Claudia Buch: Completing the Banking and Capital Markets Union – where do we stand?

Statement by Prof Claudia Buch, Deputy President of the Deutsche Bundesbank, at the SUERF-Deutsche Bundesbank-IMFS Conference on "SSM at 1", Frankfurt am Main, 4 February 2016.

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The financial crisis and the ensuing sovereign debt crisis have revealed weaknesses in the European financial architecture. Although capital market integration in Europe intensified prior to the crisis, it took place mostly via debt capital markets. This form of financial integration turned out to be vulnerable at the outbreak of the financial crisis. Many European countries experienced a reversal of capital flows and a "sudden stop" as investors moved their funds into safe havens. Fragmentation of European capital markets increased, and a mutually reinforcing feedback loop between risks of banks and sovereigns (the "sovereign-bank nexus") emerged.

After the crisis, several policy initiatives have been launched which strengthen the institutional framework in Europe (Deutsche Bundesbank 2015a). The enhanced Stability and Growth Pact strengthens incentives to follow prudent fiscal policy while retaining decentralised responsibility for fiscal policy. The European Stability Mechanism (ESM) introduces a crisis resolution mechanism with elements of risk-sharing under well-defined conditions. Collective Action Clauses in sovereign debt contracts complement these new rules. The Banking Union, which has become effective in November 2014, has been a key step in terms of transferring supervisory power to the European level with the aim to improve both, the monitoring of risks and mechanisms of dealing with distress in the banking sector (Buch 2014). This note discusses the scope of reforms in the financial sector with a focus on open issues to be addressed in future reforms.

Completing the Banking Union

The Banking Union rests on two main pillars: The Single Supervisory Mechanism (SSM) has given the ECB responsibility for supervising the significant banks in the euro zone and the ability to assume direct supervision over smaller institutions. In cooperation with national supervisors, the ECB is now able to apply a uniform set of prudential standards and supervisory culture across the European banking sector. The second pillar of the Banking Union is the Single Resolution Mechanism (SRM), which started in January 2016, and builds on the Bank Recovery and Resolution Directive (BRRD). The implementation of resolution powers, in particular the bail-in-instrument, and the creation of the Single Resolution Fund (SRF), are at the core of the SRM.

Taken together, these reforms reduce the probability of bank distress and improve the ability to deal with distress events through improved private sector risk sharing mechanisms. Public bail outs become less likely. In this sense, the Banking Union addresses the sovereign-bank-nexus by reducing the probability that distressed banks negatively affect sovereign risk. At the same time, additional reforms can contribute to further increase the resilience of the European financial system and to enhance the consistency of the new institutional framework (Deutsche Bundesbank 2014a):

Limiting banks' exposures to sovereign risk: The Banking Union has no direct implications for the prudential regulations of banks. Most importantly, it does not address the regulatory treatment of banks' exposure to sovereign risk. Under current prudential regulations, sovereign debt is treated as risk-free when calculating banks' capital requirements, and large exposure limits do not apply. This creates incentives for banks to hold exposures vis-à-vis governments with potential negative implications for private sector lending and financial stability. Abolishing this preferential treatment of sovereign debt in prudential regulation would thus be an important complement to the institutional reforms that are already under way (Deutsche Bundesbank 2014b).

Completing the macroprudential toolbox: The ECB has also been given macroprudential powers. The main responsibility for the implementation of macroprudential measures still lies with national authorities. In the German case, some key macroprudential instruments are still missing. In 2015, the German Financial Stability Council has thus issued a recommendation to create the legal basis for macroprudential instruments addressing potential systemic risks in the market for mortgage loans.[1] Many other European countries have instruments available to set minimum standards for loan-to-value ratios, debt-service to income ratios, or minimum amortization requirements. In addition to the recommendation to create the necessary legal instruments in Germany, the recommendation of the Council also refers to the additional statistical requirements. Current reporting systems for banks in Germany do not allow monitoring risks resulting from mortgage lending and in particular possible changes in lending standards.

Ensure sufficient loss-absorbing capacity and limit exemptions from bail in: Improved regulations and supervision reduce the probability of bank distress, but they do not eliminate these risks. Banks thus need to have sufficient loss-absorbing capacity to successfully prevent the use of public funds in case when a resolution becomes necessary. Internationally, standards for Total Loss-Absorbing Capacity (TLAC) for global systemically important banks (G-SIBs) have been agreed upon last year. In Europe, Minimum Requirement for Eligible Liabilities (MREL) apply. Some discretionary scope in the use of the bail-in instrument, as granted by the BRRD and the rules on state aid, may be necessary to prevent systemic contagion. But this flexibility opens a door to political influence and may threaten the credibility of the instrument. Discretionary exceptions should, therefore, be made only under rare and strictly defined circumstances. A statuory "systemic risk exemption" that would require, for instance, a strong majority among relevant stakeholders such as finance ministers for any deviation from a bail-in in could be an appropriate institutional hurdle.

Reform complex decision-making in the SSM and SRM: The current institutional set up of the Banking Union has been shaped by limitations of what is currently permitted within the boundaries of European primary law. As a result, decision-making procedures within the SSM and the SRM are overly complex and can lead to possible conflicts of interest. The ECB's Governing Council, for instance, is the ultimate decision making body for both, monetary policy and supervisory decisions. A clear separation of the ECB's responsibilities for banking supervision and monetary policy would be desirable. Also, rules governing the participation of the European Commission and the Council in the decision-making procedures of the SRM could be streamlined. Both changes, however, would require amendments to primary union law.

