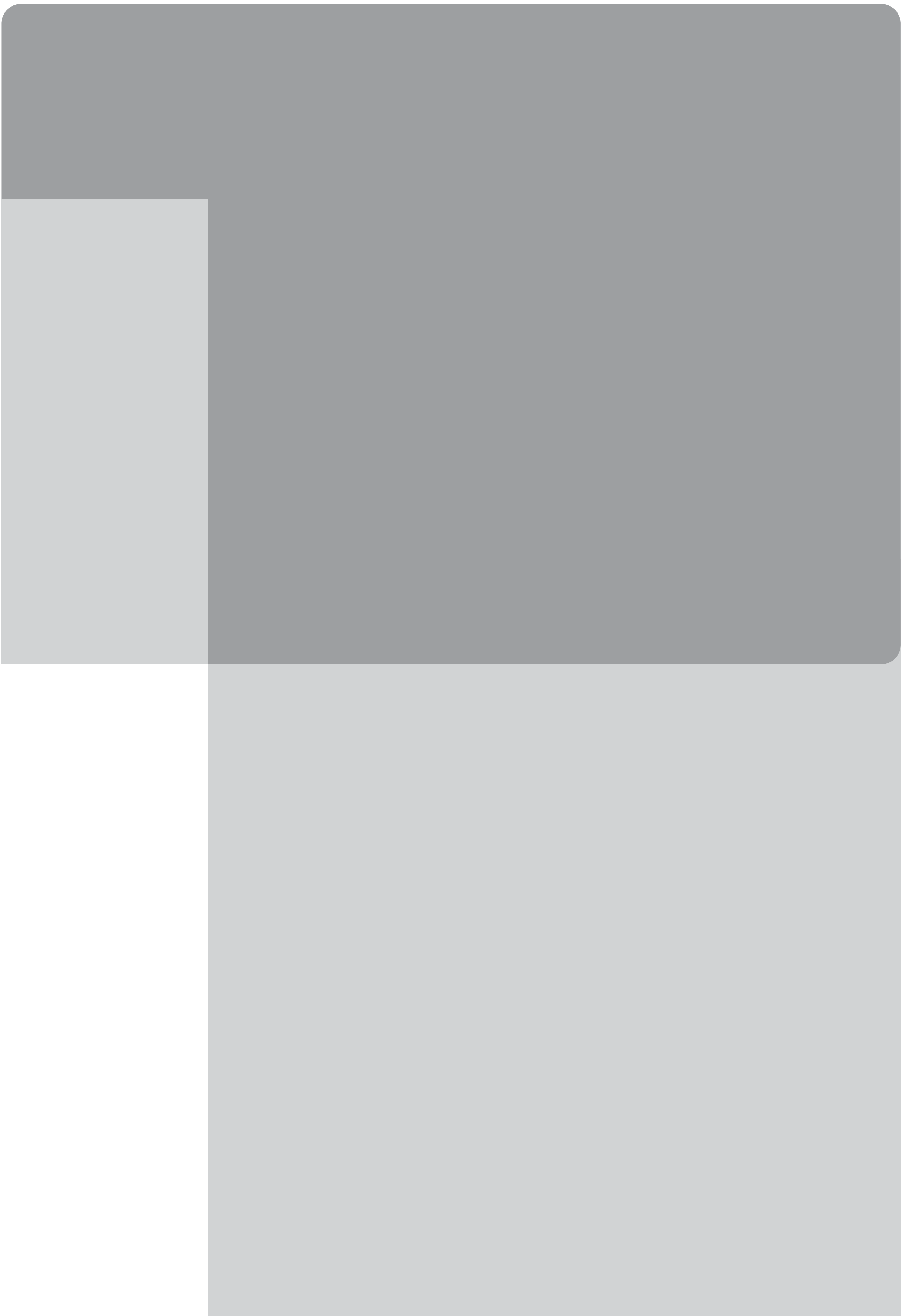

CAPITAL MARKETS UNION: A VISION FOR THE LONG TERM

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1 INTRODUCTION

The European Commission has created momentum around the idea of a European Capital Markets Union (CMU). The expression was first used by then Commission president-elect Jean-Claude Juncker in the initial exposition of his policy agenda in mid-2014[1]. Since then, CMU has been prominently included in the title and job description of the Commissioner for financial services – or to give him his full title, the Commissioner for Financial Stability, Financial Services and Capital Markets Union[2]. The Commission published a green paper on CMU in February 2015[3]. The announcement of CMU as a policy priority has elicited a number of substantial contributions from a variety of stakeholders, both before and after the publication of the green paper[4].

