REGULATORY UPDATE - ZAGREB APRIL 2020
Policy note drafted by the Eurofi Secretariat

CMU 2.0: what is needed, by whom and when?

1. The EU capital market legislative framework has been significantly enriched with CMU 1.0, but concrete impacts are still limited

Launched in 2015, the Capital Markets Union initiative (CMU) aims to develop and further integrate capital markets in the EU in order to diversify the financing of EU enterprises - particularly the most innovative and fastest growing ones - and better connect savings to investment across the Union, providing savers with improved long-term investment opportunities. An additional more macro-level objective is to enhance the resilience of the EU economy with a diversification of funding sources and a development of cross-border capital markets (contributing to private risk sharing across the EU).

The Commission proposed two action plans including legislative and non-legislative measures aiming to bring more investors to the market, facilitate access to capital markets for issuers and improve the functioning of EU markets notably on a cross-border basis, which have now been mostly implemented. The initial CMU Action Plan published in September 2015 set out 33 actions concerning securitisation, investment funds, prudential calibrations, prospectuses, etc.[1] Following the mid-term review of the CMU, an additional set of measures was proposed by the Commission in 2017, covering different objectives such as the strengthening of the powers of the ESAs, the development of fintech, the promotion of sustainable finance, the facilitation of SME listing, private pensions (with the PEPP framework[2]) and support for the growth of local capital markets. With these two action plans, the Commission has chosen an evolutionary approach to the CMU addressing a broad range of drivers and building on the pre-existing EU securities legislations such as MiFID, EMIR, CSDR, UCITS, etc.[3] , rather than a more radical plan addressing market fundamentals such as, insolvency, tax and securities ownership laws, common infrastructure, etc.

Despite this improvement of the EU capital market framework, the general feeling is that much remains to be done to achieve the CMU. A first reason is that EU capital markets have not significantly grown over the last few years, except non-bank funding through debt securities, and they remain quite under-developed compared to the US or UK for example. In addition, there is persistent fragmentation in the EU, with limited cross-border flows and fragmented infrastructure (see Annex 1). Secondly there is frustration with CMU 1.0 among many stakeholders due to the protracted negotiation process and also the lowering of the initial ambitions of certain proposals such as the ESAs review, in order to enable the co-legislators to reach an agreement. The piecemeal fashion in which the proposals were made, the lack of ex-ante political agreement on the main components of the CMU action plan and the absence of an overall implementation timetable, beyond the adoption of the legislative texts are additional issues that have also been put forward.

2. Completing the CMU remains a priority of the Commission and the Council

Completing the CMU was reasserted as a centrepiece of the legislative agenda by the new Commission, in particular to ensure SMEs have access to the financing they need to grow, innovate and scale up. The Council also reaffirmed at the Ecofin of 5 December 2019 the need to further intensify policy efforts for deepening the CMU and set 5 main objectives: (i) enhanced access to finance for EU businesses, especially SMEs; (ii) removal of structural and legal barriers for increased cross border capital flows; (iii) provision of incentives and removal of obstacles for well-informed retail savers to invest; (iv) support the transition to sustainable economies; (v) embrace technological progress and digitalization, and a sixth objective of strengthening the global competitiveness of EU capital markets building on local markets and ecosystems.

Several reports on the CMU published in the last months of 2019[4] recommend similar areas of work (see Annex 2). There are however some nuances in their approaches. Some focus more on building the fundamentals of an integrated EU capital market. This is the case of the IMF staff paper published in September 2019 which recommends the central provision of issuer information (an "EU EDGAR"[5]), streamlined withholding tax procedures, improved insolvency procedures, enhanced supervision and a new portable pension product. Others, such as the Next CMU report, recommend a very wide list of objectives ranging from specific regulatory measures to improve the financing of SMEs and investment conditions for retail and institutional investors to broader policy recommendations such as strengthening the international role of the euro or increasing financial flow fluidity between EU financial market places. While all these themes seem relevant in theory, the challenge now is to identify the priorities to start with, likely to have the strongest impact in the short and medium term and to define a clear sequence of action to relaunch the CMU project.

