

Véron, Nicolas

**Research Report**

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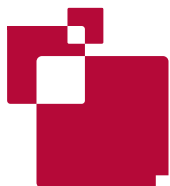
# EUROPE'S SINGLE SUPERVISORY MECHANISM AND THE LONG JOURNEY TOWARDS BANKING UNION

NICOLAS VÉRON

## Highlights

- Problems in the banking system are at the core of the current crisis. The establishment of a banking union is a necessary (though not sufficient) condition for eventual crisis resolution that respects the integrity of the euro.
- The European Commission's proposal for the establishment of a Single Supervisory Mechanism and related reform of the European Banking Authority (EBA) do not and cannot create a fully-fledged banking union, but represent a broadly adequate step on the basis of the leaders' declaration of 29 June 2012 and of the decision to use Article 127(6) of the treaty as legal basis.
- The proposal rightly endows the European Central Bank (ECB) with broad authority over all banks within the supervisory mechanism's geographical perimeter; however, the status of non-euro area member states willing to participate in this mechanism, and the governance and decision-making processes of the ECB in this respect, call for further elaboration. Further adjustments are also desirable in the proposed reform of the EBA, even though they must probably retain a stop-gap character pending the more substantial review planned in 2014.

Nicolas Véron ([nicholas.veron@bruegel.org](mailto:nicholas.veron@bruegel.org)) is a Senior Fellow at Bruegel and Visiting Fellow at the Peterson Institute for International Economics. This Policy Contribution was prepared as a briefing paper for the European Parliament Economic and Monetary Affairs Committee's Monetary Dialogue. The views expressed are those of the author(s) alone. Copyright remains with the European Parliament at all times.



## EUROPE'S SINGLE SUPERVISORY MECHANISM AND THE LONG JOURNEY TOWARDS BANKING UNION

NICOLAS VÉRON, OCTOBER 2012

**THE ECONOMIC AND FISCAL ASPECTS OF THE CRISIS** in the euro area were at least partly understood early on, but it has taken more time to reach a (still incomplete, but meaningful) consensus on the importance of dynamics in the banking sector for understanding crisis developments. The 'doom loop' linking sovereign and banking credit conditions has been correctly identified as a key transmission channel that needs to be addressed to prevent further deterioration and so that eventual improvements can be envisaged. This makes it imperative for European policymakers to include the creation of a banking union in their broader vision for crisis management and resolution.

Given the intrinsic interdependencies between banking policy and fiscal policy, and the limitations of the existing common policy framework for fiscal matters, it is impossible to create this banking union in one single step. The creation of a Single Supervisory Mechanism (SSM) is an important move that will not complete the creation of a European banking union, but may be its cornerstone and could also, crucially and under the terms of the euro-area summit statement of 29 June 2012<sup>1</sup>, enable the direct intervention of the European Stability Mechanism (ESM) and thus a major improvement in the effectiveness of Europe's crisis management strategy for dealing with the banking aspects of the crisis.

As with fiscal policy, there is a strong interdependence between banking policy and monetary policy, which has motivated the choice of the European Central Bank (ECB) as central actor of the SSM, and the use of Article 127(6) as the legal basis for the SSM's establishment. However, banking policy and monetary policy should and will remain separate, which also justifies allowing the SSM to cover more EU member states than only those participating in the euro area. The European Commission's

proposal published on 12 September 2012 goes in this direction as it introduces the possibility of "close supervisory cooperation" between such member states and the SSM, though a more inclusive approach that permits those member states to become effective members of the SSM (and participants in its collective governance and decision-making) would be preferable.

The Commission's proposal rightly endows the ECB with sweeping authority over all banks within the SSM's geographical perimeter, which is a proper application of the principles of subsidiarity and proportionality given the policy aims of the SSM's establishment. However, more decentralisation of decision-making may be sought for macro-prudential policy decisions; and safeguard mechanisms may be provided for non-euro area member states that participate in the SSM. In terms of governance and accountability, the Commission's proposal would benefit from further elaboration, including: the creation of a more compact decision-making body for individual supervisory decisions, which should not be subject to diplomatic balances among member states; more direct accountability to the Council and European Parliament, including for appointments; and more direct inclusion of non-euro area member states participating in the SSM in governance and decision-making, even if Article 127(6) implies that ultimate authority must reside with the ECB's Governing Council.

