Vítor Constâncio: Synergies between banking union and capital markets union

Keynote speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the joint conference of the European Commission and European Central Bank on European Financial Integration, Brussels, 19 May 2017.

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Banking union and capital markets union are undoubtedly the two central policy initiatives to catalyse financial integration in the EU. Consequently, they received a great deal of attention in the ECB's report on Financial Integration in Europe over the last years and stand at the centre of today's conference.[1] The benefits of the two initiatives are known. Banking union increases the resilience of the banking sector, facilitates sector consolidation and enhances the cross border credit market, expanding its financing capabilities and reducing intermediation costs. Capital markets union contributes to diversify sources of finance for our economies and creates a risk-sharing channel that helps smooth out incomes and consumption via cross-border holdings of financial assets. In this perspective, I welcome the initiatives by the Commission in the context of the review of the CRD IV/CRR and of the second communication regarding the progress of capital markets union.

In the past, it was sometimes argued that banks and capital markets were competing with each other for a limited amount of viable investment opportunities.[2] Some have even seen capital markets as threatening traditional banking models. However, banks and capital markets are rather closely interconnected as parts of the wider financial system: banks and markets complement each other in financing the real economy. Therefore, we should not treat banking union and capital markets union as two mutually exclusive projects but rather see them as mutually reinforcing initiatives that can bring the Single Market for financial services to the next level. In my speech today, I will argue that there are very good reasons to think about banking union and capital markets union together, to capture the synergies between them and to work on overcoming the impediments that constrain both of them.

The need to reap these synergies is particularly compelling at this crucial moment in time, in which the U.K. has announced its departure from the EU. The prospect that the largest financial centre in Europe will drift away from the EU27 Single Market brings a number of specific challenges and opportunities for the further development of the banking union and capital markets union.

On the one hand, London is an important provider of financial services to firms in the EU, in particular as regards capital market services. In the future, firms may have less access to these financial services and to U.K. capital markets and these services may need to be relocated to or developed in the EU27.[3] This process of business relocation and development needs to be managed, notably from a regulatory and supervisory perspective.

On the other hand, the departure of the largest non-banking union Member State is an opportunity to explore the interlinkages between capital markets union and banking union. All remaining 27 Member States have a vital interest in the success of both policy initiatives thus furthering financial integration.

Let me therefore now go into more detail on how banking union supports capital markets union and vice-versa.

Banking union supports capital markets union

Banks are important players in capital markets. They are active as service-providers, investors

and issuers. Recent studies propose that banks and capital markets not only compete for servicing a limited pool of investment projects but also co-operate. Complementarities between banks and capital markets are becoming more and more apparent, broadening the set of financing sources the ultimate borrower can choose from.[4] There are many areas where markets and banks offer complementary information and funding services, among them: (i) issuance of bonds, where banks provide a number of advisory and administrative services for the issuer; (ii) securitisation, where banks focus on credit analysis and markets focus on financing; and (iii) bank capital, where capital markets reduce the financing friction by lowering banks' cost of equity, and enable banks to raise additional equity to expand their lending scope.

Given these synergies, I see at least two channels through which the banking system can contribute to the development of capital markets in the EU. Firstly, a more *resilient* banking system supports the smooth functioning of capital markets. For example, resilient banks are more likely to act as market makers for certain capital market instruments and may ideally buffer extreme price movements in times of crisis. Furthermore, well-capitalised banks are less likely to be forced to fire sale certain asset classes. This leads to less market disruptions in times of crisis. In addition, prospering banks will be able to invest more resources into the development of new capital market products and services. And this is the first important reason why banking union matters for capital markets union: the banking union has been designed to increase the resilience of banks and a more resilient banking system supports the development of capital markets, which is one of the objectives of capital markets union.

Secondly, an increasingly *integrated* banking system should also support the integration of capital markets in the EU. Further regulatory and supervisory convergence should make cross-border operations and cross-border mergers of banks easier. For example, a bank that was so far predominantly active in the market of country A could be encouraged by regulatory convergence to also offer its capital market services to clients in country B. In this way the bank would expand and diversify its customer base and possibly even the exposures on its balance sheet. Capital markets in country B would thus benefit from a larger number of available providers and products. The cross-border holdings of capital market instruments would increase. The integration of capital markets could also be accelerated by cross-border mergers of banks. Cross-border banks have an inherent interest in driving forward the permeability of national capital markets as they could benefit from scale-effects by reaping cross border efficiency potential.

For the banking system to become more *resilient* and more *integrated* and hence support the resilience and integration of capital markets, we need to complete banking union. So let me highlight what, in my view, are the most important missing elements in the banking union.

