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A critical assessment of the European approach to financial reforms

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1. Introduction

In the past, the serious problems facing Europe have often been addressed through reform of the institutional architecture, sometimes leading, as in the case of the Economic and Monetary Union, to a deepening of certain features of the unification process. The recent crisis could have led to a breakdown in the European construction, especially in its later phase characterised by potential sovereign debt defaults. On the contrary, however, the response to the Lehman debacle was an extra boost to the convergence process sanctioned by the Lisbon Treaty. The lesson drawn from the crisis was to re-draft the European institutional architecture, and not only in the financial sphere. Common goals were re-focused and the institutional set-up redesigned, not secondarily aiming at more limited national discretion and increased enforcement of common rules. The reforms in the financial sector are thus to be analysed as part of the reshaping of the entire design.

For a full understanding of the European responses to the crisis, the paper starts by outlining the salient characteristics of the European financial system (section 2). The three legs of the EU architecture are then discussed, arguing that EU financial regulation and supervision requires a particularly robust construction to prevent the financial sector from generating such heavy negative externalities as to disrupt the delicate equilibria on which the European monetary and fiscal constructions rest (section 3). Although the reforms of the institutional architecture are going in the right direction, doubts can be raised as to whether, following the international approach to financial re-

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regulation, the European financial systems will gain the extra resilience required by the peculiar European construction (section 4). Central to this re-regulation process is the new calibration of bank capital requirements embodied in Basel 3. Taking the perspective of sustainable financing needs of growing economies, we argue that if we accept a purely prudential approach to bank regulation, then Basel 3 constitutes a positive step with respect to the previous regime. However, attempts to meet the limitations of the prudential approach by radically hardening capital requirements, as some suggest, could jeopardise economic growth. Furthermore, with heterogeneous, non-globalised national banking systems and their different contributions to the financing of economic growth a one-size-fits-all rule is both nonsense and in practice unattainable. Contrary to the current official EU approach, structural measures affecting the morphology of the financial system are required to tailor finance to the economy and prevent endogenously created financial crises from endangering the entire EU construction (section 5). Although the recent proposal of the Vickers Commission on ring-fencing UK retail banking goes in this direction, we argue that a more radical ring-fencing is required if the inevitable public intervention in future crises is to retain general social relevance and acceptability (section 6). The conclusive section sums up the previous arguments.

2. Pre-crisis financial features and fragilities

The determinants of European financial fragilities are best analysed by focusing on banking systems, due both to their dominance in financial intermediation (table 1) and the prevalent universal banking business model.

However, the landscape is not uniform across European countries (table 2), with Ireland and the UK showing the highest combination of level and growth of bankarisation.

Table 1 - Bank assets and loans as a percentage of GDP

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

Note: loans exclude financial intermediaries and general government as counterparties. Stocks are annual averages.
Sources: Web data statistics of Eurostat, ECB, Federal Reserve, IMF.

Table 2 - *Bank assets as a percentage of GDP*

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

Source: ECB Statistical Data Warehouse. Total assets are annual averages.

The increased weight of the European banks – especially the larger ones – is significantly accounted for by their market activities. They have

loomed substantially larger in the areas of investment banking (securities underwriting and loan syndication), securities trading and market making, especially after the introduction of the euro, which boosted the growth and integration of the European capital markets (European Commission, 2007). "European banks are also the major managers of collective investment schemes, with a market share of over 80% in many countries." (Mörttinen *et al.*, 2005, p. 11). Moreover, from 2000 to 2007 the volume of securitisation originated by banks increased tenfold, due mainly to mortgages (European Commission, 2009a).

The high and indeed rising level of bankarisation is heightening the banks' systemic relevance for the whole European area.

As shown by the recent crisis, a common and relevant fragility factor is the reliance of European banks on non-deposit liabilities (short- and long-term bonds, covered bonds, money market and interbank market) (table 3). According to a study by the ECB (2009), European banks have,

Table 3 – *Banks' market funding as % of total funding*

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

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

particularly as from 2003, experienced a sharp increase in maturity and currency mismatches, thus taking on increasing funding, counterparty and exchange risks.

A further common feature of European banks is their high leverage (table 4), mainly due to their combining commercial and investment banking activities. Countries showing higher levels and more vigorous growth of bankarisation also experienced an increase in leverage (again, Ireland and the UK).

Table 4 – *Banks' leverage*

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

Note: the leverage is computed as total assets/common equity. Source: for Europe BankScope, unconsolidated balance sheets; for USA Federal Reserve, Web data statistics, all commercial banks.

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

Table 5 – *Cross-country correlations*

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

Source: authors' calculations on data specified in tables 2, 3, and 4.

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

Although the EU banking systems show common distinctive features with respect to other areas, the previous tables show considerable cross-country dispersions. In particular, large differences in leverage also reflect business models more oriented to commercial (Italy and Spain) or universal banking (France, Germany and the UK). With reference to the recent crisis, other idiosyncratic factors played their part in bringing on systemic bank crises in some of the EU countries: exposure to impaired assets, originating in the United States (the UK, Germany), exposure to collapse of local real estate markets (the UK, Ireland, Spain, Denmark), exposure to emerging economies in Central and Eastern Europe (Sweden, Finland, Austria, Greece, Belgium, the Netherlands) and banks' net cross-border borrowing (Ireland, Portugal, Spain, Greece, Italy) (European Commission, 2010a). A summary of specific vulnerabilities is shown in table 6.

Table 6 – Vulnerabilities of EU banking systems

	Housing bubbles (1)	Large exposure to US toxic assets (1)	Large exposure to weak European emerging countries (1)	Banks' net cross-border borrowing (2)	Bank assets/GDP (3)	Leverage (4)	Hit by systemic financial crises (5)
Austria			√				√
Belgium			√		√	√	√
Denmark	√				√		√
Finland			√				
France					√	√	
Germany		√				√	√
Greece			√	√			
Ireland	√			√	√	√	√
Italy				√			
Netherlands			√		√		√
Portugal				√			
Spain	√			√			√
Sweden			√			√	
UK	√	√			√	√	√

Sources: (1) European Commission (2010a); (2) BIS, Annual Report 2009/10, Graph VI.9, p. 84; (3) see above, table 2; (4) see above, table 4; (5) Laeven and Valencia (2010): Spain has been added to update the authors' list.

