CONFRONTATIONS EUROPE

How can the CMU and Banking Union contribute to European sovereignty and economic recovery ?

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PRESENTATION

Confrontations Europe, the German Embassy in France and the Dutch Embassy in France, organized on september 17 a roundtable on the following topic : How can the CMU and Banking Union contribute to European sovereignty and economic recovery ?

Edouard-Francois de Lencquesaing, Confrontations Europe's Treasurer and Financial regulation advisor, offers an analysis of the discussions.

Confrontations Europe, in partnership with the German and Dutch Embassies in France, organized a conference on 17 September on the topic "How can the CMU and Banking Union contribute to European sovereignty and economic recovery?" This debate follows a first conference organized on 2 October 2020 in partnership with the Dutch Embassy in France right after the publication of the Commission action plan on the Capital Markets Union (CMU)(1). This second session is a prolongation of the first discussion enlarged to Germany, now bringing together three major Member States for financial integration in Europe: France, Germany and the Netherlands, represented by:

- **Dr. Jörg Kukies,** State Secretary for Financial Market and European policy at the German Federal Ministry of Finance;
- **Emmanuel Moulin**, Director General of the French Treasury;
- **Christiaan Rebergen**, Treasurer-General at the Dutch Ministry of Finance.

This debate fits in Confrontations Europe's strategy to prioritize the CMU and Banking Union (BU) as key instrumental milestones for European long-term investments and recovery strategy. CMU and BU are not mere technical or legislative tools but are at the very core of a coherent European strategy to address profound societal issues. In this context, Confrontations Europe identifies four major needs for the development of deep and liquid capital markets in the EU :

- Significant reduction of CO_2, in line with the ambitions of the European Green Deal aiming at decarbonizing the European economy, by 2050;
- Divestment of non-amortized capital not compatible with agreed CO_2 reduction levels, before 2030;
- Addressing the already tangible increase of climate risk caused by global warming ;
- Financing the fourth industrial revolution with the digital challenge and its impact on society.

Moreover, both the CMU and BU aim to make the European financial system more resilient, leading to significant reduction of financial markets fragmentation, thus increasing competitiveness both for markets participants and customers.

Our European culture of credit financing is no longer adapted to these challenges. These financially risky investments require new profiles of individual risk-takers and investors, both institutional and individual. We must therefore redefine our European mix of credit and market financing. This new mix should rely on competitive intermediaries - investment banks, brokers, fund managers, long-term investors – who need to have sufficient critical mass compared to their American or British competitors. This objective relies on a common strategic vision and appropriate regulatory framework around market infrastructures and investment instruments such as securitization, long-term investments (ELTIF) or pension strategies.

This evolution is not only technical but also addresses cultural changes. It must therefore be supported by strong political dynamic and pragmatic project management processes based on transparency, a tangible set of measured progress reports and a more ambitious supervisory framework, guaranteeing a real European single market for financial services.

I. Priorities for the achievement of the CMU: beyond the political consensus

All participants consider the CMU as a political priority, both in the twin transitions (environmental and digital) and the recovery context. In order to achieve European financial integration in the coming years, it seems crucial to first make progress on the revision of Solvency II to create new opportunities for the insurance sector to act as long-term investors. Therefore, Solvency II must be adapted to the evolution of new risks for the insurance sector, taking into account the necessary long-term structure of their portfolios. This could allow insurers to enlarge their involvement in capital markets. An ELTIF revision is also seen as crucial, as this instrument has never seen a great uptake due to excessively restrictive regulation whereas it could be a valuable instrument to mobilize savings towards long-term financing. Deep and liquid capital markets require not only the involvement of institutional investors such as insurance companies or pension funds, but also retail investors. In this context, the recent interest of citizens in retail investments must be accompanied by new protection frameworks, as cross-border transactions become more and more complicated. Therefore, the European retail investment strategy announced by the European Commission for early 2022 should include measures improving transparency to ensure accessibility of data for citizens, as well as consumer protection in the sales process, as we know that more information does not automatically lead to more rational decisions.

Participants also emphasized the need for an ambitious revision of the MiFID II/MiFIR framework. In addition, the further development of the securitization market is key to further deepening and integrating the CMU and to increase risk-sharing in European financial markets.

Cultural change also constitutes an important support for financial market integration, complementing legislative reforms. In that regard, the Tibi report(2) and its initiative to mobilize digital industry actors, regulators and the financial community to build a common vision on innovation financing is a good illustration of fruitful public-private partnerships.

Finally, the deepening of the CMU requires convergence in the European supervision. It is essential that the reforms listed above be applied in a harmonized manner within the single market, a view that seems to be unanimously supported by all participants. These developments should be followed by key performance indicators as conceived by the European Commission to track progress of our objectives and keep the momentum on the CMU.

