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>THOUGHT LEADERSHIP>

STATE OF THE EUROPEAN UNIONS

> THE EU, ECONOMIC AND MONETARY UNION, BANKING UNION AND CAPITAL MARKETS UNION

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Europe is facing challenging times. Mass migration, terrorism, Brexit, Grexit, relations with Russia and Iran – all underline growing uncertainty and insecurity in the region. How are the various European Union projects – the European Union, Economic and Monetary Union, Banking Union and Capital Markets Union faring under this burden? Here Clifford Chance experts look at the threats which these projects face and how well they are dealing with those threats.

The state of the European Union

Phillip Souta, Head of UK Public Policy, says that any assessment of the state of the European Union (EU) should begin with the economy. There has been a muted recovery in the EU and the Euro area over the last couple of years and the European Commission's Autumn forecast predicts a slight increase in growth for 2016 and 2017. The UK is set to continue its relatively solid level of growth through to 2017.

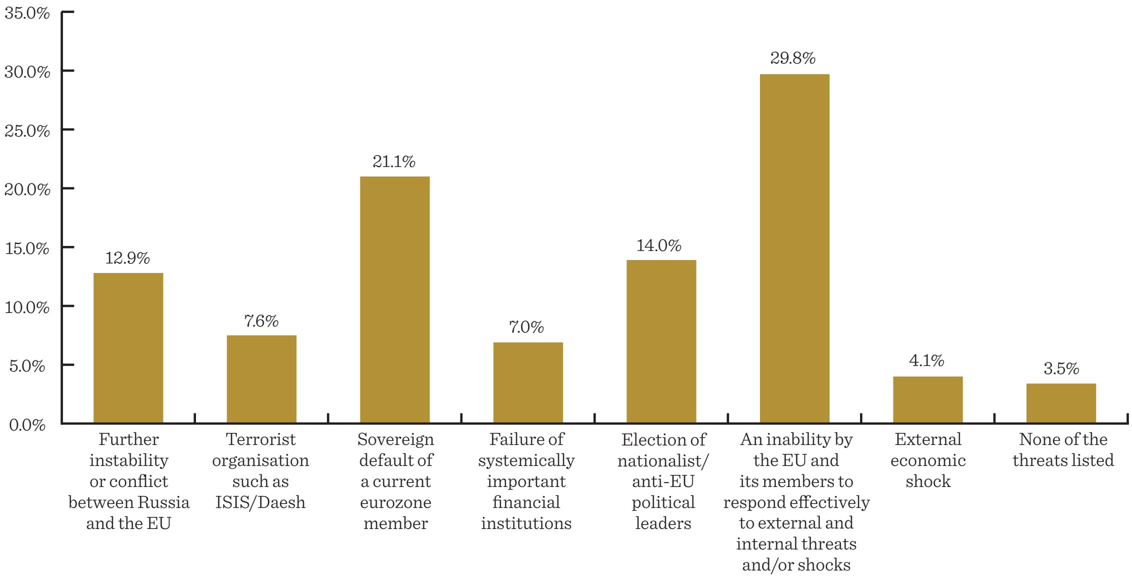
Growth has been supported by low oil prices, a relatively cheap Euro and policy interventions such as quantitative easing and asset purchase programs. On the down side, there are some significant risks with a slowdown in emerging markets and the recent turmoil in the Chinese stock market coupled with a sharp reduction in foreign trade flows.

We have drawn on data gathered in live polls conducted during our presentations on these topics in London to provide a snapshot of what our audience thinks about some of these issues, as well as, where indicated, from polls held at the AFME 10th Annual European High Yield Conference held in London on 21 October 2015 (AFME Conference). More detail on our audience polls can be found at the end of this article.

	Forecast real GDP growth (%) European Commission, European Economic Forecast, Autumn 2015		
	2015	**2016**	**2017**
Germany	1.7	1.9	1.9
France	1.1	1.4	1.7
Euro area	1.6	1.8	1.9
UK	2.5	2.4	2.2
EU	1.9	2	2.1
USA	2.6	2.8	2.7
Japan	0.7	1.1	0.5
China	6.8	6.5	6.2

We asked our audience what the greatest threat to the economic and political stability of the EU and its members was – an inability by the EU and its members to respond effectively to external and internal threats and/or shocks and sovereign default topped the poll. This was before the recent terrorist attacks in Paris.

