Summary Report of the 6th Annual Conference URPP Financial Market Regulation: "Towards the Euro's third decade"

On 6 June 2018, the sixth annual conference of the **URPP Financial Market Regulation** was held at the University of Zurich. With the Euro turning 20 in the following year, the topics of this year's conference were the regulatory challenges for Europe and its implications for Switzerland in the Euro's third decade. The fact that the next European Summit took place only some three weeks later in Brussels gave the conference's topic additional interest and gave rise to many questions from the audience of about 70 members of academia, trade and business. The **key note speeches** of the conference were given by **Charles Wyplosz** from the Graduate Institute in Geneva and **Thomas Wieser**, former Chairman of the Eurogroup Working Group. The lead organiser for this inter-disciplinary conference was URPP member **Mathias Hoffmann**, Professor of International Trade and Finance at the University of Zurich, who also moderated the event.

The conference was opened by Vice Principal **Christian Schwarzenegger** who reminded the audience of the political and economic circumstances of the time of the initial proposal for a single currency in the 1990s. The Maastricht Treaty entered into force in 1993 with the goal of creating an economic and monetary union by 1999 for all EU states except the UK and Denmark. The Treaty was initially met by doubt over the viability of the monetary project. The supporters of the Euro made comparisons with the US, a single market for labour, goods and services with no internal border controls and one common currency (the Dollar). However, Schwarzenegger drew attention to the fact that in the US the process had been reversed, that national unification was fought for in the Civil war and that the Dollar existed well before the internal market. More recently, the crisis of 2007 had shaken European monetary policy to the core and triggered a credit crisis. In the course, economic differences among member states have been aggravated, and Euroscepticism as well as nationalism are on the rise in some countries. Schwarzenegger closed his speech by stressing the need for risk sharing among member states in order for the Euro to be successful in the long run.

The Euro „Under Construction"

Charles Wyplosz

The opening keynote, The Euro „Under Construction", was given by Charles Wyplosz, Professor of International Economics at The Graduate Institute in Geneva. Wyplosz started by saying that the need for further construction had been apparent ever since the Maastricht treaty in 1993. The Treaty was precise on monetary policy (especially price stability) and its institutions, but less so on instruments (for example, interest rates or money growth). One of the biggest omissions in his view was the missing agreement over lending of last resort, one of the fundamental tasks of a central bank. Over time, the ECB had emerged as a lender of last resort but this was not unanimously accepted. This was further hampered by the unclear decision making process which involved too many players and left room for political games.

Fiscal discipline, on the other hand, was clearly defined in the 1997 Stability and Growth Pact, but had led to an excessive deficit procedure and an incompatibility between national sovereignty and obligations under the Pact. The current situation in Italy, the world's ninth largest economy with massive government debt, was a case in point. According to Wyplosz, "if Italy shakes, the sky is the limit." Returning to the aspect of financial stability, Wyplosz remarked that the Treaty was silent on crisis management and on the bail-out clause. Responsibility was left to national supervision and resolution authorities. In an emergency, their "colleges" were unable to deal with stress situations. Banking union was a major step forward, in his view, but the Union was still incomplete. Despite a common supervisor, it lacked adequate resources in the resolution fund and deposit insurance.

Concluding his speech, Wyplosz had limited expectations for the June summit in Brussels. He reminded the audience that one could not expect too much too soon; after all, in the US, the Federal Reserve was created some 137 years after the Declaration of Independence in 1776. Construction of monetary frameworks was a long, slow process, especially as the work tended to be only undertaken at crisis times, not at peace times.

Euro- and Euro-Denominated Obligations: A Private Law Perspective

Wolfgang Ernst

Prof. Dr. iur. Dres. h. c. Wolfgang Ernst, LL.M. (Regius Professor of Civil Law, University of Oxford; Professor of Roman and Private Law, University of Zürich), spoke about Euro- and Euro-denominated obligations from a private law perspective. In his speech, Ernst spoke on the assumption of a hypothetical scenario and was not giving prognosis, evaluation or assessment.

