Capital markets union: managing high expectations

March 2015 • William Wright

By pulling down artificial barriers to the free flow of capital across borders in Europe, capital markets union could help unlock hundreds of billions of euros in additional investment to boost growth and job creation.

However, it is such a wide-ranging initiative that there is a significant danger that it will fall short of the unrealistically high expectations that many people from different interest groups have set for it – particularly when it comes to the impact it will have on SME funding and the potential for developing securitisation and private placements

This paper is an attempt to manage down some of those expectations, by looking at what capital markets union is **not…**

Part 1: summary of 'what capital markets union is not':

1. It's not an academic question

Capital markets union is not a theoretical concept: by breaking down the many barriers and obstacles across Europe that are holding back the free flow of capital across borders to where it can be most effectively invested, capital markets union could unlock hundreds of billions of euros a year to help fund growth and job creation. If European capital markets closed just half of the current gap in depth with US markets, it would translate into an extra $500bn of funding for corporates a year.

2. It's not about the finance industry

It's about investors, companies, infrastructure and growth. Capital markets union can help bridge the wide but largely artificial gap between the world of finance and the real economy, and help financial markets refocus on their primary purpose of supporting investment and allocating capital. It should start from the perspective of investors and asset owners, and help to connect them as efficiently as possible to those projects and companies that need investment.

3. It's not just about securitisation

Securitisation can play a potentially important role in helping finance a recovery in Europe, but it is not a silver bullet or a quick fix. The economics of securitisation will remain relatively unattractive until monetary policy normalises (and even then) overall volumes of securitisation – particularly the securitisation of SME loans – will remain a relatively small proportion of overall bank financing. In addition, there are other ways of freeing up bank balance sheets to encourage SME lending, such as the development of an institutional loan market and capital markets for mid-sized companies.

4. It’s not really about SMEs

We need to be realistic about what capital markets can do for SMEs. Even though SMEs account for two thirds of employment in Europe they account for just 3% of capital markets activity – a similar proportion to the US (using the official definition of an SME as a company having fewer than 250 employees). Capital markets favour scale and only a small proportion of small companies will ever be suitable to access capital markets directly. For example, annual volumes of IPOs below $100m is equivalent to about two days of SME lending. The biggest boost to SME funding will be indirect, by unclogging bank balance sheets in other ways to free them up to lend more to SMEs.

5. It’s not all about private placements either (or mini-bonds or crowdfunding)

There is plenty of scope for the European private placement market to grow, but even if it hits the very high expectations set for it, the market will at best be a few percent of overall funding. European companies already raise the same amount as US companies in this market – they just raise half of it in the US instead of over here. The same caution should apply to other growing sources of finance such as mini-bonds, direct lending or crowdfunding. Every little helps – particularly when it comes to funding SMEs and mid-sized companies, but let’s be realistic about the impact they can have.

6. It’s not about the next five years

Five years is a very long time in European politics. The European Commission hopes to have ‘created’ a capital markets union by 2019, but it is unlikely that it will be able to have done much more than lay the foundations for future work. Many of the big issues – such as tax and insolvency law or the patchwork of market infrastructure across Europe – will take decades to change, and even some of the easy low hanging fruit could take years to have an impact. The most important shift required for a successful capital markets union is cultural - and that is not going to happen overnight.

7. It’s definitely not about the City of London

Capital markets union is not about the City of London or a conspiracy by free market Anglo-Saxon economics to take over Europe. The range in the depth and development of capital markets between individual countries in Europe is far wider than the gap between Europe and the US, and it will be important to build a capital markets union that works as well for countries with nascent capital markets – such as the newer members of the EU – as for highly-developed market economies, such as the Netherlands or the UK. As the largest financial centre in Europe, London has an important role to play in setting an example. If London tries to exploit its position, it will quickly kill off the project.

8. It’s not about tax and insolvency law

The diversity and complexity of different tax and insolvency law across Europe is a significant barrier to the creation of a genuine capital markets union –but addressing them head-on would go beyond the remit of the Commission and risk exhausting limited political capital on intractable legal wrangling with member states. Better to start laying the groundwork now but to focus immediate efforts on more practical and achievable projects.

