Does the EU have the players adapted to CMU objectives?

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Financial structure, Capital Markets Union and Brexit

In this difficult hour for Europe and the world, it is challenging to still keep some focus on medium-term reform agendas. But as the corona crisis management has taken shape and as companies and households embrace the new ways of working and social interaction, we also need to get on with making our economies work better in the future. One European goal is to bring the Capital Markets Union to the next level. In fact, the corona crisis will create a lot of debt, so improving the functioning of capital markets is more relevant than ever!

The need for deepening capital markets in the European Union puts the spotlight on financial structure. Traditionally, bank-based and market-based financial systems have been distinguished, but more generally the financial structure describes the mixture of different financial markets and intermediaries. The March 2020 ECB report on “Financial integration and structure in the euro area” shows that the share of marketable instruments in total financing of euro area non-financial corporations stayed closely around 20 percent since 2002. In other words, securities market instruments, such as listed shares and debt securities, finance a much smaller part of euro area companies than non-marketable instruments, such as bank loans, trade credit or unlisted shares. The marketable part, notably public equity, is significantly smaller than in the United States or Japan, and not increasing. Private equity in Europe is large and rising. But compared to major advanced countries it is not helping many young and innovative firms to grow.

More dynamic equity financing would have at least two key advantages. First, equity investors tend to be more risk-loving than debt investors and finance more innovative companies. Second, recent ECB research suggests that economies with a greater equity share decarbonise faster. Hence, the next set of measures fostering CMU should have a particular emphasis on enhancing the share of public equity in company financing and on rendering private equity a more dynamic source of risk capital.

A number of public-sector policies would have sizeable effects on the demand and supply of equity in the EU. Pension reforms enhancing private retirement savings through diversified long-term investments would have the biggest impact. Second, improving financial literacy would be important, notably by introducing basic concepts in secondary schooling. Third, removing the tax advantage of debt would be very helpful. Fourth, stepping up public funding for life sciences and technology through universities and mission-oriented investments, respectively, could make a large difference. But also, adequate labour and product market flexibility and adequate levels of corporate taxation are important framework conditions under which equity-financed entrepreneurship flourishes.

At present global investment banks service about half of euro area companies’ initial public equity offerings out of the City of London. Should regulatory equivalence with the United Kingdom not be ensured in the future, adequate relocations would have to take place or the EU to build its own capacity. It is important that the envisaged measures for advancing CMU take a forward-looking approach towards this and other implications of Brexit! ●

The views expressed are my own and not necessarily the views of the European Central Bank or the Eurosystem.

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The EU needs strong players for achieving CMU objectives

As this article is being written, the Covid 19 crisis is hitting the European continent hard. It is above all a human tragedy and a terrible shock for the European economy. Europe has so far fed on crises in order to move forward. Hopefully it will also take advantage of this crisis to improve its functioning. It is also likely that in the aftermath of the crisis, a phase of economic reconstruction will begin, in which the problems of deepening the single market will become more acute.

As far as the Capital Markets Union is concerned, the Covid 19 crisis tends to demonstrate at this stage the difficulties to respond on a pan-European basis. Without going into an exhaustive review of the outcome of this crisis, several instruments are now sorely lacking to the European supervisory agencies (the so-called ESAs: namely EBA, EIOPA and ESMA). The 2018-2019 ESAs review will be reminded as a missed opportunity to prepare for this situation. Diverging views within the EU Council have prevented the ESAs from being given necessary supervisory tools. To quote only ▶

two instances, no-action letter powers are today lacking to selectively suspend the application of certain rules and direct supervisory powers would have been helpful to simplify reporting or limit pro-cyclical effect of the supervision in a uniform manner across Europe. The fact that the only coordinated market supervision measure adopted during the crisis was to lower the threshold for short selling reporting speaks for itself.

As for European private actors, the crisis overall means that capital markets will have to bring their contribution to fill the investment gap, in a context where possibly the banking channel could be hindered by the incoming prudential requirement. Three strategic fields provide valuable examples: insurance, investment banking and private equity fund.

In this regard, insurers, which are long-term investors by nature, are key to foster equity financing for our firms, and could be mobilized for our challenges for the future, such as digital and sustainable transition. Beyond, we need such long-term countercyclical investors to stabilize EU capital markets. The review of Solvency 2 can bring a significant contribution to this objective allowing insurers to fully play their role in the economy. This review should be led consistently with a reform of accounting standards, which have an unintended negative impact on investment in equities for insurers.

