Vítor Constâncio: Why EMU requires more financial integration

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, Frankfurt am Main, 3 May 2018.

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I am pleased to host you today in Frankfurt at the Financial Integration Conference. The 2018 Financial Integration Report is the last issue published under my tenure as ECB Vice-President. I wish therefore to take this opportunity to reflect on the relevance of financial integration to Economic and Monetary Union (EMU) and provide some suggestions for future directions.

Already at the very early stages of the project, it was clear that financial integration was needed to make the Monetary Union sustainable. The 1970 Werner Report mentioned the complete liberalisation of capital transactions and the full integration of financial markets as one of three necessary conditions for a monetary union. Along with this, it was understood that the single currency would secure the full benefits of a single market for capital.

During the run-up to the Maastricht Treaty and in the context of the Delors report discussions it became clear that the dictum “one money one market” also implied addressing possible new concerns about financial stability in Economic and Monetary Union. In some cases this translated into prescient calls – like that from Alexandre Lamfalussy – for assigning the European Central Bank a role in banking supervision. Eventually however the institutional set-up of Monetary Union left financial stability considerations largely unaddressed.

This approach clearly showed its limits during the financial crisis. The financial fragmentation of EMU during the financial crisis was partly a result of the initial choices concerning EMU’s institutional architecture – to be precise, its minimalist design which left economic and financial policies mostly at national level. This was maybe due to an overriding faith in the efficiency of financial markets that – even though not shared by all of EMU’s founding fathers – prevailed in Maastricht.

It has to be acknowledged, however, that over the following years, financial market integration in EMU and at global level, accelerated at a speed that was hard to grasp in those early days after the creation of Monetary Union.

The introduction of the single currency gave a major impetus to financial integration in the euro area. Financial integration was impressive in terms of quantitative indicators but it was not sustainable – it proved to be shallow and reversible. In fact, it even contributed to the rapid contagion in the early days of the crisis.[1] We learned the hard way that a single currency requires a financial system that is sustainably integrated and, indeed, as single as possible.

Much has been done to correct the initial design failures of EMU. Along with the introduction of the euro, the EU’s Financial Services Action Plan was launched to provide an overall framework for the integration of financial services in Europe. With the surge of the financial crisis, it also became very clear that macroprudential policy needed to complement both monetary policy and microprudential supervision. The European Systemic Risk Board (ESRB) and the European Supervisory Authorities were then established at the beginning of this decade.

However, these reforms quickly proved to be insufficient to keep pace with adverse financial sector developments – especially concerning the role of the banking sector in the Monetary Union. In response, the banking union project was launched in the depths of the financial crisis in 2012. But convergence in regulatory and supervisory standards is not enough to spur the development and integration of capital markets that is needed for growth and private-risk sharing. Therefore, efforts in this direction were also undertaken, with the launch of the capital markets

union (CMU) initiative.

In short, the history of EMU is marked by an evolving search for the right institutional embedding of financial markets. And in that search, Europe has to be agile to react to changing circumstances. In doing so it has to find a balance: between markets and regulation, between liability and control, and between the European and national level. However, the crucial question is whether we will achieve a sustainable financial integration that is commensurate with a single currency.

Why financial integration is currently insufficient for EMU

The crisis made it clear that deep financial integration is essential to prevent EMU going into reverse. Financial integration in Europe and in the euro area had been growing steadily before the financial and sovereign debt crisis. However, the system was not structurally integrated and when the crisis financial erupted integration quickly reversed, exactly when it was most needed. In response to global and local shocks almost all financial markets became highly fragmented and retrenched inside domestic borders. These developments represented an existential threat to the Monetary Union and the single currency.

That fragmentation has reversed along several dimensions in the last few years. But significant room for further improvements in financial integration remains, for example in the integration of retail banking services and in the financing of the corporate sector.

Financial integration provides risk sharing mechanisms which can reduce the impact of country-specific shocks and contributes to macroeconomic stability. Internationally diversified portfolios – cross-regional and cross-border asset holdings, including firm ownership claims – are more resilient to global and local shocks and can mitigate the impact of such adverse scenarios. This is particularly true when integration occurs also in the equity markets as opposed to the current bias towards debt finance intermediated by banks.[2] For countries in a monetary union, this risk sharing mechanism is particularly important because the single monetary policy is unable to address asymmetric shocks, since other important adjustment mechanisms, for example related to fiscal policy and exchange rates, are limited. Therefore more private financial risk sharing can significantly improve the macroeconomic stabilisation of the euro area and thereby the functioning of EMU.[3] However, bear in mind that in recessionary periods, the power of this risk sharing mechanism is significantly reduced, in particular via the powerful credit channel. Let me point out that this channel accounts for about one-quarter in the United States and around 12% in the euro area, of the overall income smoothing that is achieved in both jurisdictions in normal times.[4]

Perhaps even more important, financial integration is also essential to foster economic growth. Integrated capital markets provide a wider source of financing and lower funding costs for households and firms and ultimately support innovation and the efficient allocation of capital. A financial system which allocates resources efficiently and is resilient to shocks ultimately supports the transmission of monetary policy and its effect on price stability.