What is the greatest threat to the economic and political stability of the European Union and its members?



Migration from the conflict-ridden Middle East is one of the main challenges for Europe. Three quarters of a million refugees arrived in Europe this year, mainly via Italy and Greece, a quarter of a million arrived last year and the Commission has predicted some 3 million more by 2017.

The migration crisis is causing great tension within the European Union. On one side of the argument, Jean-Claude Juncker, the President of the European Commission, has said that Europe represents a "beacon of hope." Angela Merkel, the German Chancellor, opened Germany's doors to migrants in September. There was an acrimonious European summit in June 2015 where there was no agreement on the relocation of refugees and Matteo Renzi, the Italian Prime Minister, was reported to have said: "If this is your idea of Europe, you can keep it". Statements by Viktor Orban, the Hungarian Prime Minister, provide further evidence of how acrimonious the issue is, saying: "This is not a European problem, it's a German problem, they all want to go to Germany."

In September, EU ministers agreed that there would be a relocation programme for about 160,000 refugees who had already arrived in the EU. Usually such a controversial issue would be handled by consensus, but not in this case. Hungary, the Czech Republic, Slovakia and Romania opposed the scheme and were out-voted. So far 116 people have been relocated and about 1,400 places have been made available.

That gives an indication of the scale of the problem and of the willingness to address it.

Nationalist and anti-EU parties in Europe are another problem for the EU. They are not always the same thing, but they do give rise to similar challenges. We have seen the rise of parties such as the UK Independence Party (UKIP) and the French Front National but they have not had major electoral breakthroughs so far. They are however influencing the political agenda by putting pressure on the mainstream parties.

The risk of a Greek exit from the Euro area, or Grexit, seems to have receded. Six months ago Greece was on the verge of leaving and is now reported to be considering issuing sovereign debt. That is a remarkable turnaround. However, in the next six months, it is possible that the UK could have voted to leave the EU. The British Prime Minister, David Cameron, has issued a letter to the President of the European Council, Donald Tusk, setting out the UK's negotiating objectives.

Angela Merkel is the major player in delivering Europe's response to these challenges. The Economist newspaper recently asked whether she was the "indispensible European." Its answer was 'yes'.

The EU also faces considerable geo-political risks. In the last few years, the EU has acted where it has been forced to, for example in relation to both Russia and Iran. The reluctance of the United States to play a leadership role in Russia and the Middle East, and its increased focus on Asia Pacific, as we have seen with China and the South China Sea recently, is another concern for Europe.

The capacity of individual EU members to act independently has also been degraded through pressure on their budgets. The UK's defence spending dropped by 19 per cent between 2010 and 2015 for example.

In addition, the reform of institutions such as the United Nations, the World Trade Organisation, the International Monetary Fund and the World Bank is happening so slowly that others are being established, for example, the Asian Infrastructure Investment Bank (AIIB) founded and championed by China.

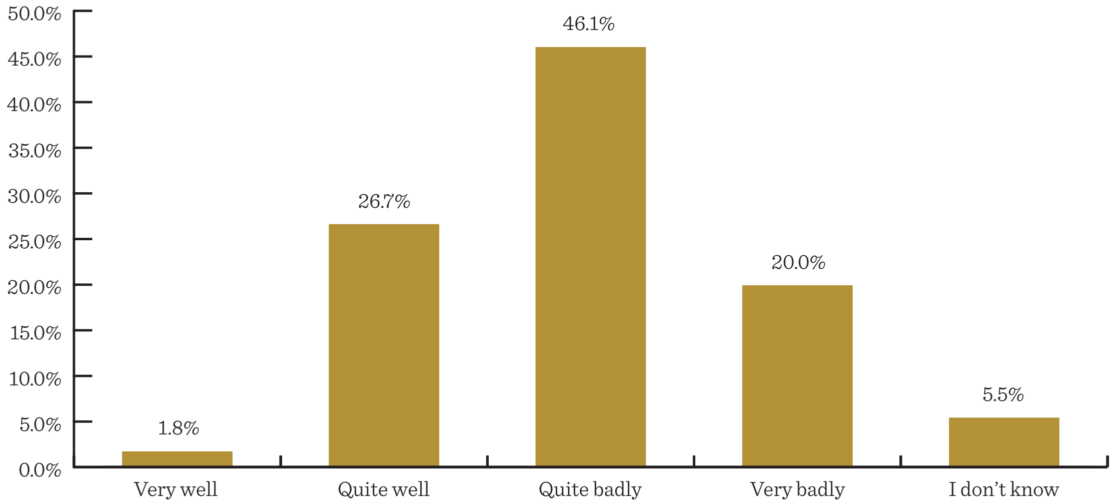
Faced with those issues, what is the EU's response? Leaders of the EU like to say it should be small on small things and big on the big things. Its recent track record however, suggests a tendency to be small on a lot of the big things. The EU has a record of proposing institutional fixes to large existential problems. That, however, is in part due to the fact that it is not a single entity, but rather a group of nations with very often conflicting approaches. So far it has managed to maintain its unity, but that unity is under pressure.

