the state where they are legally headquartered. It also obstructs the smooth operation of credit markets, hinders the smooth transmission of monetary policy as pursued by the ECB and constrains overall economic growth.

### **4.3 Restructuring of the Banking Sectors - Moral Hazard**

It has been observed in some cases that state intervention in the form of guarantees in the banking sector avoided the severe consequences of rising borrowing costs and thus obstructed banking sector restructuring and enhanced moral hazard of both banks and governments. State Aid largely took the form of guarantees attached to looser provisions than those attached to other forms of state support such as recapitalization which would require the implementation of strict restructuring procedures. Guarantees have been permitted to subsidize national banks' operations in the interbank market with merely limited requirements eventually restraining the very necessary adjustment in the sector. Thus they have deterred appropriate management of troubled assets derived as the legacy of the financial crisis. By avoiding the severe (though necessary) consequences of restructuring, moral hazard of both banks and governments has amplified.

A closer view reveals a two speed adjustment in the banking sector of the Eurozone . The pace of adjustment proceeds more rapidly in the peripheral Eurozone countries which demonstrated rather efficient attempts to implement recapitalization and reorganization procedures. Such procedures, which not least augment the domestic banks' equity holdings, were either imposed as prerequisites of external financial support or by the dread prospects of falling under severe external funding provisions, which would carry even stricter restructuring plans. In contrast, countries with banking system supported by governments, either directly via subsidization or indirectly by the fiscal status of the respective governments, demonstrated delays in the adjustment process. Banks in such countries have experienced a holdup in reorganization and recapitalization which preserved existing equity holdings and interests and imposed further losses on legacy assets. Table 2 and derived Figure 2 present the developments in capital and reserves over total assets in selected EU countries' banking sectors since the outset of the crisis. They clearly reveal that the process of adjustment has been particularly evident in peripheral countries.

The process of rationalization and resizing, although appears a common trend in the Eurozone banking system since the outset of the crisis as an attempt towards more efficient use of resources; it is especially evident in the peripheral EU countries. More specifically such process becomes visible in the increase of key banking capacity indicators, for instance population per branch and population per bank employee. According to the European Central Bank [9] the increase was superior in countries that were participating in EU / IMF financial adjustment programmes. For instance the increase in population per banking employee since 2008 was significant in Spain (38%) and Cyprus (49%).

Table 2: Capital and Reserves to Total Assets in Selected EU Countries' Banking Sectors

Source (all series) : European Central Bank								
	2007	2008	2009	2010	2011	2012	2013	2014
Austria	8,5%	7,2%	8,7%	9,2%	8,8%	10,3%	10,7%	10,3%
Belgium	5,0%	4,4%	4,8%	4,9%	4,7%	5,2%	5,9%	5,7%
Germany	4,6%	4,8%	5,1%	4,6%	4,7%	5,1%	5,8%	6,0%
Spain	6,9%	7,1%	7,8%	8,1%	10,1%	11,2%	13,6%	11,3%
Finland	7,3%	5,8%	6,0%	5,2%	4,0%	4,1%	5,0%	5,0%
France	5,5%	5,4%	5,9%	6,1%	5,9%	6,4%	6,5%	6,4%
Greece	7,5%	6,1%	8,0%	8,6%	11,1%	12,0%	14,3%	18,5%
Ireland	4,5%	4,3%	5,5%	7,3%	9,7%	11,7%	12,7%	10,3%
Italy	7,8%	7,5%	7,8%	9,2%	9,3%	8,8%	9,6%	10,5%
Netherlands	5,1%	4,1%	4,5%	4,4%	4,5%	4,7%	5,0%	5,0%
Portugal	8,0%	7,6%	8,3%	7,7%	7,2%	8,9%	10,0%	12,3%

Common Description

Dataset name: Balance Sheet Items, Frequency: Monthly, Adjustment indicator: Neither seasonally nor working day adjusted, BS reference sector breakdown: MFIs excluding ESCB, Data type: Outstanding amounts at the end of the period (stocks), Counterpart area: World not allocated (geographically), BS counterpart sector: Unspecified counterpart sector, Currency of transaction: All currencies combined, Balance sheet suffix: Euro