The evidence of table 6 does not account for the secondary effects of the financial crisis on real growth and sovereign debt, and their feedback on financial fragility. A point to bear in mind is that the full force of the crisis was mitigated in some countries by counter-cyclical fiscal stimuli (European Commission, 2009b). Countries with a high public debt, such as Italy, substantially counted only on automatic stabilizers. Furthermore, many national financial systems were saved from more serious disruption by specific state aid. Finally, starting from the second half of 2008, the ECB eased monetary policy by sharply reducing its reference interest rates, injecting large amounts of liquidity mainly by extending the collateral eligibility for open market operations to lower grade assets, and lengthening the terms of refinancing. In addition, the national central banks launched emergency liquidity assistance operations using quite different collateral and haircut requirements. As a result of this price and quantitative easing, the funding costs of banks saw a general sharp decrease in 2009 (ECB, Statistical Data Warehouse), representing a crucial lifeboat for several of them and with varying effects across Member States.

Due to the combined effect of counter-cyclical policies, the bail-outs of financial intermediaries and the reduction of public revenues due to the "great recession," the overall public deficit of the EU countries rose, according to Eurostat data, from 1.5% in 2006 to 6.4% in 2010 (from 1.4% to 6.0% in the Euro Area). The debt to GDP ratio was driven from 61.5% in 2006 to 80.0% in 2010 (from 68.4% to 85.1% in the Euro Area), expected to rise to 84% in 2011 (European Commission, 2010a). In the late 2009 market attention was shifting from the financial sector to the leveraging of the public sector, sharply increasing the spreads on sovereign debt among the Euro countries. In some cases, like Greece, the sovereign debt crisis erupted independently of the crisis, although it was aggravated by it; in other cases, like Ireland, it was crisis-specific. Countries showing similar problems, low growth and weak competitiveness for Portugal and Italy, or bank bail-outs and feeble competitiveness for Spain, began to come under markets' closer scrutiny. Since most of the EU banks have their prevalent activity in their home country, and their market rating also depends on the room left to national

public support, the downgrading of sovereign debt comes to be increasingly reflected in higher funding costs (Moody's, 2011). The danger of a negative spiral, with cross-border losses increasing the contagion and leading to a more general deterioration of public finances, has alerted the EU authorities.

Regulatory distortions and lax national supervisory practices lie behind many of the vulnerabilities exposed in table 6. Having allowed a general undervaluation of risks and their concentration, together with the financing of housing and market bubbles and the oversizing of individual banks and indeed of the whole sector, the official authorities bear a major responsibility if not for the origin of the crisis, quite certainly for its severity. We should remind that the so-called single European financial market was built upon the principle of minimum harmonisation, home country control and mutual recognition (European passport). The European Directives left ample room for national discretion in the implementation of prudential regulation and national supervision was managed with significantly different degrees of intrusiveness.[1]

Taking a longer-term perspective and considering the string of crises that have hit all countries all over the world since the 1970s, the picture offered by table 6 would have shown for each of those crises different degrees and kinds of vulnerability marring the European national financial systems. The error would be to re-draft rules and supervisory practices singling out some specific features of the recent crisis as if they were excesses of an otherwise sound system. The simple observation that the seriousness and frequency of financial crises have increased as rules and supervisory practices moved towards standards dictated by the markets, should lead to a radical revision of the overall framework. Adoption of the prudential approach to regulation has in the past decades meant shifting from authorities dictating or influencing the financial morphology to leaving it to be freely determined by the market, where cogent rules gave way to principles and the balance between rules and discretion shifted towards the latter, i.e. towards supervision (Tonveronachi, 2010b). In the few cases where supervisory practices

[1] For a discussion of European supervisory failures see Enria and Teixeira (2011).

were more severe in applying the few rules and the many principles, the generation of endogenous financial fragility and the impact of external instabilities proved milder. Negative performance by the supervisors on such a large scale cannot be put down to mere inattentiveness, as if they had nodded off. Rather, they were behaving market-friendly, as the general principles clearly stated. If, as recent experience in the USA and Europe shows, the regulatory approach is not going to be significantly changed, regulation will continue to be based on few rules and many principles, with supervisors enjoying significant discretion. In this perspective the problem is how to re-write the principles in such a way as to increase financial resilience and ensure that the supervisors stay alert. However, this is not the only solution. Public authorities could regain some control over the financial morphology through clear structural rules, thus necessarily limiting the scope of general principles and supervisory discretion.

In Europe as elsewhere, the current financial reforms and proposals are apparently moving towards stricter rules and more powerful supervision. The question arises as to whether the new rules leave more powerful supervisors with more or less discretion. The recent US reform as embodied in the Dodd-Frank Act presents an interesting mix of structural interventions and discretionary powers. For example, large financial intermediaries may be dismantled if they pose systemic threats. The point is that the definitions of systemic intermediary and systemic threat are left to the discretion of the supervisors. The balance appears to shift further in favour of discretion, giving the supervisors ample powers and increasing regulatory uncertainty (Tonveronachi, 2010b).

Given its general and idiosyncratic features, the problem is how Europe should conform to the new international rules, if it should permit the adoption of structural measures and how the resulting discretion should be shared between the national and EU authorities.

3. The three legs of the European architecture

The recent crisis has severely stressed the European construction. The propagation of fire within the single market proved just how

unprepared the overall European institutional framework was to manage systemic crisis situations. In this the EU was not alone;[2] peculiar to its construction are, however, the potential disruptive effects on the single financial market of *ad hoc* national policy responses.

Bank bail-outs were largely national, with some extemporary cross-border solutions, calling for ex-post interventions by the European Commission (EC) to contain the threats posed by national state aid to the single financial market. The same applies to fiscal counter-crisis policies whose national bias often had to be allowed as a temporary exception. When private de-leveraging produced some unsustainable public leveraging in the Euro area, two funds (the European Financial Stabilisation Mechanism and the European Financial Stability Facility) were hastily created in order to limit the spread of panic to a wider set of EMU countries. Even the ECB, considered the only real European authority and lauded for its prompt interventions, showed the limits of a construction where the national central banks were allowed to grant emergency liquidity assistance to their financial sector following widely diverse rules on guarantees and haircuts. The latitude given to national supervisors is considered, also at the EU level, as one of the main causes leading some countries to develop fragile financial systems (European Commission, 2009c; de Larosière, 2009; Fitzgerard, 2009).

