# CAPITAL MARKETS UNION: WHERE ARE WE?

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## 1. OBJECTIVES OF THE CAPITAL MARKETS UNION (CMU)

The Capital Markets Union (CMU) initiative was launched in 2015 with the objective of developing and further integrating capital markets in the EU in order to (i) diversify the financing of EU enterprises, particularly the most innovative and fastest growing ones, and (ii) provide savers with improved long-term investment opportunities while better connecting savings to investment across the Union. An additional, more macro-level objective, is to enhance the resilience of the EU economy with a diversification of funding sources and a development of cross-border capital markets (contributing in particular to private risk sharing across the EU).

Further developing and integrating EU capital markets remains a key objective in the post-Covid context to support the economic recovery and the green and digital transition objectives of the EU. Capital markets are indeed essential to finance fast-growing and innovative businesses, channel private investments towards climate and environmental targets and support the digital transformation due to their capacity to finance immaterial assets and projects and their longer term perspective.

The latest Communication on CMU (November 2021) also stresses the significant role that the CMU may play, together with the Banking Union, for enhancing the open strategic autonomy[1] of the EU and strengthening confidence in the euro. Developing deep and liquid EU capital markets and reducing the overreliance of the EU on critical third-country financial services providers is indeed crucial for securing the financing of innovative and fast-growing companies in the EU, particularly in the post-Brexit context.

## 2. CAPITAL MARKETS REMAIN UNDER-DEVELOPED AND FRAGMENTED IN THE EU

EU capital markets remain quite under-developed compared to those of other major economies such as the US[2] or the UK. The EU-27 average stock market capitalisation[3] amounted to 58% of GDP in EU-27 in 2019, compared to 115% in the UK and close to 150% in the US[4]. Following the Covid-19 crisis, the gap has widened further, with the EU market capitalisation reaching 74% of GDP as of December 2020, against 194% for the US. Also, the development of capital markets is very heterogenous across EU Member States, with market capitalization-to-GDP ratios ranging from 150% in the NL and 114% in Sweden in 2020 to less than 10% in certain Central and Eastern Europe countries such as Slovakia (5.1%), Romania (9.6%), Lithuania (7.5%) and Latvia (2.8%). Of the 27 EU Member States, 12 had a stock market capitalisation not greater than 30% of GDP in 2020. As a result capital market activity in the EU is concentrated at present in a small number of countries, with France, Germany and the NL representing 55% of total EU capital markets for example.

At the micro level, equity remains limited in the funding structure of EU non-financial corporates and the share of savings held by EU households in capital market instruments remains insufficient for ensuring adequate retirement revenues. The share of listed securities remains limited in the funding structure of EU non-financial companies (28% in the EU compared to 47% in the UK and 69% in the US[5]). In addition, according to data from the Banque de France[6], at the beginning of 2021, equity financing only represented 91% of euro area GDP, versus 220% in the United States. And the biggest EU venture capital firm is 3 times smaller than the 10th US venture capital firm, by money raised over a decade. As for EU households, on average in 2019 they held less than a third of their financial savings (32%) in securities (i.e. stocks, bonds and mutual funds), which is 20 percentage-point lower than in the US[7] and 10 to 20 percentage points lower than the EU countries that have the most developed capital markets (e.g. Nordic countries).

In addition, there is a persistent fragmentation of the EU capital markets, with a limited proportion of cross-border securities transactions and issuances and fragmented trading and post-trading infrastructure. This reduces the liquidity and depth of EU capital markets and leads to differences in the cost of capital and access to capital market instruments across the Union. There moreover seems to be a certain stagnation of cross-border flows over the last few years

1. The concept of open strategic autonomy, meaning in effect non-dependence on foreign jurisdictions or players, has progressively expanded from the security and defense dimension to many other areas, such as energy, healthcare and, with the UK exiting the EU, to the financial services.
2. Although structural differences (e.g. in the pension systems between the EU and US and in the way capital markets and banks have evolved historically in each region) mean that the US cannot be considered as a direct benchmark for the EU, the comparison with the US shows that the development potential of EU capital markets is still significant, particularly in the retail space and for the financing of SMEs.
3. Capitalisation represented by the outstanding listed shares issued by domestic firms.
4. Source The EU Capital Markets Union : Turning the tide – S&P Global – February 2020.
5. Source IMF staff discussion note "A Capital Market Union for Europe" September 2019.
6. Capital Markets Union: unleashing Europe's potential | Banque de France (banque-france.fr).
7. Source OECD, Eurostat and Federal Reserve data – See Eurofi Regulatory Update February 2022 "Retail investment: opportunities, challenges and policy proposals".

in the EU despite the implementation of harmonised securities legislations such as MiFID, EMIR and CSDR and TARGET2Securities harmonisation efforts[8].

