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Capital-Markets Union: tentative shape and priorities

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Abstract:

Capital-markets union is now being debated prior to the drafting of a specific action plan by the Commission by mid-2015. The shape this project is to take and its priorities are still hazy. Measures that support the design of truly pan-European financial instruments might be taken but should also encompass the harmonisation of legal and fiscal regulations governing funded companies. Hence, fulfilling the potential of the single capital market will require a series of coherent policies whose leitmotif should be to promote improved investor protection, market attractiveness and a "European" risk culture.

INTRODUCTION

Capital-markets union is one of the Commission's priorities, the completion of which is due to extend from 2015 to 2019. It aims to develop – for the European Union as a whole –non-bank financing of the economy in a context in which bank lending flows are struggling to support activity.

The goal is not a new one since the completion of the single capital market has already been the focus of several initiatives. It does however raise as many expectations on the part of financial players as it does questions on the part of the institutions and public opinion, who sometimes perceive an analogy with Banking Union. What will be the project's shape priorities and scope?

This study reviews the goals of capital-markets union. It recalls the constraints of bank financing in Europe. It points to some priorities that focus on certain financial instruments and at the same time defines the need to build regulatory and supervisory measures around these.

I – CAPITAL-MARKETS UNION: A WELCOME POLICY INITIATIVE THAT AIMS TO ACHIEVE THE POTENTIAL OF THE SINGLE CAPITAL MARKET

1.1. Capital-markets union aims to develop non-bank financing of the European economy

Capital markets comprise the financial flows transiting via non-bank channels. Shares, bonds, stock market listings (IPO's), private placements, securitisations, are all finance instruments concerned by the initiative. Businesses are the main beneficiaries of these instruments. The stock markets, insurers, asset or fund management companies (venture capital, private equity, hedge funds) are financiers. The clearing houses, audit firms and consultancies are financial market infrastructures and financial intermediaries, who are also involved.

Capital-markets union aims as much to harmonise existing financial instruments – in order to facilitate their use in the Union – as it does to promote the creation of new ones. Hence, the quest for diversity in the non-banking domain must absolutely be fostered by initiatives which will encourage the risk-taking that is vital for innovation [1]. The Commission's work must also ensure the harmonisation of legal and fiscal provisions that are specific to the companies receiving financing from the market and also to intermediaries and infrastructures. The latter are also concerned by supervisory provision.

The idea of market financing was first put forward by Jean-Claude Juncker in July 2014 in order to engage financial and political players with this issue. The initiative also conveyed a positive message to London with a possible referendum looming on the horizon in 2015 on the UK remaining in the Union. The importance of London as a Europe's main financial centre indeed points to many advantages for the country [2], even though the British debate over EU membership involves more issues of sovereignty (free movement of people, justice, etc …).

1. This point was highlighted by Steven Maijoor, Chairman of the European Securities and Market Authority (ESMA), during the conference Finance for growth on 6th November 2014. Parts of his speech may be found here : http://www.esma.europa.eu/content/Capital-Markets-Union-building-competitive-efficient-capital-markets-trusted-investors

2. A priori, the importance and competitiveness of the City would allow it to position itself on existing or new financial instruments, clearly taking greater advantage of the potential of the single market. However the Capital-markets union will also entail many regulations which may appear as being further impediments to a profession which does not always see the need for them. As Nicolas Véron points out, "the representatives of the City (…) are not very open to the idea whereby the City's involvement means they have to align their regulation with European general interest and not just with domestic interest." The opposite is also true: the European authorities on the continent find it difficult to accept London's position as the biggest European financial centre because of the weak influence there – either real or perceived - of community policies. See Véron, Defining Europe's capital markets union, Bruegel Policy Contribution, November 2014.

1.2. This new initiative will not include an institutional dimension which makes its analogy with Banking Union deceptive

The idea of unifying European capital markets is not a new one. The free movement of capital is indeed one of the four fundamental freedoms that were enhanced with the single market and the creation of the euro. Many measures have been introduced since 1986 to guarantee that the latter is fully effective in the financial domain. For example, the 1999 Action Plan for Financial Services (APFS) included several measures that aimed to harmonise financial regulation, the acknowledgement of national regulations and prudential supervision.

