Towards more Capital Markets Integration in Europe

Jean Hilgers,
Director
National Bank of Belgium

ABSTRACT

This is the introductory speech given by Jean Hilgers at the IMF – NBB conference "Towards more Capital Markets Integration in Europe" in Brussels on September 10, 2019.

SPEECH

I would like to take the opportunity to present some thoughts on the issue. These thoughts are likely to reflect both hope and frustration regarding the process of CMU, but above all are to be interpreted as a token of our commitment in advancing European capital market integration.

The launch of the Capital Markets Union

Almost four years ago, actually on September 30, 2015, the European Commission adopted a new plan to build a true single market for capital across the 28 member states – the Capital Markets Union. The British Commissioner, Lord Hill, was charged with one of the core missions of the Juncker-Commission: to build the so-called CMU by "fusing disparate financial markets and unclogging the pipes that channel money from investors to businesses". With this announcement of a Capital Markets Union, the Commission signalled its strong ambition and determination to fundamentally reform the European financial landscape and create a more balanced financial structure with a more prominent role for capital markets.

Yet, while the CMU is conceptually clear and – indeed – intuitively appealing, the practical organisation and implementation of such a transformation of the European financial landscape proved and still proves more complicated. Indeed, as we all know, there is not just one homogeneous European capital market; instead there exist a multitude of different capital markets, spread over 28 different countries, often subjected to different legal and regulatory frameworks. The *plural* in the term “Capital Markets Union” is not just a linguistic folly by some Brussels European bureaucrat, it genuinely reflects an underlying reality to be addressed.

It should then also not come as a surprise that relatively quickly the term “CMU” was reduced to an operational catch-all term for the many diverse measures that the European Commission has proposed ranging from, for instance, tackling legal issues and impediments for cross-border investment to cutting red tape and prospectus requirements. During the four years that passed since the announcement in 2015, many new projects were added. Currently the Commission mentions 13 legislative proposals, most of them approved or with political agreement and number of additional legislative initiatives on sustainable finance or the common consolidated corporate tax base.

The case for pushing the Capital Markets Union

The current implementation of CMU is clearly not perfect. In fact, as stated by Lord Hill when announcing the CMU in 2015, the pursuit of theoretical perfection was not/never on the CMU-agenda. But despite the imperfections, the case for CMU remains strong on various counts.

First, when evaluating the current roll-out of the CMU project, it is important to keep the right [historical] perspective. Indeed, the launch of the CMU-project occurred amidst an investment and credit crunch, where in particular European SMEs struggled to find the necessary funding. With the European banking sector restructuring as a consequence of tougher regulations and banks’ balance sheets ridden with bad loans, CMU not only answered to the need for banks to discharge excessive credit risks (for instance trough reviving the securitisation market) but also focussed on opening new funding sources for SMEs (for instance through facilitating venture capital or reporting requirements).

Second, CMU is more than just a “crisis measure”. It also constitutes another [important] step towards a longstanding European goal: that of establishing a genuine European Financial Union. The CMU is indeed a crucial step towards such an integrated and – importantly -*a more balanced* financial market. This is in particular relevant in the context of the EU, where banks continue to dominate the financial intermediation process as nowhere else in the world and capital markets remain relatively small.

Reinforcing the role of capital markets in the European financial intermediation is in fact of great importance. Deep and integrated financial markets do not only enhance the risk-sharing and the growth and innovation potential in the economy but also provide substantial risk reduction and financial stability gains. By opening up additional non-bank funding sources (especially for high-risk and long-term investments) more effective and less costly funding and risk capital become available, enhancing (risky and long-term) investments, stimulating innovation and supporting economic growth. At the same time, deep and liquid capital markets offer substantial opportunities for further risk reduction as funding will no longer uniquely hinge on the banking sector but will be diversified over a large pool of (institutional) investors, effectively reducing procyclicality and financial stability risks. Moreover, capital markets may also offer opportunities to the banks to better manage and control balance sheet risks and are as such complementing the Banking Union.

