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Renewed European Optimism Should Be Used to Reinvigorate the Capital Markets Union

The second largest economy in the world still lacks a fully integrated capital market. In 2015, the European Union was determined to bridge that gap. An action plan was launched to improve market-based financing conditions for European companies and foster economic growth.

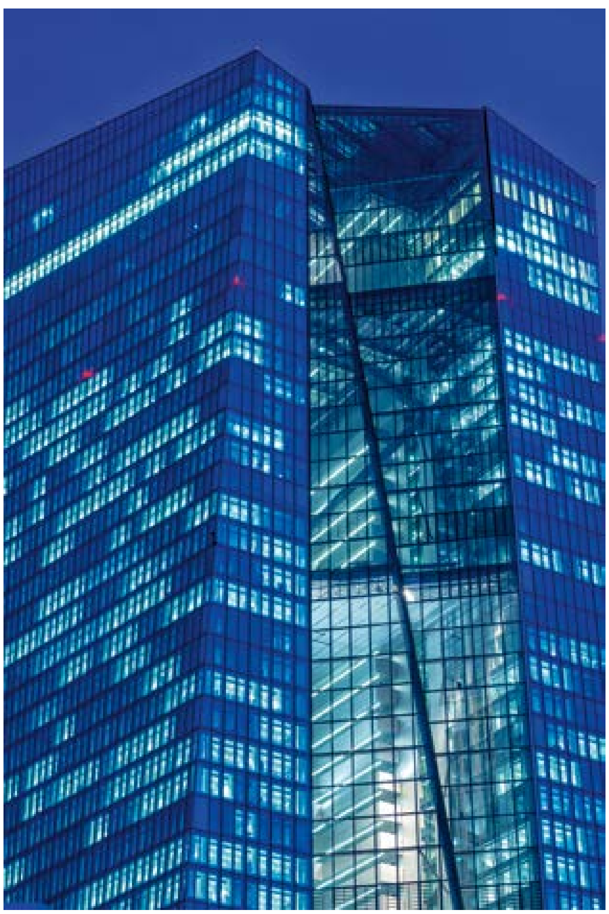
The Brexit decision slowed the project down, but confidence in Europe is returning: The recent election results in France and Germany showed that – despite undeniable Eurosceptic trends – a majority of voters share the European vision. This new optimism should be used to reinvigorate the Capital Markets Union. It will help European companies grow and create jobs and will broaden the horizon of investment opportunities in Europe.

Since the European project kicked off 60 years ago, cooperation among European member states has accomplished great feats. The integration of 28 economies into a single market has created one of the strongest economic areas in the world by creating jobs and increasing the income of European citizens. In this process, financial market integration came only relatively late to the game. Intra-European capital controls were only abolished in the late eighties, after which the introduction of the euro and the creation of the Financial Services Action Plan in 1999 sped up a process that only briefly levelled off during the sovereign debt crisis which started in 2008.

Still, as the European Commission rightly concluded in 2015, Europe has a long way to go in reaping the full benefits of a fully integrated capital market. That year, it launched the Capital Markets Union Action Plan, with the objective of fostering the contribution of market-based finance to European economic growth. Note that capital markets in the EU are only about one-third as developed as the US market, relative to GDP. Companies predominantly rely on bank financing, making the region particularly vulnerable for shocks to the banking sector.

Easier access to capital to spur growth and innovation

The positive economic impacts of a Capital Markets Union (CMU) for Europe have been widely recognized. They include having more diversified financing opportunities for companies of all sizes, and better investment opportunities for investors, which will in turn lead to more innovation and increased economic growth across all EU economies. The CMU will provide a platform for market-based financing also for start-ups, small and medium-sized companies (SMEs) by facilitating their access to capital markets. Right now, for example, many smaller European companies avoid the capital markets as a source for financing due to rather complicated requirements for publishing a prospectus for their bond issuances. One aspect of the CMU would be to relax these requirements, making it less complicated for SMEs to issue a bond and diversify their financing sources.



THE UK'S DECISION TO LEAVE THE EU SEEMS TO HAVE LED TO A LOSS OF MOMENTUM BEHIND THE CAPITAL MARKETS UNION.

European companies and investors stand to benefit

Since 2015, the Commission has been launching numerous laudable initiatives including a modernization of the EU prospectus regulation and a legislative proposal to kick-start the securitization market. Furthermore, the EC's 'Better Regulation' agenda has helped to create an environment where legislation balances the objective of economic growth with the need for financial stability thereby enabling financial institutions to better perform their intermediating role in capital markets.