A common deposit guarantee scheme as a third pillar?

The European Commission has recently presented a proposal for a European Deposit Insurance Scheme (EDIS) as a potential third pillar for the Banking Union. Presently, national deposit guarantee schemes (DGS) are being harmonised through the Depositor Guarantee Scheme Directive (DGSD) which was decided upon in 2014, but which has not fully been implemented by all member states. In the long-run, a common deposit insurance system would, in principle, be consistent with centralized supervision. It could enhance financial stability because risk would be spread more widely and the pool of available resources would be larger. However, integrating deposit insurance systems now would be premature because necessary preconditions are not met (Buch 2015).

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1 http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Meldung/2015/meldung_150630_afs_immobilien-markt.html.

As with fiscal reforms, risk-sharing mechanisms should be established only if powers to control risk-taking have been delegated to the European level as well. Hence, a de-risking of banks is necessary before further steps towards a further mutualisation of liability in the form of a common DGS can be taken. As regards policies that contribute to mitigate risks in the banking sector, regulatory reforms that limit banks' exposure to sovereign risk are crucial. Therefore, reforms of the current regulatory treatment of sovereign risk should be a pre-condition for further risk-sharing mechanisms. Because sovereign debt is not per se a risk-free asset, regulation should address both, credit risk and concentration risk of sovereign exposures of banks. Otherwise, effects of sovereign distress would be mutualised under the common deposit insurance system via the direct effects on its national banks.

In addition, there are many national and economic policy measures which, directly or indirectly, affect the risk profiles and thus the solvency of banks. For instance, differences in national insolvency laws have direct consequences for the valuation of banks' assets and the burden that creditors must bear in the event of insolvency. Hence, reforms need to strike a balance between retaining national discretion over domestic policies while, at the same time, preventing national sovereignty from risk-shifting to the European level through (changes in) regulations affecting bank solvency.

The preconditions for a common deposit insurance scheme will not be met before these issues have been resolved.

The capital markets union: enhancing channels for private sector risk-sharing

The focus of the Banking Union has been on markets for debt capital. The Capital Market Union can complement the Banking Union by supporting the development and integration of European capital markets beyond the banking sector, and by creating additional channels for private sector risk sharing. Developing and integrating markets for equity capital through the removal of impediments to efficient, non-distorted market outcomes can play an important role in this regard (Deutsche Bundesbank 2015b).

Integrated capital markets contribute to risk sharing among investors, which can generate welfare gains. In integrated markets, local risks are shared amongst investors from different regions. Individual investors can safeguard themselves against local income risks by diversifying their equity and debt-financed investment across borders. As the nominal exchange rate cannot adjust in a currency union, cross-border risk sharing plays an important role in balancing asynchronous business cycles and thus in supporting the stability of the currency union. It is therefore all the more important that capital markets function as channels for risk sharing within the European monetary union.

Yet, cross-border risk sharing is constrained if the integration of capital markets is concentrated on financial instruments with payout streams that are not contingent on an enterprise's business situation such as debt instruments. Equity investors, in contrast, directly participate in gains and losses. This serves as a buffer against losses and as a private sector risk sharing mechanism.

While stock markets in the EU are already well integrated, there are other market segments in which reforms could be beneficial.

For instance, removing institutional barriers to mergers and acquisitions could spur cross-border equity investments. This may include limiting discretionary power in the implementation of the European Takeover Directive or legal options available to national governments to block M&A transactions. It may also include reviewing to what extent corporate governance rules affect incentives for M&As.

As regards European venture capital markets, the review of the European Venture Capital Funds regulation can be a step towards more developed and integrated European equity markets. Regulation of venture capital markets should aim at creating a level playing field across Member States by limiting discretion at the national level, for instance in terms of own funds requirements and the methodology used to determine the sufficiency of own funds.

Beyond equity markets, the revitalisation of European markets for securitisations via rules for simple, transparent and standardised securitisations can strengthen European and international private sector risk-sharing.

In addition to short-term projects, the implementation of long-term goals is decisive for the success of the Capital Markets Union. Tax systems affect the choice between debt capital and equity capital, often creating incentives towards using debt finance. Assessing ways to establish an equal tax treatment of different sources of funding could thus be an important step forward. Moreover, distortions of investors' decision making emerge from heterogeneous and in some countries inefficient national insolvency laws.

Obviously, any such reform should take risks to financial stability and the potential for regulatory arbitrage into account.

Further reading

Buch, Claudia M. (2015). Stellungnahme anlässlich der öffentlichen Anhörung des Ausschusses für die Angelegenheiten der Europäischen Union des Deutschen Bundestags zum Fünf-Präsidenten-Bericht zur Vollendung der Wirtschafts- und Währungsunion, 2. November 2015.

Buch, Claudia M. (2014). The banking union – setting the course for better integrated and more stable financial markets in Europe? Speech at the Handelsblatt Annual Conference, Frankfurt am Main, 4 September 2014.

Deutsche Bundesbank (2014a), Financial Stability Review 2014: Implications of the banking union for financial stability, pp- 69–88.

Deutsche Bundesbank (2014b), Annual Report 2014, Reducing the privileged regulatory treatment of sovereign exposures, pp 23–40.

Deutsche Bundesbank (2015a). Bundesbank Monthly Report March 2015: Approaches to strengthening the regulatory framework of European monetary union. Frankfurt a.M.

Deutsche Bundesbank (2015b). Financial Stability Report 2015: Capital markets union – financial stability and risk sharing, pp. 85–94, Frankfurt a.M.