The High Level Forum (HLF) set up in November 2019 by the Commission aims to propose by the summer of 2020[6] a set of concrete and targeted policy actions, likely to be "game-changers" for the CMU, together with the method and process needed to see them through. So far, the HLF has highlighted in its February 2020 interim

---

[1] These include measures to develop securitization and covered bonds, improve Solvency II calibrations, prospectus and investment fund rules, facilitate the cross-border distribution of funds and also some non-binding measures regarding withholding tax and insolvency proceedings.

[2] Pan European Pension Product framework.

[3] Capital market regulations and directives including: MiFID / MiFIR, EMIR, CSDR, SFTR, MAR, UCITS, AIFM, etc.

[4] Including: CEPS "Rebranding the CMU" (June 2019); IMF staff discussion paper "A Capital Market Union for Europe" (Sept 2019); the Next CMU high-level group (Oct 2019); S&P The EU CMU: turning the tide (Feb 2020).

[5] EDGAR is the Electronic Data Gathering, Analysis, and Retrieval system used at the U.S. Securities and Exchange Commission (SEC). EDGAR is the primary system for submissions by companies and others who are required by law to file information with the SEC. EDGAR performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law to file forms with the US SEC. All companies, foreign and domestic, are required to file registration statements, periodic reports, and other forms electronically through EDGAR. Anyone can access and download this information for free.

[6] The initial deadline was May 2020 but it may be postponed because of the Covid-19 crisis.

report a number of areas of improvement on the basis of which these key measures will be identified[7]: (i) The financing of businesses; (ii) The strengthening of market infrastructure; (iii) Retail investment; (iv) Cross-cutting issues related to tax, insolvency procedures and supervision.

Two main factors of success of the CMU were also emphasized by the HLF. One is the need to have a clear delivery timetable that can be rigorously monitored over time by the EU institutions against a set of indicators. The second factor is the need for clear political backing with an "upfront commitment" from the Commission, the Council and the EU Parliament on a precise package of reforms.

3. Challenges and opportunities going forward: Brexit and Covid-19

In defining the priorities and course of action for CMU 2.0, two main challenges that have appeared or gained in importance since the publication of the recommendations above need to be considered.

Brexit is a first challenge.

Although the terms of a potential trade deal are still to be defined, it is now almost certain that future EU-UK relations in the financial sector will be based on bilateral equivalence. This may have major impacts on EU-27 capital markets, since at present the UK acts as a hub for many activities and UK and EU financial markets are highly integrated[8] . Many capital market activities can potentially benefit from equivalence arrangements[9] , but it is likely that costs and frictions will increase after the transition period[10], particularly if UK rules diverge over time. How these changes may affect the future dynamics of EU capital markets and CMU objectives still needs to be clearly evaluated. Developing capital market activities on the continent could be an opportunity for the EU-27 to further increase its financial independence, but so far transfers of activities from the City have been limited and on-going trends point towards a multi-polar EU capital market, requiring stronger regulatory and supervisory convergence and interconnecting market ecosystems [11].

The Covid-19 crisis is another potential game changer for the CMU.

Although it is still early to evaluate the full implications of this crisis at the time this paper is written, it is likely that it will perpetuate a macro-economic context in the EU that is not particularly favourable to the growth of capital markets. Very low interest rates used to fight recession should continue to favour debt over equity financing and encourage risk-free savings offering returns that are only slightly lower than balanced-risk securities portfolios. Secondly this crisis will probably increase macro-economic imbalances between Member States, hindering the further integration of capital and banking markets, unless some decisive steps can be made towards enhancing EU governance and some form of fiscal integration. Thirdly, at the more micro level, although financing needs will increase for all businesses, bank financing (partly supported by State guarantees) will presumably be given the priority, as the most accessible source of financing in the short-term.

