

TO THE COMMISSIONER RESPONSIBLE FOR FINANCIAL SERVICES

By Nicolas Véron

* Among the many challenges you face, the most pressing is the unfinished banking union. This perpetuates a major fragility of the euro area that still threatens its survival in case of future crises, and undermines the efficiency of financial intermediation and the international role of the euro.

Completing the banking union is thus what will define your term's overall success or failure. This highly complex project encompasses banks' concentrated sovereign exposures, European deposit insurance, other aspects of the policy regime for non-viable banks (including the resolution/insolvency framework and aspects of state aid control), and phasing out barriers to cross-border integration.

You should also promote EU-wide integration of capital markets infrastructure, step up the fight against money laundering and reaffirm the EU commitment to global financial standards.

- * BANKING UNION
- * TACKLING FRAGMENTATION
- * ANTI-MONEY LAUNDERING

1 STATE OF AFFAIRS

Your area of responsibility has gone through momentous recent developments. The good news is that Europe's decade-long systemic financial crisis, from mid-2007 to mid-2017, has been over for more than two years, despite lingering anxieties. You thus enjoy more tranquil starting conditions than your three immediate predecessors. The less good news is that the reform programme initiated at the height of the crisis is only half-finished, even after abandoning any unnecessary items. As a consequence, you face a massive policy agenda.

*UNFINISHED
REFORMS

This memo focuses on your role in the legislative and regulatory process, under which the Commission proposes financial services legislation and endorses proposals from the relevant European Union agencies for binding standards. It leaves aside your role (and that of your colleague in charge of competition) in inherently unpredictable future cases of financial crisis management.

* BANKING
SECTOR

The banking sector remains the core of Europe's financial system, despite President Juncker's Capital Markets Union initiative (on which more below). The banks are in a better state than at any point in the last twelve years, but still not great – even though the overwhelming majority of them appear to be solvent under any reasonable definition. The EU/European Economic Area (EEA)¹ are overbanked. European banks have retreated dramatically from their pre-crisis expansion overseas (McCauley *et al*, 2017), and have lost EU/EEA wholesale market share to their American competitors (Goodhart and Schoenmaker, 2016). The vagaries of Brexit, and the possible future disruption from new financial technology (fintech), generate additional concerns. For banks to be viewed as viable, further consolidation, restructuring and cost-cutting are needed. In terms of cross-border integration, the EU/EEA system has the worst of both worlds: too integrated to be immune to cross-border financial contagion, but too fragmented to have the resilience that would come with genuine system-wide risk-sharing.

The continued dominance of banking reinforces the system's most glaring current weakness, namely the bank-sovereign vicious circle that revealed itself in 2010-12 as the primary driver of the euro-area crisis. The radical policy response known as banking

union was explicitly developed from mid-2012 to break that vicious circle, but remains a halfway house².

- On the positive side, the European Central Bank, in its capacity as hub of the Single Supervisory Mechanism (SSM) under the SSM Regulation (Regulation (EU) 1024/2013), fully assumed the role of licensing authority for all credit institutions in the euro area³ in November 2014. Not everything in this transition has been smooth, but the ECB is now a credible and respected banking supervisor (see for example ECA, 2016; Schoenmaker and Véron, 2016; European Commission, 2017b; IMF, 2018).
- More awkwardly, the regime for non-viable banks⁴ that was introduced during the crisis, with high hopes of substituting market-discipline-enhancing bail-in for wasteful bail-outs⁵, is not working as intended by the crisis-era legislators. Under the EU Bank Recovery and Resolution Directive (BRRD, 2014/59/EU), non-viable banks are either resolved by an administrative authority using an EU-harmonised procedure, or if the resolution authority declines to take action (based on specific public-interest criteria), banks are liquidated under non-harmonised national law known as “*normal insolvency proceedings*”. In the euro area, the Single Resolution Board (SRB) was established in 2015 and acquired full authority in 2016 as a central resolution authority. But cases so far have revealed a general preference for normal insolvency proceedings over BRRD resolution, and correspondingly for national bail-out over BRRD-compliant bail-in, despite state aid control strictures. The only BRRD resolution by the SRB so far was that of Banco Popular Español in June 2017, but that case was not one of unambiguous insolvency and thus did not establish a precedent of senior creditor bail-in. There is a growing perception that, unless the legal regime for non-viable banks is significantly reformed, BRRD resolution and the SRB will play only a limited role, if any, in future cases of bank unviability. This perception might have been compounded by the SRB’s own difficult start (ECA, 2017; Véron, 2019).