In the same vein, the CMU will not succeed without thriving European CIBs. This is all the more true as banks will play a central role in the recovery. It is therefore desirable to ensure that the transposition of Basel III standards takes into account what other jurisdictions will actually do, in order not to put European banks at a competitive disadvantage. Similarly, the use of the European framework for Simple, Transparent and Standardized securitizations (STS) needs to be encouraged in order to facilitate the management of banks' balance sheet. To achieve this, a review of impediments to the development of STS products should be carried out.

Private equity has gathered momentum, but it should scale up in the field of venture capital. Europe needs more funds that can issue larger tickets. We need to invest much more to stay in the innovation race – on artificial intelligence, on space, on energy storage. Hence it is crucial to promote a single globally recognized European standards. As for today, the EU labels a few funds invested in non-listed assets. Among them, the European Long-Term Investment Funds ("ELTIF") appears to be in the best position to emerge as the European standard, in a UCITS-like manner for listed assets. To encourage the promotion of the ELTIF as the European standard, further work is required to ease its passporting, alleviate its fiscal treatment throughout Europe and enhance the applicable regulation in order to facilitate flows of investments and disinvestments.

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A new CMU: building strong EU public capital markets to finance the real economy

The current sanitary crisis is unleashing nationalistic tendencies that go beyond what is needed for the coordination of health measures at national level. Everywhere, we observe the temptation of "my country first", "my banks first", "keep the cash in my country for now" and many other signs of eroding European ambitions. In contrast, the Covid-19 crisis actually underlines how important public capital markets and CMU will be for the recovery, once it comes. But this will need to be a fundamentally different CMU. It will have to factor in the consequences of Brexit, recent central bank interventions and fiscal stimulus measures, as well as the very real risks of fragmentation of our capital markets.

In order to mitigate these risks, we must structure the new CMU around two ambitions.

First, a competitiveness ambition. If Europe wants to provide citizens, businesses and society at large with the tools to turn these challenges into opportunities, it needs a vibrant single market for financial services.

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In this respect, Europe must be a continent of strong and competitive finance makers, not an open territory of finance takers. Therefore, every measure contemplated in designing the new CMU must be assessed by a systematic "competitiveness test", which is more specific than the usual Commission impact assessments. This test should analyse - before new rules are introduced - whether they will make the EU's capital markets, financial institutions and infrastructure, stronger or weaker. If we want to unite capital markets, we

need capital markets to be united. If this sounds obvious, then let's do it to stop the unilateral disarmament of the European financial system.

Second, a simplification ambition. Commission President Ursula Van Der Leyen has been clear that the regulatory philosophy of the Commission should be driven by the principle of "one rule in, one rule out". This simplification ambition is key to making the new CMU a success. Across the EU, investors, asset managers, issuers and all the other market participants need a pause in the continuous flow of incremental reporting obligations and operating constraints. Too often, such measures have a material impact on operations and profitability, without any tangible contribution to the unification of markets. Before proposing new rules under the new CMU, there must be a systematic assessment of what works and what does not work in MiFID II, MAR, Prospectus, Solvency 2, CSDR and the other pieces of regulation that have transformed markets over the past few years.

Many of the intended objectives of these regulations were not reached and some unwanted consequences have emerged, without the tools to mitigate the negative impacts on EU markets. This is a credibility test for the EU's regulatory ambitions. Either the new CMU will make all market participants' lives easier, with simpler rules, and trust in EU integration will grow. Or it will continue to add reporting obligations, follow a micro-regulatory approach, and market participants will turn to their national regulators and supervisors for more pragmatic solutions. Over-regulation will kill CMU and weaken Europe.

Euronext's ambition, by nature, is to be the backbone of the European capital markets. We want the new CMU to be a success. This is why we believe it is crucial that the new CMU be radical on these joint ambitions of competitiveness and simplification. ●

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EU competitiveness does include financial services

In Europe, banking groups are the main actors offering capital markets products to retail and corporate as permitted by the regulation. Banking and Capital Markets services are complementary and mutually reinforcing, each supporting the other by broadening the financing options available to their clients. The high level of financial regulation and supervision (AML, Prudential, Conduct, Anti-fraud etc.) is the result of a few crisis and 30 years of regulatory and supervisory efforts.

