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CMU: is it on the right track?

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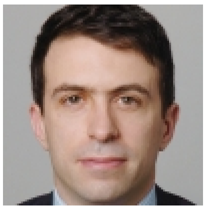

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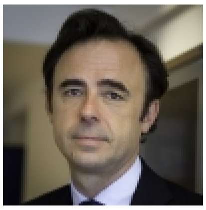

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Objectives of the session

This roundtable examined the progress made with the CMU action plan and whether the short term actions were likely to foster a significant diversification of financing and better opportunities for investors. The key longer term priorities of the CMU and the way to keep sufficient momentum over time were also discussed, as well as the need for a stronger focus on technology.

Executive Summary

The CMU, an ambitious project facing several challenges in the implementation phase

The importance of developing capital markets and of diversifying the financing of businesses in Europe that was intended with the CMU initiative was emphasised by the panel. At present EU capital markets were too fragmented and under-developed, they said, and did not allow a sufficient diversification of financial sources or an effective transformation of savings into investments across the EU. The CMU could also help to improve the stability of the financial system with a better diversification of financing. Moreover, thanks to the CMU, EU capital markets could be made more competitive and more transparent. The long term policy aim of the CMU was not to revive just individual segments of the market, but capital market financing as a whole; CMU should therefore be considered as a comprehensive undertaking.

Some speakers felt that there could be a stronger emphasis in the project on SMEs and the local financing ecosystems that were needed for them, as SMEs were the most likely to generate growth and employment. A stronger focus was also needed on measures to rebuild retail investor trust, such as investor protection measures, in order to encourage more investment.

Although it provided many opportunities, the CMU also contained significant challenges, some panellists considered. A poll conducted during the Eurofi seminar showed that 59% of participants felt that the CMU was ‘not quite’ or ‘not at all’ on the right track.

There was first a risk of loss of momentum with the four year timeframe of the CMU implementation and the relatively high number of initiatives that the action plan comprised, that were somewhat difficult to promote and explain from a political perspective. Several speakers were in favour of accelerating the implementation as much as possible. A mid-term review is to be carried out by the European Commission (EC) in 2017, in order to review priorities and instil a new momentum. A speaker also felt that it should be acknowledged that the CMU was a complex project, deeply intertwined with national traditions and cultures, which thus required careful implementation in connection with the Member States. This would take time but was essential for the success of the CMU. Ultimately the CMU should be pursued in a determined manner without expecting immediate results, an official concluded.

A second challenge was related to the economic growth and job creation objectives associated with the CMU which might be difficult to achieve with the CMU action plan alone. The CMU was a necessary, but not a sufficient condition for achieving these objectives, a panellist emphasised. Some speakers considered that a broader and more holistic approach was needed, because the achievement of the CMU objectives was also dependent upon the economic conditions prevailing in Europe; in addition diversification in the sources of financing would only work if the overall variety of financing options, including traditional banking activities, was taken into account. Such a holistic approach should encompass also the Juncker Plan, the Banking Union and measures to enhance investor trust; this approach also needed to address the banking sector with measures relating to risk reduction, the expansion of lending capacity to the real economy and SMEs in particular and a capitalisation on the links between banks and the capital markets, some speakers suggested.

The potential impediments that the ongoing bank prudential reforms could create for the development of capital markets, notably the measures targeting market making, were a further challenge, a panellist felt. There needed to be deep reflection on whether it was possible to meet Basel prudential objectives in a way that did not interfere excessively with the development of European capital markets and the financing of the economy e.g. with a possible re-calibration of certain requirements.

Progress made so far with the short term CMU actions

The implementation of the first phase of the CMU action plan was well underway with the proposals that had been made regarding securitisation and prospectuses, the recalibration of Solvency II capital requirements for investments into ELTIFs and infrastructure projects and actions conducted by the private sector regarding private placement. Several speakers however considered that the progress made so far was not sufficient and that the adoption of the pending legislative texts regarding securitisation and the prospectus review needed to be accelerated. Flexibility and adaptability also had to be built into these regulations, as capital markets evolved in a dynamic way, a panellist emphasised.

There were mixed perceptions regarding the STS (simple, transparent and standardised) securitisation proposal in particular. Securitisation was considered as the main short term initiative of the CMU, but the EU securitisation market was declining compared to covered bonds and the volumes were 8 times smaller than in the US. Even for the most liquid products, the inventory of broker dealers and trading were a small fraction of what they had been prior to the financial crisis, which made price discovery increasingly difficult and favoured volatility. There was also a reduction of transparency with increasing trading of loan portfolios instead of ABS and an increasing proportion of privately-placed transactions. There were different possible reasons for these trends, but some speakers considered that cumulative regulation played a significant part. Consideration would need to be given to the question of how to reverse these trends.

