Policy Contribution
Issue n˚07 | April 2018

Making a reality of Europe's Capital Markets Union

André Sapir, Nicolas Véron and Guntram B. Wolff

André Sapir (andre.sapir@bruegel.org) is a Senior Fellow at Bruegel

Nicolas Véron (nicolas.veron@bruegel.org) is a Senior Fellow at Bruegel and at the Peterson Institute for International Economics

Guntram B. Wolff (guntram.wolff@bruegel.org) is Director of Bruegel

This Policy Contribution is an edited version of a paper prepared for and presented at the informal meeting of European Union economic and financial affairs ministers (Informal ECOFIN), Sofia, Bulgaria, 27-28 April 2018. The authors would like to thank numerous interlocutors for their feedback and discussion in the process of writing this Policy Contribution. Excellent research assistance was provided by Inês Goncalves Raposo.

Executive summary

The deepening and integration of the European Union's capital markets is a long-term structural endeavour. Although difficult to achieve, it is worthwhile for several reasons: a meaningful body of economic analysis strongly suggests that purely bank-based financial systems are more prone to crises and might produce lower growth performance; widely-accepted analysis suggests that cross-border capital market integration can be an important complement to fiscal risk sharing; and the departure from the EU of the United Kingdom – home to the EU's main capital market centre – makes the project even more relevant. Although integrating and deepening capital markets has been a long standing goal of the EU, actual progress has been limited.

The European Commission's welcome Capital Markets Union (CMU) agenda has led to many legislative proposals to advance the development of EU capital markets. Although the European Council has repeatedly underlined the CMU's importance, only a few of these legislative proposals have been adopted. At this stage, significant progress will only be feasible if clear priorities are set. We argue that strengthening and expanding the role of the European Securities and Markets Authority (ESMA) should be prioritised because: (a) it is a relatively easily implementable step; (b) it would entrust an institution with driving the agenda forward; and (c) it would put an effective check on the potential financial stability and business conduct challenges that might arise from cross-border capital markets integration. Other major legislation, in particular on business insolvency and on personal pension products, could also be prioritised for completion during the current European Parliament legislative term.

bruegel

1 The Capital Markets Union project: great promise, difficult delivery

Capital markets play a crucial role in modern economies. Their purpose is to match the supply of funds from investors with the demand for funding from companies and governments. Sources of financing such as equity and bonds, securitisation, lending from insurance companies and asset managers or venture capital, complement lending by banks and help allocate financial resources to where they can be most efficiently deployed.

Capital markets have long been underdeveloped in Europe, partly because they tend to be fragmented along national lines. Much effort has been devoted over the years to integrate European capital markets: the Single Market project in the 1980s, with the liberalisation of capital movements and the creation of the European passport for financial services; the Financial Services Action Plan starting in 1999 and the Lamfalussy process starting in 2001; and the Larosière Report in 2009 (Larosière, 2009), which enshrined the vision of a single rulebook and resulted in the creation of the European supervisory authorities (ESAs).

The economic case for capital markets union

There were good reasons for the Juncker Commission to launch the Capital Markets Union (CMU) initiative in 2014, shortly after the 2007-09 financial crisis and the 2010-13 euro-area banking and sovereign crisis. This sequence of crises was a painful reminder that Europe needed to improve its regulatory and supervisory environment to better ensure financial stability. It was also a wake-up call that the EU economy had been too dependent on bank lending and needed a more diversified funding system in which non-bank finance would play a significant role.

According to Sapir and Wolff (2013), while it was crucial for the euro area to decide (in 2012) on the creation of a banking union to address vulnerabilities in its banking system, it was equally important for the EU – and crucial for the euro area – to complement the creation of the banking union with decisions on fostering capital market integration. As they noted, *"the EU and in particular the euro area need to develop a genuine cross-border equity and corporate bond market, in part to be able to absorb shocks…This would reduce the heavy reliance of the EU economy on bank funding and improve economic stability thanks to better financial risk sharing"*[1].

Pagano *et al* (2014) and Langfield and Pagano (2016) reviewed the debate in the finance literature on the relative merits of bank-based and market-based financing systems in terms of their effects on economic growth and on the allocation of risk. They found that the theoretical literature contains no clear-cut prediction about the superiority of one system over the other in promoting the efficient allocation of funding, and therefore better economic performance. Instead, each system seems to have a comparative advantage in funding different types of investment project, suggesting that diversification of funding systems is beneficial.

The same authors also studied empirically the extent to which banks and markets enable efficient risk sharing and enhance the resilience of the economy to macroeconomic shocks. One of their findings is that, on the macroeconomic level, bank lending is more volatile and pro-cyclical than bond financing, especially during financial crises. This suggests European countries were more affected by the financial crisis than the United States, since they are more reliant on bank finance.

On risk sharing, ECB (2017a) found that the extent of risk sharing between euro-area

1 Brühl *et al* (2015) were early supporters of the CMU initiative, because it *"would come with a greater choice set for users of European financial markets and institutions. It would, potentially, imply a boost to Europe's potential growth. And it should translate into higher employment. These are, evidently, objectives very much at the core of the European project"*. At the same time, they warned that information asymmetries, which are inherent to financial markets, would need to be adequately addressed in the CMU proposals to ensure that the project reaches its full potential.

countries and the contribution of capital markets both increased after the adoption of the euro. However, during the financial and sovereign debt crises, both declined, with the contribution of capital markets falling to a low level.

