Tuning ‘Capital Markets Union’ to deliver an engine for European Growth

December 2014
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Introduction

In September the President to the European Commission, Jean-Claude Juncker, tasked Lord Hill in a letter to the incoming Commissioner designate, with “bringing about a well-regulated and integrated Capital Markets Union, encompassing all Member States by 2019 with a real view to maximising the benefits of capital markets and non-bank financial institutions for the real economy”.

‘Capital Markets Union’ marks the beginning of an important shift in the perspective and emphasis of policymakers from a post-crisis perspective, which was a regulatory agenda very rightly dominated by measures to establish financial stability and restore confidence, to a new focus on how to regain much needed economic growth in the EU. Nevertheless, the BBA believes it will continue to be important to maintain investor protection and stability as key objectives.

BBA members strongly welcome this initiative and will do all they can to contribute further analysis on how Capital Markets Union can be achieved successfully. The BBA considers Capital Markets Union as a key opportunity for the EU and an important opportunity for financial services providers to contribute through capital markets to economic growth and to fund jobs for EU citizens. In this respect, we would urge the European Commission to help all participants become very clear as to what the full range of potential users of EU capital markets would really want from a Capital Markets Union. We note that this should be a two-way dialogue, to ensure EU citizens and retail consumers are also aware of the benefits that capital markets can offer them both directly and indirectly.

The BBA considers Capital Markets Union’s purpose to be to strengthen the single market and to deliver a single rulebook for the EU. Unlike the Financial Services Action Plan (FSAP) of the recent past it will be critical that the measures therein are not simply a menu of legislative proposals, but rather a set of effective initiatives which are capable of delivering practical real-market, economic outcomes to ensure Europe’s financial markets can deliver the financing necessary for growth. The BBA would therefore propose that a key element of the framework should be to set measurable outcome-based targets that can be achieved in the short and medium-term. Furthermore, rather than focus on creating new supervisory structures, we would encourage the EU to ensure the European Supervisory Authorities are equipped to deliver supervisory convergence and a greater shift in their focus be made towards converging day-to-day implementation rather than rule-making.

For the success of this agenda and deeper capital markets, the BBA considers it critical that the EU ensures the measures that are adopted encourage international investors and issuers into EU markets and guarantees that Europe remains open and internationally competitive.
Economic context

1. Many commentators have noted that Capital Markets Union will have a number of key benefits. A broader financial system helps promote growth as it allows a greater range of financing options, reducing the overall cost of capital, supporting more efficient resource allocation, and is more resilient in the case of shocks.

2. US businesses are less reliant on bank funding as the US has more active and diversified capital markets, providing them with a wide range of alternative funding sources. The US system has deeper equity markets willing to provide finance to a wider range of businesses and public and private debt capital market issuance is an important source of non-bank provision of credit to the economy. As a result, bank funding provides a smaller share of total credit in the US compared to the EU. Europe should recognise the benefits of some elements of the US model.

3. There is evidence that financial market depth (achieved via bank and market-based financing) is an important determinant of a country’s economic development. There is also evidence that capital markets support growth once a high level of development has been reached.

For more detail on the economic perspective of Capital Markets Union, please see Annex A.

Capital Markets Union

4. A guiding and clear mission statement for this initiative can ensure proposals included are clearly focused on outcomes. The BBA would suggest that a mission statement which encapsulates the following conditions and objectives would be helpful:

Capital Markets Union will:

- Reduce fragmentation and increase the depth of the EU’s capital markets to lower the cost of capital and improve its allocation, and by so doing, better support Europe’s growth companies to deliver jobs and advance growth in the EU economy as a whole.

- Ensure that Europe’s capital markets are internationally competitive and attractive to both investors and issuers by giving them proper protections, reduced complexity and uncertainty and increased competition. Wherever possible these measures should be non-legislative and market-based.

- Develop a more diverse financing system that is better able to withstand future economic shocks and helps to safeguard Europe’s future by making its financial system more resilient.

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Principles and Characteristics that should be integral to Capital Markets Union

5. The BBA would propose that the agenda of Capital Markets Union should be interpreted broadly rather than narrowly, identifying measures that:

- **Support scale in EU capital markets** in order to ensure they are internationally competitive and sufficiently deep and liquid. This will require ensuring that the Better Regulation agenda incorporates an assessment of EU legislation against whether it supports or inhibits issuers’ and investors’ use and access to capital markets, as well as reviewing the impact of legislation on market-making to ensure there is greater liquidity in EU capital markets.