The banking union and the CMU affect different parts of the financial system at different stages of development, but follow similar objectives to achieve a more efficient and stable financial system. They are also complementary projects: work on them should run in parallel and require a solid monetary union.

Completing banking union

The first task ahead is to complete the banking union. Each of its three pillars, notably the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the planned European Deposit Insurance Scheme (EDIS) address the risk of fragmentation. They are also all

necessary to ensure a proper balance between markets and regulations, and liability and control at European and national level.

The SSM ensures that banks are subject to the same set of rules and supervised on the basis of common standards. This reduces the risks of spillovers from bank failures to sovereigns and provides a common framework conducive to further integration in the banking markets, a process which has been lagging.

Since bank failures cannot always be avoided – and indeed this may not be desirable either, as it may undermine market discipline – we need a credible and well-functioning crisis management and resolution mechanism.

This is ensured by the second pillar of the banking union. With the setting-up of the BRRD[5], the Single Resolution Mechanism and the Single Resolution Fund (SRF), we have made a quantum leap in the institutional organisation of the EMU. However, the framework is still incomplete. Most notably, it requires a common public backstop to the SRF, which is essential to inspire full confidence in the resolution regime. In addition, it would be desirable to eliminate national divergences in the insolvency and liquidation of credit institutions, and in the implementation of the BRRD through national resolution laws. Allowing these divergences to persist ultimately implies that the geographical location of a failing bank may still influence the outcome of the resolution, which is inconsistent with the idea at the heart of a banking union.

Finally, in order to complete the banking union, we need a single, fully-fledged EDIS. The EDIS would strengthen depositors' confidence through an equal level of depositor protection across Member States and therefore promote financial integration. Ultimately, a fully-fledged EDIS would be strengthened by the pooling of resources, thus building confidence in the single currency, throughout the Monetary Union. The finalisation of the banking union through its third pillar would require an adequately sized fund, built and financed by banks by raising ex-ante contributions, accompanied by a public backstop as recommended by the ECB opinion on EDIS.[6] The calibration of these contributions should help to minimise the risk of some banking systems subsidising other banking systems in the event of a crisis. A recently published ECB Occasional Paper[7] simulating severe banking crises, demonstrates precisely that, with proper bank risk-based contributions, an almost negligible cross-border subsidisation occurs. For this reason, a crucial element of a fully-fledged EDIS would consist of risk-adjusted contributions to the fund based on bank-specific strengths and weaknesses benchmarked at the banking union level.

Progress is also needed in the framework for macroprudential regulation. I regard this as a precondition for safeguarding financial stability in an integrated market and therefore protecting the Single Market. The CRR/CRD IV[8], the ESRB and the SSM Regulations already define the key elements of the macroprudential framework, but as the framework is tested and more experience is gained the rules will need to be steadily revised. Authorities with a mandate in this area must have well-defined roles and responsibilities, including a distinct set of instruments. Current overlaps between instruments should be eliminated, and more flexibility in the macroprudential policy framework should be maintained, so that authorities can implement those measures in a consistent and timely manner, which would require significant changes to Article 458 of the CRR.

A more integrated financial market will support the emergence of new types of risk and also require extending the toolkit with new instruments. For the banking sector, this includes complementing the toolkit with borrower-based instruments (such as limits on loan-to-value, or loan-to-income ratios) as well as sectoral buffers and a time-varying leverage ratio add-on so that all aspects of systemic risks can be addressed in the banking union. Finally, the mandatory reciprocity framework needs to be expanded so as to ensure the effective mitigation of cross-border spillover effects and regulatory arbitrage across jurisdictions in the EU.

The significant progress we have made with our banking union needs to be recognised also from the international regulatory framework perspective. A case in point is the G-SIB[9] framework, which currently penalises cross-border transactions within the banking union by attaching a higher systemic risk score to banks with more transactions of that kind. This goes against the very rationale of the banking union, as it reduces the incentives for cross-border transactions and risk diversification, thus making banks more vulnerable to local shocks.

