SESSION SUMMARY - HELSINKI SEPTEMBER 2019

Refocusing CMU: key policy priorities

1. Progress made and challenges faced by the CMU initiative

1.1. Limited progress made in the effective development of EU capital markets

A policymaker indicated that the Capital Markets Union (CMU) action plan launched in 2015 is now nearing full implementation.

An industry representative was frustrated by the limited tangible progress made with the CMU in the growth of EU capital markets despite all the efforts of the Commission. Eight years ago 70% of the total funding in Europe came through banks and 30% through capital markets, and vice-versa in the US. The percentages are still the same. Another industry representative emphasized the gap that exists between the ambitions and the delivery of the CMU despite all the efforts made to implement it. This is because of the continued fragmentation of the EU capital market. The focus has mainly been on technicalities thus the overall perspective of the project, which was to put in place what is needed to unite EU capital markets, was lost.

A regulator was less pessimistic about what has been achieved. In some areas there has been much progress, even though some key others remain to be tackled. The asset management sector for example has been developing very strongly, growing into a truly European asset management sector. The same goes for trading and corporate debt issuance. There has also been very strong progress in some parts of the post-trading area, which has developed into a European or even a global market.

1.2. Challenges faced by the CMU initiative

A first challenge put forward relates to the scope and ambition of the CMU initiative.

An industry representative stated that the ambition of the CMU is probably too high and the initiative attempts to embrace too much. Another industry speaker believed that a difficulty with the current action plan is that no single measure is likely to have a major impact on the development of EU capital markets. They all have marginal contributions, so it is difficult to identify key priorities. Some issues are difficult to tackle also because they touch on core areas of member state law. A policymaker noted that what has been discovered in implementing the CMU plan is that the components of the capital markets are all interlinked. For example, fostering IPOs for SMEs also requires developing the secondary market, which in turn touches on a number of other aspects. Although there may be an issue of insufficient focus in the CMU, the challenge is that everything is connected.

The insufficient level of political commitment to the CMU initiative and to the development of capital markets is a second issue.

A regulator stated that the numerous Council meetings on CMU have demonstrated that although there is generally support for the objective of developing capital markets in Europe, there is no appetite at the political level for a rapid union of all national capital markets. So achieving a fully-fledged CMU seems a very challenging objective at this stage, but progress is still possible. An official believed that while much progress has been made over the last 10 years in the regulation of markets at the European level, many member states have failed to develop their capital markets and to change longstanding funding patterns on their national level. Germany for example was talking about increasing equity culture long before CMU but progress has been limited. Further harmonizing approaches at the European level is challenging but the real difficulty is to create domestic capital markets in the first place, which requires more than legislation. A culture change is needed, and action is needed both at the European and member state level on this. A regulator agreed that developing capital market activity at the member state level is necessary and cannot be achieved only with the implementation of a harmonized framework.

2. Opportunities and obstacles regarding the development of EU capital markets

2.1. Opportunities

An industry representative noted that there is a high level of savings in Europe but a great deal goes into bank deposits - over 30% of the total asset base – which have no yield and are even loss-making when taking inflation into account. Societies across Europe are ageing, which means there is a pensions gap that is widening; these savings are not producing any interest and it will take longer for savers to get to the same outcome. On average, participation in financial markets remains very low across Europe, which is both a challenge and an opportunity. For instance, the largest economy, Germany, has a 13% participation rate. Nominal wages have been growing at below historic pace in the last 10 years since the financial crisis, at less than 1.5%. A growth of wealth is needed in this context and the best way to do that is by investing in equities and bonds. These are volatile investments, however, in 2019, equity indices in Europe were up by +15% and broad bond indices by +9%.

Another industry representative highlighted some positive developments in different parts of the EU market that may be built upon. A first example is what has been achieved in the Nordic market, where capital markets work very effectively for small businesses. In the perspective of Brexit, some major financial institutions headquartered within and outside Europe have also been restructuring their activities and investing a great deal of resources in the EU.

2.2. Obstacles

Monetary policy: An industry representative believed that the 'elephant in the room' concerning CMU is monetary policy, which will have a major impact on the way capital markets work. If interests go up this may create solvency and liquidity problems and if they remain very low investors might favour risk-free savings that offer a return that is only slightly lower (so long as retail rates are not negative) and there is also the risk that some insurance companies or investment managers might default, potentially impacting pensioners. In addition negative rates and possible interest rate increases are something new for most market participants who have not been trained to react to such a situation. A regulator however believed that the very low or negative interest rate environment may favour a certain development of equity markets that represent the only option for increasing savings for e.g. retirement.

EU competition policy: An industry speaker moreover suggested that EU competition policy is another major obstacle to the CMU. If it remains the same, operators and financial institutions in Europe will not get stronger and the progress made in the development and integration of EU capital markets may profit mainly larger foreign financial institutions, resulting in the CMU 'garden' being 'gardened by others' in the end. On the other hand there is no reason why Europe should be a financing taker rather than a financing maker, so this issue needs to be addressed. A regulator agreed that the Commission also needs to encourage the building up of large and competitive European financial institutions in investment banking, asset management and post-trading; for instance there are currently 32 CSDs in Europe. In addition, European institutions currently do not sufficiently consider the EU as a domestic market; this needs to be encouraged.