9. It’s not about increasing savings

Europe doesn’t have a savings problem: it has an investment problem. Europe saves more of its income than the US but the majority sits in the bank earning a negative return (European bank deposits of €22 trillion are nearly three times the US). One of the biggest challenges ahead is to encourage a shift from bank deposits to investments. A good start would be for the capital markets industry to think hard about how to make the industry simpler, more efficient, and more trustworthy.

10. It’s not about more regulation

The answers to more efficient and deeper capital markets are unlikely to be found in more regulation, particularly after the barrage of reform over the past five years. You cannot regulate a capital markets union into existence. Instead, policymakers and the industry should come together to identify the main inefficiencies and barriers to deeper capital markets in Europe and work out how to overcome or remove them – while retaining a strong focus on investor protection and market supervision.

Part 2: more detail on ‘what capital markets union is not’:

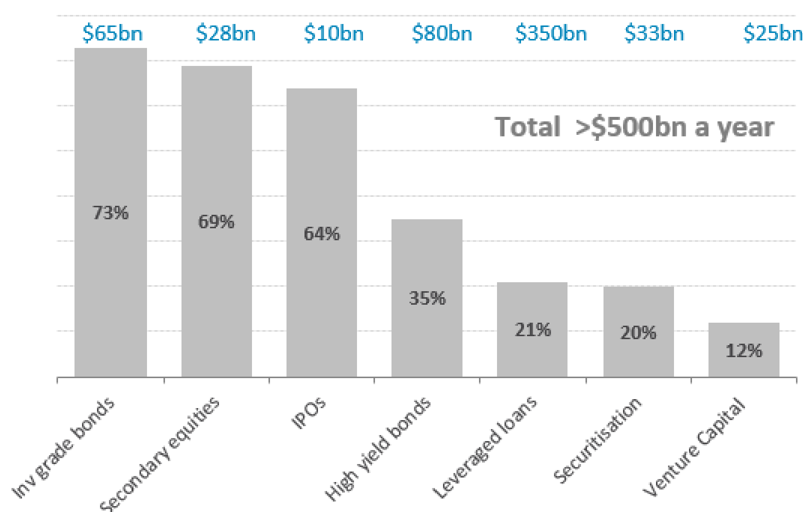
1. It's not an academic question

It could be easy to dismiss capital markets union as another eurocratic slogan or a grandiose political project from Brussels. But Capital markets union is not a theoretical concept: by breaking down some of the many barriers and obstacles across Europe that are holding back the free flow of capital across borders to where it can be most effectively invested, capital markets union could help unlock hundreds of billions of euros a year to help fund growth and job creation.

This chart shows how big some European capital markets are compared to how large they would be if they were the same size relative to GDP as in the US (it uses an average over five years from 2010 to 2014 to iron out some of the variation from one year to the next):

How deep are European capital markets?

Size of European capital markets relative to how big they would be if they were as deep as in the US relative to GDP %
(and how much extra capital could be raised per year if half of that gap were closed $bn)



Source: New Financial

For example, the European investment grade bond market is about three quarters the ‘depth’ relative to GDP as its US equivalent, while the new issue market in equities in Europe (IPOs and follow-on equity issues) is about two thirds as big.

The bigger concern is that despite rapid growth in recent years, the European high-yield bond market is about one third the size of the US, while the markets for leveraged loans (often seen as a stepping stone from bank lending to capital markets for medium-sized companies) and securitisation are only one fifth as large in relative terms. Venture capital funding in the US is eight times larger than in Europe.

From this, we can work out the gap in capacity and how much more could theoretically be raised in European capital markets if they were as developed as in the US. If we assume that capital markets

union could help close half of that gap between European and US capital markets, it could help unlock more than $500bn a year in funding for corporates.

