

Véron, Nicolas

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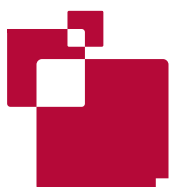
DEFINING EUROPE'S CAPITAL MARKETS UNION

NICOLAS VÉRON

Highlights

- The new European Commission has signalled that it will work to create a 'capital markets union'. This is understood as an agenda to expand the non-bank part of Europe's financial system, which is currently underdeveloped. The aim in the short term is to unlock credit provision as banks are deleveraging, and in the longer term, to favour a more diverse, competitive and resilient financial system.
- Direct regulation of individual non-bank market segments (such as securitisation, private placements or private equity) might be useful at the margin, but will not per se lead to significant capital markets development or the rebalancing of Europe's financial system away from the current dominance by banks. To reach these goals, the capital markets union agenda must be broadened to address the framework conditions for the development of individual market segments.
- Six possible areas for policy initiative are, in increasing order of potential impact and political difficulty: (1) regulation of securities and specific forms of intermediation; (2) prudential regulation, especially of insurance companies and pension funds; (3) regulation of accounting, auditing and financial transparency requirements that apply to companies that seek external finance; (4) a supervisory framework for financial infrastructure firms, such as central counterparties, that supports market integration; (5) partial harmonisation and improvement of insolvency and corporate restructuring frameworks; and (6) partial harmonisation or convergence of tax policies that specifically affect financial investment.

Nicolas Véron (n.veron@bruegel.org) is a Senior Fellow at Bruegel and a Visiting Fellow at the Peterson Institute for International Economics. A version of this Policy Contribution was prepared for a forthcoming Peterson Institute publication on EU growth policies.



DEFINING EUROPE'S CAPITAL MARKETS UNION

NICOLAS VÉRON, NOVEMBER 2014

THE IDEA OF A European Capital Markets Union (CMU) was introduced by Jean-Claude Juncker on 15 July 2014, in his first policy speech as soon-to-be-president of the European Commission¹. In September 2014, Jonathan Hill was designated to join the European Commission with the unwieldy title of Commissioner for Financial Stability, Financial Services and Capital Markets Union. To serve this aim, parts of the European Commission are being reshuffled to form a new Directorate-General for Financial Stability, Financial Services and Capital Markets Union².

However, CMU remains, at this point, a largely undefined policy object – or, as the chairman of the European Securities and Markets Authority (ESMA) put it, “*a concept under construction*”³. The construction phase is expected to last at least six months. Commissioner Hill has announced that he would “*develop an action plan by the summer of next year [2015] [...] [as a] roadmap to developing an ambitious Capital Markets Union*”⁴. In this context, this Policy Contribution is intended as an initial contribution to the collective work of defining the CMU's content and priorities. Since this work is still at an early stage, it focuses on mapping possible relevant areas for forthcoming policy initiatives, rather than specifying detailed recommendations.

The CMU idea does not come out of nowhere. The European Union has implemented policies to develop and integrate its capital markets for decades, with a number of successes, particularly since the late 1990s. It has recently adopted, and is well on its way towards implementing, a policy of banking union that will centralise banking supervision and several other aspects of banking policy for all countries of the euro area and possibly other EU member states as well. Until the moment when banking union was initiated in mid-2012, the fragmentation of Europe's banking policy framework was the biggest obstacle to the

vision of a unified European financial space. Now that this obstacle is being substantially removed, it is only logical to examine other barriers to the free flow of capital across the European economy. Also logical is the clarification that unlike the banking union, the CMU would cover all member states of the EU, including the United Kingdom as it is host to the largest financial centre in Europe (and, by some measures, in the world) in London. This clarification was made early on by Mr Juncker, and underlined by the choice of a British commissioner for the financial services portfolio.

The economic rationale for CMU is twofold, beyond the aim of market integration which is the traditional job description of the European Commission. First, in the short term, it is a part of the policy response to anaemic credit growth in the EU and overdue bank deleveraging following the excessive expansion of bank balance sheets in the five years before the crisis (2002-07), which is only now being corrected. The hope is that more dynamic capital markets and non-bank credit provision can constitute a ‘spare tyre’ in this context, to use the expression popularised by then-chairman of the Federal Reserve Board Alan Greenspan, when he advocated a similar policy of capital markets development in Asia following that region's crisis in 1997-98⁵. Second, in the longer term, CMU is seen as a way to make Europe's financial system more efficient and competitive, more resilient thanks to greater diversity, more responsive to monetary policy signals, and more able to respond to the financing needs of a vibrant innovation-driven economy. In this respect CMU can be seen as part of a broader EU-inspired agenda of structural reform. These two motivations, respectively cyclical and structural, are mutually reinforcing at the current juncture.