At the same time, we also need to remove the remaining obstacles to further integration within our banking union. Such obstacles are often due to regulatory fragmentation and ring-fencing of national markets. For example, a number of national options and discretions, such as diverging large exposure rules, are hindering the free flow of liquidity and capital in the banking union and should be harmonised further.

Turning to other parts of the financial system, we can expect that the CMU will provide further impetus to the growth of market-based finance and may present new challenges to financial stability.

Additional steps should be taken to strengthen the ability of European regulators and supervisors to address systemic risks stemming from the non-banking part of the financial sector. This could be achieved by expanding the mandate of relevant authorities and, in the medium run, by creating a single supervisor for the capital markets.

Adequate macroprudential instruments need to be envisaged as well, including instruments targeted at market-based finance. Macroprudential tools for this area either still need to be provided to authorities or need to be further clarified in respect of their application. For Securities Financing Transactions (SFT) and derivative markets, macroprudential margins and haircuts have been identified as potentially powerful tools for reducing the excessive build-up of leverage and procyclicality in these markets.[10] For alternative investment funds, the existing macroprudential leverage limit needs to be operationalised. The forthcoming review of the Alternative Investment Fund Managers Directive provides an opportunity to resolve any issues that may hinder the future implementation of this leverage limit.

Moreover, as the ESRB recently recommended, for the investment fund sector, the role of authorities when using their powers to suspend redemptions needs to be further specified in law. In addition, European Securities and Markets Authority should have a general facilitation, advisory and coordination role in relation to the National Competent Authorities’ powers to suspend redemptions in situations where there are cross-border financial stability implications.

The need for a European safe asset

The stability and integration of financial markets in the Monetary Union is also closely related to the creation of a euro area-wide safe asset, for a number of reasons. First, it could help reduce the excessive home bias in banks’ sovereign exposures, which exacerbates the feedback loop between banks and sovereigns. Reforms to the resolution regime (i.e. BRRD) have tackled the issue from one direction, from banks to the sovereign. However, at present, there is no clear solution for tackling it in the other direction, from the sovereign to the banks. The creation of a euro area-wide safe asset, composed of a pool of sovereign bonds, would lead to a reduction in the home bias of banks’ portfolios by facilitating de-risking and diversification.

Second, a euro area safe asset would be crucial for the financial integration and the capital markets union. In fact, it is necessary for the creation of an integrated, deep and liquid European bond market as a central piece of CMU. A single term structure of risk-free interest rates could serve as a euro area pricing benchmark for the valuation of bonds, equities and other assets. The safe asset could also be used as collateral, for example for repo and derivatives transactions across the euro area.

In principle, several options are available for creating a safe asset. Some options are not politically viable, while others may not be economically sound.

I am not referring to the type of eurobonds that would replace national sovereign debt as a joint liability of Member States, as these would require a deep political union. Various proposals have been put forward, but I will concentrate on just two: a variant of the European safe bonds (ESBies) or sovereign bond-backed securities (SBBS)[11] and the e-bonds as proposed in the Monti Report.[12]

The current proposal of the SBBSs refers to a tranched, synthetic bond backed by national sovereign bonds. The senior tranche would have very low risk levels, presumably below German debt, as a result of the diversification gains based on historical correlations and of the protection granted by lower-grade tranches. Market practitioners and rating agencies have been skeptical about the instrument. Their main concern is a perceived lack of diversification to ensure that the senior tranche can be indeed as safe as claimed because correlations among several countries' debt could increase in a stressful situation (as occurred during the financial crisis). Also, it may be difficult to sell the junior tranche at coupons that do not fatally compromise the overall economics of the synthetic security issuance. Indeed, if the junior tranche had to be placed at a relatively high coupon, then the senior tranche would need to offer a lower coupon than Bunds, a doubtful selling prospect. This would likely render the economics of the SBBS as unviable, which would be very unfortunate.

These obstacles could be overcome if, for instance, a small first loss tranche were to be covered by public guarantee, jointly provided by member states. Such contingent liability could be limited to a reasonable level. The success of the synthetic European Bonds would have significant benefits for financial integration and for the banking and capital markets unions.

