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CMU and Banking Union: are they complementary or antagonistic?

Two major policy initiatives aimed at strengthening and further integrating the EU financial sector

Despite the commonality of certain of the objectives of the Banking Union (BU) and of the Capital Markets Union (CMU) related to the further integration of financial markets and the improvement of risk sharing across the EU[1], these projects were structured separately and are conducted in parallel. This can be explained notably by the different circumstances that led to their inception (the Eurozone sovereign debt crisis for the BU and insufficient economic growth and investment in the EU for the CMU)[2].

The complementarities between bank and capital markets could however be better capitalized on, to the mutual benefit of both initiatives. In addition, since banks and capital markets compete for the financing of certain opportunities, there is a risk that financing may not be fully optimized if all possible instruments are not considered. There have been calls for a "financing union" combining the two initiatives (and possibly other EU programmes such as InvestEU). This holistic approach to the financing of the EU economy seems an appropriate way forward, but its practical implications still remain spelling out in greater detail.

Better capitalizing on the complementarities between banks and capital markets could enhance financing and investment

Banks and capital markets are complementary. Banks are important players in capital markets (e.g. as intermediaries in the issuance and sales of securities, market-makers, investment advisors…) and may support their further development at the domestic and cross-border levels[3]. Conversely, capital market instruments (notably equity) can finance innovation and immaterial assets more adequately than banks because they do not require the same guarantees, collateral, credit history and regularity of cash flows as bank credit and can help to provide long term resources that banks can no longer offer, due to higher prudential requirements. Other instruments such as securitisation can also strengthen the capacity of banks to support the economy, hence the framework established in the context of the CMU regarding simple, transparent and standardised (STS) securitisation[4].

Further capitalizing on these complementarities in the BU and CMU projects would help to ensure that uncovered financing or investment needs are fulfilled with the most appropriate instruments - bank or capital market based – depending on the characteristics of the project to fund[5] and the maturity of the financial sector in the jurisdiction concerned[6]. This is particularly relevant for SMEs. For most of them, bank financing is the main external source of financing in the EU, because capital market financing is relatively costly and complex for small enterprises and requires governance changes and transparency enhancement that they are not ready to make. However, for some of them - the most innovative and fast-growing ones and those investing in immaterial projects - capital market funding and notably equity financing (provided by VCs, private equity or IPOs) - is essential. This also requires the development of active local capital market ecosystems in which banks play a key role alongside other market participants and securities infrastructures.

Retail investment is a second area where the combination of bank and capital market activities is particularly relevant. Encouraging retail investors to engage more in the capital markets indeed requires an appropriate combination of investment products and order execution services provided by capital market players and the provision of investor information and advice and intermediation services mostly offered by banks at present in the EU.

A more explicit connection between the BU and the CMU would also facilitate the identification of the most appropriate drivers for improving risk and capital allocation across the EU

Cross-border capital flows are necessary to ensure an appropriate allocation of capital and risks across the EU. However investors' and banks' portfolios have increasingly become national following the Eurozone sovereign debt crisis.

At present cross-border banking activities (loans, deposits…) in the euro area are limited to a 7 to 8% share[7]. This fragmentation hinders the effective allocation of financial resources and risks across the

[1] The objective of the Banking Union (BU) is to ensure that Eurozone banks are robust and to reduce the sovereign-bank loop and market fragmentation in the monetary Union. The Capital Markets Union (CMU) aims to diversify the financing of the EU economy and increase investment opportunities with a greater role for capital markets. Both initiatives should also contribute to improving the allocation of risks and financing across EU Member States, thus enhancing the resilience of the EU financial system and economy.

[2] The CMU was launched in 2014 to stimulate investment in the EU economy and create jobs in a context where the contribution of investment to growth remained low and the investment rate was still below pre-crisis levels, whereas the Banking Union was initiated in 2012 as a response to the sovereign debt crisis aiming to strengthen banks and break the bank-sovereign debt loop.

[3] Transnational banks covering several EU jurisdictions may also facilitate the growth of capital markets across Member States.