For a better understanding of the ways in which the EU institutions have reacted to the weaknesses shown by the current crisis we must consider what the basic features of the European architecture are. The single market for goods, services, labour and capital, yet to be fully realised, is the foundation on which the entire edifice is built. The euro is a necessary complement of the single market, since the latter does not allow for beggar-thy-neighbour policies.[3] Politically, Europe is, and for many decades yet will be, a Union and not a Federation. This means that European-wide structural policies are managed at the EU-level, while

[2] In relation to cross-border crises the IMF recently asserted that the "internationalisation of banking was not adequately matched by regulatory, supervisory, and banking reforms" (IMF, 2011a, p. XVI).

[3] The opt-outs of UK and Denmark should, then, end soon. A post-crisis signal in this direction is represented by the wider adhesion to the recent Euro Plus Pact.

fiscal, countercyclical and local structural policies are matters for each Member State. The EU is, then, a bottom-up construction, with Member States necessarily tied by the enforcement of common rules (harmonisation), which in the economic sphere translate into the three legs of the European institutional construction: the regulatory and supervisory authorities (among which the financial ones), the monetary authority (ECB) and the (now enlarged) Stability and Growth Pact.

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

The entire EU construction rests, then, on keeping economic, fiscal, monetary and financial imbalances within socially and politically acceptable limits and preparing smooth resolution procedures at the first sight of a crisis. This means that each leg should be strong enough not to export systemic shocks to the other legs. Each leg represents the result of compromises among national "egoisms." Crucially, the most politically sensitive equilibrium, the fiscal one, should be the most shielded from shocks coming from the other two legs. This puts extra pressure on the

required resilience of the monetary and financial legs, which should act more as shock absorbers than as shock exporters. As the recent crisis has shown, the efficacy of enforcement, from which their credibility derives, rests on shocks not seriously disturbing these fragile equilibriums. It has also made clear how the increased interconnections between Member States have entailed further individual weaknesses throughout the whole area. Light touch supervision in some countries has directly or indirectly generated cross-border negative externalities, while economic negative and positive imbalances have contributed to weakening the edifice.

In the following pages we will focus on what should be required for the financial leg not to seriously affect the equilibria of the other two. Although the crisis has alerted all countries and regions to the dangers deriving from turmoil endogenously created by the financial sphere, the peculiar EU construction requires particularly strong systemic safety buffers to prevent the financial sector from generating such heavy negative externalities as to disrupt the delicate equilibria on which the European monetary and fiscal constructions rest.

4. The EU institutional and regulatory responses

In the financial sphere two major lessons have driven the EU authorities' responses to the crisis: the insufficiency of a supervisory framework fragmented along national lines and the inefficacy of regulation.

Concerning the first point, recent EU legislation asserts:

> "The Union cannot remain in a situation where there is no mechanism to ensure that national supervisors arrive at the best possible supervisory decisions for cross-border financial institutions; where there is insufficient cooperation and information exchange between national supervisors; where joint action by national authorities requires complicated arrangements to take account of the patchwork of regulatory and supervisory requirements; where national solutions are most often the only feasible option in responding to problems at the level of the Union, and where different interpretations of the same legal text exist." (Regulation 1093/2010, p. 13)

> "The present arrangements of the Union place too little emphasis on macro-prudential oversight and on inter-linkages between developments in the broader macroeconomic environment and the financial system. Responsibility for macro-prudential analysis remains fragmented, and is conducted by various authorities at different levels with no mechanism to ensure that macro-prudential risks are adequately identified and that warnings and recommendations are issued clearly, followed up and translated into action. A proper functioning of Union and global financial systems and the mitigation of threats thereto require enhanced consistency between macro- and micro-prudential supervision." (Regulation 1092/2010, p. 2).

Regarding past regulation, the EU shares the analysis of the G20 and the Financial Stability Board singling out the poor quality and insufficient level of bank capital, the low requirements for the trading book, the pro-cyclicality of capital requirements and fair value accounting, the disregard of liquidity risks, the limitations of risk measurement and transparency for complex financial instruments, the freedom left to unregulated non-bank actors, the systemic risk posed by large financial institutions, the pervasive presence of distorted short-term incentives and conflict of interest, and the lack of processes for orderly resolution of crises (European Commission, 2010b).

In January 2011 the new architecture of the European System of Financial Supervision was completed. As shown in figure 1, it should work as a network of the four new EU authorities and national actors, leading to a smooth interplay between macro- and micro-prudential supervision. At the pinnacle we find the European Systemic Risk Board whose task is to monitor and assess systemic risks, i.e. risks with EU-wide relevance deriving from any systemic component of the Union financial system. The ESRB may address warnings and recommendations to EU and national political bodies and supervisory authorities, with no legally binding powers. The addressees of recommendations must "comply or explain" their inaction.

As shown in table 7, representatives of the ECB and national central banks of the EU enjoy a dominant presence in the general board,[4]

[4] For the first five years the chairman of the ESRB will be the president of the ECB.

exceeding the qualified majority necessary to make the ESRB's recommendations public.

