A Vision for Capital Markets Union

A Capital Markets Union (CMU) represents a significant opportunity for the EU. It comes at a timely moment as Europe emerges from the deepest crisis in a generation. When the financial crisis hit in 2009, European policymakers responded quickly, reforming the financial sector in an effort to restore confidence and financial stability. Many consider their efforts to have succeeded. Financial market regulation has been overhauled, banks are more resilient and financial markets are more transparent. With the creation of the banking union, euro area banks now have a single supervisor and a recovery mechanism is now in place for failing banks.

However, the focus on restoring financial and economic stability has come at the cost of economic growth. The recovery in Europe has been sluggish, with EU GDP growth of 0% in 2013 and 1.3% in 2014, compared to the US, which has achieved above 2% GDP growth since 2012. While the previous Commission can be praised for their efforts, the new intake of Commissioners represents a new spring in Europe, with fresh views and a renewed focus. The Commission's priority has understandably now shifted from a focus on financial stability back towards growth. The creation of a CMU has become one of the significant policy initiatives aimed at promoting economic recovery.

A CMU can provide a vital step in enhancing growth in the EU through reducing the costs of financing, rebalancing the intermediation process by diminishing the EU's excessive dependence on bank financing and making the EU generally a more attractive place to invest. It provides a timely opportunity to develop a large, fully integrated pan-European market by unlocking barriers that have prevented the growth of capital markets both within and between member states.

What is meant by Capital Markets Union?

The idea of a CMU has been the subject of extensive discussion and writing since it was announced by President Juncker. The concept is quite general and high level but there is general agreement on what it represents: development and integration of EU capital markets with a view to rebalancing the intermediation process to improve access, diversification and efficiency of financial markets.

Following publication of its Green paper, the Commission's intentions and objectives are also now well understood and appear to have broad support. The Commission is clear that CMU is not a 'union' in a legal sense of the word like Banking Union, and unlike Banking Union it encompasses all 28 members of the EU. The Commission Green Paper presents a two part strategy. The first focuses on priorities for early action such as a review of the Prospectus Directive, the private placements market and high quality securitisation. The second part of the strategy focuses on more fundamental long term considerations impacting the development of the markets as a whole.

Why is a Capital Markets Union in Europe important?

The need to expand the role of capital markets has been highlighted in many forums:

- Financial intermediation in the EU remains concentrated and heavily dependent on the banking sector. It is estimated that between 70-80% of all intermediation in the EU is undertaken by the banking sector and the balance through the capital markets. In the US the ratios are virtually the reverse.
- Capital markets are better positioned in certain areas than banks to meet the critical needs of the EU:
  - Infrastructure finance: Investment in infrastructure is one of EU's principal priorities. In the current interest rate environment infrastructure investment can have high returns and provide an important economic stimulus. Infrastructure finance requires long term financing which has been historically provided by the banking sector. Recent regulation (for example the Net Stable Funding Ratio) has made such financing unattractive to banks. Project bonds provide a source of attractive long term financing.
  - Financing of growth companies: SMEs financing has been traditionally undertaken by banks. While this may be appropriate for most SME's a more limited group of perhaps 5-8% of businesses of all sizes have strong ambitions to grow and are also the principal source of jobs creation. For these companies capital markets financing providing equity and early stage investments are the key to their growth.
- Capital markets can indirectly support bank lending. Banks can reduce their risk profiles and meet the needs of their clients more effectively through securitising parts of their portfolios and selling these to institutional investors interested in these assets. This enables banks to free up their balance sheets and focus on activities best suited to bank finance e.g. SME lending and export finance.
- Capital markets on a pan European basis provide venture capital markets better risk diversification given the smaller number of available deals. In contrast bank lending to SME's markets are adequately diversified at a national level.
- Capital markets provide risk management tools that are important for the real economy, notably exports and infrastructural finance.
- A strong capital market can help disperse risk more effectively in the financial markets and enhance stability and resilience of the EU financial markets.

Capital markets are therefore a very important incremental source of funding and, equally importantly, they can provide funding that is not available through banks but which is critical to growth and employment creation. Unlike banks, capital markets provide a broad array of instruments with varying risk return characteristics. As a result they can address the specific needs of issuers and investors more effectively.

