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The European Capital Markets Union: how viable a goal?

The European Commission's Capital Markets Union (CMU) initiative launched on February 18, 2015 with the issuance of a Green Paper entitled Building a Capital Markets Union[1] (the Green Paper) is praiseworthy, both in terms of its goals and in terms of its approach. The dominance of bank financing in Europe has long stood out in comparison to other advanced economies, in particular the United States, and an additional source of financing, especially one which can provide equity financing, which banks do not provide, would be a welcome diversification of sources of financing. The way in which the Commission is approaching the issue, by looking both to what the private sector can provide as well as what the public sector should do, and selecting a staged approach to the project, to gather momentum for it and not to have to wait to do something until everything has been done, is also praiseworthy and seems characteristic of a welcome new way of approaching European issues. The Green Paper's prose style is also a model of legibility and accessibility for the invested lay person and refreshingly free from insider jargon. It is flanked by two much denser consultations on the Prospectus Directive[2] and securitization[3].

The benefits a CMU could bring with it for the European Union (EU) include (i) the diversification of funding sources for the "real economy" away from a quasi-monoculture of bank financing, which would contribute to the resilience of the financial system, (ii) overcoming the fragmentation of the capital markets in Europe, which could contribute to a more efficient capital allocation across the EU, replacing what is now at best a capital markets federation, with many small stock exchanges and home markets for capital with a true CMU and (iii) enhancing growth and prosperity by boosting investment in and by private companies and in infrastructure, thus helping alleviate the current high levels of unemployment.

The Green Paper focuses on some specific products, in particular securitization and infrastructure finance and on providing financing alternatives to a particular segment of European issuers, small and medium sized enterprises (SMEs). These priorities have the advantage of being concrete goals by which both the advantages and the progress of the project may be measured, but equally the drawback of appearing to be pulling together a rather scattershot set of themes from current debates in European governmental

* The opinions expressed herein are the author's own

[1] European Commission, Green Paper, Building a Capital Markets Union, COM (2015) 63 FINAL, February 18, 2015.

[2] European Commission Consultation Document, Review of the Prospectus Directive, February 18, 2015.

[3] European Commission Consultation Document, An EU framework for simple, transparent and standardized securitization, February 18, 2015.

and financial circles. In particular, pairing together aid to SMEs, the poster child of what everyone agrees Europe does well in the "real economy," and the revival of securitization, the bad boy of the financial crisis of 2008/2009, makes for quite an odd couple of priorities, and several participants at the conference questioned how much systematic thinking had gone into the Commission's proposal. Of course the Commission only took office on November 1, 2014 and the CMU proposal was pushed to the fore quickly as a matter of political and economic priority, to put as much skin on the bones of an appealing slogan launched last July 15 in the European Parliament by the newly elected Commission President, Mr. Juncker and put on the desk of a new commissioner, Lord Hill of Oareford, who leads a newly revised and renamed Directorate for Financial Stability, Financial Services and Capital Markets Union, successor to the Internal Markets and Services Directorate led by former Commissioner Barnier. That they came up with as cogent a project as they did in as short a time is a tribute to all concerned.

The Green Paper offers up a set of five principles: (i) maximizing the benefits of capital markets for the economy, jobs and growth; (ii) creating a single market for capital for all 28 Member States by removing barriers to cross-border investment and fostering stronger connections with global capital markets; (iii) being founded on financial stability, with a single rule book effectively and consistently enforced; (iv) ensuring consumer and investor protection; and (v) attracting investment "from all over the world." The goals of the project are to improve access to financing for business across Europe (in particular SMEs) and investment projects such as infrastructure; increasing and diversifying sources of funding from investors in the European Union (EU) and "all over the world;" and making markets work more effectively and efficiently within Member States and cross-border across the EU. The time line proposed by the Green Paper includes a consultation phase which closes on May 13, 2015, followed by an action plan to be published by the Commission during the third quarter 2015, with the building blocks of a "well regulated and fully functioning Capital Markets Union" in the EU by 2019[4].

The consultation is meant to identify the nature of the problems currently limiting capital markets in Europe, possible solutions and their prioritization. In line with the new European Commission's overall approach, which prides itself on introducing only one-fifth as many legislative initiatives as its predecessor, there is less emphasis on legislation and more openness to market driven solutions. In line with the pragmatism expected of a Commissioner from the United Kingdom, the proposed approach is made up of individual steps in a phased approach, meant to harvest "low hanging fruit" first to build up momentum to tackle more contentious issues in a medium term and then a long term, rather than succumbing to the temptation of offering an overarching vision of what the Capital Markets Union should look like in the end.

This approach is refreshing but also has its limitations. It shows an openness to collecting the views of both providers and users of capital and a willingness to start small to achieve a larger goal. But, precisely because the outlines of the larger goal remain

[4] Green Paper, see footnote 1 above.

rather unclear, the approach runs the risk of resulting in a grab bag of initiatives chosen because they seem easier to achieve or happen to be top of mind in Brussels or London City circles rather than because they are the best steps towards a more unified capital market in Europe. Commissioner Hill stated at an appearance at Washington's Brookings Institution on February 25, 2105 that he views this as building from the bottom up versus providing a blueprint of what the project would look like if it were being built from scratch, balancing the goal against the disruption, with early measures being the pegs in the ground which will allow the project to build momentum to tackle the more difficult questions later.

