CMU: short and longer term priorities

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

The Chair emphasised that the CMU initiative is a subject of immense importance to the future of the EU. In its latest conclusions, the European Council urged Europe to move forward on the CMU and called on the European Parliament and the Council to finalise work on the pending legislative proposals in that area before the end of the current legislative cycle.

A policy-maker stated that building the CMU is a long term project for which there has been a continuous support from European leaders since the launch of the initiative. Remarkable progress has been made in some areas of the CMU, but it is not yet finalised and work has to continue. The Commission is currently focusing on the pending proposals of the CMU action plans published in November 2021 and December 2022. The immediate priorities include the adoption by the Council and Parliament of the proposals that were made at the end of 2022 on central clearing, corporate insolvency and the Listing Act, and also the publication of two additional proposals by the Commission that are expected in the coming weeks: the Retail Investment Strategy (RIS) due to be published by the end of May, and a proposal on withholding tax aiming to simplify and accelerate procedures and also tackle tax fraud. There is an increasing sense of urgency as the end of the current political cycle is nearing to get all the proposals that are on the table adopted by the end of Q2 2024. This message has also clearly come out from the March 2023 Council conclusions.

A public representative stated that so far, the CMU's potential has not been unlocked, despite the large number of initiatives that are underway. Compared to other jurisdictions, the EU is falling behind when it comes to developing its capital markets. Our European markets still remain highly fragmented, overbanked and do not incentivise retail savers enough to invest in them. Improving regulation is part of the solution, but the CMU project needs to be addressed through a cross-sectorial approach and mobilise everyone around the objective of further developing it, i.e. citizens, businesses, supervisors and financial institutions.

A regulator observed that the completion of the CMU is progressing step-by-step. Current proposals such as the Listing Act and the European Single Access Point (ESAP) are steps in the right direction, but they are not game-changers. The Listing Act will bring useful but marginal improvements; as for ESAP, if a single access point in Europe is necessary, implementation will however take years and be costly. Regarding the remaining proposals of the CMU action plan and notably the MiFIR review, care is needed to make sure that the compromise does not distort the initial proposal of the Commission and does not maintain a fragmented approach, which is in contradiction with the CMU.

An industry representative highlighted that the CMU project had been revived five years ago, which created significant interest and hope. The two key ambitions at the time were the further integration of the capital markets in Europe and the development of retail participation, but the expected level of progress in the development of EU capital markets has not been achieved. 2022 was a bad year for capital markets, with poor performance both for fixed income and equity markets, damaging the investments of European and global investors. Even EU mutual funds, which are meant to be the backbone of cross border investment in Europe, saw €300 billion of net outflows. Retail investor participation is declining again, after an increase during the pandemic. This puts immediate urgency on not just developing a RIS to increase retail participation, but also on adapting regulations to evolutions happening in the real world, such as increasing digitalisation and consumers using their phones to invest. Some obstacles to digitalisation need to be removed, such as the obligation for all fund documentation to be physically printed and sent out.

A second industry representative stated that a key objective of the CMU is to have a more integrated market, which means breaking down barriers to the cross-border flow of investments and savings across the EU. Frictions increased in the EU financial market after stress events, such as the 2008 financial crisis and the 2010 sovereign debt crisis; these have subsided, but there is still a significant level of structural fragmentation in the market. This suggests that the measures taken to prevent and mitigate fragmentation originated by crises such as a banking crises have been effective, but there is still much work to do on the more structural areas of fragmentation in the capital market, such as corporate insolvency. Some issues that are being worked on in the context of the crisis management framework for banks can be a source of inspiration in this regard. Progress is needed on two aspects, resolution and liquidation. Areas for improvement include the clarity of definitions, the protection of creditors' interests, and reducing the complexity in the timeline of the proceedings.

A regulator stated that the objectives when the CMU was launched in 2015 were to further integrate capital markets in the EU and also to develop and deepen the markets. Much progress has been made on the first front, but not on the second one with a level of development and depth of European capital markets that remains very poor. In terms of integration, a wide range of harmonised frameworks have been adopted concerning prospectuses, market abuse, financial reporting standards and market infrastructures such as CSDs (Central Securities

Depositories) and work is underway on proposals to enhance listing, corporate insolvency rules and to set up a European Single Access Point (ESAP) and a consolidated tape. There is no issue of markets integration either when it comes to cross border investment flows in the real economy. For example only 2.5% of the assets under management of Spanish investment funds are invested in the domestic equity market. The investment flows into Spanish companies also come mainly from the rest of Europe and from non-EU investors. Capital markets across Europe are also far more integrated than banking markets.