* NON-VIABLE
BANKS

* SOVEREIGN EXPOSURES

- Most problematic, the structural drivers of the bank-sovereign vicious circle remain in place. Banks retain high levels of concentrated domestic sovereign exposures. Deposit insurance is a national competence. Because of the preference for national proceedings over BRRD resolution, and the resulting incapacitation of the SRB's Single Resolution Fund (SRF, several dozen billion euro strong but so far unused), additional (implicit) public guarantees tend to be also national – eg government guarantees of bank bonds, allowing them to be used as collateral for central bank liquidity. The instrument for direct recapitalisation of banks by the European Stability Mechanism (ESM), decided in mid-2012 but never plausibly operationalised, was officially phased out in 2018. Even assuming its future use, the SRF is widely viewed as insufficient to address a major systemic crisis, and there are ongoing discussions on how it could be complemented by mechanisms to provide liquidity in resolution. Most banks have a predominantly national scope of activity, and even those with cross-border diversification are forced by national authorities to ringfence their capital and liquidity across intra-euro-area national borders.

* UNFINISHED BANKING UNION

The Juncker Commission was not able to lead the EU to address the banking union's unfinished elements. In 2015, it made an ambitious legislative proposal to create a European Deposit Insurance Scheme (EDIS, COM/2015/586), but that has not been approved by the European Council and was watered down by the Commission itself less than two years later (COM/2017/592). The Commission has declined to address the problem of concentrated sovereign exposures, arguing unconvincingly that: 1) any regulatory changes in that space must wait for the completion of EDIS and other *“outstanding elements of the Banking Union and Capital Markets Union”*; 2) it would require an *“agreement at the global level”*; and (3) it should be part of a *“joint political decision”* that also includes a component establishing a *“European safe asset”* (European Commission, 2017a, page 23). The completion of the banking union was thus not considered in a holistic manner when euro-area reform was widely discussed during 2018. Largely as a

consequence, there has been no major cross-border consolidation in the euro-area banking sector since the crisis, despite the pent-up need for further restructuring.

2 CHALLENGES

The EU/EEA financial system is bank-dominated, overbanked and fragmented. This is not good for the European economy.

- **The system is too bank-centric.** Alternative forms of finance, including various capital-market segments, venture capital and equity finance more generally, are comparatively underdeveloped. The Juncker Commission's project of a capital markets union was ill-defined from the start, and suffered from the early decision (justifiable in the context of the then forthcoming UK referendum on Brexit, but no less crippling for that) to rule out significant changes to the market supervisory architecture. Bank financing may be best suited for traditional patterns of corporate growth, but the more dynamic sectors of Europe's economy, including advanced services and high-growth entrepreneurial firms, typically seek other forms of external financing. Rebalancing Europe's financial system away from overreliance on banking is a structural, long-term endeavour that would raise Europe's growth potential.
- **The system is overbanked.** The banking sector remains bloated with too many banks and barriers to both exit and entry, undermining its competitiveness and profitability (ESRB, 2014). Many banks survive with high cost structures within semi-protected national markets. Incumbency is protected by a dense web of national regulatory and tax distortions, governance and ownership patterns, and other idiosyncratic practices that entrench established banking structures. In stark contrast to both the US and emerging economies, there have been almost no significant new entrants into the EU/EEA banking market for more than a century. The sector's low profitability is associated with greater difficulty maintaining or replenishing adequate capital levels and with a comparatively lesser capacity to invest and innovate. The transition

* TOO MANY
BANKS



Powerful disincentives or outright barriers to cross-border integration exist both for banks and for market infrastructures

* CROSS-BORDER
INTEGRATION

- to a healthier landscape, with less incumbency protection and more scope for future new entry, would make the sector more resilient and better able to serve a dynamic European economy.
- **The system is fragmented.** Powerful disincentives or outright barriers to cross-border integration exist both for banks and for market infrastructures. National authorities insist on national ringfencing of banks' capital and liquidity, even for fully-owned subsidiaries of banking groups headquartered elsewhere in the EU/EEA⁶. This is also true in the banking union, because national authorities retain a separate mandate to ringfence under the guise of depositor protection (since deposit-guarantee schemes remain national) and/or crisis prevention (given the above-highlighted lingering implicit national guarantees)⁷. In the non-bank sector, the preservation of national capital market infrastructures, including trading platforms such as stock exchanges, clearing houses and information intermediaries, is a powerful obstacle to European capital market integration. The motives for such financial fragmentation include banking/financial nationalism, meaning the protection and/or protection of national champions in the financial sector, and what economists loosely refer to as 'financial repression', meaning the use by governments of 'their' financial sectors to pursue national objectives that might include the preferential financing of the government itself or of other favoured stakeholders. From an EU/EEA perspective, the fragmentation is detrimental for financial stability, as the bank-sovereign vicious circle during the euro-area crisis powerfully illustrated, and for investment and growth, since investors and issuers/borrowers miss out on cross-border opportunities that would be economically beneficial

