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How close are we to a Capital Markets Union?

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Introduction

The Commission's flagship initiative of the Capital Markets Union (CMU) aims to unlock funding for capital markets and find ways of linking investors and savers with growth. A number of very disparate measures will, it is hoped, have a cumulative but significant impact on the creation of a single market for capital. By the end of 2017, the Commission expects to have finalised and implemented the first phase of CMU measures. Some of these important measures include: an EU framework for simple, transparent and standardised (STS) securitisation; prospectus rules that facilitate access to capital markets and generate more, but less costly, financing opportunities; and improvements to the current venture capital and social entrepreneurship regulations (EuVECA/EuSEF).[1]

Given the Commission's priority to accelerate CMU, much more remains to be done. This year will be an exciting and intense one for prospective regulation, which will lead to the second phase of CMU actions. For example, in 2017 we expect more work on: business insolvency (early restructuring and second chance); preferential tax treatment of debt over equity; capital charges to infrastructure companies (Solvency II); and favourable loan enforcement regimes to SMEs (Capital Requirements Regulation and Directive). This is not enough, however. Further priorities such as the development of a personal pensions framework, an action plan on retail financial services, the development of a comprehensive European strategy on sustainable finance and the development of a coordinated policy approach that supports FinTech are all vital for a successful CMU.

This Commentary attempts to highlight the inefficiencies of the current CMU Action Plan.

This Commentary is a contribution to the public consultation on the Capital Markets Union mid-term review, 2017.

[1] See the Commission's Communication of 14 September 2016 for a rapid completion of the first measures proposed under the Action Plan here: http://ec.europa.eu/finance/capital-markets-union/docs/20160913-cmu-accelerating-reform_en.pdf.

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Existing inefficiencies

Key drivers of the CMU

CMU was motivated by a desire to: tackle the obstacles to growth and job creation, fill the hole that banks left behind in the financing arena (overreliance on the banking sector was akin to placing all one's eggs in a basket), and to make the EU financial system more resilient to future crises (shock-proof). So far, however, these three main drivers of the CMU have not been accompanied by vitalised structural measures that could accelerate the pace of capital market integration in Europe.

1. **Growth and jobs:** Even though they are the cornerstone of the CMU, the initiative does not contain any policy instrument that directly impacts GDP or employment. Europe has gone through a severe financial and economic crisis, with much of the region still struggling to make meaningful headway on reducing unemployment and stimulating economic growth. Macroeconomic policies across the EU remain biased towards austerity and do not adequately complement the expansionary monetary policy of the ECB and other NCBs (prosperous north vs poor south). While northern countries can expand aggregate demand by increasing public investment and reducing taxes, southern countries' macroeconomic expansion is hindered by past debts, weak banking systems and economic uncertainty.

Proposals such as a joint eurozone/EU issuance of bonds, which could probably enhance a fiscal stabilisation mechanism, improve the through-the-cycle resilience of the eurozone, provide capital markets with a liquid risk-free asset, support the diversification of European banks' balance sheets, and create cross-border banking groups, remain rather vague. Such proposals fail on legal, political, and economic grounds[2] and will always be postponed as long as Germany and other northern countries view them as an attempt to share fiscal misgovernance and structural reforms avoidance by southern countries. Political consensus plays an important role here and there is certainly nothing like that in Europe right now.

2. **Bank dependency**: The EU financial system is bank-driven and dominated by large, universal banks. The financial crisis showed us that EU would greatly benefit from rebalancing its economic structures towards a more market-based finance. The CMU should help this rebalancing process by integrating nationally fragmented capital markets. The STS securitisation is a step in the right direction, as well as the streamlining of rules for securities prospectuses and the simplification of market entry. However, more effort has to be made to support start-ups/SMEs, to reduce access barriers to public trading platforms and develop venture capital, private financing and crowdfunding. In addition, the CMU needs to attract and incorporate more actively household and corporate-sector savings in vehicles that will invest in capital markets and encourage them to diversify across the EU.

In order for the CMU to reach its main aim, to facilitate capital market development by reducing the dependency of EU economies on banks, more initiatives towards the imposition of legal restrictions on banking sector are necessary. These restrictions will encourage innovations that expand the role of capital markets at the expense of banks. We can find examples of such restrictions when looking at the US and the UK. For example, the restriction of deposit-taking banks from engaging in certain types

[2] See Gros (2011).

of market-oriented activity,[3] the ring-fencing of retail bank operations into separate legal subsidiaries[4] (UK Independent Commission on Banking, ICB), and the imposition of size limits aim at dampening the impact of a failure (Section 622 of the Dodd Frank Act).

3. **Shock absorption**: More integrated capital markets (through CMU) are expected to provide additional shock absorption capacity by increasing private-sector risk sharing, lowering economic volatility via geographic diversification of equities and bonds, enabling households and firms to lend/borrow from other economies (less impacted by given crisis), involving a more diverse investor base with different funding profiles and risk appetites.[5]

To achieve this, national differences in supervisory, regulatory, tax, and legal practices, need to be eliminated. The Commission currently works in this direction, by focusing on standardising cross-border clearing and settlement infrastructures; by formulating principles-based legislation on business insolvency and early restructuring; and by establishing a code of conduct for withholding-tax-relief principles and tax-induced disadvantages for equity financing.

