The event, co-organised by the European Commission’s Representation in Germany and the Berlin office of the German Marshall Fund of the United States, brought together representatives of governments, parliaments, the financial sector, think tanks, academia and the business sector from Europe and the US to discuss how the creation of a Capital Markets Union (CMU) can contribute to growth and stability in Europe. In three consecutive panels, participants addressed the question of optimum designs for financial systems, the roles of households and institutional investors in today’s economies, as well as the challenges for financial stability through diversified financial markets. These questions were considered from the perspective of a transatlantic comparison as substantial added value can be gained for the EU and the US by drawing on each other’s policy experience.
Report

Capital Markets Union – and important step for the EU’s recovery, but not a panacea

Nearly a decade after the first signs of the financial crisis emerged, the European Union is still an economic patient waiting for full recovery. Even though the situation differs strongly across member states, growth has generally been sluggish and output lingers below potential. In 2015, the EU-28’s economies expanded on average by just 1.5 percent. The Capital Markets Union (CMU), in short a set of measures to remove the barriers which stand between investors’ money and investment opportunities and overcome the obstacles which prevent businesses from reaching investors, is one of the key initiatives the European Commission has initiated to revive the European economy.

The goal is to complement Europe’s strong tradition of bank financing by providing alternatives to credit-based financing, hence strengthening the lacklustre recovery and attaining a long-term growth perspective. At a workshop in Berlin on 6 June 2016, representatives of national governments, the EU’s institutions and the finance sector discussed if the CMU could help to bring back prosperity to Europe – and how learning from and co-operating with the USA could help to unleash the EU economy. Some scepticism was voiced if strengthening capital markets was enough – but overall, capital market reform seems to be received positively by the financial sector and independent experts.

What is at stake when implementing the CMU?

A representative of the Commission pointed out that Europe’s “heavy reliance on its banking structure” contributed to the slow recovery. In the US, he added, small and medium enterprises (SME) received five times more funding from capital markets than in the EU, Europe’s equity markets are less than half the size of the US and the average European venture capital fund is only half the size of that in the US. Europe’s heavy reliance on bank credits, he said, made it more prone to suffer from pro-cyclical ebb and flow, a problem that could be reduced by extending capital markets. Rather than making the financial system more vulnerable, the CMU would extend cross-border risk sharing and “make the financial system more resilient and robust”. The CMU initiative comprises 33 measures under six priorities. The first priority, the Commission’s representative said, is to improve funding for start-ups and non-listed companies. Also, facilitating access to public capital markets, supporting investment in infrastructure, promoting retail and institutional investment, facilitating the recovery of the banking sector and promoting cross border investment are also key to CMU. Since the publication of the CMU Action Plan in September 2015, several measures have already been implemented, for example to set-up a new regulatory framework for securitisations to make them “Simple, Transparent and Standardised” (STS). Also, the proposal for the Prospectus Directive aims at simplifying the rules and lowering the cost for accessing capital markets, in particular for smaller companies.

Another Commission representative added that, for example, Venture Capital activity was concentrated almost exclusively in eight EU member states, “the rest is pretty much a Venture Capital desert”. This is why the CMU initiative works on several fronts to foster this essential funding source for start-ups. Overall, the key role of the CMU is to provide diversified funding sources to the European economy. “The European Union needs more wheels on vehicle to move forward”, he said. Activating capital markets will not only support businesses and growth, but it will also help European citizens that currently keep one third of their savings in bank deposits, earning meagre returns, whereas equities and bonds have, on average, delivered much higher profits over the last decades.
A foreign government representative praised capital markets as a powerful system for organising the economy, a source of innovation and a “brilliant instrument for allocating resources efficiently”. If incentives for capital markets were set correctly by regulators, they could provide lifeblood for entrepreneurship. However, he also warned that capital allocation could thrive “at or beyond the boundaries of what is allowed” and hence constant oversight was necessary.

The US, he argued, had learned its lesson from the financial crisis. Liquidity profiles of market participants were far more robust now. The reliance on wholesale credit had been reduced. Stress tests incorporated far more severe shocks, counterparty risks were now more transparent, and costs to society in case of institutional failure were limited. In summary, “it is far too early for strong conclusions, but early returns are positive”. Despite turmoil on the oil market and the economic difficulties of China, for example, markets have been functioning in an orderly way. Europe, which was an “indispensable partner for democratic capitalism”, the foreign government representative said, is also an essential interlocutor on capital market regulation. “We are sharing data, analysis and conclusions. Both sides are focused on the question of how to foster financial resilience.” The representative of a European financial market regulator added that “we have a very strong dialogue with the US.”

Overall, he said the US views the CMU as a positive initiative. Risks, the government representative argued, would be better distributed in a system with many nodes rather than in a system that relied mostly on banks.

To enable growth in Europe, the CMU is helpful, but not enough.

