



Filling the Gaps in Governance:

the Case of Europe

Franklin Allen | Elena Carletti | Joanna Gray | G. Mitu Gulati



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Published by
European University Institute (EUI)
Via dei Roccettini 9, I-50014
San Domenico di Fiesole (FI)
Italy

First Published 2016

ISBN:978-92-9084-416-7
doi:10.2870/71098
QM-01-16-531-EN-N

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Editorial matter and selection © editors 2016
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Cover artwork: Christopher Trollen

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ACKNOWLEDGEMENTS

As in the previous years, we would like to thank all the people and institutions that have helped to make the conference and the book possible. Our special thanks go to Daniela Bernardo, Francesca Elia, Giorgio Giamberini, Pierre Schlosser, Christopher Trollen, Annika Zorn, the Robert Schuman Centre for Advanced Studies (RSCAS) and the European University Institute.

The event on which the book is based was organized jointly with the Brevan Howard Centre at Imperial College, which we would like to thank for financial support, and the Baffi Carefin Centre for Applied research on International Markets, Banking, Finance at Bocconi University.

PREFACE

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Gaps in Governance

The Florence School of Banking and Finance (European University Institute) and the Brevan Howard Centre (Imperial College London) – in cooperation with BAFFI CAREFIN (Bocconi University) – organized a conference on 28 April 2016 held at the EUI in Florence with the theme of “Gaps in Governance”. This theme was inspired by the following questions. Can Greece be ejected from the Economic and Monetary Union if it restructures its debt obligations to the other Euro area states and that is deemed a violation of the No-Bailout clause? Can Northern Ireland, Wales and Scotland stay in the EU if they vote overwhelmingly against the Brexit option, but the rest of the UK votes the other way? Can Italian banks circumvent the commitment of their state to its European partners to future Bail-ins of bank creditors by providing “voluntary” assistance to a fellow bank in trouble?

All of these are basic questions about the treaty obligations of states in the European Union that are not clearly answered by the texts of any of the relevant treaties. In other words, there are major gaps in the European governance structure. Now, of course, it is not surprising that there are gaps in the treaties. Treaties are effectively long-term contracts among states and long-term collaborative contracts are famously plagued with gaps. The reasons for gaps are myriad – some topics are just too difficult to discuss at the beginning of a beautiful relationship and other stuff is too difficult to anticipate and plan for. The question that arises then though, is how to fill in the gaps *ex post*. In the contractual and statutory literatures dealing with domestic legal systems, there is a rich

literature on the optimal strategies for gap filling (although, even there, there aren't clear answers). There is a lot less, however, on how one fills incomplete treaties. And while there are nice analogies between international treaties and domestic contracts, the two are also very different animals and answers from one context do not necessarily translate perfectly to the other.

Our goal with our April 2016 conference was to begin a discussion of "Gaps in Governance" in the European governance apparatus. To keep the discussions and papers grounded in reality, we gave each panel specific topics. The first panel started with a discussion of the specific gap in governance that was produced in 2010-2011 as a result of the tension between the ECB's informal "no restructuring" mantra and the Euro area treaty requirement that there be "No Bailouts". And here, we had sovereign debt guru Lee Buchheit, the German Economic Council's Isabel Schnabel, political economics commentator Martin Sandbu of the Financial Times, and economic historian Kim Oosterlink. Unsurprisingly, given the rising debt levels of many European countries in the period since the 2010-11, the discussion focused on whether much progress had been made in governance circles about how to tackle this particular gap when the next crisis hits. The answer seemed to be a resounding no.

Following up on the first panel, a keynote address by Mario Nava from the European Commission provided an extended and empirically documented overview of the strategic areas where loopholes, be they governance gaps or economic performance gaps, are plaguing the current and possibly the future functioning of the European Banking Union.

The second panel then moved on to the matter of withdrawals, exits and expulsions from participating in different levels of European governance represented by the Euro Area and the European Union itself. The implications of the forthcoming referendum on the UK's membership of the European Union was the topic addressed by Angus Armstrong of the UK's National Institute of Economic and Social Research. He canvassed likely scenarios and presented legal and economic implications of BREXIT contrasting them with BREMAIN (should the UK vote to continue its membership of the EU). He was followed by the ECB's Phoebus Athanassiou discussing the appropriateness of withdrawal and expulsion from the monetary union as a matter of the legal black letter (his answer was no). Roland Vaubel, taking a social contract perspective, then addressed the question of what the rights of secession were of regions within states in the European Union – and in particular, the question

of whether regions like Scotland and Catalonia were entitled to remain within the EU if they decided to secede from their national governments who themselves are current member states (Uk and Spain, respectively). And finally Ramon Marimon of the European University invoked the spirit and words of Niccolò Machiavelli, writing in the 16th century to offer insights from history on how best to mediate the ever present tension between polities and their governing institutions be they Princes of the past or the leaders of the European Union and Euro Area now.

The third panel discussed the newest layer of European governance, namely the Banking Union, which seems to be plagued by gaps in governance even before it has really even got off the ground. Piers Haben from the European Banking Authority, Rosa Lastra from the Centre for Commercial Law Studies, Queen Mary University of London, Til Schuermann from Oliver Wyman and Karl Whelan from the University College Dublin all explored different aspects of the incompleteness of, and inconsistencies within, the Banking Union framework as well as pointing out its positive contribution to the improvement of oversight of Europe's banks. The missing pillars of the Banking Union – and crucially the absence of a fiscal backstop – were flagged as a potentially disruptive source to the stability of the new banking governance. More concretely, panelists came to grips with the shortcomings of stress testing, conflicts within the ECB's mandate and its current tendency to concentrate powers and how best to resolve these. Lastly, the nascent problem of Non-Performing Loans (NPLs) on the balance sheets of Europe's banks and how there is a need for far greater supervisory co-ordination in approach to measuring and dealing with these was brought forward in the policy discussion.

Patrick Honohan, former Governor of the Central Bank of Ireland, delivered a very thought provoking dinner speech which argued that the most important gap in governance that lay behind the European banking and sovereign debt crises was that which surrounded uncertainty about the ability and will of the ECB to act decisively. He argued too that further governance gaps continue and are important in light of the current discussion about (1) possible deployment by the ECB of "helicopter money", (2) continuing question marks about the implementation and operation of the new framework for bank resolution and, finally, (3) the need to revisit sovereign risk weights and concentration limits that are applied to banks in what are very different political and financial stability environments to those that pertained at the time they were first devised.

The conference follows a 2015 conference entitled "The New Finan-

cial Architecture in the Eurozone”, a 2014 conference entitled “Bearing the Losses from Bank and Sovereign Default in the Eurozone”, a 2013 conference “Political, Fiscal and Banking Union in the Eurozone”, a 2012 conference, “Governance for the Eurozone: Integration or Disintegration” and that of 2011, “Life in the Eurozone With or Without Sovereign Default.” As with all five of those previous conferences, the debate after each panel and guest speakers was lively and thoughtful. We prefer not to take a stance here on any of the issues but simply provide all the papers presented and let the reader draw his or her own conclusions.

However, what we can say for sure from our first conference on Gaps in Governance in the European treaty context is that there are many and we do not have a clear and coherent sense of how to go about filling them or indeed whether it is politically possible to fill them. The primary solution appears to have been to muddle through which seems to be a perennial European response. That said, we are optimistic that research gatherings of this sort will help us begin thinking about the next big question, which is how to come up with a coherent and easily applicable framework for engaging in gap filling.

EXECUTIVE SUMMARY

Pierre Schlosser

The incompleteness of Europe's different levels of economic governance was the theme of this Florence School of Banking and Finance conference, held under Chatham House rules. The conference consisted of three panel sessions, one keynote lecture and one dinner speech. Opening the event, organizers highlighted that the agenda for this sixth annual conference showed some continuity with the previous ones. Indeed, the crisis response ushered in a step change in terms of new instruments and rules discussed previously and whose evolution and operation was revisited at this event. However, it also entailed innovative elements that reflected changing political dynamics (e.g. popular disenchantment with aspects of European governance and the perspective of possible exits from Europe's different levels of governance).

Session 1

The first session centred around the debate on the necessity and desirability of a debt restructuring regime in EMU. This issue was considered as particularly acute given the debt overhang affecting several European countries and the potentially contagious fragilities that this could bring to bear on Europe's economies. Can a 'no debt restructuring regime' be credible? Historically speaking, as a panellist recalled, a debt restructuring occurs every year and a half. Although these processes occur much less frequently on the European continent, participants stressed that debt restructuring has been a recurrent debate since the first years of the euro crisis. Also, although it is sometimes forgotten, debt restructuring has also been implemented in successive waves during the crisis in Greece and elsewhere, leading some participants to claim that such a

solution should not be viewed with such hostility since it is in fact not without precedent.

Panellists' views converged on the inconsistency (if not overt contradiction) that the coexistence of the no bail out rule and the absence of a debt restructuring regime embodies in the design of EMU. A distinction was offered between the legal no-bail out rule and the political implementation of this rule in the form of a non-restructuring rule. This tension, it was stressed, was reinforced because of the lack of possibilities to inflate away from debt or to revert to monetary financing in the existing European framework. Progress was noted however on how the reflection about debt restructuring has evolved over the last years. With a view to exploring new alternatives to debt restructuring one panellist suggested greater reliance on equity instruments in future for sovereign financing needs. Financial engineering could provide products where sovereign equities' dividends would be linked to GDP for example.

Against the background of recent discussions on the risks of over high concentration of debt holding and on the removal of sovereign privileges, another way to limit the pressure of rising debt levels, some participants argued, was to increase the foreign ownership of domestic debts as this could be used as a form of international risk sharing. Others emphasized that foreign ownership is however a two-edged sword as during the crisis it became a handicap. Lastly, the discussion focussed on how to enforce fiscal discipline in EMU and participants asked whether a purely rules-based system could ever really work or if more European integration was the solution.

Session 2

The second session reviewed the implications of incomplete, horizontal agreements among EU and EMU member states. How to renegotiate existing agreements against the background of rising disintegration pressures, in particular the risk of the UK voting to leave the European Union (widely referred to as 'Brexit'), was the guiding question which structured the session. Panellists insisted that multiple legal constraints are ensuring that an exit, either from the EU or indeed by any participating state from EMU, is an arduous process. In particular the existence of a Treaty clause providing for the irrevocable and irreversible legal obligation for Member States of the EU (bar Denmark and the UK) of joining the euro serves the purpose of avoiding the risk that the EU (and especially so EMU)

becomes a revolving door, where entry and exit occur on a frequent basis and commitments become more flexible.

Panellists then entered into the core of the current debate on the prospect of a Brexit occurring further to the June 2016 UK referendum. The vast extent of the regulatory and supervisory implications should a Brexit materialize, was recognised. Moreover, the existence of a fundamental tension within the European space was restated. Two political objectives seem indeed to be in conflict: a loose integration centred around Treaty freedoms of the single market vs. a more tight and deep integration driven by the needs of the single currency, encapsulated in the now famous ethos of the project of 'ever closer union'. Participants identified that the area of banking and financial regulation, because it is located at the intersection of those two integration models, is under the spotlight as a source of real future tension. The risks of possible caucus voting by members of the European and Monetary and Banking Unions in setting policy direction for future single market legislation and the effects on the City of London's financial markets was also raised as an issue left open in the UK's future relationship with Europe should it vote to remain in the EU (the 'BREMAIN' solution). This fragmentation risk is particularly serious for the UK given its oversized financial sector, whose cumulated balance sheet reaches 680 % of GDP. Sub-national secession dynamics (such as in Catalonia) were also marginally addressed, as the precedent of a Brexit could lead to chain effects within established nation states.

Lastly, the issue of governance complexity was brought up to stress that in order to trust the EMU framework, people should first understand it. It was however felt that the interplay of the different levels where European economic governance takes place is becoming increasingly complex and that as a result of this, the distance between European institutions and the people is growing, not narrowing.

Session 3

The third session dealt with the incompleteness of the Banking Union (BU). The latter was considered to be a major agreement, leading to a step change in governance. However, it was also stressed that the Banking Union is full of gaps and remains an unfinished building project. As a panellist indicated, it both suffers from incomplete and missing pillars. The Banking Union has half-finished elements because its scope only covers credit institutions, because the credibility of its resolution arsenal

is contestable and because it still lacks an operational Common Deposit Insurance Scheme. The BU however is also characterised by gaps in its functions such as a clear lender of last resort and a fiscal backstop, which panellists insisted would be needed to make the BU more resilient. Inconsistencies due to the varying level of ambition and centralization between those essential elements of a genuine Banking Union were pointed out by participants.

What has, however, been recognised as a major break-through is that the oversight of Europe's banking system has improved. Sound stress tests have been conducted, although their existence should not lead, as a panellist warned, to a new wave of risk management complacency on the side of banks. Stress testing, it was suggested, is a useful instrument because it both helps to meet micro- and macro-prudential objectives. It is therefore not a coincidence that the US, for example, has become extremely reliant on such forms of supervision. In spite of its lower reliance on bank financing compared to Europe, it was indeed observed during the financial crisis that the US financial system was prone to a re-intermediation in periods when liquidity risks were on the rise. This spoke in favour of making US banks sounder through stress-testing. However, a shortcoming in the application of stress testing in Europe is the absence of a strong bank recapitalization regime. In other words, the absence of funds to recapitalize ailing banks creates incentives to limit the capital shortfall identified by the stress testing exercise, thus undermining its credibility.

A parallel development highlighted during the discussion was the concentration of powers by the ECB. The risk was to see the manifestation of the ECB's inherent conflict of interest between its price stability mandate and its new bank supervision tasks. Without denying this fundamental tension, participants disagreed however whether it was more desirable to solve this dilemma internally – by merging the two functions within one institution as is currently the case – or externally, by attributing the two objectives to two different institutions as in the so-called 'twin peaks model'. Lastly, a particularly severe challenge of bank supervision identified by participants is the high rate of Non-Performing Loans (NPLs) in several euro area Member States as this can act as a significant drag on banking profitability and therefore on the European economic recovery, panellists concluded.

BANK REGULATORY REFORM SUPPORTING GROWTH: THE WAY OUT OF THE SAFETY TRAP - Keynote Speech

Massimo Marchesi and Mario Nava¹

In this article, we first discuss the regulatory response to the financial crisis, in particular the CRD4/CRR package implementing Basel III in the EU, and its impact on improving banks financial strength. We then look at banks business, and at the long lasting present recession in the EU that followed the financial crisis, with the important contraction of EU firms' investments observed in recent years.

To investigate the reasons behind the EU long-lasting recession and the very severe reduction in investments, we start from a simple theoretical model (the Safety Trap model) which describes how in the presence of an excess demand for safe assets, when interest rates cannot sufficiently decrease, the situation leads to a long-lasting recession.

On the basis of this model, we interpret the second phase of the crisis, mainly linked to the sovereign crisis, as a situation in which safe assets suddenly disappeared, creating the conditions for a recession. We therefore conclude that not the reform of bank prudential requirements, but rather the sovereign crisis is what might lie behind the persistent economic recession and the important investment gap that has progressively

¹ Directorate-General for Financial Stability, Financial Services and Capital Markets Union of the European Commission. The views expressed in the text are the private views of the authors and may not, under any circumstances, be interpreted as stating an official position of the European Commission. This text is the edited transcription of the Keynote Lecture M. Nava delivered at the conference "Filling The Gaps In Governance: The Case Of Europe" organised by the European University Institute in Florence on 28 April 2016

grown overtime in the EU.

To support this conclusion, we review some of the consequences to be expected from a shortage of safe assets for bank liquidity management, investors' asset allocation decisions and corporate financial behaviour, that actually took place during the crisis.

Finally, we describe the role of the Juncker Plan to fill at least in part the present EU investment gap. We notice in particular how this initiative can be interpreted as an important mean to increase the supply of safe(r) assets, consistently with the Safety Trap model and the suggested explanation of the present difficult EU economic conditions.

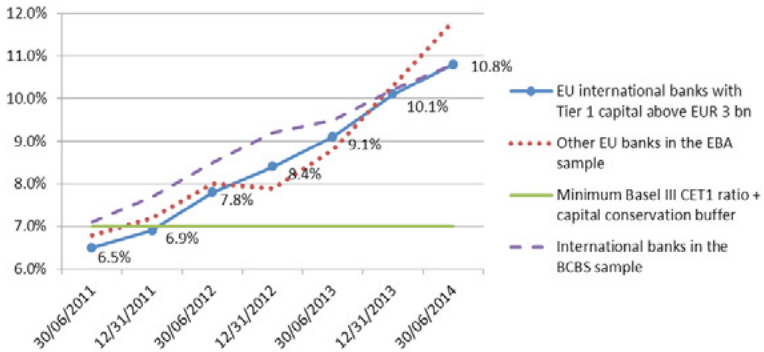
1. The regulatory response to the financial crisis and to banks undercapitalisation

CRD4/CRR is one of the main elements of the response the EU gave to the financial crisis. The CRR Regulation regulates banks liquidity, the quantity and quality of banks minimum capital, banks leverage, banks counterparty risks and the national flexibilities. The CRD4 Directive regulates the ability of the supervisors to impose prudential buffers, corporate governance rules, harmonised sanctions and general enhanced supervision rules.

CRD4/CRR created the financial stability which was so much needed to come out of the financial crisis. In response to CRD4/CRR, EU bank quality capital requirement (CET1, essentially equity) rose from 2% of Risk-Weighted Assets (RWA) to 7% of RWA, leading to an overall Minimum Capital Requirement of at least 10,5%.

The 2015 EBA Transparency exercise report published end November 2015 confirms an overall continuous improvement in the resilience of the EU banking sector, with stronger capital positions and higher leverage ratios. Actual CET1 ratios attained over times levels well above the required 7%, (see Figure 1). More precisely, the majority of banks present in June 2015 a CET1 to RWA capital ratio between 10% and 14%. Leverage ratios, represented by the ratio of Tier 1 capital over total leverage exposures, with no weighting for risk, have also increased ranging between 3% and 6%.

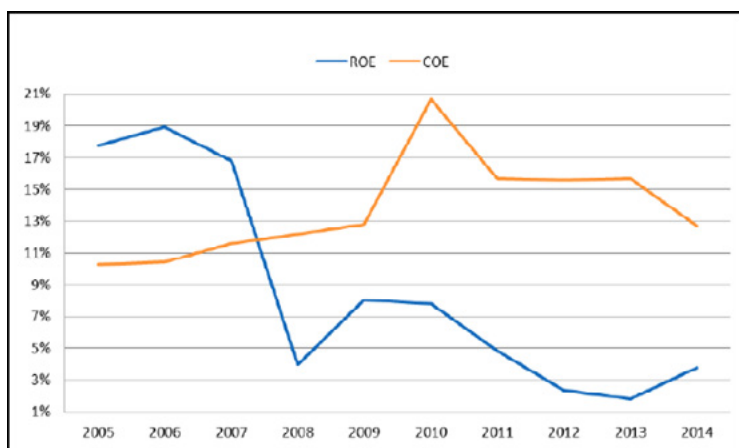
Figure 1: Common Equity Tier 1 / RWA, EBA Report – 2015 EU-wide transparency exercise



2. Recent evolution of banks' cost of equity (CoE) and return on equity (RoE)

In recent times, a concern has been voiced, more and more often by industry, that due to increased capital requirements banking may not be any more a sufficiently profitable business, and therefore a sustainable one in the long-run. For instance, in its response to CRR/CRD consultation dated 06 October 2015, the IIF writes: “In order to form the full picture of the sustainability of banks’ businesses, Cost of Equity (COE) must be considered alongside the industry’s Return on Equity (ROE). Current levels of cost and returns call this sustainability into question. The gap between COE and ROE has not improved significantly through the post-crisis recovery, with ROE levels that remain insufficient to cover banks’ COE (as shown in Figure 2). This trend has been taking place concurrently to rising capital constraints in Europe, including leverage.”

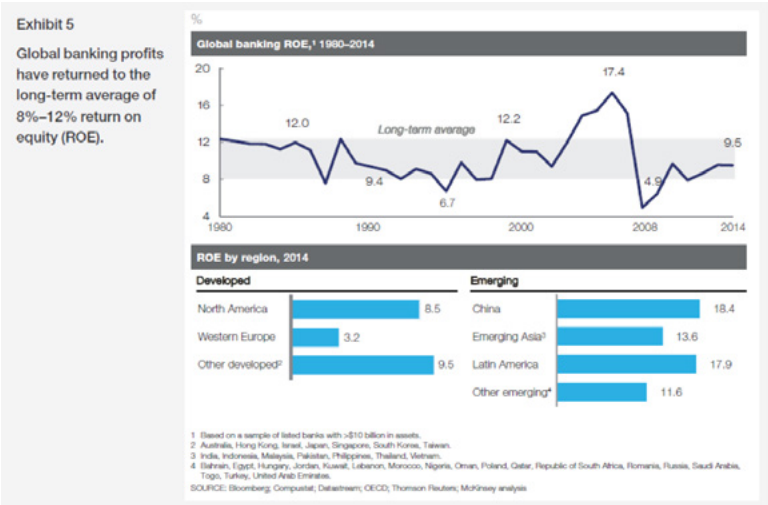
Figure 2: ROE and COE comparison on EU G-SIB banks sent by IIF in response to CRD/CRR consultation



COE and ROE are compared, and as ROE is lower than COE banks sustainability over the long-run is put into question. Regulation is also called into question, as an insufficient ROE is claimed to have developed “concurrently” to rising capital constraints, of obvious regulatory origin. As one element of regulation, the leverage ratio is prominently mentioned in the text.

However, McKinsey (see Figure 3) has recently found that, at the global level, ROE of large banks has returned to the long-term average of 8-12% after the temporary reduction due to the outburst of the financial crisis in 2008. There are nonetheless important geographical differences, with European banks still showing lower ROE than US or Asian peers.

Figure 3: ROE recent evolution calculated by McKinsey in its “The future of bank risk management” publication (2015)



ROE is, as a ratio, influenced by elements that affect net income, its numerator (higher net income = higher ROE) and by elements that affect the amount of equity banks hold, its denominator (higher equity = lower ROE).

Concerning banks’ net income, it is important to note that banks in Europe tend to rely more on interest income, and less on fee income; and interest rate margins have over time come under pressure, also due to the “flattening” of the yield curve. In fact, as banks are – generally speaking - more profitable in a steep yield curve environment (as they borrow at low spreads on the short end of the curve and lend at higher spreads on the long end), low and flat yield curves have negatively impacted EU banks’ net interest margins.

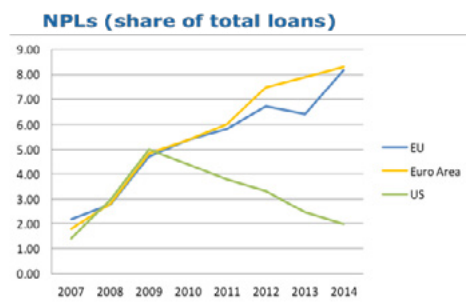
At the core of this negative development have been falling rates on the loan book of banks. They have been declining continuously and markedly over the past years, while the room to lower deposit rates has been limited in the present low interest rates environment.

A second important factor that can influence banks’ net income is obviously economic growth. Typically, in periods of low economic growth banks’ balance sheets tend to become less profitable due to the generation of more and more important amounts of Non Performing Loans (NPLs) and the need to provision them.

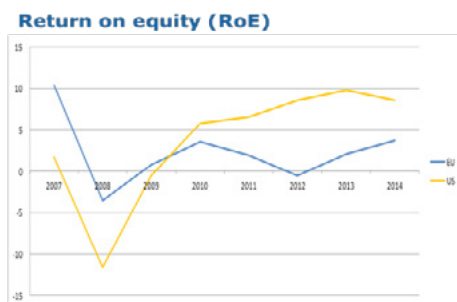
Figure 4 shows the important effect that NPLs can have on ROE, usually with a lag with respect to the time the loans have been granted. In the US, problematic loans have swiftly emerged to the surface, and banks balance sheets have then been rapidly cleaned of NPL effects. ROE has been therefore able to quickly recover in the US and to return to levels comparable to the pre-crisis period.

In several EU countries, instead, the cleaning up of banks balance sheets has been much slower, with problematic loans that emerged only much later and probably only after the severity of exercises such as the Asset Quality Review conducted by the ECB. This difficulty in cleaning up EU banks' balance sheets is indeed one important element that has acted as a "pulled handbrake" over recent years on EU banks ROE, with banks most exposed to countries that suffered most from the crisis being those where probably the gravity of the NPLs situation emerged most slowly in the books.

Figure 4: Evolution of Non Performing Loans in the US and in Europe



Source: World Bank, ECB Consolidated Banking Data and FISMA calculations



Source: ECB Consolidated Banking Data, FDIC and FISMA calculation

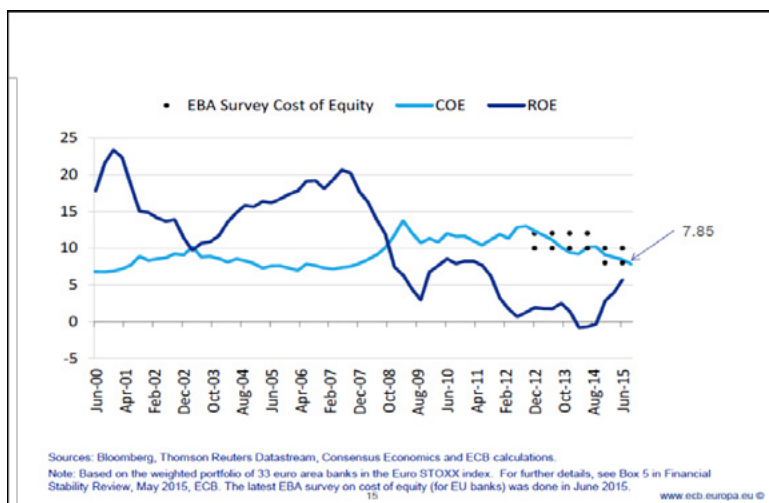
The Cost of Equity (COE) of a firm/bank represents the compensation that the market demands in exchange for owning the asset and bearing its risk (as its value could fall): it is in essence a “required ROE” for investors not to sell the bank shares in their possession. It is usually calculated on the basis of a Capital Asset Pricing Model (CAPM), where the Beta, i.e. the ratio that exists between the idiosyncratic specific riskiness of the single bank as appreciated by the market, and the undiversifiable systematic risk of the market it belongs to, plays a critical role. Very simply, the higher the Beta, *rebus sic stantibus*, the higher the COE requested by investors.²

When Minimum Capital Requirements are increased due to, for instance, a (correct) revision of risk weights on the most risky assets, if this modifies the business choices of a bank redirecting it towards business lines which are less profitable but also produce more stable profits, it is indeed possible that the banks business becomes more sustainable. This, in particular, can happen if the negative effects of the reduction in profits, i.e. a lower bank ROE, are more than outweighed by the positive effect of more stable profits, that translate into a higher reduction in the banks COE.

In relation to banks COE, it is important to know that the ECB has recently done an exercise very similar to that of the IIF mentioned above. When enlarging the sample, beyond EU G-SIBs, to a larger one made of 33 banks in the Euro Area, the situation immediately appears as less problematic (see Figure 5). COE and ROE are clearly much more converging, at least in the very recent timespan, and COE seems to have moved back much closer too pre-crisis levels.

2 In very simplified terms, the idiosyncratic riskiness (or, in financial jargon, the Beta) of a bank depends on whether its profits are more or less volatile than those of the rest of the market. When profits become relatively more stable compared to those of the market, the COE of the bank is reduced, and the bank finds more easily, supposing bank profits have not changed, investors who want to buy its shares. When instead the profits of a bank become relatively more volatile than those of the market, investors require a higher COE, and the bank finds less easily, supposing bank profits have not changed, investors who want to buy its shares.

Figure 5: ROE and COE comparison on a large sample of listed Euro Area banks



On the basis of the above, it is therefore possible to infer that during the crisis (2008–2011) investors seem to have indeed considered banks as riskier than the rest of the market, which explains the increase in COE for that period (nb: note in particular the spike after 2008). But, one could claim, especially thanks to CRD4/CRR and the important strengthening of prudential regulation that it entailed, that the market does not seem any more to consider banks so risky to demand a return much higher than in the pre-crisis period. This is better seen when using a sufficiently large sample of medium/large banks as in the ECB calculations.

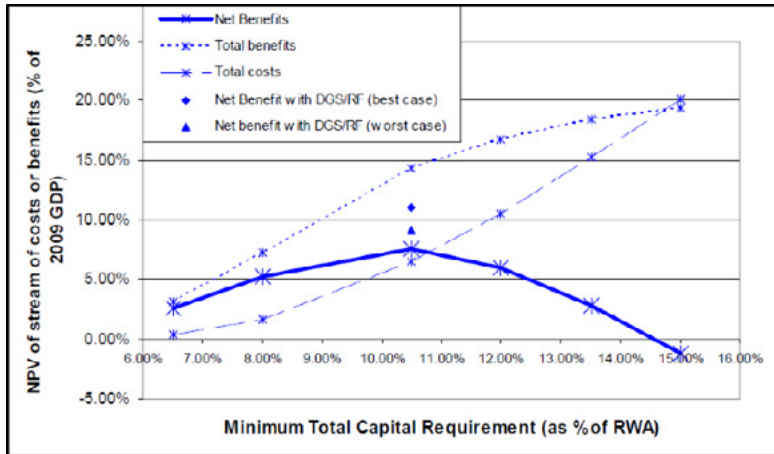
Finally, and from a more theoretical point of view, on the issue of optimal bank capital requirements, i.e. on what level of bank equity maximises sustainable growth in the long term, economists are split. On the one hand, some economist even recommend capital requirements as high as 30%. On the other hand, other economists support an opposite view considering as optimal a situation with very low capital requirements and very high leverage by banks.

In recent interventions on this topic, Jean-Claude Rochet, in a dynamic model published with Klimenko and Pfeil in 2015, concludes that the short-term impact of higher capital requirements can be very different from the long-term one. Although the two dimensions of stability (given by higher capital) and growth (given by lower capital) are con-

flicting in the short-run, in the long-run, if the capital ratio is not unreasonably high, it is possible to find an optimal equilibrium level where the economy is the most stable and it grows at a highest rate possible.

To illustrate in a simple and visual way this point, Figure 6 shows a graph presented in one of the technical annexes to the Impact Assessment of the BRRD, dated 2012. As one can see, the costs (in terms of short-term reduced growth), the benefits (in terms of long-term increased financial stability), and the net effects in the long-term is what Commission services also tried to evaluate and would tend to support the calibration achieved in Basel III and translated into CRD4/CRR.

Figure 6: Net Present Value of stream of total costs, total benefits and net benefits of CRD/CRR and BRRD



Source: BRRD IA 2014, Appendix 5, pages 189-199.

However, it should also not be forgotten that a suboptimal transition path to new capital requirements might have taken place in the recent past. After the outburst of the financial crisis, capital ratios have in fact increased very rapidly upon intense pressure coming from financial markets and in spite of capital requirements being raised only very gradually. This can have contributed to creating in Europe higher funding costs for banks which, in turn, might have contributed to lowering lending and economic growth, at least in the short term.

3. Europe's slow recovery from the economic effects of the financial crisis and its investment gap

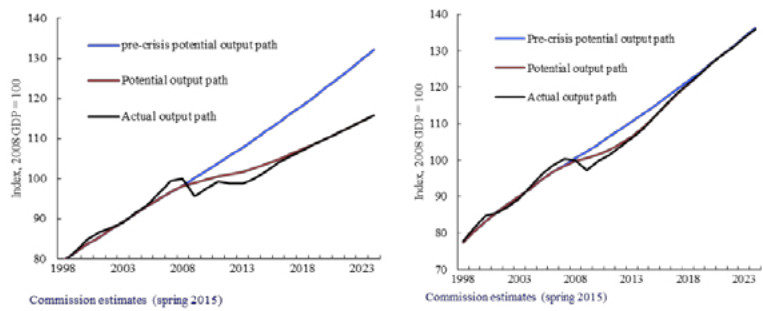
The 2008 financial crisis has deeply affected the European economy. And, credit developments have become a major source of fluctuations during the current recession. The very high correlation between variations in credit flows and variations in growth rates over recent years is indeed quite striking (see Figure 7).

Figure 7: Variations in GDP and credit flows in the Euro Area



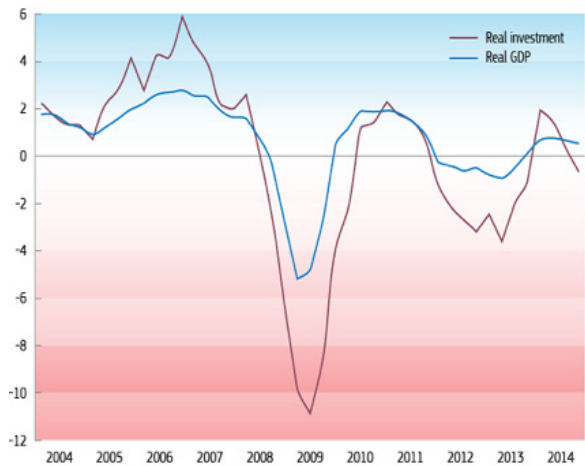
Looking at the EU in comparison with the US (see Figure 8), what emerges is how the return to the pre-crisis output path has been much quicker in the US. This created a true and remarkable gap between the EU actual and potential GDP, with substantial social consequences, such as a decrease in real GDP per capita, and a substantial increase in unemployment.

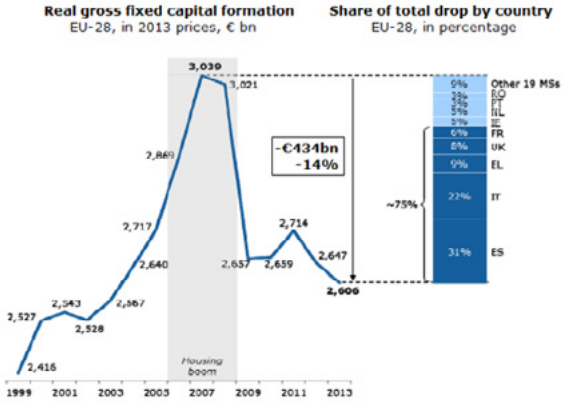
Figure 8: EU (left graph) vs US (right graph) actual and potential GDP



The financial crisis has particularly hit EU investments (see Figure 9). Annual investment in the EU has fallen by about EUR 430 billion since its peak in 2007, with reductions concentrated in few countries. At the moment, investment is estimated to remain approximately EUR 230-370 bn per year below sustainable trends. The low level of investments is one of the main reasons why Europe’s economic recovery remains weak.

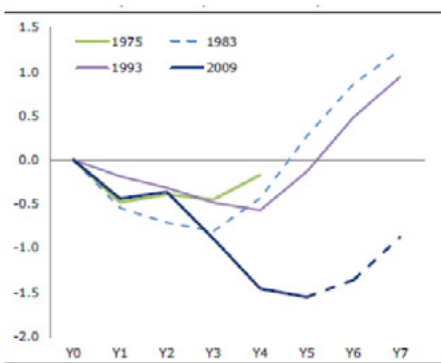
Figure 9: Year-on-year EU real GDP and real investment growth rate (first graph) and real investment absolute values (second graph)





Euro Area investment has been much weaker in recent years than would normally be expected in a 'typical' recovery. While in previous crisis investment would stop declining after two-three years, in the recent crisis investment substantially accelerated their slump after two years from the beginning of the crisis (see Figure 10). This leads to think that while housing investment certainly played a role in this decline, there must have been more than just developments in housing investment affecting the total investment-to-GDP ratio in the last few years. Recent Commission analysis shows in particular that the weakness in investment behaviour during the last crisis can be to a large extent attributed to credit factors such as deleveraging in the private sector. This private debt deleveraging has indeed started to play a more important role over time through the recession with long-lasting effects on investment dynamics.

Figure 10: Gross fixed capital formation after 2009, % of GDP, EA12 (BE, DE, IE, EL, ES, FR, IT, LU, NL, AT, PT, FI)

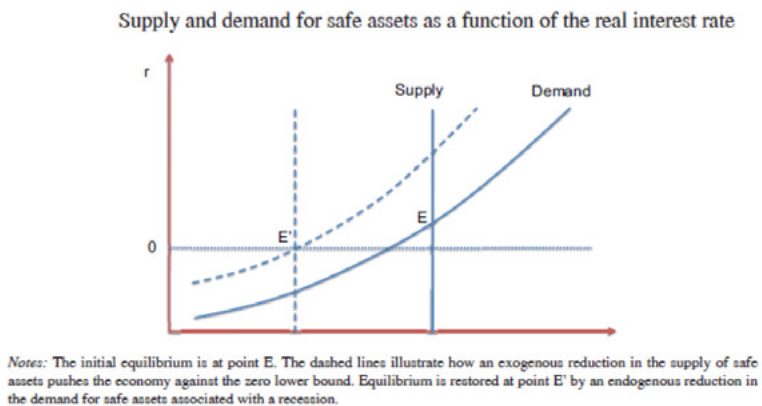


4. What lies behind the investment gap: the Safety Trap

Over the last three decades, there has been a continuous, slow but steady, fall in real interest rates, especially in the US. There are various reasons behind it, but certainly a contributing factor to it has been the presence of long periods of expansionary monetary policy, for which often the expression “great moderation era” is used among academics. Since the beginning of the new century, this fall in real interest rates has accelerated, and definitely spread outside the US to the whole world, in parallel with an increasingly expansionary monetary policy, not only in the US, but also in Europe and Asia.

Recent analyses show the importance along the years of a growing demand for safe assets on financial markets. The simple model represented in Figure 11 allows to see why. Consider an increase in the demand for safe assets, captured by an exogenous rightward shift in the demand curve. Equilibrium in the safe asset market is restored by a reduction in real interest rates. And with strong price or wage rigidities, this adjustment can only occur through a reduction in nominal interest rates. When nominal interest rates reach the zero lower bound, further reductions cannot take place. At zero nominal interest rates, there is excess demand for safe assets and excess supply of goods (i.e. an insufficient aggregate demand). Because of the deficit in the aggregate demand, output and income decrease, generating a recession.

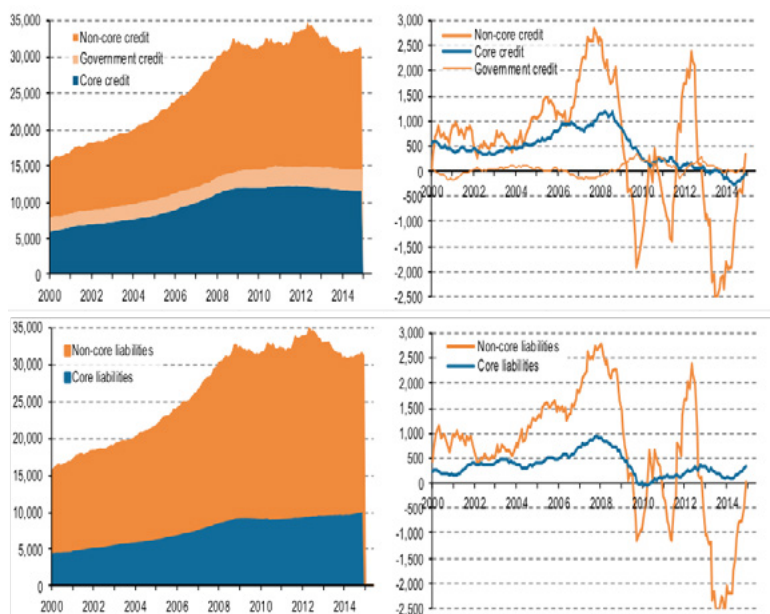
Figure 11: A simple model of the Safety Trap



The recession lowers wealth at any given real interest rate, endogenously shifting the demand curve for safe assets to the left. Equilibrium in the safe asset market is restored when the reduction in wealth matches the initial increase in the demand for safe assets at point E'. This mechanism is the essence of a safety trap. And when the economy falls into a safety trap, output can only be stimulated by reducing the demand for safe assets or by increasing their supply.

In the years before the 2008 international financial crisis, the shortage of risk-free assets proved a powerful stimulus to US and European securitisation markets, which provided large amount of “privately labelled” risk-free asset as an alternative to government bonds, increasing the supply of safe assets in response to their growing shortage. In Figure 12 one can see, for instance, the evolution of Euro Area banks assets and liabilities. In the years preceding the crisis, intra-financial assets and liabilities grew enormously (Figure 12) while, after the outburst of the crisis, a contraction of these assets led to a very unstable funding condition for banks.

Figure 12: Evolution of assets and liabilities of Euro Area MFIs 1998-2014 (Euro Area, € billion)



This dynamics depends on the fact that, in essence, large investment banks bought mortgages from retail banks (especially, but not always, in the US) and used them as the raw material from which they produced financial assets such as MBS, mortgage-backed securities, and CDO, collateralized debt obligations that materially increased the size of their balance sheet, making them even larger. Investment banks can be considered to a large extent risk neutral economic actors: they invest in a financial asset as long as there is a sufficiently positive expected return on it, and they can find enough funding on the market for their activity. Given this scenario, one can consider that the financial cycle begins with a rise in asset prices, such as real estate. This strengthens the balance sheet of banks thanks to mark-to-market accounting, especially after the securitization of those assets. As a consequence – and parallel to the role played by collateral in allowing (especially US, but also Spanish, for instance) households to borrow more when the price of their house goes up – both commercial banks and investment banks can borrow more. And the additional assets they can create/buy further increase the size of their balance sheet and push the asset prices even higher up.

When instead the price of the assets, and as a consequence of the asset-backed securities falls, the balance sheets of both commercial and investment banks suddenly weaken and they have to swiftly reduce their indebtedness in order to keep open their access to funding on the market. They therefore start selling more and more (securitized) assets, so that asset prices start falling, and then keep on falling as the downswing continues. A banking crisis obviously occurs when for several banks the fall in the value of bank assets is sufficient to wipe out bank equity.

From 2007 onwards, lots of assets perceived to be safe in the previous years, have been suddenly realised by financial markets to be indeed not safe at all. This, going back to the safety trap model, is equivalent to a reduction in the supply of safe assets, which can generate the same consequences of an increase in the demand of safe assets.

Figure 13 provides an illustration of the investors' perception of the reduction in safe assets that took place during the financial crisis. In the US the loss of the safe asset status by US government agencies such as Fannie Mae and Freddie Mac in the first phase of the crisis were to a large extent compensated by an increase of US Federal Debt held by the public. At this time, the EU was mainly hit by an important contraction in the funds made available from international investors to large EU banks, as shown also in the right graph in Figure 12. EU governments, how-

ever, intervened with important bail-outs intervention and this helped partially reducing the investor perception of risk in the banking sector, although at the expense of raising the investor perception of risk for sovereigns. It is at this time, 2009, that the European sovereign crises burst out in Europe. When that occurred, safe assets in the EU simply shrank, mostly concentrated in some countries, without any readily introduced compensating measure opposing this trend.

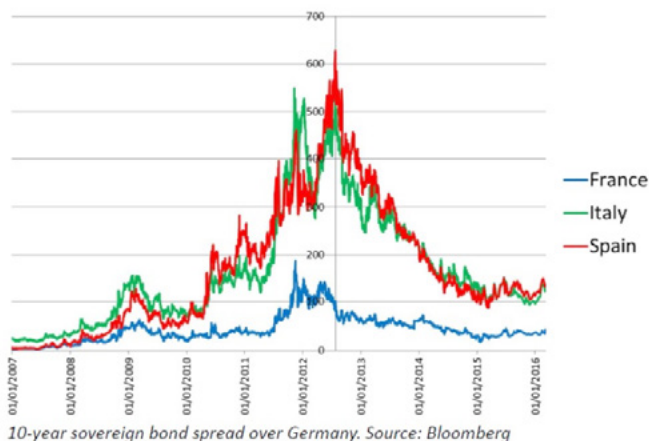
Figure 13: Evolution of safe assets in the US and some EU countries

Strong decline of safe assets from 2007 to 2011

	USD bn		% of world GDP	
	2007	2011	2007	2011
US Federal government debt held by the public	5,136	10,692	9.2%	15.8%
Held by the Federal Reserve	736	1,700	1.3%	2.5%
Held by private investors	4,401	8,992	7.9%	13.3%
GSE obligations	2,910	2,023	5.2%	3.0%
Agency- and GSE-backed mortgage pools	4,464	6,283	8.0%	9.3%
Private-issue ABS	3,901	1,277	7.0%	1.9%
German and French government debt	2,492	3,270	4.5%	4.8%
Italian and Spanish government debt	2,380	3,143	4.3%	4.7%
Safe assets	20,548	12,262	36.9%	18.1%

Note: Numbers are struck through as they are believed to have lost their 'safe-haven' status after 2007
Source: 2012 Barelays Equity Gilt Study.

Figure 14 shows that after the end of the most acute phase of the European sovereign crisis, sovereigns spreads went back to a convergence path also thanks to a series of important reforms including on the one side the Bank Recovery and Resolution Directive (BRRD) to cut the doom loop between banks and sovereigns and, on the other side, the strengthening of public finance surveillance tools within the European Semester. Still, in spite of this convergence, some sovereign spreads are higher than they were before the crisis.

Figure 14: Sovereign bond spreads in FR, IT, ES

5. The consequences of a shortage of safe assets during the sovereign crisis

Risk-free assets are a cornerstone of the functioning of the financial sector. The sudden perceived scarcity of risk-free assets created by the sovereign crisis created unfavourable conditions for economic growth in the EU in several ways.

