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CAPITAL MARKETS UNION: A VISION FOR THE LONG TERM

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Highlights

- Capital Markets Union (CMU) is a welcome initiative. It could augment economic risk sharing, set the right conditions for more dynamic development of risk capital for high-growth firms and improve choices and returns for savers. This offers major potential for benefits in terms of jobs, growth and financial resilience.
- CMU cannot be a short-term cyclical instrument to replace subdued bank lending, because financial ecosystems change slowly. Shifting financial intermediation towards capital markets and increasing cross-border integration will require action on multiple fronts, including increasing the transparency, reliability and comparability of information and addressing financial stability concerns. Some quick wins might be available but CMU's real potential can only be achieved with a long-term structural policy agenda.
- To sustain the current momentum, the EU should first commit to a limited number of key reforms, including more integrated accounting enforcement and supervision of audit firms. Second, it should set up autonomous taskforces to prepare proposals on the more complex issues: corporate credit information, financial infrastructure, insolvency, financial investment taxation and the retrospective review of recent capital markets regulation. The aim should be substantial legislative implementation by the end of the current EU parliamentary term.

This Policy Contribution was presented by the authors to the EU's finance ministers and central bank governors at the Informal ECOFIN meeting in Riga on 25 April 2015. **Nicolas Véron** is a Senior Fellow at Bruegel and a Visiting Fellow at the Peterson Institute for International Economics. **Guntram B. Wolff** is the Director of Bruegel. More information and disclosures on the authors are available at www.bruegel.org. Research assistance by Pia Hüttl and Álvaro Leandro at Bruegel is gratefully acknowledged.

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CAPITAL MARKETS UNION: A VISION FOR THE LONG TERM

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1 INTRODUCTION

The European Commission has created momentum around the idea of a European Capital Markets Union (CMU). The expression was first used by then Commission president-elect Jean-Claude Juncker in the initial exposition of his policy agenda in mid-2014[1]. Since then, CMU has been prominently included in the title and job description of the Commissioner for financial services – or to give him his full title, the Commissioner for Financial Stability, Financial Services and Capital Markets Union[2]. The Commission published a green paper on CMU in February 2015[3]. The announcement of CMU as a policy priority has elicited a number of substantial contributions from a variety of stakeholders, both before and after the publication of the green paper[4].

This mirrors a broader shift in the European policy consensus. At the outset of the financial crisis in 2007-08, European policymakers often described the bank-based nature of Europe's financial system as a factor of stability, in contrast with the more exotic features of finance in the US, such as securitisation conduits and other forms of 'shadow banking'. However, Europe's dependence on banks and the scarcity of alternative financing channels have since been identified as significant features of the European crisis and obstacles to its resolution[5]. The president of the European Central Bank (ECB) illustrated the new consensus by observing that *"the crisis has shown the drawbacks of over-reliance on a bank-centred lending model. So we also need to develop reliable sources of non-bank lending, such as equity and bond markets, securitisation, lending from insurance companies and asset managers, venture capital and crowdfunding"*[6]. In the debate on CMU, the reference to 'capital markets' is often used as shorthand for such sources of non-bank lending, and is preferred to the expression 'shadow banking', which has more negative undertones.

This shift is welcome from an economic-policy standpoint. Capital markets play an important role in sharing economic risks and smoothing consumption and investment. They can provide better access to funding. A well-designed CMU agenda should also make a substantial contribution to financial stability. The prior preference for bank-based finance ignored the advantages of a diverse financial system and the risks associated with the near-absence of alternative financing channels. It also led to insufficient development of forms of financing that are specifically suited for high-growth firms that are major potential creators European jobs[7]. During the crisis, over-reliance on banks was an obstacle to swift repair of the European banking system, and it exacerbated sudden stops and cross-border divergences in bank funding costs.

The debate will benefit from a clear articulation of the CMU's objective. We suggest that the CMU agenda should aim to ***enable access by EU economic agents to the best-suited possible financing options, while safeguarding financial stability***. This definition highlights major differences, in particular, with the banking union which is currently in a phase of implementation. The definition indicates that the CMU focus is not the financial sector but the broader European economy. Stability concerns are not the primary driver, but only a check on the development of CMU. Institutional issues are not at the core of the CMU project, even though institutional changes might be necessary to reach its aims. Its geographical scope is not centred on the euro area, but extends to the entire EU (see below). Last but not least, it is not triggered by crisis-management challenges, but is part of a broader long-term agenda of structural reform at the EU level. Banks play a vital part in capital markets, even in systems in which non-bank finance is comparatively more developed than in the EU. Thus, well-designed policies for banks and capital markets can be mutually reinforcing.

1. Juncker (2014a).
2. Juncker (2014b).
3. European Commission (2015a).
4. See in particular AFME (2015a), Anderson *et al* (2015), BlackRock (2015), Dixon (2014), European Issuers, EVCA and FESE (2015), Goldman Sachs (2015), House of Lords (2015), Martinez and Philippon (2014), Odendahl (2015), Véron (2014) and Wright (2014).
5. See eg Véron (2012), Sapir and Wolff (2013).
6. Draghi (2014).
7. This point was developed in the pre-crisis context by Philippon and Véron (2008).

The CMU agenda connects with a long history of EU capital-market building. Starting from the Treaty of Rome's expression of the freedom of movement of capital in 1957, major milestones on this historical path include the elimination of restrictions on capital movements in 1988; the Financial Services Action Plan of 1999[8], initiated in the wake of Europe's Economic and Monetary Union (EMU) and mostly implemented in the early 2000s; and the creation of European Supervisory Authorities (ESAs) in 2011, and new impetus given towards a 'single rulebook', following the Larosière Report of February 2009[9]. This historical continuity also suggests that, to deserve its labelling as a genuine 'union', the CMU agenda should go beyond the mere extension of pre-existing initiatives, even if these are important and helpful. It must envisage high-impact new steps that would trigger measurable progress towards its stated objective.

The CMU agenda is for the entire EU. The notion of a single market for capital[10] aligns with the EU's internal market policy framework. Various analyses have identified specific benefits of CMU for the euro area, particularly in terms of risk-sharing[11]. While these benefits are an important motivation for CMU, they do not analytically imply that the project should or even could be executed at the euro-area level. On the contrary, the dominance of the City of London as Europe's capital markets hub (see next section) makes it impractical and undesirable to envisage a policy framework that would be limited to a subset of EU member states. The UK government has welcomed the announcement of CMU and signalled its intent to engage actively in its shaping[12], in sharp contrast with banking union, which the UK government also welcomed but on the condition of not taking part. Envisaging a CMU that would not include the UK or other non-euro-area member states would be economically counter-productive[13].

As a contribution to shaping the CMU agenda, we suggest an analytical framework and a vision for policy. We present facts about EU capital markets (section 2), issues that should be taken into account in the development of CMU policy (section 3), corresponding policy options over the medium to long term (section 4) and suggestions for policy implementation and sequencing (section 5).

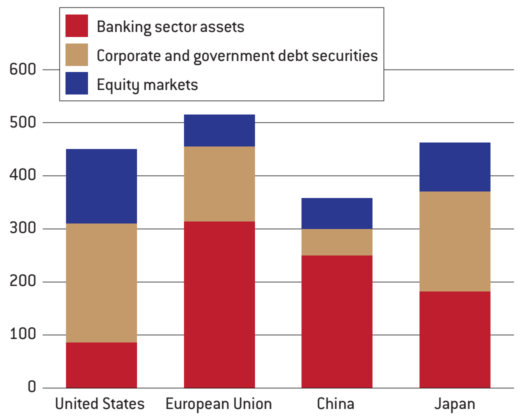
2 ASSESSING THE EU'S CAPITAL MARKETS

When analysing financial intermediation and capital markets, three perspectives are useful: the perspective of the demand for finance from corporations, households and governments; the perspective of financial intermediaries; and the perspective of asset owners such as savers or investors. All three are important in understanding differences in capital-market structures in different jurisdictions. They are equally important in identifying the challenges the EU faces when promoting the development of capital markets.

