13th EUROPEAN SEMINAR
30 June -03 July 2016, Hydra, Greece

Union, Disunion or Time for a Paradigm Shift?

POLICY PAPER

Does monetary union remain dysfunctional, & if so, what are the chances for reform: The case of financial integration

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Putting on track economic and financial integration

After an eight-year effort Euro area –during the second decade of the Economic and Monetary Union (EMU)– is still trying to find its way out of the "crisis zone" and towards a path of sustainable growth that could create prosperity for all of its citizens. During that period, the European Union (EU) and, in particular, Euro area political elite and bureaucracy, after a significant time lag since the outbreak of the 2007/2008 global financial crisis, left aside "individualism" and put back on the agenda the EMU fundamental component that was totally neglected in its first decade: economic integration. The focus –in a phase of sovereign debt crisis and distressed public finances in the Euro area– was mainly on the fiscal dimension of economic integration, even though the lack of competitiveness and the inability to deal with asymmetric shocks and unemployment pressures was (at least) of equal importance.

So, the Euro area economic governance landscape was strengthened by reforms emphasising on fiscal stability, coordination and discipline, i.e. the European Semester, "Six Pack", "Two Pack" and Fiscal Compact. The fiscal institutional setting was accompanied by Euro area mechanisms for risk and burden sharing in rescue cases of member-states and of systemically important financial institutions, i.e. European Financial Stability Facility (EFSF), European Stability Mechanism (ESM) and European Financial Stabilisation Mechanism (EFSM) for the EU.

The establishment of Euro area mechanisms of risk and burden sharing of bank rescues (e.g. Spanish banks) opened the road, but mainly created the need for a centralization of banking supervision in EMU level. When *ex-post* rescues are organized at this level, ex-ante supervision should also be moved in tandem to minimise the need for such rescues, but also their cost (Goodhart and Schoenmaker, 2009). In particular, the transfer of banking supervision to EMU level was the "solution" of the financial "trilemma" that the Euro area member-states were facing as long as the integration and cross-border activity of the European financial system was getting deeper and stronger (Charts 1 and 2).The financial "trilemma" is based on the fact that the –three– objectives of cross-border banking activity, financial stability and national financial supervision and regulation cannot be achieved at the same time, as the one of them has to give (Schoenmaker, 2011). In the case of the Euro area the latter objective had to be given in order to achieve the other two. So, the Banking Union project was a historical turning point of the financial integration, after decades of political reluctance making it a laggard of the broader European integration process.

The pre-crisis slow pace of financial integration

During the pre-crisis era, a crucial point of the financial integration process was the introduction of the euro, as the European initiatives were gradually moved away "negative" integration logic and towards a more "positive" one following the needs of a common currency area. In particular, before the EMU era the financial integration effort was based on *minimum harmonization* in regulation, *mutual recognition* of supervision decisions and *home country control* by national authorities.

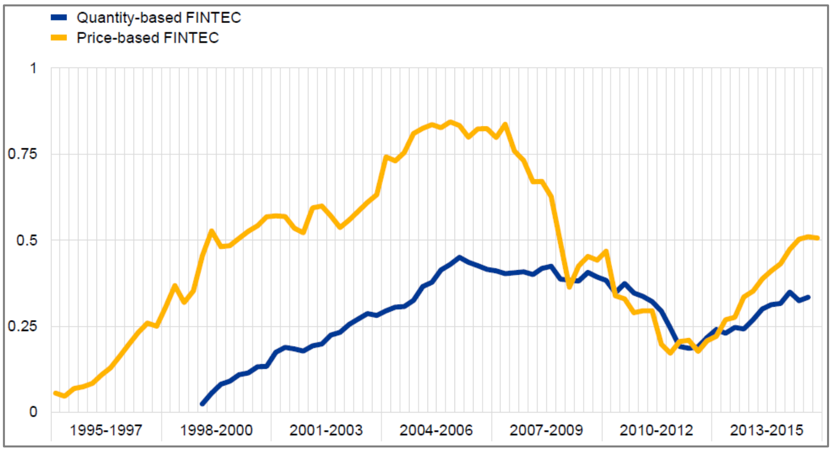
The pre-1999 main initiatives were (a) the First Banking Directive –twenty years after the Treaty of Rome– that recognized financial system's competition as a primary objective, (b) the Second Banking Directive that enhanced the efforts for a competitive financial system aligned with the above mentioned integration principles, and (c) the Directives on Capital Adequacy and on Investment Services that both established the legal basis for banks and investment firms to obtain a "European passport".

