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Finance

A union of capital markets?

Discussion Leaders: ***Debora Revoltella***, *Director, European Investment Bank (EIB);* ***Ernst-Ludwig von Thadden,*** *Professor of Economics and Finance, University of Mannheim*

Moderator: ***Diego Valiante,*** *Head of the Financial Markets Unit, CEPS*

The European Commission's action plan on capital markets offers a useful framework for numerous actions, but its questionable execution plan raises doubts about its effectiveness and ability to promote a single market for capital in Europe. How can sustainable financial integration contribute to growth and employment in Europe? How important is the single market and the consolidation of the current 28 capital markets into fewer pan-European market infrastructures?

A common deposit insurance: Why and how?

Discussion Leaders: ***Levin Holle,*** *Head, Financial Markets Department, Federal Ministry of Finance, Germany;* ***Patrick Pearson,*** *Head of unit, DG FISMA, European Commission;* ***José Luis Malo de Molina,*** *Bank of Spain Counsellor, Permanent Representation of Spain to the European Union*

Moderator: ***Daniel Gros,*** *Director, CEPS*

Deposit insurance protects mostly retail customers and could thus be viewed as consumer protection, which can be left in national hands. In a systemic crisis, however, the funds available to national deposit guarantee schemes (DGSs) will not be sufficient and the sovereign will then also be under stress (as could be observed in Portugal, Ireland and Greece). One option to consider is a system in which a euro-area common fund provides re-insurance to national DGSs in case of large, systemic shocks. But the design of the scheme must take into account linkages between banks and sovereign financing, including Emergency Liquidity Assistance and banks' exposure to their own government. Can a feasible deal be struck on all these issues?

European banks: Finally going cross-border?

Discussion Leaders: ***Luc Coene,*** *Representative to the Supervisory Board of the Single Supervisory Mechanism, European Central Bank (ECB);* ***Diederik van Wassenaer,*** *Global Head of Regulatory and International Affairs, ING;* ***Natacha Valla,*** *Deputy Director and head of the scientific programme on International Macroeconomics and Finance, Centre d'Etudes Prospectives et d'Informations Internationales (CEPII)*

Moderator: ***Willem Pieter De Groen,*** *Research Fellow, CEPS*

The European banking sector is predominantly still domestic, with only a limited number of cross-border activities. But the status quo might be about to change dramatically as a result of improvements in bank performance, reduced barriers via digital solutions and progressively harmonised legislation. Are banks indeed likely to conduct more cross-border activities? What form would this internationalisation take? And what should legislators and supervisors do to contribute to a more European banking sector?

Background

In uncertain times, greater diversity in the financial system provides stability and the necessary funding sources for economic recovery and growth. The financial crisis and the ensuing sovereign debt crisis showed that not only the intensity but also the quality of the financial integration process matters. The retrenchment of financial flows within national borders in recent years became particularly worrisome. Banking Union (BU) and the Capital Markets Union (CMU) are two important initiatives that could lead to more 'sustainable' cross-border financial flows and strengthen the virtuous circle of financial integration, financial stability and economic growth.

A union of capital markets?

CMU should be regarded as a single market project. Many of the barriers that currently hamper cross-border financial transactions require immediate action. Company and financial instruments data should be more comparable across Europe; there should be less discretion in the enforcement of accounting rules (e.g. internal valuation models); a common EU business registry; and a centralised database for company filings and so on. Rather than focus on a single headline tax rate, we should tackle the complexity of reclaim procedures for withholding tax or other procedures for the collection and refund of local taxes. These measures would reduce cost unpredictability in cross-border transactions and allow national differences to coexist with minimal harmonisation effort. In some EU countries, the tax bias in favour of debt could be reversed, with increasing tax incentives/relief for much-needed equity investments. Less discretion in the procedures during insolvency is also preferable. Further consolidation of the financial market infrastructures across business lines is also desirable due to potential synergies and the need to reduce liquidity fragmentation. Achieving the convergence of supervisory outcomes across the EU may prove very difficult without a more formal mechanism to promote convergence, however. Deeper financial integration may require ESMA's direct supervision in well-defined areas, a stronger role in the peer review process but also more independent management. Proposals on securitisation and covered bonds could allow banks to secure long-term funding to counterbalance the issuance of more costly bail-in-able financial instruments.

A common deposit insurance: Why and how?

When the entire banking system of a country is under stress, the accumulated funds in the national DGS (Deposit Guarantee Schemes) are likely to be insufficient. In principle, a common deposit insurance scheme should be better equipped to address systemic problems but this shouldn't be triggered in the first instance. There is a general consensus that the Commission's proposal for a European Deposit Insurance Scheme (EDIS) seeks to break the sovereign bank nexus. Nonetheless, there is disagreement about pre-conditioning the establishment of EDIS to the implementation of concrete measures to further reduce risks in the banking sector, in particular, whether or not banks should be restricted in their holdings of national sovereign bonds. But there are also many national and economic policy measures which, directly or indirectly, affect the risk profiles and thus the solvency of banks. Good implementation of the resolution framework is paramount to reducing both the probability and the amount of loss for the DGS. Additional measures may be required to improve the position of the insured deposits in the event of resolution, i.e. ensuring the loss absorption capacity of banks by requiring a minimum of own funds and liabilities that can be bailed in through regulation rather than the competent authorities' discretionary assessment and embedding the priority position of insured deposits in legislation.

European banks: Finally going cross-border?

The integration of wholesale banking was partially undone by the financial crisis. Commercial and retail banking remains largely fragmented along national lines. On the assets side, a strong home bias persists, which is reflected in the loan, bond and equity portfolios. Placing caps on sovereign domestic bonds' holdings may encourage diversification but it poses challenges in terms of the ability of markets to absorb potential sell-offs. QE may provide an opportunity to do this in a less disruptive way. On the liabilities side, this so-called 'schizophrenia' stems from the fact that other than the official financiers (ECB, EIB), most bondholders are domestic. A potential bail-in could trigger a negative feedback loop. At macro-level, evidence shows that banks retrenched from capital flows while institutional investors and asset managers are really taking over. Bank balance sheets are often managed at national level. This often requires an inefficient asset allocation, since banks are only partially able to use their excess deposits in one country to fund their shortages in another country, because of exposure requirements and capital charges. Whether organised as branch or subsidiary, the legal structure still matters in the current context, both from a business and supervisory perspective. Undoubtedly, there is increasing demand for cross-border services by certain customers. Digitalisation and the further harmonisation of regulation and supervisory practices will make it easier to deliver those cross-border services, i.e. products developed in one country can be sold in other countries without an expensive distribution network.

Implications for EU decision-making

Banking Union cannot rest on its two first pillars only: the Single Supervisory Mechanism (SSM) and the the Single Resolution Mechanism (SRM). Completing Banking Union involves some mutualisation of risks (through a common deposit insurance scheme) and some form of fiscal backing. While the banking sector is expected to remain the dominant source of finance for Europe's economies, a fully integrated European capital market could provide alternative funding opportunities for firms, in particular for SMEs, and better choices for investors. It could also enhance private risk-sharing in the EU, e.g. equity holdings that are resilient to asymmetric shocks.

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