[4] Other complementarities between banks and capital markets include the following aspects: The further integration of capital markets would also alleviate the costs of banks that currently need to support multiple local markets across the Union and may offer additional opportunities for banks to market certain assets (e.g. NPLs) or raise capital in different EU markets. Banks rely on liquid securities markets to manage the asset and liability side of their balance sheet dynamically e.g. in order to raise equity capital, obtain funding through wholesale debt markets or hedge exposures using financial derivatives.

[5] Bank loans and bond financing can complement ech other, since they involve e.g. different contracting and governance requirements, but they are also close substitutes, since they are both debt instruments. This substitution has been observed since the crisis. On average across the euro area, bond financing accounted for over 20% of NFCs' external funding in Q2 2017, up by 10% since 2008. Therefore an optimal choice of instruments should also include equity financing which has different characteristics from bank credit and bonds.

[6] Research findings demonstrate that, as economies develop, the marginal contribution of banks to economic growth declines while that of capital markets increases, notably because market finance is better at promoting innovation and productivity and financing new sources of growth (Source: ECB – Financial integration in Europe – May 2018).

Eurozone via the banking channel. Initial assessments show that it is unlikely that the BU will foster much progress in this respect, despite the implementation of a common supervision of the main banks of the Eurozone. Two main proposals have been put forward by the Commission for completing the BU (a common backstop for the SRF and the implementation of EDIS), but neither of these seems likely to alleviate completely the concerns of host countries at the root of the current regulatory fragmentation across the Eurozone (e.g. local add ons, ring-fencing policies…)[8]. In addition the progress made so far on the EDIS proposal is relatively limited. This would instead require tackling certain remaining risks (e.g. finishing the resolution of NPLs, diminishing the sovereign-bank loop), progressing towards a European approach to the liquidation of transnational banking groups, which does not exist at present, and making the commitment by parent bank companies to support their subsidiaries more explicit in some cases.

If progress in terms of integration and consolidation is not achievable in a reasonable timeframe in the banking sector, more integrated capital markets will be necessary for improving the allocation of risks and capital across the EU and increasing the capacity of the Union to absorb asymmetric shocks. However, the current level of integration of EU capital markets is also limited demonstrated e.g. by a relatively strong home bias in the detention of securities[9]. Much progress has been made thanks to the implementation of EU capital market regulations and TARGET2-Securities, but efforts are still needed in several areas notably to improve the consistency of the single rule book (e.g. investment fund distribution, securities post-trading…) and enhance supervisory convergence.

A further challenge is that efforts to further integrate EU capital markets should not be to the detriment of other important objectives of the CMU such as diversifying sources of financing via the development of local market ecosystems and of equity financing, in a workplan that has already been considerably widened (e.g. with the sustainable finance and fintech agendas).

A combined BU and CMU approach would facilitate the prioritization, based on their potential impact and feasibility, of the main actions in the banking and capital markets areas that may help to improve the allocation of risk and capital across the EU. However, this needs to be done in a European perspective since many of the obstacles that require tackling result from domestic decisions of Member States. This is nonetheless difficult to achieve without effective progress in the application of the Stability and Growth Pact rules in all parts of the Union. ■

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7 The share of cross-border loans to NFCs and households has slowly increased but is limited to 8% of total loans. The share of cross-border deposits amounts to 6% and is on a decreasing trend (source ECB).

8 See Eurofi note on « Optimising the Banking Union" April 2018

9 The EU fund market is still predominantly organized along national lines despite UCITS and AIFMD passports, which reduces competition and choice for investors. Although about 80% of UCITS funds and 40% of AIFs benefit from a passport, the proportion of funds actively marketed across borders is significantly lower. 70% of the total AuM are held by investment funds registered for sale only in their domestic market. Moreover only 37% of UCITS and about 3% of AIFs are registered for sale in more than 3 Member States (Source European Commission). Another indicator is that investment funds hold on average less than 30% of holdings from other euro area countries for equity funds and 40% for debt securities (Source ECB Financial integration in Europe May 2018). Moreover there is a strong home bias in equity detention with over 50% of domestic origin (source Bruegel - Making a reality of Europe's Capital Markets Union – April 2018)