CMU TOP DOWN OR BOTTOM UP APPROACH?

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Unlocking Europe's economic potential: the imperative of the CMU

Creating a well-functioning single market for capital is a necessity for Europe. It is not a new necessity, but it has certainly become a more urgent one. The free movement of capital is one of the four original pillars of the single market at the heart of the European Union project. But realising that promise has turned out to be a challenging project.

The political and economic imperative to make progress on a truly integrated Capital Markets Union (CMU) is only growing. Governments are now operating with limited budgetary space and higher borrowing costs, while at the same time facing multiple and ever-increasing demands on public finances. Europe faces an investment gap that could conservatively be placed at €1 trillion per annum when climate, digital and defence needs are added together. With an ageing population and an enlarged European Union, these numbers will only get bigger. It is clear that we will not be able to fund Europe's future through the public purse alone.

CMU also plays a key role for the competitiveness of European companies, for the possibilities they have to access financing to grow, innovate and realise their full potential in Europe. European start-ups attract less than half the funding of their US counterparts. The volume of investments in scale-ups in the United States is more than four times greater than in Europe. That is why creating a well-functioning and effective single market for capital through advancing the CMU is and should be one of the key components of our renewed focus on euro area competitiveness.

EU leaders, finance ministers and institutions have devoted unprecedented political attention to the CMU project in the past year. Starting with a call from EU leaders at the Euro Summit last March, EU finance ministers in the Eurogroup began a year-long, comprehensive and forward-looking review on how we can make the CMU a reality. This led to the Eurogroup issuing a statement in March this year, agreed by all EU finance ministers, on the shared priorities and measures to make a decisive push in getting the CMU where we want it to be. This was later endorsed by EU leaders and has been at the core of subsequent discussions at the highest political level.

Political will and ownership remain key for getting results. I am convinced that we now have both.

The agreement comprises a series of measures, targeting not only EU level initiatives but also actions required by Member States and industry. Many argue that the CMU can only be delivered top-down. I would argue it needs to be a combination of top-down and bottom-up efforts. We need the right framework conditions, the right incentive systems, but we cannot legislate or regulate deep and liquid capital markets into existence. As we now shift the focus on delivery, I see three main pillars for our efforts, which reflect the essence of the Eurogroup statement and the common views of EU finance ministers on how to progress.

One relates to what needs to be done at the EU level. In a year of transition in EU institutional leadership, this will be for the next European Commission to actively follow-up in due course.

The second and a very important one is what needs to be done at the national level. The EU is often compared unfavourably to the US when assessing the state of its capital markets. But the reality of 27 national capital markets which need to be integrated and deepened remains. This should not be used as an excuse, but it is a reality with which we need to work. The divergence in depth and development among the different national capital markets is substantial. Integration will require reducing these divergences. Much is happening at national level, from developing auto-enrolment private pension systems which have proven to be an excellent instrument for stimulating deeper capital markets, to initiatives for improving financial literary and creating cross-border investment products. The Eurogroup's work programme has been carefully calibrated to take account of the current period of institutional renewal, with an immediate focus on driving progress at the national level, before turning to EU legislative measures following the formation of the new Commission.

The last pillar relates to what the EU-based industry can do. EU institutions and member states have a major responsibility in developing the enabling conditions and removing the barriers for a deep and robust CMU. But industry has a central role to play in making full use of these opportunities to create a genuine single market for capital.

We are often reminded that political will and ownership remain key for getting results. I am convinced that we now have both.

EVA WIMMER

Director General – Federal Ministry of Finance, Germany

CMU – Bottom-up or top-down approach?

EU Finance Ministers and policymakers are advocating for actions to drive forward the Capital Markets Union. The scale and depth of capital markets align well with the immense investments required for the eco-friendly and digital overhaul of our economy. Market-based financing is the backbone for innovators to transform their concepts into novel creations. Therefore, the existence of profound and efficient capital markets in the EU is vital to stimulate growth. In recent years, several measures have been already implemented as part of the European Commission's 2020 CMU action plan, some of which are yet to fully take effect. While by now there is no question the Capital Markets Union is high up on the European agenda, tangible steps are still being debated in depth.