- *Consequences on bank liquidity and monetary policy*

In the presence of a large set of risk-free assets, the banking system can promptly use them for secured financing transactions that allow to provide it with the liquidity that it needs. For instance, sovereign debt securities, as a highly liquid relative risk-free asset, play a central role in the banking system because banks not only invest in these assets but also use them as liquidity buffer. Moreover, they serve as collateral for refinancing operations, both in the interbank market and in credit operations with the central bank. Government debt in fact represents the single most important type of collateral in these operations. But when the sovereign crisis kicked in, creating a scarcity of risk-free assets, much more collateral started being requested by investors, and the EU banking system risked becoming illiquid.

- *Consequences on financial asset allocation*

When managing their portfolios, investors take decisions on how much money to invest in the different asset classes available to them. In this process, the presence of riskless investments allows for more separation between investment decisions and risk profiles. This means that investors with different risk aversions have a wider array of investment opportunities, as they can use the riskless assets to alter the overall risk exposure of their portfolios.

The main consequences of not having sufficiently available risk-free assets during the sovereign crisis were less diversified investment portfolios, and higher risk premiums. The absence of sufficiently available riskless investments made risky investments seem even riskier to all investors. Investors then invested less in risky assets, demanded higher risk premiums (and paid lower prices) and were quicker to flee any assets in the face of danger. Put another way, not having a safe haven that they could return to made investors less willing to take risk. As a consequence, we saw lower prices for all risky assets, higher volatility in prices in financial markets and abrupt, painful market corrections.

- *Consequences on corporate financial behaviour*

Having access to risk-free assets plays an important role in corporate finance, i.e. in how firms invest their resources, the mix of debt and equity that they use to fund these assets and the choices they make in how much cash they return to shareholders in the form of dividends and stock buybacks.

In the presence of risk-free assets, cash is a neutral asset and it does not drive investment choices.³ When there are no risk-free assets or an insufficient amount of them, companies that find better cash generating investments will be viewed as more valuable than companies that do not. It can therefore be expected that some companies may generate more excess returns on their cash generating investments than on their busi-

3 Firms invest in an asset/project when they believe that they can generate returns that exceed a "hurdle rate" that reflects its risk, with the risk-free asset (and rate) being the baseline hurdle rate. For risky investments, the hurdle rate will be comprised of two components – a base of a risk-free rate and a risk premium, reflecting the perceived risk in the investment. The net present value is the measure that captures the difference between what an investment is expected to generate in cash flows (and returns) and what it needs to generate, given its risk. Investing in risk-free assets (such as cash) and earning the risk-free rate produces a zero net present value investment. Any firm should therefore look for investments that generate a positive net present value.

ness/operating investments. As a result, managers would spend more of their time and resources researching short-term cash generating investments and less on their long-term (in principle higher added value) business/operating investments. This is what happened during the second phase of the crisis, with important reduction in firms' long term investments.

Furthermore, in relation to dividend policy, when a firm has a cash surplus from its business operations, after meeting its reinvestment needs and debt obligations, it can pay the cash out as a dividend, use it to buy back stock or retain it as a cash balance. The presence of risk-free assets makes the dividend policy choice in principle neutral for the firm, as demonstrated by Modigliani and Miller in 1961. In fact, a firm that pays less dividends than the cash available for payouts, can always invest the cash in risk-free assets and thus leave investors unaffected in terms of overall returns, by substituting price appreciation for dividends.

When no/less risk-free asset is available, companies would instead be penalised when they hold back from paying dividends and invest, as the investment would in no/fewer cases be risk free. Stockholders would therefore increase the pressure on firms to have their cash back, or would discount more the value of companies that reinvest their cash. This is another important element that might have played a role in reducing EU firms' investments in the recent crisis.

6. The Juncker Plan as a mean to increase the supply of safe(r) assets

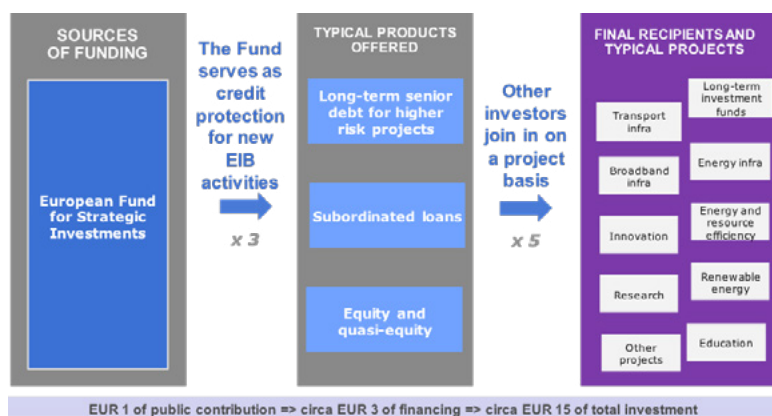
Given the protracted effect of private sector deleveraging on investment dynamics, the importance – in order to try and avoid a deeper and longer economic recession – of policies to support capital formation in the EU appears very clearly.

After three weeks into office, the Juncker Commission announced an Investment Plan aimed at reducing the EU investment gap that originated during the crisis and widened since then. Being the budget of the EU limited and in any case unsuitable for traditional demand policy, non-conventional ideas had to be put in place in order to ensure that investors could close (directly at least one third, and indirectly the other two thirds) the investment gap per year of some €300 billion required to boost growth.

EFSI builds on an important finding linked to the safety trap logic: in the current market environment, characterized by uncertainty and low investor confidence, investors seeking a safe haven for their funds tend to shy away from the risks associated with infrastructure investments. In response to that, EFSI aims to tackle the issue of low confidence and limited risk appetite on the part of investors by using public funds to absorb some of the risks involved in infrastructure projects, creating new safe assets by means of an “leveraged demand” policy, i.e. a demand policy which uses public money as a lever for private investment.

EFSI builds in fact on a guarantee of EUR 16 billion from the EU budget and EUR 5 billion in capital from the European Investment Bank (EIB). This initial contribution of EUR 21 billion serves as the basic risk buffer, enabling the EIB to then provide financing to infrastructure projects with a high risk profile, primarily through subordinated debt. This initial risk absorption by the EIB which is backed by the EFSI’s guarantees, in turn, is expected to catalyse large-scale additional investments from private investors into more senior tranches of infrastructure debt with lower risk exposure. According to Commission estimates, this leverage mechanism is expected to reach a blended multiplier effect of up to 15. In other words, every EUR 1 of public funds provided as guarantee for risk protection will catalyse a total investment of EUR 15, adding value in the real economy (see Figure 15).

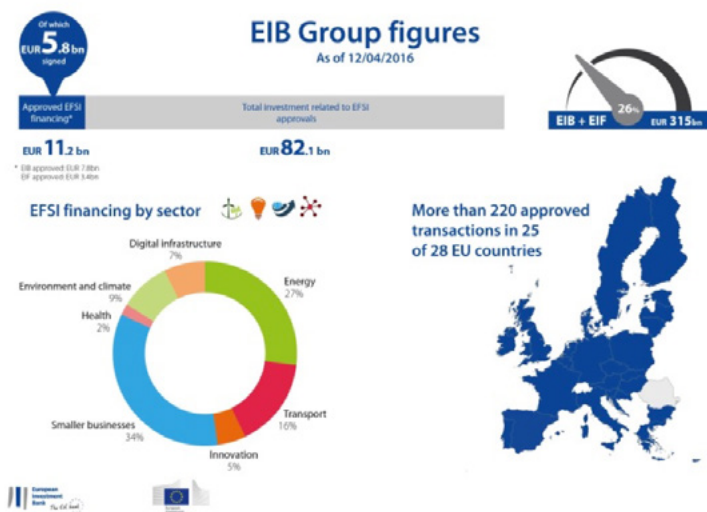
Figure 15: EFSI leverage mechanics



Based on the leverage ratio of 1:15, the initial EUR 21 billion in public contributions is expected to mobilize a total of EUR 315 billion between

2015 and 2017. Of this overall amount, approximately EUR 240 billion is earmarked for long-term strategic investments of European significance in key areas of infrastructure and innovation. Results to date are encouraging, EFSI has mobilised investments up to 82.1bn EUR, approving 11.2 bn EUR of financing (see Figure 16).

Figure 16: EFSI implementation dashboard up to 12 April 2016



The additional investment and the creation of safe(r) assets EFSI generates is an important response to the EU investment gap and a natural complement to the supply side response of repairing the financial system and strengthening bank capitalisation levels. However, EFSI is clearly just one of the possible means that could be used to increase the supply of safe(r) assets. Other means could be also considered and discussed, such as CMU and securitisation. The analysis of these other means is nonetheless beyond the scope of this paper.

Conclusion

In this article we analysed the regulatory response to the financial crisis given by the CRD4/CRR package and its merits of having improved banks financial strength.

On the issue of bank business sustainability, we concluded that the present increased level of Minimum Capital Requirements, even if

occurred at a faster speed than foreseen by the regulatory reform, does not overall appear to have made banking a non-viable business.

To investigate the reasons behind the EU long-lasting recession and the very severe reduction in investments, we suggested to look at a simple theoretical model (the Safety Trap model) which describes how in the presence of an excess demand for safe assets, when interest rates cannot sufficiently decrease, the equilibrium is re-established via a long-lasting recession.

On the basis of this model, we interpreted the second phase of the crisis, mainly linked to the sovereign crisis, as a situation in which safe assets suddenly disappeared, creating the conditions for a recession. We therefore conclude that not the reform of bank prudential requirements, but rather the sovereign crisis is what might lie behind the persistent economic recession and the important investment gap that has progressively grown overtime in the EU.

It follows that a more resilient economic EU can be obtained, in our view, by the appropriate combination of mutually supporting initiatives that, while maintaining financial stability thru initiatives such as the Banking Union, also ensure an increase in the supply of safe assets and the activation of a sufficient volumes of public-private investments such as EFSI. Other measures that we don't discuss here, such as CMU and securitization can also contribute positively to getting out of the recession by increasing the supply of safe(r) assets.

GAPS IN THE GOVERNANCE OF THE EURO AREA - DINNER SPEECH

Patrick Honohan¹

To what extent do gaps in euro area governance matter? I suggest that they matter a lot and that this issue is quite complex – even if we ask of governance no more than two things: (a) do we know who is in charge; and (b) are decision-making procedures adequate?

First I will argue that it was a major governance gap that effectively prevented the euro crisis from being addressed promptly and effectively. This gap is not the one most often mentioned in this context, relating to bank supervision. No, the gap lay in leaving unclear what European entity, if any, had the mandate, in the face of national fiscal weakness, to deploy collectively the financial resources of the Union and bring them to bear on the corrosive loss of confidence that spread during 2010-2012.

Second, I would like to illustrate the complexity by drawing on three quite live issues in the development of the monetary and banking union which display contrasting governance puzzles.

Governance gap explains depth and duration of the euro area crisis

I begin with what may seem like a large claim, namely that it was a major governance gap – and not merely a handful of policy errors – that was at the heart of the euro area crisis.

I'm not speaking about the banking supervision gap

¹ An expanded version of remarks presented at the dinner session of the Conference: "Filling the Gaps in Governance: The Case of Europe" Robert Schuman Centre for Advanced Studies, European University Institute, Florence, April 28, 2016.

It is conventional to say that the design of the euro was flawed by the omission of an active role in banking supervision. Indeed, I made that point myself over a quarter century ago.²

Now that particular architectural gap has been filled. After an astonishingly quick gestation period, the Single Supervisory Mechanism (SSM) of the ECB has been up and running now for 18 months, and it has a governance structure which seems to have functioned effectively up to now. Despite complexities deriving from pre-existing legal underpinnings of decisionmaking in the ECB (which among other things required that all substantive decisions be taken by the Governing Council), the SSM has managed to get through a very substantial body of work including the Comprehensive Assessment of the main banks in Europe—which had consequences for capital raising by some of those banks—as well as many decisions, both routine and exceptional, of the type which are the bread-and-butter of banking supervision the world over.

Valuable though it is, I doubt that having the SSM would have dramatically reduced the chances of a severe euro crisis emerging. After all, serious bank supervision failures occurred in the US and UK—countries where regional politics are not thought to be obtrusive in the governance structures of bank supervision. Perhaps an SSM-like institution might have been effective in restraining the excesses of the Irish and Spanish banking systems, but banking was not the source of the malaise that swept Greece, Portugal and Italy.

No: the lack of a “banking union” – to use the overblown term that has attached to the SSM – is not what I think was the governance gap that meant that the global financial crisis spiraled into such a deep and sustained euro area crisis.

Whose task to address the crisis of confidence?

Instead, I believe it is the lack of clarity on how the collective resources of the euro area could be deployed, in the event of a crisis of confidence

2 When I wrote: “The expectation is that the ECB will have a role [in banking supervision], it will be mainly a coordinating role. If so, an opportunity may be missed.... Arguably, a centralized bank supervision authority (whether a department of the ECB or a separate entity) with wide powers, would be more able to operate above national political pressures in acting decisively to prevent a failing bank to operate in an unsound manner...It may be worthwhile for national governments to cede power to the centre in order ‘to save them from themselves’”.

as acute and severe as emerged in 2008-10, that can be faulted.³ Until the survival of the euro itself was at risk, it could not be said to be clear that the Treaty mandated the ECB to take the steps that were technically available to it to stem and reverse the crisis of confidence. This is essentially because of the fiscal dimensions of the crisis which immediately interposed the prohibition of monetary financing as an obstacle to action.

Indeed, the monetary policy regime created by the Maastricht Treaty was designed to be robust to moderate shocks of the type that had been encountered in advanced economies in the second half of the 20th Century. The severely autonomous decisionmaking structures were well-adapted to insulating monetary policy from the kinds of political pressure that had caused repeated bursts of inflation in many countries.

The experience of the Great Moderation period suggested that managing monetary stability was something which could be left to technocrats. Central Banking was primarily a task of stabilizing inflation at a low level. (Of course this pre-supposed an effective payments and banking system, but that was something which could be thought of as part of the plumbing, requiring merely routine skills and, as such, easily assured.) Banking failures in advanced economies had been rare and – even in the case of the US savings and loan crisis – never threatening to the smooth functioning of finance at large. Isolated banking problems, even with banks that were considered too big, complex or connected to fail, could be handled by regulatory authorities with at most a short period of emergency liquidity provision by the central bank to bridge transitional issues. (The ECB even delegated the provision of emergency liquidity – ELA – to national central banks, reserving only the right for a supermajority of the Governing Council to object to ELA that could threaten the monetary policy stance).

But a combination of weak supervisory and fiscal policy in several member states left the euro area ill-equipped to deal with the consequences of the almost unprecedented shock of the global financial crisis in 2008-9.

Never had it been supposed that, not only would wide swathes of the euro area banking system find it impossible to obtain needed liquidity at scale or term in the market, but that euro area national governments could also lose market access.

3 This is not the place to review the complex negotiations leading ultimately to the ESM. These were clearly necessary to deal with the most acute country-level challenges, but were not sufficient to the larger task.

The first contingency (loss of banking liquidity) was manageable within the legislative framework established for the ECB. Open-ended liquidity provision prevented disorderly failure of banks in the period 2008-10.

But the second contingency (loss of sovereign market access) presented legal challenges precisely because of the deliberate separation of the ECB from Government both through the ECB's independence and through the prohibition on monetary financing. This was reinforced by an expansive interpretation of that prohibition as applying far beyond the narrow wording of the treaty (explicitly prohibiting, as it does, the purchase of Government debt instruments *only* in the primary market, i.e. directly from the issuer). If this interpretation was pushed too far, Europe would have denied itself the ability to deploy its financial resources to the full in the face of an existential crisis.

It was not until, during 2012, the deepening debt problems of Greece above all, but also other EA member states, combined with a growing fear that some countries might exit the currency regime (an eventuality not contemplated in the Treaty, and one which raised in the market the spectre of a contagious wave of exits) made it clear that more far-reaching action by the ECB was now not only desirable, but within the ECB's mandate.

Eventually, with the announcement and detailed planning for the Outright Monetary Transactions (OMT) programme in the period July-September 2012, such action was forthcoming; the threat of break-up receded comprehensively. The OMT killed what some referred to as the run on the system. (The earlier 2010-11 asset purchase programme known as the SMP was on a limited and much smaller scale).

But that action happened almost two and a half years into the euro area phase of the crisis. Output and employment had been severely damaged in the interval, with consequences that can be felt today.

Could an OMT type solution have been adopted earlier? Technically yes. Indeed, the ability of other countries, including (within the EU) the UK, to deal with much less severe fiscal and debt market issues with Central Bank action to purchase Government securities on a very large scale had already been demonstrated almost contemporaneously.

What was lacking in the euro area's governance was clarity on what entity (if any) was responsible for and legally empowered to deal with the extraordinary situation that had emerged and in particular whether various forms of central bank action which could have had the indirect

effect of lowering the funding costs of government would be permissible given the Treaty's emphasis on monetary financing prohibition.

Only when the situation had become extremely acute did it become sufficiently clear that the ECB – where the buck inevitably stopped – must act in a very dramatic way.

The fact that its OMT programme was challenged in court – and the challenge was supported by the Bundesbank – confirms the lacuna in governance arrangements relating to action of this type. I thus believe that insufficient attention in the Treaty to the full panoply of potential interactions between Central Bank and Government contributed to a costly delay in deploying needed tools.

That big issue has now been resolved. But many smaller issues raising puzzling governance questions remain.

Types of Governance Gap in the Euro Area: Three Current Examples

Let me illustrate how lack of clarity on governance can inhibit policy-making in a few other areas of current relevance. I'm going to list three topics with contrasting governance gaps. The first one – helicopter money – has the problem that governance for it in the euro area is quite unknown. The second, bail-in and resolution, is where the governance structures seemed at last to have been settled at the European level, but the practice in the early months of the new regime differs from what one might have expected: in a sense, the ostensible governance structure is being bypassed. The third example is one where again there are well-established governance structures, but they seem unlikely to be sufficient to deliver a good result, essentially because the entities formally charged with addressing the topic are not equipped to weigh the full systemic ramifications.

Helicopter money

There has been an increasing amount of discussion about the possible deployment of an unusual policy tool namely “helicopter money”. This tool – previously confined to theoretical papers, including famous ones by Friedman and Bernanke – is considered by some to have greater potential than quantitative easing (QE) to accelerate the return of inflation to target; however it also is seen as conveying a risk of overshooting that

inflation target. Without prejudging the substantive merits of its introduction in current conditions, the question arises: what agency in the euro area has the authority and responsibility to consider, and if appropriate implement, “helicopter money”?

The tool has various alternative modes of implementation, but each of them is distinguished by the fact that new money is created and distributed without the normal quid-pro-quo of an indebtedness or the sale of an asset. Since the distribution is not based on a market transaction, its essence amounts to a grant to the recipient of the money. That is not the normal way for central banks to do business and indeed can be seen as a quasi-fiscal operation.

Here once again the central bank of a single state could discuss and legitimate actions of this type – if they were considered appropriate – by agreement with the government. But in the euro area the idea of the central bank discussing with government who should benefit from a free distribution of newly created money is certain to be questioned by many as a potential violation of Article 123. In terms of governance, we are in uncharted waters.

Bail-in and bank resolution

Here is a second area where governance lines have been quite unclear and the policy lines pursued in the euro area over the period 2008-13 were erratic and overall rather incoherent.

Who was in charge? This was at first seen as a matter for natural authorities. However, by September 2008 the ECB had already begun to take the role of facilitator (for example in the Fortis affair). Subsequently, European institutions began to take a larger role when sovereigns themselves had come under pressure.

Out of the long list of examples, I will not dwell on the well-known case of Ireland where bailing-in out-of-guarantee debt in failed banks was ruled out by the official lenders at the time of the negotiation of the EU-IMF programme in 2010.

An important contrasting case, where again European institutions – in this case including the eurogroup – were involved (at least informally), was Cyprus. There were some puzzling features of the discussion. Not only was a questionmark raised (at first) over the deposit guarantee scheme. In addition, the eventual arrangements around the bail-in were surprisingly structured in such a way as to spare depositors at Greek

branches of a Cypriot bank being resolved.

Eventually, a relatively clear governance structure was established by the BRRD and other legislation at European level, and this has been brought into force since the beginning of 2016. But at this moment, it is less clear that the structure is working out in practice fully in line with expectations. Portuguese and Italian resolution or pre-resolution cases (Novobanco bonds; Atlante investment fund) have been dealt with by national authorities in a manner not evidently foreseen in the European legislation.

Thus here we have a situation where governance seems clear in theory, but practice is not evidently in line with what one might expect. Perhaps this just reflects transitional or teething issues.

Sovereign risk weights and concentration limits

We do know which bodies are in charge of deciding and enforcing risk-weights or concentration limits for bank assets in Europe. Governance on this matter is very clear and is largely left in the hands of the micro-prudential authorities. But, when it comes to applying risk weights or concentration limits to sovereign debt, deeper political and financial stability issues arise than were imagined when the governance structures for such matters were decided. If so, we can expect the standard governance process to stall and to be superseded by some ad hoc process.

If it was only a question of risk-weights for the debt of regional governments there would be little to debate. Analogously, failing to account for sovereign default risk is certainly problematic for international banks. But the absence of a central fiscal authority in the euro area complicates this matter, and makes it much less of a technical issue than it might seem.

Indeed, the current scale of legacy overall indebtedness of some euro area sovereigns means that this issue cannot be safely settled at the level of the micro-financial supervisor. Furthermore, it is evident that if dealing with it should be done in parallel not only with an adequate collective replacement funding for deposit insurance -- that would not be at all sufficient as a counterweight to the risks potentially generated by a major change to the treatment of sovereign debt -- but also with sufficient and effective European arrangements for dealing with the fiscal costs of the failure of a bank which (despite BRRD) is too big, or too connected, to be allowed fail. More generally, introducing risk-weights raises deep

questions about the status of government guarantees in the area of bank and financial stability.

So, although the governance structure is in place (EBA, SSM), it is not sufficiently equipped to deal safely and sufficiently comprehensively with the associated challenges that are entailed in moving towards a more coherent treatment of the issue of the credit risk to banks of their holdings of member state sovereign debt. Other entities, ESRB, eurogroup, Council, will ultimately be more central in the evolution of decisions here.

Indeed, it is not clear that there is a stable and coherent solution to all of the puzzles that are raised here in the absence of a euro area fiscal authority and a collectively underpinned euro area safe asset.

Conclusion

Governance issues in the euro area remain in several dimensions.

In some cases we do not know what entity is in charge; in others the responsibility has been assigned in a manner which in practice is not working effectively.

Some of these issues are fluid and not readily resolved. As with many other aspects of financial regulation and policy for financial stability, the rules and the institutional structures are both incomplete and represent too complex a structure. A sufficiently simplified yet fully effective governance structure for banking and finance in Europe remains elusive.

PART I

Are 'No Bailout' and 'No Debt Restructuring' in the EMU Compatible?

TALKING ONE'S WAY OUT OF A DEBT CRISIS

Lee C. Buchheit and G. Mitu Gulati

Abstract

The policy of Euro-area officialdom in the period 2010-2011 was to avoid, at all costs, a default and restructuring of the sovereign debt of a member of the monetary union. This policy was motivated principally, but not exclusively, by a fear that the international capital markets, if forcibly reminded of the precarious position of overindebted, growth-challenged members of a monetary union, might recoil generally from lending to European sovereigns. In short, they feared contagion.

The only alternative to permitting a debt restructuring, of course, was an official sector bailout. The afflicted countries -- Greece (until 2012), Portugal, Ireland and Cyprus -- received loans from official sector sources sufficient to allow them to repay in full their maturing bond indebtedness. Whenever and wherever the crisis erupted, contagion was thus held in check by the blunt technique of smothering the outbreak -- in money.

The proponents of this policy argued at the time, and argue now, that many European sovereigns in 2010 were far too fragile to endure a bout of market contagion. They argued that an acute crisis needed to be averted in order to buy time for the implementation of a gradual but more durable remedy. Had the intervening eight years been used to reduce the debt vulnerabilities of the peripheral (and even some core) states, this argument would now be powerful, indeed invincible.

Unfortunately, the opposite happened. Average state indebtedness in Europe today is about one-third larger than it was in 2008. Both the member states and the market saw the reprieve as spreading a reliable official sector safety net under their exposure. So they kept on borrowing

and lending. Only the zero interest rate policies of the world's major central banks during this period have kept debt servicing costs at tolerable levels.

Imagine a treaty creating a monetary union that expressly forbids the union from assuming unsustainable debts incurred by member states. Imagine further a central bank for the monetary union that is explicitly precluded from providing monetary financing directly to member countries. If a member becomes financially overextended, how can union officials jolly the markets into continuing to lend to the country in order to stave off a debt crisis?

There are three options:

1. Assure the markets that the weak sister will indeed be bailed out, notwithstanding the treaty prohibition against doing so.
2. Artificially maintain the country's access to private capital markets by giving investors a "put" of those debt instruments -- "in unlimited quantities" -- to the union's central bank.
3. Repeatedly and relentlessly declare, as a matter both of policy and of sacred honor, that no default on, or restructuring of, sovereign debt within the union will ever be tolerated.

At the commencement of the Eurozone debt crisis in May of 2010, European officialdom could not embrace option 1 for political and other reasons.

Even broaching option 2 at that stage would have been hazardous, again for political reasons.

Which left only option 3.

The risks of attempting to talk the Eurozone out of a contagious debt crisis (as opposed to restructuring the unsustainable debt loads of the affected countries at the outset) were of course visible when the problem began in 2010. The majority of official sector players apparently persuaded themselves that this was the least bad alternative at the time. The reprieve purchased by implicitly promising bondholders an official sector guarantee of their lending to Eurozone sovereigns, however, now puts those official sector actors in a remarkably uncomfortable position. Any suggestion that the implicit guarantee is being withdrawn or even limited

could trigger another bout of the financial contagion that the guarantee was originally intended to suppress. The financial firewalls established in Europe since the onset of the crisis are manifestly insufficient to contain an outbreak of that kind. In short, the official sector may have grasped the wolf by the ears and the tiger by the tail. They cannot safely back away from the implicit promise they have given to private sector creditors but they also lack both the financial resources and the political backing to honor the promise if called upon to do so in a contagious crisis.

Limited Choices

When a sovereign debt instrument falls due, the borrower has two, but only two, choices -- pay it or don't pay it. If the borrower does not itself have the financial resources to pay and cannot access commercial markets to borrow the funds needed to refinance the maturing debt, paying requires the borrower to seek financial assistance from an official sector source, multilateral or bilateral.

The "don't pay" alternative is equally simple. The sovereign either negotiates a restructuring of the debt *before* the claim falls due (and thus avoids an actual payment default) or it fails to pay on the maturity date and attempts to negotiate a restructuring afterwards. Either way, however, "don't pay" means "restructure".

In the case of Greece in the spring of 2010 (and later in Ireland, Portugal and Cyprus), European officialdom could not promise the markets that the afflicted countries would pay their maturing bonds; this would have been tantamount to a pledge to use taxpayer money to bail the countries out. Although such a promise would undoubtedly have resulted in continued market access for the afflicted countries, uttering it aloud was unthinkable for two reasons. First, it would have instantly been attacked as inconsistent with the no-bailout provision of the treaty establishing the monetary union. Second, official sector assistance for the debtor countries was conditioned upon fiscal reform. Promising the markets a bailout -- in effect, *committing* to bail them out -- would have obviously weakened the official sector's hand in negotiating those fiscal reform programs.

Calming the markets through an official sector assurance that the debtor countries *would* pay was thus not feasible. But if the dichotomy boils down to only two choices -- pay or restructure -- the official sector could obliquely promise the markets that maturing debts would be paid

by vehemently ruling out the option that the debts would ever be restructured. Stated differently, if the only options are x or y, you don't need to say "x", you only need to promise "not y".

Abolishing the Death Penalty

This is precisely what some senior European officials attempted to do in the early years of the Eurozone debt crisis. A sovereign debt restructuring in the Eurozone, they broadcast, was impossible, unthinkable, illegal, immoral and fattening.¹ Here are some examples:

"A debt restructuring . . . would be like the death penalty -- which we have abolished in the European Union."²

"Restructuring . . . would entail a major economic, social and even humanitarian disaster within Europe."³

"How can people invest in the euro area . . . if they are told 'we are not sure if you will get your money back'? What kind of advertisement is it for the euro if we tell people 'you can come and invest but we are encouraging restructuring'?"⁴

"In the worst case, the restructuring of a member state could overshadow the effects of the Lehman bankruptcy."⁵

"A debt restructuring in Greece would have major consequences on the soundness of the banking sector in Greece as well as on any banks having exposure to Greek securities."⁶

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- 1 For vivid descriptions of what occurred, see Martin Sandbu, *Europe's Orphan: The Future of the Euro and the Politics of Debt* (2015); Paul Blustein, *Laid Low: The IMF, the Eurozone and the First Rescue of Greece*, CIGI Working Paper 61 (2015); Landon Thomas & Stephen Castle, *The Denials That Trapped Greece*, N.Y. Times, Nov. 5, 2011.
 - 2 Ralph Atkins, *Interview Transcript: Lorenzo Bini Smaghi*, member of the Executive Board of the European Central Bank, FINANCIAL TIMES, May 29, 2011.
 - 3 *Id.*
 - 4 *Id.*
 - 5 *Euro Restructuring Could Overshadow Lehman -- ECB's Stark*, REUTERS, April 23, 2011 (quoting ECB Executive Board member Jurgen Stark); see also Blustein, *supra* note 1 (reporting on ECB President Jean-Claude Trichet's fears of a Lehman-like moment in Europe should Greece embark on plans to restructure its debt in 2010).
 - 6 Jonathan Stearns, *EU's Rehn Warns of 'Devastating' Impact of Greek Restructuring*, BLOOMBERG, May 11, 2011 (quoting Olli Rehn, EU Economic and Monetary Affairs Commissioner).

Contagion

These and similar declarations of the impossibility of a sovereign default or debt restructuring in the Eurozone had one overriding objective -- avoid contagion.

"Contagion" is an interesting word. Most people immediately associate it with a communicable disease. The common cold is contagious. But so, they say, is yawning. Even a catchy tune can be said to be contagious if you find yourself humming it for the rest of the day.

"Financial contagion", in the context of a sovereign debt crisis, can describe one of two possible phenomena:

Blind contagion occurs when markets, observing fiscal malfeasance or simple misfortune in one debtor country, irrationally recoil from lending to other sovereigns that are wholly innocent of, or unaffected by, the causes of the problem in the trigger country. Blind contagion thus resembles the transmission of a communicable disease. The victim has the bad luck to be in the wrong place at the wrong time when a virus or bacterium is abroad. The sovereign victim of blind financial panic similarly suffers from bad luck; the occasional tendency of markets to become skittish and indiscriminating.

Perceptive contagion, however, results from the market's sudden realization that the causes of the financial distress in the trigger country are also present elsewhere in the region or in the asset class generally. This produces a "golly, if it could happen there, it can happen here" revelation. Countries affected by this form of contagion are not innocent victims of bad luck or bad geography. They are themselves in some way financially vulnerable and thus become predictable casualties whenever investors are forcibly reminded of the risks of sovereign fragility.

If blind contagion is best compared to catching a cold on a crowded subway, perceptive contagion resembles a midsummer cocktail party when a torrential rain storm erupts. Someone at the party, remembering that he left his car window open, bolts outside to effect a remedy. His action reminds the other guests that the front seats of their own automobiles may similarly be at risk. The result? A suddenly empty cocktail party.

Politicians usually try to convince us that sovereign financial contagion is of the *blind* variety while in practice it is normally of the *perceptive* kind.

Financial Contagion in Europe

The main propellant for the official sector's response to the Eurozone debt crisis was thus a fear of contagion -- more precisely, *perceptive* contagion -- on the part of the markets. Greece, which had been borrowing not too many months before at a spread of only 20bp over German Bunds, openly acknowledged its inability to pay its maturing debts out of its own resources. That was a revelatory moment for investors. Might the problems that were laying low the Hellenic Republic -- a huge debt stock, anemic growth, chronic public sector deficits, the inability to devalue the currency -- similarly affect other Eurozone sovereigns? Gosh, the markets might ask themselves, if it happened in Greece, could it also happen in Ireland, Portugal, Spain, Italy, Belgium or France?

The official sector therefore felt itself confronting a clear and present danger of financial contagion across other Eurozone sovereigns. Not a blind contagion, however, in which the markets react irrationally. A spasm of irrationality might have been expected to pass quickly. In 2010, the official sector feared an acutely *perceptive* contagion once investors had been reminded of the limited options facing overindebted countries that belong to a monetary union. The only effective antidote to the spread of that *perceptive* contagion, thought some in the official sector, was an assurance that Eurozone countries would never be permitted to default on or restructure their maturing debts. The implication -- which the market was left to draw for itself -- was that these countries would be the inevitable beneficiaries of a bailout if they lost market access.

When a restructuring of Greek debt did occur in early 2012, of course, Europe did not collapse. The death penalty was not reinstated. Investors did not shun other European sovereigns. There was no Lehman moment. Affected holders of Greek Government Bonds grimaced and grumbled but then moved on, as some observers had always maintained they would. As for the belief that markets, once bruised, never forgive and never forget, Greece itself punctured that theory by issuing new bonds, at a coupon of under 5%, less than two years after inflicting a savage debt restructuring on its old bondholders.

To be sure, the "no default; no restructuring" policy avoided unpleasant negotiations with the private sector creditors of Greece (until 2012), Portugal, Ireland and Cyprus. But the price of this policy was to force a substantial migration of the debts onto the shoulders of official sector creditors. What awaits now is an even more unpleasant discussion

of whether, when and how those official sector lenders will themselves provide the concessions that they generously deflected from private sector investors.

The Implications

Establishing firewalls or shock absorbers like the European Stability Mechanism (authorized share capital € 700 billion) are undoubtedly helpful to quell outbreaks of blind, irrational contagion. An afflicted country can be expected to return to normal funding operations once the panic subsides. Unless vastly expanded in size, however, such firewalls are of less utility when the problem is a fear of perceptive contagion.

By its very nature, perceptive contagion results from a sudden recognition by investors that they -- as sensible, risk averse commercial actors -- ought *not* to be lending to a group of sovereign borrowers, at least not at the coupon levels those countries have come to expect. To be effective, therefore, a financial firewall against perceptive contagion needs to have both the financial resources and the political backing necessary to fund the maturing debts of multiple countries for prolonged periods. The ESM, even augmented by IMF resources, lacks the money and the political support to attempt that gargantuan task.

The latent policy question is whether the official sector wants to consecrate a system by which the market access of a number of European countries is premised not on a sober investor assessment of the creditworthiness of the individual sovereign borrowers, but rather on the market's assumption about an inevitable official sector bailout should a bout of perceptive contagion again break out. If it does, then the objective of European fiscal integration long promoted by some commentators will have largely been achieved, indirectly of course. It strikes us as unlikely, however, that this proposition would enjoy the necessary political support were it to be put directly to the national parliaments.

ARE “NO BAILOUT” AND “NO DEBT RESTRUCTURING” IN THE EMU COMPATIBLE? A HISTORICAL PERSPECTIVE

Kim Oosterlinck

Introduction

The recent Eurozone crisis has led to an increasing interest in the management of sovereign debt crises in the framework of a union of sovereigns. The vast literature dedicated to sovereign debts has in most instances focused on sovereign viewed in isolation. The limited number of state unions explains this choice. But to which extent are the insights gained from the literature on sovereign debts in general relevant for the case of sovereigns within a union?

The feature that distinguishes sovereign debts from other debts is the sovereign nature of its issuer. And in turn, this sovereign nature is at the basis of the sovereign debt paradox: depending on the premises, sovereign debts may either be presented as risk-free assets or as extremely risky ones (Oosterlinck, 2013). The sovereign nature of the issuers creates an imbalance between the powers of the issuer and the bondholders. Sovereigns may unilaterally decide to renege on their obligation. Repaying, defaulting, restructuring or repudiating the debts are decisions that the sovereign takes alone. Sovereign debts are thus by nature “political” financial instrument. The inclusion of a sovereign within a union raises questions regarding the freedom enjoyed by the state in terms of decisions regarding its debts. To which extent are sovereigns, sovereigns within a union? The recent Eurozone debt crisis has also led to a series of suggestions regarding the rules to apply within the Union. Should sover-

eigns who find themselves in trouble be allowed to restructure their debt? Should the union or part of its members step in and bailout the distressed countries? Many voices were raised against either a bailout or a restructuring. How would these rules compare in a historical perspective? And to which extent are sovereigns bound by "the rules of the game" decided by the union? What happens when states are "created" or when part of a union decides to split?

To address these questions this note will first present the no-bailout and no restructuring rules in a historical perspective. It will then present alternative ways in a historical perspective, discuss the role of supersanctions (Mitchener and Weidenmier, 2010) as well as the potential of guaranteed bonds. The last part of the note will present the lessons from a historical state union and briefly discuss the impact on sovereign debts in the case of secessions.

1. No bailout and no restructuring: historical evidence and credibility

Bail outs and debt restructuring are two ways to help restore the financial credit of an ailing sovereign. They are however markedly different. Bailouts and bailout expectations may lead to a double moral hazard (if investors expect to be bailed out they are likely to scrutinize less the quality of the issuer, and if a sovereign expects to be bailed out its government has little incentive to follow prudent macroeconomic policies). For these reasons bailout are quite exceptional from a historical perspective. By contrast debt restructuring may be viewed as normal following a default.

Bailing out a sovereign is thus essentially an uncommon endeavor. The number of cases is extremely limited. Broadly speaking, and depending on the helping hand, bailouts may be divided into two categories. In some cases it was a sovereign which bailed out another one. In other instances, it was the underwriter who supported the failing sovereign. The motivation behind these interventions differed dramatically. In the first case, political motives seem to have been the main driver of the bailout. In the second one, the motivation was of a reputational nature. Underwriters willing to protect their good reputation helped sovereigns overcome temporary difficulties.

In 1867 Benito Juarez repudiated bonds issued by the Emperor Maximilian. According to Juarez these bonds had been floated by an illegitimate foreign ruler and there was therefore no reason for the Mexican

population to repay these. The bonds issued by Maximilian's regime had been strongly supported by its French ally, Napoleon III. Following the repudiation, and because of the high profile it had played when the bonds had been issued, the French government decided to partially bail out these bonds. The bailout of the Mexican bonds by the French government was thus essentially motivated by political reasons. In the absence of data on the holders themselves it is hard to know if political connections drove the decision to partially repay the bonds. The fact that the bailout was limited to French holders of these bonds suggests in any case that there was a good reason to extend the favor only to nationals. Wynne (1951, [2000], p. 30) estimates that bondholders managed to recover more or less 50 per cent of the face value of their investments.

Even though the amounts involved were relatively small, the Mexican bailout created a long-lasting impression on French bondholders. More than fifty years later this case was mentioned by the French press when Russia repudiated its debts¹. The parallel was certainly warranted as the French government had promoted the Russian bonds even more than the Mexican ones. As a result French holders of Russian bonds hoped someone, maybe the French government, or the French banks which had issued these bonds would reimburse them (Landon-Lane and Oosterlinck, 2006; Oosterlinck, 2016). Whereas French holders of Russian bonds hoped their government would support their claims, British holders knew from experience that Great Britain would be reluctant to bail them out. Because of the First World War new rules had been implemented in London. In practice these rules prevented any arbitrage operations. As a result prices of Russian bonds cross-listed in Paris and London began to trade at a higher price in Paris (Bernal et al., 2010). All other things being equal, this price differential represented the value assigned by French bondholders to the potential bailout. The hopes of the French bondholders never fully materialized. The French government allowed the use of coupons in arrears to subscribe to a new French loan but the limits imposed on the number of coupons to be exchanged meant bondholders only received a minimal compensation. The amounts lent by French investors to Russia were huge by any standards (Girault, 1973). This certainly explains why the French government was reluctant to recognize any financial responsibility. The fact that France was in the midst of a terrible and costly war did of course not help.

These examples show that when a country bailed out another one it

1 See for example Le Rentier, 7 June 1921.

was mostly for political motives. Expectations of bailout were thus linked to politics. In the case of bonds issued by colonies, and even though the bonds in question were by no means officially guaranteed, bondholders expected the colonial power to step in should a problem arise. The guarantee was so much ingrained in investors' beliefs that the economic fundamentals of the colonies didn't really matter in the pricing of their bonds (Accominotti et al., 2011). Of course it would be an oxymoron to talk about sovereign colonial debts. But one could credibly argue that even if they were not sovereign at the time the bonds were issued, all colonies had a non-zero likelihood to become sovereign one day. They were in a sense "sovereigns in waiting".

Banks also engaged in bailout operations during the 19th century. At the time underwriters were keen to protect their reputation. The best underwriters were able to cherry-pick the sovereigns with the best prospects and to charge them fees reflecting their reputation (Flandreau and Flores, 2009). As a result defaults were not random across underwriters. Defaults were almost unheard of for bonds issued by the best underwriters such as Rothschild. For a sovereign, managing to get its bonds issued by high quality underwriters signaled its quality (Flandreau et al., 2010). Consequently the market rapidly distinguished the quality of the bonds on basis of the underwriter. Underwriters were however not always right in their choices and sometimes lent to states which ended in trouble. To protect their reputation underwriters were then ready to financially support these states (Flandreau et al., 2010). Brazil is a case in point. In 1889 a coup deposed the Emperor of Brazil and established a republic. The next decade proved extremely turbulent on the political but also on the economic side and by 1893 Brazil was on the verge of bankruptcy. The House of Rothschild, which was acting as Brazil's underwriter, stepped in. It provided a series of rescue loans amounting to £13.1 million between 1893 and 1895 (Weller, 2015). In parallel the house supported the prices of these bonds on the secondary markets. The rescue loans allowed Brazil to overcome its financial problems but they came with conditions attached: Brazil was to follow a sound monetary policy or the loans would stop².

During the 19th century underwriters had thus a dual role as provider of liquidity and as agent to signal the quality of the bonds. The emergence

2 This clause was imposed upon Brazil because of moral hazard risk which was rapidly materializing in the form of reckless spending by the Brazilian government (Weller, 2015).

of rating agencies gradually removed incentives to engage into signaling. As a result the correlation between the quality of the underwriter and the likelihood of default has disappeared (Flandreau et al., 2010). Bailouts were in most of the time not expected. But could bondholders expect a different treatment for bonds issued in the framework of a union. There is unfortunately no historical example which would perfectly match the case of the EMU. The defaults which occurred in several states within the United States in the 1840s might however provide some insights.

Between 1841 and 1843, eight states (Arkansas, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi and Pennsylvania) declared themselves unable or unwilling to service their debts. Even though the defaults and repudiations were made by states, argues that the complex legal status of the states regarding debts allows assimilating them to sovereigns. Indeed according to English (1996, p. 272), "Under the United States Constitution, states are sovereign and cannot be compelled to repay debts". The defaults had consequences beyond the borders of the defaulting states. According to contemporaneous observers a form of contagion occurred temporarily affecting the Federal government. European investors who had suffered from the states' defaults were reluctant to lend to the Federal government fearing it might also default. It seems European bankers were conditioning lending to the Federal government to using part of the proceeds to pay the debts in default (English, 1996). Despite this attempt to coerce the Federal government, it did not bail out the various states.

2. No restructuring: historical evidence and credibility

Whereas bailouts are uncommon in historical perspective, debts restructurings seem to be the norm in case of default. On basis of data from various bondholders' associations Suter and Stamm (1992) report 120 successful debt settlements between 1820 and 1975. Agreements were reached on average after nine years of negotiations. In the vast majority of the cases negotiations led to a net loss. Suter and Stamm (1992) show that investors lost on average a third of the value of interests in arrears, experienced a reduction of 22% of the interest rate and a write-off of 18% of the bonds' original face value. These average figures hide a vast diversity in terms of settlements.

The terms of the debt restructuring may range from small losses to huge write-offs. Computing the present value of the losses is compli-

cated by the need to decide which discount rate to apply. Sturzenegger and Zettelmeyer (2008) assess the size of the haircuts by comparing the net present value of the stream of cash flow pre-default with those proposed after the settlement. To discount these cash flows they rely on the yields of the new bonds. They show that haircuts may range from relatively low figures (13%) to extremely high ones (73%). The intensity of default covers thus a broad range. History shows that debt restructuring is extremely common but it seems that the terms of the agreements have changed over time. According to Suter and Stamm (1992) in a long term perspective the terms of the deals have gradually favored more and more the debtor, with contemporaneous debt reliefs higher than the one prevailing at the beginning of the 19th century.

If restructuring is ruled out, the options become extremely limited³. One option would be to engage into what Mitchener and Weidnemier (2010) have named supersanctions (gunboat diplomacy or imposing the loss of fiscal sovereignty on the defaulter). Gunboat diplomacy would in all likelihood generate public outcry today. By contrast it has become relatively common to see direct intervention into the public finances of defaulting countries. Programs sponsored by the IMF have indeed been frequent following default. But it should be noted that these interventions usually come after some form of debt restructuring. Another option for the defaulting country would be to stick to its decision to default and refuse any form of settlement with the bondholders. In a historical perspective the only countries which managed to stick to such a position in the long run are the communist countries which repudiated their debts (Oosterlinck, 2016). But if “no restructuring” is *ex ante* announced as a rule, then the defaulter is faced with an all or nothing decision which may prompt the government of the defaulting country to favor the latter. Another alternative would be to insure that a third party (another sovereign for example) would guarantee the bonds. This will be discussed in the next section.

