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Banks keen to contribute to success of CMU

By Wim Mijs, Chief Executive, European Banking Federation

Intro:

The free flow of capital is one of the fundamental principles on which the European Union was built. The creation of a Capital Markets Union - more than fifty years after the signing of the Treaty of Rome – aspires to turn this vision into reality. Europe's banking sector – traditionally the main source of lending for Europe's entrepreneurs large and small – is ready to contribute to the success of CMU, says Wim Mijs, Chief Executive of the European Banking Federation.

The March publication of the green paper 'Building a Capital Markets Union' marks the beginning of a major initiative by the European Commission to integrate capital markets in the EU. The objective of this Capital Markets Union (CMU) is to make European capital markets more efficient, competitive and diverse, and thus also more resilient to possible shocks. Broader, deeper and more efficient capital markets are seen as a good basis for funding a dynamic and innovative economy in the EU. Reshaping the structure of capital markets in the EU to achieve a Capital Markets Union is therefore one of the most important tasks of the new European Commission.

The ultimate objective of CMU is to find alternatives to fund investments and boost economic growth, to help companies create jobs and, ultimately, to create more prosperity. The European Banking Federation (EBF) fully supports the goal of unlocking the latent investment potential in Europe's capital markets. However before concretely discussing the views in the banking sector on CMU let us make sure that we do not lose sight of the bigger picture.

The nature of the European economy is such that banks are a crucial and important factor. This will not change even when alternative sources of funding become readily available and when markets will play a bigger role. And let us also not forget that banking finance is innovating and taking up new opportunities. When we talk about alternative sources of finance, we tend to limit ourselves to responding to the role of capital markets. Many banks in Europe however are modernising their lending channels so that SMEs can access finance in more flexible and more cost-effective ways.

It's a fact that approximately two-thirds of all funding in Europe continues to be based on a preference for banks. In our part of the world there is a strong historic and cultural preference for going-to-the-bank instead of the market. Bank funding often is less complex than having to go to markets – and therefore also cheaper. That's very different from the United States, where the economy depends largely on financial markets for funding. It is important that we do not ignore these cultural differences.

Capital Markets Union may have been inspired by the fact that the bank transmission system in Europe in recent years has not managed to deliver fully what was expected. We take great comfort in comments[1] that Commissioner Jonathan Hill made in March, when he said Capital Markets Union is not about displacing banks, but about complementing the role of banks.

Still, Capital Markets Union is important as a project that can help address fragmentation in Europe's financial services markets and that can encourage renewed integration. Our sector strongly feels financial integration is tremendously important for the EU economy. The European Banking Federation, ever since it was created in 1960, works hard to contribute to that integration.

However, reality requires all of us to admit that despite all the efforts of the European Union, the financial services markets in Europe remain deeply fragmented. European Central Bank data shows that fragmentation in Europe's financial markets has even increased again during the years that followed the financial crisis.

Just to given one example: the share of cross-border debt securities in the euro area was only 16% in 2013, compared to 30% at the beginning of 2008.

One of the good things about Capital Markets Union is that it provides a clear and fresh focus on removing obstacles and on removing barriers to growth. We also very much welcome the focus of the new European Commission on growth and jobs, and also on better regulation.

Regulatory uncertainty as a barrier to growth

Turning Capital Markets Union into a success also requires all of us to acknowledge and define some of the factors that could prevent it from delivering on its potential. Regulatory uncertainty is one of them.

The European Commission's green paper makes clear that CMU has a broad scope, with the prospect of various different measures for the short, medium and long term horizons. That means we can expect many different measures. The drawback of this broad scope also is that it creates uncertainty.

[1] http://europa.eu/rapid/press-release_SPEECH-15-4494_en.htm

The financial services industry – banks as well as investors and markets - needs certainty on the limits of regulation. After the avalanche of new rules that was introduced in recent years, it is becoming difficult for our industry to keep up with the continuous flow of new regulations.

We see another risk in one of the key success factors for Capital Markets Union: the willingness of national governments to embrace change.

If fragmentation is to be addressed properly, national securities laws need to be further harmonized. But how will it for example be possible to reconcile home repossession laws in Italy with those in Sweden. In Italy it can take five years, while in Sweden a home can repossessed in merely six months. Differences such as these will not make it easy to securitize mortgages at a European level.