Capital-markets union would incorporate measures to complete the original base. It must not however be confused with Banking Union, a project launched with exemplary speed in the midst of the Spanish crisis in 2012, with the aim of breaking the destabilising link between bank and sovereign risk. The project would not entail a tangible institutional dimension to corroborate the centralisation of financial regulations and supervision [3]. However the two projects are related because Banking Union fosters the development of the markets and also because it makes greater integration of associated policies necessary.

Likewise, the dominant position held by bank financing in the European economy, which is inversely proportional to that of the US [4], makes the goal of developing financial markets of the same size within the next five years impossible. As Nicolas Véron indicates, the development of the markets is desirable in the short term in order to take over from the banks and in the long term to foster innovation which is relatively weak in the Union [5]. However the banks are still vital structures for the analysis of credit and for the long term contact with entrepreneurs – and they undoubtedly are the mark of different preferences in the organisation of the financial system [6].

1.3. Capital-markets union aims to improve the provision of capital and the diversification of financial risks

The euro zone crisis triggered off a "financial fragmentation" of the monetary, bond and stock markets which was particularly severe when there was tension over the Greek, Italian and Spanish debts. During this period the peripheral countries witnessed their incoming capital flows draining back towards the core of the zone where values, notably of those of States were deemed to be safer and assets were mainly financed with domestic liquidities. This problem became especially clear when the sovereign debts were borne by domestic banks, which was the main reason for the launch of Banking Union.

Since 2013, the prices and quantities of assets issued in euros has led to much needed convergence, a sign of "defragmentation" of the markets similar to the period prior to the crisis [7]. However, as suggested by Benoît Coeuré [8], the integration of the capital markets cannot just be seen as convergence. On the one hand the decade after 2000 illustrated, *a posteriori*, that the reduction of bond yields might reflect an undervaluation of the risks constitutive of imbalances. On the other hand, true financial integration should enable an optimal allocation of capital and the diversification of risk.

Allocation implies the freedom of financial flows which would not be impeded by risks other than those linked to the intrinsic quality of the assets. Consequently, the discriminatory factors at play in access to financing, like the origin of the borrowers and the lenders, should be reduced or eliminated, thereby enabling the market to complete unification. This might also be guaranteed by the diversification of financial risks in order to facilitate absorption of local shocks by businesses and households. From these standpoints Banking Union is a vital asset for capital-markets union.

II – THE CONSTRAINTS WEIGHING ON THE BANKS LEGITIMATE THE WISH TO DEVELOP ALTERNATIVE SOURCES OF FINANCING WHICH HAVE ALREADY INCREASED

1.1. Bank financing is still constrained due to the supply and demand of credit

The traditional analysis of the difficulties associated with the bank financing of the European economy entails distinguishing the effects of the demand for and

3. The Capital-markets union will however take full advantage of the European System of Financial Supervision (ESFS) and notably the ESMA introduced in 2009.

4. Bank financing represents around ¾ of financing in the economy in the EU, i.e. the opposite of the US.

5. See Véron, op cit.

6. See for example François Villeroy de Galhau's most recent book, L'espérance d'un Européen, Odile Jacob, 2014. The author believes "Europe, more than the US (could) be the cradle of sustainable finance," where regulation and individual responsibilities are well balanced.

7. See the ECB report, Financial integration in Europe, April 2014 and the accompanying press release: https://www.ecb.europa.eu/press/pr/date/2014/html/pr140428.en.html

8. See the speech by the ECB board member delivered during the International Capital Markets Association (ICMA) conference in Paris, 19th May 2014, available on www.ecb.europa.eu/press

the supply of credit. Some believe the lack of credit is linked to business and household specific issues such as the lack of new orders in an unstable economic environment or the need for a reduction in corporate debt. Others believe that banks are being especially constrained by prudential regulation and weak risk-sharing measures. The combination of these would lead to a drying up as well as to a rise of price of credit.

