Andreas Dombret: Monetary union, banking union, capital markets union – financial integration in Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the American Chamber of Commerce, Munich, 15 July 2015.

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1. Introduction

Ladies and gentlemen

Thank you very much for your invitation – I am delighted to be able to speak to you today. As some of you may well know, I was born in the United States and still have my US passport alongside my German one. And my international upbringing is one of the reasons why the efforts of the American Chamber of Commerce to promote and foster mutual dialogue are very close to my heart alongside the US and German passports.

The world we live in is truly globalised – countries are no longer islands but parts of a highly interconnected system. And that particularly holds true, of course, for countries which have a common currency. The year 2010 is a case in point. That was the year in which Greece's financial problems tipped the entire euro area into crisis.

2. Greece – an update

And now, five years on, Greece is still hogging the headlines. The new elections called in the country early this year marked the start of marathon negotiations that have been dragging on for more than five months now. When talks stalled a little under three weeks ago and the Greek government called a snap referendum, many thought that Greece's days in the euro area were numbered.

The referendum was followed last week by talks on the prospect of an entirely new assistance programme which early this week produced an agreement in principle. But that's not the end of the story, because negotiations hammering out a third assistance programme cannot get underway before parliaments in a number of countries have been consulted – and one of those countries is Germany. Plus there are a raft of technical issues that need to be addressed.

So although a basic accord has been reached, we should not lose sight of the challenges that lie ahead, especially so for Greece's banks – time really is of the essence here. The imposition of capital controls and bank holidays placed Greek banks in an artificial coma two-and-a-half weeks ago. But in my view, this ersatz stability does not relieve European banking supervisors of their duty to come up with a diagnosis and identify the right course of treatment for the Greek banking system. I see four particularly important questions here.

- What can be said about the health of banks domiciled in a country facing colossal financial challenges?
- What can be said about the health of banks whose balance sheets are awash with debt instruments either issued or guaranteed by their sovereign?
- And what about banks whose capital bases consist, to a very large extent, of deferred tax assets which will only be of value if and when the banks return to profitability and the sovereign is solvent?
- And last but not least: what can be said about the large proportion of non-performing loans saddling the balance sheets of Greek banks, which is more likely to have risen than declined given the bleaker economic outlook for Greece?

Even after Monday's agreement, none of these questions can really be answered with any degree of satisfaction. And if one also considers that Greek banks have been closed for more than two weeks now, it's simply impossible not to doubt their solvency. I share these doubts.

So much for the sobering diagnosis. What, then, is the right course of treatment? I am of the opinion that at least four things need to be done.

> First, any new assistance programme needs to ensure that Greek banks are adequately recapitalised. Estimations suggest a figure of up to €25 billion will be needed. That figure should be our yardstick, but it needs to be underpinned by a rigorous asset quality review. If, contrary to expectations, more capital is needed, there should be scope to top this figure up.
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> Second, an ample supply of liquidity needs to be safeguarded in case depositors plan to withdraw more cash once the recapitalised banks reopen.
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> Third, capital controls need to be gradually lifted over an extended period of time.
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> And fourth, the structure of the Greek banking sector needs to be scrutinised. What I'm getting at is this: are all four of Greece's major banks viable going concerns with a long-term future?

My remark just now about the structure of the banking sector is pertinent, not least, because it was agreed that the Greek government would transpose the European Bank Recovery and Resolution Directive (BRRD) into national law by 22 July. That would create the toolkit needed to resolve banks in an orderly fashion, first and foremost the bail-in instrument. I believe that this instrument needs to be made available in Greece as swiftly as possible – that is, ahead of the mandatory introduction date of 1 January 2016. Looking at the structure of Greece's banking sector, the question is whether it is possible to consolidate the country's banks without seriously distorting the competitive environment. This is a question that needs to be answered without delay.

To sum up – time is of the essence, especially so for Greece's banks. Everyone should be aware that Monday's basic agreement marks the start of the real work. Now it is up to all the parties concerned to do their jobs to make sure that five months of negotiations weren't in vain – and the focal point here, for me, is the Greek banking sector.