Reform of the European Banking Authority (EBA) should go further than the current proposal to address legitimate concerns of non-euro area member states, even if this comes at the price of slightly more difficult EBA decision-making, at least until the review planned in 2014. Finally, a careful consideration of priorities in the legislative agenda for the coming months is suggested.

1. Available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131359.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf).

## BACKGROUND AND AIMS

On 29 June 2012, the heads of state and government of euro-area countries issued a statement starting with: “We affirm that it is imperative to break the vicious circle between banks and sovereigns. The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism”. On 12 September 2012, the European Commission published three documents (here referred to as the Commission’s proposals): (1) a communication titled *A Roadmap towards a Banking Union*; (2) a proposal for a Council regulation based on Article 127(6), to create the Single Supervisory Mechanism with a central role conferred on the ECB; and (3) a proposal for a regulation of the European Parliament and the Council to amend the 2010 regulation establishing the EBA in order to adapt it to the creation of the SSM.

This Policy Contribution assesses the Commission’s proposals and provides recommendations to help inform the European public policy debate. Given the complexity of the issue, some arguments have been summarised and only the main policy options have been specifically considered.

## THE CONTEXT: SINGLE SUPERVISORY MECHANISM AND EUROPEAN BANKING UNION

The expression ‘banking union’ is used here to refer to a policy framework that locates key instruments of banking policy at European level to enable the formation and maintenance of an integrated European banking system. The notion that banking union is an important and indispensable component of any strategy to prevent an unraveling of the euro area has gained remarkable momentum since April 2012, as reflected by the 29 June euro-area statement. However, the banking union agenda cannot be considered in isolation from the broader crisis resolution agenda. The late-June report by the President of the European Council, *Towards a*

*genuine economic and monetary union* (Van Rompuy, 2012), provides an important and relevant reference for this agenda, with four key ‘building blocks’. These are often referred to in the public debate as banking union, fiscal union, competitiveness union and political union<sup>2</sup>.

### *The long journey towards banking union*

Banking union, as defined above, constitutes a major overhaul of Europe’s financial and economic policy framework. The radical nature of this endeavour must not be underestimated, and it would be unrealistic to try to achieve it in one single move. The creation of the SSM, as outlined in the statement of 29 June and developed in the Commission’s proposals, can only be seen as the first step on a long journey that is set to include other changes to Europe’s institutional setting and policies, as well as concrete crisis management measures that will have a major impact on the future structures of Europe’s banking system. The fact that the creation of the SSM does not immediately lead to a fully consistent and complete banking policy framework should be considered an unavoidable consequence of the ambition and complexity of the banking union project, and of its fundamental part in Europe’s broader fourfold agenda.

### *Banking union, fiscal union, political union*

In particular, there are strong interdependencies between banking union, fiscal union and political union that rule out the possibility of completing a European banking union without considerable prior progress on the two other components, a condition that is currently not met. A fully-fledged banking union requires an autonomous European resolution authority and a federal European deposit insurance system, both of which require some sufficient form of backstop from a European level of fiscal authority to acquire credibility<sup>3</sup>. The fiscal union that could provide the backstop, in turn, is difficult to envisage without a political union that would at least partly remedy the

2. See, among others, Véron (2012a) on the fourfold agenda; Pisani-Ferry, Sapir, Véron and Wolff (2012) on banking union; Marzinotto, Sapir and Wolff (2011) on fiscal union; and Véron (2012b) on political union.

3. An early version of this idea was outlined in Trichet (2011). Pisani-Ferry and Wolff (2012) specifically explore the interaction between banking union and fiscal union.

*‘Banking union constitutes a major overhaul of Europe’s financial and economic policy framework. It would be unrealistic to try to achieve it in one single move. The creation of the Single Supervisory Mechanism can only be seen as the first step.’*

“structural democratic deficit” of the EU institutions [Federal Constitutional Court of Germany, 2009].