The STS initiative to revive the securitisation market on a sound basis had the potential to spur capital market financing and to support banks' capacity to lend. For this potential to be realised, however, appropriate capital charges needed to be adopted in particular for insurance investors, otherwise there would not be sufficient buyers, a speaker claimed; these prudential requirements and whether junior tranches would be recognised as good securitisation still needed to be decided and transposed into law. In addition it should be determined whether the adjusted capital charges for banks, decided under the Basel provisions, went far enough.

Regarding infrastructure investments, the Juncker plan was regarded by one panel member as a 'good start', but it did not fundamentally change the capacity of large institutional investors to invest; the project pipeline had been increased, but mainly with small projects. A positive step forward had been made by EIOPA in defining specific capital charges for infrastructure investments, but there was still the risk that corporate infrastructure might be treated in a restrictive and rigid way.

The longer term action plan of the CMU

The longer term part of the CMU action plan concerned some of the core building blocks of the financial market and covered a number of difficult topics deeply embedded in aspects of Member State law, public administrative practice, and culture. These included insolvency and securities laws, domestic withholding tax procedures and accounting standards. Supervisory convergence was another important area of focus on which ESMA was working. Four areas related to the longer term actions of the CMU were emphasised by the panellists; these were areas where action was initiated in the short term but their full impact would only be felt in the longer term.

Forthcoming EU initiative on insolvency regimes

There was general support within the panel for the ongoing initiative of the EC regarding insolvency regimes. A consultation had been launched, with the aim of tabling a legislative proposal towards the end of the year. The EC did not intend to harmonise everything, but to focus on certain key elements. Benchmarking domestic regimes could also help to make sure that such regimes would become more efficient and predictable. Significant progress was for example being made in Italy in this regard.

The objective was to facilitate the risk assessments of cross-border investors and to reduce the time currently spent rescuing viable companies and also potentially lost with the ones that could not be rescued, all of which hindered the full achievement of the Banking Union in particular. Current EU processes were on average sub-standard compared to other OECD high income countries and excessively heterogeneous. According to AFME calculations, an increase in EU GDP by somewhere between 0.3% and 0.55% of GDP could be achieved with an improved insolvency framework.

Achieving a full harmonisation of insolvency frameworks seemed difficult, but was eventually necessary, some speakers considered, in order to obtain a full integration of EU capital markets; the approach proposed by the EC would be a first step towards this.

Capital market liquidity

Liquidity was important for the CMU. A policy-maker stressed that much care had been taken by the EC to evaluate and mitigate the potential impacts on market liquidity of ongoing regulatory initiatives such as MiFID II and Basel III and of developing asset management rules; work was also being done at FSB level on this issue. A comprehensive assessment was to be undertaken by the EC notably regarding corporate bond liquidity, the results of which would be available in 2017. Some speakers however emphasised it was a given fact that liquidity was a problem in European markets and that the situation needed to be urgently addressed, as it was not going to improve with the development of HFT and the intervention of the ECB. It was also felt that the harmonisation of tick sizes imposed by MiFID II could further impact the liquidity of SME markets, reducing the incentives for market makers to operate in this market.

Some other upcoming initiatives would have a major impact on capital markets, such as MiFID. It was felt that good work had been done in ensuring that the transparency regime in particular would strike the right balance between protecting investors and not undermining liquidity.

Taxation

Consideration would also need to be given to the issue of taxation in order to pursue the goals of market integration and greater efficiency, although this was a difficult subject to broach. Withholding tax was still a major problem in Europe; investors were often double taxed, and the EC aimed to devise proposals to address this. The differing tax treatment of equity and debt, and how this influenced issuance and investment behaviours was another issue. The current debt bias should be addressed through the EC’s legislative proposal on the common consolidated corporate tax base. Creating a catalogue of best practices that had arisen in EU Member States (e.g. fiscal incentives for SME equity investment) could also help, a panellist suggested.

Post-trading infrastructure

Creating a more efficient post-trading infrastructure in Europe and reducing costs in this area was also important for achieving the CMU objectives. Much had been done over the last few years, including EMIR, the regulation on CSDs, the SFTR legislation, and TARGET2 Securities. Next year, the EC aimed to evaluate what had already been done and what more was needed. Developing an appropriate framework for the recovery and resolution of CCP was a key issue in particular.

Technological innovation and fintech solutions: an important element of the CMU

The CMU and fintech were mutually reinforcing, several panellists stated and the importance of technology should not be underestimated by policymakers. The future of finance would be data driven, online, and heavily personalised. Fintech and technologies such as the distributed ledger, had the potential to make capital markets more efficient and broader and to develop cross-border investment, eliminating constraints related to geographic location and legacy processes and systems. Innovations, such as peer to peer lending and crowdfunding could also allow for closer ties between lenders and borrowers. In addition, data analytics and artificial intelligence used for example in robo-advice could potentially improve investor service and risk management.

However, the legal and regulatory barriers and the lack of standardisation that impeded unified capital markets would also hinder fintech development, some speakers believed. Moreover, technology created new challenges. The traditional financial sector players would need to balance the benefits of these new business opportunities against the risks of being disintermediated, and against those linked with sunk costs for obsolete ICT investments. Fintech would also lead to the loss of jobs in the financial sector, foster algo trading and the related disruption risks, and increase cyber-risks.

