Luis de Guindos: Promoting the stability and efficiency of EU financial markets beyond Brexit

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the Deutsche Bundesbank reception on the occasion of the Euro Finance Week, Frankfurt, 13 November 2018.

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It's a pleasure to be speaking to you here today. In my intervention this evening, I am accepting the challenge set by the organisers to address the topic that has been on everyone's minds lately, and which I am sure will figure prominently in this week's discussions: Brexit. This is a difficult matter to tackle given all the uncertainty around it: we do not know what kind of Brexit we will eventually have.

We are all waiting to see whether a deal will be struck in the coming days, or whether we should prepare for a hard Brexit in March 2019. But I will not comment on the ongoing negotiations. As you know, we at the ECB have already expressed our views on the immediate cliff-edge risks in the financial sector. And we will provide more insight on these risks in our Financial Stability Review, to be published later this month.

I rather see Euro Finance Week as an occasion to take a step back from the day-to-day discussions and make a clear-eyed assessment of the issues and challenges that will shape the future of the financial sector. And Brexit is certainly one of these defining issues.

So today I am going to take a broader perspective and discuss the longer-term challenges that Brexit poses for the EU. I will cover three issues that I believe need to be addressed through long-term innovation in the EU's architecture.

First, Brexit accentuates the need to develop and integrate the EU's capital markets to prepare for the likelihood that the City of London will play a reduced role in the future. We should therefore renew our ambition for the capital markets union (CMU) project.

Second, Brexit means that the EU's future relationship with the United Kingdom in financial services needs to be defined. We will need to balance reaping the benefits of financial integration with safeguarding financial stability.

Third, Brexit reminds us that we should continue to deepen Economic and Monetary Union (EMU) and bolster the Single Market beyond its financial dimension.

Renewing the ambition for the CMU project

Financial services are an area where the EU-27 and the United Kingdom have strong and deep ties. To date, in some areas, the EU has relied on the City of London to provide key financial services which are necessary to support investment and growth.

But let me first put matters into perspective, notably in terms of financial services provided to the euro area economy. The direct provision of credit from the United Kingdom is extremely limited, not exceeding 1% of credit to firms and 2% of credit to households in the euro area. Lending through loan syndicates is also small: around 10% of syndicated loans granted to euro area firms involve UK banks. Turning to securities issuance, the share of total debt and equity issued by euro area firms listed on UK exchanges ranged from 5% to 15% over last decade.

Other areas, such as securities underwriting activity, are more meaningful – with UK-domiciled banks or subsidiaries accounting for about 40% of top book-runners in debt securities issued by euro area firms. These might be relatively easy to relocate, however. Derivatives transactions conducted in London also account for about one-fifth of the euro area real economy's hedging activities.[1] Finally, UK-domiciled central counterparties play an important role in clearing euro-denominated transactions, notably over-the-counter derivatives and repos. Admittedly, cross-border clearing of derivatives contracts is one area where financial stability risks may arise in a cliff-edge Brexit scenario without sufficient mitigating actions.

The transition to a new equilibrium therefore requires the financial sector to make appropriate preparations. But a reduced role for the City of London also underlines the need for revitalising the CMU project, which will improve the efficiency of credit allocation, facilitate private risk-sharing and diversify sources of financing for the real economy. This would also contribute to enhancing the attractiveness of our markets internationally.

I see two areas where progress is needed in promoting a consistent framework of supervision and rules that underpin the functioning of capital markets.

First, further harmonising insolvency rules and consumer protection laws is essential to protect rights and contracts, create a level playing field and promote cross-border investment.

Second, cross-border holdings of equity and debt seem to be the most effective way of smoothing consumption and fostering cross-border private risk-sharing.[2] Reducing or removing the taxation bias that favours debt over equity would help equity markets develop.

But neither of these steps will be enough on their own. As continental Europe’s financial markets adapt to the new post-Brexit reality, we could see one or several financial centres emerge, possibly in competition with each other, or perhaps not competing but rather specialising in certain areas.