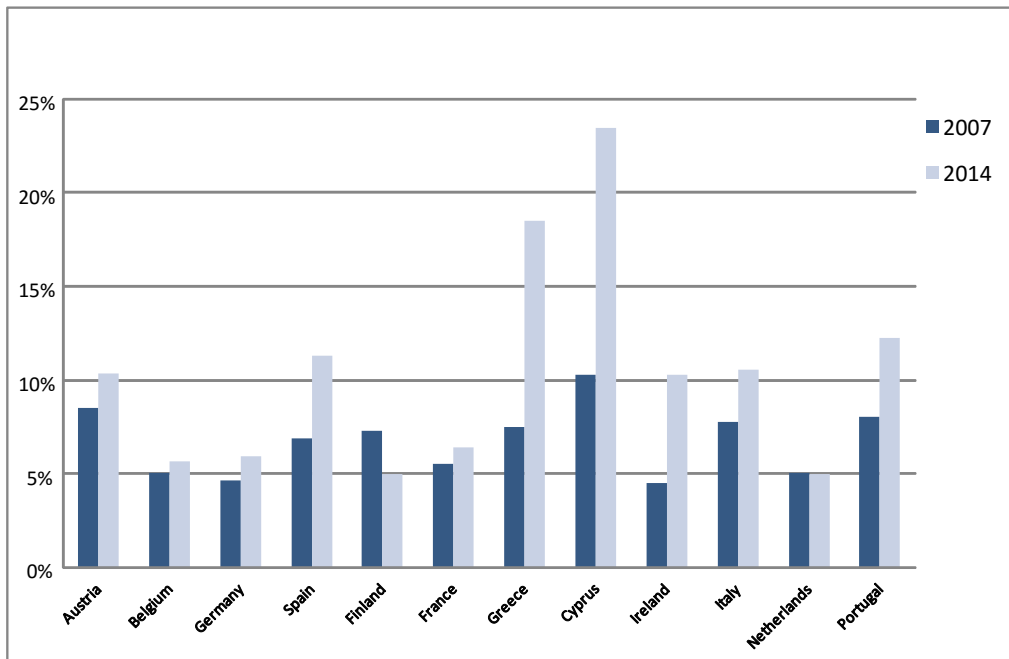
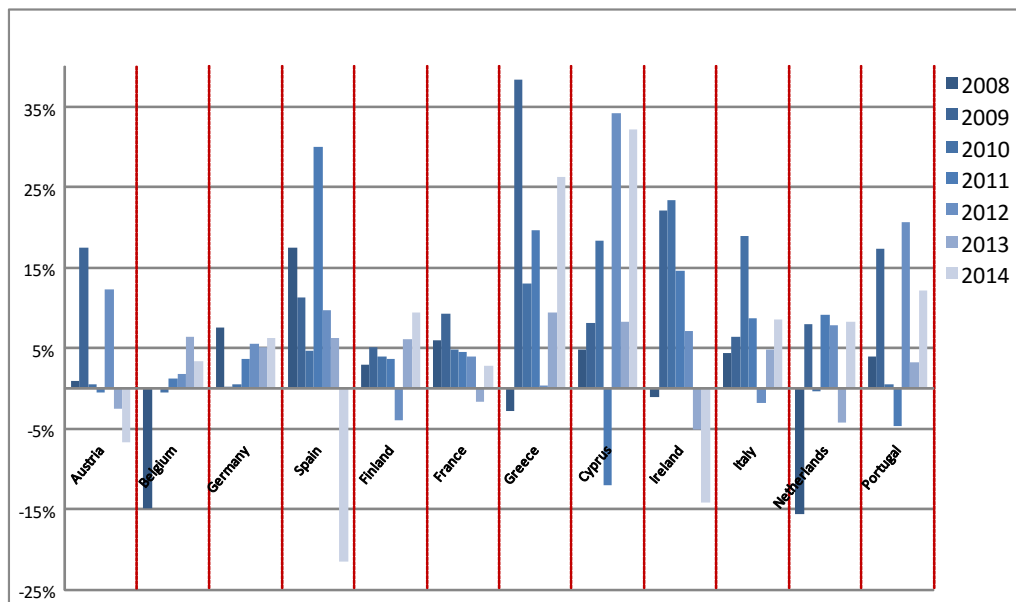


Figure 2: Capital and Reserves to Total Assets in Selected EU Countries, Banking Sectors

Countries performance on banks recapitalization could better be assessed by the annual marginal increase in capital and reserve as a percentage of the total capital and reserve since this indicator substantially eliminates any disparities in the definition of



capital amongst Member States (Figure 3). The results are revealing again that the level of adjustment was more extensive in the peripheral countries.



Source: ECB and author's calculations

Figure 3: Capital and Reserves: Marginal Increase as a Percentage of Total

In a nutshell, an adequate governments fiscal standing holds back the restructuring of the banking sector, while external funding arrangements (such as the European Stability Mechanism) operated as a powerful incentive towards recapitalization and reorganization. The present monetary arrangement amplifies governments' moral hazard as a powerful incentive to compete on their own funding and consequently generates financial fragmentation alongside national boundaries. To the extent some Eurozone Members continue to rely on the national State Aid support to the national banking sector as opposed to adjustment and restructuring, the Eurozone banking system remains fragmented with such Members attracting a significant volume of savings from peripheral countries. Thus, the governments' fiscal status play a fundamental role in pricing domestic credit risk and principally determine the funding costs (i.e. the interest rate) of both domestic banking systems and governments.

## 5 Changes in the EU State Aid Rules

Following the crisis, the EU State Aid control has loosened up since the EU Commission could not challenge governments' unsubstantiated claims that lack of public support to a specific bank would harm financial stability. In an attempt to confront the situation and contain competitive distortions, the EU Commission, since 2013, has strengthened the EU State Aid rules with the application of two core principles [10]:

- Burden sharing - ailing banks before being subject to public recapitalization should bail-in equity and subordinated debt.
- Commission assessment of comprehensive bank restructuring plans – based on two appraisals:
  - Long term viability is restored without further need for state support.
  - Competitive distortions are limited through proportionate measures (e.g. behavior measures such as constraints to acquisitions).

However, the new State Aid rules incorporated a significant redefinition of the main objective, namely financial stability. The latter is perceived not only as the need to contain systemic risk resulting from individual bank failure and maintain stability in the banking system, but also to keep funding to the economy flowing. This wider definition of financial stability (which determines State Aid acceptability) would also provide a broader ground for governments' claims in favor for State Aid compatibility. Furthermore, the time limits for State Aid exemption are set vaguely enough. Such exemption may apply as long as the crisis situation persists. In a nutshell, despite the alleged strengthening of rules, national authorities are provided with ample flexibility and discretionary power to extend State Aid to the banking sector.

The EU Commission has also identified specified national interventions falling within State Aid controls.

- *National resolution financing under State Aid control*

National resolution financing arrangements involve State Aid since it fulfills almost all State Aid assessment criteria such as the intervention is carried out by the state or through state resources, the intervention provides to the recipient an advantage on a selective basis, competition may be distorted, intervention may affect trade between Member States, ect. Thus, national resolution financing triggers the Commission intervention.

- *Deposit guarantee interventions under State Aid control*

Explicit deposit guarantee, a measure implemented to protect bank depositors, in case of a bank's inability to honor its commitments and therefore to avert bank runs and protect financial stability is particularly interesting with respect to State Aid controls [11]. All EU States have established Deposit Guarantee Schemes (DGSs) which are important elements of the financial system safety net. The Deposit Guarantee Scheme Directive (DGSD)<sup>3</sup> adopted 2014 with the aim to strengthen harmonization and financial stability by guarantying bank deposits in all Member States up to €100,000 per depositor per bank, in a case of bank winding down. However, DGS interventions may not solely involve pay out - i.e. reimbursing depositors for covered deposits within winding up banks. National DGS may also be activated to finance up to the cost of pay out (–i.e the level of covered deposits):

- resolution measures in the case of banks resolution,
- early intervention measures to restructure and restore ailing banks to health, and

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<sup>3</sup>Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJ L 173/12.06.2014 [DGSD]

- measures in the context of national insolvency proceedings implying transfer of deposit book to another institution.

