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Abstract

This paper explores financial integration dynamics in the EU since the Maastricht Treaty by providing an articulated and structured historical narrative that analyses the progress that the EU has made in building the regulatory framework for an integrated financial system by introducing supranational rules and policies. To some extent these have been conducive to financial integration since the creation of the Economic and Monetary Union. The paper identifies key stages in the EU's financial integration trajectory since the Maastricht Treaty and highlights some of the institutional, regulatory and policy issues that have contributed (and are contributing) to strengthening financial integration in the EU. While revealing a narrative of policy-led financial integration, the paper relies on two complementary analytical lenses: supranationalisation of policies fostering financial integration triggered by crises; and that regardless of crises. The article specifically elaborates on two empirical examples: the Banking Union; and enhancing the Anti-Money Laundering Framework in the EU.

Keywords

European Union, Financial Integration, Crises, Banking Union, Anti-Money Laundering; Financial integrity

Introduction

The Maastricht Treaty of 1992 represented a milestone in European integration. It created the foundations for two of the European Union's (EU) major economic projects: the internal market and the Economic and Monetary Union (EMU). Over the past three decades, many regulatory reforms and policy innovations have followed in the broader field of banking and finance and have contributed to triggering financial integration, often in the wake of and in the context of crises situations. This led the way to a third, but connected project, sometimes referred to as the European Financial Union (European Commission 2015). This paper provides an articulated structured historical narrative that analyses the progress that the EU has made in building the regulatory framework for an integrated financial system by introducing supranational rules and policies, which to some extent have been conducive to financial integration since the creation of EMU. The paper identifies key stages in the EU's financial integration trajectory since the Maastricht Treaty and explores some of the main institutional, regulatory and policy issues that have contributed (and are contributing) to strengthening financial integration in the EU. While revealing a narrative of policy-led financial integration, the paper relies on two complementary analytical lenses – supranationalisation of policies fostering financial integration triggered by crises; and that in the absence of crises – and elaborates on two empirical examples.

The journey of financial integration since Maastricht: a narrative

European financial integration has undergone twists and turns in the past three decades. In Maastricht the expectation of the founding fathers of the euro was that the creation of a common currency would be an important trigger of deeper financial integration, in particular because it would foster cross-border capital flows within the single currency union. While there was upward integration throughout the 1990s and in the years immediately following the formal euro launch in 1999, integration came to a halt with the 2007-2008 global financial crisis (GFC) and the eurozone sovereign debt crisis. It was not until the creation of the Banking Union (BU) that integration resumed, but it was halted again by the COVID-19 pandemic. Besides the effects of crises, financial integration in the EU has also been a function of the trajectory of supranationalisation of EU financial policies – which has not always been triggered by crisis or disruptive moments, but also regardless of them. For instance, the Financial Services Action Plan (FSAP) and all the changes it proposed for financial marketplaces were not linked to any crisis or disruptive moment.

(1) The concept of financial integration

A conceptual clarification of 'financial integration' appears indispensable as it can be conceived differently depending on the disciplinary lens through which it is observed. From an economic perspective, it mainly refers to a process involving the elimination of cross-border financial market barriers allowing equal access to financial services and products everywhere. Financial integration entails the existence of closely integrated financial markets in which risk-adjusted returns on assets are the same in any location in the jurisdiction. This close linkage between financial markets enables risk diversification, smooth cross-border capital flows, foreign participation in domestic financial markets and information-sharing across financial institutions and agencies. "Financial integration can then be defined, more generally, as a process leading to the removal of the relevant frictions and obstacles" in which all market participants share the same relevant characteristics, are subject to the same set of rules and "are treated equally when they are active in the market" (Constâncio 2004).

One can also approach financial integration through the concept of 'optimum financial areas,' which are defined as geographical areas within which the problem of sudden stops does not exist for the participating countries or jurisdictions, which thus benefit from geographically defined financial stability (Jones and Underhill 2014). Based on historical readings of the development of financial markets in the US and UK into optimum financial areas, Jones and Underhill define six criteria for these areas. A first set of three criteria relate to the smooth functioning of capital markets: (i) a common risk-free asset that serves counterparties as collateral for liquidity access and clearing, and as a safe haven in times of distress; (ii) a central system for sovereign debt management; and (iii) centralised counterparties and common procedures for managing the risks of communication, clearing, settlement and depositories. A second set of criteria focus on the necessary institutions to address bouts of fragility: (i) an inclusive and common framework for financial supervision and prudent oversight that protects both the broader public and banks, (ii) lender of last resort facilities for financial institutions; and (iii) sovereign and effective resolution frameworks for financial institutions, especially banks.

Focusing on the EU, one can observe that of the first three criteria only the last one has been achieved to a certain extent. Among the second set of criteria, the first one has been put in place while the last one can be considered work in progress, as we will argue below. In terms of lender of last resort facilities, the ECB has temporarily taken on this role during crisis times, including for sovereigns in the euro area, but reluctantly and with political and legal contention.

