COMPLETING ECONOMIC AND MONETARY UNION 2: FINANCIAL UNION

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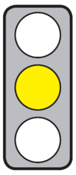
KEY ISSUES

Objective of the Measures: The five Presidents want to create a Financial Union. The Commission has set out this proposal in more detail.

Affected parties: Financial service providers and other businesses, bank customers.



Pro: The creation of a Capital Markets Union may increase efficiency, strengthen competition and push up the potential for growth.

Contra: There is no compelling case for a common deposit guarantee scheme for the eurozone.

CONTENT

Title

Report of 22 June 2015 **Completing Europe's Economic and Monetary Union**, submitted by Jean-Claude Juncker, President of the European Commission in close cooperation with Donald Tusk, President of the European Council; Jeroen Dijsselbloem, President of the Eurogroup; Mario Draghi, President of the European Central Bank and Martin Schulz, President of the European Parliament;
Communication COM(2015) 600 of 21 October 2015: **Steps towards Completing Economic and Monetary Union**

Brief Summary

► **Context and Objective**

– In the Five Presidents' Report of June 2015, the Presidents propose the creation of four Unions:
  - an Economic Union (see cep**PolicyBrief**),
  - a Financial Union (this cep**PolicyBrief**),
  - a Fiscal Union (see cep**PolicyBrief**) and
  - a Political Union (see cep**PolicyBrief**).
– The objective is to strengthen "economic policy coordination, convergence and solidarity" in the eurozone.
– The four Unions will be achieved in two stages (p. 5 Five Presidents' Report):
  - Measures under Stage 1 will be completed by 30 June 2017. All measures for the Financial Union fall under Stage 1.
  - Measures under Stage 2 will be completed by 2025 at the latest. Some of these measures require "changes" to the current "EU legal framework".
– The Financial Union consists of a Banking Union and a Capital Markets Union.
– With the aim of setting out the details of Financial Union, the Commission submitted:
  - in September 2015, an Action Plan specifically for building a Capital Markets Union [COM(2015) 468, cep**PolicyBrief** to follow] and
  - in October 2015, a Communication on all four Unions [COM(2015) 600] that also deals with the completion of the Financial Union (this cep**PolicyBrief**).
– The following analysis deals with the proposals contained in the Five Presidents' Report regarding the Financial Union and the accompanying Commission proposals.

► **Banking Union: Swift implementation and ratification**

– The five Presidents (p.11 Five Presidents' Report) and the Commission (p. 13 Communication) are pushing for swift implementation by the Member States of the Bank Resolution and Recovery Directive (BRRD, 2014/59/EU, see cep**PolicyBrief**), in order to protect tax payers from the costs of bank resolution. It should have been transposed into national law by January 2015. The Commission has initiated infringement proceedings against 12 Member States.
– In addition, the Commission is urging (p. 13 Communication) a swift transposition by the Member States of the Directive on deposit guarantee schemes (2014/59/EU, see cep**PolicyBrief**). It should have been transposed into national law by July 2015. The Commission has initiated infringement proceedings against 18 Member States.

Author: Dr. Bert Van Roosebeke | vanroosebeke@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-105 | www.cep.eu

► **Banking Union: Financing the Bank Resolution Fund**

– The five Presidents (p. 11 Five Presidents' Report) and the Commission (p. 13 Communication) are pushing for the following measures:
  - The eurozone countries are to reach swift agreement on a "bridge finance mechanism" for the period in which the common bank resolution fund (Single Resolution Fund, SRF; see cep**PolicyBrief**) is being build up.
    The SRF will assume residual bank resolution costs as from 2016. It will be supplied from the levies paid by the banks to the national compartments of the fund, whose means will be gradually mutualised. During the build-up phase, SRF resources are unlikely to be sufficient for a resolution.
  - Eurozone countries are to reach swift agreement on a common "backstop" for the SRF (see cep**Input** 01|2014).
    - The five Presidents suggest a permanent credit line from the European Stability Mechanism (ESM) in this regard. All banks participating in the SRF will subsequently reimburse any loans from the ESM.
    - The Commission talks only of a mechanism which is "fiscally neutral over the medium term".

