

Jon Cunliffe: Financial stability, the single market and Capital Markets Union

Speech by Sir Jon Cunliffe, Deputy Governor for Financial Stability of the Bank of England, at the City of London Corporation and Open Europe conference, London, 20 January 2015.

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The Treaty of Rome, signed in 1957, established the basic four freedoms of what has now become the European Union – freedom of goods, services, people and capital. I want to talk a little today about the last of these and about the development of the single market in financial services – its history, how it has dealt with the twin objectives of stability and openness and its future development, particularly the capital markets union.

The freedom of capital movement agreed in 1957 was for many years only an aspiration. In that post war world, free movement of capital must have seemed a dream. To many, with not so distant memories of the inter war years, of the collapse of an earlier period of financial globalisation and with continuous strain on the balance of payments, it might have seemed a bad dream. The risks to economic and financial stability may well have seemed too great to allow open capital markets. Open capital markets have, through history tossed and turned between being seen as an opportunity for additional trade and growth, and a potentially destabilising force.

The path to open capital markets in Europe was slow – as it was in the rest of the world. It was not fully completed until the Maastricht Treaty of 1992 when free movement of capital became a directly applicable Treaty right. And throughout this process, in recognition of the potentially destabilising effect, safeguards were included to allow member states to defend their stability, including in relation to prudential supervision.

The real push for free movement of capital came in the mid 80's when European growth was sluggish, especially compared to the US and Japan. There was a search for policies to generate economic dynamism, which led to the birth of the single market. But, of course, until capital could flow freely between member states it was not really possible to have a single market in financial services or, in the financial sector, to give effect to that other founding freedom – the freedom to provide services across the EU.

The liberalisation of capital markets in the EU was rooted in two beliefs. First and foremost that open capital markets, cross border investment and cross border financial services would create a more efficient allocation of capital through better intermediation between savers and borrowers across the EU as a whole. And, second, that the risks to economic and financial stability of an open capital account and cross border financial services could be managed by sound economic and financial policies to prevent destabilising volatility of capital flows and by good financial services regulation at the EU level.

In the EU, the regulatory framework for openness and for managing the financial stability risk around the single market in financial services was built very clearly on the principles of common rules – with force of law – commonly applied and on mutual recognition. It is worth dwelling a little on what lies behind these principles.

First is the need for the so-called 'level playing field'. To have an effective single market it is necessary to align regulation to ensure that it does not act to prevent cross-border activity or to distort competition. In this respect it is worth recalling that the Treaty talks of the "approximation" of laws and of "harmonisation". Without common rules, commonly applied, national regulation can be used to block entry and to protect national players. And, equally, it can be used to give domestic players an advantage in their cross border activities.

This is, of course, important in other areas of the single market. But it is particularly important in the single market for financial services because the risks of regulatory arbitrage are very

large and have consequences that go wider than the distortion of competition. We have seen in recent years how damaging those consequences can be in terms of financial stability. To be confident of maintaining financial stability in a single market with free movement of capital, each member state needs to be confident in the strength and in the application of prudential regulation in other member states.

This is especially important for the UK, which has the largest most internationally active and most complex financial sector in the EU. We are host to more foreign institutions than any other member state. As the Bank of England Deputy Governor with specific responsibility for Financial Stability, I can say that it is crucial that the single market for financial services is supported by a framework of common prudential rules that are fit for purpose and that are consistently applied. This is intrinsic to the ability of the Bank to deliver financial stability in the UK. The importance of this has been very powerfully and painfully underscored by the experience of recent years.

Of course, this is true internationally, outside of the EU as well as inside. One of the clear lessons of the crisis is that we did not have strong enough global standards on prudential regulation to support the integration that had taken place in international capital markets and financial services. It is not my subject for today, but there has been a sea change since the crisis with a massive international reform programme to develop and implement prudential standards and regulatory co-operation.

At the same time, however, we must not forget that while there can be very material spillover costs to other countries when things go badly wrong, the buck at the very end stops at the national level. We have strengthened the resilience of the financial system. We have made great progress towards ending “too big to fail” and towards ensuring that the risks taken by financial sector firms are truly borne by their shareholders and creditors and not by taxpayers. The EU and international reforms in progress mean that financial firms are much less likely to fail and, if and when they do, the real economy is much less likely to suffer the collapse of the critical economic functions that the financial system provides.