Further growing European capital markets should be the main objective of the CMU going forward, the regulator stated. Europe still has underdeveloped markets compared to the size of its economy and also to other major economies such as the US. The EU still has three times less market-based financing than the US, and in many EU countries the primary equity markets have run dry in the last two years. With governments having to consolidate public finances in the next decade and banks facing new and increased risks, that is a truly risky situation for the European economy. Without larger, deeper capital markets EU companies will not be able to finance the huge investments to accommodate the two large transformations: digital and green. There is also an issue of resilience because economies for which there is a higher level of capital market financing absorb shocks better than those mainly financed by banks.

An IFI representative agreed that it is easy to invest cross border in the EU and that capital does not remain within the same country where it is raised, but at the same time there are still major differences across the EU in terms of market depth. More measures are needed in the CMU to encourage investors to invest in less developed regions. This could be done in the context of the ESAP project, by providing investors with information on investment opportunities across the EU, allowing them to make the best investment choices. Developing equity markets across Europe as shock absorbers also makes sense from a macroeconomic point of view as this should help to de-risk the European economy.

2. Main short term priorities

The panellists highlighted two main priorities that the CMU initiative should focus on in the short term: developing the participation of retail investors in capital markets, and further diversifying the financing of SMEs.

2.1 Retail Investment Strategy (RIS)

A regulator emphasised the importance of the upcoming RIS. There is a real problem, especially in Southern and Eastern European countries, in terms of risk averseness of the general public and reluctance to invest into equity. There is much discussion about inducements in the context of the RIS, but the objective of improving value for money for investors seems more important, as well as enhancing advice. Supervision is another key issue to be considered in this context, as there is still no direct supervision at the European level. Many of the complaints that national competent authorities receive from retail clients concern risky products that are sold by financial institutions based in other member states and that operate through the freedom to provide services provisions, with no local branch. Work on supervisory convergence is undertaken at ESMA level but these processes are extremely time consuming and complex to manage. The home host authority relationship needs to be reflected upon, to allow the host supervisor to intervene more easily in exceptional situations of significant problems with its national retail investors.

A public representative considered that the RIS is a key short term priority of the CMU. Access to financial advice needs to be preserved and access of retail investors to capital markets needs to be increased. On paper, all EU citizens can be investors, but the reality is very far from it. 70% of consumers in the EU have never invested in financial products. There is a need to address this significant investment gap, notably through enhancing the quality of advice and ensuring a higher degree of transparency.

In terms of policy objectives concerning retail investors, the public representative suggested that the first step is to ensure a more consistent application of existing European rules and to preserve local financial market ecosystems, in order to ensure that customers can easily access advisors locally in all European member states. Rules on financial advice already exist in the MiFID Directive and need to be implemented appropriately across financial sectors, while preserving local networks. This would ensure that as many consumers as possible have access to advice with sufficient proximity. A second priority is to nurture EU competition, so as to preserve the strategic autonomy of the EU in this field. Thirdly, there is also an urgent need to promote financial literacy in Europe, both for consumers and for financial advisors.

The public representative emphasized the importance of the role played by inducements in the areas that have been mentioned and was opposed to a ban, as it would potentially lead to a substantial increase in the cost of advice and less access to advice for investors. A ban on inducements would also raise competition issues, because it could have the effect of opening the door more widely to non-EU players that do not have their own local distribution network and may end up being the main providers of financial advice to European consumers. What is needed is more regulated inducement practices, with more transparency, more availability of information for investors and also better implementation of value-for-money principles.

An industry representative stated that the priority in the short term is to develop retail participation. Retail investment will be needed to fund the green transition across the EU. In addition, with persistent inflation in the EU, the capital of savers who do not invest in capital market instruments will be eaten away day after day. Increasing retail participation in capital markets requires addressing a wide range of issues including financial education, the provision of appropriate advice, the adequate handling of non advice channels and leveraging technology. As all issues may be difficult to cover in a single proposal, a sequential approach could potentially be adopted.

On inducements the industry representative was open minded, but suggested that the issues need to be tackled in a sensible fashion. Before any dramatic changes are made to a system that is working it will be important to make sure that the alternative non-advised channel is up and running. Lessons can be learned from the UK and Dutch experiences of banning inducements. In the UK it led to an abrupt change and a significant advice gap. Many people fell out of the system with no more access to financial advice, which should be avoided in the EU. In addition, some hurdles such as insufficient digital identification are preventing customers from accessing easily investment solutions, limiting their access to the capital markets. Technology such as the use of open finance can help to facilitate the customer journey with one common access point to financial advice and can also support non-advice investment channels.