2. It's not about the finance industry

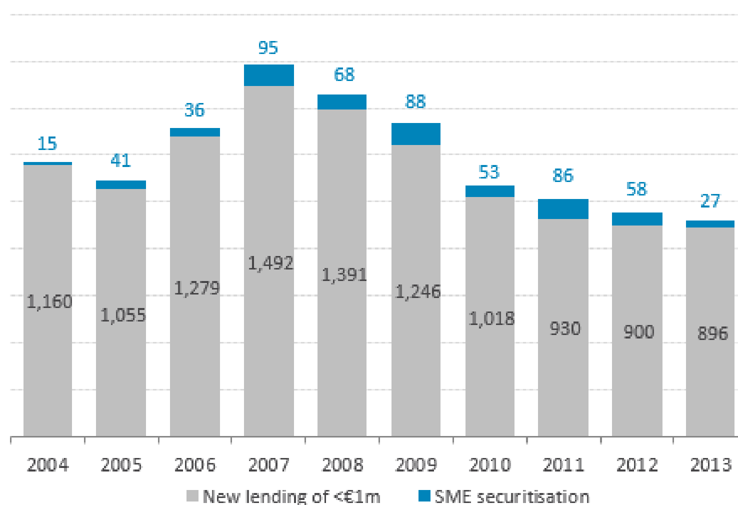
It's about investors, companies, infrastructure and growth – not about intermediaries. Capital markets union can help bridge the wide but largely artificial gap between the world of finance and the real economy, and help financial markets refocus on their primary purpose. It should start from the perspective of investors and asset owners, and how to connect them as efficiently as possible to those projects and companies that need investment.

Roughly half of all investable assets in Europe are sitting in cash in the bank rather than being invested at a time when many sectors of the European economy are crying out for capital. Capital markets union is a huge opportunity to make this mechanism more efficient. It is also an opportunity for the industry to focus more on what customers want and need, and perhaps less on what regulators think.

Perhaps where banking and the financial markets went wrong before the crisis was in forgetting that their primary purpose is to support and service the rest of the economy. If capital markets union can help restore that purpose, and help reconnect finance with the real economy, then it may prove to be one of the more valuable European projects of recent times.

3. It's not just about securitisation

Securitisation can play a potentially important role in helping finance a recovery in Europe, but it is not a silver bullet or a quick fix. The economics of securitisation will remain relatively unattractive until monetary policy normalises, and even then overall volumes of securitisation – particularly the securitisation of SME loans – will remain a relatively small proportion of overall bank financing. This chart shows gross annual volumes of new bank lending to small companies (loans of less than €1m) and the total value of SME loan securitisation over the past decade:



Source: ECB, AFME, New Financial

At its peak in 2007, the value of SME loan securitisation in Europe was $95bn, which was a little more than 10% of total securitisation volumes in Europe and less than 7% of small business lending that year. In other words, it is a potentially useful but hardly transformational funding tool. The European Commission that if securitisation volumes could return to just half of their pre-crisis levels, it could provide an additional €20bn to SMEs (against roughly €650bn in annual lending to small companies and roughly €1.5 trillion in the stock of SME lending).

In particular, it is hard to see how SME securitisation is attractive when the stimulus from central banks encourages lending at artificially low rates, while securitisation financing costs banks up to 10 times as much, with the additional obligation to the bank of retaining a chunk of each deal.

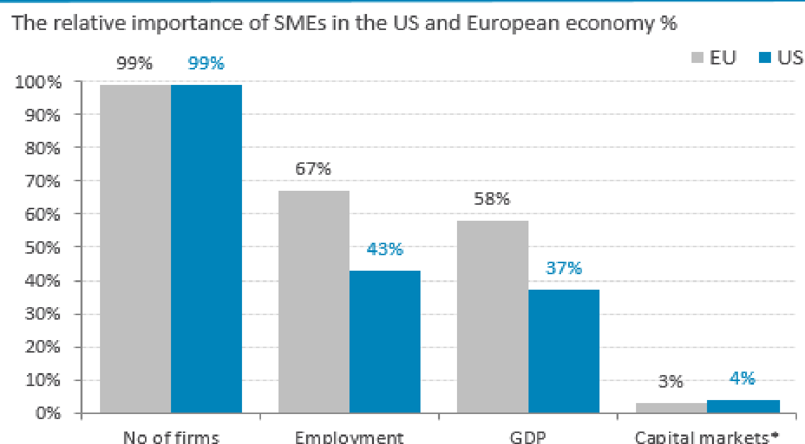
One danger of the focus on reviving securitisation in Europe is that it could crowd out other mechanisms that could help unclog bank balance sheets, such as developing an institutional loan market in Europe (whereby a loan is originated by a bank but sold on to third party investors) and encouraging the growth of capital markets for mid-sized companies that currently default to bank lending. This would free up banks to focus on their day jobs of SME lending, using their local knowledge, branch networks and credit histories to best use – and could have a bigger and faster impact on the flow of funding to SMEs.

