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The Capital Markets Union, supporting the European project and the revival of investment

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Abstract :
On 30th September the European Commission will publish an action plan on the Capital Markets Union which will cover all of the measures that it is likely to take by 2019. This initiative is useful to improve the financing of a more innovative economy and to foster the revival of long term investment. It may also help to strengthen the euro zone before steps are taken to complete it. In this sense, CMU is an integrated part of the European economic and financial policy. However, its implementation will have to be clarified in order

INTRODUCTION

The European Commission is about to publish its action plan on the Capital Markets Union (CMU) which aims to diversify the way the European Union economy is financed. This extremely technical, long term (2015-2019) project, has not yet emerged in its political dimension and still seems unable to complement the Juncker plan effectively. To foster its clarity, this study explains the CMU's goals, relates some of the ways recommended for its implementation and reviews the need to complement the measure with appropriate financial regulation and supervision.

I – THE CAPITAL MARKETS UNION CAN FOSTER THE REVIVAL OF EUROPEAN INVESTMENT AND GROWTH

1. Develop market financing in addition to that of the banks

From a strictly technical point of view Capital Markets Union aims to achieve the effective movement of capital, one of the Union's four fundamental freedoms. This concern is legitimate in that the European financial market is still organised on national bases and that in the euro zone we have witnessed financial fragmentation which is proving difficult to dissipate. Reducing impediments to capital flows would enable an optimal orientation of European savings towards profitable investments across all countries. The assets held by "dispersed" investors would also be beneficial as they spread financial risk [1].

From a more practical point of view, the Commission's project aims to develop the financing of the economy by the capital markets. As proposed resolution put forward by the French Senate recalls, "a new regulatory situation, together with market pressure and profitability requirements" has reduced the relative share of bank financing and may hamper their ability to support the economic recovery in the future [2]. In other words, although not all of the banks have been restricted in terms of their financing capabilities, they may be in the future. [3] In this context, the markets would offer complementary financing solutions.

Although the Commission quickly showed that it wanted to revive certain financial instruments, which, like securitization, played an extremely negative role in the making of the financial crisis, CMU does not mean that the European Union is moving towards the "all market" solution. Indeed it is not about pitting bank loans against market financing but rather organising a new kind of complementarity which would, in all events,

1. Concerning the theoretical aspects of CMU, see i.a. the speech by Benoît Coeuré, member of the ECB board, delivered during a conference organised by the International Capital Markets Association (ICMA) in Paris, 19th May 2014.
2. Proposal for a European resolution by the French Senate, 16th July 2015: http://www.senat.fr/leg/ppr14-640.html.
3. On this point the Commission launched a public consultation on 15th July to find out what the potential impact of bank regulation might be on loans to SMEs and infrastructure projects. See Les Echos, http://www.lesechos.fr/finance-marches/banque-assurances/021208481901-banques-bruxelles-met-a-lepreuve-ses-propres-regles-1137341.php

leave the banks with a leading role [4]. Due to their prudential enhancement, banks will emerge strengthened and will retain a close relationship with the SMEs whose specific features and projects they know well [5].

2. A political rather than a solely technical dimension

The "risk" that the Commission will privilege a legal or technical approach to achieving Capital Markets Union is however quite real. In its Green Paper published in February, the European executive noted a series of 32 priority actions, then five real goals [6]: facilitating SME access to capital markets, extending their range of investors, reviving the securitization market, stimulating long term investment and developing private placements. These lines are declined into two parallel consultations: one on the revision of the "prospectus" directive [7], the other on a European securitization framework.

The approach seems to go against the coherence of the entire project and to a certain extent against its legibility by the financial bodies involved, likewise the legislator and public opinion [8]. It would be better for everyone, as suggested by François Villeroy de Galhau, to present CMU as a series of solutions in response to the "central challenge" of how to finance investment. According to the author, "*France and Europe have to manage three potentially conflicting expectations: more innovative, riskier investments; plentiful but prudent, poorly distributed savings in the euro zone; a financial system that has been made secure for the long term after the crises of 2007-2011*" [9].