The magnitude and composition of financial intermediation are substantially different in major economies. Figure 1 shows the EU's large banking sector, while in the US, debt securities and stock markets play a major role in financial intermediation. China's financial system is still substantially smaller than the EU/US financial systems while the structures of the Japanese financial system place it between the US and EU.

The funding of the corporate sector is substantially different in different jurisdictions. Only a part of the financial system provides intermediation to the non-financial corporate sector, and the

Figure 1: Size of the financial sector and capital markets (% of GDP)



Sources: Bruegel based on IMF World Economic Outlook, World Bank, Association for Financial Markets in Europe (AFME), Securities Industry and Financial Markets Association (SIFMA), Asian Bonds Online, China Banking Regulatory commission, Board of Governors of the Federal Reserve System, European Central Bank, Bank of Japan, China Statistical Yearbook, and World Federation of Exchanges. Note: All data refer to end 2014 except EU: equity market (end 2012), Corporate and government debt securities (end 2013) and Japan: Banking sector assets (end 2013).

8. European Commission (1999).

9. European Commission (2009).

10. See Coeuré (2014).

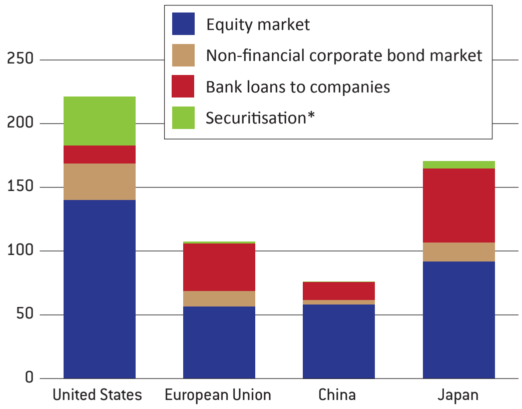
11. See eg Anderson *et al* (2015), Coeuré (2014) and Martinez and Philippon (2014).

12. See, for example, quote from UK Chancellor George Osborne in Marion Dakers, 'Europe launches blueprint for capital markets union', *The Telegraph*, 19 February 2015.

13. The only qualification would be about some limited aspects of the CMU agenda on which the legal basis would require unanimity, and this would not be achievable across all EU member states. Such aspects, eg proposals in section 4 about taxation issues, might best be addressed through enhanced cooperation.

way the corporate sector is funded is substantially different in different jurisdictions (Figure 2). EU companies, like their Japanese counterparts, rely more strongly on bank credit, while US companies rely more on equity financing, corporate bonds and securitisation. In China, corporate credit markets remain comparatively underdeveloped.

Figure 2: Size of financial intermediation to the non-financial corporate sector (% of GDP)



Source: Bruegel based on IMF World Economic Outlook, World Bank, Association for Financial Markets in Europe (AFME), Securities Industry and Financial Markets Association (SIFMA), Asian Bonds Online, OPPLand Corporation, Board of Governors of the Federal Reserve System, European Central Bank, Bank of Japan, China Statistical Yearbook and World Federation of Exchanges; *securitisation is non-financial corporate sector in the US (Commercial Mortgage backed securities) and the EU (Commercial Mortgage backed securities as well as SME securitisation) and total securitisation for China and Japan. Note: Data refers to: US: 2014; EU: 2013, except equity market (2012); China: 2014, except non-financial corporate bond market (2012) and bank loans to companies (2012); Japan: 2014.

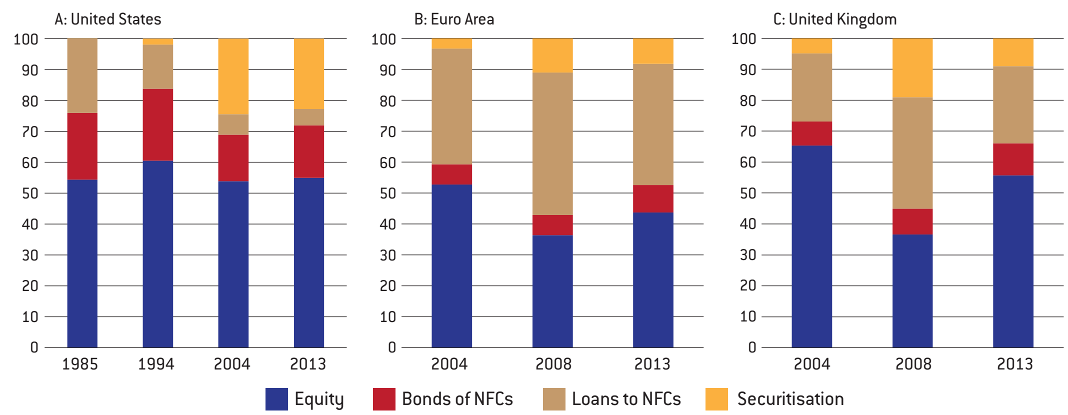
The structure of financial intermediation changes slowly. The way non-financial corporations fund themselves tends to be stable over time (Figure 3). In the United States, for example, the percentage of equity in total corporate funding has remained almost unchanged in the last 30 years. However, bank credit has become less important and was partly replaced by securitisation (Figure 4). In both the UK and the euro area, equity financing has gradually lost importance while bank lending became significantly more important until the beginning of the crisis.

There are substantial differences in the funding models in different EU countries, with bank lending, securitisation, corporate bonds and equity playing very different roles (Figure 5).

The EU financial system remains national; cross-border integration is limited. Retail banking has remained largely national with few cross-border loans and limited cross-border ownership of subsidiaries, depending on the country (Figure 6). Wholesale banking became integrated before the crisis but has since lost its cross-border importance. Cross-border corporate bond holdings declined substantially during the crisis, but recently increased. The home-bias in equity remains substantial, with 64 percent of EU equity holdings and 61 percent of euro-area equity holdings being of domestic origin.

Capital markets can play an important role in spreading economic risk across different regions

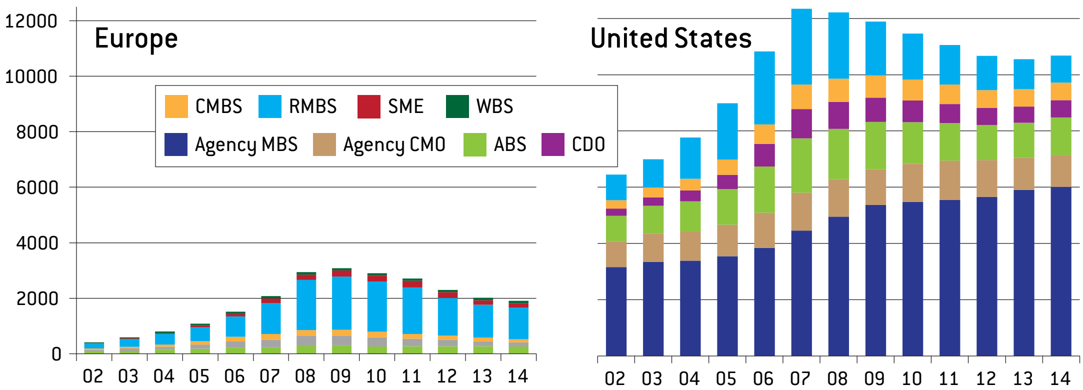
Figure 3: Size of different financial intermediation channels to the non-financial corporate sector as share of total financial intermediation



Sources: Panel 1: US Bureau of Economic Analysis, Board of Governors of the Federal Reserve System, Securities Industry and Financial Markets Association (SIFMA), World Federation of Exchanges. Panel 2: Eurostat, World Bank, Association for Financial Markets in Europe (AFME), European Central Bank; * Equity refers to 2012. Panel 3: World Bank, Office for National Statistics, Bank for International Settlements, Association for Financial Markets in Europe (AFME), European Central Bank; * Equity refers to 2012.