The other danger of reviving securitisation is where to draw the line between 'high quality' or 'simple' securitisation, and more complex structures or the securitisation of lower quality assets. Given the gradual creep of securitisation in the run-up to the crisis in terms of asset quality, complexity and standards, it is not surprising that policymakers are sceptical that it can be contained as 'good' securitisation in future.

4. It's not all about SMEs

It sometimes seems that political support for the idea of capital markets union is contingent on what it can do to help finance SMEs. But high expectations in this field are likely to be disappointed.

While SMEs are a hugely important part of the European economy – and any increase in the availability and diversity of financing should be welcome - they are inherently unsuited to capital markets financing and we are unlikely to see a sudden wave of bond issues and IPOs from SMEs. This chart summarises the role of SMEs in Europe and the US:



Source: European Commission, US census, Dealogic, New Financial

**Note: 'SME capital markets' defined as IPOs, high-yield bond issues and leveraged loans of less than $100m as a % of total issuance between 2009 to 2013*

Even though SMEs account for two thirds of employment in Europe, they account for just 3% of capital markets activity – a similar proportion to the US. These figures disguise the dominance of micro-enterprises in Europe (companies with fewer than 10 employees account for more than 90% of all companies in Europe compared with around 70% in the US).

These types of business are even less likely to use capital market funding than other SMEs. For example, average volumes in Europe over the past five years of IPOs of less than $100m (the majority of which comes from companies at the top end of the SME scale or above it) add up to around $2bn a year. That is roughly one day's worth of SME lending across lending.

A big part of the confusion comes from the definition of an SME. The official EU definition of an SME is a company that employs fewer than 250 people or has a turnover of less than €25m. It is these small companies that play such an important role in the economy and which have such a grip on the public imagination.

However, for investment bankers and asset managers, an SME could be as large as €500m or even €1bn. These companies (better described as mid-sized) can realistically access capital markets, but in Europe they still tend to rely on bank lending. Our research shows that capital markets financing for mid-sized companies on deals of less than $250m is five times bigger in the US than in Europe.

This is the real sweet spot for capital markets union, and could have the biggest impact on SME financing. By focusing on expanding access to capital markets for mid-sized companies, more of them will benefit from growth in the high-yield, leveraged loan, private placement and smaller company IPO market. This will help unblock unnecessary bank lending to mid-sized companies from bank balance sheets, which will free up additional lending capacity to SMEs.

5. And it's not all about private placements (or SME stock markets, or mini-bonds, or crowdfunding)

There is plenty of scope for the European private placement market to grow, but (as with the securitisation market) even if it hits the very high expectations set for it, the market will be a relatively small part of overall funding.

The numbers can be confusing. On paper, it looks like the US private placement market is more than twice the size of the European market, which is fragmented into different national markets such as the Schuldschein market in Germany or Euro PP market in France. In 2013, more than €46bn was raised in the US private placement market compared with less than €20bn in Europe.

However, roughly half of the volumes in the US market are from non-US issuers, with European companies accounting for just under one third of all issuance. If you add the €15bn raised by European companies in the US private placement market to the €20bn they raise in Europe, the combined €35bn is around 60% more than US companies raise in their own private placement markets.