From this point of view, CMU clearly appears to be a vital part of the European economic and financial policy, simply a political initiative [10]. This is why the Demarigny report first suggested renaming it: "*Financing and investment union*" [11]. CMU can finance innovative businesses which do not need "traditional" loans as such but rather a mix of own funds and debt instruments. It can direct euro zone savings, from the north to the south, to projects and countries that need it [12]. Ultimately it can be part of an enhanced financial framework.

3. Amongst many intentions select three simple goals

Capital Markets Union did not become any clearer with the Commission's consultation concluded at the end of May. National responses were only picked up in the specialised press and attention all too often focused on market instruments. As a result of this European Commissioner Jonathan Hill highlighted three goals which were extremely financial in their connotation: in his opinion, CMU should "*increase the number of financing options for businesses, increase the number of investment opportunities for investors and encourage cross-border investment*." [13]. The technical nature of the measures being planned, the declared goals, and the principles behind the action being promoted were all too confusing [14].

Following the Villeroy de Galhau report it seems simpler to discern three goals for CMU [15]:

- To diversify and improve financing sources to the benefit of businesses which have already initiated this change and want to continue;
- To pool plentiful savings in the euro zone where the project makes even more sense than in the Europe of 28;
- To guide European savings towards the long term, in line with the wish to retain safe, liquid assets.

These goals could be complemented by three principles of action promoted in the French response to the Commission's Green Paper [16]:

- To focus on initiatives that are directly beneficial to the financing of growth by developing regulations if necessary and by supporting market initiatives if possible [17];
- To retain an appropriate financial regulation framework, which notably means a stronger European voice within international arenas;
- To maintain a European financial "ecosystem", which is both competitive and protective of investors and consumers, comprising investors, financial issuers and intermediaries.

4. Likewise, the ambition that the Commission sometimes declares i.e. wanting to converge towards the « American intermediary free financing model » (in contrast to the European model of bank financing) might have been clumsy but does not seem any more realistic. See the report by (p. 60) of François Villeroy de Galhau on business investment financing delivered to the Prime Minister on 26th August 2015: http://www.gouvernement.fr/partage/5021-remise-du-rapport-d-etape-de-francois-villeroy-de-galhau-sur-le-financement-de-l-investissement-des

5. The defence of the bank model in support of financing SMEs is strong amongst NGOs and in Germany as seen in the stance adopted by the Chairman of the German savings banks association, see http://www.irishtimes.com/business/financial-services/german-banker-expresses-caution-on-capital-markets-union-1.2326177

6. Commission Green Paper, http://eur-lex.europa.eu/legal-content/FR/TXT/?uri=CELEX:52015DC0063

7. The « prospectus » directive covers the necessary steps taken by businesses to raise funds on the markets.

8. The many (and quite legitimate) misunderstandings that CMU has caused in French (and European) public opinion led for example Éric le Boucher to warn about the lack of correct public debate over the initiative: http://www.lesechos.fr/21/05/2015/lesechos.fr/02182848117_la-discrete---americanisation---de-l-europe-des-capitaux.htm. Other opinions such as that of Hubert de Vauplane, have highlighted that Europe « could not make people dream » with such a technical initiative. http://www.revue-banque.fr/chronique/union-des-marches-capitaux-une-ambition-inachevee

9. See the Galhau report, op cit, p. 3.

10. Some answers to the European consultation highlight the civic issue of developing a popular financial culture to restore confidence in the financial system. Cf. report by the Deutsche Börse, "Principles for a European capital markets union": https://deutsche-boerse.com/dbg/dispatch/en/kir/dbg_nav/about_us/15_Public_affairs/10_News/09_Capital_Markets_Union

11. See the Demarigny report : http://www.economie.gouv.fr/union-marches-capitaux-umc-rapport-demarigny. This terminology has also been adopted by M. Villeroy de Galhau or by Dominique Riquet, MEP, who presides the long term investment intergroup at the EP.