A more prominent role for capital markets:
This seems to be a welcome prospect for many, further discussions during the workshop showed. The German government made clear it is in favour of the capital market initiative by the Commission: “We fully support the CMU”, said a government representative in his presentation, stressing also that, while the US is not a model, some important lessons could be learned. He added that CMU measures could also benefit the EU economy by helping to develop national capital markets. Securitisation, but also lowering barriers for Venture Capital investment, would be key parts of the reform. At the same time, “in some member states such as Germany, banks will remain the major channel of financing for companies”. This is explained not only by availability of bank loans but also that some German company owners prefer debt finance rather than countenance the dilution of control that equity capital implies. This may take time to evolve.

The German official also welcomed the CMU efforts to tackle some long-standing obstacles to cross-border transactions such as insolvency and taxation, even though he warned that they will take time to bear fruit. While Europe needs to “remain ambitious in its efforts to develop a CMU”, he warned that CMU is not a “silver bullet”. “To enable growth in Europe, the CMU is helpful, but not enough.” Improving macro-economic conditions and investment opportunities in the real economy, for example through labour market reform, will provide the basis for future growth.

For the German government, “we are still living with the consequences of the financial crisis” in terms of financial stability, and “capital markets can play a role.” Understanding potential risks from more market-based financing is also a key priority of the CMU. “It is very important to fully understand how liquidity works, for example in so-called flash crashes.” The Commission’s representative supported this view, saying that, while “one of the objectives of the CMU is to spread risks through the financial system”, understanding and managing liquidity in the markets is a “key issue”.

"To enable growth in Europe, the CMU is helpful, but not enough."

A more prominent role for capital markets:
This seems to be a welcome prospect for many, further discussions during the workshop showed. The German government made clear it is in favour of the capital market initiative by the Commission: “We fully support the CMU”, said a government representative in his presentation, stressing also that, while the US is not a model, some important lessons could be learned. He added that CMU measures could also benefit the EU economy by helping to develop national capital markets. Securitisation, but also lowering barriers for Venture Capital investment, would be key parts of the reform. At the same time, “in some member states such as Germany, banks will remain the major channel of financing for companies”. This is explained not only by availability of bank loans but also that some German company owners prefer debt finance rather than countenance the dilution of control that equity capital implies. This may take time to evolve.

The German official also welcomed the CMU efforts to tackle some long-standing obstacles to cross-border transactions such as insolvency and taxation, even though he warned that they will take time to bear fruit. While Europe needs to “remain ambitious in its efforts to develop a CMU”, he warned that CMU is not a “silver bullet”. “To enable growth in Europe, the CMU is helpful, but not enough.” Improving macro-economic conditions and investment opportunities in the real economy, for example through labour market reform, will provide the basis for future growth.

For the German government, “we are still living with the consequences of the financial crisis” in terms of financial stability, and “capital markets can play a role.” Understanding potential risks from more market-based financing is also a key priority of the CMU. “It is very important to fully understand how liquidity works, for example in so-called flash crashes.” The Commission’s representative supported this view, saying that, while “one of the objectives of the CMU is to spread risks through the financial system”, understanding and managing liquidity in the markets is a “key issue”.

"To enable growth in Europe, the CMU is helpful, but not enough."

A more prominent role for capital markets:
This seems to be a welcome prospect for many, further discussions during the workshop showed. The German government made clear it is in favour of the capital market initiative by the Commission: “We fully support the CMU”, said a government representative in his presentation, stressing also that, while the US is not a model, some important lessons could be learned. He added that CMU measures could also benefit the EU economy by helping to develop national capital markets. Securitisation, but also lowering barriers for Venture Capital investment, would be key parts of the reform. At the same time, “in some member states such as Germany, banks will remain the major channel of financing for companies”. This is explained not only by availability of bank loans but also that some German company owners prefer debt finance rather than countenance the dilution of control that equity capital implies. This may take time to evolve.

The German official also welcomed the CMU efforts to tackle some long-standing obstacles to cross-border transactions such as insolvency and taxation, even though he warned that they will take time to bear fruit. While Europe needs to “remain ambitious in its efforts to develop a CMU”, he warned that CMU is not a “silver bullet”. “To enable growth in Europe, the CMU is helpful, but not enough.” Improving macro-economic conditions and investment opportunities in the real economy, for example through labour market reform, will provide the basis for future growth.

For the German government, “we are still living with the consequences of the financial crisis” in terms of financial stability, and “capital markets can play a role.” Understanding potential risks from more market-based financing is also a key priority of the CMU. “It is very important to fully understand how liquidity works, for example in so-called flash crashes.” The Commission’s representative supported this view, saying that, while “one of the objectives of the CMU is to spread risks through the financial system”, understanding and managing liquidity in the markets is a “key issue”.

"To enable growth in Europe, the CMU is helpful, but not enough."

