

The Capital Markets Union: Background and Challenges

Christian de Boissieu

Professor Emeritus at the University of Paris I Panthéon-Sorbonne

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Abstract:

The Capital Markets Union (CMU), together with the Banking Union, is a major programme of financial Europe. Its objective is to boost investment, growth, and employment through increased efficiency and deepened integration of European financial markets. This article will first review the CMU's objectives, ways, and means, and will then touch upon the challenges that must be overcome to bring such an ambitious project to completion.

After conducting preliminary work, the European Commission released an Action Plan on Building a Capital Markets Union (CMU) in September 2015. Its outward goal "to strengthen Europe's economy and stimulate investment to create jobs", was both ambitious and unambiguous. Since then, this Action Plan has been expanded, and drilled down along several broad themes on multiple occasions.

The CMU does not exactly complement the Banking Union (BU), which was launched in November 2014 when its first pillar, the single EU-wide bank supervisory mechanism was implemented. It was further strengthened in January 2016 when its second pillar, the single EU-wide bank resolution system was put in place. Indeed, the scopes of the two programmes do not overlap. The CMU is aimed at EU Member States while the BU is intended for euro area countries. It was said that the BU was also open to countries outside the euro area, should they wish to join. While a few countries appeared to express interest, they did not take any further action. In practice, it is hard to imagine a country might participate in the BU without being part of the euro area.

The CMU's Action Plan was thus released nine months before the Brexit vote. One must keep in mind—and we will discuss this further later—that the project was conceived under the assumption that the United Kingdom and London's City would be fully-fledged stakeholders in the project, and since this is no longer the case, it is now necessary to readjust the CMU's objectives, ways, and means.

After reviewing the CMU's main objectives, we will touch upon the many diverse channels used to reach said objectives, as well as the challenges and delays encountered during the project's implementation.

Relevant, ambitious objectives

Meeting the challenges of the European economic context

Until recently, the EU's major economic and social challenges have been sluggish growth and mass unemployment. Despite a stronger-than-expected recovery, this observation remains mostly relevant in 2018. Indeed, potential growth, the baseline around which actual growth fluctuates, has remained weak and future forecasts are lacklustre. In France and Germany, and in the euro area on average, annual potential growth is forecast at 1 to 1.5% (forecasts vary not only by country but also depend on the models used for each country). In Germany, demographics—despite recent immigration waves—hamper potential growth. France's potential growth is hindered by our lack of competitiveness and a relative rigidity of the labour market (this rigidity is being mitigated thanks to the structural reforms implemented since 2017).

The CMU can help foster potential growth across Europe, and therefore actual growth and employment. The project aims to place finance at the service of the real economy by boosting investment and employment. No one should expect any miracles though. The CMU is intended to supplement structural reforms implemented in Member States, in no way should it serve as a substitute for these reforms.

Strengthening European financial markets' efficiency and competitiveness

When it comes to financial markets, transaction volume is a critical argument. Indeed, economies of scale are almost unlimited and help lower unit transaction costs. The depth of a market also impacts its liquidity, as measured in reference to the turnover of the secondary market, which, since the financial crisis, has become a key factor in portfolio decisions.

With the exception of London's City, European financial markets rank well below US markets in terms of volume, depth, and liquidity. This is partly due to their fragmentation. The CMU therefore aims to fill part of this gap, which should impact the EU's attractiveness in terms of portfolio investment as well as the formation of interest rates. Today, as all empirical studies demonstrate, US long-term interest rates continue to influence long-term European rates (but the reverse is not true). Once financial markets in Continental Europe are finally able to compete with US financial centres, the determination of interest rates will be less one-sided. Behind volumes and liquidity lurks Eugene Fama's concept of "efficiency": do market prices instantly and unbiasedly reflect the available information? For a financial centre to be competitive, its degree of efficiency is critical. The European Commission's Action Plan for the CMU actually refers to the "effectiveness" of financial markets, but in practice this also relates to the concept of efficiency in financial theory.

Deepening Europe's financial integration

The crisis affecting the euro area since 2010 has increased the financial fragmentation in what should be a single capital and financial services market. For the “weakest links” of the euro area, interest-rate spreads (calculated in reference to German interest rates) have risen significantly, peaking in 2011-2012 when Greece almost withdrew from the currency area; investors tend to rely more heavily on their domestic markets, which means that the “home bias” already prevalent in portfolio selection has become even more pronounced because of the EU's internal crisis.