12. The link between CMU and the deepening of the euro zone is not really emphasised in analyses of CMU. See Paul Goldschmidt: http://communautes.agefi.fr/l-avenir-de-la-zone-euro/creation-d-une-union-des-marches-de-capitaux-au-sein-de-l-ue-une-initiative-ambi or the Galhau report.

13. See Jonathan Hill's speech at the Eurofi Forum on 10th September 2015: http://europa.eu/rapid/press-release_SPEECH-15-5624_en.htm and CMU's three goals:http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_fr.htm

14. Investors and their advisors have often highlighted the development of markets and their functioning as a goal "per se". See for example Clifford Chance, "Building a capital markets union: a five year plan". http://www.cliffordchance.com/thought_leadership/capital-markets-union.html

15. The French and German views been harmonised via a joint letter from the Finance Ministers of both countries: http://www.economie.gouv.fr/union-des-marches-capitaux-la-france-moteur-projet .

16. http://www.sgae.gouv.fr/webdav/site/sgae/shared/04_Consultations_publiques/ReponsesFR_2015/20150513_ReponseFR_Livre_vert_Union_des_%20marches_de_capitaux.pdf .

17. A market initiative can be defined as a financial project of instrument implemented by various actors in a given financial centre (eg: the NOVO funds at the Caisse des Dépôts (CDC) together with insurance companies investing in non-listed business debt instruments). In this case the European Commission could promote this type of initiative.

II – THE EUROPEAN COMMISSION'S PROJECT SHOULD BE IMPLEMENTED IN A SIMPLIFIED MANNER

1. Diversify the range of debt instruments short term

The complexity of the measures planned for by the Commission and the range of its time frame led many experts to advocate rapid implementation of measures that aim to diversify the debt instruments available to businesses [18]. These short-term measures planned for the end of 2016 – beginning of 2017 would lend the project greater credibility as they would enable support to economic recovery and the implementation of the Juncker Plan. They would not involve large companies, since these will mainly find financing on the markets, but rather mid-market companies and SMEs [19].

For the SMEs and also the mid-market companies the revival of securitization, which helps lighten bank balances, as the associated risk is borne by other investors, might be useful if the instruments are simple, transparent and standardised. For the mid-market companies which already having mixed market/bank financing that will continue in the future, direct loans from institutional investors and private placements could be useful complements. In all, safe securitization, direct lending platforms, private placements could be the first priorities of Capital Markets Union.

The Commission has indicated that as far as debt instruments are concerned it wants to move forward on all of these issues with its own regulatory approaches or in support of market initiatives. The revival of "simple, transparent, standardised" securitization [20] likewise the revision of the "prospectus" directive (own funds) seem to be its priorities [21]. Measures specific to the marketing of investment funds, (fees, administration, etc.) would also be undertaken. Other more structuring issues (bankruptcy rules, securities law) are mentioned but without a precise time frame.

2. Linking Capital Markets Union with the Juncker Plan

The regulation on the creation of the European Fund for Strategic Investment (EFSI) was approved by the European Parliament at the end of June, which made the scheme operational this summer. With help of limited facilitating public funds it fosters the catalysis of private investment to a total of 315 billion € in infrastructure projects (240 billion €) and SMEs (75 billion €). Several projects have been signed and the innovative nature of the financial instruments used, such as enhancing links between the EIB and national public banks, as well as the possibility of using a technical assistance platform augur for the modernisation of the way the economy is financed [22].

However, measures that are complementary to the Juncker Plan could be taken to guarantee its full effectiveness. These include the revision of the *Solvency II* directive and regulation that is specific to European insurance companies, which is now a point of consensus, since these texts include capital requirements that dissuade risk investment, notably in shares, and long term forecasting and investment. A "rebalancing" of these capital requirements with the aim of fostering investment in infrastructures and in securitized products seems advisable and to be part of the Commission's plan.

Two other ways that might help the Juncker Plan succeed were clearly put forward in the Villeroy de Galhau report. The first comprises "*developing investments in own cross-border funds via innovative devices*" [23]. The second calls for the creation of "standardised" European assets in support of long term infrastructures and energy transition. This would entail the establishment of an adapted prudential processing of investments in infrastructures, the implementation of the ELTIF (long term investment funds) [24], and the organisation of securitization, via the EIB, of a projects portfolio.