This mirrors a broader shift in the European policy consensus. At the outset of the financial crisis in 2007-08, European policymakers often described the bank-based nature of Europe's financial system as a factor of stability, in contrast with the more exotic features of finance in the US, such as securitisation conduits and other forms of 'shadow banking'. However, Europe's dependence on banks and the scarcity of alternative financing channels have since been identified as significant features of the European crisis and obstacles to its resolution[5]. The president of the European Central Bank (ECB) illustrated the new consensus by observing that "the crisis has shown the drawbacks of over-reliance on a bank-centred lending model. So we also need to develop reliable sources of non-bank lending, such as equity and bond markets, securitisation, lending from insurance companies and asset managers, venture capital and crowdfunding"[6]. In the debate on CMU, the reference to 'capital markets' is often used as shorthand for such sources of non-bank lending, and is preferred to the expression 'shadow banking', which has more negative undertones.

This shift is welcome from an economic-policy standpoint. Capital markets play an important role in sharing economic risks and smoothing consumption and investment. They can provide better

1. Juncker (2014a).

2. Juncker (2014b).

3. European Commission (2015a).

4. See in particular AFME (2015a), Andersen et al (2015), BlackRock (2015), Dixon (2014), European Issuers, EVCA and FESE (2015), Goldman Sachs (2015), House of Lords (2015), Martinez and Philippon (2014), Odendahl (2015), Véron (2014) and Wright (2014).

5. See eg Véron (2012), Sapir and Wolff (2013).

6. Draghi (2014).

7. This point was developed in the pre-crisis context by Philippon and Véron (2008).

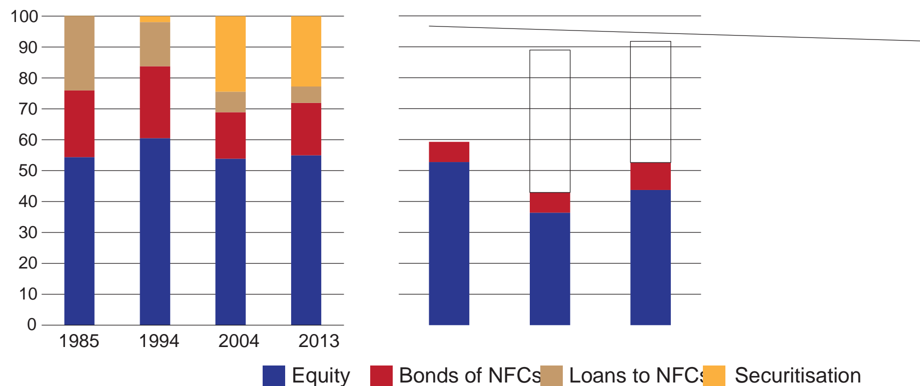
way the corporate sector is funded is substantially different in different jurisdictions (Figure 2). EU companies, like their Japanese counterparts, rely more strongly on bank credit, while US companies rely more on equity financing, corporate bonds and securitisation. In China, corporate credit markets remain comparatively underdeveloped.

The structure of financial intermediation changes slowly. The way non-financial corporations fund themselves tends to be stable over time (Figure 3). In the United States, for example, the percentage of equity in total corporate funding has remained almost unchanged in the last 30 years. However, bank credit has become less important and was partly replaced by securitisation (Figure 4). In both the UK and the euro area, equity financing has gradually lost importance while bank lending became significantly more important until the beginning of the crisis.

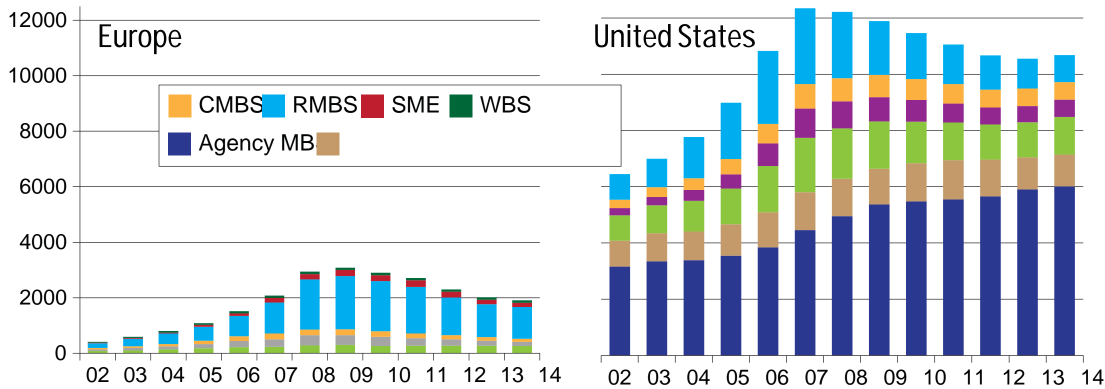
There are substantial differences in the funding models in different EU countries, with bank lending, securitisation, corporate bonds and equity playing very different roles (Figure 5).

The EU financial system remains national; cross-border integration is limited. Retail banking has remained largely national with few cross-border loans and limited cross-border ownership of subsidiaries, depending on the country (Figure 6). Wholesale banking became integrated before the crisis but has since lost its cross-border importance. Cross-border corporate bond holdings declined substantially during the crisis, but recently increased. The home-bias in equity remains substantial, with 64 percent of EU equity holdings and 61 percent of euro-area equity holdings being of domestic origin.