After the introduction of the euro, the pre-1999 principles, taking into account the benefits in terms *inter alia* of financial stability and financial (cross-border) development, were turned into obstacles of financial integration than forwarding conditions. There were already significant integration pressures and dynamics in specific sectors of the financial system, i.e. money markets, derivatives and bond markets (Kiehlborn and Mietzner, 2005). So, financial integration moved slowly from national and autonomous regulation and supervision towards *regulatory harmonization* and *supervision coordination*.

In particular, the main post-1999 initiatives and changes in the European institutional framework were (a) the 1999-2005 Financial Services Action Plan focusing on a genuine European financial market, (b) the adoption of the so-called "fast-track" Lamfalussy process based on a complex four-level process of rule making and enhanced cooperation among the EU member-states supervisory agencies, and (c) the new architecture –based on the Lamfalussy framework that expanded from capital market to banking and insurance markets– of the three Committees composed of senior representatives of supervisory authorities and focused on advice provision and coordination on regulation and supervision in the EU. These new bodies were the Committee of European Banking Supervisors, the Committee of

European Securities Regulators, and the Committee of European Insurance and Occupational Pensions Supervisors. Along with the institutional changes, the main regulatory initiatives of the period were (a) the Capital Adequacy Directive II that introduced "Basel II" rule to the EU framework, and (b) the Markets in Financial Instruments Directive emphasizing on regulatory harmonization, competition enhancement and consumer protection in the EU investment services sector.

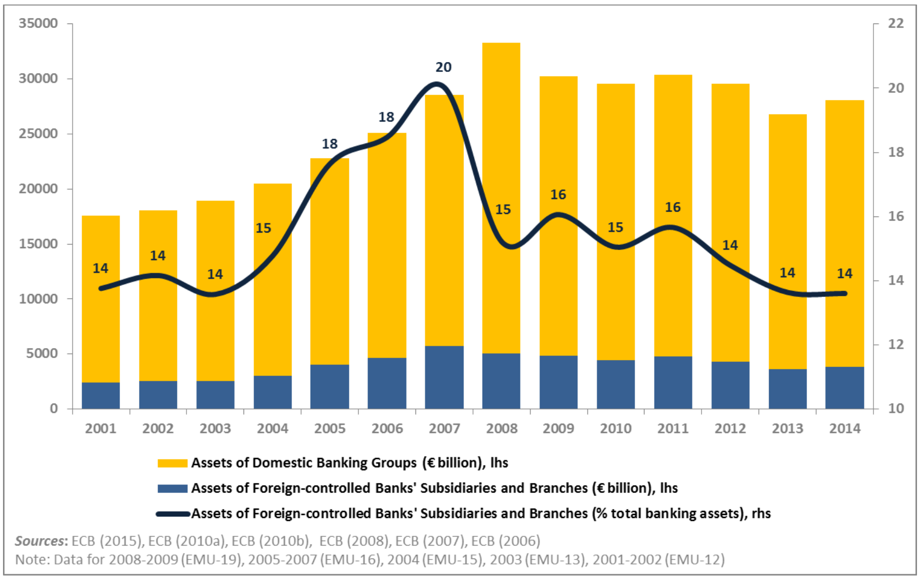
Chart 1 : Price-based and Quantity-based Financial Integration Composites (FINTECs)



Notes: The price-based FINTEC aggregates ten indicators covering the period from the first quarter of 1995 to the fourth quarter of 2015, and the quantity-based FINTEC aggregates five indicators available from the first quarter of 1999 to the third quarter of 2015. The FINTEC is bounded between zero (full fragmentation) and one (full integration). Increases in the FINTEC signal higher financial integration.