- **Support the movement of capital across borders**; such as measures to increase securitisation of loans to businesses and unlocking cross-border pension fund investments.

- **Support issuers of all sizes across the EU and internationally**; for example by encouraging private placements for firms, particularly for small and medium-sized firms, who may not be ready to list, and by ensuring there is an appropriate framework to facilitate firms’ transitions from small enterprise to large company (i.e. that ‘cliff edges’ are not inadvertently created).

- **Support investors across the EU and internationally**; through for example harmonising and simplifying information prospectus requirements.

- **Strengthen the infrastructure that supports capital markets issuance and trading**, for example by pursuing the development of a recovery and resolution regime for Central Counterparty Clearing Platforms and other Financial Market Infrastructures.

6. The BBA would strongly welcome a Capital Markets Union agenda that is a non-legislative approach to Capital Markets Union wherever possible and would encourage innovative and flexible market-based solutions to deliver powerful results. In offering more detailed suggestions, some key assumptions should underpin this initiative, as outlined below.

7. **Banks are integral to the development of capital markets in Europe and support other participants in using capital markets**: Banks and capital markets are not competing sources of financing. They are complementary and Capital Markets Union should ensure the framework for a virtuous co-evolution of banks and capital markets. The development of one should not be perceived as being at the expense of the other. Banks are not only direct lenders, but play a critical role in capital markets as intermediaries. By acting as intermediaries, banks encourage the circulation of savings capacity to be moved around the economy creating jobs and growth. Indeed, financial intermediation offers major benefits of:

- **Maturity (converting short-term liabilities to long-term assets, i.e. banks deal with large number of savers and borrowers, and reconcile their conflicting needs);**

- **Risk transformation (converting risky investments into relatively risk-free ones, i.e. lending to multiple borrowers to spread the risk);**

- **Convenience denomination, i.e. matching small deposits with large loans and large deposits with small loans.**

It is possible for this to be done by direct contact between the ultimate borrowers, but there are major cost disadvantages of direct finance. Banks also play a role in market-making which contributes significantly to liquidity in capital markets. This encourages investors such as pension funds (who may be a source of market-based finance) to invest in shares that would otherwise be illiquid. Additionally, banks’ role in securitisations has the effect of certifying a borrower’s credit quality via credit analysis and the capital market provides financing. Whilst policymakers have generally focused on direct lending, more strategic policy thought needs to be done to ensure that financial intermediation can provide support for other sources of funding. Capital Markets Union provides a key opportunity to address this, including taking a fresh look at how prudential rules might be impacting market-making.
8. Drawing on international comparisons for good practice (often for these purposes, with the US), are helpful, but should be done thoughtfully: It should be borne in mind that statistics on the extent of non-bank finance in the US are impacted by the existence of the government-sponsored enterprises whilst Europe's Member States have and will continue to evolve differently. Further, not all processes or structures of good international practice need to be applied or re-developed nationally. For example, capital markets in Member States whose scale is possibly too small to justify the development of an efficient capital market must be enabled to access larger financial markets to ensure economies of scale, rather than try to replicate these locally. To this end, initiatives should be aimed at ensuring improved access to the larger financial centres across Europe, linking local economies to the regional or international capital market infrastructures. Initiatives aimed at adding depth to the major financial centres in Europe can also therefore be of benefit to the markets in other Member States, and this will ultimately help their domestic capital markets to develop. The European Commission's initiatives in the area of private placements for example should be supported as it provides an alternative to bank lending and bond issuances for mid cap and large issuers, and by so doing, diversifies the means of funding for firms. This latter example illustrates an appropriate use of the US experience in offering loans underpinned by a safe harbour exemption, similar to good practice in the German capital markets. In this context, both these models might therefore be usefully explored further, to strengthen European private placements markets. One additional point is that non-bank financing funding in EU national markets is also at different stages of development, and measures to support this development should be considered. The EU should be confident that the measures it is proposing are not stifling these important sources of financing, whilst having due regard to financial stability and investor protection.

