SESSION SUMMARY - BERLIN SEPTEMBER 2020

CMU: is the High-Level Forum report the right way forward and what are the next steps?

1. Implications of the COVID crisis for the CMU

Several speakers on the panel emphasized the importance of the Capital Markets Union (CMU) for addressing the economic challenges caused by the COVID crisis.

A policy-maker stated that CMU is a key priority for the EU and has become even more urgent with the COVID-19 crisis because the recovery cannot be financed through public finance alone. Private finance is also needed to fund the green and digital transformations of the EU economy and to relaunch job creation. A new CMU action plan will be published at the end of September covering areas such as access to finance, market infrastructure, retail investor participation and the removal of barriers to cross-border investment. A public representative stressed that CMU is needed in particular to make it easier for SMEs to access equity and to provide savers with appropriate investment opportunities. An industry representative felt that in the face of the challenges raised by the COVID crisis, CMU potentially creates major opportunities for Europe. These include the possibility to double the size of the European capital markets and to increase the share of savings flowing into productive, socially useful, sustainable long-term investment, thus improving prospects for the next generation.

While strongly supporting the CMU, a regulator emphasized that it will come too late for addressing the consequences of the COVID-19 crisis and that we will measure how detrimental it is not to have a CMU in this context. This is particularly regrettable concerning equity financing, which is needed for diversifying funding sources and avoiding an excessive growth of indebtedness. A strong push forward regarding the CMU to prepare for the next crisis was advocated by the regulator, who also underlined that Europe does not have the right supervisory tools either to deal with crisis management. As an example, embedded in the founding regulation of the ESAs is an article about so-called action in emergencies, but this process is too complex to trigger and delegating to an authority which is not the regular ground supervisor in order to take some urgent decisions is not likely to work. Additionally when supervisory decisions have been made in the past for mitigating certain market risks, such as short selling bans or the implementation of liquidity tools to limit fund outflows, different options were taken across the EU by domestic supervisors for tackling the same risks: such a lack of harmonisation is neither effective nor sustainable.

An industry representative agreed that the completion of CMU may arrive too late for this crisis. Despite this, progress must be made in its implementation, because every minute lost will protract and delay the recovery of the EU economy further. CMU is essential and unavoidable for economic recovery in Europe and the current scheme that has been proposed is the right way forward. But there has been a lack of rigour and urgency over the last few years with the implementation of the first stages of the CMU, which should not be reproduced. Governments and banks responded appropriately at the beginning of the COVID crisis and avoided a credit crunch and liquidity crisis. However, this has significantly increased the level of debt and when leverage is poured into a fragile economy at such a magnitude, it is only a question of time for the solvency rates of corporate balance sheets to hit rock bottom. A discussion is needed on the next steps for repairing corporate balance sheets. The provision of further leverage is not the right response. Rather, access to private equity is required. Another industry representative observed that it is not just government and corporate balance sheets that are stressed as a result of the COVID crisis but also the private individuals' balance sheets.

An official also noted that the financial sector and governments had responded adequately to the COVID crisis, avoiding a credit crunch. There now has to be consideration of how the financing process can be normalized going forward, following this expansion of credit. CMU plays a part in this and particularly the measures related to simple, transparent and standardised (STS) securitisation. There is also a need to revive the discussion concerning the secondary trading of non-performing loans (NPL). NPL numbers are not yet increasing to critical levels, but it is just a question of time, because there is always a correlation between recessionary tendencies and the growth of NPLs.

An industry representative explained that the situation is variable across the EU. In the Nordic region, SMEs that needed capital used the stock exchange to get it. The reason for the success of the stock market in Sweden in particular is education and tax. The tax system has been relatively favourable for retail investors for many years. Statistics also show that companies that list on public markets grow faster and create more jobs.

The official pointed out some other encouraging developments in Europe on which the CMU can potentially build. Good progress has been made in terms of digitalisation. Europe also has the potential to become a hub for venture capital (VC). A great deal of venture activity is being conducted by the EIB and several domestic development banks and venture finance incentives are also being included in the public funds provided in response to the crisis. This is the case for example in Germany where the €10 billion "future fund" will include incentives to stimulate VC activity and maximize its impact.

2. Key areas covered by the CMU HLF report

The CMU High-Level Forum (HLF) report was very positively received by the speakers on the panel, who considered that it constitutes a well-balanced and comprehensive action plan covering both supply and demand factors. It is also relevant that it combines a top-down vision of the approach needed for developing EU capital markets with a granular description of the practical actions that need to be implemented and a detailed timeframe. An official noted that the calendar for implementation is ambitious, but it can be achieved. The coherence of the package and the mutually reinforcing nature of the actions proposed were also emphasized, meaning that there should be no cherry-picking within the CMU action plan.

2.1 Key themes highlighted by the panellists

2.1.1 Access by companies and particularly SMEs to more diversified financing

An industry representative indicated that about 75% of the European economy is financed by bank loans, which is not a healthy situation. An official emphasized the importance of providing SMEs with a proper choice between banking finance and capital markets. Another official stressed the relevance of the measures proposed in the HLF report regarding listing rules and the facilitation of IPOs.

