CMU priorities: what can be done in this European political cycle?

1. Progress made with the Capital Markets Union (CMU) initiative

1.1 Progress made with the implementation of the CMU action plan

A policy-maker believed that progress is being made on the CMU, whilst recognising that the project takes time. The CMU is very important in the current economic context to support the funding of the economy and the green and digital transformations. There is also a high level of political support for the CMU, as has been demonstrated in many European Council and Euro Summit statement. The Commission presented the project as a long-term initiative and it is the continuation of efforts launched 30 years ago to further integrate EU financial markets. A wide range of actions are needed, both legislative and non-legislative. EU legislators are taking action, but market operators are also expected to contribute to make CMU happen.

The policy-maker explained that the Commission set out a first CMU action plan in 2015. With the exception of one, the corresponding legislative proposals have all been adopted and are in force. A second action plan was subsequently published in 2020, on which significant progress is being made also. A package of actions was proposed in 2021 for implementing this action plan, including a review of the European Long-Term Investment Fund (ELTIF) and Alternative Investment Fund Managers (AIFMD) directives, of the Markets in Financial Instruments Regulation (MiFIR) including the proposal to set up a consolidated tape and the implementation of a European Single Access Point (ESAP) for corporate financial and non-financial information.

The policy-maker noted that in terms of concrete impacts from the CMU, a gradual increase in the participation of retail investors in capital markets has been observed in the EU over the last few years. That has been helped by the pandemic and the acceleration of the digitalisation of markets. European companies are also looking more to market financing than just bank financing, but the trend still needs to be accelerated.

A regulator agreed that the CMU is a long-running project that requires continuous efforts and step-by-step progress. It is clear that there is no single silver bullet that will deliver it. Incremental progress has been made, but the aims of the CMU have clearly not yet been achieved and continued political momentum is needed. Having a strong European capital market is essential for tackling the many economic and geopolitical challenges that Europe is facing. The supervisory authorities have a key role to play in terms of implementation of the regulatory requirements related to the CMU legislative packages and of market oversight. ESMA will be contributing in particular to the efforts made to enhance the provision of adequate data and market information with the ESAP project and potentially the consolidated tape, but these are challenging initiatives that will require the availability of the right resources and capabilities.

A second regulator was less optimistic about the progress made with the CMU. Much effort is being made, but the results do not seem very significant so far. The goals are simple and more relevant than ever, but the approach needs more dynamism. There may also be a branding issue, because it is not easy to understand what the CMU is, contrary to the Banking Union (BU) from which its branding was derived. The Banking Union had three pillars, two of which have been fully implemented, and it has an intellectual coherence. The CMU is more a package of different measures aiming to build a deeper capital market for Europe and diversify financing sources. An industry representative agreed that progress is slow, but remained optimistic about the capacity of Europe to move forward on the CMU initiative.

1.2 Next steps and challenges facing the CMU

A policy-maker reported that important additional actions are planned for the coming months. One is a retail investment strategy that the Commission is working on, together with a review of listing requirements aiming to make it easier for smaller companies to go public. Another important but complex issue is the heterogeneity of corporate insolvency laws in the EU that always comes up as one of the top priorities in public consultations and on which the Commission is planning to make proposals in the coming months.

The Chair noted that there is also a clearing proposal scheduled on the Commission agenda before Christmas 2022. There is effectively only 18 months left of the current European political cycle. This leaves until mid-2023 to make new legislative proposals, and then preparations for the parliamentary elections and for a new European Commission will start, meaning that any agreements on other new texts may need to wait for 2025. A political booster is needed to deliver as much as possible by 2023.

The policy-maker responded that the Commission is making good progress on the proposals that are on the table and it is expected that the whole of the November 2021 CMU package will be agreed in the current mandate. The Commission also hopes that this will be the case for the upcoming proposals on retail, insolvency laws and corporate listing.

A regulator supported the sense of urgency around the CMU. It is important to make the legislative and regulatory progress that is needed over the next few months for accelerating the CMU. The upcoming proposals regarding the listing review and the retail investment strategy are very much awaited in particular.

An industry representative agreed that while progress has been made, the sense of urgency needs to change on CMU with a stronger focus on timing and a reconsideration of the priorities. A functioning CMU in Europe is needed right now. Absent of that, new dependencies are being created at a time when Europe is trying to reduce geopolitical dependencies. The post-Covid recovery and the investments that are needed in many areas such as the green transition, reducing the dependence on fossil fuel, rebuilding supply chains, enhancing infrastructure, and defence, including cyber defence all require a significant amount of additional capital.

