CEPS Policy Priorities for 2019-2024

Finance for Sustainable Growth

Willem Pieter De Groen

5 March 2019
Originally published as a part of the CEPS Paperback
What Comes After the Last Chance Commission?

Willem Pieter de Groen is Research Fellow and Head of the Financial Markets and Institutions Unit at CEPS. The author is grateful to CEPS colleagues Cinzia Alcidi, Cosmina Amariei and Karel Lannoo for contributions to this paper.

As an institution, CEPS takes no position on questions of European policy. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (www.ceps.eu)

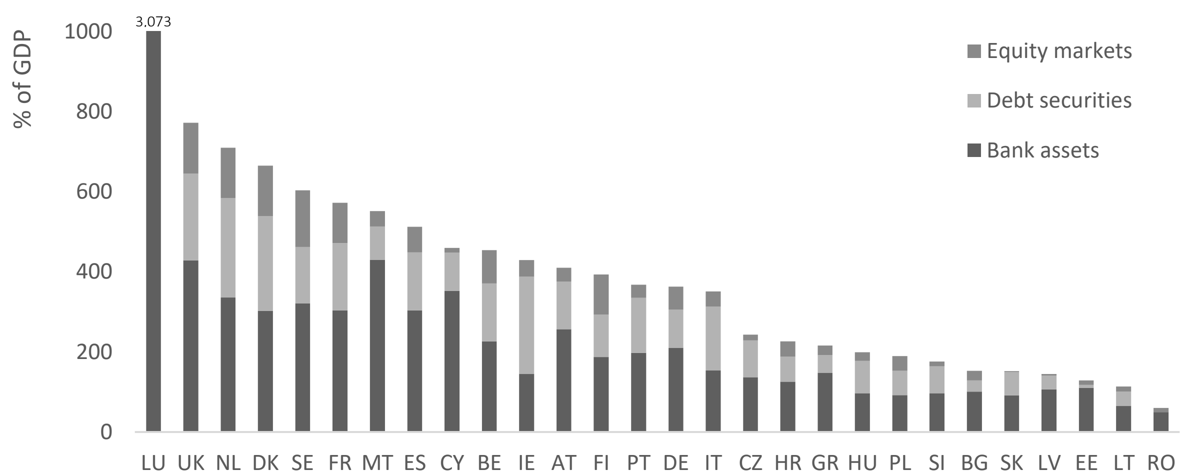
The financial system, acting as intermediary between savers and borrowers, investors and entrepreneurs, sellers and consumers, plays a pivotal role in the functioning of the EU economy. The development of financial markets and institutions can therefore be a significant factor in inclusive and sustainable economic growth. However, this not only requires a partial shift in policies, but also in the way these rules are determined to take into consideration the increasing complexity and ever more rapid changes in financial sectors and society.

In general, policies to develop the EU financial system further should focus more on access and efficiency than on deepening (increasing its size). According to the latest research, increasing the size of developed financial systems adds little to economic growth, but can make the system more fragile as was demonstrated by the 2007-09 global financial and 2010-12 Eurozone economic crises. Looking at the size of the financial systems in the EU, the member states in the west and north have significantly larger financial systems than those in the east and some in the south. The latter would therefore be better served by a deepening of their financial system than the former, which are better served by measures focusing on efficiency and access. Ongoing digital transformation and climate change actions might work as a catalyst in this respect, while Brexit constitutes a serious obstacle to financial development.

Policies to develop the EU financial system further should focus more on access and efficiency than on deepening.

In the aftermath of the financial and economic crises, many measures were introduced to make the EU financial system safer and more resilient. During the Juncker Commission the focus on the one hand was on completing these measures such as the Banking Union, and on the other to contribute to economic growth and job creation for instance by the launch of the Capital Markets Union (CMU). In this way, the finance agenda contributed to three out of the ten priorities of the Juncker Commission: a new boost for jobs, growth and investment (Priority 1); a deeper and fairer internal market with a strengthened industrial base (Priority 4); and a deeper and fairer economic and monetary union (Priority 5).

Figure 1. Size of the financial sector as share of GDP (end-2017)



Note: No comparable information on debt securities issued was available for Romania.
Source: AMECO (2018), BIS (2018), ECB (2018) and ECMI Statistical Package (2018).

The following sections will discuss both the main initiatives that the European Commission has taken in the area of finance during the Juncker Commission as well as recommendations for the new Commission.

Completing the Banking Union

The Banking Union was initiated in 2012 in response to the economic crisis in order to break the sovereign bank nexus. During the financial and economic crises governments and central banks injected roughly €2,500 billion into Eurozone banks to avoid destabilisation of the financial system (De Groen, 2018). Part of the funds were to cover the losses on government exposures. In turn, the funds required for the banking system in Cyprus, Greece, Ireland, Spain and Portugal, and their economic and fiscal situation, pushed Eurozone countries to lend almost €300 billion to these countries.

