Vítor Constâncio: Capital Markets Union and the European monetary and financial framework

Keynote speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at Chatham House, London, 21 March 2016.

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Ladies and gentlemen,

A well-functioning, diversified and deeply integrated capital market is of key relevance for the European Central Bank. This explains why we have supported the European Commission's initiative to establish a capital markets union (CMU) from the very beginning.

In my remarks, I will focus on the ways CMU could contribute to the achievement of the most important tasks of the Eurosystem and to enhance the economic and welfare effects of the euro area:

First, financial integration and capital markets' development can facilitate ***the transmission of monetary policy*** in the euro area.

Second, a more diversified financial system with capital markets complementing bank-based financing can increase the shock absorbing capacity of the European economy, thereby contributing to ***macroeconomic and financial stability***.

Third, integration of capital markets increases the ***private risk-sharing across countries***, which improves the response to asymmetric shocks by allowing income and consumption smoothing through cross-border holdings of equity and debt instruments.

1. Capital markets and the transmission of monetary policy

Achieving the CMU requires both enhancing financial integration, and developing and deepening financial markets. These developments affect the transmission of both standard and non-standard monetary policies.

In many theories of the monetary policy transmission mechanism, information asymmetries and other credit market inefficiencies play a central role in amplifying and propagating the effects of changes in interest rates on real activity, namely via their impact on lending rates.[1] This mechanism, which is often referred to as the credit view of monetary policy, could be interpreted as suggesting that reducing those inefficiencies would undermine the credit channel and decrease the impact of monetary policy on the real economy.

Such theories, however, typically abstract from the effect of improved market efficiency on savers' willingness to lend. If information disclosure is inadequate – to the extent that investors refrain from lending to borrowers – expansionary monetary policies can exert only a limited impact on the real economy through a compression of borrowing costs. Structural ***measures that increase the information flow*** and support the allocation of credit to productive activities can therefore contribute to accelerating the transmission of monetary policy to the real economy.

Recent evidence lends support to the idea of a positive relationship between the effectiveness of monetary policy and the efficiency of financial markets. For instance, a cross-country comparison of the effects of the expansionary balance sheet policies implemented in the euro

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[1] Bernanke, B.S. and Gertler, M. (1995), "Inside the Black Box: The Credit Channel of Monetary Policy Transmission", J*ournal of Economic Perspectives*, Vol. 9 (4), pp. 27–48; Peersman, G. and Smets, F. (2005), "The Industry Effects of Monetary Policy in the Euro Area", *The Economic Journal*, Vol. 115 (503), April, pp. 319–42.

area between 2009 and 2012 shows that the impact on output was strongest in the countries with the most well-capitalised domestic banking systems.[2]

A second set of measures which could be undertaken in the context of the CMU agenda relates to the ***harmonisation of legal systems***. Evidence for the euro area suggests a strong link between the legal structure of a country and its financial architecture,[3] and shows that cross-country differences in those systems are a source of asymmetry vis-à-vis the monetary transmission mechanism.[4]

The CMU debate has brought to light the importance of going beyond the harmonisation of financial legislation, and of tackling barriers resulting from taxation or corporate and insolvency laws.

According to a recent study by the Association of Financial Markets in Europe (AFME), the current patchwork of insolvency frameworks is estimated to increase the cost of corporate debt by between 18 and 37 basis points. On the other hand, if all Member States were to reach a recovery rate of at least 85%, this could translate into an aggregate GDP gain of between 0.3 and 0.55%.[5]

By deepening capital markets, CMU implies a move towards a more market-based financial system that can facilitate the conduct of monetary policy through its effects on the transmission mechanism. It is a well-documented empirical regularity that yields and asset prices respond faster to changes in monetary policy decisions than bank lending rates.[6] The slow adjustment of bank rates is thus a contributing factor behind the delayed impact of monetary policy on the real economy. Consequently, by improving access to market-based finance, the development of the CMU can help increase the speed at which monetary policy is transmitted to the real economy.

2. CMU, financial stability and the scope of unconventional monetary policy

The development of the CMU can also increase the economy's resilience to large adverse shocks and limit the need for policy intervention in times of crisis.[7]

Measures that promote more diversification of financing instruments revive the securitisation market and encourage a resilient form of financial integration, are particularly important in this respect.