3. Guaranteed bonds, Eurobonds, State Union and Secession

To avoid bailing out or restructuring one may wonder whether some prophylactic measures could help. Maybe a sovereign could guarantee

3 In fact Buchheit and Gulati (2016) exploit the limited number of options to argue that by signalling their unwillingness to restructure senior European official were in fact signaling their willingness to bail out bondholders during the Eurozone crisis.

the bonds issued by another one. Or the debt could be mutualized in the framework of a Union, in a way close to the blue and red bonds suggested by Delpla and von Weizsäcker (2010).

Guaranteeing the bonds issued by another state is probably as uncommon as bailing out another state⁴. Esteves and Tunçer (2016) analyze the case of five guaranteed bonds issued in Europe during the 19th century. All the loans in question were linked to a war or a military campaign. The guarantors were European powers (depending on the loan Austria-Hungary, France, Germany, Great Britain, Italy or Russia) and in many instances there were several guarantors for a given loan. The market distinguished the guaranteed bonds from the others (Esteves and Tunçer, 2016). The spreads between normal bonds issued by a given country and its guaranteed equivalent seldom fell below 100 basis points. Markets thus valued the guarantee.

The case of guaranteed bonds is insightful but the amounts guaranteed were relatively modest compared to the debts of most guarantors. Furthermore, since these bonds were related to specific events, they did not engage the guarantor for any other bond. By contrast, when sovereigns join to form a new country, one may expect that the commitment will be of a long-term nature. There are very few examples of independent countries merging to become a new country. Italy is probably the best case one could imagine in order to analyze this issue.

The Italian unification was a gradual process. More than 25 years passed by between the first independence war (1848-1849) and the final unification of Italy in 1871. Before the unification seven independent entities ruled parts of Italy: the Kingdom of Two Sicilies, the Kingdom of Piedmont Sardinia, the Kingdom of Lombardy-Venetia (under Austrian rule), the Grand Duchy of Tuscany, the Duchy of Modena, the Duchy of Parma and the Papal States. Four out of the seven sovereigns (all but the Duchies) had issued debts in Antwerp and Paris prior to unification. These debts were actively traded on these markets.

Collet (2012, 2013) exploits the price evolution of these debts to gauge market reactions regarding the Italian unification. The first independence war failed but the second one paved the way to the creation of Italy. In 1861, Victor Emmanuel II proclaimed himself king of Italy. The new Italian state was composed of all the seven entities but for the Papal States

4 This section only deals with guarantees which were clearly defined in terms of scope and nature. Guarantees by sovereign may however be much more complex (see Buchheit and Gulati, 2014)

and the Kingdom of Lombardy Venetia. The debts from the former independent entities were merged to create a new Italian debt. Markets were however suspicious and decided to trade the bonds by referring to the previous state they had belonged to. Collet (2012, 2013) exploits this element to assess how markets perceived the new Italian bonds. She shows that the new Italian bonds traded at a higher yield than the weighted average of its constituent entities. In fact their yields were close to those of the worst credit before the unification (bonds issued by the kingdom of Piedmont-Sardinia). Furthermore Collet (2012, 2013) finds that yields began to converge only in 1871 when the unification was completed but also when taxes were harmonized across the country.

The Italian example is not very encouraging for mutualized European debts. Markets seem indeed reluctant to view these bonds in a positive manner unless fiscal union is established. Guaranteeing bonds seems a bit less problematic but one may wonder if large scale issues of guaranteed bonds would not lead to a different outcome than the one observed in history. Furthermore both cases ignore the likelihood that part of union may wish to secede. In this case the common debt has to be partitioned. Following the Vienna Congress in 1815, the Netherlands acquired the formerly Austrian territory which would become Belgium in 1830. The debts from the two entities were merged into a new debt. The Dutch debts dwarfed those from the South of the country. When Belgium managed to become independent, the question of the partition of the debts arose. Belgian representative wanted each former entity to take back its own debts. Their view did not prevail however, and Belgium was forced to take half of the overall debts on the grounds that it had a population similar in size than the Dutch one (Collet, 2012). This example clearly highlights an additional risk when it comes to mutualizing debts. The US civil war provides another example of debts affected by Secession. The debts issued by the Confederacy were repudiated and ended up valueless (Oosterlinck and Weidenmier, 2007; Mitchener et al., 2015).

4. Conclusion

The statement that no bailout would ever occur could, from a historical perspective, be viewed as credible. The number and the nature of bailouts which happened in the past suggest indeed that bailouts are uncommon. This is the case even for states belonging to a union. By contrast announcing no restructuring seems hardly credible. As a matter of fact restructurings are the norm when sovereign default and history is replete with examples of restructuring.

The creation and the potential dissolution of unions raise further questions. The example of the Italian unification would tend to indicate that markets penalize at first the newly created country. One may further conjecture on basis of this example that fiscal union is viewed as a condition for markets to believe in the credibility of the union. As for dissolution or secession they raise the question of the apportionment of the debts. In the absence of an international recognized rule, the apportionment is usually done on an *ad hoc* basis. This creates uncertainty regarding the amounts to be taken over by the different parties. If the credit rating of these entities differs, this uncertainty will in all likelihood be reflected in the bonds' yields.

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ARE “NO BAILOUT” AND “NO DEBT RESTRUCTURING” IN THE EMU COMPATIBLE? HOW TO UNDERSTAND THE DILEMMA

Martin Sandbu

The question that was raised in the title of this conference panel was well-posed, for two reasons. First, it captures the widespread sense that Europe’s single currency was constructed as a halfway house that cannot keep standing without some serious structural strengthening. Second, it highlights a particular policy choice that had to be made at the very start of the sovereign debt crisis: whether or not to refinance Greece’s public debt through official rescue loans in May 2010. I have argued elsewhere¹ that most of the eurozone’s awful economic performance and fragmenting political fabric since then, must be blamed on policymakers’ making the wrong choice then.

In this essay, I set aside the question of whether one should prefer bailing debtors out or bailing creditors in, and explore whether the dilemma can be avoided in the first place. In the first section, I show that in principle, the answer is yes. In the second, I show that in practice, however the eurozone countries closed off the alternatives routes out of the dilemma. That was not something they were predetermined to do because of the nature of monetary unification, but an effect of the policy choices they made or failed to make. In the third section, I draw conclusions about what this means for the way forward for the European Monetary Union.

1 Martin Sandbu, *Europe’s Orphan: The future of the euro and the politics of debt*, Princeton University Press 2015.

Are “No Bailout” and “No Debt Restructuring” compatible in general?

Yes. The dilemma between bailing out a debtor and “bailing in” the creditors by restructuring the debt is not, in general, a dilemma. The dilemma only binds when all the escape routes are closed off. What are these escape routes? Here we consider them in the abstract, before turning to the concrete case of the European Monetary Union.

A. No debt

If there is no debt, there is nothing to bail out and nothing to restructure: the dilemma does not arise.

This need not mean a situation of financial autarky, in which a country or a state cuts itself off from outside financing. That could presumably only be achieved, if at all, by running permanent surpluses and keeping large reserves for cash management. That is rarely feasible, and never optimal. (Norway runs large surpluses and has an \$800bn sovereign wealth fund for the benefit of its 5m citizens, but it still issues sovereign debt in small portions for cash management purposes and to provide financial markets with benchmark assets in Norwegian currency.)

Instead, “no debt” could be understood as a situation where a country or a state funds its deficits with capital that takes other forms than debt. For national economies as a whole (including the private sector not just the government), non-debt financing is conventional if insufficiently common. Alternatives financing the current account with debt include portfolio equity funding (foreigners investing in the domestic stock market) or foreign direct investment (foreigners buying productive assets such as companies, real estate, or mines).

For governments, debt financing - whether through marketable bonds or non-marketable bank loans - is virtually the only game in town. But economists have designed more equity-like funding products for governments too. Robert Shiller, for example, proposes non-redeemable securities that would pay an amount defined as a fixed share of the country’s gross domestic product.² And many have advocated a greater use of GDP-indexed debt, where repayment and debt service would vary in step with the health of the debtor economy, again akin to how corporate

2 Robert Shiller, *Finance and the Good Society*, Princeton University Press 2012.

equity can pay greater dividends in good times than in bad ones.³

The general point is that in the absence of debt, or when the bulk of external financing takes the form of irredeemable investment such as FDI or equity, the choice between bailout and debt restructuring need not be faced. One way to escape the dilemma, then, is for governments to fund themselves in ways that have the characteristics of equity rather than debt.

B. No refinancing

If it's not reliance on external capital generally, but specifically debt that can make the dilemma bind, what is it about debt that is dangerous?

It is the characteristic that debt *falls due*, that is to say, a creditor's right to redeem the loan at a particular maturity date or under specific conditions. Debtor unable honour their debts, who therefore must either be bailed out or restructure their obligations, are typically brought to this point not by unaffordable interest service but by a bulky redemption requirement.

It is often observed that sovereigns rarely *pay back* their debts. In historical cases when public debt-to-GDP ratios have come down it has usually been thanks to growing (nominal) GDP more than a falling absolute level of debt. Instead of paying down and retiring maturing bonds, governments typically roll them over into new bonds. A debt crisis tends to happen when private investors refuse to play their part of that game, and old creditors insist on being paid back what they are due on redemption while new creditors refuse to buy the new bonds whose proceeds would normally repay the maturing ones.

The average maturity of OECD country governments' debt has tended to be in the 5-8 year range. In the eurozone when the crisis hit (2008), this average maturity ranged from just under 4 years (Finland) to just over 8 years (Greece). Now a 5 year average maturity means that on average, the whole stock of debt is rolled over every five years, or on average one-fifth needs to be rolled over every year. Given that the debt structure is usually front-loaded, the typical short-term rollover requirement is probably even greater than that. So if a typical government's debt level approaches

3 Olivier Blanchard, Paolo Mauro, and Julien Acalin, “The case for growth-indexed bonds in advanced economies today”, Peterson Institute for International Economics Policy Brief 2-2016, <https://piie.com/publications/policy-briefs/case-growth-indexed-bonds-advanced-economies-today>.

(let alone exceeds) 100 per cent of annual GDP, it may be looking at refinancing the equivalent of one-fifth of its economy every year. It's immediately clear that in low-inflation environments this dwarfs interest costs as well as all but the most exceptional budget deficits.

This also means that as long as big refinancing humps could be avoided, so can the choice between bailout and restructuring, even when a government is debt-financed. For concreteness, consider a country that has 100 different bond issues outstanding, with maturities falling evenly on every year over the next century. If the total principal is 100% of annual GDP, then even in a refinancing crisis, the debtor government would only need to find an additional 1% of GDP in any one year to pay the maturing bond from its own resources instead of rolling it over. Since that is eminently possible at only a small economic cost, neither a bailout nor a restructuring would be needed in a refinancing crisis, which would make it unlikely for one to occur in the first place.

C. Money printing

Finally, the dilemma between bail-out and restructuring can be avoided if the debt is denominated in a currency that debtor can issue at will. In sovereign finance, this the case when the government can call on its central bank to print the currency in which the debt obligations are denominated, but it should be noted that the principle is more general. "Payment-in-kind" securities allow private borrowers to pay coupons in new debt securities, which is equivalent to monetary financing for a government.

We shall ignore this way out of the dilemma. One reason for doing so is that our interest is in Europe's monetary union whose members have foresworn this option. Another is that from a strictly economic point of view, it can be seen as equivalent to either an outright restructuring (when inflation erodes the real debt burden) or a tax (money printing redistributes resources from domestic currency holders to the government).

Are “No Bailout” and “No Debt Restructuring” compatible in the euro?

The previous section showed how the dilemma posited in the title question actually has a number of escape routes. Accordingly, this section rephrases the question as asking the degree to which the eurozone has, intentionally or unintentionally, left these escape routes open, or alternatively acted so as to tighten the dilemma.

We can immediately dispose of the money printing option: by entering the euro, member states gave up national control of the base money supply and agreed to a ban on primary-market financing of governments by the European Central Bank. That means eurozone governments can never rely on the central bank in a situation where refinancing cannot be found for maturing debt, which is where the dilemma binds. The best it can hope for is that central bank policies make such situations less likely, for example if secondary market purchases of the bonds of the government encourages private investors to keep refinancing the debt.

There is more to say about the other two escape routes: “no debt” and “no refinancing”.

A. “No debt” in the eurozone

This was, in a limited sense, precisely what the Maastricht Treaty attempted to legislate. Would-be euro members faced a strict entry condition on public deficits and a less strict one on the public debt-to-GDP ratio. The 3% fiscal deficit-to-GDP limit and 60% debt-to-GDP limit also function as “reference” values for what is counted as acceptable fiscal behaviour after entry to the euro, in the monitoring (and now sanctioning) framework that has been steadily tightened since the global financial crisis.

There are many reasons, by now well understood, why this ostensible “no debt” (or at least “low debt”) requirement did not actually help to avoid the bailout-or-restructuring dilemma in the crisis. The least important (but not unimportant) reason is that many countries had very high legacy debt levels from before the euro; and that a number of countries (notoriously France and Germany in 2003-4) exceeded the deficit limit during the euro’s first decade. A much more important reason is that the fiscal rules focused only on explicit government debt, not on govern-

ments’ contingent liabilities, let alone liabilities they might gratuitously volunteer to take off private debtors’ shoulders.

Thus Ireland was passing the Maastricht criteria with flying colours before the crisis, even as its banking system was loading up on debt. When Dublin decided to stand behind its banks, debts worth several times annual GDP migrated onto the government’s balance sheet, which immediately sank under its own weight.

It should be noted that the nationalisation of private debts is itself a result of a parallel dilemma between bailouts and restructuring at the private-sector level. Most of the most crisis-hit eurozone countries, and all those that received official rescue loans, saw their public debt increase in part as a result of having bailed out banks. And the justification for these bank bailouts was that a restructuring of senior bank bonds had to be prevented, even though they generally constituted entirely private transactions between banks and investors. In other words, when eurozone governments faced the dilemma between bailout and bailin in their banking sectors, they usually made choices which forced the dilemma onto the public sector.

B. “No refinancing” in the eurozone

While the eurozone’s attempts to limit public debt were unsuccessful, limits on refinancing requirements were hardly even attempted. There was no general policy before the sovereign debt crisis on making liquidity crisis impossible by evening out redemption dates sufficiently. Even after it became clear that large refinancing requirements could get vulnerable countries in trouble, there has been little in the way of forceful action.

Even in the absence of a general policy, some individual did achieve longer average debt maturities in the decade and a half between the Maastricht Treaty and the global financial crisis. In Italy, Spain and Portugal, average maturities went from about 3 years or less in the mid-1990s to above 6 years in 2007.⁴ It was, of course, not enough; and the progress stopped with the debt crisis. Greece, uniquely, saw a huge extension of its maturities as part of the 2012 sovereign debt restructuring package,

4 Martin Sandbu, “The Virtue of Flexibility”, 18 May 2016, <http://on.ft.com/1Tnv08t>. Data from the OECD central government debt database, available on <https://stats.oecd.org/index.aspx?queryid=8089>.

which took average maturities from 7 to 16 years.⁵

And it does seem like the benign financial environment that finally was put in place by the European Central Bank's large-scale asset purchase programme, announced in January 2015, has provided a window of opportunity for governments to unilaterally “reprofile” their debts by issuing longer-dated bonds to replace shorter-maturity ones: so far in 2016, Ireland has issued a 100-year bond and Spain several 50-year ones. It is too soon to say, however, whether this opportunity will be used vigorously enough to make a difference.

Where should the eurozone go from here?

The overall conclusion from the argument up to this point is that the eurozone can in principle do a lot but has in practice done vanishingly little to avoid the dilemma between sovereign bailouts and sovereign debt restructuring. That conclusion, however, should be seen as optimistic in the sense that it points straightforwardly to how the eurozone countries can do better. Those recommendations fall naturally into three categories.

Keep up the good work. In three areas, current policy efforts go in the right direction. They are: the tentative debt management efforts mentioned above; the new rules on banking which require investors to be bailed in before governments bail banks out; and the work to promote a “capital markets union” in the EU. The first of these help to cut average annual refinancing needs. The latter two help to keep public balance sheets safe from bad private debts - the former by writing down private debts directly, the latter by encouraging alternatives to debt funding for private businesses. All of these are positive and should be pushed further.

Sweep the legacy away. Even in the best case scenario, the aforementioned reforms will not do much more than chip away at the existing large overhang of public debts, close to or above 100 per cent of GDP in many eurozone countries. As the benign financing environment may not last forever, it would be good to deal with the debt overhang while the times are good. Since the taboo on sovereign debt restructuring was broken by the Greek bond swap in 2012, after which the world did not end but Athens actually returned to markets for a while within two years, a lot of good research has gone into how to make a broader sovereign debt swap work. Two recent plans by prominent economists propose con-

5 European Central Bank data, available on http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=121.GST.A.GR.N.B0X13.MAV.B1300.SA.Y, accessed 18 May 2016.

verting existing sovereign bonds into perpetual zero-coupon debt, with the loss covered by the future revenue stream of ECB seigniorage revenue which would otherwise have accrued to national government budgets.⁶ I would go further and explore negotiating a simultaneous large-scale restructuring plan with private holders of the bonds of the most indebted eurozone countries, backed by retroactive insertion of collective action clauses where necessary and feasible. Given that a more sustainable debt profile is also less risky, there should be an opportunity to negotiate something that a majority of creditors would agree to, especially in the current environment where yield is hard to come by.

Be more radical in the future. Finally, there should be a willingness to explore much more exotic instruments for sovereign finance in the future. Even the least radical option, GDP-linked bonds, would be a big break with tradition. But from a financial perspective, there is nothing particularly mysterious about them. And the economic attraction is that they would make debt behave a little more like equity - in a word, they avoid the dilemma in the title question. There is solid research showing bonds that suspend payments when growth is bad may be treated as less risky and therefore command higher prices among investors.⁷ Other possibilities are perpetual bonds (a return to tradition rather than a break with it) or collateralised bonds that permit settling by handing over the collateral rather than in cash in a sort of built-in debt-for-equity swap.⁸

There are two slightly contradictory points to finish on. One is that there are many ways to "equitise" sovereign finance in the eurozone, and so one should let a thousand flowers bloom as states experiment with different types of new sovereign securities. The other is that the success of a financial security depends on critical mass: the deeper and more liquid the market for it is, the greater the attraction to investors and therefore the more attractive the pricing for the sovereign issuer. This is an argu-

6 See Pierre Páris and Charles Wyplosz, "The PADRE plan: Politically Acceptable Debt Restructuring in the Eurozone", 28 January 2014, <http://voxeu.org/article/padre-plan-politically-acceptable-debt-restructuring-eurozone> and Giancarlo Corsetti, Lars P Feld, Philip R. Lane, Lucrezia Reichlin, Hélène Rey, Dimitri Vayanos, and Beatrice Weder di Mauro, "A New Start for the Eurozone: Dealing with Debt", 15 April 2015, <http://voxeu.org/content/new-start-eurozone-dealing-debt>.

7 David Barr, Oliver Bush and Alex Pienkowski, "GDP-linked bonds and sovereign default", Bank of England Working Paper No. 484, January 2014, <http://www.bankofengland.co.uk/research/Documents/workingpapers/2014/wp484.pdf>.

8 Olivier Garnier (2014). "Eurozone: Promoting Risk-Sharing Through Cross-Border Ownership of Equity Capital", *Applied Economics Quarterly* Vol. 60, No. 2, pp. 107-113, doi: 10.3790/aeq.60.2.107.

ment for a large, concerted effort at introducing new types of sovereign finance for many eurozone issuers at once and en masse - which could best be achieved if it were part of a large-scale, multi-country restructuring operation to get rid of the large existing debt overhang.

So if there is a case for letting a thousand flowers bloom, there is a parallel case for managing the blooming - a case, to paraphrase Voltaire, for the eurozone countries to collaboratively cultivate their gardens.

CREDITOR PARTICIPATION CLAUSES: MAKING NO BAIL-OUT CREDIBLE IN THE EURO AREA

Jochen Andritzky, Lars P. Feld, Christoph M. Schmidt,
Isabel Schnabel, and Volker Wieland¹

Europe is still in a fragile situation. Threats are coming from many sides. The macroeconomic environment has weakened: The world economy has been slowing down, especially due to lower growth in China and other emerging economies. Consumer price inflation has remained low in spite of an ultra-loose monetary policy in the euro area and elsewhere, mainly due to the massive decline in oil prices. The political situation has become less stable, with nationalist parties gaining ground in many countries, an increasing polarisation of the population, and the political balance shifting towards parties opposing reforms and consolidation. Epitomising these hazards, the danger of Brexit is looming.

Moreover, public debt levels are very high by historical standards, and the threat of a return of the euro area crisis is not banned. Greece, which is back in the headlines, may be a special case, but rising spreads in other countries like Portugal demonstrate that the problem is not confined to Greece. Finally, while the issue of refugee migration has dropped out of media attention, the current solution may not prove durable. Given these fragilities, the question of how to move forward in Europe is of great importance: Should we strive for more integration, or rather strengthen the existing framework?

¹ Feld, Schmidt, Schnabel, and Wieland are members of the German Council of Economic Experts, and Andritzky is its Secretary General. The Council is politically independent and stipulated by law to support all decision-makers in the economic and political sphere as well as the general public in Germany in forming their views about economic policy and its potential risks. To this end, every November it presents an annual report to the German federal government and the general public.

National sovereignty and no bail-out as the only viable option

We start from the presumption that any consistent framework for the euro area has to satisfy the fundamental principle of the unity of liability and control, implying that those who take the decisions are also responsible for bearing the resulting costs. This leaves only two fundamental options: transferring fiscal and economic sovereignty to European level, and allowing for the assumption of joint liability, or retaining sovereignty at national level, while excluding joint liability for government debt.

The first option would necessitate a central decision-making authority at European level, which would have the power to enforce tax increases, spending cuts, and even structural reforms. Given the resistance of many countries to give up sovereignty even in areas where it is generally accepted that the subsidiarity principle would call for European action, it seems highly unlikely that this option will garner support in the near future. This implies that only the second option is feasible. The main challenge is how the principle of no joint liability – the *no bail-out clause* enshrined in the European treaties – can be rendered credible.

Lack of credibility of the no bail-out clause

Regardless of high debt levels, sovereign bond spreads in the euro area remain low, displaying the lack of credibility of the no bail-out clause quite plainly. With the inception of the euro, spreads among sovereign bonds shrank to almost zero, in spite of large differences in countries' fundamentals. Hence, market discipline was mooted, reducing incentives for consolidation and structural reforms. The financial crisis, but even more the euro area crisis, served as a wake-up call, reminding investors that not all euro area countries were equally risky. In the middle of 2012, the crisis threatened to become self-fulfilling, and it was only stopped by the intervention of the European Central Bank, which reduced spreads almost immediately – though not to pre-crisis levels.

There are generally two ways to ensure that there is no bail-out. One is fiscal rules, which reduce the chances that countries may run into a debt crisis in the first place. There are plenty of rules in the euro area, such as the Stability and Growth Pact, and these have been strengthened substantially in recent years. However, there is a lack of enforcement, so that a build-up of high public debt levels has not been avoided. Neither were the rules able to ensure a reduction of debt levels in recent years, although

admittedly the situation may have been even worse in the absence of such rules.

If a debt crisis has already materialized, the only option to avoid a bail-out is sovereign default. However, due to fear of contagion and the lack of a functioning crisis mechanism containing such contagion, a restructuring of sovereign debt was largely prevented in the crisis, except for the case of Greece and (to a much smaller extent) of Cyprus. In fact, the official language has been that sovereign default should generally be precluded. This was underscored by the treatment of sovereign exposures in financial regulation – they were and still are treated as risk-free.

Rendering the no bail-out clause credible is necessary to make the euro area architecture sustainable. As public debt remains high, shocks could trigger further debt crises. The ESM established in 2012 can provide financial assistance in liquidity crises and helps to contain contagion. But the ESM is not allowed to extend loans to a country whose debt is unsustainable, since this would mean putting itself at risk. Yet, liquidity and solvency crises are inherently difficult to distinguish, particularly at the outset of a crisis.

Furthermore, when debt levels are high, a large portion of financial assistance has to be spent on repaying private creditors. Given limits to the ESM's lending capacity, this reduces its firepower and its credibility as insurance mechanism against crises, at least for larger member countries. It is therefore desirable to involve creditors in crisis resolution, thereby also spreading the burden of adjustment more broadly. To this end, ESM lending needs to be enhanced by a mechanism to facilitate creditor participation in crises.

A proposal to enhance the ESM through Creditor Participation Clauses

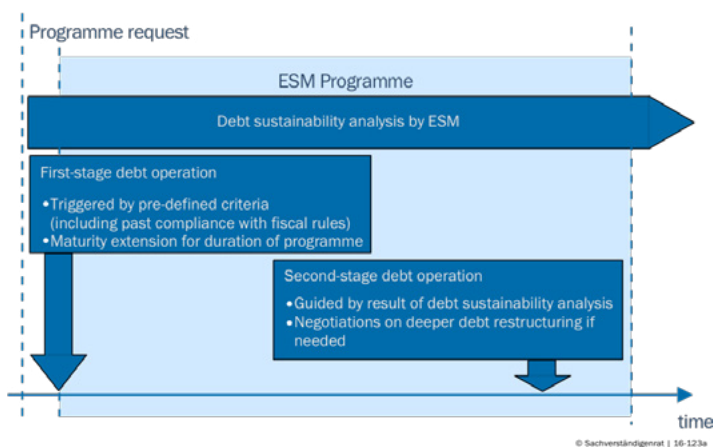
We propose a mechanism to involve creditors in ESM financial assistance programmes by employing *Creditor Participation Clauses (CPCs)*. The mechanism provides for an orderly and rule-based restructuring of sovereign debt if debt is unsustainable, ensuring equitable burden sharing and avoiding a shift of debt to the official sector. By stabilising investors' expectations already ex ante, this reduces uncertainty and thereby contributes to financial stability. This is important as the mechanism must not become destabilising itself, which would make its application incredible.

Moreover, from an ex-post perspective, ad-hoc creditor participation as in the case of Greece can be avoided, thereby reducing the potential costs of restructuring. By forcing creditors to contribute to crisis resolution, the required financing envelope provided by the ESM is reduced. In turn, this could allow the ESM to provide financial assistance programmes with longer duration, such as 5 years or even longer, and free up resources to allow for a more gradual fiscal adjustment and to compensate for potential costs of structural reforms.

The German Council of Economic Experts first proposed such a mechanism in 2015 (GCEE, 2015), which is described in more detail in Andritzky et al. (2016a). The proposal combines several aspects found in previous proposals (see Andritzky et al., 2016a, or Zettelmeyer, 2016, for an overview) and adds some additional features. Its overall design is similar to the IMF's new lending framework.

The proposal is based on the following principles: First, the mechanism can only be applied as part of an ESM programme and is triggered by the programme request. This ensures that countries do not trigger the mechanism intentionally to get rid of excessive debt, as the ESM programme ought to come with strict macroeconomic conditionality. Second, it stipulates a two-stage procedure re-establishing liquidity first before tackling a potential solvency problem. This takes account of the fact that, at the onset of a crisis, it is difficult to distinguish between liquidity and solvency crises. The two-stage procedure is illustrated in Figure 1.

Figure 1: Timeline of the proposed mechanism.



While both stages comprise an assessment of debt sustainability, the first stage is to be based on hard, pre-defined criteria (including past compliance with fiscal rules), whereas the second stage requires a deep debt sustainability analysis. If debt exceeds the triggers in the first stage, the disbursement of ESM funds becomes conditional on the agreement on a maturity extension for the duration of the ESM programme. If debt is found to be unsustainable in the second stage, negotiations are taken up about a deeper debt restructuring, including the possibility of haircuts, towards the end of the programme or prior to market re-entry.

If investors correctly anticipate the consequences of fiscal profligacy and price the risk of restructuring accordingly, market discipline – and hence fiscal discipline – is re-established. Important challenges concern the avoidance of holdouts and litigation, and of an intentional activation or circumvention of the mechanism, as well as the transition to the new regime.

Transition to the new regime

The transition to the new regime requires dealing with countries' legacy debt. The German Council proposes to phase in the mechanism slowly, for instance by only counting newly issued debt or debt issued to fund current deficits towards the thresholds used in the first stage. This new debt should feature enhanced collective action clauses (CACs) with single-limb voting and hence stronger aggregation than the previously introduced euro-CACs, in order to mitigate holdout problems. In addition, the threat of litigation may be reduced by an enforcement moratorium anchored in the ESM Treaty, as proposed by Buchheit et al. (2013).

Existing bonds will gradually be replaced by the new bonds falling under the new regime. Nevertheless, old debt has to remain restructurable to avoid shifting the burden to new creditors only. Depending on the need to roll over debt and the level of debt to begin with, it takes some time until the first-stage criteria get bite. For a country like Germany, where public debt levels are projected to fall below 60 percent, this may not happen at all in the foreseeable future (see Andritzky et al, 2016a, for detailed simulations).

Possible Objections

Two major objections against the introduction of such a mechanism are its presumed effects on the cost of sovereign debt and the issue of burden sharing. In light of the existing empirical literature, the effect of the new CACs on the cost of sovereign debt is uncertain. There is little evidence that the cost of sovereign debt increases (see the overview by Trebesch, 2015). Analysing the effects of the new euro-CACs, Carletti et al. (2016) show that the affected bonds even trade at lower yields. The overall cost of sovereign debt has not increased. Interestingly, the quality of the legal system seems to matter: the decrease in yields is higher, the better the legal system. This speaks in favour of pushing for reforms of insolvency regimes, which stands high on the agenda also in the context of the European Capital Markets Union and the treatment of non-performing loans.

While the empirical findings on the cost of sovereign debt may mitigate some of the concerns of the opponents of introducing creditor participation, another major concern is the strong home bias in the holdings of government debt. Therefore, the political economy is very different from typical debt restructurings in emerging markets where a large share of the debt holders is foreign. In the euro area, the burden sharing largely has to take place domestically.

Most problematic is the large share of government debt holdings by domestic banks. This could make a debt restructuring difficult as a haircut on government debt could threaten the stability of the banking sector, which would make restructuring unattractive. Part of this home bias may actually originate from bailout expectations and may disappear once market discipline is re-established. Crucially, the introduction of CPCs has to be accompanied by a removal of regulatory privileges for sovereign exposures. As argued elsewhere (GCEE, 2015; Andritzky et al., 2016b), the critical issue is the introduction of large-exposure limits to ensure sufficient diversification. Then a restructuring of the debt of a particular country would be less likely to constitute a threat to banking sector stability.

Conclusion

To conclude, the need for a credible mechanism to involve private creditors in the resolution of public debt crises has become ever more urgent in light of rising debt levels and the threat of a return of the crisis in the euro area. A mechanism like the proposed CPCs that enhances the ESM's firepower and protects the funds provided by euro area taxpayers is necessary to make the no bail-out clause credible. Furthermore, such a mechanism would help to re-establish market discipline, set incentives to reduce excessive debt burdens, and thereby help preventing future debt crises. The design of the transition is crucial in order to deal with legacy debt problems. The home bias in government debt holdings and the sovereign-bank nexus make restructuring politically challenging. This makes it even more important to introduce such a mechanism, which would mitigate both problems and make it less likely that a debt restructuring becomes necessary at all.

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PART II

Incomplete Contracts?
Filling the Governance Gap
in the European Union

THE UK REFERENDUM AND GOVERNANCE OF FINANCIAL SERVICES

Angus Armstrong¹

This paper looks at some governance issues that arise in financial services related to the UK's referendum on EU membership. If the UK chooses to leave the EU this would be brought into effect through Article 50 of the EU Treaty and then repeal of the UK's European Communities Act (1972). This would end the supremacy of EU law in the UK and the UK would no longer be bound by EU regulations or have the right participate in its institutions.² This legal step would have important governance consequences, including for financial services.

1. UK financial services

The UK, and the City of London in particular, has been a leading financial centre for around two centuries. Today financial services contribute 8% to national output, and according to a trade body, when support services are included this may be as high as 12%.³ They add twice to the balance of payments: first, to the current account as the largest net exporter of financial services in the world; and, second, to the financial account

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2 Section 2(1) of the European Communities Act (1972) states “all such rights, powers, liabilities, obligations and restrictions from time to time created or arising under the Treaties, and all such remedies and procedures from time to time provided for by or under the Treaties, as in accordance with the Treaties are without further enactment to be given legal effect or used in the United Kingdom shall be recognised and available in law, and be enforced, allowed and followed accordingly.”

3 The CityUK, 2016, A practitioner's guide to Brexit.

attracting the largest share of the UK's inward foreign direct investment (FDI). Financial services also contributed 12% to income tax and 15% to corporation tax receipts in 2012-13.⁴

The creation of the European Single Market in financial services began in earnest with the Financial Services Action Plan (1998). This enshrined the dual principles of a single market - a single set of rules and mutual recognition for products and services. This allows regulated firms in any Member State to establish a presence anywhere, or sell services to anyone, in the rest of the EU without requiring any further regulatory permission. This is known as 'passporting' which is synonymous with the Single Market.

Passporting is extremely beneficial to the UK. Together with a supportive political environment for finance, and a relatively coherent regulatory structure, many financial firms from outside the EU, in particular the US and Switzerland, have chosen to locate their EU headquarters in the UK. If they are registered and regulated by the UK authorities, then they have full access to the markets of the rest of the EU. Similarly, financial firms from the rest of the EU are free to establish in the UK and benefit from the agglomeration of financial firms and supportive political and financial environment.

(a) Size and diversity⁵

An important contextual point for understanding the governance of UK finance is that the sector is large and has a substantial domestic banking system. Table 1 shows the size of each activity on a residency basis (i.e. within the UK border) relative to national output.⁶ Banking is roughly split between domestic and foreign owned institutions. On a national basis, UK banking sector assets including overseas operations are approximately 450% of GDP. This is an important distinction between the UK and Luxembourg, a Eurozone country, which has a large but almost entirely foreign owned banking systems. Given the diversity of financial services, not all activities will be equally affected by EU membership.

4 Data from HM Government. Note, the contribution to corporation tax was above 25% before the crisis.

5 This section draws on Armstrong (2016).

6 See Armstrong (2016) for more details on the structure of the UK financial system. These measures exclude interbank assets and liabilities and derivatives and so avoids double counting.

Table 1: UK financial sector by residency (2014)⁷

	£bn	% of GDP
UK banks	3,631	200%
Foreign banks	3,374	186%
Finance cos & SPVs	480	26%
Pension funds	1,430	79%
Insurance	1,830	101%
Unit, investment trusts & ETFs	880	48%
Hedge funds & private equity	760	42%
	12,385	682%

Source: Table B1 Bank Stats and Burrows and Low (2015)

Perhaps the defining feature of the UK's financial sector is the large presence of overseas firms. According to the Bank of England, around half of the world's largest financial firms, commercial and investment banks, insurers, asset managers and hedge funds have their EU headquarters in the UK.⁸ This is in large part due to passporting.⁹ UK based firms also have almost full access to the Eurozone's financial infrastructure, despite being outside of the single currency area. In particular, the payments system can be accessed by all firms in the European Economic Area (EEA), although on a slightly differentiated basis (see below).

As an international financial centre, the UK financial system is a multi-currency area. Figure 2 shows that less than half of UK banking sector assets are denominated in Sterling. This is important when considering access to infrastructure and who supplies which currency in an emergency. The presence of international firms also has implications for FDI. When an overseas firm establishes a presence in the UK this gener-

7 Adapted from Burrows and Low, 2015, Mapping the UK financial system, Bank of England Quarterly Bulletin. Note that balance sheets show stocks and GDP is a flow. However, this is conventional use of the data.

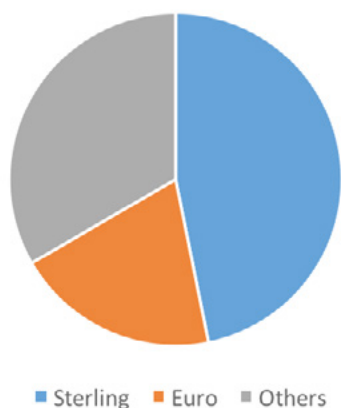
8 Bank of England, 2015, EU Membership and the Bank of England. In 2014 there were 348 banking companies in the UK; 248 are incorporated overseas of which 170 are from outside of the European Economic Area (EEA).

9 The City has the largest share of EU investment banking, wholesale finance, insurance, asset management and hedge funds (various sources).

ates inward direct investment. If it then sets up branches in the rest of the EU, this creates outward direct investment. The UK is the second largest hub for FDI in the world and by far the largest centre in the EU. Of the £937bn stock of FDI in 2012, 43% is from the EU and 40% of the total is related to financial services.¹⁰

Figure 2: Currency denomination of banking assets (2015)

UK Banking sector assets: currency denomination



Source: Bank Stats Table B1

(b) Financial governance

The UK has a relatively coherent governance structure for the financial sector.¹¹ Given that domestic banks are ultimately a contingent fiscal liability on UK taxpayers, bank supervision and regulation is delegated to the Bank of England which reports to parliament.¹² This ensures that ‘he who pays the piper, calls the tune’.¹³ Good governance also requires that supervision and lender of last resort operations are also within the same

10 OECD.stat FDI series <https://stats.oecd.org>

11 This is not to say that there is a coherent governance in individual financial institutions.

12 According to the National Audit Office (2010), UK tax payers were exposed to £955bn of potential losses in the crisis. The potential exposure extends to insurance as US firm AIG was bailed-out by US taxpayers.

13 This old Scottish adage was first applied to finance by Goodhart and Schoenmaker. See Schoenmaker (2013).

institution. This is an important reason why the UK has its own currency as long as it intends to remain a global financial centre.

However, finance is a global industry which requires international regulation. This creates a well-known tension in governance between international regulation and the policy domain of the nation state. A working solution for the UK is that international regulation is guided by G20, the Financial Stability Board (FSB) and Global Standard Setting Bodies (GSSBs) and that the UK is influential at these fora. The EC implements the global standards set by these fora as EU regulations. Since the financial crisis the EC has increasingly sought maximum harmonisation of regulations across the EU. Some regulations are seen as unnecessarily intrusive.¹⁴

An important governance gap exists between Eurozone and other EU Member States. Eurozone countries have a qualified majority at the Council of Ministers so they can, in theory, caucus or operate as a single bloc to pass legislation in their own interests. The EU Heads of State Agreement in February goes some way to address this issue. First, it reinforces the principle of non-discrimination on the basis of currency. Second, the UK is permitted to attend the influential Eurogroup and raise matters of real concern to the Council. However, there is, in short, no good answer to the threat of caucusing by Eurozone nations.¹⁵

(c) Options after Brexit

Three legal frameworks for the UK outside of the EU are routinely discussed. The simplest is for the UK to join the EEA, the 'Norway' option. This would allow UK firms full access to the Single Market and the Eurozone's financial infrastructure. However, this would be unsatisfactory for such a large country and the UK would have much less influence on EU financial regulation. The Leave campaign has rightly excluded this as a viable solution.

At the other end of the spectrum, the UK could revert back to its membership of the World Trade Organisation (WTO). Some financial services are included under the WTO, but there is no comprehensive

14 For example, the EU's bonus cap for smaller companies and the Alternative Investment Fund Managers Directive (AIFMD) is thought to be unnecessarily burdensome on hedge funds.

15 Some suggest that the UK should have a veto over financial services regulation, similar to France having a veto over changes to the Common Agricultural Policy. However, finance is intrinsic to all transactions.

coverage. The UK would no longer be obliged to follow EU regulation and there would be no assumption of passporting rights or access to the financial infrastructure. The process of review of any breach of trading obligations is cumbersome. A firm would have to lobby the government to take its case to the WTO, which can take years.

The third option is for the UK to re-join the European Free Trade Area (EFTA) and negotiate a bi-lateral agreement with the EU for financial services, the so-called 'Swiss' option. Again there is no presumption of passporting or access to the Eurozone's financial infrastructure. The dispute settlement process would be the the EFTA Court, which is a simpler and a more effective process for judgements relating to the rules of the Single Market than WTO.

A key issue is whether the UK gains greater or less regulatory control outside the EU. If the UK is to have access to the single market for financial services its regulations must be deemed 'equivalent' to the EU. This judgement is in the gift of the EU Council as EU laws will always be sovereign in the EU.¹⁶ Second, in reality there is limited scope in practice for discretion for an international financial centre. Schoenmaker (2013) shows that if institutions operate across borders, regulatory discretion at the national level is inconsistent with financial stability.¹⁷ Third, outside of the EU the UK would have only consultative input into EU regulations but would have to abide by the outcomes.

2. EU financial infrastructure and the UK

An important reason why the UK can dominate Euro financial services, is that all EU and EEA countries have almost full access to the Eurozone financial infrastructure. This is unusual as access to financial infrastructure is usually limited by the boundary of the legal tender issued by the central bank. The Eurozone is unusual as there is not an alignment between the infrastructure and currency area. The issue is whether the UK would continue to have access to the Eurozone financial infrastructure if outside the EU.

(a) Payments system

All central banks, commercial banks and designated financial institutions

¹⁶ At present 'equivalence' is granted on the basis of the package of regulations. There has been discussion that this become 'line by line' equivalence.

¹⁷ See Schoenmaker (2013) above.

in the EU and EEA are invited to join the Eurozone payment system, whether or not they are in the Eurozone. Institutions are permitted to be direct members of the system. However, to protect Eurozone counterparties the non-Eurozone institutions have restrictions on counterparty exposures and have no access to overnight credit (including lender of last resort).

Given the scale of Euro transactions in the UK, access to the payments system is essential. Where there are substantial Euro imbalances, UK banks already often use the central bank of a Eurozone country. For example, Lloyds Bank London is reported to hold its Euro reserves account with the Dutch Central Bank. Access to central bank finance, such as lender of last resort, would be provided against collateral delivered by the Lloyds Bank local office.

If the UK were to leave the EU (and not join the EEA) then banks in the UK could no longer be direct members of the payments system. The key issue is again whether the UK is recognised as being regulatory 'equivalent'. If so, then firms in the UK could continue to use branches within the EEA (or more effectively, within the EU). If the UK were not treated as 'equivalent', they would have to operate through subsidiaries in the Eurozone. This would make Euro banking via the UK more expensive and erode the attraction of the UK as a conduit for non-EU institutions.

(b) Regulatory Collateral

Leaving the EEA may mean that certain UK assets are no longer eligible as collateral for ECB for liquidity. At present assets denominated in Euro, such as corporate debt, covered bonds and ABS tranches (and possibly non-marketable debts) issued within the EEA and of the appropriate credit standard are eligible as collateral. If the UK is outside of the EEA, in the short term the ECB can simply amend its collateral requirements, but longer term this comes back to regulatory equivalence issue. There may also be consequences for the regulatory treatment of securitisations. UK securitisations may no longer be eligible for inclusion in the Liquidity Coverage Ratio as the underlying assets would be outside the EU.

(c) Central counterparties

Another important part of the financial infrastructure is central counterparties (CCPs). In response to the global financial crisis, G20 committed to standardizing derivatives and moving trading from opaque over-the-

counter bi-lateral transactions on to CCPs. The idea is that this creates greater transparency, security and enhances risk management. CCPs are especially important to the City which is the global centre of derivatives and securities trading. These activities complement international banking and insurance activities.

Analogous to the payments system discussion, the issue is where CCPs should be located when dealing with large volumes of Euro denominated contracts. CCPs are recognised as a source of systemic risk. According to the ECB, they should be located within the Eurozone to be within the legal jurisdiction of the central bank responsible for supplying the currency in question. The UK sought a judicial review by the European Court of Justice (ECJ) which annulled the policy on the basis that the Treaties grant the ECB competence for payments but not settlements.

The next twist is of particular importance for the referendum debate. The Bank of England and ECB agreed to joint oversight of CCPs and reciprocal currency swaps to facilitate multi-currency liquidity support. This extends the existing swap agreements between the Federal Reserve and five major central banks. Note that this is not a pre-commitment and there is no indication of amount.¹⁸ However, Prime Minister Cameron re-affirmed the continuation of this liquidity support by negotiating a 'no discrimination' clause on the basis of currency in the Heads of State Agreement in February 2016.

If the UK leaves the EU it would no longer be a shareholder of the ECB, it would not have access to the ECJ for judicial review of Treaty interpretations and the 'no discrimination' clause would not come into force. It is difficult to see why the ECB would be interested in renewing an arrangement that it had not wanted in the first place. The Fed has swap lines with other nations, but they do not have anything like one-third of wholesale markets offshore. This volume of Euro transactions could complicate reserves management and obstruct monetary policy.

(d) Resolution procedures

Large international financial systems bring risks as well as rewards. When cross border institutions fail, the actions of one government spill-over to other governments. Agreements between governments to cooperate have a poor track record as they end up acting in the interests of their own tax-

¹⁸ Pre-commitment would violate sovereign control of a central bank.

payers.¹⁹ Ideally, the answer is to remove any dependence on taxpayers. Both the UK and EU have introduced resolution procedures where the idea is that equity and subordinated debt holders absorb the losses – or are ‘bailed-in’ – to at least minimise the cost on taxpayers. The hope is that ‘bail-in’ is less contagious than ‘bail-out’.

