Financial Union: the Policy Agenda

Nicolas Véron[1]

1. Taking Stock

It is increasingly a matter of consensus that progress towards a better financial union in the euro area and European Union is a desirable, perhaps indispensable component to ensure sufficient resilience of the euro area framework. Private-sector risk-sharing can be a powerful absorber of asymmetric shocks, potentially as much as fiscal expenditure and transfers.

Financial union in turn is typically described as resulting from a combination of banking union and capital markets union. Banking union is a comparatively recent project (initiated in mid-2012) that has made major advanced in recent years, with the now well-established framework of European banking supervision centered on the European Central Bank; the new resolution framework (Bank Recovery & Resolution Directive and, for the euro area, Single Resolution Mechanism) which is now fully in force but remains yet untested; and further components that have been debated to a certain extent but remain at most on the drawing board, such as a European Deposit Insurance Scheme (proposed by the European Commission in November 2015 but not endorsed yet by member states) and the related but separate challenge of exposure limits on banks' sovereign debt portfolios.

By contrast, the Capital Markets Union is a new label on what is already a decades-long endeavor of integrating and developing the European Union's non-bank financial sector through EU legislation, but since its announcement in mid-2014 there have been no game-changing policy initiatives – the few pieces of new legislation introduced under the CMU moniker, e.g. on securitization and prospectus, can be viewed as evolutionary adjustments in line with the European Commission's decades-long legislative activity at a rather below-average pace. Furthermore, the UK vote to exit the European Union must lead to an extensive reframing of the CMU debate, which has not yet been explicitly specified by EU policymakers. Since so much of the EU capital markets are concentrated in the UK, Brexit represents major change in this area. Even though such change was evidently not desired from the EU27 side, it represents a mix of opportunities (e.g. of accelerating capital markets development in the EU27) and risks (e.g. regulatory competition among the EU27 countries to attract new business could result in a harmful race to the bottom, both in terms of conduct and of financial stability).

2. Banking Union build-up

There is a natural sequence for strengthening the euro area's banking union. First, the ECB together with relevant National Competent Authorities must reassure the remaining doubters that it is an effective supervisor for all banks in the system, not only better than the national frameworks it replaced but also good enough to restore confidence in the banking system, efficient capital allocation, and continuous financial stability. There has been much action and progress in the past two years but more remains needed to achieve this aim, primarily in Italy – where it is to be hoped for that more forceful supervisory action will be undertaken after the December referendum, irrespective of its result – and in the rest of the euro area as well. Specifically, the approach centered on Joint Supervisory Teams for significant banks appears to work reasonably well, but the ECB still has to convince observers that it has an effective approach to ensure consistency, proportionality, and supervisory effectiveness when it comes to the euro area's 3,000-odd smaller banks, or "less significant institutions."

[1]Bruegel / Peterson Institute for International Economics

The next steps will be to formulate a policy package that makes the banking union more effective and specifically goes further than what has been done so far to break the potentially harmful linkages between banks and sovereigns. This is where there is a natural complementarity between reducing banks' exposures to their home-country sovereign on the one hand, and pooling the explicit public guarantee of deposits to make it country-neutral on the other hand. On the latter, the Commission's EDIS proposal is a sound starting point, but on the former there is a need for more debate both in terms of technical preparation and of public acceptance. This observer's strong preference would be for a framework of sovereign exposure limits (as opposed to sovereign risk-weights), calibrated in order to strongly reduce the currently high national home bias but to not materially constrain the aggregate amount of euro-area sovereign bonds held by an individual bank. The transition regime is a specific challenge that will probably call for imaginative solution in order to prevent any risk of self-fulfilling market destabilization.

In complement to this effort, further initiatives are needed to harmonize the banking rulebook in areas that include capital, loss-absorbing capacity, but also bank-specific insolvency frameworks in order to achieve a genuine single resolution mechanism (since resolution is always defined as a better alternative to insolvency, it cannot be single as long as insolvency regimes are divergent).

Over a longer time horizon, further changes could be brought to banking union, in alignment with possible future progress towards fiscal policy integration. Nevertheless, much can already be done in the next few years within the existing treaty framework.

3. The Impact of Brexit

The implementation of the UK decision to leave the European Union raises a number of challenges for financial sector policy and calls for a more strategic approach than has recently been the case from the side of the EU27. While much remains to be clarified as to the exact sequence and timeframe of negotiations, it can be reasonably expected that the UK will effectively leave the Internal Market in 2019, even though a transition beyond that date may be achieved to facilitate an orderly redeployment and adjustment of financial activities.

One specific short-term challenge is about the European Banking Authority (EBA). Unquestionably, Brexit will modify the distribution of influence within the EBA: to mention only one metric, the euro area represents roughly two-thirds of total banking assets in the EU28 but nine-tenths in the EU27. Nevertheless, not all non-euro member states of the EU27 will join the banking union (let alone the euro) in the medium term, and as a consequence, the EBA will keep continued relevance even if its governance may need adjustment at some future point. The real emergency, however, is to decide on its future location, so as to minimize the loss of talent and to maximize operational continuity. For this reason, it is to be hoped that this decision on future location will be made early on during the Brexit negotiation sequence and not left for the later phases of political horse-trading.

At a much broader level, the imminence of Brexit should foster a fundamental rethink of the policy structures supporting capital markets integrity, investor protection, and stability of non-bank segments in the EU27. In a nutshell, the current architecture of partially harmonized rules and almost entirely decentralized enforcement is not robust enough to meet the challenge of Brexit. The regulation and supervision of critical market infrastructure firms should be comprehensively pooled at the European level, and so should essential components of the conduct framework including audit firm supervision, accounting standards enforcement, and much more. From this standpoint the exit of the UK represents a threat but also an opportunity, since the removal of the UK veto makes it possible to consider a reinforcement of the regulatory and/or supervisory authority of the ECB and the European Securities and Markets Authority in particular.

In addition, recent developments in Italy in particular underline the need to reinforce European arrangements for consumer financial protection and make sure that this crucial public policy function, justified by the information asymmetry inherent to finance and especially retail financial services, is not subordinated to considerations of financial stability or economic nationalism. This is another missing piece in the current lopsided architecture of European financial services policy framework.