CMU and Banking Union: complementary or antagonistic?

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A primer on the inherent complementarity of banking and capital markets

Financial systems play a key role for growth and stability. Notably, they offer agents with surpluses of funds means to invest them profitably and use the proceeds for consumption or real investment in the future. Agents with shortages of funds they offer means to acquire what they need and engage in consumption or real investment immediately. In other words, a well-functioning financial system supports re-allocating resources over time and across agents or sectors.

The relevant services are typically provided through a mixture of financial intermediaries and markets, the so-called financial structure. The economic literature emphasises the distinction between banks and capital markets. This terminology is also picked up for some policy initiatives, such as the European Banking Union and the European Capital Markets Union. For example, traditional banks are regarded as providing particularly intertemporal insurance to borrowers and depositors, whereas equity markets are regarded as providing particularly cross-sectional diversification to investors. The broad-brushed labelling is certainly useful for effective project management, communication purposes and some research. But it should not mask the wider variety of intermediaries, markets and services needed in a modern financial system and their different complementary roles.

There are many more examples of such complementarities. One is the ability to switch funding sources, sometimes referred to under the headline “spare tyre theory”. Empirical research has shown that in financial systems with well-developed loan, corporate bond and equity markets if one of these funding sources for non-financial corporations dries up then one or both of the others compensate for it, at least partly. Another example relates to which funding channel is best for which type of real investment. Recent research suggests that public and private capital markets, notably equity markets, tend to be better in funding highly risky investments and investments in frontier technologies. Bank lending tends to be better in funding medium-to-low-level risks and more traditional industries. A third example concerns different forms that financial integration can take across regions or countries. Cross-border holdings of equity claims are found to be particularly effective in fostering private financial risk sharing, i.e. smoothing aggregate consumption of countries or regions. But also cross-border retail lending and borrowing can contribute to it materially. Whereas the equity holdings can probably be achieved through various forms of investment funds, it is hard to see how the credit channel can operate without significant cross-border bank consolidation. Finally, the ability to securitise loans creates complementarities between banks and capital markets. The possibility to distribute >>>

>>> the securitised products via capital markets allows banks to create space on their balance sheets for the origination of new loans (obviously, securitisation should be of the simple, transparent and standardised type that avoids the problems experienced in the financial crisis).

In a case like the euro area, in which banks still play a very strong role and capital markets need to develop more, also transitional dynamics need to be taken into account. If banks would not adjust their business models, competition from capital markets could undermine their already low profitability. Part of the banks will remain competitive for lending on a relationship basis (e.g. in local markets), whereas other banks would have to develop their business models, e.g. incorporating stronger investment banking services. The latter will require, inter alia, a certain scale and distribution channels for multiple countries, which could also be achieved through more cross-border bank consolidation in the euro area. All this, and also different starting positions of different countries, may meet some resistance and would have to be accompanied by banking supervisory vigilance and a level playing field between banks' and other intermediaries' regulations. My overall conclusion, however, is that the European Banking Union and the Capital Markets Union are strongly complementary. ●

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Felix Hufeld

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CMU and Banking Union are complementary

The mere fact that a broad and liquid capital market in the EU may create opportunities for banks shows that the Capital Markets Union (CMU) and the Banking Union are in fact complementary. Not only do banks grant loans, they also have expertise as structurers and advisors, on both the credit and equity side. However, in the current environment, the abilities of banks and capital markets to fuel the economy vary largely. In addition, there are considerable national differences in the ratios between market capitalisation and GDP. While capital market penetration is around 250 percent in the UK and 260 percent in the US, the figures for the EU-27 average around 150 percent. Roughly speaking, 80 percent of corporate loans in the EU are bank loans, whereas in the US the opposite is true: around 80 percent of loans stem from the corporate bond market. A slowdown in the securitisation market due to the financial crisis has contributed to this environment. Despite the concept of the "European Passport", capital markets tend to be fragmented. The typical retail investor, alongside many institutional investors, still primarily invests in national markets ("home bias").