According to the Commission, DGSs funds utilized for pay put or financing resolution measures up to covered deposits do not constitute State Aid. However, in the case those funds are used in the restructuring of credit institutions constitute State Aid providing the imputability to the state: that is DGSs funds are accumulated by law imposed contributions and the decision as to the funds utilization is taken by a state authority. However, as it would be pointed out further on, DGS interventions would prove to be highly controversial within the State Aid context.

## **6 The Banking Union Arrangement**

The Banking Union (BU) is considered by the EU Commission as a core aspect of the Economic and Monetary Union (EMU). Particular aspects of the BU with respect to national State Aids are considered below.

### **6.1 The Rationale**

The BU was designed to deal with the problems that currently plague the European financial sector and to guarantee the integrity of the euro [12]. The high degree of interrelationship in the euro area implies that national policies are fraught with cross-border externalities leading to the so called ‘financial trilemma’ in terms of the unfeasibility of attaining simultaneously three objectives: financial stability and financial integration and national banking supervision [13]. In this respect the BU rationale is:

- to diminish cross-border externalities emerged by government interventions in banking,
- to reduce the misjudgement of risks by the banking sector which could contribute to wide imbalances and undermine the financial stability of entire Member States,
- to limit the bank-sovereign loop consequently reducing market fragmentation and ensuring a level playing field,
- to eliminate the vicious link between banks and public finances,
- to attain smooth transmission of monetary policy and ensuring similar interest rate levels across the eurozone.

### **6.2 The Institutional Setting**

The BU is based on centralized application of EU-wide rules for banks in the euro area. Up to now two pillars of the BU are completed: The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM)<sup>4</sup>.

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<sup>4</sup>Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225/30.07.2014 [SRM Regulation]

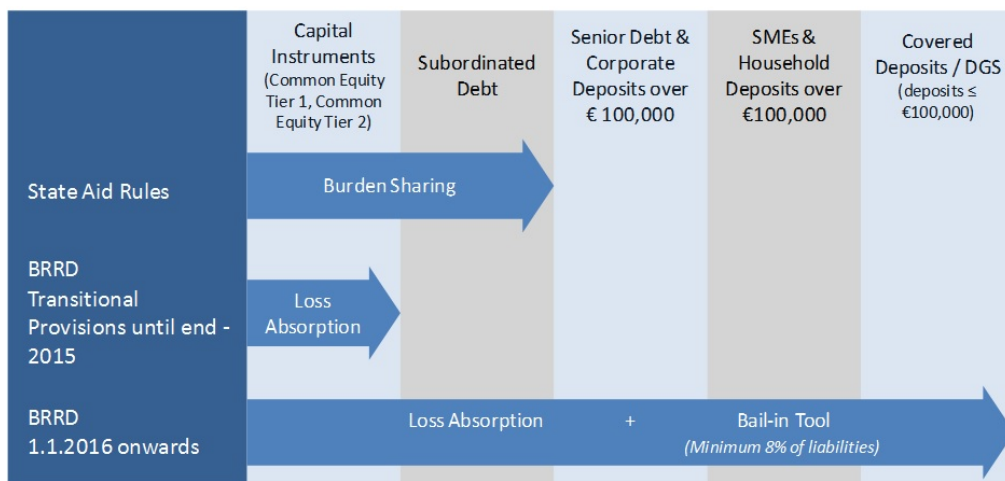
The SSM provides to the European Central Bank responsibility for supervision effectively of all banking institutions in the euro area based on a Single Rule Book. The SRM provides for a European arrangement to bank resolution through a Single Resolution Board (SRB) administering and supported by a Single Resolution Fund (SRF) which could contribute to resolution in case of necessity, under firm conditions. The Fund will be gradually developed through contributions from the banking sector to a target level of at least 1% of covered deposits (i.e. deposits up to €100 000 per depositor per bank) in the BU by 2024; an equivalent anticipated amount of €55 billion. In the transitional period, as the SRF is increasingly accumulated to its target level, Member States are required to provide an efficient bridge financing mechanism for the SRF to cover the costs of ailing banks resolutions.

The SRM apart from the SRF financed by banks contributions incorporates precise reorganization ‘bail-in’ procedures in the case of bank resolution with the aim to entail a fairer burden sharing amongst the various stakeholders and to contain banks’ moral hazard. Nevertheless, the BRRD<sup>5</sup> incorporates bail-in rules more stringent than State Aid requirements for burden sharing. State aid rules requires for bail-in merely of equity and junior debt. In the BRRD, the full application of the bail-in instrument after 1.1.2016 surpasses the State Aid requirements by demanding additionally partial bail-in of senior debt and setting minimum bail-inable liabilities of 8%. Only the transitional rules incorporated in the BRRD fall short of State Aid requirements. The interaction between State Aid rules and the BRRD is highlighted in Figure 4.

As it will be demonstrated, the misalignment of the two notions would have far reaching consequences.

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<sup>5</sup>Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173, 12.6.2014 [BRRD].



#### **Exceptions**

- State Aid: • Financial Stability  
• Disproportionate Results
- BRRD: • Exceptional exclusion of liabilities (Art. 44 (3))

Figure 4: Combination of State Aid Rules and BRRD

Furthermore, a common backstop (that is a common financing facility) supporting the SRF in case of a need exceeding its available resources, is an open issue [14]. The privately (bank) financed SRF will be efficient only if it is linked to a resource which is:

- potentially unlimited, and
- neutral.