As the European Investment Bank or the European Central Bank regularly point out, the way businesses perceive risks and the yields of their investments seems to be a preponderant factor in their low demand for investment loans [9]. According to this logic, the economic environment, especially in countries in crisis, and therefore their ability to increase their market bargaining power, has a negative influence. Likewise, debt reduction initiatives in certain sectors, particular in SME's and the peripheral countries, will not encourage them to incur more debt.

As far as supply is concerned, it is above all the banks' financing conditions which are important in defining their lending capacity (and their margins), likewise their perception of the debt market. The nature of monetary policy (volume of liquidities provided by the ECB, types of assets purchased, communication) is important together with the traditional analyses of credit risk. However, the banks' ability to take risks given their regulatory (prudential) constraints and to share them also indicates how free they are to act.

1.2. This interpretation would benefit however from a wider reading especially after the introduction of the Single Supervisory Mechanism

From the point of view of demand, as with the problems in ensuring the recovery of investment across Europe, economic uncertainty is a vital problem which is restricting businesses and households in their investment decisions [10]. Undoubtedly, this accounts a great deal for sluggish credit demand, as it does for the effective risk taking on the part of the banks. And yet the economic environment depends in the main – especially in some countries, like France and Italy – on the credibility of the economic policies which are primarily the responsibility of the State, and on psychological factors which are not all the responsibility of businesses themselves.

As the EIB suggests, the determination to reduce corporate debt is still a problem [11]. However, it is concentrated in a limited number of Member States (like Portugal and Cyprus), in certain sectors and within SMEs. This process has to continue and might be fostered by government measures [12] without being considered to be the only source of the problem. Moreover, access to finance has not been classed as being the main problem experienced by businesses since the start of the crisis. The economic environment, reflected in the real ability to find clients for productions is however almost always the "main issue".

From the point of view of supply the regulatory constraints, which weigh heavily on banking establishments, are now managed by the latter quite well, even though not all of the technical measures have yet been decided [13]. Regulatory constraints have led to a reduction in bank balance sheets and their profitability, which explain the decline in their risk taking. However, other measures that support risk-taking exist such as the consolidation of bank balance sheets, a task enabled with the entry into force of the Single Supervisory Mechanism (SSM), and risk-sharing measures, like public credit guarantees and financial carry/risk instruments, such as Project Bonds [14].

In addition to this, banks are not really constrained by access to liquidities. Since the start of the crisis, the ECB has provided a great amount of cheap liquidities and promised to continue to do so with the TLTRO programme. Some executives like Ulrich Schröder, Chairman of the KfW, are categorical about this: there is no problem with the supply of credit in Europe [15]. Moreover, the most recent options announced and expected regarding monetary policy by players on the market focus on new rounds of government security purchases and on corporate private debt and not directly on bank liquidity [16].

The entry into force of the SSM, the first pillar of Banking Union, on 4th November 2014, is also a major step towards improving the granting of credit in Europe.

The asset quality review and the stress tests have enabled the ECB and the banks to establish transparency regarding bank balance sheets [17]. This

__9.__ See the recent EIB study, Unlocking lending in Europe, October 2014, those of the FEI, European small business finance outlook, or those by the ECB, Surveys on SME access to finance.

__10.__ See Oliver Marty, "For the recovery of investment in Europe" European Issue n°325, Robert Schuman Foundation, September 2014, a text suggests that macro-economic uncertainty and the ability (which are closely related) of the States or local communities to commit financially and politically to projects based on increasingly complex financial schemes, is decisive for the achievement of the 300 billion euro investment plan hoped for by Jean-Claude Juncker.

__11.__ See EIB, op cit.

__12.__ See EIB, op cit, pp. 40-44, an specific approach to the settlement of non-performing loans can be shaped differently: « bad bank » internal the group in question, approach via special purpose vehicles (SPV), or the creation of public structures for the management of non-performing assets.

__13.__ A recent prudential initiative, the TLAC (total loss absorbing capacity), which aims to oblige systemic banks into having additional capital buffers enabling their liquidation without the use of public money, was accepted by the G20 in Brisbane and still has to be fine-tuned in time for the next summit.

__14.__ See Marty, op cit.

__15.__ Speech given during the conference, Finance for growth, towards a capital markets union, Brussels, 6th November.

__16.__ ECB President, Mario Draghi, said in September 2014, that the ECB would launch a new asset purchase programme notably securitised instruments. It was understand that following this the sum of this programme would then be used by the institution to increase its balance sheet by 1,000 billion euro.