At first glance, a shift away from credit financing for companies in the real economy towards more capital market-driven forms of financing may seem like a migration between two different worlds. Capital market financing and raising funds via bank loans are largely seen as antagonistic. A shift to more market financing is often considered a threat to banks' business models with their focus on bank loans, which have traditionally played a major role especially in continental Europe. However, even if this concern may occasionally prove to be valid, this view is short-sighted against the overarching concept and framework of the current European initiatives. Indeed, at second glance, the issue is less black-and-white than it would first appear.

The goals of the Banking Union and the Capital Markets Union complement one another. The Banking Union, with the Single Supervisory Mechanism, aims to maintain a solid and resilient banking landscape. Resilient credit institutions are in a position to play an active role in the capital markets e.g. as brokers, market makers, structurers and advisors. >>>

>>> Likewise, a well-functioning, more integrated Capital Markets Union will create a broad range of business opportunities for banks as well as other financial institutions.

This is due to the following reasons:
1. Banks will be increasingly in demand for this form of market-based financing. Above all, as mentioned above, for their role as structurers and consultants.
2. From a bank's point of view, an increase in capital market financing could be an incentive to acquire more commission-driven income. In this field, European banks and savings banks are still lagging behind their US competitors. The yields of many European banks are still too interest-bearing, which is a problem especially in view of the very long persistence of low interest rates and flat yield curves. The surplus of interest-bearing business is also one of the reasons for the low capitalisation in some EU countries.
3. The large role played by bank loans in financing companies, especially SMEs, may not continue in the aftermath of the financial crisis since regulation has called for a deleveraging of banks. In order to sustain the required funding level, sources of financing should become more diversified.

Outlook

European elections are coming up next month. The European Commission's five-year term is about to end. Nonetheless, we may already anticipate that the efforts to foster a truly integrated EU capital market will remain a key focus in the new legislative period. The Commission has accelerated this process and further initiatives are underway to boost the role of both banks and insurance undertakings, taking the Pan-European Pension Product into account. 2019 will thus not only see the conclusion of the "CMU initiative" launched in 2015. We must also use the momentum gained by clarifying the steps to be taken to ensure the smooth functioning of a pan-European capital market, allowing for cross-border economies of scale, enhanced investor protection, a broader range of finance and investment products and, of course, more convergent regulation. ●

Stéphane Boujnah

Chief Executive Officer and Chairman of the Managing Board, Euronext

Banking Union & CMU - the building blocks to strengthen EU financial integration

Banks and capital markets are fundamentally interconnected as parts of the wider financial system. They complement each other in the financing of the real economy and represent mutually reinforcing initiatives that can strengthen the EU Financial Services Internal Market. I have witnessed and, somehow, contributed to the development of both pillars, in particular from my time at Santander and now at Euronext.

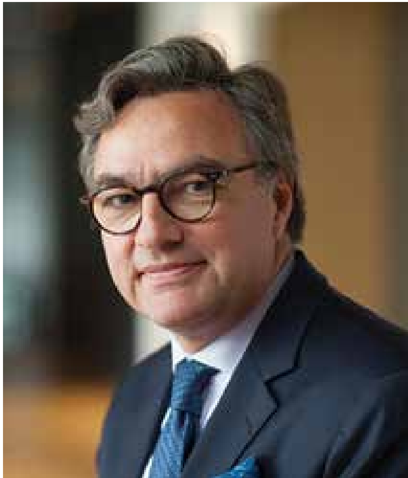
A focus on exploring synergies between Banking Union and CMU is critical in the context of a collective ambition by the EU27 to strengthen the provision of capital markets services within the EU.

Banking Union supports a more resilient banking system which in turn underpins the smooth functioning of capital markets. Secondly, a more integrated banking system also supports capital markets' integration, particularly via further regulatory and supervisory convergence facilitating the provision of cross-border services by banks. In parallel, a more integrated European capital market will also support cross-border activities and the resilience of banks.

While significantly more integrated capital markets have the potential to reduce the need on banks to develop extensive local expertise for each national capital market, this must be balanced: securing thriving local market ecosystems remains critical, particularly when it comes to the financing of SME and midcap companies.

Euronext, as the operator of Regulated Markets and MTFs across six EU Member States reiterates the need to deliver a strong Single Rulebook with convergent supervisory practices as a means of underpinning the integrated markets we operate.