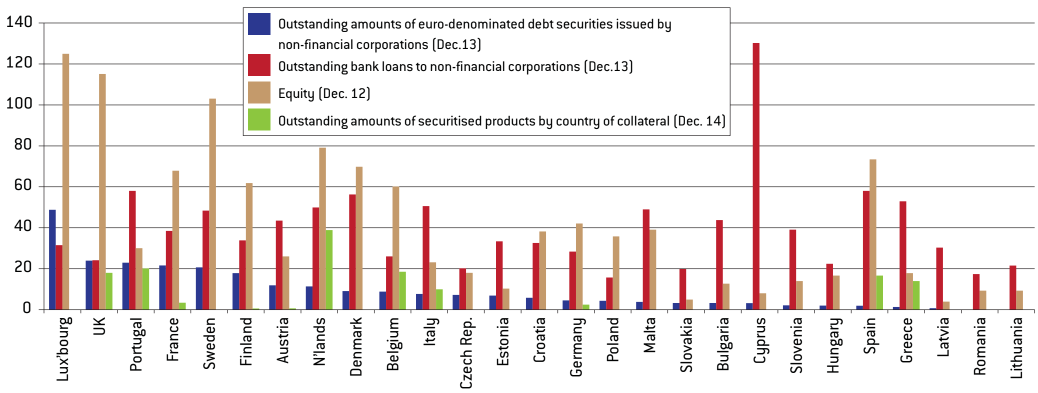
and jurisdictions. A substantial body of literature provides evidence that well-integrated and deep capital markets can spread country and region-specific risk, smoothing the impact of deep recessions on consumption and investment (Figure 7)[14]. Such economic risk sharing requires substantial cross-border equity holdings in particular.

Figure 4: US and European securitisation outstanding (US$ billions)



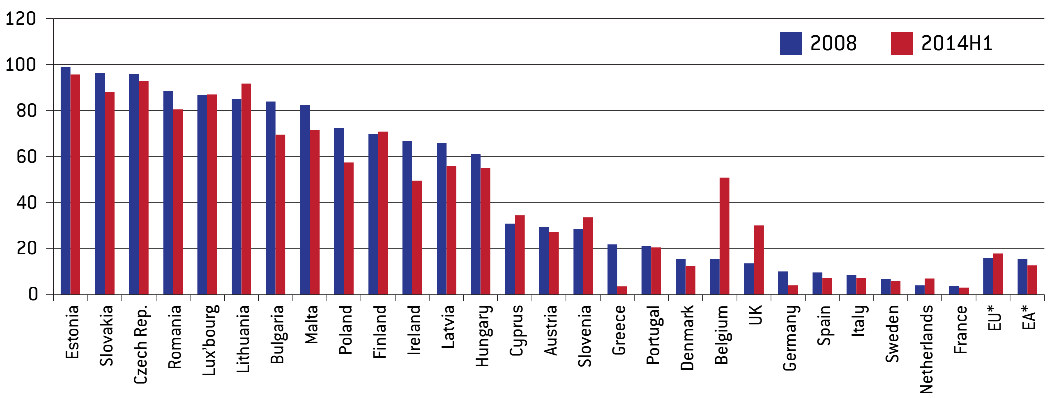
Source: Bruegel using SIFMA. Note: European volumes include transactions from the European Economic Area (EEA) countries and certain non-EEA countries located on the geographic European continent (Turkey, Kazakhstan, Iceland, Georgia, Russian Federation). Whole business securitisations (WBS), commercial mortgage-backed securities (CMBS), small and medium-sized enterprise securitisations (SME), other asset-backed securities (ABS) collateralised debt obligations (CDO), residential mortgage-backed securities (RMBS), Agency collateralised mortgage obligations (Agency CMO), Agency mortgage-backed securities (Agency MBS).

Figure 5: Breakdown of financing channels by EU country (in % of the respective country's GDP)



Source: Bruegel based on ECB, World Bank, AFME. Note: 'Equity' is defined as market capitalisation of listed companies; data was transformed using the GDP of the respective period.

Figure 6: Share of assets held by foreign banks (in %)

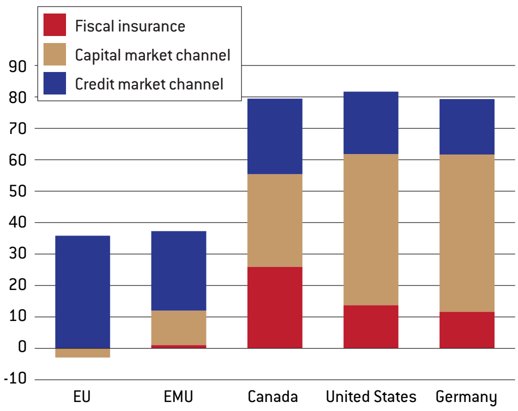


Source: European Central Bank. Note: Foreign banks are defined as subsidiaries and branches that are controlled by either an EU or a non-EU parent that is 'foreign' from the reporting country's point of view.

14. See Sorensen and Yosha (1998), Bijlsma and Zwart (2013), Allard *et al* (2013), European Commission (2015b).

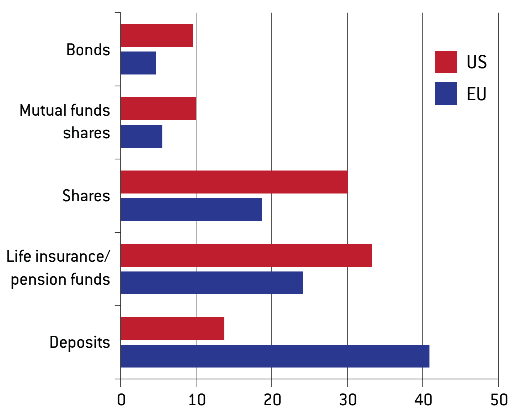
Funding models are not only determined by the behaviour of corporations but also by the behaviour of savers. When savers invest significant amounts of their savings in equity, then funding with equity becomes easier for corporations. Conversely, if savers put their money mostly into bank deposits, banks tend to play a greater financial intermediation role. **EU households predominantly save in deposits while US households predominantly save in shares, life insurance and pension funds.** Figure 8 shows that EU households save much less in bonds, stocks and insurance than US households. Instead, they have more than 40 percent of their financial wealth in the form of deposits. Also, the level of financial wealth is very different in the EU and the US. As of 2012, the average household in the EU15 (before the 2004 enlargement) held €39,160 in net financial wealth, while the average US household held €110,227. **The different savings patterns give banks a greater role in financial intermediation in the EU than in the US.**

Figure 7: Risk sharing (% of shock smoothed by the different channels)



Source: IMF (2013), Figure 2.

Figure 8: Financial portfolio of households in the EU and US (in % of total financial assets)



Source: OECD (2011).

