Luis de Guindos: Building the EU's capital markets - what remains to be done

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the Association for Financial Markets in Europe Conference, Supervision and Integration Opportunities for European Banking and Capital Markets, Frankfurt am Main, 23 May 2019.

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It is a pleasure to be here today to share my thoughts on the future of capital markets union (CMU). CMU is undoubtedly a key project for the Association for Financial Markets in Europe (AFME), but it is also important for the European Central Bank (ECB).

The primary objective of CMU is to foster deep and diversified capital markets that provide a wide source of financing options to European companies and citizens and act as an engine for investment, innovation and growth. Vibrant EU equity markets and truly diversified cross-border debt markets would complement traditional bank lending by fostering risk-taking and investment.[1]

Indeed, capital markets can, for instance, provide different forms of funding sources that are better tailored to firms' needs along their stage of development. A well-functioning CMU would also complement the banking union by providing channels to mobilise the large existing pool of savings towards financing the economy. It could help facing tomorrow's challenges, such as climate change and digital innovation.

Within our Economic and Monetary Union, more integrated capital markets can also help to cushion shocks to parts of the euro area, thereby enhancing the resilience of the euro area as a whole.[2] From the companies' point of view, cross-border ownership would mean that they have a wider pool of investors and potentially more stable sources of capital available for their investments. From the side of investors, diversified portfolios would help them hedge against country-specific risks. Cross-border capital markets and banks would thus provide the level of private risk-sharing we need to ensure the long-term resilience of the euro area.

In my remarks today I will argue:

- First, that financial markets are playing an increasingly important role in funding the economy, but more needs to be done to foster sustainable cross-border financial integration and risk-sharing;
- Second, that a revamped CMU agenda should be geared towards addressing the challenges facing Europe, such as Brexit, and ensuring that capital markets growth does not endanger financial stability;
- And finally, I will highlight the important synergies that exist between the capital markets and banking union projects.

How far away is a European capital markets union?

First, the good news: we are seeing a change in the structure of financial markets. The non-bank sector continues to grow. It is playing an increasing role in providing a stable source of funding to the European economy. Financing of euro area companies' via debt securities and non-bank loans has increased from 24% to 36% in the last ten years.[3] In fact, in this period, issuance by companies grew from 8% to 10% of GDP.[4] Turning to equity financing, listed equity issued by non-financial companies increased from 36% of GDP in 2014 to 41% in 2018. The total market capitalisation of listed companies in the EU is now above pre-crisis levels.

Another positive is that European investment funds are playing an increasingly important role in cross-border integration. This helps investors spread their holdings across countries and achieve better diversification than they would through direct holdings of assets. The sector is also contributing to integration in the euro area corporate bond markets: almost 80% of investment funds' holdings of euro area-issued bonds are non-domestic, i.e., issued outside their own domicile.[5]

But the picture for the overall financial system is mixed. We see positive developments in the convergence of asset prices across the euro area – what we call price-based integration. However, the post-crisis reintegration of cross-border asset holdings, which we call quantity-based integration, has stalled.[6]

Consequently, while most initiatives under the CMU action plan are on the path to completion, a "CMU effect" on the cross-border integration of capital markets is yet to be seen. One reason is that despite general support for the CMU project, progress in addressing core barriers to further integration has been too slow.

Let me take a few examples: steps have been taken in harmonising elements of insolvency frameworks, such as 'early restructuring' and 'second chance'. But these do not cover the conditions for opening insolvency proceedings nor the ranking of claims. As such, they are not enough to facilitate cross-border investment. Similarly, more should be done to remove overlaps in cross-border withholding taxes and reduce home bias in investment strategies. In my view, we need a single rulebook in a wide range of areas also covering consumer protection, anti-money laundering, or accounting rules for a successful CMU.

Another reason for a limited "CMU effect" is that some of the agreed initiatives were only recently implemented. Take the securitisation package, for example. Important technical regulatory acts are still pending which prevent the new framework from being applied in full and are a source of uncertainty for those who would like to use it. It is therefore too early to assess the success of this measure.

More importantly however, some proposals will not deliver their full potential. In the case of the pan-European personal pension product, the recent agreement gave birth to a rather complex product for which key elements are left to the discretion of Member States. Lack of ambition in the cross-border portability of the instrument may limit its capacity to facilitate labour mobility and the mobilisation of savings across borders in the absence of geographical diversification requirement for investments.

