Assessing Capital Markets Union

Quarterly Assessment by Paul Richards

Summary

It is too early to make an assessment of Capital Markets Union, but not too early to give a market view of the tests by which Capital Markets Union should in future be assessed. There are a number of potential tests for assessing its impact in future. The main tests at a *macroeconomic* level relate to the impact of Capital Markets Union on economic growth in the EU and the EU's international competitiveness. Capital Markets Union may also have a *microeconomic* impact through its reforms of the structure of capital markets: eg on secondary market liquidity, infrastructure investment, product development, the balance between wholesale and retail markets, and between debt and equity. Finally, there is a question about the timescale over which the impact of Capital Markets Union can be assessed.

Introduction

1 The European Commission's initiative on Capital Markets Union is intended to encourage sustainable economic growth in the EU by using the capital markets to channel savings into investment. Capital Markets Union is an initiative relating to the EU as a whole. It is distinct from – but designed to be complementary to – Banking Union in the euro area. Following consultation on a Green Paper earlier this year, on 30 September the Commission launched an Action Plan on *Building a Capital Markets Union*. There is no single solution. The Action Plan proposes a series of 33 steps for delivering Capital Markets Union under the following heads:

- providing more funding choices for Europe's businesses and SMEs;
- ensuring an appropriate regulatory environment for long-term and sustainable investment and financing of Europe's infrastructure;
- increasing investment and choices for retail and institutional investors;
- enhancing the capacity of banks to lend; and
- bringing down cross-border barriers and developing capital markets for all 28 EU Member States.

2 This Quarterly Assessment considers those steps in the Commission's Action Plan on Capital Markets Union that are most relevant to the international cross-border securities markets in which ICMA members are involved. It is too early to make an assessment of Capital Markets Union, but not too early to give a market view of the tests by which Capital Markets Union should in future be assessed. There are a number of potential tests for assessing its impact in future. The main tests at a *macroeconomic* level relate to the impact of Capital Markets Union on economic growth in the EU and the EU's international competitiveness. Capital Markets Union may also have a *microeconomic* impact through its reforms of the structure of capital markets: eg on secondary market liquidity, infrastructure investment, product development, the balance between wholesale and retail markets, and between debt and equity. Finally, there is a question about the timescale over which the impact of Capital Markets Union can be assessed.

3 Each of these issues is considered briefly in turn in this Quarterly Assessment. Individual proposals which affect ICMA members from the Commission's Action Plan are considered in detail later in the Quarterly Report.

Economic growth

4 The first test is whether Capital Markets Union will encourage sustainable economic growth in the EU. Although the economies of the EU and the US are of broadly similar size, capital market financing in the EU represents a much smaller proportion of GDP than in the

The first test is whether Capital Markets Union will encourage sustainable economic growth in the EU.

US, if capital markets are defined as debt and equity securities. Under the European Commission's initiative for Capital Markets Union, US capital markets provide a potential point of reference. There may be lessons in the EU to learn from US experience, while recognising that the EU has different traditions and characteristics.

5 The main difference is that the EU has traditionally relied on banks to finance growth in the real economy to a much greater extent than the US. But bank financing in the EU is now constrained by regulation implemented in response to the international financial crisis with the objective of enhancing financial stability. Bank capital and liquidity requirements have been increased, particularly for systemically important financial institutions, and a leverage ratio has been imposed. Whereas banks in the US were recapitalised very shortly after the crisis, banks in the EU have taken much longer to be recapitalised and have been slower to be restructured. The level of non-performing bank loans is higher in the EU than in the US. EU bank lending to businesses has still not fully recovered from the crisis *(Chart 1).*

6 Capital Markets Union is not designed to replace bank financing, but to complement it. If sources of funding in the EU are diversified by making greater use of capital markets, the Commission hopes that they could help to finance a sustainable economic recovery in the EU. Diversification could also help to make the financial system more stable by reducing the EU's dependence on a single source of finance. Clearly, progress towards Capital Markets Union in the EU depends on the continuation of a level playing field for competition across the single EU market between market participants in the euro area and in the rest of the EU.