9. Reviewing elements of existing and planned legislation (both at Level 1 and 2) is critical to ensure that measures adopted do not unintentionally thwart the objective of growth in capital markets: Following the crisis much has been done to restore financial stability to Europe's banks and financial markets, nevertheless, the speed and radical nature of these measures both currently implemented and in the pipeline may have fostered forces which inhibit growth and funding through capital markets. For example, it is widely recognised that bank capital rules under CRD III and Solvency II do not encourage securitisation and do not differentiate between complex and simpler forms of securitisation. Harmonising disclosure requirements on an EU-wide basis would also be helpful. Furthermore, it will be critical going forward that the Better Regulation agenda and the principle of subsidiarity are better integrated into the assessment of whether to legislate in the future and should shape legislation where it is still deemed necessary at EU level. For example, proposals for banking structural reform, or a new financial transaction tax, or proposals that undermine CNAV MMFs, could significantly undermine the objective of Capital Markets Union and its attractiveness to external investors.

10. An example of legislative impacts running counter to the objective of Capital Markets Union, in a Level 2 context, relates to proposals under MiFID on capital markets research. ESMA has proposed that investment research should be regarded as an inducement and therefore should not be funded from dealing commission. The proposals will have wide-ranging impacts, including reducing the incentives for researchers to provide research on EU SMEs and midcap firms, where more information is actually needed if these firms are likely to benefit from access to EU capital markets, and reducing the EU's attractiveness to international investors as the reduction in research coverage is likely to stifle investment into EU companies from the US and Asia.

11. Integrating with other EU initiatives for maximum effectiveness: For maximum success that delivers economic growth and jobs for EU citizens, it will be valuable to consider how initiatives can be integrated with other EU agendas, and again, this need not be purely legislative. For example, the development of a green kite-mark and accreditation of green bonds could helpfully encourage environmentally-minded investors with specific recognition in investor rules and thus support the efforts of Commissioner Cañete, in encouraging economic growth that is environmentally sustainable. Similarly, ensuring that financial regulation is technology neutral and supportive of the digital agenda will be critical both in job growth and competitiveness of Europe. BBA members welcome Juncker's investment plan for Europe and the EU initiatives to support long-term investments which will particularly assist in financing infrastructure projects.
12. **Capital Markets Union must deliver for the retail investor and the EU citizen**: Much of the recent efforts to review legislation following the financial crisis have been intended to restore confidence, ensure greater transparency and protect investors. This remains important. The ability of retail investors to grow their pension savings, through greater product choice, deeper and more liquid capital markets, particularly following the financial crisis, is critical. The European Commission should reflect on how the EU’s extensive retail network can better aid the ultimate goal of Capital Markets Union and in particular, what benefits this can deliver for SMEs. As noted by Lord Hill, the European Commission could reflect further on how it supports the fostering of national retail saver programmes into investment into small businesses. For example this might be done through, peer-to-peer/crowd-funding platforms.

13. **Developing deeper capital markets in Europe will require that Europe remains attractive to investors and issuers internationally**: The EU should avoid unnecessary divergences in applying international standards where possible and should review the EU legislation in place with this in mind. The EU can also demonstrate its leadership by not being bound to excessive emphasis on reciprocal access. Where ‘equivalence tests’ are proposed these should be implemented in a consistent manner across EU legislation to ensure certainty for international investors. The EU’s stance in the Transatlantic Trade and Investment Partnership (TTIP) and other free trade and service agreements developed on a multilateral basis and bilaterally with others, such as Canada and India, could also encourage international investors and issuers to EU markets. This should be encouraged.

**Better Regulation**

14. Robust impact assessments and cost-benefit analysis is key and it would be important for regulation to both improve the markets from a financial stability/investor confidence perspective and to supplement this with a second assessment, namely that any proposal should be able to demonstrate how it contributes to economic growth. In this respect, impact assessments should also be carried out after the adoption of regulation rather than at the outset alone, given that inter-institutional negotiation can significantly change the character of the proposal.

**Supervisory Convergence**

15. **Supervisory convergence and a single rulebook will significantly contribute to Capital Markets Union** and the BBA believes this should be a key priority of the ESAs. In conducting the ESA review, the European Commission in August 2014 and the Council on 8 November 2014, concurred that the aim should be to “**make full use of the current supervisory framework to improve supervisory convergence**”.
Annex A: Capital Markets Union - some economic considerations

Europe has a more “bank-centric” model than the US

It is a well-trailed fact that Europe has a more “bank-centric” financial system than the US. In the EU three quarters of financing of the corporate sector derives from the banking system, whereas in the US three quarters derives from non-bank financing.

