UNLOCKING INVESTMENT

The European Commission has unveiled its plans to create a Capital Markets Union. Philip Smith examines the implications

ILLUSTRATION: IMAGE SOURCE

In February, EU Commissioner Lord Hill launched a three-month consultation on his ambitious Capital Markets Union (CMU). It is a bold initiative that bids to improve business access to finance through deeper, liquid and more integrated capital markets.

The green paper, *Building a Capital Markets Union*, sets out the options that could be available, and the policy levers that need to be pulled, in order to create a Europe-wide finance market. This market would give businesses and investors greater opportunities throughout the 28 member states, irrespective of borders and nationality.

It is ambitious in timing and in scope; Lord Hill is aiming to develop an action plan that will put in place the building blocks for a fully functioning capital markets union by 2019. That is only four years away.

Great expectations

The ambition in scope is laid bare in the green paper. “The direction we need to take is clear: to build a single market for capital from the bottom up, identifying barriers and knocking them down one by one,” says Hill, who is responsible for financial stability and financial services as well as CMU. “Capital Markets Union is about unlocking liquidity that is abundant, but currently frozen, and putting it to work in support of Europe’s businesses, and particularly SMEs. The free flow of capital was one of the fundamental principles on which the EU was built. More than 50 years on from the Treaty of Rome, let us seize the opportunity to turn that vision into reality.”

The paper sets out four objectives that the Commission is aiming to achieve through CMU. First, it wants to improve access to finance for all businesses and infrastructure projects across Europe. Second, it wants to help SMEs raise finance as easily as large companies. Third, the Commission is aiming to create a single market for capital by removing barriers to cross-border investments. Finally, there is a desire to diversify the funding of the economy and reduce the cost of raising capital.

Simon Lewis, chief executive of the Association for Financial Markets in Europe, welcomes the proposals, saying: "Capital Markets Union is an essential reform project to revive the EU economy, and the financial industry can and will make an important contribution." He adds that he particularly welcomes the emphasis that Lord Hill is placing on securitisation and the Prospectus Directive (a directive specifying the requirements for prospectuses that are prepared for investors when securities are issued), both of which are subject to separate consultations in the coming months.

Lewis's views are echoed by Sally Scutt, deputy chief executive of the British Bankers' Association (BBA), who says that the initiative is extremely important for the EU's attempts to kick-start growth in Europe. "We would like the final proposals to reduce fragmentation and increase the depth of Europe's capital markets, which will lower the cost of capital, improve its allocation and ultimately better support Europe's growth companies to create jobs," she says.

It has, however, also been suggested that there could be resistance to CMU among certain sections of the banking community, particularly those regional banks that are focused on national markets and medium-sized companies. But the BBA believes there is little to fear because it does not see banks and capital markets as competitors; it sees them as complementary.

Yet Scutt warns that the proposals need to be seen in the context of other EU plans that could prove counterproductive. "Introducing a financial transaction tax or restricting banks' ability to conduct market-making activities for their clients through further structural reform could undermine attempts to inject greater liquidity into capital markets," she says.

Problems and pitfalls

So what are the real problems that CMU is trying to address, and what are the pitfalls that could lie ahead? As Hill says, the free movement of capital was enshrined in the Treaty of Rome more than half a century ago. But the European Commission argues that capital markets today remain fragmented and are typically organised on national lines. This was brought into sharp relief following the financial crisis of 2008, since when the degree of financial market integration across the EU has fallen, with banks and investors retreating to home markets.

So, from a position of heading towards a unified market, similar to that seen across the Atlantic in the economic powerhouse of the US, Europe appears to have turned around, and is heading back towards a position of 28 smaller markets with less liquidity, and therefore less investment and capital available to be put to use by business to help achieve the Commission's stated aim of creating more jobs and economic growth.

The differences between the US and European environments are laid bare in *The EU IPO Report: Rebuilding IPOs in Europe*, a new report from the EU IPO Task Force, a group led by quoted company membership association European Issuers, the European Private Equity & Venture Capital Association and the Federation of European Securities Exchanges. Highlighting the 'lost investment' in the European economy, the report compared the actual levels of certain investments (such as leverage loans, high-yield bonds, initial public offerings (IPOs) and private equity (PE)) with their potential size if European capital markets were as big relative to GDP as in the US.