Delivering on this objective should not, however, undermine core elements of successful local market ecosystems, including the unique competencies of local regulators. As such, the focus should be on strengthening supervisory convergence, based on a recognition of the respective responsibilities of national and European authorities. ●



Jacques Beyssade

Secretary General,
Groupe BPCE

More complementarity thanks to a more ambitious CMU and a more proportionate BU

Europe is heavily reliant on bank loans to finance its economy. This is one of the key reasons why developing additional market-based funding options - which can act as a "spare tyre" when bank lending is constrained - has rightly become a major objective of the EU and of its CMU project.

Surely reforms that will disproportionately impact how banks operate have the potential to affect capital markets too, but at the same time ensuring financial stability and economic growth share complementary goals; and both can be articulated in a dynamic way. For instance, the concern of the BU to reduce the size of banks' balance sheets finds an answer in the goal of CMU to increase the size of financing of the EU economy by capital markets.

On paper banking groups, and BPCE in particular, are set to be quality players in both fields (financing through bank intermediation and capital markets) by their very nature as universal banks and in the case of BPCE by its strong balance sheet and diversified business model.

However, the articulation of the CMU and the BU has proven hard to implement and both the CMU and the Banking Union have faced strong headwinds on their own right.

For the BU the latest Risk Reduction Package, still designed on a solo basis, does not consider transnational banking groups at the consolidated level, but as a sum of separate subsidiaries. This, and the fact that it did not respond to the needs of many host Member States to have their concerns addressed, ensured an unsatisfactory outcome. For the CMU the STS securitisation framework, the Pan-European Personal Pension Product, and encouraging cross-border investment are good intentions but today the consensus is that the CMU needs a new start.

Against this backdrop, should we not be more ambitious with the CMU, especially in times of Brexit uncertainty, while addressing the points that can be taken forward today with regards to the Banking Union?

To serve this ambition let's be more focused on sustainable finance, probably the flagship in the years to come, and retirement needs which still call for solutions. The Commission could also address the need to involve more retail investors into the CMU, ensure SME research and securitisation and foster global standards for financing EU companies.

On Banking Union, financial regulation needs to be proportionate to the risks involved, well-calibrated and adaptable to evolving circumstances. We should not apply to all banks or to all portfolios the same set of criteria, taking into account the diversity of business models and corresponding risks. Diversity is a strength for any ecosystem; let's draw the consequences that specific markets (such as real estate or specialised lending) need an appropriate treatment when finalising Basel III. This is how regulation could be tailored to the specificity of the EU and the goals of the Banking Union. ●

Carmine Di Noia

Commissioner, Commissione Nazionale per le Società e la Borsa (CONSOB)

CMU and Banking Union: it takes two to tango!

It is unquestionable that Capital Markets Union (CMU) and the Banking Union complement each other.

A greater cross-border financial risk sharing supports the functioning of the European Union by smoothing economic cycles and improving the capacity to absorb shocks. With a more integrated Single Market banks could exploit cross-border economies of scale more easily. On the other side a more resilient banking system supports the development of capital markets, which is one of the objectives of capital markets union, as prospering banks will be able to invest more resources into the development of new capital market products and services. Bank-based and market-based financing systems have a comparative advantage in funding different types of investment project. The end-result is clear: we broaden the set of financing sources the ultimate borrower can choose from.

We should take the chance to move forward merging the two initiatives in a single long-term holistic project: a truly "EU Financial Union". How? Intervening on the regulatory and supervisory EU architecture.

It is widely acknowledged that the traditional boundaries between banking, insurance, and securities are blurring. In addition, the major European banks and insurances companies are listed on regulated markets and therefore are subject to the

complex bulk of European securities regulation (market abuse, prospectus, transparency, and so on). Financial law however is still organized along sectoral lines. The model is outdated and generates frictions between >>>

>>> regulatory objectives, in particular between micro-stability and transparency goals: information that need to be disclosed according to the securities regulation may be detrimental for the stability of the financial issuer, leading to a very delicate scenario both for market players and supervisory authorities.

While completing the rulebook for Banking Union and CMU, we might consider a consolidated official version of pre-existing rules, adjusted to work smoothly in an "all finance" environment.