The European Central Bank has welcomed the CMU initiative. It considers that *"the CMU is the natural complement to the banking union – it will strengthen EMU and deepen the Single Market. It will…help foster financial stability…, thereby increasing the resilience of the financial system and the economy at large"* (ECB, 2017a). We concur with the ECB that more cross-border private financial risk sharing will support the functioning of Economic and Monetary Union by smoothing the effects of economic cycles. In particular, cross-border equity ownership and foreign direct investment have better shock-absorption properties than cross-border bank lending that in crisis times can lead to sudden stops, especially if the banking union remains incomplete.

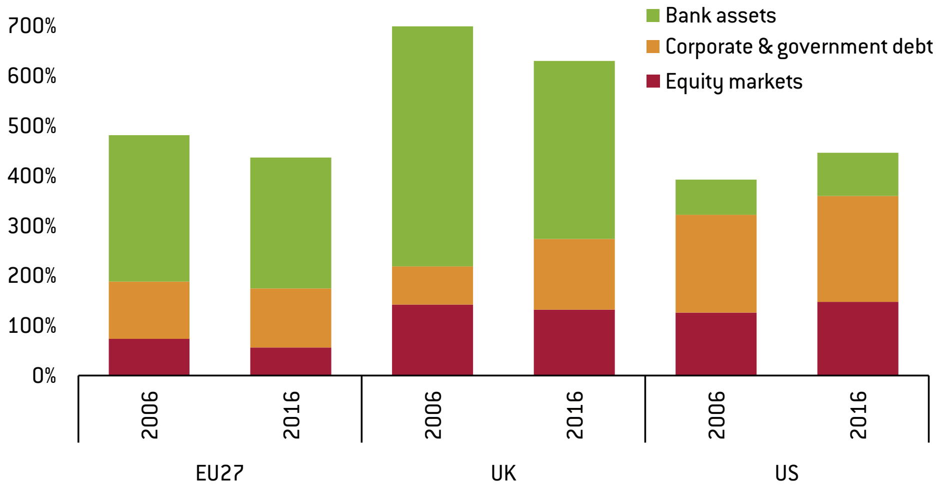
CMU and banking union are complementary long-term projects. The emergence of more cross-border banks will help the development of European capital markets. Conversely, a successful CMU will make pan-European banking business models comparatively more attractive. These two policies are to be viewed as complements, not substitutes.

The widespread recognition that the EU economy and Economic and Monetary Union would have probably had a less difficult time during the financial and sovereign debt crises if capital markets had been more developed was essential to the CMU initiative. It gave a major impetus to the Juncker Commission to try and overcome the political economy obstacles that had long plagued the development and integration of such markets.

The empirical picture so far: little progress

But so far, there has been little change in long-established financial intermediation channels[2]. The EU's financial activity is more dominated by bank lending than that of the US (and to some extent the UK), where equity and debt play a bigger role (Figure 1).

Figure 1: Size of the financial sector and capital markets, % GDP



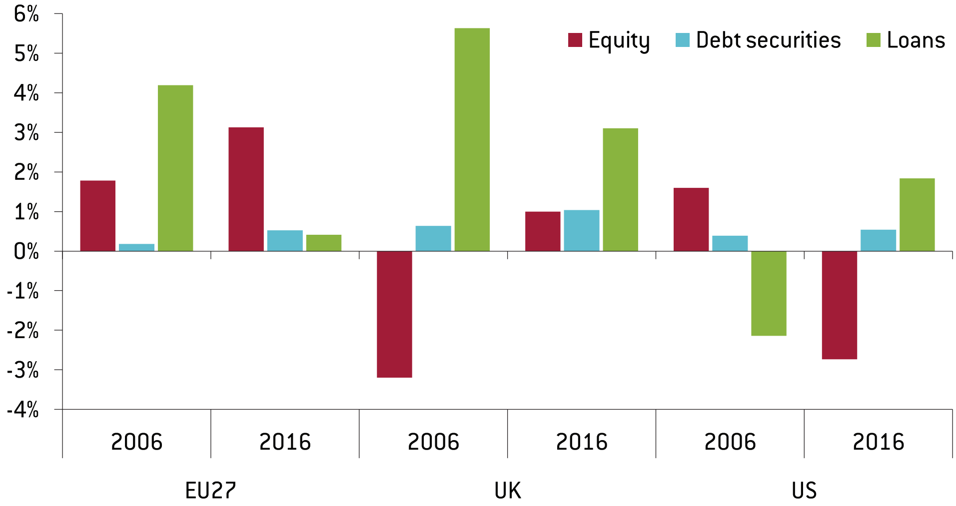
Bruegel based on IMF World Economic Outlook, Bloomberg, Association for Financial Markets in Europe (AFME), Securities Industry and Financial Markets Association (SIFMA). EU27 is the EU excluding the UK.

Bank lending was the prevailing channel of financial intermediation to non-financial corporations in most EU countries before the crisis but became less relevant in 2016 as bank

2 Véron (2014) and Quaglia, Howarth and Liebe (2016) discuss the way special interests might hinder the development of capital markets.

credit growth remained subdued, reflecting a combination of deleveraging and in some cases supply constraints (Figure 2 and Figure A1 in the annex). Debt securities such as corporate bonds also play a role, but mostly for large companies. Equity financing has meanwhile increased in importance in the EU27 but rarely to fund SMEs (Figure A2 in annex).