Source: ECB (2016)

Chart 2: Assets of Domestic Banking Groups and Foreign-controlled Subsidiaries and Branches



However, the post-1999 reformative agenda did not include the centralization of financial or banking supervision in EU level along with the gradual regulatory harmonization and supervision coordination, leaving the control and supervision in national level. Thus, the financial "trilemma" remained in place. The reluctance of the EU political elite to transfer supervision in EU or Euro area level affected the other two "trilemma" components. In an ultra-favourable Euro area environment the actual financial and banking cross-border activity – although increased– did not reach the (potential) high integration levels that the new environment would allow. According to the calculations of the European Central Bank (ECB), quantity-based financial integration increased during the pre-crisis period but remained below 50%, retaining a gap with price-based integration that exceeded 75% (Chart 1). In the banking market particularly, the share of subsidiaries and branches from foreign-controlled banks to total banking assets increased to 20% in 2007 from 14% in 2001 –remaining the less integrated market of the European financial system (Chart 2). However, both the integration and stability of the Euro area financial system were seriously harmed from the 2007/2008 global financial crisis, pointing out the structural deficiency of not addressing the "trilemma".

Turning financial integration towards a union

The reluctance of the Euro area political elite for a centralised mechanism of banking supervision in EMU level remained in place during the first years that followed the 2007/2008 global financial crisis. Since the burden of banking rescues remained on the fiscal capacity of the member-states –even though it was huge after the outbreak of the crisis– the scenario of a single Euro area mechanism was not on the top of the European agenda. However, the spill-over of the financial crisis to a Euro area sovereign debt crisis and the inability of the European economy to return to a strong growth path (along with the new adverse effect to the banking market) underlined the limits of "individualism" and the necessity for common reaction. Thus, along with a more active monetary policy, the establishment of Euro area mechanisms for financial support to distressed member-states and for rescues of banks in a logic of (private and fiscal) risk and burden sharing were decided. The latter, inevitably, required the transfer of banking supervision in EMU level in order to minimize the possibility or the cost of a rescue. So, the Banking Union was set on track.

The Banking Union project –in terms of supervisory architecture–completed the "low-expectations" European System of Financial Supervision that was set in place as the EU institutional response to the 2007/2008 financial crisis. In particular, based on the "de Larosiere" report on financial supervision in the EU, the European System of Financial Supervision included the European Systemic Risk Board and the three European Supervisory Authorities in an environment of cooperation with the national supervisors. The European Systemic Risk Board is closely related to the ECB (i.e. ECB's President is the Chair, the Board and its Secretariat are settled at ECB's office) and is responsible for macro-prudential supervision of the financial system in the EU, focusing on issuing of warnings and recommendations. The three new authorities are the European Banking Authority (settled in London) the European Insurance and Occupational Pensions Authority (settled in Frankfurt) and the European Securities and Markets Authority (settled in Paris) and, substantially, replaced the pre-existing Committees of the "Lamfalussy" framework. The framework was proved slowly, institutional weak, ineffective for cross-border activity and without macro-prudential dimension (Alexander *et al*., 2007; de Larosiere, 2009; Alexander, 2010). The new authorities focus on the micro-prudential dimension of supervision emphasising on the EU financial supervision harmonization by developing the single rulebook (with prudential standards) for individual financial institutions.

However, micro-prudential banking supervision in the EU remained decentralized being unable, on the one hand, to adequately respond to the sovereign debt and banking market distress nexus and, on the other hand, to provide answer to the financial "trilemma". After the centralization of bank rescuing and risk sharing in EMU level, the establishment of a Banking Union focused on micro-prudential supervision in the Euro area seemed necessary in order to –officially– "*[...] break the link between banks and sovereigns [...]* (Van Rompuy *et al*., 2012)" and –unofficially–minimize the cost and possibility of a rescue.

The Banking Union of the Euro area has three pillars, even though the attention to the third one is –unfortunately– for the time being minimal. The first pillar is the Single Supervisory Mechanism under the ECB that is a fundamental step away from the previous concept of home country control, minimum harmonization and mutual recognition (Buch *et al*., 2014). In particular, the Single Supervisory Mechanism is responsible for the direct (micro-prudential) supervision of the systemically important financial institutions that hold around 82% of banking assets in the Euro area. Its main aims are to ensure the safety and soundness of the European banking system, to increase financial integration and stability and to ensure consistent supervision through (a) establishing a common approach to day-to-day supervision, (b) taking harmonised supervisory actions and corrective measures, and (c) ensuring the consistent application of regulations and supervisory policies. The "less important" banks are still supervised by the national authorities under a framework of close cooperation with the ECB, which can be directly involved in case one of these banks faces difficulties to follow the high supervisory standards. Along with the national supervisory authorities, the Single Supervisory Mechanism cooperate closely with the European Banking Authority –especially in the stress testing of Euro area banks, like in 2015– even though the scope of competences of the latter was restricted after the establishment of the ECB's new supervisory mechanism (Wymeersch, 2015).