The CMU aims to counter these centrifugal tendencies by fighting off fragmentation, thus boosting financial integration in the EU. Which also means bolstering the transfer and reinvestment of savings from countries and regions with financing capacity to countries and regions in need of financing. This objective is often presented as monetary transfers from the North to the South of Europe. To some extent, this observation is correct, but if you look into the statistics of each Member State, it might be a bit oversimplifying. The challenge here is political rather than financial. The “right” financial institutions and the “right” financial tools can quite realistically be put in place to carry out such transfers. Countries with a savings surplus also tend to display structural current account surpluses, whereas countries with a savings deficit tend (by definition) to run chronic current account deficits. Is Germany, a country with a twin surplus (for both current account and savings), politically and culturally willing to finance part of Southern Europe or even a country like France? This is doubtful, given that Germany and countries like the Netherlands or Finland that usually follow in the German footsteps, have been opposing the third pillar of the BU—the implementation of a European deposit guarantee scheme. If the Germans no longer want to pay for “others”, this implies that the reinvestment of savings within the EU, whether through private networks or public institutions, will prove to be more complicated than initially posited in the CMU's Action Plan.

Enabling disintermediation

Europe has recently entered a new financing disintermediation phase, following an earlier phase during the 1980s through 1990s. This was due in part to stricter requirements for bank financing under the Basel III framework, and also to the emergence of new types of financing such as crowdfunding or “fintech” in general. When producing comparative analyses of financial systems, economists usually make a distinction between two modes of financing: bank financing and market financing i.e., disintermediated financing. To more accurately reflect current reality, it is necessary to consider three types of financing: 1/ bank, market, and hedge fund financing, 2/ private equity, 3/ monetary market funds, property funds, etc. Some funds are connected to banks, in which case they fall under bank financing, while funds independent from financial intermediaries represent non-bank financing.

The CMU's objective is thus to enable and even accelerate the process of disintermediation across Continental Europe, which would happen regardless. The rise of non-bank financing is likely to generate winners and losers. It constitutes a challenge for SMEs, who are highly dependent on bank financing because of their limited access to market financing. This explains why the CMU includes special arrangements for SMEs, which we will review later on, and which allow to "manage" and somehow mitigate the immediate outcomes of disintermediation.

Promoting long-term financing

Putting finance at the service of the real economy means that it is necessary to consider the time horizon of financing projects. Without getting into too much detail, one can expect that the two liquidity ratios introduced by Basel III will restrict long-term bank financing. Paradoxically, we are entering an era in which long-term financing will be increasingly necessary, for instance to finance sustainable development, the fight against climate change and the objectives of the COP21, various types of infrastructure projects, etc. The CMU aims to bolster such long-term financing activity. But good intentions are often not enough. Financial markets—often criticised for their short-sightedness—must be encouraged to take a longer perspective through relevant public measures, notably tax incentives. When it comes to financing through funds, some are focused on the short term by design, like monetary market funds or hedge funds, while others, like private equity funds, opt for a medium- to long-term outlook.

A project with multiple, diverse, and complementary directions

Boosting securitisation in Europe

Without securitisation, i.e., without the ability to resell unmatured loans on a secondary market, banks would be much more reluctant to grant loans, especially when it comes to long-term credit such as for housing. Stimulating securitisation, which connects banks and markets, is a necessary measure—but by no means sufficient—in order to reinforce disintermediation while making it easy for banks to manage their commitments.

Together, we must learn from the 2008 financial crisis. Securitisation as it existed before 2007 in the United States or elsewhere was too complex and opaque. As a result, and for other reasons as well, ratings agencies had tended to overrate securitisation vehicles.

Learning from the financial crisis means that we need to start with a clean slate. Within the framework of the CMU, the European Commission promotes the "STS" label (Simple, Transparent, Standardised). While it is hard to argue against that, the question remains as to who should award this label? The European Securities and Markets Authority (ESMA), the EU financial regulatory authority, might have taken on that role or even the ratings agencies, as long as they didn't repeat the mistakes made prior to 2007. It was decided that the institution originating the securitisation would award itself the shiny label *ex-ante*, with

ESMA being involved only *ex-post* at best. How this process will work out in the long run remains to be seen. Without jumping to conclusions, this poses the risk of a real conflict of interest for the originator of the securitisation.

Supporting SMEs

In many European countries, growth and employment are positively correlated with the health of SMEs, which itself depends on their ability to obtain financing. The CMU must ensure that SMEs benefit from the growth of financial markets, which as we saw earlier, is not a given.