"Nationalist and anti-EU parties in Europe are another problem for the EU."

Phillip Souta, Head of UK Public Policy, London

Our audience believed that the EU would deal “quite badly” with the challenges of 2016.

How well do you think the EU and it members will deal with the internal and external challenges that they are likely to face over the next 12 months?



Economic and monetary union

Partner Simon Gleeson reminds us that there was Economic Union before there was Monetary Union. The treaties provide for the European Commission to take a leading role in the formulation of economic policy. Perhaps surprisingly, the UK Government signed up to an arrangement in which the Commission sets regular economic targets for the European Union as a whole.

Economic and monetary union (EMU) became the fast-track to the Euro with three stages. All member states of the Union, except for Denmark and the UK, are supposedly on a path to joining the Euro. Those who are not currently members of the Euro divide into the likes of Sweden and Poland who have no immediate or medium term intentions to join, and south eastern European members who are keen to make progress, but whose rapid accession to the Euro area is likely to be opposed by Germany. At the moment there is therefore a fairly stable relationship between the Euro-ins and the Euro-outs.

In 2010-2011 we saw the advent of “genuine” EMU. This had its roots in proposals from then French President Francois Mitterrand and has been part of the French agenda in relation to EMU since its birth. It involves further European centralisation including the notion that at least some sovereign debt should be raised centrally at the EU level and then lent outwards to member states. Even in those days it was clear that a centralised component of this was what was described as a completely integrated Banking Union.

Banking Union is often used as shorthand for a single supervision and cross border deposit guarantee scheme. For those who want further financial integration in Europe, Banking Union is an essential component.

"Genuine" EMU has now gone further to become "deep, genuine and fair." It involves moving the European Stability Mechanism into the new treaty and a Euro area treasury. Such a treasury would not just consist of a sovereign debt issuance capability but would be closer to the role of a real treasury with the capacity to actively manage debt. It also entails the convergence of key bench-mark standards such as on labour markets, competitiveness and the business environment.

Adhering countries are eligible for participation in the "economic shock absorption mechanism." This is a transfer mechanism aimed at meeting periodic shocks but not at permanent income equalising transfers between countries. Countries could draw on this in the event of a downturn or shock to their economic business cycle. It also envisages increasing harmonisation of decision-making on national budgets and economic policies, including taxation and employment policies.

The EU's attempts to create effective shock absorption mechanisms are in large part based on the optimal currency area theories. The intention is to try and make Europe more like the United States in the sense that if the government of California gets into trouble, there should be no impact on the economics of a bank based there. Whereas if the government of Greece gets into trouble, no matter how well a major Greek bank might be capitalised, it will still be in trouble. This is not a eurozone project; it is an EU-wide project.

Under protocol 25 to the Treaty of the European Union, the UK has a number of carve-outs. Its powers in the field of monetary policy are not affected by the Treaty; it is not subject to the provisions of the Treaty relating to excessive deficits; and it is not concerned by the provisions of the Treaty relating to the European System of Central Banks (ESCB), the European Central Bank (ECB) or the regulations and decisions adopted by those institutions.