A potentially unlimited resource implies being inexhaustible, even in cases of severe systemic crises. This is the case of the US and UK where the backstop is officially limited, but de facto unlimited, as governments can essentially request central bank money when the private financed resources prove insufficient to tackle the crisis. Without a common fiscal backstop, the European resolution fund with its narrow capability, allows substantial room for lender of last resort role to the governments and sustains uncertainty and financial fragmentation.

A neutral backstop implies indiscrimination in terms of the nationality of a bank.

At present the European Stability Mechanism (ESM) is set to assume the role of the fiscal backstop without nevertheless fulfilling neither of the two prescribed prerequisites and thus being inefficient in performing such a role. The ESM is neither potentially unlimited nor neutral as been an intergovernmental institution. In these terms the European Central Bank seems the appropriate institution to proficiently accomplish the role of the backstop.

Since an efficient common Eurozone fiscal backstop is lacking, bank resolution in the Eurozone still requires national intervention such as bailouts and last-resort involvement to support national banks in case of necessity.

The third pillar of the BU is currently missing. This is the European Deposit Insurance System (EDIS), aiming at increasing depositor confidence and economic efficiency. The issue was highlighted in the Five Presidents' report on a roadmap for completing

the EMU [15]. The Commission recently put forward a proposal for EDIS. For argumentative reasons this will be analyzed further on. In the mid-term the Deposit Guarantee Scheme Directive (DGSD) guarantees bank deposits up to €100,000 per depositor per bank and harmonizes national financing arrangements, setting a target level of 0.8% of covered deposits in ten years period. Given the level of inflicted deposits in the case of systemic crisis, the national DGS would explicitly or implicitly rely on fiscal backstops. In critical issues the Directive merely confirms an existing position in terms of DGSs remaining national schemes with the public sector operating as a back-stop to such schemes, maintaining the link between banks and governments. Furthermore the DGSD provides to national DGSs ample discretionary power to apply “early intervention” measures, instead of resolution or winding down, to banks in rapid financial descent. Such measures include the provision of financing to restructure and restore such banks utilizing the resources alternatively being used to reimburse depositors for covered deposits. As it has been stated, according to the Commission, DGSs funds utilized to reimburse depositors are not considered State Aid; yet those funds used in the restructuring of credit institutions constitute State Aid if they are imputable to the state -i.e DGSs funds are accumulated mandatory and utilized according to a state authority’s decision. This will give rise to a major controversy between the EU Commission and the Member States.

However, the distinction between the DGS interventions for payout and DGSs intervention for restructuring with respect to qualification as State Aid is bound to create arguments and disputes between the Commission and certain Member States. The declared BU objective to break the vicious link between banks and public finances and protect taxpayers renders the said distinction essentially irrelevant. Such irrelevance is further illustrated by the criterion as to the DGS intervention option (payout or restructuring) which is based on the principle of least cost to the DGS and thus on economic efficiency grounds. Furthermore a designed DGS corporate governance structure with the decision making body including solely industry members does not fulfill the imputability to the state criterion to include any DGS intervention within State Aids control.

### **6.3 National Authorities Actual and Potential Interventions**

The BU arrangement is incomplete. Governments may still intervene by providing their own financial assistance in circumstances the common financial resources fall short of the respective losses. In turn, such intervention distorts borrowing costs for domestic versus non-domestic banks. According to the BU rules promoting centralized bank supervision, the ECB is responsible for the effective and consistent Single Supervisory Mechanism (SSM) operation, guaranteeing a unified implementation of prudential supervision. Despite these rules, EMU governments seem reluctant to concede control over their banking institutions and increasingly defy the ECB’s mandate to exercise uniform supervisory practice within the SSM.

A German banking act allegedly designed to align the German banking resolution law with the Single Resolution Mechanism (SRM), delegates certain competences to the German Finance Ministry to issue rules on internal governance, risk management, outsourcing and recovery plans of credit institutions (Deutsche Bundesbank, Eurosystem ,2015). This act, completely out of line with the objectives of the BU, contains the SSM effectiveness. It significantly challenges the ECB’s mandate to

establish a unified and consistent approach of prudential supervision preserving the unity and integrity of the internal market and preventing regulatory arbitrage. In this play Germany is not alone in deterring the ECB attempts to unify a range of national banking systems with strong historical roots, (eg savings and mutual banks in Germany and Austria). The Italian authorities have recently criticized the ECB current decisions about higher capital requirements for euro-area banks as damaging for the fragile economy. Diverging national regulations and administrative practices contribute to fragmentation of the applicable prudential rules and deprive the ECB's capacity to establish uniform conditions of competition and deliver level playing field across the SSM.

Both the BRRD and the Deposit Guarantee Schemes Directive (DGSD) incorporate early "intervention rules" that would emerge as the major areas of controversy. The BRRD empowers supervisors, in case of institutions in rapid financial descent, to require implementation of recovery plans, capital increases, management body/shareholder meetings or management removal. Nevertheless, early intervention triggers differ extensively in national BRRD transposition laws creating national competencies and restraining the single supervision of significant banks by the ECB. In the case of Germany rules are set rigidly enough to disallow implementation of ECB early intervention measures unless the respective bank is already on the edge of collapse. Such regulations vitiate the measure of discretion available to ECB, violate the BRRD principle and cement the sovereigns- banks connections.

National authorities and governments acting resourcefully enough may circumvent European rules and competencies. As long as such authorities are allowed to intervene ahead of the resolution process under the SRM, even in the case of a proficient resolution mechanism, existing distortions would be sustained along with capital flights away from countries with perceived weak fiscal status, disparities on borrowing cost across member states and fragmentation of national financial markets. The DGSD allows Member States to circumvent the rigid SRM system and apply more flexible rules. According to the DGSD a Member State may allow a DGS to provide its available financial resources for implementing alternative measures designed to avoid credit institutions insolvency under certain conditions such as:

- the resolution authority has not taken any resolution action;
- the DGS has the appropriate systems and procedures to apply alternative measures and monitor affiliated risks;
- the use of alternative measures is linked to conditionality (e.g. rigorous risk monitoring) imposed on the respective institutions.