There may be a temptation to de-prioritize CMU in this context, but this would be a mistake, because some issues such as the funding of innovative and growing SMEs that are not adequately served by banks or the need to provide savers with investment solutions delivering higher returns in the long term will remain crucial (despite questions that the recent equity market crash may raise). In addition the need to rebalance debt with longer term equity funding and investment will become even more important in an environment where debt levels will have significantly increased. The Covid-19 crisis may however justify in the short term a clearer focus on these latter priorities, as well as on trends such as digitalisation and sustainable finance that remain relevant in this crisis - rather than on the realisation of a fully integrated EU capital market or on broader objectives related to the strengthening of the role of the euro.

[7] 1) the financing of businesses: (i) fostering single pan-European access by investors to comparable company data; (ii) widening capital supply for businesses through adequate long-term investment vehicles; (iii) increasing the risk appetite of institutional investors; (iv) facilitating the listing of companies; (v) strengthening the range of tools available to financial intermediaries including securitisation. 2) the strengthening of market infrastructure with (i) a better integration and efficiency of trading and post-trading and (ii) measures for improving the liquidity of secondary markets. 3) retail investment with (i) measures to provide adequate occupational and personal pension products and (ii) measures to improve financial literacy, equity culture and access to high-quality advice. 4) cross-cutting issues requiring further work: (i) tax related obstacles to cross-border investment notably concerning withholding tax; (ii) the legal certainty of outcomes notably concerning national insolvency proceedings and (iii) the convergence of supervisory outcomes across Europe in order to remove regulatory arbitrage. Some other cross-cutting issues were identified relating to financial innovation, the transition towards sustainable investment and possible synergies between public and private instruments.

[8] In particular for certain financial services linked to derivatives markets and investment banking activities. For example, between 2012 and 2018, almost half of all debt and equity issuance for euro area non-financial corporations was carried out by global banks based in London. Almost 90% of all over-the-counter (OTC) derivatives positions taken by euro area institutions were cleared at UK global clearing houses in December 2019. In August last year, over a quarter of uncleared OTC derivatives held by euro area institutions were sourced from the United Kingdom. In some cases, the City represents a gateway to global financial markets for euro area financial and non-financial firms, allowing them to tap into global capital and liquidity pools. The growth of non-bank financing in the euro area is also driven mostly by entities based in the UK. In other areas, however, reliance on London is quite limited. For instance, UK-domiciled banks only play a marginal role in direct lending to euro area households and non-financial companies. (Source L. de Guindos, ECB speech January 2020).

[9] Equivalence regimes exist for financial services related to securities and derivatives transactions (MiFID, EMIR, CSDR, SFTR) and for services and products targeting professional customers and eligible counterparties (investment services under MiFIR, AIFMD) and reinsurance activities. There is also an EU equivalence regime for credit rating agencies and financial benchmarks. However, most core banking and financial activities are not subject to an equivalence regime providing access to the single market. This includes deposit-taking and lending in accordance with the Capital Requirements Directive; payment services in accordance with the Payment Services Directive; and investment services for retail clients. In addition there is no third-country regime for investment funds targeting retail clients (UCITS and AIFs) and most insurance activities except reinsurance.

[10] The transition period is due to end in December 2020, unless it is extended because of the Covid-19 crisis

[11] For example a sizeable fraction of asset management firms and insurance companies that are relocating activities from the UK as a result of Brexit have moved to either Ireland or Luxembourg and the Netherlands is attracting a substantial amount of trading platforms, exchanges and fintech companies.

ANNEX 1

EU capital markets remain under-developed and fragmented despite recent progress in non-bank funding

Capital markets, particularly related to tradable instruments, have not significantly developed across the EU over the last few years and still lack liquidity and depth from a global standpoint.

The EU-27 average stock market capitalisation is still much lower than that of the US and UK (58% of GDP in EU-27 with many countries having practically inexistent capital markets, compared to 115% in the UK and close to 150% in the US) [12] and the share of listed securities remains limited in the funding structure of EU non-financial companies (28% compared to 47% in the UK and 69% in the US)[13] .

There are however some positive evolutions in terms of funding diversification outside the banking sector, with for example a significant growth of financing provided by non-banks to companies in the EU through the purchase of debt securities , a significant part of which however originates from London[14]. In addition there are no major funding problems in the EU for businesses, except for innovative and growing SMEs that may not have access to sufficient venture capital in the EU or may be rationed out of funding because of a lack of tangible collateral such as machinery or a plant that banks usually require.

