

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

1. Objectives of the Capital Markets Union (CMU) and achievements so far

1.1. Rationale for the CMU and main objectives

A regulator stressed that the CMU aims to achieve a better balance between the banking system and the non banking system, make the financial system more competitive and provide companies and investors with more financing choice and a better return on their savings or investments.

The CMU is often talked about as if it is one system, but in reality it covers a very broad range of different channels of financing and funding varying from venture capital and asset management to derivatives. Although the term CMU was introduced at the outset of the current Commission, the CMU has arguably been in construction for 30 or 40 years since the first attempts to achieve more harmonised rules and regulations for the financial markets.

An official observed that a 'capital markets union' does not mean building a united capital market, but a union of capital markets. This implies achieving a certain level of consistency across the capital markets of different member states, although these are at different stages of development. In addition, there is a vertical dimension in the CMU, since it is composed of different markets such as investment funds, derivatives..., as mentioned by the previous speaker.

The CMU should also play a role in mitigating risk, the official added. The use of CMU for developing risk sharing across the EU through the private sector is important to consider, because it may provide an additional safeguard against possible stress events. The public sector also has an important role to play in the development of CMU, establishing legislation and putting the right incentives in place. For example, in the Venture Capital (VC) market, public funds represent one fourth of investments and this proportion is increasing. The public sector should consider whether more is needed.

A Central Bank official outlined that entrepreneurs in some parts of the EU are constrained by a lack of finances when there is at the same time an unprecedented savings glut in the EU with savers seeking higher returns. The savings surplus in the Eurozone has been steadily increasing in the last decade to reach almost €450 billion in 2018 and the situation is similar in the EU as a whole. Despite this, member states with savings deficits are only marginally benefitting from capital flows coming from these surplus countries, as a large portion of these funds is being lent to the rest of the world. Monetary policy has been forced to innovate with a refinancing programme dedicated to supporting further access to lending in the Eurozone.

In this context the CMU project proposes a bold vision complementary to the Banking Union, aiming to diversify access to finance, especially for small and medium size enterprises and to increase risk sharing across the Union.

1.2. Progress made with the implementation of the CMU

A policy-maker noted that the Commission has delivered all the legislative building blocks that it committed to in the initial 2015 CMU action plan and in the mid term review in 2017. Very large consultations took place in the market prior to this and all the interesting and feasible ideas that emerged at the time were taken into account. Unfortunately the co legislators have moved quite slowly in

the adoption of these proposals and reduced the ambition and / or increased the complexity of some of them. The glass is therefore half full. Some CMU measures have started to produce effects, although it is very difficult to disentangle the causality. If there is the embryo of a CMU, it is for large corporates, because the progress made in capital markets for SMEs is limited for the time being. There is more capital market financing in bonds for large corporates, but it is unclear whether that is related to CMU measures or if it is the result of banks lending less.

It remains to be seen whether the market will "colonise" the new possibilities offered in other areas by the CMU measures adopted. There are also some missed opportunities. The best example is PEPP, which has lost its pan European characteristics, so it is not the product the market asked for. Authorisation and supervision will be very complex and the resulting cost will be high for these products. Consequently the market for PEPPs is expected to be limited.

A regulator confirmed that progress with the CMU is "diverse". In corporate debt markets, asset management, derivatives and post trading major steps forward have been made. It could be argued that there is now a "derivatives union", with consistent rules across the EU and elements of central supervision. Securities clearing and settlement has also moved from very national systems to essentially European systems and even international ones. There are however other areas of the capital markets where progress is still very difficult. Equity financing and IPOs are still at very low levels across most of the EU, as well as cross-border funding by the capital markets. The participation of retail investors in capital markets through either equity or investment funds is also very limited.

Another regulator was more optimistic. The progress made over the last 30 years in Europe in terms of development and further integration of capital markets has been quite impressive and further progress should be possible. Changes are quite obvious in many countries such as Spain for example, where there have been huge improvements in terms of products distributed and access to financing for companies.

An industry representative stressed that one key achievement of the CMU is putting capital markets at the top of the agenda and this should continue. The EU institutions need to pursue their efforts not only to complete the financial stability agenda of the CMU, but also to bring down the barriers across member states.

2. Issues and challenges facing the CMU

2.1. Political backing by the Member States

The question with the CMU, a regulator suggested, is why it is so difficult to make progress, when all stakeholders at the market and political level seem to be in favour of it. An official disagreed that everyone is in favour of the CMU, because if every finance minister in the EU in particular was supportive much more would have been achieved regarding PEPP and the ESA review. One issue is that capital markets are more complicated to explain to a minister or to make ministers interested in than with banks or insurance. This is not always due to national objectives but in some cases also a lack of understanding.