Detailed Summary

1. The CMU, an ambitious project facing several challenges in the implementation phase

Objectives and ambition of the CMU

The Chair stated that the Capital Markets Union initiative (CMU) had been underway for some time, and the rationale for it was well known. The CMU was about making more resources available to businesses, and also about having more risk bearing capital and equity in the system; one of the issues with the EU financial system and economy was a high reliance on debt. The CMU could also help to increase the stability of the financial system with a better balance between capital markets and the banking system. The CMU also aimed at improving the competitiveness of EU capital markets and better serving retail investors with more transparency and lower costs.

The means by which the objectives of CMU would be achieved were quite well known, the Chair believed. These involved removing the barriers to information and ensuring that better information was available regarding, for example, SMEs located in other Member States. This could be done through improved ratings and financial information. The CMU was also about developing securitisation, making EU companies' access to capital markets easier through prospectus regulation, and reducing the costs for firms to issue capital without negatively impacting investor protection. Another building block of the CMU was investor protection: to have successful participation by retail consumers in the capital market, it was important that these customers should feel comfortable, and were well protected. Finally, improved supervision was also necessary.

A banking industry representative agreed that the CMU was an important initiative; it was a matter of vision and courage. Rather than just being about increasing capital in Europe, CMU was about augmenting the diversity of capital in Europe. This would reduce systemic risk, and would hopefully lower the cost of capital and increase support for jobs and growth in Europe, as well as producing new revenue streams for the financial services industry. Estimates made by the Association for Financial Markets in Europe (AFME) showed that if the market capitalisation of European equity markets was equal to 100% of European GDP, this would provide an extra €5 trillion of invested funds in the EU. The New Financial think tank had presented similar figures, but in a slightly different way; they had calculated that if, over the past five years, European countries with smaller capital markets had increased the size of their capital markets to the current European average, then there would have been an extra €6 trillion to invest. This constituted a significant prize, beyond the vision, and it was everyone's responsibility to try and achieve this.

A representative of a stock exchange considered that the CMU was positive, but priorities needed to be set; in Europe, what was most important was creating more jobs and he did not feel that sufficient emphasis had been put on this in the CMU. 'SMEs' in Europe included some quite large companies; however the smaller SMEs were the ones that created the most jobs, as was demonstrated by multiple studies. Some studies in Sweden had shown that the SMEs raising capital on the public markets were creating more jobs and growth than the other comparable companies. More risk capital therefore needed to be made available for smaller companies, and although this would not be easy, there were some things that could be done. One of the most important issues in this regard was making sure that local market ecosystems were functioning in individual European countries, and making sure that regulatory measures did not endanger them. Another key element was directing the money that was currently deposited in banks with negative or zero interest rates towards better investments. Data gathered over the last few years indicated that people were putting more money into bank accounts, and investing less and less in equity markets. The opposite needed to take place if jobs were to be created.

Moreover, the rules and the needs of investors required much more attention in the CMU for it to be successful, a public representative believed. The single market for investors, and in particular retail investors, was far from complete, and the EC should engage in ambitious actions in this respect. Gaining the trust of investors was key for achieving a good output from CMU initiatives, and trust would not be gained simply by transferring risks from financial institutions to investors, but it would be enhanced by setting up a quality regime for investor protection. Trust would also be earned through taking a holistic approach towards the CMU, which included, but was not limited to, the legislative measures currently under consideration.

A banking industry representative stated that the European Commission (EC) had set out an ambitious, but realistic, plan for the CMU. It had the potential to diversify finance, increase resilience, and transform the way in which the European economy works. There was no single measure that would act as a 'silver bullet' though; the project would take a number of years to be realised. Much of the focus was on new initiatives, and how these were progressing, but the willingness of the European Commission, Council and Parliament to re examine what had already been implemented and what was planned for the future was also important.

An official stated that no single measure in the CMU project would be decisive in measuring the success of building the CMU: the long term policy aim was not to revive individual segments of the market, but capital market financing as a whole. The CMU should therefore be considered as a single undertaking, and further steps in the pipeline would be welcome.

A policy-maker stressed that the CMU was by its very nature a long term project, dealing with deep structural reforms of the financial system which require the engagement of market players and the Member States. Structural reforms could be difficult to refine and implement at a national level, but the goal was to do so in the European Union's 28 Member States; this would inevitably take time. The goal was to foster market integration, but also to develop new sources of finance, and Member States needed to be patient, remain determined and, where possible, accelerate the process.

Challenges facing the CMU in the implementation phase

The CMU project was not simply about opportunities, but also contained significant challenges, a banking industry representative emphasised. A poll organised during the seminar by Eurofi showed that 59% of participants felt that the CMU was not quite or not at all on the right track and therefore that it was not moving as quickly as possible or going in exactly the right direction.