* FINANCIAL
NATIONALISM

compared to what is available in closed national financial systems.

These are not the only challenges in the current situation. A major new theme has emerged in 2018 with the multiplication of high-profile cases of apparent breaches of EU anti-money laundering (AML) legislation, itself a transposition of a global framework developed since the 1990s. In turn, the ineffective AML supervisory framework could contribute to further system fragmentation along national lines, as national authorities understandably seek to protect their countries from other member states' AML failures. More broadly, the supervision of financial firms' conduct of business, and the corresponding protection of financial-services consumers, savers and investors, may have suffered from the overarching priority given to financial stability and prudential concerns during the decade of systemic fragility. Specifically, there have been massive cases of banks selling their own high-risk equity and debt to their own clients in several member states, thus egregiously exploiting the asymmetries of information inherent to finance – occasionally with the acquiescence, if not the encouragement, of national authorities.

The relative lack of global attractiveness of the EU/EEA financial system is a major cause of the comparatively underdeveloped international role of the euro: the ECB president noted that *“if markets are to entertain the possibility of an enhanced [international] role for the euro, we need to consider what the conditions are that underpin the [US] dollar’s dominance. The list is long, but the fact that the dollar is an expression of an integrated capital market is certainly one of those conditions”* (Draghi, 2019). An additional challenge is to ensure that the policy framework for the financial system adequately takes into account issues of long-term investment and environmental sustainability (Schoenmaker and Schramade, 2019).

3 RECOMMENDATIONS

The following recommendations assume no prospect of EU treaty change during your term. They do not include issues outside of your scope that were envisaged under the Juncker Commission’s capital markets union agenda, such as corporate or individual insolvency

law reform. They also do not examine the case for reforming the banking communication on state aid, last revised in July 2013, which is a matter for your colleague in charge of competition.

General framing

Given the centrality of banks in EU/EEA finance, the completion of the banking union, understood as breaking the bank-sovereign vicious circle, must be your highest priority. It is challenging but possible to achieve it during your term, and this opportunity should not be missed this time. None of your other issues is nearly as important.

The EU/EEA financial system's rebalancing away from bank dominance is a longer-term objective, for which you should lay sustainable foundations. You should not feel obliged to retain the Juncker Commission's slogan of "*capital markets union*", which implies a false symmetry with the banking union and frankly has become associated with failure. You may rather simply refer to achieving a true single market for financial services, including capital markets.

You should also complement the past decade's emphasis on financial stability during the crisis years, and more recently on financial development, with a long overdue reaffirmation of the need for financial protection – appropriately protecting depositors, savers, investors, consumers of financial services and the integrity of the EU/EEA financial system. The most urgent task is to restore credibility to European AML policy.

Banking union

Breaking the bank-sovereign vicious circle means delinking bank credit conditions from sovereign credit inside the euro area⁸. You should adopt a four-pronged approach:

- 1. Reduce banks' concentrated domestic sovereign exposures** so that each member state's banking system can plausibly survive an episode of sovereign debt restructuring. You should focus on the problem at hand, which is concentration risk not credit risk. (Addressing sovereign credit risk is neither necessary nor sufficient to break the bank-sovereign vicious circle, and would undermine euro-area stability in the absence of a fiscal

union). To tackle it, you should introduce ‘sovereign concentration charges’ for euro-area sovereign exposures of euro-area banks, as an amendment to the EU capital requirements regulation (Véron, 2017). Contrary to an often-heard fallacy, such sovereign concentration charges would not put euro-area banks at an international competitive disadvantage, since banks can avoid any additional capital requirements by properly diversifying their euro-area sovereign exposures without necessarily reducing their aggregate level.

