Salvatore Rossi: Finance for growth – a capital markets union

Keynote address by Mr Salvatore Rossi, Senior Deputy Governor of the Bank of Italy, at the Rome Investment Forum 2015 "Financing Long-Term Europe", Rome, 11 December 2015.

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I would like to comment on the proposal for a capital markets union (CMU) by raising ***three questions***, and giving some tentative answers to all of them.

The ***first*** question is: do we actually need a CMU in Europe? Should it really be a priority in the European policy agenda?

My answer is a resounding "yes!". The question may seem rhetorical, given the tide of apologetic documents, papers, and seminars (including perhaps this one) that have been dedicated to the project since its official launch last year. However, I think it"s important to keep in mind the reasons for that "yes", because hesitations and even open dislike are quite widespread in some countries and sectors.

The fact is that the European economies, with the partial exception of the UK, are strongly dependent on banks for their financing needs. Too dependent. Let me explain why.

A wide literature (I have in mind for example a very recent piece of empirical research by Langfield and Pagano, 2015), shows that economic growth tends to be lower in economies with a bank-based financial structure, particularly at times of falling asset prices, and systemic risk to be higher. A "bank bias", as L&P dub it, is bad, in any circumstance.

But even if we believed, just for the sake of the argument, in the optimality of banking dominance in our financial systems, here comes another hard fact: also as a consequence of the new regulatory and supervisory framework, banks are less and less willing to lend money to risky borrowers such as SMEs, because of the heavy burden of non-performing loans which is the legacy of the crisis; because more capital is required against risky assets, and capital is costly. Requests for more capital buffers come from all international regulating bodies, both at the global level (Financial Stability Board, Basel Committee) and at the European level (Single Supervisory Mechanism – SSM), as a shield against a new, devastating financial crisis. Up to now, in Europe the effect has been procyclical: notwithstanding the cheap, abundant liquidity supplied by the ECB, banks are reluctant to increase lending to the real economy.

The corporate sector, especially in southern Europe, is mostly made up of SMEs, for which access to financial and capital markets is difficult, if not impossible. Hence, we have an inconsistent trio: an economic structure mostly requesting bank finance, regulators concerned with the risks posed by banks" activity, and banks consequently stepping back from ample parts of the credit markets.

How to sort ourselves out? One way is to move the European financial structure from intermediaries towards markets (Visco, 2015). This will indeed require national efforts, but more is needed: an integrated European-wide capital market, with harmonised and SME-friendly rules. In other words, a CMU.

The ***second*** question is: can we consider a European CMU a realistic project?

This time my answer is much more doubtful.

The idea for a CMU was first put forward by the President of the European Commission before the European Parliament in July 2014 (Juncker, 2014), in very ambitious language. Last September the Commission presented an action plan to transform that enlightened vision into reality (EC, 2015). From one document to the other the degree of ambition was apparently scaled down. As Nicolas Véron (2015) recently noted, the plan "mostly boils down to pruning existing rules and correcting some of [the] EU"s own recent regulatory overreach".

But this is supposed to be the normal business of the Commission. Let"s check whether this harsh judgment is well founded.

What does CMU mean in substance? It means creating a single market of non-bank financial services: the belated completion of the Single Market project of the "80s. A first attempt at merging European financial markets fifteen years ago did not succeed. In the goods market the main obstacles to integration were technical standards: harmonising them was the crucial move. In the financial services market, obstacles are of various kinds: every country has its own legal system, tax treatment, accounting standards, and prudential regulation (Danielsson et al., 2015). These specificities are entrenched with local costumes and traditions, and in some cases they protect national champions. Harmonising the myriad of laws, taxes, and regulations in a short period of time, as the urgency of the matter would require, is extremely challenging.

The most delicate problem has to do with the UK. It's quite obvious that a European CMU excluding the City of London would have little sense. But the UK Government is highly sensitive about London's competitive advantage as the financial hub of Europe, and the issue will remain almost intractable until the referendum on the UK remaining part of the European Union is held.

The ***third*** question is: what can be done to facilitate/accelerate the process of creating a pan-European CMU?

The approach followed by the action plan is a step-by-step one. Such an approach was recommended, not by chance, by most of the stakeholders involved in a wide public consultation held by the Commission in the first half of this year. Is it the right approach? In principle, one might have preferred a bolder attitude, one that addressed simultaneously and directly all the needed harmonisation in the fields, for instance, of bankruptcy laws, taxes, investor protection and market infrastructure regulations: a Thatcher-like "big bang". But that would have been definitely unrealistic.

What the action plan intends to do, and I quote a key passage of the document, is to proceed "from the bottom up, identifying barriers and knocking them down one by one, creating a sense of momentum". Among those to be knocked down first are, according to the plan:

- red tape and information asymmetries making it too costly for SMEs to list on equity and debt markets;
- specific rules in both the new European insurance regulatory framework (Solvency 2) and in the capital requirement regulation for banks (CRR) preventing insurance companies and banks from getting more involved in the business of financing infrastructure investment;
- a sort of damnation still weighing on securitisation after the global financial crisis (asset-backed securities were labelled "toxic sludge"), while, if simple and transparent, it could be a fundamental tool to bridge the gap between SMEs and financial markets.
- and so on and so forth ...

These are all good intentions. Are they sufficient to create a "sense of momentum"? We will see.

The risk is that we fall into a sort of "Ten Little Indians" trap. A risk still present, for example, in the banking union story.

Banking union was conceived as an institutional framework with three pillars (Rossi, 2015): an SSM, a Single Resolution Mechanism (SRM), and a Single Deposit Insurance Scheme (SDIS). The three pillars were originally meant to be concurrent, symmetric, and logically connected. But the outcome has been different. The SSM was swiftly realised because it was seen as a prerequisite for restoring mutual trust among countries after the sovereign debt crisis. But mistrust has remained. On the crucial issue of bank resolution, after long and tiresome negotiations it has been decided that sharing the cost of a banking crisis among all the eurozone countries is not for now; it is foreseen as the final step in a process lasting many years, and in any case it will involve private funds only (the Single Resolution Fund, financed by all the eurozone banks). The use of money from the taxpayers of countries other than the one where the bank's head office is located has been ruled out – contrary to the original intention (anyhow, the use of national public money is in general forbidden by state aid rules). As to the SDIS, it was first postponed to an indefinite future; more recently, a proposal has been presented by the European Commission, but envisaging the same many-year process before reaching a mutualisation such as the one established for the Single Resolution Fund.

The CMU, needless to say, is a totally different endeavour. Still, overcoming the variety of national habits and interests will be a formidable task, the inherent difficulty of which must not be underestimated if we want CMU eventually to succeed.

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