The importance of increasing equity financing particularly for SMEs was stressed by several speakers The more equity there is in the financing system the better the risk is spread throughout the economy, and the less entities are vulnerable to any particular whim or crisis that comes through the banking system, a market observer noted. A public representative considered that SMEs need to become more comfortable accessing the equity markets. An industry representative suggested that regarding SMEs there is a need to work both on the supply (issuance) and on the demand sides. In this regard, the European single access point proposed by the HLF for facilitating the access to company financial and ESG data will be critical, because a standardised set of data is needed to be able to analyse companies and investment opportunities and to then direct money where it can be used most effectively. The need to review prudential frameworks for fostering more institutional investment in equity was also emphasized. However the industry representative stressed that there should be caution when allowing SMEs to disclose less information compared to larger companies, because the larger pension funds and investors in particular need maximum transparency.

2.1.2 Development of retail investment

A public representative stated that there is a need to focus on financial education, because investors who are most likely to diversify their investment portfolios are those who have sufficient financial knowledge. An official confirmed that retail investors must be prioritised. They have to be able to not just access the capital markets in Europe but also to do so with sufficient trust and also with an understanding of the implications of investing in capital markets. That requires improving the level of investor protection and financial literacy. An industry representative agreed, suggesting that investor education should start at an early age through the educational system and that the financial industry is ready to contribute to this effort. Providing effective digital platforms is also essential for facilitating further retail investment.

The industry representative also emphasized the link that needs to be made between the objective of developing retail investment and pension issues in Europe. Considering on-going demographic changes and the difficulty of sustaining the public pension schemes, it is obvious that the private sector needs to contribute more to retirement savings. This view on long-term pension savings needs to be clearly brought into CMU 2.0.

2.1.3 Further integration and competitiveness of EU capital markets

A public representative suggested that removing legal and fiscal barriers, such as those related to the withholding tax, and creating a market infrastructure that allows equity to move more easily across the EU are essential for building a more competitive CMU that can attract more capital within the EU and also from foreign countries. This is particularly important with the UK leaving the EU. There is a need to attract foreign companies to the EU capital markets to find investment and also to provide EU companies with sufficient capital for funding their expansion. An official agreed that further harmonisation and achieving a large enough internal market for capital are essential and supported the ideas put forward in the CMU HLF report in this regard.

A market observer queried whether merging smaller exchanges into a pan-European platform could help to build a more dynamic capital market in Europe likely to increase the liquidity of EU SME markets in particular. An industry representative did not believe that there is much added value in consolidating domestic exchanges further. Synergies and scalability can be achieved in other ways, for example by sharing the same trading or surveillance systems or by interconnecting platforms digitally. This is the way forward that has been chosen in the Nordics. Domestic exchanges serving local needs share the same platform and technology but have not been fully consolidated.

2.2 Proposals requiring stronger emphasis in the new CMU action plan

Two main areas of improvement that could have been more strongly emphasized in the CMU HLF report were mentioned by certain speakers: the improvement of securities market transparency and a further integration of supervision.

2.2.1 Market transparency

While supporting the Report of the High Level Forum and most of its recommendations, a regulator noted that a proposal to establish a European consolidated tape is missing in the Report, as such a tool is needed for improving the post-trade transparency of equity and bond markets. An industry representative disagreed, considering that a European consolidated tape would not constitute a game changer for the development of EU capital markets. The focus should rather be, as suggested previously, on helping SMEs to gain access to the capital markets and on strengthening equity financing. With MiFID II the European market has become 'darker and darker', but this is more the result of changes in the market structure with the strong development of Systematic Internalisers (SI) and over-the-counter (OTC) transactions. Only large size orders should be transacted on SIs and OTC. This issue needs addressing in the new CMU action plan.

2.2.2 Integrated supervision at the EU level

A regulator emphasized that the issue of supervision is key for the CMU, but is not properly addressed in the recommendations of the HLF. The basics for a union in the area of capital markets are very simple. There needs to be a single rulebook and a harmonised implementation of it, based on harmonised supervision. The problem is that at present there is no real single rulebook because a large part of the EU legislation is based on directives and even with regulations there is often the possibility of opting-out from detailed EU guidelines. For example, answers to Q&A at Level 3 are not binding. The proposal of the HLF will result in increasing the level of scrutiny that the ESAs exert on domestic supervisors, rather than favouring a truly European supervision. This is not an appropriate response to the issue, because it maintains nationalistic approaches, increases bureaucracy and limits the agility of supervision at EU level. The only sensible answer is a more integrated European supervision. This is especially relevant for cross-border entities and financial activities, which are essential for the CMU, and for ensuring financial stability. The recent crisis has revealed deficiencies in this respect. In addition, it is necessary to consider that the current patchwork of national rules and supervisors that favours regulatory arbitrage and jurisdiction shopping is not attractive for third-country investors. Not addressing this issue will be very detrimental for the CMU project.

