REGULATION

A Capital Markets Union for Europe: preliminary reflections

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Overview

- **No clear definition of the Capital Markets Union has been provided so far. Instead, it should be regarded as a wide range of initiatives in different fields, aimed at ending the existing fragmentation of European capital markets, as well as providing alternative sources of finance for businesses.** Ultimately, this proposal seeks to achieve a more balanced funding structure and to provide easier access to credit for European companies, especially for SMEs, in order to promote investment, jobs and growth.
- **The idea comes out as a new solution but it is an old issue**. Indeed, the idea of free movement of capital was at the core of the Single Market, which dates back to the Single European Act (1986). The label, therefore, can be misleading about the real content of the Capital Markets Union.

What is it?

- **Despite that there is not a concrete definition yet, some ideas might be highlighted. What this project really brings about is the harmonization of rules across Member States, in order to eliminate the barriers that prevent the integration of capital markets.** This does not necessarily imply same or unique rules, as standardization might be enough in some cases. The existing barriers are not gathered just in financial markets, but depend also on a broad number of cross-cutting factors, such as insolvency laws, company law, governing laws, information requirements, taxation, etc. For example, inconsistencies in insolvency laws across Member States create high costs and difficulties for businesses with cross-border activities and ownership, and consequently deter investors from other European countries to invest on other European firms.

What is not?

- **In principle, this project should not be seen as an initiative which aims at achieving the merging of European stock exchanges or fixed income markets,** although this might end up happening as a result of increased integration and competition. The objective of the Capital Market Union is not to reduce bank financing, which will still play a predominant role in the near future, but to start creating the adequate framework for the moment when capital market becomes highly integrated in Europe so as to maximize the benefits of capital markets and diversified financing channels for the real economy.
- **Finally, the term Capital Markets Union might be considered as a way to replicate the terminology of the Banking Union**. However, it should be noted that there are important differences in the scope and in the setting of both projects as we will further analyse. In any case, it is a needed complement to the banking union to continue working to reduce financial fragmentation in Europe.

Table 1

Initiatives under the scope of the Capital Markets Union

Objective	Initiative
High Quality Securitisation*	• Definition and regulatory framework
Development of private placement and covered bonds in Europe*	• Analysis of key drivers of success in other locations, and possible replication at EU-wide level • Review of the treatment of covered bonds under CRR and possible development of an EU framework
Ending the underdevelopment of European equity and corporate bond markets	• Ending the debt vs. equity bias in taxation • Promotion of Venture Capital, crowdfunding, angel investing… • Bringing these markets closer to SMEs
Promotion of alternative (nonbank) sources of finance	• Insurance companies • Pension funds • Hedge funds • Peer-to-peer lending
Initiatives to improve access to finance for SMEs	• Cross-border information on SMEs • Proportionate disclosure requirements for smaller issuers • Creation of equity and bond markets dedicated to SMEs
Promotion of long-term financing*	• Proposal of European Long Term Investment Funds (ELTIF), expected to be finalized by end 2014.
Harmonization of national legislative frameworks	• Governing Laws • Insolvency Laws • Accounting and disclosure requirements

*Priorities for early action

Source: BBVA Research

Main features in the construction of the Capital Markets Unión

- **Scope:** The Capital Markets Union is a project for the whole European Union, that is, for all 28 EU Member States as opposed to the Banking Union, which was envisaged primarily as a Eurozone project (18 Member States although open to non-euro countries). There are two reasons for the difference in scope: first, the idea of free circulation of capital is in the DNA of the European construction and second, the role of the United Kingdom is important to guarantee the success of the project, since it is the home of Europe’s most important capital market.
- **Authorities:** The European Commission and the European Securities and Markets Association (ESMA) are the key players. These institutions would be in charge of regulating and overseeing the functioning of the Capital Markets Union. The new European Commission that took office in November incorporates a new regulatory portfolio, *Financial Stability, Financial Services and Capital Markets Union*, under the responsibility of the British Jonathan Hill, determined to put in place by 2019 the foundations of the Union. In accordance to the new and more transversal working structure of the Commission, the project will be achieved in coordination with other Commissioners, who would have a more or less direct participation. In particular, it is expected that Commissioner Biekowska, in charge of *Internal Market, Industry, Entrepreneurship & SMEs* will be directly involved. In any case, at this stage of the process, there are no expectations of creating new authorities to take over the responsibilities of developing this so called Capital Market Union, as in turn it has been the case in the banking union. This is mainly due to the fact that the capital markets union is seen as a deepening of the single markets, with no comparable sharing of sovereignty and therefore very little common governance implications, at least in its early stages.

