GSK Update

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Capital Markets Union – What is coming up?

Executive Summary

> The EU Commission wants to establish a Capital Markets Union (CMU). On 18 February a respective "Green Paper" and in summer 2015 a "White Paper" including concrete regulatory proposals shall be published. Thus, it is still a concept under construction.

> The Capital Markets Union shall (independent from any bank) stimulate financing of the European economy through capital markets, especially in regard of small and medium-sized companies. This should promote economic growth and provide investors with a broader Europe-wide choice of investment opportunities with higher returns.

> Topics of the Capital Markets Union are (i) standardisation of rules and market practices for capital markets products (e.g. high-quality securitisation, private placements and crowdfunding); (ii) tax equality between debt and equity investments; (iii) reduction of the fragmentation of European markets through national insolvency laws and (iv) improved accessibility to better comparable company information for investors.

> Furthermore, new rules for European Long Term Investment Funds (ELTIFs), a revision of the Prospectus Directive (80/390/EEC) as well as of the legislation for covered bonds (in Germany this relates to the provisions of the *Pfandbrief Act*) and many more are subject to discussion.

On 15 July 2014, Jean-Claude Juncker, at the time not yet president of the European Commission, in a speech before the European Parliament mentioned for the first time the idea of an EU Capital Markets Union (CMU) as one key task of his presidency. Capital markets should be further developed and integrated in order to improve the financing for the economy and reduce the costs for raising capital, especially for small and medium-sized companies.

In September 2014, Jonathan Hill became EU Commissioner for the newly established sector of Financial Stability, Financial Services and Capital Markets Union. In a speech on 6 November 2014, he further defined the idea of a Capital Markets Union. In this view, it is a project for all 28 EU Member States (i.e. not only – as the Banking Union – for the Euro Zone and other volunteers). The CMU should include, *inter alia*, the rules, documentations and market practices for products like securitised instruments, private placements or crowdfunding as well as the equalisation of the tax treatment of debt and equity investments as well as dealing with the diverging national insolvency laws. Also the standardisation on a cross-border basis of information being accessible for investors in order to assess the risk of investing in small or medium-sized companies is an issue.

In words of Steven Maijoor, Chair of the European Securities and Markets Authority (ESMA), the Capital Markets Union may currently still be a "concept under construction" – meaning a not yet defined object of European politics. However, there is already a large team in Brussels working on it in order to bring the idea to life. On 18 February, there will be a "Green Paper" for consultation and discussion of this topic. Jonathan Hill's professed aim is the publication of a "White Paper" (with first concrete regulatory proposals) in summer 2015. So what will we be faced with?

1. Economic Context

Europe recovers much slower from the international financial and economic crisis than for example the US. Even in Germany a decelerating growth can be observed today. The economic recovery is impeded by political and, subsequently, economic uncertainties concerning Greece' future in the Euro-Zone (keyword "Grexit") and the newly emerging east/west conflict in the Ukraine. Deflation has become a real risk for the Euro Zone – significantly more realistic than former inflationary fears of some Germans. The restrictive fiscal policy of many EU Member States necessary due to their sins of the past hampers the economic recovery. And thus it is, currently in particular the European Central Bank (ECB) which strives to accelerate economic growth by its monetary policy, lately with its Euro 1,140 billion "Quantitative Easing" (QE) project.

EU businesses get about 80% of their financing from banks, and only 20% from the capital markets. Therefore, the ECB currently tries to reach more economic growth by using new means such as QE. However, this is still in line with the traditional "open market policy" applied by European central banks over the last decades, which meant that central banks increased the supply of money to banks in order to enable them to grant more loans to businesses and thereby function as a "transmission belt" for the economy. Today, the often disregarded problem is that it is not the lack of liquidity why banks recently more and more refrain from the granting of loans. A major cause for this is in fact the regulatory tsunami in recent years which considerably increased the regulatory (in particular capital and liquidity) requirements (keywords: Basel 3, CRR, CRD 4, EMIR etc.). As a consequence, various traditional banking and especially lending business became economically unviable. Just gradually these correlations are recognised and assessed correctly, as recent statements by Jonathan Hill (EU Commissioner) or Yves Mensch (Member of the ECB's Executive Board) may demonstrate.

The idea of a Capital Markets Union approaches this problem in a different way: It should strengthen the financing of the economy in a way independent from banks, by focusing on corporate finance via capital markets, and thereby contribute to economic growth. The better access to a broader and Europe-wide selection of investment possibilities with higher returns should make Europe more attractive to investors and, at the same time, should offer European companies (in particular small and medium-sized companies) a better avenue to alternative and favourable forms of financing.

2. Basis of the CMU

More opportunities for both, European companies and investors, are the two sides of the new medal Capital Markets Union. The European capital markets should become integrated, well (but only to the degree necessary) regulated and liquid. There should be more cross-border investment opportunities and actual investments and that not only in the short term but also in the long term investment area.