The Chair noted that the capital needs in Europe for the green transition alone exceed €500 billion per year, and a capital markets function is essential for fuelling these investments.

The industry representative added that increasing the attractiveness of European markets for wholesale investors is essential, otherwise European companies will increasingly be seeking capital through listing in the US and in Asia. Europe already depends very much on US and Asian technology, on the US defence infrastructure, and energy imports.

The industry representative added that because of the insufficiency of capital market funding there is the perpetuation of the distortion in Europe that long-term capital is being provided by banks, when they should be focusing more on facilitating access to and providing liquidity for the capital markets. Instead, banks are tying a great deal of long-term capital in their balance sheets.

The Chair observed that this is a question of strategic autonomy. The industry representative agreed, noting that this concept in the capital markets area rests on the idea of facilitating a sufficient depth of liquidity in European markets. However the post-Brexit discussions in the clearing area focus on arguing about how to allocate liquidity across the Channel, which leaves major opportunities for US banks that tap into both EU and UK liquidity pools. This discussion goes beyond regulation and is a matter of geopolitical industrial design for European financial markets which needs to be recalibrated.

2. Key priorities for delivering the CMU

The speakers were asked for their suggestions in terms of priorities for delivering the CMU and accelerating its implementation.

A regulator suggested that it is necessary to streamline the CMU and re-focus it on a limited number of essential areas, because not everything in the current package is of equal importance. The first priority is to increase the depth and liquidity of wholesale markets. A large part of the CMU discussion focuses on retail markets and facilitating retail access, but it is the wholesale markets that drive the growth and liquidity of capital markets. Retail investors use capital markets and have some directional power with the investment choices they make, but they do not make the markets, which are very largely wholesale driven. Implementing the conditions in Europe for driving deeper and more competitive wholesale capital markets is essential. These include predictable regulation and supervision and an efficient market structure. In this respect, the present high number of wholesale capital market clusters across the EU needs to be rationalised. For retail markets that are more domestic, there can be more fragmentation. Securitisation is also essential for driving more financing into the markets and getting more velocity in bank balance sheets.

The regulator stated that the second priority is levelling up the supervisory standards in the EU, as has been done in the banking sector with the Single Supervisory Mechanism (SSM). Progress has been made in terms of supervisory convergence but improvement is still needed. Capital markets are currently still extremely difficult to supervise in the EU because financial institutions have business activities and corporate structures spread across several member states. One of the objectives of this is to arbitrage the different regulatory and supervisory setups that exist across the EU. This means that domestic supervisors are often supervising only one part of the chain without having a responsibility for the whole chain, which is dangerous and inefficient. It is necessary to accept a more European and consistent approach of supervision in order to support deeper clusters of capital market activity and less energy should be spent on competing between member states for capital market activity.

An industry representative stated that the CMU should focus in priority on SME and retail financing. It is essential for SMEs to get access to capital, because that allows them to build a European or global business plan rather than a local one and to grow faster, creating three to four times more jobs than similar companies that are not listed. Retail participation is also very important for SME markets. A large part of the success of IPOs in Sweden has been supported by retail participation. In 2021 130 new SMEs were listed in Sweden; around one-third of the capital raised came from retail, and 50% of the day to day trading is retail. Retail participation is also important for larger companies, as shown by the decision made by Volvo to list in Sweden because of the strong retail market there. Retail and wholesale markets work together and an active, well-functioning retail market supports the wholesale market. If the appropriate measures are put in place then Europe can win a large number of listings going forward and secure financing for SMEs.

The industry representative regretted that some of the current CMU proposals are taking the focus away from retail participation and SME financing, with much time spent on creating a consolidated tape (CT) for example. A CT can contribute to the functioning of European capital markets, but its relevance for retail investor needs or for increasing SME capital market financing is relatively limited.