In other words, further progress on the path towards fiscal union, including a less limited and more robust framework for jointly-issued securities than with under the present ESM, and towards political union, including a political setting that would make it possible to back such joint issuance with a credible prospect of future revenue, is required for a completion of European banking union that would compellingly meet the heads of state and government's objective “to break the vicious circle between banks and sovereigns”. Without such progress, the European interbank market will remain impaired by the perception of credit risk on some but not all of the sovereign securities that provide the collateral of reference; credit rating agencies will not be able to lift the ‘sovereign cap’ that keeps the creditworthiness measure of banks at most equal to that of their home member state; and the incentives that prompted many European banks to amass considerable portfolios of sovereign securities issued by their home member state, and to engage in more abrupt deleveraging outside of the country than inside, will remain largely in place.

In the author's assessment and on the basis of the 29 June statement, the Commission's proposals go about as far as possible in the direction of banking union at this stage, given these current limitations on other major aspects of the European policy and political agenda.

#### *SSM and a European approach to bank crisis management*

The 29 June statement reads: “When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalise banks directly”. Thus, the effective establishment of the SSM is specified as a precondition for what in practice means a partial transfer of the responsibility for bank crisis management and resolution from the national to the European level through the ESM.

Such a transfer is arguably a necessary and

urgent condition to address Europe's banking system fragility<sup>4</sup>. Delay, all things being equal, inevitably adds to the eventual cost of crisis resolution. By making it conditional on the effective establishment of the SSM, the heads of state and government have created an intriguing link between the parallel agendas of supervisory institution-building and bank crisis management. It could be argued that this condition was not indispensable and adds rigidity and delay to the overall crisis reaction framework. Conversely, it is understandable that the leaders would have desired the SSM to provide institutional continuity in to a European bank crisis management and resolution process that promises to be complex and protracted. The Commission's proposals respect this sequence by not taking any specific position on the crisis management actions that may be considered once the SSM is in place.

#### *The euro area, non-euro area countries and the single market*

The geographical perimeter of the SSM and banking union cannot yet be considered a settled question. The initial political initiative, as expressed in the 29 June 2012 statement, came from euro-area member states, even though it was endorsed the same day by the European Council. But while the euro-area crisis clearly triggered the move towards banking union, the treaty-enshrined aim of a single market for banking services, combined with significant levels of banking-sector integration between euro area and non-euro area EU member states, mean that all EU member states should take part in the discussion about the establishment of the SSM. This would imply a slightly different framework than in the Commission's proposal, which reserves SSM membership to euro-area member states and only allows an option of “close supervisory cooperation” for other EU member states.

There are technical arguments in favour of having, as much as possible, the same perimeters for banking union and monetary union<sup>5</sup>. However, given, on the one hand, that the SSM falls short of a full banking union and in particular does not include at this stage a common system of deposit insurance, and on the other hand, the fact that the euro area can be joined by all EU member states

4. An early advocacy of this approach is in Posen and Véron (2009).

5. This issue is further explored in Pisani-Ferry, Sapir, Véron and Wolff (2012).

that comply with its admission criteria, the EU should adopt an approach that opens participation in the SSM to all member states that desire it, with an adequate balance of rights and responsibilities. Inclusiveness and flexibility are in order – even though at least one EU member state, the United Kingdom, has made it clear that it will not participate in the SSM.

It may be relevant in this respect to notice that while the euro area represents the vast majority of the EU's banking assets, the UK represents the vast majority of banking assets in the rest of the EU, as illustrated by Figure 1.

The 29 June euro-area statement refers to Article 127(6) for the establishment of the SSM. This article reads: *"The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings"*. This implies unanimity on the part of EU member states, ie each non-euro area member state has a veto. Simultaneously, it implies that the European supervisor at the centre of the SSM is the ECB itself, which potentially makes it more difficult to include non-euro area member states in the

banking union with adequate rights and responsibilities. This also potentially limits options in terms of the supervisor's accountability to political authorities and the European public, and of ring-fencing the independence of monetary policy from the distinct constraints of supervisory policy. These aspects are further examined in the next section of this Policy Contribution.

### SSM DESIGN BASED ON ARTICLE 127(6)

This section is based on the European Commission's *Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*, COM (2012) 511, published on 12 September 2012.

