After Brexit: rebooting EU-27 financial integration

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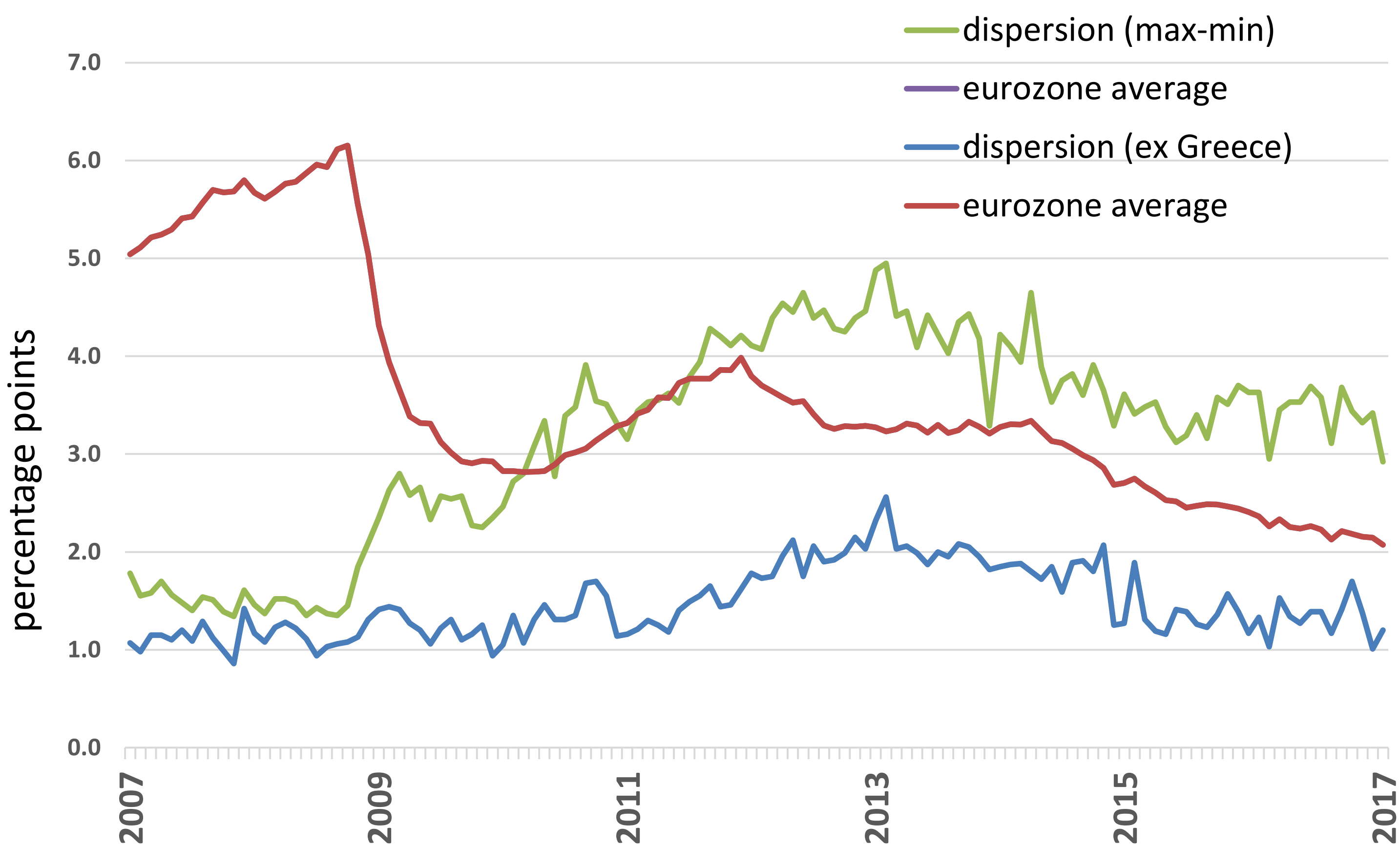
Outline

