Capital markets union in Europe: Initial impressions

Douglas J. Elliott, Fellow, Economic Studies

One of the major current projects of the European Union (EU) is to create a "Capital Markets Union" to complement its new "Banking Union." The core idea is to build up the role of financial markets in Europe and to diversify away from a financial system that remains very bank-centric. This is one of the few areas where Europe quite explicitly wants to move in the direction of the United States, partially in recognition that having a system with a better balance between banks and markets aided us during the financial crisis and its aftermath.

Capital Markets Union is a major initiative of President Juncker and the new European Commission that took office in the fall of last year. There is broad and often enthusiastic support in Europe for the initiative, but there is also a great deal of uncertainty about what "Capital Markets Union" means and what the project will do. Some clarity has arrived with the issuance on February 18th of a consultative "green paper" by the European Commission[1], along with supporting background documents, although much remains unclear.

Some further clarity may be achieved when Lord Hill, the European commissioner for financial stability, financial regulation and capital markets union, speaks at Brookings on February 25.

Here are some initial thoughts on Capital Markets Union, based on the green paper and previous discussions in Europe.

Capital Markets Union is a very good idea overall

As with the Banking Union, it has been obvious for years to most analysts that it would be good for the EU to have more integrated, efficient, and effective financial markets. The green paper starts by laying out the following broad objectives on which there has been agreement in principle for many years:

- Unlock more investment for all companies, especially small and medium-sized enterprises (SMEs), and for infrastructure projects;
- Attract more investment into the EU from the rest of the world; and
- Make the financial system more stable by opening up a wider range of funding sources.

There have even been baby steps in the past to achieve these objectives, again similar to the early evolution of the Banking Union, where there were initial steps years ago, but all the hardest and most important things were deferred. Therefore, it is certainly a positive development that the political winds have finally caught the sails just right and significant progress can probably be made now to integrate and improve capital markets. In this case, the politics revolves around the strong focus of the Commission on "jobs and growth" and the nearly universal acceptance by European leaders of this prioritization.

Whatever the final outcome, this focus on integrating capital markets and improving their effectiveness and efficiency in Europe is a big improvement over the substantial periods when capital markets have been viewed with real suspicion, especially in parts of Continental Europe. Even now, there is still considerable momentum for a financial transactions tax designed explicitly in part to "put sand in the gears" of the financial markets and a number of member states are working together to design such a tax. Too much of the political attention in Europe in the past has been on measures such as these that would make markets work less well and more expensively. Even if this new initiative achieved nothing else, the change in emphasis should help block harmful changes.

More positively, there is quite a lot that can be done, as discussed below, and at least some progress will doubtless be made.

The benefits for SMEs are being oversold

There is a virtually complete consensus in Europe that SMEs need help and that one of the key problems is a

1. Available at http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf

difficulty in obtaining sufficient finance at reasonable prices. Improving the availability of funding for SMEs is a worthy goal, and one shared by many other countries, including the United States and China. However, the high level of political support for SMEs often leads to exaggerations that can distort policy and public perceptions of policy.

My particular concern is that Capital Markets Union is being sold by many politicians almost solely on the basis of the aid it can provide SMEs. (To their credit, the Commissioner and his staff have been more circumspect than the politicians in that regard.) This may lead to a de-emphasis of many sensible measures that would aid the functioning of capital markets but will have relatively little effect on SMEs. Perhaps worse in the long run, it may cause Capital Markets Union to be judged primarily on its success in aiding SMEs. This may lead to severe disappointment, as capital markets are unlikely to have much direct benefit for small firms and even among the medium-sized companies the ability to access capital markets will remain limited. That disappointment may make it impossible to take additional useful steps.

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Banks, and other financial intermediaries, are actually in a better position than financial markets to make the investment in building the relationships and knowledge of SMEs that is necessary for sound credit decisions. That knowledge is important because SMEs vary hugely in their business prospects and risks, particularly when compared across countries. Banks are also in a better position than markets to intervene with borrowers who run into trouble, especially through their own mistakes. Loan covenants give banks rights to step in and force actions in a way that is very difficult to do through markets. Further, relationships built over years give banks informal clout to encourage action.

Good market structures can aid banks and therefore indirectly help the SMEs, such as by facilitating securitization of SME loans. However, it will be important to ensure that banks retain a very considerable portion of the risk and reward from these loans, so that they will have sufficient incentives to do a good job of analyzing the credit risk of each loan and to intervene appropriately if necessary when things go wrong at the firms.

Another positive indirect effect is likely to come from a change in emphasis at the banks. The more that large and medium-sized firms switch their borrowing to the financial markets from banks, the more incentive there will be for banks to lend to SMEs, where they have clear competitive advantages.