The different savings patterns also have important implications for maturity transformation. The maturity structure of savings in the US and the EU is substantially different: US savers invest a much larger share of their savings in assets with long maturities, including equity, life insurance and pension funds, while EU savers invest in instruments that are easily accessible such as deposits. As a consequence, the financial system has to provide different levels of maturity transformation in the different jurisdictions if it wants to achieve the same funding structure of corporates.

Rather than small and medium-sized enterprises (SMEs) in general, it is young, high-growth companies that play the central role in EU job creation. It is often mentioned in policy debates that more than 65 percent of EU employment and more than 55 percent of EU value added is contributed by SMEs . But it is even more important that young firms, as opposed to older companies, are the true engines of job creation. According to OECD research, about half of all new jobs are created by young firms, and these young firms have always been net job creators throughout the business cycle (with high-growth firms playing the most important role), even during the financial crisis[15]. Hence, if creating jobs is a key goal, the financing and growth of such young, high-growth firms is a central challenge for the EU.

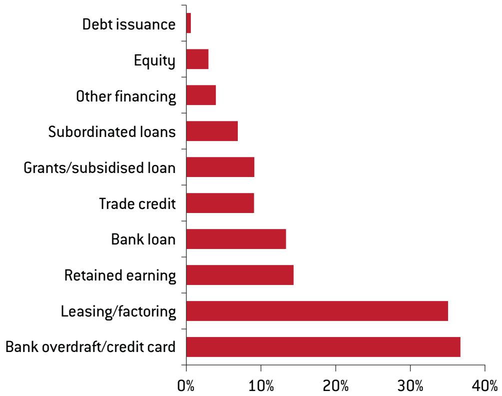
Most SMEs will continue to rely on bank funding, but securitisation and non-bank credit could play greater roles to improve funding of larger SMEs. The role of SMEs in capital markets is minimal. They predominantly rely on bank lending for their funding (Figure 9 on the next page). To the extent that bank lending is a constraint because of limits to banks' balance sheets, securitisation could free up additional lending. The securitisation market for SMEs is particularly strong in Spain and Italy. However, it serves more to create assets eligible for the collateral operations of the ECB than to free up banks' balance sheet capacities. Most of the newly issued securities are retained (Figure 10). Developing a more dynamic market for creating and placing SME credit as securities could be a helpful avenue to improve funding for

15. Criscuolo *et al* (2014).

SMEs. Realistically, however, this would only make a difference for a minority of larger SMEs, given the idiosyncratic nature of SME credit risk and the cost of documenting securitisation. Beyond securitisation, service innovators that do not have tangible collateral to pledge need access to high-risk forms of credit such as mezzanine and high-yield debt, which are typically not offered by traditional banking[16].

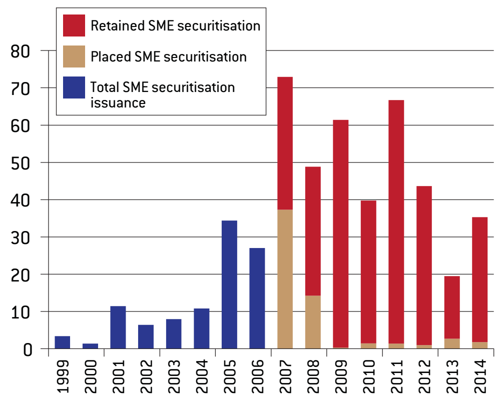
Financial services tend to concentrate in hubs. In the EU in particular, wholesale financial activity is already highly concentrated in London, and if anything, the recent years of crisis appear to have accelerated the concentration because banks have been forced to restructure their less-efficient activities. A recent survey suggests that 77 per-

Figure 9: Sources of SME financing in the past six months (% of EU28 SMEs)



Source: Bruegel based on European Commission, SAFE 2014.

Figure 10: European SME securitisation issuance by retention (in € billions)



Source: AFME; Note: since 2007, the total issuance can be split between 'retained' and 'placed', where 'placed' refers to securitisations placed with investors on the primary market and 'retained' refers to securitisations retained by banks to create liquidity buffers and to access ECB liquidity.

cent of highly-paid financial executives in the EU are based in the UK. The next most significant group is in Germany, representing only 6 percent of the total[17]. Similarly, the UK's share of total derivatives transactions in the EU rose from 61 percent to 77 percent in the 15 years to 2013 (London's share in the global total also rose during this period, from 33 to 43 percent). As of 2013, the next largest share in the EU was France's, at only 7 percent of the EU total[18].

3 ANALYTICAL TAKEAWAYS

Because the structure of financial systems changes slowly, CMU should not be seen as a 'quick fix' substitute for repairing the bank-lending channel where still needed. To revive economic growth and investment in the short term, policymakers are right to rely on ECB monetary policy measures, including the quantitative easing programme started in March 2015; on the work by the European Single Supervisory Mechanism and Single Resolution Board to repair banks' balance sheets and achieve a return of trust to Europe's banking sector; and on initiatives to boost investment, such as the Juncker investment plan at the EU level and national confidence-building measures. Even though an assessment is not within the scope of this paper, these actions all have growth- and job-boosting potential in the short-term. By contrast, hopes that CMU would play a meaningful role in EU economic recovery from the crisis are likely to be disappointed.

CMU should be designed and thought of as structural and long-term transformation of financial intermediation in the EU. It cannot serve as a short-term stimulus to boost finance. Rushing it through subsidies or tax or regulatory privileges will be distorting and ultimately counter-productive and should be avoided. What counts is to create the right framework conditions so that the new financial ecosystem can develop at its own pace, which will be gradual.

The two objectives of enhancing capital markets development and of fostering cross-border financial integration are distinct and might require different policies. Europe's financial system can be characterised by two fundamental features. First, capital market finance is compara-

16. This point is further developed in Philippon and Véron (2008).

17. European Banking Authority (2014).

18. Bruegel calculations based on the Triennal Central Bank Survey of foreign exchange and derivatives market activity in 2013, available at: http://www.bis.org/publ/rpfx13.htm.

'Deeper capital markets offer a greater variety of funding options and easier access to finance for corporations. They also increase the options for households to save and invest.'

tively underdeveloped in most countries given their general level of economic development. Second, financial markets still remain predominantly national, as measured by high home bias in investment patterns. The two issues are linked but call for different policies. While the response in the first case should be to improve conditions for capital market intermediation in every country, the second issue should be addressed by harmonising and standardising the national financial intermediation rules and practices.

CMU should combine the benefits of deepening and integrating financial markets. Both are beneficial and mutually reinforcing. Integration across borders, not least in equity markets, brings economic risk mitigation and reduces the financial-sovereign vicious circle. It also increases competition and allows for scale effects, which should help to generally reduce funding costs. This integration will also contribute to the development of markets. Deeper capital markets, in turn, offer a greater variety of funding options and easier access to finance for different kinds of corporations. They also increase the options for households to save and invest.

Most SMEs will remain reliant on banks for their external funding and will not be directly impacted by CMU. However, CMU should have material impact to broaden financing options for high-growth companies of all sizes and dynamic medium-sized firms. It is misleading to characterise CMU as a project to target primarily SMEs. SMEs will continue to rely predominantly on banks, even though larger SMEs might gain capital market access through better-developed corporate loan securitisation. Large corporations already have decent access to capital markets. Where CMU offers most potential is for high-growth companies, which lack access to risk capital[19] and for medium-sized companies, which currently have much more limited access to capital markets than large groups.

