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The New Financial Architecture in the Eurozone

Conference at the European University Institute
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Highlights

The logic, features and future shape of the new financial architecture of the Eurozone were discussed under Chatham House Rules on the occasion of a high-level conference hosted in Florence on 23 April 2015, by the European University Institute in cooperation with Imperial College London. The conference was attended by central bankers, EU policy-makers, members of the financial industry as well as by academics. The following key conclusions came out from the discussion:

1. Despite its incomplete nature, the Banking Union represents a great achievement in terms of financial stability control, thus ensuring a more resilient euro area.
2. By contrast, the exact objective, scope and institutional capabilities of the Capital Markets Union remain a puzzle to many participants.
3. Risks of regulatory fragmentation arising between the European Union and the Euro Area are somewhat exaggerated, it was overall felt. The existence of European platforms such as the European System of Financial Supervision (ESFS) acts as a safeguard to the integrity of the single market.



Background

Meeting in June 2012, at the height of the euro crisis, European heads of state and government established a “Banking Union” with a view to breaking the deadly embrace between sovereigns and their home-grown banks. Following this policy commitment, two major mechanisms came into life to provide a sounder institutional framework for the euro area’s banking system. The Single Supervisory Mechanism (SSM), adopted in December 2012 and located within the European Central Bank (ECB), strives to improve the supervision of Euro-area banks by centralizing it at a supranational level. The Single Resolution Mechanism (SRM), which followed one year later, foresees the constitution of a privately financed resolution fund of € 55 bn to address insolvent banks. Other elements complement the overall concept, although they remain to be adopted (i.e. a European Deposit Guarantee Scheme and a fiscal backstop) or fully enforced (i.e. the Single Rulebook).

In the meantime, the entry into office of the Juncker Commission in September 2014 coincided with a new priority: establishing a European Capital Markets Union. A Green Paper was hence published on this topic by the Commission on 18 February 2015 and it stirred a debate on the key regulatory barriers impeding such a Union. The creation of both a Banking Union and a Capital Markets Union occurs against the backdrop of a hectic reform activity of the European Union institutions in banking and finance regulation. Over the past 5 years, 41 new directives and regulations have been adopted to strengthen and reinforce Europe’s banking and financial markets regulation. This caused uproar in several Member States, including in the United Kingdom, which heavily relies on the City for its prosperity. As a result, the UK has become increasingly defiant about integration steps taken at euro area level, leading some analysts to consider it as a possible argument in favour of a British exit from the EU (also called “Brexit”).

Figure 1: Natacha Valla (CEPII), Mario Nava (EC) and Giovanni Dell’Ariccia (IMF)



1. Is the Banking Union stable and resilient as it looks?

The first conference session revolved around the intricacies and challenges left open by the recently established Banking Union (BU). While some attendees contested the idea that Europe can praise itself to have a genuine Banking Union, the overall mood in the audience was that with the advent of the SSM and of the SRM substantial progress was made in terms of centralized supervisory and resolution capabilities. In contrast to earlier timid and slow attempts to promote further harmonization steps in this domain (like the Segré Report or the De Larosière Report), the Banking Union materialized literally over a matter of weeks. Its advent coincided with an intellectual shift from bail-out towards bail-in considerations. There was however also broad agreement, despite the advances made, on the incomplete and at times complex nature of the BU and of its chaotic governance. The BU’s announcement, one participant claimed, was much more effective in quelling turbulences than its actual implementation.