Three main challenges that the CMU needed to overcome were outlined by the panellists: the risk of a loss of momentum in the CMU project, the fact that the CMU action plan might not be sufficient to achieve the growth and job creation objectives associated with the CMU and the potential impacts of banking prudential regulations on the development of EU capital markets.

The risk of a loss of momentum in the CMU project

There was a significant political risk that the CMU project would lose momentum, a banking industry representative considered; there were several reasons for this. A first issue was the UK EU referendum of 23 June. Another issue was that the CMU project was difficult to explain and promote, from a political perspective. It was made up of 33 relatively small individual initiatives that would all take place over a four year time period. Given the challenges that Europe faced, this was quite a lengthy period of time. As per the comments made the previous day of the Eurofi seminar by a Central Bank Governor, the European public authorities had been 'buying time' for politicians to act. It was very important that politicians should act in support of the CMU, and maintain momentum in both short and long term initiatives.

An official agreed that increasing the momentum of the CMU was a major collective challenge; an acceleration of the project would be useful, and was warranted.

Another official stated that when major shifts such as the CMU were implemented, including new pieces of legislation, it was extremely important that there should be a strong sense of the need for convergence from the beginning. Maintaining or increasing the momentum of CMU was essential, but two facts needed to be borne in mind: the first was that this was a very complex project, and was not an easy task for the EC or for legislators to take on; many problems needed to be solved and a sufficient level of ambition was required, as well as the right tools. The second issue was to realise that this was not just a question of setting the right objectives and rules at the European level, but also of finding ways to implement them with national financing traditions, local cultures, and the ways in which people worked and ran their enterprises in different Member States, with which the CMU objectives were deeply intertwined. The EC was right to look at these implementation issues carefully and to take them into account: this was not only important for finding the right solutions, but also for gaining momentum, because these reforms needed selling to both market participants and member states.

A policy-maker commented that the EC planned to carry out a midterm review of the implementation of the action plan on CMU in 2017, which would be a good opportunity to instil a new momentum in the project and redefine priorities if needed.

The challenge of achieving the economic growth and job creation objectives associated with the CMU

An official felt that the objectives of the CMU project were such that policymakers and the financial industry could not undertake them alone; they needed to be pursued cooperatively, in a constructive spirit with all other major economic stakeholders and the Member States. Expectations about the wider implications of the CMU for the European economy should not be overplayed, unless a more comprehensive and ambitious approach was taken to reviving growth and jobs in Europe. CMU was indeed a necessary, but not sufficient, condition for enhancing credit for the real economy. The CMU could contribute to the effective channelling of savings into investment, but it was part of a wider coherent framework that included the full development of the Juncker plan and the completion of the Banking Union. Moreover further steps were needed to build a resilient framework that was effective in addressing systemic crises and progressing towards credible prospects for financial stability. Only in this wider context would a fully developed CMU further strengthen the system, facilitate diversified sources of financing – especially for SMEs – and deepen the single market.

Moreover, the single market for capital was too fragmented, and did not completely allow the effective transformation of savings into investments across the EU. Its relative underdevelopment hindered the healthy diversification of financial sources, at a time when banks were experiencing difficulties in maintaining financial support for the economy. In addition, capital markets mirrored economic developments, and as such, if recovery was weak and did not spur confidence in the future, investments would lag behind. Ultimately, CMU should be pursued in a determined manner, without expecting immediate results from all actions, given that some of them needed to be developed and implemented over time. In addition, other financial and economic conditions needed to develop in parallel if the goal of reviving financial markets and investments was to be met.

A public representative agreed that the goals associated with the CMU might not be achievable through the CMU alone. The measures currently under discussion in the CMU action plan were likely to contribute positively to diversifying the sources of financing of European businesses, but their scope was not sufficient. A holistic approach was needed, which would address also the economic conditions of businesses in Europe and in the different Member States and the actions needed to enhance investor trust and also take into account the traditional sources of financing provided by banks.

The current economic conditions prevailing in Member States needed further scrutiny, regarding whether or not they were likely to allow a revival of the business landscape. New European level financial market regulation could not solve economic shortcomings at a national level and induce a healthy and sustainable economic environment, which was part of national ownership. As such, efforts were needed that went beyond the present legislative package of CMU related measures.

In addition, further diversifying the sources of financing would only work if the overall variety of financing options was taken into account. Traditionally, most Member States in the European Union had a large share of credit financing and in the short term, market based financing could not substitute for traditional bank based financing. Any policy response aimed at enhancing the creation of CMU would need to address the banking sector as well, including measures relating to risk reduction and the expansion of lending capacity to the real economy.

An official emphasised that smaller banks and financial institutions had a particularly important role to play in relation to local SME finance. It was important to take a look at the issue of proportionality for these institutions, and also in other areas, to ensure that the burden of regulation was proportionate to what these institutions could deliver. Banking finance would continue to be the most important source of funding for SMEs and finance in Europe, and of particular importance were those elements that provided a link between capital markets and banking. It was necessary to assess in particular the overall impact that Basel regulations were having on securities and capital markets.