A second industry representative agreed that both the retail and wholesale markets are important, but suggested that the wholesale end is most important for developing capital markets in the first place. Developing retail access to capital markets that do not benefit from the depth, scale and resilience that strong wholesale markets provide can actually undermine investor protection because shallow markets often lead to higher volatility and risks. The first issue to be addressed is securitisation. The second issue would be to fix all the enablers to the further development of cross-border capital markets in the EU that are not yet in place, such as withholding tax, corporate insolvency rules and depository passporting. The third piece would be enhancing the liquidity of EU markets in order to make them more attractive notably for pension funds. An additional objective should be to maintain the leading position that the EU has acquired on sustainable finance. Europe has indeed doubled its market share on mainstream green bonds. In 2021 53% of all green bonds issued were from Europe, and in 2022 the year-to-date figure is 40%.

The industry representative added that banks will need to bridge the gap in terms of capital provision until EU capital markets reach a sufficient scale and level of competitiveness. This would require allowing banks to redeploy capital currently committed in schemes like the Single Resolution Fund (SRF). €66 billion are tied up, going potentially to €80 billion by the end of 2023, which corresponds to a €1.5 trillion lending capacity. Putting the SRF funds at use could help to tackle the economic problems that Europe is currently facing such as the energy crisis. Focus is also needed on some Basel III measures which are too stringent for EU banks. The recalibration of the timing of some of the macroprudential measures needs to be examined, particularly on the countercyclical buffers, so that they are implemented at a time when buffers can be constituted and not when additional funding is needed for the EU economy.

A regulator stated that progress is needed both on the wholesale and retail sides of the market, which are mutually reinforcing. In addition, the different components of the financial system – i.e. banking, insurance, capital markets, pensions - should be brought together. Developing a capital market is not just looking at the potential individual contributions of instruments such as securitisation or market players such as stock exchanges, but about building the whole infrastructure that is needed to make a capital market happen. Further effort also needs to be made on supervisory convergence in order to implement regulatory measures in a consistent way on the ground across the EU and achieve consistent supervisory outcomes. This is an incremental process underway under the aegis of ESMA that involves bringing the national supervisors to focus on common priorities and identifying key issues where common action is important.

A third industry representative agreed with the suggestion that Europe should pick a few urgent battles and deliver appropriate solutions in these areas. Introducing any new complexity and restrictions should also be avoided. One topic that is particularly notable and could not be more urgent is the carbon space. Europe is in the lead, but this advantage should not be squandered and the market which is already functioning should not be disrupted, as competition from other jurisdictions on ESG is growing. The need for capital in terms of what it will take to decarbonise the economies and reduce energy imports into Europe over the period between now and 2050 stands at €10 trillion. That cannot be funded by governments and cannot be supported by the balance sheet of banks. The investment that is needed to build the necessary infrastructure will need to come through the capital market, which will require creativity. Implementing the taxonomy is important, but the market should ultimately be an investor-led market, not a compliance-led market. The industry representative cautioned against restricting the successful Emissions Trading System (ETS) and the carbon market infrastructure in Europe, in particular, as this may create unnecessary price rises for SMEs and hinder the achievement of decarbonisation goals. The digital agenda is another area where the EU has an advantage with the digital finance framework and the distributed ledger technology (DLT) pilot regime that needs building on without adding complexities and restrictions.

A fourth industry representative also agreed with the idea of stripping back the laundry list of the CMU. Nobody is against the CMU, but the challenge is getting it done because it is a complex package. There are two main essential objectives: ensuring the free flow of capital across retail and institutional markets and providing a common ground and level playing field for everyone across the EU 27. The current fragmented pockets of liquidity across member states hinder an effective flow of capital in the Union. Three key issues need highlighting in this perspective. Europe is still lacking a common pan-European framework for dividend taxation and this impacts both retail and institutional investors. There is also an absence of a depository passport for custodian banks, which means that investment funds are essentially restricted to a national deposit bank, when they should have a free choice of provider across the EU. A third area of focus should be pensions, where there are interconnections and capital flows between the retail and institutional parts of the market. A focus on pensions is important because of demographics, with the ageing population, and also because pension funds could help to deepen and broaden the capital markets, when considering examples such as the US 401(k) system. This is also important to consider in a context of high inflation which may reduce retail saving capacity. A regulator agreed with the importance of developing pension regimes via wholesale intermediaries that may provide depth in the capital markets.

A policy-maker agreed that both the retail and wholesale sides of the market are important. Pensions are an important but challenging topic, given the national prerogatives, that is being examined by the Commission. The US has a capital markets based pension system, but it is more complicated to achieve in the EU because there are 27 different pension and taxation regimes, as well as different historical traditions.