7 These objectives have the best prospect of being realised if the monetary and fiscal policies set by the authorities across the EU are appropriate, and any risks to financial stability, including any risks arising from the integration of markets, are appropriately regulated:

- In the first case, economic recovery has so far been much more pronounced in the US than in the euro area *(Chart 2).* There is consequently an increasing divergence between the policy response by the US authorities and the authorities in the euro area. In the US, the Federal Reserve concluded its quantitative easing (QE) programme some time ago and raised short-term US interest rates – by 0.25% – in December 2015 for the first time since 2006. In the euro area, the ECB only began its own QE programme of sovereign bond purchases in the secondary market in March 2015, with the objective of raising the level of euro-area inflation to its target level of below – but close to – 2%, and with the effect of weakening the euro exchange rate, which should encourage net exports. In December 2015, the ECB Governing Council decided to extend the completion date for the programme from September 2016 for at least a further six months at the same rate of €60 billion per month, but also to reinvest the proceeds of maturing bonds, while reducing its deposit rate from minus 0.2% to minus 0.3%.
- In the second case, the financial resilience of market firms and the stability of the financial system have been strengthened since the crisis: in particular, through an increase in bank capital and liquidity requirements, accompanied by stress tests, on the prudential side; and through much more intrusive regulation of the conduct of their business. While it is important to maintain financial stability, and counter emerging risks such as threats to cyber-security, the focus now needs to shift to achieving sustainable economic growth. This is where the Commission hopes that the Capital Markets Union initiative can help.

International competitiveness

8 To realise their full potential, capital markets in the EU need to be competitive not only with other forms of financing (eg bank lending), but also EU capital markets need to be competitive internationally (eg with North America and Asia). There are two important considerations here.

9 The first is whether the financial institutions involved in EU capital markets are internationally competitive themselves. Recently, European-based investment banks appear to have lost market share to US-based investment

Capital markets in the EU need to be competitive not only with other forms of financing but also competitive internationally.

banks. There are questions about whether this is because financial regulation in the EU is more onerous than in the US or EU financial institutions have been subject to higher fines and penalties; whether early recapitalisation and restructuring after the crisis has helped US-based investment banks; and how important it is to be based in a large domestic market like the US; or some combination of reasons. The test for the EU is to ensure a level playing field for all capital market participants.

10 The second and related consideration is how to make the domestic capital market in the EU as competitive as possible. Capital Markets Union is intended to help complete a single EU capital market: for example, by removing the remaining barriers to capital markets business across borders in the EU, and reducing market fragmentation as a result. There are still a significant number of cross-border barriers, despite previous attempts over many years to remove them, for example:

- barriers relating to the financial market infrastructure: it is still much more expensive to process financial transactions across borders within the EU than in the US, though TARGET2-Securities is designed to improve cross-border efficiency, when it becomes fully operational;
- differences between the 28 EU Member States in the way they treat insolvency, securities ownership across borders and withholding tax; and
- a new Financial Transaction Tax, which is still being negotiated among 10 Member States in the euro area, even though it is not consistent with the objectives of EU Capital Markets Union.

None of these issues will be easy politically to resolve within the EU. Nor will it be easy to ensure regulatory equivalence between the EU and "third countries".

11 However, it is encouraging that the new European Commission has introduced a "better regulation" agenda, whose objective is to improve the quality of EU regulation rather than its quantity, and to assess its overall impact. Around 40 separate new legislative acts were introduced in the EU at speed in the immediate response to the international financial crisis. Not surprisingly, they do not all fit well together, and there are a number of unintended consequences. The Commission hopes to identify these through its Call for Evidence on the cumulative impact of EU financial regulatory reform, while keeping the thrust of the regulatory reform programme unchanged. ICMA is responding to the Call for Evidence, focusing on the impact of regulatory reform on secondary market liquidity.

> **To make EU capital markets work well they need to be liquid.**

Secondary market liquidity

12 To make EU capital markets work well and be competitive internationally, they need to be liquid. (Market liquidity means the ability to trade one financial asset for another without a significant impact on the price.) The US dollar is currently much the most widely used reserve currency internationally, and the US Treasury market is the most liquid international securities market. In the euro area, government bonds are issued by 19 different governments, and there is no euro-area benchmark government yield curve. The ECB's QE programme injects liquid reserves into the financial system, but also takes market liquidity out of the system (eg by reducing the amount of collateral available for use in repo transactions, unless the collateral is recycled). This is particularly the case when the ECB purchases private sector assets, such as covered bonds, where the market is much more limited in size than the sovereign and agency bond market sector.

