CMU way forward

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

EU needs to level up the Capital Markets Union

The overarching aim of the CMU project is to transform the EU capital markets into a fully integrated and globally competitive capital market. It is admittedly a very ambitious objective, which requires a complex combination of actions to turn it into a success.

Among the various key success factors for establishing the CMU is an optimal regulatory framework, and the CMU action plan featured a substantial overhaul in this regard. Since the announcement of the action plan in September 2015, a large number of legislative changes have been proposed by the European Commission, and a majority of them have been agreed politically.

Despite the progress made, and the overall fairly high level of capital market integration in Europe in areas like asset management, trading, and post-trading, I believe we need to do more to successfully achieve the CMU. Especially the modest progress on equity markets and low levels of household participation in capital markets are sources of concern.

As a matter of fact, European companies continue to receive a significant share of their funding from bank loans rather than from capital markets, which negatively affects the stability of the financial system and the economic growth in the EU. A banking oriented financial system tends to favour debt, while an increased role of equity would reduce risks to the financial system and would better support innovative economic activity.

It is vital to make progress and extend our CMU efforts, and further improve the relevant conditions and regulatory framework. Some of the key improvements are outside the area of financial regulation, like the treatment of equity in tax systems. However, improvements are also needed regarding financial regulation.

Firstly, we need to develop a larger and deeper European retail investor base. Today, European households own substantial financial assets which have steadily increased in the last decade. However, their participation in capital markets is overall low, especially when compared to the US. To provide households with adequate incentives to place their money in capital markets, one key challenge is finding the right balance between offering attractive investment opportunities and ensuring that retail investors are sufficiently protected. Retail investors should have access to transparent, efficient, and low-cost fund products. We could achieve this by, inter alia, improving the availability of simple products and provide clear, comprehensible and comparable information as well as addressing product distribution, by ending conflicts of interests in the distribution chain. Additional measures should focus on increasing the demand for capital market products, e.g. through pension reforms to support households in meeting their retirement savings.

Secondly, we need to look at sources of funding for SMEs and their access to equity markets. There is already a fairly well-integrated EU capital market for large listed issuers. However, most SMEs, in addition to relying on bank finance, tend to privilege local markets due to easier access and lower information asymmetries for investors. The number of IPOs

>>> is currently very low. Despite some targeted actions under the CMU Action Plan, including the creation of the SME Growth Markets and changes to the Prospectus Regulation, this area needs more attention. Available options could include the strengthening of specific market segments for SMEs that – based on the proportionality criterion – would be subject to reduced regulation, also by looking at which type of investor should have access to this SME segment. Other measures to look at concern the standardisation of information on SMEs to reduce information asymmetries, especially cross-border.

To sum up, I would like to underline that Brexit only reinforces the urgency of the goal of a successful CMU. In the aftermath of Brexit, capital markets should play a more important role in the EU's financial system and should compete effectively vis-a-vis other major financial centres outside the EU. This can only be achieved if the EU capital markets are more sizable and further integrated, through a range of measures that should increase retail participation in capital markets and access to equity markets for SMEs. ESMA will continue to support these goals and will remain actively involved to facilitate implementation of next steps. ●

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Europe needs capital market integration

Europe lacks an integrated capital market. Not only are firms relatively highly dependent on bank loans, but European capital markets are also sharply segmented along national lines. Almost half of EU insurers' and pension funds' equity investments are in their home jurisdictions. This is especially so in the largest countries, notably, Germany, France, and Spain.

Such segmentation is costly. First, firms face sharply divergent financing costs based purely on national domicile; our analysis shows that firms in, say, Greece, pay 250 basis points more on debt, on average, than comparable firms in the same industry in, say. France. Second, innovation and growth potential suffer; our analysis shows that firms with limited collateral to offer—think of your typical start-up—grow faster in more developed capital markets where venture capital is available. Third, private cross border risk-sharing suffers; we show that domestic consumption is four times more sensitive to local shocks in the 28 EU countries than in, say, the 50 U.S. states.

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>>> Our survey of European capital market players—national regulators and fund managers—highlights important obstacles to integration. Deficiencies in national insolvency frameworks, regulatory quality, disclosure and listing requirements, audit quality, and withholding tax refund procedures come out as important barriers to larger intra-EU capital flows. The United Kingdom scores higher in most areas than euro area or the EU? 27 countries.

