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The European Banking and Capital Markets Unions: Challenges and Risks

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1. Introduction

I would like to thank the Fondazione Italianieuropei and the Foundation for European Progressive Studies for inviting me to this conference. It is a pleasure to be here to discuss the opportunities and risks associated with the European Banking Union (BU) and Capital Markets Union (CMU). It is a very topical subject. In order to relaunch economic growth in the eurozone, the policies adopted at both national and European levels must be complemented by adequate financial support to the real economy. The institutional set up of the BU and the CMU is crucial to this end.

I will first give an account of what has been achieved so far at the European level to foster the reintegration of the financial markets and spur economic growth in the Euro area. I will concentrate on the project for Banking Union (BU), arguing that its first stage, namely the Single Supervisory Mechanism (SSM) has been crucial to reaffirm the commitment of all eurozone member countries to the single currency and to foster financial integration. This means that the SSM has already contributed to the sustainable growth of output and employment in Europe, even if that contribution is hard to pinpoint or measure. Second, I will offer a reflection on the further steps we have to take in order to ensure that the project delivers on its stated objectives. Finally, I will touch upon some of the Capital Markets Union initiatives, concentrating on those designed to increase access to finance for small and medium-sized enterprises.

2. Banking Union: the main achievements

We must not underestimate what has already been accomplished by the BU project. This thorough overhaul of the euro area supervisory architecture took place in – indeed, was motivated by – an environment marked by unsatisfactory economic growth, increasing perceptions of sovereign risk and mounting doubts on the very survival of the euro.

The BU project has already helped the stabilization efforts in the Eurozone, which is a pre-requisite for economic growth. First, it gave an important signal of the willingness of the member countries to forge ahead with unification. In itself, this provided a potent antidote to the sovereign debt crisis, whose key determinant had been lack of confidence in the single currency project. Second, common supervision and a centralized resolution authority lay the basis for financial stability.

Banking Union, together with other national and European policies – in particular, the monetary policy measures recently decided by the Governing Council of the ECB – is already contributing to the normalization in credit conditions for firms and households. The comprehensive assessment of the balance sheets of the largest euro area banks, which preceded the launch of the (SSM), enhanced transparency and dispelled doubts about the banks' resilience. Further progress is expected as the SSM brings harmonization of supervisory and business practices, reducing investors' perception of risks. Although complete normalization in credit conditions will likely require definitive exit from the crisis and a return to stable economic growth, signs of gradual improvement can already be discerned in the surveys conducted by the Eurosystem and in other indicators.

Banking Union has imparted a strong impulse to the efficiency of the financial system by fostering competition across euro area countries. Consider for example the recent decree on the governance of the cooperative banks in Italy. The initiative is the product of a good many years of reflection on the shortcomings of the cooperative structure for listed or very large banks; at the same time, it can be read as part of a broader reform effort to bring the Italian economy up to the best European standards of efficiency.

3. How to consolidate a promising start

The important steps already taken need to be followed by further progress, on several fronts. Since the list would be long, I shall mention just one general issue and two specific ones.

The overarching issue: further progress towards European integration is essential. We should not forget that the current crisis was provoked, in part, precisely by lack of progress in European integration following the adoption of the single monetary policy. The BU project has gotten the process started again, helping to defuse the crisis. But we must not make the same mistake twice; the integration process cannot be allowed to stall again. Progress in this direction is particularly difficult at present, because national centrifugal forces seem strong. They are visible in various forms: growing support for anti-euro or euro-skeptical political parties in several countries, for one, and the difficulties encountered by European and Eurozone institutions in discussing issues from an area-wide perspective, for another. National interests and perspectives are strong. Take, for instance, the distinction between core and periphery, which has become standard in many discussions and official publications.

If unification is to advance, we must reinforce mutual trust at the international level. This must be achieved over time, through consistent behavior on the part of all parties and recognizing that it is in the interest of every member state to factor in the need to reduce negative spillovers from one economy to the others. If we succeed, it will gradually become clear that there is no conflict between European financial integration and financial stability; indeed, that by favoring the cross-border diversification of risks, financial integration will foster financial stability.

Let me now turn to some specific issues.

Micro- versus Macroprudential policies. Throughout 2014 and since the launch of the SSM, the European supervisory authorities have focused mainly on the capital position of banks. This emphasis on strong capitalization was necessary to restore confidence. Now that the comprehensive assessment has shown that the European banking system is solid, it is essential to avoid inducing pro-cyclical behavior by banks, curtailing lending to the economy. Let me elaborate on this issue.

Any bank, taken individually, may have an incentive to strengthen its capital adequacy by curtailing lending. This does not have strong counterindications if other banks have incentives to expand lending. But if all the banks seek to deleverage at the same time, this could trigger a credit crunch, with adverse repercussions on the economy and ultimately on the banking system itself. The crisis drove this simple lesson in externalities home emphatically, prompting the creation of macroprudential authorities in most countries.[1] And as we know, the incentives of micro- and macroprudential authorities are aligned during economic expansions (both policies should be tightened, to strengthen the resilience of single banks and to "lean against the wind" of an aggregate credit boom). However, they tend to diverge during downturns, when, as I just now observed, the macroprudential authority should be wary of imposing stiffer capital requirements.

