Capital Markets Union – Who Will Invest?
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Philipp Hildebrand Panel Intervention

I. Getting the perspective right.

I do not usually accept speaking engagements where I am asked to present the industry view. But in this case the question is genuinely one of public interest and one that has been conspicuously missing from initial reflexions.

It is nice and well to debate the goals and desirable features and reform needs of a capital markets union—in a nutshell offering a more efficient and sounder plumbing to the financing of the EU's economy, notably its predominantly small and medium size businesses. But this objective can only really be achieved if the resulting framework appeals to those with funding to invest—not just to those with funding needs. So it is very welcome that this conference has a session dedicated to the investor perspective.

In these introductory remarks I would like to give an overview of what investors want but also raise a few questions about where they will come from, questions that have been equally absent from the public debate I have seen so far. I will conclude with two words of caution.

II. What do investors want?

For investors, there is an emerging consensus that the following ingredients are needed and, for now, lacking:

- Simplicity: amazingly given when the so-called single market started, it is still not possible for financial services firms to "passport" their services across member states' borders as freely as banks, let alone car manufacturers, do, and investing capital across borders is a major headache. Likewise, it is far too complex for a retail investor to shop around across borders for the best investment product.

- Transparency: investors need to know what they invest in; right now disclosure requirements, credit registries and credit ratings are nowhere near where they should be to give confidence to invest in all but the top tier of European corporates. That is a huge hindrance.

- Adequate incentives: the key investments that the CMU initiative purports to promote—such as long-term investments, notably in infrastructure, securitizations-- are penalized compared to other investment products (e.g., tax regime, risk weights). In some cases, to jump start the market, some form of government support might be worth considering, e.g., for venture capital.

- Liquidity: not absolutely all investors want that, but most do. And in Europe most market segments are simply too small to provide it. On top of that, a number of countries are considering a financial transactions tax which, by discouraging transactions, would by definition further reduce existing liquidity.

This brings us to the elephant in the room of cross-border securities. Only with such securities can European capital markets reach a size and scale comparable to the US, providing adequate liquidity and risk diversification. Indeed without such securities one might challenge whether there is a capital markets union at all. A very encouraging first step to deal with the thorny issue of cross-border investment, especially in the area of private capital, was taken with the European Long Term Investment Funds (ELTIFs)—which are not perfect but have the merit of allowing a fund based in one member state to access investment opportunities across the entire single market. Developing the concept of a true investment or asset passport for both ELTIFs and other funds on the same model should be facilitated.

To go further and have genuine cross-border securities, two difficulties come to mind however, both quite challenging.

- One is the need for a minimum degree of harmonization of underlying legal regimes, notably insolvency regimes across countries; without this, pooling securities across borders would be like pooling apples and oranges, a result that makes a very unattractive investment product.

- The other is the creation of cross border "risk free" benchmarks off which to price the rest of the market. Indeed without such a step to prime the cross-border securities market it is somewhat doubtful whether it can emerge at all. The question though is will there be any time soon sufficient political appetite for such a step? This seems doubtful, sadly.

III. Where Will Investors Come From?

One issue in need of clarification is the following: Is the goal of CMU to bring new investors to the table from outside the EU, or to prompt existing ones to reallocate their savings from the banking system to the capital markets? And can we be sure this reallocation is pareto-optimal?

A case can be made that there is scope to bring new investors/investments to the table: the EU as a whole runs a sizable current account surplus, meaning it exports its savings to the rest of the world, to the tune of nearly €300 per year. By definition, these exported savings reflect a lack of sufficient attractive investment opportunities within the EU. In part this has been because of difficulties in the real economy. But in part also, arguably, because of inadequate financial market "plumbing". Thus, if CMU facilitates the creation of new and attractive EU investment products, more financing could indeed be available and tis would benefit the EU economy.

But this current account surplus likely has a large cyclical component. So in steady state, what CMU would accomplish is a reallocation of existing "investments". Would that necessarily improve economic efficiency? Let's consider separately institutional and retail investors.

- Institutional investors are heavily invested in government paper, which gives them the liquidity, safety characteristics many need. If they suddenly switch a large chunk of their holdings to private sector securities, the cost of government borrowing will go up, assuming constant supply. Perhaps now is a good time for such a switch: supply is in fact shrinking, and demand from banks has increased owing to post GFC regulations. ECB QE will be an additional source of demand for the next two years. This is therefore a good time to implement this shift without disruption.

- Retail investors/households keep over half of their savings on average in cash in bank deposits. On the one hand these can be seen as idle, inefficient investments that will create difficulties down the road as households realize they have insufficient savings to smooth consumption through their retirement. On the other hand, they constitute funding for banks that allows them to lend. To the extent the creation of CMU is a response to fears of credit contraction, or insufficient credit growth, as European banks delever under the effect of post crisis regulations, competing for their deposit base may not have the intended effect. One would need to study whether £1000 in a bank account generate more or less SME funding than £1000 in an ETF. The answer is not completely obvious.

IV. Two words of caution

Speaking from the perspective of a financial market participant, it is heartening to see the recent enthusiasm for the capital markets union. But two caveats are in order:

- First, the financial markets that are at the heart of the capital markets union are largely the same institutions as the so-called “shadow banks” that continue to be eyed with great suspicion and in the line of fire of various recent and ongoing regulatory reviews. There is no question that markets need to be regulated. The key is to do that without hindering their development. I understand Lord Hill has promised to launch a review of the impact on jobs and growth of the multitude of financial market regulations that have popped up since the crisis and that is exactly the right approach.

- Second, as in everything, one should be mindful not to overpromise. CMU has been hailed, amongst others, as a way to bring more financing to SMEs. But here too the comparison with the US is instructive. Despite capital markets playing a hugely bigger role in financing the US economy than in the EU, SMEs have almost no access to them, just like in Europe. What capital markets finance a lot more in the US than in the EU is mortgages and medium to large enterprises. And that frees up space on banks’ balance sheets to lend to those small businesses that do not have an alternative.

In sum, the CMU is a welcome and overdue initiative. One needs to be mindful as it unfolds to keep in mind all the relevant perspectives—the demand and the supply sides, the forest and the trees.