That does not mean that the private placement market cannot play a bigger role in Europe. The European market has grown fourfold over the past five years and a single market with simpler documentation could easily hit €50bn or perhaps even €100bn a year. However, that needs to be put in context of more than €2.7 trillion in debt financing for mid-sized companies that needs to be refinanced between now and 2018 (according to S&P).

Private placements are also often touted as a tool for increased SME funding. But with a deal sweetspot of between €100m and €250m, the market will be of limited help to SMEs (except indirectly by helping to free up space on bank balance sheets). And it is unclear whether European investors have the skills or capacity in private placements to step up and provide enough demand.

It's a similar story with other markets such as mini-bonds, direct lending, SME stockmarkets and crowdfunding. To be clear: every little helps when it comes to financing SMEs and medium-sized companies – and a wider and more diverse range of financing channels would be a huge benefit of capital markets union, but supporters of these different markets need to be more realistic about their potential impact.

6. It's not about the next five years

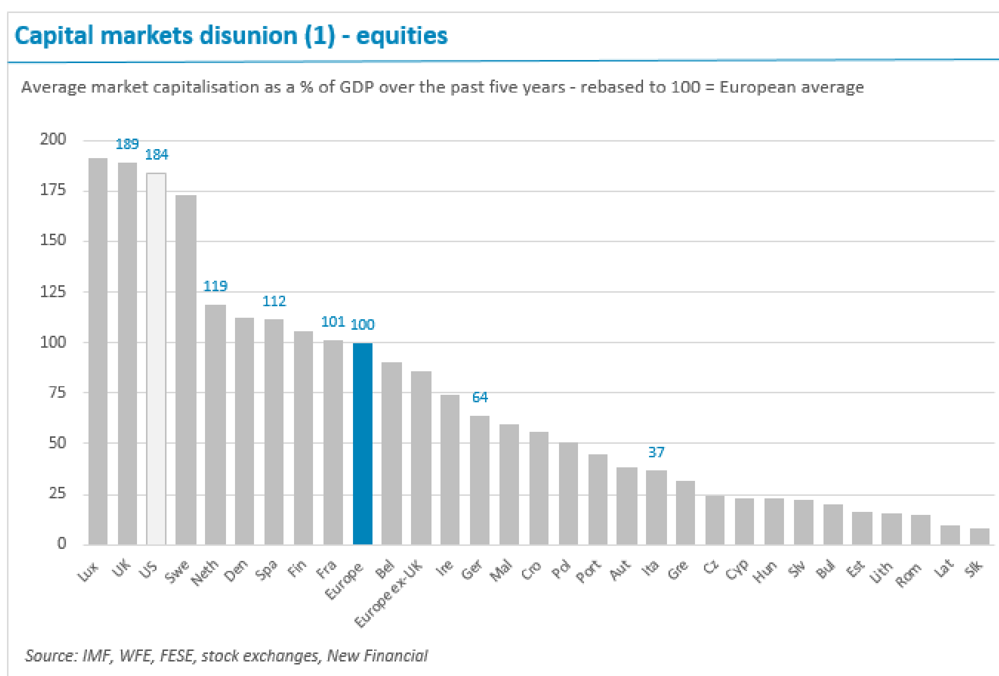
Five years is a very long time in European politics. The European Commission hopes to have 'created' a capital markets union by 2019, but it is unlikely that it will be able to have done much more than lay the foundations for future work. That in itself will be a huge achievement, not least because many of the big issues – such as the variation in tax and insolvency law or the patchwork of market infrastructure across Europe – will take decades to change, and even some of the easy low hanging fruit could take years to have an impact.

To be more than just a series of legislative patches, capital markets union will require a fundamental cultural shift in Europe away from bank financing and the safety of bank deposits to a more entrepreneurial approach to finance and higher risk (with potentially higher reward) approach to investment. That is not going to happen overnight, and it is not within the remit of the European Commission to dictate such a change.