On the investor side, issues are two-fold. The share of savings held in shares or investment funds by EU households is limited[15] and only a small proportion of households invest in capital market instruments [16]. As for EU institutional investors, many of them continue to invest predominantly in assets outside the EU in search of yield [17].

EU capital markets are also still highly fragmented, with a persistent home bias in investments [18], and cross-border capital flows have not recovered pre-2008 crisis levels. The market infrastructure also remains fragmented[19] , although efforts have been made to unify regulation and lift the Giovannini cross-border barriers with the European Post-Trading Forum (EPTF) group. This notably leads to differences in the cost of funding and in the access to capital market instruments (e.g. venture capital) across EU Member States[20] .

ANNEX 2

Mapping of CMU 2.0 proposals

A number of reports were published during the second semester of 2019 and at the beginning of 2020, aiming to identify policy priorities for the CMU going forward including CEPS "Rebranding the CMU" (June 2019); IMF staff discussion paper "A Capital Market Union for Europe" (Sept 2019); the Next CMU high-level group (Oct 2019); S&P The EU CMU: turning the tide (Feb 2020).

A mapping of the actions proposed by these reports (see page 4 below) shows that they relate to 5 main areas:

- Demand for capital market products: increasing of the demand of retail and/or institutional investors for capital market products and facilitating the access of investors to the capital markets on a domestic and cross-border basis
- Supply of securities: facilitating the access of issuers to the market in terms of complexity and cost and improving investment vehicles
- Improvement of the current market structure and processes: lifting the barriers to cross-border transactions, improving the resilience and efficiency of infrastructures and intermediaries and developing fintech solutions
- Further supervisory and regulatory convergence: stronger supervisory powers and coordination to improve the consistency of regulations and their enforcement across the EU
- New market developments: development of an EU sustainable finance market, of a government bond market for the euro area and reinforcement of local capital markets in the EU.

These initiatives identify a wide range of areas of work similar to those covered by the initial CMU action plans, combining cross-border and domestic development objectives related to demand and supply factors, digitalisation and sustainable investment.

There are however some nuances. The IMF staff paper published in September 2019 for example takes a more selective approach, mainly focused on building the fundamentals of an integrated EU capital market (central provision of issuer information (an "EU EDGAR"), streamlined withholding tax procedures, improved insolvency procedures, enhanced supervision and a new portable pension product). Certain reports also propose developing new markets in addition to sustainable finance related to euro area debt. Others still, focus more on the retail side of demand as a relatively untapped potential. ■

---

[12] Source The EU Capital Markets Union : Turning the tide – S&P Global – February 2020

[13] Source IMF staff discussion note "A Capital Market Union for Europe" September 2019.

[14] The balance between banks and non-bank financial institutions in the EU has been evolving in recent years: although still very much bank-based, our economy is increasingly financed by non-bank institutions. In the euro area, total assets held by non-banks have almost doubled over the last ten years, growing from €23 trillion in 2008 to €45 trillion in June 2019. Non-banks currently account for around 55% of the euro area financial sector. Their fast growth reflects their expanding role in financing the euro area real economy. Whereas in 2008 non-banks accounted for 14% of the euro area financial sector's loans to non-financial corporations, that share roughly doubled in a decade. Non-banks provide a steady net flow of financing to non-financial corporations through the purchase of debt securities. (Source L. de Guindos, ECB speech January 2020).

[15] Cash and bank deposits amount to 30% of the total assets of EU households, compared to 12.3% in the US and equity and debt securities represent 21% of total savings in Europe, compared to 41% in the US (End 2017 - Source CEPS – Rebranding Capital Markets Union – June 2019)

[16] Moreover only 20% of euro area households hold stocks or investment fund units, and only 1/3 invest in voluntary pension and insurance schemes (Source IMF staff discussion note "A Capital Market Union for Europe" September 2019).