Figure 2: Size of different financial intermediation channels to the non-financial corporate sector as share of GDP, 2016 and 2006

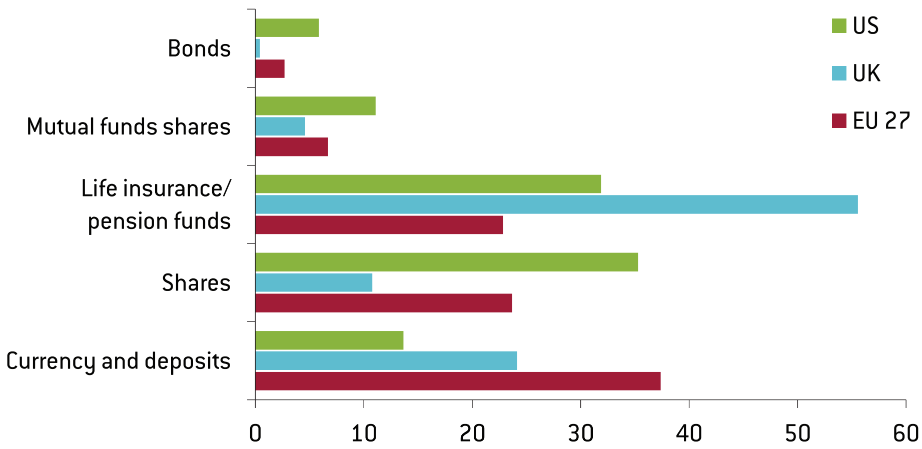


Source: Eurostat and Federal Reserve. Note: Given the volatility of flows we use three-year averages.

Private sector debt is relatively high in many EU countries and many countries have found it difficult to reduce corporate and household debt overhangs, in part because of non-existent capital markets for non-performing loans (Ahearne and Wolff, 2012; Demertzis and Lehman, 2017).

The financial portfolios of households in the EU27 remain strongly biased in favour of bank deposits, while equity plays a lesser role than in the US (Figure 3).

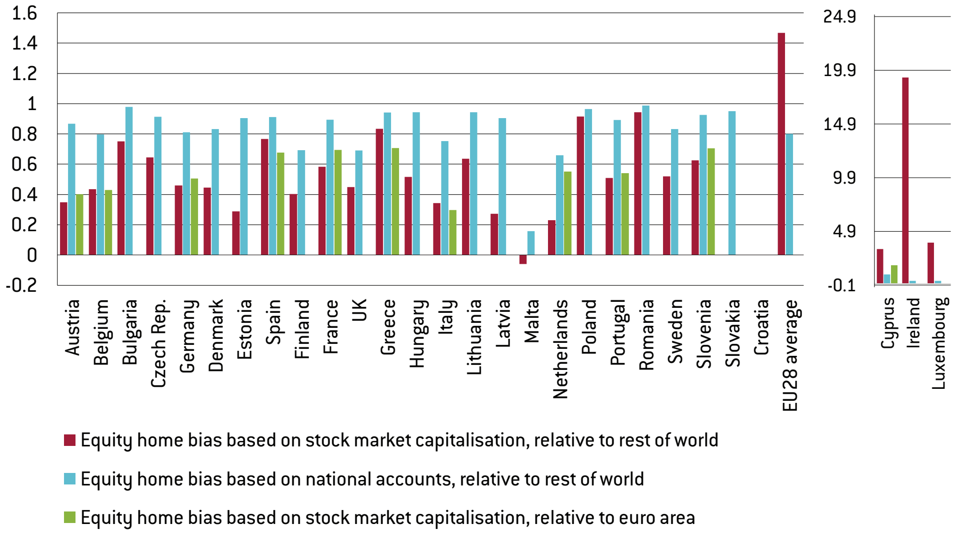
Figure 3: Financial portfolio of households in the EU and US (% of total financial assets), 2016



Source: OECD National Accounts at a Glance.

Not only do capital markets play only a modest role in the financing of the European economy compared to bank lending, financial intermediation also remains mostly national. For example, the proportion of equity that is of domestic origin often exceeds 50 percent, a strong home bias that effectively prevents risk-sharing across borders (Figure 4). Also, bank lending is mostly national and cross-border asset holdings, let alone cross-border bank mergers, have not even recovered to pre-crisis levels (Sapir and Wolff, 2013; Goncalves Raposo and Wolff, 2017, Figure A3 in the annex).

Figure 4: Equity home bias



Sources: Darvas and Schoenmaker (2017), Bruegel based on IMF CPIS and ECB. Note: Equity home bias relative to the rest of the world is presented as in Darvas and Schoenmaker (2017) for 2014. Equity home bias relative to the euro area is computed for 2016. The indicator is computed as one minus the ratio of the share of foreign equities in the home and world portfolios. An equity home bias of 1 implies that domestic investors invest 100 percent in domestic equity. An indicator of 0 signals no home bias, a negative indicator signals a bias for holding foreign securities.

The European Union's CMU-related legislative initiatives so far

In February 2015, barely three months after taking office, the Juncker Commission published a green paper on CMU (European Commission, 2015a). In September 2015, it issued its action plan listing the legislative and non-legislative proposals it would table in 2015-18 for constructing the CMU (European Commission, 2015b). The action plan covers six areas: (1) financing for innovation, start-ups and non-listed companies; (2) entering and raising capital on public markets; (3) facilitating long-term investment; (4) fostering retail and institutional investment; (5) facilitating securitisation; and (6) facilitating cross-border investment. In June 2017, the Commission published a mid-term review taking stock of the progress so far and adding new priorities to its CMU action plan (European Commission, 2017).

At the time of writing, in April 2018, progress on the CMU can be described as follows:

- Legislation listed in the 2015 action plan, proposed by the Commission and adopted by the Council and/or Parliament: a regulation of June 2017 (Regulation (EU) 2017/1129) replacing the earlier securities prospectus directive; a regulation of December 2017 creating a new regime for securitisation (Regulation (EU) 2017/2402); and a regulation of October 2017 creating a new regime for European venture capital funds and European social entrepreneurship funds (Regulation (EU) 2017/1991).

