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Delegations will find attached a background paper prepared by the European Commission on financial markets integration and economic growth for the EU EFTA Ecofin meeting on 13 November 2012

Encl.:

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS
International economic and financial relations, global governance
Globalisation - Trade – Development

DIRECTORATE GENERAL
INTERNAL MARKET
Financial services policy, relations with the Council

FINANCIAL MARKETS INTEGRATION AND ECONOMIC GROWTH

Background Paper

for the

EU EFTA ECOFIN Meeting

13 November

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Introduction

Financial market developments are intrinsically linked to increasing prosperity. As Ferguson and Wascher (2004)[1] show, extended periods of strong productivity growth which are characterized by technology development are accompanied by an improved availability of finance alongside changes in organizational structures and investments in human capital.

At the same time, the global economic and financial crisis as well as the euro area sovereign debt crisis shows that the relationship between financial development and economic growth is not always and everywhere linear. Financial innovations may have offered opportunities to improve the risk-return trade-off and promoted the availability of finance, but the risk distribution associated with financial innovations can be opaque. The crisis has illustrated how risk can by-pass even the most advanced risk management tools used by financial institutions.

The financial crisis has prompted a re-thinking of financial supervision at the global level. In the context of earlier financial innovations, heightened financial risk and a pressure to deleverage, policy actions address the resulting uncertainty about the fragility of the financial system. In the recent past, a set of major decisions has been taken to address the sovereign debt crisis in the euro area. The strategy the EU has put into place encompasses different dimensions including determined efforts to ensure fiscal sustainability, an ambitious agenda for growth, support to countries in difficulty, and a strengthening of euro area governance.

Last year's background paper already gave a broad overview of the actions taken in relation to the euro area sovereign debt crisis. In this year's background paper, the focus will be on those actions taken related to financial market integration in the EU. It starts with a section on cross-border banking in the EU and continues by presenting an overview of the recent initiatives undertaken in order to strengthen financial regulation and oversight at the EU level with a focus on their implications for the European Economic Area and European Free Trade Area.

Cross-border banking and economic growth in the EU

Global cross-border bank lending increased by a multiple of 4 between 1999 and 2008. Cross border banking can have many benefits in terms of promoting the efficient allocation of global pools of capital, increasing local banking competition, strengthening risk sharing (for both host nation and bank) and developing the provision of financial services in fast growing emerging markets.

[1] Roger Ferguson and William Wascher (2004), "Distinguished lecture on economics in government: Lessons from past productivity booms", Journal of Economic Perspectives, Vol. 18 (2), Spring 2004

But we know by now that cross border banking can generate risks. There are costs as well as benefits. The flipside of greater risk sharing in response to idiosyncratic shocks is the increased propagation of risks in response to common shocks. And the lack of clarity generated by home-host oversight of banks impedes their effective supervision and resolution.

The explosion in cross border banking has partially reversed – falling by ⅓ for the euro area banks but less so globally – in the last four years. Banks have faced the need to deleverage, driven especially by funding pressures. Political and regulatory pressures meant banks largely resorted to cuts in cross border lending to achieve the newly set targets, concentrating more instead on their home markets. Bank lending accounts for around ⅔ of the credit provided to euro area corporates. So, bank lending is integral to the health of European economies. Some parts of the private sector, such as SME's (which accounts for ⅔ of all employment in the EU), are especially reliant on bank lending. Therefore, the on-going process of bank deleveraging – which albeit differences across regions and countries seems set to continue in the near future – poses difficult challenges.

Deleveraging has to take place in many banking systems simultaneously, at a time when global growth prospects look set to weaken in the near term. Moreover, global growth is weak at a time when more growth would instead be warranted, to help enhancing debt sustainability. So there is a delicate balance to strike in terms of the appropriate strength and the optimal degree of control that should be exerted over the deleveraging process.

The EU, conscious of the need to allow deleveraging where it is warranted and maintain growth to the maximum possible degree, has introduced several important policy initiatives.

- **First, ECB policy actions.** Most important is the ECB's very large initiative to help banks access funding through its 3-year LTROs in December 2011 and February 2012. The ECB has also made extensive use of central bank swap lines to alleviate pressures in $ funding markets.

