European Financial Reform: The State of Play

The regulatory legacy of the 2007-08 global financial crisis is not settled. Most of the reforms meant to prevent a new global credit freeze and the ensuing deterioration of bank balance sheets are still being implemented. Major examples include the Dodd-Frank legislation in the United States and the global Basel III capital adequacy rules. The final shape of European financial reforms is similarly uncertain. What makes European reform more difficult is the unique – and uniquely challenging – set of problems that EU leaders face. The EU's task is twofold: (1) it must prevent financial flows across a highly integrated group of countries from pushing financial market participants toward insolvency in the event of a crisis. (2) it must address the fact that large European banks operate internationally but are regulated and bailed out domestically. This has placed a tremendous burden on cash-strapped eurozone economies – a burden that has directly contributed to sovereign debt crises in the eurozone periphery.

These twin imperatives are driving a multi-pronged reform effort. The Commission is pressing ahead with long-standing plans to complete the single market for financial services, implementing a single system for euro payments and strengthening the rules governing cross-border trade in securities and derivatives. As the crisis made clear, however, these measures would not be sufficient to stabilize the European financial space. In response, the eurozone has begun the lengthy and sometimes-contentious implementation of a set of reforms collectively known as "Banking Union." Finally, against the wishes of countries like the United Kingdom and Sweden, eleven member states have chosen to implement a tax on all financial transactions in an attempt to restrain destabilizing high-frequency trading and speculation.

The backgrounds behind these policy initiatives have been the subject of past EUCE briefs. The purpose of this brief is to highlight was has been accomplished, changed, or abandoned during the negotiation and implementation phases of these reforms, establishing the state of play in the

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ongoing EU financial reform process (as of June 2014). The first section presents the current state of the EU single market for financial services, the second details the progress toward banking union. The third section then covers the fractious debate over a European financial transactions tax. The brief concludes with an assessment of how successful these measures are likely to be amidst an environment that seems increasingly hostile to the European project.

State of the Single Market

The establishment of a single European market for financial services has been a major EU goal since the renewed push to complete the single market began in the mid-1980s. There have been major successes in the drive to establish a single European financial market: barriers to cross-border capital flows have been dismantled and rules barring foreign competition in domestic financial markets have been abolished. Even so, the Europeanization of finance has gone much further in some markets than others. There are relatively robust European markets for interbank lending, corporate bonds, and, until 2009, sovereign debt. However, much of this internationalization is concentrated among a small group of very large banks. Moreover, loan and equities markets remain decidedly national and cross-border mergers of European banks are uncommon outside of Eastern and Central Europe.[1]

This means that European finance is still characterized by a great deal of home bias. Even prior to the global financial crisis, the vast majority of most European banks' assets and liabilities were domestic, with less than 25 percent accounted for by activities in the rest of the EU.[2] In other words, retail banking remains national even as bank-to-bank relations between large institutions have internationalized. Such national fragmentation means that (1) financing costs continue to differ across national boundaries; (2) domestic borrowers remain relatively reliant on local financial institutions to provide them with funding; and (3) disruption of the limited channels through which international funding does flow can starve an entire country of international capital.

This second and third points are crucially important with respect to the ongoing concerns over European sovereign debt. National banking systems and European sovereigns are still dangerously intertwined: governments rely primarily on domestic banks for funding, and banks

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rely on their governments remaining creditworthy and offering emergency support.[3] This domestic reliance is particularly problematic in an environment where cross-border capital flows take place through a limited number of channels, as is the case in contemporary Europe. The danger is that international flows can be shut off relatively easily, leading to the problem of "sudden stops" which can quickly shut an entire economy off from international capital.[4] The onset of the financial crisis led European leaders to conclude that nothing short of full banking union would be capable of addressing these problems.

Before addressing banking union, however, two pre-crisis components of the single market agenda are worth noting. The first of these is the creation of a Single Euro Payments Area (SEPA). The idea of a single format for all eurozone money transfers was in the research stage as the global crisis struck. SEPA aims to harmonize rules and conditions governing transfers between banks and between consumers and retailers, reducing transaction costs and speeding the payments process.[5] This would effectively improve the connectivity of financial market participants across the entire eurozone. Adopted in 2012, SEPA will fully enter force by August 1, 2014. The migration to SEPA was meant to be complete by February 2014; however, the six-month extension to August should be sufficient for completing the process.[6]

The second pre-crisis initiative, the Markets in Financial Instruments Directive (MiFID) entered force in 2007. MiFID's objective was to streamline European rules governing investment services as well as the trading of financial products: debt securities, equities, derivatives, and other structured projects. In theory, this should facilitate the cross-border provision of financial services and ease the international transfer of assets, expanding the number of conduits through which international capital flows. However, the outbreak of the global financial crisis quickly revealed MiFID as insufficient to the task of regulating ever-innovating financial markets. One crucial failing was that it did not regulate the trade in over-the-counter (OTC) derivative contracts.[7]

Consequently, a replacement for MiFID – MiFID 2 – is currently in development. The Commission hopes to use this new framework to address the OTC market, high-frequency trading firms, commodities derivatives seen as abusive, and introduce various transparency

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measures.[8] Yet despite the launch of the MiFID 2 consultations in 2011, no directive exists and the European Commission is still engaged in the fact-finding process. Implementation of such a new set of rules is unlikely within the next three to four years.

