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Financial stability, the Single Market and Capital Markets Union

In a speech on Tuesday to a conference organised by the City of London Corporation and Open Europe, Jon Cunliffe discusses how the European Union has achieved and should continue to achieve a balance between developing a single market for financial services and the need for financial stability. Jon sets out how the establishment of a Capital Markets Union can help to further the objective of encouraging the free movement of capital in the EU by promoting the development of market-based financing.

Jon notes that the regulatory framework for openness and for managing the financial stability risk around the single market in financial services in the EU was built on the principles of common rules – with force of law – commonly applied and on mutual recognition. This is key, because to be confident of maintaining financial stability in a single market with free movement of capital, each member state needs to be confident in the strength and in the application of prudential regulation in other member states.

“This is especially important for the UK, which has the largest, most internationally active and most complex financial sector in the EU. We are host to more foreign institutions than any other member state.“ Jon says. “I can say that it is crucial that the single market for financial services is supported by a framework of common prudential rules that are fit for purpose and that are consistently applied. This is intrinsic to the ability of the Bank to deliver financial stability in the UK.”

Jon also makes the point that as national authorities are ultimately held to account when things go wrong, there needs to be room for national flexibility within common EU rules, and he highlights the rules on capital requirements (CRD4), recovery and resolution and the EU supervisory authorities as examples of regulation where this balance has been achieved.

”Given the very different circumstances and risks faced by different member states, it is also important that the rules allow sufficient flexibility to recognise national financial stability responsibilities. And that they are applied by national authorities that have responsibility for financial stability. For the UK, stability depends on the working together of EU rules and well-aligned national authorities.”

Turning to the issue of Capital Markets Union, Jon recommends that the objectives should be threefold: first, to put European savings to better use by deepening and diversifying the sources of finance available to business and offering more investment choices and portfolio diversification to savers. Second, to enable greater risk sharing across the EU by creating deeper cross-border markets. And third, to create resilience by ensuring that if the banking system is damaged, there is an effective alternative channel of finance to the real economy.

Reforms will be needed to both supply and demand to achieve these objectives.

On the supply side, measures will be needed that enable household and corporate savings to flow to vehicles that will invest in capital markets, and investors will need to be encouraged to allocate capital across borders, reducing their "home bias". In addition, authorities will need to take a fundamental look at the way that Europeans save and examine whether there are obstacles and competitive distortions that restrict savings through financial markets.

On the demand side, Jon suggests that more diverse forms of borrowing will be needed and could include forms of finance in which investors directly acquire assets, such as equity and corporate bonds, and indirect forms of finance in which banks and markets work together through securitisation markets to lend to the real economy. A more integrated capital market would provide deeper equity markets that could enable a wider range of corporates to issue equity. As equity provides the most efficient forms of risk-sharing, Jon suggests that this area should be a priority for CMU.

Jon cautions, however, that while increasing the scale of cross-border capital flows across Europe brings benefits, they can also amplify crises when things go wrong, which is why they have to be built on a foundation of sustainable economic policies, good regulation and robust institutional structures. Moreover, while Capital Markets Union will need to have regard to financial stability, it does not require institutional change.

He concludes that the step change needed in market-based financing in the EU to achieve a full Capital Markets Union will be a marathon not a sprint. "Though there may be early wins, it will involve a carefully planned, detailed and sustained effort over a number of years and in a very wide range of areas. The benefits, however, could be very large indeed."

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