In the European Banking Union (EBU) the resolution procedure is overseen by the Single Resolution Mechanism. The advantage is that decisions are to be taken with regard to all members and not along national lines. In theory, this reduces the coordination problem.

Resolution of an institutions operating across the UK and the EBU requires cooperation between the ECB and Bank of England. Deutsche Bank is an example of a systemically important institution in the London and Frankfurt. If the UK remains a member of the EU, a collegiate relationship is more likely. The UK would also have the right of a judicial review by the ECJ against any perceived discrimination. If the UK is outside the EU this may reduce the prospect of cooperative behaviour. Given the size of the UK financial system, this may be a significant safeguard.

3. Brexit and possible implications

This paper has focussed on the governance of UK financial services and the possible consequences of Brexit. As the Eurozone has amply demonstrated, where there are governance inconsistencies this leads to risk shifting and the movement of capital beyond borders and multiple equilibria can occur.

The UK faces a trade-off which is crystallised in the EU referendum. If the UK stays in the EU it is exposed to the risk of caucusing by Eurozone member states. As Eurozone nations move towards ‘ever greater union’ this increases the likelihood that their interests coincide. The non-discrimination on the basis of currency included in the Heads of State Agreement in February is the only defence against this possibility. In reality, there is no answer to this question as the UK holding a veto on such an important issue is impossible.

If the UK leaves the EU this would raise challenges for the financial services industry. In the near term, the UK would look to be treated as a

19 For example, the when Lehman Brothers failed the cash reserves were taken out of its London subsidiary over the weekend, Fortis bank was finally resolved along national boundaries and the UK government famously used anti-terrorist legislation to prevent the Icelandic government removing resources out of UK bank offices.

regulatory ‘equivalent’ country to maintain access to the Single Market. This means that the UK would transpose and adopt EU regulation with no meaningful gain in regulatory sovereignty but continue to have access to the Single Market. The EU is likely to grant equivalence and permit full ‘passporting’ and UK bank branches in the Eurozone could still be used for large Euro denominated transactions.

However, the interesting question is whether this is viewed by private investors and institutions as a stable equilibrium over the medium term. The UK would have only a consultative role in setting EU financial policy. The EU has already introduced regulations which the UK has opposed. Without the influence of the UK there is a risk that this happens more often. If the UK were at risk of being no longer considered ‘equivalent’, this would diminish the UK as a location for EU headquarters. There would be a regulatory ‘Sword of Damocles’ hanging over UK financial services.²⁰

If the UK leaves the EU, the CCPs with a large share of Euro business are likely to migrate to the Eurozone. Even if the ECB were to agree to keeping the current swap arrangement, this would have no basis in international law and no legal enforcement mechanism. If the UK is outside the EU it would no longer be a shareholder of the ECB. This would reduce the incentive to find a cooperative solution to resolving a failed cross-border institution.

Finally, some have argued that by leaving the EU this would finally reduce the size of the UK financial system and remove the contingent liability on UK taxpayers. Given that many banks are bigger today than they were before the crisis, it is easy to have some sympathy with this view. However, choosing to leave the EU as a means of achieving a smaller financial sector is rather like going to the end of the earth to find some peace and quiet: there are easier ways of achieving the same outcome.

20 Experienced commentators such as Wolfgang Munchau in the FT (3rd March 2013) suggest that “if the Eurozone has a collective interest in anything, it is to stop the City acting as its main financial centre.”

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REFLECTIONS ON THE INTERPRETATION, SCOPE AND PRACTICAL APPLICATION OF ARTICLE 50 TEU

Phoebus L. Athanassiou¹

Despite having expressly recognized the right of the Member States of the European Union to unilaterally withdraw from the Union, Article 50 of the Treaty on European Union is silent in terms of its possible application to euro area Member States. The silence of ‘the exit clause’ raises questions, over which clarity is desirable, and the same is true of two related issues, germane to, but distinct from, one another: (i) the extent to which Article 50 TEU or the concept of EU citizenship could provide a legal basis for an automatic accession to the EU of newly established, seceding state entities, and (ii) the extent to which the prospect of the loss of EU citizenship, in an EU exit or secession scenario, can provide the foundation for individual claims to its preservation or continuing enjoyment, notwithstanding the acts of exit or secession. We examine, below, the legal parameters of the potential application of Article 50 TEU to euro area Member States, possible alternatives to Article 50 TEU, and the

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relevance of Article 50 TEU and EU citizenship in an EU exit or secession scenario. The conclusions to which we come are as follows: (i) given its unilateral nature, and in light of the legal irreversibility of the transition to the single currency, the exit clause does not provide a sound legal basis for a euro area Member State's exit from EMU; (ii) barring recourse to Article 352 TFEU, which would, however, be far from unproblematic, there is, *de lege lata*, no obvious legal formula through which to accommodate a euro area exit; (iii) neither Article 50 TEU nor the concept of EU citizenship are apt to provide a basis for an automatic or accelerated accession to the EU, for the benefit of a seceding state entity; and (iv) the concept of EU citizenship could, however, serve as the basis for justiciable claims brought by individuals, desirous of preserving its benefits in an EU secession scenario.

1. Member State withdrawal from the EU under Article 50 TEU

One of the less well-known innovations brought about by the Treaty of Lisbon was that of the introduction, through Article 50 TEU, of a right for the Member States to unilaterally withdraw from the EU.² Whilst public international law (PIL) recognizes the existence of a sovereign right to withdraw from consensual commitments,³ including *unilaterally*,⁴ it was at best questionable, pre-Lisbon, whether EU Member States could have availed themselves of a right to withdraw from the EU, espe-

2 There is no historic precedent of a member state withdrawal from the EU. However, Greenland, at the relevant time a part of Denmark, agreed on its withdrawal from what was then the European Economic Communities (see F. Harhoff, 'Greenland's Withdrawal from the European Communities', 20 *Common Market Law Review* 20 (1983), p. 13).

3 Under PIL, a right of withdrawal may exist *either because the parties to a treaty mutually agree that withdrawal is permissible, whether at the time of the treaty's drafting or ex post* (see Art. 54 of the 1969 Vienna Convention on the Law of Treaties, *UN Treaty Series*, vol. 1155, 331) *or because it is possible to read a right of withdrawal into a treaty, whether by interpreting the parties' intentions or because such a right would be consistent with the nature of the treaty itself* (*ibid*, Art. 56).

4 Under PIL, unilateral withdrawal is possible under the *rebus sic standibus* ('fundamental change of circumstances') clause of Art. 62 of the 1969 Vienna Convention on the Law of Treaties. On the relevance of Art. 62 in the EU context, see J. Hill, 'The EEC: the right of member state withdrawal' (1982) 12 *Georgia Journal of International and Comparative Law* p. 335; S. Berglund, 'Prison or voluntary cooperation? The possibility of withdrawal from the EU' (2006) 29 *Scandinavian Political Studies* p. 147; and Athanassiou (op. cit., asterisked fn.) pp. 12-18.

cially if purporting to do so *unilaterally*,⁵ given the perpetual nature of the Treaties,⁶ and the judicially declared irrevocability of the transfer of sovereignty from the Member States to the EU.⁷ Post-Lisbon, the right of the EU Member States to withdraw from the Union has been formally recognized, and it could, therefore, be exercised in the future.⁸

As formulated, the exit clause raises a number of pertinent legal issues, *inter alia* with regard to its subject matter and scope *rationae personae*.

Despite referring to “*an agreement [emphasis is ours] setting out the arrangements for [a Member State’s] withdrawal*”, the exit clause establishes an unlimited right of unilateral withdrawal of a Member State from the EU, even where no exit agreement has been achieved between the withdrawing Member State and its EU partners, within the two year negotiation period stipulated in Article 50 TEU.⁹ A Member State’s right to withdraw from the EU by virtue of Article 50 TEU is not, in other words, a function of the outcome of the negotiations referred to in its paragraph 2, between that Member State and the Council, nor is its exercise subject to any express contractual limitations.¹⁰ The EU legislator’s rec-

5 The possibility of unilateral denunciation of EU membership has been envisaged by national courts in several jurisdictions, including the UK (*McCarthy’s Ltd v Smith* [1979] 3 All ER 325), France (*Administration des Douanes v Société Cafés Jacque Vabre & J Weigel et Cie SARL* [1975] 2 CMLR p. 336) and Germany (*Maastricht Urteil* (BVerfGE 89, 155 vom 12. Oktober 1993); *Lisbon Urteil* (BVerfG, 2 BvE 2/08 vom 30.6.2009)). The negotiated departure of Greenland would appear to confirm that *unilateral* withdrawal was, at least originally, neither intended nor implied under the Treaties (see F. Harhoff (op. cit., fn. 1), pp. 28-31). It has been argued that, ‘it was the very fact that Greenland remained a part of Denmark that made it necessary that its withdrawal from the EC be a negotiated one’ (M. Happold, ‘Independence: in or out of Europe? An independent Scotland and the EU’ (2000) 49 *International and Comparative Law Quarterly*, p. 15, at p. 32), meaning that Denmark could have *unilaterally* denounced Greenland’s participation in the Communities if no consent had been reached for its departure.

6 See Art. 53 TEU.

7 See Section 2, *infra*.

8 At the time of writing, Great Britain was preparing for a simple ‘in/out’ referendum, scheduled for June 2016, to determine the future of the UK in the European Union.

9 Paragraph 3 of Article 50 TEU is relevant here. It follows from that provision that the expiry of the time limit of two years since the application by a member state of its withdrawal request is sufficient to automatically cut the bond that connected it with its partners. See, *inter alia*, J. Herbst, ‘Observations on the Right to Withdraw from the European Union: Who are the “Masters of the Treaties”?’; 6 *German Law Journal* (2005), p. 1756; R. Smits, ‘The European Constitution and EMU: An appraisal’, 42 *Common Market Law Review* (2005), pp. 464-465; and J. Zeh, ‘Recht auf Austritt’, 2 *Zeitschrift für Europarechtliche Studien* (2004), p. 201.

10 See paragraph 1 of Article 50 TEU and its statement re withdrawal of Member States “in accordance with [their] own constitutional requirements”.

ognition of a *unilateral right* of withdrawal from the EU sits uncomfortably with the *sui generis* “constitutional” character of the European legal order, as reflected in the case law of the Court of Justice of the European Union (CJEU),¹¹ and it is difficult to reconcile with the regular process for the amendment of the Treaties, as per Article 48 TEU (of which a Member State’s withdrawal would constitute an example *par excellence*).¹² In this author’s view, it is also not covered, not even *per analogiam*, by the *limited* right of unilateral withdrawal of a state from its conventional obligations under the Treaty of Vienna.¹³

Turning to the scope *rationae personae* of the exit clause, Article 50 TEU does not elaborate on the conditions of its possible application to Member States of the euro area, as distinct from non EMU-participating EU Member States, despite the particularities of the participation of the former in the European integration process, and the complexity of their inter-dependencies, on account of the surrender of their sovereignty in matters of monetary policy. Can Article 50 TEU be interpreted as providing a sound legal basis for the exit of euro area and non-participating Member States alike and, if not, are there any alternatives thereto? The legal parameters of the possible application of Article 50 TEU to a Member State of the euro area, and alternative withdrawal paths, are briefly outlined in Sections 2 and 3, below.

A word of caution is apposite, on what Sections 2 and 3, below, will *not* cover. Our analysis, below, is purely legal. Its aim is to explore *de jure* avenues for the withdrawal of a Member State from the euro area. The conclusion to which we come here (namely, that no such avenues appear to exist) is without prejudice to *unilateral* action on the part of a euro area Member State (such as, for instance, the issuance of IOUs), the *de facto* implication of which could be to bring a Member State outside the

11 See inter alia case 26/62 *Van Gend en Loos v Administratie der Belastingen* [1963] ECR 1- case 6/64 *Costa v ENEL* [1964] ECR 585- case 294/83 *Parti Ecologiste ‘Les Verts’ v European Parliament* [1986] ECR 1339, paragraph 23; and F. Mancini, ‘The Making of a Constitution for Europe’, 26 *Common Market Law Review* (1989), p. 595 according to whom, ‘If one were asked to synthesise the direction in which the case law produced in Luxembourg has moved since 1957, one would have to say that it coincides with the making of a constitution for Europe’ (p. 595).

12 *Contra* Zeh, *op.cit.*, (op. cit., fn. 8), p. 209, who comes to the conclusion that the withdrawal clause is lawful as a reflection of the member states’ independence; and Herbst (*op.cit.*, fn. 8), p. 1758-1759, who expresses the opinion that the participation of the Council in the withdrawal process legalises the withdrawal clause.

13 See Articles 56 and 62 of the Treaty of Vienna of 23th May 1969 (UN, Treaty Series, folio 1155, 331).

euro area.¹⁴ However, such unilateral action would surely not amount to a *de jure* EMU-exit path but, merely, to an act, the logical implication of which would, in purely practical terms, be equivalent to a euro area exit. However subtle, this difference is significant in legal terms, and should inform the reader's understanding of the views expressed by this author in the remainder of this study.

2. Application of Article 50 TEU to EMU-participating Member States

Whatever its logic, the silence of the 'exit clause' of Article 50 TEU on its potential application to euro area Member States has attracted criticism, *inter alia* for generating legal (un)certainty.¹⁵ As formulated, the exit clause is open to two interpretations in terms of its application, or otherwise, to EMU-participating Member States. The first is that Member States have, at least indirectly, established a right of unilateral termination of the Treaties *in their totality*, which would also cover Title VIII of the Treaty (on Economic and Monetary Policy). What this would entail is that no special withdrawal process is necessary in the case of euro area Member States. A second, radically opposed, interpretation is that Member States participating in the Third Stage of EMU cannot withdraw from it on the basis of Article 50 TEU unless they were to simultaneously repudiate their EU membership. Which of these two interpretations would be the most plausible?

Starting with the first interpretation, it is worth recalling that, contrary to the accession of a Member State to the EU, its subsequent, non-

14 To take the example of IOUs, the implications of their issuance by a euro area Member State would depend on their particular features, with an emphasis on whether or not a particular IOU would qualify as legal tender. In the euro area, Article 128(1) TFEU lays down the legal tender status of euro banknotes, and Article 11 of Regulation EC/974/98 on the introduction of the euro does likewise with regard to euro coins. The unilateral introduction of Any substitute payment scheme which, on account of its particular features, would qualify as legal tender or amount to a form of currency/quasi currency in competition with the euro, would contradict Article 16 of the Statute, for circumventing the ECB Governing Council authorisation required for the issuance of notes having the status of legal tender within the Union.

15 See Smits (op.cit., fn. 8), pp. 464-465; and H. Scott, 'When the Euro Falls Apart', 1-2 *International Finance* (1998), p. 207, where the focus is on the danger of speculation against the common currency (p. 211), as well as J.-V. Louis, 'Monetary policy and central banking in the Constitution', in ECB, *Legal Aspects of the European System of Central Banks, Liber Amicorum Paolo Zamboni Garavelli* (2005), p. 27, where concerns are expressed over the likelihood of the withdrawal clause leading to a multiplication of "disaster clauses" to deal with possible alterations in the composition of the Eurozone (p. 28).

time-bound accession to EMU constitutes a *legal obligation*,¹⁶ except for Member States with a permanent derogation from some of the provisions of Title VIII of TFEU¹⁷. Thus, while a Member State can, by virtue of Article 50 TEU, repudiate its rights and obligations under the Treaties *in their entirety*, and withdraw from the EU two years after submitting the relevant withdrawal request, no revocation of its decision to participate in EMU would appear to be legally possible, as this would automatically constitute a breach of its contractual (Treaty-based) obligation to accede to EMU. In conclusion, a Member State's withdrawal from EMU without its simultaneous withdrawal from the EU would not appear legally feasible. This legal objection is additional to reservations arising from the *unilateral* nature of the right to withdraw from the EU under the exit clause, which, in any event, renders the exit clause manifestly unsuitable as a means of dissolving the particularly complex bond between an EMU-participating Member State and its EMU partners.¹⁸

Turning to the second, competing interpretation (i.e. that EMU-participating Member States cannot legitimately withdraw from it, on the basis of the exit clause), it is worth recalling that, whether read in isolation or, *a fortiori*, in conjunction with one another, Article 3 TEU, Articles 119 and 140 (3) TFEU, Protocol 4 on the Statute of the European System of Central Banks and the European Central Bank, and Protocol 24 to the Treaty of Maastricht on the Member States' transition to the third stage of EMU, leave little room for doubt that the EU Member States' EMU participation was intended to represent a legally irreversible development.¹⁹ Consequently, it is only by way of an agreement (and certainly not by invoking the unilateral right of withdrawal from the EU introduced by Article 50 TEU) that a Member State's exit from EMU could, in theory, be possible.²⁰ This interpretative approach is not

16 See Articles 129 (1), 131, 140 (1) and (2) and 141-142 TFEU.

17 See Protocol 15 (United Kingdom) and Protocols 16 and 17 (Denmark).

18 Indeed, through the EMU, the ultimate purpose of the Founding Fathers of the Treaty of Rome, Robert Schuman and Jean Monnet has been accomplished: that is, that the member states' economies interlock to such degree that any reversion to the *status quo ante* would be legally and practically impossible.

19 By expressly referring to the establishment of EMU as an EU objective and to the 'irrevocable' fixing of the conversion rates at which national currencies are to be exchanged for the euro, the foregoing provisions draw attention to the irreversibility of the process leading to a Member State's adoption of the single currency and, thereafter, to its lasting character. Also see C. Proctor, 'The Future of the Euro – What Happens if a Member State Leaves?' 17 *European Business Law Review* (2006), p. 930.

20 Smits (op.cit., fn. 8), p. 465.

devoid of problems. First, it runs against the common sense appeal of the *a maiore ad minus* argument that militates in favour of the first interpretation.²¹ Second, accepting it is tantamount to accepting that there are no less than two withdrawal processes, one for EMU-participating Member States (whose withdrawal would only be possible subject to the achievement of an agreement, at least as far as the termination of their EMU participation is concerned) and another, less stringent one, for all other Member States (where unilateral withdrawal would – also – be feasible, under the exit clause). The better view – understood as the one that can best be reconciled with the legal irreversibility of a Member State's accession to EMU – is that Article 50 TEU cannot serve as a valid legal basis for an EMU-participating Member State's withdrawal from the euro area.

However the above may be, the difficulty of choosing between these competing interpretations demonstrates the extent of the problem created by the ill-considered introduction of an ill-defined right of unilateral withdrawal from the EU. It also illustrates the need for the resulting gap in the Treaties to be addressed, at the earliest available opportunity, so that the answers to the questions raised by the exit clause, especially with regard to its application, or otherwise, to EMU-participating Member States, can emerge directly from the text of the Treaties, without the need for its prior, authentic interpretation by the CJEU.

3. What alternatives to Article 50 TEU for EMU-participating Member States?

Given that Article 50 TEU appears manifestly unsuitable as the basis for organising a Member State's exit from EMU, the only *de jure* (EU primary law-sanctioned) alternative would be to rely on the flexibility clause of Article 352 TFEU. For the reasons explained below, this clause would only provide an imperfect legal basis, of questionable validity.

Article 352 TFEU allows the European Council to adopt measures where action by the EU proves necessary to attain one of the Treaty objectives, without the Treaties having provided the necessary powers. The Council would have to act *unanimously*, on a proposal from the Commission and after obtaining the consent of the European Parliament. The EU objective at stake would be the preservation of EMU, which is

21 One could argue that, by accepting the possibility of termination of the Treaties in their entirety, the European legislator has also accepted the possibility of termination of a sub-set thereof, in this case, Title VIII TFEU.

one of the Union objectives. To activate Article 352 TFEU, the Commission would need to prepare a draft Council Decision, in cooperation with the European Council Presidency, the ECB and the interested Member State, the aim of which would be to (i) authorise withdrawal from EMU, and (ii) lay down the details of such withdrawal. What would precede the adoption of the Council Decision is the conclusion of an ‘exit agreement’, the terms of which would presumably be part of the Decision. The consent of the European Parliament for the activation of Article 352 TFEU would be necessary, and the same is true of the consent of national parliaments, where such consent is required under the relevant national legal and constitutional order. By suspending the application to the departing Member State of all EMU-related Articles, the Council Decision would relegate that Member State to the status of a Member State with a derogation, with the Governor of its NCB only sitting at the General Council.

Recourse to Article 352 TFEU would not be legally unproblematic, for two fundamental reasons no less. The first is that the Treaty appears to have exhausted the matter of euro introduction under Articles 139-144 TFEU, meaning that there is no residual scope for further regulation on the basis of Article 352 TFEU. The second is that, as it can readily be inferred from several provisions of the TEU, the TFEU and secondary EU law (see above, Section 2), the introduction of the euro was intended to be irrevocable and irreversible. For the above reasons, reliance on Article 352 TFEU would not appear to represent a viable option.

In light of the above, the conclusion to which we come is that there is, *de lege lata*, no obvious legal formula through which to accommodate a euro area exit, and certainly not if this were to take the form of a unilateral, non-negotiated withdrawal, on the basis of Article 50 TEU. The remainder of this study examines the extent to which Article 50 TEU or the concept of EU citizenship could be generative of an automatic right to EU accession or serve as a source of rights that individuals could draw on, in an EU exit or secession scenario.

4. EU secession and exit – application of Article 50 TEU and the relevance of the concept of EU citizenship

A few words are apposite on a distinct scenario, also with an impact on the composition of the EU and/or EMU, that of secession of *part* of the territory of an EU Member State. ‘Secession’ is, needless to say, not the same as ‘withdrawal’, within the meaning of Article 50 TEU, which only

contemplates the *wholesale* departure of a Member State from the EU. Hence, Article 50 TEU cannot directly be applied in a secession scenario. Secession is, however, a germane concept: if EU law allows Member States to withdraw from the EU *in toto*, what would it have to say about the legal consequences of the separation from a Member State of part of its territory? In particular, would EU law recognize an *automatic* right of accession to the EU for the benefit of newly created ('seceding') state entities (leading, per force, to an 'internal enlargement' of the EU) or would it resist any attempt at 'accession from within'?

Unlike in the case of a Member State's withdrawal *in toto* from the EU, secession is not addressed in primary EU law. Outside Article 49 TEU, there is *no* dedicated Treaty provision specifically on the situation of newly created state entities and/or on their EU accession (or (re-) accession) rights. This is hardly surprising: the general principles of EU law, including those of equal treatment, legal certainty and legitimate expectations, require that the uniformly applicable enlargement conditions in place apply *erga omnes*, to ensure that one can objectively ascertain whether or not the terms, conditions and procedure applicable to EU accessions have been complied with in any given case. In the case of the EU Treaties, the terms and conditions in question are to be found in Article 49 TEU.²² Besides, following the introduction by the Treaty of Lisbon of an exit clause, even a former Member State would need to comply with the procedure set out in Article 49 TEU if it wished to re-join the EU.²³ There is no indication, in EU primary law, that a more lenient regime could apply to a seceding state entity, nor is there anything in the Treaties to suggest the existence of any obligation for the rump Member State to withdraw from the EU²⁴ or to otherwise re-negotiate its relationship with its partners merely because of incidents of secession affecting its territory and population.²⁵

22 Post-Lisbon, eligibility is also subject to a candidate's compliance with the values referred to in Art. 2 TEU, which candidate countries must 'commit' to 'promote'.

23 See Art. 50 (5) TEU.

24 See J. Crawford and A. Boyle, 'Annex A - Opinion: Referendum on the Independence of Scotland – International Law Aspects' in 'Scotland analysis: devolution and the implications of Scottish independence', 12 February 2013, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/79408/Annex_A.pdf, last accessed on 28. 04. 2016, at pp. 68 and 99 (arguing that the UK's EU membership would not 'lapse' in the event that Scotland would attain its independence).

25 For the extent to which such adjustments to the rump Member State would need to be reflected in the EU Treaties, see K. Lenaerts and P. Van Nuffel, *Constitutional Law of the EU* (Thomson/Sweet & Maxwell, 2005), p. 356.

Despite the fact that Article 50 TEU is of no direct relevance to a secession scenario, it seems difficult to argue that what applies to the whole should not apply to its parts: it is, in other words, difficult to argue that a former Member State should be treated less favorably than a newly created state entity resulting from secession that was never part of the European family *as a sovereign state*. Far from enjoying any right of automatic accession, a new state entity resulting from secession should therefore be expected to comply with the Treaties' enlargement conditionality policy as a condition precedent to its EU accession²⁶. Absent any dedicated primary law provision, and lacking any indication that, in a secession scenario, EU law would treat the seceding state entity as a successor state, newly created state entities wishing to join the ranks of the EU would need to forge their own relationship with it. Compliance with the Copenhagen criteria would be the foundation of that relationship.²⁷

In short, newly created state entities would need to comply with the normal EU accession conditions and procedure before they can join the EU: they would, in other words, need to 'join the queue' of accession countries,²⁸ provided they have been granted the status of a candidate country,²⁹ and fulfill the admission criteria.³⁰ As regards EMU participation, although this is mandatory for all EU Member States (except for those that have negotiated a permanent derogation), it does not derive automatically from EU membership: it is, instead, subject to condition-

26 See for instance C. Hillion, 'Enlargement of the EU: the discrepancy between accession conditionality and membership obligations' (2004) 27 *Fordham International Law Journal*, p. 715; M. Cremona, 'Enlargement and external policy' in M. Cremona (ed.), *The enlargement of the EU* (OUP, Oxford, 2003); P-C Müller-Graff, 'Legal framework for EU-CEEC relations' in M. Maresceau (ed.), *Enlarging the EU* (Longman, London, 1997).

27 These criteria were established by the Copenhagen European Council in 1993 and strengthened by the Madrid European Council in 1995 (see http://ec.europa.eu/enlargement/policy/glossary/terms/accession-criteria_en.htm, last accessed on 28.04.2016).

28 See M. Weller 'A foregone conclusion?' (2012) *New Law Journal*, Vol. 162, Issue 7537, available at <http://www.newlawjournal.co.uk/nlj/content/foregone-conclusion>, last accessed on 28. 04. 2016, p. 1.

29 On the determination and application of the political criteria of enlargement, conditionality and the procedure for membership see, for instance, A. Tatham, "'Don't mention divorce at the wedding, darling!': EU accession and withdrawal after Lisbon" in A. Biondi *et al* (eds.), *EU law after Lisbon* (OUP, Oxford, 2012), pp. 131-134.

30 The above conclusion is without prejudice to the *factual* possibility of a speedier accession in the case of a newly created state entity or, *in extremis*, of a 'simplified' accession procedure to reflect the fact that the newly created state entity is the product of separation from an existing Member State.

ality outside the enlargement process, in the form of compliance with the so-called Maastricht economic and legal convergence criteria.³¹ Thus, unless the Treaty were to be amended, state entities created through secession from EMU-participating Member States would also have to follow the same path to EMU accession as their precursors, despite having formerly been part of an EMU-participating Member State. There is, therefore, no compelling *legal* argument in favour of an automatic (or 'accelerated') succession to EU membership for the benefit of seceding state entities.

The above is without prejudice to an assessment of the extent to which the concept of EU citizenship, even if not per se generative of EU accession in an EU secession scenario, could provide the basis, for *individual* claims for its preservation in an EU exit or secession scenario. The remainder of this paper addressed this question.

Whilst *a priori* legally permissible, under Article 50 TEU, failure to negotiate a withdrawal agreement would risk leaving unregulated the future relations between the EU and the withdrawing Member State, inter alia with regard to the status and rights of at least some of the withdrawing Member State's nationals as EU citizens (as well as those of other EU Member State nationals living within its borders). If there is a common thread running through the CJEU's jurisprudence on EU citizenship, this is that the Court will exercise its powers of judicial review to protect Member State nationals as EU citizens whenever a Member State purports to deploy its normative sovereignty in matters of nationality and residence law in a manner that either runs counter to established EU law principles (non-discrimination-equal treatment, proportionality or the rule of law)³² or deprives EU citizens of their Treaty freedoms (rights of free movement and establishment) or exposes Member State nationals to the disproportionate risk of the loss of any of their fundamental rights (protection against statelessness or the right to family life). What is also clear is that the Court has over the years challenged Member State sovereignty in matters of nationality law through its EU citizenship-related jurisprudence: contrary to earlier scholarly opinion, which was generally

31 See http://ec.europa.eu/economy_finance/euro/adoption/who_can_join/index_en.htm, last accessed on 28.04.2016.

32 With respect to the protection of the rule of law in the EU, it has been argued that the 'right to live under EU law' could be included in the substance of Union Citizenship (see A. von Bogdandy and M. Ioannidis, 'Systemic Deficiency in the Rule of Law: What It Is, What Has Been Done, What Can Be Done' (2014) 51 *Common Market Law Review* p. 59, at p. 76).

dismissive of the concept of EU citizenship,³³ contemporary literature has hailed the emancipatory potential of the Court's more recent jurisprudence and its potential to superimpose the concept of EU citizenship over that of Member State nationality,³⁴ meaning that EU citizenship need not be automatically lost through the loss of Member State citizenship.³⁵

In an EU exit scenario the eventual loss of EU citizenship would not be the consequence of unilateral administrative action taken by the departing Member State, the consequence of which would be to restrict the enjoyment by private individuals of the substance of their EU citizenship rights: the decision to exit would be a conscious and deeply political choice of the people of the withdrawing Member State and/or its democratically elected government to sever their hitherto ties with the EU. Arguably, such decisions are not by their very nature amenable to judicial review. Furthermore, the risk of statelessness that weighed so heavily in one of the Court's more famous EU-citizenship-related rulings (*Rottmann*) would not be present in an exit scenario: the inhabitants of the withdrawing Member State would not become stateless, meaning

33 For instance, it has been argued that, 'the national citizenship is the primary and original status, whereas the European citizenship which derives from it, is a secondary citizenship' (see V. Lippolis, 'European Citizenship: What It Is and What It Could Be', in M. la Torre (ed.), *European Citizenship: An Institutional Challenge* (The Hague: Kluwer Law International, 1998), p. 318); and that EU citizenship is 'little more than a cynical exercise in public relations on the part of the High Contracting Parties' (J. H. Weiler, 'Citizenship and Human Rights', in J. Winter et al. (eds.), *Reforming the Treaty on European Union* (The Hague: Kluwer Law International, 1996), p. 65).

34 See, for instance, D. Kenealy and S. Mac Lennan, 'Sincere Cooperation, Respect for Democracy and EU Citizenship: Sufficient to Guarantee Scotland's Future in the European Union?' (2014) *ELJ*, Vol. 20, Issue 5, p. 591 ('[I]t appears [...] that the ECJ does not consider EU citizenship as being dependent upon Member State nationality'); D. Kostakopoulou, 'When Citizens Become Foreigners' (2014) 20 *European Law Journal* p. 447 at p. 449 ('EU citizenship is neither a reflection of national citizenships nor a nominal citizenship corollary to the fully fledged or 'real' national citizenships'); and D. Kochenov, 'The Citizenship Paradigm' (2012) 15 *Cambridge Yearbook of European Legal Studies*, p. 196 ('There is an independent – albeit a *ius tractum*-based – status of EU citizenship').

35 See Y. Gounin, 'Les dynamiques d'écèlement d'États dans l'Union européenne: casse-tête juridique, défi politique' (2013) 78 *Politique Étrangère* p. 11 at p. 21.

that the proportionality test should be easier to fulfil.³⁶ It could, therefore, be argued, that in an EU withdrawal scenario, neither the right to equal treatment and non-discrimination nor any of the Treaty freedoms would import a *positive law* obligation on the withdrawing Member State to take action to legally protect the enjoyment by individuals of their former EU citizenship rights, notwithstanding the act of withdrawal.³⁷

Different considerations would apply in a secession scenario. Here, any decision by the rump Member State to deprive the inhabitants of the seceding state entity of their nationality (and through it, EU citizenship) *could* be subject to judicial review by the Court. Indeed, what is clear from the case-law of the CJEU is that the revocation (and, by implication, also the withdrawal) of EU Citizenship *are* matters of interest to EU law, given their impact on the affected individuals' ability to continue enjoying the rights attaching to their status as EU citizens (inter alia, the rights to free movement, establishment and equal treatment). What the actual *outcome* of such judicial review would be is an altogether different matter, and much would depend on the application of the CJEU's proportionality test, and whether the decisions referred to above would satisfy that test. Because of its knock-on effect on the ability of the seceding state entity's inhabitants to exercise their EU citizenship rights, the wholesale withdrawal, in a secession scenario, of Member State nationality from the seceding state entity's inhabitants would clearly have consequences analogous to their exclusion not only from the territory of the Member State of which they were, pre-secession, nationals, but also from the territory

36 Referring to the Court's ruling in *Rottmann*, a commentator has stated that, 'if a withdrawal of nationality that may even lead to statelessness might be justified, wouldn't that be also the case when the loss of nationality is the consequence of a voluntary acquisition of another nationality? A measure entailing the *ex lege* loss of nationality in this case would also be validated in international law, and the proportionality would be easier to justify than when the adverse consequence is statelessness' (see P. G. Andrade, 'State Succession and EU Citizenship', in C. Brölmann and T. Vandamme (eds.), *Secession Within the Union. Intersection Points of International and European Law* (Amsterdam Centre for European Law and Governance and Amsterdam Center for International Law, 2014)).

37 Compare Rieder, who, drawing on the German Constitutional Court's ruling in the *Maastricht Case*, and on *Rottmann*, argues that there is a distinction to be made between the attribution of Member State nationality (which is a matter for the Member States) and its loss (which may transcend the boundaries of the member States), and that 'none of the Member States were forced to confer the status of EU citizenship on their citizens but, once they have, [...], they cannot simply withdraw this status' (C. M. Rieder, 'The Withdrawal Clause of the Lisbon Treaty in the Light of EU Citizenship: Between Disintegration and Integration' (2013) 37 *Fordham International Law Journal* p. 147, at p. 172).

of the Union as a whole.

Whatever the case may be, it is undisputed that the nationals of both withdrawing Member States and seceding State entities deserve protection to avert the personal hardship and great inconvenience they would be exposed to in the event of secession or withdrawal. This would remain true even if we were to exclude, *arguendo*, the existence of any justiciable claim to the continuing protection of EU citizenship rights post-exit or secession.³⁸ In such a case, other practical solutions would need to be explored, by way of negotiations, to mitigate the obvious negative consequences of secession or withdrawal for the citizens of the seceding state entity or the withdrawing Member State, in terms of the loss of their citizenship rights.

Concluding remarks

The silence of Article 50 TEU on its application, or otherwise, to EMU-participating Member States, combined with the unilateral character of the right of withdrawal enshrined by it, are the source of legitimate legal concerns. As the exit clause only allows Member States to terminate the Treaties in their entirety, and to withdraw from the EU two years after the submission of their withdrawal request even if no agreement has been achieved, the mere revocation of their decision to participate in the EMU would be a legal impossibility, as, on the one hand, it would constitute a breach of their contractual (Treaty) obligation to accede thereto and, on the other, it would be contrary to the irreversible character of the participation of a Member State in the Third Stage of the EMU. Consequently, a Euro area Member State's withdrawal from the Euroarea would not be possible without its simultaneous withdrawal from the EU. Recourse to Article 352 TFEU, as an alternative route through which to organise the withdrawal of a Euroarea Member State, could be open to legal challenges, given, that *first* the Treaty would appear to have exhausted the matter of euro introduction under Articles 139-144

38 Referring to Scotland, it has been argued that, 'whatever may be the desirability of preserving and protecting citizenship rights and whatever may be the force of the duty of sincere cooperation, these cannot, it is suggested, serve to defeat the rights of other interested and affected parties from vetoing Scottish membership of the EU, if they believe that it is in their interests so to do' (K. A. Armstrong, 'After "Ever Closer Union": Negotiating Withdrawal, Secession, and Accession', (2014) 37 *Fordham International Law Journal Online* p. 119 at p. 125). Also see J. Shaw, 'Citizenship in an Independent Scotland: Legal Status and Political Implications' (2013) *CITSEE Working Paper Series* No. 2013/34.

TFEU, and *second* it can be readily inferred from several provisions of the TEU, the TFEU and secondary EU law that the introduction of the euro was intended to be irrevocable. Besides, as a matter of EU law, no automatic right to EU accession in a genuine secession scenario, for the benefit of a newly-created state entity, can be extrapolated on the basis of Article 50 TEU. Finally, while in an exit scenario Member States would not be bound to take action to preserve the status or rights attaching to EU citizenship post-exit, in a secession scenario, any decision by the rump Member State authorities to deprive the seceding state entity inhabitants of their nationality could be subject to judicial review by the ECJ, on the basis of its EU citizenship-related jurisprudence.

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INCOMPLETE CONTRACTS? FILLING THE GOVERNANCE GAP IN THE EUROPEAN UNION: NICCOLÒ IS BACK!

Ramon Marimon

I had been riding for a while since daybreak, far into the Chianti. Thirsty, I stopped at a remote house to ask for water and there he was... at work, as if time had never passed, surrounded by old manuscripts and new books, dressed as in the paintings I had seen. No need to play the actor, alone at dawn in a remote house, it had to be him. So, I asked him: 'Niccolò is that you?' He simply said:

In my previous life I reduced my knowledge of the actions of great men to a small volume and sent it to the Magnificent Lorenzo de' Medici. I cannot say it was my best writing but now I see "The Prince" has become the most popular piece and I am remembered by it.

Now that, five hundred years later, I am back, I see I have more to learn, since this is no longer a world of kingdoms and principalities but of interdependent peoples, where a prince is also a partner and, therefore, must act as a prince of his people and as a partner in the partnerships of the dominions of Europe, being the European Union or the Euro Area. Not a simple task, even if these partnerships have secured peace for a long time.

I am very thankful for having been given this second chance and I am exiling myself again from my beloved Florence to study, reflect and write about how men – and women, I must add – should behave as partners, not just princes, and how they should develop their partnerships, not only to secure peace but also to bring prosperity to their people.

Then he looked at me and asked: *and who are you, dressed like that with these strange shoes and funny hat?* [I had on my usual colourful cycling outfit and helmet]. I said, ‘well I am a professor of economics at a place called the European University Institute, just under the hills of Fiesole, where we celebrated the 500th anniversary of your “Il Principe” three years ago with a conference.’

I could not tell from his face whether he was simply unimpressed by my answer or annoyed by my interruption, when he added,

Yes, I can give you some water and even bread, but since you said you work in a European something place, up in Fiesole, let me ask you a few questions...

What is this European stuff that you are working on? I am reading about what you call the European Union and there are many things I still don't understand.

It really caught me by surprise, but what else could I expect on that strange morning, so I just said what I had had in mind while cycling along: ‘I was just thinking what to say at a conference where I am supposed to talk about “Incomplete Contracts? Filling the Governance Gap in the European Union,” perhaps you can help me...’

Do you mean that people should be governed by complete contracts? What a bad idea! What would be left to govern if everything had been already contracted? Furthermore... and then he took an old manuscript from the table and read:

“The prince can gain the people to himself in many modes, for which one cannot give certain rule because modes vary according to circumstances, and so they will be left out. I will conclude only that for a prince it is necessary to have the people friendly; otherwise he has no remedy in adversity.”¹

I said, ‘well no, I was thinking more about the “Filling the Governance Gap in the European Union”’

That's a good idea! Since as I said there are many things I don't understand of this European Union, is this what you mean by 'gaps'? and he took the

1 Obviously we were talking in Italian, although sometimes I had a hard time understanding his archaic sentences and I think he also had a hard time understanding my Spanish-Catalan accent. In any case, later in my office I took my English copy of Niccolò Machiavelli's *The Prince*, U. of Chicago Press, 1985, and I recognized what he read on p.40, as I now transcribe.

book up again and read:

“As it happens with this as the physicians say of consumption, that in the beginning of the illness it is easy to cure and difficult to recognize, but in the progress of time, when it has not been recognized and treated in the beginning, it becomes easy to recognize and difficult to cure. So it happens in affairs of state, because when one recognizes from afar the evils that arise in a state (which is not given but to one who is prudent), they are soon healed; but when they are left to grow because they are not recognized, to the point that everyone recognizes them, there is no longer any remedy for them.”²

You see, it seems to me as if you have had bad physicians in this European Union, what is all this talk about exits?

I was going to say something, when he said, almost shouting

Grexit, Catxit and Brexit...

these are dead ends!

and, therefore, empty threats, if coming from a prince.

‘You mean Grexit from the euro area?’ I said, and he quickly replied with the same tone

Who breaks a partnership, the strong or the weak partner?

‘The strong...’

so?

And I inquired: ‘but then, shouldn’t the strong expel the weak if it misbehaves?’

not if the partnership is to endure...

draw the lines without false promises

and, most of the time,

use the carrot not the stick!

again, with the book in hand:

“For injuries must be done all together, so that, being tasted less, they offend less; and benefits should be done little by little so that they may be

2 (idem) p. 12.

tasted better³.”

‘What about Catexit from Spain? Should the partnership accept internal fragmentation?’

No, since any group of people can find their prince and postulate him, or her, as a partner... The partnership will dilute, unless it becomes a higher principality with a strong prince, no longer a partnership.

‘What if there is Catexit and they behave properly, as they claim they will?’

The same, if the partnership is to endure.

‘And Brexit from the European Union?’

Is Britain a weak or a strong partner?

‘Well,’ I said, ‘she is not a weak one and could be a strong one, but she refrains from being so.’

What prevents her? What limits her within the EU partnership?

What might the exit gain be?

I was not fully convinced and insisted: ‘Grexit, Catxit and Brexit... what if it comes from the people?’

The same, these are dead ends!

although they may happen, since people often forget how interdependent they are with other people and they may trade losses for – religiously perceived – self-esteem;

and princes – or those who would like to be such – can turn this to their advantage.

But, remember, for the partnership and the partner-prince it is necessary to have the people friendly!

And, in a low voice, he added:

That’s why it seems to me that you may have had bad physicians in this European Union... That’s why I think the illnesses will remain even if there are no exits to regret.

Not giving up, I insisted: ‘What about security, migration and other global problem gaps?’ He looked at me, as if I was not getting the point, and said

3 (ibid) p.38.

*is it not always the same?
if the partnership is to endure...
draw the lines without false promises
and, most of the time,
use the carrot not the stick!*
...
*but, remember, the partnership
cannot beg for carrots from the princes!*

I decided to change topic. 'What about the European Union and euro area institutional gaps?'

Tell me about it, I want to learn.

It was getting late (I was sure my wife would be thinking that I had got lost yet again on my ride, but I didn't dare take out my smartphone and send a WhatsApp) and actually he had still not even given me any water, but I explained...

'We have an unusual governance with a good number of formal bodies of the European Union: the European Council, the European Parliament, the European Commission, etc.⁴, but when we had our main crisis it was a euro crisis, not a European Union crisis, and the main governing bodies, which have had many meetings, sometimes deep into the night, have been informal bodies – the Eurogroup and the Euro Council – together with the euro body 'par-excellence': the European Central Bank. And, while this may seem a weak arrangement to you, it is said 'Europe grows out of its crises' and this one has not been an exception....'

Before I could go on, he interrupted me,

yes, I have read this claim – wasn't it Jean Monnet who said it first?—and I always thought it was an odd claim, didn't you Europeans have two major wars last century which also grew out of crises?

And he let me continue my description: 'Besides the ECB, since 2010 we also have: the Fiscal Compact (FC), through which countries exercise fiscal restraint to avoid another debt crisis; the Macroeconomic Imbalance Procedure (MIP), to coordinate and oversee structural reforms, fiscal policies and prevent macroeconomic imbalances; the European Stability

4 The Council of the European Union (ministers), the European Economic and Social Committee, the Committee of Regions, the European Investment Bank and the European Investment Fund.

Mechanism (ESM) a crisis mechanism, which has already helped Cyprus and the banking sectors in Spain and Greece, and lastly, in a very short period of time, there have been great advances made towards the creation of a European Banking Union (EBU), which should provide greater financial stability and help to break the pernicious private–sovereign debt link. Furthermore, we also have “The Five Presidents’ Report” which sets a roadmap for “Completing Europe’s Economic and Monetary Union.”

I may have gone too far since he abruptly interrupted me.

I appreciate your explanations, but let me ask you three things:

First of all, MIP, ESM, EBU, EMU, ECB... In my times I used names of people – like Francesco Sforza, Cesare Borgia – of countries – Germany, France – etc. but I never confused readers with acronyms, why am I haunted by them as soon as I start reading about the European Union?

I said nothing.

These ‘Five Presidents,’ where they chosen with the favour of the people or with the favour of the great? Since, as you know from my book [showing it to me], it made a difference in how princes should behave and I presume it would also make a difference for partner-princes nowadays.

‘Partly, a combination of the two,’ I said.--

This is dangerous, you know - serving several masters one may end up serving none. Furthermore, first, when I say ‘people’ I refer to all the people of the European Union – or maybe it would be better to say here, of the euro area – but it seems that when you say ‘some princes are chosen with the favour of the people’, you mean their own country people, not the euro area people. Second, even if I learned, and appreciated, the virtues of having an independent prince of the ECB, a master of reference seems necessary: the formal European Parliament, the informal Eurocouncil, who? Third, it seems that the ‘great’ today are the same countries that I was already referring to five hundred years ago!

But back to your description of the progress being made with all these new acronyms:

Isn’t this a little too complex, since, in order to trust, people must understand?

Is it working?

I started saying, ‘well it’s not so easy...’, when I noticed something on one side of his table: an iPad!, ‘... but you still dress in Renaissance clothes and you have an iPad?’