Total financing in the US is more diversified. As well as having larger stock and bond markets, the US system has a large non-bank provision of credit to the economy. As a result bank credit is a much smaller share of total credit in the US and much smaller than the EU.

![Bank and non-bank financing 2011](chart)

Source: The World Bank

<table>
<thead>
<tr>
<th>Share of bank credit as a % GDP</th>
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<tbody>
<tr>
<td>UK</td>
<td>202</td>
</tr>
<tr>
<td>Euro area</td>
<td>115</td>
</tr>
<tr>
<td>US</td>
<td>56</td>
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Source: The World Bank

Diversifying the financial system supports growth and increases resilience

Why does this matter? A more diversified financial system is more resilient in the case of shocks. A broader financial system helps promote growth as it allows a greater range of financing options, more efficient resource allocation and is more resilient in the case of shocks.

When banks are deleveraging and adjusting to the new post-crisis regulatory environment it is important to ensure that alternative forms of finance are available to support the real economy.
There is evidence that financial market depth (achieved via either bank or market-based financing) is an important determinant of a country’s economic development. There is also evidence that capital markets support growth once a high level of development has been reached.

**Strong capital markets and banks are not mutually exclusive but support each other in the development of a diverse and robust financing system**

It is often the case that bank-based and market-based financing are seen as being mutually exclusive. This is not the case; the two systems are mutually dependent.

**Capital market development varies considerably across Europe**

Capital markets within member states across the EU are at different levels of development and the extent of cross-border investment is low. Here we can use the following taxonomy:

- Member states which have virtually no capital markets activity
- Member states where there is some but limited capital markets activity
- Member states which contain major financial centres

**Europe has seen a reversal of financial integration since the crisis**

The chart below is one measure of cross-border financial integration in Europe. It shows cross-border holdings of different asset classes by banks (interbank lending, holdings of stocks and bonds and cross-border lending to the real economy).

It shows a very different pattern before and after the financial crisis. Financial integration increased between the formation of the euro and the financial crisis and then reversed post-crisis. It also shows a varied degree of integration across different assets. The inter-bank market became quite integrated, whereas cross-border lending and holdings of shares are much less so – in essence these markets remain predominantly national.

![Chart of EA cross border asset holdings by EA banks](chart.png)

**Source:** The ECB
The move towards a banking union was in many ways a policy response to this fragmentation. The development of a true Capital Markets Union would further bolster the extent to which savings are recycled into productive investment across the EU.

**Balance of payments imbalances have reversed**

Many have characterised the Eurozone crisis as a “balance of payments crisis” between the core and the periphery. It was argued that the current account deficits built up during the boom years in peripheral Europe needed to be offset by a reduction in the corresponding surplus in the core.

In fact what has happened is the adjustment has been borne by peripheral countries’ deep recessions and the adjustment in Germany has been limited. What held the system together were the increasing Target 2 imbalances on the ECB’s balance sheet.

In addition the adjustments in underlying competitiveness (reflected by relative unit labour costs) have not been as great and much remains to be done to improve the relative competitive strength of the periphery versus the core. Structural changes which support this process and help to increase the ease with which savings in the core are recycled into domestic investment in the periphery will increase the robustness of the euro area economy and lessen the reliance upon monetary interventions to act as a sticking plaster to address the problem.

![Balance of Payments Current A/c (% of GDP, IMF forecasts)](image)

Source: The IMF
Developing broader and deeper capital markets will support growth

Firstly it is important to continue to develop EU capital markets to take advantage of economies of scale in the European market. This will ensure that the cost of capital is minimised and support growth and investment across the EU.

Secondly the development of a Capital Markets Union can support the effective recycling of savings to investment within the EU and the Eurozone. This will make the system more robust, ease adjustment processes in the peripheral countries and make the system less dependent upon official monetary interventions which are not sustainable in the long-term and may militate against structural adjustment in the short-term.

Finally it is important to broaden capital market access across the EU. This will allow a more diverse source of funding to complement banks and allow capital to be allocated more efficiently across the European economy.
For more information on Tuning ‘Capital Markets Union’ to deliver an engine for European Growth please contact: Ashley Dorrington on ashley.dorrington@bba.org.uk