Yves Mersch: Capital markets union – the "why" and the "how"

Dinner speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the joint EIB-IMF high-level workshop, Brussels, 22 October 2014.

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Dear Mr Tănăsescu (Mihai Tănăsescu, Board Member of the EIB),

Ladies and Gentlemen,

In four days' time, the European Central Bank (ECB) will disclose the results of its comprehensive assessment of banks' balance sheets – what we have called a financial health check. This will mark the end of a tremendous effort by both banks and supervisors. Around 6,000 experts have been working full-time over the past twelve months to review the balance sheets of 130 banks in the euro area and Lithuania. Together, these banks represent roughly 85% of total bank assets in the euro area.

One reason you are here tonight may be not only the dinner but also that you would like me to let you in on the secret of the numbers we will publish at noon on Sunday.

I am afraid I have to keep you on the edge of your seats for four more days. Before we can disclose the outcome, we have to give banks the opportunity to review their results and prepare for publication. That review period will start tomorrow.

What we already know is that the banks that will fall under our direct supervision have strengthened their balance sheets by almost €203bn since the summer of 2013. This includes €59.8bn of gross equity issuance, €31.6bn issuance of contingent convertible bonds (CoCos), €26bn of retained earnings, €18.3bn of asset sales, €17.6bn of one-off items and additional provisioning and about €50bn of other measures.

These numbers show that even before the results are announced, the comprehensive assessment is delivering on its objective of repairing and strengthening banks' balance sheets as the ECB takes on its new supervisory responsibilities.

But tonight, I would like to look beyond Sunday to the bigger picture surrounding the comprehensive assessment. What some perceive as a burdensome exercise, analysing very technical aspects of bank balance sheets, is in reality a display of the ambition to create a more integrated financial market in Europe.

The comprehensive assessment is an important prerequisite and foundation for the Single Supervisory Mechanism (SSM), which will start operating on 4 November. Together, they constitute a sea change in Europe's banking markets. For the first time, common legislation and rules will be applied by a single authority, strongly increasing transparency and banks' comparability across countries.

But we must recognise that we have not reached the end of the journey. A single supervisor can more easily ensure comparability where there are single rules. Remember the discussion about the different national definitions of non-performing loans in the context of the asset quality review. This is a telling example that the singleness of Europe's financial market is still challenged by piecemeal national rules and standards.

In addition to banking supervision, there is a second area where fragmentation of Europe's financial market remains a stumbling block. Seven years after the first shock waves of the financial crisis and two years after the sovereign debt crisis in the euro area, economic recovery is still some way off: euro area real GDP remained unchanged between the first and second quarters of this year. Unemployment is still at 11.5%. Prices in September rose by only 0.3% – and measures of inflation expectations have gone down.

To restart growth, we must open financing channels, especially for small and medium-sized enterprises (SMEs). And this can best happen when financial markets are fully integrated.

In the light of these various concerns, the aspiration to complete the single financial market has returned to the top of the agenda – and quite rightly so. The latest focus for this discussion is the creation of a European capital markets union.

Why a capital markets union?

Expectations for the project of a capital markets union are high. But to date, there is no common understanding of what it means or what it should look like. For the financial industry, it means new business opportunities; for financial stability experts, it means better control of shadow banking; and for entrepreneurs, it means better access to funding sources.

As central banker, I would stress another major advantage of more integrated financial markets in the euro area: it would greatly facilitate the implementation of the ECB's monetary policy.

We are clearly at the beginning of the discussion of a capital markets union. But I believe that a broad public discussion is exactly what we need to generate ideas and start the opinion-forming process. I therefore welcome the fact that Lord Hill has announced his intention to consult a broad range of stakeholders and conduct analyses before presenting more concrete proposals. I too do not have a ready-made blueprint in my bottom drawer.

It is time to spell out more clearly what we want and what we do not need, what we can achieve and what we should not attempt. This way we can prevent the capital markets union from becoming a 'Jack of all trades, master of none'.

In my view, the various motivations for a capital markets union can be summarised under two main objectives:

On the one hand, we need to find ways to generate growth. In a way, the euro area economy is like a plane flying on only one engine: bank financing. To increase the speed and stability of the plane, it would be good to add a second engine: capital market financing. Hence, we must seek to deepen capital markets so that they can play a more important role in supporting the real economy. And we must name areas where removing frictions between national markets can bring new business.

