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Eliminating the cost of non-Europe in capital markets

Karel Lannoo

The European Commission should undertake a **radical upgrade of the Capital Markets Union (CMU)**, along the lines of the Single Supervisory Mechanism (SSM), but with a focus on strengthening the role of the European Securities and Markets Authority (ESMA) and the European supervisory authorities (ESAs). With the implementation of some key measures regarding market abuse and benchmarks, and soon also of MiFID II, only a more unified supervisory framework will deliver the Union that Europe needs for its capital markets. Fragmented supervision gives way to regulatory competition, reduces investor protection and ultimately increases the cost of capital, as investors stay on the side lines.

Two years after the announcement of the CMU Action Plan, there is now an opportunity for the EU to upgrade and strengthen its supervisory structure for capital markets. The experience of the SSM, albeit short, shows the benefits of a more unified structure, with a unique supervisory template and database, multinational supervisory teams and a single supervisor. But experience so far with the SSM also demonstrates how much remains to be done on a day-to-day basis to make the single system work. The ongoing SSM consultation on standards for non-performing loans, 25 years after the start of the single financial market, is proof of just how much banking union remains a work in progress.

It cannot be stated enough that the **lack of integration in Europe's capital markets imposes a high cost** on both firms and investors. Capital markets currently lack the depth and scale to provide the funds for innovative firms to grow. For a European-wide IPO or rights issues, for example, even under the current proposal, a company's prospectus needs to be authorised by 28 different authorities, in 28 different member states with 28 different registers – none of which has the depth or breadth of that seen in the US capital market. And even if the issuer wanted to be listed on a more liquid foreign market, the prospectus must be approved by the home member state's competent authority. Only an effective single market can overcome this inefficiency.

The following examples are perhaps more telling than a long article: the EU currently has 15 companies with a market capitalisation exceeding $100 billion; the US has 42. Moreover, the average market capitalisation of these 15 EU firms is only about one-third that of the US firms. Tesla, the US car manufacturer that was virtually unheard of a few years ago, has acquired a market capitalisation worth half that of the centenarian Daimler. Tesla has not made a single euro in profit yet, but it is extremely innovative and expanding at an astonishing rate.

Karel Lannoo is Chief Executive Officer of CEPS and General Manager of ECMI.

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It is obvious that EU capital markets have a long way to go before they can support innovation and growth in a similar manner and magnitude to that seen in the US. Put differently, if a truly innovative European firm goes to the market today in search of capital, there is a good chance that it will end up in the hands of a US corporation – one that will drive its growth forward.

The same applies to investors. **Investment products in Europe lack the scale and size** of similar products in the US, and as a result the costs for investors are higher and the returns lower. In the end this means that savings languish in zero-yielding deposits rather than being invested in the markets. The EU currently has about 32,750 different mutual funds, with an average size of €227 million, compared to 7,923 in the US, with an average size of €1,648 million (2014 data). The end result is that it is more difficult to invest funds in less liquid products, such as infrastructure, which affects returns. But it also affects the cost of investing in funds, and this is reflected in the total expense ratio of funds or the management fee, which at 1.8% is the double of the US rate, at 0.8%.

The way the EU has dealt with capital markets regulatory issues over the last few years is by **adding layer upon layer of new rules**, to achieve a single rulebook and a level playing field. In a key measure like MiFID, which regulates the conduct of intermediaries in capital markets, the density of rules has increased by a factor of at least 12 over the last 10 years. MiFID I, which came into force in 2007, was an increase of a factor of 3.5, measured in terms of words in the main acts and secondary legislation, compared to the original Investment Services Directive. And MiFID II is an increase of 3.5 again compared to MiFID I. This means that to achieve this single rulebook, rulemaking has spiralled out of control. Or, to ensure that there is no regulatory competition, rules need to be identical in the 28 member states.

To bring this regulatory levelling-up process to a halt, we need to **strengthen the rule-enforcement and interpretative powers of the** ESAs, to the same degree as the SSM did for the supervision of banks. In this sense, Brexit could be seen as an opportunity because member states have one excuse less for not going in this direction. In addition, the expected relocation of EBA should be an occasion to revisit the EU's supervisory structure, and to move to a 'twin peaks' model in supervision, whereby all regulatory agencies will be moved under one roof, to create the second peak. This could facilitate the division of labour in the agencies, as on capital markets issues the two other agencies often intervene alongside ESMA, with EBA for prudential rules, also for capital market intermediaries (i.e. the trading book), and EIOPA for fund-related issues. This is demonstrated by the increasing number of regulatory actions taken by the Joint Committee of the ESAs, given the overlapping competences. Furthermore, a review of the agencies could revisit its decision-making structure, since today the board voting power is, unlike the SSM (and the Single Resolution Board), only in the hands of the member states.

This is not institution building, **it is consolidating and rendering the current structure more efficient**. Today, capital market supervision is spread over diverse institutions in the member states, much more so than banking. Some countries have an FSA structure, others a twin-peak structure, and others still a specialised capital markets supervisor. In addition, the EU has recently created more capital markets supervisory competences, such as for benchmarks, derivative markets, rating and data reporting agencies. But it is only for rating agencies and trade repositories for derivative markets that these powers were passed on to ESMA. For the others, member states are expected to create the supervisory capacity they do not have. This is most evident for benchmarks, where the expertise resided with ESMA, in cooperation with IOSCO. For central counterparties (CCPs), as they concern a few systemically relevant entities with global reach, it would be much more consistent to have one supervisor, from a financial stability perspective, than colleges, whose ineffectiveness is an unwelcome reminder of the banking crisis. There is also a concern about the difference in supervisory methods and statutes of such entities.

An EU-wide capital markets agency could also become the single prospectus authorisation agency for public offerings, or validate EU fund prospectuses. Following the division of labour within the SSM between 'less significant' and 'significant' institutions, small offerings or funds could be authorised locally, with a '*droit de regard*' by the European agency. Large offerings

and funds appealing to a European investor base could be authorised uniquely by the European agency.

In its updated report on Capital Markets Union (14 September 2016), the **European Commission proposed an acceleration of its implementation**. Reference was made to the Five Presidents report, which advocated a single European capital markets supervisor. Since much of the rulemaking is complete, an empowered capital markets supervisor is the only way to deliver the benefits of a single market.

Let us try to live up to the promises made and the expectations created of that market. The figures cited above should make it clear that this is not a matter that can wait; in fact, it is urgent for the competitiveness of Europe's capital markets and for the investment returns that households need.