In the area of resolution, we need to continue to push forward on establishing a permanent backstop to the Single Resolution Fund (SRF) that would increase the credibility of the system in systemic crises. In the area of deposit insurance, we should recognise the fundamental importance of a European Deposit Insurance Scheme when it comes to underpinning the trust in our currency and to achieve a uniform system whereby the same confidence in bank deposits as money applies throughout the whole banking union. Last but not least, banking union can only be completed via a strong Single Rulebook which reduces national discretions and allows liquidity to flow freely in the banking union to seek its most productive use. The ECB will make proposals on the issue in the context of its contribution to the review of the CRD IV/CRR proposed by the European Commission that we find insufficient in the domain of national discretions. Further progress on the banking union could also provide a rationale for recognising that cross-border lending activities within the banking union would benefit from a unified cross-country supervisory setup and could therefore be treated like within-country lending under the framework for Global Systemically Important Banks. There is obviously a need to better understand the potential impact of such a change on financial integration and capital markets and I am looking forward to see more analysis on this issue.

Additionally, we need to make the banking union unassailable to the challenges posed by the departure of the U.K. from the European Union, both in terms of resilience and level playing field. Opportunities for regulatory arbitrage and possible concentration of systemic risk at a national level would lead to market fragmentation and thus threaten financial stability. While prudential supervision in the euro area is now entrusted to the ECB which minimizes these risks, market activity is subject to national supervision and oversight. The risks are likely to increase with Brexit, when activities of financial institutions could be reallocated across the EU.[5] The ECB stands ready to technically support a smooth transition for banks choosing to move to or reorganise their activities within the euro area in the context of Brexit. The ECB will ensure that all banks operating in the euro area meet equally high supervisory standards, thus ensuring the safety and soundness of the European banking system. In this context, the borderline between the banking system and capital markets may become important, in particular when capital market participants or non-bank intermediaries fulfil typical bank functions. Appropriate regulation and supervision would have to ensure that similar risks are treated similarly and that regulatory arbitrage is avoided.

Capital markets union supports banking union

I will now turn to the synergies running in the opposite direction and elaborate on how capital markets union supports banking union. The very essence of the argument is that more integrated and jointly regulated capital markets would also support cross-border activities and resilience of banks. But let me be more specific.

Firstly, in a significantly more integrated capital market, banks would no longer need to develop local expertise for each national capital market. They could exploit cross-border economies of scale more easily by offering similar or even the same products and services in another Member State. By operating in a larger, integrated market, banks would likely increase the cross-border holdings of assets and be able to build larger and more diversified collateral pools for securitised products and covered bonds. The former effect could also contribute to a significant reduction of the sovereign bank nexus. Secondly, banks could also benefit from larger investor bases for their capital-market related funding instruments.

Another possible side effect for banking union could be that deeper, more integrated and efficient markets for certain assets, such as non-performing exposures, could lead to higher market values of these assets. This would support the clean-up of bank balance sheets.

Alongside these opportunities of capital markets union, we need to recognise that such fundamental changes in the structure of the financial system would require revisiting regulatory approaches.[6] In this regard, I want to highlight three aspects:

First, a Single Rulebook and an integrated supervisor for capital markets are key ingredients to support the integration of capital markets and would ultimately also allow banks to thrive from more stable capital markets. The establishment of ESMA has been a major step towards fostering convergence of national supervisory practices. But the supervision of securities markets remains at the national level, which fragments the application of EU legislation. ESMA could play a much larger role in ensuring consistent transposition and effective enforcement of rules agreed at EU level. In the longer term, capital markets union warrants a single European capital markets supervisor. In this context, the move towards direct European supervisory powers for certain segments of capital markets seems justified, particularly when major financial market infrastructures have systemic implications on the entire EU market. A medium-term centralisation of supervision for central counterparties (CCPs) would enhance the supervisory framework for these highly systemic infrastructures, as well as ensure consistent cross-border supervision.

Second, an increased non-bank sector should go hand in hand with an expansion of the

microprudential framework for non-banks. What we need is a coherent and well-supervised regulatory perimeter for non-banks that are engaged in bank-like activities to avoid regulatory arbitrage. At times when risks legitimately shift towards the non-bank sector, heightened vigilance is required to avoid that such risks spill back and compromise the soundness of credit institutions and of the financial system as a whole. For example, large investment firms with substantial cross-border links can pose risks that need to be addressed at the European level.