CMU seeks the expansion of equity and credit market segments that have been limited in size until now in comparison to bank intermediation. In

1. Jean-Claude Juncker (2014) ‘A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change’, Opening Statement in the European Parliament Plenary Session, 15 July, http://ec.europa.eu/about/juncker-commission/docs/pg_en.pdf.

2. European Commission press release (2014) ‘The Juncker Commission: a strong and experienced team standing for change’, IP/14/984, 10 September.

3. Steven Maijoor (2014) speech at the *Finance for Growth Conference* in Brussels, 6 November, <http://www.esma.europa.eu/content/Capital-Markets-Union-building-competitive-efficient-capital-markets-trusted-investors>.

4. Jonathan Hill (2014) ‘Capital markets union – Finance serving the economy’, speech in Brussels, 6 November, http://europa.eu/rapid/press-release_SPEECH-14-1460_en.htm.

5. Speech at the 1999 *Financial Markets Conference* of the Federal Reserve Bank of Atlanta, <http://www.federalreserve.gov/boarddocs/speeches/1999/19991019.htm>.

this sense 'capital markets' should be understood as shorthand for a long list of market segments, whose common point is that they are not about bank intermediation. The list includes venture capital, private equity investment, public equity issuance and initial public offerings, corporate bond issuance, corporate debt securitisation, the direct purchase of loans by insurers and investment funds from banks, and credit intermediation by specialised non-bank financial firms, such as leasing companies or consumer finance companies. CMU is therefore of a fundamentally different nature from banking union: the closeness of the two policy slogans, banking union and CMU, is a rather unhelpful false symmetry. In the case of banking union, the main objective is to centralise a banking policy framework, the fragmentation of which along national lines has been proven deeply dysfunctional in the EU context, because the incentives of individual national supervisors to be driven by banking nationalism collided with their prudential mandate. The aim of banking union is not to develop banking in the EU; rather it is to check its existing development with an adequate supervisory system. By contrast, in CMU, centralisation is not the primary driver and is subordinated to the developmental agenda.

Nevertheless, a measure of policy centralisation is needed to realise the CMU ambition of development of EU capital markets and non-bank intermediation, for at least three reasons. First, the crisis has provided a reminder that adequate regulation is indispensable to a properly functioning financial system: in accordance with the subsidiarity principle, such regulation must be provided at least partly at the scale of the market itself, which in the CMU vision is pan-European, in order to avoid loopholes, regulatory arbitrage and misaligned incentives. Second, experience in related areas, including competition policy and banking union itself, suggests that an EU-wide approach is the best way to overcome entrenched political economy constraints that have repressed the development of capital markets and non-bank finance until now. Third, while banking union and

CMU are two separate agendas, there are links between the two. The consolidation of supervisory and other banking policies within the banking union area (which includes the euro area, plus all non-euro EU member states that may join the Single Supervisory Mechanism on a voluntary 'close cooperation' basis) will inevitably trigger a need for policy integration in related activities, for example accounting and auditing policies which are important inputs to the supervisory framework.

As noted above, capital markets and non-bank financial intermediation cover myriads of segments and sub-segments, and are characterised by a significant intensity of innovation. CMU policy should not seek to freeze market structures in their currently underdeveloped form but, on the contrary, to create a favourable environment for the development of new intermediation segments and new financing contracts, with effective but not excessive safeguards against systemic risk. In this respect, it is somewhat odd that some early suggestions of blueprints for CMU tended to read as catalogues of market segments, as if each of these needed to be specifically legislated to fulfil its potential⁶. Rather than this curiously *dirigiste* impulse, a more growth-friendly CMU approach should embody a form of financial *Ordnungspolitik*, setting an adequate framework for the invention and development of efficient financial services and contractual arrangements.

An ambitious CMU agenda will face challenges. As always in finance, it will displace powerful interests, starting with those of banks, which intensely dislike the prospect of competition from alternative financing channels. Banking advocates will warn against the perils of 'shadow banking' and regulatory arbitrage, while ignoring that their own core features of deposit collection and high leverage justify higher levels of protection against systemic risk. Furthermore, a capital-markets development agenda will run against deeply-seated ideological scepticism, particularly in parts of continental Europe where markets are viewed

'Capital markets union policy should not seek to freeze market structures in their currently underdeveloped form but should create a favourable environment for the development of new intermediation segments and new financing contracts.'