The second pillar is the Single Resolution Mechanism that complements the Single Supervisory Mechanism. Its purpose is to ensure the efficient resolution of failing banks with –officially– "*[...] minimal costs for taxpayers and to the real economy [...]*" through a Single Resolution Board and a Single Resolution Fund, financed by the banking sector. In particular, the objective of the new mechanism is that the cost of resolution, before the funding support of the fund, will have first to be borne by the shareholders and creditors of the failing banks, under the Bank Recovery and Resolution Directive. The fund will be built up over (at least) an eight-year period, during which the banking market will contribute annually around 12.5% of the target amount (around €6.8 bn.). The total target size of the Fund will equal 1% of the covered deposits of all banks of the Banking Union. In absolute terms and based on 2011 data on banks' balance sheets, it should represent around €55 bn. when fully operational. Like the Single Supervisory Mechanism, the Single Resolution Mechanism and, particularly, the Board works in close cooperation with the national resolution authorities covers the systemically important financial institutions, whilst the smaller banks are under the responsibility of the national authorities.

The third pillar is the one that remains –unfortunately– unfinished, as the intergovernmental discussions in the Euro area did not lead to a decision on a single deposit guarantee mechanism or scheme but remained on the low integration level of harmonization of the national deposit guarantee schemes. However, in 2015, the European Commission –after the "five Presidents" report– reopened the institutional process by proposing a European Deposit Insurance Scheme that would develop over time and in three stages. It would consist of a re-insurance of national deposit guarantee schemes and after three years it would move to a co-insurance scheme, in which the contribution of single European scheme will progressively increase over time; until 2024 when the European Deposit Insurance Scheme will be able to fully guarantee deposits in the Banking Union. Along with the new European scheme, a European Deposit Insurance Fund will be established and funded directly by bank contributions adjusted for risk, whilst its management is proposed to be intrusted to the Single Resolution Board (Single Resolution Fund is expected also to be fully operational by 2024).

The European Commission, after its proposal for the centralization and integration of the deposit guarantee scheme in the Euro area, proposed the establishment of a Capital Markets Union in the EU, "allowing" also non-EMU member-states with significant capital market activity (i.e. United Kingdom) to participate. In particular, according to the proposal and the action plan (under the UK Commissioner), the new project aims to "*[...] break down barriers that are blocking cross-border investments in the EU to make it easier for companies and infrastructure projects to get the finance [...]*" in the framework of the ambitious "Juncker" Investment Plan. Thus, along with bank-based funding, market-based funding –including *inter alia* capital markets, investment funds, venture capital, crowdfunding, asset management industry– would correspond to the financing needs of companies and projects that struggle to get funding, especially small and medium-sized enterprises and start-ups. In this framework, the key principles of the Capital Markets Union action plan are (a) the creation of more opportunities for investors, (b) the connection of financing to the real economy, (c) the fostering of a strong and sound financial system, and (d) the deepening of financial integration and competition. However, for the time being, there is no specific EU planning for a new centralized supervisory architecture, as the policy emphasis is mainly on the regulatory initiatives of harmonization and barriers removal – the "Single Market" approach. This approach is more favourable for non-EMU member-states that are very reluctant to such kind of responsibility transfer. So, during the first phase of the plan, the actions are focused on securitization market and on investment by insurers and reinsurers in infrastructure projects.

Finally, along with the changes in the Euro area supervisory architecture, a series of regulatory initiatives took place during the post-crisis period. These initiatives focus through regulations and directives on investment fund management, capital requirements, credit rating agencies, market abuse, market infrastructure and derivatives, short selling, bank recovery and resolution, financial instruments, and retail and insurance-based investment products.

Concluding remarks: Trends and challenges

The Banking Union ended an era of political reluctance concerning the integration and institutional centralization of the supervisory environment of the Euro area banking market. In particular, the new integration effort answered the previous decades financial "trilemma" by establishing a Euro area supervisory mechanism with micro-prudential supervisory responsibilities accompanied by a Euro area institutional landscape of macro-prudential supervision, bank resolution and risk sharing. So, the road for the other two "trilemma" elements to expand –i.e. cross-border integration and financial stability– is open. The first positive signs have already been observed as – according to ECB (2015)– the degree of financial integration in the Euro area has entered in a path of improvement after the announcement of the Banking Union and the outright monetary transaction framework in 2012, reaching the following years a level comparable to the one before the sovereign debt crisis (Chart 1).