Another official was struck by the extensiveness of the CMU 2015 action plan. This is an advantage because having the big picture from the start is always better than combining separate parts, but

it is also a disadvantage because efforts have to be spread out over a very wide agenda.

A policy maker stated that there is a duty to assess the progress made so far without complacency and ask the member states whether they are ready collectively to do what it takes to make the CMU happen, which so far is not obvious. Market participants have not yet had time to implement all the measures adopted, but the CMU suffers from an insufficient level of ambition at the political level. One difficulty with the CMU is that it is very different from the Banking Union in terms of implementation, in the sense that the Banking Union is mainly an institutional construction and could be put in place immediately. Concerning the CMU, the legislations adopted first need to be put in place in order to provide the incentives needed for intermediation to happen and once this has been done, the market needs to take advantage of the new possibilities offered and develop the market.

A Central Bank official observed that there is a certain “fatigue” in Europe about attempts to implement the CMU despite the strong support still shown to the initiative at the highest level e.g. recently by the President of the Bundesbank and the Governor of the Banque de France. Maybe that is because the problem that the CMU was designed to address (i.e. the potential restrictions of bank balance sheets due to additional regulatory requirements implemented after the financial crisis) has somewhat diminished with the loose monetary policy that has been put in place which means that there is sufficient funding available. The own resources of companies have also increased in some countries such as Germany.

A regulator wondered whether the focus of several actions of the CMU on debt financing and supporting bank funding is not an obstacle to the further diversification of funding. A Central Bank official noted that there has been a limited shift of bank funding to capital markets funding already. This needs to be developed, but not necessarily at the cross border level.

2.2. Reducing fragmentation in the EU

A policy maker stated that most of the reasons why there is no real CMU at present, despite the new EU legislation that has been adopted, are due to frictions between member states caused in particular by different rules and supervisory practices.

Infringement procedures do not seem to be the right way forward because at best the European Court of Justice will rule after 5 years of assessment that the Commission was right and this will not help progress on the ground. The Commission therefore decided to adopt a different approach. People were sent to each of the member states in order to assess with the local authorities and market operators the current barriers to financing and identify solutions to address them in a bilateral non legislative way. A report was subsequently published, which was quite sensitive because the barriers identified nearly all protect certain parts of the domestic business. This report was then shown to the Economic and Finance Committee (the committee of the European Union in charge of promoting policy coordination among the Member States) and then nothing happened. This exercise will therefore have to be restarted in the next term of the Commission because it is essential.

Besides these issues there are also some objective reasons why capital markets have not developed in certain EU countries, the policy-maker added, mostly related to the limited size and profit potential of these markets. Technology could however offer opportunities to develop smaller markets and connect them to the larger EU financial centres. Other speakers agreed that technology such as blockchain can help in the further integration of capital markets.

An industry representative emphasized that achieving further consistency in the application of rules is essential as it has a major impact on the possibility of doing business across Europe.

A regulator observed that one solution for achieving more consistency in the implementation of EU legislations could be to transform directives into regulations. When looking at MiFID for example, there

are many more differences in its implementation across member states than with EMIR. An industry representative suggested that MiFID will need reviewing more broadly in the backdrop of Brexit. Some objectives will need to be readjusted. The impacts so far in terms of transparency are fairly limited and fragmentation in the market needs to be reduced.

A Central Bank official believed that the limits have been reached in terms of the harmonisation of the legal framework across member states, who do not understand why they should change their whole insolvency law just for the CMU. Maybe the concept of the 28th or 29th regime could be reintroduced as an alternative for wholesale markets, as it does not require a harmonisation of all member states’ laws and can focus on specific areas.

2.3. Impact of Brexit on the CMU

A regulator remarked that it is often said that the UK leaving the EU may have a major negative impact on the CMU given the important role played by the UK in EU capital markets, but Brexit also offers opportunities for the EU27 to further develop its capital markets and financial centres.

An official agreed that Brexit should be an argument in favour of developing capital markets in the EU and this should help to increase the backing of the CMU by finance ministers. However, with the probable departure of the UK, the EU will be losing a major partner, including in the making of rules. It will be a challenge for the remaining 27 member states to outline a appropriate vision for a European CMU going forward and to set the rules needed to develop capital markets in a sufficient way in terms of liquidity, risk taking, etc. Until now the UK has helped a great deal in designing European capital market regulations alongside the Commission.