Ernst started by reminding the audience that the legal framework of the Euro monetary union was footed in primary and secondary law. According to the primary law set out in Art. 128 (1) TFEU ECB-authorised banknotes "shall be the only such notes to have the status of legal tender within the Union." The secondary law consists of First, Second and Third Euro-Regulation from 1997/98 and the three Coin Regulations. Turning to the consequences of violations, Ernst contrasted lawful (EU-law compliant) domestic currency legislation and unlawful tampering with the Euro. Examples of the latter are the replacement of the EURO with a national currency or the introduction of a parallel currency on national level. However, many monetary instruments do not qualify as legal tender (for example, vouchers, and local exchange trading systems such as private issuers, barter-clubs [WIR-money]). As non-legal tender instruments, they are not in conflict with EU law, stressed Ernst.

Then Ernst took a topical example from the news. There are plans in Italy to introduce the "Mini-BoT", buoni ordinari del tesoro, short term treasury bills. These would be a claim against the government, non-interest bearing, securitized, physical notes in small denominations. They would be transferable and as such could be used as means of payment (taxes) *vis à vis* the State and state-controlled entities (e.g. gas stations).

Would Mini-BoTs violate EU law? The legal issue boils down to the definition of legal tender. As neither the TFEU nor the Regulations define legal tender, a hint could be found in Art. 11 Council Regulation (EC) No. 974/98: "... these coins shall be the only coins which have the status of legal tender in all these Member States. Except for the issuing authority and for those persons specifically designated by the national legislation of the issuing Member State, no party shall be obliged to accept more than 50 coins in any single payment." So, in effect, legal tender was that kind of money which a creditor must accept by law, and only physical money qualifies as legal tender. In addition, some act of parliament or statutory instrument is required, binding the judiciary. Ernst concluded that mini-BoTs were not legal tender, as no Euro-creditor would be forced to accept them. Even in future potential applications of Mini-Bots (such as in social security payments, or salaries of state personnel), foreign creditors would not be affected. Only if one turned mini-BoTs into legal tender by setting an official exchange rate and forcing every Euro creditor to accept them as payment, then there would be a clear breach of Treaty. For Ernst, the idea of mini-BoTs could be seen as politically attractive, as their existence would allow to implement a currency reform in an emergency more swiftly.

Summarising, Ernst looked that the consequences of EU violation. The primacy of EU law implies that national currency law may not be applied, and that no court in a member state country would be allowed to rely on a national currency reform act. The matter would be referred to the ECJ. Exit from the euro system could only come about by Treaty change, and this is a very complicated procedure. Inclusion in the Euro-zone comes about by virtue of the membership in the EU, they are not separate memberships and cannot be disentangled. Past exemptions were granted to Denmark and UK. There is no mechanism to allow member states to go out of Eurozone.

Risk-Sharing Mechanisms for the Euro Area

Mathias Hoffmann

Mathias Hoffmann, Professor of International Trade and Finance at the University of Zurich, presented his paper, co-authored with Egor Maslov (UZH), Bent E. Sorensen (University of Houston) and Iryna Stewen (University of Mainz) titled „Are Banking and Capital Markets Union Complements? Evidence from Channels of Risk Sharing in the Eurozone ".

Hoffmann's presentation started from the observation that the Euro amounted to the creation of an integrated European interbank market but that real (or direct) banking integration in the Eurozone –- defined as direct lending of banks to the real sector across border or through international branching of banks that are structured as multi-country operations – had remained very limited. He then specifically focused on the implications of this peculiar structure of banking integration for macroeconomic risk sharing in the Eurozone. According to Hoffmann, there was very little evidence on the link between banking integration and risk sharing at the international level but important intra-national evidence from the US that could inform this analysis. In their paper, Hoffmann and his co-authors started by documenting the way in which the nature of banking integration in the Eurozone had affected the patterns of risk sharing in the Eurozone and illustrated in which way these patterns are similar to the impact of US state-level banking deregulation on inter-state risk sharing in the U.S. during the 1980s.

