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Capital Markets Union

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Introduction

The Capital Markets Union (CMU) is a flagship initiative of the European Commission, which was first announced by the Commission on 26 November 2014. The aim of the CMU is to create a single market for capital for all Member States by removing barriers to cross-border investment and to lower costs of funding within the EU, which the Commission hopes will contribute to enhancing growth and creating jobs. According to the Commission, European businesses remain heavily reliant on banks for funding and this could be complemented by using stronger capital markets to provide an additional source of financing, which may not only attract more investment into the EU but also make the financial system more stable as it will open up a wider range of funding sources.

Investment Plan for Europe

The Commission intends to deliver the CMU by 2019 via a range of steps, or building blocks, in the context of the 'Investment Plan for Europe'. The Investment Plan for Europe is built on three main strands:

(1) the creation of a new European Fund for Strategic Investments (EFSI), guaranteed with public money, to mobilise at least €315 billion of additional investment over the next three years (2015 – 2017);

(2) the establishment of a credible project pipeline coupled with an assistance programme to channel investments where they are most needed; and

(3) a roadmap to make Europe more attractive for investment and remove regulatory bottlenecks.

The building blocks of the CMU should create an environment in which small and medium-sized enterprises (SMEs) can raise financing more easily, the costs of investing and access to investment products converge across the EU, the ability to obtain credit through capital markets is increasingly straightforward and seeking funding in another Member State is not impeded by unnecessary legal or supervisory barriers.

Key principals of the CMU

The CMU is based on the following key principles:

(a) to maximise the benefits of capital markets for the economy, to boost growth and jobs;

(b) to create a real single market for capital for all Member States by removing barriers to cross-border investment within the EU and fostering stronger connections with global capital markets;

(c) to build on the firm foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced;

(d) to ensure an effective level of investor and consumer protection;

(e) to help to attract investment from all over the world; and

(f) to contribute towards enhancing EU competitiveness.

Green Paper

One of the Commission's first steps was to publish a Green Paper on 18 February this year, in which it explained why the CMU was necessary and what its aims would be, as well as outlining the priority areas of work being carried out by the Commission and areas for discussion to develop and integrate capital markets. The purpose of the Green Paper was to start the debate at EU and national levels on possible short and long-term measures to achieve the objectives of the CMU and it has attracted a number of comments from interested parties, including ESMA, the Bank of England and the FCA.

The priorities highlighted in the Green Paper include certain short-term priority actions, some of which were also identified in the Investment Plan for Europe:

(a) lowering barriers to accessing capital markets through a review of the current prospectus regime;

(b) widening the investor base for SMEs by improving credit information on SMEs;

(c) developing proposals to encourage 'high-quality' securitisation and to free up banks' balance sheets;

(d) supporting the take-up of long term investment funds (ELTIFs); and

(e) supporting industry-led work to develop European private placement markets.

These actions will be carried out over the next five years in accordance with the Commission's Action Plan, which the Commission intends to adopt in September 2015.

Although the Commission envisages that some legislative measures will be needed to implement the aims of the CMU, it acknowledges that legislation might not always be the appropriate policy response and that in many cases it will be up to the market to deliver solutions.

Benefits of the CMU

SMEs

According to the Commission, SMEs are struggling to get funding, particularly in those countries worse hit by the financial crisis, as bank finance is often difficult to access or insufficient for larger companies. Further, SMEs and start-ups in Europe have less access to venture capital and other alternative sources of funding, as compared with, for example, the U.S. The CMU should help SMEs gain improved access to financing, including risk capital, at reasonable costs, as they will be able to tap into more diverse sources of funding from investors within and outside the EU.

The Commission also wants to develop a common minimum set of comparable information for credit reporting and assessment that could help to attract funding to SMEs and to standardise credit quality information to help develop financial instruments to refinance SME loans. In the Green Paper, the Commission notes that work on credit scoring has started and has received broad support from Member States. Credit scoring provides investors and lenders with information on the creditworthiness of SMEs and potential action in this area could help diversify the financing of innovative and high growth start-ups.

The Commission plans to hold workshops on SME credit information in 2015.

Prospectus Directive

The Prospectus Directive is the gateway to capital markets for many firms, as prospectuses help to provide an equivalent level of investor protection across the EU and to enable the comparability of investment options for investors across the EU. However, the amount of administrative, human and financial resources needed to draw up prospectuses make it costly and administratively burdensome for SMEs and start-ups to produce. The Commission has therefore launched a review of the Directive in order to improve its effectiveness and lower burdens on small firms, which should make it easier for companies to raise capital throughout the EU.

Private Placement

Although the current EU regulatory framework allows private placements, the Commission considers there is room for improvement, as private placements have the potential to broaden the availability of finance for medium to large unlisted companies. The Commission has undertaken a mapping exercise of national private placement regimes and it notes that barriers to the development of a pan-European private placement market include the lack of standardised processes and documentation, information on the creditworthiness of issuers as well as lack of liquidity in secondary markets.

The Commission has welcomed the publication of a Pan-European Corporate Private Placement Market Guide by the International Capital Market Association (ICMA) in February 2015, which is intended to provide a framework of best practices for pan-European private placement (PEPP) transactions focussing on corporate debt. The Commission is of the view that it could help facilitate the creation of a European private placement market in the short-term.