To boost the role of capital markets in financial intermediation, the perspectives of savers, financial intermediaries and non-financial firms are all important. The shape of the financial ecosystem depends on decisions taken by all three categories and the framework conditions that affect them. Changes in the funding mix for non-financial corporations have implications for financial intermediaries as well as for savers. For example, strengthening equity funding implies that investors need to accept higher risk and longer maturities. While the current pattern of European savings in low-risk, short-maturity instruments is probably rooted in preferences and demographic structures, it is also encouraged by specific tax and regulatory policies. These policies should be amended to further the objective of better funding for the European economy, including through equity instruments. Similarly, corporate governance and ownership patterns that are dominated by family control in several EU member states might contribute to companies' reluctance to tap external sources of finance, especially those outside banks. But a more favourable policy framework could incentivise a significant number of companies to change their financing patterns in a manner that would be more conducive to investment and job creation. Financial intermediation and in particular banks are also central. Banks perform important functions in terms of maturity transformation, financial engineering and the overcoming of information asymmetries, and they have the capacity to deal with regulatory and supervisory differences between countries. Increasing harmonisation across EU countries could allow other organisations or even savers to engage directly in cross-border activity more easily. However, this also means that non-banks take certain risks, including in terms of maturity transformation.

Deeper and more integrated capital markets should spread economic risk, but potential financial stability risks need to be managed. The economic literature and the empirical evidence are clear that financial integration is a good way to spread economic risk. But the emergence of new financial players also raises financial stability concerns, especially when they engage in maturity transformation and/or financial engineering. There are risks at the level of instruments, institutions

19. Veugelers (2011).

and the system. While not identical to those from banking, financial stability risks from capital markets and non-bank finance need to be adequately monitored and, if necessary, mitigated through appropriate regulation. Thus, **financial stability considerations should be an integral part of CMU**. This raises questions about regulation, supervision and resolution and the allocation of these tasks to relevant institutions.

To achieve a different pattern of household investment, protection of savers is fundamental. Households and savers will only invest in financial products if they are transparent and comply with clear and reliable rules. Deposits in the EU enjoy the extraordinary privilege of a high deposit insurance guarantee. By contrast, other forms of financial investment have much more limited protection if any, and are often opaque and difficult to understand. Adequate safeguards for savers and investors should therefore be an important part of CMU and might require a strengthening of both legislation and supervision. Consumer protection also needs to be adequately calibrated so that it does not stifle risk taking and innovation.

All member states will gain from better access to finance and better returns for savers, even though some will host more financial-sector activity than others. In an integrated market, financial firms tend to concentrate in a limited number of locations, especially in terms of wholesale market activity. The US financial system, for example, is dominated by the role of New York and a few other spots such as Boston, Chicago, and the San Francisco Bay Area. Yet, Texas or Ohio can still prosper without a capital market of their own, or even locally-headquartered large banks. There are only three stock exchanges in the US, as opposed to 13 in the EU[20]. Similarly, CMU does not mean that all member states have to gain in terms of the development of their own financial services sectors. On the contrary, comparative advantage should be allowed to play its role. From this perspective, CMU would have a distributional impact on EU member states, given the different strengths of their comparative advantage in financial services. This distributional impact of CMU, however, should not shift attention from its more significant impact on non-financial corporate funding and improved saving opportunities, which would be positive in all member states even though the magnitude would vary. Local financial ecosystems now work through private equity and investment communities, not local financial infrastructure such as stock exchanges. To reap efficiency gains, CMU should be allowed to disrupt currently protected national infrastructure platforms and other entrenched financial market structures.

CMU goes beyond a narrow definition of financial services policy. Financing patterns are determined not only by securities, conduct and prudential rules that are specific to the financial sector, but also by other policies that shape the behaviour of companies, savers and financial intermediaries, such as those that govern the sharing of information and data, insolvency frameworks and tax policies. This broad scope is reflected in the policy proposals of the following section.

4 POLICY AGENDA

The following recommendations are based on the analytical framework presented in the previous section, and on the current stage of development of capital markets policy in the EU. They also follow extensive discussions with a wide range of stakeholders[21] and a review of available surveys and evidence. It is not implied that all the following items must be delivered in full for the CMU to be a long-term success, nor indeed that this list is exhaustive – other significant initiatives may be needed, possibly in the wake of new technological developments. Nevertheless, these items all appear important if the goals of the CMU as expressed by the European Commission and tentatively defined in this paper's introduction are to be met.

System-wide surveillance. Most EU member states have a long tradition of monitoring risks in their national banking systems. In the euro area, the implementation of banking union offers the prospect of much-improved supranational banking risk monitoring. However, the surveillance of a more complex financial system in which the role of banks could gradually become less dominant implies new challenges, which call for an adequate infrastructure[22]. This echoes legitimate con-

20. Based on membership of the Federation of European Securities Exchanges (FESE) and the World Federation of Exchanges (WFE). These groups are, respectively, BATS, Nasdaq and the New York Stock Exchange (part of ICE) in the US; and the stock exchange groups headquartered respectively in Amsterdam (Euronext), Athens, Bucharest, Bulgaria, Cyprus, Frankfurt (Deutsche Börse), Ireland, Luxembourg, Madrid, Malta, Stockholm (part of Nasdaq OMX), Vienna (CEE Stock Exchange), and Warsaw in the EU. This list does not include the separate stock exchanges in Bratislava and Zagreb, which do not appear on the FESE membership list.

21. These included a brainstorming workshop held at Bruegel on 24 November 2014, a presentation by the authors at a meeting of the EU Financial Services Committee on 20 January 2015, participation of the authors and their Bruegel colleagues in a range of conferences and other events organised by third parties in a number of different EU member states, and numerous bilateral conversations with interlocutors in academia, the public policy community, the private sector and other segments of European civil society. The authors are also grateful to all those who have given feedback on early drafts of this paper.

22. Among others, Wright (2014) notes that *"there is a striking inconsistency in data in some parts of the [EU] capital markets"*.

cerns about 'shadow banking' and the possibility of financial risks migrating to parts of the financial system where they might escape public monitoring. New initiatives are needed both on data collection, which currently tends to be fragmented across different systems, and on institutional architecture, a particular challenge given the strong interdependencies between the euro area (which accounts for a majority of the EU's economy), the UK (which hosts the main hub of EU capital markets) and other non-euro member states. One solution might be to **beef up the capacity of the European Systemic Risk Board** (ESRB) to collect and analyse granular data and thus to bring Europe closer to the vision of a holistic real-time 'risk map'[23], in conjunction with efforts led by the Bank for International Settlements (BIS) and Financial Stability Board (FSB) at the global level.

Financial product regulation. In the wake of earlier efforts to move towards a single rulebook for capital markets regulation, the EU should continue to work towards a clearly articulated, simple and effective regulatory framework for those financial market activities that cannot simply be left to the discipline of the markets. This should include the completion of projects that have already been announced or are at various stages of development by the European Commission and other EU institutions, including on European Long-Term Investment Funds (ELTIFs)[24], securitisation[25], the revision of the Prospectus Directive[26] and private placements[27]. It should also include additional initiatives such as a revision of the EU framework for Undertakings for Collective Investment in Transferable Securities (UCITS), the reference fund status for retail investment in the EU, in order to enable direct investment by UCITS in loans originated by banks, because the current curbs on such investment appear excessive from the standpoint of both financial stability and investor protection. The EU should also further replace directives with regulations to close loopholes, reduce national 'gold-plating' (the addition of idiosyncratic national provisions in the legislative transposition of EU directives) and ensure pan-EU regulatory consistency. Such regulatory actions form the bulk of the concrete policy proposals described in the European Commission's green paper on CMU. It should however be kept in mind that while necessary, these measures would be far from sufficient to enable significant development and integration of EU capital markets.