After all, it's not just Greece we're talking about here but the euro area as a whole. And many seem to believe that the crisis in and over Greece has cast doubts over the very process of European integration. But I do not share that view. The proper response, in my view, is not less, but more, integration. And we took a major step towards deeper integration by launching the European banking union.

But we need to look beyond the banking sector and train our sights on the capital markets as well. Extending and integrating the capital markets can also contribute to shoring up the foundations underpinning monetary union. After all, a common currency needs integrated financial markets to thrive.

This idea of a capital markets union has increasingly taken shape in recent months. Back in February, the European Commission presented a green paper outlining a framework for a European capital markets union. The Bundesbank sees the capital markets union as a sensible project that is conducive to deepening European financial integration further still – not only in the euro area but across the European Union.

But how exactly do we define a capital markets union, and how can we make this idea reality?

3. Diversification – strengthening the capital markets

The European capital markets union essentially sets out to achieve two goals. First, to strengthen the role played by the capital markets in funding the real economy. Second, to deepen capital market integration across national borders.

The first goal sometimes prompts the question whether a financial system geared to the capital markets is superior to one built around banks. Empirical research into this question can be summarised quite succinctly – we're not quite sure. But what we do know is that both systems have their merits, which vary depending on how well a country's economy is developed and how it is faring at a given point in time.

The better developed an economy, the less the banking sector spurs growth and the more capital market financing comes into play. Also, market-based financial systems help to take the sting out of recessions that follow in the wake of financial crises. Bank-based financial systems, meanwhile, are more adept at evening out "normal" cyclical fluctuations.

However, the latest financial crisis has opened up another vista. A system in which the real economy is wholly reliant on a single source of financing – be it the banking sector or the capital market – will run into difficulties when that well runs dry.

So, at the end of the day, it's not a question of choosing either one or the other. The idea behind the European capital markets union is not to give up on bank-based financing, but to harness capital market financing as an add-on. And Europe still offers plenty of potential in this respect. Measured in terms of economic output, the US equity market is more than one-and-a-half times the size of its European counterpart, while the US venture capital market is five times the size of that in Europe, and the US securitisation market is larger still than the European market.

It ultimately all comes down to the old economic adage that you shouldn't put all your eggs in one basket. Or, to couch it in rather more technical terms, it's all about diversifying the sources of corporate financing. If we give the capital markets a more prominent role in funding the real economy, that will give businesses broader and better access to funding – to the notable benefit of small and medium-sized enterprises. What it will also do is create a more efficient financial system that can better support sustained economic growth.

4. Integration – establishing a single capital market

The second objective of the European capital markets union is to deepen the integration of the capital markets. What benefits do integrated capital markets have to offer? One of the biggest advantages, undoubtedly, is that they can help to improve risk sharing. The underlying technical question is this: to what degree does an economic shock impair private consumption?

And this is where the capital markets perform a key buffer function. In the USA, for example, the integrated markets for capital cushion around 40% of total cyclical fluctuations between the US federal states. If a negative shock hits an industry or a specific region, then this loss is spread widely beyond that region. But in return, shareholders throughout the country also receive a share of the profits during the good times. The credit markets, meanwhile, play less of a role as a buffer, cushioning around 25% of cyclical fluctuations. Fiscal buffers play by far the least important role, with fiscal mechanisms cushioning just 10–15% of economic shocks. All in all, the different buffers absorb almost 80% of an economic shock before it can have an adverse effect on private consumption.

The situation in Europe is slightly different: here, it is primarily the credit markets which act as buffers – and not particularly effectively at that. All told, just 40% of a shock is cushioned before it can hit private consumption. So boosting the role of the capital markets and integrating them more effectively across national borders would help to improve risk sharing in Europe and dampen fluctuations in consumption.

In summary, then, a capital markets union offers two takeaways. First, strengthening the role of the capital markets as a source of funding for the real economy can promote economic growth. Second, integrating the capital markets more deeply across national borders can improve risk sharing. The bottom line is that the European capital markets union is a worthwhile project.