Regrettably, the UK's decision to leave the EU seems to have led to a loss of momentum behind the Capital Markets Union. This was partly due to the perception that the spoils of the project were mostly intended for the City of London. However, the reverse is true.

As the New Financial think tank demonstrated in a recent study, companies in the EU27 (i.e. the EU without the UK) rely on bank lending for just under 80 percent of their debt funding, compared with 55 percent in the UK. Long-term pools of capital (such as pension fund assets) represent just two-thirds of GDP in the EU27, compared with nearly 200 percent in the UK.

This represents a huge potential opportunity for the EU27 economy. If capital markets in the EU27 were as deep relative to GDP as in the EU28 today, it would mean an additional €2 trillion in long-term capital that could be put to work in the EU27 economy, while reducing reliance on bank funding.

The majority support for pro-EU parties in the French and German elections has led to some resurgence of trust in the European project. Judging from his recent State of the Union speech, European Commission President Juncker seems intent to translate this trust into concrete policy action.

Liquidity, third-country access and a single rule book as elements of success

The time is right for a CMU, but it also needs to be done the right way. The success of the project does not only hinge on measures that facilitate access to capital market financing, such as simplified prospectus requirements, but includes a number of additional considerations, in order to reap the various benefits:

- **First,** the European Commission should strive with renewed energy to converge the supervisory approaches in the European member states. The consistent application of a single rulebook across the EU will lead to more efficient and integrated capital markets. Each such harmonization should be considered on its own merits, and in the context of global consistency, with a view to converging towards a globally consistent approach.

  European Supervisory Authorities play a crucial role in promoting supervisory convergence. To ensure that they are well equipped for this task, careful consideration should be given to their governance, resourcing, mandates, and responsibilities, as well as their interaction with market participants. The recently published legislative proposals to review the powers of the European Supervisory Authorities set an important step in that direction.
- **Secondly,** there is reason to be concerned that the cumulative impact of interest rate dynamics, changes in regulation, and market structure is having a dampening effect on market liquidity. Market participants report that they have experienced a reduction in liquidity in normal times. Investors feel less able to trade their desired size without materially impacting the price. As we move into the next phase of CMU, it will be crucial for the European Commission to seek ways to use policy to add liquidity back into markets. For instance, the special role of market makers, who put their own capital at risk by providing liquidity to their clients, should be recognized and fostered by legislation.

POLICYMAKERS SHOULD THINK GLOBALLY, AS FINANCIAL TECHNOLOGY IS NOT LIMITED BY GEOGRAPHIC BOUNDARIES OR BY LEGAL AND REGULATORY REGIMES.

- **Thirdly,** the CMU's objective of removing barriers and reducing the cost of deploying capital across the EU can only be fully achieved if it becomes a template for wider market access. The ability for American or Asian sources of financial capital to be deployed within the EU, to aid economic development and employment growth, is dependent on the ability of third-country financial services firms to access the European market on comparable terms to EU firms and investors. The involvement of non-EU financial service providers will contribute to the success of the Capital Markets Union by stimulating competition and financial product innovation in the provision of capital to EU firms.

  While the European Commission recognized the importance of this international component to the CMU in its 2015 Action Plan, the Brexit decision has increased sensitivities around Europe's approach to third countries. Although this is understandable, it is important that European policymakers continue to look outward if they are to reap the full benefits of market-based finance to the European economy. A CMU that does not facilitate third-country access will reduce competition, innovation, and ultimately the flow of capital into the EU.
- **Fourthly,** the CMU is an excellent opportunity to further benefit from the opportunities offered by Financial Technology. Innovation and digitization have the potential to increase the range of products on offer in capital markets, as well as the availability of these products and the speed and cost of execution. With these opportunities, though, come new risks, and it is important that these risks are monitored carefully. These risks include cybersecurity, the importance of which has increased with the further digitization of financial services. There are a number of principles which could help policymakers achieve a balance between supporting innovation and maintaining customer protection and financial stability.

  Policymakers should think globally, as financial technology is not limited by geographic boundaries or by legal and regulatory regimes. There is value in flexibility – a one-size-fits-all or overly prescriptive approach could slow technology innovation. Finally, policy should be 'activity-based', as certain technologies may have a broad range of applications that could be constrained by 'technology-based' regulatory schemes.

To conclude, a CMU offers real gains for Europe's customers and consumers. The opportunities offered by the recent resurgence of trust in the European Union should now be used to finalize this important project.