This underpins the relevance of the CMU agenda for the coming years and the importance of making CMU a reality.

Revitalising the CMU agenda to face new challenges

My second point today is that a revamped CMU agenda would help the EU to face up to new challenges.

The departure of the United Kingdom from the EU is undoubtedly one such challenge. As a response, CMU should continue to aim to develop and integrate the EU's capital markets in a context in which capital market activities throughout Europe are being reorganised.

In the new post-Brexit reality, we could see one or more financial centres emerge in continental Europe, possibly in competition with each other, or perhaps each specialising in certain areas. CMU should facilitate this transition by creating a framework that supports the emergence of an integrated financial market and avoids a return to a fragmentation of activities.

In this context, a successful CMU means that the continued expansion of the non-bank sector should be accompanied – rather than followed – by a revision of the prudential and supervisory framework. Importantly, we need to develop macroprudential policies for the non-bank sector at the system level to ensure that the system absorbs shocks, rather than amplifying exuberance and stresses.

Ultimately, this would warrant a discussion on a potential move towards more centralised supervision of financial markets. The recent reform of the European Supervisory Authorities falls short of adapting Europe's supervisory framework to the ambition of CMU. The review did not result in a broad revision of the powers and mandate of the ESAs, nor in a strengthening of the European perspective in the ESAs governance. Ultimately, the growth and integration of capital markets need to be reflected in the EU's supervisory set-up.

Reaping the synergies between CMU and banking union

This brings me to my last point: we should take advantage of the synergies between CMU and banking union.

More efficient markets could complement banking union by offering ways to mobilise EU savings to finance young and innovative firms. Fostering equity investment by addressing the debt-equity bias would support the development of an equity culture and increase households' return on their savings, for example. It could furthermore enhance financial stability through the reduction of leverage in the corporate system. At the same time removing barriers to the functioning of cross-border debt markets would facilitate a smooth allocation of the savings surplus across the euro area.

Creating an EU playing field in terms of insolvency regimes, taxation and supervision would support both the objectives of CMU and the banking union. In fact, strong cross-border banks and cross-border ownership of assets would reduce the risk of disruptive capital flight in crisis times, while also reducing the bank-sovereign nexus.

To achieve CMU and banking union, we should also look at controversial issues such as the need for a European safe asset. There is no other currency union in existence in which regional debt is considered to be the safe asset. Addressing this gap would support the banking and capital markets by creating a homogeneous product of a high quality and significant size that could become a benchmark for investors. If designed in a way that doesn't undermine incentives for sound national fiscal policies, a safe asset would help to mitigate the bank-sovereign nexus, reduce cross-border safe-haven flows and improve financial integration, thereby also enhancing the effectiveness of our monetary policy. And, last but not least, this would contribute to enhancing the attractiveness of European capital markets and ultimately support the international role of the euro.

Promoting European responses to achieve CMU

Let me conclude with two messages.

First, convincing investors and companies to venture outside their borders requires certainty and homogeneity on the regulatory conditions that apply abroad. This means that the core aspects of national policies need to be further harmonised and implemented in a consistent way to support the integration of capital and banking markets. Banks and capital markets should complement each other in channelling savings for productive uses and fostering investment in innovative firms.

Second, moving towards CMU and banking union should also reflect the ambition we have shown in our supervisory and regulatory set-up. It should support a coherent European response to new challenges such as Brexit and the development of non-bank finance. And it should not shy away from addressing gaps in our regulatory and institutional framework.

[1] ECB (2018), "Special feature A: Financial development, financial structure and growth: evidence fromEurope", *Financial integration in Europe*.

[2] ECB (2016), "Special Feature A: Financial integration and risk sharing in a monetary union", *Financial integration in Europe*.

[3] ECB Financial Stability Review, (2019), forthcoming, May.

[4] European Commission (2019), "*Capital Markets Union: progress on building a Single Market for capital for a strong Economic and Monetary Union*", European Commission contribution to the European Council.

[5] ECB (2018), "Special feature B: Integrating euro area corporate bond markets: benefits and potential financial stability challenges", *Financial integration in Europe*.

[6] The ECB's price-based composite indicator of financial integration shows a pronounced increase during 2017, while quantity-based integration has stalled since 2015 (see *Indicators of financial integration in the euro area*).