- Legislation listed in the 2015 action plan, proposed by the Commission but not yet adopted by the Council and/or Parliament: a directive on a Common Consolidated Corporate Tax Base (CCCTB) proposed in October 2016 (COM(2016) 685); and a directive proposed in November 2016 on business insolvency and early restructuring (COM(2016) 723).
- Legislation listed in the 2015 action plan and abandoned by the Commission: none.
- Legislation added to the action plan by the 2017 mid-term review, proposed by the Commission but not yet adopted by the EU co-legislators: a regulation creating a pan-European personal pension product proposed in June 2017 (COM(2017) 343); a regulation amending the role of the European Securities and Markets Authority (ESMA) and the other ESAs proposed in September 2017 (COM(2017) 536, hereinafter ESA Review or ESAR)[3]; a regulation on the prudential requirements for investment firms proposed in December 2017 (COM(2017) 790); a regulation on the law applicable to the third-party effects of cross-border assignments of claims proposed in March 2018 (COM(2018) 096); a regulation on crowdfunding proposed in March 2018 (COM(2018) 109); a directive and a regulation on covered bonds proposed in March 2018 (COM(2018) 093); a directive and a regulation modifying the existing framework on the cross-border distribution of investment funds proposed in March 2018 (COM(2018) 110); and a directive on markets for non-performing loans (NPLs) proposed in March 2018.
- Legislation added to the action plan by the 2017 mid-term review and abandoned by the Commission: none.
- Legislation formally outside the CMU action plan but directly relevant to the CMU project: a regulation amending the European Market Infrastructure Regulation (EMIR) to create a new framework for the recovery and resolution of central counterparties (CCPs), proposed in November 2016 (COM(2016) 856); another amendment proposal to streamline EMIR in May 2017 (COM(2017) 208); and a proposal on CCP supervision amending both the ESMA Regulation and EMIR (COM(2017) 331, June 2017). These three proposals are often collectively referred to as 'EMIR2'.
- Legislation that the Commission still plans to propose in 2018 and 2019: none[4].

This list testifies to the Juncker Commission's intense legislative activity. Altogether it has put forward 13 different pieces of legislation, which map into five of the six areas of its 2015 action plan. In addition, the Commission has made legislative proposals on CCPs and market infrastructure, and adopted a host of non-legislative decisions in favour of the CMU – including on facilitation of long-term investment, the action plan's only area where the Commission has proposed no new legislation.

If and when they are adopted, these legislative texts would amount in our view to significant achievements in the pursuit of the goal of building a Capital Markets Union, though they would by no means represent the completion of that project. In the meantime, much remains to be done and we agree with the European Commission's (2018) call for the European Parliament and the Council *"to accelerate work on all pending legislative proposals relevant for the completion of Capital Markets Union, to ensure their adoption before the elections to the European Parliament in mid-2019 at the latest"*.

An important question is whether the urgency of the CMU policy agenda is further reinforced by Brexit and possibly also by the development of fintech.

Between 40 and 80 percent (depending on the segment of the market) of all capital markets activity in the EU is conducted in the United Kingdom (Wright, 2017). Obviously, London is a global financial centre and not all of this activity, therefore, involves EU27-based clients. Sapir, Schoenmaker and Véron (2017) made a rough estimate that about 35 percent of the London-based activity of investment banks – key players in capital market transactions – is

3 See also European Parliament (2018).

4 According to the annex of European Commission (2018).

related to EU27-based clients. Thus, depending on the extent to which UK-based financial firms lose their EU passporting rights after Brexit, the UK's exit from the EU could involve sizeable migration of capital market activity from London to EU27 locations.

This situation entails both risks and opportunities for the EU27 in the pursuit of the CMU agenda. These translate into concrete policy choices on the removal of barriers to cross-border activities and the oversight of EU capital markets. Such choices need to be resolved urgently[5]. The objective is to make the EU27 a more attractive place to conduct capital market operations while avoiding a regulatory race to the bottom among the 27 member states. Therefore, we share the view of the Commission that Brexit strengthens the case for CMU[6].

Fintech could also significantly alter certain segments of capital markets. Unless developments in this area trigger appropriate changes to the EU regulatory and supervisory environment, there is a serious danger that a fragmented and uncompetitive fintech landscape could become a permanent feature of EU27 capital markets (Demertzis, Merler and Wolff, 2018).

2 Institutional architecture reform as a catalyst: a stronger ESMA as the key to progress

The supervisory challenge

A highly stylised but broadly apt description of the current status of capital markets policy is that (1) financial regulatory harmonisation has made considerable progress in the last near-20 years since the Financial Services Action Plan of 1999, with EU financial legislation increasingly taking the form of regulations and not just directives (even though several areas of insufficient harmonisation persist); (2) supervisory integration remains extremely limited outside of the euro-area banking sector, with only small market segments directly supervised by ESMA and a still weak (though improved) framework for ESMA-led supervisory convergence; and (3) almost no convergence yet in broader legislative areas that frame the operation of capital markets but also serve other primary purposes, such as in insolvency, taxation, housing finance and pensions.

Specifically, a lesson of the past two decades is that even fully harmonised legislation can still lead to diverging national outcomes if EU laws are enforced only by national competent authorities (NCAs). Many (though not all) areas of EU capital markets regulation have been extensively harmonised, bringing the vision of a single rulebook close to reality, but practitioners know that this has not brought consistency in regulatory practice or a seamless single market. Examples include the Markets in Financial Instruments Directive and Regulation (MiFID/MiFIR), the European Market Infrastructure Regulation (EMIR), and the accounting and auditing framework, as framed in particular by the EU accounting regulation of 2002 and the latest audit regulation and directive, both of 2014. In all these cases, the rulebook is mostly or entirely harmonised, but supervision and enforcement is mostly in the hands of NCAs such as securities regulators or audit supervisors. In accounting and financial reporting, a similar observation (established by more abundant analytical literature) applies at the global level: many jurisdictions, including the EU, have adopted identical or near-identical versions of International Financial Reporting Standards (IFRS), but full convergence of practices and outcomes has not been achieved[7].