Regulation of financial entities. In addition to the regulation of financial products and activities, many financial firms are subject to specific regulatory, supervisory and in some cases resolution frameworks that impact on their role in the development of EU financial markets. Such regulation is generally motivated by concerns about financial stability, given the specific nature of financial systemic risk, and/or about financial conduct, not least because of the multiplicity of information asymmetries that exist in finance. In this respect, legislation currently under discussion on **banking structural reform** is of particular importance[28]. The detailed analysis of this proposal is beyond the scope of this paper. However, it would seem appropriate to take into account the CMU's objectives of capital markets development in the legislative discussion and finalisation of this text. Other significant bank-related regulatory projects with significant implications for capital markets include further EU implementation of the global Basel III Accord, and the future EU transposition of the forthcoming global standards on banks' Total Loss-Absorbing Capacity (TLAC). EU legislators could contemplate delaying completion of banking structural reform legislation so that closely-related TLAC concerns can be incorporated.

Aside from banks, **insurers** are crucial participants in European capital markets as investors. The ongoing implementation of the new Solvency 2 regime should be completed in 2016 as currently planned, to minimise regulatory uncertainty. However, this package deters investment by insurers in riskier market segments such as equities, under a framework that is largely inspired by the prudential regulation of banks and does not adequately take into account the longer maturities of insurance liabilities. EU legislators should consider rapid review of Solvency 2 in order to achieve a better balance between the need to maintain the long-term solvency of insurers and the concern not to unnecessarily hamper their potential as long-term risk-taking investors in the European economy. Also, the EU should consider adjustments to regulations adopted in the heat of the crisis – for example, those on alternative investment funds and on credit rating agencies – in

23. See eg Issing and Krahnen (2009).

24. The European Commission published a legislative proposal on ELTIFs in June 2013, which is currently going through the EU legislative process.

25. A consultation is currently underway on *"simple, transparent and standardised securitisation"* (European Commission, 2015c).

26. On this too, a consultation was started at the time of publication of the CMU green paper (European Commission, 2015d).

27. See a proposal outline for a harmonised single EU private placement regime in Houmann & Gleeson (2015).

28. European Commission (2014).

order to take into account the impact of their early implementation on EU capital markets activity.

One category of intermediaries that European policymakers have often tried to actively promote is **venture capital (VC) funds**. The development of VCs is seen as desirable because it is associated with high-growth technical innovators. However, the record of policies aimed at stimulating VC development through provision of public money, either in the form of public VCs or co-investment of public funds with private-sector VCs, is not compelling. The main reason is that the control mechanisms that are inherent in any use of public funding easily enter into conflict with the high-risk, high-return logic of VC investment, including the way VC investments are chosen, and even more so the way they might be discontinued when the company receiving investment is not sufficiently successful. In addition, the injection of significant amounts of public money into comparatively small VC markets in individual member states has often led to market and price distortions which have ended up penalising rather than helping the most innovation-oriented VCs. Thus, the EU should refrain from throwing public money at the VC market, including though the European Investment Fund (EIF). The best way to encourage a vibrant European VC industry is to work on their investment environment rather than interfere directly with their activity. Our proposals, below, should contribute to such an approach, because they focus on the framework conditions in which capital markets can develop.

EU-level regulatory implementation and enforcement. Overwhelming evidence from market participants suggests that the current regime of national implementation and enforcement of even the most-harmonised EU regulations results in diverging practices and market fragmentation. Companies and investors cannot simply transpose their experience of regulations in one member state to another, and need country-specific legal advice in each member state. In a recent survey, investors cited the complexity of such differences and the discrepancies in rules (resulting from national rules and from gold-plating of EU laws) as the two most important barriers to investment in the EU[29]. The creation of the European Securities and Markets Authority (ESMA) in 2011 provides an existing infrastructure for the implementation and enforcement of EU legislation in a consistent manner, but ESMA needs to be further empowered to act as an effective regulator rather than a weak coordination mechanism. The chairman of ESMA recently noted that *"Given the breadth and complexity of the single rulebook, regulators need to make many choices regarding their supervision, including the interpretation of the rules and the intensity of supervision. Diversity in these choices will have the result that the single rulebook will not in fact be seen as such by investors and market participants"*[30]. An EU Court of Justice ruling in 2014 provided additional legal security on the granting of authority to ESMA on matters of capital markets regulation[31] and ESMA is already the sole supervisor for certain categories of capital market participants, including credit rating agencies and trade repositories.

Specifically, the **authority to approve new securities issuance and to authorise funds** under legislation such as UCITS and AIFM may be transferred to ESMA, with a transfer back to national authorities of much of the actual regulatory work but as part of a binding EU network in which ESMA would have effective policy control[32]. Other areas, such as EU competition policy and (in the euro area) the prudential supervision of banks within the Single Supervisory Mechanism, provide examples of such patterns of delegation that ensure both regulatory consistency and a large degree of operational decentralisation.

Similarly, the **enforcement of EU capital markets regulation** should be at least partly pooled at the level of ESMA with wide operational delegation back to the national authorities, in order to ensure that sanctions for non-observance are not simply evaded by market participants by moving their activity from stricter to more lenient EU jurisdic-

'Overwhelming evidence from market participants suggests that the current regime of national implementation and enforcement of even the most-harmonised EU regulations results in diverging practices and market fragmentation.'

29. AFME (2015a), Figure 1.

30. Maijoor (2015).

31. Judgement of the Court in case C-270/12, UK vs Parliament and Council, 22 January 2014, analysed eg in Pelkmans and Simoncini (2014).

32. Both proposals, referred to as a 'European System of Listing Authorities' and a 'European System of EU Fund Approval' respectively, are in Houmann and Gleeson (2015).

tions (a practice often described as 'forum-shopping'), for example in relation to rules on securities issuance and investor protection. Similarly, obligations related to system-wide risk monitoring, including the requirement to report derivatives transactions to central repositories, are currently enforced very differently in different member states, and a transfer of enforcement responsibility to ESMA would result both in lower costs and in much improved compliance. The possibility of coexistence of national and European enforcement regimes should be carefully assessed, but must not be considered an intractable problem per se. The long-standing situation in the US in which federal and state-level enforcement frameworks operate simultaneously, especially in states with significant financial activity such as New York, shows that such coexistence can be managed. In parallel, the Commission should be more assertive in its task of single market enforcement through infringement procedures when needed, in cases of national legislation that is not compliant with the EU framework.

Of course, such regulatory centralisation would require decision at the appropriate political level, as was the case when the decision to create ESMA and the other ESAs was made in June 2009. It would also probably entail reform of ESMA itself. Section 5 further discusses some of the related challenges.

Accounting and auditing. Financial information has been justifiably described as the lifeblood of capital markets[33], and the availability of high-quality and comparable financial information on issuers across the EU is a crucial condition for the success of CMU. The EU adoption of International Financial Reporting Standards (IFRS), decided in 2002 and implemented in 2005-06, was a huge step in this direction, but more needs to be done. There remain wide differences between member states in IFRS implementation and enforcement and in other aspects of financial disclosure. Two main reforms should be considered in this area.