The potential impacts of banking prudential reforms on the development of EU capital markets

A banking industry representative stressed that the banking reforms were having an impact on the functioning of capital markets, including secondary market liquidity. It was now necessary to reflect on whether it was possible to meet prudential objectives in a way that did not interfere with the development of European capital markets and the financing of the economy. The objective was not to dispute or dismantle the regulatory reforms, which had led to better capitalised and more resilient financial institutions, but to recalibrate them in order to rectify unintended consequences, and tackle inconsistencies, so that they did not impede the development of capital markets.

The bank structural reform would also have important consequences for capital markets. There had been much focus on separation requirements, and this was a very important debate, but not enough attention had been paid to the issue of proprietary trading. The speaker did not object to the ban of speculative trading per se, but stressed that its potential impact on market making and on long term investment, whether equity or debt investment, should be taken into account.

2. Progress made with the short term actions of the CMU action plan

Progress was being made with the CMU short term actions but some of them were lagging behind

The EC had delivered what was necessary for the implementation of the first phase of the CMU project, a policy maker claimed, with a sound proposal on securitisation, a proposal regarding prospectuses and the recalibration of Solvency II capital requirements for investments into ELTIFs and infrastructure projects. This was a good start from a project perspective; it now needed to be translated into economic results on the ground.

An official agreed that since the announcement of the CMU action plan last September, the steps that had been taken were broadly positive. The first goal was to finish, and quickly deliver, the legislative proposals that were already under discussion. Progress had been achieved on three key legislative initiatives: the infrastructure asset class prudential requirements aimed at fostering investments by insurance companies under Solvency II; the general approach reached in record time on the package of legislative proposals regarding STS (simple, transparent and standardised) securitisation; and the advance in negotiations on the proposal for a prospectus regulation.

The revival of the European securitisation markets, the simplification of the prospectus regime and the creation of a separate asset class for infrastructure investments were all welcome and valid developments, a public representative concurred. But the progress that had been achieved thus far was not sufficient. The European Parliament was working on pending draft legislation regarding these topics, and anticipated success in concluding a constructive approach, potentially more quickly than expected. The Parliament also advocated an early review of the SME supporting factor in the European banking regulation in order to ensure that this instrument could continue on a solid legal basis.

The short term actions of the CMU action plan published in September 2015 demonstrated a mixed picture, an industry player believed. Two initiatives had made progress, and promised substantial benefits: these were the recalibration of Solvency II risk weights for infrastructure investments, and the private sector work on the EU private placement framework. It was hoped that some concrete actions would also arise out of the recent Call for Evidence on the EU regulatory framework; a policy paper was expected for the summer. Other important initiatives were however currently stalled, or would be subject to lengthy implementation, although they were urgently needed. This was the case of STS securitisation and the proposal for reviewing the prospectus regulation.

A banking industry representative noted some other initiatives that were in the pipeline and that could have an impact on capital markets. MiFID was hugely important for achieving the right calibration of transparency requirements, and the EC, ESMA and the European Parliament had all done good work to ensure that the transparency regime was designed and calibrated in a way that would strike the right balance between protecting investors and providing transparency without undermining liquidity.

There were mixed perceptions regarding the STS securitisation proposal

The proposal for a STS securitisation regime was well advanced, an industry representative considered; the EC had been very prompt, and the proposal contained the right elements. The securitisation package encompassed a definition of what an STS securitisation was, a lowering of the capital charges for banks, and also potentially for insurance companies that invested in those products. One question that still needed to be considered was the extent to which the proposed changes to capital charges were going to have an impact on the market. This proposal effectively reversed planned increases in capital charges, which were part of the Basel provisions, but had yet to be implemented. It would need to be determined whether this went far enough. Considering the current state of flux in the European securitisation market, it would be beneficial for this package to be finalised and implemented relatively soon.

An official considered that the STS initiative to revive the EU securitisation market on a sounder basis had the potential to encourage capital market financing and to support banks' capacity to lend. For this potential to be realised, however, a broader economic and financial framework would need to be put in place, and these measures would need to be transposed effectively into law. This was already the case for the treatment of infrastructure under Solvency II, but not for STS securitisation and further progress was urgently needed.

Another official was concerned that the state of the EU securitisation market was not improving; volumes were flat, and it was eight times smaller than the US market. There were many reasons for that, which were not only regulatory issues, but as regulation could create the right incentives, it was important that this work should be finalised. He hoped that the European Parliament would consider this issue swiftly, express any doubts, and engage in discussion. The Solvency II framework should also be quickly clarified since when dealing with the European long term investment fund (ELTIF), Solvency II had been an important factor for the creation of interest and appetite.

An industry representative emphasised that insurers were waiting for the STS regulation to be implemented, so that they would know what the next steps were. They hoped that this would be dealt with in the European Parliament sooner than next January, and that the prudential requirements for insurance investors would be fixed soon after; otherwise, a market might be created in which there would not be sufficient buyers. Insurers were not clear on how the capital charge was going to change; whether the junior tranches would be recognised as good securitisation had not yet been decided either, which was important for insurers. Third party certification could also be useful.