We need EU rules to enable and support the single market in financial services. And, though they are not as effective as a framework for open capital markets because they do not have force of law, we need global prudential standards properly and consistently applied to support a global capital market. We need the rules and standards and cooperation between regulators to prevent adverse spillovers between countries and to manage them if they occur. But we should be clear that while we have reduced the risks and consequences, were we to see a major system wide shock that led to a systemic crisis, it is only governments and national authorities that can ultimately provide the confidence to ensure there is not systemic failure. In the EU context, it is worth noting that there is only a fleeting reference in the Treaties to financial stability; it is the references and powers relating to the single market that have been the basis for the EU rules on prudential regulation.

To be clear. The point here is not that there is some irreconcilable conflict between the rules of the single market and financial stability. They can and generally do reinforce each other. As I have said, it is important to financial stability in general – and the UK’s financial stability in particular – that the single market is supported by strong prudential rules that have force of law. The point is rather that the ultimate responsibility for financial stability – with one major exception to which I will return – lies with the governments, supervisors, central banks – who are accountable to national legislatures.

To a large extent this necessary balance between the rules for the single market and financial stability is automatically achieved by the fact that the rules themselves have to be negotiated and agreed between the authorities of member states. But given the very different circumstances and risks faced by different member states, it is also important that the rules allow sufficient flexibility to recognise national financial stability responsibilities. And that they are applied by national authorities that have responsibility for financial stability. For the UK, stability depends on the working together of EU rules and well-aligned national authorities.

The important and recent exception, of course, is the euro area that through the creation of the Banking Union – the single supervisor and the single resolution authority – has brought financial stability responsibility to the euro level to sit alongside the monetary stability responsibilities of the ECB. The rationale for this was brutally underlined in the euro crisis. The members of the euro share more than a single market. They share a currency, they share risk of the break up of that currency and they share a lender of last resort. With the creation of the European Stability Mechanism, they have begun to share a common backstop. At that level of integration, it is right to ask to what extent financial stability is ultimately primarily a national responsibility and where the buck should stop. The creation and full implementation of the Banking Union should in my view increase the financial stability of the currency union, thereby improving stability for everyone in the EU. It is, however, impossible to ignore the fact that to do so, the Banking Union must continue to develop the necessary backstops – painful though that may sometimes be. There are agreed plans to move further in this direction. It is important that they are implemented.

To return to the history for a moment, one sees the need to find a balance between the single market and financial stability in the way in which Europe ultimately came to free movement of capital, with strong Treaty prohibitions on restrictions but within that – and within constraints – a recognition of the need for member states to be able to take the necessary action to defend stability including in relation to prudential supervision.

We have moved on a great deal since then in the EU and in our understanding of the benefit of open capital markets and how to manage the risk. We have learned some very painful lessons. But I think we continue to see that balance in the EU's recent major reform of the regulatory framework that underpins the single market in financial services. I will give three examples.

First, CRD4, the EU's prudential capital standard for banks, includes a number of important areas in which member states' prudential authorities can act to increase the capital of the banks for which they are responsible to deal with specific risks they face at the national level. The negotiations around this were not easy. But it was particularly important for the Bank of England which, through the Financial Policy Committee, is the UK's macroprudential authority to have this flexibility to raise capital above the levels in the EU rules to address risks to UK financial stability. I would highlight two other points from CRD4. First, the legislation also provides that when national authorities take action of this sort within their jurisdiction, it is reciprocated, with regard to that jurisdiction, by the authorities of other member states. Second, there are proportionate protections in the legislation to ensure these flexibilities are used truly for prudential purposes and not abused by member states.

Second, the recently agreed Bank Recovery and Resolution Directive (BRRD), which sets common EU rules including on state support for banks in resolution but allows for national flexibility in their application, aligned to national insolvency regimes, by national resolution authorities or in the Banking Union's case, the new Single Resolution Board. Like CRD4, the BRRD reinforces financial stability by ensuring that the actions of national resolution authorities are recognised in other member states.

I would single out another aspect of the BRRD. It follows the international standard for resolution developed by the Financial Stability Board – the “Key Attributes of Effective Resolution Regimes for Financial Institutions”. There is a more general point here. The EU capital market and financial sector exists in a globally integrated market. It is in our economic interest for the EU to be as integrated as possible with that global market. As I have said, that market needs to be supported by properly implemented international standards. The EU and its member states need to play an active role in shaping those standards. And once international standards have been agreed, it is in the EU's interest that it implements them – as in the BRRD.