This significant integration project was characterized by two main trends. The first trend was the strengthening of the ECB's institutional role in the Euro area monetary and financial landscape. The Euro area central bank moved against the academic debate that supported the institutional distinction of price stability responsibility and banking supervision (Di Noia and Di Giorgio, 1999; Ioannidou, 2005; Masciandaro and Volpicella, 2014) and followed the post-crisis new supervisory approach that suggested central bank's (further) involvement in financial supervision (Staikouras and Triantopoulos, 2016). Apart from the theoretical debate, ECB seemed like the only capable and credible institution to successfully undertake banking supervision in an extremely limited time horizon; especially, if the ECB's momentum thanks to the crisis management is taken into account (Chang, 2015). In particular, along with maintaining price stability, various tasks of the ECB were supporting EU economic policies; lender of last resort for banks; collateral policy; quantitative easing (and through asset purchases); sterilised government bond purchases; designing, approving and monitoring financial assistance programmes; possible participation in macroeconomic surveillance missions; and agent for the secondary market activities of the European Financial Stability Fund and the European Stability Mechanism (Dravas and Merler, 2013). So, after ECB's strong involvement in the European Systemic Risk Board and the Single Supervisory Mechanism, the new tasks are macro-prudential supervision, micro-prudential supervision and comprehensive banks' balance-sheet assessment. These new tasks made ECB the basic pillar of financial stability in the Euro area.

The second trend –as has already mentioned– was the new logic of "positive" integration through the centralization of institutions in Euro area level. It is a trend that must continue in order to complete the financial integration project through the improvement of the current institutional situation and the expansion to other (than the banking) markets. So, the main mid-term challenges on the financial integration project are three.

The first challenge is the integration of the deposit guarantee scheme under, mainly, the three-stage proposal of the European Commission that could lead –in 2024– to a Single Deposit Insurance and Resolution Board with finally fully-fledged Deposit Insurance and Resolution Funds or (a common) Fund (Schoenmaker, 2015). It is a "unitary" approach based on the rationale that the decision of a resolution authority concerning the financing or not of a failing bank must take into account the potential cost for the deposit insurer that might come up in case the bank is left to fail (Gros, 2015). This would further enhance stability in the Euro area financial system.

The second challenge is the "fine-tuning" of the architecture of the Banking Union by focusing on the better coordination in the institutional framework and on the role of the European Banking Authority. In particular, the institutional landscape of the Banking Union includes a number of bodies –i.e. ECB, Single Supervisory Mechanism, Single Resolution Mechanism and Single Resolution Fund, European Banking Authority, European Systemic Risk Board, European Commission, ECOFIN, European Stability Mechanism, and national authorities–that create concerns about the coordination and the "on-time" response, whilst, according to Schoenmaker (2015), there may be "fights" between the agencies operating at different levels. Concerning the European Banking Authority, it is a fact that after the establishment of the Single Supervisory Mechanism the range of the authority's responsibilities is restricted and is focused on rulemaking, acting more like "regulatory" authority than a supervisory one (Wymeersch, 2015). So, it would be interesting, taking also into account the architecture of the Capital Markets Union, to (a) review the responsibilities of the European Supervisory Authorities in order to increase their supervisory role –especially concerning the financial institutions that are not covered by the single mechanism, and (b) examine the case of high-level body to strengthen coordination and efficiency of the framework.

The third challenge is the establishment of a strong Capital Markets Union following the trend of "positive" integration and institutional centralization of the Banking Union. This means that the integration philosophy will have to move away from the current "Single Market" approach of regulatory harmonization and barriers removal and follow the proposal of the "five Presidents" report for a single supervisory mechanism in the capital markets. Such a turn, even though it will not be in favour of some non-EMU member-states (which are traditionally reluctant to centralized architecture), will contribute significantly –according to the financial "trilemma"– to the cross-border capital market activity and the financial stability. Thus, the current regulatory initiatives could be accompanied by an EU or Euro area single supervisory mechanism and the two "Unions" could eventually establish a broader Financial Union in the Euro area.

So, after decades of political reluctance, financial integration seems to have the chance to change from a laggard into a driving force of the broader European integration process.

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