One mistake that could be made through an over-emphasis on SMEs would be an excessive reliance on, and loose regulation of, crowd funding tools. There are natural credit cycles that mean that lending money overly cheaply to SMEs could look like a smart move for years at a time, only to be revealed as foolish when a recession hits and the credit losses more than wipe out the earlier profits. Unsophisticated investors in any part of finance that has these characteristics can easily find themselves lulled into a false sense of security by the easy early gains. Even experienced bankers exhibit this kind of cyclical behavior, but it is muted considerably by memories of losses, sophisticated analytical tools, and good bank supervision. Crowd funders are unlikely to have this, at least in the early days.

A counter-argument is that good crowd funding programs will be run by experienced lenders who will know to avoid, or minimize, these cyclical problems. However, these managers will have the wrong incentives if the system is not run properly. They could easily end up with the incentive to maximize loan volumes, and therefore their fees, in the good times, with the ability to walk away from the losses borne by their investors in the bad times. Good regulation and supervision can counter these incentives to some extent, although it is impossible to avoid the issue completely if the crowd funding firms take fees without bearing loan losses.

The same theoretical problems exist with asset managers who specialize in banks loans as investments, but there are good rules about diversification, transparency, and truth in marketing in place to reduce these risks. Crowd funding needs equivalent protections tailored to its somewhat different approach, including the use of the internet to match borrowers and lenders.

The Capital Markets Union should appropriately balance pragmatism and ambition

The EU needs to be pragmatic and to take account of the very real obstacles to integrating Europe's capital markets. At the same time, there is more political momentum for Capital Markets Union than there has ever been and this enthusiasm may well wane over time, which argues for moving forward ambitiously now. Balancing these two priorities will be critical.

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There is a great deal of variation across the EU member states in how important their financial markets are and how they operate, as well as in public and political attitudes towards those markets. Further, markets operate within the context of business law, bankruptcy law, and tax rules. All of these still vary quite widely across the EU and there is no prospect of this heterogeneity vanishing anytime soon.

These differences place strong limits on how far the integration of capital markets can proceed in Europe. For example, investments in higher risk credit SMEs are not fully comparable across countries with substantially different insolvency laws that create major differences in the frequency of bankruptcy and the severity of losses from bankruptcy. Pretending that these differences do not exist or are not material would only store up problems for the future.

The initiative on Capital Markets Union needs to combine a focus on smaller steps that can be successful over the next few years with the creation of momentum to tackle the larger issues of integration that involve the trickier topics of differences in law and taxation. The Commission's green paper holds out hope of capturing that balance, but it is clearer on the shorter-term steps than it is on how to begin building momentum on the harder and ultimately more important items. The good news is that the smaller steps would have a significant positive cumulative impact even if no progress were made on the larger goals.

Some of the steps that the Commission has suggested are ripe for action are as follows. The italicized words are quotations from the green paper; the summaries are my own:

Lowering barriers to accessing capital markets. This step is particularly focused on reviewing the rules for prospectuses to make it easier and cheaper for firms to go to the market, while still preserving proper investor protections.

Widening the investor base for SMEs. This action focuses initially on generating standardized credit information and credit scores to make it easier for investors to compare lending opportunities across SMEs.

Building sustainable securitization. This point expands on an existing European effort to revive securitization markets by defining a class of “high quality” securitizations that could be given more favorable regulatory treatment, as well as receiving market recognition for the benefits of their improved structure.

Boosting long-term investment. The Commission is seeking suggestions for how to support the recently finalized regulatory framework for European Long-term Investment Funds.

Developing European private placement markets. Private placements exist in a useful middle ground between full-fledged public offerings and bilaterally negotiated loans or share sales. Investors in these products are normally sophisticated institutions that are willing to do their own homework, but still require some ability to gain liquidity by selling their investment before maturity if desired. Europe’s private placement markets are much smaller than those in the US, as the Commission points out. The Commission identifies several “barriers to the development of pan-European markets” which “include differences in national insolvency laws, lack of standardized processes, documentation and information on the credit worthiness of issuers.” It notes that a consortium of industry groups has been developing standards for a new, integrated EU private placement market, which the Commission welcomes and will presumably follow up on to provide regulatory support.

Taken together, these five priority areas have the scope to make a real difference in Europe’s capital markets, but there will need to be bigger steps in the years ahead to truly achieve an effective Capital Markets Union. The green paper acknowledges the importance of tackling a whole range of broader issues on which it gives some detail. However, the paper gives little guidance about what the Commission might propose to do in regard to these tougher issues, focusing more on raising the points and asking for suggestions. This is not unusual for a green paper, which is normally produced when there is not yet sufficient clarity and consensus for a “white paper” laying out proposals.

Summary

A true Capital Markets Union is a good and potentially very useful initiative, which also has the virtue of making it harder for harmful but politically attractive proposals to gain traction. The Commission’s green paper is a useful starting point, which hopefully will build momentum for the many detailed actions that will need to be taken to translate rhetoric into action. It will also be important that momentum be built for the harder long-term tasks that will be necessary. However, it will be difficult to judge this for some time to come.