The problem with this approach is that it may just as easily lose as gain momentum. There is a well observed phenomenon in the arc of reforms after a crisis, according to which the pendulum swings most strongly towards reform in the immediate aftermath of a crisis, which is when it is easiest to undertake the most difficult reforms, and then swings back the other way, making additional reforms ever more difficult. The 2008/2009 crisis provided the impetus for the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the United States (US) and the Basel III reforms at the G-20 level. Both those reforms are being increasingly called into question by segments of the financial industry and certain politicians as the financial crisis recedes into the past. Likewise the Euro crisis provided the impetus for the Banking Union in the Eurozone. The CMU is at least in part a reaction to the slower recovery from these two crises in the EU, but whether there is enough impetus left from either of these crises to fuel serious reforms in the capital markets in Europe and whether that impetus will wax or wane over the life of the project is yet to be seen. It is to be feared that in the absence of either a big idea to ignite enthusiasm for the project or a deepening of the current stagnation into another crisis, the impetus is likely to wane, in particular in view of what could be termed a rather relaxed timetable with building blocks (not completion) in place only by 2019. Of course, the year 2019 was presumably chosen as a practical "drop dead" date for legislation, since that is when the current legislative term of the European Parliament ends and any legislation not adopted by them would face an uncertain future with a new Parliament and Commission.

The issue of momentum is an important one given that it is likely to affect central elements of the project. One example of this is enunciated in the third principle of the Green Paper, "a single rulebook for financial services which is effectively <u>and consistently</u> enforced"[5] (emphasis added). This raises the question of how to deal with the discretion that the 28 Member State securities regulators have in interpreting the rules of the "single rule book" that the European Securities Markets Authority (ESMA) writes. Anyone who has ever participated in a cross-border initial public offering (IPO) in the EU knows how different these interpretations can be. As Nicolas Véron and Gutram Wolff note in their excellent piece on the CMU, "[o]verwhelming evidence from market participants suggests that the current regime of national implementation and enforcement of even the most harmonized EU regulations results in diverging practices and market

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[5] Green Paper, p.5.

fragmentation."[6] The problem is very well put in a speech they cite by Steven Maijoor, Chair of ESMA in which he said that the breadth and complexity of the single rule book gives regulators the latitude to make so many choices, including interpretation of the rules and intensity of supervision that "diversity in these choices will have the result that the single rule book will not in fact be seen as such by investors and market participants."[7] We will return below to how difficult solving this problem may be from an institutional point of view and it is not clear that putting off its resolution will make it easier to deal with in the future. The staged approach may simply result in kicking the bigger cans down the road, an exercise in which many commentators think Europe has few peers, with the exception of course of the United States.

In his February 25 remarks at Brookings, Lord Hill said the project was an ambitious one, but the Green Paper leaves open how ambitious it will be and one public sector participant in the conference queried whether the consensus we were achieving in favor of the project might not be due precisely to the uncertainty over how ambitious it would be. A more systematic approach towards CMU, as suggested by Cyrus Ardalan, Vice Chairman of Barclays Bank, would involve an attempt to match up fundamental drivers for the three main constituencies in the capital markets, issuers, investors and intermediaries with the key reforms required to facilitate those drivers to create an effective ecosystem in which products will develop. I would add that for each driver it will be important to distinguish "nice to have" elements from essential elements. For more detail, I refer the reader to the accompanying article by Cyrus Ardalan in this volume.

It is quite clear that the contrast between the US and the EU in terms of the percentage of financing provided by the capital markets and the banking sector, coupled with the slower recovery of the EU from the crisis of 2008/2009 and the natural limitations on banks expanding the provision of credit in the aftermath of a balance sheet crisis, exacerbated in this instance by changes in capital requirements for banks in reaction to the last crisis, have naturally turned minds to thinking that Europe could profit from expanding the proportion of financing channeled through the capital markets rather than through banks.

It is generally – albeit not universally – accepted that in a balance sheet recession not only does the private sector focus on paying down debt and is thus reluctant to borrow and spend, causing sustained weakness in aggregate demand and lower growth, but that the banking sector is also less willing to lend because it needs to improve its balance sheet and increase its reserves. Thus, the natural tendency of the private sector to retrench is reinforced by the difficulty the banking sector has in providing funding. A bank which is deleveraging in a recession is generally doing so not by raising new equity

[6] Nicolas Véron and Gutram B. Wolff, Capital Markets Union: A Vision for the Long Term, Bruegel Policy Contribution, Issue 2015/05, April 2015, p.11

[7] Steven Maijoor, "Regulations, pension funds and efficient financial markets," Speech at the National Association of Pension Funds Investment Conference in Edinburgh, March 2015.

capital in the market, but by shedding assets in various ways, including by not rolling over existing loans or extending new ones. Shedding assets also maintains downward pressure on asset prices which can exacerbate bank losses, making them even more reluctant to lend, regardless of whether there are borrowers willing to take on new debt. While the extent of this reluctance appears to depend on the strength of the balance sheet of the banks involved and the degree to which they rely on wholesale funding, with banks which have the weakest balance sheets and are most reliant on wholesale funding most being severely affected, there is ample evidence that the banking sector is a pro-cyclical element in a balance sheet recession, as bankers' ability to borrow from each other and to replenish their capital from the market is reduced. Over time, as bank balance sheets recover, this effect will diminish, which could also have the effect of slowing the momentum for the more difficult reforms required by CMU.

For the moment, however, the effect is present and the reforms in the capital adequacy rules for banks under the Basel III regime have contributed to reinforcing this element. Banks not only have to hold more capital, with many elements which previously counted as capital being phased out, but will also need to maintain a leverage ratio based on total balance sheet assets, not just measured by risk weighted assets, so that the bar for bank capital is being raised at a time when sources to replenish it, whether from the market or from retained earnings are not plentiful.

There is on the other hand academic research which supports the idea that in the aftermath of a balance sheet recession capital markets will be in a position to provide more financing more rapidly than a banking sector which needs to deleverage, and also that there is an argument from financial stability in favor of diversifying away from a monoculture of bank financing towards a more balanced approach to financing the "real economy". As one of the participants in the conference, Andreas Dombret, member of the Executive Board of the Deutsche Bundesbank noted in his remarks, this has nothing to do with deciding which of bank or capital markets financing is superior to the other, and everything to do with diversification of funding sources. Professor Dombret suggested that capital markets based financing may increase pro-cyclicality, but I think that the 2008/2009 crisis provides evidence that banks which themselves rely in part on capital markets financing are just as likely to be pro-cyclical in their lending. When the value of assets increases banks can both lend more against the rising value of borrowers' collateral and themselves borrow more against their own assets in the repurchase agreement market. A corporate treasurer who relied on a single source of credit would be viewed as at best naive and at worst negligent in her duties. Surely the same should apply to countries and regions.