If the EU-27 financial markets deepen, diversify and expand across borders, there is a clear flipside: these developments will need to be accompanied by sufficient oversight and tools to avoid the build-up of risks in certain parts of the system. That is why, in my speech yesterday,[3] I called for the macroprudential toolkit to be expanded to address potential risks around interconnection, liquidity, leverage and cross-border activities of non-bank financial institutions – in particular, investment funds. I also argued that we should consider elevating the responsibility for supervising these institutions, and potentially activating macroprudential tools, to the European level.

More consistent market oversight and enforcement of the relevant regulations will level the playing field. It will also facilitate cross-border integration because market participants will know they will be subject to the same rules across borders. At the same time, more centralised supervision would prevent harmful regulatory arbitrage. Ultimately, as a long-term goal we could also consider creating a single supervisor for capital markets.

Reaping the benefits of financial integration after Brexit while safeguarding stability

Developing a sound institutional framework to ensure sustainable financial integration is also at the core of my second point – the EU’s future relationship with the United Kingdom in the field of financial services.

To be clear, the ECB does not participate in Brexit political negotiations. So I will only be outlining considerations from the perspective of our monetary policy mandate, our supervisory responsibilities and our role in promoting financial stability.

The Single Market includes a common rulebook for financial services and an institutional framework of supervisory and oversight authorities. This framework allows European and national authorities to cooperate, exchange information and manage opportunities and risks arising in the Single Market. It is a careful balancing act between integrating Member States’ financial markets on the one hand, and safeguarding national and European financial stability on the other.

The United Kingdom's decision to leave the Single Market and its institutional framework means we have to perform an additional balancing act – one where we balance ensuring that EU financial markets are integrated and can interact efficiently with a non-EU country against the need to safeguard financial stability. There are benefits in maintaining a high level of integration with the United Kingdom after Brexit, and indeed, trade openness is in the DNA of the EU. But Brexit also entails making important policy choices regarding how open the EU's financial markets need to be, and what measures need to be in place to ensure financial stability, protect EU consumers and investors and safeguard the Single Market.

While not confirmed, current discussions indicate that the way in which we will interact with the United Kingdom in the area of financial services will be based on the EU's existing equivalence regime, with some expected enhancement. The aim would be to ensure sufficient regulatory and supervisory cooperation, information exchange and mechanisms to minimise unwarranted disruption in the functioning of markets linked to a potential loss of market access. This will of course be vital for the UK-EU situation after Brexit, but also provides an opportunity for our relations with other key non-EU countries.

However, a key principle underpinning third-country regimes needs to be maintained: we should avoid a situation in which non-EU firms are able to operate across the Single Market on the basis of a different rulebook and without a proper institutional framework. We cannot permit opportunities for regulatory arbitrage and let risks build up in the financial system.

It is also crucial that Brexit does not lead to a race to the bottom in regulatory and supervisory standards, and that the efforts that have been made to strengthen the financial architecture of the EU following the crisis do not unravel.

The framework thus needs to provide sufficient safeguards for maintaining financial stability. And, as risks differ across financial services, this in turn implies that different financial services may need to be regulated by different third-country models.

In the short term, a number of proposals should be adopted.

First, on the review of the prudential framework for banks (the Capital Requirements Regulation and Directive) the European Commission proposed that non-EU headquartered banks with subsidiaries in the euro area would establish an intermediate parent undertaking within the EU. This would bring certain non-EU branches under the umbrella of European banking supervision, as is established practice in the United Kingdom and United States. Going forward, further harmonisation of the regulatory and supervisory framework of third-country branches in the Union would be of the essence.

Second, we need to adapt how large investment firms are supervised to reflect the many similarities between their activities and those of banks. It therefore makes sense to supervise these investment firms as if they were banks, in line with the principle that similar risks are treated in a similar manner.

Last but not least, we need to finalise the review of the European Market Infrastructure Regulation. Currently, the system is not designed to cope with major systemic central counterparties operating from outside the EU. We therefore need to adapt it to the post-Brexit reality and enhance the role for the central banks to monitor and address risks to the EU's financial system.

Creating a prosperous and stable macroeconomic environment: reducing and sharing risks in our monetary union

Brexit is, or at least should be, acting as a catalyst to modernise the architecture of the EU's capital markets and safeguard their stability. These markets have to be embedded in a resilient EMU across all its dimensions – which is my third point today.