Alternatively, a European entity could issue e-bonds as a pure securitisation of sizable amounts of national sovereign bonds but with a preferred creditor status over national sovereign bonds. Such a structure would be less efficient and could increase the cost of issuing the non-preferential part of national debt that is not included in the securitisation. However, this could even act as a disciplining device and would not necessarily imply an increase in the costs of the total debt issuance. The amounts achieved could nevertheless be considerable. For instance, according to a recent working paper of the Peterson Institute, in order to have an expected five-year loss rate of 0.5% or lower, the European entity could securitise 50% of a country's debt or 25% of its GDP.[13]

Capital Markets Union, financial integration and economic growth

A European safe asset is crucial for the CMU project which in turn important for economic growth. A big and liquid market, both of debt and equity, would spur innovation and enable the development of an efficient venture capital market. This relates to the importance of boosting the euro area's capacity to engage in activities conducive to innovation and productivity growth. In the years since the Great Recession, the pace of productivity growth in Europe has been persistently slow. In fact, European productivity growth had already started to stagnate during the mid-1990s.[14] While some economists have argued that this is all part of a global secular decline in growth, driven by factors such as an ageing population and growth convergence across emerging markets,[15] others believe that scientific progress will keep pushing the technological frontier forward.[16]

In any case, it is vital that we have financing mechanisms in place in Europe that can support science and technology's contribution to economic growth. One powerful way in which policy can assist this process is by stimulating the emergence of deep and integrated European capital markets. Capital markets, after all, play an important role in sharing economic risks and in smoothing consumption.[17] But even more fundamentally, they contribute greatly to innovation

and growth. Evidence increasingly suggests that while both banks and markets are important for the financing of economic growth, non-bank financial intermediation provides a relatively more powerful contribution to innovation and productivity-enhancing activities in modern sophisticated economies,[18] also in the euro area.[19] Importantly, complementarities between banks and markets increase, as the economy develops,[20] and so deep capital markets will end up complementing banks as sources of financing. While the European Commission's current CMU initiative is an important step in the right direction, a much more ambitious agenda for bolstering capital markets in Europe is needed in the future.

Developing well-functioning capital markets which support economic growth across Europe requires a comprehensive approach. To that end, Europe needs to boost the supply of equity finance. Policies which stimulate individual ownership of traded shares, such as reducing the tax advantage of debt over equity or enhancing financial literacy, can have a material effect on public equity markets in Europe. At the same time, because stock markets often penalise companies which undertake radical, but uncertain, innovative activities, the contribution of private equity – particularly in the form of early-stage venture capital finance – is indispensable, as a critical mass of angel investors who can provide financing for medium-size projects is also needed. Only with a deep, liquid market is it possible to launch IPOs of successful projects that can offset the losses with projects that fail.

Harmonising insolvency rules across jurisdictions would be a major step towards supporting capital markets. This is critical for mobilising finance through capital markets, as it would create incentives and favourable conditions for institutional investors to overcome the home bias in their investment strategies. This is especially true for pension investment, as large private pension funds tend to be a complement to deep capital markets. We need to establish a harmonised regulatory environment for new types of finance, such as crowd funding. The emergence of increasingly complex financial products needs to be accompanied by adequate consumer protection of financial investment, in order to safeguard financial stability and ensure the protection of individual investors.

The second component of a comprehensive approach entails policies that will stimulate entrepreneurship. High-tech entrepreneurial firms that aspire to go public should be supported and facilitated by stock exchanges specialising in IPOs for young innovative companies. A reduction in the wedge between corporate income taxes and personal income taxes has already been shown to have a strong positive effect on high-tech investment in a European context.[21] Last but not least, the efficient application of R&D tax incentives and increased public funding of private research universities, whose labs often make key scientific and technological breakthroughs, are other important avenues for stimulating innovation and the commercialisation of science.

Conclusion

Let me conclude. So far, measures adopted in the context of the CMU initiative, albeit positive and helpful, are not yet commensurate with the ambition of the project. With CMU, we should aim to reach a situation where both issuers and investors enjoy the same basic legal rights concerning capital markets activity regardless of the EU country where they are located.

The CMU project involves all EU member states but it is particularly important for the euro area member countries. It is a big waste to have taken the huge step to adopt a single currency and continue to forgo the benefits that could be reaped by creating a true banking and capital markets union. I believe that euro area countries should forge ahead in enhanced co-operation in order to achieve CMU more rapidly.

We should however, be well aware that CMU requires a European safe asset, the harmonisation of taxes on financial products, a convergence of company law, including on bankruptcy, the

creation of a single rule book of regulation for markets activity and ultimately a European Single Securities Market Supervisor. The other big condition is a rock solid monetary union so that assets' risks and returns are not significantly influenced by redenomination risk but exclusively by their idiosyncratic features. A heavy toll, I know, but I will believe that the CMU project is possible when I see authorities start making inroads in some of those difficult issues.

Thank you for your attention.

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