Professor Dombret also cites empirical studies for the United States showing that integrated capital markets cushion around 40% of the cyclical fluctuations among the US federal states, with an additional 25% being smoothed by the credit markets, leaving 10-20% to be cushioned by fiscal policy, and only 20% to be absorbed by consumption, thus leading to less volatility in consumption, the engine of economic activity. Currently in Europe it is the credit markets which absorb the shock so that 60% of the effect must be absorbed by consumption, leading to significantly greater volatility. The recent Bank of England study on the CMU published in February 2015[8], puts it this way: a 10% fall in income in EU countries can depress household consumption by up to 0.6%, versus 0.2% in the US and Canada. As one of the public sector participants at the conference put it, capital markets, especially equity capital markets, allow cross-border risk sharing in a way that cross-border lending cannot.

There are also important political considerations which speak in favor of the project. It allows the EU to develop "a project for 28", i.e. one involving all the European Union Member States. Coming after the Banking Union which only involved 18 and then 19 Member States, this can be a way to keep the EU's financial center, London, in the game at a time when the status of the UK as a member of the EU is again being put in question. It also holds out the promise of being able to do something to boost growth in Europe at a time where the European Union, as a result of the policies applied in Greece, Ireland, Portugal and Spain as a condition of EU support in their debt crises, has increasingly become associated with austerity and sacrifice, rather than peace and prosperity, thus resulting in alarmingly low levels of support for the European Union even in countries that were among the initial signatories of the Treaty of Rome. Doing this in a way which promises to increase access by the poster boys of the EU's real economy, the SMEs, to more diverse sources of financing is an additional bonus. Europeans are reflexively pro-SMEs. SMEs are not corporate giants, which can be hard to love, but family owned enterprises. There are 21.6 million of them and they employ 88 million people, representing 58% of Europe's value added and 67% of Europe's employment. According to ECB data quoted in the AFME/BCG study discussed more fully below[9], loans to non-financials in the Eurozone and the UK have fallen by 11% over the course of 2013. If one focuses on loans to the non-financial sector of less than €1 million, which can be used as a proxy for lending to SMEs, those loans fell by 4% according to this study, with the fall being greatest in the countries most affected by the crisis. However, as discussed more fully below, it is not entirely clear that any shortfall in SME financing is due to supply side rather than demand side issues, so that, as Douglas Elliott of Brookings has observed, promoting the CMU as an aid program for SMEs may backfire if, for cultural or practical reasons, SMEs turn out to be uninterested in capital market access.

However, at a time when EU banks are suffering from narrowed margins due to low interest rates and tightened capital adequacy rules, offering them an alternative source of revenue through fee-based capital market activities which are less capital intensive than their traditional lending business, should be welcomed by the industry

[8] Niki Anderson, Martin Brooke, Michael Hume and Miriam Kűrtősiová, Bank of England Financial Stability Paper No. 33, A European Capital Markets Union: implications for growth and stability, February 2015.

[9] Association for Financial Markets in Europe and the Boston Consulting Group, Bridging the growth gap, Investor Views on European and US capital markets and how they drive investment and economic growth, February 2015.

itself. A revival of securitization should allow banks to reduce their balance sheets while increasing their lending capacity in proportion to the loans they can securitize. Of course, these last two initiatives will also profit the so-called shadow banking sector, a group even less popular that the regulated banks. At some point, the political implications of this issue will no doubt have to be faced up to. But in the meantime one could also say there is a political dimension in the project for the financial sector as well. It has been the subject of much criticism since 2008 for its role in the financial crisis and the recession which followed. It is now being offered an opportunity to show what it can do for the common good to help promote growth and investment in the real economy. This is not an opportunity it should let slip away, but one it should rather grasp with enthusiasm.

In responding to the consultation, however, I would hope the industry would be careful that its response not be seen primarily as a wish list for the rollback of regulatory reforms and political initiatives undertaken since the financial crisis. It is clear that some reforms seem to go in a direction incompatible with the goals of a CMU. For instance, the proposed financial transactions tax (FTT) proposed by the Commission in September 2011 to apply to transactions in shares, bonds and derivative products among financial institutions seems incompatible with the goal of boosting liquidity and reducing volatility in capital markets. Less liquidity and more volatility may also result from the new leverage ratio introduced under the Basel III rules, since the ratio is expected to reduce the inventory of securities financial institutions can afford to hold.

Lord Hill has been quoted as saying that “now is a sensible time to take stock of the overall impact of regulation, in particular the legislation of the last five years, and look at it through the prism of jobs and growth …To make sure that we have got the balance right between reducing risk and fostering growth.” This is clearly music to the ears of the industry, but I would hope its response will be carefully calibrated with reference to both political and economic realities. There is, for example, evidence that regulators and supervisors are concerned about the impact of the leverage ratio and would be open to reasoned evidence that its effect might be counterproductive. A systemic argument can also be made that this measure repeats the mistake of pre-crisis regulation in that it focusses on the health of individual institutions while ignoring its macro-economic effects on the stability of the markets in which the institutions operate. I see no similar evidence of official concern on the FTT front.