13 Corporate bond market liquidity in both EU and US markets has deteriorated since the crisis as banks have retrenched and the regulatory costs for banks of acting as market makers have increased. Market makers have run down their inventories, on some measures by up to 75%; and several sell-side market firms have withdrawn from market making altogether. Corporate bond spreads have widened *(Chart 3)*. This is not so much of concern in the case of those corporate bonds which are bought by investors with the intention of holding them to maturity. But in the case of those corporate bonds which have traditionally been liquid, the market-making model for providing secondary market liquidity has effectively been broken. It is not yet clear what will replace it:

- If the sell side acts only as an agency broker rather than as a market-making principal, that will not in itself provide market liquidity.
- Asset managers on the buy side may not be willing to take over the traditional market-making function from the sell side, particularly as asset managers are acting in a fiduciary capacity on behalf of their clients rather than operating on their own account.
- Trading on electronic platforms is still at a relatively early stage of development in the European market. One of the key questions is whether electronic trading platforms effectively create liquidity in the market or not.

14 A separate question being considered by the European Commission is whether greater standardisation of corporate bond issuance would contribute to liquidity.

Standardisation can mean two different things:

- Some large and frequent issuers of corporate debt in the EU already issue bonds as benchmarks, though there are not as many companies sufficiently large to be able to benchmark their issues in the EU as in the US. Smaller companies in the EU mainly issue bonds less frequently and in smaller amounts. They need to be able to determine when they do so, and have the flexibility to match their liabilities. For smaller issuers, standardisation of new issuance is unlikely to be helpful.
- In the case of offer documentation for new corporate debt issues, on the other hand, the market is substantially standardised already on the basis of regulatory requirements and the ICMA Primary Market Handbook, which is consistent with them.

In both these cases, the degree of standardisation should be a matter for the market to resolve, not for further EU regulation.

15 The problem of a lack of liquidity in the secondary market has been contained over the past few years by the strength of the primary market: bond yields have fallen to historically very low levels, while new corporate issuance has been at record levels over the past year. But when the bond market in the EU turns, and interest rates follow the US and begin to rise, lack of liquidity could well become a much more significant problem for investors. The problem would be compounded if the liquidity of investment funds (whose liabilities to savers are payable on demand but whose assets in financial markets can only be realised over a period of time) were to be called into question. A rise in short-term interest rates could also lead to capital losses for those investors, such as insurance companies, some of which already have a mismatch between the low current return on their financial assets and the higher historic cost of their financial liabilities.

Infrastructure investment

16 The historically very low interest rates which have prevailed since the international financial crisis should in theory make long-term investment in infrastructure by the private sector more attractive, once confidence recovers.

The public sector is expected to play a larger role in infrastructure projects.

The Commission is supportive of the steps which ICMA has taken under the pan-European private placement initiative.

Indeed, insurance companies and pension funds look for long-dated investments backed by stable cash flows to match their long-term liability structures. But there is still a regulatory disadvantage (eg in terms of capital charges) for insurance companies to make long-term investments in the EU under Solvency II. Although the investments are illiquid, capital is charged on them on the basis that the investments can be realised in the short term. The European Commission is due to reconsider the level of capital charges when Solvency II comes up for review.

17 Under Capital Markets Union, the public sector is expected to play a larger role in infrastructure projects through the Investment Plan for Europe under the aegis of the European Investment Bank and the European Commission. The Commission is projecting that €315 billion of additional investment can be mobilised by the public and private sectors under its European Fund for Strategic Investments *(Chart 4)*. There are two key tests for the effectiveness of the Investment Plan for Europe. One is the value for money from investment: the main challenge is to identify a sufficient number of infrastructure projects which are financially viable so as to attract private sector investment. The other is the composition of the risk-sharing arrangements between the public and private sectors, which are likely to affect the ratio of private sector capital raised in relation to the public sector's involvement through investment or guarantees.

Capital market products

18 Some capital market products – such as private placements and securitisations – are not as well developed in the EU as in the US, and the European Commission's initiative on Capital Markets Union is intended to encourage their EU development:

- *Private placements:* European corporate issuers have often issued private placements in the US rather than in their home market. The pattern is changing in response to the pan-European private placement initiative, which builds on national market precedents (eg in Germany, France and the UK). In the Action Plan, the Commission states that it is supportive of the steps which ICMA has taken under the pan-European private placement initiative.

