Briefing on the principles that should underpin the development of a Capital Markets Union in Europe

Foreword from Rachel Lomax, Chair of the IRSG Council

In Jean-Claude Juncker's political guidelines for the incoming European Commission, he proposed a Capital Markets Union to develop and integrate European capital markets. The IRSG is pleased to note that he has made this a high priority ambition for his forthcoming presidency. We believe that the development of a European Capital Markets Union has the potential to rebalance Europe's excessive comparative reliance on bank funding, and help to lower the cost of raising capital in Europe, thereby making it a more attractive place to invest.

Securities markets account for as much as 70% of all corporate fundraising in the US. In Europe on the other hand, banks have traditionally accounted for the majority of lending to businesses. There are however indicators that bond markets have since 2011 outpaced banks in the provision of new funding. The historical over-reliance on bank finance in Europe undoubtedly amplified the effect of the crisis. Since SMEs are particularly dependent on banks, access to finance for small and new businesses has been hit especially hard.

We have developed seven principles that should underpin the development of a more balanced European financial system to better support business investment and economic growth. These principles represent the high-level views of a cross-sectoral group of financial institutions and their advisers about how the ambitions Jean-Claude Juncker has set out for a Capital Markets Union might best be developed. They are described in detail in this briefing.

TheCityUK, which co-sponsors the IRSG with the City of London Corporation, plans to take forward these ideas as part of its EU research programme which aims to develop a broader EU reform agenda to further promote competitiveness, growth and jobs. Lord Green, Chairman of TheCityUK's Advisory Council, who is personally overseeing this work, will be launching the next phase of this programme on 4 November 2014 at TheCityUK's Annual Dinner in London.

We all know that Europe needs to meet great challenges if it is to sustain its distinctive social model and compete in new high-growth markets around the world. As part of its contribution to meeting these challenges, the IRSG is committed to seeking new ways of harnessing personal savings and of diversifying the sources of finance within Europe.

Rachel Lomax

Principles for the development of a Capital Markets Union in brief

1. **Dynamic and innovative capital markets can facilitate sustainable economic growth**
2. **A Capital Markets Union should include all 28 Member States**
3. **The global competitiveness of the EU's financial sector should be maintained**
4. **Financial stability, investor protection and market integrity are essential elements of sustainable capital markets**
5. **Europe can benefit from innovation and new technologies**
6. **Non-legislative and market-based solutions approaches should be used wherever possible**
7. **Capital markets development can work in tandem with other policy priorities**

Background on Capital Markets in Europe

Over recent years, EU policymakers have expressed the desire for capital markets to comprise a more substantial role as a provider of finance within the European financial system. Post-crisis deleveraging and the shift towards more stringent capital requirements have contributed to constraints on the availability of finance, particularly for SMEs.[1] Market finance solutions such as private placement and securitisation have been mooted as alternatives to traditional bank lending for certain customers and purposes.[2] Furthermore, the capital markets channel of financial intermediation is regarded as means of mitigating the economic impact of shocks to the banking system.[3]

Capital markets provide long-term debt and equity finance for governments and the corporate sector. They channel savings and investment between suppliers of capital such as retail investors and institutional investors, and users of capital like businesses, government and individuals – through equity and debt instruments. Capital markets include primary markets, where new stock and bond issues are sold to investors, and secondary markets, which trade existing securities and where holders of these securities can exchange them with one another at market prices. As capital markets typically involve issuing instruments for the medium term and long term, they are distinct from money markets, which deal in financial instruments with maturities not exceeding one year.

Capital markets represent an important part of the financial system globally, although in Europe they figure less prominently than in some other advanced economies. In 2013, the volume of equity and fixed income securities traded on major exchanges amounted to over $70 trillion. Funds raised through IPOs globally amounted to $163 billion, a fifth of which was raised on European bourses. Compared to other advanced economies, financial intermediation in Europe is more reliant on banks than capital markets.

Free movement of capital is a core element of the Single Market and one of the 'four freedoms'. It gained its current status with the institution of the Maastricht Treaty in 1994. In the EU's current legal framework

[1] TheCityUK / Ares & Co, *Alternative Finance for SMEs and Mid-Market Companies*, October 2013.
[2] Ibid, see also: Bank of England and European Central Bank, *The case for a better functioning securitisation market in the European Union*, May 2014.
[3] International Regulatory Strategy Group, *Financing Europe's investment and economic growth*, June 2014.