#### Geographical perimeter

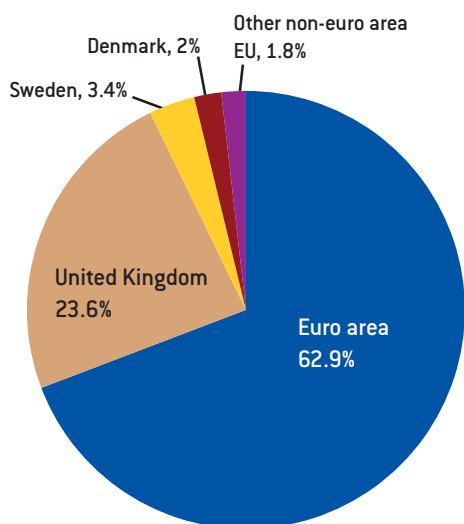
The proposal suggests that the geographical perimeter of the SSM is the euro area, and adds the possibility of "close supervisory cooperation" for those non-euro area member states that desire it. As argued above, this may be seen as not inclusive enough given the possible legitimate aspiration of non-euro area countries to participate in the future banking union. The SSM must include all euro-area member states, as in the current proposal, but should also include the possibility of actual membership for other EU member states that desire to participate, as some are likely to do. The SSM regulation may specify the process through which non-euro area member states would voluntarily become part of the SSM, including possibly the adoption of adequate domestic legislation.

In the same spirit, the termination of SSM membership should be seen as a political rather than technical decision. As a consequence it should be subjected to a high threshold and be a responsibility of the European Council, rather than of the ECB as suggested in the current proposal [Article 6.5].

#### Mandate and powers

The proposal confers on the ECB broad powers to supervise banks based within the SSM's geographical perimeter, to access relevant

Figure 1: Total assets of credit institutions in EU member states



Source: ECB. Note: data for June 2011.

information, and to take appropriate remedial action. This is appropriate and necessary to ensure the effectiveness of the SSM. The experience of the EBA in 2011-12 suggests that the objectives of the SSM cannot be attained if the main supervisory authority remains at the member-state level. Furthermore, the proposal makes appropriate provisions to enable existing national supervisory authorities to carry out a significant share of the actual supervisory tasks and assessments, in an adequate relationship with the ECB so that the ECB retains ultimate authority.

One possible exception, however, relates to macro-prudential policy instruments, including the ability to impose additional prudential buffers on banks related to national credit conditions. Article 4.1(d) of the proposal appears to centralise such decisions at ECB level. While coordination by the ECB is certainly in order, further capacity for initiative by national authorities in this matter would be more consistent with the principles suggested by the European Systemic Risk Board (ESRB) in the context of the legislative discussion on capital requirements (ESRB, 2012).

Also, non-euro area member states participating in the SSM may be granted a greater degree of autonomy from the decisions of the central supervisor than euro-area member states, in order to take into account interactions with their national monetary and fiscal policies, including the fact that they are not covered by the ESM. This could take the form of a safeguard clause that could be invoked, with due justification and an appropriate procedure, to limit the direct application of ECB decisions as currently set out in Article 6 of the proposal.

#### *Banks brought under the SSM's authority*

The proposal includes all euro-area based banks and credit institutions within the SSM's scope of authority. This is consistent with the heads of state and governments' stated aim "to break the vicious circle between banks and sovereigns". This aim cannot be attained if significant sections of individual member states' banking systems remain within a purely national policy framework, even if these sections are composed of small or

medium-sized banks. Thus, the Commission's proposal on this aspect is based on a rigorous application of the principle of subsidiarity in accordance with the stated policy objective.

#### *Governance, accountability and independence*

One lesson from the EBA experience is that governance arrangements matter greatly to the success of a newly established supervisory authority at the European level. In this area, the Commission's proposal has scope for improvement.