Elements

Jonathan Hill has explicitly identified four main elements of the future CMU: (i) the standardisation of still deviating national rules on, documentations and market practices of capital markets products. He explicitly makes the very different examples of securitisation instruments, private placements and crowdfunding. (ii) In his view, current tax laws fovour debt over equity financings and this should be reconsidered. (iii) Reconsideration should also apply to the differences in national insolvency rules which lead to an unhealthy fragmentation of European markets. And (iv) investors needed more and better access to better comparable company data, in particular relating to smaller and medium-sized companies, in order to better assess the risks of cross-border investments.

First steps

As first steps towards CMU Jonathan Hill has proposed the following: (i) the Commission proposal for a regulation on European Long Term Investment Funds (ELTIFs) should already be implemented this year in order to enable such ELTIFs to quickly start to finance desperately needed infrastructure projects. (ii) The EU should, in coordination with respective global endeavours, establish a regulatory framework in regard of high quality securitisation. (iii) Very soon the current rules of the Prospectus

Directive (in order to make it easier for small and medium-sized companies to address foreign investors via exchange trading) should be reviewed. Furthermore, also the rules on covered bonds (in Germany this means especially the rules of the *Pfandbrief Act*) as well as those for private placements should be re-examined. And (iv), in a more long term view, one should think about how better access to credit information (company data) on small and medium-sized companies can be achieved.

3. Proposals

At the end of 2014, these first thoughts on the future CMU have already led to a row of more specific proposals from the financial sector.

For example, Nicolas Verón from Bruegel Policy Contribution has rightfully pointed out that there is such a multitude of capital markets segments, subsegments and products that the typical innovation intensity of this sector should not be endangered by regulation. Therefore, in contrast, it were important to create a good legal environment for the development of new financial constructs and new ways of intermediation of financial products by applying a sound "*Ordnungspolitik*" (regulatory policy). As examples he mentions in this context venture capital, private equity, public equity offerings and IPOs, the issue of company bonds, the direct purchase of loans from banks by insurance companies and investment funds, credit intermediation through specialised non-banks such as leasing companies and consumer credit providers. Moreover, he finds the securitisation rules for both banks (Basel 3) and insurance companies (Solvency 2) too restrictive, the so-called "fair value accounting" for insurance companies in regard of securitisation inappropriate, proposes to make the International Financial Reporting Standards (IFRS) mandatory for all European banks (which would be harsh for those German banks still doing their accounting under the national Trade Code (HGB) rules), and to separately supervise central counterparties (CCPs).

Particularly elaborate is the "An agenda for the capital markets union" study of the Association for Financial Markets in Europe (afme) which proposes not only the setting of specific 5 years targets for the CMU (e.g. an increase of the share of capital markets financing by 10 %, the doubling of the annual issue volumes of securitisation transactions and of private placements, etc.) but also an action plan (e.g. supporting industry initiatives on high quality securitisation and in regard of private placements as well as a revision of the respective regulatory framework, especially the regulatory capital requirements, the Prospectus Directive, the Takeover Directive and the tax regime for the equity financing of small and medium-sized companies; also more harmonisation of national insolvency rules with the EU; better integration of clearing and settlement systems; creation of a new securities law regarding the use of property in securities as collateral (which aims at the EU Commission´s SLL project); etc.).

Similar targets (as those proposed by afme) were also put forward by the Federation of European Securities Exchanges (FESE), namely a stock exchange market capitalisation of 100 % until the end of 2020. Also equal treatment of domestic and foreign investors and their proper information are subjects FESE is concerned about. Moreover, capital markets should be open to large as well as to smaller companies, should be well regulated and supervised (in particular also dealing with systemic risks) and transparent.

Already on 27 March 2014 the EU Commission itself had published a Notice on the long-term financing of the European economy, which today reads like a kind of quarry for the future CMU. It speaks of the necessity for infrastructure and climate protection bonds and of bonds for social projects as well as of ELTIFs and of the review of existing EU rules such as the Prospectus Directive, the Transparency Directive and the Markets in Financial Instruments Directive (Mifid). Moreover, the Commission work regarding distinguishing high quality from other securitisation transactions, a review of the covered bonds market and of the private placement markets are also mentioned as well as a better access to data for the financing of small and medium-sized companies, the promotion of infrastructure finance, the new evaluation of accounting standards and of tax stimuli for equity investments.

Besides a lot of praise for the idea of CMU, there is, particularly among banks, also some not unjustified concern that this project could also to some degree suppress the important project of regulating the shadow banking sector. A high German civil servant recently mentioned that he sees CMU as the possible start of a new deregulation and unfortunately he did not mean it in an approving manner.

4. Next steps

Some, if not many, of these proposals will now become the subject of discussion regarding the specific design of the CMU. The Commission´s "Green Paper" planned to be published on 18 February 2015 will put such thoughts up for consultation and discussion. It will be exciting to see which of them will make their way as specific proposals for regulation into the "White Paper" planned to be published in summer 2015. We´ll keep you posted!

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