Luis de Guindos: Redesigning Europe's financial landscape

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the 6th Frankfurt Conference on Financial Market Policy, Frankfurt am Main, 14 December 2018.

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It is a pleasure to be here today.

As you know, there is a long tradition of the ECB participating in SAFE conferences here in Frankfurt. The second conference in 2014 was already dedicated to "Banking beyond banks" acknowledging important changes underway in the European financial landscape.[1] Indeed, this was a prescient choice of topic given the growth of the non-bank sector, which has continued unabated ever since. In a recent speech[2], I also highlighted the rapid growth of asset management in the euro area and at the global level, and the impact this is having on the structure of the euro area financial sector. In fact, in 2008, total assets held by investment funds made up just 15% of banking sector assets. In 2017, these assets had grown to 42% of total banking sector assets, amounting to €12 trillion. As the non-bank sector continues to grow, so does the need to ensure that our supervisory and regulatory framework is fit for purpose.

At the same time, banks still play an important role in many areas of Europe's financial system, notably in the financing of small and medium-sized enterprises (SMEs). So a healthy banking sector remains crucial to financing the economy, and despite the progress made in improving the resilience of European banks, some legacy issues from the crisis continue to weigh on the system.

This has two implications for strengthening the financial pillar of Economic and Monetary Union (EMU), which will be the topic of my speech today.

First, we need to shore up the banking sector further by thoroughly completing the reform agenda that emerged in response to the crisis. This means taking the remaining steps to complete the banking union – in terms of both risk reduction and risk-sharing.

Second, we need to facilitate the growing role capital markets and the non-bank sector can play in financing economic growth in a sustainable and resilient manner. This requires boosting the capital markets union (CMU) agenda while ensuring that authorities are equipped to face the new challenges of a changing financial landscape. This will require the fragmentation of European capital markets to be overcome and the macroprudential toolkit to be extended beyond the banking system to cover, in particular, the investment fund sector.

Finalising post-crisis reforms

I welcome the decisions taken by the Eurogroup[3] to continue advancing the banking union, reforming the European Stability Mechanism and building euro area fiscal instruments.

In the financial sector – which is my focus today – the response to the crisis has centred on addressing weaknesses in the regulatory and institutional framework. The new European regulatory framework is making Europe's banks more resilient and gives authorities the tools to act when risks begin to build up. Furthermore, banking union elevates the supervision and resolution of banks to the European level.

This strategy has paid off: substantial risk reduction has been achieved, is ongoing and should continue. Banks now hold more and better-quality capital than in the past[4], and have improved their liquidity positions and leverage. Addressing legacy issues, such as high levels of non-performing loans (NPLs), is progressing well. For banks under direct ECB supervision, NPL

levels fell from €958 billion when the Single Supervisory Mechanism was launched to €657 billion in June 2018. The framework for resolution, following the introduction of BRRD and the implementation of Minimum Requirements of Eligible Liabilities (MREL) also contribute to increase buffers, reduce risk and thereby the scope for risk sharing.

However, the euro area's financial architecture is not yet complete.

There is some good news: there is now an agreement to make the common backstop to the Single Resolution Fund (SRF) operational, which will instil confidence in the markets that bank resolutions will happen in an orderly fashion. There is also a recognition that it is time to start political discussions on the missing third pillar of the banking union – a European deposit insurance scheme (EDIS). The high level group in charge of the discussions must be ambitious and ensure that we live up to the agenda laid down in the roadmap on completing the banking union agreed by finance ministers in 2016.[5]

The ECB has often made the point that the opposing sides of the debate – risk reduction versus risk-sharing, and private risk-sharing versus public risk-sharing – are in fact complementary.[6]

Completing the institutional leg of the banking union, with the SRF and EDIS, would move us closer to a level playing field. In a genuine banking union, banks would operate across borders and diversify their sources of income, which would allow them to continue lending to the real economy even when faced with localised shocks. This would create private risk-sharing across the euro area and shield regions from localised credit crunches.

But a level playing field for banking would also enable risk reduction. Increased cross-border competition between banks, backed by a solid system of European supervision and the winding down of unwarranted national protections, could further incentivize banks into getting their balance sheets in order.

At the same time, the SRF and EDIS would also constitute a form of private risk-sharing by providing a final, powerful backstop. They enable bank resolution, limit contagion in the case of bank defaults thereby contributing to safeguarding overall financial stability. This, in turn, would reduce the need for public risk-sharing in the first place. Such an approach is borne out by the experience of other advanced economies, such as the United States, where hundreds of banks were resolved successfully by the Federal Deposit Insurance Corporation with no long-term fiscal costs.

While the case for completing the banking union is strong, supporting EDIS is seen by some as tilting at windmills. Indeed, three years after the initial Commission proposal, progress has been very limited. But the potential benefits of EDIS are not the illusions of a romantic daydreamer like Don Quixote; they are, in fact, very real. EDIS would provide uniform confidence in deposits across Europe which would be beneficial for all European economies, as no single banking system is immune to a potential bank default. EDIS would therefore further underpin EMU by ensuring that a €1 deposit is just as safe, and just as valuable, wherever you are in the euro area.

Fostering the resilient and sustainable development of Europe's financial landscape

Completing the post-crisis agenda is therefore crucial, but we should not only look back. After dealing with banking sector fragilities, we should now be shifting our attention to the steadily growing non-banking system, which is changing Europe's financial landscape and whose potential to contribute to growth has not been fully unlocked.