On the other hand, we need to ensure financial stability in the longer term. An impressive amount of regulation has been introduced since the crisis began, tackling several fundamental problems in our regulatory set-up. Indeed, the crisis showed that our initial rules were in some areas too lax and too heterogeneous across countries to ensure the stability and singleness of Europe's financial market. At the same time, we should avoid excesses: more regulation does not always mean more stability.

In many instances, the two objectives of growth and financial stability complement each other. I believe that greater integration of markets can be key to both. Fifteen years after the financial services action plan, it is time for another big step forward for Europe's single financial market.

How to implement a capital markets union?

So what measures do we need to take to achieve these objectives? To my mind, a comprehensive capital markets union requires thinking along three dimensions.

The first is the opening of the market itself: in this regard, we have already achieved a great deal within the EU. The second is the introduction of common regulatory standards. And the third consists of the institutional structures that enforce these regulatory standards.

I will elaborate on the second dimension and also make some remarks on the third dimension.

Regulatory dimension

Let me first address the regulatory dimension. Financial markets are complex systems with many different players, products, infrastructures and currencies. As a consequence, financial markets are at the intersection of many different fields of legal rules, including contract law, corporate governance, capital requirements, insolvency, taxation and consumer protection.

To ensure that a single financial market delivers growth and stability, all of these fields need to be taken into account. Let me illustrate this for the financial market segment that is the focus of this high-level workshop. To revive the securitisation market and to ensure its stability, there are three regulatory fields where I believe that action is necessary: ABS regulation; insolvency law; and payment and settlement systems. Let me discuss each in turn.

ABS regulation

The first key challenge for the securitisation market is the lack of standardisation at the European level and the heavy capital charges for an asset class that have been set internationally. Take the ABS market, which we have been looking closely at for some time. We believe that it could be an important channel for increased lending to SMEs.

Because of their size, SMEs generally cannot issue bonds. In addition, the risk of non-payment and the low liquidity of loans to SMEs in difficult times are major hurdles for SMEs to get financing, even through the banking channel. In this regard, securitisation can help to connect SME financing needs with the funds of bank and non-bank investors. It can do so by assisting banks' ability to fund and distribute risk. Here we believe that having a consistent approach to securitisation underpinning various pieces of legislation is key to attracting a broader investor base and to de-stigmatising European securitisations.

Let me say clearly: no one wants to have the complex, opaque products of the pre-crisis years. Repackaging the umpteenth tranche of a financial derivative should be a thing of the past. 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 US and European experiences.

Since the start of the 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%. It makes little sense to calibrate the international rules solely on the basis of US experiences. It would be like calibrating the price of flood insurance for Madrid on the experience of New Orleans.

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 constraints 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 European securitisation market. We have received positive responses from the Commission and the Member States.

The proposals are derived in part from the quality and transparency requirements that central banks place on ABS, which can be deposited as collateral in monetary policy operations. And as a central bank, our demands have always been very high.

Let me add, that in this regard, the ABS market is a good example of how a capital markets union can also benefit our monetary policy, besides generating growth and promoting financial stability.

Insolvency law

The second regulatory obstacle for a single market for securitised products is the heterogeneity of insolvency rules across the EU. This applies to both financial and non-financial companies. The Council Regulation on cross-border insolvency proceedings establishes a common framework of basic rules regarding the competent courts, the applicable law and the recognition of court decisions. But within this framework, national laws differ substantially in how far they protect the different stakeholders in insolvency.

For example, the rights of preferential creditors differ substantially in some cases. Different prescriptions on the filing and verification of claims can also cause frictions. Heterogeneity becomes all the more important in dealing with the insolvency of multi-national enterprise groups. All in all, the heterogeneity of insolvency rules complicates the creation of homogenous asset pools and therefore the securitisation process. The Commission proposal to review the Regulation on cross-border insolvency makes suggestions how to improve this situation in the right direction.

Payment and settlement systems

The third regulatory challenge for the securitisation market is the field of payment systems and securities settlement. Despite much progress over the past decade, securities settlement in the euro area remains fragmented, inefficient and not very customer-friendly. This is not just a problem for smaller businesses, for which adapting to different conditions in the Member States often entails high costs, but also for the integration and functioning of the single market as a whole. A striking comparison is often made with the US, an economic area of comparable size: settling a cross-border securities transaction in Europe has been estimated to cost at least ten times as much as in the US!

This issue can be solved by establishing European market infrastructures for 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.