The Banking Union is supposed to avoid Eurozone banks requiring government funds. To achieve this, the supervision and resolution of systemically important banks has been moved to the Eurozone level – with the ECB responsible for supervision and the SRB for resolution of these banks. The Commission intends to complete this with a deposit insurance. In recent years; the Commission has come up with several proposals to establish a Eurozone Deposit Insurance Scheme (EDIS), but despite efforts to reduce the risks in the banking sector, there seems insufficient political support from member states for the proposed forms of EDIS. The potential mutualisation of losses appears to be the main reason why member states oppose EDIS. Given the importance for the functioning of the Eurozone financial crisis management framework, alternatives such as a re-insurance scheme should be considered going forward (Gros, 2015).

In addition, bank failures since the establishment of the resolution mechanism and several analytical reports have exposed some shortcomings of the resolution mechanism. In particular, the resolution mechanism was circumvented several times. Instead of the resolution mechanism, precautionary recapitalisation and insolvency regimes were used, which allowed national governments to inject funds in failing banks (De Groen, 2017). Moreover, although discussions in the Council have made progress, there is still no final agreement on a backstop for the resolution fund or on liquidity for resolution, which limits the Single Resolution Board's capacity for orderly resolving banks.

Finally, a completed Banking Union should indeed avoid governments being required to bail-out their banks. However, the reverse relation – governments causing losses for banks – has not been addressed effectively. The exemption from the large exposure requirement for banks holding government bonds and zero risk weight for government bonds should be reconsidered to reduce the home bias in bond holdings as well as the potential destabilisation of banks due to failing governments (De Groen, 2015).

Creating a true Capital Markets Union

The development of deep and liquid capital markets should provide SMEs in particular and other businesses an alternative to the currently dominant bank financing as well as facilitate private risk-sharing (Valiante, 2016). The need for the development of EU capital markets increased during the Juncker Commission with the announcement of the UK's departure, as it currently hosts the largest EU capital market. The UK has a particularly important role in the derivatives market, which led the Commission to launch a proposal covering derivatives clearing in third countries.

In total the CMU action plan included 13 legislative proposals, excluding the three legislative proposals related to sustainable finance. Although all the proposals initially foreseen have been published by the Commission, only the three proposals related to venture capital, securitisation and the prospectus directive were adopted by November 2018. On most of the other proposals covering new products and services (pensions, covered bonds and collective investment funds), prudential rules (investment firms, SME accessing growth markets and taxation) as well as market supervision and resolution (central counterparties), the Parliament and Council reached an agreement just before the end of the legislature. Proposals on crowdfunding, preventive restructuring, cross-border claims, second chance measures, European supervisory authorities are as of March 2019 still being discussed by the Parliament and Council.

The European capital markets programme should be fundamentally revised after an extensive assessment of the options.

Overall, CMU did not have a meaningful impact on the growth of market financing in Europe. Bank financing remains by far the preferred source of external finance, even at a higher cost. More needs be done to tackle the bias towards debt financing, in regulation, perceptions, tax systems and the policy debate. Debt financing is not suited to start-ups and high-growth companies – only equity financing can provide what is needed. The European capital markets programme should therefore be fundamentally revised after an extensive assessment of the options.

Promoting sustainable finance

Europe aims to be at the forefront of international efforts to deliver on the UN 2030 Agenda and Sustainable Development Goals and the Paris Climate Agreement. In the context of the CMU, the Commission has committed to unlocking the full potential of public and private investment to support the transition towards a low-carbon, circular and resource-efficient economy. The three packages launched so far include: i) a taxonomy for environmental sustainability of investment instruments; ii) rules on disclosure of sustainability risks; and, iii) minimum standards for low-carbon benchmarks.

But more will need to be done to mainstream sustainable investments. It is often argued that current market prices do not accurately reflect environmental and social externalities because of the failure to put in place adequate market mechanisms, regulations, taxation or other policies. The integration of Environmental, Social and Governance (ESG) factors would improve

the inclusion of these externalities. For this, a workable, flexible and dynamic taxonomy should be developed for integration in investment and advisory processes.

The use of financial legislation to provide incentives or disincentives for investments deemed sustainable or not should be exercised with caution. For example, lowering the risk weights for the calibration of bank capital requirements or the capital charges for insurance companies' solvency position based on a newly developed EU taxonomy on sustainable activities must have a sound prudential basis. This is essential in order to avoid misallocation of resources.