* EUROPEAN
DEPOSIT
INSURANCE
SCHEME

2. Protect explicitly insured deposits identically across the euro area with a well-designed EDIS. This is critical for mass confidence and should be the bedrock of political acceptance of the banking union. Your proposal should ensure that insured deposits, currently under a maximum of €100,000 per account, benefit from the exact same credible and unconditional protection in all euro-area member states, with no ifs and no buts. Otherwise, the differentials in public confidence will leave too much scope for disruptive national bank runs in some crisis scenarios. For the same reason, the EDIS should be centrally managed by a single EU agency (most likely the SRB), with national authorities deprived of any role other than as automatic paying agents⁹.

3. Review the regime for non-viable banks so that it works similarly in all member states and does not rely on implicit national fiscal guarantees. This implies significant and perhaps full harmonisation of ‘normal insolvency proceedings’ for banks in the euro area, and presumably also a role for the SRB in administering these. You should also consider, possibly at a later stage, enabling either the European Stability Mechanism (ESM) or the SRB to wield, under appropriate conditions, financial tools that might be necessary to defend financial stability, such as providing liquidity guarantees to banks or participating in precautionary recapitalisations, in addition to the ESM’s role as backstop to both the (existing) SRF and (future) EDIS.

* NATIONAL
RINGFENCING

4. The three previous actions will allow the passing of legislation to put an end to national ringfencing of bank capital and/or liquidity within the euro area. In addition, the financial stability



Measures to complete the banking union should be a single package of decisions by EU leaders, though their implementation would necessarily be differentiated

* FINANCIAL
STABILITY
CONCERNS

benefits of banks' geographical diversification should be properly acknowledged in the regulatory and supervisory framework (Jokivuolle and Virén, 2019).

The last point underlines the fact that despite their complexity, these four action items should be envisaged as a single package of decisions by EU leaders, even though their implementation would necessarily be differentiated in terms of legislation and transitional arrangements. Such a comprehensive package would be unambiguously beneficial to every member state, even though some of its individual components might not be perceived as such. It would powerfully incentivise the market-driven restructuring, diversification and cross-border integration that the European banking system needs, as argued in the previous section of this memo.

Capital markets supervision

To promote less fragmented and thus deeper and more liquid EU/EEA capital markets, you should prioritise the integration of their underlying infrastructures. This will not happen as long as infrastructures located in different member states, even those that are systemically important or even critical at European (let alone global) scale, are separately supervised by national authorities. You may think of it as a textbook case of application of the treaty principle of subsidiarity. The post-crisis EU/EEA financial framework stipulates that no financial firm or market should remain unregulated if it potentially raises financial stability or integrity concerns. If these concerns have pan-European significance, which is evidently the case for systemically critical financial infrastructure, they should be supervised at European level, as banks in the euro area already are.

The European Securities and Markets Authority (ESMA), which already supervises credit ratings agencies and trade repositories¹⁰, is the obvious candidate for such a mandate, complemented where relevant by the ECB. But for that, ESMA itself needs to be reformed in order to become a credible and independent financial supervisor, a role that was not immediately envisaged when EU legislators enacted the legislation creating it in 2010. This entails more compact governance, akin to that of the permanent session of the SRB, and a revised funding framework.

Anti-money laundering

The importance of proper AML supervision and enforcement, in an era of rising geopolitical threats, and the failure of the existing EU regime to defend its credibility given the multiple above-mentioned cases of breaches, should force a fundamental rethink. The EU/EEA's AML problem can be analysed as another vicious circle: criminal money laundering tends to concentrate in member states with more permissive regimes, which generates local benefits, which create incentives for the national regime to become more permissive not less. Given the binding EU/EEA single market framework, the system is only as strong as its weakest (national) link or links. As memorably put by one EU head of government, *"it's a little bit like fighting rats. I can make sure that I get the rats out of my house and my house will be clean, but what about my neighbours?"*¹¹

Creating yet another EU agency should not be envisaged lightly, but is justified by the significance of the EU/EEA's AML challenge. You should propose legislation to establish a European AML Authority as an independent AML supervisor, working with national competent authorities and the SSM, but empowered to directly access information and impose financial penalties on significant offenders. Its remit should cover not only banks but also all other 'obliged entities' under the EU AML legislation (Kirschenbaum and Véron, 2018).

Global leadership

The EU has an obvious strategic interest in a functioning rules-based international order. First, you should better align EU legislation with global standards where divergence is not evidently in the EU

interest. This could include phasing out the EU ‘carve-outs’ from international financial reporting standards (unless the global standard-setter itself modifies the relevant standards in a way that would be endorsed by EU regulation); amending EU bank capital requirements legislation to make it fully compliant with the Basel accord (see BCBS, 2014); and strengthening the independence of the SRB in line with the Financial Stability Board’s key attributes for effective resolution regimes (IMF, 2018, paragraph 34).