Increased harmonization and consistent implementation of EU rules re-open the debate around the European supervisory framework, something that the current ESAs review proposal is trying to address.

The lack of a single securities regulator is a major loophole in the CMU edifice as it is certainly too late for having different supervision for different legal entities performing the same economic activities. A balanced solution might consist in shifting to a federal model based on the size of the capital market supervised entity: SICMIs (i.e. Sistemically Important Capital Markets Institutions) should be authorized and supervised at the central level, while other entities would fall under the umbrella of national authorities.

With stronger legal basis, the Single Supervisory Mechanism could be extended to cover insurance firms and ESMA would be empowered with direct supervisory and enforcement tasks over SICMIs. The endpoint would be a 4-peaks federal model (macro-stability, micro stability, investor protection and competition) irrespective of the nature of intermediaries, with coordination committees at national and central level provided by policy makers and EU Commission. ●

Tanate Phutrakul

Chief Financial Officer, ING Groep N.V.

Without Banking Union, no Capital Markets Union

The Capital Markets Union (CMU) is a difficult beast. There is near universal consensus that establishing CMU is a good thing. It will help diversify the EU economy's sources of financing. This should strengthen financial stability. The availability of alternative financing channels should reduce

the amplifying cyclical feedback effects that finance can have on the economy. Moreover, in an increasingly complex and unpredictable world, having deep, liquid financial markets at home adds to the EU's ability to maintain economic stability at home and an open, multilateral, rule-based economic and financial system in the world.

While these goals are broadly subscribed to, there is much less consensus on how to bring about truly integrated financial markets in the EU. What is clear, is that banks play a pivotal role in building Capital Markets Union. Europe's economy is still largely bank-financed. Banks remain the dominant lenders in most countries. By classic means like securitisation, banks can unlock assets to investors for which otherwise no market exists. As finance develops and digitisation progresses, banks will increasingly also be able to serve investors via new channels. Banks are building platforms, intermediating between borrowers and investors. Banks may also specialise in certain functions in the credit supply chain, e.g. client checks, credit risk assessment and loan servicing.

In applying new digital tools, banks like ING are benefiting from economies of scale. The bigger the market, the better and more efficient services can be provided. So yes please, let's implement the CMU today, we all stand to benefit. But let's also not forget that Banking Union is the sine qua non for building Capital Markets Union and for strengthening the role of the euro. A bank like ING services clients throughout Europe. We could strengthen our role as EU-wide suppliers and intermediaries on an integrated EU capital market – provided we are able to manage our liabilities and our assets in a consolidated and seamless way. Only then are we optimally able to channel savings from where they are in excess supply, to where investment is needed the most.

This means that the impediments we know all too well today, including local ringfencing of liquidity, assets and capital, should be removed. That is only feasible if banking risks are managed at the EU level. Which is why when talking about CMU and a strong euro, we are only just a step or two away from stressing the need to manage banking risks at the EU level. The Single Supervisory Mechanism is there, the Single Resolution Mechanism is mostly in place (although a bigger liquidity backstop would be welcome). Yet we still sorely miss a European Deposit Insurance Fund and a way to address skewed sovereign exposures at banks. It is of limited use to discuss how to build CMU, if we not address at the same time these remaining Banking Union issues. ●

Jean Naslin

Executive Director, Head of Public Affairs, CaixaBank

Banking sector and capital markets: union creates strength

This debate cannot be reduced to «banks versus capital markets». Both rather complement each other.

Bank lending is associated with an important process of ex ante credit scoring and a deeply rooted relationship between bank and customer. Information regarding debtor is less asymmetric, reducing costs. Monitoring and selecting projects foster stronger corporate governance policies which improves credit capacity >>>

>>> of the private sector. At the same time, reduction of asymmetric information resulting from lending historical data impact positively access to market by banks clients and bank intermediation. Specifically, companies with some association with banks enjoy lower costs for debt and equity issuances compared with those firms with a lesser degree of association. So the effects of traditional bank activities go beyond the sphere of banking per se.