"It is important to note that the UK does not have a blanket carve-out from EMU as a whole."
Simon Gleeson, Partner, London

It is important to note that the UK therefore does not have a blanket carve-out from EMU as a whole. It has a very specific carve-out from certain aspects of the Euro project. In theory and as far as a lot of European member states are concerned, Europe remains a single economic project. The perspective of the UK government at the moment is that there is a eurozone and there is a non-eurozone, they are different and have separate economic paths – this is in tension with the European treaties.

European Banking Union

Partner Marc Benzler says that the Banking Union only applies to member states forming part of the eurozone. The Banking Union has three pillars. Under the first pillar, the ECB acts as central prudential supervisory authority for credit institutions located in the eurozone, through the Single Supervisory Mechanism, which is separated from the ECB's monetary policy function.

There are 19 EU member states in the eurozone and the ECB supervises more globally systemically important banks than any other regulatory authority. Also, by assets supervised, it is the largest regulatory authority in the world.

The second pillar of the Banking Union is the Single Resolution Mechanism with the Single Resolution Board located in Brussels acting as a central European resolution authority, mainly coordinating the measures of the national resolution authorities. Even more importantly, the Single Resolution Board is responsible for administering the Single Resolution Fund, a mutualisation of national resolution funds within the Euro area.

The third pillar is the European Deposit Insurance Scheme, the details of which will be proposed later this year. This is probably the most controversial part of the Banking Union, as a number of member states are currently opposed to the mutualisation of the national deposit guarantee schemes which are likely to be the most significant feature of this pillar.

Everything is based on the single rule book which is made up of directly applicable EU law and EU directives which need to be implemented by the member states. The London-based European Banking Authority (EBA) is in charge of the Single Rulebook aiming to provide a single set of harmonised prudential rules which institutions throughout the EU must respect. In particular, the EBA achieves this by issuing guidelines and by coordinating the answering questions from stakeholders on the practical implementation of the relevant EU regulation and directives. The Single Rulebook applies to the ECB as to any other prudential supervisory authority.

Under the Single Supervisory Mechanism, the ECB directly supervises "significant" credit institutions, largely designated on the basis of their size and importance in the relevant member state. These consist of about 123 groups of credit institutions which in turn roughly consist of 1,200 individual institutions.

> "The national competent authorities are in charge but subject to any guidelines issued by the ECB."
>
> **Marc Benzler**, Partner, Frankfurt

With respect to day-to-day supervision, the ECB is supported by the national competent authorities in the individual member states. These are largely the bank regulators that were in charge before the ECB took over. The less significant institutions, which number about 3,400 credit institutions, are only indirectly supervised by the ECB. That means that the national competent authorities are in charge but subject to any guidelines issued by the ECB.

It is important to note that under the Single Supervisory Mechanism the ECB is the only supervisory authority with the power to grant banking licences, irrespective of whether the institutions are significant or less significant and the ECB is also responsible for approving any acquisitions of qualifying holdings in eurozone credit institutions. The ECB has no jurisdiction however, for example, in respect of payment services, markets and financial instruments and anti-money laundering.

The Single Supervisory Mechanism is interesting from a European law perspective because when acting under it, the ECB is one of the few European institutions which has direct administrative powers. Whilst the Single Supervisory Mechanism regulations provide a good basis for exercising these powers, a lot will ultimately need to be decided by the courts.

If a party is not happy with a decision of the ECB, there is an internal administrative review process at the Administrative Board of Review. If that fails, then any ECB decision can be brought before the European Courts. This raises the question of what happens if a national competent authority has acted on the instructions of the ECB? Is this an ECB decision or is this a decision which then can only be brought before the relevant member state's courts?

Where the ECB is directly competent for supervising institutions, it will also apply national laws i.e., directives which have been implemented in the relevant member state's national laws. If a decision based on national law is brought before the European Courts, the question is whether a European Court can decide on matters of interpretation of national law.