Fostering the development of more diverse financial instruments for ***borrowers,*** as well as facilitating their substitutability, contributes to partially shielding the economy from disturbances that may hit the banking sector, thereby enhancing financial stability and reducing the need for non-standard monetary policy measures aimed at restoring the flow of credit to

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2 Boeckx, J., Dossche, M. and Peersman, G. (2014), "Effectiveness and transmission of the ECB's balance sheet policies", *Working Paper Research Series*, No 275, National Bank of Belgium, December.

3 La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R.W. (1998), "Law and Finance", *Journal of Political Economy*, Vol. 106 (6), pp. 1113–55.

4 Cecchetti, S.G. (1999), "Legal structure, Financial Structure, and the Monetary Policy Transmission Mechanism", *FRBNY Economic Policy Review*, Federal Reserve Bank of New York, July, pp. 9–28; Danthine, J-P., Giavazzi, F. and von Thadden, E-L. (2000), "European Financial Markets After EMU: A First Assessment", *CEPR Discussion Papers*, No 2413.

5 Association for Financial Markets in Europe (2016), *Potential economic gains from reforming insolvency law in Europe*, February.

6 De Bondt, G., Mojon, B. and Valla, N. (2005), "Term structure and the sluggishness of retail bank interest rates in euro area countries", *Working Paper Series*, No 518, ECB, September.

7 De Fiore, F. and Uhlig, H. (2015), "Corporate Debt Structure and the Financial Crisis", *Journal of Money, Credit and Banking*, Vol. 47 (8), pp. 1571–98.

households and non-financial corporations. This does not imply that CMU would change the structure of the European financial system to make it similar to the American one where market-based financing dominates. History and theory do not demonstrate that a system overwhelmingly dominated by financial markets is more efficient to promote long-term growth than a more bank-based structure. Developments since 1945 prove this assertion: Europe's growth led to a substantial catching up with the US, keeping its different financial system. In spite of the role of capital markets in the US, SMEs continue to be financed mostly by banks with the significant help of guarantees provided by the US Small Business Association to the tune of USD 30 billion per year.

Deeper equity markets however, constitute an unquestionable advantage to the US, notably in relation to the role of venture capital in promoting innovation. For the expansion of such an activity it is important to dispose of a deep equity market that can provide significant returns in successful IPOs (Initial Public Offers) that can offset losses incurred by failing risky projects. Overall, it is true that at this stage, Europe will benefit from a more balanced structure between market-based and bank-based financial system which CMU will help to develop.

Looking forward, an important step in the establishment of the CMU is the ***revitalization of the securitisation market***. Early measures proposed in the CMU Action Plan[8] can be conducive to capital relief for originators, thus contributing to freeing up banks' balance sheet and increasing lending to the real economy. These actions help monetary policy to provide the necessary accommodative stance in crisis times, particularly when interest rates are close to the zero lower bound. In addition, improved functioning of the securitisation market increases the supply of high-quality collatera[9] and expands the pool of eligible assets in the context of the ECB's asset purchase programmes.

CMU initiatives that promote a resilient form of financial integration by restricting fragile cross-border debt exposures can reduce the emergence of financial fragmentation in periods of crisis, which in turn will contribute to a well-functioning single monetary policy.

3. CMU fosters private risk-sharing and a more resilient financial integration

CMU can lead to a more resilient EMU through promoting private risk-sharing mechanisms that allow income and consumption smoothing across countries, also known as risk-sharing. Risk-sharing can increase welfare by reducing sensitivity of income growth to output growth in a country. In a monetary union, risk-sharing is particularly important because monetary policy is unable to address asymmetric, country-specific shocks, whereby some countries are in a recession while others may be booming. The effective risk-sharing in the United States is essential in making the US a successful monetary union.

There are three main mechanisms that risk-sharing can take between member states in a political and economic area. First, countries can share risk via cross-ownership of productive assets, a mechanism facilitated by developed capital markets. Second, a system of taxes and transfers can serve as a vehicle for further income smoothing. Third, member states can smooth consumption by adjusting their asset portfolios, by lending and borrowing in international credit markets, for example.

