European capital market integration: where have we got to and how far to go?

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On 6 June 2018, CFA Institute hosted a conference at the European Parliament in Brussels on the progress of the European Commission's flagship Capital Markets Union project, which aims to create a single EU-wide market for capital by 2019. Josina Kamerling reviews the discussion and evaluates the proposed regulation and the challenges and opportunities that accompany it.

Freedom of capital movement was one of the founding principles of the European Union as enshrined in the Treaty of Rome in 1957. However, some sixty-years later Europe's capital markets remain relatively underdeveloped and highly fragmented. The reality is that the financial sector of the world's largest single market operates in a regulatory environment that has vastly disparate approaches to issues such as tax, regulation and insolvency.

Against this backdrop, in September 2015, the EU Commission initiated the Capital Markets Union (CMU) project. The objective was to foster stronger economic growth in Europe by creating broader and more integrated capital markets, removing barriers to cross-border investment, reducing the cost of capital raising and improving access to financing for businesses, especially for small and medium-sized enterprises, which play a crucial role in Europe's economy.

With the 2019 implementation date imminent, we hosted a conference to examine the viability and challenges facing the CMU in a post-Brexit environment.

The genesis of the CMU in September 2015 coincided with the gestation of Brexit, voted into existence nine months later by a slim majority of the UK electorate. Although the exit of the region's largest capital market caused some speakers to question the continued rationale for the CMU, John Berrigan deputy director-general for financial stability at the European Commission, noted that Brexit renders the need stronger than ever. Without the City, said Berrigan, Europe will be even more bank dependent, intensifying the need for a more diversified funding pool.

Furthermore, the funding needed to fulfil Europe's obligations under The Paris Agreement and the United Nations Sustainable Development Goals, will necessitate a systemic change in Europe's investment culture as the public sector will be unable to fill the funding gap alone. The scale of the EU's obligations under these accords will be substantial: an additional €180 billion per annum to meet the energy and climate objectives alone, rising to €300 billion per annum when resource and water management are included.

Wolf Klinz, a German MEP, argued that the post Brexit increase in cross border activity will also add to the need for a CMU because the portions of London's financial services industry that transplant to the EU27 will not flow to one destination. Rather, the European model of specialisation will see different jurisdictions focus on various specialities with high-frequency trading migrating to one region and broking, post-trade activities and asset management to others. This geographic dispersion will render cross-national co-operation and standardised supervision essential. Klinz noted that most supervisory failure is not due to misinterpretation of the rules but standards of implementation. The reality, said Klinz, is that the EU has no way to measure individual states' supervision, so it is important to progress with the proposed independent reviews on European Supervisory Authorities (ESAs). The reviews would be under the responsibility of a new executive board of the ESAs, which would replace the existing management boards. The executive boards would be composed of independent members, ensuring more effective and impartial coordination of supervisory practices.

Klinz's point that regulatory initiatives constitute only one half of the equation, with an adequate supervisory regime the other, was also made by several policymakers and regulators at the debate. The EU framework for financial regulation was entirely overhauled in the wake of the 2009 crisis and Europe now has a substantial body of legislation in the form of the "common rule book" governing the financial sector. However, as noted by the speakers, it can only be considered a common rule book if the rules are implemented consistently across member states. As things stand, supervisory arbitrage remains a significant stumbling block to the implementation of the CMU. For this reason, the focus of attention has been gradually shifting to supervisory consistency and convergence, which is the hallmark of a single market, said Berrigan.

This convergence will necessitate an overhaul of the European supervisory authorities. Integrated capital markets will require that the ESAs and ESMA, in particular, should be granted more supervisory powers to better apply a single rulebook for capital markets. Although some member states have objected to this, as the objective of the CMU is to build a single capital market in the future, the fact that current arrangements work today is no guarantee that they will be adequate in the much more integrated environment envisioned under CMU, argued Berrigan.

Irrespective of Brexit, the extent of the issues, extant and potential, stemming from Europe's capital market immaturity were emphasised by Jacques de Larosière, chair of the 2009 high-level expert group on EU financial supervision. De Larosière observed that although the European economy is as large as the United States, Europe's equity markets are less than half the size and its debt markets less than a third. As a result, European firms are over-reliant on bank lending with 86% of new funding in 2017 coming from banks versus 14% from the capital markets. In the absence of an alternate source of finance the fragility of Europe's economy in the event of another banking crisis is evident. Aligned with this is the fact that growth remains low in the eurozone: between 2010-2017 annual growth rates were 1.2% versus 2.1% in the US.

Lack of access to a vibrant capital market has also affected the economic wellbeing of Europe's households argued de Larosière. Although the average EU family accumulates savings at around twice the rate of its US counterpart, savings held in equities represent just 1.18 times annual GDP versus 2.9 times annual GDP in the US. Given the moribund post-crisis interest rate environment, it is clear that Europe's savers are being short-changed.

The need for haste in finalising the implementation of the CMU, not only to meet the self-imposed 2019 deadline, but also to get in front of emergent political headwinds was a recurring theme. Marco Lamandini, Professor of Commercial Law at the University of Bologna, noted that the wave of national self-determination sweeping the political landscape renders greater supra-national harmonisation more challenging to achieve.

Aside from geopolitical pressures, the rate of change within the asset management industry is also a challenge observed Peter De Proft, Director General at the European Fund and Asset Management Association, as emergent technologies such as fintech and blockchain will radically alter the financial services landscape.

To summarise the discussions of the day, it is essential that consideration of the greater good is essential in creating a market that is an engine for sustainable growth. However, we are at an inflection point. The important work around CMU and capital markets legislation, projects, and files must indeed continue to foster the development and future of the Eurozone, but it was acknowledged that widespread societal ennui and disillusionment with the financial industry must also be addressed. Finance is still not fixed, as there remains a fundamental disconnect between the basic principle of the industry – which is to connect those who have the means to save with those who need to borrow – with integrity and ethics creating the trust that is needed for the healthy function of the capital markets.