A range of banking activities is increasingly carried out by non-banks, notably insurance companies and the investment fund sector at large. Total assets of the euro area investment fund sector have expanded by roughly 170% between 2008 and 2017, on account of both net cash inflows and rising asset valuations.

Deeper and more efficient bond and equity markets in Europe would permit economies of scale and allow capital to be allocated to the most productive uses at the European level, in line with the Single Market objectives. By enhancing cross-border private risk-sharing and consumption smoothing through cross-border holdings of assets, CMU can reduce the need for public risk-sharing.

Developing capital markets would also alleviate the shortage of risk capital[7] that hinders the growth of Europe's innovative start-ups and SMEs by increasing the presence of investors with high risk-bearing capacity. As in the case of depositors, issuers and investors should enjoy the same legal rights in capital market activities across the EU, irrespectively of their country of domicile. Furthermore, 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.[8]

In terms of legislation, the CMU agenda has already yielded some positive results, but a more ambitious long-term approach should be pursued.

On insolvency frameworks, the Commission has put forward a number of proposals[9] which aim to enhance aspects, such as the efficiency of debt recovery procedures.

In the realm of taxation, adopting the proposal on a common consolidated corporate tax base would help to reduce or remove the bias towards debt over equity in some Member States, thereby facilitating the development of equity markets.

The creation of a pan-European personal pension product, for instance, would help channel more savings into long-term investments through a portable, pan-European product.

Finally, fostering a deep and efficient CMU means reviewing the supervisory framework to align it with the cross-border nature of capital markets, enhance supervisory and regulatory convergence and remove possibilities for regulatory arbitrage, also crucial in the context of Brexit.

Indeed, the non-bank financial sector may harbour leverage and liquidity risks, requiring additional efforts to address emerging vulnerabilities at the system level.

First, the asset management sector is highly connected with other parts of the financial system through ownership links, common asset exposures and the provision of wholesale funding to banks.

Second, liquidity mismatches and leverage often build up slowly over time. In the euro area, we see that investment funds have been taking on higher credit risk and duration risk in the current market environment. And there are strong indications that liquidity risks are building up in the sector with the share of less-liquid assets in the sector growing continuously since the global financial crisis.

Third, the overall leverage of the sector is difficult to grasp. Alternative investment funds do not face any binding restrictions on leverage. A tail of highly leveraged bond and hedge funds with leverage multipliers exceeding 30 compares to an average leverage ratio for banks of below 20 in the euro area.

As the global crisis has shown, we must remain vigilant to possible new risks that might emerge in the financial system. We need to better understand the macroprudential dimension of risk in the investment fund sector. And we need to further enhance the sector's resilience to system-wide shocks.

The existing regulatory framework, with the Undertakings for Collective Investment in Transferable Securities and Alternative Investment Fund Managers Directives as the main

building blocks, is well designed to address micro-prudential and consumer protection concerns. However, additional tools need to be developed to address rising risks in the investment fund sector from a macroprudential perspective.

Macroprudential policy is primarily preventive. The toolkit available to macroprudential authorities should include ex ante tools to limit the build-up of risks associated with liquidity and leverage in the investment fund sector, such as minimum mandatory liquidity buffers and redemption notice periods.

The investment fund industry in the EU is furthermore highly concentrated in a few jurisdictions, but – due to the diverse asset holdings and investor locations – the impact of adverse developments in this sector may be felt across the EU. So we should consider elevating the supervision of investment funds and the potential activation of macroprudential tools to the European level. This would be also in line with the spirit of CMU.

A comprehensive, long-term European strategy for a more complete financial union

Let me conclude. Finalising EMU reforms, completing banking union and capital markets union must stand out as unquestionable objectives. We need to pursue a comprehensive long-term European strategy for building a more complete financial union that fosters both risk-sharing and risk reduction, which, as I argued, are two sides of the same coin. This will strengthen the financial system in the long run.

Achieving these objectives hinges on building a strong degree of trust between Member States and European institutions. It fundamentally hinges on looking beyond short-term national benefits and pursuing European goals. Europe should live up to its ambitions.

Thank you for your attention.

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[1] See Constâncio, V. (2014), "Beyond traditional banking: a new credit system coming out of the shadows", speech at the 2nd Frankfurt Conference on Financial Market Policy: Banking Beyond Banks, organised by the SAFE Policy Center of Goethe University, Frankfurt am Main, 17 October.

[2] 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 the Opening Conference of the 21st Euro Finance Week, Frankfurt am Main, 12 November.

[3] See the Eurogroup report to Leaders on EMU deepening.

[4] The fully-loaded CET1 ratio of significant institutions was 13.8% in the second quarter of this year, up by 2.6 percentage points compared with the last quarter of 2014.

[5] See the press release from the European Council.

[6] For example, 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.

[7] See AFME (2017), *The shortage of risk capital for Europe's high growth businesses*, March.

[8] See de Guindos, L. (2018), "Promoting the stability and efficiency of EU financial markets beyond Brexit", speech at the Deutsche Bundesbank reception on the occasion of Euro Finance Week, Frankfurt am Main, 13 November.

[9] See European Commission (2018), "Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral", 14 March.