CMU: bottom-up or top-down approach?

1. Progress made with the CMU initiative

The Chair noted that the beginning of a new political cycle in the EU is an appropriate time to review what has been achieved on the CMU and what actions need to be taken going forward. There is appetite to do more. There is a need to identify what more needs to be done and how future steps in the CMU initiative will be taken. The Commission is likely to prepare a strategy on the CMU for the next political cycle, possibly under the new label of a savings and investment union.

1.1 Effectiveness of top-down actions for achieving the objectives of CMU

An official considered that the CMU initiatives to improve the functioning of capital markets have been quite effective. Much has been done to strengthen and harmonise the regulatory framework. However, differing national implementation of these rules must be avoided to facilitate the common design and distribution of products across the EU. There are very effective common rules for investment funds with the UCITS and AIFM directives and the recently reviewed ELTIF regulation. Consistent customer information rules have been developed with the PRIIPs regulation. The capital market framework has also been strengthened with the significant work conducted on MIFID, MiFIR and CSDR. Europe has robust infrastructures and two international central securities depositories (ICSDs). Trading is also quite efficient, although a significant amount of equity trading takes place in systematic internalisers (SIs) and banks.

A second official remarked that a great deal of progress has been made on the European capital market regulatory framework. Top-down regulations that have been adopted at the European level address many important areas including for example investor protection, information provision to investors and the listing of smaller companies.

An industry representative stated that the CMU top-down actions implemented so far in the securities markets have had a mixed effect. The evolution has been positive on the clearing side. EMIR introduced open access and interoperability rules and has reduced costs. In equities clearing, five central counterparties (CCPs) concentrate 80% of securities clearing and costs have reduced by 60%. However, some major CMU initiatives have been quite unsuccessful, with significant unintended consequences for the market. MiFID and the first version of MiFIR have not worked as expected. The aim was to increase competition and lower trading costs, but these legislations mainly led to liquidity fragmentation with a huge number of OTC trading venues. This also impacts initial public offerings (IPOs), as the liquidity of the secondary market is an important factor when deciding where to list. The measures taken in the settlement layer with the CSDR have not been effective either, with 27 CSDs still operating in Europe compared to one in the US and the persistence of different withholding taxes and insolvency laws across Europe fragmenting the market.

A third official highlighted that MiFID has resulted in numerous trading venues for securities, raising questions about their necessity. Currently, only 35-40% of equity trading occurs on exchanges, with the remainder happening on SIs or in dark pools. Whether this development is beneficial should be further assessed.

A fourth official noted that after 10 years of work on CMU, there is now a greater sense of urgency to make decisive progress. However, there is currently a lack of conviction in a number of EU member states about CMU. Too much time has been spent thinking about how to develop capital markets in Europe and not enough thought has been given to how CMU will benefit the EU's smaller capital markets. The CEE (central and eastern Europe) countries in particular, except Poland, have much smaller and less liquid capital markets than the rest of the EU. Savings primarily go through banks and to government securities, which represent the bulk of the capital markets in the region and most of the funding of companies is bank financing. In a more integrated European capital market liquidity and trading will tend to gravitate to the largest financial centres because investors prefer to concentrate their trading for simplification. Countries with underdeveloped markets do not trust that flows will eventually trickle back down to them if the trading ecosystem concentrates on the large economies. Similar situations have arisen previously in the banking sector. For example, it was said that the presence of western European banks in the CEE countries would insulate them from a crisis, while in reality it accelerated the transmission of the global financial crisis into those countries.

An industry representative suggested that, as a result of the political focus of CMU being centred in Brussels, the tools used to advance the CMU agenda have largely consisted of regulatory and harmonisation efforts. Although progress has been made with the regulatory framework, the EU's capital markets have not yet expanded to a scale in proportion with the EU's gross domestic product (GDP). Public policy can support the drive towards deeper and more competitive capital markets in the EU, but markets cannot be regulated or supervised into existence

At present there is too large a gap between the goals of CMU and what is possible within the current political conditions. Closing this gap could be transformative and could accelerate the pace of the positive change already observed. The EU's trading landscape compares very favourably with that of the US, because it has many competing channels, but the EU post-trading landscape is complex and expensive. Market participants have to build separate connectivity into each domestic infrastructure to trade, which creates frictions and costs and fragments liquidity.