In the Franco-German roadmap from September 2023 the idea was brought up to explore the potential of a bottom-up approach to the CMU. The CMU agenda had been focusing on harmonization primarily. The idea is that it can be beneficial to improve buy-in and ownership at domestic levels by both private and public stakeholders as well as to address the heterogeneity of capital market structures and the domestic peculiarities of funding sources in each Member State. In a nutshell: Deeping national capital markets can also contribute to deepening the EU capital market as a whole. The Eurogroup in inclusive format has taken up this idea in its March statement on the future of Capital Markets Union and regularly coordinates the exchange of best practices among Member States, with input from the European Commission.

In line with this concept, the German government is focussing on fostering capital markets access for SMEs and especially start-ups and cutting red tape (e.g. Financing for the Future Act, German "Wachstumsinitiative"). Further regulatory measures are on the political agenda. Furthermore, a dedicated industry task force consisting of practitioners has taken up its work: Their goal is to advise in more detail what concrete measures are needed to help the EU securitisation market play its role for financing our economies and their transition. Moreover, in order to expand financial education and to mobilize more private capital, the Ministry of Finance and the Ministry of Education and Research have started a national financial literacy initiative. Within this initiative, the OECD is currently developing recommendations for a financial literacy strategy for Germany which will be presented this September.

It is essential to state that the question of the right way of proceeding with respect to CMU - bottom-up or top-down approach - is not a matter of either-or. Rather, they should be viewed as complementary strategies that must go hand in hand.

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One example for the complementary nature of the approaches is the discussion around European Investment Products. The Eurogroup has invited interested Member States and the European Commission in the Eurogroup statement from March 2024 to examine the potential of developing a framework for a common cross-border market-based investment or savings products for citizens and assess its impact. Well-designed investment products for retail investors might be a good way to deepen the EU capital markets, provide more funding for the EU economy and infrastructure and simultaneously involve citizens directly in the CMU project. In addition, this can serve as a stepping stone towards an improved financial literacy. In order to avoid creating duplicate structures, an important principle in the development of the investment product framework should be a direct integration into existent national structures. Here, the cooperation on both the European and national level is essential.

Another case where both bottom-up and top-down initiatives come together is the topic of supervision. On the one hand side, we should start with improvements in the convergence of the legislative framework. On the other hand, at ESAs, the promotion of cross-border competition, and the reduction of red tape should be more in focus. As pointed out by the new President of the European Commission, better lawmaking and reducing red tape has to be a joint task – with all institutions involved. So, also the ESAs can contribute to building an efficient and safe but less burdensome regulatory environment for all stakeholders involved. In any case, however, a bottom-up approach should not be confused with a Capital Markets Union of the willing, that would lead to a fragmentation of the process. Like the IMF Managing Director Georgieva has recently said: Let us not forget that the U in CMU stands for Union.

Building a strong Capital Markets Union is, though worthwhile, a manifold endeavour. A combination of EU-wide and national measures will be the key to advancing the European capital market.

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A top down approach for a healthy bottom up evolution of the CMU

The Capital Markets Union - for already a decade one of the key projects in the EU. Looking at the recent reports and this year's discussions of the regulators on the way forward, one may see the CMU as a Common Main Urgency. No doubt, capital markets are important. They shall be cared for, deepened and interlinked. And here we run into the question – shall we go the usual top-down route or rather leave the way free for a bottom-up evolution?

The EU regulatory framework shall set boundaries for financial market participants in order to preserve financial stability, especially by setting key prudential requirements, as well as fair competition and adequate level of investor/depositor protection. These are the basic elements of a desirable EU top-down approach, applicable for capital markets and the CMU as well. These boundaries shall not represent unnecessary, not to say unintended barriers, like excessive administrative burden or any limitations beyond what is really necessary. The role of the regulators is, first of all, to create adequately simple, understandable and easily applicable set of rules, whilst avoiding duplications and overlaps across the framework. All directives and regulations relevant for capital market, which are indeed many, are pieces of a puzzle that need to fit together. Such an easy-to-use framework will attract the industry and let the market grow. Better attract than force! Less barriers and no unnecessary regulatory burden will lead to lower costs and help the national markets to evolve naturally, become more interlinked and be together a strong competitor on the global playground as well as a robust funding partner for EU needs.

Is it time now for the top-downers to take a break, when it comes to deepening of the CMU? Absolutely not. They may now seize the moment of the birth of a new political cycle, take a helicopter view over the EU financial market legislation in all its interactions and carry out a holistic analysis, where we are, followed by the necessary cleaning, if identified as useful. A well-polished diamond is of a greater value and so is a well-tuned EU regulatory framework.