First, responsibility for IFRS enforcement should be granted to a newly created **office of the European Chief Accountant** (in reference to the equivalent authority in the US, which is hosted by the Securities and Exchange Commission). This office, which could be envisaged either as part of ESMA or as a new organisation, would be given functional authority over the existing national competent bodies[34] for purposes of IFRS implementation. Second, the loopholes in EU auditing legislation (including after its latest revision in 2014) should be closed to constitute a genuine single rulebook, and the **supervision of audit firms should be pooled** at European level in a specialised agency that could be subject to oversight by ESMA (in a relationship similar to that between the US Public Company Accounting Oversight Board and the Securities and Exchange Commission).

In addition, the European Commission should further explore the costs and benefits of reforming accounting obligations that are not currently within the scope of IFRS, namely the financial statements of individual entities and of unlisted companies. While there might be a case for harmonisation[35], this should be robustly assessed on the basis of the subsidiarity principle. It should also be considered in liaison with proposals to reform corporate taxation, because tax accounting is one of the main drivers of non-IFRS financial reporting in many if not all EU member states: a move towards harmonisation of the corporate income tax base would have obvious spillovers in terms of harmonisation of single-entity accounting requirements[36].

Corporate credit information. Alongside financial information covered by accounting and auditing frameworks, information about corporate risk and credit is similarly important in order to stimulate market-based investment. Even though situations differ in member states, capital market participants in the EU other than banks and central banks currently have only limited access to credit information about SMEs and even many large companies (aside from the limited number that are rated by credit rating agencies). The European Commission has started work on improving the availability and quality of such information, as announced in the CMU green paper. But this raises issues of confidentiality and market structure, and should also be connected with the ambitious ECB project of building an analytical credit dataset (known as AnaCredit) which would also cover a large part of the SME credit landscape[37].

33. See eg Levitt (1999).

34. Depending on national circumstances, these are currently either accounting enforcement units within securities regulators (as in France, Italy, the Netherlands and Spain), or hosted by other specialised public authorities (eg the Financial Reporting Council in the UK), or private-sector bodies empowered by law (eg the Financial Reporting Enforcement Panel in Germany).

35. For example, Maijoor (2015) argues that *"we should consider moving to a common accounting language for SMEs that would like to grow and get a broader investor base. That language should be based on IFRS but not as extensive as the standard set of IFRS"*.

36. It should be noted however that the current EU project for a Common Consolidated Corporate Tax Base (CCCTB) would be only an option for companies, and its adoption would thus not have obvious impact in terms of accounting frameworks.

37. See eg Damia and Israël (2014).

'A better insolvency framework allows for a better re-allocation of capital and more growth. In many EU member states, inefficient and antiquated frameworks for insolvency and debt restructuring deter corporate investment and high-risk segments of credit.'

Financial infrastructure. As noted in the previous section, the European landscape for trading and post-trading infrastructure is marked by extraordinary complexity and fragmentation. This is due in large part to the complex legacies of past national systems, and also to the lingering symbolic potency of stock exchanges as emblems of national economic strength and sovereignty. In the early 2000s, the European Commission promoted a strategic review that resulted in two landmark reports by a group chaired by Alberto Giovannini and identified 15 'Giovannini barriers' to efficient cross-border clearing and settlement in the EU. Even after initiatives including the adoption in 2014 of a new EU Regulation on Central Securities Depositories and the creation by the ECB of the T2S (Target2Securities) platform for securities settlements, many of these barriers still remain[38]. As identified in the Giovannini reports, the EU should aim to reduce or eliminate the current difference between cross-border securities transactions and transactions within a single EU country. The specific but systemically important challenge posed by the prudential supervision of derivatives clearing houses (known in the EU as CCPs, or central counter-parties) is discussed in the next section.

Insolvency and financial restructuring frameworks. A growing literature has identified insolvency law and debt-restructuring practices as major determinants of corporate credit[39]. In the EU, the understanding of this issue has been recently enhanced by observation of significant insolvency reforms in countries under assistance programmes, such as Ireland. A better insolvency framework allows for a better re-allocation of capital and more growth. In many EU member states, inefficient and antiquated frameworks for insolvency and debt restructuring deter corporate investment and high-risk segments of credit (such as mezzanine and high-yield debt), because investors and creditors are insufficiently protected in case of insolvency, and the conduct of the insolvency process fails to maximise the prospects for asset recovery. Additional inefficiency arises from the lack of consistency of insolvency provisions across borders, but the first-order issue appears to be the inadequacies of national insolvency frameworks in terms of the laws themselves and the way they are implemented through courts and the work of specialised service providers and professions. In this area, full harmonisation is unrealistic even over the long-term, given deeply embedded differences in national legal frameworks. However, the EU could stimulate a coordinated reform process with common principles and harmonisation of a limited set of relevant aspects[40], with appropriate benchmarking and monitoring at the EU level. In parallel, the creation of a specific EU insolvency regime for banks, administered by an EU court, appears indispensable in the medium term to complete the legal framework of banking union and especially the vision of a Single Resolution Mechanism.

Taxation of savings and investment. Since taxation always acts as a key driver of investor behaviour, differences in frameworks for the taxation of savings are a contributor to market fragmentation and to the difficulty of creating powerful, simple, pan-European market segments for investment. In many member states, tax frameworks also contribute to the orientation of savings towards low-risk, short-maturity instruments. Because EU-wide unanimity is likely to be unattainable, joint projects for the taxation of savings could be envisaged by subsets of member states using the enhanced cooperation procedure. This procedure has already formed the basis for the initiative to create a European Financial Transactions Tax (FTT), but unfortunately this project still appears ill-designed. Protracted discussions over the FTT and, if eventually adopted, its implementation might act as a brake on investment, with detrimental economic consequences. EU member states should instead focus their energies on harmonised taxation of savings, reforming the tax disadvantage given to equity relative to debt and other initiatives that could stimulate investment and market development.

38. See in particular https://www.ecb.europa.eu/paym/t2s/about/about/html/index.en.html and https://www.ecb.europa.eu/paym/t2s/about/html/giovannini.en.html for a description by the ECB of the complexity of clearing and settlement, the Giovannini barriers, and the expected impact of T2S.

39. See eg Djankov, McLiesh and Shleifer (2007), Davydenko and Franks (2008) and Plantin, Thesmar and Tirole (2013).

40. See a recent set of proposals in AFME (2015b).

Possible further items. As mentioned above, this list is not intended to be exhaustive. In particular, reforms of pensions and housing policies could have very significant impact on capital markets, for example with the creation of pan-European pension fund systems or covered-bond markets. However, these developments would have social and political implications far beyond concerns about capital markets development. Consequently, we consider them to be beyond the remit of the CMU agenda. However, CMU-related aspects may usefully be considered in relevant future discussions.

5 IMPLEMENTATION AND SEQUENCING

Maintaining the momentum. A welcome momentum on CMU as a high-level priority for the entire EU has been created. It is important to maintain this momentum through adequate calibration and sequencing of future actions. The delivery of 'quick wins' on ongoing projects of financial product regulation (ELTIFs, securitisation, the prospectus directive and private placement) is important in this regard. However, these will be no substitute for more ambitious initiatives with transformative long-term impact that would justify the 'union' label. CMU, if ambitiously executed, can eventually deliver tangible benefits to EU citizens in terms of more jobs, growth, and a more stable financial system. The challenge will be to keep the momentum going despite the structural nature of the effort and the technical nature of the project, which makes it difficult to explain to broader audiences. Fortunately, the new EU consensus, which recognises the need for stronger capital markets as a way to make the financial system both more efficient and more resilient, is supportive. However, the political and technical obstacles should not be underestimated. Given the complexity of some of the issues listed in the previous section, it is not realistic to expect a detailed blueprint on all of them by the second half of 2015, when the Commission is expected to publish a CMU action plan.