__17.__ See Dominique Perrut, "The ECB's health-check of the banks - a necessary but not sufficient step for reforming the euro", European Issue n°332, Robert Schuman Foundation, November2014.

is particularly important in terms of addressing the issue of non-performing loans, which as the EIB points out, have grown twofold in the euro zone since 2009 and weigh in particular on the granting of credit by the banks in the peripheral countries [18]. Thorough knowledge about and valuing of portfolio can promote the development of a selling market for these assets which is limited at present [19].

Likewise, the exercise of reviewing assets, then the testing of balance sheets has led to the establishment of a list of under-capitalized banks. Of the 25 banks at risk, requested to communicate their recapitalisation plans, 12 had already undertaken the required action to recover adequate levels in view of the prudential rules and 13 estimated their recapitalisation requirements to a total of 9.5 billion €. After 9th November, the deadline for the delivery of the recapitalisation plans, only 8 banks were still in a critical situation, with requirements estimated at around 6.5 billion € [20], mainly in Italy, Portugal and Ireland.

Banking Union is of course far from complete: the need to come to agreement over the matching contribution of the Single Resolution Mechanism (SRM) fund, likewise its borrowing capacity is still important. However the adoption of the first pillar is undeniably a major step forward, a necessary condition both in substance, since it enables the establishment of balance sheet transparency, and in form, since it is the guarantee of confidence for bankers and entrepreneurs, leading possibly to the resumption of cross-border mergers [21]. But, in itself, this step will not be enough to restore credit flows in the euro zone.

1.3. Capital market financing replaced the banks at the beginning of the crisis

Since the beginning of the crisis, constraints weighing on the banks led European businesses towards capital markets, even if this was easier for the large companies and in certain countries, notably at the core of the euro zone. The net issuance of corporate bonds and shares has been maintained at a positive level since 2008 and the share of corporate bonds in the overall corporate debt rose from 7.5% in 2008 to 11.5% at the end of 2013. Disintermediated financing costs, which are lower than those of the banks, have emerged on this market.

The attractiveness of other financial instruments like covered bonds, securitised loans (ABS), and private placements, all involved in capital-markets union, has been unequal. Covered bonds maintained a rather high level of issuance during the crisis and on three occasions benefited from specific asset purchases on the part of the ECB (2009, 2011 and 2014). European private placements were actively issued in the US where the market is deeper [22]. The emission of securitised products has declined significantly since 2008, their only aim being to receive ECB financing, i.e. as collateral.

However, as Benoît Coeuré [23] points out, access to capital markets is unequal across the euro zone: the issuance of corporate bonds was highly focused in countries where there was no tension (without any drop in net bank flows). Likewise, the understanding – by way of a chain of intermediaries – of the legal regime applicable to emissions in the peripheral countries has been an impediment to the development of cross-border flows. The harmonisation of regulations on cross-border operations is therefore one of the major stakes in capital-markets union.

The EIB also indicates, via a useful mapping instrument, that the substitution of bank financing has been easier in countries where the capital markets are well developed, in France, Germany, the Netherlands, Sweden and in the UK for example [24]. But for the case of Spain, most of the peripheral countries, where banks were constrained (Greece, Ireland, Italy, Portugal) have not enjoyed any substantial benefit from the markets. Countries in Central and Eastern Europe as well as in the Baltic states also have underdeveloped capital markets which hints at the potential of capital-markets union in these countries.