Furthermore, Europe’s representation in global financial regulatory bodies has failed to catch up with changes in the global financial landscape and in the EU’s own internal arrangements. Specifically, the Basel Committee on Banking Supervision includes representatives from seven euro-area countries as full members, plus those from the ECB. This situation constitutes indefensible overrepresentation, given that individual euro-area member states no longer set bank prudential supervisory policy, and undermines the reputation of both the EU and the Basel Committee in the eyes of the rest of the world. You should encourage the relevant euro-area countries to voluntarily terminate their memberships. A comparable approach could be applied to the Financial Stability Board (especially its Steering Committee) and possibly also to other global bodies.

Concluding thoughts

Many more technical aspects of financial services legislation and regulation will also require revision or reform during your term, but cannot be mentioned here for lack of space. One of these could be a revision of the EU insurance solvency legislation to better incentivise investment in long-term high-return assets. The recommendations in this memo might seem daunting. You should keep in mind, however, that they are much less radical than what was actually achieved during the Commission’s crisis term in 2010-14. Your duty now is to make what started then work, and to finish the job.

NOTES

- 1 Unless otherwise indicated, EU/EEA refers in this memo to the territorial scope of the internal market in financial services, namely where EU financial services legislation has binding effect. This is meant to also encompass the United Kingdom should it stay in the single market after Brexit, eg during the transition period as defined in the Withdrawal Agreement.
- 2 The banking union area is currently identical to the euro area, but is expected to expand beyond it during your term, through the process known as close cooperation defined by the SSM Regulation (Regulation (EU) No 1024/2013). Bulgaria has applied for close cooperation, and other EU member states are likely to follow.
- 3 The European Central Bank is the second banking supervisor in the world by aggregate assets of supervised entities, behind its Chinese counterpart but well ahead of US ones. Contrary to a widespread misconception, its authority covers all euro-area banks no matter how small. While the ECB generally exercises its mandate over smaller banks indirectly through the delegation of day-to-day supervision to the relevant national authorities, it is the only decision-making authority for core matters such as license approvals and withdrawals and the vetting of significant changes in ownership ('qualifying holdings').
- 4 'Non-viable' is used here as shorthand for the qualification of "*failing or likely to fail*", defined in the BRRD.
- 5 'Bail-out' is a colloquial expression that generally refers to the use of public money to reimburse a weak or failing bank's claimants, especially creditors. 'Bail-in' is specifically defined in BRRD as an administrative decision by a bank resolution authority to impose losses on liability-holders in certain resolution scenarios. Bail-in is also used colloquially in a broader sense to refer to the imposition of losses in situations other than BRRD resolution, eg in precautionary recapitalisations (also defined by BRRD). The currently applicable EU Banking Communication (2013/C 216/01) refers to bail-out and bail-in in this colloquial sense.
- 6 In Poland, national authorities also insist on a separate domestic listing for the largest banks.
- 7 The recently enacted revision of the BRRD further expanded the ringfencing capacity of national authorities.
- 8 Non-euro-area EU countries will inevitably retain some correlation between bank credit and sovereign credit, even if they join the banking union through close cooperation.
- 9 This rules out 'deposit re-insurance' designs (other than during an initial transition), because these leave the possibility of deposit insurance being held hostage to political negotiation in a systemic crisis, as happened in Cyprus in March 2013. However, the system may legitimately retain country-specific features to account for differentiated banking structures and risk patterns that are not directly correlated with sovereign credit. It may also accommodate idiosyncratic sub-national arrangements (or 'pillars' as currently exist in Austria, Germany, Italy, and Portugal) and voluntary top-up regimes (as for German commercial banks). The design could ensure that the system's 'first loss' in case of idiosyncratic bank failures is incurred at national (or 'pillar') level, thus preserving sound incentives (Schnabel and Véron, 2018).
- 10 Due disclosure: the author is an independent non-executive board member of the European trade repository arm of DTCC (the Depository Trust and Clearing Corporation), which is supervised by ESMA.
- 11 Latvian Prime Minister Krisjanis Karins to Latvian parliamentarians, quoted in Foo Yun Chee, 'EU needs central supervisor to tackle money laundering "rats": Latvia's PM', *Reuters*, 17 April 2019.

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