Banking Union

The most significant component of the European reform agenda is the establishment of a banking union. Aside from limited European measures such as MiFID, pre-crisis regulation of European banks was primarily national, loosely coordinated at the European level through entities like the Committee of European Banking Supervisors (CEBS). The crisis made it clear that allowing financial institutions to operate on a European scale – but with national regulators and national responsibility for resolving a bank failure – was problematic. To that end, European leaders in 2012 announced plans for an ambitious banking union, currently consisting of three "pillars" meant to address this failing: the Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and Single Rulebook. The SSM shifts supervision of large eurozone banks to the European Central Bank (ECB), the SRM establishes a single fund for resolving failing banks, and the Single Rulebook sets out the legislative guidelines binding all EU banks.

The SSM is the pillar of banking union that is closest to being realized. The ECB is due to begin supervising the 128 largest eurozone banks on November 4, 2014. This will put nearly 85 percent of all banking assets in the eurozone under the direct supervision of the ECB. Responsibility for overseeing the smaller 6000 banks in the euro area will remain with national authorities – though the ECB is permitted to directly assume supervision of any bank it chooses. The November handoff is an important milestone: it effectively draws a line between the pre-SSM (domestic) and post-SSM (supranational) regulatory eras. As part of the handover, the ECB needs to ascertain the health of each of the banks for which it is assuming responsibility.

In order to do this, the ECB is currently engaged in a "comprehensive assessment" of those 128 banks. The assessment has two components: (1) an asset quality review measuring the valuation and adequacy of banks' assets and collateral and (2) a stress test to examine the banks' stability under various adverse scenarios.[9] The stress test simulates a major disturbance in global bond markets and a seven-percent contraction of eurozone GDP. The assessment itself has been

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subject to some criticism, with conditions and expectations that have led some bank chiefs and analysts to describe the process as tantamount to putting a heart attack victim to a thorough physical – or simply as "sloppy."[10] The results of the assessment – and potential recommendations – are due to be published in October, just prior to the handover. The findings of the comprehensive assessment are particularly significant because unhealthy banks may require assistance. Whether that assistance should come from national sources or from common resources remains highly contentious.

That contentiousness largely concerns the SRM – arguably the most crucial and controversial pillar of banking union. After two years of discussions and a marathon final negotiating session, the European Parliament and eurozone finance ministers agreed to a framework for the SRM on March 20, 2014. Parliamentary negotiators had sought a large and communal fund for the SRM: all member state banks would contribute to a fund which could be deployed across the entire eurozone – ideally with access to the €500 billion in bailout funds set aside in the European Stability Mechanism (ESM). Finance ministers from more stable Northern European countries, particularly Germany, balked at the notion of a common bailout fund. Instead, they argued for a network of smaller national funds distinct from the ESM. Overall, the final agreement looks closer to the German vision than the parliamentary one.[11]

As currently envisioned, the SRM will consist of €55 billion to be collected from banks over the next eight years. 40 percent of the funds will be available for common use in the first year of the fund, rising to 60 percent in the second year. The decision over what banks are failing and what approach is called for are largely left to the ECB – though there are limited ways in which finance ministers could override the ECB's decisions.[12] The degree of mutualization remains a major German concern, as does the possibility that SRM funds could be used to recapitalize banks suffering from problems revealed during the ongoing comprehensive assessment. That is, Finland, Germany, and the Netherlands have argued that banks' pre-handover problems are the legacy of past *domestic* mistakes and should not be resolved with common funds.[13]

The March 20 agreement may be as far as Germany is willing to go. However, it is unlikely that the SRM as currently structured will be sufficient to break the dangerous bank-sovereign

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relationship at the heart of Europe's present crisis. The size problem is particularly noteworthy: Dexia's 2011 bailout saw the Belgian, French, and Luxembourg governments guarantee the struggling bank access to up to €90 billion over ten years.[14] In short, the fund would have struggled to match the package offered to just one bank, let alone 128. Moreover, the complicated procedure involved in processing disbursements and the German hesitance toward mutualization will limit the capacity of the SRM to recapitalize a major failing bank under crisis conditions. If the SRM is unable to step in, the burden will continue to fall on fiscally strapped member states.

The final pillar of banking union – the single rulebook – is a growing collection of rules and directives meant to govern banks across the entire EU. These rules include relatively straightforward pieces of prudential oversight like guidelines on capital requirements and risk assessments. One significant piece of legislation, the Bank Recovery and Resolution Directive (BRRD), provides much of the legislative support for the SRM. It compels banks to contribute to the resolution fund and requiring them to develop plans for their own recoveries. Moreover, it requires "bail-ins" – i.e., additional capital injections from shareholders and large creditors – before any public funds or the SRM resources are committed to a bailout. It is hoped that this feature of the BRRD will reduce the need for bailouts, rendering the small size of the SRM fund unimportant.