However, these reforms largely depend on the progress of related initiatives such as harmonising accounting and auditing and increasing the role of the European Securities and Markets Authority (ESMA), which oversees consistent enforcement of EU rules in all 28 member states. While the CMU can help expand risk-sharing through capital markets, the adjustment to asymmetric shocks in the eurozone will further require some additional element of fiscal union, such as a joint Eurobond, cyclical adjustment fund, or common unemployment insurance.

Other key areas that need to be speeded up

Further areas that require attention in CMU discussions are post-trade infrastructure, online services and FinTech, crowdfunding, loan-originating funds, and cross-border distribution of funds. These areas are important for unlocking funding for capital markets and finding ways to linking investors and savers with growth.

4. **Post-trade infrastructure**: Although another keystone of the CMU project, developing an EU-wide capital market by bringing down national barriers, is not new.[6] Creating more efficient capital markets

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[3] For example, proprietary trading, or other types of activities that were deemed by the US Congress to be incompatible as a policy matter with the appropriate risk profile and customer-driven mission of banking entities. However, looking at the US, one challenge in implementing the Volcker Rule is complying with the market-making exemption to the prohibition on proprietary trading. The ambiguity as to what is legal market-making and what is prohibited proprietary trading may push dealers covered by the Volcker Rule toward more conservative trading strategies, leading to less liquid markets. While some would argue that dealers not affected by the Volcker Rule will step in to provide liquidity, recent empirical evidence (Bao et al., 2016) finds that the net effect is a less liquid market.

[4] These subsidiaries should be governed by their own prudential safeguards.

[5] See the speech by Eurogroup President Jeroen Dijsselbloem at the Tatra Summit in Bratislava, 4, November 2015 (www.consilium.europa.eu/en/press/press-releases/2015/11/04-jd-speech-tatra-summit/) and Alcidi and Thirion (2016).

[6] In fact, the free flow of capital was one of the fundamental principles on which the EU was built, and this idea has fed into many EU initiatives and projects. These undertakings ranged from the 1988 deregulation of capital movements in the EU (European Commission, 1989) to the 1999 Financial Services Action Plan, to the proposals set forth by the Giovannini Group (from 2001) for removing obstacles to the cross-border clearing and settlement of securities transactions.

was cited as an explicit goal of monetary union. The CMU is a further step towards the completion of a single European capital market. Within this scope, one of Commission's priorities is to remove barriers in the post-trading environment. Efficient and safe post-trade infrastructures are key elements of well-functioning capital markets.

Even after initiatives including the adoption in 2014 of a new EU Regulation on Central Securities Depositories[7] and the creation by the European Central Bank of the Target2-Securities (T2S) platform[8] for securities settlements, many of the Giovannini barriers[9] remain. As identified in the Giovannini reports,[10] the EU should aim to reduce or eliminate the current difference between cross-border securities transactions and transactions within a single EU country.

More efficient settlement of transactions and processing would occur as everyone would see the same data and updates would be circulated quickly across the market. Cash transactions could settle in (near) real-time since the trade is complete when the next update to the blockchain is agreed, embedding the transfer of ownership of an asset or other agreement. This would remove the need for post-trade affirmation or confirmation and central clearing during the settlement cycle (which has in some cases been shortened to minutes or even seconds). Since all participants would now use the same underlying dataset for trade-related processes, the blockchain would reduce the scope for data errors, disputes and reconciliation lags, which would speed up the end-to-end process.

Currently, an expert group (European Post-Trade Forum, EPTF) has been established to assess the evolution of the EU post-trade landscape following recent legislative changes, market developments and the emergence of new technologies. The group will also assess the extent to which the Giovannini barriers have been removed and identify any new or emerging barriers. In parallel, the Commission will propose a future legislative initiative to determine with legal certainty which national law will apply to security ownership and to third party effects of the assignment of claims.

5. Online services and FinTech: In order to promote the FinTech sector, the Commission needs to ensure that the regulatory environment strikes the right balance between enabling the development of FinTech and ensuring confidence and protection for investors.[11] Retail investors currently receive limited rewards for assuming the high risks associated with market based investments, because of large intermediation and distribution fees. MiFID II (Markets in Financial Instruments Directive), PRIIPs (Packaged Retail and Insurance-based Investment Products) and IDD (Insurance Distribution Directive) are expected to change the landscape governing investment advice and product disclosure and enforce investors' confidence in capital markets.

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[7] See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0909&from=en.

[8] See www.ecb.europa.eu/paym/t2s/html/index.en.html.

[9] See www.ecb.europa.eu/paym/t2s/about/html/giovannini.en.html.

[10] The first Giovannini Group (2001) report identified 15 barriers which were preventing efficient cross-border clearing and settlement of securities in the EU, while the second Giovannini Group (2003) report addressed the actions to be undertaken to eliminate the problems identified in the first report.