What can be realistically achieved?

The size and sophistication of the European economy provides the EU with an opportunity to create one of the largest and most sophisticated capital markets. Significant progress has already been made in recent years through the Financial Services Action Plan and the work of the Giovannini Group, however, much more needs to be achieved.

For these markets to develop, they need to be attractive to institutions seeking, as well as investors providing, finance. A vibrant and efficient capital market requires breadth, depth and liquidity. Issuers want ease of use, flexibility, low relative cost and realistic requirements on disclosure. Investors seek returns, liquidity, security and ease of investing compared to other investment opportunities. Finally we need to have institutions that bring issuers and investors together, providing liquidity and promoting the development and use of these markets and fostering innovation. This involves banks and other institutions such as financial exchanges focused on capital markets.

The expansion of capital markets in the EU raises significant challenges and it is important that realistic goals are set and expectations managed against these. The US capital market should be studied when considering Capital Markets Union, but it is important to recognise that the US model can never simply be replicated in the EU, as it has a number of unique and specific characteristics:

- The relative size of US capital markets is partly attributable to the stock and ongoing issuance of mortgage backed securities. This distinction derives from a number of sources including government guarantees and tax incentives.
- US capital markets have enjoyed a more harmonised legislative framework for a great deal longer than the EU. Institutional and cultural distinctions follow directly from this basic distinction of time.
- The growth of US capital markets over the years has been driven by a number of significant policy initiatives, the unintended consequence of which has been to promote capital markets. These have included Glass-Steagall, interstate banking restrictions, and Regulation Q.
- European firms are more likely to be held privately, and to wish to remain so. Some of this may change as capital markets develop in the EU. However there are significant cultural differences that exist and are likely to remain for some time.
- US institutional asset pools are both larger and more actively engaged in the capital markets than their European counterparts. This is the case notwithstanding the fact that saving levels are comparable in the two markets.

A successful CMU can significantly improve the balance of intermediation in the EU. It would however be unrealistic to expect the percentage of intermediation in the EU undertaken through the capital markets to approach those of the US. An important initial piece of work that needs to be undertaken is a comprehensive assessment of the extent to which rebalancing is both realistic and desirable. This would set out by product the opportunities for an expanded capital markets in the EU given current institutional and economic structures. This should be analysed by country as large national differences exist across the EU. A road map for policy makers and market participants would provide an important benchmark against which opportunities can be assessed, progress judged and expectations managed. It would also form an important element in the action plan discussed later.

Achieving CMU: Develop a supportive financial eco-system and the market will do the rest

Moving the EU capital markets even half way towards the share of capital markets intermediation in the US would require a near doubling of capital markets in the EU. Such an increase involves significant changes. These well need to go beyond tweaking with a subset of product. It will necessitate a change of the whole complex intermediation eco-system. This is a project and will need to be carefully managed in a phased approach over a long period of time. The Commission Green Paper recognises this by separating its discussion into two sections namely priorities for early action and measures to develop and integrate capital markets over the longer run.

The Commission’s focus on securitisation, private placement regime, and the Prospectus Directive are important and sensible initiatives. However they are unlikely to result in a significant shift in the balance of intermediation. While pursuing these initiatives will provide key early ‘wins’ which are important for momentum, it is vital that focus on the more challenging long term structural requirements of a capital markets union are not lost. Short term tactical gains, while important, should not be achieved at the expense of more broad based change. The two must be pursued simultaneously. A clear and comprehensive road map will help safeguard this.

By adopting a holistic approach and preparing a comprehensive framework the EU can identify and help put in place the prerequisites for capital markets to thrive. Financial intermediaries are dynamic and innovative. If provided with the right environment and incentives, they will drive growth of the capital markets and a rebalancing of the intermediation process will follow.

An EU framework should establish a taxonomy identifying the key stakeholders on one side and their respective drivers to engage in the capital markets on the other. The key stakeholders are the issuers of capital markets securities who need financing, investors who manage savings and intermediaries who bring these two parties together. A variety of factors drives their respective decisions and can be grouped in a number of ways. One simple approach would be to look at the various drivers according to their impact on the ease, cost and willingness of each of the stakeholders to engage.