Figure 1 – *The European system of financial supervision*

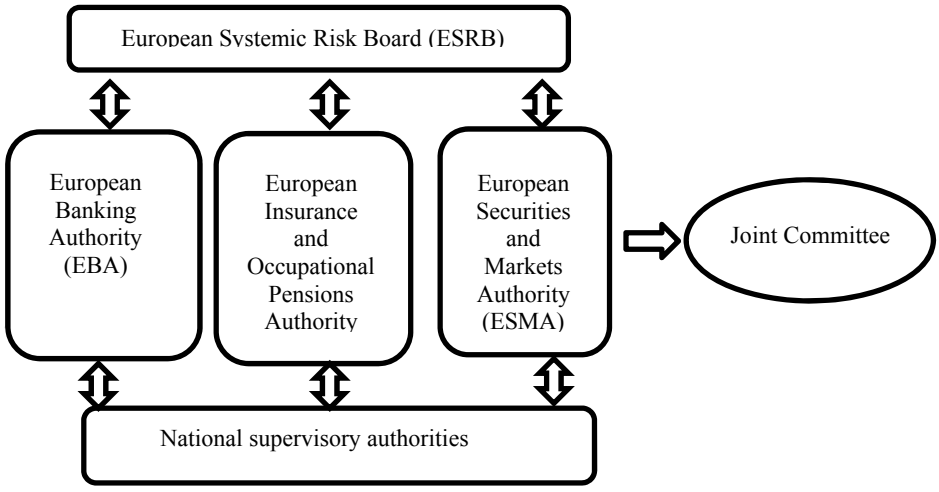

Table 7 – *The governance of the ESRB*

Structure	*ECB*	*NCBs*	*ESAs*	*EC*	*SC*	*TC*	*EFC*	*NSAs*	*Experts*	*Total*
General board	2	27	3	1	3	1	(1)	(27)		37 (28)
Steering committee	3	4	3	1	1	1	1			14
Technical committee	1	27	3	2	1		1	27		62
Scientific committee						1			15	16

Note: NCBs: national central banks; EC: European Commission; SC: Scientific committee; TC: Technical committee; EFC: Economic and financial committee; NSAs: national supervisory authorities; figures in brackets denote presence without voting rights.

An important aspect of cooperation within the network is access to and exchange of information and evaluations, particularly crucial for the functioning of the ESRB.

The three supervisory authorities (ESAs) are in charge of micro-prudential supervision and cooperate through a Joint Committee on matters related to financial conglomerates and other cross-sectoral issues.[5] The voting components of each ESA are the heads of the national public authority competent for the specific supervision of each Member State. From the point of view adopted in the present paper, the most relevant task attributed to the three ESAs is to deepen the single EU financial market by producing a single rulebook of binding technical standards and ensuring its consistent application through common supervisory practices. When finally endorsed by the European Commission, their decisions are legally binding. They also have direct enforcement powers to settle disagreements between national supervisors and between single institutions and their supervisors. When an emergency situation is declared by the Council, an ESA may adopt decisions directly applicable to individual authorities and institutions, calling for necessary actions or requiring them to desist from certain practices.

Alongside construction of this new institutional architecture, the EU has begun revising and updating its regulatory framework, an as yet largely unfinished job. Just as the EU shares with the G20 and FSB the analysis of regulatory failures, it also shares the international approach to re-regulation. In short, there is no radical departure from the previous prudential approach; its weaknesses are seen as remediable with larger doses of the same medicine (capital), the introduction of further prudential requirements (liquidity), allowing for some flexibility starting from higher total requirements (buffer stocks), better aligning some incentives (remunerations and dividends) and weakening conflicts of interest (credit rating agencies), establishing mandatory colleges of supervisors for cross-border banks, modifying the regulatory level-playing-field in order to make large institutions pay for their contribution to systemic risk, subjecting previously unregulated institutions to new or more stringent transparency requirements, driving over the counter

[5] ESMA is also empowered with supervision of credit rating agencies.

(OTC) products into regulated central counterparties, and strengthening market infrastructures.

As in the USA with the Dodd-Frank Act, EU re-regulation is, however, mainly oriented to shield taxpayers from the costs of future crises rather than preventing them. It is clearly stated that micro-efficiency must remain a prime goal of regulation and that this objective is best served by a prudential approach to regulation. Many official documents recognise that it is impossible, in these conditions, to prevent future crises, although efforts must be directed towards decreasing their likelihood and severity; as a consequence much of the re-regulatory attention must focus on crisis resolution (Council of the European Union, 2009). Due to its peculiar construction, this problem is particularly serious in the EU due to the existence of large pan-European financial groups.

The choice between alternative EU institutional architectures has been driven by what so far appears to be the approach that will be taken for the resolution of crises. For instance, the centralisation of supervision at the EU level, at least for cross-border institutions, should have required, in the absence of a federal budget, clear and stringent ex ante of burden sharing agreements (Goodhart and Schoenmaker, 2006). On top of the practical difficulties of such agreements there is the issue of the discretionary powers that inevitably bear on supervisors when deciding when and how to intervene (e.g. the choice between failure and recapitalisation) for banks pertaining to different jurisdictions. It is surely significant that the two main tools for crisis resolution, the pre-funded deposit guarantee schemes and resolution funds, are being proposed as national and not EU institutions (European Commission, 2010c).

The new EU institutional architecture responds to a certain extent to the failure of the previous one that saw divergences in national rules and practices leading to excessively "light touch" styles of supervision. If we are to believe in the efficacy of the analyses, warnings and recommendations of the ESRB, a new EU-wide systemic perspective can be said to have been added.

Here, however, we must stress three points whose relevance is not confined to Europe alone. First, the efficacy of any type of institutional superstructure crucially depends on the tasks and powers it has been

assigned. Second, it is highly questionable to focus regulation on crisis management, which implies that micro-efficiency will continue to prevail over financial stability. More comprehensive reckoning of the social costs of crises, for instance in terms of lost growth and unemployment, is seldom fully taken into account when advocating the prudential model. The illusion driving current regulatory reforms safeguarding tax-payers often hides the interests of politicians anxious to avoid painful budget measures, often seen by their constituencies as bail-out of financial lobbies. Third, the discredit suffered by a framework based on the efficient market hypothesis, i.e. on the ability to measure risks correctly, has not lead regulators to a radical revision of their approach. A substantial part of this revision should be prompted by the understanding that if finance is primarily to serve sustainable growth, financial morphology cannot be left to the market (Tonveronachi, 2010a).

5. Implications of switching to Basel 3

The tightening of previous rules by Basel 3 has come in for criticism on two accounts. On the one hand, the proposed strengthening of capital requirements is considered insufficient should a systemic crisis hit. Roughly, the argument is that a higher capitalisation does not substantially increase the cost of capital while increasing its resilience (Admati *et al.*, 2010; King, 2010). On the other hand, the significant costs accruing with the new measures are considered hardly justified by the resulting benefits unless they are associated with structural measures capable of limiting the ex ante probability and severity of endogenously created financial crises.