This is of crucial importance to the UK and to the UK's financial stability. The UK is the home to financial firms and infrastructure that are truly global in their reach and activity. While much

of this activity involves the EU, a very large amount does not. If EU regulation and internationally agreed standards diverge materially, it will both create barriers to that activity and opportunities for regulatory arbitrage making it more difficult to ensure UK financial stability.

My third example is the European Supervisory Authorities – the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA). These were established to provide more detailed common rule making so that the EU Single Market in financial services could be supported by a common rule-book underneath the framework of high-level legislation. This search for more detailed alignment of regulation and standards has I think been a general feature of the post crisis reforms in the EU and more widely. The ESAs are governed by their boards, comprising national supervisory authorities, which are also responsible for the majority of their financing. They set and advise the Commission on the rules and standards – they do not engage directly in the prudential supervision of firms.

The European Supervisory Authorities perform another important function. I have talked about common rules, commonly applied. There are of course enforcement mechanisms in the Treaties to ensure member States properly observe the EU legislation. But the need for this in financial services has been especially recognised with the ESAs having the capability to conduct peer reviews and for binding arbitration when one national authority believes another has not properly implemented or applied the rules. This is a powerful mechanism to prevent regulatory arbitrage and the risk of adverse spillovers between member states. It is one that does not generally exist elsewhere within the single market.

There are other examples. The general point however is that it is possible to find where necessary the balance between financial stability and the single market and the EU has, by and large, been able to do so. I hope and expect this will continue as we move into the next phase of the development of the single market – what has now become known as the Capital Markets Union and to which I now want to turn.

Capital Markets Union

The motivation to create a single, integrated, capital market in the EU is not new. As I have noted, the potential benefits to economic growth and “dynamism” at a time when growth in Europe was sluggish drove the efforts in the 1980s to liberalise capital accounts and create the single market in financial services. The reforms inspired in the 1990s by the Giovannini report aimed to create an integrated, well-functioning financial market to “help the EU economy by encouraging the right investments to be made in the right places” and so to “contribute to higher economic growth and employment.”

And we should not under-estimate what has been achieved. To take one example, the UCITS regime launched then and refined over the years has enabled the growth of EU investment funds, operating with a passport across member states, with nearly €8 trillion of assets. It has become a gold standard for institutional and retail investors – so much so that it has been adopted by jurisdictions outside the EU.

But for all the progress, market as opposed to bank-based financing is still very undeveloped in the EU compared to the US. We should of course be a little careful about the comparison; the EU is not a federal country but a single market of member states with different histories, cultures and languages. It may not be possible to attain the level of cross-border investment across EU members as exists across US states. But the relative size of market-based financing in the US compared to the EU illustrates graphically the scope in the EU to go much further.

Looked at from the savers perspective, as a percentage of GDP, savings held in EU mutual funds are around 50% of the US level. For pension funds, it's 35%. Looked at from the borrower end, in the EU equity markets are only 60% of their US counterparts, corporate

bond markets 35% and securitisation 20%. As a result, bank loans account for just over 10% of non-financial company borrowing in the US against 30% in the EU. Banking system assets are over 300% of GDP in the EU, against around 70% in the US.

Europe is not short of savings. Far from it. Europe saves €2.7 trillion a year – 20% of EU GDP. In the US by contrast saving is \$2.8 trillion – about 17% of GDP. The question is whether those savings are being used most productively. For example, in the case of households, they remain compartmentalised in member states and predominantly locked up in the banking system, which is still healing. Bank deposits, as a share of household financial assets, are three times the US level. And they are heavily concentrated in financial assets like debt instruments that do not encourage risk capital.

The objectives of Capital Market Union should be threefold. First to put European savings to better use by deepening and diversifying the sources of finance available to business and offering more investment choices and portfolio diversification to savers. As was recognised in the Giovannini report 20 years ago, there is very good reason to believe that improving the efficiency with which savers are matched to borrowers increases economic performance.

The second objective should be to enable greater risk sharing across the EU by creating deeper cross border markets. Cross border investment allows economic risks – upside and downside – to be shared across individual countries. Done in the right way, this can help to smooth out the impact of the economic shocks that hit individual countries – reducing the danger of economies sliding into very deep recessions that can permanently damage their ability to grow. While this smoothing through risk sharing is of benefit to all EU members, as the recent crisis has shown it is particularly important for the euro area given the relative lack of adjustment mechanisms available to individual euro members when they are hit by shocks.