A more prominent role for capital markets:
This seems to be a welcome prospect for many, further discussions during the workshop showed. The German government made clear it is in favour of the capital market initiative by the Commission: “We fully support the CMU”, said a government representative in his presentation, stressing also that, while the US is not a model, some important lessons could be learned. He added that CMU measures could also benefit the EU economy by helping to develop national capital markets. Securitisation, but also lowering barriers for Venture Capital investment, would be key parts of the reform. At the same time, “in some member states such as Germany, banks will remain the major channel of financing for companies”. This is explained not only by availability of bank loans but also that some German company owners prefer debt finance rather than countenance the dilution of control that equity capital implies. This may take time to evolve.

The German official also welcomed the CMU efforts to tackle some long-standing obstacles to cross-border transactions such as insolvency and taxation, even though he warned that they will take time to bear fruit. While Europe needs to “remain ambitious in its efforts to develop a CMU”, he warned that CMU is not a “silver bullet”. “To enable growth in Europe, the CMU is helpful, but not enough.” Improving macro-economic conditions and investment opportunities in the real economy, for example through labour market reform, will provide the basis for future growth.

For the German government, “we are still living with the consequences of the financial crisis” in terms of financial stability, and “capital markets can play a role.” Understanding potential risks from more market-based financing is also a key priority of the CMU. “It is very important to fully understand how liquidity works, for example in so-called flash crashes.” The Commission’s representative supported this view, saying that, while “one of the objectives of the CMU is to spread risks through the financial system”, understanding and managing liquidity in the markets is a “key issue”.

"To enable growth in Europe, the CMU is helpful, but not enough."

A more prominent role for capital markets:
This seems to be a welcome prospect for many, further discussions during the workshop showed. The German government made clear it is in favour of the capital market initiative by the Commission: “We fully support the CMU”, said a government representative in his presentation, stressing also that, while the US is not a model, some important lessons could be learned. He added that CMU measures could also benefit the EU economy by helping to develop national capital markets. Securitisation, but also lowering barriers for Venture Capital investment, would be key parts of the reform. At the same time, “in some member states such as Germany, banks will remain the major channel of financing for companies”. This is explained not only by availability of bank loans but also that some German company owners prefer debt finance rather than countenance the dilution of control that equity capital implies. This may take time to evolve.

The German official also welcomed the CMU efforts to tackle some long-standing obstacles to cross-border transactions such as insolvency and taxation, even though he warned that they will take time to bear fruit. While Europe needs to “remain ambitious in its efforts to develop a CMU”, he warned that CMU is not a “silver bullet”. “To enable growth in Europe, the CMU is helpful, but not enough.” Improving macro-economic conditions and investment opportunities in the real economy, for example through labour market reform, will provide the basis for future growth.

For the German government, “we are still living with the consequences of the financial crisis” in terms of financial stability, and “capital markets can play a role.” Understanding potential risks from more market-based financing is also a key priority of the CMU. “It is very important to fully understand how liquidity works, for example in so-called flash crashes.” The Commission’s representative supported this view, saying that, while “one of the objectives of the CMU is to spread risks through the financial system”, understanding and managing liquidity in the markets is a “key issue”.

"To enable growth in Europe, the CMU is helpful, but not enough."
Is the CMU perhaps a premature measure?
A representative of a private bank raised the issue that the framework could be ahead of its time and that maybe European market regulation could start in earnest once the current problems in the banking system had been resolved and monetary policy had normalised. The Commission views this differently. “Sequencing does not work, we cannot sit idly by and wait until things get better. The CMU will play an important role in normalising financial markets, notably by creating deep markets in which monetary authorities can reduce their balance sheets as they revert to a more neutral monetary policy.” Also, the perspective would be long-term. Many measures would take years to be in full effect, because the European legislators would not create markets, but simply enable them. Capital markets would have to be created by investors and the private sector.

There was some critical discussion of the assumption that the US financial system, centred on strong capital markets, is inherently more efficient than the European model based on extensive bank lending. A representative of a German economic think tank argued that the situation in the US was not as different to Europe as many imagined. American SMEs, it was argued, would rely heavily on loans and credit lines as well. Applicants were most successful with small banks and their customers also reported the highest satisfaction ratings. “To me, it seems that what we really need to do in Europe is develop small banks that can serve the needs of SMEs” the member of the think tank said. She argued that reforming capital markets would not really spur growth, particularly from SME. In Italy, for example, non-performing loans on the balance sheets of banks were a huge drag on growth. “But this is something that we cannot really tackle with the CMU. Instead, banks have to be helped to get rid of their bad assets”, it was argued.

