MEMO
N°09

# DEVELOPING CAPITAL MARKETS IN EUROPE

FÉDÉRATION BANCAIRE FRANÇAISE

- What is the CMU?

- Why is the Capital Markets Union essential to financing the European economy?

- Why is a new approach required to ensure its success?

01

# WHAT IS THE CMU?

The Capital Markets Union (CMU) is an initiative launched by the European Commission in 2015 and enhanced by the Communication of 12 March 2018. Its objective is to create a single capital market, completing the Banking Union to establish a Financing Union.

The six major goals of the European Commission's CMU project are to:

- **facilitate** access to financial markets for businesses;
- **invest** in infrastructure over the long term;
- **promote** institutional and retail investment;
- **strengthen** the banks' lending capacity;
- **facilitate** cross-border investment;
- **finance** innovation, start-ups, and non-listed companies.

## Why is the CMU essential?

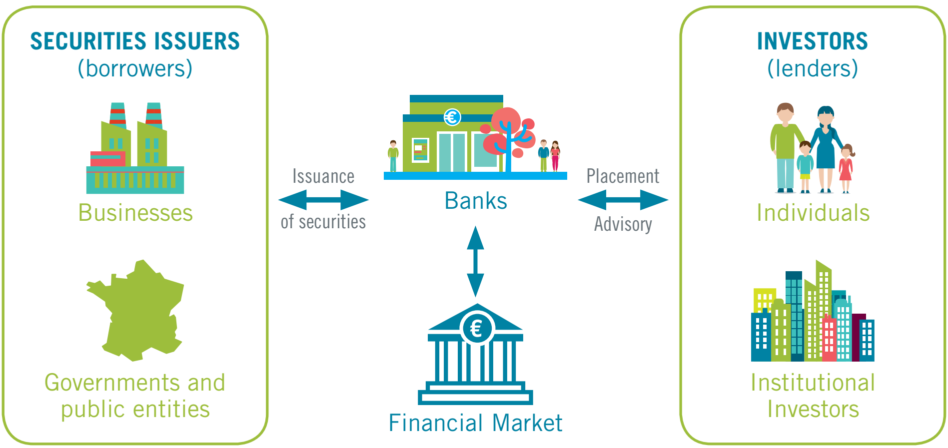
The CMU must **promote access for all businesses in the European Union** (foreign or European large caps, mid caps, SMEs, start-ups, and fintechs) **to market financing,** providing an effective alternative to bank loans.

As a result of the new prudential requirements restricting bank lending, **the capital markets** have been **called upon to play an increasing role** in financing Europe's economy. They must also make it possible to maintain the banks' capacity to lend via securitisation[1].

The CMU must make it possible for abundant **European savings** to **finance the economy** with players and financial circuits that are suitable and successful.

Just like the Banking Union, the CMU is also important for the **sovereignty and integrity of the eurozone**.

## THE ROLE OF BANKS IN THE CAPITAL MARKETS



## Concrete proposals from the FBF in 2015

Once the European Commission's work was launched in 2015, the banking profession supported the approach and developed proposals to:

- **create** a common label for securitisation methods[1] that are safe and transparent, supported by the European institutions; and create a public agency for European securitisation like Fannie Mae in cooperation with European public institutions;
- **develop** the emergence of a European private placement market in euro (Euro-PP);
- **promote** the creation of a euro-denominated negotiable debt instrument market;
- **encourage** the convergence of supervisory practices within the EU to create a real Capital Markets Union and remove barriers to cross-border investment;
- **define** a common framework that facilitates market access for small and medium enterprises;
- **develop** solid market infrastructures;
- **promote** long-term European investment; and
- **adapt** the Prospectus directive.

Against the backdrop of **Brexit**, there is an ever-growing need for strong European capital markets, and for an upgrade of political and technical market making skills. Today, London remains the primary financial centre in Europe for both trading and clearing (while France takes the first place in the eurozone). For the sake of its **sovereignty and financial stability**, Continental Europe must develop its capital markets.

(1) See glossary, p. 12

## What is the status on Continental European capital markets?

➤ **In Continental Europe,** credit financing has a **76%** share, while market financing has 24%.

