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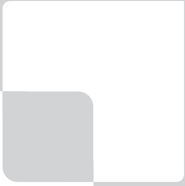
DEFINING EUROP
CAPITAL MARKET



this sense 'capital markets' should be understood as shorthand for a long list of market segments, whose common point is that they are not about bank intermediation. The list includes venture capital, private equity investment, public equity issuance and initial public offerings, corporate bond issuance, corporate debt securitisation, the direct purchase of loans by insurers and investment funds from banks, and credit intermediation by specialised non-bank financial firms, such as leasing companies or consumer finance companies. CMU is therefore of a fundamentally different nature from banking union: the closeness of the two policy slogans, banking union and CMU, is a rather unhelpful false symmetry. In the case of banking union, the main objective is to centralise a banking policy framework, the fragmentation of which along national lines has been proven deeply dysfunctional in the EU context, because the incentives of individual national supervisors to be driven by banking nationalism collided with their prudential mandate. The aim of banking union is not to develop banking in the EU; rather it is to check its existing development with an adequate supervisory system. By contrast, in CMU, centralisation is not the primary driver and is subordinated to the developmental agenda.

Nevertheless, a measure of policy centralisation is needed to realise the CMU ambition of development of EU capital markets and non-bank intermediation, for at least three reasons. First, the crisis has provided a reminder that adequate regulation is indispensable to a properly functioning financial system: in accordance with the subsidiarity principle, such regulation must be provided at least partly at the scale of the market itself, which in the CMU vision is pan-European, in order to avoid loopholes, regulatory arbitrage and misaligned incentives. Second, experience in related areas, including competition policy and banking union itself, suggests that an EU-wide approach is the best way to overcome entrenched political economy constraints that have repressed the development of capital markets and non-bank finance until now. Third, while banking union and CMU are two separate agendas, there are links between the two. The consolidation of supervisory and other banking policies within the banking union-area (which includes the euro area, plus all non-euro EU member states that may join the Single Supervisory Mechanism on a voluntary 'close cooperation' basis) will inevitably trigger a need for policy integration in related activities, for example accounting and auditing policies which are important inputs to the supervisory framework.

As noted above, capital markets and non-bank financial intermediation cover myriads of segments and sub-segments, and are characterised by a significant intensity of innovation. CMU policy should not seek to freeze market structures in their currently underdeveloped form but, on the contrary, to create a favourable environment for the development of new intermediation segments and new financing contracts, with effective but not excessive safeguards against systemic risk. In this respect, it is somewhat odd that some early suggestions of blueprints for CMU tended to read as catalogues of market segments, as if each of these needed to be specifically legislated to fulfil its potential[6]. Rather than this curiously dirigiste impulse, a more growth-friendly CMU approach should embody a form of financial Ordnungspolitik, setting an adequate framework for the invention and development of efficient financial services and contractual arrangements.

An ambitious CMU agenda will face challenges. As always in finance, it will displace powerful interests, starting with those of banks, which intensely dislike the prospect of competition from alternative financing channels. Banking advocates will warn against the perils of 'shadow banking' and regulatory arbitrage, while ignoring that their own core features of deposit collection and high leverage justify higher levels of protection against systemic risk. Furthermore, a capital-markets development agenda will run against deeply-seated ideological scepticism, particularly in parts of continental Europe where markets are viewed

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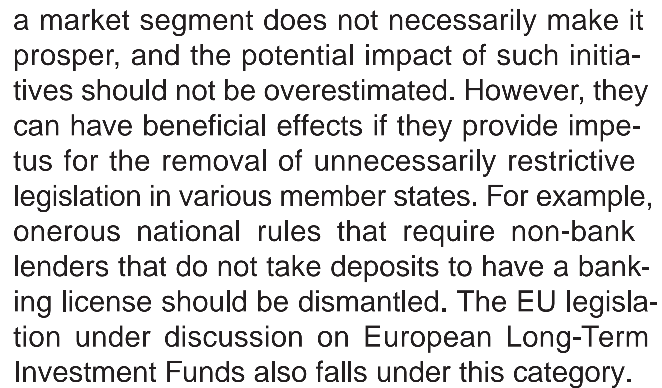
6. See for example Hugo Dixon (2014) 'Unlocking Europe's capital markets union', Centre for European Reform (London), October.



a market segment does not necessarily make it prosper, and the potential impact of such initiatives should not be overestimated. However, they can have beneficial effects if they provide impetus for the removal of unnecessarily restrictive legislation in various member states. For example, onerous national rules that require non-bank lenders that do not take deposits to have a banking license should be dismantled. The EU legislation under discussion on European Long-Term Investment Funds also falls under this category.

2. Review of prudential frameworks

Regulators should reconsider prudential requirements that unnecessarily discourage investment in unrated corporate credit and other market segments. In banking regulation, there are suggestions that the current version of Basel III is too harsh on securitisation, and a discussion has started on their possible relaxation. A wider scope for review arguably exists in prudential requirements on insurers and pension funds, which have tended to mimic banking requirements, partly ignoring the fact that these players can legitimately take different risks from banks given the longer maturity of their liabilities. While so-called fair-value measurement is generally adequate for the financial accounting treatment of financial instruments, it is much less suitable for prudential accounting, especially of assets that match long-dated liabilities. The Solvency II Directive (for insurers) and the Occupational Pension Funds Directive should be reviewed accordingly, as well as EU positions in international negotiations, especially on capital requirements for globally active insurance firms.

7. See International Regulatory Strategy Group (2014) 'Briefing on the principles that should underpin the development of a Capital Markets Union in Europe', City of London/TheCityUK.

8. UK House of Lords (2014) transcript of evidence taken by the Select Committee on the European Union, Sub-Committee A on Economic and Financial Affairs, 9 September.

9. On a related theme, it is worth noting that the ECB has taken steps towards the gradual formation of a credit register that would cover the entire banking union area. See the ECB Decision of 24 February 2014 on the organisation of preparatory measures for the collection of granular credit data by the European System of Central Banks,

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by unanimity or through enhanced cooperation, as well as simplification and stabilisation of national tax regimes. In addition, the EU should build on existing studies and national experiences to explore a rebalancing of the current differentiated tax treatment of equity and debt, which generally favours the latter to the detriment of the former.

The third and fourth of these areas could result in the transfer of some regulatory and supervisory functions from the national to the EU level. It would be a mistake to bar such transfers a priori as a political no-go. EU-level supervision already exists within ESMA, for derivatives trade repositories and credit rating agencies. President Juncker's mission letter to Commissioner Hill asks him to reform ESMA's governance and funding: this reform should include consideration of ESMA's current and possible future expanded role as a supervisor, or whether EU-level supervisory functions for non-bank firms would be better placed in one or several new agencies to be created. A location in London for such a new agency or agencies, or for new functions to be developed within ESMA, could be envisaged to meet concerns in the UK that EU-level supervision might become too remote from Europe's main financial centre.

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