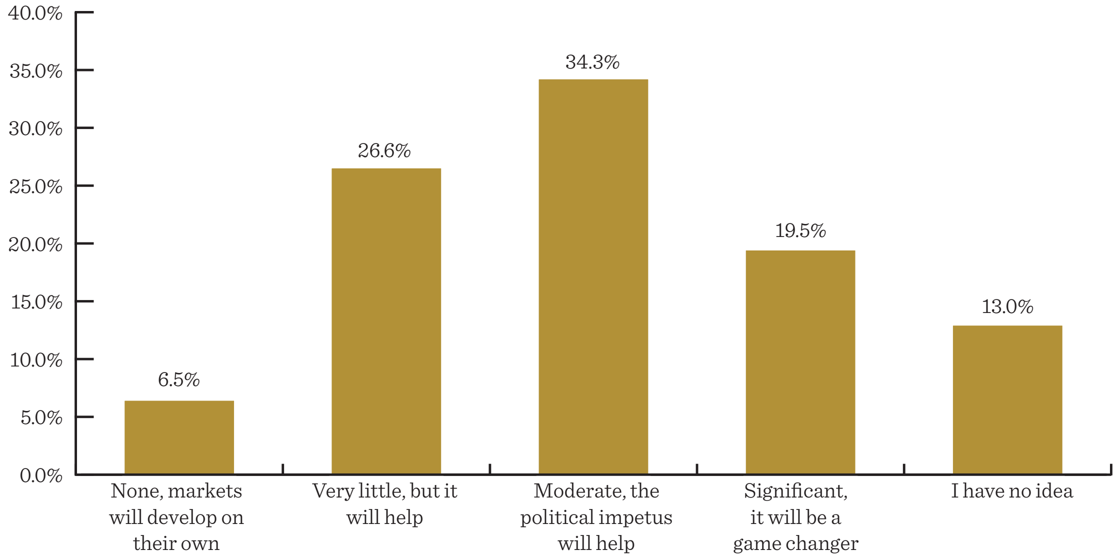
With 19 participating states with different implementations of directives, it is very difficult to maintain a level playing field. That is one of the great concerns of the ECB. However, this is exactly the reason why the ECB has been put in charge of the Single Supervisory Mechanism. The ECB wants to reduce national discretions and options and together with the European Banking Authority build a more cohesive regulatory framework. In a recently published opinion, the ECB stated that it has a "mandate to carry out prudential supervision with full regard for the unity and integrity of the internal market with a view to preventing regulatory arbitrage".

Capital Markets Union

Capital Markets Union (CMU) has been identified as a key next step in the progression of the European Union itself, as well as Economic and Monetary Union and Banking Union, and is an important means to enhance the availability of capital across Europe, especially for SMEs. Partner Michael Dakin says that the European Union's *Action Plan on Building a Capital Markets Union* notes that: "The Commission's top priority is to strengthen Europe's economy and stimulate investment to create jobs." Furthermore, it puts CMU into a historical perspective in noting that: "The free flow of capital was one of the fundamental principles on which the EU was built." Finally, it contextualises the role of CMU in the wider European project by noting: "Capital Markets Union will reinforce the third pillar of the Investment Plan for Europe. It will offer benefits for all 28 member states, while also buttressing Economic and Monetary Union by supporting economic convergence and helping to absorb economic shocks in the euro area, as set out in the report of the Five Presidents on Completing Economic and Monetary Union."

While the political will behind CMU is certain and the commitment to implementation is high, market perceptions on its commercial impact are more mixed with a majority of participants in our poll believing that it will only have a small to moderate impact on the markets.

What impact, if any, do you think the implementation of a Capital Markets Union would have on financial markets?