A debate has started over the desirable relationship between the SSM and the ECB. The ECB is widely viewed as a strong and credible institution, and it is understandable that this credibility should be leveraged to the benefit of the new SSM. Furthermore, there are multiple connections between monetary policy and supervisory policy, not least in the operation of the ECB's function as lender-of-last-resort to the euro-area banking system. Also, the use of Article 127(6) explicitly implies vesting the European level of supervisory authority in the ECB. However, supervision might involve individual decisions with high political impact and its medium-term compatibility with an independent conduct of monetary policy is open to question. This would suggest that the European supervisor should have more autonomy *vis-à-vis* the ECB, and more accountability to political authorities at the EU level, than is the case in the Commission's proposal. An optimal response to all these considerations requires careful fine-tuning and institutional creativity.

A useful guiding vision could be to consider the medium-term relationship between the ECB and the SSM along the lines of that between the Bank for International Settlements (BIS) and the Financial Stability Board (FSB) in Basel, even though evidently with a very different set of institutional constraints and responsibilities. The BIS hosts and finances the FSB but there is considerable autonomy, and the more political nature of the FSB does not encroach on the independence of the BIS. Partly for reasons of expediency, the FSB started operations without an autonomous legal personality or independent funding, but there is now a discussion to modify



these features. Similarly, and especially in the context of possible future treaty changes, in a longer-term perspective the ECB could be considered the incubator of a European supervisory function that may gradually gain autonomy. This however is not possible currently given the decision to base it on Article 127(6).

At present, improvements that may be considered could include:

- Identifying the supervisory function within the ECB under a specific name (such as 'European Banking Supervisor'), which would mark its separation from the rest of the ECB's activities;
- Replacing the currently proposed (and confusingly named) 'supervisory board' with a two-tier structure<sup>6</sup>:
  - A compact SSM executive board, comprising between five and nine members to make effective supervisory decisions affecting individual credit institutions in the European interest;
  - A larger prudential council that would include representatives of national supervisors, including those of non-euro area member states participating in the SSM; the latter may have a reduced voting weight as a *quid pro quo* for their higher degree of autonomy, as suggested above. The prudential council would exercise oversight over the action of the SSM executive board on individual cases, and decide on broader matters of policy, such as the positions recommended by the ECB in the elaboration of binding technical standards at the EBA.

This setup would ensure the indispensable effectiveness of individual supervisory decisions that should not be held up by the balancing of national interests in diplomatic negotiations, while safeguarding the interests and engagement of all participating member states in setting supervisory policy. In turn, both the SSM executive board and prudential council should be adequately

subjected to the ultimate authority of the ECB's Governing Council.

- Making the appointment process for the members of SSM executive board more akin to that of the members of the ECB's own executive board (ie, by the European Council after consultation with the European Parliament), while keeping the proposal's provision that the chair should be one of the ECB's executive board members. However, it is unclear why the vice chair should be a central banker selected by and from the ECB's Governing Council (Article 19.2 of the proposal);
- Extending the possible length of tenure of the Board's members including its chair, as the currently proposed maximum of five years non-renewable (Article 19.7) appears exceedingly short and not in line with international good practice.

#### EBA REFORM

This section is based on the European Commission's *Proposal for a Regulation of the European Parliament and the Council amending regulation (EU) No 1093/2010 establishing a European Supervisory Authority (...)*, COM (2012) 512, published on 12 September 2012.

The consolidation of the supervisory frameworks of at least 17 member states under the authority of the ECB has a disruptive impact on the fledgling institutional balance of the EBA. It is unlikely that fully consistent responses to the corresponding institutional challenges can be found in the current phase of reform, especially given the lingering uncertainty about major elements of Europe's future banking policy framework. Thus, it appears reasonable at this stage to adopt incremental, *ad-hoc* adjustments that keep the functioning of the EBA viable if not optimal in the immediate future, and to delay any further fundamental changes until the planned 2014 review of the three European Supervisory Authorities. This is broadly the approach adopted in the Commission's proposal.

*'The consolidation of the supervisory frameworks of at least 17 member states under the ECB's authority disrupts the fledgling institutional balance of the EBA. Incremental, ad-hoc adjustments should keep the functioning of the EBA viable until the 2014 review.'*

6. A comparable setup with an Executive Board of nine members is proposed in Car-massi, Di Noia and Micossi (2012).



However, even under this 'stopgap' approach, the Commission does not appear to have gone far enough to address the legitimate concerns of member states that would not participate in the SSM. In principle, authorities of SSM member states that vote in the EBA's Supervisory Board retain their autonomy, but in practice, it is likely that coordination will be sought so that their votes are in line with policies adopted by the SSM as a whole. In particular, according to the proposal, it will be very difficult for non-euro area member states to oppose a position that would be shared by all SSM member states (even assuming that the geographical perimeter of the SSM is limited to the current euro area) in a decision made by qualified majority voting (QMV).