Markets, in turn, fundamentally have two strengths, they help share risks between players according to their preferences and especially their risk tolerance. When markets in which debt securities or equity are traded are sufficiently liquid and the investor base is broad, corporate financing costs tend to fall. A minimal size of firm and issuance is normally required, however. The possibility of trading securities on the secondary market enhances price formation as prices reflect, in the absence of any significant distortions, approximately the aggregate expectations of investors regarding the viability of projects.

So banks and markets are far from being separate, sealed compartments even more so when we add securitisation into the mix, a natural link between banks and markets.

In the absence of a common framework, capital markets are unlikely to replace bank financing. Companies in the euro area still have very limited access to corporate bond and equity markets. This is largely due to the euro area's predominance of small firms where the vast majority of funds obtained by issuing debt are concentrated in just a few very large companies.

In addition, concentration of systemic risks at national level constrain truly EU free flows of capital and liquidity, all of which probably further exacerbated post BREXIT. Supervision and enforcement are still mostly in the hands of NCAs. Far too many national barriers or legal impediments such as insolvency tend to lead to regulatory arbitrage. A single rule book needs to be supplemented by single supervision. Only small market segments are directly supervised by ESMA, calling for enhanced supervisory powers and reinforced governance for ESAs generally. This is particularly relevant in the context of BREXIT where ESMA can play a key role in handling equivalence, a particularly relevant challenge.

Existing fragmentation of financial markets constrain free flows of capital and liquidity weakening the development of true pan European players. Finally, short of further European integration and a full banking union including Solidarity mechanisms and home host trust, large cross boarder banking, both retail and wholesale, cannot be incentivized. Major integration of the European banking system is key to a successful integration of financial markets. ●

Michael Percival

EMEA Head of Regulatory Affairs, JPMorgan

Keeping European financial markets at the deep end of the liquidity pool

Europe's policymakers have recognised the need to develop the region's capital markets. JPMorgan fully subscribes to that objective, in support of greater access to competitive financing and risk management for European firms. Part of the equation, which should not be lost, is the value for the continent of remaining strongly connected to global financial flows.

Accessing global liquidity

The EU has a good track record of facilitating cross-border financial flows, both within the EU and between the EU and rest of world. JPMorgan's activities in the EU are a testament to that. Brexit has caused us to examine collectively those flows afresh to consider the costs and benefits. We believe that the benefits are significant: cross-border flows allow us to bring global risk management and financing liquidity to clients in the EU. Conversely, EU investors are able to diversify their holdings and access global investment opportunities. These flows diversify financing globally and bring greater resilience to the system.

As policymakers further the Capital Markets Union and Banking Union we believe they should consider how to reduce frictions affecting cross-border flows, both intra-EU and between the EU and rest of world. These frictions might arise from direct 'barriers to entry', through disproportionate locational requirements, or even from differential application of rules, potentially undermining a 'level playing field'. Sometimes, for example with the Benchmarks Regulation, EU expectations for third countries to have equivalent regimes (which is not always the case) creates a barrier to cross-border flows.

Strong banks support capital markets

Improving the resilience of the EU banking sector will support capital markets; balance sheet is used for underwriting and making markets in securities, for example. EU policymakers are rightly considering how banks in the EU can achieve more robust balance sheets and stronger earnings, which in turn could drive stronger capital markets activity and growth.

Much work is underway to address NPLs, though stronger profitability for banks in the EU remains elusive. Greater capital markets activity should support bank earnings, through additional fee income and other revenues. Capital markets activity will also diversify bank earnings, while providing a conduit for transfer of risk from balance sheets.

Where to from here?

Deeper capital markets and a stronger banking sector will help EU growth and resilience. A deeper capital market will also support the Euro's international role – a separate European Commission objective. We have observed in the context of Brexit some commentators suggesting greater 'autonomy' for EU financial markets, with less connection to London. We believe policymakers need to nevertheless ensure continued connectivity between EU and global markets. Fragmented markets tend not to benefit consumers or economies, but rather the vested interests that have enhanced market power within a sub-market. The EU does not need to go down that path. Rather, the EU should have the confidence to maintain its course of facilitating cross-border flows, to stay connected globally and ensure continued access to the deepest liquidity pools. ●