[11] The Commission set up an internal task force (Financial Technology Task Force, FTTF), which brings together services responsible for financial regulation, for the Digital Single Market, competition and for a consumer protection policy. With the engagement of outside experts and stakeholders, the Commission aims at formulating policy-oriented recommendations and propose measures in the course of 2017. See https://ec.europa.eu/digital-single-market/en/digital-single-market.

The move towards the 'online distribution' of investment products, as well as the new FinTech ecosystem, undeniably represent a huge opportunity to develop further advisory services and open-access online distribution platforms. But for these changes to be successful, they should be accompanied by a critical and comprehensive assessment of the investment solutions and by outcomes proposed to retail investors. Initiatives such as the Smarter Consumer Communications,[12] which changes the way information is communicated and delivered to customers, and the Regulatory Sandbox,[13] which allows businesses to test innovative products, services, business models and delivery mechanisms in a live environment, could set a great example.

6. Crowdfunding: Despite the expansion of funding sources available to SMEs (especially non-bank funding via private equity and peer-to-peer investment and borrowing), securities-based crowdfunding and peer-to-peer business lending still represent a small share of SME's funding. A number of reasons for this are i) a non-harmonised legislation on crowdfunding across member states, ii) a lack of credit information about SMEs[14] which narrows access to crowdfunding, as well as to other funding sources, iii) a lack of information/knowledge and awareness of securities based on crowdfunding and peer-to-peer lending amongst investors.

This being said, it should be noted that the Commission is taking steps towards assessing national regimes and best practice and monitoring the evolution of the crowdfunding sector. However, the current fragmentation and local dimension of these activities will certainly benefit from the MiFID II passport or initiatives that aim to develop the cross-border crowdfunding business and harmonise existing EU legislation with existing and upcoming national regulatory frameworks.[15]

7. Loan-originating funds: Loan-originating funds can play an important role and be a useful source of non-bank credit. ESMA has issued an opinion on loan-originating funds in April 2016, with the scope to identify elements that should be part of a possible European framework on loan origination.[16] However, it is not clear whether this consultation will lead to a concrete legislative proposal for a Europe-wide regime for lending by funds, or whether it will lead to a review of the current market landscape. It is also unclear what will happen to non-EU fund structures and how, if at all, an EU legislative proposal would approach lending into the EU by such funds.

The Action Plan identifies that EuVECAs (European Venture Capital Funds) and ELTIFs (European Long-Term Investment Funds) can, to an extent, originate loans. This is aside from bespoke regimes that some member states (notably Ireland and Luxembourg) introduce into their national frameworks to frame the conditional under which alternative investment funds can originate loans. The Commission needs to work to assess the need for a coordinated approach to loan origination by funds and the case for a future EU framework.

8. Cross-border distribution of funds: Despite the fact that 80% of UCITS (Undertakings for Collective Investment in Transferable Securities) and 40% of AIF (Alternative Investment Funds) are marketed

[12] See www.fca.org.uk/publications/discussion-papers/smarter-consumer-communications-further-step-journey.

[13] See www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox.

[14] See post-event report of ECMI Lunchtime Seminar on "Removing Information Barriers to Investment in SMEs": www.eurocapitalmarkets.org/events/lunchtime-events/removing-information-barriers-investment-smes.

[15] The European Crowdfunding Stakeholder Forum assists the Commission in developing policies for crowdfunding.

[16] See ESMA (2016).

cross-border, the distribution of funds remain geographically limited.[17] The success of the CMU largely depends on the removal of unjustified national barriers to the free movement of capital. Latest data reveal that a third of funds marketed cross-border are sold in only one other member state and another third in no more than four other member states. Some of the reasons for inefficiency are i) a concentrated fund distribution channels in individual member states; ii) cultural preferences and iii) a lack of incentives to compete across borders.

For the Commission to ensure easier cross-border investments, a number of challenges have to be tackled. First, tax barriers, such as withholding tax procedures. Member states need to conclude a double-taxation agreement to avoid double taxation to investors. Second, divergences in corporate governance frameworks between member states, which may discourage investors from making cross-border investments. Third, divergences in supervisory outcomes. ESMA should focus on achieving convergence of the supervisory frameworks and ensure a better financial integration within member states.[18] Moreover, ESMA is determined to ensure adequate investor protection independently of the location of the firm providing the services.[19]

Conclusion

To conclude, the European Commission has to ensure that the key aim of the CMU and the Action Plan is to improve the capital markets themselves, rather than making it easier for large institutions to invest more and extend their product and services offers. The focus should be on increasing transparency, making capital markets more accessible to smaller businesses, incentivising long-term private investment in listed equities, encouraging the development and use of disruptive technology and, ultimately, creating jobs.

This year will prove crucial for the successful implementation of the CMU Action Plan and the delivery of its full potential to support growth in Europe. Moreover, the impact that events such as Brexit, the French and German national elections will have on CMU, of course remains to be seen. The current environment of political instability and uncertainty mirrors the fact that the EU is at a crossroads, with decisive years ahead. It seems that the goal – the completion of CMU by 2019 – is moving backwards and farther away.

[17] See EC (2017).

[18] See Demarigny (2015).

[19] See ESMA (2017).

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