To measure the extent of financial integration in the EU and the euro area, one can also refer to the indicators to identify the state of financial integration in the EU commonly used by the ECB: price-based and quantity-based indicators in the most important financial markets (Fig. 1 below): banking, money markets, bonds and equities (ECB, 2022). There has been greater variation in financial integration as gauged by the price indicator, reaching a high right before the onset of the GFC and a low during the eurozone sovereign debt crisis in 2012. In this paper, however, we consider financial integration as a process that entails rule harmonisation and supranationalisation of financial sector policies, and common rules to integrate banking and capital markets. Our analysis focuses on these factors rather than aiming to broadly examine the process of removing barriers and intensifying cross-border capital flows or performing an in-depth assessment of price- or quantity-based indicators. We identify key moments in the trajectory of financial integration in the EU, particularly since the GFC, considering the emergence of new policy agendas, rules, reforms, institutional bodies and policies affecting market participants and banking and financial institutions that have contributed to developing and strengthening the EU's regulatory and supervisory financial frameworks. It should be recognised at the same time that the last phenomenon has not only been fuelled by a long context of crises, but also resulted from needs to respond to particular threats or to deal with specific risks.

Since the 2010s there has been a wide range of relevant literature on crisis-driven integration by multiple and multidimensional crises, which signified 'big momentum' in European integration theory. A common denominator in EU studies is that many different logics (such as intergovernmental cooperation and deliberation, and neofunctionalist, neoinstitutionalist and federalist approaches) operate at the same time and they are not necessarily competing or exclusive (Ferrara and Kriesi 2021, Schimmelfennig 2018). In our approach, we do not deny the analytical utility of existing crisis-led integration frameworks and neither that of approaches that argue that some crises do not necessarily drive great policy reforms but instead support maintaining the status quo (Falkner 2016). It is clear that Europe at times goes deep into cycles of policy failure, which become quite visible in times of crisis, as the failing forward analytical framework (Jones et. al. 2021) shows. In turbulent times it is common for the EU and Member State national governments to be more willing to act to correct some of the weaknesses in existing policies and institutional architecture that become visible in times of crisis. However, as we will see, financial integration in the EU has not only occurred or been exclusively driven in crisis moments. In this paper, we analyse the phenomenon of financial integration in the EU by exploring how the EU has reacted to specific crisis moments, and to particular risks or threats in the economic and financial domain. We do so by looking at different examples of regulatory innovations, reforms and particular policy responses that have sometimes contributed to strengthening the role of supranational institutions (mainly the ECB, the European Commission and the European Supervisory Agencies (ESAs), rather than focusing on the dynamics and interactions of actors in the framework of decision-making and policy processes or on the level of politicisation of particular crises.

(2) Financial integration triggered by crises and financial integration regardless of crises

Crises usually motivate Member States and supranational institutions to respond, but not always with the intention of deepening integration or enhancing supranational control, especially regarding the interests of some countries. Sometimes integration appears to be an 'unintended consequence.' Crises also act as catalysts for policy innovations related to specific fields or areas. They foster the adoption of new policy agendas, roadmaps and pieces of legislation that imply relevant steps towards deeper financial integration. In this paper, however, we do not intend to argue that crises are the *only* events that can contribute to triggering integration, regulatory changes and the creation of new rules, and neither that all periods of turmoil can be considered crises. Instead, we see crises as events that often appear to be incentives or stimuli to reform and improve certain regulatory frameworks, to modify existing instruments or to create new ones, but we also observe that financial integration has not only occurred due to crises but also despite them. We therefore distinguish two possible explanatory features in the journey of financial integration in the EU in recent decades:

- Financial integration triggered by crises
- Financial integration regardless of crises

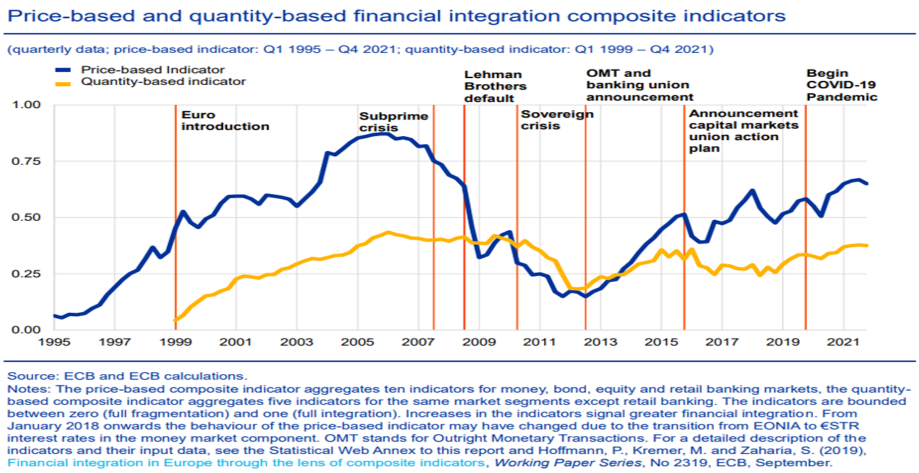
As we will see, both crisis moments and perceptions and recognitions of risks or threats offer opportunities for regulatory reforms or the introduction of new rules and instruments that seek to address the impact of a disruptive moment, cope with a particular challenge or pressure, or deal with existing failures in the EU. We aim to identify and explain the dynamics of cases in which financial integration occurs as a consequence of a response to an economic and financial crisis (*financial integration triggered by crises*) and as a response to a specific unprecedented event, risk or threat (*financial integration regardless of crises*). Among the former, we can identify sets of actions taken and responses primarily made in reaction to a crisis or to the consequences of a disruptive event in a certain policy domain aiming to address a specific problem and create new tools and instruments for crisis management by providing a policy solution and introducing novel mechanisms and new legislative instruments or reforming previous ones. This is inspired by W. Churchill's famous statement, when he was working to form the United Nations after WWII: "Never let a good crisis go to waste."