1.2 Actions implemented at member state level to develop national capital markets

An industry representative observed that national governments can act to develop their capital markets in cooperation with regulators and the financial industry. The Nordics and Baltics are good examples of this. The success of the Swedish market is a result of local financial market infrastructures working with the government, industry and pension funds to help improve financial literacy and an ecosystem that allows innovation to flourish. The Baltics have collaborated on joint regulation and have been able to consolidate three CSDs into one. This can be done on a regional level provided it makes commercial sense.

An official noted that significant action has been taken at the national level in some member states to develop financial literacy and ensure that investors can make informed decisions. In the Czech Republic for example, financial education has been a mandatory part of the school curriculum for more than a decade, which has been successful. To help citizens select the investment products that are most relevant for them, a Corporate Bond Scorecard tool has also been developed, classifying corporate bonds according to criteria that are relevant for retail investors.

2. Combining top-down and bottom-up approaches in the future steps of CMU

The Chair observed that the President of the European Central Bank (ECB) has suggested that a more top-down approach to CMU is needed at least in certain areas. Mario Draghi has shared a similar view on supervision in particular.

An official stated that top-down and bottom-up approaches will both be needed in the next steps of CMU with an appropriate balance between the two. Top-down actions can be perceived as controversial by member states but are needed to drive coherent actions at EU level and can also indirectly support the development of national markets. Investor protection, investor and issuer financial literacy, which are essential for encouraging more investment and funding through the capital markets are areas where joint action makes sense, although attention must also be paid to national specificities. The same is true for revitalising the securitisation market, which can be an adequate method to increase bank funding. Market fragmentation is a more controversial issue. Consolidation of post-trading market infrastructures can be worrying for countries with a smaller capital market. However, there are significant opportunities to reduce the current fragmentation of venues in the trading space, which would be a less politically sensitive question.

A second official agreed that both top-down and bottom-up approaches will be needed to achieve the overall goals of CMU. A number of aspects must also be determined by demand and supply with no intervention from the public authorities, such as the pricing of securities. A top-down approach is needed to assist member states in growing and deepening their national capital markets. The work conducted at the EU level in particular by the Financial Services Committee (FSC) and the Eurogroup on CMU should help ministers to agree a common work plan with deliveries in the short and mid-term and identify the main messages to convey. The European institutions also have a role to play in fostering the exchange of best practices between member states and market players and ensuring that there is effective cooperation at EU level. Achieving the desired CMU outcomes will take time. Sweden, which now has a vibrant capital market, launched the first initiatives aimed at developing its capital markets in the late 1970s.

Bottom-up approaches conducted at member state level could include tax incentives to attract investors to the capital markets. This has worked in many countries, such as Sweden, the US, the UK or the Netherlands. But this incentive needs to be implemented at the national level because taxation is and needs to stay a national competence. In the Czech Republic, the same tax treatment is applied to all types of long-term saving and investment products that aim to prepare for retirement. National-level measures are also needed to inform SMEs about the benefits of capital markets and provide guidance on how to obtain funding. A guide for SMEs has been introduced in the Czech Republic with explanations about the capital markets, how to approach them and the importance of diversifying financing sources.

A third official emphasised that, while financial regulation should be harmonised as much as possible at the European level to build the internal market and simplify requirements for cross-border players, member states must improve the functioning of their local markets. Some parts of the market will remain mostly domestic such as SME markets. SME bonds tend to be distributed to local investors, because investors in other member states do not know the companies issuing them.