- **Second, the Vienna II initiative.** This is a voluntary agreement between public and private sector authorities to: (i) avoid disorderly deleveraging in CESEE countries; (ii) address gaps and overlaps in cross border oversight to provide stable conditions and expectations for business; and (iii) foster mutual trust in supervisory practices of home and host authorities. It builds on the highly successful Vienna I initiative. The aim is not to prevent deleveraging, but to avoid that it results into a downward spiral of growth.

- **Third, the EBA-led capitalisation programme.** The EBA set target capital ratios for major European banks of 9% by the end of June 2012. That target was exceeded at the deadline. In total, more than €200bn of capital was raised between December 2011 and June 2012. Importantly, the impact of de-leveraging was minimised by placing a strong emphasis on directly raising fresh bank capital instead of reducing risk-weighted assets.

- **<u>Fourth, schemes to increase lending directly.</u>** This has been developed particularly in the UK, with the experience of the "Funding for Lending Scheme". Under this scheme, banks receive direct central bank funding, within predefined limits, with the quantity and price of the support directly dependent upon the degree to which banks keep lending to the real economy.

- **<u>Fifth, Home-host initiatives.</u>** Their importance was already acknowledged in the 2011 EU-wide recapitalization plan, which called on home-host initiatives to discourage deleveraging in all Member States. However, they have received an additional boost through the Commission's CRR/CRD IV directive.

EU-EEA issues regarding financial regulation

The majority of the legislative initiatives included in the financial services reform programme has now been adopted by the Council and Parliament. Part of the reform programme consists of directly applicable regulations without need for transposition in national legislation. Legislation adopted so far includes, for example, the "Solvency II" Directive on capital requirements in the insurance sector, rules on bank remuneration and bonuses in the third Capital Requirements Directive, an EU-wide supervision regime for credit rating agencies, creation of a genuine internal market for alternative investment fund managers and European Market Infrastructure Regulation.

In addition, the co-legislators currently discuss the Commission's proposals for a reform of the capital requirements for credit institutions and investment firms (CRD IV), a review of the Markets in Financial Instruments Directive and for a framework for the recovery and resolution of credit institutions and investment firms.

All these pieces of legislation are internal market legislation adopted under article 114 of the Treaty and destined for incorporation in the EEA Agreement. For as long as legislation is in force in the EU but not in the EFTA-EEA States, there will be a temporary danger to the level playing field and to integrity of the EEA internal market.

The EFTA-EEA States continue discussions with the EU side on how to ensure that this significant volume of legislation is included in the EEA Agreement. Both sides continue to agree on the need to ensure the timely incorporation of the legislation, including the Regulations establishing the European supervisory framework on which, to date, limited progress has been noted. The issue of how to reflect the direct European Supervisory Authorities' powers vis-à-vis national authorities or vis-à-vis financial institutions in the EFTA-EEA States is subject to on-going discussions at technical level. Danger of distortion of competition and regulatory arbitrage could exist on a longer-term basis with Switzerland, if the rules in the EU and Switzerland diverge significantly.

Furthermore, the Single Supervisory Mechanism (SSM) proposed by the Commission will reassure citizens and markets that a common, high level of prudential regulation will be consistently applied to all banks. This will help build the necessary trust between EU Member States, which is a pre-condition for the introduction of any common financial arrangements to protect depositors and support the orderly resolution of failing banks. The SSM is the stepping-stone to a Banking Union that should be subsequently complemented by a common system for deposit protection and integrated bank crisis management. The Banking Union will improve the resilience of the Economic and Monetary Union and will, therefore, contribute to enhancing financial stability in the Euro area and beyond. The creation of the banking union shall neither compromise the unity and integrity of the single market, nor its four freedoms, which remain one of the greatest achievements of European integration. In light of this, the proposed legislative package on the SSM intends to fully preserve the role of the European Banking Authority (EBA).

Authors: Tatyana Filipova (financial markets regulation and oversight), Phil Evans (cross-border banking) and Willem Kooi (introduction and coordination)

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