The range number of drivers is large. Some of the key ones to consider are:

- Standardisation of rules: Creating a common framework for securities ownership rights, simplification and harmonisation of the core requirements of the Prospectus Directive and divergences in listing requirements for exchanges.
- Disclosure requirements: Initiatives to develop light touch but consistent disclosure requirements notably in presenting key credit data on a comparative basis would greatly facilitate capital markets access. Many EU corporations remain private and therefore provide limited information and are reluctant to provide full disclosure on their activities.
- Capital costs: The costs of undertaking capital markets activities need to be looked at in their totality. These include capital costs associated with market making activities, inventory financing through the repo markets and the costs of mandatory holding securitised products. A similar analysis would need to be undertaken from the perspective of investors under Solvency II.
- Insolvency regimes: EU bankruptcy regimes vary hugely across Member States which result in significant differences in recovery levels. Insolvency law should be harmonised across the EU to bring consistency and certainty.
- Fiscal incentives: Tax treatment of equity and debt differ greatly. The tax deductibility of debt and taxation of equity and dividends distort the equity markets. . Equally, transaction taxes on tradable assets have a direct arithmetic impact on liquidity, ultimately reducing price certainty and increasing the cost of raising capital.
- Transaction costs: Taxes and levies on transactions can significantly increase the costs of intermediation through the capital markets. This is particularly true with smaller stocks and less liquid fixed income assets. The FTT is an example of a pan-European initiative with material risks for liquidity as witnessed in Sweden.
- Liquidity: The provision of liquidity for capital market instruments is a fundamental prerequisite for the development of capital markets. Within growth markets, illiquidity the ‘liquidity risk premium’ may reduce the amount of money raised in the primary markets by up to 40 per cent by creating uncertainty over the price formation of the secondary market. Recent regulatory changes have led to a significant decline in liquidity in capital markets. The impact of this needs to be carefully assessed and any negative consequences addressed.
- Administrative and legal restrictions: While most investment schemes are accessible in theory by non-nationals, driven by state aid rules, in practice these schemes are challenging to use outside of each member state. Venture markets are naturally continental in scale due to the difficulty in diversifying risk within single countries.

Member States need to create schemes which are more directly accessible, or which allow companies to access investment from investors from other schemes without the requirements of each scheme proving incompatible. More generally there needs to be greater coherence of policies to ensure interoperability of different regional systems and schemes.

Making capital markets easier to use and reducing costs of intermediation will go a long way to a gradual rebalancing of the markets. However this will also need to be supplemented by specific measures that increase the willingness of stakeholders to use capital markets.

Firstly knowledge of capital markets products is poor and fragmented. A program of educating stakeholders will be important to increase awareness and take up of products. Intermediaries have an important role to play in this area. However the lack of trust in capital market products will make this challenging and require careful and thoughtful management.

Secondly Europe still lags behind the US and increasingly Asia when it comes to embracing a culture of entrepreneurialism. This is particularly important in that job creation is driven to a large extent by these growth companies and they have the most to gain from the capital markets. It is important, in the context of CMU, to examine national attitudes to entrepreneurialism recognising differences in education, risk appetite and treatment of failed businesses, both culturally and through the credit rating system. As part of this the Commission should consider the success of start-up hubs such as Silicon Valley and increasingly London's Tech City where an inspiring entrepreneur can go to connect with a diverse network, productive environment and specialised funding.

Achieving CMU: Developing strong institutions to promote capital markets

A final area that is critical to the development of capital markets is the role of financial intermediaries. This is an area which has not received much attention and yet which is central to the whole process. Financial intermediaries have a number of important roles including:

- Identifying both investors and issuers and bringing them together
- Educating participants on the markets and providing them with ongoing information on market developments and opportunities
- Structuring transactions to meet the needs of a diverse range of clients
- Providing liquidity and creating markets for financial products
- Linking pools of liquidity across markets
- Supporting clients to manage their market risks
- Sponsoring the development of the capital markets as a whole through innovation and advocacy

For CMU to develop an environment where strong capital market oriented institutions exist and thrive must exist. These will need to comprise of both large global but also strong regional institutions that are familiar with local markets and with small and medium sized companies. The existence of strong European entities will be critical as they are both most familiar with local conditions but also have a strong vested interest in building these markets and introducing local firms to the capital markets.