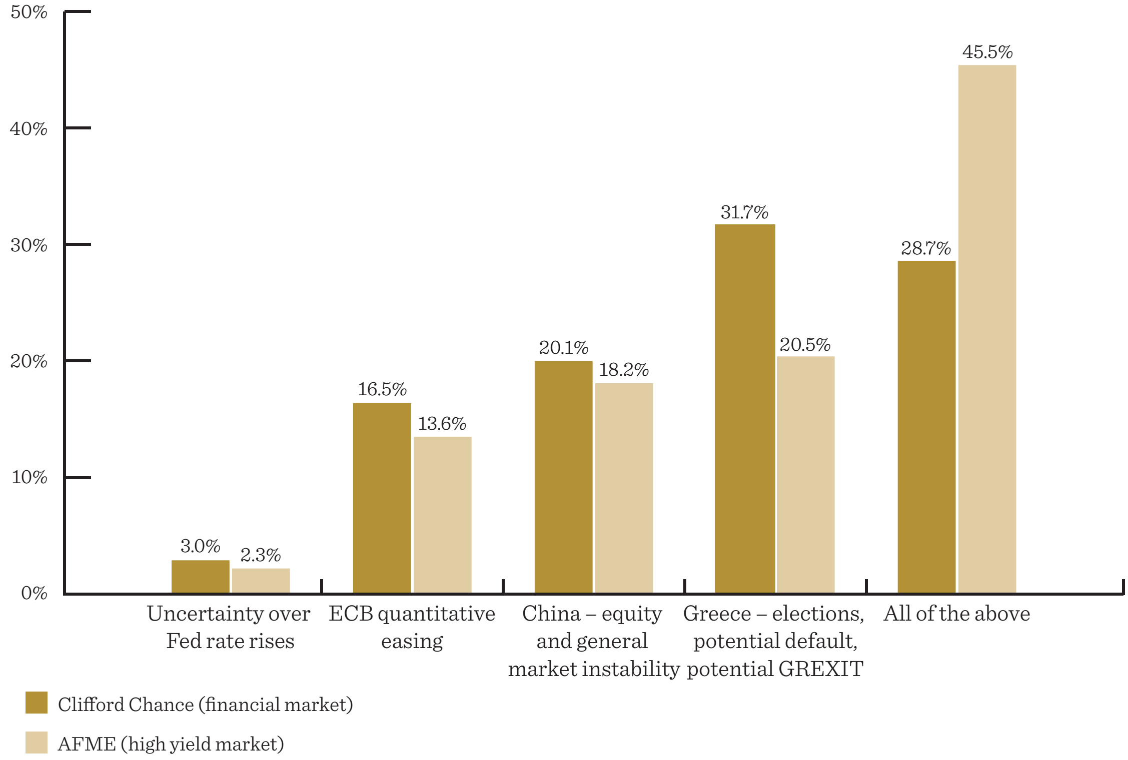
To this end, commentators have observed that while the CMU Action Plan is very good at describing the issues and the need for CMU, it is not as effective as an actual plan of action in terms of accomplishing union.

"Capital Markets Union has been identified as a key next step in the progression of the European Union itself."

Michael Dakin, Partner, London

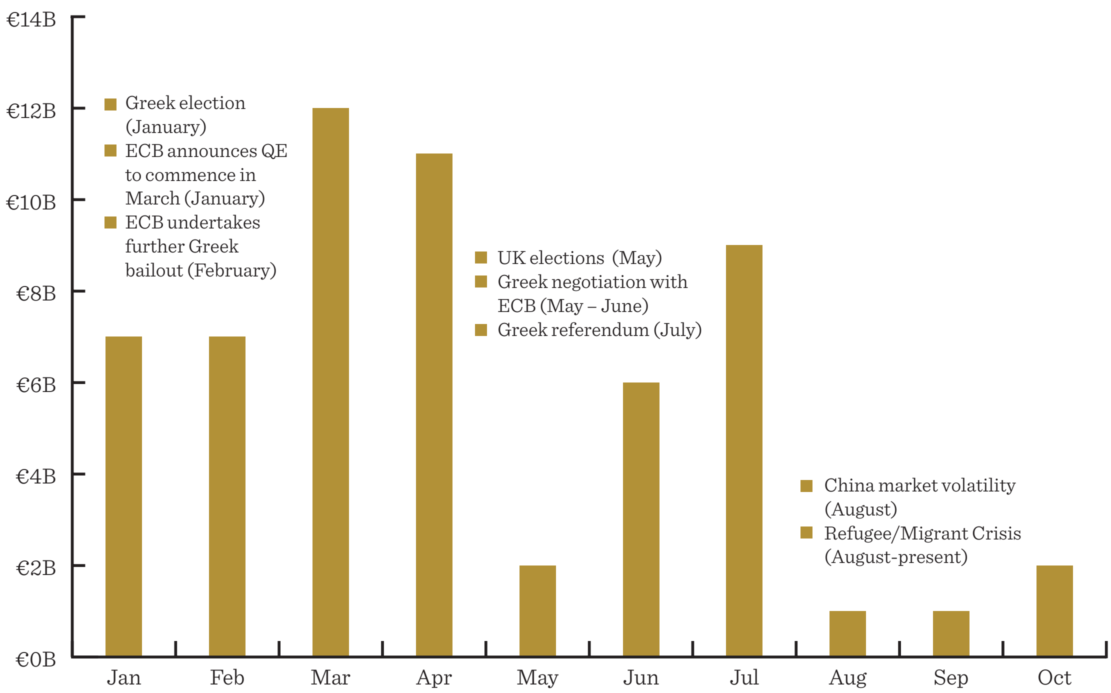
While CMU's market impact is uncertain, it is clear that over the last 18 months political events and developments in Europe and abroad have had the greatest influence on the markets and the availability and cost of capital – it seems likely that this will continue to be the case in the near term. In our audience poll the single biggest development cited as having had the greatest impact on capital markets in 2015 related to Greece, its elections, negotiations with the ECB, the potential Greek sovereign default and Grexit; which option was the second most cited event at the AFME Conference. Understandably, many poll participants cited the combination of the many developments in 2015 as driving the markets.