When financial integration occurs *regardless of crises*, we observe certain transformations, regulatory changes and new policies created to deal with a particular future threat, risk or hazard, and also seeking to address existing challenges or problems. As we will see, on some occasions the existence of specific risks or common threats (e.g. financial crime, war, the possibility of economic collapse and risk of financial instability), make conditions more favourable for cooperation between the EU Member States and collective action to preserve the integrity of the EU polity and deepen European integration. This is not to say, however, that certain regulatory reforms or policy innovations cannot at the same time be triggered by a specific crisis or as a response to a threat or risk (*regardless of crises*). In fact, some regulatory changes in the financial and economic domains are results of both, seeking to manage, minimise or eliminate certain risks and to deal with certain problems in specific contexts or failures in the system. It is important to emphasise that both types of dynamics (crisis and non-crisis) are important driving forces of the objectives and narrative that have accompanied the EU since its origin: to promote and move towards deeper integration. In the following sections we provide examples in which we can recognise these two dynamics of financial integration.

Financial integration after Maastricht: Examples of financial integration triggered by crises and regardless of crises

European financial integration has taken twists and turns in the past three decades. After Maastricht, the expectation was that creation of the euro would be an important trigger of deeper financial integration, in particular higher cross-border capital flows. While we witnessed upward integration throughout the 1990s and the years immediately following the formal euro launch in 1999, integration came to a halt with the 2007-2008 GFC. It was not until the creation of the Banking Union that integration resumed, but it was further halted – but only temporarily – by the Covid-19 pandemic, as the following graph from the ECB latest biannual Financial Integration and Structure report indicates (Fig.1).

Figure 1. Price-based and quantity based financial integration composite indicators



Source: ECB and ECB calculations.

Notes: The price-based composite indicator aggregates ten indicators for money, bond, equity and retail banking markets, the quantity based composite indicator aggregates five indicators for the same market segments except retail banking. The indicators are bounded between zero (full fragmentation) and one (full integration). Increases in the indicators signal greater financial integration. From January 2018 onwards the behaviour of the price-based indicator may have changed due to the transition from EONIA to €STR interest rates in the money market component. OMT stands for Outright Monetary Transactions. For a detailed description of the indicators and their input data, see Hoffmann, P., Kremer, M. and Zaharia, S. (2019), Financial integration in Europe through the lens of composite indicators, Working Paper Series, No 2319, ECB, September.

Besides the effects of crises, financial integration in the EU has also been a function of the supranationalisation of financial policies in the EU. Before the GFC, financial regulatory and supervisory integration were somewhat slow, despite the fact that cross-border capital flows in the EU (especially in the euro area) and efforts to remove barriers in financial markets have been present since the 1980s with the single market project and the creation of the European financial services passport. In the 1990s, the Maastricht Treaty introduced free movement of capital as a fundamental part of internal market freedoms and removed all restrictions on the movement of capital between EU countries.

Initially, financial integration was mostly a question of exchanging goods and removing barriers, but the 2008-2010s crises represented an opportunity for regulatory reforms and new rules and instruments to address the impact of a disruptive moment, a particular challenge and pressures or to deal with existing failures in the EU. On many occasions the existence of crisis pressures or common threats (e.g. financial crime, war, the possibility of economic collapse) have made conditions more favourable for cooperation between the EU Member States and collective action to preserve the integrity of the EU polity and deepen integration. Crises usually motivate Member States and supranational institutions to respond, but not always with the intention of deepening integration or enhancing supranational control – especially regarding the positions and interests of some Member States. Sometimes this appears as an 'unintended consequence.' They also act as catalysts for policy innovations related to specific fields or areas. While policies are not always concrete responses to crises, they foster the adoption of new policy agendas, roadmaps and pieces of legislation that lead to relevant steps towards deeper integration. Nevertheless, some scholars have discovered that certain crises can act as catalysts of 'disintegration.' Texeira (2020) describes the period between 2008 and 2010 as a time of disintegration through crises, and others consider that some crises have contributed to triggering disintegrative dynamics in the EU, such as the membership crisis characterised by the Brexit process (Zielonka 2012; Rosamond 2016).

Taking things chronologically, one can observe that the creation of the single currency led to increased interdependence of financial actors across borders up to a level at which risks of a regime of 'financial dominance' became real. Despite constituting a threat to the common currency, the euro sovereign debt crisis did not lead to the formalisation of a genuine fiscal union as many advocates of a Hamiltonian moment had hoped. However, thanks among other things to the worrying and out of hand dynamics of the bank-sovereign doom loop, it paved the way to construction of the Banking Union and its central actors (the Single Supervisory Mechanism and the Single Resolution Mechanism), and the creation of the European System of Financial Supervision (ESFS).

