Capital Markets Union: building competitive, efficient capital markets trusted by investors

Finance for Growth – Towards a Capital Markets Union
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Ladies and Gentlemen,

Let me first of all thank the Italian Presidency of the Council of the European Union (EU) and the European Commission for organising this conference on "Finance for Growth". Following its launch by President Juncker in July 2014, the Capital Markets Union (CMU) is now a concept under construction and I am very happy to have been invited to contribute today to its development. When doing so, we should remember the clear objective from President Juncker who stated that the CMU should maximise the benefits of capital markets and non-bank financial institutions for the real economy.

Let me say straightaway that whatever proposal comes to the drawing table to develop the CMU to finance Europe's economic growth, there are in my view two essential dynamics. First, it is about the accelerated integration of EU capital markets and, second, it encompasses all 28 Member States. Let me start with the latter one.

On the need to encompass all 28 Member States I can be brief, the more countries that participate, the greater the benefits. Limiting the number of countries involved would simply reduce the benefits that can be generated.

Developing an integrated EU capital market goes back to the first EU Directives in the 70s harmonising company law and financial reporting requirements. This long-term process is now more than four decades old and has recently gathered speed with the implementation of the regulatory response to the financial crisis. Indeed, while many of the new rules were implemented with a strong focus on financial stability, in reality they have been as important for further integrating the EU capital market. For example, the changes in the area of over-the-counter (OTC) derivatives show that we are well underway with the creation of an EU single market for OTC derivatives.

Despite the many efforts of the past four decades, and the good results achieved, the EU capital market is still fragmented which limits its potential. For example, an institutional investor wanting to invest in a mid-sized company will still have a strong bias towards companies in its own Member-State. There are transactions not happening that otherwise would be beneficial both for the investor and the company because of this home bias. The reason for this stems from a complex set of barriers relating to such issues as transparency of Small and Medium-sized Entities (SMEs), differences in their governance and cross-border differences in the ownership of shares. In sum, we are only halfway there. While the EU capital market has integrated steadily in the past four decades it is not yet comparable with, for example, the US capital market.

With a five year time-horizon in mind, what is needed to achieve a strong and integrated capital market to increase capital availability and to support economic growth in all 28 Member States? In my view, there are four main building blocks:

(1) greater diversity in funding;
(2) increasing the efficiency of capital markets;
(3) strengthening and harmonisation of supervision; and
(4) increasing the attractiveness of capital markets both for EU investors and for investors from outside the Union.

I will discuss each of those four building blocks and will dwell, in particular, on the last one: increasing the attractiveness of capital markets. As every market trader knows, building a market place will not ensure that customers will automatically come. In other words, an integrated EU capital market without internal barriers will as such not attract investors and so increasing the attractiveness of EU capital markets for investors needs to be part of the CMU.

Let me now start with the first building block, which is *greater diversity in financing.* Today about a third of EU non-financial companies' liabilities are bank loans. By contrast, in the United States (US), where companies are much more reliant on capital markets for their financing, they only account for about 7% of non-financial companies' liabilities[1]. European SMEs are particularly exposed, as they historically have strongly depended on bank funding. This is an issue for the EU economy, as traditional sources of financing remain subdued. Notably, banks are still undergoing a necessary process of structural change, and have been reducing their lending. A more diversified system with greater involvement of institutional or non-bank investors and higher shares of direct capital market financing is needed to fill the funding gap.

Greater diversity in funding is not only about more non-bank funding, it is also about developing and maintaining a wide variety of funding channels within the non-banking sector, including investment funds, Initial Public Offerings (IPOs), venture capital, securitisation, private equity and crowd funding. I think it is up to investors and market participants to decide which channel best suits their investment and funding needs, and policy makers and regulators should be careful in assuming the superiority of one channel over the other.

Of course, we are all already working hard on improving and developing this wide variety of funding channels, for example with the Alternative Investment Fund Managers Directive (AIFMD), the revised Markets in Financial Instruments Directive (MiFID II) and the Regulation on Venture Capital Funds. However, I am convinced that much more can be done.

Before I move on to the second building block, let me mention two important additional benefits of a wide variety of funding channels. First, the banking sector is very concentrated and given its dominance, our financial system as a whole is very concentrated. A strong and diversified non-banking sector will increase choice and the number of players in the financial system, make it more competitive and less prone to too-big-to-fail situations. Second, the non-banking sector has more options for equity funding while the banking channel is primarily debt-based. More equity funding will help increasing our investments without increasing the indebtedness of our economy.

Second, policies aimed at *increasing the efficiency of EU capital markets* are needed to increase capital market financing with deep, liquid and well-functioning markets in the EU necessary condition. This is affected by many factors, including disclosure requirements, accounting standards, corporate governance, transparency around pricing and the legal arrangements regarding the various stages of a financial instrument's life-cycle. To illustrate

[1] International Monetary Fund (2014) Euro Area Policies, Country Report No. 14/199

one of the many barriers that we still have, a recent Oxera study shows that it costs an average investor 430 EUR per month to obtain a full real-time picture of equity prices in the EU, while the same service costs a US investor 58 EUR[2].

As there are still many barriers, it is not realistic to think we will be able to remove all barriers within five years. So, when building the CMU concept, we need to assess which changes will have the biggest impact on EU capital market efficiency and many questions need to be answered in that respect. To name just a few:

Should we consider simplifying the requirements for prospectuses?