He asked me: *How long have you been in Florence?* ‘Fifteen years or so’ I replied. *Not even if you were a second or third generation here would you be considered a Florentine. The true Florentine families of my time are still here and since some of them owed me favours, it didn’t take me too long to find their progenitors (they still keep their names) and, in return, a young man came to visit me with this iPad and installed in this old house something he called WiFi (what is happening with the Italian, language?⁵). In any case, I really like it! I would have written ‘Il Principe’ in two weeks if I had had one then.*

‘So, let me show you something...’ and I opened the “europeansnapshot.com” of Thomas Cooley and Peter Rupert. ‘If we normalize the real yearly Growth Domestic Product of all the countries at 1 in 2008 at the start of the financial crisis, then we can see the recession and recovery for most, but not equally for all.’



‘For example, in the aftermath of the euro crisis we still have an unsolved Greece gap and, even if the other euro-crisis countries are growing, with the exception of Ireland, we still have a euro area divide gap. That is what makes it difficult for it to function.’

5 Speaking in Italian, he said “WeeFee”.

In the case of Greece, were the lines ever drawn? I have seen no lines, while huge new debts and detailed ‘adjustment programmes’ have been thrown at them... with most Greeks falling into despair and their banks in disarray. Is this how your partnership manages the stick and the carrot?

I certainly didn’t want to argue this one, so I just said: ‘I really like chatting with you Niccolò, but I just came in for a glass of water...’ Sorry, *I am not used to talking and I got carried away, here is the water and the bread, but let me ask you a few last questions* (at that point I sent a WhatsApp to my wife, without mentioning Niccolò...).

This Fiscal Compact and the Macroeconomic Imbalance Procedure, I can see some rationality in partners making a commitment to the former, and some good partnership intentions with the latter, but is it working? Are these credible mechanisms? Would they be enough to prevent other crises?

‘I understand your concerns. Let me show you another couple of things on your iPad. Look at these numbers for the United Kingdom and Spain. Both countries had relatively high deficits in 2014 and both have grown more than the EU average in the last two years. However the Uk, which has not signed the Fiscal Compact, has reduced its deficit, while Spain, who rushed to have it in its constitution, has not. I am sure that the partnership, as you call it, will verbally – perhaps also in writing - admonish Spain, and the current Spanish prince will make promises of fiscal restraint to his European partners, while promising tax reductions to his people-voters and, in the U.K., people will make fun of the hypocrisy of the European partnership.’

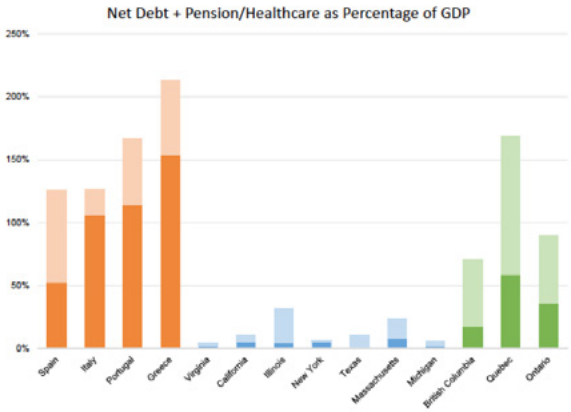
	GDP growth 2014	GDP growth 2015	Surplus/ GDP 2014	Surplus/ GDP 2015	Surplus/ GDP 2015 (rev.)	Debt/ GDP 2015
<i>U.K.</i>	2.9	2.3	-5.6	-4.4	-3.9	89.2
<i>Spain</i>	1.4	3.2	-5.9	-5.1	-5.0	99.2

‘I have just downloaded a Voxeu piece in your iPad for you, with a reference to an interesting article⁶ comparing the U.S., Canada and Europe. The authors, Arellano et al., show (see Figures 1 and 2 from their article)

6 Cristina Arellano, Andy Atkeson, Mark L. J. Wright. 2015. “External and Public Debt Crises”, NBER Macroeconomics Annual. <http://voxeu.org/article/public-debt-crises-us-vs-eu-private-borrower-impact>

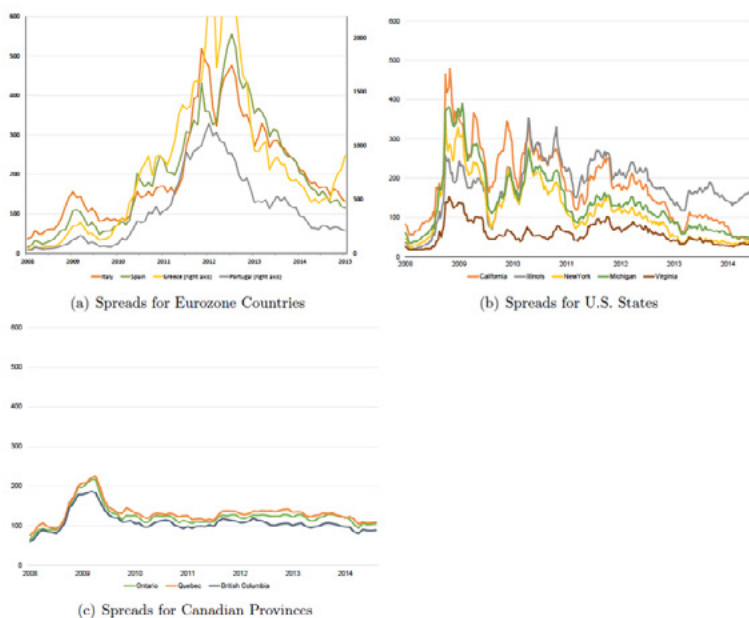
how in the last decade, states in Canada have large liabilities, with respect to their GDP, as European countries do also, in contrast with U.S. states, who do not have large liabilities. Yet, in contrast to European countries and U.S. states, Canada's states have been perceived as financially safe in this decade of crises. They argue, and document somewhat convincingly, that there are two causes behind these facts. In Canada and in the U.S., and in contrast with Europe, the government does not interfere with the private financial sector. Canadian states, in addition, have more fiscal flexibility than do U.S. states or European countries. The European Banking Union and a more integrated – less national – capital market (called the European Capital Union) should prevent governments from interfering, however, it is not clear whether the current more flexible interpretation of the Fiscal Compact will provide European countries with the fiscal flexibility that Canadian states have or, in your language, princes who do not know how to behave as princes-partners will still need a straightjacket to prevent them from generating a new crisis.'

Figure 2 : Net and Pension/Health care Liabilities to GDP



You also mentioned that there is a European institution for crises, which is not the church, as it was in my times, you said the ESM? But I see in your colourful picture that some countries are more prone to severe crises than others. How can some countries always give to others, if it is not for a religious mandate, and if they do, wouldn't the receivers get used to it and make no effort to prevent new crises?

Figure 1: Government Spreads in Europe, U.S., and Canadian Provinces



‘Well, you certainly have a point and you are not the first one to make it. Yes, it is the ESM and it is designed to act, using your words, when “it becomes easy to recognize but difficult to cure.” But we can do better than that and, as the Five Presidents have said, we should: we can design a proper risk-sharing mechanism, which accounts for both of your concerns. As a matter of fact, I am working on this, with some co-authors, and I can tell you more about it some other day’⁷.

Now it was starting to get late, but he insisted,

And you also mentioned a European Banking Union, can you tell me more about it?

‘As you may recall, in your times a Florin was not worth the same in a Florence bank as in a Paris bank, and something a little like this still happens: one euro deposited in a bank is not the same in Athens as in Rome.

7 Árpád Ábrahám, Eva Cárceles-Poveda, Yan Liu, and Ramon Marimon. 2016. “On the optimal design of a Financial Stability Fund,” manuscript, European University Institute.

Also we would like to break the existing tight connection between private and public borrowing. It is quite amazing that in just four years the SSM and the SRM have been put in place.'

What?

'Oh sorry, I meant the Single Supervisory Mechanism, hosted by the European Central Bank, and the Single Resolution Mechanism. Now we only need a properly funded Resolution Fund and European Deposit Insurance, to have a European Banking Union.'

Isn't this a little too complex, and how will be properly funded if not by the taxes of the people? Our pioneer banking system (not a union) was much simpler and we knew who would fund it – the Medici, for example – and we didn't bother to distinguish between public and private debts. By the way, I read something about 'Limited-Purpose Banking', as a way to revamp the existing banking system, so prone to bank-runs and other crises, making it simpler, more transparent and stable, by simply restricting banks to be only financial intermediaries, as funds are between investors and savers. Less creative, but maybe we should leave the creativity in the hands of the artists, not of the bankers.

This reminds me that I know an acronym that you haven't mentioned. When the young man came with the iPad, I asked him what he was doing, and he said he was in banking, as his family has been for the last five hundred years. So I asked him what was new in banking and he replied: QE, the QE of the BCE!

So, I was wondering, with this not-properly-funded European Banking Union, the new mechanisms to solve crises and share risks, the BCE doing QE, which, for what I understood from the young man, may also involve taking risks by the BCE, don't you think that with all this stuff the euro area will need some financial facility? That we have a missing body in all this design? Say, something like the Treasury that I see they have in the U.S. and in the U.K.?

'You have a point again, and again you are not the first one to mention it, even the Five Presidents say something like that in their report. Unfortunately, they don't say any more than you do. Well, I think that I had better get going. But let me ask you one thing, before I leave: after all your readings and our talk, what would you say about "Filling the Governance Gap in the European Area?"' In a clear voice, he replied:

is it not always the same?

if the partnership is to endure...

draw the lines without false promises

and, most of the time,

use the carrot not the stick!

but remember,

carrots (& sticks) must be credible

(and no begging princes for carrots),

in order to be credible, partnership policies and institutions

need to be understood (so keep them simple)

endurance is far-sighted, while it is easy to make

people friendly by being short-sighted,

most of all, remember that

there is no room for just princes

in this interdependent world,

a prince must also be a partner

and be trusted by the people as partner & prince,

*and what I said for *The Prince* applies to *The Partnership*:*

(and he read for the last time)

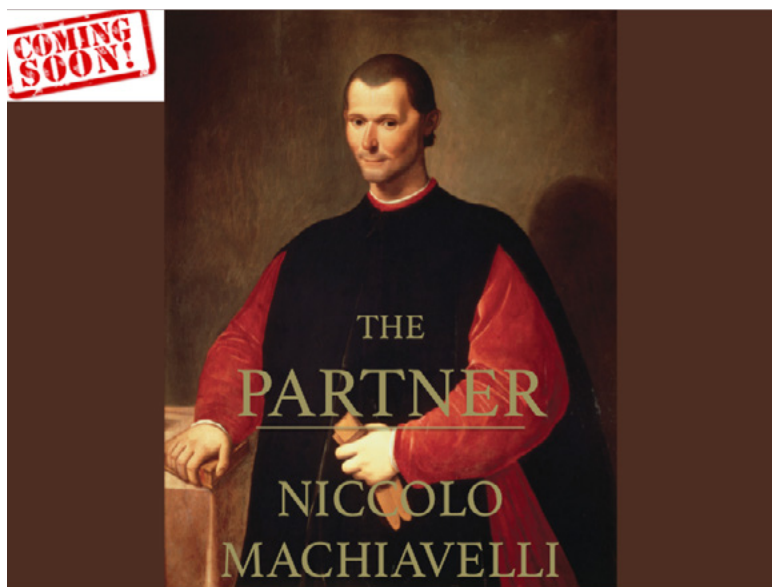
“So let a Prince win and maintain his state:

the means will always be judged honourable,

and will be praised by everyone⁸.”

(and with this I left, I left him with his manuscripts, his books, his iPad and his solitude).

8 (ibid) p. 71.



EXIT RULES FOR REGIONS OF EU MEMBER STATES

Roland Vaubel

There are three countries in the world which have established legal procedures for the potential secession of their regions: Switzerland (1979), Canada (1998) and the Uk (2015). In all three countries secession requires a referendum in the region. In Switzerland the referendum may be triggered by a regional popular initiative. In Canada and the Uk a vote by the regional parliament is required. In the Uk the national parliament respects the result of the regional referendum. In Canada each province has the right to hold a referendum on secession but the procedure also requires the assent of the other provinces and the Canadian government because the constitution has to be amended.¹ In Switzerland the citizens of a region may vote to secede from a canton (province) but the rest of the canton has to agree as well, and there has to be a nationwide referendum because any change in the number of cantons requires a constitutional amendment. This is how the new Canton Jura seceded from Canton Berne in 1979². To summarize, the regional referendum is binding in the Uk but not in Canada and Switzerland. However, even non-binding referenda can be very effective.

Three countries is a very small number. There seems to be a gap in governance. Several authors – e.g. Lee Bucheit³ – have suggested that it may have to be filled by an international organisation (e.g., the European

1 Supreme Court of Canada, Reference re Secession of Quebec, [1998] 2 S.C.R. 217, August 2000, and the Canadian Clarity Act S.C. 2000, c.26, June 29, 2000.

2 For more details see C. Dominicé, “The Secession of the Canton Jura in Switzerland”, in: M.G. Kohen (ed.), *Secession: International Law Perspectives*, Cambridge University Press: Cambridge 2006.

3 Lee C. Bucheit, *Secession: The Legitimacy of Self-Determination*, Yale University Press: New Haven CT 1978, p. 245.

Union). An international organisation is less biased against secession than the national majority is. However, there are vested interests which also bias international organisations against regional secession from a member state. The representatives of the member states in the international organisation are representatives of the national majorities. Moreover, the bureaucrats, parliamentarians and judges of the international organisation aim to expand their power and prestige by advocating political centralisation.

This may explain why neither the United Nations nor the European Union recognize the right of secession. The Council of Europe has even adopted a resolution stating that it aims to “prevent secession” (2011, No. 1832). The following quotations from leading politicians of the European Union may serve as examples:

- Martin Schulz, President of the European Parliament: “I am very worried about divisive tendencies due to separatists movements in the Member States - especially at a time of crisis”.⁴
- Elmar Brok, Chairman of the Committee on Foreign Affairs of the European Parliament: “Regional disintegration is poison to Europe”.⁵
- Herman van Rompuy, former President of the European Council: “Breaking up countries is contrary to the growth of the European Union ... We support unity of the members”.⁶ “Nobody has anything to gain from separatism in the world of today ... How can separatism help? The word of the future is ‘union.’”⁷

Since national governments as well as international organisations are biased against secession of a region, almost all secessions in history have been unconstitutional. There are 22 European countries which owe their existence to secessions: Switzerland (1291), Sweden (1523), the Netherlands (1579), Portugal (1640), Greece (1827), Belgium (1831), Norway (1905), Finland (1917), Ireland (1921), Iceland (1944), the three Baltic states (1990), Belarus (1990), Ukraine (1991), Russia (1991), Slovenia (1991), Croatia (1991), Macedonia (1991), Bosnia Herzegovina (1992),

4 See V. Capodici, „Das Gespenst des Separatismus geht um in Europa“, Basler Zeitung, October 18, 2012 (translation by the author).

5 Ibid.

6 Belgian TV channel VRT, September 21, 2014.

7 In D. Boffey, “European Chief Pours Scorn on Scottish Independence”, Observer (London), November 4, 2012.

Slovakia (1992) and Montenegro (2006). With the exception of Norway's breakaway from Sweden, all of these secessions have been unconstitutional.⁸

A governance gap also exists with respect to an important special issue: it is not clear whether seceding regions retain their membership in international organisations, for example, in the European Union. The European Commission claims that they lose their membership. Here are some quotations:

- Romano Prodi, former President of the European Commission: "When a part of the territory of a Member State ceases to be part of that state, e.g., because the territory becomes an independent state, the treaties will no longer apply to that territory."⁹
- José Manuel Barroso, another former President of the European Commission: "A region which secedes from a Member State, automatically ceases to be part of the European Union".¹⁰ "Of course, it will be extremely difficult to get approval of all the Member States to have a new member coming from another Member State."¹¹
- Jean-Claude Juncker, the current President of the European Commission: "... Mr. Barroso has already answered the question about EU membership. I have nothing to add."¹²

8 The constitution of Yugoslavia, it is true, recognized the right of secession. But the procedure was not specified, and the Yugoslav government waged war to prevent the secessions.

The secession of Slovakia from Czechoslovakia was finally agreed in November 1992 but it started with a unilateral declaration of independence in July 1992, which was unconstitutional. Ukraine and Russia left the USSR on December 8, 1991 – two weeks before the Soviet Union was dissolved by the remaining members.

9 R. Prodi, "Answer Given by Mr. Prodi on Behalf of the Commission", Official Journal of the European Union, 2004, C 84/E, 422.

10 J.M. Barroso, Letter from José Manuel Barroso to Lord Tugendhat, December 10, 2012. Available at http://www.parliament.Uk/documents/lords-committees/economic-affairs/ScottishIndependence/EA68_Scotland_and_the_EU_Barroso%27s_reply_to_Lord_Tugendhat_101212.pdf

11 Die Presse (Vienna), „Barroso: Unabhängiges Katalonien muss aus EU austreten“, November 17, 2012. (translation by the author)

12 Talk with MEPs, BBC News, "Scottish independence: 'I will respect referendum result', says Juncker", July 10, 2014 (available at www.bbc.com/news/Uk-scotland-scotland-politics-28231347).

- Viviane Reding, former Commissioner of Justice and Vice-President of the Commission: “Catalonia, if it seceded from Spain, could not remain in the European Union as a separate member.”¹³

However, this issue is not to be decided by the Commission. It has to be decided by the member states (as the Commission admits¹⁴).

The legal position taken by the European Commission has no basis in the EU treaties, nor is there a precedent.¹⁵ There is no such rule in the UN Charter nor in any other UN agreement. The Vienna Convention on Succession of States in Respect of Treaties does not cover membership in international organisations.¹⁶ There are merely practices, and they vary considerably among international organisations. I give a few examples¹⁷:

- The UN, it is true, usually refuses to automatically keep a seceding region as a Member State but it retains the rump state. However, there are exceptions. When Syria seceded from the United Arab Republic with Egypt in 1961 the UN kept Syria unconditionally as a member. When Montenegro seceded from Serbia in 2006, both had to reapply for membership in the UN.
- The International Monetary Fund and the World Bank kept the Yugoslav successor states as well as Slovakia and the Czech Republic as members under certain conditions which happened to be satisfied.
- The World Meteorological Organization, the Universal

13 El Pais (Madrid), „La Comisión Europea assume las tesis de Rajoy sobre una Cataluña fuera de la UE“, October 30, 2012 translation by the author).

14 Commission Spokeswoman Pia Ahrenkilde-Hansen, May 14, 2014, as quoted in: G.M.D. Duerr, *Secessionism and the European Union*, Lexington Books: Lanham 2015, p. 163.

15 The independence of Algeria (1962) and the autonomy of Greenland (1979) cannot serve as precedents because these countries did not wish to stay in the EEC/EC. Indeed, Greenland wanted autonomy precisely because it did not wish to be part of the EC.

16 According to Art 4, the Convention is “without prejudice to the rules concerning acquisition of membership”. Apparently, the UN did not want to limit its discretion and bargaining power with regard to new members.

17 See A. Zimmermann, *Staatenachfolge in völkerrechtlichen Verträgen*, Springer: Berlin 2000. K.G. Bühler, *State Succession and Membership in International Organisations*, Kluwer: The Hague 2001. J. Crawford and A. Boyle, “Opinion: Referendum on the Independence of Scotland – International Law Aspects”, in HM Government, *Scotland Analysis: Devolution and Implications of Scottish Independence* (Cm 8554, February), Annex A, The Stationary Office: Norwich 2013.

Postal Union and the International Atomic Energy Organization kept these countries without any conditions.

- The Council of Europe asked both Slovakia and the Czech Republic to reapply.
- The World Intellectual Property Organization wanted the seceding Soviet Republics of Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan merely to confirm their membership in the organisation.

These examples should suffice to show that a uniform practice does not exist.

In the literature, we find three major objections to the Commission's view that a seceding region automatically ceases to be part of the EU.

First, Sir David Edward, a former British judge at the European Court of Justice, has argued that since Art 50 TEU provides for negotiations prior to the departure of a Member State of the EU, there must also be negotiations prior to the departure of a region of a Member State of the EU: "The EU institutions and all the Member States (including the UK as existing) would be obliged to enter into negotiations [with Scotland], before separation took place, to determine the future relationship within the EU of separate parts of the former UK and the other Member States."¹⁸

Second, Matas I Dalmases and three co-authors¹⁹, all legal scholars from Catalonia, have suggested that automatic exclusion is incompatible with the values of the European Union as stated in the Treaties, notably with respect for democracy, the regions, cultural diversity and the right of minorities. Like Edward, they suggest that notification of secession of a region has to be followed by negotiations within the European Union and ultimately treaty amendment.

Third, Yves Gounin, chief of staff at the French Ministry of European Affairs until 2012, has pointed out that since the European Court of Justice has declared citizenship of the European Union to be separate from, and additional to, citizenship of the Member State, EU citizenship cannot

18 D. Edward, "Scotland and the European Union", Scottish Constitutional Futures Forum, December 17, 2012 (available in the internet).

19 J. Matas I Dalmases, A. Gonzales Bondia, J. Jaria I Manzano and L. Roman I Martin, *The Internal Enlargement of the European Union*, Centre Maurits Coppieters: Brussels 2011.

automatically be lost by giving up national citizenship.²⁰

I view this issue from a social contract perspective. There are two internally consistent solutions for succession when a part of a state unilaterally secedes from the rest or when parts of a state agree to separate:

- Either none of the parts keep the international rights and obligations of the predecessor state because the people of each part are no longer identical with the people of the predecessor state who have agreed to those rights and obligations. (As mentioned this was the UN position with regard to Montenegro and Serbia and the Council of Europe position with regard to Slovakia and the Czech Republic.)
- Or, in the interest of maintaining stability and predictability, each of the parts initially succeeds in the rights and obligations of the predecessor state but is subsequently free to withdraw. (This is the general principle of succession enshrined in Art 34 of the Vienna Convention – without prejudice to membership in international organisations.) If the parts do not meet their joint obligations to the international organisation, they may be challenged in its court or be expelled. If they cannot agree on how to share their rights, they cannot exercise them. Of course, they may subsequently renegotiate their rights and obligations with the other members of the international organisation.

Whichever of these consistent solutions is preferred, the UN tendency to recognize one of the parts – the larger or passive one – is unsatisfactory from a contractarian point of view. However, it can easily be explained by vested interest: the UN Assembly contains representatives of the national majorities, and the UN staff wants to unite – not to decentralise. For the same reasons, the EU threat to expel Catalonia but keep Spain is both unacceptable and due to vested interest. The EU has become an international policy cartel of national majorities that prevents the national minorities from seceding and forces them into submission.

20 Y. Gounin, «Les dynamiques d'écèlement d'États dans l'Union européenne: casse-tête juridique, défi politique», *Politique Etrangère*, vol. 4, 2014, pp. 11-22.

CAN GREECE BE EXPELLED FROM THE EUROZONE? TOWARD A DEFAULT RULE ON EXPULSION FROM INTERNATIONAL ORGANIZATIONS

Joseph Blocher, Mitu Gulati & Laurence R. Helfer¹

Abstract

The ongoing European crisis has raised uncomfortable questions about the conditions under which treaty-based unions of nations like the EU or the EMU can legally expel a member—Greece being the most obvious candidate. The EU, for example, has rules governing the voluntary withdrawal of members, but says nothing about whether a member can be expelled. As a matter of international law, what does the silence mean? Put differently: What is the default rule regarding expulsions when a treaty says nothing about forced withdrawals? Is there an absolute bar on expulsion, as some have suggested? Conversely, is there an implicit right to expel? Or can material breaches of a treaty justify expulsion? And if fault is not required, must the expelled member state be compensated in some way?

¹ Faculty, DUke Law School. For conversations about this topic, thanks to Patrick Bolton, Lee Buchheit, Paul Stephan and Roland Vaubel.

Introduction

The Greek sovereign debt crisis has resulted in three bailout packages, a dramatic restructuring of Greek debt, and multiple sets of Greek governments.² The saga is wearing the patience of the other members of the Euro area. In moments of frustration, some have argued that Greece should be expelled from the Eurozone, either because it has violated the sacrosanct “no bailout” clause by seeking relief from its EMU lenders or because it gained admittance to the Eurozone in the first place based on fraudulent numbers.³ But many Greeks do not wish to leave, especially if they would have to also leave the EU as a result.⁴

The political struggle in turn raises a legal question about whether and under what circumstances international law permits a supranational or international organization (IO) to expel a member state.⁵ The Lisbon Treaty is—like many other such treaties—silent on the matter of expulsion (although it does follow the general trend of permitting withdrawal⁶), so the crucial issue is what default rule applies in to these treaties or IOs.⁷

Many commentators have a strong response: In the absence of an

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- 2 Greece's Debt Crisis Explained, N.Y. Times, Nov. 9, 2015, <http://www.nytimes.com/interactive/2015/business/international/greece-debt-crisis-euro.html>.
 - 3 The question of expulsion in the EU context had come up earlier, in the context of the Irish rejection of the Lisbon Treaty in 2008. See Vincent Browne, Truth About the EU and Ireland After Lisbon, Politico, July 31, 2008. On the Greek matter, see, e.g., Leo Cendrowicz, Greek Debt Crisis: Alexis Tsipras Given Ultimatum – Push Through Cuts This Week Or Leave Euro, The Independent, July 12, 2015 (reporting the threat made to Greece that either it take on more austerity in July 2015 or take a “time out” from the Euro); Dalia Fahmy & Elisabeth Behrmann, Germans Tired of Greek Demands Want Country to Exit Euro, Bloomberg, March 15, 2015 (reporting that 52% of Germans polled wanted Greece to exit the Euro; with 80% of Germans polled taking the view that Greece “isn't behaving seriously towards its European partners”); Germans Call For Greece to Leave the Euro, After “No” Referandum Vote, Fortune, July 5, 2015; Jochen Bittner, It's Time for Greece to Leave the Euro, N.Y. Times, July 7, 2015.
 - 4 E.g., Aggelos Skordas, New Opinion Polls Show that Greeks Want SYRIZA, Samaras, and the Euro, Greek Reporter, Jan 4, 2015.
 - 5 Phoebe Athanassiou, Withdrawal and Expulsion from the EU and EMU: Some Reflections, European Central Bank Working Paper Series No. 10 (Dec. 2009) 35.
 - 6 Article 50 provides that “[a]ny Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
 - 7 On the withdrawal option that was put into place in 2009, under Article 50 of the TEU, see Phaedon Nicolaides, Withdrawal From the European Union: A Typology of Effects, 20 MJ: Maastricht J. Eur. & Comp. L. 2 (2013). Jacques Delors himself has argued that the relevant treaties should be revised, and that “[t]he new treaty should make it possible to kick a country out of the euro zone if a majority of 75 percent are in favour.” Vicky Buffery, Delors Urges Giving EU Power to Eject Nations from Euro, Reuters (Oct. 18, 2011), <http://www.reuters.com/article/eurozone-delors-idUSL5E7LI2KF20111018>.

explicit agreement to the contrary, nothing can legally justify the expulsion of a member state from an IO. To do so, they say, would violate the sovereignty of the expelled nation or the relevant treaty. This appears to be the conventional wisdom about the prospect of expelling Greece from the Eurozone.

In a 2009 ECB Working Paper, Phoebus Athanassiou considered the possibility of expelling a member state from the EMU and concluded:

[N]ot only is a collective right of expulsion not provided for in the text of the treaties, but, what is more, the legitimacy of its assertion or introduction would be highly questionable, both legally and conceptually.⁸

Echoing that sentiment, Annie Lowrey wrote in *Foreign Policy*:

[The EU bylaws] provide no option for kicking a country out, no matter how much other member countries might want to. Even if Greece invaded France — and it would take as much for Brussels to contemplate expulsion — the European Commission, a body of ministers that initiates EU laws, would have to craft new legislation to do it.⁹

Similarly, Steve Peers, University of Essex Professor of EU Law and Human Rights, wrote:

There's no reference in the Treaties to any power of a Member State to leave EMU once it joins, or of the EU institutions to remove that Member State from EMU, whether it agrees to that or not. A Member State can leave EMU by leaving the EU, but there's no Treaty power to throw a Member State out of the EU, or to suggest that any Member State might ever be under the obligation to leave. . . . The argument for a forced Grexit does not even have a fig leaf to hide its illegality.¹⁰

We disagree. The Lisbon Treaty does not specifically provide for expulsion, but nor does it prohibit it. And while a general presumption against expulsion may be sensible as a matter of law and policy, it is a mistake—legally and otherwise—to conclude that the *default rule* for IOs and treaties should be a flat prohibition on expulsion. The question, we argue, is

8 Athanassiou, *supra* note 5.

9 Annie Lowrey, Could Greece Get Kicked Out of the European Union? No, FP Explainer (Mar. 23, 2010), <http://foreignpolicy.com/2010/03/23/could-greece-get-kicked-out-of-the-european-union/>.

10 Steve Peers, Is Temporary Grexit Possible? EMU as Hotel California, July 11, 2015, EU Law Analysis Blog, <http://eulawanalysis.blogspot.co.uk/2015/07/is-temporary-grexit-legally-possible.html>.

not whether expulsion should be permitted at all, but under what circumstances.

To admit the possibility of expulsion even when a treaty does not provide that option raises a host of other difficult questions. What about *de facto* versus *de jure* expulsion? Some IOs have, instead of expelling members, effectively excluded them from the organization by, for example, refusing to accept their representatives' credentials.¹¹ Analogous means might be available in the Greek context. Could, for example, Germany and the other Euro area nations essentially force a buy out by either "forgiving" the Greek debt or treating it like a gift conditioned on Greece's "voluntary" exit from the monetary union? Or could the ECB effectively force Greece to exit the EMU by denying it access to its facilities because of some action that Greece was taking that it deemed inappropriate (e.g., a debt restructuring)?

If *de facto* or *de jure* expulsion is possible in at least some circumstances, the key question is what conditions trigger its availability. Must the expelled party be at fault? If a fault-based inquiry is to be conducted, who would do this? The other member states? An international court, such as the ECJ? Some other international review body? Finally, there is enforcement. If IO members as a group want to push out a recalcitrant nation, there are likely to be few remedies available to the aggrieved state.

Our goal in this paper is not to offer definitive answers to these questions, but to suggest that considerations of both law and policy should permit expulsion in certain circumstances,¹² and to sketch out some of the considerations that might guide the use of such an extreme measure. The specific question of whether Greece could legally be expelled from the EMU is beyond the scope of our paper, nor do we have much to say about whether doing so would be a good policy decision.

I. Why Expulsion Should Be an Option

A. Inducing Cooperation in a World of Limited Sanctions

International organizations such as the United Nations, the IMF, or the EMU provide a mechanism for states to generate collective benefits—

11 South Africa Again Denied Seat by General Assembly, N.Y. Times, March 3, 1981.

12 Cf. Konstantinos D. Magliveras, Exclusion from Participation in International Organizations: The Theory and Practice Behind Member States' Expulsion and Suspension of Membership 259 (1999) ("Suspension and expulsion should be viewed as eventualities inherent in membership.").

such as security, financial stability, and the like—for their members and often for the wider world.¹³ But the members states have individual interests that will on occasion differ from that of the collective. Members usually act cooperatively even when their self-interest differs from that of the group, whether because they fear reciprocal defections by other states, a breakdown of future cooperation, harm to their reputations as good global citizens, or simply because it is the right thing to do.

Yet history demonstrates that members sometimes act in ways that violate cooperative commitments or even undermine the organization.¹⁴ And since the members in question are sovereign, there are relatively few sanctioning mechanisms that other members can use to discipline them. One of the few sanctions available is denial of the benefits of the membership in the organization.¹⁵ Under these circumstances, the threat of expulsion can provide three benefits: *first*, it penalizes (or preferably, deters) misbehavior; *second*, it allows the organization to start functioning again;¹⁶ and *third*, it incentivizes the organization to create value for its members, making the loss of those benefits a more significant threat to a state being considered for expulsion.

Scholars have long been interested in the question of how members can and should respond to unsatisfactory performance by an organization.¹⁷ We ask the opposite question: How can an organization—a collaborative enterprise—respond to unsatisfactory performance by a *member*? Members who believe that an IO is undeserving their interests—or that another member has breached its treaty obligations—often have an option to terminate the relationship by withdrawal.¹⁸ Expulsion, in many ways, raises mirror image issues. The crisis in the EMU makes

13 Kenneth W. Abbott & Duncan Snidal, Why States Act through Formal International Organizations, 42 J. Conflict Res. 3 (1998).

14 An analogy here is to clubs, that generate benefits to their members. See Alessandra Cassella & Bruno Frey, Federalism and Clubs, 36 Eur. Econ. Rev. 639 (1992).

15 Cf. Christopher F. Brummer, Soft Law and the Global System: Rule Making in the 21st Century 159-161 (2015).

16 C.W. Jenks, Expulsion from the League of Nations, 16 Brit. Y.B. Int'l L. 155, 156 (1935) ("The [expulsion] clause was introduced . . . because it was thought that a state in breach of covenant might attempt to block systematically all League business by voting against every proposal under consideration.").

17 See, e.g., Albert O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (1970).

18 See generally Laurence R. Helfer, Exiting Treaties, 91 Va. L. Rev. 157 (2005).

those questions particularly pressing.¹⁹

Like withdrawal, expulsion is an extreme remedy. So it makes sense to consider the kinds of extraordinary circumstances that might justify its use, including those in which a member is inflicting serious harms on the other members or their populations. In those extraordinary cases, expulsion may be the best way out of a terrible union.

There is no intuitive reason that such malfunctioning unions must continue. Indeed, some recent trends in international law seek to facilitate their break up by permitting regions or states to quit the relationship in extreme circumstances.²⁰ Such exits can improve overall welfare in the short run by ending the painful relationship, while deterring nations and organizations from inflicting harms on their regions and members in the first instance.

The same logic applies in the opposite direction. Holding aside the question of fault, the costs of a harmful political union are reciprocal—the union and its units all suffer from conflict. In the case of exit, those costs are thought to be the *fault* of the nation or organization, which is why the unit (region or member state) gets the withdrawal option. But that will not always be the case. Sometimes the harm is inflicted by a malefactor member (consider the USSR's invasion of Finland, when both were members of the League of Nations), and the organization should be the one with the option to terminate the relationship. It is not enough to say that doing so would violate the sovereignty or treaty rights of the expelled nation, when that nation has inflicted significant harms on other sovereigns. In such cases, we think, expulsion can be an appropriate remedy.

The right to expel misbehaving members gives the organization a key tool of influence and negotiation. This tool becomes all the more important if other tools are off the table or of limited utility, as is often the case when the sanctioned party is a sovereign state.²¹ Just as the threat of exit

19 Boyko Blagoev, *Expulsion of a Member State from the EU after Lisbon: Political Threat or Legal Reality?*, 16 *Tilburg L. Rev.* 191, 192 (2011) (“[T]he glue may no longer be strong enough to hold all these countries together.”).

20 See *infra* Section II.

21 In the EU and Euro contexts, Athanassiou recognizes this argument, but counters that the system contains adequate sanction mechanisms to discipline misbehaving members. See Athanassiou, *supra* note 4, at 36. The empirical question is whether the sanctioning mechanisms already present in the EU/Euro contexts are so effective and tough that one can conclude that the implicit agreement was that there was no possibility of expulsion. We suspect not.

gives members a particular kind of bargaining chip vis-à-vis their organizations, the threat of expulsion does likewise for organizations vis-à-vis individual members—particularly when membership brings benefits and expulsion sends a negative signal to potential future partners of the misbehaving state.²²

The expelling and expelled parties are not the only ones whose interests are at stake—it is also important to consider externalities and systemic costs. One might argue that the possibility of expulsion could reduce incentives for cooperation by reducing the value of forming an organization in the first place.²³ Organizations might also use the threat of abandonment to strike coercive or unfair bargains with members perceived to be underperforming.²⁴ Even contemplating the possibility of expulsion might corrode the commitment needed to make nations and organizations function properly.²⁵

In practice, however, we suspect that political disincentives and reputational costs will be strong enough to prevent profligate use of expulsion, just as they often dissuade nations from withdrawing from treaties even where they have an unequivocal right to do so.²⁶ In fact, IOs that do have a treaty-based power to expel a breaching member have rarely chosen to

22 Cf. Helfer, *Exiting*, supra note 17, at 1583-84 (noting that sometimes “states pursue exit (and threats of exit) not to dissociate themselves from future cooperation with other nations, but ... as a strategy to increase their voice within an intergovernmental organization or treaty-based negotiating forum”); Timothy Meyer, *Power, Exit Costs, and Renegotiation in International Law*, 51 *Harv. Int’l L.J.* 379, 382 (2010) (“A credible threat to exit an international agreement confers power on a state by allowing the state to demand a greater share of the gains from cooperation in exchange for participating”).

23 Carlos Vázquez, *Withdrawing from International Custom: Terrible Food, Small Portions*, 120 *Yale L.J. Online* 269, 270 (2011) (arguing, in the context of customary international law, that “[e]ach state’s compliance is thus an investment . . . the option of unilateral withdrawal would reduce the expected long-term payoff, which . . . would make states less likely to make the investment”).

24 Cf. Meyer, supra note 21 (noting that in reaching international agreements, “ascendant” states will typically negotiate either for a higher share of benefits or easier exit).

25 Jerzy Makarczyk, *Legal Basis for Suspension and Expulsion of a State from an International Organization*, 25 *German Yearbook Int’l L.* 476, 477 (1982) (“[E]xpulsion of a member may cause damage to the organization as well, and even to the whole concept of organized international cooperation ...”).

26 Rachel Brewster, *Unpacking the State’s Reputation*, 50 *Harv. Int’l L.J.* 231 (2009); Meyer, supra note 21, at 394 (“Retaliation and reputational sanctions, though, remain available to curb unauthorized exit. In particular, unauthorized exit is a violation of a legal obligation that can result in a reduction of a state’s reputation for complying with legal rules.”).

exercise it.²⁷ In the vast majority of cases, the organization will prefer a negotiated solution or a lesser penalty over expulsion.

Consider the IMF, which needs to induce a high level of cooperation among members in order to function effectively, and explicitly has the power to expel members. Despite having to occasionally strong arm member nations into behaving appropriately, it has only once ever expelled a member—Czechoslovakia in 1954.²⁸ Yet the fact that expulsion has been used so rarely does not mean that it lacks value; the IMF's General Counsel explained in a recent speech that the power to threaten expulsion has been invaluable in inducing good behavior and avoiding the need to expel members more often.²⁹

From the organization's perspective, the reasons for not over-using the power of expulsion are easy enough to perceive. Just as the expelled party would bear a reputational cost, so too would the organization,³⁰ thereby diminishing future opportunities for collaboration.³¹ We saw this with Greece and the EMU in 2015 where many member countries, including some that wanted Greece to adopt the path of austerity, were worried that the use of threats of expulsion would impair the future of the Euro.³² Another disincentive is the possibility that expulsion would free the expelled party from its preexisting legal obligations—an argument that Sohn has advanced against expelling breaching members from IOs.³³

27 See Blagoev, *supra* note 18, at 192; Brummer, *supra* note 14.

28 Argentina provides a recent example of this, where its systematic misreporting of data brought forth a censure from the Board of the Fund, which in turn gave the country a certain period of time within which to remedy the problem or face further action, the end point of which would be expulsion. Argentina subsequently came into line. See Motion of Censure: The Fund Blows the Whistle, *The Economist*, Feb 9, 2013.

29 See Speech by IMF General Counsel, Sean Hagan, at UNC Chapel Hill Law School, Feb 2016, at <https://vimeo.com/155031668>.

30 Helfer, *Exiting*, *supra* note 17, at 1622 (“Three variables . . . stand out in assessing exits’ distinctive reputational effects: (1) the frequency of denunciation and withdrawal; (2) the relationship between entering and exiting treaties; and (3) the risks of opportunism in light of the pervasive uncertainty of international affairs.”).

31 Other disincentives to the overuse of expulsion include the desire to attract new treaty ratifications or IO members or to engage in collaborate with other IOs.

32 See, e.g., Stacy Meichtry & Anton Troianovski, *Greek Crisis Puts French-German Ties to the Test*, *Wall St. J.*, July 14, 2015; Melissa Eddy, *Germany’s Tone Grows Sharper in Greek Crisis*, *N.Y. Times*, July 16, 2015.

33 Louis B. Sohn, *Expulsion or Forced Withdrawal from an International Organization*, 77 *Harv. L. Rev.* 1381, 1388 (1964) (in the context of USSR invasion of Finland, “Colombia made what was to become a stock argument against expulsion—that to expel the U.S.S.R. would release it from the obligations imposed by the Covenant and thus make it easier for the Soviet Government to achieve its aims”).

In general, however, we do not expect that occasional use of the expulsion power would deter the formation of IOs or the collaboration they make possible. In fact, the possibility of expulsion could *incentivize* the generation of new alliances and combinations by reducing the perceived costs of joining them in the first place, while increasing the value of agreements by providing a last-resort sanctioning mechanism.³⁴ If expulsion is not an option, then one bad actor could undermine the organization and its objectives, with the result that some highly productive collaborative relationships would never materialize.³⁵

There is, however, at least one scenario in which expulsion might be off the table, and that is where the IO has specified as much. Explicit agreements regarding the availability or processes of expulsion should generally be followed. Our argument here is that the possibility to expel in extreme circumstances should be considered a default rule, not a mandatory one. In any event, many treaties and IOs say nothing about expulsion. In those cases, we think that the lack of an explicit expulsion provision should not preclude the option, any more than the lack of a prenuptial agreement precludes the possibility of divorce.

As a default rule, therefore, the key question is what rules should govern and limit its use. Just as we reject a bright line default rule against expulsion, so too we reject a regime in which it is an unrestricted option. Fortunately, we are not writing on a blank slate—international law and practice provide some relevant guidance.

B. Incomplete Treaties and De Facto Expulsions

It is tempting to think, especially in the context of a weak member of a treaty organization that is being threatened with expulsion, that a bright line rule against expulsion protects the interests of the weak nation. We

34 This point is made particularly effectively in Christian Fahrholz & Cezary Wójcik, *The Eurozone Needs Exit Rules*, CESIFO Working Paper No. 3845, 19-20 (June 2012) (“Paradoxically, ‘exit rules’ would decrease (and not increase!) the probability of an exit, or the breakup of the Eurozone. This is because, as suggested above, spelling out the ‘exit rules’ would give the EZ what it needs, i.e. enhanced market discipline, stronger enforcement power over the Eurozone, more internal discipline in the profligate countries and reduce market uncertainty.”).

35 This same phenomenon has been observed in the context of treaties, where the existence of withdrawal rights may encourage agreement. Meyer, *supra* note 21, at 383 (“High exit costs therefore narrow the set of substantive rules that make an agreement today worth foregoing tomorrow’s bargaining power. In extreme situations, high exit costs may preclude an agreement altogether.”); see also Barbara Koremenos & Allison Nau, *Exit, No Exit*, 21 *Duke J. of Comp. & Int’l L.* 81 (2010).

do not think this is necessarily true, either in the case of Greece or in general, especially in the context of an incomplete treaty organization such as the EMU. In such scenarios, the alternative to transparent *de jure* expulsion may well be a *de facto* expulsion that may be surreptitious and comparatively more costly.³⁶

IOs and treaties involving multiple parties and complex functions (managing the monetary policy of the Euro area, for example) are necessarily “incomplete,” because it is impossible, *ex ante*, to envision and specify all of the actions that have to be taken by international bodies and their members. Incomplete agreements are not limited to international law—they arise, for example, in the context of firms seeking vertical or lateral integration. Scholars of incomplete agreements have shown that the parties delegate residual decision making authority to one side, to a subset of members, or to a third party—in this context, the ECB, which is itself controlled by some subset of the treaty members.³⁷ That third party, in turn, may have the means to deny the benefits and privileges of membership, resulting in an expulsion in all but name.

The alternative to *de jure* expulsion of a member is therefore not an open-armed embrace by the organization. A dissatisfied IO can do many things to deny organizational benefits or make life miserable for the unwanted partner.³⁸ Often an organization’s rules permit it to impose such pain. At other times, pressure may be contrary to the letter or spirit of the IO—actions that could have serious reputational costs for the organization, but might also induce the targeted member to withdraw. Cumulatively, such actions can amount to something like a *de facto* expulsion, one for which the member state may have little or no remedy.

We have already seen something like this in the case of Greece. On multiple occasions in its sovereign debt crisis, Greece has considered the possibility of restructuring its debt long before the ECB and the more powerful members of the Euro area were willing to contemplate that possibility. Both in the early years of the crisis (2010–11, *vis-à-vis* Greece’s

36 See Helfer, *Exiting Treaties*, *supra* note 17.

37 Among the classic works on this topic are Sandy Grossman & Oliver Hart, *The Cost and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. Pol. Econ. 691 (1986) and Philippe Aghion & Patrick Bolton, *An “Incomplete Contracts” Approach to Financial Contracting*, 59 Rev. Econ. Stud. 473 (1992).

38 Sohn, *supra* note 32, at 1419–20 (“[I]t would now seem that a regional organization, even in the absence of a provision on exclusion, can expel a member without Security Council authorization, at least if the decision is properly camouflaged [as merely a membership question].”).

private sector debt) and in the latter portion (2015, vis-à-vis Greece's official sector debt), Greece was told that an attempt to restructure would result in denial of access to the ECB's support.³⁹ And denial of ECB support for the banking system would have forced Greece to exit the Euro and go back to the drachma. In effect, Greece was told it must either comply with the dictates of the ECB or face *de facto* expulsion.

