Yves Mersch: For a European capital markets union – securing stability, overcoming fragmentation

Closing keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Zeit Konferenz "Banken & Wirtschaft", Chamber of Commerce and Industry, Frankfurt am Main, 10 September 2014.

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Dr Esser (Managing Director, ZEIT Verlagsgruppe),

Dr Raettig (Vice-President, Chamber of Commerce and Industry, Frankfurt am Main),

Ladies and Gentlemen,

I would first like to thank you for inviting me to deliver the closing speech of this high-calibre conference.

I would do an injustice to the participants in the previous two panel discussions if I attempted to sum up the day's deliberations. Instead, I'd like to conclude by linking together financial market policy, which has already been discussed at length today, our monetary policy and the overall functioning of Europe's Economic and Monetary Union.

A common currency in a union of states such as the European Union can only work in the long term if financial market policy, economic policy and fiscal policy interact at European level and in the Member States within the framework of common rules. In this way, the independent central bank is given the opportunity to fulfil its monetary policy mandate. Unfortunately we are quite some distance from this ideal condition.

The crisis has shown us just how much the various policies affect each other. It has shown how easily bad budgetary management, excesses in the financial markets and a steady loss of competitiveness can reinforce each other.

I am convinced that Europe has understood this. But I'm not sure if it is ready to draw all necessary conclusions.

Without doubt, some changes for the better have taken place since the beginning of the crisis: most of the Member States and in particular the programme countries have made significant efforts to put their budgets in order and improve their competitiveness. With the banking union we are now taking a decisive step at European level. It will increase the stability of the banking system in the euro area and protect taxpayers in the future more effectively against expensive bank bailouts by linking risk and liability more closely.

However, the economic recovery is still some way off: in the last quarter, the economy stagnated in the euro area. Unemployment is still at 11.5%. Prices in August rose by only 0.3%, but inflation expectations are anchored.

All in all, these figures should give us cause for concern. They point out that Europe is still not out of danger. The patient is in a sense still poorly and unfortunately relapses cannot be ruled out.

Financial market policy, fiscal policy and economic policy are still insufficiently harmonised, because all too often the political courage is lacking to push through the necessary but sometimes unpopular measures in the face of resistance. I am convinced that this is an important reason for the current economic weakness. As a result, the ECB's monetary policy cannot optimally fulfil its mandate. To change this, we need to further improve the functioning of Economic and Monetary Union. In other words, we need to draw the right conclusions from the crisis.

All three policies mentioned – financial market policy, fiscal policy and economic policy – are essential to this process. Ambitious structural reforms are just as important as good housekeeping. But as we are talking about financial market policy today, I want to focus on the completion of Europe's internal market for capital. We should not stop at the banking union. It is an important step. But the current situation in the euro area demands that we consider even more seriously how financing channels, especially for small and medium-sized enterprises, may be opened up beyond the banking system. This would also benefit the implementation of our monetary policy. That's why today I wish to speak out in favour of developing the banking union into a comprehensive capital markets union.

Monetary policy in times of uncertainty and fragmentation

A capital markets union would be an important step towards a better allocation of capital in the euro area and thus towards higher growth and employment in Europe. To understand how such a move could support the recovery in the euro area, it is advisable, however, to begin by considering our own monetary policy.

The current economic climate is unquestionably making monetary policy action very difficult. Low growth, high unemployment and very low inflation rates call for a very accommodative monetary policy in order to ensure price stability over the medium term. The ECB has been meeting this demand for quite some time.

I understand why investors in this country, mindful of their savings accounts, are viewing this policy critically. But it is true for savers as well that too low an inflation level for too long would hold back economic development in the euro area and thus the return on savings.

In addition, the Treaty requires the ECB to maintain price stability in the euro area – and this applies in both directions: the people of the euro area should be protected against any spurt in inflation and against deflation.

Over ten years ago the ECB defined price stability as an annual inflation rate of below, but close to, 2% in the medium term. For this year, however, we can expect price increases of only 0.6%, for 2015 only 1.1% and for 2016 only 1.4%. This clearly shows why our current very accommodative monetary policy stance is not only economically appropriate, but also a necessary measure to fulfil our treaty obligation. The Governing Council is unanimous on this point.

At the heart of this accommodative strategy is undoubtedly the fact that the ECB has steadily cut the interest rate on the main refinancing operations to its lowest possible point in recent years. However, the still existing functional deficits of the financial markets are hindering an optimal transmission of the monetary policy signals coming from this very low interest rate. Small and medium-sized enterprises in particular still aren't feeling enough of the monetary policy accommodation. We call this an impaired transmission mechanism.

That's why the Governing Council unanimously adopted in June a series of measures which will improve the transmission of our monetary policy: first, we decided to continue to conduct our main refinancing operations as fixed-rate tender procedures with full allotment for as long as necessary, and at least until December 2016. Banks will therefore receive as much liquidity as they need as long as they can offer adequate collateral. Second, we have reduced the interest rate on the deposit facility to below zero for the first time and cut it further last week.

