CMU post-Brexit: status quo, refocus or redesign?

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

The CMU: looking back and looking ahead

The Capital Markets Union (CMU) has been one of the most important projects of the outgoing European Commission – for several reasons. The economies of the Member States as well as the European Union (EU) as a whole would benefit greatly from deeper and more integrated capital markets, to complement a resilient banking system. After almost five years since the launch of this initiative, it is the right moment to look back at what has been achieved as well as looking ahead at what is needed to bring the CMU to fruition.

Firstly, the CMU has been designed as a combination of legislative and non-legislative initiatives. The legislative part contains a number of proposals from the European Commission, and the co-legislators diligently assessed them, and have concluded negotiations on a large number of these proposals.

Moreover, a number of regulatory enhancements in the area of financial infrastructures has been agreed (EU Benchmarks Regulation, EMIR refit and EMIR 2.2). In addition, several proposed regulatory measures on Sustainable Finance have been brought forward, including ESMA's consultation on the applicable Level 2 measures. Further, a complete framework for Level 1 and Level 2 measures under the Prospectus and Securitisation Regulations have been developed and ESMA will soon move forward with additional supervisory tasks regarding securitisations.

> *"The CMU has been designed as a combination of legislative and non-legislative initiatives."*
>
> \- STEVEN MAIJOOR

However, these new legislative acts alone cannot achieve a successful CMU with a more diverse and robust funding of the real economy. What the EU has needed and will continue to need is effective and convergent supervision of existing laws and regulations throughout the Union. In this important aspect of making the CMU a real success, the ESAs could and should play a decisive role. However, progress has been held back due to a lack of strong tools and sufficient resources to effectively ensure convergence. >>>

>>> Looking ahead, a key question is what Brexit will mean for the CMU. To my mind, the departure of the biggest financial centre creates the need to build up the required expertise and capabilities in the EU27: whatever the long-term outcome, access to the UK financial market will be less than in the current situation whereby the UK is part of the single market. Brexit also means that the EU27's capital markets should remain attractive for overseas market participants, including the UK. Equally, it will require that financial stability and investor protection would need to be assessed and addressed from an EU27 perspective.

Brexit will not only be the driver for the – much needed – further development of the CMU in the EU. As outlined above, greater efforts of a primarily non-legislative nature, aiming particularly at enhancing supervisory convergence, will be necessary to achieve a truly single capital market in Europe. ●

Olivier Guersent

Director General for Financial Stability, Financial Services and Capital Markets Union, European Commission

The future of the CMU project

Building a Capital Markets Union has been a key priority for the Juncker Commission. At the heart of the Single Market, this project strengthens the Economic and Monetary Union, fosters the international role of the euro and promotes access to capital markets for firms and citizens. This is most relevant for smaller countries, through links between their local capital market ecosystems and deeper pools of capital across the EU. Deeper integration of capital markets, together with more integrated banking systems, can also help maintain cross-border capital flows and sustain investments in Member States suffering large asymmetric macroeconomic shocks.

> *"The new Commission will find a solid base, on which to decide the next steps."*
>
> \- OLIVIER GUERSENT

The European Commission has delivered what it promised. It has tabled all the legislative proposals envisioned in the Capital Markets Union Action Plan and Mid-term review and has called on the co-legislators to conclude their work on these key building blocks before the European Parliament elections in May 2019. The Commission has also delivered on a large number of non-legislative actions related to the Capital Markets Union that will provide key contributions towards deep and liquid capital markets by addressing areas such as distribution of retail investment products, drivers of institutional investment and corporate finance for entrepreneurs and start-ups.

Provided that the co-legislators manage to conclude their work on as many as possible of the pending proposals currently under negotiation, the new Commission will find a solid base, on which to decide the next steps necessary to put in place a vibrant Capital Markets Union in the EU.

It will be for the future Commission to decide on future policies but there is no doubt that Capital Markets Union will continue to feature prominently on the agenda. CMU is a long-term single market project entailing an EU-wide structural reform that can deliver more economic growth through funding of innovation and better use >>>

>>> of new financial technologies, financial stability through greater private risk sharing, and more efficient EU-wide markets through greater access to capital markets services for businesses and citizens across the European Union.