At this point it is worth noting that the Green Paper assumes that the CMU agenda will promote investment in infrastructure and by SMEs, which will in turn promote a return to growth. There is however a line of thinking to the effect that the pre-crisis levels of growth people have in mind, especially when they analyse the current recovery, may simply not be sustainable and thus that there is no “investment gap” to be closed by measures such as the CMU. One need not adhere to the overall theory of secular stagnation put forward by Larry Summers to be concerned by the sharp demographic slowdown in Europe, coupled with lower total factor productivity growth. Daniel Gros examines these factors in CEPS Policy Brief No. 236[10] and comes to the conclusion that current demographic trends in Europe imply a significantly lower growth rate, which in turn implies that a lower (equilibrium) investment-to-GDP ratio will be needed to keep the capital/output ratio in Europe constant. Thus, seeking to boost the investment rate in the short term may succeed mostly in pulling forward investments which might have been made anyway and not really contribute to growth. Alternatively, it could result in reducing the rate of return on investment which would tend to contribute to moving investment out of Europe. In other words, there could be elements of pushing on a string in trying to increase investment. It is my personal impression that businesses, including SMEs, are not investing mainly because they do not see increased demand for their goods and services sufficient to justify the cost of the investment. The conclusion Daniel Gros reaches is that increasing consumption must come first, as it has in the recoveries in the US and the United Kingdom. Unfortunately there is little evidence of a consensus to do this in the EU.

Because SMEs are largely privately held, we have only anecdotal information on why they do what they do. We have better information about publicly held companies whose public reporting shows many of them sitting on large amounts of cash and using more of that cash to repurchase their own stock, pay dividends or acquire existing productive capacity from other companies rather than to make new investments to expand their own productive facilities. This would tend to reinforce the view that industry in general does not see a lot of productive investment opportunities in the current economic climate, regardless of whether or not funds are available for this purpose.

To come back down to earth from the macroeconomic sphere, a second issue raised by the CMU project is where will the investors for the expanded capital markets come from? As the excellent Bank of England Financial Stability Paper No. 35 of February 2015 on the CMU cited above[11] points out, banks provide the lion's share of financing in Europe because that's where the European savings are, not in mutual funds, pension funds, asset management companies, venture capital funds, the equity markets and bonds. One of the participants at the conference suggested that half of European savings are held in the form of bank deposits. The Commission Staff Working Document accompanying the Green Paper notes that 96% of EU households have deposits with a bank, but only 5% have direct investments in bonds and 10% in shares, while 11% own shares of a mutual fund and 33% are invested in a pension plan or life insurance. Looking at asset allocation, the Staff sees currency and deposits representing 33% of households' financial assets. In contrast, US households hold only 13% of their financial assets in bank deposits, compared to 31% in equity[12]. What will push these savings

[10] Daniel Gros, CEPS Policy Brief No. 326, Investment as the key to recovery in the euro area? 18 November 2014.

[11] See footnote 3 above.

[12] Commission Staff Working Document, Initial reflections on the obstacles to the development of deep and integrated EU capital markets, accompanying the document Green Paper Building a Capital Markets Union, February 18, 2015, p.28-29.

towards the capital markets? Perhaps zero and negative interest rates will help. But so long as most European pensions are either provided by the state or simply by line items on corporate balance sheets rather than by segregated funds to be invested independently as in the US, it is hard to see where the European money is to come from.

There was a lively debate at the conference on whether it was too late for this European pattern to change. One academic panelist challenged the status quo by pointing out that if European corporates came to the same conclusion US corporates had come to, which is that payments into a defined contribution plan could be considerably cheaper for them than an ongoing commitment to provide a defined benefit to retirees, this pattern could change in Europe as well. With pension and retirement obligations being discounted at record low interest rates, these are sure to be growing at an alarming rate, so that a shift to defined contribution payments should be making more and more sense to corporations. Dirk Schoenmaker's contribution to this volume sets out this argument in more detail. It is also possible that in countries which realize that public pensions may not be sufficient to allow a comfortable retirement, the development of privately funded supplemental retirement funds, such as the "Riester Pension" in Germany, may provide additional private sector funds to be invested in capital markets products. But as matters stand, the estimates the Bank of England arrives at in Financial Stability Paper No. 33 are that currently the sources for capital market investments in Europe range from between 20 to 50% of the amounts available in the United States, broken down by categories of investors. The only exception appears to be the insurance sector, which looks to be 50% larger in Europe, but which is about to become subject to new investment rules under the Solvency II regime for capital adequacy which may significantly restrict its ability to invest freely, as noted in a January 2015 IMF Staff Discussion Note on securitization[13] to which I will return below.

But even if the funds to be invested in the capital markets were equal as a percentage of GDP on both sides of the Atlantic, the impediments in Europe, which both the Green Paper and the Bank of England paper point out would remain. These revolve around market fragmentation, due in part to a "home bias" on the part of investors, especially individual investors, fed by large information asymmetries, including the continuing difficulty in obtaining information about cross-border investment opportunities within Europe, which result in a lack of market depth and liquidity, two key components for attracting outside investment, not only from "all over the world" but also from other Member States. Small scale opportunities will not attract investors, especially institutional investors, in large numbers, especially if the cost of acquiring information is high and the difficulties in exiting an investment are also high. The Bank of England CMU paper cites a 2007 study by BME Consulting according to which 36% of EU investors polled did not even know they could invest in another EU country. Views gathered by the European Union Committee of the UK House of Lords indicated that

[13] Miguel Segoviano, Bradley Jones, Peter Lindner and Johannes Blankenheim, IMF Staff Discussion Paper, Securitization: The Road Ahead, January 2015.

some 94% of European citizens shied away from buying a foreign financial product[14]. There is also considerable fragmentation in terms of infrastructure. Véron and Wolff note that whereas there are only three stock exchanges in the US there are either 13 or 15 in the European Union, depending on whose statistics you use.[15]