II. Priorities for the Banking Union: back to basics

A political consensus has yet to be reached on the Banking Union. One of the most controversial outstanding issues is the achievement of the European Deposit Insurance Scheme (EDIS). In response to Europe's sovereign debt crisis, EU governments have already agreed to create a single banking supervisor and a single resolution mechanism for failed lenders. But efforts to complete the project have stalled over plans for an EU-wide deposit guarantee. Germany has been calling for progress on all elements of the Banking Union, including on an integrated internal market for the banking sector. In addition, Germany and the Netherlands want to address the issue of concentrated risk on bank balance sheets related to sovereign risks, in order to tackle the sovereign-bank nexus.

This issue has seen little to no progress in recent years, but has gained renewed urgency in view of the latest increase in levels of sovereign exposure in a number of banks during the Covid-19 crisis. This development further stresses the need for a legislative proposal from the European Commission to make progress with the architecture of the Banking Union.

For France, the Banking Union's paradigm should shift from risk reduction, which has dominated its policy design over the past decade, to the competitiveness of the European banking sector vis-à-vis its British and American competitors. France also specifically calls for a revision of the crisis management framework, which still has too many loopholes in terms of implicit guarantees on banks and state intervention. The Netherlands also pointed out that it is key to protect public funds, thereby supporting the review of the state aid framework. The EU should incentivize the use of the Single Resolution Mechanism, and reduce overcapacity to help the banking sector improve profitability. Finally, a crucial element for the achievement of the Banking Union is the development of EU-wide banks, able to compete globally and overcome internal competition.

Furthermore, there are still questions about finalizing the implementation of Basel III, with the Netherlands arguing for full and strict implementation, while France and Germany advocate for a full implementation taking into account the financing of the real economy and avoiding a significant increase in capital requirements for the European banking sector. The European financial sector has been able to help companies and households during Covid hardships, partly because they had sufficient capital requirements on their balance sheets. The Dutch government thus pleads for a strict and full implementation of Basel III by 2027, a position that was shared by 25 national central banks and supervisors in a joint letter sent to the European regulators on 7 September(3) . Moreover, the EBA annual report indicates that there is hardly any bank going into trouble to reach Basel III capital requirements standards at the moment(4). On the other hand, the EBA report on Basel III reforms (5) shows that an implementation of Basel III to the letter could result in €800 billion less lending to households and businesses, which could hamper the EU's future sustainable growth in the post-Covid context. In addition, raising capital requirements too quickly could lead to an unlevelled playing field with the US which would further damage the competitiveness of European banks. Finally, in the view of the three governments, Basel III leaves enough room for interpretation for the 27 to find a compromise between strengthening the resilience of the EU banking sector while ensuring the financing of the real economy and the recovery of the European economy.

The above developments are taking place in a very specific political context, between German and French major elections, offering a small window of opportunity for significant progress. Moreover, France will hold the rotating Presidency of the Council in the first half of 2022, with numerous financial legislative initiatives planned to further develop the CMU and BU: Basel III completion, the Solvency II review, CSRD, AML-CFT… Furthermore, all participants agreed on the need to address broader political issues to contribute to the achievement of the CMU and BU, including on corporate tax systems and outcomes of insolvency procedures.

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Finally, the Covid crisis and the environmental transition pose considerable challenges for the EU economy, which is not fully equipped to meet them at the moment. Too many European companies still rely on US capital markets for equity financing. The recent example of BioNTech, a centrepiece of the European vaccination effort, which relied heavily on US private investors and infrastructure to raise funds, illustrates the limits of the European financial markets. Furthermore, banks have been important partners during the Covid-19 crisis to maintain the economy afloat, but their valuations remain low, and the European banking sector is currently losing market shares both globally and within the single market. In this context, Europe needs a true Union for investments, encompassing both CMU and BU, to channel savings towards most productive investments and maximize our sustainable growth potential. Competitive and resilient banks need capital markets for their own financing needs as well as to increase their profitability through high added-value activities and conversely, there cannot be a deep and liquid European capital markets without competitive banks acting as advisors, intermediaries, and market makers.

Footnotes :

(1) A Capital Markets Union for people and businesses – New action plan, European Commission, 24/09/2020

(2) Financer la quatrième révolution industrielle, lever le verrou du financement des entreprises technologiques, Philippe Tibi, July 2019

(3) The EU should stick to the Basel III agreement, 25 national central banks and supervisors (from 20 Member States), 07/09/2021

(4) EBA annual report – 2020, European Banking Authority, 26/06/2021

(5) Basel III reforms : updated impact study, European Banking Authority, 31/12/2019

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