Developing non-bank financing for SMEs implies the removal of the structural barriers affecting the supply and demand of securities. As far as supply is concerned, SME owners may hesitate to open even a tiny part of their capital, for fear of letting in a “Trojan horse”, which might challenge the way they manage the business. The CMU cannot pretend to provide an effective workaround for that. In all our countries, the minimum equity stake that can be sold in an SME IPO on SME-focused exchanges (like Alternext for Euronext) was gradually lowered, but we haven’t witnessed a jump in SME listings. The CMU’s preferred policy is to lower transaction costs for SMEs that seek financing on capital markets. To this end, the EU’s Prospectus Directive was revised to lower the requirements and in turn, costs, for applicant companies.

As far as demand for securities is concerned, investors are not exactly rushing to invest in SMEs, even when, as is the case in France, tax incentives are granted. This is mainly due to the high risk, low transparency and lack of liquidity on the SME secondary market. Even when these securities are accessible through products offered by commercial banks that allow for mutualisation of risk, they still fail to garner much momentum, as shown in France by the lack of interest for the *PEA PME* (a share savings plan focused on SMEs) in spite of the tax incentives offered.

Creating European financial vehicles

Several initiatives were launched to create EU-wide savings products.

European Venture Capital funds (EuVEECAs) were introduced by a 2013 EU Regulation before the CMU was even launched. Their goal is to promote the financing of unlisted companies to investors, professional or not, who commit to investing a minimum of 100,000 euros. These funds were met with tepid enthusiasm due to a reported lack of transparency about potential risk, and the heterogeneous nature of the SMEs targeted. These concerns are amplified by the European dimension of the investment, and add up to the obstacles already found on domestic markets. The CMU breathed new life into EuVEECAs after a few adjustments were made. Investors’ concerns are similar for the European Social Entrepreneurship Funds (EuSEFs), also launched in 2013 and which might find renewed momentum thanks to the CMU.

As for European Long-Term Investment Funds (ELTIFs), they offer an interesting potential. Launched in 2015 in close coordination with the launch of the CMU, they aim to bring long-term funding to support infrastructure projects, unlisted companies, or even SMEs listed on stock exchanges. Today, ELTIFs are approved by their domestic financial regulator—not by ESMA. As of May 2018, France’s financial markets regulator AMF had approved 9 ELTIF vehicles since 2016. At the EU level, a positive move was made with the relaxing of the Solvency II Directive in relation to this type of financial vehicle, which lowered the equity requirements for insurance companies investing in ELTIFs compared to the initial regulations.

Besides, the EU has decided to harmonise regulations regarding crowdfunding. This is a welcome initiative, as crowdfunding platforms operate beyond borders and that domestic regulations have until now been very diverse. In 2018, the European Commission launched a consultation on a proposed regulation on crowdfunding, aiming to wrap it up by the end of the year. Across Europe, discussions on the contents of the regulation involve, among others, the maximum value of the projects to be financed or ESMA’s future role. The stakes for France are not insignificant, given that our country is the second largest European market for crowdfunding behind the United Kingdom.

Last, there is a project to create an EU retirement savings product, which is actually how the CMU got started in the first place. Not much progress has been made, however, on this ambitious project. The requirements are indeed stringent, as this type of product can only make sense if it can rely on total tax harmonisation across the EU. While the project sounds like a good idea, its implementation is extremely complex.

Connecting the CMU and the Juncker Plan

Channelling savings towards investment projects to boost investment and growth is the leading theme not only of the CMU but also of the Juncker Plan, which was announced in July 2014 before the CMU was launched, and which now must be coordinated with it.

Scheduled to end in 2018, the Juncker Plan was extended through 2020, and its budget was increased from 350 billion euros in public and private financing to 500 billion euros over the entire period. The Juncker Plan relies on the European Investment Bank (EIB), and especially on the European Fund for Strategic Investments (EFSI), which is essentially managed by the EIB. The Juncker Plan’s targets are similar to the CMU’s and include financing of infrastructure projects, of innovative SMEs or mid-sized companies, or of the energy transition.

Implementation challenges

A preliminary assessment of the CMU

At its inception, the CMU's Action Plan identified 33 initiatives or "actions". According to the European Commission, half of these initiatives were completed by the end of 2016. In June 2017, a set of nine priority actions were added, addressing topics such as fintech, sustainable finance, or cross-border investments. It still is too early to assess progress on these new initiatives.