A banking industry representative stated that although securitisation was considered as the main short term initiative in the CMU, by the time the regulation was in place, there might not be any securitisation specialists left. Over the first quarter of 2016, securitisation issuance had been $15 billion in placed transactions in Europe: this was less than China, and China had only entered the securitisation market two years ago. Of that $15 billion only $8 billion had been RMBS, which was a securitisation based on mortgages. By comparison, the covered bond market constituted $65 billion in benchmarked transactions, and more than $100 billion of all other transactions.

This was the effect of regulation, which had been cumulative over the last five or six years, the speaker considered. There was also a decreasing number of broker dealers: four broker dealers had exited the market over the course of the last few months, and less trading was taking place. Even for the most liquid products, the inventory of broker dealers was a fraction – possibly 20% - of what it had been prior to the financial crisis. Additionally, with the decline in inventory and trading, price discovery had become increasingly difficult. This led to significant volatility when a marginal trade took place, and did not contribute to a fluid and regular market. The Dutch central bank had recently published a report that showed that, for the first time ever, the covered bonds outstanding in the NL exceeded the outstanding RMBS. This was significant because besides the UK, the NL had been the most developed securitisation market in Europe, prior to the crisis. The question, therefore, was how to reverse these trends.

From the perspective of the securitisation market, other negative trends regarding capital markets were becoming visible. The first of these was the increasing fragmentation of capital markets by product and by region. A decline in product availability was taking place, with investors taking much shorter investment horizons rather than transferring risk into capital markets. There was also a reduction of liquidity and given the evolution in the market, a reduction of transparency was taking place, despite the efforts that had been made to improve it; this reduction had partly arisen from a change in trading. They were no longer trading ABS, but loan portfolios instead and a loan portfolio transfer did not lead to any disclosure. A move was taking place from publicly distributed transactions with a large number of investors, to almost privately placed transactions, or transactions that had been pre placed with a very small number of investors.

Capital markets reacted dynamically to developments, the industry speaker stressed, and regulating them required flexibility and adaptability. The speeding-up of the securitisation regulation was a positive sign, but it had to be borne in mind that there had been a precedent of negative securitisation regulation in 2009, with the repackaged proposal under Solvency II which had been quite slow. Improved securitisation treatment would probably not come into effect until 2017, and possibly even 2018. This was a long time to wait for the market to develop. The EC and the EU Parliament should be asked to accelerate necessary changes, related to both securitisation and other CMU changes, and to build flexibility and adaptability into these regulations in order to address market developments on an ongoing basis.

Expected impact of the Juncker Plan and of the infrastructure asset class

The Juncker plan was a good start and some short term progress was possible with it, an insurance industry speaker noted, but it did not fundamentally change the capacity to invest of large institutional investors. For the time being, it had increased the pipeline of projects, but these were mainly small projects, that were not relevant for many large institutional investors. A next step was possibly finding a way to invest in equity, which had been discussed with the EIB. The European Investment Project Portal (EIPP) due to offer a range of projects for investment could also be helpful.

Regarding regulatory capital charges, a positive step forward had been made by EIOPA in defining a specific infrastructure asset class with an adjusted capital charge. The speaker was however still concerned by the treatment of corporate infrastructures where risks could arise from a restrictive definition of projects, from potentially rigid criteria and calibrations that might remain too high.

A consultation paper was issued recently by EIOPA on the identification and calibration of other infrastructure investment risk categories i.e. infrastructure corporates. It contained mainly two directions: one was an extension of the concept of SPV, which would allow some corporates that had identified cash flow to have the same capital charge as the one that had recently been adapted for the debt side. Linking to indices, which was the other aspect of the proposal, was not so easy; clear difficulties could be seen in it. EIOPA was hesitating in some cases, even where there was evidence on the debt side that it could go as low as a -50% capital charge and also data was still lacking.

3. The Longer Term Action Plan of the CMU

Further action was required in several key areas of the CMU action plan

The longer term priorities of the CMU action plan were discussed.

An industry representative stated that the longer term part of the CMU action plan concerned some of the core building blocks of the financial market and included a number of difficult topics, many of which were deeply embedded in member state law, public administrative practice, and culture. These topics included accounting standards, insolvency and securities law, and domestic withholding tax procedures. There had already been some positive developments regarding these longer term actions. The speaker was encouraged by the amount of interest that had been shown regarding the CMU by industry associations and think tanks.

A certain number of areas related to longer term actions of the CMU and where further work was needed, were emphasised by the panellists: insolvency regimes, capital market liquidity, taxation and post-trading infrastructure in particular.

A policy-maker stressed that supervisory convergence should be another area of focus; there should be more convergence of supervisory practices, and of the way in which supervisors interpreted and applied European law. The EC welcomed the steps that ESMA had taken in this regard, with the publication of a first annual supervisory convergence work programme and the creation of a supervisory convergence standing committee. The EC anticipated that ESMA would be further developing its activities in this area, and was convinced that this would deliver benefits.