A fourth official also suggested that both top-down and bottom-up approaches are needed. Those looking at CMU from a bottom-up perspective are usually more concerned with having sufficient access to funding, whereas those looking at CMU top-down want to improve market liquidity and efficiency. Action at the European level is necessary to remove the barriers that hinder cross-border business within the EU, such as insolvency law and withholding tax, but much can also be done at the national and private sector levels to grow the markets. Business is quintessentially bottom-up. Businesses operate within the existing rules to decide where to list and where to get money from, which can be within or outside the EU. Trust-building is critical for business and requires an appropriate alignment of the bottom-up and top-down perspectives.

An industry representative highlighted the need for adequate alignment and synergy between the actions undertaken at the EU and member state levels. Achieving a seismic change in capital markets is about scale and enhancing a number of dimensions such as liquidity. This requires clear direction and a credible agenda. The UK and EU both have insufficient exposure of retail money to capital markets due to regulatory hurdles and tax treatment issues. Stamp duty for example perversely incentivises investment outside the union, typically into the US. Increased retail investment will not have a significant short-term impact on market liquidity but is essential for meeting the political conditions needed for capital markets to develop in Europe. European governments and citizens must be convinced that capital markets are beneficial for European savers and firms, especially given the lack of growth in most European economies.

Another industry representative considered that increased participation of households can have a decisive impact on the growth of European capital markets. If retail participation was comparable to that in the US, approximately €4 trillion of savings could be unlocked for the European capital market. This is achievable with sufficient political will. National governments can build effective pension systems over time, as demonstrated by the examples of Sweden, Denmark and the Netherlands, and can incentivise investment in the capital markets with tax incentives.

The conditions must also be created for companies to remain in Europe and find adequate risk capital. Risk capital will be brought into the market if companies are productive, profitable and innovative and if it is more attractive for savers to invest in the capital markets than to leave the money in savings accounts. As detailed in the Draghi report, there are many sectors in which the EU is still a world leader, such as industrial technology, clean tech, biotech and pharmaceuticals. These sectors must be nurtured and financed. This can be done at private sector level. Actions are however needed to make it cheaper and easier for companies to list, trade and access risk capital in Europe.

3. A top-down approach to simplifying EU regulation

An official emphasised that over-regulation and the excessively complex regulation is a major issue in the financial sector, including for capital markets, as it increases costs and creates inefficiencies. A top-down approach will be needed to reduce this over-regulation, for example simplifying reporting and alleviating administrative burdens. An active participation of member states can be expected to achieve this, as this is not a politically controversial issue.

A second official agreed that the first priority for top-down action should be a rationalisation of the current European capital market regulatory framework, starting with a holistic analysis of the overall framework and the identification of the overlaps and inconsistencies between the legislations composing it. Capital market professionals, issuers and investors need a transparent regulatory framework that is easy to apply and to comply with.

A third official acknowledged that the European framework could be further streamlined. The different layers of regulation with Level 2 and 3 requirements in addition to the Level 1 text result in complexity. As stated by Ursula von der Leyen, a key topic for the new legislative cycle is to reduce costs and make the European framework easier to use. This is highly relevant to the CMU discussion.

The Chair noted that certain recent regulations, such as the Listing Act, aim to provide simplification and improve consistency between various pieces of legislation pertaining to SME listings.

4. Focusing on key priorities in terms of impact and feasibility

An industry representative suggested that thoroughly addressing a smaller number of important aspects in the CMU would be preferable to trying to solve all the problems identified. This will result in a clearer and more credible agenda that will be more effective in attracting investment. Policy should focus on key measures that will provide funding and investment opportunities for the European economy and citizens and remove the obstacles to achieving this.

An official considered that rather than trying to solve every problem, the focus should be on the actions that will have the largest impact and are the least politically controversial and thus easier to implement. A thorough analysis of the improvements needed is necessary before taking action. There are two types of action to be taken in the capital markets area: long-term actions aimed at laying a sustainable foundation for future growth and stability, and short-term actions focusing on "low-hanging fruit" aimed at addressing immediate challenges and strengthening Europe's competitive position. Priority should be given to the second type of action, given the importance of enhancing the competitiveness of the European economy and the significant role that capital markets can potentially play in achieving this objective.