Building on earlier research, Hoffmann distinguished between three main components of risk sharing: private income smoothing, countercyclical net transfers from the federal government, and procyclical savings behaviour. Briefly, the mechanisms are as follows: output of a given country will generate income in other countries if ownership of firms is diversified across countries. As dividends and capital gains accrue to owners across countries, this helps diversify income, making it less volatile – this type of risk sharing is therefore often labelled income smoothing or 'capital market' risk sharing. Further, for given income, countries can isolate consumption from fluctuations by selling or purchasing assets; that is, from countercyclical savings behaviour. This helps making consumption less volatile, and is therefore often labelled consumption smoothing.

Hoffmann then presented empirical findings for the EMU that showed that direct banking integration was associated with more risk sharing through cross-border capital income flows prior to 2008. He also highlighted that this impact of direct banking integration was also found for the U.S. after the deregulation in the 1980s, suggesting that direct banking integration seem to be robustly associated with more income smoothing or 'capital market risk sharing'. However, during the recent financial crisis, risk sharing among EMU members had dropped significantly and almost dried up. Hoffmann showed that this drop was largely doe to a collapse in consumption smoothing and was driven by a drop in cross-border interbank lending, while capital market smoothing remained relatively stable. These findings suggest that interbank and direct banking integration have very different implications for macroeconomic risk sharing: Direct integration improves risk sharing through capital incomes flows. Because income smoothing seems to be very robust during aggregate downturns, direct banking integration therefore leads to 'good' risk sharing, i.e. risk sharing that is robust to major systemic downturns. Conversely, interbank integration is not robust to country-specific banking-sector shocks and therefore leads to a drop in risk sharing during severe recessions and systemic banking crises. Hoffmann then presented a stylized DSGE-model to explain these empirical findings. A key prediction of this model is that banking union (understood as a set of policy measures that encourages direct banking integration) would indeed lead to a bigger role for risk sharing through equity markets. The reason was that, in the model direct banking integration improved firms' access to finance and made wage payments and employment more resilieant to country-specific shocks – but at the cost of increased volatility in profits. This suggests that real banking integration and capital market union are complements and that robust risk sharing in the EMU requires both.

Central Bank independence in light of constitutional principles

Seraina Grünewald

Next was Prof. Dr. iur. Seraina Grünewald, Assistant Professor of Financial Market Law at the University of Zurich. She gave a speech about central bank independence. Her starting point was that the crisis had transformed central banks. Their (initial) narrow focus had become wider to include restoring financial stability and preserving the Euro. In her talk, Grünewald looked at the institutional empowerment of the ECB and how this affected central bank independence.

The ECB's powers extend beyond core monetary pillars (namely the functions of micro prudential and some limited macro-prudential supervision to institutional framework [SSM]), to macro-prudential oversight (ESRB) and participation in negotiation and monitoring of economic adjustment programmes. Looking in turn at the "new separation of powers", Grünewald stated that the ECB had expertise in a technical matter but this alone was not enough. It needed to be removed from the election cycle to be credible to the long-term commitment to the public interest (e.g. low inflation). As the single monetary policy setter for the Euro area with 19 member states, it needed to be shielded from national influence. Next Grünewald looked at whether the rationale for independence in monetary policy had changed. "Accountable independence" of the ECB was provided by (i) independence (Art. 130 TFEU and safeguards of institutional, personal and financial independence) and (ii) accountability (monetary dialogue, reporting obligations, judicial review). However, in reality, there was "fuzzy" policy inter-dependence. From a legal perspective, the ECB mandate and "broad discretion" were accommodative and indirect (distributive) effects did not change the monetary nature of a measure.