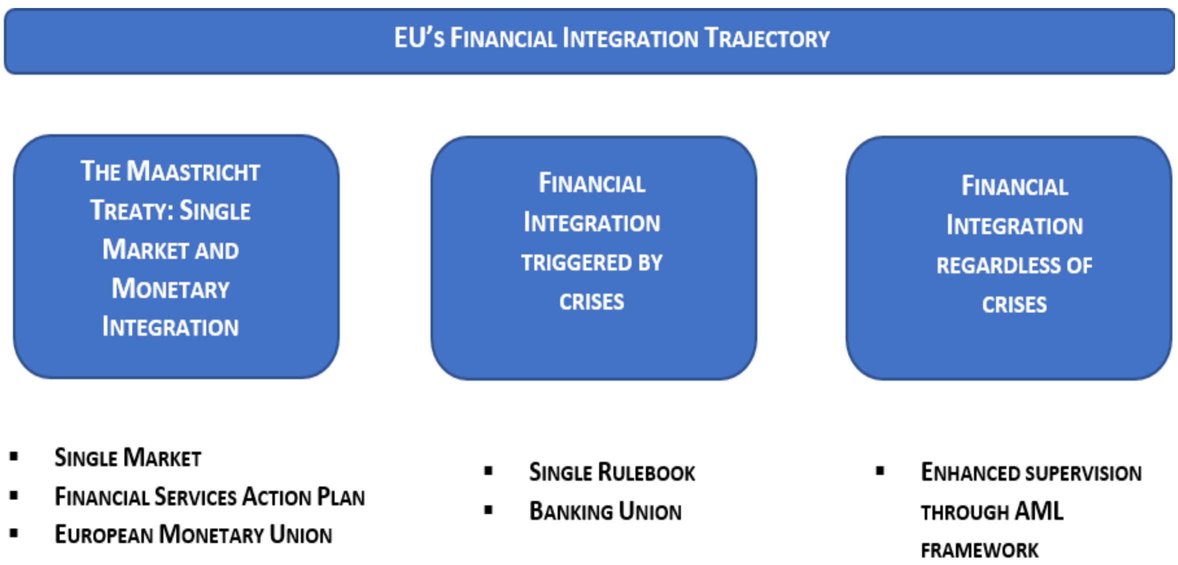
After the creation of the Single Resolution Board (SRB) and the ESFS, and in sync with the end of the euro sovereign debt crisis, further centralisation of financial policies in the EU came to a halt. Following the Banking Union, the Capital Markets Union (CMU) was seen by many as a possible milestone in the ongoing process of economic and financial integration in the EU (Allen et. al., 2019). While there were attempts, in particular in the Five Presidents Report of 2015 to push for the advent of a CMU as the second component of the European Financial Union (the Banking Union being the first component), seven years after the publication of the report and two years after the start of the pandemic the BU and the CMU are no more complete than they were in 2015.

The BU and the creation of the ESFS and the CMU – together with other relevant and unique sets of regulations affecting the financial spectrum, the main objectives of which include among other things the construction of sound regulatory and supervisory frameworks, strong macroprudential instruments and, ultimately, a 'safe financial system' – have been key developments in the process of financial integration in recent decades. Many of these instruments were created and introduced in the context of the 2010s economic and financial crises despite being considered or envisaged in earlier periods. There are some academic works that argue that the idea of an integrated banking system was already present in Europe in the late 1960s (Mourlon-Druol 2016), although it did not become a relevant and clear project at that time as there were neither adequate conditions for it nor political will on the part of the Member States. It was the GFC and the sovereign debt crisis in the eurozone that triggered the start of construction of the BU. The eurozone crisis exposed some of the weaknesses and failures of the eurozone's economic governance architecture and the absence of a consolidated system of banking and financial supervision. In addition, in the midst of the financial crisis, the 2009 Larosiére Report envisaged a single rulebook and the creation of the ESAs. As for the CMU, the Treaty of Rome already mentioned the need to ensure free movement of capital between the Member States but this idea only acquired a more robust form in 2015 in the aftermath of the eurozone crisis with the Juncker Plan.

On the other hand, there are also significant examples of financial integration occurring not necessarily in response to a disruptive or crisis-driven moment or not even as an attempt to manage a crisis. The strengthening of the digital and sustainable finance agendas in the EU – especially in the 2020s – has not necessarily been triggered by crises. Instead, the new instruments and policies introduced aim to adapt EU policy and regulatory frameworks to new contexts, trends and megatrends, such as climate change, the need to transition to a low-carbon economy and the rapid growth of technological innovation and digitalisation. Examples of this include recent regulatory developments in the area of sustainable finance, such as the EU Taxonomy Regulation, the Sustainable Finance Disclosure Regulation, the Corporate Sustainability Reporting Directive and the proposal for an EU Green Bond Standard, among others. In the area of digital finance, the main components of the Digital Finance Strategy seek to harmonise rules in many areas (e.g. the regulation of crypto-assets, open finance and the creation of common standards for digital operational resilience, among other things), thus contributing to fostering financial integration. Moreover, in some cases, preventive actions taken to address specific risk threats also drive relevant new agendas, such as strengthening of the anti-money laundering and counter-terrorism financing framework, which aims to prevent and tackle financial crime and preserve the integrity of European Financial Union.

Therefore, we observe that the trajectory of financial integration in the EU since the 2010s has been accompanied by crises, external threats, politics, trends, policy improvements and regulatory reforms, but it is not only determined by crises. We therefore identify key stages in which we can recognise features of financial integration triggered by crises and regardless of crises.

