ECMI Commentary
No. 40/5 October 2015

Light and shadows in Europe's new Action Plan for Capital Markets Union

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The European Commission's Action Plan consists, in a nutshell, of a short list of technical proposals and a longer one of (rather general) potential actions. Overall, the plan indeed proposes to achieve some short-term objectives, such as a reduction of listing costs for SMEs, but it lacks long-term vision. The plan bundles actions under rather generic objectives of long-term finance or cross-border investing. Improving the informational infrastructure (e.g. accounting standards, company data) and cross-border enforcement of rules is left to vaguely defined future actions, but these constitute the core of the capital markets infrastructure. Without a well-defined set of measurable objectives, the whole plan may lose political momentum and become an opportunity for interested parties to cherry pick their pet provisions. Building a single market, i.e. removing cross-border obstacles to capital circulation, is too challenging a task to simply appear as one of many items on a long list of general objectives, which incidentally do not include institutional reform. The ultimate risk is that the Commission may just miss a unique opportunity to revamp and improve the financial integration process in Europe after almost a decade of harmful financial retrenchment.

On 30 September 2015, the European Commission released with great fanfare a Communication including an action plan for a Capital Market Union (CMU) in Europe. President Juncker's commitment in July 2014 to deliver CMU, strengthened by the call in the recent 'Five Presidents' Report' for a financial union via a renewed financial integration process, managed to create political awareness about the importance of well-developed capital markets for economic growth. Hence, CMU created momentum to overcome the lack of depth and fragmentation of Europe's capital markets.

But those that were expecting more concrete and immediate steps towards the removal of cross-border barriers to promote a truly unrestricted movement of capital across Europe will have to wait. The actionable part of the plan is for now just a follow-up on some well-known issues (also included) in the last long-term finance Communication released in 2014. Initiatives to increase financing opportunities for start-ups and small- and medium-sized enterprises (SMEs), infrastructure financing and securitisation are all commendable objectives, but they can hardly be a 'game changer' for Europe's capital markets.

An ambitious plan?

The plan sets very broad goals, with the aim of:

- Creating more and better funding opportunities for European firms (for SMEs, in particular),
- Improving the listing environment,
- Boosting long-term finance,
- Fostering EU-wide distribution of financial instruments for retail and institutional investors,
- Increasing banking capacity and
- Eliminating barriers to cross-border investing.

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The plan is accompanied by three legislative proposals for amendments to the prospectus Directive (2010/73/EU), the capital requirements Regulation (hereinafter CRR, 575/2013/EU) and the Solvency II Directive (2009/138/EC). Other proposals will follow in the coming months (see Table 1).

Table 1. Matching objectives and proposals of the CMU action plan

Key objective	Actions	Purpose
More funding opportunities for European firms (SMEs, in particular)	- Funds-of-funds in EuVECA - EuVECA and EuSEF option for large fund managers - Best practices on tax incentives for EuVECAs & SEFs - Harmonised feedback for SME bank loans - Pan-European credit information system (SMEs) - EU advisory hub for SMEs - Regime for loan-originating funds - Best practices for private placement	- Open access to institutional investors - Promote availability of start-up equity capital - Increase information flows from SMEs to banks and vice versa - Fostering new funding models (loans & debt securities)
Improving the listing environment	- A European advisory structures for issuers - Higher threshold for prospectus (>€500k) - More lenient listing requirements in SME growth markets - Monitor liquidity in corporate bond secondary markets - Support for voluntary & tailored-made accounting standards for SMEs - Proposal on common corporate tax base & opening discussion on debt/equity bias	- Streamline information and reduce one-off and on-going costs for SMEs equity listing - Reduce tax bias between equity and debt instruments
Boosting long-term finance	- Amendments to Solvency II to favour investments in infrastructure and ELTIFs - Amendments to CRR to favour investments in infrastructure - Assessment of cumulative impact of reforms on the investment environment - Attention to environment, social & governance (ESG)	- Facilitate channelling of investments from institutional investors and banks in project finance
Fostering EU-wide distribution of financial instruments for retail and institutional investors	- Green Paper on retail financial services and insurance - Comprehensive assessment of distribution & advice channels of investment products for retail investors to define potential policy actions - Evaluation of a European personal pension product - Assessment of potential amendments to Solvency II for private equity and privately placed debt	- Improve cross-border choice and access to investment products for retail investors (for investment and retirement) - Promote access for investments of institutional investors (e.g. insurance) and remove barriers to cross-border distribution
Increasing bank funding capacity	- Promoting credit unions across Europe - Amendments to Solvency II and CRR for simple, transparent and standardised (STS) securitisation - Consultation on a pan-European regime for covered bonds	- Provide additional funding sources for SMEs - Restart capital market-based funding for banks to improve access to finance for SMEs
Eliminating infrastructure barriers to cross-border investing	- Proposal for uniform rules to ensure certainty surrounding security ownership - Review of the progress on the removal of the Giovannini barriers for post-trading and cross-border clearing and settlement - Map and remove barriers to free movement of capital, using a 'collaborative approach' with national authorities (with a report at the end of 2016) - Legislative proposal on business insolvency to remove barriers to capital flow - Withholding tax relief principles and investigation on tax obstacles for life insurers and pension funds - Macroprudential review of market-based finance	- Uniform application of the single rulebook and updated macroprudential framework - Removal of barriers to free movement of capital for market infrastructure and selected areas (e.g. insolvency) - Limit double taxation in cross-border financial transactions