And, the third objective should be to create resilience by ensuring that if the banking system is damaged there is an effective alternative channel of finance to the real economy. It is very probable that one of the reasons the US has recovered faster from its financial crisis than Europe is that in the US banks do not dominate the provision of finance to anything like the same degree as in the EU. When the banking system was damaged in the US, a well-developed alternative existed to help meet the financing needs of the real economy.

To achieve these three objectives, reforms will be needed on both the supply and demand side of the equation.

The supply side of the equation has two dimensions. First, enabling more household and corporate savings to flow to vehicles that will invest in capital markets. And second, encouraging more investors to allocate capital across the borders of EU members – or, to give it its technical name, to reduce “home bias”.

As I have noted, assets under management in Europe outside the banking system are typically around half the size of the US. Creating large pools of market-based private capital is in part about creating the right investment vehicles.

It will also require a more fundamental look at the way Europeans save and the way those savings are invested, including for their pensions which in many member states are concentrated in public sector schemes. In practice, this will mean examining whether there are obstacles and competitive distortions that restrict savings being invested in financial markets; ensuring investors have the information they need including about the landscape of investment options; and reducing any barriers that restrict market access or encourage any home-bias in portfolios. The result of these examinations could well entail greater standardisation of investment products. UCITS could be a model here.

The demand side of the equation involves enabling borrowers to access funds from market-based sources. Creating more diverse forms of borrowings will be part of the story. This could include forms of finance in which investors directly acquire assets, such as equity and

corporate bonds, and indirect forms of finance in which banks and markets work together through securitisation markets to lend to the real economy.

The US example is again useful here. Despite the US having an equity market that is nearly twice as large as that of the EU as a proportion of GDP, the leverage of non-financial companies is only marginally higher in the US than in the EU. The reason is that the companies in the euro area, particularly smaller ones, have equity but issue a much smaller proportion of marketable quoted equities, instead relying heavily on non-marketable, unquoted shares. A more integrated capital market would provide deeper, more liquid equity markets in which a wide range of corporates could issue equity and risks could be shared more widely.

More broadly, areas where reforms could improve borrowers access to market-based financing could include: public platforms, such as, “mini-bond” markets for SMEs, which have enjoyed some success in Italy in particular; pan-European private placement markets which channel funds directly from non-bank investors, such as, insurers and pension funds to mainly medium-sized companies (currently only Germany and France have private placement markets of any notable size) and encouraging the emergence of simple, transparent and robust securitisation markets.¹

Increasing the scale of cross border capital flows across Europe brings benefits. But it is not without risks. One does not have to go back to where I started today – in the late 1950s – to find examples of the power of cross border flows to amplify crises when it all goes wrong. That is why they have to be built on the foundation of sustainable economic policies, good regulation and robust institutional structures.

The nature of capital flows matters too. Europe was not short of cross border flows before the crisis. But they were concentrated in interbank lending and in debt often held by highly leveraged investors. Inter-bank lending can of course be a very dangerous way to share risks between economies, particularly if the banking system is highly leveraged. If losses have to be shared on a large scale this can put the core of the financial system in peril. Corporate bonds and securitised assets can have similar risks, especially if they are effectively held in the banking system. Debt instruments generally can be destabilising if they cannot easily be restructured when losses occur. Equity provides the most efficient form of risk sharing, suggesting perhaps that this area should be a priority for CMU. The nature of investors also matters in ensuring that an increase in cross border market-based financing in the EU does not increase financial stability risks. In general, sources of market-based financing are more likely to be resilient if the investor base is diverse, not excessively reliant on leverage and “sticky”.

It is abundantly clear from all of the above that achieving the necessary step change in market-based financing in the EU means a marathon not a sprint. Although it shares its nomenclature with Banking Union, Capital Markets Union is a very different animal. The former is essentially designed to improve stability of and between the euro members through institutional change and moving major financial stability responsibilities to sit at the euro level alongside monetary stability. It was possible to make these institutional changes relatively quickly, though their implementation will take longer. Capital Markets Union, in contrast, aims to deepen and widen the single market, though it needs to have regard to financial stability. It does not require institutional change. Though there may be early wins, it will involve a carefully planned, detailed and sustained effort over a number of years and in a very wide range of areas. The benefits however could be very large indeed.

¹ For a discussion of possible policy options, see “The case for a better functioning securitisation market in the European Union”, Discussion Paper, May 2014, Bank of England and European Central Bank.