Fig. 2. The EU's financial integration trajectory since Maastricht: some examples



(1) Maastricht, the single market and the EMU: preparing the ground for further financial integration

The consolidation of the single market and the creation of the EMU can be considered a key stage in the historical development and process of financial integration. The idea of building a European Monetary Union emerged strongly in the early 1970s with the Pierre Werner Report (1970),[1] which called for the realisation of monetary union by 1980. However, it was not until the end of the Cold War period that the EMU project and the single market became clearer.

Beside completion of the EU's internal market by 1992, the European Monetary Union was a clear objective already in the late 1980s and was finally introduced in the Maastricht Treaty. However, the Exchange Rate Mechanism (ERM) crisis that took place between 1992 and 1993 seemed to weaken the Maastricht plans and the Member States' ability to progress towards a full EMU (Coakley 1995). This crisis made evident the disrupting role of a series of fixed rules and tensions among differing economic policies in different states, and it brought relevant risks in the transition towards the adoption of a single currency. However, "by the end of 1995, the ERM crisis was effectively resolved. A majority of ERM members re-affirmed their commitment to adopt a single currency, while others – notably the UK, Sweden and Denmark – opted for remaining outside the currency area and instead embraced inflation targeting as their monetary framework" (Corsetti, Eichengreen, Hale and Tallman 2019). In 1999 with the introduction of the euro, monetary policy in the euro area was transferred from the Member States to a new supranational institution: the European Central Bank (ECB).

The Maastricht Treaty introduced a comprehensive system of rules and standards for the functioning of the single market to be applied equally in all EU Member States, guaranteeing the free movement of persons, goods, capital and services. The internal market benefited from the existence of a single currency that facilitated exchanges throughout the euro area. Also in 1999, the European Commission presented the Financial Services Action Plan, which was an important attempt to improve financial integration in the EU. It aimed to remove barriers limiting the provision of financial services in all EU Member States and to strengthen prudential structures to prevent financial risks and improve supervisory practices. Although it was not fully implemented at the time, it emerged as an important step in the process of financial integration and acted as the catalyst for many important pieces of legislation regulating financial markets in the EU (i.e. MIFID 1 & 2, MIFIR and the Prospectus Regulation). Moreover, as has been discussed in the literature, the introduction of the latter was of significant relevance in the development of the CMU and the European integration project in general (cf. Panagopoulos et.al. 2015; Moloney 2016).

(2) Financial Integration triggered by crises: the Banking Union

In the aftermath of the GFC and the sovereign debt crisis, important legislative changes led to the establishment of the Banking Union framework, the supranationalisation of banking supervision and to new authorities being set up within the ESFS. The BU (still under construction) was a clear reaction to the two crises and it advanced financial integration and improved financial supervision (especially in the euro area).

1 Cf. Report to the Council and the Commission on the realisation by stages of the Economic and Monetary Union in the Community, "Werner Report." Supplement to Bulletin II-1970 of the European Communities, Luxembourg, 8 October 1970 https://ec.europa.eu/economy_finance/publications/pages/publication6142_en.pdf. Accessed 20/12/2022.

In 2012, in the 'Van Rompuy Report', the President of the European Council identified what today is called the Banking Union. The Banking Union was launched in 2014 as a three-pillar project, and its main aims were to strengthen banking supervision and reverse the fragmentation of the EU banking market. To achieve these aims, the Banking Union framework required three major moves: supervisory convergence by centralising the supervision of the most significant institutions in one authority, the ECB; a single framework for the orderly resolution of failing banks and banking groups with a minimum impact on the real economy and the public finances of the participating Member States; and a – not yet in place – harmonised deposit guarantee scheme set up to protect retail deposits in the EU. In detail, the moves made in the BU project reformed the EU banking landscape by setting up the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), and the intention to establish in the future a European Deposit Insurance Scheme (EDIS). The first pillar, including the Single Rulebook, has been fully operational since November 2014, the second pillar has been operating without an important piece of its structure, and the third one is (for now) on hold, as a lack of political consensus has prevented any significant progress since it was proposed in 2015.

Overall, and even though European supervision is still work in progress, one can consider the SSM a success paving the way towards a common supervisory culture and approach in the EU. The SRM, on the other hand, is much less centralised and centralised funding will only be in place in 2023. Before knowing what the European Commission's (EC) proposal following the Crisis Management Deposit Insurance (CMDI) review will bring, a current major gap is that resolution options are only available for banks when such resolution is in the public interest (focusing mostly on financial stability concerns). All other banks have to go into national insolvency proceedings, which vary quite a lot across member countries, some being court-based and others administrative. This is not only inefficient but also leaves gaps, such as when the regulator declares a bank is failing or likely to fail but the court finds the bank is still solvent and so it cannot enter insolvency proceedings, as was the case of the Latvian ABLV Bank and its subsidiary in Luxembourg.[2] So far, there have been few resolution cases for the SRB (most prominently the Banco Popular Español in Spain and Sberbank in Austria) and preventive recapitalisation at the national level is still a popular instrument in some Member States, even though the reforms were meant to put an end to bail-outs.

Despite its incompleteness, it is persuasive to believe that the BU was the step needed for more financial integration in the EU and for establishment of the internal market. In 2012 when financial stability was at stake, it was logical to deepen financial integration through a Fiscal Union of all the Member States. However, in a time of crisis it was not politically feasible to choose this option as it entailed higher cross-border costs. Some authors therefore claim that the launch of the Banking Union was a reaction by the EU to the eurozone sovereign debt crisis. Others say it is a necessary pillar to deepen the EMU, or a necessary next step in financial integration (Noyer 2000; Delors 2001).[3] Perhaps one can argue that it is both: "Prior to a crisis, strong supervision ensures that the banking sector is resilient and capable of withstanding shocks. During and after a crisis, a robust safety net is needed to contain spillovers and contagion effects" (Regling 2021).