Notes: Actions listed in red will be immediately implemented as a result of this plan. ELTIFs, EuVECAs and EuSEFs stand for European Long-Term Investment Funds, European Venture Capital Funds and European Social Entrepreneurship Funds They are a sub-category of alternative funds investing in specific assets, according to European legislation, and can use the European passport granted to alternative investment fund managers. See http://ec.europa.eu/finance/investment/index_en.htm for more information.

Source: Author.

Immediate actions are only limited to some fund and listing requirements, as well as a change in capital requirements for banks and insurance to give regulation-driven incentives to invest in infrastructure and SMEs. Future actions are sometimes clear, as they define a specific output to be produced, such as a Green Paper on retail financial services and insurance products, but they mostly remain undefined under unclear objectives. In effect, the plan falls short of long-term actionable objectives, such as the creation of an informational infrastructure (including accounting standards and harmonised company data) and greater enforcement powers. The latter, in particular, may require institutional reforms that the Commission seems rather unwilling to commit to. Even the current peer-review model among the European agencies and national authorities, which relies on 'moral suasion' of recommendations, is unable to ensure uniform implementation of EU rules and supervisory practices by national member states. Authorities like ESMA and their governance may need to be part of these reforms.

A questionable execution?

The plan is designed around a list of actions to improve access for users and providers of funds across Europe. Let us look at a few examples.

For users of funds, constraints have to be removed to facilitate SME financing, through lower listing costs and greater funding choices. SME access to finance, however, has been high on the EU agenda even more prominently since the end of the financial crisis, as the credit crunch hit bank-dependent small and medium firms. It also figured in the long-term finance Communication and later in most of the financial reforms coming out of the Commission (e.g. MiFID II SMEs growth markets). The burden of capital market funding for SMEs has been addressed at national level in several member states, with limited success so far and often resulting in distortive government subsidies. Smaller SMEs mostly access short-term bank funding (like bank overdrafts or even consumer credit) mainly because of the limited information flow (in quantity and quality) and collateral made available to banks. If we take a European average, moreover, SMEs (in particular smaller ones) are not performing particularly well compared to mid and large cap companies. Successful start-ups are only a tiny fraction of the total. Hence, it might just be financially not viable for banks to provide long-term funding to (small) SMEs. In this case, actions to strengthen alternative funding sources, like private equity, venture capital or crowdfunding (e.g. peer-to-peer lending), may be potentially more successful than traditional market funding. Bigger SMEs, instead, might suffer from a more traditional credit crunch because the credit assessment of the bank in times of crisis may consider the collateral of the firm insufficient to qualify for more long-term credit, despite the fact that these firms provide sufficient information. Traditional market-funding options via a small equity or debt issuance might play a role there.