The success of CMU will depend to a significant extent on how the EU handles the proposal to break up banks and the financial transaction tax. If we are not careful, these plans will harm liquidity and weigh down capital markets. Banking Structural Reform should not be introduced without carefully considering the unintended consequences. This risks a scenario where the EU goes full throttle - with the hand brake on.

With that in mind, Europe's banking sector would welcome a regulatory pause. That could give more time to make sure that we correctly implement the existing regulatory framework, with MiFID II, MiFIR, the Single Rule Book and BRRD. These new regulations should not be allowed to complicate CMU.

Key objectives: efficient demand, easier risk allocation, appropriate balance

We believe that CMU should achieve three objectives in order to bring about a more integrated market:

1. It should increase the efficiency of the capital market by bringing investment opportunities for savers and investors more into line with the demand for capital. This can be achieved by broadening the availability of diverse corporate finance options and by expanding the range of investments open to savers and investors.
2. It should make risk allocation easier by improving cross-border investment opportunities. This would help to better absorb the effects of economic shocks on individual Member States.

3. It should ensure that the capital market and the banking sector each contribute an appropriate share to funding the economy. This could make the economy more resilient to economic shocks.

The CMU project requires joint efforts to be successful. The EBF also stresses that efforts should be carried out by all actors in the European economy, including banks and Member State governments.

A fundamental prerequisite for the success of CMU are economic reforms which help to restore confidence in the capital markets. Above all in the countries hit by crisis, such reforms are a *sine qua non* for improving the international competitiveness of their domestic economy.

Only then will new regulation have a chance of creating a broader, deeper and more efficient capital market. Without restoring investor confidence both in the stability of the capital markets and in sound economic and fiscal policy, all measures to establish CMU – whatever its precise design – will be in vain.

Ten priority points to consider

In preparing its official position that will be submitted to the European Commission, the EBF has identified a list of ten key priorities for establishment of the CMU:

1. Ensure a level playing-field between markets and between EU and non-EU actors
2. A 'one-size-fits-all' approach will not work
3. Complete the Single Rulebook
4. Do no harm to existing markets
5. Emphasise importance of liquidity and market-making
6. Revise rules for Securitisation
7. Review the Prospectus Directive
8. Remove existing tax barriers
9. Promote tax transparency for cross-border shareholders
10. Improve financial education and SME knowledge

Key points

1. Ensure a level playing-field

The Commission must ensure a level-playing field for all actors in financial markets, and there should be equal terms for all market participants. To ensure an effective Single Market it is necessary to align regulation to ensure that it does not act to prevent cross-border activity or to distort competition.

Alternative channels of funding to bank intermediation will be essential to create a CMU, however these channels must be appropriately regulated. So-called 'Shadow Banking' activities should not benefit from less onerous or even preferential regulatory treatment, and should be subject to the principle of 'same risks, same rules'.

2. A 'one-size-fits-all' approach will not work

Proportionality must be a key principle of the Commission in developing the CMU. A one-size-fits-all approach will not take into account the different risks of different activities and business models within EU capital markets. The Commission must take into account the different cultural, economic and legal frameworks in EU jurisdictions, and disproportionate measures could lead to serious unintended consequences and further fragmentation of capital markets.

3. Complete the Single Rulebook

The implementation and completion of a true Single Rulebook would help to remove uncertainty for investing in capital markets. The Single Rulebook must be complemented by close convergence of supervisory practices that must be effectively and consistently enforced across all Member States. This will help to create a Single Market for capital for all 28 Member States and would help to remove barriers to cross-border investment within the EU.

Member States must avoid 'gold-plating' legislation, which would disturb the single market. Member States should not be competing on legislation, but instead should be competing on business-friendliness and reliable environments to attract investment.

4. Do no harm to existing markets

Policy-makers need to avoid introducing any measures that are likely to have a negative impact on capital flows and investment. This would hinder the overall objective of the CMU. The Commission must in particular avoid unintended consequences on capital structures which could risk further fragmentation in financial markets. A good example of this is the implementation of MiFID II and MiFIR, which if not calibrated correctly could create distortions in financial markets, leading to further fragmentation and higher costs for investors.