2 The ECB's declaration that the Latvian ABLV Bank was failing was followed by an assessment by the SRB that a resolution procedure was not in the public interest. While the Latvian parent shareholders decided to liquidate the bank voluntarily, the Luxembourg subsidiary was initially not declared insolvent and for a while remained in limbo.

3 Here it is helpful to recall the 'bicycle theory,' according to which economic integration must keep going or it will fall over. According to this view, once Europe achieves a sufficient degree of financial integration political integration would follow spontaneously.

The construction of the Banking Union as a reaction (and response) to the eurozone sovereign debt crisis

One can argue that the post-crisis financial regulatory reform known as the BU was a reaction by the EU to the global financial and euro debt crises. Policy efforts to reply to the crises, to advance financial integration during crises and to prevent instability relaunched academic discussion in the legal sphere, which prompted multiple doctrinal works on the BU framework (Barucci et al. 2014; Binder et al. 2016; Busch et al. 2020). The controversial novelties introduced by the new Banking Union rules also encouraged a few normative analyses (Grundmann S. et al. 2019; Culpepper et al. 2019; Restoy et al. 2020; Stiefmueller 2017). Given the different policy considerations at stake, legal scholars do not necessarily agree on what has been achieved by the Banking Union. Disagreement is also present in the policy sphere, in which SSM is frequently deemed operational but SRM and (the lack of) EDIS cause multiple controversies. As Andrea Enria states, "[…] the more we move away from the first pillar of the Banking Union, the more political and intergovernmental elements emerge" (Enria 2022).

The SSM has already achieved a high degree of consistency in the supervision of banks, and by harmonising national legislation the Single Rulebook indirectly removed barriers to cross-border integration. In the absence of a single treasury and of a truly fiscal union, the SRM still has no answer to the liquidity needs after the resolution of a bank. A fully functional resolution framework complemented by a common backstop to the Single Resolution Fund can pave the way for the introduction of EDIS. A common deposit insurance scheme would add a European layer to the existing national deposit guarantee schemes and would harmonise the level of depositor confidence regardless of the location of the bank, which would further advance integration among eurozone countries. For now, that step is not in the pipeline

After the crisis: completing the Banking Union

Completion of the BU has attracted a lot of attention in the last decade in EU policy debates. Tortuous litigation in supervision and resolution cases has also received the solid attention of academic scholarship (Zilioli and Wojcik 2021). More recently, the Court of Justice decision in the Banco Popular Español case closed a debate concerning fulfilment of the conditions for adoption of a resolution scheme, which affected the owners of capital instruments in Banco Popular Español before the resolution in June 2017.[4]

This greater focus on supervisory and resolution measures adopted in the European financial sector has surely been influenced by the increasing EU efforts during the eurozone sovereign debt crisis to protect financial stability while minimising the use of public funds on non-viable banks (Zilioli and Wojcik 2021).[5] According to the 2022 Single Resolution Board Work Priorities, one of its key aims is to establish a common backstop for the Single Resolution Fund (Single Resolution Board, 2022), which is pending ratification by Italy of the agreement to reform the European Stability Mechanism Treaty. However, other policy objectives, including further enhancement of financial integration in crises, are being pursued. What policy aim is the post-crisis legal framework, including the Banking Union, trying to achieve? Financial stability, financial integration or both? Which aim is more important? And are there trade-offs?

4 *Cf.* Court of Justice of the European Union (2022), Judgments of the General Court in Cases T-481/17 *Fundación Tatiana Pérez de Guzmán el Bueno* and *SFL v SRB*, T-510/17 *Del Valle Ruiz and Others v Commission and SRB*, T-523/17 *Eleveté Invest Group and Others v Commission and SRB*, T-570/17 *Algebris (UK) and Anchorage Capital Group v Commission* and T-628/17 *Aeris Invest v Commission and SRB*, Communications Directorate, Press and Information Unit. Available at: https://curia.europa.eu/jcms/upload/docs/application/pdf/2022-06/cp220090en.pdf . Accessed 22/12/2022.

5 A paramount example is the preliminary request of the Slovenian Court regarding the Communication from the Commission on the Application, from 1 August 2013, of State Aid Rules to Support Measures in Favour of Banks in the Context of the Financial Crisis (2013/C 216/01) (2013 Banking Communication). See the *Kotnik* case: https://curia.europa.eu/juris/liste.jsf?language=en&td=ALL&num=C-526/14 Accessed 22/12/2022.

In addition to harmonised banking supervision, effective resolution planning and crisis management of banks are crucial for the credibility of the BU. Making the second pillar more robust will also enhance the chances of establishing a common deposit insurance scheme without burdening national budgets. Completing the BU will ultimately contribute to achieving an integrated European banking sector. It will also strengthen the chances of achieving a Fiscal Union, a long awaited milestone in the history of the EU. How many political and intergovernmental battles will be needed to achieve this? The next one might be around the corner, after the EC publishes the CMDI review.