A second official suggested that top-down actions should focus on a limited number of priorities that are likely to have short term impact and are relatively easy to deliver, so that member state politicians and citizens perceive the benefits. Considering the three elements of CMU in turn, capital is already available in the form of abundant household savings that need to be used in a more active way. The focus should now be on developing and deepening the markets, following which there will be a natural demand for further integration. At that point, a union can be created, but this stage has not yet been reached. At present, SMEs and retail investors remain focused on their national market.

The discussion on centralisation of supervision and further consolidation of infrastructure should be postponed, as there is currently no broad consensus on these issues and therefore a high probability that the discussions will not reach a conclusion. This has happened before, for example in the case of the European Deposit Insurance Scheme (EDIS), where the discussion was blocked because there was no initial consensus. Instead, priority should be given to areas where there is broad agreement.

A third official stated that the focus should be on the key issues that are hindering demand and supply of capital. On the demand side, it must be easier for retail customers to invest in capital markets rather than leaving their money in deposit accounts. On the supply side, the funding of firms on the capital markets must be facilitated. A top-down approach is preferable to achieve these objectives, but there should be a focus on simplification. On the demand side, UCITS are a good example of the benefit that a European approach to investment products can bring to facilitate cross-border investment. Further harmonising insolvency law is another priority, but rather than harmonising the whole area, only the elements that are specific to capital markets and those that concern the settlement finality directive, which plays a critical role in protecting financial markets during insolvencies, need to be addressed. The same targeted approach could be applied to other Giovannini barriers that hinder post-trading integration and cross-border transactions. On the supply side, SME listing is a first priority. It should be as easy as possible for SMEs to list on public markets. An additional area that needs to be simplified is reporting. In Germany, a consultation has been launched to assess how reporting requirements could be simplified.

A fourth official highlighted two priorities that the CMU should focus on. Further consolidation of infrastructures is a first priority, as it will help to reduce transaction costs and facilitate cross border transactions. The Baltic countries all wanted to retain a domestic stock exchange, so the CSDs were consolidated. Rationalising the post-trade infrastructure is an urgent project that does not require public sector intervention. Work is ongoing with eight stock exchanges in central, eastern and southeastern Europe (CESEE) to create a common infrastructure, that will allow investors to invest in any security in that region through a single point of entry.

Attracting savings to the capital markets is a second priority. This will first require an adequate offering of investment products and pension funds to intermediate investments, because most savers will not want or do not have time to invest directly in the capital market. These products are lacking in the CESEE region. The EU level can assist here, providing common product frameworks. Secondly, financial education is needed to build investor trust and also to convince other stakeholders that capital markets development is a key driver of competitiveness. Once this is understood, regulatory convergence can be built. The Baltics are again a good example of this. The Baltics converged their regulations to the extent that they were considered as a single market by index providers such as MSCI. The Baltics then moved from being frontier markets to emerging markets, which was very successful for attracting capital. In addition, adequate insolvency laws and efficient taxation rules are needed to encourage investment in the capital markets.

5. Enhancing the governance of the CMU project

The Chair asked whether improvements are needed in terms of the governance of the CMU project. At present several entities are involved in the governance of the CMU, including the ECOFIN council, the Eurogroup, the Commission and the FSC.

An industry representative commented that, instead of creating new bodies or possibly a super body to run the CMU, the roles and mandates of the existing bodies must be clearly defined to ensure that the right competence and expertise are in place for decision making.

An official emphasised that a European super agency is not needed to steer the CMU. Top-down support from Brussels in response to bottom-up political will from different countries built on a clear competitiveness agenda is a type of governance that could support the development of capital markets going forward. Private-sector money will then come in.

Wrap-up

The Chair summarised that panellists agree that a combination of top-down and bottom-up measures are needed. The nature of the specific actions should dictate whether the process chosen is either top down or bottom up. Panellists also advised further simplification of European rules and maybe also of national rules. Great importance should be attached to developing national markets in a consistent way, with interconnection between local markets where appropriate so as not to contradict the aim of developing integrated, deep and liquid markets at a European level.