Guided by the survey results, our empirical analysis finds that lowering such barriers offers the prospect of powerful macroeconomic benefits, including a reduction in firms' funding costs, an increase in intra-EU portfolio capital flows, and higher risk-sharing across countries. If Italy, for example, were able to improve its insolvency practices to best-in-class standards, it would reduce its firms' average debt funding cost by some 25 basis points—this is not small change. If Portugal were able to raise its insolvency standards and regulatory quality to those of the United Kingdom and Belgium, respectively, those two countries' portfolio asset claims on Portugal would double. Resilience to local shocks would increase accordingly.

We propose that policy efforts focus on three targeted sets of initiatives at the EU level to help achieve greater capital market integration:

- to enhance transparency, we propose instituting centralized, standardized, and compulsory electronic reporting for all issuers, irrespective of size, on an ongoing basis. This would be a major change to the European reporting framework. Furthermore, digital technologies could be used to improve the efficiency of cross border withholding tax reclaims;

- to improve regulatory quality, we favor strengthening ESMA's supervisory convergence role; bringing systemic entities such as CCPs and large investment firms under centralized oversight; lowering the regulatory ceiling on administrative costs associated with the Pan-European Personal Pension product; and maximum regulatory cooperation with all third countries, recognizing the global nature of capital markets;

- to improve insolvency regimes, we see a role for the European Commission, first, in carefully collecting data in an area where the existing information is unreliable; second, in developing a code of good standards for core features of corporate insolvency and debt enforcement processes; and, third, in systematically following up on member states' progress toward observing such standards—in essence, we propose a "name and shame" approach modeled on the Basel Core Principles process. We are aware that progress here will take time. ●

Leonique van Houwelingen

Chief Executive Officer, The Bank of New York Mellon SA/NV

Delivering CMU – using a mission-orientated approach

The story so far of the CMU project is very largely a story of frustration. There is little sign that the CMU project has had a material effect on the development of capital markets in Europe. This is disappointing as the CMU project - by facilitating the collection and channelling of savings into productive investments – is a necessary pre-condition for broader policy efforts to tackle fundamental social and environmental challenges in Europe. And because Europe, with its resources, skills, and diversity, has the capabilities to tackle these challenges, if only it succeeds in organising itself. >>>

>>> The CMU project is complex, and has a large number of very diverse stakeholders, including retail investors, SMEs, intermediaries, securities regulators and Member States. We need to find ways to bundle the forces of these stakeholders, and to reinvigorate the CMU project.

One important source of ideas is the work of Professor Mariana Mazzucato, who currently holds the Chair in the Economic of Innovation and Public Value at University College London. In 2018, she wrote for the European Commission a report entitled "Mission-Orientated Research & Innovation in the European Union". This report describes the interaction of actors involved in research and innovation in ways which are similar to the description of capital market eco-systems; it sets out an explicit objective of increasing investment and of creating opportunities for investment-led growth, and it sets out specific suggestions as to how research and innovation policy can be successful, and can help deliver solutions to broad societal problems. One key idea of the report is that innovation and research policy need an explicit mechanism that connects a broad societal challenge (a "Grand Challenge") with the portfolio of individual projects and bottom-up experimentation, which is the day-to-day reality of innovation and research.

Such a connecting mechanism is a "mission". A "mission" is a tool to focus research, innovation and investment on critical problems, bring together and encourage collaboration between different actors and sectors, and create positive spill-overs.

"We should use key elements from the Mazzucato Report for the CMU project."

- LEONIQUE VAN HOUWELINGEN

In June 2019, the Centre for European Policy Studies (CEPS) published a report entitled "Rebranding Capital Markets Union: a Market Finance Action Plan". The report contains a valuable description of a capital market as a complex system with diverse actors, from both the private and public sectors. It contains recommendations with respect to bond and equity markets, the promotion of retail participation in capital markets, and the introduction of a set of indicators to measure progress towards more market-based finance.

The report also stresses the need for political support at the highest level if CMU is to achieve its objectives. One of the major problems of the CMU project is that each individual proposal has been viewed, and discussed, in isolation. What this means is that each initiative (Pan-European Personal Pensions, withholding tax, insolvency, post-trade, etc.) is faced with a daunting set of obstacles, and with scepticism that it can actually deliver material change.

We should use key elements from the Mazzucato Report for the CMU project, including the ideas that (i) the definition of a mission should include a clear, targeted policy outcome; (ii) a mission should engage the public, and should have clear societal relevance; (iii) a mission should involve actors from both the private and public sectors (possibly in a "co-creation" framework); and (iv) the trajectory of a mission to reach an outcome must be based on a bottom-up approach of multiple solutions. Many of the core elements of capital markets (resources, information, communication and trust) are very similar to the core elements of the research and innovation process.

We should also use the CEPS Report, as it provides a framework for specific action with relation to improving the functioning of capital markets.

