Benoît Cœuré: European capital markets - priorities and challenges

Dinner remarks by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the International Swaps and Derivatives Association, Frankfurt am Main, 25 June 2019.

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The past decade has seen remarkable achievements in strengthening global financial regulation, and in making our economies safer and more resilient, thanks in large part to the work of the international community under the auspices of the Financial Stability Board (FSB).

But now, more than ten years after the crisis, priorities have shifted and there are concerns that the cooperative multilateral order that has underpinned past international achievements is increasingly being questioned.

In my remarks this evening I will argue that dismantling regulatory standards would be a mistake, and would add to market fragmentation. I will also argue that the current low levels of financial integration in the euro area are inefficient, and that, as a response, we need to intensify our efforts if we want to achieve tangible progress in completing banking union and creating a true capital markets union (CMU).

In the last part of my remarks I will briefly touch on the ongoing reform of interest rate benchmarks, which is essential to safeguard the smooth transmission of monetary policy and the resilience of the financial system.

Market fragmentation as a source of concern

The achievements of the FSB and the global standard-setting bodies since the financial crisis are remarkable. By rolling out international standards and new principles for regulatory cooperation, they have made global financial markets more integrated and our financial system safer and more resilient, protecting taxpayers from costly bailouts.

We have also made significant progress at a regional level. In the euro area, we now have a single banking supervisor that harmonises supervisory actions across participating countries. At the level of the European Union (EU), the Commission and the co-legislators have also strengthened the single rulebook and launched an ambitious agenda for creating a CMU.

But with the financial crisis gradually disappearing in the rear-view mirror, ambition for further reforms is weakening and reluctance to implement already agreed standards is rising.

Hidden forms of financial protectionism, or a relaxation of regulation, would turn back the clock on internationally agreed rules, revive distrust, and risk regulatory arbitrage and a race to the bottom.

As a result, market fragmentation has become one of the more pressing issues for global standard-setting bodies and the financial community in recent months. The Japanese G20 presidency has identified market fragmentation as a key priority, and the FSB published its report on the matter just ahead of the G20 Finance Ministers and Central Bank Governors Meeting in Fukuoka on 8 and 9 June.[1] ISDA itself prominently discussed the topic at its 34th Annual General Meeting in Hong Kong earlier this year.

Market fragmentation can arise for a number of reasons, such as technological differences, divergent tax regimes or differences in local financial structures. Diverging regulation and supervisory practices can also play a role here.

Not all types of market fragmentation are harmful. Stricter financial regulation in some parts of the world, for example, may help promote financial stability more widely by mitigating perilous cross-border spillovers, insofar as it does not increase risk taking in foreign markets.[2] Other types of fragmentation may come with real economic costs, however.

In Europe, for example, financial integration has gone into reverse since the crisis broke and is only very gradually coming back. Today, intra-euro area cross-border risk sharing is at uncomfortably low levels.[3] And without private risk sharing, country-specific shocks will continue to cause persistent dispersion in economic outcomes across euro area countries, undermining real convergence and hampering the conduct of the single monetary policy.

Priorities for CMU after Brexit

It is this type of fragmentation that I would like to focus on in the remainder of my remarks.

Financial disintegration is particularly harmful in a currency union where deeper and more liquid financial markets should be able to compensate for the absence of other intra-regional shock absorbers, such as flexible exchange rates. Financial markets that can absorb shocks efficiently, and contribute to macroeconomic stabilisation and resilience, do not waste costly political capital. And they create more policy space in downturns, for both fiscal and monetary policy.[4]

I am not arguing here that public risk sharing is irrelevant. But progress towards a euro area fiscal capacity with stabilising features, however desirable, will be a long journey. Better private risk sharing mechanisms can only make it more acceptable. As the US monetary union shows, both private and public risk sharing are in fact complements, not substitutes.

A true CMU could contribute to filling a substantial part of this void and help diversify and reduce risk in the euro area. Significant progress has already been made. Under the outgoing European Commission, 11 of the 13 legislative initiatives tabled under the current CMU action plan were finalised, together with most of the non-legislative actions.

But the pace with which co-legislators, and Member States in particular, have progressed on individual initiatives has been much slower. Ring-fencing and considerable differences in national legislation mean that CMU remains incomplete in many respects, while new challenges for financial integration have emerged.