At present the Institutional Protection Schemes (IPS) operated by the German Savings Banks Association and the National Association of German Cooperative Banks, both recognised as DGSs, fulfill said conditions. The IPSs protect the affiliated institutions and ensures that each member is able to meet continuously its obligations especially with respect to deposits and bearer bonds. They mainly implement preventive measures designed at averting any financial difficulty posed to an institution's continued existence as an ongoing concern. Bank insolvencies and paying out on depositor insurance claims are unknown to the IPSs Network. Essentially IPSs use their financial resources to restructure ailing banks without being subject to state aid

controls. Other countries, like Italy and France, are set to develop similar devices portrayed as privately funded schemes.

In particular, the Italian DGS has mostly involved in banking crisis management through alternative interventions rather than depositors reimbursement. Under the DGSD, a national DGS may use its available financial resources not only to execute a payout, but also to perform “alternative measures” i.e. interventions to prevent a bank failure, before any resolution action under BRRD, or specific interventions, such as transfer of assets and liabilities and deposit book transfer under national insolvency proceedings in order to ensure continuity of business. The respective interventions are allowed on the “least cost” basis -i.e. the costs do not exceed the net amount of compensating covered depositors.

Alternative measures allowing transfer of assets and liabilities to a viable bank allows ample protection of depositors in conjunction with senior bondholders rescue, eliminating any diffusion of negative externalities with knock on effects to the entire banking system. Nevertheless, shareholders and junior bondholders’ claims remain unsatisfied by the acquiring entity reducing any potential for moral hazard.

According to the Italian authorities alternative measures should not be subject to the EU state aid rules given that firstly, the objective of such measures is not to rescue senior bondholders, but to preserve the continuity of business and secondly, the failing bank is liquidated.

However, the European Commission holds the position that a pure deposit book transfer does not involve transfer of economic activity and therefore does not constitute State Aid; yet the transfer of assets and liabilities from the failing bank to another entity comprises economic transfer and thus State Aid. Furthermore the application of alternative measures implies leads de facto to the exemption of senior debtholders liabilities from any potential “haircut” reversing the hierarchy of the insolvency procedure by the operation of the bail-in instrument under the BRRD. In this respect alternative measures entail a mechanism that equates covered depositors with senior debtholders in the case of a failing bank which runs contrary to the concept of the Banking Union. Finally, the application of the least cost principle within the EDIS framework would prove challenging since is a rather subjective exercise taking into consideration factors such as financial stability which cannot be calculated objectively and national insolvency procedures are not harmonized in the EU.

On April Italian financial institutions have settled to launch the “Atlante Fund” to support distressed banks and to alleviate apprehensions about the Italian banking system suffering from non performing loans. The Fund of 5 billion euro is designed to operate as a backstop for the Italian banking sector with a mandate to purchase shares in imminent right issues at ailing institutions and acquire non-performing loans, effectively providing guarantees for junior debt, where investor demand is low.

Although the Fund derived after extensive discussions between the government, the Bank of Italy (Central bank) and financial institutions including state lender Cassa Depositi e Prestiti, it is portrayed predominantly as a private industry scheme designed to operate as a privately majority-owned fund in order to avoid violating EU State aid rules. The objective of this private sector bail out scheme is twofold: firstly to induce private investors to inject capital to ailing regional banks and secondly to evade compliance with the painful EU State Aid rules requiring drastic measures of any bank that receives public support. Such measures impose bail-in in failing banks’ bondholders whose ranks may include retail investors and are considered politically



toxic in Italy. It is expected that the new improvised instrument will avoid a repeat of the protracted wrangling with the EU Commission that obstructed a previous bank support scheme.

The Fund is designed to operate as a privately majority-owned fund. It is intended to set up with contributions not only from credit institutions but also insurers and asset managers with a limited ability to borrow to scale up the size of its investments. In this respect various institutions have pledged to contribute to the fund, with even healthy banks willing to subscribe to the pledge commitments in an effort to avoid a bail-in of an Italian bank which may trigger a chain reaction under conditions of loss of confidence with knock on effects on the entire Italian banking system.

The new bail-out fund would face EU scrutiny with respect to the applications of the EU state aid rules which provide that even a private support fund is deemed as State Aid if the government performs as custodian over the fund and the decision on the use of resources is imputable to the State.

In a nutshell banks may be resolved outside the official SRM framework. The European institutions established appropriate BU rules to provide a tight SRM arrangement with bail-in focus; nevertheless, they did not eliminate the potential of national authorities' actions in bailing out banking resolution. The operation of such a dual system with the SRM on the one hand and the national intervention on the other would have far reaching consequences. Countries with a strong fiscal status would opt in for the latter and resolve their credit institutions less painfully, via devices of state guarantees or DGSs involvement in the form of early intervention, or IPSs, without even been subject to the EU State Aid control. Since as already stated, such controls in the case DGSs interventions are challenged by national authorities. Alternatively countries in weak fiscal position would be compelled to rely on the former. National State Aid would remain a major source of banking markets fragmentation within the Eurozone. As long as sovereigns and national DGS remain the backstops to banks, the powerful bank-sovereign loop will persist, national authorities would have a powerful incentive to preserve their supervision over national banks and borrowing costs will depend on the respective national fiscal status.

#### **6.4 National Liability over the Banking Sector and Moral Hazard**

National liability over the banking sector is conceptually linked to national State Aid but runs contrary to the unification of the banking sectors which the BU, by definition, ought to provide. Nevertheless, it has been maintained under the BU arrangement though it has emerged as a core issue of political dispute and debate.

In the case of Spanish crisis, the initial Spanish proposal envisaged for direct ESM recapitalization of Spanish banks would have ended with a mutualization of legacy burdens; yet, the finally (conclusively) adopted procedure of directing ESM funds through the government's recapitalization fund involved an explicit Spanish government liability for the debt service.

