Senior European Experts

Capital Markets Union

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Introduction

Capital markets offer diversified mechanisms for linking potential investors with those seeking types of finance other than direct bank lending. Capital markets harness savings and investments at the personal level and aggregate them with other forms of finance to form financial products (generally long-term debt and equity-based securities) which can be used by those requiring significant finance for long-term investments, projects or business expansion. In the EU these markets have been used mainly by large organisations, whether governments or major businesses. The Capital Markets Union (CMU) initiative seeks to extend their flexibility, range and availability to those seeking finance at all levels.[1]

EU capital markets at present are mostly shallow and are under-utilised for a number of reasons, including divergent rules and practices between the EU Member States and their divergent rules and practices in relation to the regulation of capital markets. A CMU could bring significant benefits to the EU economy by opening up greater sources of finance for businesses and public sector investment.

Establishing a CMU is one of the main policy aims of the President of the European Commission, Jean-Claude Juncker. In February 2015, the Commission published a Green Paper identifying a number of priorities for the CMU project and beginning a wide-ranging consultation with Member States, national parliaments, citizens, SMEs, NGOs and the financial sector in order for the Commission to formulate a precise Action Plan for creating a CMU.[2]

This briefing paper considers what progress has been made so far in creating a CMU, what specific benefits it could bring to the EU, and what challenges need to be overcome in order to make it a reality.

Background

In 1957, the Treaty of Rome established the Common Market and introduced the four fundamental freedoms, one of which was the free movement of capital. Despite the time that has elapsed since the Treaty was signed, a fully functioning single market for capital does not yet exist.[3] Some progress was made in the 1970s and 1980s, when company law and financial reporting requirements were harmonised and national capital movement controls were liberalised across the EU in the 1980s. Further policies and reforms have been introduced since in a piecemeal manner.[4]

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[1] IRSG, *Briefing on the principles that should underpin the development of a Capital Markets Union in Europe*, 24 September 2014, p. 2

[2] European Commission, *Green Paper: Building a Capital Markets Union*, 18 February 2015, pp. 2-3

[3] *Treaty Establishing the European Economic Community*, 25 March 1957, 298 UNTS 11, Article 3(c) at p. 4; Jonathan Hill, *Speech: Capital Markets Union – finance serving the economy*, 6 November 2014, p. 4

[4] *Council Directive 88/361/EEC for the implementation of Article 67 of the Treaty*, 1988 OJ L 178/5; Steven Maijoor, *Speech: Capital Markets Union: building competitive, efficient capital markets trusted by investors*, European Securities and Markets Authority, 6 November 2014, p. 1

Though this progress has encouraged a limited integration of EU capital markets, their size and strength is significantly less than those of other leading global economies. The global capital market is huge, worth approximately $212 trillion in 2010.[5] Most of the world's largest economies make extensive use of capital markets – Japan and the US have market capitalisations worth 92 and 143 per cent of GDP, respectively – but the European Union, as an economy, does not.[6] It has a market capitalisation of only 64.5 per cent of GDP and the extent to which individual Member States use capital markets differs considerably. For example, Luxembourg, Sweden and the UK, the main users of capital markets in the EU, have market capitalisations of 125, 112 and 121 per cent, respectively; by comparison, the market capitalisations of Cyprus, Latvia, Lithuania and Slovakia are all less than 10 per cent (nine, four, eight and six per cent, respectively).[7] Many Member States, as well as the EU as a whole, are therefore failing to take advantage of the long-term finance that capital markets provide. This has been detrimental to the EU economy: had EU capital markets been as developed as those of the US, for example, $9.2 trillion could have been raised in the period 2008-2013; the same markets actually raised $4.2 trillion in that period, demonstrating their underdevelopment but, more importantly, also their potential.[8]

This is one of two key reasons why EU policymakers want to develop European capital markets further and to have these markets perform a more substantial role in the European financial system. Another is their desire to complement recent EU banking reforms, which are likely to enforce bank tightening and so place limits on bank lending. These reforms began with the formation of the banking union in 2012, which aimed to stabilise the Eurozone banking system.[9] Banking union was introduced in order to integrate policy and regulation within a centralised supervisory system which would bring about a more stable and resilient banking system but with limited emphasis on further developing banking within the EU. This differs from the approach to CMU, which is driven primarily by a desire to release further capital for investment by removing barriers and deepening capital markets rather than centralising regulation or policy.[10] President Juncker sees CMU as an essential counterpart to the banking union, with both working in tandem to ensure a robust European financial sector and, by extension, economy, arguing that progress on establishing a banking union could reduce any risks arising from a rapid expansion of financial markets.[11]