Art. 63 TFEU stipulates that 'all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited', building on the provisions in Art. 26 (2) TFEU. Free movement of capital is also the only freedom that extends to third countries; not only are restrictions on capital movements and payments between EU Member States prohibited, so too are restrictions between EU Member States and third countries (Art. 63(2) TFEU).

This integration of capital markets is of crucial importance to the efficient allocation of capital, which contributes to jobs and growth across the EU. However, as a recent report by the European Central Bank[4] shows, levels of integration in European financial markets have not fully recovered since the crisis. For example, the share of Monetary Financial Institutions' cross-border holdings of debt securities issued by euro area and EU corporates and sovereigns, a relevant quantity indicator of financial integration, was about 22% in 2013 and has nearly halved since it peaked at 40% in 2005.

Principles for the development of a Capital Markets Union

Principle I: Dynamic and innovative capital markets can facilitate sustainable economic growth
The further development and integration of European capital markets represents an untapped opportunity to strengthen the internal market and raise living standards for European citizens. The Banking Union and accompanying reforms that stabilised the Economic and Monetary Union have laid the groundwork for a Capital Markets Union that will facilitate capital formation in the context of Jean-Claude Juncker's agenda for jobs, growth and industrial development. Contributing to this objective should be the main test of any reforms, as opposed to harmonisation or centralisation for their own sake. Dynamic and innovative capital markets will bring benefits for firms through increased access to capital markets at lower costs, and for savers through a wider range of investment opportunities and higher returns. Wherever possible, the development of capital markets should focus on facilitating private sector growth organically, through the emergence of dynamic and innovative capital markets, not post-crisis repair and risk aversion.

Principle II: Capital Markets Union should include all 28 Member States
The benefits of the UK's EU membership are large and varied both to the UK and the EU, and some are more tangible than others. The EU benefits from having London, one of only a handful of truly global financial centres, as its hub and entry point for companies based outside Europe wanting to access the Single Market. London and the wider UK therefore help to create economic growth and jobs across the EU. The jobs and growth agenda can be furthered by ensuring a level playing field, an ambition we share with European institutions and want to further as much as possible. The access to a global capital market within the EU's borders also helps to reduce the cost of raising capital for EU firms. In the first half of 2014, the London Stock Exchange accounted for €15.9bn in IPOs, nearly half of the European total. Some 126 companies from EU countries were listed on the London Stock Exchange's (LSE) markets in June 2014. The UK's substantial domestic market in bonds is complemented by London's continuing role as a major centre for issuance and the trading of international bonds. The UK's financial services sector therefore impacts how EU businesses are funded, how pensions are paid for, how companies hedge their risk and how governments use financial markets to service public spending. Financial integration allows for deeper financial markets, improvement in allocation of capital and more opportunities for risk diversification. The development of a policy or supervisory mechanism for a Capital Markets Union that excludes non-Eurozone countries would risk fragmenting European capital markets to the detriment of all Member States.

Principle III: The global competitiveness of the EU's financial sector should be maintained
A further principle for the development of a Capital Markets Union should be the maintenance of competitiveness of the European financial sector and openness to global corporates, investors and fund

[4] European Central Bank, *Financial Integration in Europe,* April 2014.

managers. Such openness increases the investment opportunities for investors and deepens the pool of capital available for European firms. Since the financial crisis there has been a general tightening of third country access to the EU. For example, the delay in finalising equivalence determination for third country regimes under the Credit Rating Agencies Regulation caused some concern amongst market participants. Of particular concern are provisions in MIFID II that have the potential to restrict access to service-provision from non-EU countries, and provisions in AIFMD which limited European firms' ability to contract with third party asset managers. As the Commission has emphasised, 90% of world-wide growth is generated outside the EU[5]. Third country access rules in European regulations should avoid limiting the ability of EU investors to access high-growth emerging markets and of EU businesses to transact with third country counterparties. Where third country rules are put in place, it is important that they are agreed on an objective basis and not as veiled protectionism.