The report reveals that there was some $3,725bn 'lost' in leveraged loans, $775bn in high-yield bonds, $110bn in IPOs and $390bn in PE. Quite some difference.

As MEP Philippe de Backer, chairman of the Task Force, says: "In order to deliver a Capital Markets Union in Europe that can provide more diverse funding sources for companies and cut the cost of raising capital, notably for smaller companies, we need policymakers, regulators and industry to work together to deliver reforms to regulation, to the tax regime and to market practices that will make IPO funding through the public markets accessible to all European companies."

Although the report focuses on IPOs, its conclusions cut across the whole equity and capital piste. It calls for a more balanced and flexible regulatory environment, easing of constraints that restrict investors' access to markets, improved tax incentives and

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KEY PRINCIPLES

The European Commission's green paper identifies the following key principles, which should underpin a Capital Markets Union:

- **It should maximise the benefits of capital markets for the economy, growth and jobs;**
- **It should create a single market for capital for all 28 member states by removing barriers to cross-border investment within the EU and fostering stronger connections with global capital markets;**
- **It should be built on firm foundations of financial stability, with a single rule book for financial services that is effectively and consistently enforced;**
- **It should ensure an effective level of investor protection; and**
- **It should help to attract investment from all over the world and increase EU competitiveness.**

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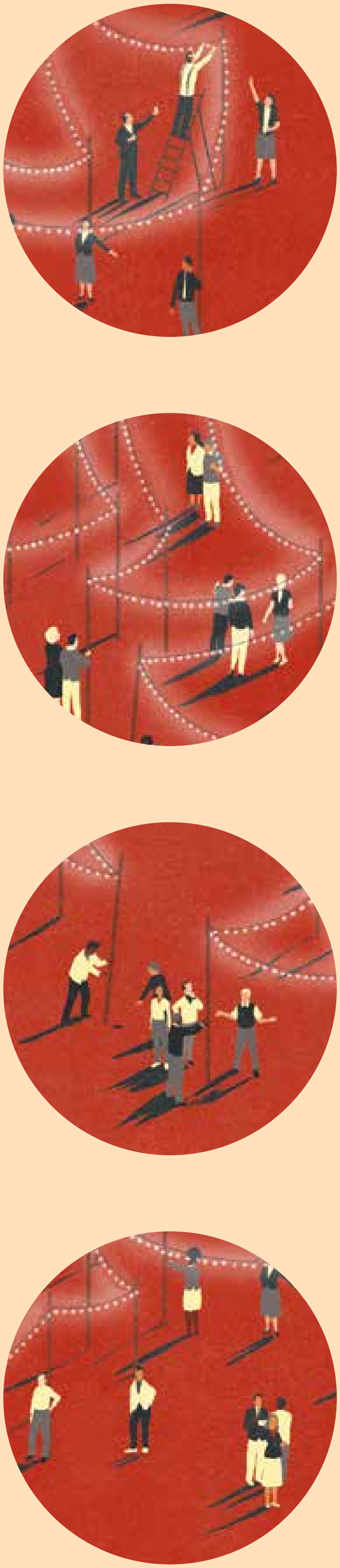

a market system that better serves companies at different stages and different types of investors.

But, perhaps most importantly, it calls for the creation of an equity culture in Europe through education and non-legislative initiatives.

Emphasis on equity

This last conclusion is an area that needs to be tackled head-on if the CMU idea is to gain any traction, according John Grout, ACT's policy and technical director. "It is very important to start to educate the whole of Europe about equity," Grout says. "If you are going to set up a European-wide capital market for both equity and bonds, you are starting with a low level of education in much of Europe. If the Commission does not come up with soft actions rather than hard law, it will fail."

It is one of several points highlighted in a European Commission staff document that accompanied the publication of Lord Hill's green paper. The briefing paper recognises that Europe has traditionally relied more on bank finance, with European total bank assets far exceeding those of the US. But even this hides wide variations between different countries and their appetite for equity investment. For example, domestic stock market capitalisation exceeded 121% of GDP in the UK, compared with less than 10% in Latvia, Cyprus and Lithuania.