Similarly, a representative of a large private financial institution said that the EU’s central priority should not be the development of capital markets, but should fix the most pressing issues in its banking sector. “If the core issues are not being solved, we will continue to have great difficulties”, he said, also bringing up the issue of non-performing loans accumulated by banks in Southern Europe. Suffering banks, he argued, should be recapitalised with funds from the European Central Bank to solve the problem. Secondly, “Europe has to do whatever it takes to make sovereign debt a bullet proof investment category”, he said, referring to recurring doubts about the sustainability of government debt in some Southern European EU member states.

The Commission argued that CMU was not designed to resolve immediate concerns and solve problems in the banking sector, but to provide a better long-term growth perspective. A representative of a European financial markets regulator said that many measures of CMU would have an impact only after three to five years, “maybe even longer”. Regarding the criticism that instead, small banks should be strengthened, a representative of the Commission argued that he is “not very convinced by the small bank model and not at all convinced that the way to go is more small banks”. Europe would need a transition from the bank-centred model – and this would be possible, because financial cultures such as a reliance on loans “are a function of incentive frameworks”, citing Ireland as an example were reforms have made the country much more entrepreneurial.

A representative of the German banking sector analysed that “European banks are literally an ocean apart” from their US competitors and lamented that they were still under stress. In the EU, banks traded on average below their book value, whilst in the US they traded at 1.5 times book value. Early, aggressive intervention by the US central bank (FED) and stable
growth had helped. In Europe, on the other hand, banks would suffer from regulatory changes, which would be a “big drag”, particularly on European investment banks. Margins on lending, he argued further, were at a meagre one percent, whereas in the US, they stood at three percent, hence strengthening the build-up of capital in banks that would cushion future blows. The think tank representative responded that “competition among banks is high in Europe and if margins on lending are low, this is not a bad, but a good message for companies. Having no large investment banks and national champions is not necessarily bad news for Europe’s economy.”

If capital markets replace some parts of European bank lending, how far should this go, a representative of a large private bank inquired. “CMU is a process, it will stabilise at a certain point. But there certainly is no set target”, the Commission’s representative noted.

Securitisation was another hot topic in the CMU discussion. In Europe, the reputation of financial products that package loans and make them tradeable has suffered because the financial crisis in the US was caused by defaulting Asset Backed Securities (ABS) tied to the housing market. A representative of a state-owned European development bank said that the market had shrunk substantially since the financial crisis, dropping from a volume of 400 billion euros in 2006 to 215 billion in 2014 and with a focus on niche markets such as car loans. "The market is close to being dead", he said. The development bank, hence, in principle fully supported the initiative to make securities more attractive. “Securitisation is key to the success of the CMU.” It would, for example, allow banks to move pooled loans off their balance sheet and hence lower capital requirements.

However, some elements of the proposal to make them “Simple, Transparent and Standardised” (STS) of the Commission are problematic, according to his view. Even though it was understandable that there were deep political reservations about potential risks which the Commission had to take these into account, the result was “not a simple product, but a product for experts” with 50 criteria that had to be complied with to be considered STS. He supported a list of critical comments made by European Banks about STS, the representative argued.

For example, banks structuring the securitised products could face harsh penalties if they were found to be non-compliant with the STS criteria. A securities expert from a private company agreed and added that the banks would still play a key role in the securitisation market. “We should foster ideas on how to use expertise of banks to make good products for capital markets” he proposed, using banks, for example, as service providers.

A Commission representative acknowledged that the battle to revive the securitisation market was not an easy one. “We are trying to revive securitisation markets against the backdrop of a very serious crisis”, he said. “Unwieldy looking rules”, he argued, were necessary to dispel fears about the products, which were very present both in the public and in the EU parliament, the co-legislator that is reviewing the Commission’s proposal. Regarding the perceived competition or complementarity between the banking sector and new capital markets, he said that the Commission was aiming at “good cross fertilisation between capital markets and banks. CMU is not taking bread out of the mouth of the banks – on the contrary, banks will be intermediate much of the business that makes up CMU.”

The Commission also sees CMU as an opportunity for capital markets to support green investment. “We perceive that there is a need to frame a coherent policy to facilitate an orderly transition of capital towards less carbon-intensive technology”, he said. International investors are showing greater demand for green bonds and other finance vehicles that could be an opportunity for Europe. But currently, there is uncertainty and lack of clarity about what constitutes a green investment, and ways in which issuers and investors communicate about their green credentials.
Overall, the Commission said that awareness shown by the participants at the workshop about the need to improve the functioning of capital markets was “very encouraging”. Fears about the banking system losing out, it was argued, were misplaced. It was he said, a “false dichotomy” because one of the main beneficiaries of CMU should be the banking system. Also, he acknowledged the concern that the banking system still needed to be fixed in Europe and noted that the European Commission is working intensively on these issues.

“But we cannot wait for the impact of other measures to kick-in, we have to build a diversified financial system now, in order to make more creative use of public and private finance, to support larger investment flows into the real economy.”
Some impressions from the Conference