Third, CMU is not only relevant within the EU, but has potentially also an important role to play in the strengthening of the international role of the euro. I will not develop the argument further, but it is clear that from a political economy perspective it becomes important to strengthen the euro's position. ….]

But financial stability risks need to be monitored closely

But CMU is no free lunch either. As capital markets grow in importance and a more balanced financial structure develops, one must remain vigilant to potential new risks that may arise in the financial system. Interconnectedness between systemic banks and the non-bank sector may become more important going forward and may carry risk for financial stability as well. Just as a reminder, the financial crisis of 1929 originated in the US stock market but lead – fuelled among others by strong interconnectedness of the US banking sector – to a systemic crisis. As capital markets develop further and become more prominent, we need to understand better the macroprudential dimensions of risks in the financial sector (banks and non-banks alike) and the regulatory and supervisory framework should evolve alongside the developments in the financial sector.

The way forward: how far away is the Capital Markets Union?

So, how far away is the European Capital Markets Union? This is a difficult question to answer. But let me share with you some observations.

First, so far, there has been no "big-bang CMU-effect" in the integration of European capital markets. One reason for this may be that despite the broad support for CMU in the EU – across countries and in the financial sector – progress in addressing the fundamental impediments has been slow and the proposed measures sometimes provide only a partial fix to existing barriers. Maybe it is still too early to assess the final impact of the proposed measures -as many have only been adopted recently – but, so far, no strong CMU effects are noticeable.

Which brings me to my second observation. With hindsight, one could ask the question whether the current mix between supply- and demand-side measures as adopted by the European Institutions has been the most appropriate one. Going over the different legislative proposals, there seems to be a strong focus on supply-oriented measures. For instance, the safe and transparent securitisations or covered bonds proposals have as underlying motivation to allow banks to obtain cheaper funding and to off-load excessive credit risk from the balance sheets. The new investment firms' regulation makes the regulatory framework more proportionate for smaller investment firms and the regulations on venture capital funds simplify the entry for asset managers. Yet, while improving supply conditions is a crucial, necessary, step towards CMU, it is by no means sufficient. [As a famous English proverb – also used in Belgian politics- states: 'You can lead a horse to water, but you can't make it drink]. Indeed, even under the ideal supply conditions, *demand for capital* should follow (supply) and increase significantly. This implies a structural shift in existing [corporate] demand for external funding, which remains up till today shaped and moulded by bank-intermediated finance.

Third, at the current juncture, we should not ignore the elephant in the room. With Brexit pending, "European" – that is EU-27 – capital markets will be significantly reduced. In the context of CMU, it will be crucial to follow up how this exit will shape future European capital markets. On the one hand, potential relocations of financial institutions from the City towards the EU-27, may help kickstarting mainland capital markets. On the other hand, it is unlikely that the City will lose its leading role as a central hub in global finance and capital markets any time soon. How to develop and deepen integrated European capital markets in this context remains an important open question going forward.

Finally – and ending on a positive note – even in the absence of a big-bang in CMU, progress has been made and the European financial structure is gradually changing. There are indeed encouraging signs. The importance of non-bank intermediated finance is gradually increasing in Europe and is expected to grow further. By now – in the broad definition – the non-bank financial intermediation sector (NBFI) [estimated at approximately € 42 trillion in 2018] is almost as large as the EU banking sector [estimated at approximately € 43 trillion in 2018] and is providing important net funding to the European corporations. Importantly non-bank finance is not only growing in absolute terms (as indicated by total assets), but also gains ground relative to the European banking sector and slowly tilting the balance. Moreover, in view of the many structural challenges ahead including the need for sustainable finance, the European capital markets are expected to gain in importance. It is thus of paramount importance to support and speed up this ongoing transformation.

In this context, the CMU-project should remain high on the [political] agenda as it has the potential to act as a catalyst in the development of efficient and deep European capital markets. Developing CMU – also at the local level - requires however many important decisions and -importantly – the right guidance and perspective. Therefore, we welcome the new research and insights on CMU provided by IMF and the panel, which may help us in keeping on course. Therefore, without further ado I yield with pleasure the floor and would like to invite Poul to take the floor.