For example, Target2Securities is the Eurosystem's response to the high fragmentation that characterises the infrastructure supporting capital markets in Europe. T2S will be a new IT platform performing the real-time settlement of securities transactions against central bank money across European borders. T2S will settle all securities, both debt securities and equities. The T2S platform is now fully developed. This year is reserved for testing and it is set to go live in June 2015. This will be a major event with a strong impact on the financial services industry in Europe.

All of this applies fully to ABS markets. Their settlement infrastructure will become more integrated and overcome obstacles that have so far hindered cross-border trade.

The standardisation of ABS, further harmonisation of insolvency laws and the integration of settlement systems are three illustrations from the securitisation market showing how the regulatory dimension of a capital markets union can achieve progress by accelerating existing initiatives and launching additional ones.

More generally, the regulatory dimension implies both a deepening and broadening of the single rulebook. Deepening means that prudential rules should converge further where undue carve outs remain. Broadening means that the single rulebook should be expanded to other areas that affect the single financial market.

Institutional dimension

Beyond the regulatory dimension of a capital markets union, there are a number of institutional questions related to consistency across market segments, multi-level governance, actors and geographical scope.

As regards consistency, we need to ask ourselves: how much integration do we need beyond the banking system? If banking supervision is becoming European, can payment systems continue to be monitored nationally? What about new technologies? Do we wait until they are established in the old national frameworks before we try to negotiate mutual acceptance, or harmonisation, or should we foster creativity and efficiency by offering from the outset a Europe-wide single framework?

As regards multi-level governance, we must identify the areas in which the EU can take the initiative and those in which the Member States can be active. Can we rely on directives with national leeway in their implementation or do we need to make use of Regulations that are directly applicable?

As regards actors, there is the question of where we should rely on decentralised application of common rules and where we need institutions at EU level to implement common rules? What functions could be performed, for example, by the European supervisory authorities, whose activities and tasks are currently being reviewed in Brussels?

As regards geographical scope, it is important that we strive to make the capital markets union a project of the EU28 to reinforce the single financial market as a whole. Nevertheless, it is clear that the euro area has a particular interest in increased financial integration to pave the road towards a genuine monetary and economic union.

Conclusions

Let me conclude. Some may argue that the capital markets union is old wine in new bottles. I disagree. What is old are the problems that we need to overcome. But for that we need new measures that we have not previously been able to implement – either because of a lack of political will or because of an insufficiently clear plan on how to implement them. Art. 114 of the TFEU gives a clear mandate for this purpose.

The capital markets union is not so much about a couple of high-profile actions but more about a larger series of less visible initiatives. And that is why we need the capital markets union as connector and label. To operate with this term will help to raise awareness, to define overall objectives, to prioritise resources and to ensure consistency of the individual measures.

Ladies and gentlemen,

The overall situation of the European economy makes it abundantly clear that we cannot wait for a miracle to end a period of low growth. We are not out of the danger zone. The patient is still fragile and unfortunately relapses cannot be ruled out.

As I have explained, a capital markets union can provide very important impulses for both economic recovery and financial stability. I am aware that some of the proposals are ambitious and cannot be implemented overnight. But the fact that the incoming President of the European Commission has already taken up the idea makes me optimistic. The challenge in the coming months will be to create greater political awareness of the enormous importance of this highly technical area for Europe’s economy.

At the same time, I want to point out that a capital markets union cannot be our only area of action. Financial policy, fiscal policy and economic policy are all equally important to keep the recovery on track. Governance of the euro area can be thought of like the gearbox of a car. The cogs do not all need to be of equal size but they all need to be moving in the same direction. If only one cog starts going the wrong way, the whole car grinds to a halt. Non-respect of agreed rules by some is clearly establishing moral hazard risks for the actions of others.

Many things in the euro area need to come together to create an environment in which businesses and entrepreneurs can generate added value. Ernest Solvay, after whom the library in which the workshop will take place tomorrow is named, provides us with a good example. In the early 1860s, he had a brilliant idea for the industrial production of sodium carbonate. But it took the perseverance of several financiers and ten years before the process was ready to be used on an industrial scale. And Solvay relied on a patent to protect the intellectual property that ultimately formed the basis of his corporate success.

Over 150 years later, a capital markets union can help the Ernest Solvays of today. It can enable all Europe's entrepreneurs to obtain the financing they need to turn their innovative ideas into successful businesses that will create jobs and promote sustained prosperity.

Thank you for your attention.