III – CAPITAL-MARKETS UNION COULD DRAW BENEFIT FROM PAN-EUROPEAN FINANCIAL INSTRUMENTS PROVIDED THERE IS HARMONISATION OF ASSOCIATED REGULATIONS AND SUPERVISORY FRAMEWORK

1.1. The development of pan-European financial instruments ensuring the integrity of the European capital market

Capital-markets union might at first aim to develop truly pan-European financial instruments if these

18. *"Non-performing" loans are said to represent 50% of outstanding bank loans in Cyprus 34% in Greece, 25% in Ireland. These bad loans are particularly concentrated in certain sectors like real estate. See EIB, op cit*

19. *The EIB states that high transaction costs and the limitation of markets to certain types of loans (excluding SMEs and real estate) are the obstacles preventing the development of this market. See EIB, op cit.*

20. *Four banks, in Greece an in Slovenia, sent rescue plans approved by Brussels. Since the Franco-Belgian bank Dexia is now being dismantled there are only 8 establishments which have to explain their recapitalisation plans within the next 6 to 9 months. On this issue see the newspaper article in "Les Échos", Début du repêchage des banques recalées aux tests de résistance, 12 November 2014.*

21. *Merger-acquisition operations should start again after the creation of the Single Supervisory Mechanism (SSM). Forming bigger cross-border bank groups is useful in the diversification of risks.*

22. *See G. Wehinger and Iota Kaousar Nasr, Non bank debt financing for SMEs : the role of securitisation, private placements and bonds, OECD Journal, 2014.*

23. *See Benoît Coeuré, op cit.*

24. *See EIB, op cit, pp. 28-29, in which « clusters » indicative of the development of the capital markets and their influence over bank financing are established , available on: http://www.eib.org/infocentre/publications/all/unlocking-lending-in-europe.htm*

have already proven their efficacy and security from a national point of view and if their use, facilitated across the Union, is useful in overcoming insufficient bank credit supplies. If this is the case the European Commission would first remove all legal and fiscal impediments specific to these securities, and yet ensure the harmonisation of the governance of the businesses financed as well as the regulation and supervision of any intermediary players (auditors and consultancies) and market infrastructures (clearing houses).

Five "model products" might be developed Europe-wide, notably to the benefit of SME's, which have traditionally found it difficult to access the markets:

- Asset backed securities: closely linked to the subprime markets, this practice entails bundling loan instruments of varying risk levels for their resale to investors. Accordingly, they are placed off-balance sheet, freeing up the banks' regulatory capital allowances enabling them to use other assets as collateral, and so they can lend more to companies and households. This instrument (ABS) can potentially be used to repackage risks related to peripheral states, or can be bundled with specific (classes of) assets, such as small business credits, for whom this arrangement can be critical.

- Covered bonds: these instruments are mainly linked to real estate assets and public sector loans and are similar to securitization but remain in the balance sheet. They enable risk diversification and also provide significant security and "dual recourse" opportunities against both the underlying asset (collateral) and the issuer [25]. However they have not been greatly developed to the benefit of SME loan portfolio.

- Corporate bonds: bond securities, which are useful in the emission of debt, are traditionally used by large companies. The volume of transactions has increased since 2008 but in a limited number of countries which are not subject to market stress. This fragmentation reflects national divergence in securities and bankruptcy laws, which do not promote trans-national investments. Likewise, SMEs do not use them very much.

- Private placements are an alternative to public insurances (on the stock exchange) and can potentially diversify investors' risks. Credit analysis and reporting obligations are traditionally not as strict as with other debt products. Since the beginning of the crisis European issuances have been made on the American US PP market which, according to an OECD study, holds one third of European placements [26].

- Pension plans: an opportunity for the Commission might lie in developing harmonised measures on the "third pillar" (capital accumulation plans: savings, pensions, life-insurance). This measure would then aim to develop pension funds in the European countries which do not yet have them and also measures to foster the portability of social rights, which might also increase the mobility of workers in Europe [27].

1.2. Improvements might be provided to each of these instruments taking on board the regulation of the assets being financed

Regarding securisation, several economists agree on the potential for the development of the European market, bringing it up to 3 or 4 trillion €. If the demand for securitised products by investors is weak due to the crisis and the depreciation of several instruments, issuance can be fostered by a more specific approach to regulation, thereby aiming to distinguish, in the prudential rules of Basel III, the simple, low risk products (typically linked to the SMEs) from those which are less so. Likewise the harmonisation of bankruptcy schemes of underlying businesses, the standardisation of reporting obligations and harmonised credit analysis methods seem vital in view of the potential creation of a European format [28].