Participants proved to be particularly convinced by the strength of the new supervisory capabilities of the SSM, backed by the credibility of the ECB. Nevertheless, the duplicity of roles between the ECB’s monetary policy function and its banking supervision function remains a crucial challenge faced by the institution. So far however, Chinese Walls seem to be operational and conflicts of interests between the SSM’s Supervisory Board and the ECB appear to be neutralized by the new governance framework. Participants agreed that it was too early to tell whether the current governance is optimal as it was recognised that the Eurozone architecture is still in the process of being built-up and is likely to take more than a decade to reach its maturity. Criticism was stronger on the Single Resolution Mechanism whose firepower remains too limited to make a key contribution towards financial stability. Touching on the borders of the current Banking Union, one participant complained about the fact that state guarantees of banks seems so far to be a non-issue although nothing seems to prevent the ECB to exclude those assets from being eligible as collateral for ECB credit provision. Another attendee explained that absent a European Deposit Guarantee Scheme, European savers would continue to face a fragmented system of Deposit Guarantee Scheme with varying values throughout Europe. Lastly, against the background of the coordination role it performed during the phase of national bail-outs, the role and scope of EU competition policy in the future banking union was questioned.

Overall, some reassuring signals came from a tour *d’horizon* of the European banking sector whose fundamental health is sounder than a few years back. There has been considerable deleveraging, a substantial shift in the liability structure (from



Figure 2: Natacha Valla (CEPII), Mario Nava (EC), Brigid Laffan (EUI), Elena Carletti (Chair), Christos Hadjiemmanuil (LSE) and Sascha Steffen (ESMT)



wholesale funding to deposit funding) and capitalization has improved markedly. Several participants even claimed that the European banking sector is now over-capitalized compared to its profitability. However, there remain challenges in assessing risky assets and as a result in determining the adequate risk weights. Similarly, there is no clear evidence that the loop between sovereigns and banks has been reduced. Lastly, the proclaimed single rule book is not 100% unified nor is it fully implemented. There are thus challenges left open on the Banking Union side.

Public keynote lecture: Rethinking Banking Supervision from an SSM perspective

Ignazio Angeloni, Member of the Supervisory Board of the Single Supervisory Mechanism, addressed the audience in a public keynote¹. He highlighted the peculiar nature of banking supervisors' role in an intellectual dialogue with the seminal works performed by late Tommaso Padoa-Schioppa. Mr Angeloni encouraged a stronger dialogue between academics and supervisors.

2. Is a Capital Markets Union needed?

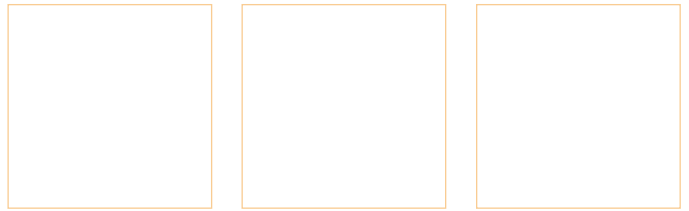
The second session dealt with the Capital Markets Union (CMU). The CMU's declared objective is to pursue deeper capital markets and enhance their integration to diversify sources of funding and provide an alternative to banks. Compared to the US, whose financing model relies more on financial markets – not to mention the 100% equity model of the Silicon

Valley – Europe is characterised by a twin focus on bank financing and on debt financing (as opposed to market-based & equity financing). As one participant put it, both bank-based and market-based systems should however complement each other to fit the varying risk appetite of the demand side. In this spirit, the audience seemed to agree that efforts towards a Banking Union and towards a CMU should go hand in hand.

However, participants were puzzled by the exact meaning and regulatory implications of a CMU. Despite the merits of the recent Green Paper, its scope and precise building blocks are not yet clearly delineated. As such CMU risks falling short of expectations. This has led some to believe that, at best, it is in line with earlier reform mapping attempts like the Financial Services Action Plans or the Giovannini Reports or, at worse, that it remains a mere PR exercise. Consensus gathered on the idea that the emergence of a genuine CMU in Europe is impeded by political, fiscal and most importantly legal factors. A key challenge lies with the co-existence of several national legal systems with their distinctive culture and logic; the persistence of which is likely to hamper the convergence of capital markets regulation principles and practices. Insolvency law is a case in point. The argument was illustrated by the varying stringency of Collective Action Clauses (CACs) in Northern and Southern Europe as most recent CACs have been quite oddly written under local law. Lastly, delegates felt that the CMU will not improve SME's market access as the latter are structurally attracted by bank financing because of their limited funding needs and information access.