[17] Source The EU Capital Markets Union : Turning the tide – S&P Global – February 2020

[18] Almost half of EU insurers' equity holdings are in firms based in the insurer's home country, rising to 60% in Spin, 70-75% in Germany, the NL and Austria, and 80% in France. The pattern for debt holdings is similar. For pension funds equity home bias is highest in France, Portugal and Spain. (Source IMF staff discussion paper referenced further up)

[19] with 25 exchanges, 17 clearing houses and 19 central securities depositories across the EU

[20] The IMF paper referenced further up shows that typical non-financial companies in Spain for example will pay 60 bp more on debt funding than its peers in Germany and 40 bp more in Italy.

Main proposals of a sample of recent CMU action plans

	CMU action plan I (2015)	CMU review action plan (2016)	HLF categories (2020)	Next CMU (2019)	CEPS (2019)	IMF (2019)	S&P (2020)
Cross-border demand	Barriers to bank held information on SMEs		Access to comparable company data	European Electronic Access Point (EU EDGAR)	Single access point to corporate information	Centralised, standardised reporting by all issuers	
	Best practices withholding tax	Conflict of laws rules for third party effects	Withholding tax issues	Simplification / harmonisation withholding tax procedures		Streamlined withholding tax procedures	
	Insolvency proceedings			Reinforce effectiveness of insolvency regimes across EU		Improve insolvency procedures (EU mini standards, best practices)	
	Fund cross-border distribution					Improve new portable pension product	
Institutional demand	CRR / Solvency II calibrations for infra, Prudential treatment of private equity		Increase risk appetite	Review Solvency II and IFRS9 to incentivise equity holding			
			Liquidity of secondary markets	MiFID II consolidated tape			Consolidated tape
Retail demand		PEPP framework	Adequate occupational and personal pension products	Adequate pensions, Workplace schemes, employee shareholder plans			
	Green paper on retail investment services		Devt of financial literacy, equity culture and advice	Minimum harmonized tax incentive	More transparency of fund costs		Simple and transparent equity products: index-funds
				New High Net Worth category with adapted protection rules			
Supply-related (issuers)	Securisation and covered bond frameworks		Devt of securitsation	Revitalise securitisation markets			
	Review of prospectus directive, assessment of barriers to SME growth markets	SME listing package and proportioanlity for SME growth markets	Facilitate SME listing	Simplified access to equity markets for SMEs MidCaps: Review SME growth market threshold to 500 Mio, alleviate requirements (e.g. MiFID II research unbundling requirement)	Proportionality for access to SME growth markets, consistent SME definition in regulations		
	Debt-Equity bias						
	VC fund of fund framework, EuVECA, EuSEF review, Loan origination fund approach		Devt of long-term investment vehicles	Favour the emergence of large-scale VC funds (e.g. with public funding, tax measures), boosting of ELTIF, EuVECA, EuSEF			
	Crowdfunding framework						
Market structure and processes		EPTF workplan to lift post-trading barriers	Better integration and efficiency of trading / post-trading	Review of CDSR to extend the range of products offered		Centralize oversight of systemic non-bank infrastructures (CCPs) and large investment firms	Clarify the business case of the CMU for banks
		Prudential treatment of investment firms		Support cross-border invest bank mergers reviewing prudential and legal requirements			
		Fintech framework		EU wide digital finance action plan (EU sandbox, digital readiness of legislation, data protection, cybersecurity)			
				Pan-EU payment market			
Supervisory and regulatory convergence		ESA review to improve supervisory convergence and direct supervision powers	Convergence of supervisory outcomes	More coherent supervisory framework improving allocation of powers	Increased supervisory convergence to improve enforcement and investor protection	Upgrade ESMA's supervisory convergence role	
				Reassess regulatory / supervisory balance		Pursue close cooperation with non-EU jurisdictions	
New market development		EU strategy for local capital market devt		A common market for reference assets for the euro area	Devt of Government bond markets and euro safe asset		
		Sustainable / ESG investment	Transition towards sustainable finance	Sovereign green bond market Non-financial reporting standards for NFCs on ESG			Sustainable investment strategy (investor education, ESG criteria, centralised exchange for sustainable SMEs)