What macro factors do you believe had the greatest impact on the European financial market/high yield market in 2015 to date?



Using the European High Yield market as a proxy for the wider financial market, these developments can be seen as major drivers of availability of capital and new issuance of bonds. As illustrated in the European new issuance chart below, market flows closely tracked political developments with a subdued January and February reflecting the uncertainty around the Greek elections and a potential further Greek bailout. March and April saw substantially stronger market conditions on the back of the launch of ECB open market purchases in mid-March, but slowed down by mid-April due to a combination of market seasonality around the Easter holiday and the onset of the UK election campaign. The Easter slow-down continued through mid-July due to uncertainty and concern around the Greek negotiations with the ECB and the related default, referendum and Grexit fears. While July as a whole looks like a successful month, it is noteworthy that nearly €8 billion of the total monthly issuance came in a single week – the week commencing July 20, the first date that Greek banks were re-opened. Political and global economic conditions since August, including instability in Chinese markets, have resulted in historically low issuance levels.

European high-yield bond issuance

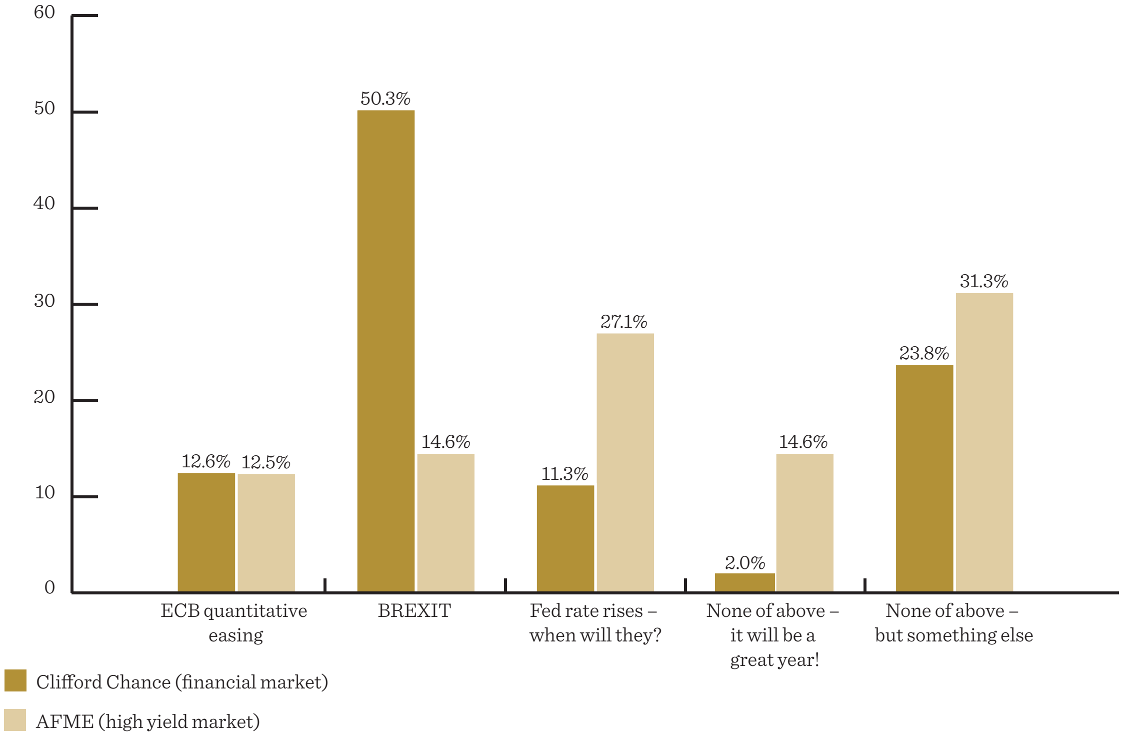


ISSUANCE DATA S&P CAPITAL IQ LCD/KEY EVENTS – CLIFFORD CHANCE

Conditions in 2016 are expected to remain uncertain with an expectation that political and related developments will continue to drive the availability of capital. Our survey revealed some very interesting results, which illustrate how quickly events develop and sentiment changes. The participants at the AFME Conference on 21 October 2015 were more optimistic with nearly 30% of the participants hopeful that 2016 would prove to be a good year for European High Yield.

The audience consensus at the Clifford Chance Perspectives Series seminars on 10 and 11 November 2015 was more muted with half of the audience concerned about the UK's role in the EU and potential Brexit (it being noted that the AFME poll occurred prior to US economic developments and subsequent US Federal Reserve Bank announcements addressing Federal monetary policy which explains, in part, the differential in voting in respect of the "Fed rate rise" alternative). Perhaps most interestingly of all, is the "Black Swan" option – an unknown or unidentified development that will have the greatest impact. Nearly a quarter of participants selected this option. A concern that was realised just days after the Clifford Chance poll was taken, with the terrorist atrocities in Paris.

What macro factors do you believe will have the greatest impact on the European financial market/high yield market in 2016