In contrast to the banking union – which resolutely entailed the centralization of powers in the hands of a supranational supervisor – the CMU appears, in its current form, as a legally

¹ The keynote speech is publicly available [here](#).



focused endeavour to remove barriers to cross-border trade. Yet, one participant argued that the CMU would end up sooner or later with a genuine and centralized CMU supervisor. Another delegate insisted that in the future the discussion would revolve around the mandate and scope for action of a 'prudential markets' supervisor and of its interaction with the banking supervisor. This will prove difficult as the two areas have different supervision logics: one focuses on actors (banks) while the other deals with activities (financial markets). On the other extreme of the spectrum, some participants questioned whether one would really need a European capital markets union in the first place. Diversifying the funding of Europe's economies could also be achieved within the realm of national markets.

Figure 3: Ignazio Angeloni | European Central Bank



3. Single Market vs. Eurozone

The last session dealt with the inconsistencies and possible tension stemming from the existence of a dual EU-Euro Area regulatory system. The first point of possible friction would lie with the narrow focus of the BU's SSM on the euro area. One participant explained that there are nine EU countries which are not part of the SSM. Yet, those nine countries host six out of the EU's fifteen systemically important banks. Those six banks have subsidiaries in the euro area. He thus asked whether it was so unreasonable to expect regulatory inconsistencies between the EU and the Euro Area. Several speakers pointed, however, to the existing bridges between single market institutions and the banking union, outlining the latter's openness to new participants. Asked whether non-SSM countries were likely to join in the future, one participant explained that the SSM is leaned very strongly on the ECB, which means that the

ultimate decision-making powers of non-euro area members would be structurally weaker than Euro Area members if they decided to join (making this more unlikely). The existence of the European System of Financial Stability (ESFS) was greeted as a safeguard to prevent regulatory fragmentation. Yet, in addition, joint-stress tests across EU jurisdictions could be promoted to avoid blind spots and the reinforcement of the European Systemic Risk Board could be contemplated (e.g. through the creation of a permanent head); the ESRB is indeed the only EU-wide macro-prudential institution.

Participants then considered the implications of the adopted capital requirements regulations for EU and Euro Area economies in view of possible divergences. While much of the immediate 'fixing' was done in the Euro Area, the EU level is however the level where the new Basel III requirements were transposed into law - through the Capital Requirements Directive IV and Capital Requirements Regulation. The aim was to increase the harmonization of prudential policies to avoid the build-up of financial instability risks (e.g. pro-cyclicality, too big too fail phenomena, contagion and fire-sale risks). As part of this development, the varying attitude towards capital requirements across EU and Euro Area countries (and before and after the crisis) was pointed out by a participant. Before the crisis, all EU Member States experienced a race to the bottom in the apparent belief that markets were self-regulating. After the crisis, the trend in some non-euro area countries seems to be opposite, i.e. one marked by 'gold-plating' capital requirements, doing more than necessary.

Another dividing line is the differing approach towards fiscal policy. As a speaker highlighted, outside of the euro area, policy makers can coordinate effectively fiscal, monetary and prudential policies, while in the SSM world fiscal policies remain at the national level and are difficult to coordinate among themselves, let alone with the other policies. With the Six Pack, the fiscal interdependence (mostly) among euro area members has been recognised. Greater cooperation has been achieved, in particular against the background of financial stability spill-overs. By contrast, this awareness is not yet so developed among all EU countries. However, the mood was not alarmist about the fragmentation risk that the progressive deepening of the Euro Area would pose to countries remaining outside of the euro area. The argument was advanced that any regulatory effort performed at the level of the euro area would in any case amount to a *de facto* European harmonization. The point was thus made that one should stop treating the euro area as a single large Member State. In the absence of credible scenarios of Grexit and Brexit, antagonizing the EU and the Euro Area would thus constitute nothing more than an irrelevant distraction.



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