6. See for example Hugo Dixon (2014) 'Unlocking Europe's capital markets union', Centre for European Reform (London), October.

with inherent suspicion. This obstacle is made more powerful by the failure of economists so far to produce a convincing model for the financial sector that would provide a consensus basis to quantify the economic benefits of market-friendly reform. Finally, as previously mentioned, the agenda will have to include a measure of policy centralisation, even though (unlike in banking union) this should be seen as a means for development of markets and not as an end in itself. This is sure to elicit robust resistance on grounds of claims of national sovereignty, in the UK and also in other member states.

The UK situation is made unique by the high concentration in London of wholesale market activity, but also of other segments such as private equity and hedge funds. Representatives of the City of London are quick to underline the benefits that the EU reaps from having a globally leading financial centre on its territory. But they generally shy away from acknowledging that a logical implication must be to align its regulatory framework with the European public interest and not only the local one⁷. As Simon Gleeson, a prominent British legal expert on financial services regulation, put it, *"we still do not have sufficient European control of the City of London to leave other European Governments happy with the fact that increasingly Europe has only one financial centre, and that is it"*⁸. This issue must also be considered within the current UK domestic political context, marked by uncertainty about government attitudes to the EU and even about future continuation of EU membership.

In terms of policy content, an initial mapping suggests six main areas for possible inclusion in the CMU agenda, listed by increasing order of potential economic impact and political difficulty.

1. Regulation of specific market segments

This is the area where there is the greatest consensus and the one that has been most commented on so far. Possible items include a definition of simple and transparent securitisation products, amendments to the Transparency Directive to facilitate medium-sized companies' market access and some harmonisation of frameworks for private placements. As noted earlier, regulating

a market segment does not necessarily make it prosper, and the potential impact of such initiatives should not be overestimated. However, they can have beneficial effects if they provide impetus for the removal of unnecessarily restrictive legislation in various member states. For example, onerous national rules that require non-bank lenders that do not take deposits to have a banking license should be dismantled. The EU legislation under discussion on European Long-Term Investment Funds also falls under this category.

2. Review of prudential frameworks

Regulators should reconsider prudential requirements that unnecessarily discourage investment in unrated corporate credit and other market segments. In banking regulation, there are suggestions that the current version of Basel III is too harsh on securitisation, and a discussion has started on their possible relaxation. A wider scope for review arguably exists in prudential requirements on insurers and pension funds, which have tended to mimic banking requirements, partly ignoring the fact that these players can legitimately take different risks from banks given the longer maturity of their liabilities. While so-called fair-value measurement is generally adequate for the financial accounting treatment of financial instruments, it is much less suitable for prudential accounting, especially of assets that match long-dated liabilities. The Solvency II Directive (for insurers) and the Occupational Pension Funds Directive should be reviewed accordingly, as well as EU positions in international negotiations, especially on capital requirements for globally active insurance firms.

3. Financial transparency, accounting and auditing

Financial information is the lifeblood of capital markets. While banks can use their relationships with borrowers to assess their creditworthiness, non-bank investors generally need reliable public financial data. The EU decision in 2002 to adopt International Financial Reporting Standards (IFRS) was a momentous step forward in this area. But public financial information in the EU remains of generally insufficient quality and comparability across member states. Moreover, IFRS are only mandated for listed companies' consolidated

7. See International Regulatory Strategy Group (2014) 'Briefing on the principles that should underpin the development of a Capital Markets Union in Europe', City of London/TheCityUK.

8. UK House of Lords (2014) transcript of evidence taken by the Select Committee on the European Union, Sub-Committee A on Economic and Financial Affairs, 9 September.

financials, and single-entity accounts and financial reporting of unlisted groups (including many banks supervised by the European Central Bank) still use divergent national accounting standards. Furthermore, even IFRS reporting is audited by audit firms that are organised and regulated on a national and often divergent basis, and enforced by national capital markets authorities, resulting in widespread non-convergent 'nostalgic accounting' (perpetuating some accounting practices linked to the national standards that were replaced by IFRS in the 2000s), which hampers financial reporting quality and comparability. A reform agenda could include (1) harmonising EU regulation of auditors and creating an EU regulator for the largest audit firms (something that recently adopted EU audit legislation signally failed to achieve); (2) establishing a European Chief Accountant with authority over IFRS enforcement, either within the European Securities and Markets Authority (ESMA) or as a new EU agency; and (3) requiring the use of IFRS by all unlisted banks, to enable consistent banking supervision⁹.