The first criticism accepts the prudential approach argument that a correct level of capitalisation reduces the probability and severity of the crises; it differs on the optimal level. The logic is always to compare the output losses due to higher capitalisation with the output benefits deriving from a supposedly more robust banking system. Leaving banks free to take on risks, a substantial increase in capital requirements then appears more than reasonable. However, even supposing that higher capital requirements

have a neutral effect on funding costs, they affect the potential growth of bank assets for any given level of operating profitability.

Let us perform a very simple exercise on long-term sustainable bank asset growth. Assuming that banks grow with internal funds, we may write the following equation:[6]

$$Max\ AG = (1 - POR) * ROA * L = (1 - POR) * ROA * \frac{1}{\frac{K}{RWA} * RW}$$

where *Max AG* is the maximum nominal annual rate of growth of assets given supervisory asset risk weighting and capital requirements, *POR* is the pay-out ratio, *ROA* the return on assets (net income/total assets), *L* the maximum leverage expressed as total assets (*TA*) over common equity (*K*), *RW* the risk-weight ratio and *RWA* risk-weighted assets. The exercise assumes that banks always comply with minimum capital requirements; if a capital buffer exists at the outset it is maintained as a percentage of total capital.

Table 8 compares two typical banks under the Basel 2 and Basel 3 regimes. For Basel 2 we present the case of a bank oriented to market instruments and innovative products (RW = 30%, K/RWA = 2%) and of a conservative commercial bank (RW = 70%, K/RWA = 4%). Since the major changes in Basel 2 with respect to Basel 1.5 did not concern the trading book, we can take the first as also exemplifying the previous regime.

Basel 3 introduces changes in the previous calibration on two fronts: higher capital requirement in terms of common equity and higher risk weights. The minimum common equity is now 7%. In a recent meeting, the oversight body of the Basel Committee on Banking Supervision proposed that global systemically important banks (G-SIBs) should be required to hold a common equity buffer over the minimum "ranging from 1% to 2.5%, depending on a bank's systemic importance. [...] The assessment methodology for G-SIBs is based on an indicator-based approach and comprises five broad categories: size, interconnectedness,

[6] For the derivation of a similar equation see Morelli (2011).

lack of substitutability, global (cross-jurisdictional) activity and complexity." Furthermore, "[t]o provide a disincentive for banks facing the highest charge to increase materially their global systemic importance in the future, an additional 1% surcharge would be applied in such circumstances." (Basel Committee, 2011).[7] Less clear-cut are the effects on the average RW of adopting the new risk weights for trading and securitisation, since they depend on the mix of bank activities, risk-evaluations made by internal models and non-homogeneous accounting rules. We may suppose that the increase will be negligible for traditional commercial banks and more significant for banks oriented to market instruments and innovative products (universal banks).

In table 8 we show the results of the exercise made under the two alternative regulatory regimes, distinguishing between the two types of banks and assuming a common 50% pay-out ratio. Under Basel 2, commercial and universal banks were characterised by large differences in RW and K/RWA. For both types of banks asset growth was largely unconstrained with respect to the annual increase in nominal GDP. Even a typical German bank with ROA at 0.22% would have had no problem in financing the German average nominal GDP growth of the period 1992-2007, of 3.3%. What is striking is the difference in the growth potential of the two types of banks. Where the two represented large and small-medium sizes, a clear trend towards concentration was potentially promoted.

Under Basel 3 the advantage of universal banks for risk weights is maintained, although weakened by the 50% increase of RW we have postulated.[8] The inverse is true for capital requirements, assuming that extra capital buffers will be applied to systemic banks. In table 8 we apply a 1% buffer to large universal banks and the full 2.5% to G-SIBs. We also compute for all banks the constraining capability of the cap on maximum leverage tentatively suggested by Basel 3. The last column

[7] Taken literally, the proposal does not apply to banks that are systemically important only at national or regional levels, which then should not be required to hold additional buffers. In our view, this is a highly questionable position.

[8] Judging from the data recently released by EBA (2011) we are assuming more than the double of what could be the effective increase of the average RW for this type of banks. According to EBA's data, in general these banks do not go back to the higher RWs prior the introduction of Basel 2.

Table 8 – *Annual potential asset growth for typical banks*

Regulatory regime	Basel 2		Basel 3				Low Leverage
Banks	Universal	Commercial	Universal	G-SIBs	Commercial	All	All
RW, %	30	70	45	45	70	Suggested cap on leverage	
K/RWA,%	2	4	8	9.5	7		
Leverage max as TA/Tier1	83.3	35.7	23.4	20.2	16.8	33	10
ROA, %	Max AG, %		Max AG, %				Max AG, %*
0.2	16.7	3.6	2.8	2.3	2.0	4.0	1.2
0.3	25.0	5.4	4.2	3.5	3.1	6.0	1.8
0.4	33.3	7.1	5.6	4.7	4.1	8.0	2.4
0.5	41.6	8.9	6.9	5.8	5.1	10.0	3.0
0.6	50.0	10.7	8.3	7.0	6.1	12.0	3.6
0.7	58.3	12.5	9.7	8.2	7.1	14.0	4.2
0.8	66.7	14.3	11.1	9.4	8.2	16.0	4.8
0.9	75.0	16.1	12.5	10.5	9.2	18.0	5.4
1.0	83.3	17.9	13.9	11.7	10.2	20.0	6.0
1.1	91.7	19.6	15.3	12.9	11.2	22.0	6.6
1.2	100.0	21.4	16.7	14.0	12.2	24.0	7.2

* Applying the Basel 3 proportion of T1/CT1, the leverage in terms of CT1 is 12.

simulates the effects of proposals calling for a much higher capitalisation (e.g. Admati *et al.*, 2010); we have set the maximum leverage at what generally was its pre-deregulation value.