Securitisation

Prior to the financial crisis, securitisation played an important role in the financing of the economy, particularly in Europe. However, the role played by opaque and complex securitisation during the financial crisis led to securitisation levels to decline significantly worldwide and, unlike the U.S., these have remained low in Europe.

The Commission believes that securitisation has considerable potential if developed properly and can play an important role in transferring risk and increasing the capacity for banks to lend more to the economy. It therefore intends to establish an EU framework for simple, transparent and standardised securitisation with the aim of:

(a) re-starting the markets so that simple, transparent and standardised securitisation can act as an effective funding channel;

(b) allowing risks to be transferred to a wide range of institutional investors;

(c) allowing securitisation to act as a funding mechanism for both banks and non-banks; and

(d) protecting investors by avoiding the re-introduction of 'originate to distribute' models of securitisation.

In its recent February consultation on securitisation, the Commission sought views on the following issues as preparation for its proposal on building a sustainable securitisation model:

(i) the adequacy of current identification criteria for qualifying securitisation instruments;

(ii) the development of identification criteria for short-term instruments which are not included in the current eligibility criteria;

(iii) whether current risk retention rules should be adjusted for qualifying instruments;

(iv) whether a certification or licensing system should be established to ensure compliance with the EU criteria for qualifying instruments;

(v) whether adjustments are needed to existing EU regulatory frameworks that contain securitisation provisions, such as the UCITS Directive and the AIFMD;.

(vi) whether changes should be made to credit ratings methodologies to mitigate the impact of sovereign ceilings;

(vii) the adequacy of the current prudential treatment of banks and investment firms investing in securitisations; and

(viii) the development of securitisations for SMEs.

Institutional investors

The Commission considers that the CMU will benefit institutional investors, as they will have a greater choice of investments, accessible at lower costs with effective investor protection. The Green Paper seeks to identify measures which could attract a greater flow of capital from institutional investors to a broader range of assets, such as long-term projects, start-ups and SMEs. These include measures to: reduce the costs of setting up and marketing investment funds across borders; boost investment in infrastructure; develop personal pensions; and promote the provision of risk capital.

ELTIFs

European Long Term Investment Funds (ELTIFs) are designed to attract investors who are looking to invest in companies and projects for the long term, such as airport concessions, transport infrastructure, electricity grids, in addition to 'social' infrastructure such as housing, hospitals or municipal services. As such, ELTIFs are an integral part of the drive to improve the long-term funding of the EU's economy, which is embodied by the creation of the new EFSI.

Effect of CMU on current legislation

The Commission has said that the CMU needs to be well-regulated and built on financial stability, but there are fears amongst market participants that implementing the building blocks will lead to further regulation. The Commission states that the objective of the CMU is not to undo the reforms agreed during the past few years in response to the financial crisis, but acknowledges that barriers to an integrated capital market include divergences in areas such as tax, company and insolvency laws across the EU, which are difficult, as matters of policy, to overcome.

Responses to the Green Paper

ESMA has welcomed the CMU initiative, stating that its main objectives, namely enhancing investor protection and promoting stable and orderly financial markets, are fully aligned with the objectives of the CMU. Its response contains specific proposals where improvements could be made relating to access to credit information for SMEs and increasing cross-border retail participation in investment funds such as UCITS. ESMA adds, however, that to achieve the benefits of CMU, an increased participation of investors will be essential and the level of confidence and trust of investors (and especially retail investors) in capital markets needs to grow. Therefore, all CMU initiatives, especially the ones that could give investors greater access to capital markets, need to embed investor protection objectives to ensure the long term viability of a greater role of capital markets.

The FCA has also welcomed the initiative and in its response it set out a number of overarching perspectives that it believes to be critical in enabling the development of CMU to be as effective as possible. These include the following: (i) there is already a substantial body of legislation promoting a single capital market in Europe and so the main building blocks are already in place; (ii) the FCA believes that a greater supply of investor finance will require appropriate investor protection and suggests that the Commission consider progressing its past proposals to create an EU insurance guarantee scheme framework and to amend the Investor Compensation Schemes Directive; (iii) the FCA considers that more consistent supervision within the current framework could bring significant benefits; (iv) the CMU should embrace the opportunities of new technology and potential gains from effective competition; and (v) European markets need to be embedded in a globally competitive landscape. The FCA also sets out priorities for action that it believes should be important elements of the CMU action plan, namely in relation to enhancing the supply of investor finance and demand for capital.

The Bank of England has also responded positively and considers that the CMU will be at its most effective where it has clear economic objectives. The Bank's response considers a wide range of policy proposals that it believes will support economic growth and stability. It also highlights a number of key impediments to achieving CMU and explains how the Bank proposals could help overcome them, with the aid of a set of over-arching considerations that cut across all impediments.

Next steps

The Commission hosted a public hearing on the "Next steps to build a Capital Markets Union" on 8 June 2015. During his speech at the hearing, Jonathan Hill, Commissioner for the Financial Stability, Financial Services and Capital Markets Union Directorate General (DG FISMA), said that the next steps would be to publish the Commission's Action Plan in September, outlining the Commission's short-term priority actions as referred to above and which would draw on the first findings from the Commission's consultations, followed by concrete proposals, some within a few weeks of the Action Plan.

If you would like to discuss this further, please contact Claire Cummings at
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