Banks contribute to the collective interest while expanding their expertise and their range of services including capital market solutions to corporate and retail clients. Banks are helping clients to diversify their source of financing or investments as advisers, issuers, information providers, brokers, market-makers, asset managers, insurers and payment providers. Banks are naturally very well placed, with their strong client knowledge and the development of long-term partnerships to educate them, to help them adapt to all stages of their development, advise them on the best way to enter and use capital markets.

European companies need, in their immediate environment, stable and long-term financing partners to preserve their competitiveness, especially in case of crisis. It is becoming increasingly clear that EU needs a strategic financial autonomy: make bolder decisions, retain talents and their added value & profits, build on stable, reactive, and efficient financing channels, with decision centers located near European companies and key markets infrastructures. Regulation should support this need, especially in the context of the Brexit. EU is losing the UK's well-integrated financial center and its key market infrastructures (LCH, LME, LSE etc.). UK is intending to diverge while keeping access as much as possible to the EU market. It is time for EU decision makers to make the competitiveness of our financial industry one of the top objectives of all EU financial services regulation in addition to address financial stability and client protection needs.

For instance, the implementation of global standards (e.g. Basel) should not undermine our current strengths and specificities (e.g. infrastructure financing). The calibration of the EU market access is also crucial: an interdealer regime is needed to access worldwide liquidity, while all significant client activities should progressively be performed from Europe. Each equivalence should remain unilateral, granted after a thorough review, assessing competitiveness, financial stability and client protection, requesting an EU entity above a certain volume of activity.

> *EU needs strong European financial players to build an attractive and sustainable CMU.*

EU market attractiveness deserves more national and supervisory convergences, a prudential recognition of the Eurozone as a single jurisdiction and well-known measures to improve the quality of the client marketing/selling process (MIFID, PRIIPS). It also needs to foster an EU digital and green market: we would suggest creating an EU database to cover among others, NFRD corporate requirements, while maintaining reasonable costs for users.

To build an efficient CMU at the service of its economy, the EU needs to improve the attractiveness of its market for end-users as well as to preserve the competitiveness of its financial actors. ●

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EU Capital Markets integration: be pragmatic and focused for real achievements

Today there is full consensus that the CMU project did not deliver enough during the previous European Commission mandate: even if some progress have been made in some specific, but limited areas, much still needs to be done.

In view of ensuring that right measures will be embraced, it is important to understand why integration of capital markets has still to be pursued despite huge efforts already produced. First, national specificities due to multiple cultural, economic and historical factors, still exist between Member States and are deeply rooted. Many regulatory initiatives to reduce this fragmentation have been launched but are stil to be effectively implemented (such as the CSD Regulation) to produce their full effect and reinforce capital markets integration.

At the same time, we still see diverging interpretations in the effective implementation and local transposition phase. This is typically the case for reporting requirements where national discretion still prevails. The insufficient cooperation between national competent authorities on this part, plus the absence of truly convergent supervision in many instances, harms the emergence of a truly single market and consequently the provision of cross-border services.

Complexity of the regulatory framework is another impediment to the effective capital markets integration. Due to heavy and costly requirements that may need to be replicated across jurisdictions, few players are ready and properly equipped to engage in cross-border investments or provision of such services.

In that context what should be the main priorities of public authorities to enhance the role of capital markets in completing the CMU? First reconsider the list of identified obstacles to this integration and select pragmatically which ones should be tackled in priority. The approach must be selective and realistic to ensure real progress will be achieved. As an illustration, whereas practices for corporate actions and withholding tax should be further harmonised, harmonisation of securities law should not be pushed forward.

Next recommendation is about addressing the current complexity of some EU measures that impede the developments of cross-border activities across the EU. Some regulatory regimes should be reviewed to simplify current requirements and introduce further proportionality when relevant. The revision process launched for MIFID2-MIFIR is a great news in this respect provided that it does not deviate from the initial target of limited and focused review.

> *The approach must be selective and realistic to ensure that real progress will be achieved.*

It is also crucial that there is an increasing cooperation between national policy makers and supervisors. In that space, additional powers should also be given to the ESAs where transversal approach should prevail across the EU.

This comprehensive set of measures should result in preserving and even strengthening the competitiveness of the EU financial sector. In parallel, leveraging new technologies to solve some persisting integration issues should be given the required level of attention. Fostering harmonisation and standardisation, while ensuring level playing field between all players, should prevail in this new space to ensure a real transversal framework will emerge and that errors from the past will be avoided. ●