The present state of the economy in the Eurozone offers a textbook case of the potential tension between micro- and macroprudential policies. There is broad agreement (eg within the ESRB) that macro risks – low nominal growth in particular – are among the more serious threats to financial stability. In the Eurozone credit growth is negative, and the credit/GDP gap (the main indicator set by the Basel rules to steer the countercyclical capital buffer) is amply negative in most countries. Fully aware that relaunching nominal economic growth in the Eurozone is the paramount objective, the ECB has embarked on a program of quantitative easing.

[1] See the de Larosière report, 2009.

In this environment, macroprudential policy needs to lean decisively against the wind and act to rekindle credit and economic growth. But in practice it is not doing so. Indeed, most recent macroprudential actions at national level have further tightened capital requirements, in response to national problems. Coupled with the ongoing micro-level tightening, these measures could ultimately aggravate the risks of persistently low nominal growth.

There are certainly good reasons, on which I shall not elaborate here, for leaving area-wide macroprudential instruments on hold. At the same time, since under the Regulation the SSM has both micro- and macroprudential responsibilities, I believe that reflection on this issue is warranted.

The complexity of the European system of financial supervision is extraordinary. This complexity follows from two main factors. First, there are a large number of actors on the stage – at both national and supranational levels, with both micro- and macro-prudential objectives – and in interaction with one another. Legislators, perfectly well aware that the new set of rules that originated the system may need some fine tuning, incorporated the deadlines of a revision process in the rules themselves. Time and experience will tell just how much room there is for simplification. Second, EU member countries are still characterized by different accounting and legal regimes. Convergence is necessary for company, insolvency and taxation law in particular, but a gradual approach will be inevitable. Meanwhile, an effort by all stakeholders will be necessary to get the system to work effectively and to ensure a level playing field.

Heterogeneity is found in the area of supervision as well, but here I am confident that the SSM will bring relatively swift convergence in supervisory practices. My own very preliminary assessment of the functioning of the SSM is positive. The progress achieved in such a short time has been amazing. Nonetheless, we are still at the very first stages, and adjustments may well be necessary. We need to avoid the risks of inefficiency that stem from the complexity of the machinery. A huge number of issues – and of related decisions – are brought to the attention of the Supervisory Board; this threatens to deflect attention from proper reflection on the more important issues. I am sure that we shall be able to flexibly adapt the framework as needs arise.

4. The Capital Markets Union

That European firms rely too heavily on banks for external funds has been known for decades, but the crisis has now thrown the dangers of this model into sharp relief, highlighting the need to enhance the role of market funding. The Capital Markets Union (CMU) initiative is directed to this ambitious goal. Further development of non-bank sources of funding seems possible, if we compare the European to the more market-oriented economies. European businesses get the bulk of their financing from banks, while in the US market-based financing is much more highly developed, even for SMEs.

The Commission has set an ambitious agenda in this field, with the aim of channeling funds to Europe's businesses, particularly SMEs. The agenda includes an effort to revitalize the market for sound (simple) securitizations (which requires work at EU level to design a consistent framework and avoid regulatory arbitrage); harmonization of the market for covered bonds, building on the successful experiences of some European countries in order to generalize best practices; stimulation of crowd-funding initiatives, gradually eliminating significant national differences in legislation and supervisory approaches; enhancement of the small-scale corporate bond markets via mini-bonds; and endorsement of the efforts to identify a common framework for private placement transactions.[2] The Commission is also working to improve and standardize information on firms, in particular SMEs, and the related disclosure and transparency requirements. The scarcity of such comparable information is a deterrent to cross-border financing, which cuts across the different market segments and types of instruments.

In the medium to long term, the CMU can bring significant benefits: broadening and diversifying the EU financial market, thus improving its resilience, efficiency and competitiveness; eliciting greater long-term financing; and enhancing the supply of equity, to encourage euro-area firms to rely less on bank credit and to rebalance their capital structure.

In the short term, the efforts to enhance market-based sources of funding are part of the policy response to pronounced bank deleveraging within the EU and the attendant anemic credit growth. Some of the items on the Commission's agenda may be crucial to this end. Indeed, bank

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[2] This effort is being undertaken by the Pan-European Private Placement Working Group, led by the International Capital Market Association. The European Council has welcomed these initiatives and invited the Commission to take stock of their outcome and consider at the same time how policy actions could play a supportive role in the development of a sustainable private placement market in the EU.

deleveraging itself, together with the search for higher yields by institutional investors, may be a powerful catalyst for the development of these alternative sources of external funds.

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To conclude, a lot has been achieved but a lot remains to be done in order to create a stable and efficient financial market in the Eurozone. In order to succeed, we must avoid piecemeal policies and work in order to reinforce mutual trust at the international level. A comprehensive view of all the trade-offs entailed in the various policy measures is required in order to safeguard the stability of individual financial institutions, with the key objective of ensuring the availability of resources for investment and economic growth.

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