3. Further areas of focus of the CMU action plan

3.1 Securitisation

The Chair asked when the Commission would address the EU securitisation framework, which is an important driver for the development of capital markets in Europe. This is an area where regulators probably went too far in terms of restrictions and which would need reconsidering, because most of the failed securitisation tranches in 2008 were not of European origin.

A policy-maker explained that there are two aspects to consider. One is the securitisation regulation, which built a new framework for the market. The Commission has reviewed the functioning of that Regulation, noting that it has not worked as well as hoped for. The second aspect is the capital requirements side, which is the main point that was emphasised by market participants in the public consultation ran by the Commission some time ago. A mandate has been given to the three European Supervisory Authorities (ESAs) by the Commission to assess this issue. Based on their feedback, a decision will be made on how to address this matter. Before reopening the rules, it is important also to consider that there are different stakeholders in the debate and that in 2016 the European Parliament had strong views on securitisation and its role in the economy.

An industry representative stated that an acceleration of the work on the securitisation framework is necessary. EU securitisation markets are dramatically lagging behind the US, with volumes being left at less than 25% of where they were before 2008. The US market has now exceeded the levels before the 2008 crisis, and are now almost 10 times the size of the European securitisation market in terms of issuance.

Another industry representative agreed that securitisation can be an important driver for EU capital markets. What is needed is to reduce the complexity of the requirements around capital in particular, as well as other restrictions that hinder potential momentum around these instruments.

3.2 Developing retail investment

A regulator stated that greater participation of retail investors is needed. Some Nordic countries have shown that this is possible. It is expected that the upcoming proposals from the Commission regarding the Retail Investment Strategy due to be put forward in 2023 will foster progress in this area.

Answering a question from the Chair about the role of taxes, an industry representative noted that tax plays an important role in attracting retail investors. Sweden developed an investment saving account that is very successful, with more than 30% of the population holding such an account. Taxation is much lower for investments in securities through this saving account compared to direct investment. With the investment saving account there is also a simplification of tax declarations, with all tax declarations reported by the intermediary which handles the account. Beyond taxation, the existence of a proper market ecosystem is important for increasing retail participation with advisors, retail banks and brokers able to support retail investors. A further component is financial education. In Sweden, the stock exchange invests a great deal of effort in this area with an education programme. Some work is done in schools, but most of the initiatives are directed towards local banks and brokers to educate them about how to build an appropriate portfolio.

A policy-maker noted that DG TAXUD is working on tax issues related to capital markets and would put forward some proposals concerning withholding tax shortly.

3.3 Developing SME markets and simplifying listing

An industry representative explained that their company, a group of stock exchanges operating in the Nordic and Baltic regions, has a strong focus on helping SMEs get access to capital through the exchanges. Sweden has been the most successful in developing capital market financing for SMEs, with 130 companies listed last year. The stock exchange played a role, but this success is also the result of a political decision taken 10 years ago to diversify the financing of SMEs and ensure that the exchanges contribute alongside banks to the provision of capital for SMEs. The Swedish model was copied to a large extent in Finland, where the SME market is successful, but Denmark did not put the same focus on equity markets, retaining a high level of taxes for equity investment in particular. As a result, the size of the Danish SME stock market is one-third that of Sweden, and the number of new SME company listings is limiting.

A second industry representative emphasised the importance of improving the listing regime in the EU. Investors have different investment choices and companies also have choices about where to list, therefore it is essential to have adequate rules to retain these flows in Europe. In 2017, 25 European countries listed in the US rather than in their local jurisdiction. 50% of those were German, and 50% were in the healthcare sector. In the technology, media and telecom (TMT) space the situation is more favourable with more listings in Europe. The number of companies considering listing now is decreasing with the anticipation of a recessionary environment, but now is the right time to improve the market infrastructure and rules, so that when the backlog of European companies that want to go public are ready, Europe has a sufficiently attractive environment for them to list locally. That requires paying attention to the free float levels in particular, for entrepreneurs who want to retain control over their company. This could lead to a higher velocity of smaller listings, breeding healthier capital markets for the future.

A third industry representative agreed that simplifying the listing requirements and prospectuses would be relevant. On Nasdaq's First North growth market, only a short company description of around 60 pages is required for the smaller companies that want to list. Retail investors are likely to read a short and understandable document, but not the 300 page descriptions that are usually provided.

A regulator noted that it is positive that changes to the Listing Act are envisaged, because more capability is needed for companies to raise capital on the market.