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Putting the Capital Markets Union on sustainable foundations

Written by

Daniela Gabor , Associate Professor UWE Bristol

Jakob Vestergaard, Senior Researcher. Danish Institute for International Studies (DIIS)

At the end of September 2015, the European Commission launched its Action Plan for a European Capital Markets Union (CMU). By European standards, this 'most significant EU proposal for the last 10 years' has proceeded at rapid pace under the leadership of the British Commissioner Lord Hill. For those attuned to the complexities of European politics, the CMU is a peace offering from Brussels (Berlin/Frankfurt) designed to showcase the strategic benefits that UK (and its City) enjoys from EU membership. Its (referendum) politics aside, the CMU's ambitions are great: SME financing and job creation, growth via capital markets. Yet, we argue, if the CMU is to make a substantial and lasting contribution to investment and job creation in Europe, it must be accompanied by reforms that address systemic risk in securities-based financial systems and enhance pan-European supervision of securitization and repo markets.

Press conference by Jonathan Hill, Member of the EC, on the Capital Markets Union Action Plan. Date: 30/09/2015 © European Union, 2015/Source: EC - Audiovisual Service , Shimera/Photo: Jacquemart Jennifer

The crisis of European banking after the collapse of Lehman was a crisis of market-based banking. European banks engaged in structured finance and other off-balance sheet activities were threatened by insolvency in 2008, leading to significant bail-out costs for European sovereigns. According to IMF research, 18 out of the 25 TBTF European banks vulnerable due to their trading activities required bailouts after 2008. Since, as the IMF put it, 'the vast majority of global finance is intermediated by a handful of large, complex financial institutions', initial regulatory efforts focused on reforming banks that had migrated to leveraged, interconnected, market-based activities. This also involved – through the FSB – global initiatives to curtail banks' involvement in shadow banking, particularly in securitization and repo markets.

In this context, it is remarkable to see the growing consensus that growth in Europe requires more market-based finance. The European Commission makes the following case: banks are still repairing balance sheets, new regulatory regimes increase their costs, making lending – to SMEs and other businesses – expensive. Allowing banks to engage more in capital market lending via securitisation, and to fund it in short-term money markets, would improve lending conditions in Europe, restarting growth. Those familiar with Perry Mehrling and Zoltan Pozsar's work will recognise this 'money market funding of capital market lending' as shadow banking.

Ironically, all evidence suggests that a Capital Markets Union is unlikely to improve SME financing. It's unclear how much European SMEs are constrained not by limited access to finance, but by shortage of customers (i.e, demand). Stefanie Schulte, from RWGV, a German cooperative banks association, argues that even in the United States, the country upheld by the Commission as the model country in terms of capital markets, SME loan securitization is small and supported by public guarantees. Here in Europe, when Germany recently tried to help SMEs issue bonds, the result was a wave of defaults and insolvencies. That experience suggests that the policy goal should not be to to reduce SME's reliance on bank lending, but to nurture competitive and viable relationship banking. The argument of an over banked Europe compared to US is also bogus, Schulte argues:

"U.S. Federal Deposit Insurance Corporation (FDIC) counts more than 6400 credit institutions, among them thousands of small, privately owned, regionally active community banks. Community banks provide almost half of all small business loans in the U.S. In addition to this, there are more than 6000 credit unions. Per 1 million citizens, there are more than 40 banks and credit unions in the U.S. Now compare this to Europe: Here, Germany is one of the few countries with a relatively high density of banks. There are nearly 23 banks, credit cooperatives and savings banks per 1 million [German] Citizens".

Four issues are essential to address for a sustainable CMU:

First, it is of paramount importance that key principles of "good securitisation" are not watered-down through pressure from large, international banks. Insisting that banks have a "skin in the game" is meant to avoid the perverse incentives that led to the global financial crisis. At the levels discussed now, however, risk retention requirements are too small to matter. Similarly, ongoing industry pressure to include synthetic forms of securitization in the CMU framework completely undermines the key notion of "simple" securitisation. The current ambiguity on whether to allow tranching in the forms of securitisation that are to be deemed 'high quality' also severely undermines the notion of simple and transparent securitization – since tranching by its very nature renders securitized products complex and opaque. A sustainable CMU must stand firm on the core principles – allowing only truly simple securitization in the framework, and insisting on substantial risk retention on the part of issuers. If it does not, it risks undermining rather than enhancing prosperity and growth in Europe.

Second, the CMU is likely to further increase the systemic importance of large banks in capital markets. Until recently, regulators in Europe were contemplating banking separation reforms to address the problem of too-big-to-fail banks. With the CMU, TBTF banks are likely to become larger still, as they will play key roles in reviving securitisation as issuers and market-makers. For their market-making activities, banks rely on collateralized funding markets, where borrowing against collateral makes leverage cheapest. So when the CMU speaks of the importance of "collateral fluidity", it is essentially saying that we should ensure that collateral based funding for large banks remains unregulated although there is compelling evidence since the global financial crisis that banks run on each other in wholesale funding markets. Two implications result from this: (1) the sustainable CMU must abandon the notion of "freely flowing" collateral, instead adopting the (already watered down) minimum haircut requirements framework developed by the FSB and (2) serious banking separation reform must be pursued in parallel.

Third, regulators should take note that national supervisory regimes for capital markets are neither converging nor consistent. A pan-European agency that regulates European capital markets directly will be necessary to mitigate the cross-border nature of systemic risk in integrated capital markets, just as the Banking Union proved indispensable to adequately supervise large, cross-border European banks. Integrated capital markets are still vulnerable to sudden shifts in market liquidity, as the global financial crisis demonstrated that even very large markets can see liquidity evaporating rapidly. Without a pan-European regulator that can take countercyclical measures, it is difficult to see how systemic risks arising from European capital markets could be effectively addressed. An institutions-based regulatory regime – the one we have been building since 2008 – is ill suited to address (capital) market fragilities. A sustainable CMU must recognize that integrated capital markets cannot have segmented regulation.

Fourth, the action plan unveiled last week promotes a private Capital Markets Union. While the Commission has been reluctant to spell out the implications for government bond markets, it is important to recognize that the cornerstone of financial systems, government bond markets, have been (further) segmented by first the banking and then the sovereign debt crisis. Recent improvements are mainly due to the ECB's quantitative easing (QE) and OMT commitments. Yet such unconventional monetary policies are designed to be temporary, while Europe has seen growing pressures for revisiting the preferential regulatory treatment of government bonds. Alberto Giovannini, one of the early architects of the European financial architecture, reminds us that 'a very large proportion of the securities-based financial system requires means of transactions, and riskless government securities are best candidates'. How can capital markets function without risk-free sovereigns? Credit ratings and market liquidity will matter even more, thus sharpening the existing asymmetries between 'periphery' and 'core' (read Germany) governments. Since the latter are more inclined to run budget surpluses, the second answer is exactly what brought us the 2008 crisis of shadow banking: private sector takes over the provision of 'safe assets'. A sustainable CMU should aim to eradicate existing asymmetries in market liquidity so that integrated government bond markets support the convergence in the costs of market funding for businesses across Europe.

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