Given that the EU financial system will remain predominantly bank-based, completing banking union in all its dimensions is certainly a key priority.

For this, we need to continue to forcefully address the legacy issues which are still weighing on the stability of the banking sector and damaging trust among Member States. This includes addressing the stock of non-performing loans (NPLs) and Level 2 and 3 exposures. Progress has been made: over the past three years, the NPL stock of significant banks decreased by one-third, supported by our supervisory action. The proportion of significant institutions' total assets accounted for jointly by Level 1, 2 and 3 assets has also fallen from over 30% to 23%.[4] However, further efforts are needed from banks, supervisors and regulators.

At the same time, we should establish a credible common backstop to the Single Resolution Fund and create a European deposit insurance scheme. And, yes, this implies risk-sharing. But as I have argued before, a complete banking union is also a confidence-building mechanism that contributes to risk reduction, for example by enabling the credible and effective resolution of banks.[5]

As demonstrated by the financial crisis, financial markets do not operate in a vacuum. Their strength and resilience can lift economic growth and shield sovereigns. But the dependence also runs the other way: flourishing and resilient financial markets depend on a stable macroeconomic environment. That is why further steps to reduce and share risks in the fiscal and economic spheres are critical.

Without fiscal policy space or sound economic policies, even well-functioning financial markets can be adversely impacted during downturns as growth slows, banks' balance sheets weaken and financial integration goes into reverse. To underpin the financial and fiscal spheres with strong growth, we need to reflect on how to bolster the implementation of structural reforms – an area which has seen lacklustre progress in recent years.

As we look for ways to increase potential growth, Brexit also reminds us of the opportunities available by deepening the Single Market – the "E" in EMU. With the departure of the United Kingdom and its 66 million citizens, the Single Market will obviously shrink, but it has always had two dimensions which can be leveraged to increase its benefits. One is its geographical size; the other is its depth.

So it is crucial that we complete the Single Market for services and expand its reach into new areas, especially those that are relevant for innovation, such as the digital economy. This is an essential driver of economic progress that benefits consumers, businesses and the economy as a whole and will also provide a healthy ecosystem for financial services.[6]

Conclusion

Let me conclude. The unifying theme of the three priorities I have outlined today can be summarised by looking at the nature of the Single Market. In a nutshell, the Single Market – including for financial services – provides a framework in which integration is accompanied by supervisory and regulatory convergence through common rules and institutions. It is this landscape of rules and institutions which provides the necessary protection for people and businesses to engage in cross-border activities. It is a framework that has delivered tremendous benefits to its members. It is extremely valuable and needs to be protected.

Whatever the outcome of the negotiations with the United Kingdom, the integrity of the Single Market must be ensured. And we should constantly show the public how our reforms will benefit ordinary people.

Brexit underscores the need to move ahead with securing all facets and institutional foundations of our Union. A Union which has led to peace on the Continent. A Union which has provided great benefits for the people of Europe, increasing living standards across Member States and bringing them closer together. But this great European project has to do more than just reflect on its past achievements. It needs to continue improving itself to deliver visible benefits for people's day-to-day lives. I am confident Europe will once again rise to the challenge.

Thank you.

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1 See, ECB (2017) Financial Stability Review, May, Box 1. Figures relate to financial services provided to the non-financial corporate sector.

2 See Cimadomo, J., Furtuna, O. and Giuliodori, M. (2018), "Private and public risk sharing in the euro area", *Working Paper Series*, No 2148, ECB, May.

3 See de Guindos, L. (2018), "Coming to the forefront: the rising role of the investment fund sector for financial stability in the euro area", Speech at Opening Conference, 21st Euro Finance Week, Frankfurt am Main, 12 November.

4 Level 3 assets decreased from €188 billion to €132 billion, constituting less than 1% of significant institutions' total assets.

5 See de Guindos, L. (2018), "Building a resilient Economic and Monetary Union", Lectio magistralis opening the XXIX Edition of the Masters Programme in European Union law of the University Carlos III of Madrid, 5 October.

6 See: www.europarl.europa.eu/EPRS/EPRS_STUDY_536353_CoNE_Single_Market_I.pdf