5 As discussed by Sapir, Schoenmaker and Véron (2017).

6 See, for example, the Commission in its June 2017 mid-term review and again in its March 2018 Communication on CMU (European Commission, 2017 and 2018a).

7 See for example Ball (2016) and Tokar (2016) for an exchange of arguments and references on this debate.

As recently as ten years ago, supranational supervision in the EU was widely viewed as a possibly desirable but wholly unrealistic proposition. This has now changed fundamentally, first with the creation of ESMA in January 2011 and then with the transfer of prudential supervisory authority over euro-area banks to the ECB in November 2014. Furthermore, the decision of the UK to leave the EU will remove a consistent and powerful voice against supervisory integration from EU legislative debates.

Even so, the institutional integration of capital markets supervision has so far only progressed in haphazard steps. ESMA is not primarily designed as a supervisory authority, but rather (like its siblings the European Banking Authority and the European Insurance and Occupational Pensions Authority) as an assisting agency to the European Commission for the preparation of highly technical financial-market rules, complemented by constrained tasks of supervisory coordination. The addition, in 2011 and 2013 respectively, of direct supervisory tasks in relation to credit rating agencies (CRAs) and trade repositories (TRs)[8] was limited to newly supervised market segments, and was not accompanied by adjustments to ESMA's governance to bring it closer to best practices for independent supervisors.

European policymakers should consider the institutional strengthening of ESMA as the catalyst for the fulfilment of their CMU objectives. Creating a stronger central authority would increase the drive towards regulatory harmonisation and would increase the trust of capital markets in moves towards integration. In other words, a stronger ESMA is necessary because regulatory harmonisation alone will unlikely be sufficient for market integration. Furthermore, this step could be implemented relatively rapidly (compared to action on the above-listed broader legislative challenges, in which substantial convergence can only be envisaged as a long-term project). It is also a feasible step, as the establishment of the Single Supervisory Mechanism (SSM) as an authoritative financial supervisor with a major scope of responsibility has shown[9].

A vision for a stronger ESMA

The European Commission's legislative proposals on the review of ESAs (ESAR) and CCP supervision (in EMIR2) together form an appropriate basis for this discussion. The former is about the governance and funding of ESMA (and the other ESAs), while one of the key contributions of the latter is to put third-country CCPs under ESMA's supervisory authority.

In our view, a three-pronged approach should guide the policy discussion on the Commission's legislative proposals on ESAR.

First, ESMA should be more explicitly acknowledged as a supervisory authority, in contrast to EBA and EIOPA which are more aligned with the initial compromise of the Larosière Report of 2009, namely as instruments of integrated technical rulemaking and supervisory coordination[10].

Second, in order to take on more fully its supervisory role, ESMA needs an institutional overhaul to bolster its independence and authority. In its current governance framework, all

8 Disclosure: one of the authors (Nicolas Véron) has since 2013 been an independent board member at DTCC Derivatives Repository plc (formerly DTCC Derivatives Repository Ltd), a TR supervised by ESMA.

9 Legal arguments that the Meroni jurisprudence would prevent ESMA from assuming more autonomous authority are unconvincing: see eg Lintner (2017).

10 This fundamental divergence of paths between the three ESAs is similarly emphasised in European Parliament (2018). The EBA is highly unlikely to ever be granted supervisory authority of its own because the SSM has been created in the meantime. As for insurance, it appears more likely in the long run that the ECB may expand its supervisory scope in that area (involving treaty change), than having EIOPA built up as a separate supranational supervisory authority. Because of the secular trend of blurring boundaries between banking, insurance, and other financial firms, the institutional separation of prudential supervision of insurers from that of banks is increasingly outdated. EU member states that keep them separate are increasingly few (namely Cyprus, Greece, Italy, Luxembourg, Portugal, Slovenia and Spain). China also recently decided to merge its banking and insurance supervisory commissions. Article 127(6) of the Treaty on the Functioning of the EU, however, currently prohibits the assumption of insurance supervisory tasks by the ECB.

policy decisions are taken by the board of supervisors, which is a purely intergovernmental body (the chair has no voting rights)[11]. ESMA's funding, by a mix of EU budget funds and national contributions, is also not conducive to independence from political interference. Instead, its funding should come entirely from levies on the capital markets industry, with a clear framework of EU-level accountability akin to those created for the SSM and the Single Resolution Board (SRB). This would ensure a more credible claim to independence than the European Commission's proposed mix of national and EU resources and capital-markets levies, and would be in line with international best practice[12]. At the core of ESMA should be a compact decision-making board with a clear framework in which it is accountable to EU institutions. This would be broadly similar to the SRB. All NCAs should remain involved in some ESMA decisions, such as those on rulemaking.

Given the highly specialised skillset needed for the supervision of specific market segments, ESMA's core decision-making board should rely on excellent segment-specific staff expertise in areas such as CCPs, investment bank business conduct or audit supervision. However, we advise against the fragmentation of decision-making authority to prevent dysfunction and inefficiency[13].