Grout warns that expectations must be realistic, and that change will not happen overnight, and perhaps not for many years. "If there is an expectation that they will get much done in less than a generation, they will fail. If there is not a real understanding of what equity is and what it does, why you might invest in it and how you might invest in it if you are a smaller investor, it could take 20 years for people to become used to it."

The staff paper also notes that more than 60% of EU citizens surveyed in 2013 stated that they had lost confidence in the financial sector as a result of the financial crisis. This low level of confidence, the paper says, hinders the flow of savings into capital market instruments.

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Who's the boss?

One way to solve this lack of confidence problem would be to address issues over supervision. Significant progress has been made in strengthening the regulation and supervision of capital markets across the EU. But, as the staff paper itself concedes, while there has been considerable progress in harmonising rules needed for the transparency and integrity of securities markets, legislation relating to investors' rights in securities is not yet harmonised. Different member states define securities in different ways. Some stakeholders argue that this hampers the integration of EU capital markets because investors in one member state cannot correctly assess the investment risk in another member state.

This is a point raised by Andrew Strange, financial services risk and regulation director at PwC. He says: "While there is an important role for the European Supervisory Authorities, firms will want to consider carefully which bodies should get responsibility under CMU. Already we have seen the Bank of England suggest that this is not necessary, and we expect regulators in the UK to oppose ceding additional powers. Firms across the EU will not welcome any further uncertainty, particularly the eurozone banks that are getting used to the reality of direct European Banking Authority supervision."

The House of Lords EU sub-committee on economic and financial affairs backs this view. The committee's chairman, Lord Harrison, says: "Of course, we need to tread carefully. A move to more diversified sources of funding needs to go hand in hand with improved investor protection, and greater clarity for the consumer."

A further issue revolves around which companies could benefit from the CMU initiative. While the Commission talks about SMEs, it is clear that capital markets are really only relevant for mid-cap and larger companies. The costs of going direct to the markets for financing rather than to banks are significantly higher.

As Marte Borhaug, senior policy adviser on financial services for the Confederation of British Industry, told a stakeholder's meeting hosted by Lord Harrison prior to the release of the green paper, it was important to focus on who CMU was trying to help and ensure it was not just talking about SMEs in terms of their size, but whether they were growing and had the ambition to grow. She added that there were things that could be done to improve the market, but companies also needed to take the initiative to look for alternative sources of finance.

Learning curve

SMEs could still benefit, however. As Grout says: "If you further the ability of larger companies to take funding from the market rather than from banks, banks might need to look for something else to do, and that might mean lending to SMEs. It is a second tier effect."

So what will this mean for corporate treasurers? If the objective of the CMU is to reduce the reliance upon bank debt, then larger and mid-sized companies will have to go to the markets, argues Grout. "The relevance to treasurers is that they need to follow what is going on; they will need to work out how they are going to use capital markets and when they are going to use capital markets. How will they explain this to their boards?

"There will be a learning curve for treasurers, and the nature of their relationships with banks and the capital markets will change."

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PHOTOGRAPH: CHARLIE BEST

THE TREASURER'S VIEW

"The objectives of the proposals on Capital Markets Union are quite laudable," says James Kelly, head of treasury at pest controller Rentokil Initial. He notes that while there are some "big challenges" to the proposal, such as encouraging investment across borders and changing the preference for funding in-country, the benefits could be significant if the union is successful.

Kelly continues: "At the moment, euro markets are receptive to smaller trades, such as our recent €50m floating-rate note, but in more volatile markets, minimum deal sizes would be substantially higher. Creating a broader range of markets, including developing the private placement market and encouraging peer-to-peer lending, would reduce the risk for borrowers of either not being able to raise money or only being able to raise an amount that is substantially more than is needed."

He concludes: "Clearly, there's no guarantee of success and we've seen with the Single Euro Payments Area how timescales can slip. But, overall, these are initiatives that should be encouraged."