Capital markets union: aims and benefits

The main barrier identified by the European Commission in its Green Paper relates to the weaknesses in the Prospectus Directive, the legislation governing the EU-wide regime for the publication of financial prospectuses, legal documents that businesses are obliged to publish and distribute to investors when seeking investment.[12] The Directive harmonises the requirements for drawing up, approving and distributing prospectuses across the EU

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[5] Charles Roxburgh, Susan Lund & John Piotrowski, *Mapping global capital markets 2011*, McKinsey Global Institute, 16 August 2011, p. 13

[6] World Federation of Exchanges, *2013 WFE Market Highlights*, 28 January 2014, p. 5; World Bank, *Gross domestic product 2013*, 16 December 2014, p. 1

[7] European Commission, *Capital markets in the EU*, 18 February 2015, p. 1

[8] William Wright, *Driving Growth: Making the Case for Bigger and Better Capital Markets in Europe*, New Financial, 18 September 2014, pp. 3, 6

[9] European Commission, *An Investment Plan for Europe*, 26 November 2014, p. 14

[10] Nicolas Véron, *Defining Europe's Capital Markets Union*, Bruegel, 13 November 2014, p. 3

[11] Jean-Claude Juncker, *A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change*, 15 July 2014, p. 7

[12] *Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC*, 2003 OJ L 345/64

yet the administrative and financial costs of producing them, and getting them approved by the appropriate National Competent Authority, remain high and overly complicated.[13] The Commission has launched a separate consultation on the Prospectus Directive to review and correct its shortcomings, with Lord Hill indicating that he would prefer to rely on a market-based solution rather than introducing new legislation.[14] Reducing these burdens should make it easier and more affordable for investment issuers to raise funds through capital markets.

It has been suggested that small and medium-sized enterprises (SMEs) could benefit substantially from this diversification and are a particular focus of Lord Hill.[15] At present, only the biggest businesses can realistically access capital markets; SMEs are typically limited to accessing finance through banks. But with European banks limiting their credit facilities due to the global economic conditions and problems in the eurozone, the demand for finance is outstripping supply; in this situation, larger businesses are seen as being more likely to succeed and therefore receive the lion's share of investment.[16] By opening up the EU's capital markets, the CMU could free up bank balance sheets and enable banks to focus on smaller businesses currently missing out on investment, and also provide an alternative to traditional sources of finance.[17]

Spending on infrastructure across the EU could benefit substantially from a CMU. As with SMEs, banks are reducing investment in infrastructure at a time when the EU is eager to begin large-scale infrastructure projects to boost the economy. The European Commission estimates €2 trillion of investment is needed for telecoms, transport and energy infrastructure by 2020.[18] A CMU could encourage infrastructure investment in the EU as well as providing a much-needed economic boost.

It has been argued that deeper and broader capital markets can also provide for a stronger and more stable economy. There is relatively little competition in the EU banking sector, which has the effect of making the financial system as a whole highly concentrated. This is of major concern since this was an important factor in the global economic crisis and threatens to undermine the recovery.[19] By diversifying the financial sector, CMU should help to distribute risk away from banks and reduce the accumulation of systemic risk in any one institution; this in turn should limit the risk and impact of banking sector problems being transmitted into the wider economy.[20] Further, if capital markets in the EU are made more effective by a CMU then central banks should be better able to manage periods of low inflation or deflation. This would be particularly beneficial for the European Central Bank, whose macroeconomic policies, such as quantitative easing, designed to boost the

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[13] House of Lords European Union Committee, *11th Report of Session 2014-15: Capital Markets Union: a welcome start*, HL 139, 20 March 2015, p. 16

[14] European Commission, *Review of the Prospectus Directive*, 18 February 2015; House of Lords, *Unrevised transcript of evidence taken before The Select Committee on the European Union Sub-Committee A (Economic and Financial Affairs) Inquiry on Capital Markets Union*, 3 February 2015, p. 8

[15] Jonathan Hill, *supra* n. 3, p. 3

[16] Hugo Dixon, *Unlocking Europe's capital markets union*, Centre for European Reform, 14 October 2014, pp. 1-3; for more on recent issues affecting the eurozone, see Senior European Experts, *The Eurozone: Recent Developments*, March 2015

[17] William Wright, *supra* n. 8, pp. 3, 10

[18] European Commission, 'Investment needs', 19 October 2011

[19] Steven Maijoor, *supra* n. 4, p. 2; Hugo Dixon, *supra* n. 16, p. 3

[20] William Wright, *supra* n. 8, p. 10

eurozone economy, would be more effective if European capital markets were closer to the scale of those in Japan and the USA.[21]

Challenges

There are three main challenges to creating a capital markets union in the EU. The first is the practical problem of activating the private sector to provide market-based solutions. CMU will require market participants – investors and businesses – to invest in manpower and systems in the expectation that they will benefit in the long term. There could be an initial inertia on the part of these participants as each waits for the other to make use of the removal of barriers. This could result in a Catch-22: investors do not come forward until there are securities to invest in but businesses avoid issuing securities until there are ready investors.[22] However, these risks may be mitigated if investors and businesses play an active and interested role, as in the CMU consultation, especially in relation to the Prospectus Directive, where they have a direct interest in helping to improve the way that capital markets operate.