A policy maker stated that Brexit will have an impact on the CMU whatever the final Brexit scenario, but many member states do not properly take the Brexit risk into account in their thinking about the CMU. There are a number of things that could have been done better in the CMU in order to better prepare for Brexit. Many believe that the UK and EU are so dependent on each other that they will remain very closely aligned, but that dependence is not a sustainable strategy for the City outside the EU. There will therefore be a common incentive to gradually dis align, with the UK diversifying the markets where it operates and the EU progressively diversifying its sources of finance, which includes growing a CMU. The EU can also increase its connections with other financial centres, like New York, although this would not be the best course of action for the EU.

3. Priorities going forward

3.1. Options for raising political commitment in favour of the CMU

Several speakers emphasized that the CMU would remain a major priority of the EU going forward, but the next steps and priorities of the project need to be carefully and collectively thought out.

An official suggested that political awareness and consensus about the potential benefits of the CMU need increasing. This requires a simpler and more motivating pitch likely to obtain more commitment from political decision-makers in favour of the CMU. It should focus on the ability of the CMU to help finance the growth of EU economies more autonomously. This is preferable to other possible objectives that may be either too broad (such as strengthening the role of the Euro) or too specific or divisive (such as the cross-border development of certain financial markets or increasing retail engagement). Ministers need to be given a long-term perspective that illustrates potential for tangible results. Once a simple and clear target for the development of capital markets in the EU has been agreed, then policy-makers and the market can figure out how it can be achieved. Agreeing on this should be easier than on many other issues, because it does not involve any public money. It is not about achieving full integration.

A Central Bank official believed that one potential obstacle to the CMU is that with the current loose monetary policy there is enough

money in the system at present and therefore no real pain that could motivate its achievement. One remaining issue though is the excess savings (above € 400 billion) mentioned by a previous speaker, which are mainly in the Northern part of Europe and at the same time TLTROs (Targeted longer-term refinancing operations¹) of about the same size need to be issued by the European Central Bank in southern European countries to allow them to refinance their lending operators. The official suggested that the ambition of the CMU could potentially be focused more on bringing money from northern to southern Europe and also on the wholesale area in terms of who is ready to take the risk for the cross border investment required.

3.2. Enhancing SME financing through the capital markets and encouraging the development of IPOs

A Central Bank stated that as the implementation of the CMU draws closer, structural challenges are becoming more apparent, such as the prevalence of SMEs in the EU and the limited access of these companies to capital markets, which should be given priority in the CMU in order to ensure the effectiveness of the overall project.

The official stressed that improving the financing of SMEs is crucial for new job creation and innovation in the EU. However, SMEs are often family businesses that do not naturally finance themselves from public capital markets. At present only 3000 SMEs are listed in the EU out of a total of approximately 20 million. Different demand side factors in particular, such as the cost of IPOs, corporate governance requirements, fiscal treatment more favourable to loan than equity financing and low interest rates affect the financing of SMEs through the capital markets. Newly adopted European legislation aims to reduce some of these impediments, but many issues remain relevant.

The main solution in sight for accommodating both the objectives of the CMU and SME preferences would consist in capitalising more on synergies with bank financing and on technological progress, the speaker believed. The securitisation of loan portfolios is part of the solution. Credit institutions should also be able to play a role in transferring part of financing to the capital market, as they are well positioned to assess the risks of SMEs for which they already provide financial services. Banks' supply of SME financing can be improved also by using the capital market to secure notes, while lowering the financial risk.

An official commented that it is first important to better understand the financing needs of different types of SMEs. If small enterprises are asked whether they need the CMU the answer will be almost unanimously no, because many of them can get money from a bank. Small enterprises in the EU usually do not want to open their equity to outside investors, which is why comparisons with the US are often not valid.

A policy maker disagreed that SMEs do not need capital markets. Tech companies in particular need equity to develop. At present when they do not find equity in Europe they go elsewhere. More tech companies are needed in the EU as innovation is a major part of competitiveness in the current world.

The official agreed that the lack of high-tech start ups in Europe and the movement of larger tech companies to other jurisdictions outside Europe needs addressing. One of the measures to resolve this would be to facilitate access to equity, however that will not prevent the companies that have the opportunity to move to another jurisdiction outside Europe from doing so. Retaining these companies in Europe should be a key public policy objective.

An industry representative stated that it is very important to help companies raise capital in order to support their expansion plans and to help their transition from private to public markets. Some measures have been implemented by the Commission to foster the development of primary markets but many players in the industry

believe that a fundamental rethink of the IPO process in Europe is needed in a context where the market remains at a very low level. Evidence shows that some companies prefer raising money on the US market. This can be partly explained by some investor-related factors such as the greater patience of US investors post-IPO, but there are other factors as well.