➤ **In the United States,** conversely, most corporate finance is raised through the markets (**70%**), with bank lending accounting for only 30%[(2)].

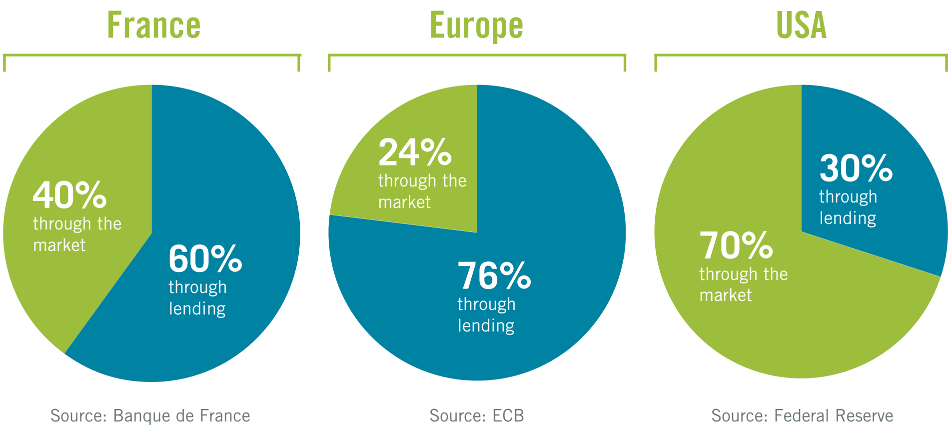
➤ **In France,** most businesses use bank loans, even though the market financing / bank loan mix is developing quickly and nearly **40%** of their financing now comes through the markets (compared to 31% in 2009).

There is an imbalance in the European Union between **surplus savings in certain countries and investment shortfalls in others**, caused by **fragmented markets**. The prudential rules, especially their application, may exacerbate this fragmentation.

In spite of sound knowledge of the markets and their customers' needs, **European corporate and investment banks (CIBs) do not have the advantage** of a unified domestic market. Therefore, European corporate financing costs are sub-optimal.

(2) The capital markets equal 150% of GDP in the US compared to 70% in the European Union.

## SOURCES OF FUNDING FOR BUSINESSES IN 2017



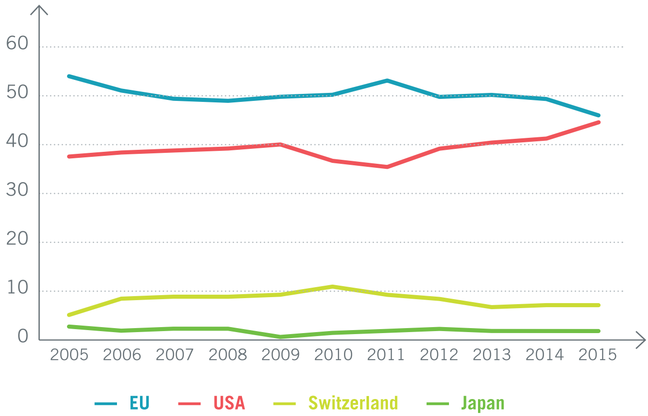
A competitiveness problem has been observed in the European banking industry, along with **distortions of competition** between EU banks and non-EU banks brought about by:

- the existence of an **integrated market in the US**;
- **international prudential treatment** promoting the highly disintermediated American financing model: US banks sell their outstanding loans to the agencies Fannie Mae and Freddy Mac, thereby reducing the size of their balance sheet;
- **regulatory differences** between the EU and third countries: the rules on separation of market activities adopted by the US (Volcker Rule) are less strict than those adopted by certain EU Member States (specifically under French law).

## CHANGES IN MARKET SHARES OF INVESTMENT BANKS WITHIN THE EMEA AREA

### (Europe, Middle East, Africa)

Source: March 2016 Bruegel study, based on Thomson Reuters




CIBs[3] play a fundamental role in financing and hedging corporate, infrastructure, and public-sector risks. The FBF has made an educational film in which clients explain specifically how CIBs have met their different needs: IPOs, currency hedging, bond finance, private placement, green bond issues, etc.