### 3. PROGRESS MADE WITH THE CMU INITIATIVE

Two CMU action plans, including legislative and non-legislative measures, were adopted successively in 2015 and 2017 and have now been mostly implemented. With these two action plans, the Commission has chosen an evolutionary approach addressing a broad range of drivers and building on the pre-existing EU securities legislations such as MiFID, EMIR, CSDR, UCITS, AIFMD etc.. Measures tackling market fundamentals, such as insolvency, tax and securities ownership laws, common supervision or market structure issues, on which a political consensus is more difficult to obtain, are considered to be longer term objectives and have largely been left out so far.

The initial CMU Action Plan published in September 2015 set out 33 actions concerning securitisation, investment funds, prudential calibrations, prospectuses, etc[9]. Following the mid-term review of the CMU, a new set of measures was proposed by the Commission in 2017, covering additional objectives such as the strengthening of the powers of the European Supervisory Authorities (ESAs), the development of fintech, the promotion of sustainable finance, the facilitation of SME listing, private pensions (with the Pan European Pension Product (PEPP) framework) and support for the growth of local capital markets.

Despite this significant enhancement of the EU capital market framework, the general feeling among market stakeholders is that much remains to be done to achieve the CMU. This perception was expressed in particular by the High Level Forum group (HLF) set up by the Commission to make proposals for relaunching the CMU, which published a report in June 2020 proposing a new set of measures considered to be potential 'game-changers' for the CMU and which have since been integrated by the Commission in the new CMU action plan published in September 2020.

A first reason for this perception is that EU capital markets have not significantly grown over the last few years, except non-bank funding through debt securities, as shown by the figures above.

Secondly, there is frustration among many market stakeholders with the CMU process due to a mix of reasons that include the protracted implementation of the two first action plans, the lowering of the initial ambitions of certain proposals such as those concerning the ESAs' operations, the shortcomings of certain new rules or instruments (e.g. securitisation, ELTIF or PEPP) and the lack of clearly identifiable priorities around which a stronger dynamic may be built. There is also the perception of a gap between the strong political commitment to CMU in general and to the objectives of the actions plans (e.g. expressed by the Council at the December 2020 Ecofin meeting) and the slow speed at which the initiative has progressed so far and also the reluctance of certain member states to support certain CMU-related legislative proposals.

The HLF suggested that a tripartite institutional agreement between the Commission, the Council and the Parliament on the main components of the CMU action plan, as well as a strict monitoring of the overall CMU implementation timetable, would be needed for building stronger momentum around the CMU going forward. Progress has been made in terms of monitoring and the Council endorsed a large part of the September 2020 action plan in December the same year. But the need to build a stronger political commitment among EU political leaders around a set of more concrete objectives and some key priorities (related e.g. to the cost and diversity of financing, the scaling up potential of EU corporates and the financial prospects for EU citizens or the necessary degree of harmonisation of rules) has been regularly put forward by public authority and financial industry representatives since then, notably at recent Eurofi meetings.

### 4. OBJECTIVES AND LEGISLATIVE MEASURES OF THE NEW CMU ACTION PLAN PUBLISHED IN NOVEMBER 2021

The Commission published in September 2020 a new action plan for completing the Capital Markets Union (CMU) based on the recommendations of the HLF report. This new plan has a more specific focus on developing retail investment. It also puts forward stronger ambitions than previous ones in terms of EU capital market integration (e.g. addressing controversial fragmentation issues such as insolvency regimes or withholding tax, which hamper cross-border investment), although these latter actions were considered to be more a 'medium term' objective by the Ecofin in December 2020. There is also the objective of correcting some existing measures with the improvement of instruments that have not delivered all the benefits expected in the previous stages of the CMU, such as ELTIF funds and STS (simple, transparent and standardised) securitisation and a review of insurance and banking prudential requirements impacting long term investment.