Large companies tend to report more comprehensive ESG metrics and therefore dominate the portfolio of sustainable investment portfolios. However, when it comes to access to sustainable assets/products, a priority should be to ensure that other important economic actors such as SMEs and innovative, growth companies are also well represented in the portfolios. Moreover, the investment products should be available to both high net worth individuals, institutional investors and retail investors (Amariei, 2018).

Control the ongoing digital transformation

Fundamental change is ongoing on the tech side, which provides both opportunities and threats to the financial system. The precise implications of technical developments are difficult to predict, but they are affecting all aspects of the market, from retail to wholesale, the entire value chain, products and processes. In essence, digitalisation will give financial service providers the opportunity to reduce costs and improve intermediation, thereby promoting more accessible and efficient financial markets (CEPS, UCC and LIST, 2016).

In turn, technical developments are also creating some challenges. Financial services are heavily regulated, which limits the possibility for newcomers to enter the market. This raises the fundamental question whether the level playing field should be based on the activities or the level of risks involved. A more proportional approach ('same risks-same rules' level playing field) could spur innovation and new entrants. However, to avoid malpractice and potential destabilisation the new or changing providers, products and services should be closely monitored.

Moreover, digital transformation brings specific challenges. Providers can, for example, be based in faraway jurisdictions, subject to different rules, but without the user realising and the supervisor controlling. The dependence on IT also raises fundamental issues for the cybersecurity of networks (Lannoo, 2018).

Integrational considerations

A large share of EU financial legislation has its origin in international bodies. The EU and several individual member states participating in the Financial Stability Board have committed to implementing the main international standards and codes as well as participating in peer reviews. In the aftermath of the global financial crisis, many international initiatives focused on making systemic banks in general and globally systemically important banks in particular more

resilient. Almost all of the standards and codes agreed in the aftermath of the financial crisis have been adopted and are currently or have been implemented in the EU.

The finalised Basel III reforms agreed at the end of 2018 remain the main standards that still need to be transposed in the EU. Basel standards are mainly designed for internationally active banks, but are traditionally applied to all banks in the EU. Taking into consideration the different role that these banks play in the financial system and the distinction that has already between made between the supervision of significant and less significant banks in the Eurozone, it should be assessed whether a simplified regime for less significant banks would not be more appropriate, allowing these mostly retail banks to focus on lending to the real economy.

The reforms in the aftermath of the financial crisis have contributed to the harmonisation of financial services legislation and coordination between supervisors across the EU. The supervision of credit rating agencies and trade repositories has even been concentrated within the European Securities Markets Authority (ESMA). Within the Eurozone the supervision of significant banks and the resolution of significant and cross-border banks are also now concentrated within the Single Supervisory Mechanism and Single Resolution Mechanism respectively. However, cross-border activities remain limited. This is partially explained by the large differences between member states in consumer protection rules, anti-money laundering implementation, non-financial legislation (accounting, insolvency, taxation, etc.) and different market practices.