Third, ESMA's scope of responsibility should be clarified and expanded. The underpinning long-term vision should be one in which wholesale market oversight is directly performed by ESMA, while tasks with a more retail orientation (ie the protection of savers and investors) are still mostly performed by NCAs but with binding tools for ESMA to enforce true supervisory convergence. Even though the boundary between wholesale and retail capital markets supervision is somewhat judgmental, such a broad division of labour would be both practical and politically legitimate. It cannot be achieved in one fell swoop, however, if only because ESMA is currently very far from having the operational capability to assume all wholesale market oversight. This is why governance and funding reform should be front-loaded in the sequence of reform.

The EU co-legislators should therefore carefully consider the proposals on the table and amend them as suitable[14]. In the future, additional legislative projects may be needed to further develop the proposed vision, for example by establishing direct ESMA supervisory authority over EU-based CCPs and trading venues, audit supervision and IFRS enforcement[15], or specifically reinforcing its supervisory convergence tools in these and/or other areas. These, however, cannot realistically be initiated during the current European Parliamentary term.

11 ESMA's more compact management board only deals with organisational issues such as the agency's budget and human resources policy.

12 For practical reasons, however, the collection of levies on behalf of ESMA from smaller financial firms could be left to the national competent authorities. A compromise solution would be to separately identify ESMA's costs linked to rulemaking (as opposed to supervisory) activity, and to have these covered by contributions from the member states' and/or EU budgets. We believe, however, that full funding of ESMA by levies on the capital markets industry would be both simpler and more consistent.

13 In the United States, longstanding challenges arise from multiple separate authorities coexisting at the federal level. Many state-level regulators also still play a significant role, even though overall the system is much more integrated than in Europe. See GAO (2016) for reference analysis.

14 This Policy Contribution is not the place for detailed recommendations, but we would suggest consideration of the following items: the elevation of the proposed executive board, possibly expanded to five or seven full-time members, as ESMA's highest decision-making body, replacing in this role the Board of Supervisors, and the assumption by that executive board of the CCP supervisory authority entrusted in the EMIR2 proposal to an ill-conceived (and confusingly labelled) 'CCP executive session'; the full funding of ESMA through levies on capital markets participants; and possibly as an offset to help swift adoption, scaling down controversial proposals such as direct ESMA authority over certain prospectuses and investment funds, or ESMA's role in the delegation or outsourcing of key functions to third-country entities, specifically in the asset management industry (Art. 31 ESAR). These issues are not urgent, and the one on delegation sends an ambiguous signal as to the international openness of the CMU in the context of Brexit. Our suggestions here are in line with Demarigny and Lannoo (2018), who provide more detail and context.

15 Among others, the ECB (2017b, page 6) has called for the integration of IFRS endorsement and enforcement at the EU level, implying ESMA authority over these areas.

3 The long road to a real CMU

The deepening and integration of EU capital markets is a long-term structural endeavour that will require persistence and hard work[16]. Although difficult, this work is important for several reasons. First, as the economic literature strongly suggests, purely bank-based financial systems are more prone to crises and might produce lower growth. Second, the literature also suggests that cross-border capital market integration can be an important complement to fiscal risk sharing and is therefore particularly important to Europe's monetary union. Third, the urgency of making concrete progress with the CMU initiative at this point in time is further reinforced by the departure of the UK – home to the EU's main capital market centre – from the EU.

The Juncker Commission has now tabled all the legislative proposals it intended to put forward as part of the CMU initiative. So far, as noted above, only three of these proposals have been adopted by the EU co-legislators. At its March 2018 meeting, the European Council, once again, endorsed the importance of the CMU project, but the real question is which of the Commission proposals the Council and Parliament should prioritise, because it is difficult to imagine they will be able to adopt all the proposals before the next elections to the European Parliament in May 2019.

In our view, and as we have argued, the reform of ESMA deserves special attention as a relatively easily implementable next step. Strengthening ESMA as a core institution of CMU would help to implement the CMU legislation in the spirit of genuine integration, and to drive forward the process of developing and integrating European capital markets[17]. It would also be an important step to recognise from the outset that more-integrated cross-border capital markets will require a cross-border supervisory structure to ensure proper financial stability and business conduct oversight. This would be much preferable to fostering cross-border integration first and only later confronting possible negative consequences.

The CMU project obviously goes well beyond ESMA reform. Progress needs to be made in the areas of insolvency, taxation of investments and savings, housing finance and pensions. We also note that venture capital markets in Europe are underdeveloped and that accessing financing for scale-ups is more difficult, reducing Europe's growth potential (Duruflé, Hellmann, Wilson 2017). Equity funding more generally in the EU is comparatively weak. A number of regulatory and tax policies give the advantage to debt financing, with negative implications for financial stability and growth[18]. Without progress in these areas, capital markets in Europe are likely to remain highly fragmented along national lines, undermining financial stability, and are unlikely to more strongly enhance Europe's growth potential.

It would be useful therefore to use what remains of the current legislative term to address not only ESMA reform but also some other significant CMU legislation. This would strongly anchor expectations and demonstrate the political will to structurally transform European capital markets. Our discussions with stakeholders suggest it would be particularly promising to focus on the proposals on business insolvency and on personal pension products.

Major differences in insolvency regimes and uncertainty over the application of insolvency regimes in multi-country operations are significant obstacles to greater cross-border capital market integration. The Commission's proposal was regarded by several of our interlocutors as a good starting point for the long-term project of greater harmonisation of insolvency regimes, and also of great importance to the banking union[19].

16 This was already noted by Véron and Wolff (2015).

17 Allen and Pastor (2018) concur that expanding the powers of ESMA is key to the success of the CMU project.

18 The Commission's CCCTB initiative includes proposals for reducing the debt-equity tax bias and thereby potentially lowering the cost of equity.