One way to overcome this obstacle would be to subject such decisions, including the approval of binding technical standards, to a higher threshold of majority than the usual EU QMV formula. Other similar adjustments may be in order in other areas of the EBA's activity, including decisions on binding mediation, actions in emergency situations and appointment decisions. All things being equal, such adjustments might make it more difficult to reach the voting threshold and thus may have a negative impact on the quality of EBA decision-making, but this could be seen as an inevitable consequence of the creation of the SSM, at least until the 2014 review.

#### OTHER LEGISLATION CURRENTLY UNDER CONSIDERATION BY THE EUROPEAN PARLIAMENT

In its Communication COM (2012) 510, *A roadmap towards a banking union*, published on 12 September 2012, the European Commission links the establishment of the SSM and EBA reform to the adoption "before the end of 2012" of three additional pieces of legislation, namely on capital requirements (proposal of July 2011), deposit guarantee schemes (proposal of July 2010) and recovery and resolution tools for banks in crisis (proposal of June 2012). It also indicates that "*the Commission envisages notably making a proposal for a single resolution mechanism which would govern the resolution of banks and coordinate in particular the application of resolution tools to banks within the banking union*". Furthermore, the conclusions of the High-

Level Expert Group on possible reforms to the structure of the EU banking sector, chaired by Bank of Finland Governor Erkki Liikanen, could give rise to additional legislative projects<sup>7</sup>.

These various legislative processes, however, should be considered with different degrees of urgency. A natural sequence would be to prioritise the legislation on capital requirements, not least because of the deadline of January 2013 for the start of implementation of the Basel III Accord. On the other aspects, it would be natural to envisage reconsideration in the new context created by the prospect of a European banking union. Specifically, the issue of recovery and resolution tools could be examined together with the Commission's future proposal on a single resolution mechanism, which one would expect might be published in the course of 2013; and the reform of deposit guarantee schemes can be delayed until a clarification of how the issue of deposit insurance is to be addressed on a supranational basis in the future banking union framework. Such rescheduling of course would be without prejudice to the possible adoption of legislation on special resolution regimes and/or reform of deposit insurance systems in individual member states, which may be imposed by circumstances on an emergency basis, and for which the above-mentioned EU legislative proposals may provide a source of inspiration, if not a binding framework.

#### CONCLUSION

It is to be hoped that a workable compromise for the initial establishment of the SSM based on Article 127(6) and corresponding EBA reform can be reached in the next few weeks. Energetic steps towards a resolution of Europe's current banking fragility are urgently needed, and the euro-area summit statement of 29 June makes the effective establishment of the SSM a precondition for such steps. The cost to Europe's citizens of further delay could be extremely significant, not only in financially but also politically and socially.

The bulk of the Commission's proposal can thus be supported, though improvements should be insisted on, particularly on the accountability of the future European supervisory function within

7. The report was published on 2 October 2012, and is available at [http://ec.europa.eu/internal\\_market/bank/docs/high-level\\_expert\\_group/report\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf)

the ECB; inclusiveness of the SSM *vis-à-vis* non-euro area member states that desire to participate in the banking union; and further safeguards for non-euro area member states in the *ad-hoc* reform of the EBA, pending the 2014 review which could result in more fundamental changes.

The establishment of the SSM is only one step on a longer path towards European banking union, which itself cannot be considered in isolation from the challenges of fiscal union and political union.

Losing the current momentum for the completion of this early step would be unfortunate, not only in itself but because it would reinforce the European public's and global investors' doubts about the ability of European leaders to make effective decisions. The 29 June statement contains a promise of supervisory integration and centralised bank crisis management. Europe's leaders now need to deliver on this promise if they are to maintain, or regain, the trust of their constituents.

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