#### 4.1. Legislative proposals published in November 2021

In November 2021, the Commission subsequently put forward **a set of four legislative proposals** for implementing the September 2020 action plan:

8. See Eurofi Summary High Level Seminar 2021 Lisbon. The ECB's high-level indicators suggest that in quantitative terms the increase of cross-border transactions in the EU has not been significant over the last few years. T2S cross-CSD settlement data as a proxy seems to be stagnating at around 3% of T2S's total turnover recently. Data on CSD links shows a similar picture to general ECB security settlements. Holdings via CSD links seem stable at around 21% of securities outstanding with no increase since the Central Securities Depositories Regulation's (CSDR) introduction or the T2S go-live. When looking at the cross-border issuance of securities, quantitative data from the eligible asset database suggests that securities' cross-border issuance across national CSDs is stable at relatively low absolute levels.
9. These include measures to develop securitization and covered bonds, improve Solvency II calibrations, prospectus and investment fund rules, facilitate the cross-border distribution of funds and also some non-binding measures regarding withholding tax and insolvency proceedings.

- **Setting up of a European Single Access Point (ESAP)** to financial and sustainability-related information on EU companies and financial products in a digitally useable format, aiming to make SMEs in particular more easily accessible and visible to both EU and international investors such as business angels, venture capital and private equity funds. The ESAP will build on existing information channels and be developed, operated and governed by ESMA.

- **Improving the European Long Term Investment Funds (ELTIF) framework** aiming to channel long-term financing to SMEs and infrastructure projects in order to make ELTIFs more attractive for investors and easier for asset managers to operate and market. A broadening of the scope of eligible assets and investments and a reduction of certain fund rule limitations were proposed to allow fund managers to benefit from greater flexibility in the design of ELTIF investment strategies and portfolio compositions. A reduction of the investment threshold and the introduction of an additional liquidity window redemption mechanism were also proposed for retail investors.

- **Enhancing the Alternative Investment Fund Managers Directive (AIFMD)** in order to better integrate the EU Alternative Investment Funds (AIFs) market, improve investor protection and better monitor the risks to financial stability posed by AIFs. The changes proposed include: the introduction of common minimal rules regarding loan-originating funds (i.e. the direct lending by AIFs to companies) allowing them to operate cross-border and addressing potential risks related to this type of lending; a harmonisation of liquidity management tools (LMT) in order to facilitate the management of liquidity risks posed by open-ended AIFs; a clarification of the rules on portfolio management delegation to support a more coherent approach to these activities by AIFMs and to facilitate their supervision; the possibility for National Competent Authorities to allow AIFs to appoint a depositary situated in another Member State; measures to allow depositaries to obtain the necessary information for their oversight duties when fund assets are safekept by a CSD; and measures to remove reporting duplications and to facilitate access to relevant data by national and EU authorities. In addition the UCITS directive will be updated to reflect the changes made to the AIFMD where necessary, for instance on LMTs, delegation and reporting.

- **Reviewing the MiFIR regulation** in order to tackle the main transparency and level playing field issues posed by current rules and enhance the competitiveness of EU capital markets at the international level. A major objective of the MiFIR review is the introduction of an EU-wide consolidated tape for shares, bonds, exchange-traded funds (ETFs) and derivatives based on close to real-time data that would be available to all market participants including retail investors. Secondly, the proposal aims to improve EU trading rules to enhance transparency and ensure a level playing field between execution platforms by banning the execution of small trades on dark pools, reviewing waiver and deferral rules, introducing obligations for systematic internalisers relating to the publication of firm quotes and the matching at midpoint, and banning payment for order flow[10]. The MiFIR review proposals also aim to increase the competitiveness of EU financial markets by removing the open access obligation for exchange traded derivatives (in order to improve legal certainty and suppress disincentives for exchanges to create innovative financial products)[11] and also by adjusting the scope of the EU share and derivative trading obligations[12] and aligning trading and clearing obligations for derivatives.