Insufficient literacy and experience of capital markets: The insufficient engagement of retail investors and SME issuers in capital markets was stressed by several panellists. A regulator explained that many European households still tend to save through deposits despite the low yields offered. It is important for households to increase their participation in capital markets, because people need to make a reasonable return on their savings in order to be able to finance the higher costs of education, pensions and housing. The inefficiency of the current distribution system of financial products across the EU is another important factor, the regulator believed, because about one-third of gross returns are lost in distribution costs.

Bank-based financing system: A regulator explained that the current bank-based structure of funding in the EU is an obstacle because it is automatically more focused on debt and less on risk-bearing capacity. Another regulator observed that there is also a diminishing willingness of companies to go public, resulting in a low level of IPOs, which is nevertheless not only a European issue.

Impacts of existing financial regulations: Several speakers considered that some existing EU financial regulations may hold back the further growth of capital markets.

Building capital market ecosystems is a very difficult task and inevitably involves favouring a degree of risk taking, an industry speaker explained, which goes against most of the efforts made over the last few years to put in place regulations aiming to decrease risk.

Another industry representative noted several areas where the EU regulation has been structured in a 'counterproductive' way. The PEPP (Pan-European personal pension product) is a first example. This is a positive initiative that has adequate components like a default fund investment option, but when it is examined in detail, several issues appear. For example, there is a 1% fee cap, which might make sense from a consumer protection perspective, but it also risks limiting the number of providers interested in these products and stifling competition. In addition, there are calls for a capital guarantee, but it is known that having a complete guarantee on the capital invested is the most expensive way to invest and is not needed in a long-term perspective. There are many smarter ways of providing savers with an appropriate level of protection, such as the target-date concept initiated in the US, whereby a fund changes its asset allocation over time in order to reach a very low-risk profile by the time of retirement. The Packaged Retail and Insurance-based Investment Products (PRIIPs) regulation is another matter for concern, the speaker felt. Although efforts to improve product information are commendable, the PRIIPs disclosure methodologies around expected performance and transaction costs in particular are unhelpful for investors and represent an additional burden for asset managers. Individual investors end up with too much information and no advice.

A third industry representative emphasized the possible negative consequences of Solvency II for the CMU. Solvency II might avoid the default of some smaller insurance companies or pension funds by beefing up their reserves but also prevents most of them from investing in equities, which may have more serious repercussions on the economy and savers than a possible default, particularly in an environment of negative interest rates. An objective evaluation of the impacts of MiFID II on EU capital markets is also needed, the speaker believed. The ambition of MiFID II was right, but several rules have adverse consequences. For example, the intention was to promote SME financing, but the price unbunding rules have in effect led to a suppression of research for most SMEs and to an elimination of SME brokers. In order to reactivate the CMU, the first priority is therefore to review EU legislations such as MiFID II, PRIIPs and Solvency II and identify the rules that may discourage investors and particularly retail ones from investing in equity.

A regulator agreed that parts of MiFID II and PRIIPs have not been helpful and have hindered access to certain financial products, notably bonds, thus requiring a review.

3. Way forward for the CMU

3.1. Building political momentum with a renewed objective and narrative

A regulator suggested that increasing the political momentum around the CMU is essential for relaunching the initiative. While the Banking Union could be mostly achieved through European legislation, this is not the case for the CMU because changes are also needed at member state level in terms of regulation and market structure. In order to increase political backing for the CMU, it is important to link its objectives to areas that voters care about such as the creation of jobs and the financing of the economy. The sustainable finance agenda is another element likely to help build more political momentum, because the low-carbon transition cannot be wholly financed through public means. In addition, this is an area where the EU has the opportunity to build a European approach from scratch. This is also true to a certain extent for digitalisation and new technologies, however in this latter case, existing regulations need to be reviewed in order to identify potential obstacles, the regulator stated; under current regulations security tokens cannot be developed for example. An industry speaker added that sustainable investment is an area where Europe has gained considerable expertise and leadership and where it can develop a differentiating approach to investment. Another industry representative agreed with the importance of increasing the political commitment in favour of the CMU but felt this would not be sufficient because many member states have lost confidence in high level European projects such as the CMU. Such projects need to be made more understandable, accessible and something that people can relate to.

An official emphasized that an analytical assessment at the European level is necessary to identify the measures and priorities that are likely to have the strongest impact on the development of the capital market ecosystem. Germany, France and the Netherlands have asked a group of experts to provide their input on this by the end of September. These recommendations should be a basis on which an appropriate narrative can be developed and further political commitment obtained.

An industry representative added that the CMU means different things to different people, therefore a rephrasing of the CMU objective is needed. Capital markets do not happen overnight and a hard deadline for delivering the CMU cannot be fixed. There needs to be a discussion about how to build efficient markets to deliver capital to those who need it across Europe and how to further integrate them, which are the main objectives of CMU. CMU should not be a fortress-Europe market either, because it also needs to give investors and savers in Europe opportunities outside Europe, and vice-versa.