19 Looking ahead, the Commission's initiatives could be complemented by proposals for the harmonisation of other core insolvency aspects and for the establishment of harmonised out-of-court processes. Some of these proposals are also relevant in the context of the completion of the banking union. For instance, the absence of out-of-court settlement mechanisms has been identified by the ECB Banking Supervision as obstacle to efficient resolving of NPLs ('Stock-take of national supervisory practices and legal frameworks related to NPLs', available at https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170630.en.html).

Adoption of the pan-European personal pension product proposal (PEPP) would also be an important step forward. It would provide a concrete response to a concrete demand for cross-border pension products from individuals who work in several countries.

Overall, we consider it is high time to make the CMU project real. Support for the project has been pledged at the highest political level several times. But capital markets will only transform with concrete action. ESMA reform should be a priority but cannot be the only one. Policymakers need to set priorities that will move the project forward.

References

Ahearne, A. and G. Wolff (2012) 'The debt challenge in Europe', *Working Paper* 2012/02, Bruegel

Allen, F. and L. Pastor (2018) 'The Capital Markets Union: key challenges', *CEPR Discussion Paper Series*, DP 12761, Centre for Economic Policy Research

Ball, R. (2016) 'IFRS – 10 years later', *Accounting and Business Research* 46(5): 545-571

Brühl, V., H. Gründl, A. Hackethal, H.H. Kotz, J.P. Krahnen and T. Tröger (2015) 'Comments on the EU Commission's capital markets union project', *White Pape*r No. 27, SAFE Policy Center, Goethe University, Frankfurt

Darvas, Z. and D. Schoenmaker (2017) 'Institutional investors and home bias in Europe's Capital Markets Union', *Working Paper* 02/2017, Bruegel

De Larosière, J., L. Balcerowicz, O. Issing, R. Masera, C. McCarthy, L. Nyberg, J. Pérez and O. Ruding (2009) *Report of the High-Level Group on Financial Supervision in the EU*, European Commission

Demarigny, F. and K. Lannoo (2018) 'Navigating the minefield of the ESA review', *ECMI Commentary* No. 49, European Capital Markets Institute

Demertzis, M. and A. Lehmann (2017) 'Tackling Europe's crisis legacy: a comprehensive strategy for bad loans and debt restructuring', *Policy Contribution* 11/2017, Bruegel

Demertzis, M., S. Merler and G.Wolff (2018) 'Capital Markets Union and the Fintech Opportunity', *Journal of Financial Regulation*, Volume 4, Issue 1

Duruflé, G., T. Hellmann and K. Wilson (2017) 'From start-up to scale-up: examining public policies for the financing of high-growth ventures', *Working Paper* 04/2017, Bruegel

European Central Bank (2017a) *Financial integration in Europe*, May

European Central Bank (2017b) 'ECB contribution to the European Commission's consultation on the operations of the European Supervisory Authorities', June, available at https://www.ecb.europa.eu/pub/pdf/other/ecb.consultation_on_operations_of_ESA_201707.en.pdf?293cf1575920e5a08e0b54165f961e62

European Commission (2015a) 'Building a Capital Markets Union', COM(2015) 63

European Commission (2015b) 'Action Paper on Building a Capital Markets Union', COM(2015) 468

European Commission (2017) 'On the Mid-Term Review of the Capital Markets Union Action Plan', COM(2017) 292

European Commission (2018) 'Completing the Capital Markets Union by 2019 – time to accelerate delivery', COM(2018) 114 final

European Parliament (2018) 'Working Document on the proposals to amend the European System of Financial Supervision', 23 January, available at http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-616.735&format=PDF&language=EN&secondRef=01

GAO (2016) *Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness*, Report to Congressional Requesters GAO-16-175, US Government Accountability Office

Gonçalves Raposo, I. and G. Wolff (2017) 'How has banking union changed mergers and acquisitions?' *Bruegel Blog*, 13 September

Langfield, S. and M. Pagano (2016) 'Bank bias in Europe: effects on systemic risk and growth,' *Economic Policy* 31(85): 51-106

Lintner, P. (2017) 'De/centralized Decision Making Under the European Resolution Framework: Does *Meroni* Hamper the Creation of a European Resolution Authority?' *European Business Organization Law Review* 18:3

Pagano, M., S. Langfield, V. Acharya, A. Boot, M. Brunnermeier, C. Buch, M. Hellwig, A. Sapir and I. van den Burg (2014) *Is Europe overbanked?* Report no.4 of the European Systemic Risk Board's Advisory Scientific Committee

Quaglia, L., D. Howarth and M. Liebe (2016) 'The Political Economy of European Capital Markets Union,' *Journal of Common Market Studies* 54 (S1): 185-203

Sapir, A., D.Schoenmaker and N. Véron (2017) 'Making the best of Brexit for the EU27 financial system,' *Policy Brief* 2017/1, Bruegel

Sapir, A. and G. Wolff (2013) 'The neglected side of banking union: reshaping Europe's financial system,' *Policy Contribution* presented at the informal ECOFIN, 14 September, Vilnius, Bruegel

Tokar, M. (2016) 'IFRS – ten years later: a standard-setter's view,' *Accounting and Business Research* 46(5): 572-576