The United Kingdom's departure from the single market calls for a thorough reflection on how to promote an efficient, competitive and integrated financial system underpinned by strong supervision ensuring investor protection, preserving market integrity and financial stability. Brexit makes the implementation of Capital Markets Union even more important for Europe, building on a large and developed banking sector and with segments that are already well developed in the EU-27, such as private placement, covered bonds, investment funds, and insurance. It requires a full implementation of the Action Plan to ensure that the impact on the ground is felt as soon as possible and will allow starting work on new priorities.

These include strong market infrastructures, based on the ongoing proposals in the post-trading landscape. Capital Markets Union will have the strength of multiple and diverse financial centres, which will provide opportunities for innovation and specialisation and will require strong supervisory convergence actions.

There are three key reasons why Capital Markets Union will stick with us for a long time:

1. Cross-border capital markets and banking activities are a formidable risk absorption tool, when it comes to economic shocks. There is still much potential for greater capital flow diversification and private risk sharing.
2. Building a CMU is crucial to make our EU economy more innovative and open to new digital trends. Market-based funding is best suited for high-risk-high-return projects, whose innovative nature can boost economic growth via the productivity channel.
3. The free movement of capital and services is an essential element of the EU's Single Market. The Capital Markets Union seeks to make progress on the functioning of the Single Market, by ensuring that all companies and investors have access to capital markets across the EU on equal terms.

The Commission can only put in place building blocks to restore the intermediation channels, but it will be for supervisors and market participants to use these blocks to build a functioning and integrated Capital Markets Union. ●

Sebastián Albella Amigo

Chairman, Spanish Securities and Exchange Commission (CNMV)

Integrated and efficient supervision does not mean centralised supervision

From the outset, the supervisory component has been considered an important part of the Capital Markets Union (CMU) project. Moving towards a more coherent and harmonised supervision across Europe contributes to greater integration and efficiency of the European capital markets. The June 2017 European Commission statement on the Mid-Term review of the CMU Action Plan emphasised this, highlighting the priority of the reform of the European Supervisory Authorities (ESAs).

Accordingly, in September 2017 the European Commission (EC) presented a proposal for the reform. Almost a year and a half later, it is still being discussed by the European institutions and it is currently (March 2019) in the phase of trilogue negotiations between the EC, the Council and the Parliament.

The debate on the issue has moved between two "extreme" positions or attitudes (obviously both very civilised and legitimate):

a) The first one, inspired by the ultimate objective of creating a single securities supervisor in the EU, a kind of European SEC that centralises all relevant supervisory functions of EU capital markets.
b) The second approach considers ESMA only as a "members-driven organisation", that is, a kind of club or mere association of supervisors. >>>

>>> In my view, the most appropriate stance is a mid-point between the two approaches.

"Robust national supervisors help ensure a plurality of financial centres with a critical mass."

- SEBASTIÁN ALBELLA AMIGO

It is essential to strengthen ESMA in the context of the CMU action plan, especially in light of Brexit. ESMA should have more power (should use more proactively tools such as the breach of EU Law, have the power to set up common supervisory priorities, play a greater role in peer reviews, etc.). However, ESMA should remain essentially a body that coordinates the Competent National Authorities (NCA) and promotes supervisory convergence.

The debate, by the way, concerns a fact that is rarely explicitly referred to: the different realities in Europe. On the one hand, the large countries and some medium-sized countries; and on the other hand, the many countries with a much smaller size in terms of population, GDP and the importance of their markets. The NCAs of the large countries are at an appropriate distance to supervise effectively. Quality supervision requires certain proximity but also a minimum distance from the market participants. In addition, NCAs in these countries are equipped to supervise any type of situation and supervise markets with a critical mass and a significant number of retail investors.

The EC stressed in its proposal the importance of an integrated supervisory system. I agree completely. But integrated supervision does not necessarily mean more centralised supervision. The direction and the objectives of the reform are compatible with respecting what I like to call the supervisory factor at the national level.

The Member States must continue to have robust supervisory bodies, with relevant powers, which will help ensure that we continue having in Europe a plurality of markets and financial centres with a critical mass. In addition, this will enable us to achieve a European capital market with greater penetration that really helps to improve the financing of the companies, not just the large ones, and reduce their level of dependence on bank financing, one of the main objectives of the CMU. ●

Thomas Book

Member of the Executive Board, Deutsche Börse Group

The European Growth Case

Over the last two years, the world has been rapidly changing. Regulation, technology and investment behaviors continue to shape the way markets work, impacting economic growth and the resilience of the financial system. In this context, two projects are of special importance: the Capital Markets Union (CMU) and the initiative around the international role of the Euro.