The second challenge is the possible resistance to the idea of CMU from a variety of different stakeholders. As discussed above, invigorated capital markets should result in more competition in financial services, which, while beneficial to end users, possibly challenges the interests of the banks and money markets that currently dominate the European financial sector. There is also the issue of ideological scepticism, especially in Southern Europe, where markets and financial institutions are viewed with inherent suspicion; many people in a number of EU Member States still see the 2008 financial crisis as having been caused by securitisation. This in turn feeds into the argument often made by critics of the EU that the benefits of EU membership are captured solely by big business and the already wealthy.[23]

The third and last challenge relates to national sovereignty. Though not to the same extent as in banking union, CMU will require some new regulation and coordination. The UK Government, while generally in favour of CMU, is eager to avoid introducing a pan-EU supervisory framework for CMU, stating that ultimate responsibility should remain with Member States.[24] It should be possible to form a CMU while keeping harmonisation to a minimum. Lord Hill has stated repeatedly that he wishes as much as possible to avoid introducing new legislation.[25]

Future prospects

Work is now underway to address the various obstacles to CMU. The Commission's launch of the Green Paper on CMU in February 2015 marks a positive step in the process to get the project off the ground.[26] Submissions to the consultation should provide a body of evidence as a basis for the European Commission to formulate a policy for the creation of a fully-fledged single market in capital, which should take the EU one step closer towards the completion of the Single Market begun in 1957.

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[21] Hugo Dixon, *supra* n. 16, p. 3; see Senior European Experts, *supra* n. 16

[22] Hugo Dixon, *supra* n. 16, p. 4

[23] Nicolas Véron, *supra* n. 10, pp. 3-4

[24] House of Lords European Union Committee, *supra* n. 13, pp. 29, 44

[25] Hugo Dixon, *supra* n. 16, pp. 2, 5; Jonathan Hill, *supra* n. 3, p. 4

[26] Jonathan Hill, *supra* n. 3, p. 3; European Commission, 'Public consultation: Building a Capital Markets Union', 12 March 2015

The Prospectus Directive is a cornerstone of EU capital markets regulation and is the subject of a separate consultation. This is the second time the Directive has been reviewed and demonstrates the Commission's desire to reduce administrative and financial burdens for businesses, especially SMEs, as part of its overall drive to pass better legislation. Following the consultation, the Commission may opt to propose a standardised prospectus template similar to the US. This should have two results: first, prospectuses should be easier to produce, which should save time and money, allowing more businesses to access capital markets; and second, it should make prospectuses simpler, making them more navigable and therefore more useful to investors.[27]

Along with reform of the Prospectus Directive, development of a high-quality securitisation market (the market for converting loans and assets into tradeable securities) is a vital part of CMU. This is the subject of a consultation also launched at the same time as the Green Paper.[28] The Commission's main aim here is to ensure that the securitisation market develops to provide jobs and growth as part of its overall Investment Plan for Europe but in a sustainable fashion in order to avoid making the same mistakes that led to the 2008 financial crisis.[29] However, as discussed above, many EU countries, particularly those in southern Europe, remain suspicious of securitisation; the Commission's main task here should be to convince these countries about the need for securitisation and what benefits it can bring, as part of the overall CMU project.

While City opinion is generally positive towards CMU, Lord Hill has warned that consideration of Member States' tax policies in regard to capital markets, though necessary in the context of CMU, will carry significant political implications.[30] Further, establishing a CMU could raise new issues about future reforms in financial services, such as harmonising corporate governance and strengthening shareholder rights.[31]

The Commission's CMU initiative is potentially of considerable importance to the EU's economy. Much will depend on the responses to the Commission's consultation exercises, where the focus needs to be on practical steps to improve the working of European capital markets.

June 2015

[27] Hugo Dixon, *supra* n. 16, p. 7
[28] European Commission, *An EU framework for simple, transparent and standardised securitisation*, 18 February 2015
[29] *Ibid.*, p. 2
[30] House of Lords, *supra* n. 14, p. 4
[31] Steven Maijoor, *supra* n. 4, p. 4

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