European Shadow Financial Regulatory Committee
(www.esfrc.eu)

Europe under Threat: The Political Dynamics of Brexit Interacting with Weakness in the European Financial System

Statement No. 42
London, September 16, 2016

The EU stands at a critical juncture after the Brexit referendum. Brexit added to the uncertainty about the future direction of the integration processafter years of crisis in the Southern member states of the Eurozone, weakness in their banking systems and economic stagnation. There is no doubt that in economic and political terms the outcome of the British referendum is a serious threat to the future of the European project, a project that has brought peace and security in Europe for 60 years.

At the same time there are indications that the European banking and financial system is still fragile and might even be heading towards yet another crisis. If that were to materialize it would certainly reinforce the disintegrating effects following the Brexit decision.

There are thus two immediate problems for the EU. One is how to cope with the immediate consequences of Brexit in terms of the economic and financial governance of the EU. And the second one is how to limit the negative dynamics of the political discourse in Europe, including the feelings amongst large parts of the population in EU Member States, for whom the European project might have become more of a threat than a promise.

The meeting of the European Council on this very day is expected to set a new direction to address the perceived lack of legitimacy of the integration process. Surprisingly, despite of the danger of another financial meltdown, financial markets and institutions are not on the agenda.

In this statement, the European Shadow Financial Regulatory Committee (ESFRC)makes the following recommendations.

First, access to the single market carries rights as well as obligations. This must be taken into account in the negotiations, bearing in mind that the UK and the EU should reach a mutually beneficial agreement in line with the spirit of the European project, based on market economies and liberal democracy.

Second, the banking union must obtain greater credibility by enabling weak banks to either close down or be recapitalized with a minimum of public sector support. At the same time it must be recognized that a credible public sector backstop is essential for effective crisis management and that current political tendencies in the EU to limit public intervention by all means can be misguided and might contribute to financial instability.

Third, we expand on current plans for a basket of measures that aim at solving acute problems and at the same time restoring public confidence in the European project. An important part of this basket should be the advancement of Capital Markets Union, including a more ambitious version of the European Fund for Strategic Investments (EFSI) to supportinvestment across the EU.

Before elaborating on the specific proposals we note that the EU integration process has been standing on three legs. One is the mobility of goods, services, capital and people. The second is the principle of a single passport with mutual recognition based on prior harmonization. The third leg -for the member states of the Eurozone - is monetary union coupled with banking union. These legs have different lengths and are wobbly to different degrees. Brexit seems to be to a large extent the result of lack of acceptance of free mobility of people in the UK while many in the country support the single passport in financial services.

The fragility of the European banking system

Political disorder and uncertainty have reinforced each other to create a vicious circle increasing the fragility of the European banking system. One reason is that many banks in the Eurozone suffered from legacy problems at the time the Banking Union was planned. These problems include insufficient capital, non-performing loans, risky derivatives, excess holding of national government securities, as well as inadequate business models and corporate governance. The intention was to correct many of these defects inherited from the past before the ECB was to take over supervisory responsibilities for large banks in 2014. This task has not been fully completed yet.

A second source of the present fragility is becoming a major preoccupation: the pillars that make up the substance of the Banking Union are still far from being in place. Many aspects of the *single rulebook*, including crucial ones like the criteria to calculate capital and non-performing loans, still need to be implemented. The *single supervision* pillar is the only one that has been fully realized so far. The *single resolution* pillar lacks an adequate fiscal backstop to make the bail-in principle credible for systemically important banks in particular. As for the *European deposit insurance scheme* there is a strong political resistance in accepting the risk sharing principle that goes with this pillar as well aswith the single resolution pillar.

The Banking Union should be strong enough to allow the authorities to act with a sufficient degree of discretion to accommodate the special features of the various banks and national banking systems without losing independence and credibility. It often appears that the European rules are a mixture of excessive rigidity and inadequate rigor. This remaining unfitness of the Banking Union – more than five years since its indispensability became clear for economists and policy makers – constitutes a continuous threat to the Eurozone.

Actions to accelerate the completion of the Banking Union are urgent and should enter the agenda of the EU authorities without further delays. A serious shock like Brexit should not distract their attention from this task.

Access to the single market in financial services

The EU and the UK need to act sensitively to advance European capital market integration in spite of Brexit. For the UK this is a priority in the light of the role London has played as the major international financial center in Europe. The right balance must be struck between the obligations imposed by having access to the single market (including harmonization of rules and free movement of labor) and respect for different traditions, practices and preferences in these countries. The principle of a single passport for financial services firms across the EU cannot be literally applied after Brexit. However, it is desirable to find suitable ways of accommodating the interests behind the single passport concept, which requires mutual recognition on the basis of prior harmonization.

Economic activity in Europerelies on banks to a much greater degree than in the US. There is little doubt that the EU would benefit from an increasing role of securities markets. The Capital Markets Union (CMU) should help to diversify and amplify sources of finance and ensure that capital can move freely across borders and be put to productive use. This should create a more efficient and resilient financial system, deepening financial integration and increasing competition.

The efficient functioning of equity markets is especially important given the decline in the number of companies going public (IPOs) and the increase in de-listings, resulting in fewer companies being listed in Europe. Moreover, liquidity in capital markets has been declining and systemic risk increasing. Other areas that need attention are Central Counterparties (CCPs), money market funds, hedge funds as well as investment funds and asset managers. Although most investment funds and asset managers are already regulated in their home countries, the case for minimum harmonization is strengthened when providers of these services become

systemically important. Such minimum standards could be the purview of a systemic risk oversight board for all countries accepting the single passport. This needs to be addressed in the future in more detail.

Boosting growth in Europe

The EU badly needs a boost to growth. The current growth rate is much too low to create enough jobs to substantially lower unemployment in the southern countries. Europe is still on the brink of deflation. Most international institutions, including the IMF and OECD, are recommending a substantial increase of investments in Europe's infrastructure, including bridges, roads, sustainable energy, electricity power grids, and research and education. Given the fact that interest rates are historically low, there is a great opportunity to finance investments at low cost.

In our view, a new public investment fund operating under the auspices of the European Investment Bank (EIB) in Luxembourg should be set up in order to finance new infrastructure projects in the EU countries for an amount of up to €1,000bn. This new fund would be part of the Capital Markets Union initiative.

Based upon a capital base of €50bn provided by the taxpayers of the EU countries, the fund would issue new bonds amounting to €950bn on European capital markets. European countries will have strong incentives for proposing credible projects. Those projects should not only give a short-term impetus to spending, but should also structurally lift Europe's growth potential. These proposals will have to be evaluated by the EIB, which will have to be assisted in this process by external advisors and consultants.

The updated plan by Jean-Claude Juncker, President of the European Commission, presented earlier this week to double the amount of the European Fund for Strategic Investments (EFSI) to €630bn by 2022, is not likely to be successful. It still relies on co-financing by private-sector investors, which appears to be problematic due to

concerns about liquidity and transparency about long-term returns on these projects.

There are four clear benefits to our proposal.

First, an investment impulse of up to €1,000bn in the near future would stimulate economic demand and reduce unemployment substantially.

Second, higher investments in Europe's infrastructure and knowledge-based economy are strengthening the supply side of the economy, thereby enhancing Europe's competitiveness and longer-term growth potential.

Third, our proposal should be seen as part of a larger package in which, as part of a grand deal, countries such as France and Italy commit to a detailed agenda of implementing structural reforms of their economies, especially in their labour and services markets and pension systems.

Fourth, it would be visibly effective and could contribute to changing the political dynamics in the sense of strengthening public support for the European project and the EU.