The Bank of England Paper also considers cultural factors which might result in European SMEs' relative lack of resort to the capital markets as compared to their US counterparts. It notes that in Europe SMEs are largely family owned enterprises which are carrying on an inter-generational project rather than companies founded by an individual with a view to cashing out in an initial public offering. They are consequently publicity shy and disinclined to provide public disclosure about themselves. These observations ring true to my ears. One need only think of how large the family owned Italian clothing and fashion houses became before finally consenting to open their capital to outsiders. I think it is quite possible that even with enhanced access to capital markets, the bulk of SMEs will decline to take advantage of the opportunity to allow other investors into their equity. There is also the question of how much appetite new capital markets investors will have for equity investments, especially illiquid ones in SMEs. A recent report in the German press noted that Germans spend more per year on bananas than on purchases of shares of stock.[16] It has long been known that Germany, a country of risk adverse people, lacks an "equity culture," but even in the US, generally thought of as the home of equity investing, recent studies show that 78% among the younger generation of the Millennials, are not inclined to invest in stock[17]. Will EU investors be less averse to equities than US Millennials? The historical evidence tends to point to a greater risk aversion among European investors in general, as evidenced by data cited by Véron and Wolff on the maturity of investments, which shows a greater preference for shorter term maturity investments in Europe.[18] This would negate one of the main advantages of capital markets over bank lending, which is the ability to provide loss-absorbing equity capital. I suspect that many of the calculations of the financial stability advantages of the capital markets cited by Professor Dombret and the Bank of England paper depend on this effect. Capital from the capital markets is more shock absorbent than bank debt if it takes the form of equity. If it takes the form of bonds you will end up with the same need for painful restructuring as with bank loans, although if it is held outside the country of the issuer it will have a risk sharing effect across the Union. It is also important to understand, as the excellent Commission Staff Working Document

[14] House of Lords, European Union Committee 11th Report of Session 2014-15, Capital Markets Union: a welcome start, 20 March 2015, p.13.

[15] See footnote 6 above, p.9.

[16] Cash.ONLiNE, Der deutshe Haushalt gibt mehr Geld für Bananen als für Aktien aus, Leider. April 23, 2015

[17] Srividya Kalyanaraman, Millennials are saving but their fear of stocks could hurt them, investmentnews.com, April 21, 2015.

[18] See footnote 6 above, p.6.

accompanying the Green Paper notes, that investor home bias is greatest in EU equity markets, thus limiting the extent to which potential losses can be shared across borders.[19] Véron and Wolff cite a figure of 64% of EU equity holdings being of domestic origins[20] and it recently made headlines in Germany than over 50% of the shares of the companies in the Dax index were held by non-Germans. This is one of the dangers I noted above in identifying the success of the CMU with the number of SMEs which take advantage of the capital markets.

I think that a much stronger argument can be made in favor of SME receptivity to properly structured private placements of their debt, based on my experience over the years with their willingness to cross the Atlantic to access the US private placement market, a topic to which I will return below. The Bank of England Financial Stability Paper also endorses this possibility and there are estimates that up to 35% of the US private placement market is made up of European issuers. However, there is a certain softness to the data on whether SMEs have a funding gap. An analysis cited in the February 2015 AFME/BCG report entitled Bridging the growth gap cited above[21], is to the effect that more money is available to European SMEs than to US SMEs, with the outstanding stock of SME finance in the US standing at €1.2 trillion versus €2.0 trillion in Europe and gross financing at €571 billion in the US compared to €926 billion in Europe. While the SME sector is larger in Europe than in the US, providing far more employment (67% versus 49%) and more of the value added (58% versus 46%) according to the report, so that one would expect them to receive more financing, this suggests that a more differentiated view of the financing needs of SMEs may be necessary.

One of the conference participants, Anshu Jain, Co-Chief Executive Officer of Deutsche Bank, cited statistics according to which lending in the EU periphery remains 29% below its pre-crisis peak, while it has fully recovered in the core and that 17% of Spanish SMEs and 14% of Italian SMEs cite access to finance as their most pressing problem as compared with only 9% of German SMEs. Perhaps more importantly, loans below €1 million, those most likely to be made to SMEs, carry an average interest rate of 3%, almost double the 1.63% for loans above €1 million, with interest rate “spreads” between European large caps and SMEs having widened by 47% since 2008. For further details, please refer to Anshu Jain’s contribution to this volume. The Commission Staff Working Document contains similar data on loan spreads.[22] So there does seem to be regional need for SME financing which could benefit from a more uniform access to capital. Some differences will of course remain. With liquidity being dependent on the size of bond issues, an interest rate differential between SMEs and large caps is to be expected.

[19] See footnote 10 above, p.13.

[20] See footnote 6 above, p.4.

[21] See footnote 3 above, p.27.

[22] See footnote 10 above, p.24

With respect to securitization, the Bank of England rightly notes that the size of the US market is influenced - distorted might not be too strong a word - by the presence of the so-called Government Sponsored Enterprises (GSEs), known as Fannie Mae and Freddie Mac, which are now also government controlled since September 2008. They still repackage over 70% of US mortgages, providing a large, liquid and uniform market for securitization products in comparison with the much more fragmented European markets. To that I would add that the US also has the student loan market as a source of homogeneous securitizable loans due to the exorbitant cost of higher education in the US as well as a larger auto loan market, so that the sources for underlying assets available for securitization are correspondingly larger. In contrast, the European market for securitization has historically been reduced by the preference to date of many banks to issue so-called "covered bonds" based on the German Pfandbrief model, under which the loans stay on the originating bank's balance sheet. Covered bonds have three significant advantages for the issuing bank. These bonds can be used as collateral for central bank lending, they get better capital treatment and a percentage of them can count towards the new liquidity requirement under Basel III. So they have been syphoning off much of the raw material for securitization in Europe and, all things being equal, may continue to keep the securitization market smaller than in the US. However, another new feature of Basel III, the leverage ratio, may change that equilibrium. The assets in the "cover" for the covered bonds will in turn have to be covered by a minimum amount of capital, regardless of their risk weighting. This will almost certainly make further issuances of covered bonds more expensive for the issuing bank as keeping a mortgage portfolio on a bank's balance sheet will be more expensive. Although the existing cover for already issued bonds will remain trapped on the issuers' balance sheets, this should free up future assets for securitization. The impact on this trend of purchases by the European Central Bank of covered bonds as part of tis quantitative easing program is for the moment uncertain.