The single rulebook also contains guidelines for an EU-wide deposit guarantee scheme. However, the ECB as well as influential outside commentators have argued that deposit guarantees must be a standalone pillar within banking union. They have repeatedly called for deposit insurance patterned along the lines of the US Federal Deposit Insurance Corporation – with protections guaranteed by the EU rather than by member states.[15] As it stands now, the deposit insurance component of banking union is relatively weak: the rulebook mandates that member states offer €100,000 in deposit insurance but does not provide any resources to ensure that member states can meet their commitments.[16] The abandonment of an earlier, more ambitious pan-European deposit scheme can be chalked up to German opposition grounded in concerns that domestic savings might be transferred to customers of failing foreign banks.[17]

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Financial Transactions Tax

Some of the most acrimonious debate has surrounded an additional proposed reform: the idea of a financial transactions tax (FTT). The basic premise of the FTT is to levy a very small tax on all sales of debt securities, equities, and derivatives. This, proponents argue, will penalize high-frequency traders and large-scale speculators while having only a minimal impact on most investors. Opponents argue that such a tax is inefficient and will lead investors to shift activities abroad in attempting to evade taxation. The debate has sharply divided EU member states.

The European Commission's initial 2011 proposal intended to roll out an FTT across the entire EU. While popular with voters, the original plan met sharp opposition from the United Kingdom and Sweden. As the envisioned tax required unanimous approval, it became quickly apparent that an EU-wide FTT was not possible. Consequently, eleven member states – Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia, and Spain – opted to move ahead under the "enhanced cooperation" rules that allow groups of member states to pursue initiatives under the aegis of the EU but without cooperation of the bloc.[18]

Despite scaled-down ambitions, debate over the FTT remains acrid. Disagreements among the eleven participating states mean that little progress has been made despite a self-imposed 2016 deadline for implementation.[19] Although some guidelines were laid out in a 2013 Commission proposal, questions remain over the final form the tax will take. Notably, there has been some discussion of cutting the tax from the initially proposed 0.1 percent rate (on debt securities and equities) to 0.01 percent – a move that would drastically reduce anticipated revenues.[20] While not participating in the FTT, the United Kingdom has continued its vocal opposition to the plan by lodging a challenge with the European Court of Justice. That challenge was rejected in April 2014 on the grounds that it was premature – the court effectively found that the UK could not challenge a law that does not yet exist.[21]

A Look Ahead

This examination of the state of play in European financial regulation reveals an extremely fragile situation. Relatively technical and procedural fixes remain possible and the EU has been

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successful at altering some rules governing cross-border financial interactions. This has been demonstrated through continued progress toward a European payments system, the imposition of European capital adequacy standards, the adoption of pan-European deposit guarantee rules, and ultimately the acceptance of the ECB's new role as the SSM. This last achievement is arguably the most significant development in post-crisis reform, entailing a limited transfer of regulatory competency to the European level.

However, there are significant obstacles to further measures that require either common support for member states or the transfer of new powers to the European level. Germany and its fiscally stable allies have been steadfast in their opposition to the mutualization of liabilities across the EU or eurozone, limited communal funding within the SRM notwithstanding. Britain and its allies have similarly been adamant in opposition to rules like the FTT, which transfer new competencies to the EU level and might entail economic costs. Furthermore, the May 2014 European elections made it clear that many member states are facing populist backlashes against the European project. This will subject any transfer of money or power to the European level to a heightened level of scrutiny.

These developments are problematic for a very simple reason: the success of European financial reform will require member states to do precisely those things to which certain member states and constituencies are objecting. It is impossible to envision a functioning banking union, for instance, that does not transfer funds across borders, extend new powers to European authorities, or both. Indeed, the completion of a robust banking union will almost certainly require treaty revisions in order to create adequate insolvency protection and centralized resolution and deposit guarantee schemes.

Absent new communal commitments and additional powers for European authorities, the financial reforms currently under discussion cannot address the systemic weaknesses at the heart of the eurozone debt crisis. Without major changes, national governments will remain vulnerable to large failures within their domestic financial systems. Financial institutions' liabilities in the EU amount to well over 500 percent of the entire bloc's GDP. In countries like Ireland, Luxembourg, the Netherlands, and the United Kingdom, that figure is over 1000 percent of

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domestic output.[22] With sovereign debt burdens already high, national governments are poorly positioned to step in and rescue their domestic banking systems if there is need. Likewise, in such a dire scenario, governments would be hard-pressed to meet their deposit guarantee obligations. Under the status quo, a financial system failure would need to threaten a sovereign default before the truly common European backstop – the ESM – can lend the economic strength of the bloc to a stricken member.

The purpose of Europe's financial reform agenda is to (1) prevent the emergence of a new crisis and (2) put the structures in place to ensure stability in the event that a crisis does occur. The fixes that are being put in place – focused as they are on regulation and the streamlining of the single market for financial services – might achieve the former goal. In the event that the new rules fail, they have little hope of achieving the latter.

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