Capital markets can play an important role in spreading economic risk across different regions



and jurisdictions. A substantial body of literature provides evidence that well-integrated and deep capital markets can spread country and region-specific risk, smoothing the impact of deep recessions on consumption and investment (Figure 7)[14]. Such economic risk sharing requires substantial cross-border equity holdings in particular.



14. See Sorensen and Yosha (1998), Bijlsma and Zwart (2013), Allard et al (2013), European Commission (2015b).

'Deeper capital markets offer a greater variety of funding options and easier access to fin

tively underdeveloped in most countries given their general level of economic development. Second, financial markets still remain predominantly national, as measured by high home bias in investment patterns. The two issues are linked but call for different policies. While the response in the first case should be to improve conditions for capital market intermediation in every country, the second issue should be addressed by harmonising and standardising the national financial intermediation rules and practices.

CMU should combine the benefits of deepening and integrating financial markets. Both are beneficial and mutually reinforcing. Integration across borders, not least in equity markets, brings economic risk mitigation and reduces the financial-sovereign vicious circle. It also increases competition and allows for scale effects, which should help to generally reduce funding costs. This integration will also contribute to the development of markets. Deeper capital markets, in turn, offer a greater variety of funding options and easier access to finance for different kinds of corporations. They also increase the options for households to save and invest.

Most SMEs will remain reliant on banks for their external funding and will not be directly impacted by CMU. However, CMU should have a material impact to broaden financing options for high-growth companies of all sizes and dynamic medium-sized firms. It is misleading to characterise CMU as a project to target primarily SMEs. SMEs will continue to rely predominantly on banks, even though larger SMEs might gain capital market access through better-developed corporate loan securitisation. Large corporations already have decent access to capital markets. Where CMU offers most potential is for high-growth companies, which lack access to risk capital[19], and for medium-sized companies, which currently have much more limited access to capital markets than large groups.

To boost the role of capital markets in financial intermediation, the perspectives of savers, financial intermediaries and non-financial firms are all important. The shape of the financial ecosystem depends on decisions taken by all three categories and the framework conditions that affect them. Changes in the funding mix for non-financial corporations have implications for financial intermediaries as well as for savers. For example, strengthening equity funding implies that investors need to accept higher risk and longer maturities. While the current pattern of European savings in low-risk, short-maturity instruments is probably rooted in preferences and demographic structures, it is also encouraged by specific tax and regulatory policies. These policies should be amended to further the objective of better funding for the European economy, including through equity instruments. Similarly, corporate governance and ownership patterns that are dominated by family control in several EU member states might contribute to companies' reluctance to tap external sources of finance, especially those outside banks. But a more favourable policy framework could incentivise a significant number of companies to change their financing patterns in a manner that would be more conducive to investment and job creation. Financial intermediation and in particular banks are also central. Banks perform important functions in terms of maturity transformation, financial engineering and the overcoming of information asymmetries, and they have the capacity to deal with regulatory and supervisory differences between countries. Increasing harmonisation across EU countries could allow other organisations or even savers to engage directly in cross-border activity more easily. However, this also means that non-banks take certain risks, including in terms of maturity transformation.

Deeper and more integrated capital markets should spread economic risk, but potential financial stability risks need to be managed. The economic literature and the empirical evidence are clear that financial integration is a good way to spread economic risk. But the emergence of new financial players also raises financial stability concerns, especially when they engage in maturity transformation and/or financial engineering. There are risks at the level of instruments, institutions

19. Veugelers (2011).

20. Based on membership of the Federation of European Securities Exchanges (FESE) and the World Federation of Exchanges (WFE). These groups are, respectively, BATS, Nasdaq and the New York Stock Exchange (part of ICE) in the US; and the stock exchange groups headquartered respectively in Amsterdam (Euronext), Athens, Bucharest, Bulgaria, Cyprus, Frankfurt (Deutsche Börse), Ireland, Luxembourg, Madrid, Malta, Stockholm (part of Nasdaq OMX), Vienna (CEE Stock Exchange), and Warsaw in the EU. This list does not include the separate stock exchanges in Bratislava and Zagreb, which do not appear on the FESE membership list.

21. These included a brainstorming workshop held at Bruegel on 24 November 2014, a presentation by the authors at a meeting of the EU Financial Services Committee on 20 January 2015, participation of the authors and their Bruegel colleagues in a range of conferences and other events organised by third parties in a number of different EU member states, and numerous bilateral conversations with interlocutors in academia, the public policy community, the private sector and other segments of European civil society. The authors are also grateful to all those who have given feedback on early drafts of this paper.

22. Among others, Wright (2014) notes that "there is a striking inconsistency in data in some parts of the [EU] capital markets"