By the way, this is not to punish the banks, as I have often read. Rather, we are giving them an incentive not to park liquidity at the central bank, but to pass it on in a productive way to the real economy. In an environment in which it is already difficult for businesses to gain access to capital for their own investments, it is important that banks also provide sufficient funds for profitable projects.

Third, we have decided, within a framework of eight targeted longer-term refinancing operations, to make available long-term liquidity to banks for a period up to 2018 – in proportion to their credit volume relative to the real economy. Thus, banks are encouraged to lend to enterprises in the euro area. At the same time, the uncertainty about the liquidity situation of banks is reduced, so that banks can increasingly lend each other money again, even across the borders of the Member States.

The focus of this instrument on the real economy is particularly illustrated by the fact that not only in the first step is the existing loan portfolio crucial for the allocation of liquidity, but also in the second step the trend over the period of the transaction will be considered. Thus, banks are required to expand further their lending to business and households in the coming months and years.

To reinforce these measures, the Governing Council decided last week to start purchasing asset-backed securities (ABS) as well as covered bonds, such as *Pfandbriefe*, in October. The details of these two programmes will be announced after the Council meeting in early October.

The decision to start buying ABS is the first result of intensive preparations that are still ongoing. For me it is clear that these measures are aimed at the monetary policy transmission channel. They should not be equated with a broad programme of quantitative easing (QE), nor with overtures to it.

Moreover, the economic logic of the Anglo-Saxon QE programmes cannot be applied one to one to a bank-financed economic system like that of the euro area. Also, QE effectiveness would be questionable in the light of the eroded yields of marketable securities. The surge in the markets for interest-bearing securities would also strain the soundness of our balance sheet, should we make large-scale purchases in such an environment. And it goes almost without saying that the purchase of government bonds would raise considerable institutional, instrumental and legal issues.

Although some are apparently pushing in this direction, this option would only be considered on two conditions:

1. if prices stay at their current very low level for too long, and
2. strict compliance with our monetary policy mandate.

But back to the market for ABS. We have been looking at this closely for some time. We believe that it could be an important channel for increased lending to small and medium-sized enterprises.

Because of their size, SMEs cannot generally issue bonds. If banks now get a chance to securitise loans to SMEs, and to sell them to other investors, a major obstacle to long-term lending to these enterprises is removed, namely the risk of non-payment and the low liquidity of these loans in difficult times.

A functioning ABS market can therefore make an important contribution to ensuring that our monetary policy has an impact right across the real economy.

This brings me back to my initial hypothesis – namely that monetary policy in the euro area may work better if other policy areas play their part. Because the dynamics of the ABS market are significantly influenced by the regulatory framework. And there is still work to be done here.

Let me say quite clearly: no one wants to have the complex, opaque products of the pre-crisis years. Also, repackagings of the umpteenth tranche of a financial derivative should be things of the past.

No one wants to promote a certain class of product just for its own sake. And securitised sub-prime mortgages in the United States certainly made an inglorious contribution to the emergence of the financial crisis. But the regulatory framework should be appropriate for the actual risk. And in this respect there are significant differences between current and previous securitisations and between the experiences in the US and those in Europe.

Since the start of the 2007–08 financial crisis, the default rates of European ABS were on average between 0.6% and 1.5%. In the US over the same period, they were on average 9.3% to 18.4%. European SME ABS are even further below these default rates, at about 0.1%.

The current rules lump all ABS together and are much too conservative. They effectively question their existence.

Under the current regulatory conditions simple, transparent ABS built on real assets face almost as many problems as much more complex financial products. The ECB has therefore, in cooperation with the Bank of England, made a number of proposals for a better functioning securitisation market in the European Union. That this approach has been welcomed in principle by the governments of the Member States is shown by the joint working paper of the finance ministries in Berlin and Paris.

The proposals are derived in part from the quality and transparency demands that the central banks place on ABS, which can be deposited as collateral in monetary policy operations. And because we, as a central bank, have to protect our balance sheet, these demands have always been very high. The ABS market is therefore a good example of how financial market policy can benefit our monetary policy and can also contribute to the recovery in the euro area. Thus, two goals of good financial market policy in the European context can be named: it should be growth-friendly and it should support a successful implementation of monetary policy. There is, of course, a third goal, which goes back to before the financial crisis: maintaining financial stability and mitigating systemic risks.

From the banking union to the capital markets union

For the banking sector, this triad has been understood and implemented to a large extent, although some work still remains to be done. The banking union with the Single Supervisory Mechanism at the ECB is a milestone in the history of European integration. Our comprehensive balance sheet valuation and our stress test will bring about greater transparency and a healthier banking system in the euro area. The Single Resolution Mechanism (SRM) will play its part too. It will lessen the risk that taxpayers in future will have to foot the bill to rescue banks in trouble. In addition, it will continue to tackle the fragmentation by sustainably reducing the interdependence of banks and governments.