Jean Claude Trichet, the head of the ECB in April 2011, suggested as much in his response to the prospect of extending the maturities of some of the Greek debt:

The central bank's president inform[ed] the Greek prime minister in no uncertain terms that a decision to extend maturities would lead to the ECB pulling the plug on the support mechanism keeping the Greek banking system alive. The immediate effect of such a move would be to force Greece to leave the euro and print its own money to avoid the sudden death of its banks.⁴⁰

The German finance minister's plan to induce Grexit in July 2015, at least as reported by *Der Spiegel*, was of the same basic form:

The ministers agreed to formulate such strict conditions for a third aid package that the Greek government would never be able to accept them. As a means to push Greece out of the euro, Schäuble had devised a so-called trust fund, into which all revenues from the sale of Greek assets would flow. For Greek Prime Minister Alexis Tsipras, that would have been impertinent enough. But the conservative ministers wanted to go even further and demand that the fund be located in Luxembourg, a stipulation Tsipras could not possibly accept.⁴¹

In both cases, Greece capitulated to the threats of expulsion.

39 On the 2010-11 events, Paul Blustein has written:

Much blame [for the failure to restructure the debt early] belongs with Trichet and his ECB colleagues, who threatened to cut off emergency aid to Greek banks if Athens tampered in the least with its debt obligations. The ECB's rigid stance stifled discussion of more far-reaching debt restructuring proposals, even though German officials were by then eager to make private lenders share some of the burden of the Greek rescue. Paul Blustein, *The Greek Crisis: Human Errors and Divine Forgiveness*, Longitude, Feb 20, 2015.

As for 2015, see Ian Traynor & Larry Elliott, *Greece Given Days to Agree to Bailout Deal or Face Banking Collapse and Grexit*, *The Guardian*, July 7, 2015.

40 See Yannis Palailogos, *How Trichet Threatened to Cut Greece Off*, *Ekathimerini*, Nov 3, 2014.

41 See *A Government Divided: Schauble's Push for Grexit Puts Merkel on the Defensive*, *Spiegel Online*, July 17, 2015.

European institutions have used similar measures to threaten expulsions in other contexts. The recent secession movements in Catalonia and Scotland provide ready examples. In both cases, high level European officials made statements to the effect that if these regions seceded, they would be expelled from the EU.⁴² And, once expelled, reentry was not by any means assured; Spain, in particular, was expected to block Scottish reentry.⁴³ If expulsion from the EU was not permitted, one would not have thought that there would have been any value to making these threats. As Roland Vaubel has pointed out, however, there is nothing in the EU treaties that addresses the context of a regional secession (and in effect the question of whether the right to membership of the EU belongs to the people in a divisible fashion or to the government in an indivisible form).⁴⁴

To reiterate our core claim—in the context of a highly incomplete treaty, where the right of residual decision making has to be delegated or allocated to a third party, formal *de jure* expulsion is not the only possibility. The *de facto* power to expel may well already exist, which means that an unwanted member may be largely shut out of participating in the organization and enjoying its benefits. The question is not *whether* expulsion is possible, but when it should be permitted and subject to what restrictions. In the following section, we begin to identify, in broad terms, the existing legal rules.

II. Background Principles of International Law

A. *Expulsion from Treaty Organizations*

Expulsion from treaties and IOs, both temporarily and permanently, has long been recognized as a remedy that can be imposed against a member state that materially breaches its obligations.⁴⁵ Sometimes expulsion is explicitly contemplated in an IO's constitutive documents; in other instances it can be inferred from background principles of international law.

42 See Roland Vaubel, *Secession in the European Union*, 33 *Econ. Affairs* 288 (2013); see also Government of Catalonia, *Report: Paths for Catalonia's Integration Into the European Union* (October 2014).

43 See Severin Carrell & Ashifa Kassam, *Scottish Independence: Spain Blocks Alex Salmond's Hopes For EU Transition*, *The Guardian*, Nov. 27, 2013.

44 Vaubel, *supra* note 41..

45 See generally Magliveras, *supra* note 11; Nagendra Singh, *Termination of Membership of International Organizations* (1958).

1. *Expulsion Clauses*

To a greater degree than national constitutions, treaty-based organizations—including institutions that aspire to universal membership—such as the League of Nations, the United Nations, and the IMF—have made explicit provision for the expulsion of member states.⁴⁶

Given the awkwardness of making provision for exit at the formation stage and the difficulty of specifying ahead of time the conditions under which expulsion may occur, the fact that expulsion clauses are ever included in constitutive documents is somewhat striking.⁴⁷ The aversion to acknowledging exit and expulsion is evident in the views of Woodrow Wilson, architect of the League of Nations:

[T]here can be no special, selfish economic combinations within the League and no employment of any form of economic boycott or exclusion except as the power of economic penalty by exclusion from the markets of the world may be vested in the League of Nations as a means of discipline and control.⁴⁸

And yet the Covenant adopted by the League of the Nations in 1919 did ultimately contain an explicit provision, Article 16(4), which provided that a member could be “declared to be no longer a Member of the League” if it were to violate the League’s covenants.⁴⁹ Wilson himself described Article 16(4) as permitting “expulsion from the League in certain extraordinary circumstances.”⁵⁰

In keeping with Wilson’s discomfort with the prospect of expulsion,

46 Makarczyk, *supra* note 24, at 477 (“In a number of organizations the right to suspend or expel a member has been more or less precisely defined in the statutory provisions.”).

47 Magliveras, *supra* note 11, at 65 (“The history of the international community after World War II has shown that states are usually disinclined to introduce expulsion clauses in constitutive instruments. However, at the same time, they have acknowledged the importance of expulsion as a means of ‘punishing’ those Members pursuing[] what is being perceived as[] unacceptable policies, even though the latter might not necessarily conflict with the constitutions.”)..

48 Quoted in Magliveras, *supra* note 11, at 7.

49 Hans Kelsen, *Sanctions in International Law under the Charter of the United Nations*, 31 Iowa L.R. 499, 508 (1946).

50 Sohn, *supra* note 32, at 1381.

Article 16(4) seems to have been treated as a live provision,⁵¹ but one to be used sparingly.⁵² In 1927, the Council issued a report confirming that the League could invoke 16(4) to expel a Member state for failing to pay its contributions and failing to show a willingness to remedy that failure in the immediate future.⁵³ But to our knowledge, 16(4) was applied only once, in 1939, when the USSR was expelled for the obviously serious offense of invading Finland.⁵⁴

The League of Nations would itself be replaced by the United Nations following the war, but expulsion remained an explicit part of the organization's constitutive document. Article 6 of the U.N. Charter provides:

A Member of the United Nations which has persistently violated the Principles contained in the present Charter may be expelled from the Organization by the General Assembly upon the recommendation of the Security Council.

This Article was met with hesitation,⁵⁵ and has never officially been used,⁵⁶ though temporary expulsion was essentially accomplished when South Africa's credentials were rejected as a way of excluding it from the

51 *Id.* at 1393 (noting that “the expulsion provision was raised also in connection with the obligation to contribute to the expenses of the League of Nations, and the obligation ‘to secure just treatment of the native inhabitants of territories’ under the control of a member of the League.”).

52 *Id.* at 1386 (“Neither in the Japanese aggression against China, nor in the case of the Italian aggression against China, nor in the case of the Italian aggression against Ethiopia, was there a formal attempt at expulsion.”)

53 Magliveras, *supra* note 11., at 15 (citing Doc.C.128.1927.V, 1927 LNOJ 381).

54 *Id.* at 22. Interestingly, the official Decision actually described the situation as if it were a withdrawal, saying that the USSR had “placed itself outside the League of Nations.” *Id.* at 25 (quoting 1939 LNOJ 506). See also Leo Gross, *Was the Soviet Union Expelled from the League of Nations?*, 39 *Am. J. Int'l L.* 35, 42 (1945) (“Having regard to the circumstances attending the vote of the Council, it seems necessary to conclude that the Council's resolution of December 14, 1939, did not have the legal effect of terminating the membership of the USSR in the League of Nations.”).

55 *Inter-American Juridical Comm., Recommendation and Reports: Official Documents, 1942-1944*, at 144 (1945) (“Provision should, no doubt, be made for the possibility of a state violating its obligations. But in such case the particular state should be disciplined, not expelled. Expulsion would only tend to create factions in the international community.”).

56 This does not mean that nations have never invoked it. Magliveras, *supra* note 11, at 46 n.101 (noting that “it was Syria that on 22 December 1955 introduced a draft SC Resolution which, *inter alia*, called upon all Members to decide to expel Israel, UN-Doc.S/3519, 1955 YBUN 35; no vote was taken on it.”).

General Assembly during the apartheid era.⁵⁷ (The rejection of credentials is one procedural way to achieve the *de facto* exclusion without actually going through with a formal expulsion.⁵⁸)

The League of Nations and United Nations are the most significant examples of organizations with explicit expulsion clauses, because of their prominence and the fact that they were largely designed to be inclusive, universal, and dependent on a high degree of consensus for decisionmaking. But the constitutive instruments of various regional and subject-specific organizations contain expulsion clauses,⁵⁹ which have occasionally been exercised.⁶⁰ Article 8 of the Statute of the Council of Europe, for example, says that “[a]ny member which has seriously violated” the “principles of the rule of law and the enjoyment by all persons within its jurisdiction of human rights and fundamental freedoms” may be declared to not be a Member as from such date as the Committee of Ministers may determine.⁶¹ Interestingly, given the identity of the players in the current crisis, the closest that the Council ever came to suspending or expelling a member was Greece, whose 1967-74 military regime was alleged to have committed serious human rights abuses.⁶²

As noted above, one organization for which the ability to expel a misbehaving member has been seen as important is the IMF, whose Articles of Amendment explicitly provide for compelling a member to withdraw.⁶³ The IMF was put in place after World War II, in large part to protect against the “beggar thy neighbor” policies with respect to exchange rates and trade policy that many countries had followed in the prior era.⁶⁴ To perform that policing task—ensuring that the global exchange rate system worked in a fair and efficient manner—it was crucial that the IMF’s teams

57 See generally Alden Abbott et al., *The General Assembly, 29th Session: The Decredentization of South Africa*, 16 *Harv. Int’l. L.J.* 576 (1975); see also Magliveras, *supra* note 11, at 45-46 (noting that “the political balances in the Council prevented a recommendation for South Africa’s expulsion”).

58 Sohn, *supra* note 32, at 1422.

59 Magliveras, *supra* note 11, at 88-93 (describing suspension and expulsion from Common Market for Eastern and Southern Africa); Pact of the League of Arab States, March 22, 1945, art. 18, para. 2, 70 *U.N.T.S.* 259 (1950); Convention for European Economic Cooperation, April 16, 1948, art. 26, *Cmd. No. 7796 (B.T.S. No. 59)*, at 18.

60 Makarczyk, *supra* note 24, at 485 (noting expulsion Czechoslovakia from the IMF).

61 Statute of the Council of Europe, May 5, 1949, art. 3 & 7, 87 *U.N.T.S.* 106, 108 (1951).

62 Magliveras, *supra* note 11, at 80-83.

63 Brummer, *supra* note 14, at 159 (categorizing the Fund as a “hard law” institution).

64 E.g. Morris Goldstein, *The IMF as Global Umpire for Exchange Rate Policies*, in C. Fred Bergsten and the World Economy 314 (date)

be able to obtain accurate information about individual nations to prevent cheating.⁶⁵ The IMF's primary tool to ensure cooperation was the threat of denying misbehaving members the benefits of membership.⁶⁶

2. Default Rules: The Analogy to Withdrawal

Not all treaties or IOs explicitly provide for expulsion.⁶⁷ Some commentators read these silences as precluding expulsion, based on what they see as the "well-established principle of international law that where a constituent instrument is silent in respect of [expulsion], there is no inherent right vested in the organization [to expel]."⁶⁸ We think, to the contrary, that background rules of treaty interpretation provide support for a default rule that a member state can be expelled from an IO or treaty, at least in case of a material breach.⁶⁹

To illustrate, we begin with an extreme but real historical example. If Article 16(4) had never been written, would the League of Nations have been legally required to keep the USSR as a member in 1939, despite having concluded that it had breached the Covenant by invading another member state? It seems implausible to argue that it would. Magliveras, in his treatise on the law of suspension and expulsion from international organizations, concludes that the Covenant's express expulsion clause "was not creating any new special regime but was declaratory of the majority view which, if applied by analogy, meant that breach of any Covenant provision entitled the other signatory parties to terminate it vis-à-vis the delinquent party, i.e. exclude it from the continuous operation of the Covenant."⁷⁰

The ability to effectively expel a state that has materially breached an

65 See Hagan speech, *supra* note 28.

66 See *id.* Expulsion from the IMF occurs only after a couple of initial steps. First, the member's voting rights are suspended and then the ability to use the fund's resources is removed. See *id.* Over the years, these penalties have been applied to Sudan, Somalia and Zimbabwe. Only one member has been expelled, Czechoslovakia in 1954, for failing to adequately give the Fund information.

67 See, e.g., Brummer, *supra* note 14, at 159; Sohn, *supra* note 32, at 1417-19.

68 Singh, *supra* note 44, at 79. Singh was writing nearly 60 years ago, before even the Vienna Convention. Athanassiou, senior counsel at the ECB, has taken essentially the same position. See Athanassiou, *supra* note 4, at 31-36.

69 Makarczyk, *supra* note 24, at 487 ("The problem to be studied now can be formulated as follows: can the right to suspend or expel a member, in case the statute is silent, be implied in emergency situations? I do not think it possible to give a general answer to this question.").

70 Magliveras, *supra* note 11, at 17.

international law obligation was codified the Vienna Convention on the Law of Treaties.⁷¹ Under Article 60 of the VCLT, a “material breach” of a multilateral treaty by one party—defined as “(a) a repudiation of the treaty not sanctioned by the present Convention; or (b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty”⁷²—entitles “the other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either: (i) in the relations between themselves and the defaulting State, or (ii) as between all the parties.”⁷³

Unsurprisingly, it is difficult to say in the abstract what constitutes a “material” breach.⁷⁴ An example is when the Soviets unlawfully shot down a Korean airliner in 1983. That was deemed to be a material breach of a number of air services treaties specifying that treaty parties would ensure the safety of the aircrafts of the other treaty members.⁷⁵ But one can also imagine less extreme examples. Some have argued that Greece requiring a bailout from the EMU in violation of the “no bailout” clause of Article 125 of the Lisbon Treaty is a material breach, since that clause is deemed by many to be a core term.⁷⁶

71 Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331. Magliveras notes that if an international organization’s “constitutive instrument contains suspension or expulsion clauses, the organization has been delegated the power to proceed accordingly; if not, Article 60 of the Vienna Convention could be applied.” Magliveras, *supra* note 11, at 232-233; see also *id.* at 3 (“Since it is the minority of constitutive instruments which contain express suspension and/or expulsion clauses, this lacuna is addressed by arguing that the Vienna Convention on the Law of Treaties and the rules on permitted countermeasures could be invoked and applied by analogy in appropriate cases.”); Chi Carmody, *On Expelling Nigeria from the Commonwealth*, 34 Canadian Y.B. Int’l L. 273, 284 (1996) (“The Vienna Convention has never been invoked to resolve a disputed expulsion, but a number of the convention’s articles apply to such a situation.”).

72 Vienna Convention, Article 60(3); see also Ian Brownlie, *Principles of Public International Law* 622 (7th ed. 2008).

73 Vienna Convention, Article 60(2)(a).

74 See Anthony Aust, *Handbook of International Law* 96 (2d ed. 2007) (pointing to UN-SCR 1441 (2002)); see also Carmody, *supra* note 70, at 285 (describing wrongdoing sufficient to justify expulsion as “a material breach of a tenet that is central to the association’s aims”).

75 See Ghislaine Richard, KAL 007: The Legal Fallout, *Annals of Air & Space L.* 146, 150 (1983); Kevin Chamberlain, *Collective Suspension of Air Services*, Int’l & Comp. L. Q. 616, 630 (1983).

76 For a discussion of the articulation of this view by Germany’s finance minister, Wolfgang Schauble, and others, see Karl Whelan, “Alice in Schauble Land: Where Rules Mean What Wolfgang Schauble Says They Mean,” July 17, 2015, at <https://medium.com/bull-market/alice-in-sch%C3%A4uble-land-where-rules-mean-what-wolfgang-says-they-mean-f0f327fa8a6d#yqjfr8p>

A material breach of IO constitutive instrument, Magliveras explains, “would lead either to the suspension of the malefactor state’s membership rights or to its expulsion, or to the suspension of operations of the organisation in question or even to its dissolution.”⁷⁷ In other words, expulsion of the recalcitrant member can be effectuated by the (admittedly cumbersome) process of a mass withdrawal followed immediately by reconstituting the organization without the breaching state.⁷⁸

The VCLT and state practice also recognize exit rights without a prior material breach. For example, Article 56 specifies that states may withdraw if a right of withdrawal is implicit in the nature of the treaty or intended by the parties (although not codified in the text itself).⁷⁹ And Article 62 provides that a fundamental change of circumstances may trigger a withdrawal, even without a material breach by either party.⁸⁰

When states negotiate treaties, they often include explicit exit provisions. As one of us has previously written, “[m]ost multilateral treaties contain broad and permissive withdrawal clauses that do not condition exit upon the consent of other state parties or review by international tribunals.”⁸¹ Because exit and expulsion are closely related, these clauses arguably provide further evidence that treaty law and practice support a norm of expulsion in cases of serious misbehavior—even if a treaty does not expressly provide for expulsion. The fact that exit provisions

77 Id. at 235.

78 Many of the discussions of how the Euro area should move to a “two-speed” system where northern European nations and southern ones would be operating under different rules are effectively this—expulsion by withdrawal and reconstitution. E.g., IESE Staff Discussion, *Is a 2-Speed Euro the Solution for the Eurozone*, 9/3/2015, <http://blog.iese.edu/economics/2015/03/09/quick-question-is-a-2-speed-euro-the-solution-for-the-eurozone/> (quoting Professor Alfredo Pastor: “One imagines that a two-speed euro is a polite name for a eurozone without Greece. That is economically possible, and may even be good for Greece and the others. But how could one erase the feeling of failure in Greece and the bad feeling that will result from it?”).

79 For a discussion of these provisions, see Phedon Nicolaides, *Withdrawal From the European Union: A Typology of Effects*, 20 MJ 2 (2013).

80 VCLT art. 62, para 1; For a discussion of these provisions, see Phedon Nicolaides, *Withdrawal From the European Union: A Typology of Effects*, 20 MJ 2 (2013).

81 Helfer, *Exiting*, *supra* note 17, at 67. See also Aust, *supra* note 73, at 279 (“Most multilateral treaties of unlimited duration will allow a party an unconditional right to withdraw.”).

are rarely invoked⁸² suggests that expulsion will similarly arise only in extreme circumstances.⁸³

A critic might argue that the commonality of withdrawal positions suggests exactly the opposite: That expulsion provisions were considered and rejected and that means that expulsion is not permitted under any circumstances. The point is a fair one, and we have three preliminary responses.

First, while we concede that silence in a treaty's text likely means that the parties were not able to agree on the rules under which expulsion would be permitted, this also implies that they did not agree on a flat ban on expulsion. Failure to agree ahead of time on the specific conditions under which expulsion could occur might simply mean that this was a matter on which agreement could not be reached *and* on which the failure to agree was not a deal breaker.⁸⁴ Put differently, it may have been one of the matters on which the agreement was in effect to allow parties to work their differences out without predetermined rules and, if things could not be worked out, to refer any disputes to a third party such as a court.

Again, the analogy to incomplete contracts or collaborative contracts is helpful. As Gilson, Sabel and Scott ("GSS") have shown, it is difficult in collaborative ventures to specify all contingencies in a contract ahead of time.⁸⁵ What this means is that the parties have in effect agreed to work

82 Curtis A. Bradley & Mitu Gulati, *Withdrawing from International Custom*, 120 Yale L.J. 202, 246 (2010) ("Commentators have evinced few concerns ... about excessive withdrawals from multilateral treaties."); Anna T. Katselas, *Exit, Voice, and Loyalty in Investment Treaty Arbitration*, 93 Neb. L. Rev. 313, 342 (2014) ("At least 180 states have executed BITs, and of those states, a small number appear to have embarked on the long and open road towards full, formal club resignation.")..

83 Helfer, *Exiting*, supra note 17, at 1601 ("[F]ew treaties—at least outside the trade context—can credibly threaten to impose monetary penalties or other sanctions."); Egon Schwelb, *Withdrawal from the United Nations: The Indonesian Intermezzo*, 61 Am. J. Int'l L. 661, 672 (1967) ("[T]he United Nations has no legal remedy to enforce its claims for continued membership of the state purporting to withdraw."); Rosendorff & Milner, at 834-35 (arguing that a nation exercising the escape clause of GATT is constrained by the fact that the escaping state compensate adversely affected members or else face retaliation).

84 For a discussion of the situations where parties have effectively "agreed to disagree", see Omri Ben-Shahar, *Filling Gaps in Deliberately Incomplete Contracts*, 2 Wisc. L. Rev. 389 (2005). Ben-Shahar's solution (a pro defendant default), while attractive, probably would not work in circumstances where the agreements in question give residual control rights to one side or the other (thereby making de jure and de facto expulsion much the same).

85 E.g., Ronald J. Gilson, Charles Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine*, 110 Colum. L. Rev. 1377 (2010).

out their differences without the need of formal rules—in the manner in which collaborators in cooperative venture would be expected to. But this does not rule out the possibility that some types of behavior could be determined at a later date to justify expulsion.⁸⁶

Second, if the goal is to give parties the rules that they would have agreed to had they been able to foresee the circumstances at hand, it is worth considering the fact that we have not come across a single treaty that contains an explicit and categorical prohibition on expulsion. By contrast, empirical work that one of us has done on exiting treaties shows that there are many that explicitly allow for withdrawal under certain sets of conditions. Those two facts suggest that the default rule, in the case of silence, should not be a ban on all expulsions. No one, in the circumstances where they are able to come to agreement, ever seems to choose that rule.

Third, there are good reasons not to ban expulsion in perpetuity. Even if negotiators are willing to enter into agreements that preclude expulsion or exit forever, no matter what the changes in circumstances or what kinds of misbehavior the other parties engage in, such agreements should be treated with somewhat more suspicion when they purport to bind future actors who face problems unforeseeable at the time of the agreement's creation.⁸⁷ Along those lines, note that older treaties are subject to withdrawal at higher rates.⁸⁸

What, then, explains the lack of expulsion provisions? Perhaps the issue is simply that treaty partners do not wish to make provision in their constitutive documents for the same reason that couples do not like to discuss divorce on their wedding day. In either scenario, the failure to specify an exit option does not preclude exit.

III. Toward a Three Part Framework

Having argued that expulsion is sometimes desirable, and then that it is not always illegal, we now sketch—in general terms—a framework with which to evaluate it. Our thoughts are tentative. Every IO is unique in its legal arrangements, history, and political incentives. Nevertheless, it is

86 Id. at 1416-17 (discussing the *Eli Lilly* case).

87 We argue elsewhere that such agreements should be defeasible even within the national context. See Joseph Blocher & Mitu Gulati, *Expulsion*, __ L. & Contemp. Prob. __ (2016, forthcoming).

88 Helfer, *Exiting Treaties*, *supra* note 17.

possible to imagine three broad categories of cases that apply where an IO-creating treaty is silent on expulsion.

First, take the well-behaving member state. The default rule for treaties that have no explicit provisions on expulsion should be that such a state may not be expelled. We derive this from the premise that nations enter into collaborative relationships with the assumption that problems will almost always be worked out cooperatively. Expulsion is a last resort solution when it is clear that one or more of the parties are consistently undermining the cooperative venture. This perspective is also consistent with existing international law. As explained above,⁸⁹ members typically cannot be expelled from IOs unless they have engaged in material breaches of basic commitments or there has been a fundamental change in the core understandings underlying the organization.⁹⁰ Well-behaved members, even if they are otherwise undesirable, cannot be kicked out absent a radical change in the foundational understandings underlying the organization.

This does not, however, mean that treaty and IO memberships are frozen in place, only that the IO and the member state would have to agree on any changes. If an organization wanted to expel a well-behaved but undesirable member, it would have to do so by negotiating with the member. The member could hold out—its right to remain in the nation would be protected by a “property right” in the Calabresi/Melamed sense⁹¹—but a deal might be reached in some cases, particularly since the other states likely have the power to make membership undesirable. As discussed at the outset, some elite German intellectuals have wanted the EMU to extend similar treatment to Greece.⁹² Such agreements would have to be monitored for fraud, threats of force and the like, the existence of which—in keeping with existing treaty law—would void the agreement. But in general, if a member state is not at fault for the deteriorating relationship, then it cannot be expelled against its will.

Second, on the opposite end of the spectrum, members that are misbehaving in the extreme—for example by declaring war on other mem-

89 See *supra* Section II.C.

90 Sohn, *supra* note 32, at 1400 (quoting 7 U.N. Conf. Int'l Org. Docs. 330-31 (1945)).

91 See Guido Calabresi & A. Douglas Melamed, Property Rules, Liability Rules and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089 (1972).

92 The obvious references here are to the “time out” and “gift” proposals of Wolfgang Schauble and Hans Werner Sinn in 2015 vis-à-vis Greece. See note 97, *infra* & 75, *supra*.

bers or actively working to undermine an IO—can be expelled at the option of remaining members. Such an extreme remedy is, we argue, implicit in all interstate cooperative ventures that involve establishing an organization to achieve shared objectives.⁹³

Most of the time, in an association of nations with repeated dealings, nations will have sufficient built in incentives to cooperate. However, there will be rare cases where a particular member is undermining the organization's *raison d'être*. It is in this narrow set of circumstances—where the minority member is essentially “oppressing” the organization as a whole—that the threat of expulsion—and, if need be, the removal of the offending state by the remaining members—can play an important role. It may be necessary, however, to provide the minority member with notice and an opportunity to cure its misconduct and access to a third-party decisionmaker to ensure that the process is not abusive or pretextual.

Exactly what circumstances justify remedial expulsion will inevitably be dependent on context, subject to dispute, and near impossible to specify *ex ante*. But this is not an unfamiliar scenario in complex or relational contracting contexts where a full set of future contingencies cannot be specified ahead of time and vague concepts such as “good faith” and “reasonable efforts” are used *ex post* as gap fillers.

Harder questions arise in scenarios where the members arguably bargained for a perpetual union. As noted at the outset, some have argued that Greece cannot be expelled from the EU no matter what it does—even if it were to invade a fellow member.⁹⁴ But even if it were clear that expulsion were expressly forbidden by the terms of a constitutive treaty—and, to reiterate, we are aware of no such example—remedial expulsion might still be justifiable in extreme circumstances.

In the end, such arguments are probably unnecessary—in a situation that demanded it, a nation would simply engage in remedial expulsion, regardless of what the legal authorities say on the matter.⁹⁵ For example,

93 As the U.S. argued in defending the expulsion of Cuba from the OAS—an IO without an express exclusion clause—“no regional body can be forced to accept or maintain the presence of a government which the members of that regional body determine to be violating the very terms of the charter of that body.” 46 Dep’t St. Bull. 657, 689 (1962).

94 Lowrey, *supra* note 8 (rejecting possibility of EU expulsion “even if Greece invaded France”).

95 Joseph H. Weiler, *The Transformation of Europe*, 100 Yale L.J. 2403, 2412 (1991) (“It takes no particular insight to suggest that should a Member State consider withdrawing from the [European Coal and Steel] Community, the legal argument will not be the critical or determining consideration.”).

we suspect that Greece would be expelled if its domestic Central Bank were to start printing excessive amounts of Euros, in contravention of the clear constraints imposed by the ECB. At this point, expulsion would be regarded as a valid exercise of political—if not legal—power. We have tried to show that it would be both, and that the power to expel (like the power to withdraw) should be thought of as a *remedy* and not necessarily as something the parties must bargain for *ex ante*. In the language of relational or incomplete contracts, because the standard for expulsion is necessarily going to be a function of circumstances—whether or not an action constitutes misbehavior worthy of expulsion or an excusable action because of unforeseeable events—it may not be easy to specify in advance.

Third and finally, there is a middle category—one in which members are not actively undermining the organization, but are nonetheless falling significantly short of their obligations. In those scenarios, we suggest (even more tentatively) that the member *can* be expelled against its will, but that it is owed compensation as a result.

These scenarios could in principle be included in our broad default rule against involuntary expulsion of well-behaved members. But it is still worth considering the possibility of expulsion in situations short of the horrific malefactor regions above. After all, forbidding expulsion does not mean that the situation will necessarily be resolved peacefully within the existing union. Eliminating the exit or expulsion options *should* increase voice, but that does not mean that it *will*.

Once again, the Greek debt crisis provides a useful illustration. As noted, some have argued that a Greek default on its ECB debt or that debt owed to the other Eurozone nations would constitute a bailout, violating the sacrosanct “no bailout” clause of the Lisbon treaty, and that expulsion should be on the table as a remedy.⁹⁶ Others have argued that Greece can be expelled because the numbers it used to gain admittance into the Eurozone in the first place were fraudulent.⁹⁷ Implicit in both sets of arguments is a notion of fault, which, if sufficiently extreme, could push it into our category of remedial expulsion.

But not all of those urging Grexit have invoked fault-based arguments. A few commentators have suggested the equivalent of a forced buy out.

96 See *supra* note 2 and sources cited therein.

97 See, e.g., Steve Peers, The Law of Grexit: What Does EU Law Say About Leaving Economic and Monetary Union, 28 June 2015, <http://eulawanalysis.blogspot.com/2015/06/the-law-of-grexit-what-does-eu-law-say.html>.

The suggestion is that Germany and the other Euro area nations either “forgive” the Greek debt or treat it like a gift conditioned on Greece’s “voluntary” exit from the monetary union.⁹⁸ Would this kind of compensation be permissible? Could it be given as an incentive for a “voluntary” Greek exit? If so, what kind of approval would Greece have to give? Could the sitting government make the decision on its own or would there need to be a referendum? What about approval from the populations of the other Euro area national governments, their legislatures and so on? And what if there were certain regions in Greece that did not wish to take the buyout and were willing to pay back their share of the Greek sovereign debt owed to the other Euro member states?

These are uncomfortable questions, and we do not have ready answers. But refusing to acknowledge them does not avoid the underlying problem. Our goal in this paper is far more modest—to describe a general proposition without fleshing out all of the details. But we are mindful of the latter’s importance or difficulty. Rules would have to be developed regarding how serious or persistent an offense must be in order to trigger the right of remedial expulsion. In exercising it, nations and organizations should presumably be subject to a requirement of good faith vis-à-vis each other,⁹⁹ which would also need to be elaborated. It may be that a forum or a review process would have to be established to deter pretextual or abusive expulsions.¹⁰⁰ These are the kinds of challenges scholars and practitioners can and must confront, rather than dismissing expulsion as an option altogether.

98 Hans-Werner Sinn, *Why Greece Should Leave the Eurozone*, N.Y. Times, July 24, 2015, Hans-Werner Sinn, *Why Grexit Could be Good For Greece*, CNN Money, July 7, 2015.

99 Vienna Convention, art. 26 (“Every treaty in force is binding upon the parties to it and must be performed by them in good faith.”); *Gabčíkovo-Nagymaros Project* (Hung./Slovk.), 1997 I.C.J. 7, para. 142 (Sept. 25) (noting that this provision “obliges the Parties to apply [the treaty] in a reasonable way and in such a manner that its purpose can be realized”).

100 Magliveras, *supra* note 11, at 2 (suggesting ICJ in the context of the UN, noting that “the majority of organizations lack judicial mechanisms for settling such disputes in an authoritative, final, and binding manner”); *id.* at 39 (“The question which should be the proper organ to decide (a) whether a Member had breached the Principles and (b) whether the breach was perpetrated in a persistent fashion has not been addressed in the Charter. Indeed, with only a limited number of exceptions, constitutions of international organizations do not deal with this issue.”).

PART III

Gaps in Governance: The Banking Union

GOVERNANCE GAPS & ASYMMETRIC CONVERGENCE

Piers Haben¹

“No human face is exactly the same in its lines on each side, no branch in its symmetry. All admit irregularity as they imply change; and to banish imperfection is to destroy expression...All things are literally better, lovelier, and more beloved for the imperfections”
John Ruskin

Introduction

The title of this conference is governance gaps and the session in which I have been asked to intervene is titled governance gaps in the banking union. I intend to approach this issue from the EBA's perspective, which is firmly entrenched down in the roots of the micro prudential world. Other panelists are better placed to draw attention to some of the high level current gaps in governance in the Banking Union as the project unfolds. In fact it is miraculous that the BU project has moved forward so fast and unsurprising that there are steps still outstanding, such as completing the Deposit Guarantee Scheme. But these are acknowledged and consideration on how to address them is underway. And so from the micro prudential perspective, rather than identifying the big picture gaps per-se, I intend to reflect on some of the asymmetries in governance that affect our day to day work, These asymmetries are a choice and by design,

¹ Director of Oversight at European Banking Authority. This text is the edited transcription of my speech at the conference conference “Filling The Gaps In Governance: The Case Of Europe “ organised by the European University Institute in Florence on 28 April 2016. The views expressed in the text are the private views of the author and may not, under any circumstances, be interpreted as stating an official position of the European Banking Authority.

but such asymmetries may anyway look rather like gaps depending on your perspective.

I will nonetheless, start by offering some constrained remarks on the big picture governance asymmetries. In particular, identifying two ways in which some existing asymmetries between governance of the micro prudential level and the fiscal level have impacted the life of the EBA to date: the stress test, particularly in 2011; and dealing with Non Performing Loans in the current juncture.

Then I will look at two more micro focused areas where there are, by design, governance asymmetries which have been left in place in order to respect the democratic wishes of the Co-legislators when establishing the European Supervisory Authorities (ESAs).

- i) The first area relates to supervisory convergence- by which I mean comparability of supervisory approach and consistency of supervisory outcomes, across the single market. This has become more, not less, pressing in the face of de facto convergence in the Eurozone with questions over comparability of approaches and consistency in outcomes across the rest of the single market,
- ii) The second area is the asymmetry between a single micro prudential rule book for the single market, and macro prudential decision making at a national level.

The text below attempts to demonstrate how these are relevant for effective functioning of the single market and in particular from the stand point of avoiding the prevention of cross-border activity, distorting competition and impeding free movement of capital².

Constrained remarks on high level governance asymmetries

Two incidents in the EBA's early life shine a light on high level governance issues. In particular, whilst rules are set at the EU level, fiscal responsibility remains clearly at the national level³ and the absence of clear coor-

2 http://ec.europa.eu/finance/capital/index_en.htm

3 See, for instance, A. Enria (2013), "Often EU authorities are criticised for not having acted swiftly and decisively enough in addressing the weaknesses of the banking sector. I acknowledge that the absence of a common fiscal capacity and the complexity of our decision making mechanisms have made the management of the crisis particularly challenging, causing delays and uncertainties in the policies for the banking sector. Nonetheless, we made significant progress.

dination and cooperation between fiscal authorities has been criticised in some quarters as having arguably influenced the recovery of the EU banking sector in a different direction from that which was available in e.g. the US⁴. Of course, issues around fiscal cooperation and coordination are most directly relevant for the Eurozone. However, they resonate, at least in terms of communications, in the process of repair of the EU banking system as a whole.

The first incident relates to the 2011 stress test. In the first months of the EBA's existence, in 2011, the handful of staff we had in place were occupied not only with the establishment of the new authority – we spent the Christmas break of 2010/2011 getting IT contracts signed whilst working on recruitment plans and worrying about office space – but also preparing the ground for the highly anticipated EU wide stress test. In our small authority a group of around six people, ably supported in the latter stages by volunteers from national authorities who camped out in our London offices, coordinated this exercise. The EBA mandate is to initiate and coordinate an EU wide stress test⁵. This limited mandate meant that responsibility for receiving the results from banks, and challenging them, rests with competent supervisory authorities, before sending final results to the EBA to publish them as an EU data hub.

The 2011 EU wide stress test was analytically sound with a scenario provided by the ESRB and a robust methodology that effectively prohibited any bank mitigating action as a result of the static balance sheet assumption. The stress showed provisions of around EUR 200bn in each of the two years, equivalent to the loss rates of 2009 repeated in two consecutive years⁶. Many analysts judged the July stress tests too mild, mainly because they did not explicitly consider the default of Greek sovereign debt. “But this misses the point. The EBA stress tests were a great step forward from the point of view of disclosure. For the first time, markets could see full information on each bank's exposures, by country, debtor type, and maturity. Moreover, sovereign exposure and funding costs of individual institutions were disclosed, both historical and in the

4 <http://www.niesr.ac.Uk/sites/default/files/publications/dp374.pdf>, <https://www.imf.org/external/pubs/ft/wp/2013/wp13178.pdf>

5 <http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing>

6 https://www.eba.europa.eu/documents/10180/15935/EBA_ST_2011_Summary_Report_v6.pdf/54a9ec8e-3a44-449f-9a5f-e820cc2c2f0a

adverse scenario”⁷.

The exercise has nonetheless, been unfavourably compared to the US stress tests, in particular the crisis stress test of 2009. Critics argue that a major difference is that in the US there was a single pot of money with which to announce a big bang type recapitalisation of the banking sector at a time of crisis when uncertainty about the banking sector as a whole necessitated some drastic action. Some have argued that without such a clear incentive structure, supervisors follow the rules of the exercise without pushing the boundaries to exercise conservative judgement needed to identify ever larger holes⁸. I am not sure this is the case but it certainly influenced the communication around the exercise as outsiders looked for a big bang type approach to recapitalisation, which anyway occurred both before and after the stress test. Before the stress test there were significant pre-emptive actions by banks to raise capital. In a coordinated exercise, in which the stress test is run on a bottom up basis banks run the test themselves and are then challenged by supervisors. The incentive then is for banks to front run the exercise by strengthening their capital base in advance of the exercise in order to demonstrate resilience in the results as happened in 2011⁹. After the stress test, the EBA followed up with a recapitalization exercise¹⁰ which saw further significant capital raised by banks. Nonetheless, our communication challenge remained without a single message at one point in time that banks should recap or the state(s) would do so.

The second example relates to supervisory efforts to deal with non-performing loans. The EBA, alongside many others, has been making the case that the high and persistent levels of NPLs across the EU has been a key driver of sluggish profitability and restricted new lending into the real economy for some years¹¹.

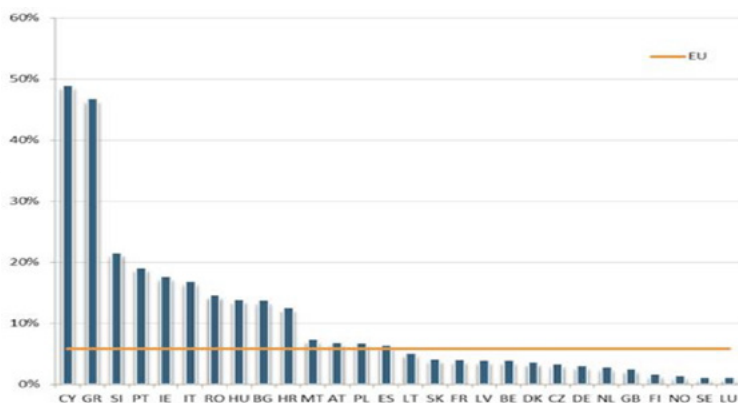
7 M. Onado and A. Resti (2011), “European Banking Authority and the capital of European banks: Don’t shoot the messenger”, VoXEU.

8 <https://www.imf.org/external/pubs/ft/wp/2013/wp13178.pdf>

9 https://www.eba.europa.eu/documents/10180/15935/EBA_ST_2011_Summary_Report_v6.pdf/54a9ec8e-3a44-449f-9a5f-e820cc2c2f0a “Based on end 2010 information only, the EBA exercise shows that 20 banks would fall below the 5% CT1 threshold. However, the EBA allowed specific capital actions ...to be considered in the results. Banks were therefore incentivised to strengthen their capital positions ahead of the stress test”

10 <https://www.eba.europa.eu/-/eba-publishes-final-report-on-the-recapitalisation-of-european-banks-and-paves-the-way-for-the-transition-to-the-crd-iv-framework>

11 <http://www.eba.europa.eu/documents/10180/1315397/EBA+RISK+ASSESSMENT+REPORT.pdf/46d91b9a-f393-4b54-96eb-df06ca01bec5>



Source: EBA Risk Dashboard (Q4 2015 data).

The EBA has done its bit by providing supervisors with a common definition for the first time that facilitated measurement not only of actual NPLs but also forced banks to measure and assess loans that were forborne¹². But recognition is one step. Action to resolve NPLs is another, more important step. Supervisors are currently pushing banks to strengthen provisions, improve arrears management practices, and consider how to write off and sell NPLs. However, effective action on NPLs requires also effective opportunities to remove NPLs from the balance sheet. Partly this can be facilitated by transparency. But evidence globally¹³ suggests additional measures are needed including effective secondary markets and at times the creation of Asset Management Companies. At present this can only be handled nationally leading to varying approaches across the EU, with various trials at legislative frameworks and always cognisant of the DG Comp imperatives to avoid state aid. So whilst supervisory action is coordinated at the EU level, and taken uniformly within the banking union, there are important steps needed to address NPLs that remain, by design, at national level. Investors remain confused and spend time in each case trying to figure out the details. Some common European thinking and communication around coordinated mechanisms for legal frameworks and support for AMCs, could make a difference at this

12 <https://www.eba.europa.eu/documents/10180/449802/EBA-Rec-2013-04+Recommendations+on+asset+quality+reviews.pdf>

13 <https://www.imf.org/external/pubs/ft/sdn/2015/sdn1519.pdf>

crucial time to enhance price discovery on NPLs, promote a secondary market and set EU banks back on course to recovery and productive lending into the real economy.

Micro level governance symmetries

Now to the two more micro focused issues. These may seem somewhat trivial compared to the big picture issues discussed elsewhere in this conference. However, I would like to demonstrate why these are important and can have a significant impact on both capital movement and competition.

To say these asymmetries in governance have been put in place by design is to recognise the legitimate process that was used to establish both the EBA and the SSM. That is for the single market as a whole supervision remains at the level of the competent authority which means, now, the SSM for Euro area countries and national level for other countries until such time as they join the Euro or voluntarily sign a close cooperation agreement with the SSM. At the same time, in recognition of the potential impact that divergence in supervisory approaches and outcomes, sticking plaster solutions have been put in place recognising the dangers for competition and free movement of capital if there is supervisory divergence, i.e. incomparable approaches and inconsistent outcomes.

Similarly, one of the great lessons of the financial and sovereign crisis that has beset the EU since 2008, has been the need for more effective macro prudential policy designed to address macro imbalances, in particular excessive credit growth in an economy. The ESRB was established to draw coherence between macro prudential policies but primary responsibility for major prudential policy rests with national authorities across the EU. The coordinated solution to this democratic decision has been the role of the ESRB, and to some extent, the EBA, in being aware of national macro prudential decisions and in rare cases to offer an opinion on it. The text below will attempt to draw out the risks that, inadvertently, uncoordinated use of macro prudential policies could stifle competition and hinder free movement of capital across the single market.

Governance of micro prudential supervision across the single market.

It is crystal clear, and widely accepted, that we need a single rule book in the single market. The single rule book is accepted as necessary and governance for the single rule book is in place from the highest level of the co-legislatures right down to the rather complex voting mechanisms at the EBA's Board of Supervisors. The latter includes Qualified majority voting with special double simple majority safeguards for non SSM authorities at the EBA table.

Supervisory implementation of the single rule book, and all its associated decisions on additional capital and liquidity a bank must hold, is clearly the domain of competent authorities. That is the SSM for Eurozone countries in the Banking Union and national supervisors elsewhere.

The welcome advent of the Banking Union means de facto supervisory convergence within the Banking Union but throws into sharp relief the potential for divergence of supervisory approaches and inconsistency in supervisory outcomes between the SSM and non-SSM countries and the associated risks to the single market in terms of competition and free movement of capital.

The current governance arrangements thus raise legitimate questions about the degree of proscription, or even oversight, that's relevant for the various supervisory approaches across the EU and consideration what these decisions mean for free movement of capital and a level playing field from a competitive perspective.

The impact of supervisory decisions ranges from choices over "national discretion items" that provide some interpretations of the rule book, to choices over how supervisors apply additional capital and liquidity requirements on banks and other supervisory measures such as dividend restrictions and limits on coupon payments on some type of bonds.

The answer to how these questions over convergence of supervisory decision making are currently addressed is reflected in the rather open ended mandate for the EBA in terms of supervisory convergence which requires us to actively foster supervisory convergence across the Union with the aim of establishing a common supervisory culture. This mandate does not, however, specify what outcomes it seeks to achieve or what enforcement powers the EBA has if there is a material divergence in supervisory activity.

What mechanisms does the EBA have?

The desired outcomes are more clear for specific decisions on cross border groups than for the banking sector as a whole.