> **The potential benefits in the long term mean that it is important to take the necessary steps as soon as practicable.**

- *Securitisations:* The reputation of securitisation in the EU was damaged by the crisis, even though losses were much lower for securitisations originated in the EU than in the US. In an attempt to overcome the problem, the Commission has proposed new legislation to promote simple, transparent and standardised (STS) securitisations. There are two main issues to be resolved: first of all, linking STS to a sufficient reduction in capital charges to incentivise investment, without the reduction being offset by increases in capital charges elsewhere (eg as a result of the Fundamental Review of the Trading Book); and second, devising a fail-safe procedure for deciding whether a securitisation should be categorised as STS or not. If successful, the revival of the securitisation market, through sales by banks to investors, should free up bank balance sheets for more lending (eg to small businesses).
- *Covered bonds:* The Commission has consulted stakeholders on the feasibility of a pan-European framework for covered bonds, owing to differences between a number of well-functioning national covered bond frameworks.
- *Green bonds:* The Commission is monitoring developments in the green bond market, which is coordinated through the Green Bond Principles, for which ICMA provides the Secretariat.

Wholesale and retail financial markets

19 To be internationally competitive, wholesale markets in the EU need to be free from barriers across borders. But there are also barriers in the EU to retail investment across borders. While retail investors need to be offered more investor protection than wholesale investors, it is important that the remaining retail barriers across borders are removed, because retail investment is one of the largest potential markets for growth in the EU (eg in response to provision for retirement) in the period ahead. Steps need to be taken to make cross-border retail issuance (eg by pan-European issuers) more attractive. Retail investors traditionally have a "home bias".

20 The Commission's proposal for a revised Prospectus Regulation is intended to encourage cross-border retail investment. It is not clear whether eliminating the €100,000 denomination threshold under the Commission's proposal will help to improve market liquidity by encouraging issues in smaller denominations. But even if it does, there needs to be some other way of distinguishing between wholesale issues distributed solely to institutional investors and issues sold to retail investors. If not, retail disclosure standards could be applied to wholesale issues, raising the regulatory burden, increasing costs in the wholesale market and damaging EU competitiveness.

21 In addition, the Commission has launched a consultation which looks at the retail market across the EU for financial services such as insurance, mortgages, loans, payments and bank accounts. The Commission is seeking to identify unjustified barriers that consumers face when they want to use such services across borders in the EU, as a first step towards deciding how best to remove them so as to increase competition and consumer choice. An Action Plan on *Retail Financial Services* is due to follow later in 2016.

Debt and equity markets

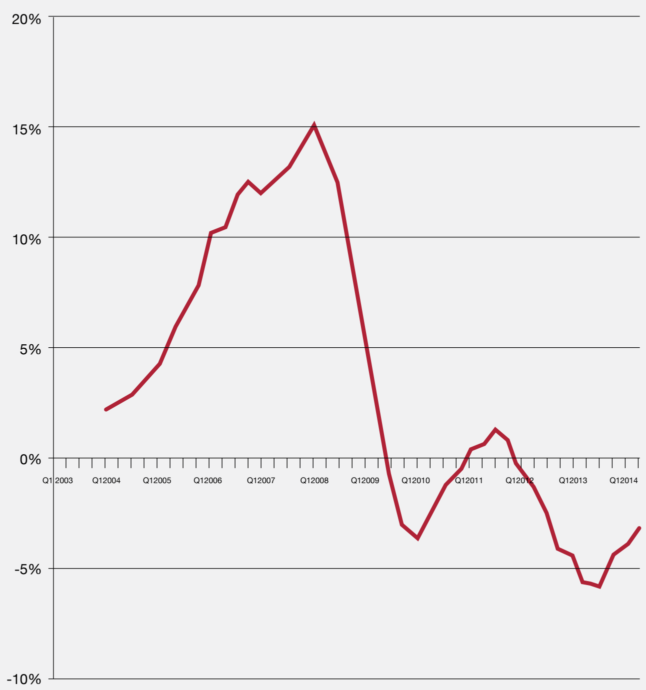
22 Since the crisis, the question of whether there is "too much debt" has become the subject of political debate. Did too much debt cause the crisis, or was it one of the consequences of the crisis? Is it justified to give preferential tax treatment to debt, by deducting interest rate payments against tax? And if not, should the preferential tax treatment on debt be removed, or should greater preference be given to equity (eg by making dividend income tax-exempt) so as to encourage equity investment? Under Capital Markets Union, the European Commission is due to prepare a proposal in 2016, as part of the work on the Common Consolidated Corporate Tax Base. To be effective, any such proposal would need to be agreed on a global basis (as in the case of a number of other corporate tax issues). The potential impact on the real economy would also need to be assessed.