Should we start harmonising corporate governance of companies?

What can be done in the area of shareholder rights?

MIFID II/MIFIR will contribute to the CMU by increasing the deepness and liquidity of capital markets. This not only holds for equity, but for a broader range of financial instruments including bonds and derivatives. The increase should be the result of a large number of measures, including for example improving pre- and post-trade transparency, the limitation of dark trading and moving OTC derivatives on-exchange. However, the benefits of MIFID II/MIFIR are at this stage still only on paper. The success of this important piece of legislation will also depend on its implementation and require a major effort by all parties involved in the upcoming years, including from industry, investors, national regulators and ESMA.

Relevant for increasing the efficiency of EU capital markets is also which legislative instruments we use to achieve that. In the past years, more and more rulemaking has shifted from Directives to Regulations. This is clearly illustrated with the “R” in many of the new acronyms of our rulebook: EMIR, CSDR, MIFIR, MAR etc. In my view, we should maintain this direction and when possible, favour a Regulation over a Directive. While Directives achieve broad harmonisation, they do not remove all barriers which will harm both investors and the financial industry in doing business across all 28 Member States.

The third building block concerns *strengthening and harmonising supervision*. This is necessary to reinforce financial stability throughout the EU, to ensure that the same basic technical rules are applied, supervised and enforced consistently, to identify risks in the

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[2] Oxera (2014) *Pricing of market data services. An economic analysis.*

system at an early stage, to be able to act together effectively in emergency situations and in resolving disagreements among supervisors.

Converged supervision, by which I mean consistent application of the same rules and using similar approaches, across the 28 Member States is needed to ensure that the single rulebook on paper becomes a single market in practice. Given the breadth and complexity of the single rulebook, regulators need to make many choices regarding their supervision, including the interpretation of the rules and the intensity of supervision. Diversity in these choices will have the result that the single rulebook will not in fact be seen as such by investors and market participants.

When building the CMU there are a number of important issues that we need to address regarding supervisory convergence.

First, what should the objective be? Should we opt for the same supervisory approaches or will it be sufficient to focus on the same supervisory outcomes?

Second, it is common wisdom that supervisory convergence is especially important for wholesale markets, while for retail markets we accept more national differences. However, are widely varying retail investor protection practices consistent with a CMU in which investors are assumed to invest across the 28 Member States?

Third, all three ESAs have convergence tools and all three have worked hard, together with the national regulators, to improve the consistency of supervision. However, it is also fair to say that with the strong focus on regulatory reform in response to the crisis, the track record is not as extensive as in the single rulebook area. As we more frequently deploy these tools, and gain experience, we need to assess whether they are sufficiently effective to establish the CMU or whether stronger European coordination mechanisms are needed.

Let me now move to the fourth and final building block which is *increasing the attractiveness of the EU capital markets for investors*. This building block concerns both EU and non-EU investors.

A successful CMU requires active participation by investors, including retail investors. Therefore, a high level of investor protection is essential for a successful CMU. Only when investors feel sufficiently empowered will they be willing to enter the capital markets and participate. As trust in the financial sector is generally low, a lot of work remains to be done here. While this has gradually been improving, in 2013 only 35% of retail investors trusted investment services providers to respect consumer protection rules[3].

This lack of trust is especially problematic in the European environment where there is a preference to save via deposits, which are government guaranteed, and where private household investment conservatism persists – in the last 10 years households reduced their securities holdings in their portfolios from 27 to 23%. This compares with almost 40% in the US.[4] Of course, this structural difference between the EU and US goes back a long way in history with strong cultural forces at play.

Restoring investors' trust is primarily the responsibility of the financial sector, however, regulation and supervision should support this process. While the early phase of the regulatory response to the financial crisis focused on stability and prudential objectives, later on important regulatory measures have been agreed, like MIFID II/MIFIR and PRIIPS, which should contribute to a higher level of investor protection. The information provided to retail investors and the introduction of the Key Investment Document (KID) will contribute to that. What kind of information do investors really need and how should it be presented? Opportunities lie ahead with this new legislation. But again, good implementation will be essential in ensuring that this becomes a reality and requires major efforts from all parties involved.

Let me now move to the international dimension. We should not only persuade Europeans to invest but also attract investors from abroad. How can Europe be attractive for investors outside the EU and maintain and improve its role as a cornerstone of the international financial markets? Essential for this objective is striking the right balance between being an open financial market attracting foreign investment while maintaining our standards regarding stability and investor protection. A concrete and successful example in this area is the EU UCITS investment sector.

Of course, being a cornerstone of international financial markets also requires the EU to lead internationally on debates on financial market regulation.

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[3] European Commission (2013), Market Monitoring Survey, 2010-2013.
[4] Source: ECB and FED.

Conclusion

Ladies and gentlemen, the European Union faces enormous challenges and the European economy is by no means *out of the woods*. We need to take action now. I genuinely believe that the best response is a strong, safe, and well-supervised EU capital market which allows the economy to flourish again.

The CMU should be based on an accelerated integration of the capital markets of the 28 Member States. The end goal should be a CMU that is competitive, efficient and that provides a wide range of funding channels. Above all, it should be trusted by investors.

Let us work on that together.

Thank you for your attention.