While the CMU looks at how to develop a competitive and attractive EU landscape to enable future growth opportunities, the Euro initiative aims at assessing the role of the common currency and its potential. From a market infrastructure perspective, both are vital when it comes to fostering economic growth.

We need to attract foreign investment flows into the Eurozone. A true Single Market in the EU is a precondition for meeting this objective. We need to further reduce barriers across Member States, finalize the stability agenda and embrace financial innovation. At the same time, we need to ensure that foreign investors find an attractive and efficient market infrastructure and the right investment vehicles.

This is where market infrastructure providers like Deutsche Börse Group come into play. As a natural partner to the regulator, we build safe, strong and resilient markets and we innovate to offer tailor-made products and services. Current examples are our market-led solution that allows banks, asset managers and pension funds to clear their Euro denominated business in the EU27 and the extension of our trading hours to the Asian time zones. From China to Korea, investors can now hedge their euro exposure in their own time zones.

Both initiatives meet the market's needs. On the Euro clearing side, we gained 10 percent market share in one year. And in only three months, 1 million contracts were traded during the Asian trading hours. With these successes, we support the regulatory agenda by providing the infrastructure that is needed for economic growth.

2019 will be an important year to bring a new life to the CMU with the upcoming elections in the European Parliament and the renewal of the top leadership positions across the EU institutions. It will not only be important for the EU internally but also externally in light of recent global challenges.

"The future of the CMU should tie in a more strategic vision of the EU."

- THOMAS BOOK

The future of the CMU should tie in a more strategic vision of the EU. Last year, President Juncker declared in his State of the Union speech that "the Euro must become the face and the instrument of a new, more sovereign Europe and the geopolitical situation makes this Europe's hour: the time for European sovereignty has come." We support this vision and have already started to embrace it by developing liquid commodities markets (gas, electricity and emission allowances) that settle in Euro.

This shows how regulation and market-led initiatives can work hand in hand to support competitive and sovereign EU financial markets to create growth while ensuring financial stability. ●

Stefan Gavell

Global Head of Regulatory, Industry & Government Affairs, State Street Corporation

An EU Capital Markets Union needs permanent capital

Ahead of the next European Commission's mandate, and with the UK's departure from the EU approaching, it is a good time to consider what's next for the EU Capital Markets Union project. In order to ensure we continue to further deepen Europe's capital markets policy makers should focus less on intermediation activities, which are mobile and increasingly technology enabled, and worry more about the underlying sources of long-term risk capital.

Whilst the EU and US are roughly equivalent in GDP, the EU still lags far behind the US in sources of long-term risk capital. PensionsEurope membership data indicates that the total of European 2nd and 3rd pillar assets represent only 21% of the US equivalents (2nd pillar and IRAs), insurance assets are more heavily orientated towards government debt with twice the allocation as in the US, and UCITS assets are less slightly less than half the size of the equivalent in the US.

Further to this, while banks play a more important role in financing the EU economy relative to the US, they also have difficulty in securing capital from EU indigenous investors. As such, approximately 40% of Tier 1 and Tier 2 European bank capital issuance (by volume) was able to be targeted at US investors in 2018.

"In order to have a viable EU capital market, we need deeper sources of long-term risk capital."

\- STEFAN GAVELL

In order to have a viable EU capital market, we need deeper sources of long-term risk capital. This includes the further development of Member State pensions markets, including removing barriers to cross-border investments, the realisation of the Pan-European Personal Pension Product and the better alignment of initiatives to promote investment in infrastructure with pension fund needs. Consideration should also be given to adjustments to insurance regulation that encourages diversification of holdings away from government debt.