Two aspects that could be improved concern free float requirements and measures to support secondary market liquidity post-IPO. Free float requirements in Europe tend to be much higher than in the US, which increases constraints for SMEs wanting to transition from the private to the public market. The goal is not to copy the US, but these requirements could be reassessed. In addition free float requirements tend to vary from country to country and from deal to deal, making it far harder to plan for an IPO. The second aspect is that secondary market liquidity post IPO tends to be lower in Europe than in the US, which can partly be explained by different free float requirements, as companies tend to go more often and in smaller sizes to the market in the US than in Europe, particularly in the technology sector.

3.3. Encouraging long-term investment in equities

An industry representative expressed disappointment that PEPP does not have more momentum. The need for long-term capital in Europe is much put forward, yet some EU regulatory regimes seem to promote liquidity at the expense of long-term investment. Insurance has the kind of long-term liabilities that should be invested long-term, yet Solvency II, which is more of a bank type regulatory regime, is forcing insurance companies to go shorter and less risky. Solvency II is due to be reviewed in 2020, which is a great opportunity to address that. Comparisons with the US show that the government debt holdings of European insurance companies are twice the level of the US. It would also be worth assessing national pension regimes to make sure that they are investing sufficiently into assets that are naturally long-term such as equities and longer term projects. However this has been discouraged in many jurisdictions.

Investment funds are another sector where some disincentives need addressing. UCITS is a huge global success, but it is still only half the size of the US equivalent market when GDPs are similar. One issue is that when a product develops, regulators immediately start questioning why; they examine the risks that this entails and seek to add rules. ETFs are an example of this. These are low cost products which are well suited both for institutional and retail clients because they are liquid and index funds allow them to invest in the whole index. Another layer of regulation seems unnecessary for these products, which are already very well regulated under UCITS and which have not posed any specific risks.

3.4. Continuing the integration of EU capital markets

An industry representative stated that a key objective of the CMU is continuing to bring down the barriers across Member States in the capital markets area. Further harmonizing insolvency laws and taxes in particular should be at the top of the agenda, even if it is very ambitious and will take time. Harmonisation within the EU is very important for strengthening the competitiveness of Europe globally because it is necessary to attract more investment flows into Europe, particularly in the perspective of Brexit which was not on the table when the CMU was initially designed.

It is also very important for the next Commission to have a political vision and a plan defining the role that financial markets should play in reducing the dependency of the EU on third-country financial centres and facilitating investment in Europe in order to ensure its competitiveness and growth. The initiative to strengthen the international role of the euro is crucial because it leads into much more strategic thinking about the role that financial markets should play in promoting the euro, positioning Europe vis-à-vis the US and Asia and what financial market structure is needed in this perspective.

¹ Through TLTROs the ECB provides long-term loans to banks and offers them an incentive to increase their lending to businesses and consumers in the euro-area. This helps to return inflation rates to levels below, but close to 2% over the medium-term.

Market infrastructures based in the EU can contribute in several ways to strengthening the international role of the euro, for instance by helping to set up, together with the banks that have shifted activities to the EU in the perspective of Brexit, a liquidity pool in the EU for the clearing of interest rate swaps, which would facilitate hedging in the EU. Another example is the trading of debt futures and European equity index futures that has started during Asian hours in December, which helps to facilitate Asian flows coming into the euro and hedge the exposures into the currency. Another area where progress can be made is the improvement of price discovery to the benefit of all market participants.

Another industry representative added that promoting the cross border distribution of investment products is also necessary. A useful EU legislation has recently been adopted with this objective, but some unintended consequences of MiFID II and PRIIPs that may impact retail investors or the distribution of US index funds for example need reviewing.

4. The role of supervision in implementing the CMU

4.1. The possible need for more supervisory convergence and cooperation for implementing the CMU

A regulator noted that more integrated and effective supervision, more supervisory convergence and cooperation between supervisory authorities have been considered very important parts of the CMU from the outset, as they contribute to the greater integration and efficiency of European capital markets. More coordination and supervisory convergence are particularly important in areas such as the cross border provision of services to retail investors, where it is essential to have not only more consistent practices and protocols, but also to promote investor confidence through a sufficient level of supervision throughout Europe. ESMA should play an important role in ensuring that services provided cross border to non professional investors are effectively supervised by the relevant home country, but should also encourage home countries to accept help and cooperation from host countries.