Securitisation would draw greater benefit from the programmes announced by the ECB. This might involve loans to SMEs or other businesses and products linked to real estate, markets of different size [29]. As suggested by Altomonte and Bussoli [30], the purchase of corporate ABS might indirectly free capital from balance sheets and draw full benefit from the most recent liquidities programme launched by the ECB (TLRTO), thereby freeing up bank credit. However, the authors stress that the changes made to the regulatory framework and to technical barriers are vital to support the effectiveness of this option.

Corporate bond law could be harmonised in order to facilitate cross-border financial flows. The partial harmonisation of legislation governing bankruptcy or the restructuring of businesses and their taxation

25. *See Wehinger, G. et al, op cit.*

26. *See the study by G. Wehinger and Iota Kaousar Nasr, op cit, OECD Journal, 2014.*

27. *On the issue of youth employment and European mobility see the book by François Villeroy de Galhau, op cit, and the critique by Olivier Marty, published by Slate and available on: http://blog.slate.fr/europe-27etc/16139/francois-villeroy-de-galhau-lance-un-appel-constructif-en-faveur-de-l%E2%80%99europe/*

28. *See BEI, op cit.*

29. *The "asset backed securities (ABS)" market linked to SMEs and business assets was estimated by Altomonte and Bussoli, in Juuly 2014, at 68 billion euros, whilst that of the "residential mortgage backed securities » (RMBS) totalled 500 billion euro. On this issue see Altomonte and Bussoli, Asset backed securities : the key to unlocking Europe's credit markets ?, Bruegel Policy Contribution July 2014.*

30. *See Altomonte and Bussoli, op cit, November 2014.*

might be useful. The development of specific bond funds for SMEs or the facilitation of flotation for high potential SMEs are other ideas under promotion, notably by Wehinger [31] or in France, the "PME Finance" Association. Likewise, reporting obligations on bond issuances might be facilitated.

Covered bonds might benefit from the harmonisation of information about underlying businesses, uniform national legislation, specific measures that aim to include SMEs. Private placements should lead to harmonised and more transparent issuer information; they should be the focus of appropriate capital charges; secondary markets might even be created.

1.3. Establishing a list of priorities as part of a wider coherent regulation and supervisory plan

After consultation with those involved in the project for capital-markets union is due to be the focus of an action plan by mid-2015. To date the "working programme" does not seem to have been decided. Securitisation, corporate bonds and covered bonds are instruments on which initial work might be undertaken, if it is agreed that this also includes measures regarding loan assets: securities' law therefore goes hand in hand with the harmonisation of corporate governance, taxation and accounting rules. Likewise, the supervision of clearing houses and the harmonised regulation of audit companies are measures specific to market infrastructures and to the intermediary players in finance which must not be neglected.

Nicolas Véron believes that there should be six stages in the organisation of the priorities of capital-markets union, progressing from the easiest to the hardest, thereby also reflecting the potential impact of the selected measures. The supervision of market infrastructures, including clearing houses, business insolvency schemes, and tax issues are the most complicated measures but also the most useful [32]. The legislator should not forget, as Steven Maijoor suggests, that investor protection, the international attractiveness of the markets and the development of a risk culture fostered by equity financing must be promoted as transversal goals [33].

CONCLUSION

Capital-markets union raises as many expectations as it does questions. Commissioner Jonathan Hill's wish for an action plan by mid-2015 based on an economic analysis of the difficulties inherent to bank financing and a consultation of those involved, will lead to the establishment of a list of priorities. The development of standardised pan-European financial instruments might be the first goal around which to establish a set of coherent regulations and supervisory methods of the entities being financed, intermediaries and market infrastructures. Hence, it is vital to have measures that address governance, the taxation of businesses and savings, as well as the regulation of audit firms and the supervision of clearing houses.

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31. See Wehinger, G. et al, op cit.

32. Regarding corporate governance, the harmonisation of bankruptcy arrangements, restructuring outside judicial proceedings are desirable in Nicolas Véron's opinion. Regarding taxation savings, products must be the focus of fiscal harmonisation in the EU, fiscal measures must be simplified and fiscal pressure stabilised. The fiscal processing of equity instruments must be different from that of reduced debts to the benefit of the latter. See Véron, op cit, Nov. 2014.

33. See Maijoor, op cit.

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