This rise of index funds presents another opportunity to tap permanent capital. These funds have been growing steadily in Europe, and are expected to grow from 14% of total assets under management in 2017 to between 22-27% by 2025. Unlike actively managed funds, index funds are required to maintain their investments as long as the underlying instrument comprises part of the index. This results in low turnover of investments as compared with active funds and as a result index fund managers focus on creating the conditions for long-term value creation at the companies in which they invest. Index funds managers do not seek to micromanage corporate decisions but rather, given their long-term perspective, seek to establish high level governance standards at the companies they invest in, to ensure that company boards and management have the framework to make good decisions, and do not ignore long-term factors that may impact their viability.

In addition to these benefits, index funds provide European investors with diversified portfolios at low cost, resulting in a win-win situation for both investors as well as for the development of a self-sustaining European Capital Markets Union. ●

Xavier Larnaudie-Eiffel

Deputy Chief Executive Officer, CNP Assurances

2020 Solvency II review is opportunity for EC to deliver on CMU objectives

The European insurance industry very much welcomed, at the end of 2014, the European Commission's ambitious Investment Plan for Europe and the Capital Markets Union (CMU) project, with the overarching aim of supporting growth and jobs in Europe.

The EC rightly recognised from the beginning that the insurance industry would be at the centre of the CMU project, given the important role that insurers play as the largest European institutional investors with more than €10trn of assets under management. In fact, through the long-term and savings products insurers provide, the industry has a strong duty to policyholders to provide returns. This has become increasingly challenging over recent years due to low interest rates and a very conservative prudential regulatory framework (Solvency II).

The CMU was therefore welcomed by insurers as a way to remove the regulatory barriers in Solvency II that prevent them from investing optimally. A few years down the line, we can confirm

that there have been positive changes in the areas of infrastructure and securitisations. Solvency II capital requirements >>>

>>> and their calibrations have been investigated and revised in a way that better reflects insurers' risk exposure. One cannot, however, ignore the fact that these assets represent less than 5% of our portfolios, so — while positive — the changes have a limited impact.

For the past two years, insurers have been calling on the Commission to use the 2018 review of Solvency II to do more to support the CMU objectives; for example, to review both the capital requirements for long-term investment in equity and the risk margin. The latter is an extra capital buffer of around €200bn that particularly affects long-term products and negatively impacts insurers' capacity to invest long-term. At the time of writing, the EC's final proposals for the 2018 review are still not known, but are not expected to propose material changes that would support the CMU. This makes the 2018 review a missed opportunity.

"Fixing the challenges Solvency II creates for long term business would make a real difference to the economy."

- XAVIER LARNAUDIE-EIFFEL

Looking ahead, the insurance industry continues to fully support the objectives of the CMU to remove regulatory barriers and support investment, and strongly believes this should remain an objective of the next Commission. A wide review of Solvency II is due by the end of 2020. The EC should use it to investigate the concerns raised by the industry and propose changes where these are justified. It should not shy away from asking some essential questions, such as whether the current Solvency II assumption that insurers would be forced to sell their entire portfolio at a huge loss in a time of stress is reasonable and backed by evidence.

Answering this question requires a thorough approach and joint effort from supervisors, regulators, academia and the industry. Fixing the challenges Solvency II creates for long-term business, while maintaining it as a strong risk-based system, would make a real difference to the economy.

Policymakers need to recognise that requiring insurers to hold too much capital can be as damaging for consumers and the economy as requiring them to hold too little. Finding the right balance is not easy, but it is definitely worth the effort. ●

Sébastien Raspiller

Assistant Secretary, Ministry of Economy and Finance, France

Financing the future of the European Union

The Capital Market Union (CMU) corresponds to the profound necessity to complete the single market in a vital area of the European economy: that of its financing. Without a doubt this explains why the ambition of this project has not been derailed by Brexit. If anything, this makes the CMU all the more urgent, as it is supposed to answer some fundamental questions: how does Europe project itself as a financial player? how do we ensure that our businesses find enough funding? that our retail investors are offered a wide choice of saving opportunities?

Despite its initial ambition, the outcome of CMU is usually said to have been disappointing. Figures show that financial markets are still fragmented in many areas, ranging from the distribution of funds or insurance products, to the possibility for innovation to easily spill over from one member state to the next.

Brexit challenges the European economy in two ways. Locating the main pools of liquidity outside the Union implies that the Union's dependence on external financing will increase, as well as its reliance on foreign supervisory decisions, which may be of more concern especially in times of crisis. With regard to the financial relations with third countries, it is paramount to ensure none of our regulation core principles will be defeated. Thus, third country equivalence regimes need to safeguard level playing field, market integrity and curb systemic risks.