Principle IV: Financial stability, investor protection and market integrity are essential elements of sustainable capital markets
Of course, any financial services framework must have regard not only for competitiveness and openness but also financial stability, investor protection and market integrity. The European regulatory framework, including such legislation as MIFID II/MIFIR and UCITS V, remains world-class in terms of investor protection. If the shift from bank to capital markets intermediation is to be accompanied by a corresponding shift in the allocation of individuals' savings from bank deposits to securities, it will be important to consider how well-equipped European savers and their advisers are to assess and account for the different types of risk involved, particularly in certain Member States with less developed markets for investment advice. Again, legislation will not necessarily be the most effective response. The IRSG suggests that an EU-wide study be undertaken into building an equity culture in Europe, including the role of financial education and retail distribution.

Principle V: Europe can benefit from innovation and new technologies
In a related vein, it will be important for a Capital Markets Union to allow for innovative and efficient financial markets. Increasingly, technology is disrupting the traditional models of intermediation, including through new platforms for retail investors and SMEs, for instance in the areas of payments, fund platforms, supply chain finance, peer-to-peer lending and crowdfunding. The EU should also look to successful models of unified capital markets from other jurisdictions such as Japan and the United States. Again, the capital markets framework should allow for consumers of financial services to enjoy the benefits of innovation and consequent efficiency gains.

Principle VI: Non-legislative and market-based solutions approaches should be used wherever possible
A great deal of post-crisis regulatory reform was achieved by the Barroso Commission II, and the next mandate will entail a substantial programme of Level II legislation and implementation of this agenda. Not only will this programme test the capacity of financial institutions and regulatory authorities, it will moreover be important to ascertain its cumulative impact so that measures can be calibrated, unintended consequences can be addressed, and existing regulations made to work as intended. Non-legislative and market-based solutions should therefore be the preferred means for developing a Capital Markets Union, while ensuring that all 28 Member States respect the principles put forward. Indeed, it will be important to consider how the implementation of measures such as Solvency II and CRD IV facilitate capital markets development. Another important non-legislative tool is a rigorous competition regime[6] to guard against European capital markets being distorted by state-subsidised lending. Just as implicit subsidies related to 'too big to fail' are being addressed through legislation including the Bank Recovery and Resolution Directive, other types of state-subsidised lending should be investigated where warranted and addressed appropriately. In those circumscribed areas where legislation may be

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[5] European Commission, *Trade: a key source of growth and jobs for the EU,* February 2013
[6] See Daniel Seikel, *How the European Commission deepened financial market integration. The battle over the liberalization of public banks in Germany*, Journal of European Public Policy, June 2013.

warranted, such as securities law and insolvency procedures, it will be important that stakeholders are appropriately engaged and that the impacts are rigorously assessed for their impact on the jobs and growth agenda.

Principle VII: Capital markets development can work in tandem with other policy priorities
Finally, a Capital Markets Union should develop in a way that is coherent with the wider policy agenda that has been set out. The important work on reviving securitisation markets and developing a European private placement regime described in the Commission's Long Term Finance Communication represent important ways of ensuring that SME lending is encouraged in the policy framework. It is important that this work is undertaken in close collaboration with cross-sectoral market participants. Jean-Claude Juncker's aspirations for a European Energy Union that delivers affordable and sustainable energy will require significant investment. To that end, work should be undertaken on a European framework for the definition and accreditation of green bonds together with specific recognition in investors' rules. Infrastructure development brings immediate economic benefits in the initial construction phase and lasting economic and social benefits once projects are completed. Policymakers should continue to review the calibration of long-term assets under EU legislation to ensure that finance for infrastructure projects is not restricted.

About the International Regulatory Strategy Group

The IRSG is a practitioner-led body comprising leading UK-based figures from the financial and related professional services industry. It aims to be one of the preeminent cross-sectoral groups in Europe for the financial and related professional services industry to discuss and act upon regulatory developments. With an overall goal of sustainable economic growth, it seeks to identify opportunities for engagement with governments, regulators and European and international institutions to promote an international framework that will facilitate open and competitive capital markets globally. The IRSG is co-sponsored by the City of London Corporation and TheCityUK.