The CMU project, and sustainable finance more generally, are necessary elements in our efforts to deal with the "Grand Challenge" of climate change adaptation and mitigation, or what could be called a "European Green Deal". ●

Robert Ophèle

Chairman, Autorité des Marchés Financiers (AMF)

Making CMU work: without of a strong political will, CMU will be a long journey

Europe enters a new legislature in a unique context in several respects: politically, with a fresh impetus to find amongst Member States and a novel balance of powers in the Parliament after the recent elections; institutionally, with the challenge to tackle the exit of the UK and to rethink the role and position of the EU on the global scene. In that context, the completion of the CMU, while necessary, remains uncertain since it will encounter the same hurdles that have derailed or slackened the project during the recent mandate.

The CMU project was launched in 2015 in order to establish the building blocks of an integrated capital market in the EU by 2019. The 2015 action plan was updated in June 2017, one year after the UK referendum, by strengthening existing actions and introducing new measures. What was seen as useful at a time when the EU had a dominant financial center, which, to a large extent, alleviated the fragmentation of its capital markets, should be considered as necessary with the exit of the UK since this will leave the EU27 with several competing middle-sized financial centers. And everybody supported (and still supports) the general ambition: creating more opportunities for investors, connecting financing to the real economy, fostering a stronger and more resilient financial system, deepening financial integration and increasing competition.

Nevertheless, little has been achieved; to some extent, this should not come as a surprise. For issues that do not fall within the EU's exclusive competence, and unlike monetary policy for the Members States whose currency is the euro, capital market issues are under shared competence. The principle of subsidiarity applies and rules out EU intervention when an issue can be dealt with effectively by Member States. The EU is only legitimate to act when the latter are unable to satisfactorily achieve the objectives pursued, and if value can be added by EU level action. Actually, the CMU is not perceived as an absolute necessity and very few countries are ready to abandon part of their sovereignty to build a convincing CMU. The subsidiarity principle is not leading to a fully-fledged CMU.

How can we overcome these difficulties? While the cards are obviously in the hands of the European co-legislators, it is our responsibility, as national regulators, to document how detrimental it is for the EU globally, but also for every Member State individually, to have fragmented and unattractive internal financial markets. And why it is not desirable to depend in the long run on third countries for the management of EU savings, for the funding of our large investment projects and for the development of European corporations abroad.

The CMU is therefore a legitimate objective. What could be the priorities? Let me mention three:

- we need similar bankruptcy and collateral collection rules; similarity is key for issuing debt on a Union wide basis and for the securitization of debt, especially if you intend to pool debt issued under different jurisdictions. Chapter 11 is one of the key US integration factors;
- we need to remove the Giovannini barriers as updated by the EPTF with the harmonization of segregation requirements of client assets, of operational registration procedures and shareholder identification procedures, and of processing of corporate actions;
- we also need strong supervisory convergence. Both the ESA review and EMIR 2.2 have sent clear signals from Member States, refusing to increase the direct powers

>>> of ESMA and to strengthen its governance. These regulations have nevertheless reinforced the supervisory convergence tools and we should make full use of them. The relevance of many EU financial institutions and market infrastructures goes far beyond the national perimeter; they deserve a common EU supervisory treatment. The passport, which is at the core of the CMU and is widely used in asset management, cannot be sustained in the medium run without a strong supervisory convergence.

I do believe that we will have the opportunity to make decisive progress towards the CMU. Many key regulations (MIFID/MIFIR, AIFMD, PRIIPS, CSDR ...) will be reviewed; new financial domains, which will shape our capital markets' future, are still to be covered by European regulations: digital finance and sustainable finance. We should not miss these opportunities. ●

Christian Staub

Managing Director Europe, Fidelity International

Weighing the opportunity cost of low retail investor participation

With around 30% of EU household savings languishing in deposits or currency, and public pension systems under pressure, the opportunity cost to EU's ageing population of not investing in market-based instruments is too high to ignore.

This is not to say that market exposure should be a priority for all households; many must prioritise paying down debt and putting cash aside to cover contingencies. And many more are already invested via workplace pensions.

But we think it should be a higher priority for policymakers in their capacity as agents of gradual but paradigmatic change. So, our first recommendation for the CMU over the next 5 years is that the project reconnects with its founding objective of stimulating market exposure for EU households.

"Policymakers should leverage PSD2's competitive logic to direct household savings into market products."

\- CHRISTIAN STAUB

Under the pan-European Personal Pension Product (PEPP), for example, we welcome the inclusion of a fund-based default option. However, we maintain that a better alternative to the 1% fee cap would have been a higher threshold encouraging providers into the market and the PEPP to build scale, with policymakers lowering the threshold later on. Leaving advice costs outside the cap could give the PEPP a better chance of take-off, as could allowing alternatives to full-strength MiFID advice for what is already a highly prescribed product.