The prospect of the withdrawal of the United Kingdom of course is expected to lead to more fragmentation as far as the financial services concentrated so far in this country are concerned. The coming CMU 2.0 will have to factor in an increasingly multipolar landscape.

The review of the European supervisory agencies launched by the Commission in 2017 was meant to be a cornerstone of the CMU. The principle of harmonized regulation for the nationally-supervised activities and European supervision for transnational activities must be a driving principle for the CMU - but it is not enough. In this matter one can sometimes measure the distance between the posturing and the concrete actions to which we are ready.

The CMU project must strive to build a financial system in order to gear towards enhanced market performance and a competitive European financial sector. Following this objective, "tech for finance" offers new avenues for consumers and professionals alike: not only do these technologies allow significant cost savings, but they as well increase competition, market liquidity and broaden market access. France will pioneer a new framework for blockchain-based financial solutions. We now want to work at the European level in order to ensure that we collectively seize those opportunities though flexible and open-minded regulatory approaches, as long as investor protection and financial stability are preserved.

Sustainable finance is also now more than just a trend in the European financial landscape. Though financial regulation cannot be a substitute for an ambitious climate agenda, finance flows shall be made consistent with a pathway towards low greenhouse gas emissions and climate-resilient development, as set out by the Paris Agreement - and Europe can be at the forefront of this adventure. We believe it is important to take adequate time to reach a well-functioning regulation, it will be one of our main priorities in the early months of the forthcoming term of the European Commission. ●

Rimantas Šadžius

Member, European Court of Auditors

Looking beyond numbers – EU auditors' focus on European financial sector

Checking numbers, balance sheets and accuracy of annual reports of financial institutions – this is how "audit in the financial sector" is commonly perceived by people, even by professionals. Yet, the European Court of Auditors (ECA), the EU's official external auditor based in Luxembourg, aims at much wider perspective. This is in line with our strong EU Treaty-based mandate, permitting us to audit also the performance of any European funds and EU policies and give respective recommendations to institutions.

In the aftermath of the 2008-2009 crisis, the ECA recognised that much more is needed to promote efficiency and adequate accountability in the EU financial and economic governance, where EU institutions can and should add significant value, and convergence of national actions at Member States level is vital. In recent years we conducted a number of interesting audits focused in these fields, e.g. on Banking Union (SSM and SRM); implementation of the Stability and Growth Pact; performance of the European Supervisory Authorities (ESAs).

Systemic challenges in insurance supervision in Europe

Recent audit of the European Insurance and Occupational Pensions Authority (EIOPA) manifestly showed how EU financial market fragmentation stood on the way of reforms undertaken to secure financial stability, harmonize regulation or improve supervision. We looked in detail at cross-border insurance business supervision and found that despite EIOPA clearly took a significant – and often informal – co-ordination effort, the current EU legal framework itself features systemic weaknesses. It creates a situation where supervision (or lack of it) of the entities depends solely on the legal form of a business rather than on its nature.

So, there appear wrong incentives for some insurers to take advantage of freedom of establishment or services in jurisdictions with less stringent standards of supervision; and national authorities lack tools to counteract this. Clear for us: in genuine single market, its shortfalls call for Europe-wide solutions. Our recommendation to address in the European law these detrimental cross-border effects, I think, came just in time, given ongoing debate on revision of legal mandate and powers of the three ESAs.

"Clear for us: in genuine single market, its shortfalls call for Europe-wide solutions."

- RIMANTAS ŠADŽIUS

Looking forward to a comprehensive CMU assessment

The ECA is now starting another big journey: an audit of the progress in the European Capital Markets Union (CMU) project. Our intention is to check whether the EU has in reality delivered on its promise to diversify business financing and ease access to non-bank resources within and across national borders, in particular for smaller entities.

We will also reflect on whether, by going in this direction, the EU has managed to maintain a level-playing field and sufficiently protected market participants on both – demand and supply – sides.

Applying our audit evidence collection tools and scrutinizing action of EU authorities, we at the same time will keep close contact with European business associations and public financial institutions, to ensure our final recommendations are relevant and practical for agility of the evolving CMU.