Staged process. As a consequence, the Commission's action plan could combine firm policy announcements that demonstrate commitment with the launch of processes for further study on the most difficult and complex items.

The area of accounting and auditing may be judged particularly promising for a firm policy announcement later in 2015, especially the two main proposals outlined in the previous section on IFRS enforcement and audit regulation and oversight. The need for high-quality comparable information across the EU can hardly be disputed as a precondition for CMU. Financial practitioners recognise that the current policy framework does not achieve this aim. The EU can capitalise on the successful adoption of IFRS a decade ago to claim legitimacy in this area. Furthermore, reform is made more urgent by the need for cross-border accounting and auditing consistency in the euro area to support the operation of banking union. Early commitments would also be desirable on other proposals made in the previous section, such as on system-wide monitoring, listing authority, fund approval and enforcement.

To tackle the most complex areas, the EU could create **parallel processes of analysis and development of policy proposals** in the following five areas: corporate credit information; financial infrastructure; insolvency and debt restructuring; financial investment taxation; and the retrospective review of the aggregate impact of capital markets regulation passed in the last decade, echoing the Commission's intent to undertake this type of retrospective analysis[41]. Given the complex and technical nature of these topics, and also the fact that they span the remits of several commissioners and directorates-general within the Commission, it would be advisable to **entrust autonomous taskforces with the analysis and the development of corresponding policy proposals**. Their specific design and governance might vary for different issues and should take into consideration past processes that were judged successful[42]. The action plan should also set target dates for these taskforces to deliver detailed proposals, say in late 2016 or early 2017, so that subsequent legislative implementation could be well underway by the time the current EU legislative term ends in mid-2019.

Institutional issues. Many of the policy proposals in the previous section imply institutional changes. They envisage an expansion of the authority granted to both ESMA and the ESRB, and the creation of new EU-level bodies, which may be

41. Hill (2015) declared his intention *"to take a close look at the cumulative effect of the laws we have passed to make sure we have got the balance right between reducing risk and fostering growth"*.

42. Examples of successful task forces include, at the EU level, the Giovannini Group and the Larosière report, both of which were supported directly by the European Commission; and in individual member states, the Independent Commission on Banking in the UK, which was supported by an autonomous temporary secretariat composed of officials seconded from several government departments and agencies.

needed to ensure adequate independence and/or specialised expertise (for example for the oversight of audit firms).

There have been several expressions of concern in early debates about CMU, particularly in the UK, about the risk that proposals for institutional change might work against achieving the aims of CMU. For example, the UK House of Lords argued that *"any attempt to establish a system of pan-EU supervision would not only be contentious, but could prove an unhelpful distraction from the necessary reforms that Capital Markets Union is seeking to bring about"*[43]. However, this argument misleadingly paints the institutional question as black-and-white, and ignores the fact that ESMA is already mandated to supervise credit rating agencies and trade repositories on a pan-EU basis.

In reality, **the institutional question is of a practical, not ideological nature**. Some CMU aims can be attained without changes to the respective institutions' mandates, and some cannot. This is best determined case by case. Both the present and the future situations are and will be hybrids between two extremes, in which supervision is respectively all-national (an unnecessary step backwards from the status quo) or all-European (an unrealistic and unnecessary prospect that would sit oddly with the subsidiarity principle).

A more helpful distinction is between prudential supervision, which is typically coupled to a resolution framework with possible fiscal implications, and other aspects of financial supervision such as authorisations of funds and of securities issuances, and enforcement of capital markets rules. In the current phase of EU integration, the former could be pooled within the banking-union area, but pooling across the entire EU appears more problematic, given potential fiscal implications for which taxpayers are the final backstop. By contrast, **EU-level pooling of authority over the regulation of financial conduct would not *"impinge in any way on the fiscal responsibilities of member states"*** (to quote from the legislation that created ESMA and the other ESAs). The logic that led EU member states, including the UK, to support the creation of ESMA has not changed, and an adjustment of ESMA authority should not be considered intrinsically contentious if it can help to address certain issues better than the current division of labour among national authorities.

The current setup of ESMA and other EU-level agencies should not be considered untouchable. On the contrary, it needs change. The funding mechanism envisaged for the ESAs has not functioned effectively[44], and their governance has proved less than optimal in terms of effectiveness, independence and quality of the decision-making process[45]. The **reform of the ESAs' governance and funding**, which is specifically expressed as part of the mandate given to the commissioner for financial services by the Commission's President[46], should thus be closely coordinated with the development of the CMU project. In the case of ESMA, the increased concentration of capital markets activity (though not of the economic benefits of strong capital markets) in a limited subset of member states raises particular questions about a framework in which each member state is currently represented on the ESMA supervisory board by its national securities regulator.

As mentioned in the previous section, the prudential oversight of CCPs is a special case. The recent reforms of derivatives markets have increased the systemic importance of CCPs, and their implementation is still far from complete. The reform agenda itself, as defined at the global level during the September 2009 G20 Pittsburgh Summit, has not taken into account cross-border interdependencies in a fully adequate manner. Thus, the challenges posed by CCPs with significant international activity, such as those affiliated with the London Stock Exchange and ICE groups in the UK, raise both global and intra-EU coordination questions. It would be advisable for the EU to find answers to such questions to be delivered at the global level, difficult as that may be, before it envisages their permanent settlement in a con-

'Some CMU aims can be attained without changes to the institutions' mandates, and some cannot. This is best determined case by case. Both the present and the future situations are and will be hybrids between two extremes: all-national supervision, and all-European supervision.'

43. House of Lords (2015), paragraph 75.

44. See eg the joint letter sent by the Chairs of the three ESAs to the ECOFIN president on 5 November 2014, available at https://eiopa.europa.eu/Publications/Other%20Documents/ESAs_2014-41__Joint_ESAs_letter_to_EU_Council_Presidency_-_ESAs_Budget_2015_.pdf.

45. The most striking example has arguably been the ill-starred stress testing of EU banks coordinated by the European Banking Authority (EBA) in 2011, which was marred by governance shortcomings in spite of the best efforts of a competent EBA leadership and staff.

46. Juncker (2015b).

sistent manner inside the EU. In this respect, the best way to avoid politically challenging debates about supranational supervision, be it at EU or global level, would be to devise and adopt strictly rules-based resolution mechanisms which give no discretion to authorities, and distribute losses automatically among market participants in the unlikely event of a systemic failure. While such rules-based mechanisms cannot be entirely practical for banks, they might be better suited to the distinguishing features of international CCPs.

International consistency. The economic impact of CMU on the EU depends in part on its international openness. As the financial services commissioner recently put it, *"the CMU is not about closing doors to the outside world. On the contrary, we want to see more investment from outside investors"*[47]. This implies that, as an indispensable complement to its CMU agenda, the EU should champion international financial regulatory standards and other global initiatives as it has done previously – not least its landmark adoption of IFRS a decade ago. The EU should look critically at past episodes, for example, related to the design and implementation of the Alternative Investment Fund Managers Directive (AIFMD) or the European Market Infrastructure Regulation (EMIR), which triggered debates about discrimination against non-EU service providers. The EU should be exemplary in complying with global standards. It should fully support global bodies with agendas and mandates that are aligned with the objectives of CMU, in particular the Financial Stability Board (FSB), Committee on Payments and Market Infrastructures (CPMI) and International Organisation of Securities Commissions (IOSCO). Far from being driven by idealism, such global commitments would respond to the EU's hard-nosed vested interest in favour of an open and rules-based international financial order.

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