An official added that in the medium to long term, there would also be a need to examine possibilities for promoting venture capital investments and loan originating funds.

Forthcoming EU initiative on insolvency regimes

There was general support among the panellists for the ongoing initiative of the EC regarding insolvency regimes.

A policy-maker stressed the importance of addressing insolvency issues. A consultation had been launched on insolvency law, with the aim of tabling a legislative proposal towards the end of the year. The EC did not intend to harmonise everything, but to harmonise some key elements of national laws in order to ensure that time was not spent rescuing companies that were not viable, and that viable companies could be rescued more quickly. Benchmarking could help, but so could some convergence of national laws towards the most efficient laws in Europe. By doing this, the EC also hoped to facilitate risk assessments and investment decisions for cross-border investors in foreign companies within the EU. The EC was determined to deliver on this towards the end of 2016.

An industry speaker mentioned that the Association for Financial Markets in Europe (AFME) had recently published a report, which suggested that improvements in insolvency frameworks could lead to an increase in EU GDP of 0.3% to 0.55%. Another interesting report regarding Europe’s untapped capital market had been published by the Centre for European Policy Studies (CEPS) that identified 36 priority barriers that needed to be overcome including insolvency rules. The recently published EC consultation paper on insolvency law was encouraging and indicated the willingness of the EC to tackle this issue. Individual Member States, Italy for example, were also engaging in initiatives in relation to insolvency laws. These would support the banking system and, if implemented, would encourage further growth.

This forthcoming EC initiative on insolvency regimes was particularly relevant, an official emphasised. A great deal of progress was indeed being made in Italy in this regard, and more would be announced in the coming weeks. Although the project would be initiated in the short term, its full impact would be felt in the long term; it could not be reasonably expected that national insolvency regimes would be harmonised overnight, or that a full harmonisation was necessary to increase the effectiveness of national insolvency frameworks. However, further convergence of national insolvency regimes was necessary for a fully integrated European financial market. Investment decisions needed to be based on a sound comparison of prospective returns, and cross border investors needed to be aware of the different rules applicable to recovery procedures. These rules could not be ‘excessively heterogeneous’ if there was to be a true single market for capital.

An official considered that differing or inappropriate insolvency proceedings were both a barrier to cross border investment flows and a banking union issue. One way to approach this was to benchmark regimes and to ensure that they were efficient, predictable and not too costly. Benchmarking would not necessarily lead to harmonisation, but would favour a comparison between different countries and help to identify improvements that could be brought to existing frameworks. The second approach was to harmonise frameworks, which was much more ambitious, but might be necessary over the long term. It was however important not to delay the first part of the agenda: harmonisation would be best, but comparison and incremental improvements were a good first step. 'The best was probably the enemy of the good' in such a case.

Another official agreed that there was a clear need to take action in relation to insolvency in Europe. The World Bank's 'Doing Business' report ranked countries from zero to 16, 16 being the highest, and the best and worst performers within the EU had ratings of 16 and 7, respectively. The EU's average was below the OECD's average for high income countries. There was therefore need for action to be taken. This was both a short and a long term issue, the speaker concurred, and one indeed where 'the best may be the enemy of the good'. The EC's initiative including a benchmarking approach had a great deal of merit, and should be used to identify key areas for focused action before building on these with elements of focused harmonisation.

Capital market liquidity

Market liquidity was also important for the development of the CMU, several speakers emphasised.

The issue of market liquidity was being taken very seriously within the EC, a policy-maker claimed. Much effort had been made to get the MiFID II calibration right for non equity transparency. Prudent proposals had been issued recently by the EC. Secondly, in the area of asset management, the EC participated in the work of the FSB, and was intending to participate in the work of IOSCO as well. The Basel III rules also were very important for market liquidity, and the EC would assess very carefully the possible impacts of the leverage ratio, the net stable funding ratio, and the fundamental review of the trading book on market activities. Finally, the EC is undertaking a comprehensive review of the functioning of corporate markets in the EU, focusing on how market liquidity could be improved, the results of which would be available in 2017.

This assessment should be an opportunity to better understand liquidity trends across asset classes, how prudential regulation had impacted the supply of liquidity and whether challenges for the asset management industry were being addressed, an official stated. The FSB was already doing some work on these topics, and further work was needed at the European level. The report on corporate bond market liquidity that the EC was planning to produce was an important element, but new policies might also be necessary.

An industry representative stated that, while further analysis of liquidity in EU capital markets would be helpful, the decrease of liquidity was a given fact and was already observed by practitioners in the market. The repo market was decreasing, and it took time to sell corporate securities in the market. In the US, the largest provider of liquidity was high frequency trading, and this was of concern to all players in the sector, because they could get out of the market very quickly. The intervention by the ECB was not going to improve liquidity and it would be quite a disaster if they started to go into the primary market.