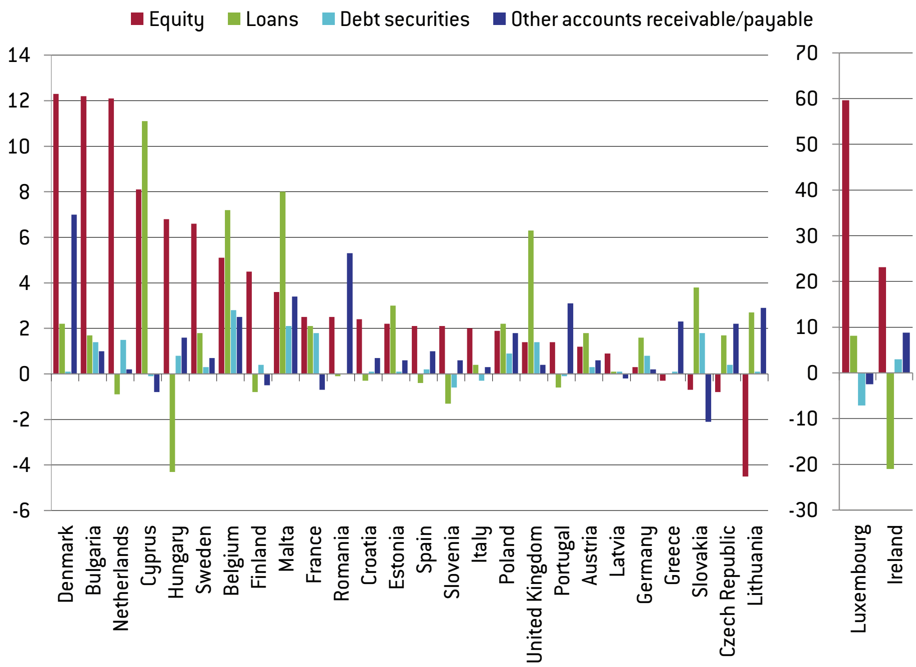
Véron, N. (2014) 'Defining Europe's Capital Markets Union,' *Policy Contribution* 2014/02, Bruegel

Véron, N. and G. Wolff (2015) 'Capital Markets Union: a vision for the long term,' *Journal of Financial Regulation* 2(1): 130–153

Wright , W. (2017) 'What have the capital markets ever done for us? And how could they do it better? Analysis of the central role of investment banks and asset managers in driving growth,' *New Financial*, February

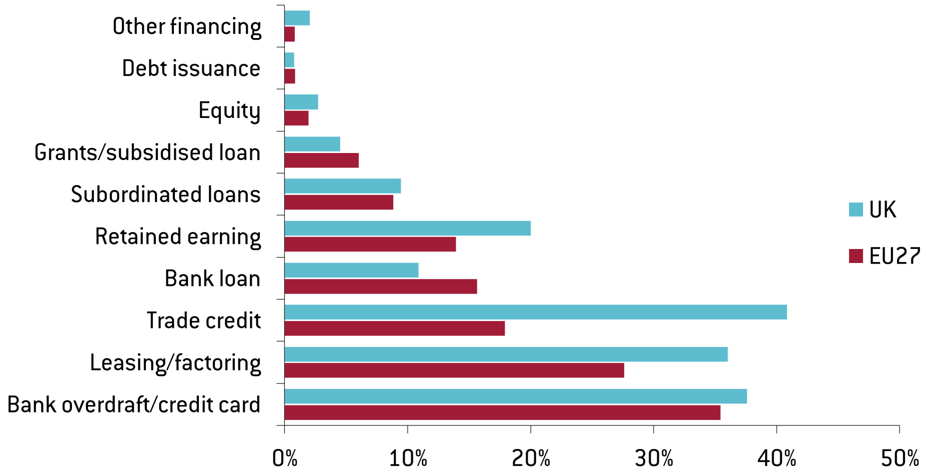
Annex

Figure A.1: Size of different financial intermediation channels to the non-financial corporate sector, % of GDP, 2016



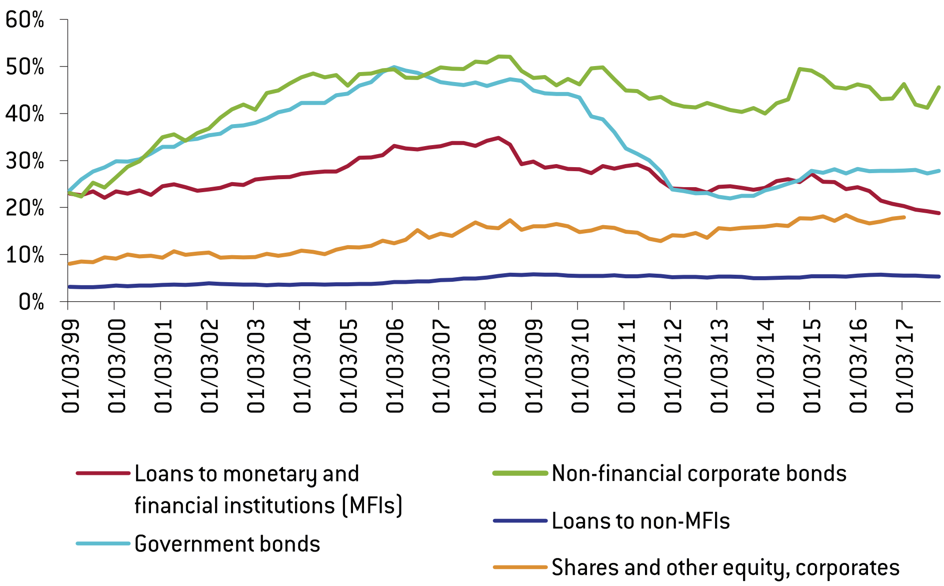
Source: Eurostat financial flows [nasa_10_f_tr]. Note: Loans exclude intra-NFC loans.

Figure A.2: Sources of SME financing in the past six months (% of EU28 SMEs)



Source: Bruegel based on European Commission, ECB SAFE survey, wave 17 (November 2017).

Figure A.3: Cross-border holdings of assets of euro-area Monetary and Financial Institutions (MFIs) as % of total assets



Source: Bruegel based on ECB.