The United Kingdom's departure from the EU's Single Market, in particular, will by its very nature affect the shape of Europe's future financial market architecture. A large number of banks and investment firms are in the process of establishing or expanding their euro area presence with a view to ensuring that they can continue to serve the Single Market after Brexit.

Plans submitted to the ECB indicate that this can be expected to result in a substantial relocation of activity to the euro area, in the order of over €1 trillion in bank assets, and that, at least in the short term, activity will move to a number of euro area countries, possibly resulting in the development of a multi-centric European financial system.

While the landscape may evolve further in the future, in a financial system with a number of increasingly important hubs, as opposed to one dominant hub in London, it will be more important than ever for these hubs to be able to efficiently interact with one another and to avoid differences across Member States providing opportunities for regulatory arbitrage.

So, Brexit reinforces the urgency with which we should pursue policies that address barriers to capital market integration in the EU. This discussion is also closely connected to the parallel discussion on the global role of the euro, which fundamentally depends on our ability to build deeper and more efficient financial markets.[5]

Advancing CMU should therefore be a top priority for the new European Commission and Parliament. The ECB is a key stakeholder in this discussion, as the transmission of our single monetary policy crucially depends on the degree of financial integration in the euro area.

But we should recognise that not all of the numerous initiatives adopted under the CMU action plan will have the same impact. And some initiatives with greater potential, such as the creation of a common safe asset, will face considerable political resistance in the short term.

We should therefore choose our battles wisely when discussing policy priorities that could improve Europe's financial market architecture in the short term. So what areas should we focus on when shaping CMU in the future? In the view of the ECB, there are three high-priority areas.

Harmonising insolvency frameworks

The first relates to harmonising insolvency frameworks – an area in which synergies between the banking union and the capital markets union are particularly strong. High non-performing loan ratios, and their effects on growth and bank lending, are a case in point.

Transparent and efficient insolvency frameworks are the backbone of cross-border capital markets transactions. They safeguard trust and legal certainty for issuers and investors. And by fostering effective and efficient resolution actions, they increase the expected return on investment and thereby stimulate investment in both credit and capital markets. The end result is higher rates of economic growth, more dynamic local economies and higher levels of private risk sharing.

Some progress has already been made, most notably through the proposal on preventive restructuring frameworks, second chance, and measures to increase the efficiency of restructuring, insolvency and discharge procedures.

But the Commission proposal fell short of harmonising core aspects of insolvency, such as rules on conditions for opening insolvency proceedings, a common definition of insolvency, ranking of claims and avoidance actions in general. And for various aspects that were included in the proposal, it has become clear that, at the current stage, we face significant challenges in overcoming prevailing divergences in views among Member States.

It thus makes sense for EU legislators to tackle this issue in stages, and focus first on harmonising *specific* elements of insolvency frameworks. Full harmonisation of creditor hierarchy in bank insolvency, for example, is one area where achieving tangible results would have a high impact.

A harmonised depositor preference rule would help create a level playing field for debt issuance by banks and enhance the robustness of their resolution framework, which benefits the overall stability of the financial system and, in turn, strengthens banks' capacity to support the wider economy.

More generally, a clear credit hierarchy for all companies, not just banks, would provide cross-border investors with greater comparability and transparency on the ranking of their claims in insolvency.

Supervisory convergence and the oversight and supervision of central counterparties

The second area that we should prioritise on the CMU agenda relates to supervisory convergence.

The final outcome of the review of the three European Supervisory Authorities (ESAs) fell short of its initial ambitions, in particular on governance aspects, where national authorities retain a leading role despite a strengthened profile for the ESAs' chairpersons.

Ever-more sophisticated technologies and products, climate change and the rise of cybercrime increasingly require a highly coordinated European approach and a governance and accountability structure for the European Securities and Markets Authority (ESMA) that is more consistent with its status as a fully-fledged supervisory body.

Consider Facebook's plan to launch a new global digital currency, the implications of which are now being scrutinised by a G7 working group, which I chair. Such initiatives naturally require a global response, including a harmonised pan-European position.

To put it simply, truly integrated European capital markets will ultimately require a single capital markets supervisor, much in the same spirit as we have a single bank supervisor today.

Take the role of ESMA in the supervision of central counterparties (CCPs). Given that the brunt of default risk in EU CCPs is borne by their clearing members, most of whom are directly supervised and resolved at the European level, the principle of aligning liability and responsibility clearly implies European supervision of EU CCPs.