A European capital market did not really exist prior to the introduction of the euro. Before that, markets were regional and domestic with individual country and currency specific markets providing only a modest level of capital. The UK remains a less liquid market in the best of times and despite a recent flurry in Sterling, denominated issues taking advantage of a market window before the certainty around Brexit, 2016 is expected to be a challenging year.

European Capital Markets Union cannot exist without the European Union itself or Economic and Monetary Union and unless the stability of these unions are secured, efforts around CMU will not succeed. In any event, political uncertainty is likely to remain the key driver of the capital markets, in Europe and globally.

Conclusion

Faced with significant political and economic challenges, Europe is clearly not standing still. On a few occasions it has managed to demonstrate unexpected unity in the face of considerable threats, for example in its imposition of sanctions on Russia. In other areas it has managed to seemingly just about avoid – or at the very least postpone – very negative events such as Grexit. The migration crisis has not so far been met with an effective European response and continues to put enormous pressure on its ability to act collectively.

In the fields of its Economic, Monetary, banking and Capital Markets Unions, Europe continues to take steps to strengthen its ability to trade across its borders, increase access to finance and resolve failing institutions without also triggering a sovereign debt crisis. As it faces British attempts to renegotiate its relationship with the EU, the impact of those areas on the UK and the whole of the EU will be crucial.

The two main messages from our poll were that people expect 2016 to hold entirely new risks, and that confidence in the EU's ability to meet them is low. So far, the EU has just about managed.

Note on audience poll figures

- The audience live-polling figures included in this piece are not intended to be representative of wider market sentiment.
- They can however be taken as an indication of market sentiment at the time of the vote, as expressed by the individuals who chose to attend these events.
- The figures have been combined from voting which took place at two events in London on 10 and 11 November 2015. 86 people attended the event in Canary Wharf, and 72 people attended the event in the City. We have combined those results. Each person was given an electronic voting key-pad and asked to choose from pre-selected options.
- In addition, polls were taken at the AFME 10th Annual European High Yield Conference on 21 October 2015. The Conference was attended by more than 200 high yield market participants, with 38 and 42 delegates participating in the voting on the referenced polls, respectively (see results on pages 10 and 12).
- The audience consisted largely of individuals working in or in relation to financial services, whether at financial service providers and institutions, regulators, policy makers and other interested parties.

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*Linda Widyati and Partners in association with Clifford Chance.

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