Relatively strong governance mechanisms are in place to ensure that decision making for **cross border banking groups**, those that operate across the boundaries of the SSM and other competent authorities in the EU¹⁴. In particular, supervisors of cross border groups have to establish colleges of supervisors for cross border EU banks that are legally mandated to undertake joint risk assessments based on common methodologies, set by the EBA, and reach joint decisions on any additional capital or liquidity required as well as on recovery plans. The EBA monitors such interactions and can offer advice on guidance to improve the process. Substantively there are set timelines for reaching joint decisions and if there is no agreement on substance then the EBA can work to assist the various authorities find agreement and the EBA regulation provides a provision for “binding mediation”. This mechanism is however, reasonably restricted. It relates only to specific decisions and only then if one CA or more approaches the EBA for assistance. Whilst the EBA has been able to assist in mediating disputes informally during its five year history the EBA has not activated its formal mediation process. In any case this process governs decisions for individual banking groups but does not speak to comparability of approach and consistency of outcomes across banks. Nor does it speak to general supervisory convergence. In both cases the mechanisms for ensuring comparability of approaches and consistency of outcomes remains somewhat open ended as below.

For more **general supervisory convergence** the EBA has three main tools:

1. **Policy products.** The EBA has a specific mandate to produce standards, guidelines and other tools to promote a common supervisory culture and supervisory convergence. The EBA has a limited mandate to produce binding standards for cross border joint decision making. There is more scope for comply or explain guidelines and the most prominent of these is the 200 pages of SREP guidelines which determine how supervisory reviews are conducted and which came into force in 2016. (<https://www.eba.europa.eu/doc->

14 <http://www.eba.europa.eu/supervisory-convergence/supervisory-colleges>

uments/10180/935249/EBA-GL-2014-13+%28Guidelines+on+SREP+methodologies+and+processes%29.pdf). The EBA can also provide own initiative guidelines if there appears to be a need such as for IRRBB (https://www.eba.europa.eu/documents/10180/1084098/EBA-GL-2015-08_EN_GL+on+IRRBB.pdf). And the EBA can add material to a non-mandatory supervisory handbook which is not public.

2. **Training:** The provision of common training for EU supervisors is a key component in forging a common supervisory culture and with limited resources the EBA endeavours to provide common training on key areas such as the SREP guidelines, or assessments of recovery plans.
3. **Assessments.** The EBA has a number of tools to assess convergence, report on them and recommend changes and additional policy products. These include formal peer reviews (insert reference) and the EBA staffs reports on convergence report and on college functioning.

The text below aims to demonstrate how supervisory decisions can impact on capital resources in particular with a material impact the level playing field for banks operating in the single market and for efficiency of capital and liquidity allocation.

Pillar 2 decisions

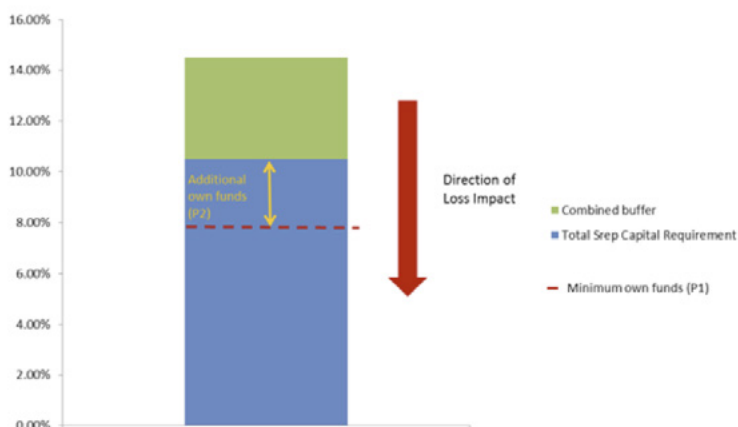
A look at supervisory decisions on capital and the subsequent restrictions on dividends in 2016 illustrate the potential cost of long term divergence in supervisory approaches and inconsistency in outcomes. Of course, the welcome creation of the SSM means, de facto, supervisory convergence for banks under the SSM's direct supervision¹⁵. However, convergence in a large part of the single market accentuates the potential for supervisory divergence between the SSM and non SSM CAs unless conscious attention is paid to effective coordination.

During 2015 a number of questions were raised about how some key components of the Pillar 2 decisions were being arrived at and articulated. Market participants raised these issues and the EBA itself identified some areas that needed to be clearly communicated from a supervi-

¹⁵ Even within the SSM some national discretions remain, although these are being phased out. And macro prudential decisions including on the combined buffer remain at national level as explained below.

sory convergence perspective¹⁶.

In the first instance there was uncertainty about the stacking order of Pillar 1 capital, Pillar 2 capital requirements and the combined capital buffer and the associated trigger for restrictions on dividends¹⁷. To help explain this simply please see the diagram below.



Source: EBA Opinion November 2015. <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-24+Opinion+on+MDA.pdf>

This diagram illustrates the Pillar 1 minimum which is set according to the single rule book, and in which any differences across the EU are driven primarily by residual national discretion items¹⁸. The additional Pillar 2 requirement is set by supervisors on an idiosyncratic basis but based on common guidelines from the EBA. The combined buffer contains some mandatory elements and some elements that are decided by a mixture of national authorities and competent authorities. Questions were raised in 2016 about the appropriate stacking order and whether Pillar 2 requirements were binding as different practices were observed in different jurisdictions. Furthermore questions were asked about whether

16 <https://www.eba.europa.eu/documents/10180/950548/Supervisory+convergence+report.pdf/9f49ddf9-232f-4062-b34e-ff671d440081>

17 <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-24+Opinion+on+MDA.pdf>

18 Some argue that differences in the way that supervisors authoritise banks' risk models to determine risk weights. This is an issue the EBA is addressing. <https://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-01+Opinion+on+IRB+implementation.pdf>

Pillar 2 should contain elements of the combined buffer, if not set by macro prudential authorities, and whether in all cases the outcomes of stress tests should be included in the Pillar 2 minimum. Such questions create uncertainty for investors in banks and for banks in their capital planning. Moreover, in some cases differing supervisory practices can have a material impact on the level at which restrictions on distributions were triggered and calculated. This difference amounted to hundreds of basis in capital for some banks and has an associated impact on the level playing field for banks as issuers and for movement of capital for investors.

As noted above, the EBA does have tools to respond to potential differences and so far is making headway. Training on agreed supervisory approaches; assessment of their implementation and producing additional policy guidance if needed are all vital, and seem to work, but they do have limitations. For example, EBA guidelines are comply or explain for competent authorities. Our recommendations are not legally binding, even if they do signal a clear message to the outside world. In this sense the asymmetries between rule making and decision making are recognised, and tools are in place to address them. But those tools eventually could fail without goodwill and conscious attention on all sides.

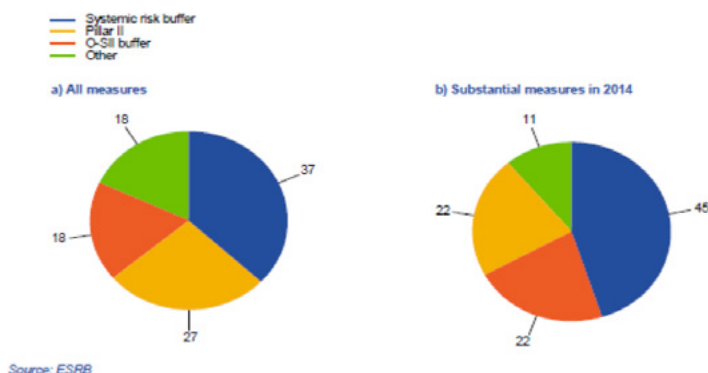
Governance of the interplay between micro and macro prudential supervision

The second area of relevance from a governance perspective is the interplay between macro and micro prudential regulation. The micro and macro prudential frameworks have been designed in different ways with the micro prudential framework inherently EU-oriented to avoid impediments to competition and the free movement of capital. The macro prudential framework has been designed to be national, with some coordination. This has been done since macroprudential problems tend to be “country” specific and require national measures. But this raises the theoretical possibility that macro prudential measures can inadvertently, or deliberately, impede the free flow of capital. There is thus by design an asymmetry between rules and decision making on individual banks and decisions on broader macro economic policy tools. Once again this asymmetry is clearly recognised as a challenge for the integrity of the single market, and the integrity of the micro prudential framework. To that end the co legislators put in place a coordination mechanism. In this

case the coordination mechanism rests primarily with the European Systemic Risk Board (ESRB) but also with the EBA to whom some, but not all, macro prudential measures should be notified and in a few cases the EBA is asked to opine.¹⁹

This means that whilst there is a clear single rule book for micro prudential measures, along with the safeguards outlined above, the setting is different for the range of macro prudential measures. Yet at the same time many of these macro prudential measures have a micro prudential implication as the table²⁰ below illustrates. This table shows that around a quarter of the significant measures notified in 2014 used the Pillar 2 mechanism that is largely within the remit of supervisory decision making.

Relative frequency of use of various types of measures for addressing misaligned incentives (percentages)



The rationale for having asymmetric governance of macro and micro prudential measures rests with the concern that macro prudential imbalances occur primarily within the national economy and are best dealt with at that level i.e. macro economic imbalances such as bubbles in real estate or an overheating economy are most identifiable and actioned upon at national level. Conversely, micro prudential decisions are made

19 <https://www.eba.europa.eu/documents/10180/950548/EBA+report+on+the+range+of+practices+regarding+macroprudential+policy+measures.pdf> pages 10-11 shows the full range of measures.

20 http://www.esrb.europa.eu/pub/pdf/other/150625_review_macroprudential_policy_one_year_after_intro_crdcrr.en.pdf?df070310a7c696c1f77537da8994c294

on individual banks, in a comparable and consistent way across the single market. The challenge is when macro prudential decisions interact with both the integrity and consistency of both the micro prudential decisions on individual banks and on the functioning of the single market as a whole.

Two examples illustrate these points.

The first relates to the integrity of the micro prudential framework. We can see from the chart above that many macro prudential decisions use the Pillar 2 framework. Often this is simply because it is the easiest and most flexible tool. If for example a macro prudential authority is worried about excessive increase in house prices it can impose higher risk weights for all exposures by that country's banks towards residential mortgages, via the P2 framework. This makes sense from a macro prudential perspective as it has the effect of reducing banks' appetite to lend ever more to this market. But it also interacts with the micro prudential framework and the functioning of the single market. In the first instance higher risk weights increase the amount of capital that a bank needs to hold under Pillar 1. Micro prudential supervisors will already have made an assessment on the appropriate capital to hold, having approved the relevant risk weighting model for a bank and also then having assessed the relevant capital and may have asked for additional capital resources to be held under Pillar 2²¹. For example there could already be adjustments to Pillar 1 model validation rules to add additional conservativeness into the model outcomes or additional capital could be held under Pillar 2 for example for concentration risk to the housing market. Or some capital guidance may be in place based on stress test outcomes for the hypothetical event that house prices crash. To that end it is key that there is coordination and interaction between the relevant macro prudential and micro prudential authority. This can happen at the national level but becomes more complicated for cross border groups when the decisions on Pillar 2 are made by colleges of supervisors that comprise both home and host authorities. Effective coordination, including appropriate timing and sequencing, are then key to ensure that macro prudential decisions work with the grain of the micro prudential framework and do not disrupt it.

21 [https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+\(Guidelines+on+SREP+methodologies+and+processes\).pdf](https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+(Guidelines+on+SREP+methodologies+and+processes).pdf)

The second example relates to the integrity of the single market and has two components. Simple macro prudential add-ons may be used to ensure capital or liquidity resources stay within a country. This can make sense from a country perspective but can also be costly for a banking group trying to operate across borders and maximise the efficiency of its capital and liquidity resources. And if such measures are put in place at the last minute then it can also disrupt effective contingency planning. The second component is the need for reciprocity across the single market of macro prudential measures. That is a national macro prudential authority can order additional capital for exposures to the home market on domestic banks (banking groups and subsidiaries based in that jurisdiction). However, this may or may not apply to branches of other banks that passport into the domestic market. This both risk effectively undermining the measure itself and provides an unequal competitive setting within the single market. Based on early surveys very few macro prudential measures were voluntarily reciprocated²². This again requires coordination between macro prudential authorities in the country setting the macro prudential measures and all relevant micro prudential authorities.

As noted above the tools for effective coordination between macro and micro prudential regulation are in place. Notifications are being provided and the EU has a very positive record on transparency in this regard e.g. publications by the ESRB and the EBA are not found in other jurisdictions globally. From a governance perspective effective coordination relies on good cooperation and there is no easily identifiable mandatory method of restricting macro prudential measures if they may have an impact on the micro prudential regime or the single market²³. This may not be a problem when cooperation and coordination are working effectively. But all participants should be aware of the risks if those mechanisms break down.

22 <https://www.eba.europa.eu/documents/10180/950548/EBA+report+on+the+range+of+practices+regarding+macroprudential+policy+measures.pdf> page 15. To note some measures are mandatorily reciprocated.

23 In the most extreme cases, infringement proceedings are available for clear cases of impeding the key rights enshrined in the treaties. But experience suggests that most measures are not so extreme.

Conclusion

In conclusion, it is clear that, from a single market perspective, asymmetries in governance within micro prudential supervision and between micro and macro prudential regulation exist by design. A single rule, and a mandate for supervisory convergence at the EU level, sit alongside supervisory responsibility for implementation and for all decisions at the level of the competent authority. At the same time the single micro prudential rule book and micro prudential decision making, sit alongside national level decisions on macro prudential policy. The latter is particular pertinent within the banking union where micro prudential decisions are taken at the level of the SSM but national authorities implement many of the macro prudential tools.

Such asymmetries in governance respect the will of the co-legislators but come with risks. These risks are recognized. They are currently addressed by coordination and cooperation mechanisms. The argument is not that those arrangements should change. Rather, all participants should be profoundly aware of the impact that any slip in these coordination and cooperation arrangements may have. Recent events demonstrate the potential cost of such differences for banks, and investors in banks, and thus the impact from the perspective of competition, and free movement of capital, across the single market.

BANKING UNION: AN INCOMPLETE BUILDING

Rosa M. Lastra¹

In contrast to the construct of European Monetary Union – a long and protracted journey that commenced with the establishment of the European Monetary System in 1978-9 and only became a reality when the Maastricht Treaty was signed in 1992 – European Banking Union (EBU) was a much quicker process. Though the intellectual foundations for centralized supervision were advocated by some from the very start of EMU, the urgency with which the actual banking union plan was conceived in 2012 and subsequently executed was made possible by the political consensus that surrounded the need to provide European supervision and crisis management of euro area credit institutions lest the euro area would disintegrate. The advent of European Banking Union took place at a time in which the vicious link between bank debt and sovereign debt engulfed the euro area.

However, like any project adopted under such tense and tight circumstances, there are gaps in the resulting governance structure. Banking union is an incomplete building. There are several gaps, inconsistencies and missing components. Some of these gaps predated the crisis. Some others were magnified as a consequence of the crisis.

First, EMU suffers from a congenital flawed institutional design; in the words of Alexandre Lamfalussy, EMU rests upon a strong ‘M’ (the monetary pillar with the euro as the single currency and the European Central Bank as the monetary authority) and a weak ‘E’ (the economic pillar, where economic – fiscal - union is in a fact a misnomer, and what

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we have is economic coordination).² The weakness of the ‘E’ and by extension the weakness of the supervisory pillar became apparent during the twin financial and sovereign debt crisis in the eurozone.

Second, there is divergence in the actual construction of the three pillars upon which banking union rests, given their different legal basis (Article 127.6 TFEU in the case of the SSM, Article 114 TFEU in the case of the SRM), their governance structure and the actual degree of centralization achieved so far.

Third, as discussed in some detail in the ensuing sections, there is the ‘missing pillar’, a fourth necessary pillar for a working banking union, namely lender of last resort.

Fourth, in the absence of a true fiscal union, there is only a limited fiscal backstop in the form of the European Stability Mechanism (ESM).

Fifth, the ECB faces fundamental challenges in the pursuit of multiple goals (monetary stability and financial stability) and in the discharge of multiple responsibilities.

Sixth, there are the problems of jurisdictional domain, with the single market on the one hand and the European banking union on the other hand, plus the related issues of complexity, coordination, legitimacy and accountability.

Seventh, since the contours between supervision, early intervention, recovery and resolution are porous and since there are multiple authorities involved in what effectively is a seamless process, gaps in coordination can arise. Since time is of the essence in any crisis situation, this is a cause for concern.

Eighth, there is incompleteness in the pursuit of systemic risk control and financial stability, since banking union (and centralized supervision) only extends to credit institutions, while responsibility for the supervision of securities and insurance remains mostly at the national level. The European financial architecture for the single market, with EBA, ESMA and EIOPA, is an example of increasing federalization of financial supervision but does not constitute centralization of supervisory responsibilities. The ‘financial trilemma’ conceived by Niels Thygesen and developed by Dirk Schoenmaker³ looms in the background: you cannot have financial stability, integrated markets and

2 Alexandre Lamfalussy remarked in an interview with The Guardian on 16 August 2003: ‘The great weakness of EMU is the E. The M part is institutionally well organized. We have a solid framework. We don’t have that for economic policy.’

3 http://personal.vu.nl/d.schoenmaker/Financial_Trilemma.pdf

national supervision. The latter has to go... And not just for banks... Ninth, gaps can arise from the exercise of macroprudential supervision, since responsibility for it is divided between the ECB, the ESRB and national authorities.

Finally, there is the question of what constitutes 'adequate supervision', given the need to adopt a comprehensive approach that assesses – like the acronym CAMEL indicates – the different elements that determine bank soundness. Attention is now finally turning to the asset side of banks' balance sheets, where divergence in the measurement of Non Performing Loans (NPLs) has been a feature that hinders meaningful cross-country comparison and compromises the effectiveness and credibility of stress tests in different jurisdictions.⁴

The pillars of banking union

Banking union is based upon three pillars.⁵ While the first pillar, 'single supervision' has already been completed with the establishment of the Single Supervisory Mechanism (SSM), the second pillar, 'single resolution', with the Single Resolution Mechanism (SRM) - aligned with the EU Bank Recovery and Resolution Directive (BRRD)⁶ - and a Single Resolution Fund, is still in the process of being implemented. The third pillar, 'common deposit protection',⁷ is yet to be constructed (though a proposal was published in November 2015). As indicated in the introduction,

4 <http://www.bankofengland.co.uk/research/Pages/workingpapers/2016/swp594.aspx>

5 Underpinning these three pillars is the concept of a common supervisory rule book, laying down uniform terms for the authorisation and withdrawal of credit institutions, for the conduct of micro-prudential supervision over credit institutions, for the resolution of non-viable credit institutions and for the operation of deposit guarantee schemes.

6 The BRRD was published in the OJ in June 2014. See 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, 12/06/2014, p. 190–348. See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0190.01.ENG

7 The rationale for a common deposit insurance scheme is clear: with perfect capital mobility, in order to prevent a flight of deposits from troubled countries to countries perceived to be 'safe', one needs to convince ordinary citizens that a euro in a bank account in one Euro area Member State is the worth the same and is as secure as a euro in a bank account in another Euro area Member State. This is a real challenge, as the experience in Cyprus evidenced.

there is a missing pillar: a clear lender of last resort role for the European Central Bank.⁸

Challenges for the ECB with the advent of Banking Union⁹

The ECB is no longer just a price stability oriented monetary authority. Since November 2014, the ECB is also key micro supervisory authority for credit institutions in the eurozone. Furthermore, the ECB has also been granted some macro-prudential powers in the pursuit of financial stability.

A price-stability-oriented independent central bank was a basic tenet in the early 1990s supported by economic theory and empirical evidence which became embedded in the Maastricht Treaty and widely accepted in the developed and developing World. This explains why price stability is unambiguously mentioned in Art 127(1) TFEU as the primary objective of the ESCB while the tenuous reference to financial stability in Art 127(5) TFEU indicates the hesitant tone of the treaty drafters in giving this goal equal footing to the goal of price stability (“The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system”). The enabling clause advocated by Tommaso Padoa-Schioppa auspiciously found its way in the final text

8 See Lastra, Rosa “Reflections on Banking Union, Lender of Last Resort and Supervisory Discretion”, in *From Monetary Union to Banking Union, on the Way to Capital Markets Union – New Opportunities for European Integration*, (ECB Legal Conference), European Central Bank, 2015, pp. 154-173 and “Lender of Last Resort and Banking Union” Chapter 6 in *European Banking Union. Prospects and Challenges* (ed. By Juan E. Castañeda, David, G. Mayes and Geoffrey Wood) Routledge, 2015, pp. 109 – 128. For a recent comparative analysis on lender of last resort in a number of jurisdictions see my forthcoming chapter entitled “Emergency Liquidity Assistance and Systemic Risk” to be published as Chapter 7 in a book on *Systemic Risk, Institutional Design, and the Regulation of Financial Markets* (edited by Anita Anand) to be published by Oxford University Press, 2016-17.

9 This section draws heavily on the Report on “The Interaction between Monetary Policy and Bank Regulation” co-written by Charles Goodhart and myself for the European Parliament, available at the dedicated section (Economic Policies) of ECON website: <http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.Html> (Tab Heading: 2015).

Monetary policy has entered uncharted territory following the great financial crisis. While prior to the crisis it had broadly converged toward one with a price stability (inflation) target and a short term interest rate as a policy tool, there is now a 2nd variant of monetary policy, which involves varying both the size, and perhaps, the composition of a central bank's balance sheet, with implications for monetary policy and also for financial stability.

of the Treaty - Art. 127(6), thus providing a Treaty basis for the SSM. Times have changed after the crisis and though in practice the primary objective of central banking has become financial stability (also for the ECB) (Buiter, 2015),¹⁰ the Treaty remains unaltered.

Functionally when it was created the ECB resembled the 'Bundesbank model' of one agency (the central bank), one primary objective (price stability) and one main instrument (monetary policy), in line with the Tinbergen rule. This relative simplicity (one goal, one instrument, one authority) in the pursuit of monetary stability contrasts with the multiplicity and complexity that characterize the pursuit of financial stability and the conduct of central banking in the aftermath of the global financial crisis.

Financial stability co-exists with other goals (such as price stability, growth, employment, consumer protection); there are multiple instruments to achieve this goal (supervision, regulation, lender of last resort/ELA, resolution and crisis management, monetary policy, fiscal policy etc.) and the central bank shares responsibility for maintaining financial stability with other authorities at different levels of governance (national, European and international).¹¹ Financial stability (systemic risk control) is a goal that transcends geographic boundaries and institutional mandates. But the very definition of financial stability remains a matter of controversy.

The Dodd Frank Act 2010 in the USA reinforced the financial stability mandate of the Federal Reserve System (the overriding objective) and the law governing the Bank of England in the UK has also been revised to reflect the twin mandate of monetary stability and financial stability. At the EU level, while the hierarchy of objectives remains (price stability reigns supreme in the Treaty), the mandate of the ECB has been substantially expanded via secondary legislation (the SSM regulation and ensuing normative) into the field of prudential supervision.

The ECB has also some macro-prudential powers, according to

10 See Willem H. Buiter at <http://willembuiter.com/sintra.pdf>

11 The Financial Stability Oversight Council (FSOC) in the US is a good example of the multiple authorities involved in the pursuit of financial stability. The FSOC is made up of ten voting members under the chairmanship of the Secretary of the Treasury (the other nine members are the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chair of the SEC, the Chair of the Commodity Future Trading Commission, the Chair of FDIC, the Chair of the Federal Housing Finance Agency, the chair of the National Credit Union Administration, and an independent member with insurance expertise) and five nonvoting members.

Article 5 of the SSM Regulation. And the ECB is also involved in the pre-insolvency phase in resolution. Early intervention (in the context of the SSM regulation) comprises actions taken before the threshold conditions for resolution are met, and before the institution is insolvent or likely to become insolvent. The boundaries between supervision at the ‘end of the supervisory spectrum’, early intervention/PCA, recovery and resolution are not always clear. Given its role as micro-prudential supervisor with powers for early intervention, the ECB is likely to play a major role in the commencement of resolution proceedings.¹² This imposes an additional challenge.

Supervision and crisis management are part of a seamless process, which requires timely communication and coordination between the competent authorities, as well as judgment in the exercise of discretion. Supervision is also a thankless task, prone to litigation. Indeed, while judicial review of monetary policy measures might be limited, the same cannot be said with regard to the review of supervisory decisions (actions or omissions). The limits of the ECB’s authority in the pursuit of financial stability remain open, considering also the interconnection between banking markets and other markets (sovereign debt, derivative, etc.) and the designation of systemically important financial institutions. The role of law and judicial review in the demarcation of such limits also needs further clarification.

The financial architecture of Europe is now rather complex both jurisdictionally and structurally. The jurisdictional domain of the ESAs and ESRB is the whole EU/single market, while the jurisdictional domain of the SSM is restricted to the eurozone and those countries that adopt close cooperation agreements with the ECB. The structure of supervision is now divided between centralized powers in banking and decentralization and segmentation in other areas of the financial sector. This will require the ECB/SSM to cooperate very closely with national securities and insurance regulators.

12 According to Art 4.1 (i) of the SSM Regulation the ECB is empowered:

“To carry out supervisory tasks in relation to recovery plans, and early intervention where a credit institution or group in relation to which the ECB is the consolidating supervisor, does not meet or is likely to breach the applicable prudential requirements, and, only in the cases explicitly stipulated by relevant Union law for competent authorities, structural changes required from credit institutions to prevent financial stress or failure, excluding any resolution powers.”

The missing pillar of banking union: LOLR¹³

Though LOLR is not included as a pillar of the current banking union plan, in my opinion it is clearly the fourth 'missing pillar'. LOLR is the first line of defence in a crisis. Central banks provide liquidity when no other sources of liquidity are readily available (or at least are not available at 'reasonable market prices').

The decision to serve as lender of last resort can be taken either to support a single bank suffering from a liquidity crisis (individual bank liquidity) or to preserve the stability of the banking system as a whole, by supplying extra reserves to all banks suffering from large cash withdrawals (market liquidity). An individual bank problem can, however, quickly convert into a system problem, if a sudden collapse of confidence in one bank spreads by contagion to other banks.

LOLR therefore comes in two forms. The first form is the traditional Thornton-Bagehot¹⁴ 'LOLR model' of collateralised lines of credit to individual illiquid but solvent¹⁵ banks;¹⁶ the second form is the provision of 'market liquidity assistance' via ordinary open market operations and via extraordinary or unconventional measures.

The ECB has clear competence – a competence which it has exercised widely – when it comes to the second form, while – due to its own restric-

13 This section draws heavily on the recent contributions to other books cited in footnote 8.

14 The theoretical foundations of the lender of last resort doctrine were first set by Thornton in 1802 and then by Bagehot in 1873, who further elaborated and refined them. See Henry Thornton, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* (Fairfield, NJ: AM Kelley, 1991, originally published in 1802); Walter Bagehot, *Lombard Street. A Description of the Money Market* (New York: Wiley, 1999, originally published in 1873). Recent studies of the work of Thornton and Bagehot on the LOLR are found in Thomas M Humphrey, 'The Classical Concept of the Lender of Last Resort' (1975) 61(1) *Federal Reserve Bank of Richmond Economic Review* 2; Michael D Bordo, 'Alternative Views and Historical Experience' (1990) 76(1) *Federal Reserve Bank of Richmond Economic Review* 18.

15 Though the issue of solvency is often inserted here, Geoffrey Wood reminded me in private correspondence that Hawtrey (*The Art of Central Banking*, Frank Cass & Co. 1932, 1st edition) had pointed out it is not easy quickly to determine solvency, and not necessary either so long as acceptable collateral is offered. See also Geoffrey Wood, 'The Lender of Last Resort Reconsidered', *Journal of Financial Services Research* 18: 2/3 2000, pp. 203-227 (Kluwer Academic Publishers).

16 See Rosa Lastra 'Lender of Last Resort, an International Perspective', *International and Comparative Law Quarterly*, ICLQ, Volume 48, 1999, April 1999, pp. 340-361; and Lastra and Andrew Campbell, 'Revisiting the Lender of Last Resort', *Banking and Finance Law Review*, Vol. 24, No. 3, June 2009.

tive interpretation of the ESCB Statute - it does not have so far competence with regard to the first form. In 1998, the ECB adopted a restrictive reading of the ECB competences, concluding that the provision of lender of last resort assistance to specific illiquid individual institutions was a national task of the National Central Banks (NCBs) in line with Article 14.4 of the ESCB Statute (a provision which allows NCBs to perform non-ESCB tasks on their own responsibility and liability).¹⁷ Therefore the classic collateralised lines of credit to individual institutions remain the responsibility of the national central banks, at their own cost, but with the fiat of the ECB. Thus, the risks and costs arising from such provision are incurred by the relevant National Central Bank (NCB), though a number of procedures ought to be followed.¹⁸ This awkward interpretation was

17 Article 14.4 reads as follows: 'National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB'. The ECB can assess whether a given LOLR operation by a National Central Bank (NCB) interferes with monetary policy and, if so, either prohibit it or subject it to conditions. To this effect, the ECB has some internal rules (MoU) requiring ex ante notification to the Governing Council of such LOLR operation (Article 14.4). I thank Antonio Sainz de Vicuña for observations on this point. The following is an excerpt from the ECB Annual Report 1999 (p. 98): 'The institutional framework for financial stability in the EU and in the euro area is based on national competence and international cooperation.... Co-ordination mechanisms are primarily called for within the Eurosystem. This is the case for emergency liquidity assistance (ELA), which embraces the support given by central banks in exceptional circumstances and on a case-by-case basis to temporarily illiquid institutions and markets.... If and when appropriate, the necessary mechanisms to tackle a financial crisis are in place. The main guiding principle is that the competent NCB takes the decision concerning the provision of ELA to an institution operating in its jurisdiction. This would take place under the responsibility and at the cost of the NCB in question. (...) The agreement on ELA is internal to the Eurosystem and does not affect the existing arrangements between central banks and supervisors at the national level or bilateral or multilateral co-operation among supervisors and between the latter and the Eurosystem'.

18 This subject however has always triggered much controversy. See, inter alia, Charles Goodhart (ed), *Which Lender of Last Resort for Europe* (London: Central Banking Publications, 2000), Jeroen Kremers, Dirk Schoenmaker, and Peter J Wierts (eds), *Financial Supervision in Europe* (Cheltenham: Edward Elgar Publishing, 2001), chs 4 and 5, Tommaso Padoa-Schioppa, *Regulating Finance* (Oxford: Oxford University Press, 2004) chs 7 and 8, and Xavier Freixas, 'Crisis Management in Europe' in Jeroen Kremer, Dirk Schoenmaker, and Peter Wierts (eds), *Financial Supervision in Europe* (Cheltenham: Edward Elgar, 2003) 110. For a critique of the ECB's interpretation of its powers in respect of ELA, see René Smits, *European supervisors in the credit crisis: issues of competence and competition*, chapter 15 in Mario Giovanoli and Diego Devos (eds), *International Monetary and Financial Law – The Global Crisis*, Oxford 2010, at 310-311.

reaffirmed in a resolution of the Governing Council of 17 October 2013.¹⁹

When prudential supervision was at the national level, it was perhaps logical to assume that the national authorities had the adequate expertise and information to assess the problems of banks within their jurisdictions (assistance on a rainy day – supervision on a sunny day). But now that supervision is European, the ECB should be at all effects lender of last resort for all those institutions it now supervises.

Granting the ECB a clear LOLR does not require a Treaty change. The ECB is already competent to provide liquidity assistance to ‘financially sound’ banks. ELA/LOLR links monetary policy and supervision [thus the complementarity between monetary policy, supervision and liquidity assistance]. All is needed is a reinterpretation of Art 14.4 in the light of new circumstances (Banking Union) and in accordance with Art. 18 and the principle of subsidiarity. At the very least such an interpretation is required for significant institutions.

Since the SSM became operational on 4 November 2014, the ECB should formally be the ultimate provider of liquidity in the euro area, both in cases of market liquidity and in cases of individual liquidity assistance, is a necessary consequence of the transfer of supervisory powers from the national to the European level.²⁰ The National Competent

19 See ELA Decision by the ECB of 18 October 2013, at http://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf

ELA means the provision by a Eurosystem national central bank (NCB) of (a) central bank money and/or (b) any other assistance that may lead to an increase in central bank money to a solvent financial institution, or group of solvent financial institutions, that is facing temporary liquidity problems, without such operation being part of the single monetary policy. Responsibility for the provision of ELA lies with the NCB(s) concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB.

NCBs must inform the ECB within two days of a ELA operation, with details of the counterparties involved, the value of the operation, the haircuts and collateral applied and the rate of interest paid on the funds. A limit of € 500 million in ELA assistance can be provided to a given financial institution or group of institutions before the NCB(s) involved must inform the ECB as early as possible prior to the extension of the intended assistance. If the overall volume of ELA operations passes €2 billion for a given central bank, the Governing Council considers whether there is a risk that the ELA involved may interfere with the objectives and tasks of the Eurosystem. Upon the request of the NCB(s) concerned, the Governing Council may then decide to set a threshold and not to object to intended ELA operations that are below that threshold and conducted within a pre-specified short period of time.

20 Notwithstanding the ECB Decision of 18 October 2013 on ELA (Emergency Liquidity Assistance) at http://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf which assigns ‘responsibility for the provision of ELA’ to the ‘NCB(s) concerned’, further specifying that ‘This means that any cost of, and the risks arising from, the provision of ELA are incurred by the relevant NCB’.

Authority (NCA) is neither the monetary policy authority nor the supervisor. The only advantage of continuing with the current interpretation is that any eventual loss is not shared (but yet it would have an impact on the whole euro area).

The ECB has been always competent to act as LOLR if the crisis originates in the payments system, according to Art 127(2) TFEU, which states that the European System of Central Banks (ESCB) is entrusted with the 'smooth operation of payment systems'. The ECB is also competent in the case of a general liquidity dry up to provide market liquidity according to Article 18 of the ESCB Statute, and the ECB has amply used this competence during the crisis, even leading to legal questioning of whether it has exceeded its mandate. Indeed, even before banking union, Article 18 provided a perfectly valid legal basis for the ECB to provide the two forms of ELA/LOLR.

And according to Article 5.3 TEU (principle of subsidiarity): 'In areas which do not fall within its exclusive competence, the Union shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.'

In a crisis action by the ECB is more effective than action by a national central bank or national authority. National supervisory authorities do not have the ability, authority, or inclination to deal effectively with externalities with cross-border effects. The ECB is able to better judge the risk of contagion.

Further Reflections on Lender of last resort in the context of banking union²¹

As I wrote in an article with Luis Garicano in 2010²²: ‘The lender of last resort function can only be undertaken by a central bank. The involvement of central banks in financial stability originates in their role as monopolist suppliers of fiat money and in their role as bankers’ bank. Only the ultimate supplier of money can provide the necessary stabilizing function in a nationwide scramble for liquidity, as the financial crisis has amply evidenced, with conventional and non-conventional monetary policy operations (quantitative easing and others). This is a clear lesson of the crisis in the UK, where the problems of Northern Rock caught the Bank of England by surprise: having timely information is particularly crucial during financial crises and the best way to ensure access is to have daily supervision by the central bank, as the literature has noted.’²³

While the Fed and the Bank of England have emphasized the complementarity²⁴ between monetary policy, macro-prudential policy, lender of last resort and micro-prudential supervision, the ECB on the

21 This section draws on Chapter 10 of Lastra, *International Financial and Monetary Law*, second edition, Oxford University Press, Oxford, 2015. See also chapter 7 for the non conventional responses by the ECB to the Crisis and Lastra, ‘Banking Union and Single Market: Conflict or Companionship?’ *Fordham International Law Journal*, Vol. 36, No. 5, 2013, pp. 1189-1223, for a consideration of how banking union fits within the single market in financial services. See also ‘European Banking Union’, by Rosa Lastra, Bernd Krauskopf, Christos Gortsos and René Smits, MOCOMILA report to the ILA meeting in Washington DC, April 2014, at <http://www.ila-hq.org/en/committees/index.cfm/cid/22>

22 Luis Garicano and Rosa Lastra, ‘Towards a new Architecture for Financial Stability: Seven Principles’, *Journal of International Economic Law*, Vol. 13, No. 3, September 2010, pp. 597-621.

23 See Charles Goodhart and Dirk Schoenmaker ‘Institutional Separation between Supervisory and Monetary Agencies’ and Charles Goodhart, ‘Price Stability and Financial Fragility’ both in Charles Goodhart (ed), *The Central Bank and the Financial System* (Basingstoke: MacMillan Press, 1993). Joseph G. Haubrich, ‘Combining Bank Supervision and Monetary Policy’, *Federal Reserve Bank of Cleveland Economic Commentary*, November 1996. Clive B. Briault and Richard K. Abrams and Michael W. Taylor. Joe Peek, Eric S. Rosengren, and Geoffrey M. B. Tootell ‘Is Bank Supervision Central to Central Banking?’, 114(2) *Quarterly Journal of Economics* (1999), at 629-53.

24 The Fed conceives of its monetary policy as having been largely grafted onto its stabilization and supervisory functions, and regards such functions as a prerequisite and complement of its monetary policy responsibilities. In the UK, the Bank of England launched its One Bank – One Mission strategic plan in March 2015 stressing the links between the 3Ms: Monetary policy, macro-prudential and micro-prudential supervision.

other hand has highlighted the separation between monetary policy and banking supervision in a Decision of 17 September 2014, in accordance with Article 25(2) of the SSM Regulation.²⁵ However, the reality of central banking is one of complementarity of functions, which explains why they are placed under the same roof; if one wants to have the functions truly separate, then assign them to different entities.²⁶

Conflicts of interest between monetary policy and banking supervision are of course possible, but there are ways to solve or mitigate them. The SSM Regulation establishes a mediation panel to deal with such conflicts.²⁷

LOLR/ELA links monetary policy and supervision. Only the ultimate supplier of money can provide the necessary stabilizing function in a nationwide scramble for liquidity, as the financial crisis amply demonstrated, with conventional and non-conventional monetary policy measures.

Fiscal Assistance and State Aid Rules

The problem with having the ECB as LOLR is, of course, the ‘fiscal back-stop’ if the institution receiving the assistance is no longer illiquid, but insolvent. The only way to deal with this effectively is to stick to the ‘true nature’ of lender of last resort (assisting illiquid but solvent institutions)²⁸ combined with a clear and strict application of the EU state aid rules.

25 Article 25(2) SSM Regulation: “The ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. The tasks conferred on the ECB by this Regulation shall neither interfere with, nor be determined by, its tasks relating to monetary policy. The tasks conferred on the ECB by this Regulation shall moreover not interfere with its tasks in relation to the ESRB or any other tasks.

26 On the subject of separation between monetary policy and supervision the seminal article by Charles Goodhart and Dirk Schoenmaker, ‘Should the Functions of Monetary Policy and Banking Supervision be Separated?’ (1995) Oxford University Papers, Vol. 47, No. 4, 539–560, summarizes the pros and cons.

27 Article 25(5) of the SSM Regulation: “With a view to ensuring separation between monetary policy and supervisory tasks, the ECB shall create a mediation panel. This panel shall resolve differences of views expressed by the competent authorities of participating Member States concerned regarding an objection of the Governing Council to a draft decision by the Supervisory Board.” According to Article 32(1) of the SSM Regulation The European Commission is due to evaluate by the end of 2015 the effectiveness of the separation between supervisory and monetary policy functions within the ECB.

28 Of course the difference between illiquidity and insolvency is not easy to access; in a crisis it is often a time line...

Goodhart points out, 'a central bank can create liquidity, but it cannot provide for new injections of equity capital. Only the fiscal authority can do that.'²⁹ The central bank should not lend over an extended period of time, committing taxpayers' money, without the explicit approval of the fiscal authority.³⁰ Any extended lending becomes the responsibility of the fiscal authority.

A limited fiscal backstop in Europe is provided via the European Stability Mechanism.³¹ The ESM is modelled upon the IMF (but with more limited funding, with lending capacity of EUR 500 billion, backed up by an authorised capital of 700 billion³²), though it also has a direct recapitalisation instrument.

In practice, the central bank and the Treasury/Ministry of Finance (MoF) need to work together in the case of a support operation. This can be arranged at the national level relatively easily. The problem at the EU level – as the recent financial crisis amply demonstrated – is that the relevant fiscal authorities are by definition national. Fiscal policy in the euroarea remains decentralized and the Member States are competent, albeit subject to increasing coordination, conditionality and stringent rules. Thus, while the Bank of England is ultimately backed by the fiscal resources of the UK Treasury (though it must comply with the EU rules on state aid and the prohibition of monetary financing) and the Federal Reserve System is ultimately backed by the fiscal resources of the US Treasury, the ECB does not have a European fiscal counterpart yet. In the US, while the Federal Reserve System provided ample liquidity

29 See Charles Goodhart, Foreword to the book by Tommaso Padoa-Schioppa, *Regulating Finance* (Oxford: Oxford University Press, 2004) xvii.

30 In the EU the prohibition of monetisation of government debt, also known as 'monetary financing' in accordance with the provisions of Article 123 TFEU applies.

31 The European Stability Mechanism Treaty, concluded in Brussels on 2 February 2012, entered into force on 27 September 2012. The ESM was inaugurated on 8 October 2012 following the ratification by all the euro area Members. The Pringle ruling confirmed the legality of the ESM in 2012. See Case C370/12, *REFERENCE for a preliminary ruling under Article 267 TFEU from the Supreme Court (Ireland)*, made by decision of 31 July 2012, received at the Court on 3 August 2012, in the proceedings *Thomas Pringle v Government of Ireland*. <http://curia.europa.eu/juris/document/document.jsf?text=&docid=130381&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=37623> *Pringle v. Ir.*, [2012] IESC 47, para. 5 (S.C.) (Ir.), at http://www.courts.ie/_80256F2B00356A6B.nsf/0/E7504392B159245080257A4C00517D6A?Open&Highlight=0,pringle,~language_en~.

32 The ESM raises funds by issuing money market instruments and medium and long-term debt with maturities of up to 30 years, which are backed by a paid-in capital of EUR 80bn and the irrevocable and unconditional obligation of ESM Member States to provide their contribution to ESM's authorised capital stock.

assistance (both market liquidity and individual liquidity assistance), the Treasury provided the necessary capital with the TARP (Troubled Asset Relief Programme).

Another problem is that what constitutes 'ordinary' liquidity assistance as opposed to 'emergency'/LOLR liquidity assistance becomes blurred during a crisis, since the drying of the inter-bank market gives the central bank a primary role in the provision of liquidity.

A further twist is provided by the need to comply with the EU rules on state aid. Because an inherent subsidy exists whenever the central bank lends to an insolvent institution, under the EU rules on state aid, the granting of emergency aid to banking institutions can be considered illegal in some cases. The Luxembourg Court of Justice recognized in a ground-breaking decision, the *Züchner case*, that EU competition rules are also applicable to the banking sector.³³

On 5 December 2007, the EU Commission in its approval of the rescue aid package for Northern Rock concluded 'that the emergency liquidity assistance provided by the Bank of England on 14th September 2007, which was secured by sufficient collateral and was interest-bearing, did not constitute state aid'.³⁴ The Commission Communication of 13 October 2008 further reiterated this point.³⁵ In establishing a single market in financial services, it is important that the Treaty's state aid rules are applied consistently and equally to the banking sector, though with

33 See Case 172/80 *Züchner v Bayerische Vereinsbank* [1981] ECR 2021.

34 <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1859&format=HTML&aged=1&language=EN&guiLanguage=en>. 'However, the guarantee on deposits granted by the Treasury on 17th September, as well as the measures granted on 9th October, which provided further liquidity and guarantees to Northern Rock and were secured by a Treasury indemnity, do constitute state aid.' On 17 March 2008, six months after the first state aid measures ('rescue aid') took place, the UK authorities submitted to the Commission a restructuring plan. The Commission then launched an in-depth investigation into this 'restructuring aid'. See <<http://europa.eu/rapid/press-ReleasesAction.do?reference=IP/08/489>>.

35 Official Journal C 270, 25.10.2008, paragraph 51: '[T]he Commission considers for instance that activities of central banks related to monetary policy, such as open market operations and standing facilities, are not caught by the State aid rules. Dedicated support to a specific financial institution may also be found not to constitute aid in specific circumstances. The Commission considers that the provision of central banks' funds to the financial institution in such a case may be found not to constitute aid when a number of conditions are met, such as: the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package; the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value; the central bank charges a penal interest rate to the beneficiary; the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.'

a regard to the peculiarities and sensitivities of the financial markets.³⁶

In August 2013 the Commission published another Communication extending the 'crisis rules' for banks.³⁷ According to paragraph 53 of this August 2013 communication: 'Liquidity support and guarantees on liabilities temporarily stabilise the liability side of a bank's balance sheet. Therefore, unlike recapitalisation or impaired asset measures which in principle must be preceded by the notification of a restructuring plan by the Member State concerned and approval by the Commission before they can be granted, the Commission can accept that Member States notify guarantees and liquidity support to be granted after approval on a temporary basis as rescue aid before a restructuring plan is approved.'

And paragraph 62 further clarifies: 'The ordinary activities of central banks related to monetary policy, such as open market operations and standing facilities, do not fall within the scope of the State aid rules. Dedicated support to a specific credit institution (commonly referred to as 'emergency liquidity assistance') may constitute aid unless the following cumulative conditions are met:

- (a) the credit institutions is temporarily illiquid but solvent at the moment of the liquidity provision and is not part of a larger aid package;
- (b) the facility is fully secured by collateral to which appropriate haircuts are applied, in function of its quality and market value;
- (c) the central bank charges a penal interest rate to the beneficiary;
- (d) the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State'.