PEPP policymaking seems to have had its original market-facing instincts blunted in other areas. For example, its preference for capital guarantees counters prevailing wisdom that such guarantees subtract more in cost than they add in certainty. This is a lesson that policymakers are coming to terms with in DC markets, yet debate remains over including the cost of guarantee within the same PEPP fee cap. Not doing so clearly misleads >>>

>>> potential investors about the PEPP's value-for-money; while our preference is Target Date Funds which offer near-perfect capital guarantee at a fraction of the cost.

Our second recommendation is that the CMU is given a clearer objective to strengthen competition between retail investment options - a natural safety-net to policy designed to stimulate retail participation in capital markets. We encourage policymakers to pay closer attention to the product disclosure policy that ultimately drives retail consumer decision-making.

In terms of existing data, the ESAs February 2019 reports on the relative cost and performance of the EU's investment products were worrying in the lack of useable data they discovered. Retail-friendly fund data was readily available but somewhat patchy, while data on bank- and insurance-based products was almost entirely absent. This clearly hinders investor choice between products. In terms of future choice-data we must solve PRIIPS. The technical problems with disclosure methodologies are known. Here we advocate that policy should allow product-specific disclosure standards to pivot away from an original ethos of comparability towards a new ethos of understandability.

We also encourage policymakers to refresh their view of where customers make choices about investment products and exposure in the first place. EU investors no longer buy funds on a stand-alone basis but rather buy into broader investment services, either in the form of a portfolio or wrapper or via investment advice. To be effective, investor choice ('value for money') policy must be relocated to the intermediary closest to the end customer. It is here that policy must empower customers to make effective choices.

Our final recommendation is that CMU policymakers greater consider the transformative potential that Open Banking may have on saving patterns. Policymakers should look to appropriate but extend the competitive logic of PSD2 and view it as means of drawing household savings out of cash deposits and into investment products. Where PEPP uses tax efficiency to encourage this shift, PSD2 will allow retail investment platforms to leverage technology to nudge customers in the same direction.

Fidelity has already launched a pilot enabling users of our UK platform to view their deposit savings alongside their investment holdings - a powerful tool for cross-comparing the relative performance of these assets. Any extension beyond this will need creative policy control. But tech-based guidance, advice and transaction tools that allow EU households to re-allocate their assets towards the market exposure their retired selves need is a key industry's challenge over the next 5 years. ●

Kevin Wall

**Chief Executive Officer,
Barclays Europe**

Unlocking the growth potential of Europe

Barclays has been supportive of Capital Markets Union (CMU) since its conception. We remain supportive today.

Important progress has been made over the past five years but CMU is not a small undertaking and the new European Commission and European Parliament terms provide an opportunity to develop fresh ideas and a renewed impetus. The core rationale for CMU remains. Addressing our over-reliance on traditional lending channels can both support long-term growth and enhance economic stability. >>>

>>> We should be clear, this does not mean replacing traditional lending channels. Rather, it is about helping markets develop to provide funding that is generally not provided through banks. It can bring together our need to find sources of patient capital and our long-term need for investment returns to meet our savings gap.

It is also about augmenting banks capacities to lend in their core areas and to help banks develop the markets where direct lending or funding is not the answer.

Let's look at these in turn.

The funding challenge for Europe's SMEs is often misunderstood. While it is clear that there is a gap for SME accessible risk finance, it is not by any means obvious that there is a gap for traditional loan finance or finance more generally for businesses with clear trading histories and reasonable expectations of repayment.

What is needed is to provide a bridge from conceptualisation of a business to the traditional capital markets, and to make equity available at the smaller levels. We call this idea the 'Pre-Capital Markets Union'.

CMU will require strong wholesale/investment banking institutions that can promote the development of capital markets through bringing users and providers of funding together efficiently. These will need to comprise of both large global but also strong local and regional institutions that are familiar with local markets and have a strong vested interest in building these markets and bringing local firms to the capital markets.

Barclays European investment banking activities have recently been consolidated under our Irish subsidiary and other global firms have been undertaking similar changes, in a variety of locations. This helps cement that vested interest to develop pan-European capital markets, leveraging our global operations and vice-versa.

Some of the regulatory changes required to support this are not particularly new or innovative but they require an understanding of the inter-linkages between policy areas and the political and supervisory will to address them.

Home-host issues are an obvious example, within the Eurozone, within the EU more widely, and internationally.