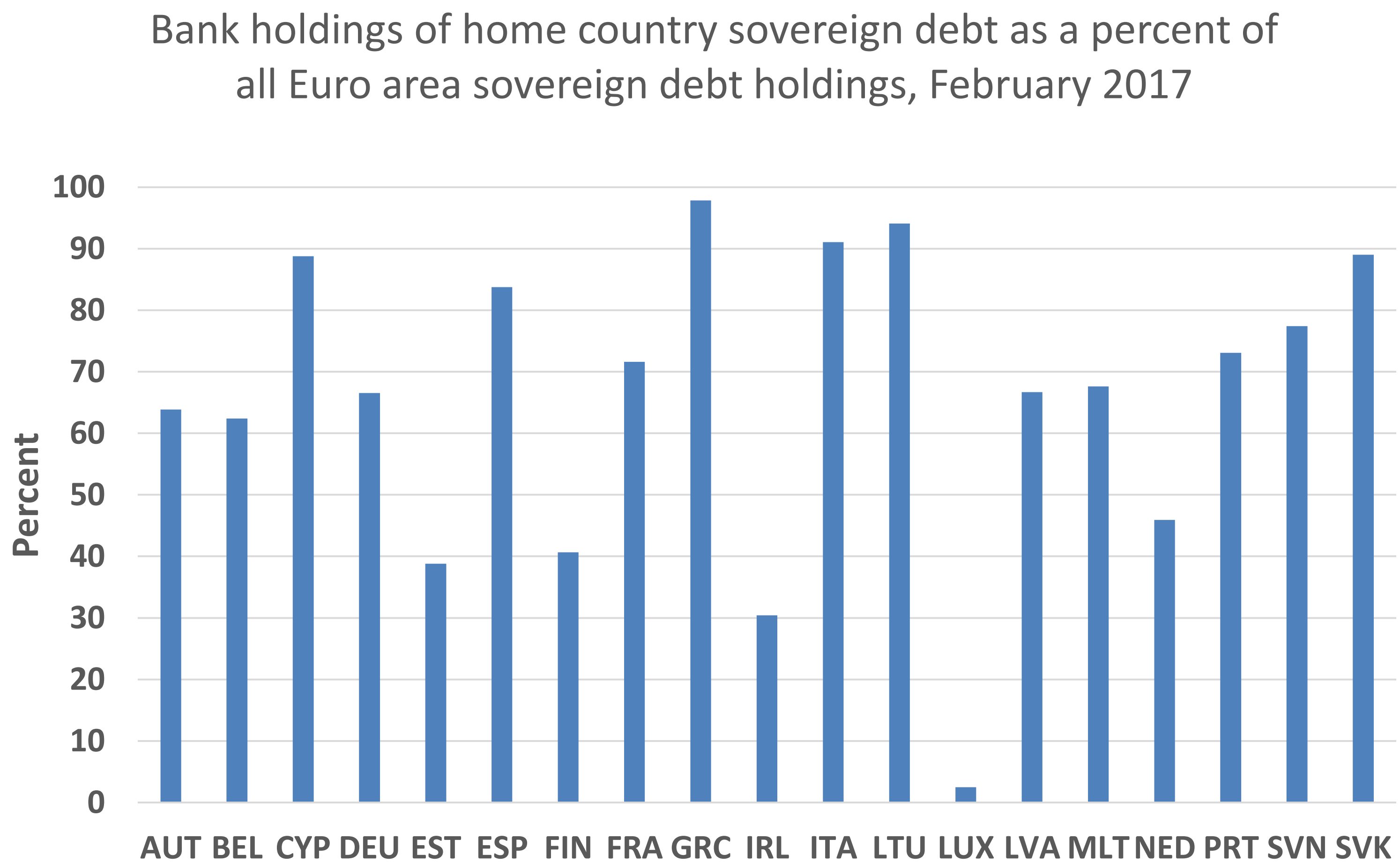
1. Two charts on the state of financial integration
2. The problems
3. How Brexit magnifies these problems
4. The solutions
5. Why the solutions are so hard to implement

Euro Area Bank Lending Rates for Non-Financial Corporates



Source: ECB and author's calculations.
Note: . Austria, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain.