Turning to the question of if the same degree of independence applied to the new functions, Grünewald answered that Art. 130 TFEU applied to supervision but it was a bad fit. Operational independence applied instead. Art. 130 TFEU did not apply to macro prudential oversight by ESRB; it was secondary legislation that established the impartiality requirement. Art. 130 TFEU did not apply to ESM Troika, and there were no relevant legal sources for legal independence. Grünewald identified this as a gap in the law. Lastly, with regards to whether the new functions posed a threat to independence in monetary policy, Grünewald stressed the principle of separation. This implied the idea of independence of functions from each other. However, intra-institutional separation remained incomplete. The Governing Council was the ultimate decision-maker for both pillars. Overall, the objective of price stability seemed to prevail. A real concern was the unclear position of the ECB *vis à vis* the Troika.

Concluding, Grünewald summarized that the rationale for independence in monetary policy had not changed radically. While the same degree of independence did not apply to the new functions, this was less of a concern for supervision and more likely an issue for Troika matters.

Brexit, EMU Reform and the future of Europe

Federico Fabbrini

In his talk, Prof. Federico Fabbrini, Professor of European Law at the Dublin City University, Director of the Brexit Institute, drew on his recent work and publications, namely on European governance in Europe and the law and politics of Brexit.

Part of the answer for the current sources of the dynamics of disintegration were to be found in the past, namely in the so-called "British Question". In the view of Fabbrini, the UK joined Common Market in 1973 on the basis of a "misunderstanding". The Referendum of 1973 phrased the question as whether UK should stay in the "common market", thus disregarding the political element of the union. The UK had been at odds ever since, and especially since the Maastricht Treaty 1992 by opt-outs (no Euro), opposition and special deals.

The Brexit Referendum from June 2016 and the subsequent notification of withdrawal under Art. 50 TEU in March 2017 led to the begin of negotiations. In phase 1 ("divorce"), mainly three items were under discussion: (i) citizens' rights, (ii) the border Ireland / Northern Ireland and (iii) the financial bill. Negotiations were slow and complicated by the General Election. The Joint EU/UK report in December 2017 showed sufficient progress and phase 2 of negotiations (framework of future relations) have commenced in 2018.

At present, Brexit negotiations undergo simultaneous developments. For one, the drafting of the withdrawal agreement (including the transition deal) and negotiations on the future EU/UK relations' conditions. These included economic relations, security, defence and thematic cooperation (aviation, R& D). The legal challenges were manifold. In particular, the future solution for the border Ireland/Northern Ireland (territory of the UK) was crucial. Fabbrini reminded the audience that the 1988 solution (the Belfast Good Friday agreement) was in part facilitated by the existence of the EU and that this would remain a crucial element for reconciliation. There was commitment in Dublin (and London) that the safeguard of the peace agreement was paramount but the finding of a solution proved difficult. The December 2017 report recommended a three pronged solution: (i) economic (new co-operation, no need for the border), (ii) technical (new technology) and (iii) regulatory (alignment, NI remains part of EU). An orderly transition was part of the withdrawal treaty. If not, there would be a "crash out" (i.e. hard Brexit).

For future EU/UK Relations, Fabbrini saw signs for a satisfactory solution. There was the option of the UK remaining inside Single Market and Custom Union (along the lines of Norwegian EEA agreement/Swiss model) for the first two years. Beyond 2020, there were expectations for a new model of economic cooperation after a period of transition. For the future of Europe, Fabbrini foresaw EU reforms in response to euro-crisis. This could mean a new EMU constitutional architecture (i.e. a deeper Eurozone integration for the 19 member states), enhanced by the Bratislava & Rome Declaration and the election of Macron. However, the European question had also opened deep rifts (distrust) between the EU 27 countries, namely a Euro and migration crisis. Fabbrini summarised this with naming teleological tension; market vs. polity. Looking forward, Fabbrini could envisage two types of Europe, namely a constitutional differentiation between the political union and the common market. In this scenario, there would be an inner circle (Eurozone countries) which would be sharing in sovereignty, and an outer circle (rest of EU + UK + CH *et al.*) which would pursue a model of economic integration. His conclusion was that the future of UK/EU relations after Brexit and the future of Europe were deeply linked.