(3) Financial integration regardless of crises: preservation of the integrity of the financial union through AML legislation

New policy agendas and regulatory developments are contributing to the process of financial integration in the EU by harmonising rules and enhancing supranational supervision of financial institutions in many different areas, as a response to specific global trends and megatrends (i.e. climate change, digitalisation, globalisation), and to cope with potential risks or threats. A clear example of this is the strengthening of the anti-money laundering (AML) framework and the emergence of the EU digital and sustainable finance agendas, which aim to strengthen the competences and supervisory powers of the ESAs in several domains.

While prudential bank supervision has been centralised in the form of the SSM, market conduct and financial crime monitoring are still firmly at the national level, mostly driven by global rather than European initiatives. Recent money laundering scandals might change this, especially with the recent decision to set up a new European Anti-Money Laundering Authority (AMLA). Part of the 2021 legislative package proposed by the EC, creation of the AMLA is the cornerstone of the regulatory response to a systemic threat from illicit funds infiltrating the European financial system. This decisive move aimed at strengthening the existing anti-money laundering framework in the EU is characterised by an intention to further centralise the coordination of efforts at the supranational level.

The AML framework and financial integration

The role of the EU AML framework in the context of financial integration can be described as twofold. On the one hand, in the globalised economy the framework is a crucial element safeguarding the integrity and good reputation of the EU financial sector. This integrity and this reputation are indispensable for further EU financial integration but can be put at risk by illicit activities. From the neo-functionalist perspective as discussed earlier, this first aspect of the role of the AML framework and AML cooperation in financial integration can be seen as “a spillover from monetary integration” (Blauvelt 2014). In other words, the degree of financial integration in the EU requires further integration and coordination efforts on other fronts, including AML. On the other hand, the AML framework itself can be considered a vehicle for further financial integration. This role of the framework is revealed in its aim to enhance cross-border supervisory cooperation and convergence of supervisory practices among EU member states (Kalemli-Ozcan, Papaioannou and Peydró 2010).

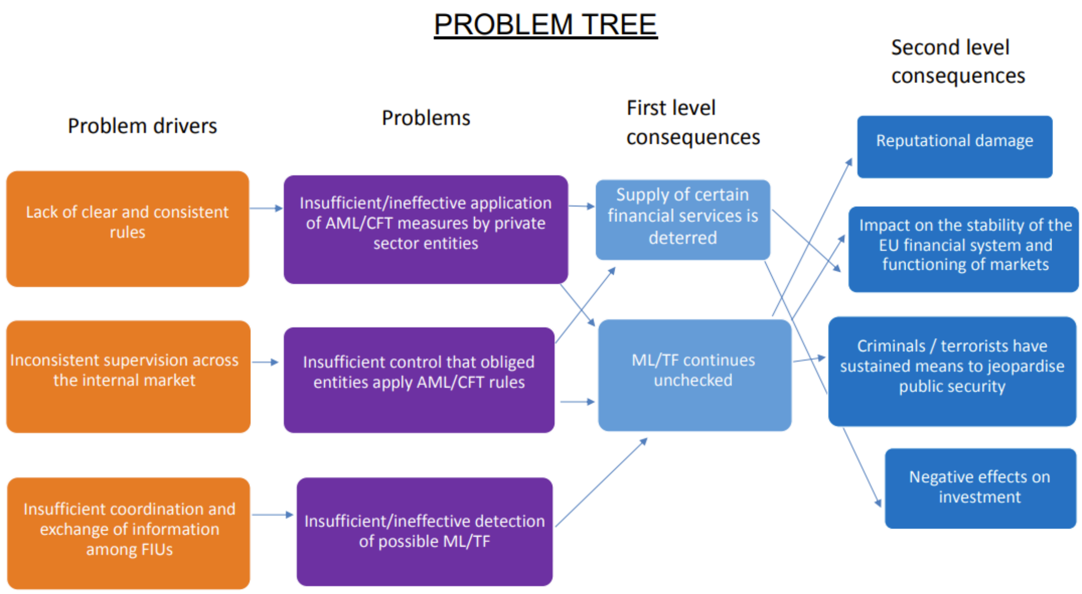
A number of recent money laundering scandals undermining the reputation of the EU financial sector have led to significant updates of the AML framework, including adoption of the fifth directive (AMLD5) in 2018 (implemented in 2020). Following a wave of scandals in Cyprus, Denmark, Estonia, Latvia, Malta, the Netherlands and the United Kingdom, the shortcomings of the EU AML framework became more evident and highlighted the strong need for enhanced EU-level supervisory engagement to tackle the “vicious circle of supervisory corrosion” (Kirschenbaum and Véron, 2018). Although a robust regulatory framework was in place, the system was shown to be prone to significant errors. The European Commission underlined the lack of effectiveness of the EU rules and blamed misaligned supervision and enforcement across the EU, which undermined the integrity and reputation of the EU financial sector, and financial stability of the internal market and individual banks (European Commission 2018).

Risks to financial integrity as a catalyst for further integration

Perhaps the most significant illustration of the weaknesses in the EU AML framework is the example of Danske bank and its Estonian branch in 2017-2018. Although the scandal led to the closure of the local branch and a ripple of repercussions across the Baltic and the Nordic country banking sectors, it did not result in a crisis comparable in scale to the GFC, which led to the creation of the BU. However, the case exposed a number of risks and potential damage that a misfiring AML framework can cause to the EU banking sector. Most prominently, the case revealed the weaknesses and inefficiencies of the system resulting from enforcement at the national level, the need for effective information exchange between supervisory authorities and the lack of skill and resources to address complex cross-jurisdictional cases. Moreover, the Danske case illustrated the scale at which illicit funds can infiltrate the EU financial sector by exploiting one institution in one jurisdiction to threaten the entire single market.