3. Initiate long term structural projects

Capital Markets Union also involves committing to long term projects, of a legal, fiscal or economic nature which would all be likely to promote the free movement of capital in the Union. Many projects have been discussed, including by the Commission, but some, such as tax harmonisation, are particularly difficult. Moreover securities law would demand convergence that does not seem decisive in the short

18. See for example N. Véron, "Defining Europe's capital markets union", http://bruegel.org/2014/11/defining-europes-capital-markets-union/ ; N. Véron and G. Wolff, "Capital markets Union : a vision for the long term", http://bruegel.org/2015/04/capital-markets-union-a-vision-for-the-long-term/ and O. Marty, « L'Union des marchés de capitaux : quels contours, quelles priorités ? », http://www.robert-schuman.eu/fr/doc/questions-d-europe/qe-335-fr.pdf

19. In effect it is harder for SMEs to access the markets than it is for mid market companies or large groups since they are not of critical size, nor do they have the human resources required to manage the associated obligations.

20. The criteria set would guarantee the simplicity and the similarity of assets and would exclude all types of "double securitization" or synthetic securitization which bear counterbalance or liquidity risks. See Commissioner Hill's speech at Eurofi, op cit.

21. See Reuters, http://www.reuters.com/article/2015/09/04/us-eu-markets-regulations-idUSKCN0R31X520150904 , http://www.economist.com/news/finance-and-economics/21664169-creating-american-style-capital-markets-europe-will-be-hard-vision-and-reality

22. On this issue see the earlier work of P. Maystadt, former EIB President on reviving investment http://www.robert-schuman.eu/fr/questions-d-europe/0337-relancer-l-investissement and O. Marty http://www.robert-schuman.eu/fr/questions-d-europe/0347-le-plan-juncker-vecteur-d-une-ambition-europeenne-renouvelee et http://www.robert-schuman.eu/fr/questions-d-europe/0362-le-plan-juncker-une-chance-concrete-pour-l-europe .

23. See the Galhau report, op cit, pp. 71-76. The EFSI responsible for the SMEs in the Juncker Plan might contribute to providing investment funds and notably capital risk – of a greater volume than that which exists today. Likewise and according to an idea put forward by O. Garnier, chief economist at the Société Générale, and of the Euro 50 Group the "European Savings and Investment Fund" might be provided with loans from the Juncker Plan to invest in own funds in the countries of the South. The promotion of European capital risk, both on national and European bases returns to many national contributions like that of the UK.

24. See also C. Dargnat, Director of the EFAMA, the European Fund and Asset Management Association http://www.revue-banque.fr/banque-investissement-marches-gestion-actifs/article/creer-un-ecosysteme-europeen-pour-investissemen See de Galhau Report, op cit, pp. 78-81.

term. According to some analyses, and given the first response in the press, there are three simultaneous priority projects [25] :

- **Bankruptcy rules:** European continental law is considered to be typified by greater protection of employees and government creditors in the event of company bankruptcy as well as by complex jurisprudence [26]. If a "pan-European" more risk-friendly regime cannot be set in place, like that in America, the harmonisation of the regimes applicable to bank creditors in the euro zone is provided for in the Demarigny report. The Commission is said to have started preparatory work to harmonise some aspects of the insolvency regimes [27] ;

- **Economic information on SMEs:** is vital to non-bank financing on the part of insurance companies and assets managers. Increasing this on a European base might entail opening up various national bases such as the French FIBEN at the Banque de France, or the creation of private European platforms that pool and organise a fee-paying exchange of data from multiple bank sources. The Commission seems to have moved forward on this point;

- **Consumer protection:** this issue has moved forward since the implementation of many texts such as the MIFID I and the MIFID II, but national rules and practices differ and the offer of cross-border "risk" products which will develop under CMU, should focus on the quality of investment solutions rather than strict rules surrounding marketing that the Commission seems to want to initiate.