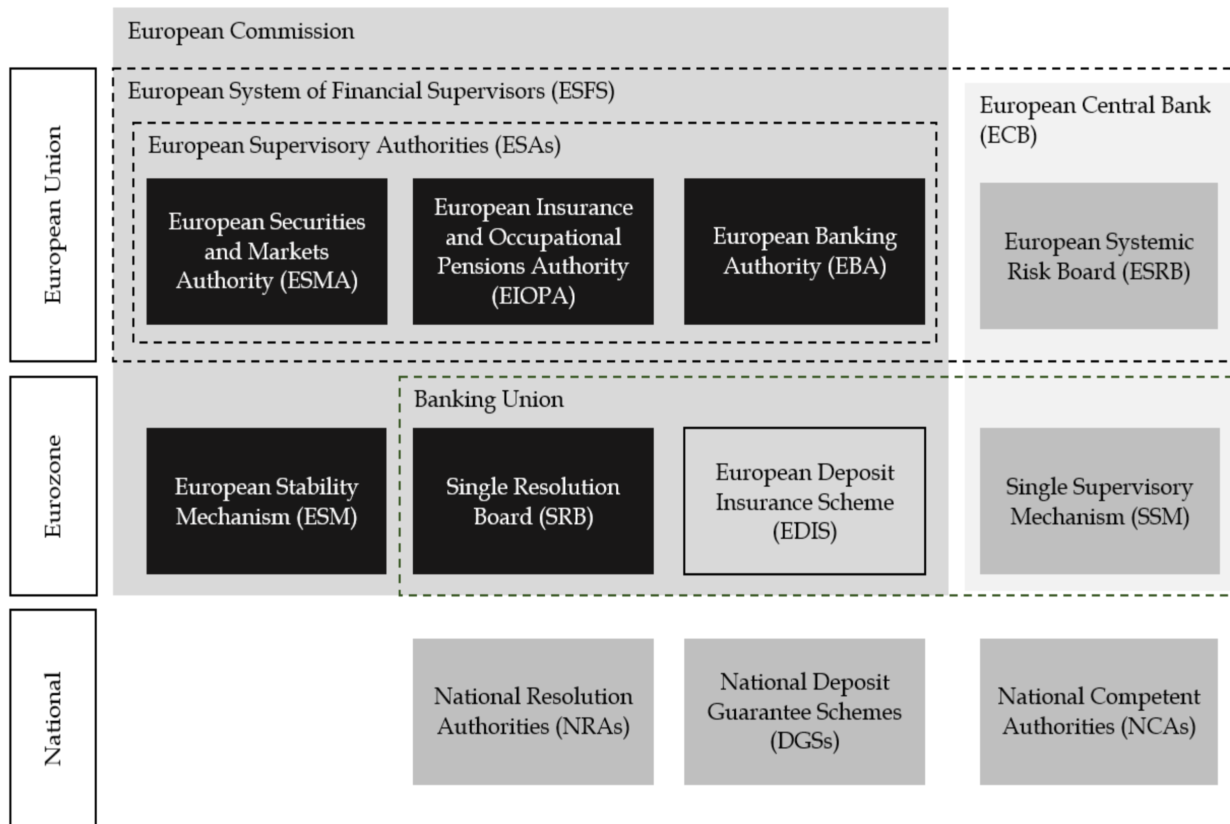
Institutional considerations

The change in policymaking procedure due to the new Commission structure with cross-cutting Vice-Presidents has had limited impact on financial services legislation. Jonathan Hill was Commissioner responsible for financial stability, financial services and CMU from November 2014 until he stepped down in June 2016, after the UK decided to leave the EU. Hill's responsibilities were taken over by Vice-President Valdis Dombrovskis, which has not led to any notable adjustments to the financial services agenda.

The institutional framework for financial services has, however, changed drastically in the aftermath of the financial crisis. At EU level, the European Supervisory Authorities were established. They are primarily responsible for promoting supervisory convergence and coordination as well as the preparation of technical standards and guidelines. In addition, the European Systemic Risk Board is responsible for the coordination of macro-prudential policies.

Although the ESAs have independent chairpersons most of the decision-making power is with the board of supervisors, in which national supervisors have nearly all the votes. This significant role for national supervisors in decision-making increases red tape. Empowering the chairperson could contribute to making the authorities more effective as well as potentially giving them a more prominent role in the legislative process (Lamandini, 2018).

Figure 2. EU financial institutional framework



Source: Authors' elaborations.

Financial legislation is becoming increasingly complex and prescriptive. Policymakers and Members of the European Parliament are regularly indicating that they are no longer able to assess the appropriateness of the legislation. Moreover, the legislative cycle easily takes a couple of years, whereas the sector is changing at an ever faster pace. This requires a legislative procedure that allows for swifter changes and more coordination between policy areas. Legislation at a higher level (more principle-based and coherent across policy areas) complemented by technical standards that can be changed more easily should allow for faster policy responses and leverage the technical expertise that is available within the ESAs in preparing the standards.

Key priorities for the next Commission

- Complete the Banking Union
- Create a true Capital Markets Union
- Promoting sustainable finance
- Control the ongoing digital transformation
- Empower European supervisory authorities

References

Amariei, C. (2018), "Enabling Sustainable Savings and Investment Channels in Europe: Opportunities and Challenges", 3rd Interim Report of the CEPS-ECMI Task Force on Asset Allocation in Europe, Brussels: ECMI.

CEPS, UCC, LIST (2016), Study on the role of digitalisation and innovation in creating a true single market for retail financial services and insurance, European Commission Directorate-General for Financial Stability, Financial Services and Capital Markets Union.

De Groen, W.P. (2015), "The ECB's QE: Time to break the doom loop between banks and their governments", CEPS Policy Brief, CEPS, Brussels, 13 March.

De Groen, W.P. (2017), "The provision of critical functions at global, national or regional level, In-Depth Analysis", European Parliament, Brussels.

De Groen, W.P. (2018), "Financing bank resolution: An alternative solution for arranging the liquidity required, In-Depth Analysis", European Parliament, Brussels.

Gros, D. (2015), "Completing the Banking Union: Deposit Insurance", CEPS Policy Brief No. 335, CEPS, Brussels, December.

Lamandini, M. (2018), "A supervisory architecture fit for CMU: Aiming at a moving target?", ECMI Commentary, ECMI, Brussels, 9 August.

Lannoo, K. (2018), "Cyber finance challenges demand a unified response, CEPS Policy Insights", CEPS, Brussels, 25 October.

Valiante, D. (2016), *Europe's Untapped Capital Market: Rethinking integration after the great financial crisis*, Brussels/London: CEPS/Rowman & Littlefield International.