36 From the beginning of the global financial crisis in the autumn of 2008 to December 2010, the Commission issued four communications which provided detailed guidance on the criteria for the compatibility of State support to financial institutions with the requirements of Article 107(3)(b) of TFEU: (1) Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (Banking Communication); (2) Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (Recapitalisation Communication); (3) Communication from the Commission on the treatment of impaired assets in the Community banking sector (Impaired Assets Communication) and (4) Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (Restructuring Communication). See http://ec.europa.eu/competition/state_aid/legislation/temporary.html

37 Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), 2013/C 216/01, at [http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730\(01\)](http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730(01))

It is rather interesting that the Thornton-Bagehot doctrinal principles find their way into a legal text. Paragraph 63 of this 2013 Communication further specifies that: ‘interventions by deposit guarantee funds to reimburse depositors in accordance with Member States’ obligations under Directive 94/19/EC on deposit-guarantee scheme do not constitute state aid’.

Concluding observations

Much has been written during the crisis about the Treaty constraints within which the ECB operates, notably the prohibition of monetary financing of Article 123 TFEU and the no-bail out clause of Article 125 TFEU. The Greek drama³⁸ however reminds us that there are limits as to how much central banks can do with the tools at their disposal - monetary policy and emergency liquidity assistance - to deal with the causes and effects of a crisis in the absence of fiscal and structural reforms.

This contribution considered several gaps in the governance of European Banking Union with emphasis on what I refer to as the missing pillar of banking union, namely lender of last resort or emergency liquidity assistance (ELA). ELA in all forms should be an ECB competence, in accordance with Article 18 of the ESCB Statute, Article 127 of TFEU and the principle of subsidiarity.

As regards market liquidity the ECB has provided ample support beyond normal operations in part because the politicians could not agree on anyone else doing it (eventually the ESM was established – limited fiscal backstop – following a number of temporary facilities), in part because the ECB committed to do everything it could within the limits of its mandate (often stretching it via creative interpretation albeit in conformity with the law/Treaty requirements) to avoid the collapse of the euro.

In terms of individual liquidity assistance, the ECB’s own restrictive interpretation of Article 14.4 of the ESCB Statute (a provision which allows NCBs to perform non-ESCB tasks on their own responsibility

38 The ‘extend and pretend policies’ when it comes to sovereign debt ‘management’ (restructuring) cannot hide a few uncomfortable truths. The ECB may have to take losses. Memories of the LDC crisis in the 1980s and the lost decade in Latin America cast a long shadow on the current situation in some euro area Member States -- it took years for the Brady plan to replace the misguided Baker Plan. Where you draw the dividing line for loss sharing arrangements and who provides what sort of support are key issues yet to be solved.

and liability) is a stumbling block in the road to the fourth pillar of banking union. Such interpretation of Article 14.4 is somewhat awkward and clouded with uncertainty, since the ECB can provide some forms of ELA (open market operations and discount policies for example) but not others (classic collateralised lines to individual institutions, which remain the responsibility of the national central banks, at their own cost, but with the fiat of the ECB). The case for a more expansive interpretation of Article 14.4 has been reinforced with banking union: assistance in a rainy day, supervision on a sunny day, ...

In the USA, federalisation of liquidity assistance and supervision took place in 1913 with the establishment of the Federal Reserve System.³⁹ With the advent of banking union, the ECB should be the ultimate provider of liquidity in the euro area, both in cases of market liquidity and in cases of individual liquidity assistance. This is a necessary consequence of the transfer of supervisory powers to the ECB.

39 In the US, federalisation of bank insolvency (today resolution) and deposit insurance took place in 1933 with the establishment of FDIC. In the same way as in supervision we went from Lamfalussy to De Larosiere to SSM (the Single Supervisory Mechanism), when it comes to resolution, the Single Resolution Mechanism (SRM) is only a first step in the way towards the design of an adequate resolution framework.

BANKING UNION AND THE ECB AS LENDER OF LAST RESORT

Karl Whelan

1. Introduction

The idea of a euro area “banking union” is often discussed but the reality is that the euro area is still a very long way from having a fully integrated and coherent banking system. I’m not sure if a formal definition of a well-functioning banking union exists but one could imagine it having a number of key features. These would include a common set of regulations, a single supervisory body, a common source of funding for bank resolution and a common deposit insurance scheme. The euro area now has the first and second item on this list, is moving slowly towards the third item (a resolution fund) and is thinking about someday having the final item (common deposit insurance) in the sense that the European Commission has a proposal for common deposit insurance but it is unclear whether this will get broad political backing.

These features are not, on their own, sufficient to have a stable and well-functioning unified banking system. Another important element is free movement of capital – depositors should be always free to move their money between banks in different geographical areas and should feel that their deposits are equally safe in all parts of the system. A final crucial part of a well-functioning banking union is a clear and reliable lender of last resort. Maturity transformation is a key aspect of why fractional reserve banking systems are useful but it is also accounts for why these systems are prone to periods of instability. Without a clear guarantee that solvent institutions will always have access to liquidity from the central bank, financial crises will be a recurring feature.

In this paper, I focus on how the lender of last resort function works in the euro area. I will argue that the Eurosystem does not provide a clear and transparent lender of last resort facility and discuss how this has promoted financial instability and has critically undermined free movement of capital in the euro area. Until this weakness in the euro area's policy infrastructure is fixed, it will be difficult to have a truly successful banking union.

The structure of this paper is as follows. Section 2 discusses the role played in the banking system by central banks as lender of last resort and then outlines how the Eurosystem approaches lending to banks, including its Emergency Liquidity Assistance (ELA) procedures. Section 3 provides an in-depth discussion of three different cases in which the ELA was provided – in Ireland, in Cyprus and in Greece. Section 4 puts forward some new proposals for the Eurosystem's emergency lending procedures.

2. The Eurosystem's Lending Procedures

In modern times, monetary policy – open market operations designed to regulate the supply and cost of liquidity – is seen as the principal task of central banks. However, up until the mid-twentieth century, the key function of central banks was their role as a lender of last resort in times of crisis. Perhaps the most famous discussion of lender of last resort policy is Walter Bagehot's (1873) *Lombard Street*. Bagehot's recommendations are summarised by former Bank of England Deputy Governor Paul Tucker (2009) as

to avert panic, central banks should lend early and freely (i.e. without limit), to solvent firms, against good collateral, and at "high rates".

Tucker's speech noted that Bagehot was concerned that

the Bank of England should acknowledge its role in stemming panics, and set out its principles for doing so: "The Bank has never laid down any clear or sound policy on the subject."

Somewhat incredibly, this is exactly the situation the European Central Bank is in today. It has no clear or sound policy on how to stem panics. Here I will describe the Eurosystem's procedures for lending to banks. The description comes in two parts, first covering the Eurosystem's standard monetary policy operations and then discussing what is known as Emergency Liquidity Assistance.

2.1 Collateral in the ECB's Standard Monetary Policy Operations

Textbook descriptions of monetary policy operations tend to focus on open market operations in which securities are permanently bought or sold. The ECB's approach to monetary policy, however, has been to influence liquidity conditions and the terms of credit via loans to banks through its so-called refinancing operations.

An important aspect of the ECB's refinancing operations is a set of explicit collateral requirements describing the assets that banks must pledge to obtain loans. These collateral requirements reflect the important potential opportunity cost associated with creating money to provide loans to banks. Money creation can, under some conditions, create inflation, thus passing on indirect costs to the public. Even in the absence of an impact on inflation, it is important to consider the risk that is taken on by a central bank when creating money to purchase assets: If an asset purchase goes badly, there is an opportunity cost arising from the fact that the central bank could have purchased a different asset that could have generated positive returns which could then have been remitted back to central governments. In particular, the provision of credit to weak banks that are then unable to repay the loans provides a potentially unfair publicly-funded boost to the creditors of these banks.

Since its inception, the ECB has had a comprehensive risk assessment framework based on the requirement that banks must submit collateral from a specified list of eligible assets in order to obtain a standard loan from the Eurosystem. Lending to banks in the euro area is a decentralised operation with the loans being provided by the national central banks (NCBs). If a bank defaults on a loan provided by a NCB, this collateral is then taken by the NCB. If the acquired collateral fails to cover the value of the original loan, the agreed procedure is that the losses incurred will be shared across all of the members of the Eurosystem.

The Eurosystem has always had a broad collateral framework, incorporating a large amount of assets of different types. The framework involves a risk assessment of each eligible asset with a "haircut" set so that, for example, if an asset has a 10 percent haircut, a bank that pledges a face value of €100 million of this asset as collateral will be entitled to a loan of €90 million.

While the availability of a public list of eligible collateral makes the terms of standard Eurosystem loans that prevail at any point in time clear to the public, that is not the same thing as saying the rules are fixed.

Indeed, the ECB Governing Council regularly makes decisions to adjust the framework by adding and subtracting various items from its eligible collateral list or by adjusting the appropriate haircuts.

For example, to facilitate its move to a “full allotment” policy in 2008 as well as subsequent monetary policy measures such as Long Term Refinancing Operations (LTROs), ensuring they were not undermined a shortage of collateral, the ECB has made a number of technical changes to its collateral framework in recent years. The number of specific changes is too long to list here – ECB (2013) contains a detailed description – but a few are worth noting. The credit threshold required for most assets to qualify as eligible collateral has been lowered from A- to BBB-. Various adjustments have been made to make it easier for asset-backed securities (ABS) to become eligible and new criteria were drawn up to allow NCBs to accept nonmarketable bank loans (additional credit claims) as collateral.

Perhaps the more important example to illustrate the discretionary and judgemental nature of the ECB's eligible collateral list has been the treatment in recent years of various assets either issued by or backed by the Greek government. At various different times in recent years, depending on how negotiations were going between Greece and the troika, the ECB Governing Council has taken various types of Greek assets off the eligible list, with the assets often returning to the list at a later stage.

2.2. Emergency Liquidity Assistance

One might imagine that the ECB's eligible collateral list and its accompanying set of haircuts together define its policy as a lender of last resort to banks. However, this is not the case. The experience of recent years has shown that in many of the cases where euro area banks have come under severe financial strain, the banks have used up all of their eligible collateral to obtain funds via refinancing operations but still need to borrow more from the Eurosystem.

It turns out banks can still receive credit from the Eurosystem using non-eligible collateral. These loans are called Emergency Liquidity Assistance (ELA). In many cases, the legal basis for provision of ELA pre-dates the euro. The national central banks in the Euro area were founded prior to the start of EMU and thus each have pre-existing legal powers and obligations. Some are given various regulatory and supervisory powers while some are not. More importantly, it is common for national central

banks to be given an explicit set of powers related to financial stability.

Despite the existence of numerous ELA programmes in the Eurosystem since 2008, the ECB Governing Council has been extremely tight-lipped in its discussions of these programmes. Only in October 2013 did the Governing Council provide an official description of how ELA programmes work and this description is quite terse.¹

Based on this description and other sources, my understanding is that ELA programmes operate as follows.

- ELA is not a Eurosystem programme. It can be issued by any NCB without consulting the ECB Governing Council.
- However, procedures exist that require any NCB issuing ELA to inform the ECB within two business days after the operation is carried out and provide detailed information on the nature of the lending, including the collateral pledged.
- The ECB Governing Council can decide via a two-thirds majority vote – consistent with Article 14.4 of the “Protocol on the Statute of the European System of Central Banks and of the European Central Bank – that ELA operations interfere with the objectives and tasks of the Eurosystem. After such a vote, the Governing Council can order the NCB to restrict its ELA programme.
- Unlike regular Eurosystem liquidity-providing operations, all risk associated with ELA falls on the NCB that grants the loans.

These rules are pretty vague. They don’t describe the circumstances under which the ECB considers ELA to be appropriate nor do they make clear the criteria by which the ECB arrives at a decision that an ELA programme “interferes with the objectives and tasks of the Eurosystem.” Vague rules have the potential to lead to confusion and controversy and this is exactly what has happened in recent years.

3. The Eurosystem’s Experience with ELA

Despite its clear (though adjustable) policies on eligible collateral for monetary policy operations, the ECB has no clear procedures for dealing with banks that have used all of their eligible collateral but that still wish to borrow from the Eurosystem. This position is unsatisfactory and has

1 This document can be found at https://www.ecb.europa.eu/pub/pdf/other/201402_elaprocedures.en.pdf?e716d1d560392b10142724f50c6bf66a

been very damaging to the reputation of the ECB. In this section, I discuss three examples of where ELA has been used and point to a number of questions these examples raise.

3.1 Ireland

From the beginning of Ireland's banking crisis in late 2008, it was clear that Anglo Irish Bank, which had specialised in commercial property lending, was in serious trouble. The bank was nationalised in early 2009 and was suffering from substantial deposit withdrawals when the Central Bank of Ireland agreed in March 2009 to provide it with €11.5 billion in ELA. As the sovereign debt crisis intensified through 2010, the pace of deposit withdrawals from Anglo Irish intensified and its ELA borrowings moved up sharply. See Figure 3 for a graph of regular Eurosystem lending as well as ELA to the six Irish banks that had been provided with a near-blanket liability guarantee by the Irish government in September 2008.

Over the course of 2010, the other main Irish banks also came under pressure from deposit outflows. The September 2008 guarantee had been put in place for two years and the covered banks had issued a large amount of bonds that matured prior to September 2010. As September 2010 came and went, they failed to find new sources of private sector funding. Thus, these banks increased their reliance on ECB funding and eventually also applied for ELA.²

ECB officials had spent much of 2010 publicly discussing their plans to implement an "exit strategy" from their fixed-rate full allotment policy. The developments at Ireland's banks were clearly working against this plan. In September 2010, ECB officials including Jean-Claude Trichet began making public statements about their unhappiness with (unnamed) "addict banks" that were reliant on Eurosystem funding.³

Based on the recent release of letters by the ECB, we know now that Jean-Claude Trichet sent a letter to Ireland's Finance minister, Brian Lenihan, on October 15, 2010 which warned⁴

I would like to re-emphasize that the current large provision of liquidity by the Eurosystem and the Central Bank of Ireland to entities such as Anglo

2 See Whelan (2014) for a more detailed discussion of Ireland's banking crisis.

3 See for example, the Financial Times article from September 13, 2010 "Fears grow over banks addicted to ECB funding"
<http://www.ft.com/intl/cms/s/0/580109dc-bf43-11df-a789-00144feab49a.html>

4 This letter is available at https://www.ecb.europa.eu/press/shared/pdf/2010-10-15_Letter_ECB_President_to_IE_FinMin.pdf?05f2367e74897b4aa2641f31d639d1c3

Irish Bank should not be taken for granted as a long-term solution. Given these principles, the Governing Council cannot commit to maintaining the size of its funding to these institutions on a permanent basis.

By November 2010, total Eurosystem funding for the Irish banks had reached about €140 billion which was around 85% of Irish GDP and almost a quarter of total Eurosystem lending. At this point, the ECB played a crucial role in Ireland's application for a bailout from the EU and IMF. Jean-Claude Trichet sent a letter to Brian Lenihan threatening to cut off ELA funding unless the Irish government submitted a formal request to the EU for an adjustment programme.⁵ The specific wording of this part of the letter was as follows.

It is the position of the Governing Council that it is only if we receive in writing a commitment from the Irish government vis-a-vis the Eurosystem on the four following points that we can authorise further provisions of ELA to Irish financial institutions:

- 1) The Irish government shall send a request for financial support to the Eurogroup;*
- 2) The request shall include the commitment to undertake decisive actions in the areas of fiscal consolidation, structural reforms and financial sector restructuring, in agreement with the European Commission, the International Monetary Fund and the ECB;*
- 3) The plan for the restructuring of the Irish financial sector shall include the provision of the necessary capital to those Irish banks needing it and will be funded by the financial resources provided at the European and international level to the Irish government as well as by financial means currently available to the Irish government, including existing cash reserves of the Irish government;*
- 4) The repayment of the funds provided in the form of ELA shall be fully guaranteed by the Irish government, which would ensure the payment of immediate compensation to the Central Bank of Ireland in the event of missed payments on the side of the recipient institutions.*

Ireland applied for financial assistance and its EU-IMF bailout programme began in late 2010. Deposits continued to flow out of the Irish banking system for a number of months and ELA actually increased sig-

5 The November letter from Trichet to Lenihan is available at https://www.ecb.europa.eu/press/shared/pdf/2010-11-19_Letter_ECB_President_to%20IE_FinMin.pdf?83824135ba733b6091e930d3a25314c9

nificantly over those months, from €43 billion in November 2010 to €68 billion in February 2012. However, the banking system began to stabilise after the release of official stress tests and a large recapitalisation. Ireland's ELA programme ended in February 2013 when Anglo's successor organisation, the Irish Bank Resolution Corporation was put into liquidation.

The ECB's actions in relation to its interactions with the Irish banking system raise many questions.

- Given the size of the emerging solvency problem at Anglo Irish Bank in Spring 2010, why did the Governing Council approve such a large initial ELA programme?
- If the ECB were relying on the Irish state's backing for Anglo as reassurance that the bank's solvency would be maintained, at what point did doubts about the state's ability to provide this assistance emerge?
- If the solvency of the Irish banks was required for continuing ELA programmes, why did the ECB not limit itself to a demand for recapitalisation of these banks? Almost certainly, the Irish government would have had to apply for an official programme to meet this demand. But why not let the government make this decision instead of insisting on "*decisive actions in the areas of fiscal consolidation, structural reforms*"? Which aspects of the ECB's legal mandate allow it to demand fiscal consolidation and structural reforms as a condition to supply funding to individual banks?

Mario Draghi deserves credit for releasing these letters. However, the ECB's response to the release has completely avoided the important questions about ELA programmes that the letters raise.

3.2 Cyprus

If anything, the ECB's role in providing and subsequently restricting ELA to banks in Cyprus is even more murky and problematic.

While the situation with Cyprus's two largest banks became known to the wider European public in March 2013, it was clear to closer observers from early 2012 that these banks were in severe difficulties. Due to ill-advised purchases of Greek government bonds, poorly-timed expansions into the Greek market and a weakening Cypriot economy, both Bank of Cyprus (BoC) and Laiki Bank were effectively insolvent from early 2011 onwards.

The restructuring of Greek sovereign bonds sharply reduced Laiki's stock of assets that could be used as collateral for regular Eurosystem monetary policy operations. In October 2011, Laiki applied to the Central Bank of Cyprus (CBC) for emergency liquidity assistance (ELA) which is a form of central bank funding on non-standard terms. By November 2011, Laiki had €2.5 billion in ELA funding from the CBC and the amount of this funding increased significantly over the first seven months of 2012.

Because no other bank in Cyprus appears to have been receiving ELA at the time, we can track the evolution of Laiki's ELA in late 2011 and 2012 using publicly-available information on the CBC's balance sheet. This balance sheet recorded ELA under the heading "Other Assets" until April 2013 when it began recording it under "Other Claims". (There have been some small other items recorded under these entries but they are tiny relative to the ELA funding.)

In February 2012, the European Banking Authority (EBA) communicated that Laiki needed a recapitalisation of €1.97 billion while BoC required €1.56 billion. The government of Cyprus was effectively shut out of the sovereign bond market at this point and against a background of a worsening economy, it was not possible for BoC and Laiki to raise the private investment required to meet the EBA's core equity requirements by June 2012.

In May 2012, the government of Cyprus agreed to underwrite a €1.8 billion capital raising exercise for Laiki. On June 25, 2012, Fitch became the final ratings agency to downgrade Cyprus to below investment-grade. On the same day, the government of Cyprus submitted an application for financial assistance from the Eurozone's bailout funds. Two days later, BoC requested state aid of €500 million to allow it to meet its EBA core equity requirements.

During the period following the application for financial assistance and the final agreement on this assistance in March 2013, the capital position of the Cypriot banks continued to worsen. BoC booked new provisions for bad loans of €2.3 billion in 2012 and by the end of the year, the bank was insolvent with core equity of minus €407 million. The EBA assessed Laiki's accounts again in June 2012 and found an additional capital shortfall of €1.1 billion. Laiki did not publish year-end accounts for 2012 but their final published results for the first nine months of the year showed an additional €1.67 billion in losses, again leaving the bank on the brink of balance sheet insolvency.

As information circulated on Laiki's capital shortfall and its failure to obtain any private equity, deposit outflows increased, particularly at its Greek branches. The CBC's "Other Claims" series shows an increase from €3.9 billion in April 2012 to €5.9 billion in May 2012 and €8.2 billion in June 2012. (See Figure 4 for a graph of lending from the Central Bank of Cyprus).

The increase in ELA in May 2012 reflected deposit outflows. The June increase, however, also reflected decisions by the ECB that further reduced Laiki's ability to take part in normal Eurosystem operations. Its Greek covered bonds were downgraded and deemed ineligible as collateral while Fitch's downgrade of Cypriot government bonds led to these bonds also being taken off the ECB's collateral list. As a result of these decisions, regular Eurosystem lending by the CBC declined by €1 billion in June 2012.

In July 2012, the ECB removed Laiki from its list of eligible counterparties due to concerns about its solvency, a decision that it can take on the basis of the rules governing its risk control framework. By the end of July 2012, Laiki had no regular Eurosystem funding and its ELA was about €9.6 billion. This seems to have been about as much ELA as the Eurosystem was willing to lend the bank. The former Governor of the CBC, Panicos Demetriades, has explained that *"after the Eurogroup of 21 January 2013, Laiki Bank's ability to raise emergency liquidity reached a plateau due to the reduction in the value of its available collateral."*⁶

After a long period of delay, which included an election in February 2013, a financial assistance package for Cyprus was agreed in March under extremely stressed circumstances.

At a meeting of the Eurogroup of finance ministers that ended in the early hours of March 16, the ECB's representative Jörg Asmussen stated that the Governing Council was unwilling to continue authorising ELA to Cypriot banks unless these banks were restored to solvency by the end of March via writing down the value of customer deposits. It had been established by this point that the euro area member states and the IMF were only willing to provide €10 billion in funding which meant there was not enough money available to finance Cyprus's fiscal deficits and sovereign bond rollovers and also recapitalise its banks.

The final deal that was agreed with the Cypriot government required that the large amounts of ELA provided to the insolvent banks and

6 Introductory statement before the Investigation Committee on the Economy, 13 August 2013. http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12928&lang=en

deposits at Greek branches of the Cypriot banks be repaid in full: These requirements greatly increased the size of the “haircut” for depositors with the Cypriot banks. Laiki Bank was wound down and the large amount of ELA owed by Laiki was transferred to BoC.

While the deposit write-downs restored BoC to solvency, the ECB then placed hard limits on the amount of Eurosystem funding for this bank. This refusal to provide further funding for the bank was the key factor in the imposition of capital controls that are prevented people from transferring their money out of banks in Cyprus to elsewhere in the EU.

The ECB’s decisions in relation to the Cypriot banks raise a number of questions

- Did the ECB realise that Laiki was heading towards being highly insolvent when it provided it with ELA in late 2011?
- As the ECB provided more funds to Laiki in 2012, were they assuming the Cypriot government would provide the money that would restore the bank to solvency? In the end, the government did not have the capacity to do this.
- On what grounds did the ECB delay its demand for a recapitalisation of the Cypriot banks until after the 2013 election?
- At what point did ECB and the European authorities decide that the recapitalisation in Cyprus should take place via deposit write-downs?
- Why did the wind-down of Laiki bank not see the Central Bank of Cyprus take the underlying collateral that had been pledged? In other words, why was Laiki’s ELA transferred to be the responsibility of another bank?
- Did the ECB play a role in the decision to limit deposit write-downs to customers in Cyprus while leaving depositors in Greece protected?
- Given that Bank of Cyprus is now solvent, why does the ECB continue to place limits on its ELA funding, limits that have the repercussion of keeping international capital controls in place?

It is to be hoped that, as with the Irish case, the ECB will also release documents that will explain its actions in Cyprus. I suspect, however, we may be waiting a long time for such a release.

3.3 Greece

A consistent theme of the Greek debt crisis has been the ECB's regular threats (either implicit or explicit) to withdraw or cap funding for the Greek banking system. Greek government bonds and other assets backed by government guarantees were regularly withdrawn and then added again to the eligible collateral list and while they were withdrawn, the Greek banks relied on Emergency Liquidity Assistance from the Bank of Greece. These ELA programmes were constantly reviewed by the ECB Governing Council and could be cancelled at short notice if the Council decided. The issue came to a head in 2015 as negotiations between the new Syriza government and the European creditors went poorly.

One of the more interesting aspects of the Greek banking crisis of 2015 is that the major great banks had featured in the comprehensive assessment and stress test undertaken by the ECB in 2014 as it took over as the single supervisor for the euro area's banks. The results of this test, announced in October 2014, showed the Greek banks to be solvent and to have very limited need for recapitalisation to meet the ECB's requirements. Indeed, the Financial Times reported about the Greek banks *"If the final capital needs are indeed nil or very small, this could pave the way for converting €11.4bn set aside for bank recapitalisation into a precautionary credit line to help Greece exit smoothly from its bailout program"*.⁷

Despite this positive conclusion, the political uncertainty surrounding the January 2015 election led to increased speculation that the new government would default on its debts and that this could result in Greece leaving the euro. Afraid that their deposits would be redenominated into a new, weaker currency, deposits began to flow out of the Greek banking system and there was a sharp increase in ELA to the banking system to finance these outflows.

After the election of the new government, the ECB insisted that the successful negotiation of a new programme would be a necessary condition for continuing to provide more ELA. After a number of meetings in which the Governing Council raised a cap on the amount of ELA to provided, the ECB responded to the announcement by the Greek government of a referendum on the terms of a deal offered by the EU and IMF by announcing that it was placing a hard cap on the amount of ELA

7 See <http://www.ft.com/intl/cms/s/0/27fe630a-5d1f-11e4-873e-00144feabdc0.html>

that could be provided.⁸ Effectively, the ECB announced that it would not facilitate further deposit outflows from the Greek banking system. This led to the imposition of capital controls, controls that remained in place even after the Greek government agreed a new programme with the EU and IMF.

Did the ECB have to take the course of action that it chose? Consider the following alternative version of how the Greek crisis could have played out.

1. As tension builds up in Greece prior to the Greek election in early 2015, Mario Draghi assures depositors in Greece that the ECB has fully tested the Greek banks and they do not have capital shortfalls. For this reason, their money is safe.
2. Draghi announces that the ECB will thus provide full support to the Greek banks even if the government defaults on its debts, subject to those banks remaining solvent.
3. Eurozone governments agree that, should Greek banks require recapitalisation to maintain solvency, the European Stabilisation Mechanism (ESM) will provide the capital in return for an ownership stake in the banks.
4. Provided with assurances of liquidity and solvency support, there is no bank run as Greek citizens believe their banking system is safe even if the government's negotiations with creditors go badly. The ECB stays out of the negotiations for a new creditor deal for Greece (because they are not a political organisation and are not involved in directly loaning money to the government) and its officials assure everyone that the integrity of the common currency is in no way at stake.

There were no legal impediments to this scenario. Despite ECB officials consistently delivering speeches during this period that they were forced to act in the way they did by their own rules, the reality is that the ECB could have pursued this approach. Supporting banks that you have deemed solvent is pretty standard central banking practice. So Draghi's ECB could have provided full and unequivocal support to the Greek banks if they wished. They just chose not to. Similarly, procedures are in place for the ESM to invest directly in banks so a credible assurance of solvency could have been offered.

8 The announcement can be found at <http://www.ecb.europa.eu/press/pr/date/2015/html/pr150628.en.html>

Why did this not happen? Politics is the most likely answer. European governments did not want to provide assurances to Greek citizens about their banking system at the same time as their government was openly discussing the possibility of not paying back existing loans from European governments. Indeed, the ability to unleash a bank-driven “Grexit” mechanism proved to be the ace in the creditors’ pack when negotiating with Greece. Faced with massive political opposition in Germany and other Northern European countries to their existing monetary policy programmes, Mario Draghi and the ECB Governing Council decided it is better for them to play along with the creditor country squeeze on Greece than to stabilise the Greek banking system.

4. The Need for a New Approach

Central banks were put on this earth to be lenders of last resort. Dealing with complex situations in which banks are running out of liquidity and may or may not be solvent should be a core part of every central bank’s tasks. The ECB, however, does not currently play this role in a coherent and comprehensive manner.

Consider this ECB statement from 2014 in response to a *New York Times* story that revealed leaked minutes of the ECB’s discussion of the Cypriot banking situation.⁹

The ECB neither provides nor approves emergency liquidity assistance. It is the national central bank, in this case the Central Bank of Cyprus, that provides ELA to an institution that it judges to be solvent at its own risks and under its own terms and conditions. The ECB can object on monetary policy grounds; in order to do so at least two thirds of the Governing Council must see the provision of emergency liquidity as interfering with the tasks and objectives of euro area monetary policy.

So the ECB’s official line is that it doesn’t provide or approve ELA but also that it sort of does. This is a recipe for the kinds of incoherent policy that we have seen in recent years. Even more worryingly, there is plenty of evidence that political considerations have played a key role in the ECB’s decisions about whether and when to provide or cap the provision of emergency liquidity.

9 The ECB statement can be found at http://www.ecb.europa.eu/press/pr/date/2014/html/pr141017_1.en.html

It is time to develop a completely new approach for the ECB as lender of last resort. The ECB has taken over as the supervisor of the euro area's banks. This removes most of the previous arguments that were in place for the current system of ELA provision. Previously, banks were overseen by national supervisors. As such, it could be argued that those banks that got into trouble and required ELA were the responsibility of national central banks and that the risk associated with lending to these banks should be borne at a national level.

This point no longer holds. Once all of the euro area's banks have complied with the capital raising requirements from the comprehensive assessment, then they will all have an official diagnosis of good health from the ECB. If further problems arise, they should be considered the joint responsibility of all central banks in the Eurosystem.

For this reasons, I believe it is time to change the system in which lending against eligible collateral is a Eurosystem concern while ELA is a national concern. The ECB should be required to approve each and every ELA programme and have the risk shared among the Eurosystem. As an independent regulator, the ECB should also be a position to assess whether the liquidity problems for a bank applying for ELA reflect temporary problems or else reflect deeper structural issues (it is usually the latter). This should help with speeding up the process of restructuring problem banks, via recapitalisation or bail-in and the passing of the Bank Recovery and Resolution Directive now means that the tools to implement these kinds of restructuring are now largely in place. A speedier response of this sort would help to avoid a repeat of long-term ELA programmes in which Eurosystem funding is used to allow private creditors to gradually get their money safely out of insolvent banks.

Of course, this proposal will mean the ECB will have to take on more explicit responsibility for dealing with financial instability. But the two-thirds majority voting on ELA at Governing Council has already meant that the ECB is effectively taking on this responsibility already.

One complication with this proposal is that many of the NCBs have been given a financial stability responsibility to provide emergency lending to banks that is enshrined in national law. I would argue that the ECB should establish a protocol that all ELA programmes are centrally approved and subsequently request amendments to national central bank legislation if this is required.

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BANK SELF-INSURANCE, THE SAFETY NET AND STRESS TESTING

Til Schuermann¹

In his elegant analysis of the financial crisis, Mervyn King (2016) distilled its origins to three forces, one good, one bad, and one ugly. The good was a period of unprecedented stability: low inflation and steady growth, guided by independent central banks. This was accompanied, unfortunately, by a steady rise in debt levels (the bad) and the development of a fragile banking system (the ugly). We know what happened next, and in the post-crisis clean-up, the official sector has pursued two broad lines of reform. The first is a strong push to more self-insurance on the part of banks, largely through more (and better) capital and more liquidity thanks to the reforms from the Basel Committee. The second is a strengthening of the institutional ecosystem wherein banks live ... and die. A core component of that ecosystem is the banking union in Europe.

There are three pillars to that banking union:² the Single Supervisory Mechanism (SSM); the Single Resolution Mechanism (SRP); and the European Deposit Insurance Scheme (EDIS). The SSM, which came into being in November 2014, provides systematic supervision across 19 euro-countries. It mitigates uneven and inconsistent supervisory treatment of banks by centralizing and coordinating banking oversight in a single institution. Moreover, the SSM can make efficient use of scarce supervisory expertise. And it can fully leverage the main, and possibly

1 til.schuermann@oliverwyman.com. Oliver Wyman and Wharton Financial Institutions Center. I would like to thank Hector Sants and Davide Taliente for very helpful comments and suggestions, and Elena Carletti for her encouragement. All remaining errors are mine, of course.

2 Speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the ICMA Annual General Meeting and Conference 2013, organised by the International Capital Market Association, Copenhagen, 23 May 2013: <https://www.ecb.europa.eu/press/key/date/2013/html/sp130523.en.html>

only informational advantage of the supervisor (*vis à vis* the supervised): the ability to compare horizontally across banks to gain a better understanding of range of practices, weed out poor practices, pick up good practices and promulgate them. The SSM is able to make concrete micro- and macroprudential objectives of supervision, namely to assess the capital adequacy, safety and soundness of each individual bank and to assess the resilience of the banking system as a whole.

The Single Resolution Mechanism (SRM), which became fully operational just this year (1 January 2016), implements the EU-wide Bank Recovery and Resolution Directive (BRRD) in the euro area. It provides for a credible mechanism to deal with fatal events, accidental or otherwise, without threatening the stability of the financial system. Finally the EDIS, which provides deposit insurance for retail depositors up to €100,000, still remains a proposal. It was flagged by the Five Presidents Report (2015)³ as a key step towards a fully fledged banking union.

In addition to making the institutional infrastructure of our financial ecosystem more robust, regulators have imposed constraints on activities. For example, the Volcker rule forbids any proprietary trading by banks and has thus forced banks to develop ways of identifying trading activities which are market making and thus permissible (and presumably even encouraged) but not proprietary in nature. In the UK, the adoption of the proposals from the Vickers commission effectively ring-fence current accounts and overdrafts for retail and SME clients and force relationships with other parts of the group on arm's length basis, e.g. by conducting internal funding transfer on market-based terms.

Meanwhile banks have been forced into a much greater degree of self-insurance, both through the increased capital requirements of Basel III, and the increased liquidity requirements: the liquidity coverage ratio (LCR) to cover short term liquidity needs, and the net stable funding ratio (NSRF) to cover longer term funding needs. Basel III has increased the capital requirements via capital ratios in three ways. First, it has raised the minimum capital ratios for all banks and levied additional requirements for those banks deemed to be globally systemically important. Second, it has made the denominator of the ratio, the risk-weighted assets (RWA), more stringent. For example, exposures to financial institutions attract higher capital charges as do securitizations, especially complex ones. And

3 The Five Presidents' Report: Completing Europe's Economic and Monetary Union. 22 June 2015. Available at https://ec.europa.eu/priorities/publications/background-documents-economic-and-monetary-union_en

third, for capital to count towards meeting the requirements (the numerator), it has to be of a high quality such as common equity. By forcing banks to hold more (and the largest yet more) and better capital, to hold a meaningful part of the balance sheet in high quality liquid assets and to discourage the use of short term wholesale funding in favor of retail deposits and long term debt, the regulators have pushed more of the tail risk to the banks.

System-wide stress tests have been added to the supervisory toolkit – and with great success. Stress testing was widely used as a crisis response tool on both sides of the Atlantic, and it is making its way into peacetime use for assessing bank resilience to shocks. Stress testing has many virtues, among them their clarity. Stress scenarios described in terms of a sharp increase in unemployment, a drop in house prices, stock markets, and GDP are easy to understand, certainly in comparison to abstract tail probabilities that are the stuff of regulatory or economic capital models. A bank has to have enough capital to withstand a clearly and simply described financial storm and still come out sailing strong. The public can judge the severity of the scenario, the impact on the banks (and thus how conservative – or not – the banks and supervisors are in translating the scenario to bank losses), and the hurdle they need to clear to be deemed strong enough to pass.

To take two examples, Figure 1 compares two variables (real GDP growth and equity prices) for two countries (US and UK) over the course of several stress test cycles: seven for the US, conducted by the Federal Reserve, and three for the UK, conducted by the Bank of England. Stress scenarios nearly always front-load the pain: the economy and the markets experience a sharp decline followed by a recovery.⁴ The shape of the US scenarios has remained quite constant over the past six years which introduces the risk that US banks have by now prepared themselves well for just this particular scenario, as opposed to being resilient to a broader range of threats. The Bank of England's scenarios are somewhat more varied, with the most recent being notably harsher in terms of both the real economy and equity markets.

In addition to this clarity, stress testing has forced tight collaboration of the authorities across European borders due to the simultaneity and

4 Please note that US real GDP growth is on a year-on-year basis, while for the UK it is represented on a quarter-on-quarter basis; hence the difference in scale on the vertical axis. Further note that the scenario horizon is three years for the Federal Reserve test and five years for the Bank of England test.

scope of the exercise. All banks need to run the same scenario at the same time under the same conditions. Indeed the introduction of the SSM was preceded by the ECB's Comprehensive Assessment which was a combination of an Asset Quality Review (AQR) and a stress test of 130 banking groups from 19 countries, covering over 80% of total banking assets in the SSM (so about €22 trillion). The AQR was a deliberate exercise to ensure that banking organizations from countries and thus different supervisory approaches would operate from a level playing field once under the oversight of a single supervisor.

How should we assess credibility of the stress tests? Certainly the severity of the actual scenario(s) gives an immediate and easy to understand impression. But a stress test is only as severe as the impact on the capital position of the banks. The success of the early US stress test (the 2009 Supervisory Capital Assessment Program or SCAP) was in large part due to the significant impact on the banks: the capital requirement was \$75 billion. In contrast, the 2010 and 2011 European exercises yielded €3.5 billion and €2.5 billion in total capital needs respectively.

This has changed recently. The 2014 Comprehensive Assessment revealed a total capital need of nearly €25 billion. Once banks are properly capitalized, a subsequent stress test should reveal further capital needs only rarely. A measure of severity is then the capital impact or capital consumption due to the stress scenario. Table 1 compares the decline in high quality capital (common equity) across four exercises in basis points: ECB (2014), Bank of England (2015), and the two most recent CCAR tests by the Federal Reserve (2014, 2015). Aggregate capital consumption across all banks range from 340 to 400 bps, with a median bank impact of 240 to 400 bps. Banking systems on both sides of the Atlantic have clearly become more resilient. For example, the total amount of capital available to the 31 banks that participated in the 2015 CCAR after the stress (so net of capital consumption due to the stress) roughly equaled the total amount of capital in the whole US banking system at the end of 2006 at the dawn of the financial crisis.

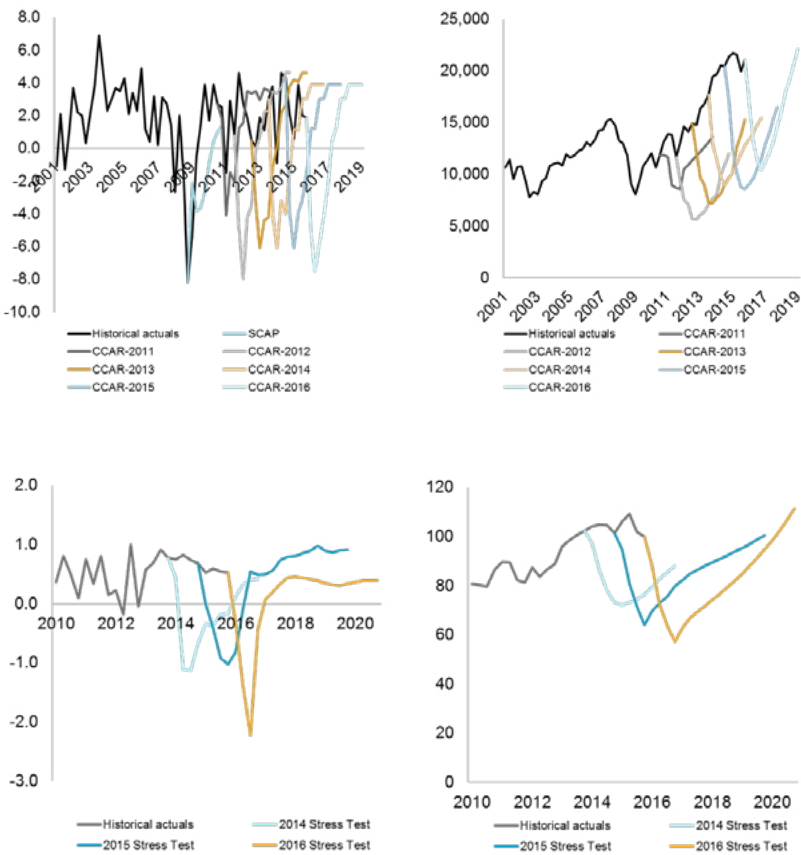
Table 1: Capital (Common Equity Tier 1 or Tier 1 Common) consumption due to stress tests; in basis points

	<i>Aggregate (all banks)</i>	<i>Median bank</i>
<i>ECB (2014)</i>	340	400
<i>Bank of England (2015)</i>	400	365
<i>Federal Reserve CCAR (2014)</i>	400	270
<i>CCAR (2015)</i>	370	240

But stress tests can't do it all. Stress testing, however effective, is not enough to span the pillars of a complete and successful banking union. Of the three pillars – the single supervisor, effective resolution, and deposit insurance – the last is the farthest from completion. Yet deposit insurance may be especially important to get right. In addition to the obvious role of small retail depositor protection and a bulwark against bank runs, it allows banks to play a critical shock absorber role when the financial system experiences adverse liquidity events. As the capital markets ceased to function properly in 2007 and 2008, and short term funding was no longer available to firms, banks re-intermediated to meet liquidity demands via loan commitments. At the same time there was a flight into the banking system, a safer place to park short term funds than, say, money market funds. This effect has been well documented; see, for example Ivashina and Scharfstein (2010), and Gatev, Schuermann and Strahan (2006) for evidence following the demise of LTCM in 1998. Importantly, this effect did not exist, at least in the US, prior to the introduction of deposit insurance; see Pennacchi (2006).

Policymakers have recognized that the creation of a banking union is a necessary step in the direction of full fledged monetary union in Europe. The challenges to implementation are daunting, but Europe is well on the way. Meanwhile, stress testing has emerged as the tool of choice to both respond to the financial crisis and as a peacetime mechanism for banking oversight. It can serve to solidify all three pillars of the banking union by providing unique insight in banks' resilience to shocks. But it is hardly the solution for filling the gaps in governance in Europe, the topic of this conference.

Figure 1: US and Uk Stress Scenarios compared



Source: US : <https://www.federalreserve.gov/bankinforeg/stress-tests-capital-planning.htm>

Uk: <http://www.bankofengland.co.Uk/financialstability/Pages/fpc/stresstest.aspx>

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Conference Programme



CONFERENCE

FILLING THE GAPS IN GOVERNANCE: THE CASE OF EUROPE

Scientific Organisers:

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Elena Carletti | Bocconi University, BAFFI CAREFIN and European University Institute

Joanna Gray | Birmingham University

Mitu Gulati | Duke University

Sala Europa

Villa Schifanoia, Via Boccaccio 121 - Firenze

28 APRIL 2016

■ INTRODUCTION

The conference will bring together leading economists, lawyers, political scientists and policy makers to discuss the current economic situation in Europe with particular emphasis on the issue of filling the gaps or incompleteness in the agreements governing economic cooperation in Europe. These agreements, implicit and explicit, range from matters such as the agreements about domestic debt/GDP levels, the “no bailout clause”, the new banking union, the use of a common currency, the agreement to include identical Collective Action Clauses in all Euro area sovereign bonds and so on.

■ PROGRAMME

09.15 - 10.15	Registration and Welcome Coffee
10.15 - 10.30	Welcome by Elena Carletti Bocconi University, BAFFI CAREFIN and European University Institute
10.30 - 12.00	Panel 1: Are “No Bailout” and “No Debt Restructuring” in the EMU Compatible?

Chair: **Mitu Gulati** | Duke University

Lee Buchheit | Cleary Gottlieb Steen & Hamilton

Kim Oosterlinck | Université Libre de Bruxelles

Martin Sandbu | Financial Times

Isabel Schnabel | University of Bonn

12.00 - 13.00 Chair: **Elena Carletti** | Bocconi University, BAFFI CAREFIN and European University Institute

Keynote Lecture: **Mario Nava** | European Commission

13.00 - 14.30 Lunch

14.30 - 16.00 **Panel 2: Incomplete Contracts? Filling the Governance Gap in the European Union**

Chair: **Joanna Gray** | Birmingham University

Angus Armstrong | National Institute of Economic and Social Research

Phoebus Athanassiou | European Central Bank

Ramon Marimon | European University Institute

Roland Vaubel | University of Mannheim

16.00 - 16.30 Coffee Break

16.30 - 18.00 **Panel 3: Gaps in Governance: The Banking Union**

Chair: **Elena Carletti** | Bocconi University, BAFFI CAREFIN and European University Institute

Piers Haben | European Banking Authority

Rosa Lastra | Centre for Commercial Law Studies (CCLS), Queen Mary University of London

Til Schuermann | Oliver Wyman

Karl Whelan | University College Dublin

18.00 - 21.00 Reception and Dinner at Villa Schifanoia

Dinner speaker: **Patrick Honohan** | Former Governor of the Central Bank of Ireland

Previous Conferences

2015

2014

2013

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2011

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This book contains the proceedings of the conference
“Filling the Gaps in Governance: The Case of Europe”,
which was held at the EUI in Florence, Italy, on 28 April 2016.

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