Nonetheless, as the January 2015 IMF Staff Discussion Note on securitization cited above[23] points out, investors incurred large losses on securitized structures in 2007/2008 and while advocates of European securitization may be right that the track record of European securitizations was far better than that of US securitizations in terms of defaults and investor losses, investors do not necessarily make these distinctions and it may take a while for investors to return. The gap between the size of the securitization markets on the two sides of the Atlantic is also enormous, with outstanding representing 59% of GDP in the US versus 11% in Europe. The Note also observes that for insurers in the EU it may be cheaper in terms of capital to hold whole loans than securitizations of those loans. Finally, the Commission's consultation paper concedes that to get this market going will likely require a revision down of the capital cost of holding such securities[24].

[23] See footnote 6 above.

[24] See footnote 3 above.

Beyond these considerations, as noted by another speaker at the conference, there are still an estimated €300 billion in European savings exported annually which might be available for investment in Europe if we could figure out whether their export is due to a lack of opportunities in Europe or problems with the plumbing of the European capital markets. Of course some of this amount is cyclical rather than structural, so would need to be adjusted, but it is a significant amount.

There is also the question of how the project proposes to attract investors "from all over the world" and with what kind of products? If the investors to be attracted are large institutions, their requirements as to type of instrument and size and liquidity of markets, given their own size and scope, may well be very different from the requirements and preferences of domestic European investors. There is no patent recipe for this. The representatives of the funds industry at the conference suggested a number of sensible measures mostly centering around the indisputable need for greater transparency. However, while agreeing that they would improve the market, I fear they will prove both expensive and difficult to implement. The Green Paper also notes a number of these, including, for SMEs, the absence of consistent accounting standards across Europe.

There is, of course, already a consistent set of accounting standards for publicly traded companies in Europe, in the form of International Financial Reporting Standards (IFRS). The problem is that the conversion from local accounting standards, for example the Handelsgesetzbuch (HGB) in Germany, under which local companies are required to prepare their individual (i.e. unconsolidated) financial statements for corporate law and tax purposes, to IFRS can be expensive and complex, as all of us who have been involved in IPOs in Europe, where IFRS statements are required, are aware. The Green Paper suggests the possibility of a simplified version of IFRS for SMEs, especially for those seeking access to certain trading venues and, presumably also for private placements. I think that a sort of "junior IFRS" for SMEs would be counter-productive. It would involve the cost of preparing a second set of financial statements, but these financials would not be acceptable for use if the SME ever wanted to take the next step and go public on a regular stock exchange, thus requiring a second conversion. The Commission Staff Working Document notes that the IASB has already developed a simplified form of IFRS financial statements for SMEs, but does not allow them to be used for listings.[25] Based on my experience with the adoption of IFRS by German companies, I would also expect a prolonged period of uncertainty and experimentation as to the content, meaning and reliability of these "junior IFRS" financials, thus reducing their usefulness to both issuers and investors.

The reflex to seek for simplification and exceptions from accounting rules is certainly a natural one. It was also part of the program which the US Congress put together in the so-called JOBS Act (the Jumpstart our Business Startups Act of 2012) but which has turned out not to be used by the intended beneficiaries, the so-called Emerging

[25] See footnote 10 above, p.26

Growth Companies (EGCs). In fact, in a list of seven potential advantages the JOBS Act provides ECGs compiled by Ernst & Young,[26] reduced financial statement requirements came in second to last among investors. The two main advantages offered by the JOBS Act according to this list were the ability to publish only two rather than three years of audited financial statements and deferred effective dates for new accounting standards. However, one year after adoption of the Act, 2/3 of the EGCs were not taking advantage of the ability to show only two years and 79% were not taking advantage of the deferred adoption of new accounting standards according to the Ernst & Young report. The failure to use slower adoption of new accounting standards may well be due to the way the Securities and Exchange Commission (SEC) implemented the rule and the three versus two years relief is a different issue from simplified financial statements, but the US experience shows that well intentioned tinkering with financial statements may not bring the expected benefits.

That said, I understand that the issue across Europe is far from trivial, both from the view of international comparability of financial statements and because of the sometimes very different principles on which "local GAAP" is based. For example, HGB statements were designed primarily for use by and protection of creditors, while IFRS attempts to reconcile the greater pro-shareholder orientation of US GAAP with a more simplified or principled approach to presentation where things such as "hidden reserves" allowed by HGB would be disclosed. However, European private issuers generally use their domestic financial statements when accessing the US private placement market and the lawyers and investors involved become familiar enough with those statements and how financial covenants work under them to do those deals, so it may be that uniform financial standards turns out to be one of those "nice to have" elements which are not "must haves".

I also tend to question how essential requirements for uniform tax treatment, corporate governance and insolvency law, which both the Green Paper and several participants at the conference have proposed could be necessary or useful for the CMU to succeed, actually are. I have no doubt as to the usefulness of these items as ways to simplify and enhance access by European issuers to the capital markets. However, there can be an element of "wish list" building in these arguments which reminds me of the two Giovannini reports on Cross-border Clearing and Settlement Arrangements in the European Union from November 2001 and April 2003, which ended up dealing with far more than just clearing and settlement. Among the barriers to clearing and settlement the reports identified, Barrier 3, for example, dealt with differences in corporate law, Barriers 11 and 12 dealt with taxation, Barrier 13 with laws of property ownership and Barrier 15 with conflicts of law.[27] If adopted, they would clearly make clearing and settlement much earlier. In the same way, all the foregoing suggestions would simplify expansion of capital markets in the European Union, but need to be examined in the context of

[26] Ernst & Young, The JOBS Act: One-year anniversary, April 2013.

[27] The Giovannini Group, Second Report on EU Clearing and Settlement Arrangements, April 2013, pp.9-13.

various parts of that market and of the overall project, including market access for SMEs, securitization and private placements.