These legislative proposals were completed by the publication in January 2022 of a **financial competence framework** for adults elaborated by the European Commission and the OECD, and due to be supplemented by a framework for young people. The aim of this framework, which defines the competences that individuals need for making sensible decisions about their personal finances and savings, is to support financial literacy initiatives to be conducted at domestic level (such as the development of national financial literacy strategies, the design of financial education programmes and tools, and the assessment of financial literacy levels). These two frameworks will also support the exchange of best practices on financial education among Member States and private stakeholders.

### 4.2. Proposals planned for 2022

In its November 2021 CMU Communication, the Commission moreover mentions 3 other proposals due to be published in 2022:

- **A Listing Review** aiming to simplify rules for companies, particularly SMEs, wanting to raise funds on public markets. This proposal due to be published in the second half of 2022 intends to cut the red tape for companies going through a listing process or already listed on EU public markets, while preserving market integrity and investor protection. It will build on the existing SME Listing Act that focuses mainly on the use of SME growth markets.

- **An Open Finance framework** aiming to allow data to be shared and re-used by financial institutions for the creation of new service[13]. This proposal intends

10. Whereby retail brokers forward the orders from their clients to a limited number of traders in exchange for compensation.
11. Open access provisions for exchange-traded derivatives indeed reduce the attractiveness for exchanges to invest in new products as competitors may be able to get access without the upfront investment, according to the Commission.
12. The proposal would refine the perimeter of the share trading obligation (STO), which requires that the majority of trading in shares takes place on trading venues or systematic internalisers, to clearly limit it to EEA ISINs. This would clarify that the exemption to the STO for shares which are infrequent, irregular or ad hoc applies to EEA shares. In addition the proposal would introduce a possibility to suspend the derivatives trading obligation (DTO) for certain investment firms that would be subject to overlapping obligations when interacting with non-EU counterparties on non-EU platforms.
13. Provided that customers agree to it and subject to data protection rules and clear security safeguards.

to provide a level playing field for existing and new entrants and will build on the work undertaken in the context of the upcoming Data Act and the on-going evaluation of the Payment Services Directive II (PSD II). In addition, the Commission will propose a supervisory data strategy to improve data standardisation and sharing in order to enable supervisors to efficiently collect and use the data they need to perform their tasks, which involves a modernisation of EU supervisory reporting.

- **Initiative to harmonise targeted aspects of the corporate insolvency framework and procedures**. The Commission intends to propose by Q3 2022 an initiative aiming to make corporate insolvency laws more similar throughout the EU, subject to an impact assessment and to further discussion with the Member States and the European Parliament.

### 4.3. Other on-going initiatives to encourage long term investment in capital markets

In parallel, changes have been proposed by the Commission to Solvency II and CRR/CRD rules aiming to encourage more long-term and equity financing from institutional investors and progress is also being made in the area of pensions:

- As part of the **review of Solvency II**, the Commission has made proposals to amend the insurance legal framework in order to further promote long-term investment by insurance companies, without harming financial stability and policy holder protection. These proposals concern notably the appropriateness of the eligibility criteria for the long-term equity asset class, the risk margin calculation, and the valuation of insurers' liabilities, with the aim of both avoiding undue pro-cyclical behaviours and better reflecting the long-term nature of the insurance business.

- In the context of the **CRR/CRD review**, the Commission moreover made proposals in terms of prudential treatment for banks aiming to avoid undue impacts from the implementation of Basel III on long-term SME equity investments by banks and on banks' and investment firms' market-making activity.

- The Commission is also developing **tools to improve pension provision and retirement savings in the EU**. A first step was the publication in November 2021 of a report on best practices in the area of pension auto-enrolment, which is a mechanism that automatically enrols individuals into a supplementary retirement savings scheme unless they explicitly opt-out, in order to ensure more adequate retirement income. In addition, the Commission is working on the development of pension dashboards[14] aiming to support Member States in the improvement of their pension systems and on the identification of best practices for the implementation of individual pension tracking systems at domestic level[15], aiming to provide citizens with an overview of their future retirement income.

14. Complementing the existing monitoring tools with more detailed information on occupational pension schemes, pension dashboards will provide Member States with a more comprehensive view of the adequacy of their pension systems, encouraging them to address shortcomings and share best practices.
15. Individual pension tracking systems will provide citizens with an overview of their future retirement income, based on their entitlements in all the pension schemes they participate in or the expected return of long-term products they invest in.