A second industry representative suggested that there is often a confusion in the debates around retail investment rules between harmonisation and uniformity. A uniformity of products and services should be avoided, because financial institutions have different types of customers with different characteristics that need different kinds of services. Different types of financial advice and information should be available at different costs, because customer needs differ. For example, retail investors have different needs in terms of information depending on the frequency of their investments, their investor profile and the size of their investments. Striking the right equilibrium in the rules with sufficient flexibility to accommodate different types of investors and financial services should be aimed for.

An IFI representative considered that while retail investors are a priority, more also needs to be done to foster institutional investment. There are a great deal of savings in the insurance sector for example. Some changes in the insurance regulation could foster more investment from these investors in the real economy. During COVID there has been an increasing level of savings which needs to be passed on to the real economy.

A regulator suggested that a further issue that needs to be considered for fostering more retail investment into capital markets is to improve awareness about the long term benefit of capital market investments compared to bank deposits or real estate, in order to reduce some investor biases.

2.2 Diversifying the financing of SMEs

A public representative stated that the financing of SMEs is another important priority. In the EU, more than 99% of companies are SMEs but the current regulatory framework is not incentivising them to diversify their sources of financing. Although more needs to be done, the Listing Act proposal which aims to reduce the administrative burden of companies wanting to list on the stock exchange is a great example of legislation aiming at increasing the attractiveness of the EU financial framework for smaller companies.

Answering a question from the Chair about whether SMEs have access to sufficient financing in the EU, an IFI representative observed that the access of SMEs to equity needs to be facilitated. The Listing Act is particularly relevant, as it will help to cut the red tape and reduce the bureaucracy that SMEs face when they go public, which they are not well equipped to handle in many cases. The implementation of the ESAP for financial and non-financial information on EU corporates is another relevant initiative, as this can help investors to have access to information related to a wider landscape of companies. This can potentially help them to diversify their investments and facilitate the flow of investment towards companies situated in less developed regions of the EU.

Regulation is however not sufficient to make markets function properly and efficiently, the IFI representative emphasised. There is also a role for public institutions acting as anchor investors to increase confidence in the market. The European Investment Fund (EIF) is playing an important role in promoting risk capital investment to support the development of SMEs, especially in the startup phase. In addition, since the launch of the CMU project a significant development of venture capital (VC) and private equity (PE) funding has been witnessed in Europe. The sector is more dynamic now. Institutional public institutions like the EIF and national promotional banks have played a key role in structuring and developing the market and supporting start-ups. However, further along the development cycle, when SMEs reach the scale up phase and are in an IPO or pre-IPO (initial public offering) position, many of them, particularly the more innovative ones, seek funding outside Europe, in the US or Asia where larger players are able to fund large tickets. What Europe needs is the development of larger funds which can put large tickets in the firms which require more funding. Over the past five years non EU investors have accounted for 64% of lead investors for fundraising rounds between €50 million and €100 million in EU companies, and 76% for fundraising above €100 million.

There is an increasing political interest in the question of the funding of scale-ups in Europe, the IFI representative added. The EIF is running an initiative for several EU countries in the context of the European Technology Champions Initiative that will create a fund of funds of almost €4 billion, due to invest in large funds which have the ability to provide tickets at least as high as €50 million. Such strategic initiatives are necessary to keep the most innovative and the most promising enterprises in Europe.

An industry representative emphasised the importance of helping SMEs to further progress on their sustainable and digital transitions. Supporting information technology improvements in SMEs is vital, because SMEs that have better access to quality information have better options for diversifying their sources of funding.

Answering a question from the Chair about the level of access to equity financing of Spanish SMEs, a regulator stated that Spain is seeing a very similar situation to most other European countries, except some Nordic countries, with a declining number of IPOs and a limited use of capital markets, due notably to interest rates close to zero and high levels of private equity financing.

The main problem concerning SME financing is that not enough companies want to go public and issue bonds or equity in the markets. The Listing Act should contribute to facilitate the process for companies of going public or issuing further secondary capital by reducing the complexity and the costs of listing processes, without putting investor protection at risk. One measure of the Listing Act need reconsidering - the proposal to eliminate insider lists, which is a mistake in terms of prevention of market abuse – but overall it is expected that this initiative will facilitate the access of SMEs to equity funding.

The DEBRA (Debt-equity bias reduction allowance) initiative, which aims to reduce the fiscal disincentives that European companies face when raising equity compared to debt financing could also be a game-changer for fostering more equity financing, the regulator suggested. It is moreover important to avoid imposing on listed companies non-financial requirements that are not strictly related to investor needs. ESG requirements for example should be imposed on all companies, not only on listed ones, otherwise that will create further disincentives to listing. The IFI representative agreed that the DEBRA initiative is relevant because the debt equity fiscal bias is an obstacle to equity issuance. A regulator also concurred that care is needed regarding market abuse and insider dealing measures.

