Capital Markets Union in Europe: an ambitious but essential objective

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Strengthening growth and employment is a top priority for Europe. And there is an increasing consensus that further integration and development of European capital markets are key elements in achieving this goal. The European Commission is therefore planning to lend its support to the creation of a true single market for capital – the Capital Markets Union (CMU). It has issued a green paper on the subject to encourage discussion.

Indeed, it is time that Europe made progress in this area. In general, European capital markets are less developed than those in other major jurisdictions. The difference is particularly striking when we compare the European Union (EU) with the United States (US). In Europe, savings are concentrated in the banking sector, businesses rely heavily on bank lending and capital markets lack depth. In terms of value, European equity amounts to about 60% of its US counterpart and corporate bonds to around 35%.

Both the bank-based financing system in continental Europe and the more market-based system in the US are the result of economic, historical and political developments. Traditionally, small and medium-sized enterprises (SMEs) in Europe rely mainly on bank loans for their funding. As a result, the importance of banks for funding the economy can partly be explained by the importance of SMEs for economic activity, which is more pronounced than in other jurisdictions. Partly as a result of this, the legal infrastructure needed for a market-based financing system remained incomplete, while the banking sector developed more strongly. Another element is the uneven development of funded pension systems in Europe, in contrast to the US. Yet another element has been the different regulatory approach followed on the two continents. As an example, the restrictions on banks' activities under the Glass-Steagall Act of 1933 certainly helped to stimulate the development of alternative ways of financing the economy, while in Europe banks reinforced their position as the main providers of funding. This is important to bear in mind when reflecting on how to achieve the Capital Markets Union in Europe: the way in which financial markets integrate (or not) will also be affected by the underlying regulatory and legislative framework, and Europe will have to find its own way, different from that of the US but also different from its – Europe's –recent past.

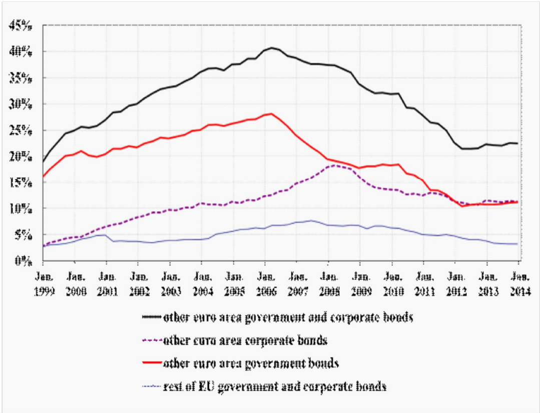
Both systems (bank-based or market-based) have their costs and benefits. However, as Europe's economy depends mainly on bank lending, the deleveraging of banks induced by the crisis has proved to be a drag on the recovery.

In the last two decades, European financial markets have started to become more market-oriented, and more integrated in terms of cross-border holdings of financial instruments. However, the crisis undermined this trend.

Chart 1

Share of MFI cross-border holdings of debt securities issued by euro area and EU corporates and sovereigns

(percentage of total holdings, excl. the Eurosystem)

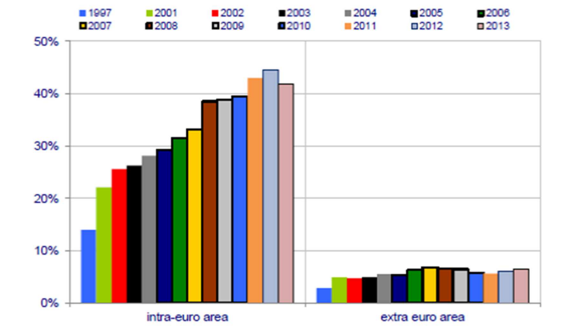


Source: ECB.
Note: Outstanding amounts are classified by the residency of the issuer. Eurosystem holdings are excluded.

Chart 2

Cross-border holdings of equity issued by euro area residents

(percentages)