Concentration of sovereign exposure of banks



Source: ECB and author's calculations

Obstacles to EU financial integration

Persistent cross-country differences in …

1. Strength of bank balance sheets:
   - Legacy NPLs
   - Home bias towards sovereigns of varying credit quality.
2. Strength of financial safety nets (deposit insurance, fiscal space)
3. Corporate and bank insolvency regimes
4. Non-bank/capital market regulation and supervision

How Brexit impacts these problems

1. Move of activities will increase systemic risk in the EU-27 and Euro area, given incomplete banking union and fragmented supervision of wholesale activities of banks.

2. Fragmentation of supervision will raise costs of capital, by encouraging concentration in one country, compared to both
   - status quo ante (all of wholesale in London)
   - unified supervision (allows geographical diversification)

   (Batsaikhan, Kalcik, and Schoenmaker 2017; Sapir, Veron and Schoenmaker 2017)

3. The upside: because of 1. and 2., Brexit may help concentrate minds both on completing banking union and building a capital markets union. In the end, EU-27 financial integration may win.

What to do? (Sapir, Veron and Schoenmaker 2017)

1. National commitments/EU-level arrangements to desist from offering lighter supervision and/or lower “substance requirements” to attract wholesale activities
2. Enhance the responsibilities/governance/funding of ESMA to a single wholesale market supervisor.
3. Complete the banking union
4. Improved oversight over financial infrastructure, like clearinghouses (“central counterparties”, CCPs).

Rest of talk: say a bit more on 2. and 3.

Reform of ESMA (Veron and Schoenmaker 2017)

Currently a supervisory convergence tool with limited direct supervisory authority (over credit agencies + trade repositories)

1. Extend supervisory authority over
   - Investment banks and securities firms
   - Clearing houses
   - Audit firms/IFRS enforcement
2. Reform governance (executive board vetted by EP, analogous to ECB, SRB)
3. Reform funding (from EU budget to small levy on capital market activities under the scrutiny of the EB)
4. Oversight over systemic non-EU financial infrastructure
5. EU-27 representation in international supervisory colleges

Completing banking union: why is it so hard?

Requires grand bargain: more mutualisation of risk against better incentives. But "better incentives" can be destabilizing when sovereign debts are still high and bank balance sheets weak.

- Common deposit insurance requires reform of regulatory treatment of sovereign exposures as the main quid pro quo
- But this could lead to much higher sovereign spreads, and lower regulatory capital in some countries …
- … unless a "safe asset" inherits the old regulatory privileges and is introduced at the same time.

This is the wisdom of the Brunnermeier et al (2017) ESB proposal (safe asset based on diversification and tranching, combined with capital charge on non-ESB sovereign exposures)

Problem: wisdom notwithstanding, political economy of ESB proposal has not been a home run.

Why does ESBs idea have so many enemies?

1. Lack of trust in a "financially engineered" product as the basis for the Euro area financial system (Lehman effect);
2. "South" worries that ESBs + capital charges on sovereign debt might reduce demand for sovereign bonds even if ESBs work as intended.
3. Both "South" and "North", worry that ESBs/EJBs might *not* work as intended: breakdown of EJB markets in a crisis?
   - South: worry about premature loss of market access
   - North: worry about pressures to bail out south ("mutualisation through the back door")
4. Private sector and South would much prefer straight-out sovereign debt mutualisation.

ESRB task force: ok - start small, introduce ESBs at the margin without changing regulatory treatment of sovereign exposures.

Problem: you lose both North and fans of decisive reform.

Conclusion

1. Brexit: a nice crisis not to be wasted
   - Market disruptions likely to be limited
   - But weaknesses of EU-27 and Euro area financial architecture brought into even sharper relief
2. The EU/Euro area financial reform agenda is clear, and long:
   - Build a proper capital markets union, including by unifying supervision over wholesale market activities and market infrastructure
   - Complete banking union.
3. The political economy is difficult, but we understand the trade-offs, and there is scope for a grand bargain.
4. All we need is leadership: Macron + […] ?