4. Supervision of financial infrastructure

The regulatory framework that applies to financial market infrastructure (FMI) firms in the EU is largely harmonised, and many such companies already operate on a cross-border or pan-European basis¹⁰. However, those FMIs that carry potential systemic risk, primarily central counterparties (CCPs, known as clearing houses in the US), remain subject to national frameworks for their supervision, contingent liquidity support, recovery and resolution. This results in serious actual or potential barriers to cross-border capital market integration, as illustrated by the recent experience in banking and by the ongoing lawsuits of the UK government against the ECB concerning claims of discrimination against non-neuro area based CCPs in its liquidity-support framework. This issue will become increasingly salient with the expected move towards central clearing of large swathes of the over-the-counter (OTC) derivatives market, scheduled in 2015 or

2016 at the latest. The EU should advocate the establishment of a global (treaty-based) supervisor and resolution authority for international CCPs, with the establishment of an EU-wide supervisory and resolution agency for CCPs as a second-best alternative.

5. Insolvency and debt restructuring frameworks

As has been highlighted by numerous studies, European insolvency frameworks tend to work too slowly, to result too often in liquidation and to protect effectively neither employment nor private creditor rights. The reasons include historical legacies and entrenched special interests, excessive protection of government and government-linked creditors, inadequate organisation and functioning of insolvency courts, and moralistic prejudices against corporate failure. Furthermore, insolvency frameworks tend to differ considerably from one member state to another, hampering the emergence of pan-European credit markets, not least for securitisation. In addition, out-of-court restructuring is underdeveloped in Europe, particularly in comparison to the US. While European insolvency reform would be a challenging endeavour both technically and politically, it should be a key component of an ambitious CMU agenda¹¹. Full harmonisation is unlikely to be a realistic objective in this area, partly because of the links between insolvency legislation and idiosyncratic national constitutional arrangements. However, EU framework legislation could help overcome national obstacles and even partial harmonisation might foster cross-border market integration. Separately, in order to move towards a more complete banking union, a specific European insolvency regime should be created for banks, at least the largest ones.

6. Taxation

Differences between national tax regimes for savings products represent a major obstacle to cross-border capital markets integration. Member states should seek more convergence in this area, either

9. On a related theme, it is worth noting that the ECB has taken steps towards the gradual formation of a credit register that would cover the entire banking union area. See the ECB Decision of 24 February 2014 on the organisation of preparatory measures for the collection of granular credit data by the European System of Central Banks, https://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2014_104_r_0008_en_txt.pdf.

10. Note: the author is an independent board member of the Global Trade Repository arm of DTCC, an FMI firm.

11. So far the European Commission has been reluctant to include insolvency law within the scope of its harmonisation agenda under the internal market policy, and has preferred to rely mostly on non-binding recommendations, except for the limited purpose of assigning jurisdiction in cross-border insolvencies. See eg 'Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency', <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014H0135&from=EN>.

'Financial market infrastructure firms that carry potential systemic risk, primarily central counterparties, remain subject to national supervisory and resolution frameworks. This results in serious actual or potential barriers to cross-border capital market integration.'

by unanimity or through enhanced cooperation, as well as simplification and stabilisation of national tax regimes. In addition, the EU should build on existing studies and national experiences to explore a rebalancing of the current differentiated tax treatment of equity and debt, which generally favours the latter to the detriment of the former.

The third and fourth of these areas could result in the transfer of some regulatory and supervisory functions from the national to the EU level. It would be a mistake to bar such transfer as an *a priori* political no-go. EU-level supervision already exists within ESMA, for derivatives trade repositories and credit rating agencies. President Juncker's mission letter to Commissioner Hill asks him to reform ESMA's governance and funding: this reform should include consideration of ESMA's current and possible future expanded role as a supervisor, or whether EU-level supervisory functions for non-bank firms would be better placed in one or several new agencies to be created. A location in London for such a new agency or agencies, or for

new functions to be developed within ESMA, could be envisaged to meet concerns in the UK that EU-level supervision might become too remote from Europe's main financial centre.

The EU debate over the next few months should determine whether a realistic CMU agenda for the next five years could include all six above-listed items or only some of them, and what prioritisation and/or time sequence might be chosen to maximise actual impact. The European Commission will need to consult widely with EU member states, relevant non-EU benchmarks, industry segments and experts. It will face challenging trade-offs. But the larger point is that, thanks in no small part to the progress made towards banking union, the promise of more integrated capital markets that would powerfully serve the EU economy has become much less utopian. This promise should not be neglected or merely tinkered with. Capital Markets Union can become a major component of the European agenda of structural reform, and the current moment of opportunity should not be missed.