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[8] European Commission (2015), "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Action plan on building a Capital Markets Union", COM (2015) 468 final, September.

[9] Bank of England and ECB (2014), *The case for a better functioning securitisation market in the European Union – A Discussion Paper*, May.

The introduction of the euro has fostered risk-sharing – available estimates suggest that 57% of shocks to country GDP per capita were smoothed in 2008–2009.[10] However, smoothing resulting from international cross-ownership of assets remained at low levels. By way of comparison, the United States has traditionally been characterised by a very high degree of income and consumption smoothing across states. Available evidence suggests that about 75% of income shocks in individual states are smoothed, with 62% of state-specific shocks being smoothed through market transactions. These can take the form of cross regional holdings of financial assets or direct investments, as well as borrowing and lending credit operations.[11]

This underlines the advantage of, in the context of CMU, being particularly focused on stimulating equity financing. Indeed, our upcoming report on financial integration[12] finds that debt finance can magnify the adverse impact of negative shocks on economic growth. In contrast, equity and foreign direct investment (FDI), and longer-maturity debt in general, are leading to a more resilient form of financial integration. One way to stimulate equity financing via the CMU agenda would be to reduce the existing bias towards debt in national taxation.

It should be underlined that a substantial effect of risk sharing via cross border holdings of financial assets is predicated on attaining a fully fledged CMU. A genuine CMU would mean achieving a high level of financial integration in order to complete the Single Market in this area. Full integration is reached if market participants with the same relevant characteristics: (i) face a single set of rules for financial instruments and/or services; (ii) have equal access to a set of financial instruments and/or services; and (iii) are equally treated when they are active in the market. This level-playing field would contribute to stimulate cross-border risk-taking between EU Member States. In the last two decades, European financial markets have increased their role in financing the economy and became more integrated in terms of cross-border holdings of financial instruments. However, the crisis impacted this tendency. In fact, the crisis revealed that part of this integration was driven by debt-based wholesale banking flows which were prone to sudden reversals in the face of shocks. In fact, a high degree of ambition and decisive legislative action is required to create the conditions for capital markets to develop and integrate. These actions are often in politically controversial fields such as in the areas of corporate law, financial product taxation and insolvency law.

Altogether, the CMU has the potential to enhance private (as opposed to public), and cross-border (as opposed to domestic) risk-sharing, which could increase the shock absorbing capacity of the European economy as a whole, and thereby help to safeguard financial stability and the resilience of our monetary union.

Challenges: New risks to financial stability

Aside from these opportunities, financial integration and the further development of non-bank financing may also create new financial stability risks.

At a general level, ***greater integration can exacerbate the size and speed of cross-border contagion***. International risk-sharing and cross-border contagion can be two sides of the same

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[10] Balli, F. and Sørensen, B.E. (2007), “Risk sharing among OECD and EU countries: The Role of Capital Gains, Capital Income, Transfers, and Saving”, *MPRA Paper*, No 10223.

[11] Sørensen, B.E. and Yosha, O. (1998), “International risk sharing and European monetary unification”, *Journal of International Economics*, Vol. 45, pp. 211–38; Afonso, A. and Furceri, D. (2008), “EMU enlargement, stabilization costs and insurance mechanisms”, *Journal of International Money and Finance*, Vol. 27 (2), pp. 169–87.

[12] ECB (to be published in April 2016), “Special Feature A – Financial integration and risk-sharing in a monetary union”, *Financial Integration in Europe*.

"financial integration coin". This explains why taking a macroprudential perspective on the financial system, is extremely important for addressing potential new sources of systemic risks.

In the first place, the role of the European Securities and Markets Authority (ESMA) in coordinating with national authorities the effective harmonised implementation of all legislation relevant for CMU has to be strengthened. We need a single rule book for capital markets the same way it is being established for the banking sector.