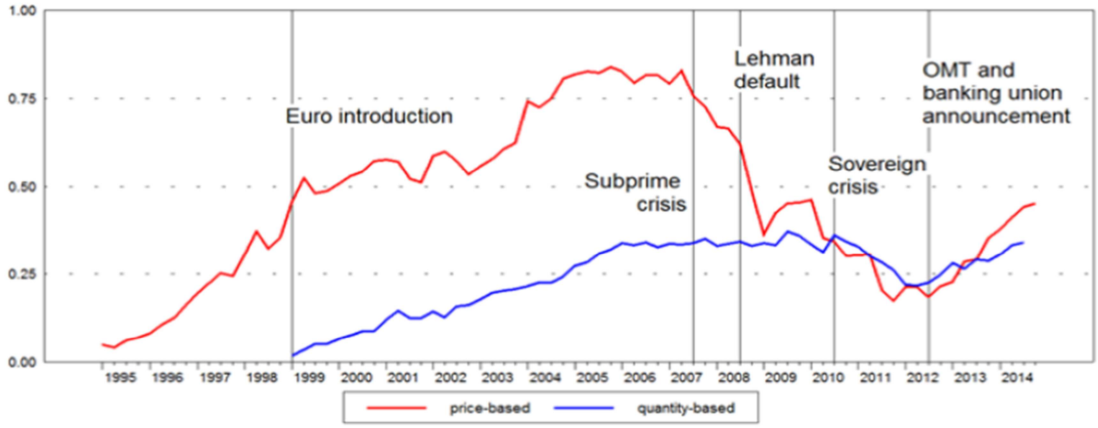


Sources: IMF, Thomson Reuters and ECB calculations.
Note: Intra-euro area is defined as the share of equity issued by euro area residents and held by residents of other euro area countries (excluding central banks). The sample includes 12 euro area countries. Extra-euro area is defined as the share of euro area equity held by non-euro area residents of the euro area (excluding central banks). Last observation: 2013.

In the early years of this century, the euro area experienced significant convergence in respect of asset prices, but then was hit by a sudden fragmentation of its financial markets when the crisis erupted. In fact, the crisis revealed that the integration had been partly driven by debt-based wholesale banking flows which were prone to sudden reversals in the face of shocks.

Today, capital markets are starting to show some signs of de-fragmentation as illustrated by the FINTEC index, designed and published by the ECB[1]. This is a welcome process, but it is no guarantee of deep and resilient financial integration.

Price-based and quantity-based financial integration composites (FINTECs)



Source: ECB and ECB calculations.
Notes: The price-based FINTEC aggregates ten indicators covering the period Q1 1995 – Q4 2014, and the quantity-based FINTEC aggregates five indicators covering the period Q1 1999 – Q3 2014. The FINTEC is bounded between zero (full fragmentation) and one (full integration).
Increases in the FINTEC signal higher financial integration.

So when promoting financial integration in Europe through the Capital Markets Union, we need to go beyond *quantitative* convergence – we should seek to promote *qualitative* integration. True financial integration implies a single market for capital supported by an adequate regulatory and legislative framework.

And indeed, establishing the Capital Markets Union is a logical step in the ongoing construction of the European Union.

Capital Markets Union is needed to complete the Single Market

Integrating capital markets is essential for the creation of a true EU-28 Single Market. In this regard, CMU should seek to increase the *effectiveness* of capital markets, in other words their ability to allocate resources and match supply of funding with demand. This will require a diversification of the sources of financing for the economy. At the same time, CMU should improve the *efficiency* of capital markets by enhancing competition among financial institutions and within the market. This would ultimately help to reduce the costs of financial intermediation, and benefit consumers and investors. Finally, CMU should seek to increase the *size* of capital markets by removing cross-border frictions – hence allowing credit and capital to flow freely throughout the market. Even the best-performing national markets in the EU lack critical mass, leading to a smaller investor base, low economies of scale and fewer financial instruments to choose from.

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[1] See the ECB's Financial Integration in Europe report, April 2015.

Capital Markets Union is essential to Economic and Monetary Union

Turning to the euro area, I would argue that a genuine capital markets union is in fact essential for the good functioning of a monetary union. Financial markets in the euro area have not seemed to provide much cross-border risk-sharing as the low levels of cross-border investment flows illustrate. This means that a negative economic shock has the greatest impact at home. CMU should ensure that financial markets are integrated in such a way as to help companies and households cushion local shocks. To achieve this, we should aim to have sizeable cross-border holdings of debt and equity and direct cross-border exposures from banks in one jurisdiction to firms and households in another. In addition, deep and well-diversified capital markets would enhance the functioning of our monetary policy, which is today constrained by the large reliance of the economy on bank financing.

Of course, increased diversification and more risk-sharing would benefit the Single Market as a whole. This is even more the case in a monetary union.

Capital Markets Union complements Banking Union

In addition, CMU will complement Banking Union. By fostering diversification and enhancing the allocation of cross-border capital, CMU will help to attain two of the core objectives of Banking Union: breaking the bank-sovereign nexus by enhancing cross-border risk-sharing; and complementing the Single Resolution Fund as a private insurance against banking crises. In parallel, CMU should aim to ensure that funding is allocated efficiently and regardless of location. Companies or individuals looking for funding in Europe should get access to this funding on the basis of their own merits, not their location.

In addition, Banking Union and the regulatory agenda addressing the "too big to fail" issue should encourage banks to reach an optimal size relative to the European market – that is, large enough to operate across borders and diversify risks, but small enough to be resolved with the resources of the Single Resolution Fund. Here, developing a European market for banking mergers and acquisitions could help to foster consolidation within the sector, achieve efficiency gains and disconnect local banks from local vested interests. Consolidation within the market could also contribute to restoring banks' profitability, thereby putting them in a better position to finance the economy.