But despite significant legislative efforts, the recent revision of the European Market Infrastructure Regulation (EMIR 2) is a lost opportunity to advance capital market union, as the competence for CCP supervision will remain almost exclusively national.

What EMIR 2 does do, however, is strengthen the EU regulatory framework with respect to clearing activities which are systemically important for the EU but take place in non-EU countries, including those provided from London after Brexit. This debate is arguably at the heart of the current discussion on fragmentation.

Instead of being based only on equivalence at jurisdiction level, the new framework will also subject systemically important non-EU CCPs to EMIR standards and supervision by ESMA. This will ensure a level playing field with EU CCPs, limiting regulatory arbitrage, and enhance CCP resilience.

One open issue is whether regulators should force swaps clearing to be relocated even if it risks increasing spatial fragmentation. EMIR 2 clearly states that recognition can only be denied as a last resort, and the ECB supports this approach.

Cooperation has, in fact, always been the ECB's preferred approach to the oversight of financial market infrastructures, as per Responsibility E of the CPMI-IOSCO Principles for Financial Market Infrastructures. In this respect, the existence of common regulatory standards for CCPs has been playing a fundamental role for underpinning co-operation arrangements, including mutual recognition.

We therefore also note with interest that the US Commodity Futures Trading Commission now intends to move to a proportional approach similar to EMIR 2, and we look forward to learning more about this new framework in the future.

I would only note that, given the importance of clearing for the stability of the global financial system, our reliance on deference depends on the depth of cooperation and information-sharing between authorities. There is still much progress to be made on that front, and the implementation of international commitments is of the essence.

Diversifying external funding for the real economy

The third area of priority for CMU should focus on broadening and deepening the funding mix of euro area firms and households. This is particularly important for the transmission of monetary policy.

Today, firms in the euro area predominately rely on bank lending for their debt financing, although the importance of non-bank financing has increased over the past ten years. The latest data indicate that bank lending accounts, on average, for around 55% of debt financing of euro area firms.[6] In the United States, by contrast, firms source around 70% of their debt financing directly from non-banks, and only 30% from banks.

In principle, bank and market-based finance tend to support economic development and living standards in similar ways.[7] But the euro area sovereign debt crisis, and the subsequent impairment of the bank lending channel, underlined that what matters for resilience and growth is that funding is diverse and avoids concentration risks.

Clearly, market financing is still too rare in the euro area and too restricted to large companies. According to the most recent survey on the access to finance of enterprises (SAFE), for the period from October 2018 to March 2019, only 11% of small and medium-sized companies (SMEs) have considered taking on equity financing, and only 3% issued debt securities.

SMEs have therefore increasingly sought to raise capital outside of public capital markets. Private equity investors, in particular, have partly filled the void left by financial markets. Their investment has increased considerably in recent years and has also benefited many young and small companies.

In 2018, total equity invested in European companies increased by 7% to €80.6 billion, the highest level recorded to date.[8] The number of companies receiving equity investment also reached its highest level, also increasing by 7% to over 7,800 companies. 86% of these were SMEs. Venture capital investment, which is particularly important for young innovative firms, stood at a historical high of €8.2 billion, funding a record 4,400 companies.

But because the United Kingdom is home to around one-fifth of the EU's private equity funds, Brexit may disrupt private equity investment as non-EU private equity funds can only be marketed in the EU under strict conditions.

In order to fill the gap left by the possible loss of UK private equity funds, we need to harmonise the myriad of existing national requirements and ensure that EU-based funds and managers are allowed to reap the full benefits of the single passport and market their products to all suitable EU investors.

All this suggests that more needs to be done to further diversify external funding of euro area firms, in particular for SMEs, which are typically the first to suffer from tightening credit conditions when the tide turns and risk aversion rises. This relates to both market *integration* and market *development*.

The role of market development

Market development entails both seizing new opportunities and making sure that existing frameworks are fit for purpose. Fintech, for example, opens up new sources of funding and new opportunities for investors, such as crowdfunding. And the work by the EU technical expert group on sustainable finance, published last week, will help deepen the market for "green" investments by laying out a common taxonomy for sustainable financial instruments.[9]

The ECB is supporting market development efforts by establishing state-of-the-art market infrastructures. In November last year, for example, the ECB launched Target Instant Payment Settlement (TIPS), which allows payment service providers to offer funds transfers to customers in real time and around the clock across Europe.[10] We have also launched a market consultation on a European mechanism for the issuance and initial distribution of debt securities (EDDI), to which we expect comments before 9 July.[11]

Cutting red tape also supports market development. I welcome the current work by the European Commission to consider ways to encourage SMEs to tap capital markets for their financing needs more often.[12] But incentives must be aligned, too. In particular, preferential tax treatment contributes to pushing firms towards debt funding. This unequal treatment might incentivise excessive leverage and hinder effective private risk sharing.