It is more than clear the EU needs to secure financing of its flagships – green and digital transition, overall resilience, including enhancement of its defence industry and future enlargement of the club. No time to rest, on the contrary. But this does not mean that the best or the only way how to finance the priorities has to be one particular sector of the financial market. It shall be left up to the interaction between demand and supply, conducted within the correctly set regulatory boundaries. A healthy functioning market is the one to determine itself which sector of the financial market or particular product satisfies the financing needs best. There may be some high-level guidance to spotlight the important goals if deemed overlooked, but this political push shall stay limited. Tax spices may boost the taste, but are in hands of EU member states and can easily cross the fine line of an unhealthy interference in the competition. There are good examples, worth following, like national Individual Savings Accounts, often linked with a more favourable tax regime, aiming at increasing savings for retirement as well as promoting capital markets. But these shall not favour one concrete product but rather leave the investor a wider choice. And as taking care of citizens of retirement age is a national responsibility, promotion of long-term products shall be handled the same way, respecting national needs and specificities.

In general, we shall not prescribe our depositors and investors a concrete way or product to go for but rather educate them in order to increase their financial literacy, thus helping them to identify all relevant options in the market, assess them correctly and pick the right option to go for. For example, the Czech Ministry of Finance developed a Corporate Bond Scorecard tool in a form of a spreadsheet guiding retail investors in assessing corporate bonds, if they decide to invest in. This tool shows which indicators are worth assessing and how to do it – just by filling the fields, getting the final score and a "traffic light style" outcome. No less important is that there needs to be wide range of investment options accessible. The EU Retail Investment Strategy should take all this into account.

The CMU will benefit most from a natural market evolution in an easy-to-use regulatory environment.

Citizens, well equipped with all necessary information and capable to make informed choices will constitute a strong demand also in the capital markets. Similarly, the SMEs may be given access to all necessary information and a helping hand in assessing these, in order to take full advantage of capital markets as a possible source of funding. All these will create a strong demand that will, together with a corresponding supply, give rise to a robust market-based bottom-up approach to increase the importance of capital markets on national level and consequently also on union level, trough natural evolution.

KATHARINE BRADDICK
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A window of opportunity for pan-European capital markets

2024 has been a festival of democracy globally and nowhere more so that in Europe where we've had the European Parliament elections, followed quickly by the UK General Election. In both the EU and the UK, we are entering new five year political cycles facing significant economic issues and with both administrations placing a heavy emphasis on capital markets as a vehicle for financing some of our major challenges. In the EU, there have been a plethora of important reports and recommendations made over recent months and we now have a menu of potential policy actions to support the further development of CMU. In choosing from the menu, policy makers should keep the following principles in mind.

- **Keep CMU on the agenda:** Literally. Political buy-in is key and it is encouraging to see that CMU is increasingly focused on at the highest political levels, including the European Council. Keep it on the agenda regularly to exchange ideas, to ensure that there is policy delivery and to ensure that there is a focus on some of the politically more difficult issues.
- **Don't ignore the hard stuff:** Looking across the reports and recommendations from the Eurogroup, the European Council, Enrico Letta, Christian Noyer, the European Central Bank, and ESMA, the only area advocated by all is securitisation. This is an important part of the picture but is clearly not enough. Progress on thorny issues such as harmonisation of the corporate insolvency framework is particularly important in addressing the challenges of fragmented legal regimes that hinder the debt market, including on securitisation.
- **Combine bottom up and top down:** It shouldn't be a question of either/or, a combination of the two is required, often in the same area. Take pensions reform, for example, where action at member state level will have a more significant effect than action at EU level but reform of the Pan-European Personal Pension Product by the EU institutions would also help on the margins. Similarly with supervision, national authorities should be working to converge supervisory practice but EU level action is required to allow the ESAs the possibility to issue no-action relief to the market.
- **Don't boil the ocean:** A limited number of significant actions will do more than a long list of more minor initiatives. It will also help give the financial industry more regulatory stability than it has enjoyed in some time. EU policymaking should now focus on supporting growth and competitiveness. To help, the EU should prioritise proposals through the lens of CMU. Any potentially costly or complex initiatives which risk the attractiveness of investing in European markets should be de-prioritised.