The EU's decision to require a 90% scalar for internal MREL (the highest level within the FSB's recommended range of 75%-90%) combined with host supervisors' discretion to layer on additional requirements increases costs without improving or facilitating resolution. It discourages investment in the EU financial services sector (especially in leverage-constrained businesses such as capital markets activities).

At an international level, although there is work ongoing at the FSB to address market fragmentation, it is not yet translating into policy outcomes at regional level. In the US, the consultations on the tailoring of rules for Foreign Banking Organisations do not point to an outcome that would indicate increased trust of the home country regime. In Europe, internal MREL is an example but we also have the increasingly fractious discussions around the continued ability of firms to access and use Europe's foremost financial centre.

The work on CMU should 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.

We could push further on securitisation, including doing more work on the securitisation of SME loans. We could look at new equity like instruments for private companies requiring more limited disclosure and avoiding loss of family control. We certainly need to continue to try to develop our venture capital market and, of course, develop our sustainable finance solutions as a matter of priority.

The list could go on but the pre-requisite is strong financial institutions operating in open, competitive, and efficient markets. ●

Stéphane Boujnah

Chief Executive Officer and Chairman
of the Managing Board, Euronext

Aim high and think holistic

The next European Commission mandate provides a unique opportunity to reframe the CMU around a holistic regulatory agenda. One of the weaknesses of CMU under the previous Commission mandate was that many of the issues underpinning the objectives are found in areas of EU legislation – such as MiFID II – which to date have not been explicitly the subject of the CMU agenda. This has contributed to a sense that the CMU deliverables have fallen short when compared to the ambitious objectives.

Accordingly, the CMU policy approach going forward would benefit from an integration of upcoming reviews of EU legislation. From the Euronext perspective, this translates primarily to MiFID II as this is the single most important piece of EU legislation impacting our ability to finance European economies. However, the same approach should also be taken to all other relevant EU legislation, such as the Market Abuse Regulation.

As part of this process, Euronext believes that legislative reviews, embedded within the CMU process, should encompass an approach to evaluation which delivers: (i) a clear benchmarking of regulations' market outcomes against the initial objectives; (ii) economic impact assessments which include a strong focus on the macroeconomic impact of regulations on the national and local ecosystems which support public capital markets; and (iii) a comprehensive approach covering all participants in the market ecosystem and value chain, particularly when it comes to determining end-user costs.

"The next Commission mandate provides an opportunity to reframe the CMU around a holistic agenda."

- STÉPHANE BOUJNAH

Also, CMU 2.0 should address in a holistic manner all the issues that prevent the flow of capital towards equity investment. This means that the concrete objectives of CMU 2.0 will have to include steps to be taken to unleash resources from insurance companies towards equity investment in the context of renewed a Solvency II.

Since CMU was launched, Euronext has continued to grow with the recent acquisition of Oslo Børs VPS complementing that of the Irish Stock Exchange in 2018. Today Euronext stands as a family of seven united regulated exchanges in Amsterdam, Brussels, Dublin, Lisbon, London, Oslo and Paris providing access to public capital markets across the continent.

One of the challenges for Euronext as a truly pan-European operator of regulated exchanges is how to reap the advantages of consolidating a deep and transparent European liquidity pool, whilst maintaining local market ecosystems across its jurisdictions. The EU faces the same challenge in the development of CMU. A careful balance needs to be struck between delivering harmonization to support consolidated liquidity pools and maintaining sufficient flexibility to nurture the diverse range of local market ecosystems on which the EU depends.

>>> Strengthening capital market financing for tech SMEs clearly demonstrates the challenge of combining the benefits of integration of EU capital markets while maintaining strong domestic capital markets. Capital market financing is particularly important for these companies as their business models are not always profitable in the short-term, meaning that bank financing is often not the best financing route.

Critically, tech SMEs are often 'globally local 'meaning they have a pan-European or international profile but rely heavily on local financing ecosystems. While the CMU and Banking Union are progressed at an EU level, it is critical to nurture these local market ecosystems, particularly focusing on the role of banks, advisors and research providers. At the same time, there needs to be a greater focus on investors taking an EU perspective. Greater market integration will strengthen institutional investment and provide enhanced financing opportunities to corporate users.

Alongside institutional investors, the ability of retail investors to invest in tech SMEs in other EU jurisdictions should also be strengthened. In this context, Fintech may have a profound impact on the way that issuers engage with retail investors.

Euronext is committed to playing a key role across the European continent in facilitating the access of companies to capital to finance innovation, economic growths and jobs. We look forward to working with the EU institutions and national authorities under CMU 2.0 to take the project to the next level and deliver the public capital markets Europe needs. ●