Having a single European banking supervisor could also help to promote cross-border lending. At the same time, an ambitious implementation of the CMU agenda would foster financial integration and facilitate banking supervision, as the Capital Markets Union would help to overcome market fragmentation along national lines, which in turn would also make cross-border supervision of banks easier.

How do we get there?

There are various hurdles and barriers to be surmounted on the way to a full capital markets union which would bring about all the benefits mentioned above. Many are known and could be overcome in the short run. However, a lot more work is needed to create the framework conditions for capital markets to develop throughout Europe. Barriers vary in size and difficulty. To overcome them, we will also need various measures, with different degrees of ambition.

One measure could be to **foster individual market segments.** Developing certain market segments, or allowing these markets to operate in a more cross-border way could be the first step towards diversifying capital markets in Europe. A number of initiatives are ongoing or have been identified by the Commission for early action in this regard. These include measures to support the development of certain market segments such as securitisation and EU covered bonds or private placement. Initiatives can also be undertaken to foster transparency in certain markets with a view to reducing information asymmetries between originators and investors, and enabling investors to perform the necessary due diligence. Such initiatives can be publicly supported but they should be market-led. This would be particularly important for SME loans and would help investors to develop their own credit models and risk metrics. Finally, there is the option of providing public risk enhancement for the development of certain markets where there is an obvious market failure. This has to be evaluated against the risk of market distortions, but don't let us fool ourselves: the European securitisation market will probably never be as deep and liquid as in the US, given the significantly different amount of public sponsoring.

However, promoting certain market segments and fostering transparency will not be sufficient to create a full CMU, and will itself require legislative action. As an example, a well-functioning securitisation market could be one of the key pillars for CMU in the short term. For this to happen, legislative action is needed to ensure an appropriate treatment of high-quality securitisation throughout the EU, in order to promote securitisation as an alternative funding tool and as a credit risk transfer tool.

Therefore, a second, more ambitious measure will be to **take legislative action** in order to foster CMU. Let me give two examples: the regulatory framework applying to market infrastructures – a key element of capital markets – is being put into place. A further step in this direction will be the legislative proposal which the Commission is preparing on a European framework for the recovery and resolution of clearing houses, based on work done by the Committee on Payments and Market Infrastructures, the International Organization of Securities Commissions and the Financial Stability Board. Another example relates to the integration of European corporate bond and equities markets, which is still being hindered by a lack of harmonisation in key areas. One area is legislation relating to rights granted by the ownership of securities, which prevents currently investors from being able to assess the investment risk in another jurisdiction on the same basis. A key step forward here would be the Securities Law Directive.

Taken together, legislative initiatives should be geared towards the creation of a single rulebook for capital markets in Europe. This would promote true financial integration by ensuring that all market participants are subject to the same set of rules, are treated equally and have equal access to that market. In general – and even if this takes time – we should not shy away from difficult issues, such as pushing forward in the fields of insolvency, corporate and tax laws as well as accounting standards, all of which play a key role in the cross-border functioning of capital markets. As long as there are barriers in these areas, financial integration, which forms the basis of CMU, will not be fully achieved. Alternatively, if action cannot be taken at EU level in the short term, a clear commitment by Member States to take steps to lower barriers and harmonise national legislation would represent significant progress.

A third measure will be to establish an **efficient monitoring framework ensuring the common application of rules** throughout the market, in addition to a sound legal and regulatory framework. A single rulebook by itself will probably not be sufficient to ensure that the same conditions prevail throughout the whole of the EU. So there is a case for ensuring at EU level the effective implementation and consistent enforcement of the rules and standards that we develop for CMU. As Europe's financial structure evolves over time, the steady state of the supervisory framework should be assessed and improved to match the needs arising from the development of CMU. In the meantime, CMU has to cater for enhanced supervisory convergence.

Conclusion

The Commission's CMU initiative is very welcome. The Capital Markets Union will in any case play a useful role in improving the allocation of capital throughout Europe and in diversifying sources of financing. However, it remains to be seen how ambitious Europe wants to be in developing a genuine capital markets union – and therefore to reap its benefits. While some low-hanging fruit should be quickly picked, I believe that we need to be bold in our objectives and give ourselves the tools to turn CMU into a reality rather than allow it to languish in the realm of wishful thinking. To quote Nelson Mandela: "It is not where you start but how high you aim that matters for success".

And the tools that we chose will shape the framework in which capital markets develop. To achieve genuine financial integration – in other words, to ensure that all market participants are subject to the same set of rules, are treated equally and have equal access to that market – will require action in a range of fields which are not always directly linked to capital markets.