Basel 3 clearly dampens both absolute values and the difference between the two types of banks. The potential for a continuous increase in bank size and sector concentration crucially depends on how much supervisors will stress large banks' internal models and make capital buffers effective. The Basel 3 tentative cap on leverage is ineffective, if not to avoid extreme outliers on RW.[9] The Low Leverage regime applied to all banks is much stricter, and makes bank growth crucially dependent on ROA.

For a better understanding of the effect of the regulatory switch on the ability to finance the growth of the economy we next consider national banking systems. Table 9 shows the average values of ROA for some EU countries for the period 2003-2007, and the banks' relevance for the financing of the economy. For both ROA and the Loans/GDP ratio we observe a considerable dispersion among the EU countries.

Table 9 – *Average ROAs and Loans/GDP ratio in some EU countries, 2003-2007*

Countries	ROA, %	Loans/GDP
Austria	0.56	0.91
Belgium	0.46	0.68
Denmark	0.90	1.51
Finland	1.04	0.66
France	0.51	0.74
Germany	0.19	0.98
Greece	0.73	0.64
Ireland	0.64	1.25
Italy	0.67	0.71
Netherlands	0.52	1.21
Portugal	0.64	1.22
Spain	0.79	1.22
Sweden	0.99	1.17
UK	0.65	0.97

Note: for the UK only large banks are considered.
Source: OECD Statistics and ECB Statistical Warehouse.

[9] According to the data contained in EBA (2011), Deutsche Bank maintains in the stressed 2012 baseline scenario an RW of 23%, equivalent to a maximum leverage of 46 assuming a 9.5% capital requirement.

Table 10 presents some simulations on national banking systems, retaining a pay-out ratio of 50%. Although maintaining the previous stylisation, we assume less pronounced risk weight differences than those of the previous example since each system averages on different types of banks.[10]

Bank asset growth in the previous Basel regimes outpaces long-term growth of nominal GDP for any realistic value of ROA. Even banking systems with dismal ROA levels, like the German one, were given the potential for more than accommodating the country's nominal GDP growth.[11] The Finnish and Swedish Max AG, given their average ROA at around 1% in the years 2003-2007, could have largely outpaced their average nominal GDP growth, respectively by 5.5% and 4.9% in the same period. Clearly, Basel 1.5 and 2 did not pose any constraint on the banks' asset growth, and the rules left ample scope for massive growth in bankarisation. This is consistent with our previous observation that vigorous growth in bankarisation was obtained thanks to high leverage and increasing recourse to the wholesale market for funding. The resulting fragilities were not the product of eluding a regulation focused on capital requirements.

As shown in the simulation reported in Table 8, Basel 3 greatly reduces both the values of potential asset growth and the differences between alternative systems. The potential resilience attributed to lower leverages makes the level of ROA even more crucial; it may allow for increasing bankarisation, as e.g. for Finland and Sweden, or become critical for financing the growth of nominal GDP. If our stylised German system does not increase its 0.21% ROA, a 3% Max AG resulting from

[10] The RW estimates for Basel 2 are drawn from the presentation by Giovanni Sabatini, Director General of the Italian Banking Association (ABI), to the conference on "European financial systems: in and out of the crisis", organised by the University of Siena and the Ford Foundation, Siena, 1-2 April, 2011. We assume that those parameters refer to country-averages.

[11] According to OECD data, the German ROA averaged 0.21% in the period 1992-2006, with a maximum of 0.36% in 1998 and 2005. A minimum of 4.4% for Max AG (assuming POR = 50%, RW = 0.6 and K/RWA = 4%) compares with a 3.3% average annual growth of nominal GDP. According to the same data, the low level of the ROA of German banks partly depends on being the income tax rate well above the European average.

Table 10 – *Annual potential asset growth for typical banking systems*

Regulatory regimes	Basel 2		Basel 3			Low Leverage
RW, %	37	63	50	65	Suggested cap on leverage	
K/RWA,%	2	4	7	7		
Leverage max as TA/Tier1	67.6	39.7	23.5	18.1	33	10
ROA, %	Max AG, %		Max AG, %			Max AG, %*
0.2	13.5	4.0	2.9	2.2	4.0	1.2
0.3	20.3	6.0	4.3	3.3	6.0	1.8
0.4	27.0	7.9	5.7	4.4	8.0	2.4
0.5	33.8	9.9	7.1	5.5	10.0	3.0
0.6	40.5	11.9	8.6	6.6	12.0	3.6
0.7	47.3	13.9	10.0	7.7	14.0	4.2
0.8	54.1	15.9	11.4	8.8	16.0	4.8
0.9	60.8	17.9	12.9	9.9	18.0	5.4
1.0	67.6	19.8	14.3	11.0	20.0	6.0
1.1	74.3	21.8	15.7	12.1	22.0	6.6
1.2	81.1	23.8	17.1	13.2	24.0	7.2

* Applying the Basel 3 proportion of T1/CT1, the leverage in terms of CT1 is 12.

the more favourable calibration will be insufficient to finance the growth of the country's nominal GDP. The effects of significantly higher common equity requirements would make the above results even more radical. However, as we have argued discussing table 8, our estimates for RW may be in some cases too high. Data from the recent stress tests from EBA (2011) attribute to the 13 main German banks an RW of 27% for the stressed 2012 baseline scenario, which, together with the 32% of the Netherlands, constitutes an outlier result. Being RWs the product of internal models and largely non transparent to outside observers, supervisors might be tempted to maintain a light touch also in the future. That is where the cap on maximum leverage may become effective.

The above results make it necessary to consider the negative effects on ROA deriving from the new regulations. It is often argued that regulatory compliance will increase fixed costs, particularly for small and medium sized banks (e.g. see Fisher, 2011). Furthermore, the EU proposals to fund ex ante national deposit guarantee schemes and to impose a levy on banks to finance national resolution funds will make significant dent in the banks' net income. Similar results will arise from the new Basel 3 liquidity requirements if they are set at significant levels. Part of the banking industry's opposition to Basel 3 comes from the argument that the new calibration will drive banks to run higher risks in order to regain profitability.