*Find the video on YouTube FBFFrance*

## The CMU, three years on: a mixed review

As part of the action plan for the CMU in 2015, several initiatives have been taken. However, they have not achieved the desired target of integrating capital markets:

- **the Securitisation[3] Regulation of 12 December 2017** introduces reduced regulatory capital charges for securitisations that are STS, i.e. **Simple** (the securitised portfolio must be uniform, for example with only mortgage loans), **Transparent** (the investor must be informed of the assets' historical performance), and **Standardised** (the bank must retain a share of the risk). Stimulating quality securitisation is one of the objectives of the CMU, but this overly strict regulation, which will come into force as of 1 January 2019, is unlikely to give this activity any boost;

(3) See glossary, p. 12

- **the Prospectus Regulation of 14 June 2017** is meant to facilitate market access for European SMEs/ISEs and clarify which information is to be published by an issuer when issuing equities or debt instruments, so that investors are fully informed. This is a positive regulation, but it will not remodel the issuance landscape. It is a limited response to the need of giving SMEs/ISEs easier access to market financing. There are more technical specifications to be adopted before it takes effect in 2019;
- **the proposal to revise the European Supervisory Authorities (ESA)** is still in discussion. It is critical that we review the remits and governance of these authorities, particularly ESMA (European Securities and Markets Authority). We must consider increasing the convergence of regulatory and supervisory mechanisms in order to ensure truly fair competition and prevent certain Member States from turning it into an argument about attractiveness.

Further to its Communication of 12 March 2018, "Completing the Capital Markets Union by 2019", the European Commission has proposed new legislative measures.

The aim of these measures, which are still awaiting adoption by the European Parliament and the Council, is to:

- introduce common rules for **covered bonds**: for the banking profession, these proposals are moving in the right direction;
- remove obstacles to **cross-border distribution of investment funds**;
- facilitate the **financing of small businesses** on the capital markets;
- and develop **sustainable financing**.

02

# OUR PROPOSALS

Our first challenge is to create the conditions for greater development of capital markets in Europe.

## Method:

## A Committee of Experts

The banking profession supports the CMU and considers in view of the proposed action plan and the main European regulations adopted so far - specifically the Prospectus Regulation and the Securitisation Regulation - that the current method has only partially achieved the objectives. Beyond a regulatory approach, it now seems necessary to prepare an ambitious and consistent overall strategy.

**The French banking profession calls for a more strategic approach.**

To factor in the impact of Brexit, which is forcing Continental Europe to develop its capital markets, and banking regulations that set limits on financing by bank balance sheets, it is essential that we start with a precise analysis of the markets' functioning with the aim of better valuing the strengths of the European market and its players.

This is a political issue, which must be launched at the ECOFIN Council and Eurogroup level in 2018, to be implemented by the new European Commission in 2019.

The FBF suggests that the European institutions organise the discussion **and invite known figures into a "Committee of Experts"**, modelled on the "Lamfalussy Committee"[1].

This Committee of Experts would be tasked with defining policies to promote the stimulus of the CMU and trace the path to be taken in the context of Brexit.

## First concrete proposals from the banking world

In addition to these strategic proposals, we think it is critical to:

- **promote the development of a pan-European securitisation market** particularly for SME loans and mortgage loans, thereby revising the Securitisation Regulation of 12 December 2017;
- **promote the reallocation of savings to corporate financing** thereby easing the conditions for marketing certain financial products (specifically in the MiFID II, PRIIPs and IDD[2] regulations).

Furthermore, to accelerate European financing for the energy transition, the FBF encourages the establishment of **prudential treatment suitable for green assets in the form of a Green Supporting Factor (GSF)** (see FBF Memo "How to Successfully Finance the Energy Transition").

## Preserving equal competition is imperative

European corporate and investment banks (CIBs) and the universal banking model, which are key in guiding customer financing on the markets, must be preserved.