A change of name was also suggested by some speakers. A regulator noted that the term CMU has become quite unpopular. One of the problems with the term is that it establishes a comparison with the Banking Union when the two projects are fundamentally different. The Banking Union is about implementing a consistent supervision of the largest banking institutions in the Eurozone, whereas the key objective of CMU is to increase the role of capital markets in the European financial system. Supervision can support that process, but that in itself will not drive the development of capital markets.

3.2. Increasing the focus on retail and SME markets

For a regulator, the key element to address is increasing the participation of households in capital markets so that they can get better returns on their savings. Pensions could be an appropriate vehicle to foster more retail investment, particularly in countries where there is resistance by households to participate directly in the capital markets.

An industry representative believed that Europe needs to get SME issuers and retail investors more involved in the capital markets. This is true both in quite developed EU capital markets and in the underdeveloped ones. Much needs to be done in terms of financial education and research to achieve this, but that should be feasible.

Another industry representative stated that the single biggest objective to achieve in Europe with capital markets is putting the individual saver and investor at the centre of efforts; this is a huge need at the European level. The limited level of retail investment has much to do with financial education and there is a huge opportunity around a public-private partnership to educate the broader public on the importance of investing in the capital markets. The opportunities offered by sustainable investing, on which Europe is at the forefront with considerable experience could also be used from an educational perspective to foster more retail investment, the speaker believed.

3.3. Improving insolvency rules and withholding tax procedures at the EU level

Several panellists believed that reviewing insolvency regimes should be a major priority of the CMU going forward.

An industry representative felt that the insolvency regime and investors' confidence in it, both retail and institutional has been a critical factor for the positive evolution of the US and UK capital markets. Making some progress on this is very likely to help attract new pools of capital into Europe. Another industry representative considered that the further harmonisation of insolvency rules at an EU level should be reflected upon, even if this is almost as ambitious as implementing a single currency. If Europe can harmonise basic rules for debtors and creditors this could unlock many issues and in particular have a significant impact on fixed income markets and clearing activities. Moving forward on this topic may be possible with the new Commission that is intending to favour more collegial work, however progress will be difficult without senior political leadership. A third industry speaker also cautioned that bankruptcy laws have many different aspects to them with many different entities involved. Converging towards pan-European standards may be too ambitious.

An official noted that although clear insolvency laws exist in Europe, a court settlement still takes up to five years in some member states. Financial laws are not sufficient to achieve appropriate results, so insolvency regimes need to be examined. Thought is also needed about tax elements. That does not necessarily mean harmonising all tax regimes, but streamlining cross-border withholding tax regimes and procedures in particular. An industry representative considered that tax and notably procedures regarding withholding taxes will be a major issue to tackle with a focus on long-term investment and cross-border investment. This is necessary to achieve a sufficient degree of harmonisation and interoperability for the capital markets infrastructure, which is a precondition for the CMU.

3.4. Reviewing existing capital market regulations and improving supervisory convergence

A regulator thought that many improvements could be made to existing financial regulations. The upcoming reviews of many key regulations, such as MiFID II, PRIIPs, and the Alternative Investment Fund Managers Directive (AIFMD) will be an opportunity to do this. Another regulator mentioned that a recent report published by AFME shows that Member states that have the biggest household participation in capital markets are those that have the strongest regulation and supervision around transparency and inducements. It is therefore important that the re-examination of these pieces of regulation is not seen as a way to reduce the current level of regulation or supervision.

A regulator stressed that following the work initiated during the previous legislature, supervisory convergence also needs to be improved in order to achieve a single supervisory approach at the EU level. This is an on-going work conducted by the European supervisory authorities (ESAs) around which there is a real momentum. Another regulator advocated new powers for ESMA. For example the supervision of CCPs could be more effectively conducted at the EU level than the present situation where there are more supervisors than CCPs in the EU27, which does not make sense.

4. Conclusion

During the discussion it appeared that there is a significant gap between the rhetoric around CMU and the action on the ground. It may be partly that politicians respond to what their voters want, and their voters do not know what is being done there and do not see what is relevant for them. The analytical focus referred to should allow the identification of priorities, the development of an appropriate narrative and the enforcement of that narrative. There are two elements of this narrative; the first is that it is good for the economy, good for growth and good for welfare, so people should want it. The second is a narrower euro-area narrative. There is much talk about the sustainability of the euro area; risk sharing is needed to make the euro area and EMU sustainable. There is a treaty prohibition on public sector risk sharing, therefore if it is to be sustainable private risk sharing is needed. Ministers must understand that they cannot simultaneously worry about the sustainability of the monetary union and not be ambitious in developing private risk-sharing channels, both through the banking union and CMU. This narrative has to be built on a proper analytical basis.

Work is needed on supervisory convergence, sustainable finance and digitalisation and also on the review of regulations to eliminate unintended effects. The regulations concerned include insolvency regimes, securitisation, tax elements including withholding tax, possible antitrust rules, SME retail access and financial education. The Commission also has to decide which priorities are the most important among these. Regarding the name and the objective of the CMU, it could be easier to stay with the idea of creating a single market for capital in the EU, which is what CMU always was and still is. ■