Many reports like those of Bruegel or the Galhau report suggest moving forward on these issues by creating dedicated autonomous task forces which would deliver their work rapidly (2016/2017) for implementation in the long term (2019). The second recommended time frame for the effective implementation of the CMU would then be launched. Depending on the source, it would seem timely to move progressively forward identifying possible convergence, i.e. common standards in national legislations whilst allowing progress to be made specifically within the euro zone.

III – THE CAPITAL MARKETS UNION WOULD BE STRENGTHENED BY AN IMPROVED REGULATORY AND SUPERVISORY STRUCTURE

1. Regulatory and supervisory progress

Capital Markets Union means the development of potential risks specific to the financial markets. This is not so much a question of supervising entities rather than following specific financial activities which, via mimetics, could severely disrupt the markets. The Commission's agenda should therefore develop or make specific provision for financial regulation and supervision, which it has already started with the directives and launch of ESMA (the European Securities and Markets Authority). Although the harmonisation of the rules is requested by investors, the regulation of market players is the cause of their mistrust.
Several projects have been identified:

- the first is to ensure the correct implementation of the "single rule book", a "corpus" of unique prudential rules for the financial sector that has been adopted, but the respect of which is not the same depending on the country. This might be strengthened: this means enhancing ESMA's effective powers of sanction, before the appointment of a single supervisor, which the French have asked for in the long run [28]. This part seems not to have been included in the Commission's proposal to date;

- the second encourages better regulation of "shadow banking" which issues loans like those that banks do. The Commission has already formally acknowledged measures to prevent risks [29]. This mainly involves asset management. It would imply making better assessment of liquidity risks and those linked to leverage effects in international and European organisations, with the aim of achieving global financial, or even systemic stability.

2. Improving systemic risk prevention

The development of market financing is leading to increased international work to contain systemic risk. This might be defined as a chain of market risks that

25. See de Galhau Report, op cit, pp. 78-81.
26. On this point see the works of the Rules for Growth think tank led by Ms Sophie Vermeille: http://droitetcroissance.fr/tag/droit-des-faillites/
27. See Reuters, op cit.
28. See the French response to the Green Paper, op cit, and Michel Sapin's, (Finance Minister) response s, http://www.economie.gouv.fr/union-des-marches-capitaux-la-france-moteur-projet. The French view is opposed to the English view, see the response given by the British government to the project on the Commission's site , op cit. .
29. Amongst others see Xavier de Jerphagnion paper on "shadow banking" http://www.revue-banque.fr/risques-reglementations/article/shadow-banking-vecteur-risques

might cause the collapse of the financial system and of the economy. Public authority response has been strong to counter this: extension of the mandates of several central banks to financial stability, micro-prudential supervision, macro-prudential policy, which aims to contain transversal chains and their links to macro-economic policy.

The two international organisations where macro-financial risk is summarised – the European Systemic Risk Board (ESRB), created in 2010 and the Basel Committee could be more efficient [30]. The former is open to too many members and has a valuable yet probably excessively disabling supervisory mandate to undertake any decisive action [31]. The latter might lead to greater unification of European voice either via better coordination or by providing one seat to the euro zone, as recommended for the IMF [32].

CONCLUSION

The Capital Markets Union may yet again be reduced to a series of technical measures when the Commission presents its action plan. These might mix simple and complicated issues and time frames, thereby damaging the legibility of the project and the way its functions with the macro-economic policy. It would seem appropriate then to organise its implementation in two movements – as advised by several experts - firstly initiatives to foster the diversification of corporate financing then more structuring steps – whilst ensuring that its communication encourages the appropriation of the project by those involved.

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30. See the Galhau report, op cit, p. 86.

31. Indeed, ESMA is responsible of macroeconomic monitoring i.e. following several market indexes in order to pinpoint the possible occurrence of systemic risk without however being able to prevent it alone.

32. This point echoes the old proposal to have a single euro zone representative within the IMF, taken up in the five presidents' report. This report also links CMU to the Financial Union which should embody the EMU. Boosted by such political support we might hope that these ideas will soon become reality.

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