A public representative stated that without single supervision there will never be a real CMU. The huge social and economic crisis that Europe is currently facing cannot be tackled by just focusing on the national interest. Moving forward on this issue will be a major challenge for the Parliament and the Council and also for the Commission, but it is essential for the effective implementation of the new CMU action plan.

A market observer explained that the HLF proposed a hybrid formula for supervision with some increase in the horizontal powers and governance of the ESAs, but with no additional direct supervisory powers. Indeed many large financial firms are not comfortable with supervision conducted at the EU level. What is needed is some rationality in defining what needs to be supervised at the EU and at the national level. The HLF report proposes some criteria for EU level supervision that include the cross-border nature of activities and their systemic relevance.

3. Links with the Banking Union, Digital Finance Strategy and Recovery package

The links between CMU and other key EU initiatives, such as Banking Union, the recently proposed Digital Finance Strategy and the EU Recovery package, were emphasized by several speakers. These different initiatives are part of an overall roadmap for relaunching growth and supporting the financing of the European economy. They are also mutually reinforcing and provide different drivers for enhancing the role of the EU financial sector.

An official emphasized the synergies between the digital finance strategy and CMU, which are 'sister projects'. It is unacceptable that a fintech in the United States can immediately access an internal market of hundreds of millions of consumers, whereas a similar start-up in Europe can only access 27 separate internal markets. Indeed, due to different consumer protection, AML, KYC requirements across the EU, the cost per unit of reaching consumers is much higher for European fintechs. A policy-maker mentioned that besides addressing fragmentation issues, the new strategy for digital finance will provide a framework for tools that may support the CMU such as DLT, crypto-assets, cloud services and artificial intelligence and will also propose adaptations to existing financial legislations in order to take into account the impacts of digitalisation.

The official also stressed the linkages between CMU and Banking Union. As long as banking markets remain fragmented across the EU, it will be difficult to develop an integrated and deep financial market in Europe such as the one that exists in the US. Market making is particularly important in this perspective and the CMU HLF report has rightly proposed measures in this area. The tension between prudential requirements and the ability for banks to provide sufficient liquidity to capital markets is something to be further considered. Prudential requirements need to be optimised in this regard, even if this is a challenging task.

That the recovery package introduces what can be interpreted as a European safe asset is encouraging, another official added, because this may support the development of a more liquid and deeper capital market in the EU.

4. Conditions of success for the implementation of the CMU HLF proposals and next steps

The need for a strong political backing of the priorities put forward in the CMU HLF report was emphasized by several speakers. A policy-maker explained that CMU is an area where close engagement with representatives from the industry and academia is indispensable for producing results, but above all, support from the member states is needed.

A public representative agreed that for moving forward on the CMU, an impulse has to come from the top with an agreement on the key recommendations of the new CMU action plan from the Commission, the Parliament and the Council. In addition, the decision-making process needs to be quicker than in the previous stages of the CMU. The current political situation in some of the member states does not make this easier, but that does not mean it is impossible. Without that high level consensus, it will be difficult to reach an agreement on the more specific proposals further down the line.

An official stressed that the necessary steps will have to be taken in the course of the German EU presidency for translating the key insights of the CMU HLF report into actual policy actions. The goal is to find agreement among the member states on priorities and give the Commission a clear mandate from the member states by the end of the year on where the priorities are and which topics to focus on. The Commission has already front-loaded part of the CMU action plan in the Capital Markets Recovery Package, which was tabled in July and aims to help businesses to access capital markets with targeted adjustments to prospectus, MiFID II and securitisation rules. It is hoped that an agreement can be reached by the end of this year on the legislative proposals corresponding to this package, as this will be an important test for the rest of the CMU action plan. Indeed, while member states all concur with the importance of the CMU, an agreement is more difficult to obtain on specific actions. In the Capital Markets Recovery Package, the most complicated issue to be tackled is probably the STS securitisation framework, as it raises controversy both in Parliament and among member states. However improving the current framework is essential for enhancing risk transfer within the EU and between banks and capital markets. In addition, the objective is not to replicate the opaque securitisation system that existed before the 2008 crisis, but to foster a standardised and transparent securitisation process in line with European standards, which hopefully will be achievable. An official felt that the timeline is ambitious and there has to be realism about the pace at which approval can occur, but their country would be supportive of the approach proposed.

The policy-maker hoped that the legislative process can be managed fast enough to obtain clarity by the end of 2020 on the support there can be from the different stakeholders on the CMU action plan that will be published at the end of September. The action plan however covers some very sensitive topics which need to be approached in a smart way. An industry representative was concerned that the political process may move forward at the cost of the more politically sensitive recommendations, specifically those on shareholder rights and withholding tax. Progress on these topics is nevertheless essential. Today an investor in European securities is faced with 27 different definitions of a legal owner, 27 different operational processes and 27 different sets of tax forms. Managing this complexity is a challenge for wholesale market participants and practically impossible for retail investors. A key priority for the work going forward is to keep the idea of a package and to deliver significant progress on all of the topics put forward in the CMU HLF report with a sufficient sense of urgency. ■