The BRRD and the SRM preserved the principle of national fiscal responsibility. The BRRD, relevant for the entire EU, merely provides the legal framework for the Internal Market in banking and does not per se endorse the BU. The SRM denies the issue of fiscal responsibility by imposing the burden of recovery and resolution exclusively on the industry with no imposition on taxpayers. The benign neglect

approach to fiscal responsibility by the EU rules essentially validates such responsibility at the national level.

Moral hazard is emerging as a core argument in favor of national responsibility over banks and against mutualization [16]. According to this argument banks' soundness depend particularly on national policies, hence national responsibility for any bailouts would assure the incorporation of these risk into the decision making. However, given the operation of SSM coupled with the externalities from maintaining contaminated and ailing financial institutions such arguments seem unpersuasive.

The consolidation of national fiscal responsibility intensifies the "core -periphery" divide, enhances moral hazards, upholds incentives for regulatory forbearance over the banks, obstructs the necessary adjustment of the financial system, preserves the fragmentation of financial and monetary systems and undermines the transmission of monetary policy.

Countries in apt fiscal position will have a powerful incentive to act preemptively of the stringent BRRD procedure and recapitalize ailing banks. The BU rules leave room for such aversion by allowing banks recapitalizations prior to the implementation of recovery and resolution procedures, provided availability of the essential funding as is the case of countries with strong fiscal positions. This impedes the essential adjustment of market structure and enhances moral hazard.

Countries in insufficient fiscal capacity may still avoid the stringent recovery and resolution procedure by exerting forbearance as in the past. To the extent this is possible, authorities in these countries act as if confronting a temporary problem hoping for an eventual recovery which would appreciate banks' assets and restore banks' solvency to appropriate levels. If this is not possible, they may again be forced to rely on ESM support with painful conditionality – in terms of measures and adjustments - which may not be feasible for some of the members.

ECB policies have to this point stabilized the system without confronting the underlying drawbacks. The decision to launch the BU was the crucial aspect behind the ECB's OMT programme, which eased the euro-zone crisis [17]. National fiscal liability, to the extent that prevents the decontamination and restructuring of the financial system, has severe repercussions on the design and the smooth transmission of the ECB monetary policy. The credit channel of monetary policy have shrunk, particularly in stressed markets experiencing highly elevated lending rates [18]. The ECB focus on monetary stability implies an explicit support to the financial system, along with those institutions that ought to be resolved but stayed afloat. The ECB is trapped by the ailing financial sector and inevitably provides financial support to doubtfully solvent banks, which in turn finance their respective governments. The perception the system protection is ECB's top priority, wanes the pressure on governments to decontaminate their banking systems. Some governments may in fact appreciate banks weaknesses as an actual advantage which provides them with an indirect access to financial resources. A great part of the funds channeled to banks though the ECB Long-Term Refinancing Operation, was subsequently lent to the respective governments [19]. From those governments' perspective, the BU in its present form provides the comfort of the ECB accountability for financial stability and consequently indirect access to financial resources.

Lender of last resort has always been a core central bank function with the provision of implicit subsidies including low short-term interest rates to ailing institutions allowing the latter to rebuild their equity by manipulating the yield curve [20] [21].

Nevertheless, such function entailing an implicit relocation of seigniorage from the central bank to the commercial institutions has side effects in terms of increased moral hazard and respective risks. The provision of long-persisting ECB assistance has oversized such side effects and contributed to the preservation of inefficient market structures and not viable banks.

### **6.5 The Playing Field and the Risk of Contagion**

A hybrid system in which the national resolution mechanisms coexists with the SRM, contributes to enhanced market fragmentation and unlevel playing field by affecting the ability and willingness of banks to expand their operations on a cross-border basis. As it has been stated, the BU arrangement leaving actual and potential government intervention largely unattached distorts competition amongst national undertakings. National policies with respect to banking entail considerable cross-border externalities with countries in strong fiscal status allowed to promote their banks via the provision of explicit or implicit guarantees. Such banks are in a better position to expand on a cross-border basis than their counterparts and constrict bank margins all across Europe. The Euro membership has enhanced the quality of intermediation leading to an increase in cross-border bank transactions and bilateral bank claims [22]. However, the euro effect in terms of money market integration and the amplified interconnectedness of the European banking systems had contributed to higher cross-border contagion risk defined within the broader concept of a systemic crisis and specifically in terms of the transmission of a shock impinging on one or a group of banks with knock on effects on banking systems in other countries irrespective of domestic fundamentals [23]. Significant second-round contagion effects may also materialize since bank failures in one country can destroy a huge size of cross-border liabilities and consequently undercut capital and ultimately banking assets in other countries [24]. Cross-border exposures and externalities generating potential for default contagion seem to have played a crucial role in the recent crisis with severe repercussion for both international and local banks albeit its origin was unconnected to the fundamentals of these banks [25] [26].