One point repeatedly made is the impediment which the "tax bias" in favour of debt over equity presents, since interest paid on debt by a corporation is tax deductible whereas dividends must be paid out of after tax earnings. While I think that this is undoubtedly true, it is just as true in the US and despite this bias on both sides of the Atlantic, one side has significantly broader and deeper capital markets. So I do not think tax bias is the key to this difference. Besides which, since under EU rules changes in EU taxation measures require unanimity of all 28 Member States, insisting that this must change could be seen as tantamount to finding the greatest conceivable obstacle and declaring it to be essential to the project. Actually, as Véron and Wolff point out, the experience of the FTT shows there is another route to tax changes within the EU, based on the enhanced cooperation procedure, which allows member states to agree among themselves and only for themselves on an approach to taxation.[28] While the FTT may be a poor example to use, given that it appears seriously at odds with the CMU, it does suggest that a basis for change could be found which does not require unanimity and thus avoids a veto by one or a few Member States. If it can be applied to throw sand in the gears of securities transactions, it could also be applied to change the tax bias towards debt, if there was the political will to do so.

With respect to the argument that absent uniform - and presumably high - corporate governance standards no one will invest, I suggest that the rush to invest in Alibaba tends to prove the contrary, as does the experience of US internet and print media companies which have two classes of stock, super voting for insiders and low voting for investors. In addition, the sometimes significant differences in state corporation law among the 50 states of the US have been taken in stride by investors. Investors are often ready to make accommodations if presented with an appealing investment case. Thus, I consider differences in corporate governance as an obstacle to be overcome, but not a "must have." I understand entirely that with respect to insolvency law differences in judicial procedure under which an insolvency proceeding may take nine months in Finland and six years in Italy is a concern. But I would suggest that it is mostly a concern in a securitization context where investors are trying to calculate not only chance of default but also loss upon default over a diverse portfolio, where loss depends crucially upon an ability to estimate how long it will take to recover a portion of one's investment. Chart 7 on p.19 of the Staff Working Document accompanying the Green Paper, taken from the World Bank Doing Business report 2014 shows how closely recoveries in insolvency correlate with the length of the insolvency proceedings in various European jurisdictions[29]. The Staff Working Document goes on to state that harmonization of procedures is only a first step and that "as long as insolvency law remains national in character" investors will have difficulty assessing the risks of cross-

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[28] See footnote 6 above, p.13.

[29] See footnote 10 above, p.20.

border investments and will be reluctant to make them[30]. Putting the bar at a European level insolvency law seems a very high hurdle indeed. So, yes, insolvency procedure can be an important concern for securitization, but as I do not believe that SME debt is likely to be securitizable, as it is far too heterogeneous, I think this issue is far less important for SME access to capital markets. I know there has been talk of securitizing SME debt, and in fact commission consultation paper on securitization cited above mentions the existence of ongoing projects to securitize SME debt in the European Investment Bank and the European Investment Fund[31]but when pushed, most experts, even on the Commission staff, acknowledge that simplified securitization would most likely apply to other bank assets. This would, as noted by Charles Roxburgh, Director General, Financial Services, HM Treasury in his statement to the House of Lords Committee, whose report is cited above, free up room on bank balance sheets for more SME lending. I think this route is more likely to be followed rather than trying to securitize SME loans themselves to any great extent. This conviction is reinforced by the data cited by Véron and Wolff concerning SME securitizations. There appears to have been virtually none which were sold to the public since 2007-8. Instead those which have occurred since, apparently principally in Italy and Spain, have been retained on the balance sheets of the issuers and used for collateral for borrowing from central banks.[32] That is to say that the originator of the loans, which knows the credit quality of the issuers retained them.

In contrast, what I do not think can be put only in the category of merely “nice to have” is, as noted earlier, a single rule book, uniformly applied, and there lies a serious problem. There is in theory an entity which is charged with setting uniform standards for the European capital markets, ESMA, but it does not have the right to overrule decisions interpreting and applying these standards by the 28 Member State securities authorities. It employs fewer than 200 people, as compared to 3,500 at the SEC or 2,500 at the UK’s Financial Conduct Authority. In fact it has fewer employees that the Finnish Financial Supervisory Authority. ESMA’s board of supervisors is made up of representatives of these authorities who hold all the votes on the board (neither the chair nor the managing director of ESMA have a vote) and half of its budget is funded by these authorities. There is an ongoing review of the European Supervisory Authorities (ESAs), including ESMA, by the Commission, but it does not exhibit any appetite to attack sensitive issues such a further centralization of authority in securities regulation. And the otherwise excellent Staff Working Document accompanying the Green Paper also tiptoes around the issue.[33]

Seen from the outside, one can conceive of two equally unpalatable solutions to this problem. The first is to turn ESMA into a European SEC or found a parallel organization to exercise direct rule making and enforcement authority towards capital

[30] See footnote 10 above, p.20.

[31] See footnote 3 above.

[32] See footnote 6 above, p.7.

[33] See footnote 10 above, p.15.

markets participants. This is in essence where the Banking Union ended up, with the European Central Bank in a position to overrule national competent authorities. Following this route in the capital markets would almost certainly guarantee alienating the 28 national authorities whose cooperation will be crucial to the success of the CMU project and the number of staff which would have to be hired to accomplish this goal would require years to assemble. The second is to make ESMA write its rules with such a level of detail that the national authorities would have little scope to interpret them differently. This would go against the way regulation has been traditionally written in the European Union, focusing on broad principles rather than crafting detailed rules. I have often compared this to writing a constitution rather than a cook book. Even if the ESMA staff were tempted to write very detailed rules, it would need far more staff than it currently has to do so and this initiative could easily be blocked at the source by the national authorities who sit on ESMA's supervisory board. While it is possible that the competent national authorities will let their powers be diminished willingly, we have an expression for the probability of such events in the US, it is like expecting turkeys to vote for Thanksgiving. The statements by Charles Roxburgh and the Bank of England to the House of Lords Committee cited above make clear that the UK is squarely against the first solution[34] and private conversations with representatives of the Bank of England convince me they are no more enthusiastic for the second.