On 20 July 2021, the EC presented an ambitious package of legislative proposals to strengthen the EU's anti-money laundering and countering the financing of terrorism (AML/CFT) rules. The package also included a proposal to create a new EU authority to fight money laundering – the AMLA. The problems prompting the proposal were many (Fig. 3). In addition to a lack of harmonisation at the level of implementation of rules, and inconsistent supervision across Member States, another key problem outlined was insufficient coordination and exchange of information among national financial intelligence units (FIUs).

Figure 3. Problem 3



Source: European Commission, Impact Assessment, 2021.

By establishing the AMLA, the Commission intended to tackle the core of the 'problem tree,' namely the inconsistency of supervision and lack of coordination. The AMLA will ensure closer cooperation between national institutions to develop common methodologies and implement sanctions. It will provide a new 'pool of expertise' at the EU level which can be relied on to improve the level and quality of supervision and ensure consistency across national jurisdictions. The new agency will become the new coordinator of the FIU network (FIU.net) and run the AML/CFT database instead of Europol and the EBA, thus consolidating coordination efforts at EU level.

As opposed to mere 'indirect oversight' capacity in which all financial entities are continuously supervised at the national level with the AMLA charged with ensuring consistent and competent application of supervisory practices, the proposed approach foresees direct powers for the AMLA to supervise and sanction selected high-risk entities. The Commission will be entitled to adopt a delegated regulation to lay down objective criteria concerning the risk level and the cross-border nature of the entities subject to direct oversight by the AMLA. A key consideration in opting for limited direct supervision was the need to ensure integrated Union-level supervision of high-risk cross-border entities. It has been suggested that with mere indirect oversight at the EU level, national authorities would be likely to remain ill-equipped to ensure effective supervision of such risky entities and complex situations, with potential implications for the EU financial sector as a whole.

Towards further integration to ensure market integrity

From the perspective of financial integration, the 2021 legislative package and the AMLA proposal is an important development. Unlike earlier efforts to increase the effectiveness of the EU AML framework that focused on creating more robust harmonised rules, the current proposal goes a step further. Although the 2021 legislative package includes legislative instruments aimed at further harmonisation, the creation of the AMLA is in contrast with other available alternatives (e.g. reinforcement of indirect supervisory powers and the role of the EBA as an AML/CFT knowledge hub). The proposal to create a new agency and therefore to take AML supervision (at least in part) up to the EU level aims to increase cooperation between the AMLA and national competent authorities and enhance risk control and response mechanisms at the EU level.

As an integrity-safeguarding measure, the AML framework aims to ensure smooth cross-border capital flows, which are endangered by large AML exposure in individual Member States or regions. It also provides certain guarantees to secure foreign participation in domestic financial markets, in particular in the banking sector, and reinforces information-sharing across financial institutions and agencies.[6] As a vehicle for further financial integration, the creation of a new EU agency fosters supervisory convergence and enhances cooperation between the EU and national levels (Lannoo and Parlour 2021). As such, it is also (and rightly so) compared to the SSM framework because of the tools used (Lannoo 2022), the governance structure and potential challenges (Lo Schiavo 2021). Therefore, by addressing the shortcomings stemming from institutional fragmentation and aiming to enhance the effectiveness of AML supervision, the new framework is likely to contribute to financial integration in the EU.

Conclusions

The European financial sector has faced and continues to face many risks and challenges. Some have materialised in the form of systemic banking crises, such as the global financial and eurozone sovereign debt crises. Others constitute medium- to long-term threats, such as money laundering undermining financial integrity. We have discussed examples of reforms of the regulatory framework in the EU both as reactions to specific crisis situations (*financial integration triggered by crises*) and reforms undertaken regardless of crises. The construction of the Banking Union (even though incomplete) was triggered by the eurozone sovereign debt crisis and the limitations in existing national and European frameworks to address immediate fragility concerns. Strengthening of the AML framework and the introduction of a new European agency in this context (AMLA), on the other hand, comes after several scandals undermining financial integrity but not acute crisis situations.

6 Consider the Scandinavian banks, which control over 80% of the lending market in some Baltic states, threatening to leave the region in the aftermath of the Danske scandal (Milne 2019).

The different approaches to reforms also allow us to look forward and make conjectures if not predictions about current and future reform efforts. On the one hand, there seems to be limited appetite for radical reform in certain areas, such as completing the BU outside a crisis situation. On the other hand, there seems to be sufficient political pressure to adopt new instruments and policies in the financial sector to address climate change and the need to transition to a low-carbon economy. Similarly, recent legislative initiatives in the area of digital finance and crypto-assets are also examples of integration efforts regardless of crises.

One decisive difference between reforms triggered by crises and reforms despite crises seems to be the urgency with which a situation requires attention. The Banking Union (and similarly at the macroeconomic level the establishment of the European Stability Mechanism and the post-Covid recovery programme) responded to immediate stability concerns. The new framework for AML and the reform initiatives concerning climate risk and digitalisation, on the other hand, are reactions to medium- to long-term challenges.

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