It isn't a question of either/or but a combination of top down and bottom up.

- **Remember Green Finance:** While we can see that across Europe there appears to be an electoral backlash against ESG policies, a policy environment supportive of net zero remains crucial. Net zero is not just good for the climate, but good for security as well, as it gives us more energy supply options. Financial services policymakers should proactively promote policies that are likely to result in greater volumes of sustainable and transition finance. While new, innovative, companies will make a substantial contribution to our transition, most of the work will come in pivoting our existing businesses and industries.
- **Resist any protectionist reflexes:** While you can allocate public money you must attract private money and that means ensuring Europe is an attractive and competitive place to invest. That said, there should be further analysis of where the large pension and other investment funds put their investors money and whether in a 'global equities' allocation model, Europe is not seeing more outflows relative to inflows from funds in other regions. This could also be something to look at in the retail market, particularly where there are tax incentives. The UK needs to look at these issues too.
- **Think about a broader European capital markets space:** The EU now has well-functioning financial services dialogues with the UK and Switzerland and should use them to look innovatively at how some of the common capital markets challenges can be met.

Finally, we should be honest that capital markets union is not the answer to all our economic ills. Addressing productivity is the bigger challenge and it will require significant focus, and often policy restraint, in the technology space, particular around Artificial Intelligence. But using our capital more productively too will certainly help along the way.

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Change is needed for CMU – Post-trade is a problem

As Europe enters the middle of the decade, we have seen fundamental challenges that began with the COVID pandemic, inflationary shift from quantative tightening, war on our borders and the transformational impact of climate change. As the EU deals with the impacts of radical changes in energy, security and defense as well as economic competition from both Asia and the US, how do we regard the CMU approach that commenced in 2014? The acceleration of change is increasing at pace as the US markets move towards T+1 and Artificial Intelligence is finding its way into the markets and the lives of the European consumer. What radical measures are needed? How can European capital markets increase in order to support the financing needed by European infrastructure and enhance the competitiveness of Europe? How does Europe generate broader and deeper pools of investments from investors as well as better flow of capital across borders?

A strong and competitive EU capital market requires developing large pools of liquidity and leveraging the savings and pensions power of the European consumer to generate a formidable base of risk capital.

The markets Nasdaq and others operate in Europe are of different sizes and stages. Local and national environments for the capital markets ecosystem have been a differentiating factor. This is why the Swedish market has developed into such a success story.

Other countries can do this as well. How? The fundamental start is to draw up local capital markets action plans, focusing on resolving specific gaps and challenges in each market. Areas to focus on are pension systems, financial literacy, retail investor engagement, digitalization, tax policies (not only tax rates but – importantly – simplification).

The European Commission should make it its mission to ensure that all Member States take these measures, by collecting best practices, and by agreeing upon updated CMU KPIs to measure our competitiveness. With a close collaboration between individual states and the European Commission we can then work to identify and implement local improvements through a CMU monitoring mechanism to counter fragmentation and strengthen our European market.

To be competitive Europe must make the commitment to remove the legacy national, legal and regulatory barriers that prevent our companies from accessing capital domestically and our investors from allocating efficiently to EU investments. Europe must allow simple interoperability between markets. Cross border differences within EU states fundamentally impact the ability of corporates to raise capital and finance. Both primary and secondary listings are materially impacted by the cost of asset servicing and the operational complexity in managing custody and securities processing across 27 different EU states with different legislation.

The CSDR has enabled consolidation of the CSDs across the EU member states. However, it has been largely ineffective in creating competition or driving down the settlement costs of investors, primarily due to substantial investments required by a CSD and the market, and the national differences in company, securities, and tax laws.

Nasdaq has taken a holistic approach to leveraging technology platforms and operational efficiencies, to develop harmonised post-trade services that deliver cross-border efficiencies and lower costs to investors and corporates. Thanks to the merger of the 3 Baltic CSDs and Icelandic CSD into the Nasdaq CSD, shared trading, settlement platforms and common rulebooks, the Baltic markets have achieved the highest degree of regional integration among the EU markets, benefiting participants and investors.