And so there must be a close watch for any distortions of competition:

- **with non-European CIBs**;
- **with investment funds**. European (or national) legislation is developing the lending capacity of certain types of funds. For these activities, these funds should be subject to the same requirements as lending institutions;
- **with investment firms (IF)**. The European Commission's proposal of 20 December 2017 must be amended so that third-country IFs that are systemic in nature are subject to the same rules as their European counterparts.

(1) Appointed by the European Council in 2000, this Lamfalussy Committee is behind the four-level approach to lawmaking established in the EU: legislation, implementing measures, enactment into national law, and control of the law.

(2) See glossary, p. 12

IOSCO[2], which currently issues recommendations, **must play a central role in ensuring a minimum level of regulatory harmonisation on a global scale**. Moreover, to prevent any distortion of competition, national regulators are responsible for standardising the application of these regulations.

## A consistent vision

Regulatory authorities must make consistent choices in regulations to promote the development of an effective CMU. Regulation must not be counter-productive: do not over-regulate, and do ensure market liquidity.

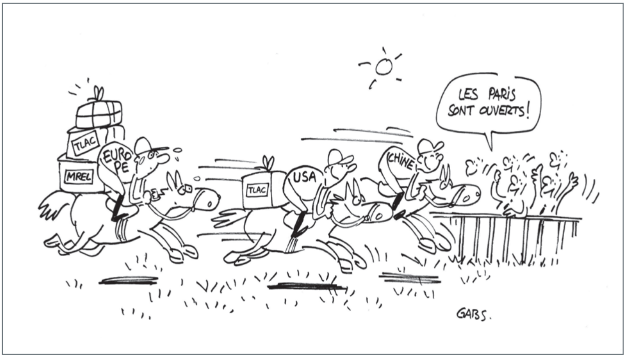



Illustration taken from Repères d'économie bancaire [Banking economy benchmarks] © RB Edition.

To this end, they must:

- **officially abandon the European financial transaction tax (FTT) project**, to avoid penalising the development of trading on EU markets;
- **define the appropriate transparency requirements applicable to the different markets**. Indeed, the proliferation of execution platforms and the heightened transparency requirements may undermine the markets' liquidity, as observed by IOSCO[(2)] in its February 2017 report on bond liquidity. The effects of the entry into force of the new Markets in Financial Instruments Directive (MiFID II)[(2)], specifically on the bond and derivatives markets, will have to be closely examined;
- **make sure that the Commission's proposal to revise EMIR[(2)] requirements** regarding the supervision of clearing houses (June 2017) does not end up penalising European banks. Indeed, **the relocation of clearing houses is a fundamental issue of sovereignty and financial stability**, but it must apply to all players, European or not, so that there is no damaging distortion of competition that could be harmful to EU banks;
- **not pre-empt the international work on reforms of market risk (FRTB) and liquidity risk (NSFR)[(2)]** and await the enactment into local law of the agreement of 7 December 2017 finalising the Basel III reform and the effective application of these reforms by all jurisdictions (specifically the US).

(2) See glossary, p. 12

# Glossary

**CIB** Corporate and Investment Bank or Corporate and Investment Banking.

**EMIR** The European Market Infrastructure Regulation of 2012 organises a more solid and transparent derivatives market.

**FRTB** The Fundamental Review of the Trading Book is a project to reform the prudential treatment of market risks, led by the Basel Committee.

**IDD** The Insurance Distribution Directive offers a new framework that applies to the distribution of insurance products by intermediaries and to direct sales made by insurers.

**IOSCO** The International Organization of Securities Commissions is made up of the regulators of the world's main stock exchanges. It is tasked with establishing international standards for improving the efficiency and transparency of the securities market, protecting investors, and facilitating cooperation among regulators.

**MIFID II** The second Markets in Financial Instruments Directive defines the new obligations in the distribution and marketing of financial instruments as well as in the organisation and transparency of the financial markets.

**NSFR** The Net Stable Funding Ratio is a long-term liquidity ratio.

**PRIIPs** The Packaged Retail Investment and Insurance Products Regulation defines the pre-contractual disclosure requirements for retail investment products and insurance-based products.

**SECURITISATION** consists of transforming a portfolio of loans or illiquid receivables into debt securities that are sold to investors.

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