Beyond formally listing which initiatives have actually started, it should be noted that some are experiencing delays in several key areas. In fact, the CMU has been at a standstill since 2017, as if the priorities of the Member States were elsewhere. Why is this happening? Several factors, each seemingly important, explain this situation: the completion of the Banking Union is facing political—not technical—hurdles; the euro area's economic recovery, while not tremendous by any means, is still better than expected, and in the short term (but certainly not in the long term), this contributes to weakening the argument that the CMU would drive stronger growth; European leaders are concerned about, and devoting more of their time, to international tensions; etc. As a matter of fact, the international context itself— particularly Donald Trump's unilateral decisions and the extraterritorial application of American rules— should compel the EU to go ahead, complete the BU, and make the CMU a reality.

A macro-financial context likely less favourable

The CMU was conceived at a time when the US Federal Reserve was in the process of ending its unconventional monetary policy. It now must exist in a different interest rate situation. The Fed has raised its interest rates on several occasions, a trend that, as of May 2018, is likely to continue. The ECB is also likely to begin tightening its policy by the end of 2018 or early 2019. In addition, Donald Trump's tax and fiscal policy, by deepening the federal budget deficit and raising inflation, is likely to help drive up US long-term interest rates, which have already been on the upswing for a while. Should that happen, European long-term interest rates are also likely to rise, an increase that may be partially mitigated by a strong euro. This is the reason why the ECB, regulators, and all professionals operating on the global markets must prepare for the financial consequences of interest-rate normalisation. Liquidity will become even more of a determining factor for the resilience of the bond markets in the wake of rising long-term interest rates. Far from discouraging the CMU's stakeholders, such an argument should encourage them to fine-tune the project's objectives, ways, and means according to the macro-financial context expected in the coming years.

The CMU without London's City

With Brexit, the United Kingdom as a whole will lose its EU passport, but the consequences for the banking and financial sectors will be particularly significant. Once the UK becomes a “third-party country”, it will need to negotiate an “equivalence” agreement with the EU27. Current negotiations focus on whether the equivalence will be global (the “enhanced equivalence” requested by the British side) or whether it will be on a case-by-case basis, depending on the activity, which is the position championed by Michel Barnier on behalf of the EU27.

Whatever the scenario, the guaranteed loss of the EU passport is already fuelling the relocation of business activity from London to Continental Europe. This should theoretically play in favour of the CMU, except when you consider two essential details. First, with London leaving the CMU, the project will lose the City's business volumes, expertise and talent. Second, while Continental Europe's financial centres would be well advised to cooperate rather than fight each other, it appears that their current frame of mind leans towards confrontation. Good examples of this include the fierce competition between pan-European stock exchange Euronext and German derivatives exchange DTB or the battle between financial centres around the potential or likely relocation on the Continent of London-based euro-clearing Central Counterparty clearing houses (CCPs). Finding the right balance between competition and cooperation between the financial centres outside London (Frankfurt, Paris, Luxembourg, Dublin, etc.) will prove critical for establishing appropriate ambitions for the CMU.

What role for ESMA?

The integration of the markets and the organisation of supervision must be closely aligned. The expansion of ESMA's remit and resources is a logical counterpart to the CMU. In fact, well before the CMU was initiated, many tasks had been gradually transferred to the EU financial regulator: the approval and monitoring of the ratings agencies; the approval of trade repositories (TRs); the drafting of guidelines regarding the implementation of directives and regulations; and so on. By design, the CMU encouraged the accelerated transfer of competences from domestic regulators-supervisors to ESMA for CCPs, EU funds such as EuVECAs and ELTIFs, and transnational crowdfunding platforms. In May 2018, the European Parliament adopted a resolution organising ESMA's control over London-based euro-clearing CCPs after Brexit. This is a topic worth monitoring, to check whether it actually is implemented.

Claiming national sovereignty (what's left of it), some Member States, and important ones at that, are dragging their feet regarding these transfers to the EU regulator, a behaviour that is fairly inconsistent. Two possible scenarios appear. The first one—the most positive, and the one that needs fighting for—is that Europeans still believe in the CMU and will do whatever it takes to bring it to completion, accepting its institutional and political implications. The second scenario has Europeans bailing out, another proof of the indecision, if not the helplessness, of the EU. A middle-of-the-road scenario is not an option here. In the long term, ambiguity is by no means constructive.