Integrated supervision is important but does not necessarily mean more centralised supervision. Member states must continue to have robust supervisory bodies with relevant powers to ensure that Europe continues to have a plurality of markets and financial centres with a critical mass. This will support the development and penetration of capital markets and help to improve the financing of companies of different sizes.

A Central Bank official stated that once the CMU has come into real existence then supervisory practices will follow. The alignment of supervisory practices has two aims. One is to avoid supervisory arbitrage, but there first need to be arbitrage possibilities and cross-border competition. The second consideration is making sure that supervisory practices do not create obstacles for the further creation of a European market.

Supervisory convergence is no longer a problem in the banking sector, because of the supervision of the most significant institutions by the SSM. Banking could serve as a benchmark from that perspective. One lesson from the SSM is that it is not a panacea for everything and the one size fits all approach is not appropriate, because markets and companies are different across member states and these specificities have to be acknowledged in supervisory practices. The risk if practices and standards are harmonised too much is that there is no room for supervisory judgement anymore which will impede the effectiveness of supervision. The Banking Union was created in reaction to the sovereign debt crisis and a regulator wondered whether it would not be better to anticipate a further integration of capital market supervision before a crisis eventually happens in the capital markets. The Central Bank official responded that it is a natural reaction to only solve problems when they arise.

A policy maker fundamentally disagreed that there is no problem in the capital markets worth fixing at present. That is a view guided

by the wish to preserve the prerogatives of domestic supervisors, which has previously hindered the creation of the ESAs. It is common sense that if people want to have the freedom to market throughout Europe there needs to be a referee that ensures that there is sufficient discipline and that risks are under control. Before the euro crisis and the Banking Union a vast majority of member states denied that there would be one day a problem justifying an enhancement of bank supervision at the EU level. A major problem might happen in the capital markets sector in a similar way and then it will be too late to react. If this is not anticipated, the end result could be the worst of all worlds. There may be enough of a single market so that risks can spread easily to other jurisdictions and not enough to be able to control them, which is exactly what happened in the insurance sector where some companies are established in countries where they do not sell a single policy and all the risks are spread over other jurisdictions. If this is the case the home supervisor does not care about the cross-border business and if there is no one in the EU with the ability to stop certain practices and to investigate through serious means and sanctions this makes the system dysfunctional.

An official noted that it is not easy to compare the SSM and the supervision of securities markets, because the SSM does not regulate banking markets, whereas ESMA has a role in regulation and may also be given some direct supervisory powers. Some middle option needs to be found.

4.2. The outcome of the ESAs review

A regulator stated that the agreed proposal for the reform of ESAs is an element of progress. The debate had moved between two extreme positions: (1) creating a single securities supervisor in the EU such as the US SEC that would centralise all relevant supervisory functions of EU capital markets and (2) limiting ESMA to a mere association of supervisors driven by its members. The most appropriate stance is a midpoint between the two approaches, the speaker believed.

There are indeed different realities in Europe with countries of different sizes, meaning that there is a variety of situations in terms of how close supervisors are to market participants and also in terms of competences, experiences and tools used. It is essential to strengthen ESMA in the context of the CMU action plan and especially in the light of Brexit. ESMA should be able to play a stronger and more pro-active role regarding breaches of EU law, the establishment of common supervisory priorities and peer reviews. ESMA should also have more independent governance, especially to launch initiatives concerning day-to-day matters. However, ESMA should remain essentially a body that coordinates the competent national authorities and promotes supervisory cooperation and convergence, but the new powers added with the ESA review should allow ESMA to play this role in a more active and stronger way and possibly with more intrusiveness.

An official also welcomed the outcome of the ESAs review, but considered that a 2.0 review would be inevitable sometime in the future. An audit of supervision in the insurance sector revealed issues related to the way cross-border business is supervised. Domestic insurance supervisors at present do not always appropriately consider cross-border business, because in some cases companies conducting cross-border activities are negligible in their home countries. In addition, national rules often focus the role of domestic supervisors on national financial stability issues. Similar approaches would be very detrimental in the capital markets area where the cross-border dimension is very strong and may be difficult to solve in the current regulatory framework. An informal role can be played by the ESAs in this respect vis-à-vis the national competent authorities, but regulations regarding interactions between the competent authorities of member states are quite limited. The ESAs can indeed only obtain information from the national competent authorities and only if they prove they need it. This makes the central supervision of internal models in the insurance sector difficult for example. There was a proposal in the Commission initiative to improve this process, but unfortunately it was not adopted. ■