Another element that would impact market liquidity was the forthcoming harmonisation of tick sizes that MiFID II would impose, an industry representative stressed; this was a mistake in this regard. Smaller companies were less liquid, by definition, and market makers were needed for providing liquidity for the market. With very small tick sizes, nobody wanted to make a market if they were not being paid for it appropriately. Differentiating tick size based on the volume and liquidity in a share was valuable; the speaker hoped that ESMA could look into this.

Taxation

Taxation was another important issue, a policy-maker stated, in order to achieve market integration and greater efficiency of markets, but it was a very difficult subject. The EC was looking at the issue of withholding tax, which was still a major problem in Europe: in practice, investors were often double taxed and this discouraged them from investing on a cross border basis. The EC was investigating the matter and hoped to come forward with solutions. This, however, was going to take time. Another issue was the debt tax bias, and the fact that investors were very often discouraged from investing in equity. Here, the EC intended to use the legislative proposal on the common consolidated corporate tax base, aimed at achieving a fairer and more efficient corporate tax system, in order to propose a number of solutions.

An industry representative agreed that it was important to think about the differing tax treatment of equity and debt. Consideration would need to be given to how this influenced decisions regarding acquisitions, private equity and issuance or investment decisions; this had the potential to change behaviour quite significantly. One idea could be for the EC to create a catalogue of best practices, identifying what had been done in the different Member States in this regard. In Sweden for example, an investment account had been implemented some years ago in which tax was only paid when money was taken out of the account; this also facilitated reporting. This account had been one of the reasons why more than 50 small companies had been listed in Sweden last year, but the concept was not replicated in Denmark and Finland.

Post-trading infrastructure

Creating a more efficient post trading infrastructure in Europe and reducing costs in this area was also important for achieving the objectives of the CMU, several speakers believed.

Much work had been done over the last few years in this area, a policy-maker stated, including EMIR, the central securities depositories (CSDs) regulation, the SFTR legislation, and TARGET2 Securities. Next year, the EC aimed to evaluate what the benefits of these reforms were and what remained to be done. An industry representative considered that the establishment of the European Post Trade Forum was encouraging; its objective was to assist the EC in the review of progress in removing Giovannini barriers to cross-border clearing and settlement, following the implementation of recent legislation and market infrastructure developments.

An official stressed that the recovery and resolution of CCPs was another important issue; discussions regarding this had been going on for some time at the EU and international levels, but it was important to deliver it now. The landscape was evolving, and the intellectual framework regarding how to address this issue was also progressing. The subject would be mature when the FSB completed its work, which was presumed to be by the end of this year. Some legislative proposals could then be expected to be put forward.

An industry player agreed that CCP issues needed fixing. The potential resolution of a CCP would be complex, but there were also issues regarding the access to CCPs through brokers and the conditions that were imposed.

4. Technological Innovation and Fintech Solutions: an important element of the CMU

Technology was an important element for the CMU, the Chair stated. It was changing the way capital markets were functioning, making them more international and more competitive. Some of these changes would probably not have been possible with policy measures.

An industry representative agreed that there was significant interconnection and symbiosis between fintech innovation and the CMU project. Fintech facilitated CMU, and CMU facilitated fintech. Fintech and technologies such as the distributed ledger (DLT), eliminated constraints related to geographic location and legacy processes and systems, which were some of the biggest barriers to transformation in banking institutions and the provision of services.

The objective of the CMU project – breaking down barriers in order to create larger, unified, wholesale capital markets and to improve retail services – was worthwhile. However, the legal and regulatory barriers that impeded unified capital markets would also impede fintech development. In his company, business increasingly involved built in digital technology, and they had invested heavily in building important market capabilities to access European capital markets, such as connectivity with the TARGET2 Securities settlement platform for the euro system. His bank was also investing in using new technologies to help with withholding tax calculations for securities issued by EU countries. Progress was being made, but this was not fast enough, the speaker felt.

An official concurred that fintech was an increasingly relevant phenomenon, and its importance should not be underestimated by policymakers, including in the context of CMU. It was mutually reinforcing with the CMU, and fintech innovations, such as peer to peer lending, crowd funding and distributed ledgers, had the potential to make EU capital markets more efficient and broader, allowing for closer ties between lenders and borrowers. However, traditional financial sector players would need to balance the benefits of these new business opportunities against the risks of being disintermediated, and the risks linked with sunk costs for obsolete information and communication technology (ICT) investments.

Answering a question from the Chair about whether technology could fundamentally change the financial sector, making it more integrated and competitive, an industry representative stated that the prospects were somewhat mixed. The future of finance, whether in wholesale or retail markets, was going to be data driven; it would be online, and either social or heavily personalised. This would ultimately be achieved through robotics, machine learning, and artificial intelligence and was already happening in relation to ‘robo advice’. Improvement in service and risk management could be expected. However this would also lead to job losses and enhance high frequency trading, which would continue to be quite disruptive in volatility terms. Robotics, machine learning and artificial intelligence were also all being potentially used by malicious actors, and with them came the risk of a ‘cyber 9/11’.