At the same time, the further development of capital markets increases competition for the banking sector and incentivises banks to take on more risk to sustain profitability.[13, 14] To ensure that there are no unintended financial stability risks, we need to strengthen the European macroprudential regulatory toolkit for banks under the CRDIV/CRR.[15]

Moreover, ***the growth of market-based financing is accompanied by the strong growth of non-bank financing that creates new risks***. Over the past few years, growth in total euro area financial assets has been primarily driven by non-bank financial entities, investment funds in particular. The low interest rate environment has also played a role in this growth, with increasing amounts of capital being allocated to investment funds in the search for yield. Between end-2009 and the first quarter of 2015, assets managed by investment funds other than money market funds almost doubled from EUR 5.4 trillion to EUR 10.5 trillion.[16]

Importantly, this rapid growth comes along with increased risk-taking.[17] In addition, the interconnectedness of the fund sector with the wider financial system, more widespread use of synthetic leverage and the increasing prevalence of demandable equity imply that potential for a systemic impact is increasing, should the investment fund industry come under stress.

In short, financial stability risks increasingly extend beyond traditional entities such as banks and insurers. This underlines the necessity of developing the macroprudential framework beyond banking.

Developing the macroprudential framework beyond banking

Let me elaborate on three important aspects of this task.

First, we need to develop a framework to ***better control the leverage of alternative investment funds*** in the European Union. Given that the use of leverage by investment funds could create and amplify systemic risk, it is important that we ensure that leverage remains within acceptable limits.

Second, we need to develop ***tools targeting liquidity in non-bank financial institutions***. With regard to investment funds, "liquidity spirals" remain always a risk. Such spirals could be triggered if funds were to be confronted with high redemptions or increased margin requirements, as these could result in forced selling on markets with low liquidity. To address

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[13] Keeley, M.C. (1990), "Deposit Insurance, Risk, and Market Power in Banking", *The American Economic Review*, Vol. 80 (5), pp. 1183–1200.

[14] Kosuke, A. and Nikolov, K. (2015), "Financial Disintermediation and Financial Fragility", *CARF Working Paper*, No CARF-F-374, November.

[15] This requires (i) ensuring that the instruments currently available are more targeted and that overlaps are eliminated, (ii) broadening the toolkit with additional instruments (such as the net stable funding ratio, leverage ratio, loan-to-value/loan-to-income ratio, debt service-to-income ratio, sectoral risk weights, etc.), (iii) streamlining the process for notification or information procedures (both in the EU and within ECB Banking Supervision), and (iv) strengthening the macroprudential function of the ECB.

[16] ECB (2015), *Report on financial structures*, October.

[17] Funds have shifted their asset allocation from higher to lower-rated debt securities, increased the average residual maturities of debt securities holdings and continued to expand their exposure to emerging markets. See the November 2015 edition of the ECB's *Financial Stability Review*.

such risks, additional liquidity requirements, guided stress tests, minimum and time-varying load, and redemptions fees should be part of the macroprudential toolbox.

Third, macroprudential authorities should be given the power to ***change margins and haircuts on derivatives and securities financing transactions (SFTs) at the transaction level in a time-varying manner***. The current margining and haircut setting practices by market participants stimulate the build-up of leverage in good times, and amplify de-leveraging in bad times. While a number of policy measures aimed at limiting the pro-cyclical effects of margin and haircut setting have been adopted or are underway, none of these steps envisage time-varying implementation of margin requirements and haircut floors by macroprudential authorities.

Conclusion

Let me conclude. I have explained how CMU has the potential to facilitate central banking tasks and thus to benefit our Monetary and Economic Union.

The Commission initiated the legislative work on CMU by making proposals including creating a framework for simple, transparent and standardised (STS) securitisation. We support this work, and call on the co-legislators to make swift progress in the adoption of these proposals.

To achieve CMU and reap the potential benefits that I have just highlighted, we will need to promote further harmonisation in areas that have so far been considered as long-term issues.

We need to be ambitious in the pursuit of our objective. In fact, CMU should be seen as a “structural reform” by which the legislators and policy makers at the EU and national level, but also market participants themselves, dismantle existing barriers to the cross-border functioning of the single market in capital. In this regard, tackling differences in insolvency law, taxation and company law will be highly relevant. As long as these obstacles remain, there will be no cross-border capital markets union.

Lastly, if CMU is successful in deepening and integrating capital markets, this development will need to be accompanied by macroprudential supervision to ensure that the potential new risks are limited.

Thank you for your attention.