The role of market integration

Market integration, in turn, leverages the potential of market development initiatives and enhances market depth. Research suggests that deeper equity markets are more effective in bringing economies closer to the technological frontier, as well as in "greening" the local economy.[13]

On the retail side, the creation of a pan-European personal pension product would go a long way towards integrating local capital markets and overcoming prevailing home biases. Unfortunately, the initial proposal was watered down and the tax treatment has been fully left to the national authorities' discretion. Renewed impetus here is vital.

Pension reforms that strengthen private retirement savings, and also contribute to the diversification of such savings into equity, would support the process.[14] In 2017, EU households held just 21% of their financial assets in shares and equity, compared with 41% in the United States.[15]

A second important lever for integration and diversification is to build on the newly adopted European covered bonds directive and to increase efforts to revive the European securitisation market, in particular SME securitisation. SME deals only accounted for around 8% of overall securitisation in 2016.[16]

Early on, the ECB and the Bank of England have called for a revitalisation of the European securitisation market, addressing the flaws evidenced by the crisis.[17] The new European Securitisation Regulation entered into force at the start of this year. We have already seen it bearing fruit, as simple, transparent and standardised securitisations have started to pick up, with 16 such transactions published on ESMA's central register between late March and early June.

The development of covered bond-like structures backed by SME loans, such as the European Secured Notes, could complement efforts to open up new financing sources for SMEs.

Benchmark rates and the need for fallback options

Before concluding, let me say a word on a matter that is very much related to the resilience of European financial markets, namely the ongoing interest rate benchmark reform, where a lot of progress has been made this year. Given ISDA's work to implement more robust fallbacks for derivatives that reference key interbank offered rates, I will focus on the role of fallbacks for EURIBOR.

EURIBOR plays an important role in the transmission of the ECB's monetary policy. It is closely linked to the interest rates that affect many businesses and households in the euro area. More than 80% of new loans to non-financial corporations in the euro area are based on floating rates, and more than 20% of new loans to households, including mortgages, are variable rate loans. In many euro area countries this share is significantly higher.

It is therefore encouraging to see that the EURIBOR reform has entered its final stages. Last month, EURIBOR's administrator, the European Money Markets Institute (EMMI), started to phase in the new hybrid methodology. The relevant supervisory authority, the Financial Services and Markets Authority, is currently assessing its compliance with the EU Benchmarks Regulation (BMR).

The outcome of this assessment is expected to be positive, allowing users to continue to reference EURIBOR beyond the deadline given by the BMR, which is expected to be extended by political agreement to the end of 2021.

Yet EURIBOR, also in its amended form, will ultimately rely on voluntary contributions by its panel banks. The BMR includes the possibility of making these contributions mandatory for a period of time, but eventually it will be up to the market, including users and panel banks, to see whether EURIBOR can be sustained in the long run.[18]

This means that we need to prepare for various eventualities. For this reason, it is important that the working group on euro risk-free rates continues its ongoing work on identifying fallbacks for EURIBOR, based on the ECB's euro short-term rate (€STR) that will be published as of 2 October this year.[19] As a first step, earlier this year the working group recommended a methodology for calculating forward-looking term rates based on the €STR.[20]

However, at the current stage, it is not certain whether and when forward-looking term rates based on €STR will become available, and for which use cases they would be suitable.[21] For this fallback solution to ultimately gain ground, we need the market to start preparing for the use of €STR as soon as possible and to build up liquid derivatives markets.

Conclusion

In any event, and with this I would like to conclude, further analysis of the appropriate fallbacks for EURIBOR, and the ways to implement them, is required. This includes the need to make decisions on trade-offs between international comparability, consistency across products and availability for use. I am sure ISDA will continue to play a vital role in finding such solutions for the euro area.

The reform of interest rate benchmarks comes at a time when more far-reaching and encompassing reforms to European capital markets are needed to promote integration, strengthen investment and boost private risk sharing.