At the same time, with the Single Supervisory Mechanism under construction, it's becoming clear that the banking union is not a system closed in on itself. Rather, Europe's banking supervision is also dependent on standards in other areas that are as uniform and transparent as possible. Some of you may be aware of the discussion about the definition of so-called "bad loans" in the context of the comprehensive assessment. Banking supervision, which has to work permanently with 18 different national regulatory regimes is neither particularly efficient, nor can it achieve the goal of comparable cross-border bank balance sheets in the long run.

Thus, in the banking sector the question arises of how far we need to think in future beyond the banking union in order to achieve a functioning internal market for financial services. To answer this question, in my opinion three dimensions play a role. The first dimension is the opening of the market itself. In this regard, we have already achieved a great deal within the EU. The second dimension is the introduction of common uniform regulatory standards for the internal financial market. The third dimension consists of common institutions which enforce these regulatory standards. How much integration do we need therefore beyond the banking system? For example, isn't it a one-sided approach only to tackle fragmentation in respect of the banking system, and how do we handle the shadow banking system in this context? If banking supervision is becoming European, can payment systems continue to be monitored nationally? How do we manage to give small and medium-sized enterprises access to capital markets beyond the banks, if those markets are fragmented and regulated in a non-uniform way?

All these questions call for a coherent response. In my view, this response could be the further development of the banking union and of the piecemeal regulation of the financial system into a real capital markets union at European Union level.

Financial markets are complex and a capital markets union would affect a large number of different areas. Allow me therefore, in conclusion, to draw attention to three points.

First, we must be certain that a stringent regulation of the banking system does not lead to a shifting of bad risks into the non-banking sectors, without ensuring that they cannot cause systemic damage there. Apart from the fact that the term “shadow banking” is a particularly unfortunate one, I regard transparency as being very important here. At the same time, only those areas should be regulated which can in fact trigger systemic risk. Innovations in the financial sector should not be blocked *per se*.

Second, many financial instruments are not uniformly European and are sometimes insufficiently comparable because of a lack of standards and a lack of transparency. I have already mentioned the problem of ABS. The lack of proper information in this area is a problem for SMEs’ access to credit. Here and in relation to many other financial instruments, regulatory actions can help to support the market. As I also mentioned, the joint paper by the Bank of England and the ECB may provide a good basis here.

Third, in the field of payment systems and securities settlement there are also challenges that a capital markets union must address: despite much progress over the past decade in payment systems, securities settlement in the euro area remains fragmented, inefficient and not very customer-friendly. This is not just a problem for smaller businesses, for whom adapting to different conditions in the Member States often entails high costs, but also for the integration and functioning of the internal market as a whole. Possible solutions include harmonised European market infrastructures for retail and large-value payment systems and the processing of securities transactions, as well as a coordinated and more harmonised monitoring of critical market infrastructures. In all these areas, in which the Eurosystem is competent, relevant initiatives were launched several years ago and have already made significant progress. In retail payments, for example, since August 2014 there has been no distinction between national credit transfers and direct debits of businesses and individuals, and cross-border ones. This, and the fact that the IBAN has become a part of our daily lives, shows how far we have progressed in the field of retail payments. The Single Euro Payments Area, SEPA, is an important European integration project from which all businesses and individuals in Europe benefit directly.

A comparable degree of integration would be also desirable for card payments, so that they are not discriminated against by virtual border posts within Europe. In the long term, there should be no “roaming charges” for European payments.

Progress has been made, but many challenges remain before the euro area can become a “single euro payment and settlement space”. These include barriers that result from differences in market practices and standards as well as tax, accounting and legal systems in the Member States. The removal of these barriers lies outside the competence of the Eurosystem. Other players must also take steps to make the capital markets union a reality.

These are just three examples, but a genuine capital markets union could go much further, of course. Differences in all these areas nurture fragmentation and could be addressed within the capital markets union project. In addition, there is also the question of the actors which could play a part. What functions could be performed, for instance, by the European supervisory authorities EBA, ESMA and EIOPA, whose activities and tasks are currently being checked in Brussels? And not least, we must identify the areas in which the EU can take the initiative and those in which the Member States can be active.

I am very aware that these ambitious proposals cannot be implemented overnight. But the fact that the future President of the European Commission has already taken up the idea makes me optimistic. The challenge in the coming months will be to create a political awareness of the enormous economic importance of this highly technical area.

Ladies and Gentlemen,

Late last year, Helmut Schmidt, the publisher of *Die Zeit* and former German Chancellor, said that it's not written in any Bible that the European Union will last until the end of the 21th century in its present form. It was an expression of concern, but he hoped that he would be wrong.

This logic also works the other way around: because the global environment in which we operate has changed radically and because Europe is today facing quite different challenges on the world's markets than it did 20 or 30 years ago, the Union also has to steadily adapt. It is good that *Die Zeit* has today brought us together here, in the spirit of Helmut Schmidt, to discuss these developments in financial market policy. And I am convinced that the capital markets union could play an important part in making Europe fit for the global challenges that the former Chancellor has been analysing for many years.

Thank you for your attention.