3. Further priorities of the CMU

A policy-maker stated that the first priority for the next five years regarding CMU is to correctly implement all the legislations that are currently on the negotiation table. Member states and the financial industry will have a significant responsibility in that regard. It is also necessary to take stock of the progress that has been accomplished over the last few years to identify pending issues. Europe's capital markets are too small compared with some other major jurisdictions, there is too much fragmentation, and there is an issue of facilitating access to the market for investors. There are also new challenges, because the world has changed since the launch of the CMU project. The transition to net zero and the fast moving digitalisation of the economy have become key objectives for which capital markets can play a role. The importance of pensions is also growing, both as a societal issue and as a challenge for the further development of capital markets in the EU. Putting the development of pension funds in a more prominent place in future CMU action plans would seem logical, although EU prerogatives are limited in that space. The Chair observed that pension funds are the bedrock of US capital markets in many respects. The development on a pan European basis of pension funds could support the development of EU capital markets and should indeed be part of the CMU agenda.

Additionally, a public representative noted that European strategic objectives to which the CMU can contribute, such as channelling private investments into the green and digital transition and enhancing Europe's strategic autonomy, should be included in the future steps of the CMU.

3.1 Cross-border supervision and supervisory convergence

The Chair asked whether more should be done to develop cross-border supervision and support supervisory convergence.

A regulator was favourable to increasing the scope of direct supervision at the European level in order to better address cross-border markets, although this is a topic that has been politically sensitive in the past. At ESMA level a peer review was recently conducted regarding the home-host relationship and the supervision of cross-border activities of investment firms under Article 16 of ESMA's legislation. For the third time in ESMA's history, use was made of Article 16, which is an exceptional clause to better monitor some players. The peer review helped to identify areas where certain NCAs needed to improve their approach to authorisation, ongoing supervision and enforcement work. Supervisory convergence however remains a cumbersome, time intensive and resource intensive process.

An industry representative added that in terms of supervisory convergence, it would be useful to make the reporting requirements for funds more scalable and usable by different authorities, and to have common definitions and benchmarks so the same piece of information can be used by different authorities and for different roles.

A second regulator observed that single supervision is not beneficial in all areas. For example it would not help companies to go public, and if they considered local processes to be too cumbersome they would just move their listing to another country.

3.2 Supporting the green transition

A regulator stated that green and sustainable finance is an example of an area that the Commission should push harder on in the future stages of the CMU, as this can foster growth which is a key objective of the CMU. Many regulations are on the table to foster sustainable finance, but following multiple political compromises at the European level during negotiations on the texts, they have ended up being very complex to implement. The Sustainable Finance Disclosure Regulation (SFDR) has different definitions of Article 8, Article 9 and Article 6. In addition, Europe has to be more ambitious for measures that may support the financing of the transition. The transition criteria are only partially taken into account in the current Corporate Sustainability Reporting Directive (CSRD) taxonomy and the related green and sustainable criteria. Transition objectives need to be reinforced in the policy framework. Green Bonds are another area where criteria may need adjusting. If the compromise on EU green bond standards leads to taxonomy criteria that are too strict, it could be difficult for the financial sector to use these tools. A more comprehensive tool is needed, but mainly targeted on the financing of the transition.

3.3 Contributing to Europe's open strategic autonomy

Answering a question from the Chair about the implications for the capital markets of the EU open strategic autonomy agenda, a regulator noted that it is necessary to consider concrete examples in the capital markets space where this may be relevant. In the EU it is necessary to develop an alternative to the UK in the clearing field for example, because clearing is strategic. The new clearing obligations proposed in December 2022 - e.g. to have active accounts at EU central counterparties (CCPs) for the clearing of a portion of certain derivatives - should contribute to the objective of encouraging more clearing activity inside the EU, which is perfectly legitimate. The difficulty with the active account obligation, however, is for regulators to define exactly what is covered by this obligation. A second example in the capital markets area that is relevant from a strategic autonomy perspective is the delegation of portfolio management activities outside the EU for EU investment funds. There is value in management companies delegating portfolio management activities to investment service providers based outside the EU, but a situation that results in shell companies being used in the EU with most of the activities based outside of the EU should be avoided. This risk has been pointed out in the ESMA peer review related to Brexit. An important aspect for supervisors is also to preserve a complete access to service providers based outside the EU in their supervisory activities.

A public representative agreed that recent proposals aimed at reducing the EU's exposure to third country CCPs would contribute to pursue the EU's strategic autonomy.