Timing

23 The timetable for implementing the Commission's Action Plan on Capital Markets Union makes it clear that progress can be expected in the EU on some issues in the short to medium term. But the most important issues – like insolvency reform, securities law and withholding tax – have previously proved politically intractable, and will take a long time fully to resolve. They will need to be resolved in order to complete a single capital market across the EU. The full impact of Capital Markets Union on EU growth and competitiveness is therefore likely to take a long time to work through. But the potential benefits in the long term mean that it is still important to take the necessary steps as soon as practicable.

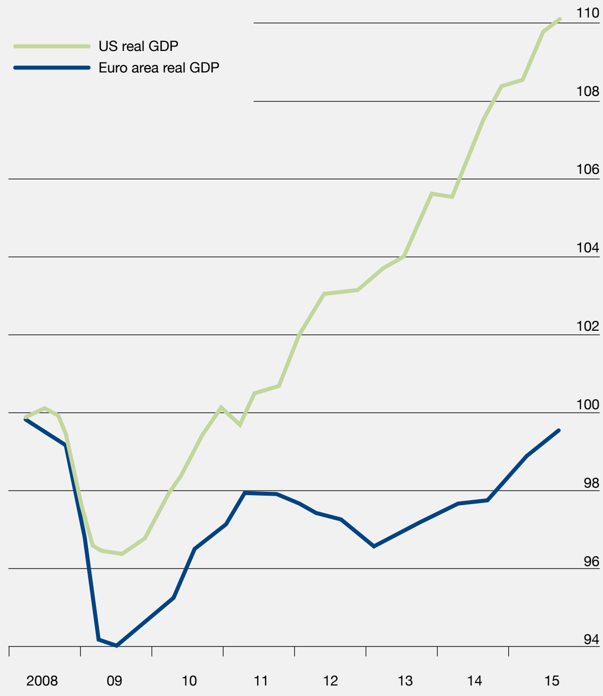
Contact: Paul Richards
paul.richards@icmagroup.org

Chart 1: EU bank lending to business: 2008-2014



Note: year-on-year. Source: European Commission

Chart 2: Euro area and US real GDP: 2008-2015



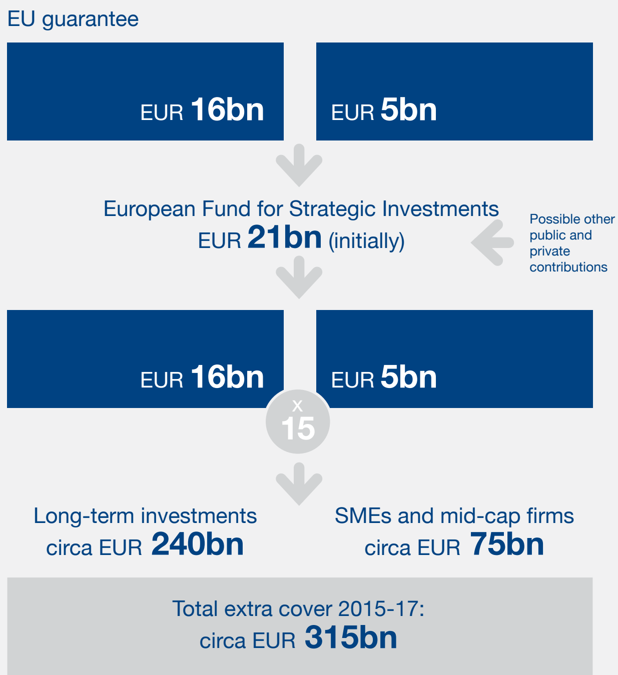
Source: Thomson Reuters; Haver Analytics

Chart 3: Corporate bond spreads

Note: EA non-financial corporate bond spreads by rating between iBoxx non-financial corporate yields and ICAP euro EURIBOR swap rates for different maturities, basis points.

Source: Thomson Reuters; ESMA

Chart 4: European Fund for Strategic Investments



Source: EIB