► **Banking Union: Common deposit guarantee scheme for the eurozone**

– As called for by the five Presidents (p. 11 Five Presidents Report), the Commission has proposed a deposit guarantee scheme for the eurozone (COM(2015) 586 of 14 November 2015). A reinsurance fund is being planned for the national deposit guarantee schemes.

– The Commission wants to take account of the "moral hazard" problems at national level and the varying financial strength of national funds by gradually increasing the "liability" of this reinsurance fund (p. 13 Communication and Art. 1 COM(2015) 586.

► **Banking Union: Regulatory treatment of sovereign debt**

– "As part of a coordinated effort at global level", the five Presidents are thinking of (p. 12 Five Presidents' Report) examining whether the level of bank exposures to sovereign debt should be limited. The Commission states that it is "committed to limiting the bank-sovereign loop" (p. 13 Communication).

► **Banking Union: Proposals from the five Presidents not taken up by the Commission**

– The Commission does not consider the proposals of the five Presidents on (p. 11-12 Five Presidents' Report),
  - reducing the "restrictive eligibility criteria" for direct bank recapitalisation by the ESM while "respecting the agreed" bail-in rules, and
  - strengthening macro-prudential regulation in the eurozone in order to detect and limit risks to the financial sector at an early stage thereby "maximising its synergies with the ECB".

► **Capital Markets Union**

– The five Presidents (p. 12 Five Presidents' Report) and the Commission (p. 14 Communication) emphasise that well-functioning capital markets ("Capital Markets Union") allow for greater diversification of financing sources so that companies "are not limited to bank finance".

– The five Presidents (p. 12 Five Presidents' Report) and the Commission (p. 14 Communication) emphasise that closer integration of capital markets could give rise to new risks to financial stability.
  - The five Presidents therefore propose uniform European capital markets supervision with extended macro-prudential powers in order to recognise and limit the risks to the stability of the whole financial system.
  - The Commission refers to work at international level in the Financial Stability Board (FSB). As part of the forthcoming review of the European Systemic Risk Board (ESRB), it wants to ensure that the national and European authorities responsible for macro-prudential supervision have the necessary tools at their disposal (Action Plan on a Capital Markets Union, COM(2015) 468, p. 6).

– As urged by the five Presidents (p. 12 Five Presidents' Report), the Commission has proposed or announced the following legislative changes:
  - reviving the EU market for high-quality securitisations [COM(2015) 472],
  - simplifying the prospectus obligations [COM(2015) 583],
  - harmonising accounting standards [announced in the Action Plan on Capital Markets Union, COM(2015) 468, p. 13],
  - removing barriers to integration contained in insolvency, company and property laws [announced in the Action Plan on Capital Markets Union, COM(2015) 468, p. 24].

Policy Context

The Five Presidents' Report builds on the 2012 "Four Presidents' Report" (which did not yet include the EP President) on Economic and Monetary Union (see cep**PolicyBrief**) and on the Commission Communication on "A blueprint for a deep and genuine economic and monetary union [COM(2012) 777]. The Euro Summit of 24 October 2014 called on the Presidents to prepare "the next steps on better economic governance" in the eurozone. In mid-2016, the Commission wants to set up an expert group to examine the "legal, economic and political preconditions" for the measures in Stage 2. In spring 2017, the Commission will submit a White Paper,

Author: Dr. Bert Van Roosebeke | Telephone +49 761 38693-105 | vanroosebeke@cep.eu

prepared by the Presidents of the other EU institutions. The White Paper will assess the progress made in Stage 1 and outline the next steps - particularly the legal measures of Stage 2.
On 10 November 2015, the Ecofin Council of Ministers rejected any kind of ESM financing mechanism for the Single Resolution Fund (SRF). Instead the Council argued in favour of credit lines from the Member States. Where necessary, the affected Member State will scale up the funds in the national compartment of the Resolution Fund.