5. Turning the idea into reality

Simple though the basic idea of a capital markets union may be, putting it into practice will be a difficult undertaking. The capital markets are a complex beast, and capital market funding comes in many shapes and sizes. Corporate bonds, private and listed equity capital, venture capital and peer-to-peer loans are just some of the instruments in the market. And integrating them affects not just the financial instruments themselves but also integral components of the respective markets, like exchanges and central counterparties.

So any attempt to establish a capital markets union will automatically involve a raft of different measures in a wide variety of areas. It's no surprise, then, that the European Commission's proposals are very wide-ranging.

The goal of boosting the role played by capital market financing can be best achieved, in my view, by placing the spotlight on the equity capital markets. That's because equity capital is a form of capital market financing that is particularly effective at stabilising fluctuations.

But let's begin with the other side of the coin, so to speak, with debt financing. Debt contract terms don't normally adapt to suit the borrower's situation. The redemption amount doesn't change when the borrower runs into difficulties. Risk is only shared with the lender if the latter grants further credit to bridge the difficult spell or agrees to a haircut if the borrower becomes insolvent.

The value of equity capital, by contrast, always moves in line with events. Equity capital is rather like an insurance policy against risk and creates a buffer that can absorb losses. Boosting the role played by equity capital financing thus curbs the incidence of insolvencies and diminishes fluctuations in investment and growth. Let us not forget that equity capital showcased this stabilising quality during the course of the European debt crisis. Debt financing in Europe was seen to be more susceptible to capital flight than was equity capital financing.

This experience would suggest it is worth considering doing away with the unequal tax treatment of equity and debt capital. Reforming the corporate taxation regime is naturally a difficult task, and strong political will would be needed to push it through. But introducing a more neutral tax regime for equity and debt capital would not only reduce the appeal of being highly leveraged, but also boost efficiency levels across the board.

As for the goal of integrating Europe's capital markets more deeply, there are a number of areas offering quick wins, one of which is the market for high-quality securitisations. Although Europe's securitisation markets came through the financial crisis relatively unscathed, they are lacklustre by comparison.

That's why a handful of initiatives have been launched to rekindle the continent's markets in securitised products. These include the European Commission's efforts to establish a framework for simple, transparent and standardised (STS) securitisations. Emphasising these three qualities is crucial, given the lessons learned from the crisis. The securitised products which contributed to the crisis were neither simple, transparent nor standardised. Quite the opposite, in fact – there was a proliferation of complex and opaque products that led to the problems we are all too familiar with. So in my eyes, the Commission's initiative is a sensible move to revitalise the securitisation market and promote the flow of funding to the real economy.

Speaking as a banking regulator, it is nonetheless important, of course, to regulate securitisations appropriately. What we should avoid at all costs is a situation in which we soften the existing financial market regulation in an effort to nurture certain market segments.

Another quick win would be to standardise the regime for private placements. Yet another would be to tweak IPO prospectus requirements in a move to do away with unnecessary red tape. Looking into the more distant future, it would make sense to harmonise insolvency law, company law and tax law.

However, we should not focus on the institutional and legal framework to the exclusion of everything else. It would probably also be worthwhile to take into account soft factors such as cultural preferences for certain forms of financing or financial literacy levels. These are areas we will also need to address if we are to achieve our goal of establishing a European capital markets union.

6. Conclusion

Ladies and gentlemen, the road to a European capital markets union is a long and winding one. The journey will be arduous and time-consuming. There will be challenges and resistance we must overcome along the way. So we need to be realistic about what we are setting out to achieve.

And yet we have travelled this road to deeper financial integration for 16 years now – since the year, in fact, in which we launched the euro as a common European currency. And we must not falter. If we want European monetary union to be a true success, we will need to press ahead towards ever deeper integration.

We took a huge stride on this path in November 2014 with the launch of the banking union. Now the next major step is in order – the establishment of a European capital markets union. A capital markets union which includes not just the member states of the euro area but embraces the entire European Union.

On that note, I would like to bring my speech to a close with a quote that has been attributed to Robert F Kennedy. “There are those that look at things the way they are, and ask why? I dream of things that never were, and ask why not?” Looking at the capital markets union, I believe we should take this confident and optimistic outlook to heart.

Thank you very much.