The need for innovation could be particularly important for smaller and medium sized companies which are of particular focus in the EU. Regional institutions may have a particularly important role to play here. Capital markets products have traditionally been developed for and marketed to large sophisticated institutions, which is where the focus of the larger banks has tended to be. The development of the high yield markets in the US is a good example. This large and important market was developed through the efforts of an individual working outside the mainstream banks.

Current measures aimed at bank structural reform, high compliance and capital costs, compensation caps and the general negative perception of investment banking all have significant negative consequences and their impact needs to be carefully assessed. The existence of a very sophisticated and broad based institutional setting in the US has been one of the key drivers of capital markets development in the US at a time when resources committed to investment banking in Europe are being cut significantly.

What should the role of the Public Sector be?

Governments and regulators will need to play an important role in fostering the growth of capital markets. Firstly they can put together a vision and roadmap against which market participants can grow their activities. The Green Paper on CMU represents an important first step in this regard. This can help nudge the private sector to move more quickly, invest and give greater priority to promoting capital markets.

Secondly they can help eliminate some of the key regulatory and policy constraints that are inhibiting the growth of the capital markets. There are many examples of regulations having unintended consequence and hampering the growth of capital markets. In other cases legislation needs to be introduced or harmonised if some of the objectives of CMU are to be achieved.

Thirdly there may be specific circumstances where the public sector could play a direct role in supporting the development of capital markets. There are cases for example of market failure and information asymmetries. The construction period and uncertainty surrounding an infrastructure project can be a major impediment to the use of project bonds providing an important role for the EIB. Information on a standardised basis from banks can be crucial to the securitisation of SME or MME loans. Fiscal incentives to encourage investments in seed capital and for start-up companies such as the UK EIS and SEIS schemes provide useful models for promoting start ups.

Finally the Commission could also look at potential opportunities to accelerate innovation and help develop markets for financial instruments that would be new to the EU and designed to address the specific characteristics and needs of the EU markets. Financial institutions often take a short term view on the economics of introducing new products or the application of existing products to a new set of users. Development costs can be high and the results uncertain and may take time to reach fruition discouraging institutions form making the necessary investment particularly in this resource constraint environment. EU institutions can act as a convenor to bring financial institutions and asset managers together to explore for example opportunities for new equity like instruments, securitisation of SME loans, crowd funding etc.

Concluding remarks: a vision for Capital Markets Union

Capital Markets Union is a timely initiative that can enhance the effectiveness, depth and scope of capital markets in the EU. Capital markets are already developed to varying degrees across the EU, benefit from a common rule book and oversight from existing supervisory bodies. However they are less liquid and deep than their US counterparts, resulting in reduced supply of credit and price certainty. This ultimately reduces the supply of and increases the cost of capital, particularly in the equity markets. The challenge is therefore to strengthen capital markets as a central component of the financial intermediation process in the EU.

This requires a detailed and comprehensive review of key drivers of capital markets development and measures to promote them. A detailed road map covering the medium term needs to be established against which this project and expectations can be managed. Tactical fixes falling within the competencies of the Commission can be implemented quickly. Issues that require all member state agreement e.g. fiscal and insolvency laws will be far more challenging and will need to be addressed over the medium term. Finally behavioural and cultural considerations can only be managed over the long run.

The road map should include the following elements for each phase:

- Review of capital markets by products and an assessment of their potential for growth
- The key drivers and prerequisites for issuers and investors to use these products and for markets to develop

- The regulatory, policy and institutional changes that need to be taken to promote change
- The measures required to provide for the right institutional setting for intermediaries to develop
- The potential role of the public sector to promote markets and deal with market failure
- The timetable for the rebalancing to occur

The EU Green Paper is an important initiative. It is however the beginning of a potentially long road. A tactical approach to promote certain products is a useful beginning. This should not however distract attention from the much greater and longer term challenge of creating an effective eco-system for capital markets to prosper and grow.