From our point of view the crucial argument relates to the overall effect on stability and to the long-term ability of banks to finance the economy. We cannot dismiss the risk that the new regulatory environment might not effectively constrain asset growth while producing a deadly mixture of flight to returns, with higher risks and/or lower competition, and the rationing of traditional loans while driving non-financial debtors even more towards volatile forms of credit.[12] Leaving banks free to choose their business model and with no constraints on their market activities, high capital requirements could lead to riskier assets, greater concentration and the expansion of systemically relevant institutions.

In such stricter conditions the regulatory level playing field applied to countries characterised by different idiosyncratic conditions becomes even more manifestly unsound. Table 9 makes it quite evident that when we consider national banking systems it becomes difficult to think in terms of a globalised market. Common general rules applying to heterogeneous conditions for bank profitability and their contribution to the financing of the economy leave room for quite different results. If micro and macro-prudential supervisors were to cooperate to maintain bankarisation within acceptable limits, discretionary subtractions or

[12] According to Demirgüç-Kunt and Huinzinga (2009) more profitable and fast growing institutions are associated with riskier strategies, predominantly relying on non-interest income (mainly trading activity) and non-deposit funding,

additions to capital buffers set at the national level to offset excessively slow or rapid growth of bank assets – probably far higher than the 2.5% recommended by the Basel Committee – should make the level playing field a mantra devoid of any significance. The picture becomes even bumpier when different types and sizes of banks rank differently in terms of profitability across countries.

The above arguments highlight the real relevance of the question as to whether the safeguard of both real GDP growth and financial resilience requires supplementing prudential measures with structural ones.

6. The case for completing reforms with structural measures

The recent US financial reform, the Dodd-Frank Act, allows for structural rules and interventions by supervisory authorities. The Volcker rules, on constraining banks in proprietary trading and their connections with hedge and private property funds, in principle introduce a soft form of specialisation, with the aim of shielding depositors and taxpayers from what are thought to be the riskiest activities of universal banking. In addition, as pointed out above, supervisors are given a mix of prudential and structural powers since they may decide to break-up large institutions, not just banks, when thought to pose serious systemic threats to financial stability. Apart from the doubts that can be expressed on the efficacy of the Volcker rules and the effective use of such supervisory powers, this contrasts with the absence of any such provisions in the EU proposal and official discussions.

When presenting its proposal for the new institutional architecture, the European Commission focused on the different options capable of reconciling the divergent interests of the home and host countries in supervising pan-European banks, with no mention of any intervention on the universal banking model (European Commission, 2009d). In addition, the Commission is interested in safeguarding the European passport, thus leaving banks free in their options for branches or subsidiaries. Furthermore, the new European System of Financial Supervision has no scope for intervention in the break-up of systemic institutions. The EU

approach rests on strengthening prudential requirements and setting up pre-funded national deposit guaranty schemes and resolution funds.

At the official level, an approach to a certain extent open to structural interventions has come from the Independent Commission on Banking set up by the British Government, known as the Vickers Commission (Vickers Commission, 2011). Given the mandate to propose reforms to improve stability and competition, the Commission explicitly considers forms of separation between retail banking and wholesale and investment banking, finally propending for a ring-fencing model. In its *Interim Report*, the Commission states that:

> "Banks must have greater loss-absorbing capacity and/or simpler and safer structures. One policy approach would be structural radicalism – for example to require retail banking and wholesale and investment banking to be in wholly separate firms. Another would be to be *laisser-faire* about structure and to seek to achieve stability by very high capital requirements across the board. The Commission, however, believes that the most effective approach is likely to be a complementary combination of more moderate measures towards loss-absorbency and structure." (*ibid*., p. 6)

The Commission discards the *laisser-faire* approach coupled with strengthened requirements since it would be difficult for crisis resolution to separate retail from the rest of the activities, bearing in mind that one of the priorities is to shield deposit guarantee schemes and tax-payers from the costs of the crises. Another potential drawback with this model stems from the difficulties for small-medium sized banks to meet higher regulatory requirements, with the probable result of increasing the degree of concentration in the banking sector. On the other hand, full separation of retail and investment activities would eliminate the benefits of universal banking, while adding few benefits with respect to a ring-fencing model.

The *Interim Report* does not offer a clear-cut proposal on ring fencing. Ring-fenced activities may range from a limited set of retail operations to a larger model of commercial banking, the extreme cases being a ring-fenced narrow bank and a non-ring-fenced traditional investment bank. The Report offers only some general principles, which

should be converted into more precise proposals after a second round of consultations. According to the *Report*, "[f]or illustrative purposes only, the retail ring-fence might require rules such as:

> • "if a subsidiary seeks a licence from the regulator to conduct retail deposit-taking, that subsidiary can only conduct activities which are permitted to take place in a retail ring-fence. The subsidiary must meet all regulatory requirements on a standalone basis;
>
> • under no circumstances can the parent company transfer capital out of the retail entity if it would result in a drop below the minimum regulatory capital ratio prescribed;
>
> • the retail subsidiary cannot own equity in other parts of the group;
>
> • intragroup exposures by, or guarantees from, the retail subsidiary will be treated as third party exposures for regulatory purposes. Cross-defaults between the retail subsidiary and the rest of the group may also need to be limited;
>
> • the retail subsidiary must have access to operational services which will continue in the event of insolvency of the rest of the group; and/or
>
> • the retail subsidiary and the rest of the group must enter into separate master netting agreements" (*ibid*., p. 192).
>
> It is also added that "[a] ring-fence could involve other and/or more stringent rules, for example imposing further constraints on the level of wholesale funding allowed in the retail bank, or requiring regulatory approval for transfers of capital out of the retail bank." (*Ibidem*).

Ring-fencing may then include further limits. For instance, the proposal by Pringle and Sandeman (2010) cited in the *Interim Report* does not allow for any capital transfer from the retail subsidiary to the parent company. It also deems that funding and guarantees from the parent institution should be prohibited and the retail arm should have exclusive access to insured deposits, while limits should be set to the proportion of its wholesale funding.