The Nasdaq example demonstrates that there are material harmonization steps that can be taken to create cross-border integration. The key obstacle in that cross-border integration is the commercial incentives of CSD owners to subscribe to harmonized, open access platform principles.
Beyond platform harmonization there still exists a further set of obstacles. National differences in laws and regulations, such as insolvency regimes, taxation (incl. tax withholding and reporting) and company laws and securities market laws. Consequently, to service issuers in their home jurisdictions, Nasdaq CSD is required to maintain local Securities Settlement Systems in each Baltic country, where issuers are registered, and securities are issued and serviced.

Europe must allow simple interoperability between markets.

The inability to harmonise CSD post-trade has a direct impact on the attractiveness to corporates for listing in the EU and equally the attractiveness of the EU securities as an investment for offshore institutional investors when they look at the comparative high costs in Europe vs other markets. Post-trade and asset servicing costs are borne by the end investor.

EU institutions need to address the issues regarding cross-border post-trade as a priority, in order for European Capital Markets not to be left behind.

FRANCIS MALIGE

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Of national exchanges and airlines...

Among EU countries, the EBRD focuses on Central and Southeast Europe, a region with entrepreneurial vitality and world-class innovation, with success stories like Skype and Bolt from the Baltics. However, the region suffers from an acute lack of access to capital; corporate success stories, when they emerge, tend to seek listing elsewhere.

In this context, the EU is discussing a broader capital markets union as a critical engine for growth, especially in competition with the US and Asia. It is an agenda that EU institutions cannot drive by themselves. Building bigger, deeper, and more integrated capital markets in Europe requires EU-wide 'top down' measures for harmonization and national-level 'bottom up' measures to increase capacity. Savings, pensions, taxation, and insurance are normally national policy matters. There are also not enough political champions aware of the crucial role of capital markets or their interlinkage with savings policies. Those who do appreciate it don't make enough noise.

Currently, the two most pressing issues of European capital markets are the lack of deep pools of long-term capital – pensions, insurance assets, retail investment, and private equity – and the complexity and fragmentation of capital market infrastructure.

Pools of capital in the EU are much smaller than in comparable economies. The gap is mostly in funded pensions, tiny in comparison to North America. In EBRD EU countries, retail investors have insufficient access to mutual funds and investment funds. Shifting more retirement savings from bank deposits to investments and building pension assets would deploy more flexible long-term capital to support the economy, jobs, and growth in the region. One way to achieve this could be for the European Commission and Member States to develop long-term investment products, such as the Pan-European Personal Pension, to create deeper funding pools for the EU economy.

Tax considerations significantly influence investor choice, affecting asset allocation, investment horizon, and choice of investment products. Member states should draw on successful experiences of Asia, Australia and North America that offer tax-advantageous investment savings accounts with a low administrative burden. These schemes channel savings into capital markets. More critically, they are often the first step toward greater financial literacy, as investors are incentivized to learn more about investment options offered through these accounts.

The true cost of fragmentation and underperforming exchanges are in lost economic opportunity.

Stock exchanges are, like national airlines, often seen as symbols of national sovereignty. However, unlike national airlines, they don't require costly bailouts and can remain profitable due to high fees, thus tend to escape scrutiny. Nevertheless, the real economy struggles because of the absence of local long-term financing alternatives: the true cost of fragmentation and underperforming exchanges are in lost economic opportunity.

The small size of individual exchanges is compounded by the complexity of clearing and settlement. There is little hope to develop single pool of capital in a continent with 22 exchange groups operating 31 exchanges for listings, 34 for trading, and 39 central clearing counterparties (CCPs) and central securities depositories (CSDs). The success of the Euronext approach and Nasdaq Nordic and Baltic markets proves that consolidation creates value.

The EBRD, building on its longstanding partnership and commitment to Central and Southeastern Europe's success, is participating in a rethink of the regional model, where consolidation focuses on integration at the operational level rather than the ownership level. This model rests on strong cooperation of local markets as equal partners, avoiding the difficulties of a takeover where the interests of one country or a single exchange group dominate. Integration built on connecting and strengthening local ecosystems makes support of a wide range of local stakeholders, especially country governments, much more achievable.

The benefits are real. By joining forces, participating exchanges could meet the growing challenges of fast-changing technological development in the financial sector. Creating a single liquid pool of assets could facilitate the graduation of countries in Central and Southeast Europe from frontier to emerging market status. Making it possible for retail investors from any country to invest in any security in the region through a single system also improve liquidity. That would draw the attention of global investors and bring new investment flows to the region.