SMEs may therefore need a more tailored response according to the sector and the size of the company. A one-size-fits-all approach will not work. Their definition also remains imprecise, especially at EU level.[1] The Commission should perhaps focus on ensuring that the information flow and market infrastructure at the heart of the financial system work well, irrespective of the nature of their users. Market competition among funding sources should benefit the economy as a whole, regardless of whether the user is or is not an SME. Therefore, the single market, as a source of competition in goods as well as funding sources, should remain the fundamental objective of the Commission's action, not just due to a Treaty mandate (Art. 3.3 TEU). By looking at the various elements of a cross-border financial transaction, the Commission could start developing tailored and more effective actions. For instance, improving the quality of the information flow is a pre-condition to the creation of any market mechanism. This would then require that the plan would focus on a set of tailored actions to increase the quality and harmonisation of company data across Europe, including accounting standards, credit information and ownership.

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[1] For more details, see Federico Infelise and Diego Valiante (2013), "Why a more accurate EU definition of SMEs matters", ECMI Commentary No. 35, 15 November, ECMI, Brussels.

Conversely, for providers of funds, the plan aims at opening up cross-border markets for investment products and distribution channels, but no concrete actions have been put forward. After decades, the participation of retail investors in cross-border flows and in capital markets more broadly is still very limited and usually takes place through expensive intermediation.

European household savings are in search of yields and are often trapped in either expensive retirement products or deposits yielding negative real interest rates. Cash and deposits have gradually reached 30% of their total financial assets (according to Eurostat), which is more than double the size for US households, which hold more savings in investment funds and shares. To address this imbalance, bold initiatives will be required to harmonise marketing rules and allow cross-border competition among product manufacturers and distributors. It will not be enough to simply create another EU-labelled product (fund manufacturing rules) or to improve upfront disclosure (e.g. prospectus for investment products).

Also in this case, the focus on a 'physical target' for these actions (retail investor, with no definition of who a 'retail investor' is) may shift the attention to retail-labelled products, while the general issue of closed national distribution mechanisms is not yet fully tackled. Would not a plan to build a common framework for distribution of investment products (with full harmonisation of marketing rules) be a more effective approach?

Finally, on enforcement, the Commission will cooperate with ESMA to step up country peer pressure, but without taking any further action to deal with the lack of legal powers that ESMA exercises vis-à-vis the role that regulation has assigned to it. Regarding governance, the initial experience of the Single Supervisory Mechanism in Banking Union can be a reference on how to make the governance more European without excessively harming the peer-review model. International peer review of national supervisors requires common institutions able to issue binding instructions to authorities that are not compliant.

Light and shadows of the CMU plan

A truly pan-European Capital Markets Union will not be created overnight. Differences among EU member states and between the EU and the US are structural and require a bold response. This Action Plan has launched the debate with few concrete proposals and many ideas for further work in several areas. The bright side of the CMU plan is certainly the attempt to unify efforts in a single plan and to exploit the political momentum surrounding the completion of the monetary union and the creation of a financial union. It also brings to the table important discussions that have been shelved in recent years, like harmonisation of tax collection and cross-border insolvency proceedings.

But more needs to be done. This plan walks on a much thinner political support compared to the Banking Union proposals. The approach of the Action Plan assumes that wholesale investors or large companies can already access a well-functioning European capital market, but this is erroneous. EU equity markets, for example, are just a fraction of US equity markets and pan-European activity is for now limited to the top liquid shares of domestic listings, with markets defined along national borders.

Is it thus so politically unimaginable to create the conditions for a single market that is no longer fragmented along national borders (28 member states with 28 trading venues), but rather is organised around sector specialisation (e.g. blue chips, mid caps, etc.)? Is there any reason why investors should fear greater consolidation across Europe's financial markets, aspiring to a pan-European market with fewer secondary marketplaces (offering either national or pan-European listings) specialised in specific sectors, such as high-tech companies (like the sector specialisation of the NASDAQ in the United States)? Fostering cross-border capital flows through the creation of a common legal and financial architecture (with a focus on information flows and enforcement) will increase resilience, as it improves the quality of financial integration through more diversified financial flows, as well as efficiency for the benefit of small and big firms and investors alike. Are there any grounds for European institutions to be afraid or suspicious of this vision? After the partial success to complete the single market for capital with the 1992 Single Market Programme and the 1999 Financial Services Action Plan, this may indeed offer the vision that will prevent the CMU from becoming another (failed) harmonisation attempt to restart financial integration.