Closing Keynote: Towards the European Banking Union: Ins versus Outs

Thomas Wieser

Thomas Wieser, former Chairman of the Eurogroup Working Group and the Financial Committee, now a senior fellow at UC Berkeley, dedicated his talk to the European Banking Union (EBU). He began by explaining the origin of the EBU which was initiated in 2012 by the G-20 Financial Stability Board as a response to the Eurozone crisis. Banking union was formulated as a policy response to this challenge. The EBU is comprised of three pillars, the Single Supervisory Mechanism (SSM) under the ECB and the Single Resolution Mechanism (SRM), which are based upon the EU's "single rulebook" or common financial regulatory framework, and the Single Deposit Guarantee Scheme (SDGS). All three pillars were the result of the implementation of the Banking Resolution and Recovery Directive of 2014.

According to Wieser, the SSM was set up because of the provisions of Art. 127 (formerly Art. 105) TEUV. It was regrettable in his eyes that Art. 127 confined the single supervisory capability to banking and excluded insurance. All euro-area states participate in the banking union, as do any EU countries which opt in. The supreme governing body of the SSM was the Supervisory Board, which reports to the ECB Governing Council. The Supervisory Board's members consist of ECB representatives and representatives from the supervisory authorities of the countries that participate in the SSM.

Going back in time, Wieser explained the predecessor of the EBU to be the European Stability Mechanism (ESM). The ESM was an intergovernmental organization located in Luxembourg. It was established in 2012 as a permanent firewall for the Eurozone, to safeguard and provide instant and direct access to financial assistance programmes for member states of the Eurozone in financial difficulty, with a maximum lending capacity of €500 billion. The ESM was a direct recapitalisation instrument and it was allowed to recapitalise without the member state having to go through a macro-economic adjustment programme. However, it was not liked by the northern members of the Union and became a political sticking point. Critics have noted that the ESM severely confines the economic sovereignty of its member states and criticised that it provided extensive powers and immunity to the board of ESM Governors without parliamentary influence or control. So the ESM was replaced by the EBU which linked any option of financial assistance to prior supervision of banks and thus greater control of member states. The effects were for one an end of industrial policy type of banks. This was especially important in an internal market. Wieser drew a comparison to the US which had emerged from the crisis relatively well structured. In the EU, on the other hand, the banks were restructured only marginally, and as a consequence, their balance sheet remained largely impaired. The result was that in Europe, the sovereign debt crisis turned into a Euro crisis. The second effect was a shift of the cost of the resolution. Bail-outs were replaced with bail-ins, the cost was shifted from tax payer to current investors and unsecured depositors. In Wieser's view, an important angle that was forgotten was the inter-temporal distribution effect. The Italian banks were a case in point. The third effect was on the cost of finance and the subsequent effect on the structure of the banking sector as banks were reconsidering their lending policy.

Wieser remarked that one result of the EBU (especially EBA) should have been a more level playing field. However, the opposite has been the case. He saw a huge amount of "options and national discretion" which had emerged over decades. Banks strive to domicile in most cost competitive country. As an example, he gave the 2017 re-organisation of Nordea to Finland. The back-stop was Brussels.

What was the impact of Brexit on EBA? Originally, the voting procedure of supervisors at the EBA had given significance to the stance of the out-countries. However, with Brexit, the outs were not just reduced by one country, but measured by size, the scales shifted dramatically. And with EBA moving to Paris, co-operation in the resolution of cross border banks and a clear procedure for cost-sharing was ever more important. Out-countries could join the EBU which in the view of Wieser was a good development. The Treaty foresaw the possibility of "enhanced cooperation", but to date there had been no applications. Which was not surprising for Wieser, as countries like Romania and Croatia did not qualify, but other countries (such as UK, Denmark, Sweden) would obviously not apply.

Wieser ended his talk by saying the EBU was a big game changer for the Euro area. However, it was key that banks became more resilient, and that for that, the cost of finance should go up, in order to accelerate structural change. The option of "enhanced cooperation" would open the possibility for out-countries to participate in a centralised resolution process and could provide an incentive for countries that wanted to join the Euro area.