There are however subtler and far more European proposals being put forward by others more versed in the intricacies of EU law and practice than I which may offer a way out of this problem. Véron and Wolff, for example suggest several bases on which ESMA's powers could be expanded.[35] While some of them strike me as overly optimistic, the idea of granting ESMA "authority to approve new securities issuances and to authorize funds under legislation such UCITS and AIFM, with a transfer back of much the actual regulatory work but as part of a binding EU network in which ESMA would have effective policy control"[36] strikes me as cleverly taking a leaf from the "single supervisory" and "single resolution" mechanisms of the Banking Union model and potentially feasible as part of a characteristically EU solution.

There are also things the private sector can do to advance the project. In particular, the financial services industry could take the lead in developing standards and documentation for a Europe wide private placement market. There are several projects ongoing in this area, including the Pan-European Corporate Private Placement project sponsored by ICMA and announced in February 2015. I find the project very promising, but for one problem, the presence of dueling forms of documentation under English and French law[37]. This is a bit reminiscent of the battle of the Betamax and VHS formats for

[34] See footnote 12 above, p.29 and 44-45.

[35] See footnote 6 above, p.15

[36] See footnote 6 above, p.11, citing a forthcoming paper by Alan Houmann and Simon Gleeson, "What would constitute an effective capital markets union".

[37] Pan-European Private Placement Working Group, Pan-European Corporate Private Placement Market Guide, February 2015, pages 8 and 9.

video cassettes, which in its day slowed down the spread of video cassettes as consumers could not make up their minds which to adopt. Uniformity can only be achieved with agreed uniform documentation. I agree with the AFME/BCG "Bridging the Growth gap" report cited above which came out almost simultaneously with the ICMA Pan-European Corporate Private Placement Market Guide in February of this year. AFME/BCG advocate standard documentation like that in use in the US debt private placement market in the form of the Model Note Purchase Agreement, developed by the private bar and used uniformly for private placements to US insurance companies. The AFME/BCG report which polled market participants reports that "[i]nterviewees emphasized that the lack of standardization in deal documentation and processes significantly hindered European Private Placement Transactions".[38] I think they are spot on with this observation. While I concede that the Model Note Purchase Agreement may be no one's idea of a masterpiece of legal drafting, the ability to boil choices down to a comprehensible few makes the process much easier on all concerned. It has done for the US private placement market what ISDA's standard terms and conditions have done for the derivatives market.

Having said that, I do not believe imitating the US is the way for the EU to go. References are often made to the JOBS Act and its impact. On that I would note that the Act was focused on facilitating IPOs for EGCs and did this primarily by removing many obstacles the SEC had put in the way of first time issuers over the years and which do not generally existing in Europe. It allows confidential filings, allows EGCs to test the waters before their prospectus has been cleared, reduces executive compensation disclosure and defers the applicability of Sarbanes Oxley Act certification, none of which are issues in Europe. We have seen above that the accounting rule relaxations have not been widely taken advantage of. The Act does contain provisions on crowd funding, but the SEC has yet to issue rules to allow them to be used and discussions with underwriters indicate a wariness towards inclusion of retail investors, so these provisions do not offer much of a model for Europe. I would also add that there is at least anecdotal evidence that institutional investors are increasingly moving into the crowd funding space in their search for yield, so that the nature of these markets may be changing in a way which the public sector has not yet perceived.

There are also any number of other ways in which the US would be a poor model for the EU. I mentioned above that Fannie Mae and Freddie Mac were largely responsible for the larger securitization market in the US. This was not intended to recommend them as a model for Europe. Although it is true that they succeeded in attracting foreign capital to the financial of the US housing market, the US has ended up with a monoculture in mortgage securitization even greater than Europe's reliance on bank financing. Securities class actions are another example Europe would do well not to follow. Finally, I am not sure the SEC is a model for Europe either, although its aura of tough enforcement and the degree of transparency and predictability of market practises

[38] See footnote 10 above, p. 12.

which have been able to develop under its rules have certainly contributed to the development and stability of capital markets in the US.

In conclusion, to return to our point of departure, I think there is a viable goal here but that there are two main problems with the Green Paper. The first is how to motivate change without overpromising results which the EU is simply not capable of delivering in the short term. The constraints on sources and uses of funds discussed above are very real and cannot be overcome in the short or medium term. Anything can be done in the long term, but that will require patience which may be incompatible with the enthusiasm needed to move the project forward. The second is that the Commission does not yet know how ambitious a project it can make the CMU. In a sense, that is up to all those who will respond to the Green Paper's call for comments. There are many positive aspects to the project. If successful, it would rectify an imbalance in financing sources in Europe which should contribute to greater financial stability. It would offer a form of financing, equity, which banks do not offer and which is more risk absorbing than bank debt. This risk absorption has the advantage of occurring automatically and not requiring the kind of potentially disruptive restructuring debt does. It might also help reduce the extensive exporting of capital from the EU which has contributed to the global imbalances economists like Ben Bernanke have blamed for contributing to everything from the 2008/2009 financial crisis to the current low interest rates. So, it is devoutly to be hoped that the response to the consultation will encourage more overt ambition as well as a more systematic approach in what emerges from the Commission this summer. As Véron and Wolff note, only "ambitious initiatives with transformative long-term impact…. would justify the 'union' label."[39]

[39] See footnote 6 above, p.14.

The Capital Markets Union (CMU) is an economic policy initiative launched by the former president of the European Commission, Jean-Claude Junker in the initial exposition of his policy agenda on 15 July 2014. The main target was to create a single market for capital in the whole territory of the EU by the end of 2019. The reasoning behind the idea was to address the issue that corporate finance relies on debt (i.e. bank loans) and the fact that capitals markets in Europe were not sufficiently