The point is that we need to be clear about what is to be – and can be – protected. Ring-fencing retail operations may at most protect deposit guarantee schemes, assuming that retail operations cannot repeat past systemic failures. Allowing non-ring-fenced banks and investment funds to finance the economy, a significant proportion of the economy would remain subject to crises coming from non-retail institutions. In addition, if stronger regulatory measures on ring-fenced retail arms produce an

incentive to shift crucial business activities elsewhere, the unintended consequences of its adoption could be to increase systemic fragility. In any case ring-fencing does not eliminate the moral hazard involved in the state intervention to bail-out institutions whose failures could severely damage the entire economy. Ring-fencing solutions appear to have a higher dose of the same shortcomings that brought the Glass-Steagall Act to an end before its formal cancellation by the 1999 Financial Services Modernisation Act (Kregel, 2010).

Considering the above proposals as applying to the entire EU, the yet unresolved problem of managing cross-border crises would find a solution restricting operations to stand-alone subsidiaries, satisfying all regulatory requirements on a local basis. As we have seen, this is clearly not the direction that the European Commission decided to pursue. On the contrary, they have promoted analyses on the merits of cancelling the existing forms of ring-fencing allowed to the subsidiaries (Hoche DBB Law, 2010). This would go in the direction preferred by the large banks asking for maximum flexibility, capital and liquidity savings and a leading supervisory authority (e.g. Unicredit, 2009). In other words, the Commission takes position in favour on what the Vickers Commission calls the *laisser-faire* approach, although without much strengthening capital requirements.

In our opinion all the reforms adopted or proposed, ring-fencing included, suffer from two main objections. First, they increase the regulatory costs for banks while subjecting the non-banking sector to minor requirements, mainly in terms of transparency and consumer protection. For a universal banking model this means encouraging the shift towards market-related activities, and hence also towards less stable sources of income, thus dis-intermediating the activity of commercial banking. Second, at the roots of the increased financial fragility of the last decades lies an increased use of debt to fund assets suffering bouts of high volatility and illiquidity. The tendency recalled in the first point necessarily increases the overall financial fragility. As a result, the dominant European intermediation model needs radical structural regulatory reform.

What in reality one should ring-fence are all forms of debt funding by financial institutions that should not be utilised to fund volatile assets and speculation. Hence all financial institutions with debt funding of any sort should be forbidden to invest in market activities. The only regulatory distinction should be between levered and non-levered institutions. Regulatory costs and fiscal levies should be used, often contrary to the existing situation, to create a comparative advantage for savings to go into levered institutions and short-term corporate borrowers to work with the levered financial sector. With a levered financial sector circumscribed within the financing of the economy, and the latter mainly linked for its daily operations to the former, it would not be a scandal if it were to count on public support in times of stress. When a crisis hits, it is of general interest that the payment system and the financing of working capital should be shielded.[13]

While the above proposal applies to all financial systems, the EU should have a specific interest in its adoption. We argued above that the EU construction is characterised by a fragile equilibrium between its three legs and, in particular, that the fiscal one should be particularly protected from shocks coming from the financial sector. The fiscal "nationalism" of the EU construction further requires adopting subsidiaries as the sole cross-border model, as also suggested by a recent IMF paper (IMF, 2011b).

Conclusions

The construction of the European single financial market was in the past the main driving force behind the creation of an EU institutional architecture for financial regulation and supervision. The main focus was on putting financial institutions and consumers of financial products on a level playing field across the European area.

The recent crisis has suggested to the EU authorities that the previous liberalisation should be remoulded so as to incorporate higher

[13] For a more detailed presentation of this proposal see Tonveronachi and Montanaro (2010).

supervisory harmonisation, stronger enforcement of common rules and practices, and enhanced stability provisions. With respect to other areas, the European financial systems present idiosyncratic features (such as the prominence of banks and their universal model) and fragilities (such as bank dependence on market funding). The varying impact of the crisis among EU countries may be traced back to general country-specific imbalances and failures of local supervisory practices. Looking ahead, the problem is whether a one-size-fits-all rulebook is consistent with national "positive" idiosyncrasies.

In order to evaluate the financial reforms already adopted and the proposals under discussion we have to look at the realities of the constraints and consistency of the entire political and institutional architecture of the Union. We have argued that of the three legs of the EU, the fiscal one is the most crucial and fragile. This means, *inter alia*, that it must be forcefully protected from serious shocks coming from the financial sector at national and cross-border levels.

The new institutional architecture of the European System of Financial Supervision (ESFS) enhances harmonisation and supervisory practices as far as the realities of the Union political construction permit. Delegating all powers to central regulatory and supervisory authorities would not be consistent with the existing national fiscal responsibilities. However, the efficacy of any institutional superstructure depends on the tasks and powers it has been assigned. The ESFS remains anchored to a purely prudential model of regulation and supervision. Prudential rulebooks are being re-written with the stricter requirements agreed upon at the international level; shared with other jurisdictions, such as the US system, is the main focus directed towards crisis resolution, although in this respect most of the work is still at the stage of preliminary proposals due to difficulties in finding solutions for cross-border crises.

Given the strength of the universal banking model, no Volcker rules are even being discussed in Europe. The European Commission remains committed to the freedom that the private sector must retain with regard financial morphology and innovation. The lack of discretionary structural powers for the EU supervisory authorities – even such vague powers as are contained in the Dodd-Frank Act with regard to systemically relevant

financial institutions – is easily accounted for by the national political and fiscal implications they might produce.

Thus the new EU institutional and regulatory architecture does not represent a significant departure from the past, leaving much financial fragility unresolved and with it the danger it poses for the fiscal leg.

The only quasi-official voice calling for structural intervention, although with an eye to the UK system, comes from the Vickers Commission. Its ring-fencing proposal for retail banking is based on the perceived limits of the current overhaul of the micro prudential regulation and of the new macro prudential supervision to shield deposits and tax-payers from future crises. We have argued that, although the Vickers proposal seems to be going in the right direction, its unintended consequences could include a more fragile overall financial system. In our opinion a forceful ring-fence should instead concern the debt of financial institutions and the short-term financing of the real economy, with regulation ceasing to go after the morphology endogenously created by the private sector and simply distinguishing between a levered and non-levered financial sector.

Finally, from the Vickers Commission as from other recent contributions, the EU should accept the minimum message that the European passport must be limited to bank subsidiaries – a very neat way to approach EU cross-border resolution problems.

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