The United Kingdom's departure from the EU reinforces the urgency with which we should pursue policies that address barriers to capital market integration in Europe and eliminate opportunities for regulatory arbitrage. More integrated capital markets will support the transmission of the single monetary policy and increase its resilience in periods of stress. Advancing CMU should therefore be a top priority for the new European Commission and Parliament.

Thank you.

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1 See FSB (2019), *FSB Report on Market Fragmentation*, 4 June.

2 See Houston, J., Lin, C. and Ma, Y. (2012), "Regulatory arbitrage and international bank flows", *Journal of Finance*, No 67, pp. 1845–1895; and Ongena, S., Popov, A. and Udell, G. (2013), "'When the cat's away the mice will play': Does regulation at home affect bank risk taking abroad?", *Journal of Financial Economics*, No 108, pp. 727–750.

3 See Cœuré, B. (2019), "Heterogeneity and the ECB's monetary policy", speech at the Banque de France Symposium & 34th SUERF Colloquium on the occasion of the 20th anniversary of the euro on "The Euro Area: Staying the Course through Uncertainties", Paris, 29 March.

4 See also Cœuré, B. (2018), "The euro area's three lines of defence", speech at the conference "Deepening of EMU", Ljubljana, 2 February.

5 See Cœuré, B. (2019), "The euro's global role in a changing world: a monetary policy perspective", speech at the Council on Foreign Relations, New York City, 15 February.

[6] See ECB (2016), “Trends in the external financing structure of euro area non-financial corporations”, *Economic Bulletin*, Issue 5.

[7] There is mounting evidence, however, that large banking systems are associated with more systemic risk and lower economic growth, in particular as countries grow richer. See Langfield, S. and Pagano, M. (2016), “Bank bias in Europe: Effects on systemic risk and growth”, *Economic Policy*, Vol. 31, No 85, pp. 51–106; and Demirgüç-Kunt, A., Feyen, E. and Levine, R. (2013), “The evolving importance of banks and securities markets”, *World Bank Economic Review*, Vol. 27, No 3, pp. 476–490.

[8] See Invest Europe (2019), *2018 European Private Equity Activity*.

[9] See EU Technical Expert Group on Sustainable Finance (2019), *Taxonomy Technical Report*, June.

[10] For additional information, see the ECB’s webpage on What is TARGET Instant Payment Settlement (TIPS)?

[11] See ECB (2019), *Market consultation on a potential Eurosystem initiative regarding a European mechanism for the issuance and initial distribution of debt securities in the European Union*, 28 May.

[12] See the European Commission’s financing programmes for SMEs; and Kremer, M. and Popov, A. (2018), “Financial development, financial structure and growth: evidence from Europe”, in *Financial integration in Europe*, ECB.

[13] See Hsu, P., Tian, X. and Xu, Y. (2014), “Financial development and innovation: Cross-country evidence”, *Journal of Financial Economics*, Vol. 112, No 1, pp. 116–135; and De Haas, R., and Popov, A. (2018), “Financial development and industrial pollution,” Tilburg University Discussion Paper 2018–024.

[14] Such efforts need to go hand-in-hand with programmes targeted at increasing financial literacy, starting in secondary school. See Cœuré, B. (2018), “Central banking in times of complexity”, panel remarks at a conference on the occasion of Sveriges Riksbank’s 350th anniversary, Stockholm, 25 May.

[15] See Report of a CEPS-ECMI Task Force on Rebranding the Capital Markets Union.

[16] See Kraemer-Eis, H. (2017), “SME securitisation in Europe – a short summary”, *European Investment Fund*.

[17] See Bank of England and ECB (2014), “The case for a better functioning securitisation market in the European Union”, Discussion Paper, May.

[18] The politically agreed amendments to the BMR will allow for the competent authority to make contributions to critical benchmarks mandatory for a maximum period of five years, in the event it considers that the representativeness of EURIBOR is put at risk.

[19] The timeline for the transition to €STR is now clear: the EMMI announced that, with the publication of the €STR, the EONIA methodology will change to the €STR plus a fixed spread, and EONIA will be discontinued on 3 January 2022, reflecting transactions of end-2021. EMMI’s announcement follows the recommendations made by the working group on euro risk-free rates.

[20] See working group on euro risk-free rates (2019), *Recommendations of the working group on euro risk-free rates on the transition path from EONIA to the €STR and on a €STR-based forward-looking term structure methodology*, 14 March.

[21] By contrast, backward-looking rates based on the €STR can be calculated as of October 2019 and used immediately to improve legal documentation.