ASSESSMENT

Economic Impact Assessment

Proper and swift implementation, particularly of the Bank Resolution and Recovery Directive (BRRD), in all eurozone countries by the end of the year, is urgently required to ensure the functioning of the Banking Union. From 2016, the bank resolution fund (SRF) will be operational; that presupposes a bail-in for which transposition of the BRRD Directive into national law is imperative. The Commission should therefore be rigorous in pursuing the infringement proceedings that it has already initiated.
Despite uniform banking supervision by the ECB, all eurozone countries still have a range of possibilities for influencing the size and risk-sensitivity of their domestic financial sectors. It was therefore logical when, on 10 November 2015, the Ecofin Council of Ministers rejected the involvement of the ESM in the financing of the bank resolution fund (SRF) and instead decided that every Member State affected will, where necessary, scale up the SRF from national funds. For reasons relating to incentives, **financing the bank resolution fund (SRF) by way of the ESM - as bridging finance or as a back-stop - should only take effect**, if need be, **once there has been reasonable financial investment by the affected Member State.** At the same time, it should not be forgotten that a range of financial aids have already been set up: direct bank recapitalisation by the ESM, ESM loans to eurozone countries for the purpose of bank recapitalisation and internal support within the SRF. All these instruments reduce the need and scope for ESM involvement when it comes to bridging finance or a backstop for the SRF.
The Commission rightly seems not to be following the suggestion of the five Presidents to reduce the barriers to direct bank recapitalisation by the ESM. The existing conditions are very balanced and coherent, also when compared with the other financing aids (see cep**Input** 01|2014).
By comparison with national deposit guarantee schemes, a common deposit guarantee scheme for the eurozone would increase the pool of insured risks, which may increase the spread of risk and make deposit guarantee schemes more efficient and robust. However, it requires compliance with a range of conditions (see cep**Input** 21|2015), which seems very unlikely to be achieved.
Firstly, risks have to be accurately priced. As a result, the participating national deposit guarantee schemes will require differing financial endowments.
Secondly, banks have to back sovereign debt with own funds. The upper limit, suggested by the five Presidents, for the volume of debt held by a bank, is in no way sufficient, otherwise a common deposit guarantee scheme could even strengthen the link between sovereign and bank solvency. This runs counter to the idea of the Banking Union.
Thirdly, the affected Member States must contribute to the costs of compensation by the deposit guarantee scheme before they have access to funds from other schemes. This is necessary to overcome the problems of "moral hazard" on the part of Member States stemming from the fact that, despite uniform banking supervision by the ECB, the eurozone countries still have a range of possibilities for influencing the size and risk-sensitivity of their domestic financial sectors. Although the Commission only wants a gradual increase in the liability of the re-insurance fund, this will not solve the aforementioned problem of "moral hazard" because Member States will increasingly be able to rely on the costs of compensation being borne by the common deposit guarantee scheme - rather than having to bear it themselves.
There is therefore no compelling case for a common deposit guarantee scheme for the eurozone.
The Commission rightly refrains from considering the call by the five Presidents to strengthen the role of the ECB in macro-prudential supervision by "maximising synergies". This idea should be rejected as long as the conflict of interest in the ECB between monetary policy and banking supervision continues to exist. What is required is an amendment to the ECB Statute.
Capital should be able to flow to those areas where it can be used most efficiently. Barriers to the free flow of capital result in losses in efficiency and growth. **The creation of a Capital Markets Union**, which provides for the removal of barriers to the free movement of capital across borders, **may therefore increase efficiency, strengthen competition and push up the potential for growth.** Whether the proposed and contemplated measures will actually allow for "greater diversification of financing sources" for businesses, beyond bank loans, depends on the details of measures and cannot be assessed in general terms.

Legal Assessment

Legislative Competency

A possible legal basis for finance market regulation is in principle provided by the internal market competence (Art. 114 TFEU) and by the competence to coordinate national provisions concerning the taking-up and pursuit of self-employed activities (Art. 53 (1) TFEU).

Subsidiarity

Dependent on the actual design of the follow-up measure.

Proportionality with respect to Member States

Dependent on the actual design of the follow-up measure.

Compatibility with EU Law in other respects

Dependent on the actual design of the follow-up measure.

Impact on German Law

Dependent on the actual design of the follow-up measure.

Conclusion

Financing the bank resolution fund (SRF) by way of the ESM - as bridging finance or as a back-stop - should only take effect once there has been reasonable financial investment by the affected Member State. There is no compelling case for a common deposit guarantee scheme for the eurozone. The creation of a Capital Markets Union may increase efficiency, strengthen competition and push up the potential for growth.