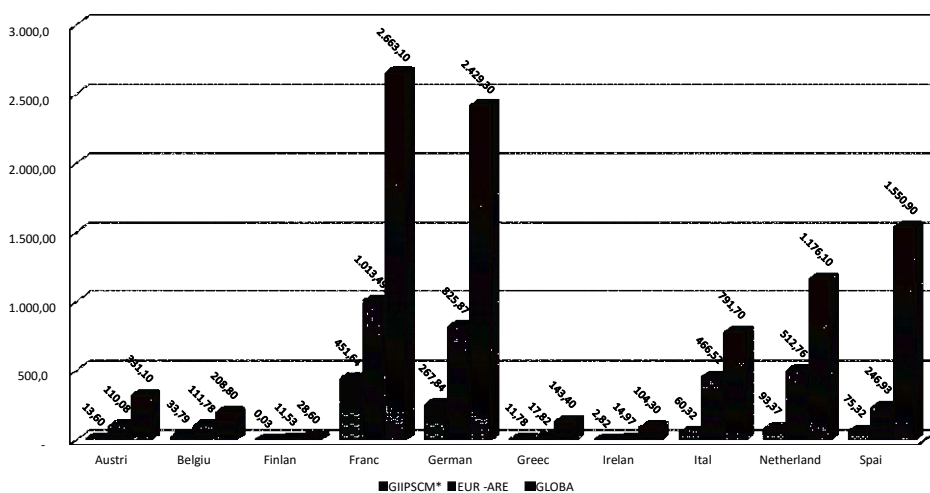
The centralized SRM decision making structure, incorporated in the BU arrangement, is a proficient device to contain loss spread across European banks and curtail insolvency contagion risk. In the BU, European authorities, rather than the national authorities, come to a decision whether to bail out a failing bank. Domestic authorities are plausibly reluctant to rescue international creditors with taxpayers' money since they are inclined towards domestic taxpayers versus foreign creditors [27]. Yet, European authorities have a stronger interest in preserving the integrity of the banking sector in the entire Euro-area and contain contagion risks. European authorities would rather experience a natural inclination towards rescuing of insolvent systemic international banks without inflicting losses on international creditors that would generate imminent transmission of financial crisis across European financial markets. A centralized organized action evades protracted negotiations between national authorities in the case of a multinational bank default. The joint regulator through a centralized decision making and intervention policy shifts the balance of interests from domestic to international stakeholders, treats international banks more favorably and is a fine tool to control systemic contagion risks. Thus the BU is in a unique position to

contain the spread of market disturbances and thus make the euro zone more resistant to shocks and contagions.

In a sense the BU arrangement provides a type of contagious risk safety-net. However, Eurozone banks' cross-border exposures are characterized by vastly uneven patterns with banks of certain Northern countries such as France Germany and the Netherlands experiencing greater international exposures than their counterparts with headquarter in the Eurozone periphery. These uneven patterns are demonstrated in Figures 5 and 6. Thus banks with headquarters in the hard core of the Eurozone mainly benefit from the contagion risk safety-net attribute of the BU arrangement and would be able to invest in existing and perspective eurozone markets whereas incurring a smaller contagion risk than under the national regulatory framework.

In other words, under the hybrid system, banks from hard core countries are not only promoted via the provision of explicit or implicit guarantees to expand their operations on a cross-border basis, but also such operations are protected against contagion risk by the SRM. It seems that the present BU arrangement does not distribute the costs and benefits of integration evenly and fairly to all of its members.

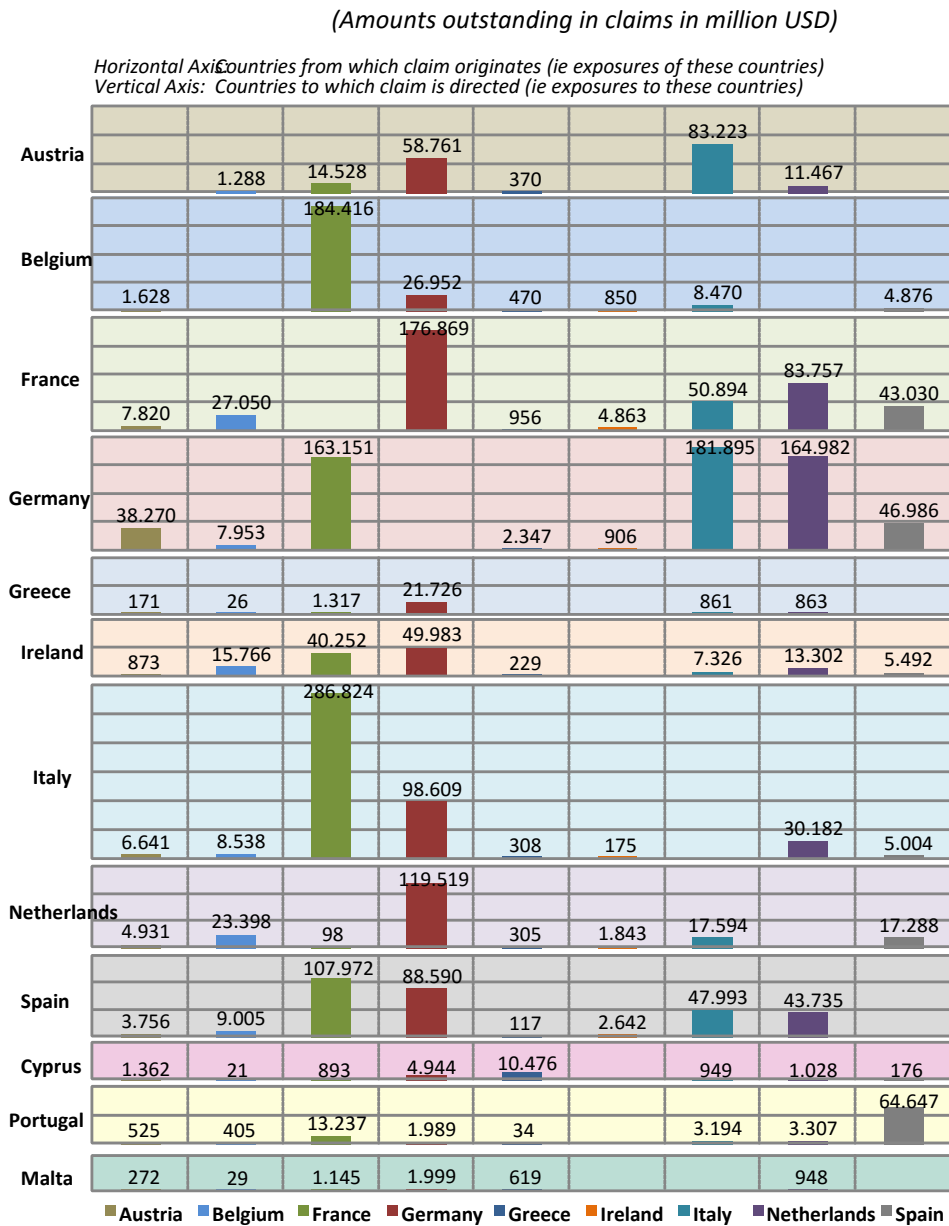
(Amounts outstanding in claims in billion USD)