5. Emphasise importance of liquidity and market-making

The success of the initiative to make capital markets more efficient will also depend on whether or not markets can be made broader and deeper and on the availability of the necessary liquidity. Market-makers serve a crucial role in financial markets by providing liquidity to facilitate market efficiency and functioning. Market-makers are critical for the financing of the economy, as was recently confirmed by the ECB.[2]

The Commission needs to place market-making and the importance of providing liquidity at the forefront of the CMU. Liquid capital markets will boost the process of moving capital from slowly growing sectors to dynamic innovative industries and raise confidence of investors.

The adoption of the Banking Structural Reform proposal without adaptations will have significant adverse impacts on the potential CMU. The separation of trading activities out of the universal bank will render market-making more expensive for customers and decrease liquidity in markets.

Hurdles and disincentives to providing liquidity and market-making may also arise from the introduction of a Financial Transaction Tax (FTT). By increasing the cost of secondary market trading – even fractionally - in participating Member States, the FTT would reduce liquidity and so make capital markets a less attractive place for investors, impacting both primary and secondary capital markets and dis-incentivising on-exchange trading and clearing. The negative consequences of the tax would be proportionate to its huge effective magnitude, taking into account the cascading effect in its application.

6. Revise rules for Securitisation

The Commission needs to revitalise the market for simple, standard and transparent securitisations, including those products suitable for SMEs. This should be based on a dedicated European securitisation framework addressing the inherent risks associated with securitisations, including a revision of the capital requirements for securitisations.

The EBF also supports a more lenient supervisory formula that replaces the current squeezing effect of external ratings. This should be applied to securitisation vehicles that comply with a set of eligibility requirements as simple, standard and transparent.

7. Review the Prospectus Directive

The Prospectus Directive needs to be reviewed to make it easier to comply with, in particular for SMEs. The threshold for producing the prospectus should be significantly higher (as it is in the US) to ease the burden on SMEs. A revised Prospectus Directive should make it easier and cheaper for firms to go to market, while still preserving a high level of investor protection.

[2] See p5 of the Opinion of the European Central Bank of 19 November 2014 on a proposal for a regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions (CON/2014/83) [Link].

8. Remove existing tax barriers

The first Giovannini Report of November 2001 identified 15 barriers associated with the clearing and settlement of cross-border securities transactions within the EU. Two of them (barriers 11 and 12) are tax barriers.

The complexity and cost of obtaining the tax relief to which an investor is legally entitled often lead investors to forego the relief. Even though the financial intermediary has access to accurate customer information and is subject to high compliance regulation standards, obtaining tax relief to which its customers are entitled is often not practicable. Full withholding at the maximum tax rate is often the outcome and constitutes a major disincentive to cross-border investment in capital markets.

National provisions requiring that taxes on securities transactions must be collected via particular local settlement systems may narrow the choice available to investors and impair cross-border activity.

9. Promote tax transparency for cross-border shareholders

All issuers and all intermediaries should comply with the same tax compliance requirements, including reporting requirements under the OECD Common Reporting Standard (CRS) and the Revised Directive on Administrative Cooperation (DAC2), i.e. all issuers and intermediaries should ensure that the beneficial owners are identified and disclosed under the prescribed procedures wherever they are located.

10. Improve financial education and SME knowledge

The Commission should take steps to improve the level of financial education in the EU, for both (retail) investors and SMEs. This would help (retail) investors to better understand the functioning of capital markets and their role within markets, while SMEs would benefit from increased knowledge of possible funding options available within capital markets.

To sum it all up, Capital Markets Union must unlock the latent potential of EU financial markets to support bank funding in the economy. It needs to result in innovative, effective initiatives that enable financial markets contribute to growth, and that instils companies with the confidence they require to invest and create more jobs.

The banking sector fully supports the European Commission's growth and jobs initiatives. We look forward to see concrete measures such as the plans to revive securitisation markets. We are actively seeking partners to collaborate on CMU as a project that centres on free circulation of capital in the EU and appreciate the renewed focus on integration in our financial services markets, ultimately completing what we in Europe started out with more than half a century ago.

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