Benefits

- **Financing the real economy.** Growth has substituted financial stability as the main priority for Europe. In an environment of banking deleveraging, alternative sources of finance become increasingly important to promote long-term investment and guarantee access to credit for SMEs, key drivers for the job creation and economic growth.
- **Ending financial fragmentation, thus creating more competitive capital markets.** In a really integrated financial system, the location of borrowers and lenders would lose importance, instead of prevailing over its creditworthiness. Besides, defragmentation of capital markets would give room to more

competition, and could allow European markets to benefit from economies of scale, which in turn would reduce the cost of capital for corporations.

- **Providing a more balanced and diversified funding structure.** The project aims at developing alternative sources of finance, which are still underdeveloped in Europe. This objective can be achieved through the revival of some market segments, such as securitisation. The European Commission is now developing a regulatory framework for **high quality securitisation**, without forgetting the lessons from the past. In addition, a Capital Markets Union can boost financial innovations, like peer-to-peer loans or crowdfunding. However, we should bear in mind that those alternative financing sources are very heterogeneous and that some of them are mean to play only a marginal role.
- **Increasing the financial system's shock absorption capacity.** The majority of corporate tax systems in Europe favour debt versus equity, which together with the existing home bias in equity holdings impedes the correct functioning of cross-border risk-sharing channels. The Capital Markets Union would increase cross-border ownership structures, reducing the impact of national shocks.

Challenges

- **Long and complex legislative process.** Achieving a truly integrated Capital Markets Union requires working in various fields: company law, securities and governing law, reporting…All of them are very complex issues and under the remit of several authorities which lead us to expect a long process before real changes can be agreed. **Subsidiarity should be a constant in the development of the Capital Markets Union**. Although some regulation at the EU level is necessary, it might not always be the preferred solution. The European Union should choose to promote harmonization of national frameworks when possible, instead of issuing new regulations as a general rule.
- **A significant structural change for the European financial system that will take time.** Traditionally, the European financial system has been very dependent on bank financing. In contrast to the United States, banks represent around 70% of the funding to the economy, while non-bank sources represent 30%. The objective of a diversified and balanced funding structure for companies is therefore a structural change which cannot be achieved overnight.

State of play and next steps

- **The Union for Capital Markets is still at a preliminary stage.** The final goal is achieving a complete freedom in capital movements in Europe through the deepening and integration of capital markets. Yet, details about the concept and its implementation remain unclear.
- **The incoming Commission led by Jean-Claude Juncker needs to start working in this field before the end of the year.** The first step would be to consult all interested parties, expected early next year, and to produce a detailed action plan by the summer of 2015, ensuring that also the European Parliament and the Council, as well as national parliaments, are on board.
- **Jonathan Hill announced three key priorities on which the Commission will start working immediately.** First, legislation on the European Long Term Investment Funds (ELTIFs) is expected to be adopted by Parliament and Council before the end of the year. Second, the Commission is committed to develop an EU framework for high-quality securitisation. Finally, the status of covered bonds and private placement in Europe will be reviewed.

Assessment

- **A Capital Markets Union could prove to be highly positive for the European economy. It completes the process initiated with the Banking Union and takes the Economic and Monetary Union further.** It tackles several of the barriers that prevent the appropriate functioning of the financial system, and it has the potential to enhance the benefits of capital markets for investments, employment, and ultimately, growth.
- **However, the proposal is ambitious and achieving the objectives set for 2019 could be challenging.** The broad range of initiatives under its scope and the cross-cutting nature of some of them demand coordination of different parties and a detailed valuation of their impact.
- Although a more balanced funding structure is necessary, the alternatives proposed are not sufficiently developed to substitute the role played by banks in financing the economy. **Therefore, it is essential to guarantee that banks can live up to their task of providing credit to the economy. All in all, developing market financing does not mean reducing bank financing.**