\* Greece, Italy, Ireland, Portugal, Spain, Cyprus, Malta

Source: BIS Consolidated Banking Statistics

Figure 5: Consolidated positions of banks resident in selected Eurozone countries on counterparties resident in GIIPSCM, Euro-Area and Global as at end 2015



Source: BIS Consolidated Banking Statistics

Figure 6: Consolidated positions of banks resident in selected Eurozone countries on counterparties (banks) resident in other Eurozone countries as at end 2015

## **6.6 The European Deposit Insurance Scheme (EDIS) Proposal**

All these problems were exposed in the framework of the Commission's proposal for an EDIS [28]. According to the Commission the EDIS is the reasonable complement of elevating responsibility for bank supervision and resolution to the BU level since the present regime incorporates a mismatch between European control and national liability. It would contain the risk of bank runs by reducing the vulnerability of national DGSs to local shocks, underpin depositors' confidence irrespective of the location of a bank, weaken the link between the banks and their national sovereign and promote a level playing field. In practical terms the EDIS involves the gradual establishment of a joint fund at the European level providing financial resources to national DGSs solely for payout functions. A thorough consideration of the proposed EDIS is premature and falls outside the scope of this paper. Nevertheless, within the national State Aid framework, the EDIS mandate, focusing solely on the payout function, would prove highly controversial.

The EDIS proposal for exclusive intervention on payout is considered by some Members States inconsistent with the "alternative measures" option under the DGSD. According to this view a national DGS within the Eurozone may not access EDIS funds for "alternative measures" and thus it will be induced to perform a payout albeit, that is not the optimal solution. Furthermore, divergence in DGSs mandates with Eurozone DGS performing solely payout function, yet non- Eurozone DGS could still undertake "alternative measures" would cause significant distortions of competition within the single market. Consequently, the different European countries (Eurozone/ Non-Eurozone) application of deposit insurance would inflict severe consequences for the Eurozone credit institutions and banking sectors.

More specifically, the German concern largely involves the regional banks which provide the bulk of lending, operate their own DGSs and rely heavily (if not exclusively) on such measures rather than resolution or liquidation of failing banks which is subject to the BU framework. The German savings banks ('Sparkassen') in particular integrated their intra-group insurance system (IPS) in conjunction with their contributions to the German DGS, rejecting to allow any portion of their IPS to be absorbed by the EDIS system. Italy and France argue that the EDIS mandate should expand to encompass "alternative measures" as an intervention instrument.

However, the above views seem to neglect the repercussions of the existing divergence emerging from different mandates of national DGSs in terms of competitive distortions which could potentially restrain the operation of the BRRD resolution framework and undermine the level playing field within the Eurozone. The alleged inconsistency of EDIS mandate raised the issue of the BRRD inconsistency. Although the BRRD made significant progress towards harmonization of bank resolution in the EU, it does not address the "alternative measures" approach of a DGS.

"Alternative measures", implementation by National DGSs is about to have an impact on any financial flows between the DGSs and EDIS and violate the principle of cost neutrality laid down in the EDIS proposal and undermine the essential homogeneous base for the risk sharing. In an ideal system, full harmonization of "alternative measures" and additional coverage of deposits" is the appropriate solution, although a more cautious and realistic approach is to assume that only partial harmonization is possible.

Raising banks contributions dedicated to “alternative measures” implementation by national DGSs i.e. performing tasks other than deposit pay-out/participation in resolution in conjunction with the EDIS would not only violate the principle of cost neutrality but also create a new “alternative” structure for bank resolution. The national DGS would be transformed into an “alternative” national resolution fund or liquidity support instrument (depending on the type of measures).

Furthermore, a serious concern emerges with regard to EDIS cross border risk sharing capacity: can both effective and limited liability DGSs coexist? Even an EDIS as envisaged by the Commission is incapable to cover large systemic risks in terms of the total potentially inflicted deposits. Furthermore, although an EDIS is imperative for the well function of the BU, without a fiscal backstop it might prove counterproductive. It could contribute to contagious risk generated by a sizeable banking failure in one Member State which could strain its financial resources. Thus, a kind of fiscal backstop is necessary even in the interim period.

The necessity of an efficient backstop is portrayed in the case of the 1930s US Great Depression when many state level DGSs went insolvent and accordingly the Federal Deposit Insurance Corporation was established as a core element of the New Deal legislation [29]. Even in the 1990s in the US, a parallel insurer- the FSLIC (Federal Savings and Loan Insurance Corporation) went bankrupt and its replacement was merged into the FDIC. Despite the fact that there are no laws requiring the US government to assume FDIC insurance liabilities, there is a clear statements at the FDIC.gov website that the 'FDIC deposit insurance is backed by the full faith and credit of the United States government.' According to the Core Principles of Effective Deposit Insurance, an effective DGS should possess a credit facility [30]—i.e. an efficient backstop.

## **7 Conclusions Policy Recommendations**

The Eurozone faces three real or potential challenges:

- instability and lack of confidence
- financial fragmentation and
- moral hazard - inadequate restructuring of the banking sector.

Given these challenges the particular objectives of the BU should be to:

- enhance and preserve confidence to the banking sector
- restore and maintain financial integration and
- contain moral hazard. These objectives are conflicting.

The economic theory reveals that attaining conflicting objectives requires an equivalent number of appropriate instruments each assigned to the specific objective. Such instruments could be:

- An outright prohibition of National State Aid to the financial system to restore financial integration, restrain banks and governments moral hazard and initiate proper economic incentives.

- A credible resolution mechanism and an efficient EDIS based on privately (bank) supplied funds linked to a common potentially unlimited European fiscal backstop in order to restore confidence in the financial system and avert bank runs.
- A thorough supervision and extensive policy conditionality carried out by European institutions.

These actions will eliminate the distortions generated by individual states to engage in economically irrational interventions such as competition on borrowing costs amongst each other with potentially precarious capital flows from the peripheral countries to the hard core.

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