Third, an adequate regulation and supervision of the non-bank financial system from a macroprudential perspective will contribute to the resilience of banking union. It is crucial that macroprudential tools become available and operational in the EU for non-banks.[7] In this context, the Commission seems to have no intention of proposing changes in the macroprudential policy instruments, which is not helpful.

All in all, a more unified set up of regulation and supervision of capital markets and its market participants would increase the resilience of capital markets and thereby also of the banking system.

The underlying rulebook

To reap the synergies between banking and capital markets union, progress in supporting legislative domains is necessary. For instance, European regulators and supervisors of banks and capital markets are confronted today with many different rules concerning insolvency law, company law and tax legislation.

Various changes in insolvency law have recently been undertaken at the national level with the aim to facilitate court-led proceedings. Yet, they often remain highly complex and costly and thereby reduce recovery values. In particular in the case of non-performing loans on banks' balance sheets, any delays in the judicial proceedings significantly affect recovery values and reduce offer prices. This leads to situations of high transaction costs and general impediments to sales of non-performing exposures. Costly judicial proceedings may not be feasible for smaller SMEs, with low levels of capital. A recent Commission proposal aims to tackle this impasse by offering an alternative to normal insolvency proceedings but still relies on court systems.[8] A complementary course of action is to encourage out-of-court settlements. A number of European countries have introduced versions of such regimes since the crisis.

Regarding tax law, the Commission has already sponsored various initiatives, concluding that non-harmonised and burdensome withholding tax procedures constitute a barrier for the securities' industry and for investors.[9] They penalise cross-border investment, disrupt financial processes such as clearing and settlement, increase the cost of cross-border trading and are ultimately incompatible with a single European securities market.

Finally, the use of International Security Identification Number (ISIN) and Legal Entity Identifier (LEI) will increase transparency in capital and banking markets, foster their integration and enhance efficiency and consumer protection. Financial markets' stakeholders need easy and reliable tools to uniquely identify financial assets, transactions, issuers, guarantors and counterparties as well as their key features. This is particularly important for data management which serves as a backbone for operational purposes for market participants and supervisors or for provision of (statistical) information to the public. The current situation is very costly for market participants. The many different proprietary identifiers and local identifiers cause difficulties as they are incomplete, overlapping, and insufficiently accurate and do not guarantee a level playing field. While the drawbacks of the current situation are known and undisputed, resistance to change by the markets is due to the fact that unique identifiers are a public good. They need to be introduced and maintained by legislation. The mandatory requirement to use the LEI should be extended to all financial instruments and not only to specific market segments. In addition to securities, the LEI and ISIN could be used for investment funds, financial derivatives

and loans.[10]

Conclusions

There are very good reasons to think about banking union and capital markets union together and to capture the synergies between them. We are talking about two inseparable parts of the financial system.

From a policy perspective, banking union and capital markets union are undoubtedly the two central catalysers of EU financial integration for the years to come. All 27 Member States have a vital interest in keeping these two engines running smoothly, especially in view of the U.K.'s departure from the EU.

Thank you for your attention.

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[1] For example, this year's report, presented here and released this morning, provides further reasons for the importance of BU and CMU and updates readers on the ECB's views on some of their most important items.

[2] See Allen, F. and D. Gale (1997), "Financial Markets, Intermediaries, and Intertemporal Smoothing", *Journal of Political Economy, Vol. 105, No. 3, pp. 523–46*; Boot, A. and A. V. Thakor (1997), "Can Relationship Banking Survive Competition?", *CEPR Discussion Paper 1592*.

[3] See Sapir, A., D. Schoenmaker, and N. Véron (2017), "Making the best of Brexit for the EU 27 financial system", *Bruegel Policy Brief, Issue 1*.

[4] See Song, F. and A. V. Thakor (2010), "Financial System Architecture and the Co-evolution of Banks and Capital Markets", *Economic Journal, 120, 547, pp. 1021–1055*.

[5] See Veron, N. and D. Schoenmaker (2017), "To Make the Best of Brexit, the European Union Needs to Beef Up ESMA",

[6] See Claessens, S. (2016), "Regulation and structural change in financial systems", in ECB, The Future of the International Monetary and Financial Architecture, Proceedings of the ECB Monetary Forum on Central Banking, pp. 188–221.

[7] See "ECB contribution on the Commission's consultation on the future of the EU macroprudential framework"

[8] See Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU.

[9] See the Giovannini Report, the Clearing and Settlement Fiscal Compliance expert group FISCO, the Tax Barrier Advisory Group (T-BAG) as well as the ECB's T2S Advisory Group.

[10] The importance of financial market data standards and global identifiers has also been discussed in Box 2 of last year's ECB report on Financial Integration in Europe.