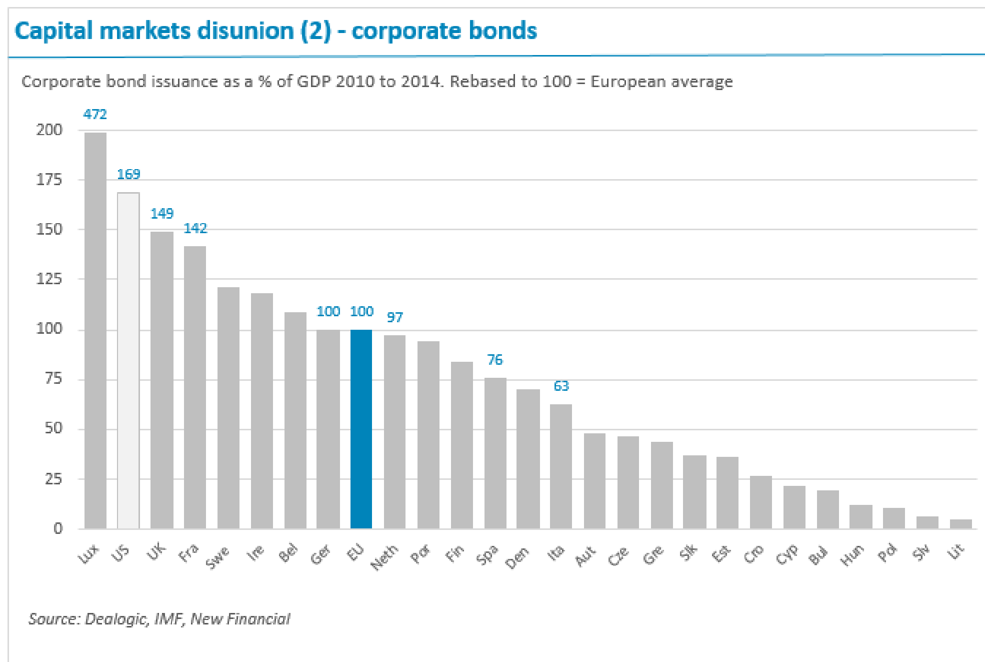
Instead, the capital markets industry has to start making a more positive case for what it does and to show companies and investors that it can be trusted to act in their interests as much as its own.

7. It's not about the City of London

Capital markets union is not about the City of London or a conspiracy by Anglo-Saxon-style free market economics to take over Europe. The range in the depth of capital markets between individual countries in Europe is far wider than the gap between Europe and the US: the following charts show the range in the development of stockmarkets and corporate bond issuance across the EU. When you compare market capitalisation to GDP, the UK and US are roughly the same level of development – and their markets are more than twice the depth of the rest of Europe.



A similar if less pronounced trend is on display in the corporate bond market: corporate bond issuance is roughly 50% bigger relative to GDP than in the rest of Europe, while some of the more recent entrants to the EU have corporate bond markets that are a fraction of the size of the rest of Europe.



(NB. Europe in these charts is the EU + Iceland, Norway and Switzerland)

This diversity has important policy implications. From a political and practical perspective it will be important to build a capital markets union that works as well for countries with nascent capital markets – such as the newer members of the EU – as for those with highly-developed market economies such as the Netherlands or the UK.

As the largest financial centre in Europe, London has an important role to play in setting an example around best practice and rebuilding trust between different market participants. If London is seen to be exploiting its position at the expense of smaller markets, political support will quickly evaporate.

8. It's not about tax and insolvency law

You don't get very far in a conversation about capital markets union before someone throws a spanner in the works mentioning the need to harmonise the wide range of insolvency law and tax treatment across different members states in Europe. Insolvency proceedings range from a few months in Ireland to more than three years in Greece, Poland and Slovakia, and despite some progress towards pan-European practices, progress has been bogged down by the different trade-offs in individual states between speeding up the process on the one hand and the treatment of creditors and employees on the other.

This trade-off, along with differences in the tax and legal treatment of securities (and differences between member states in how to resolve those differences) are beyond the remit of the Commission. While the diversity and complexity of different tax and insolvency law across Europe is a significant barrier to the creation of a genuine capital markets union – addressing them head-on risks exhausting limited political capital on intractable legal wrangling with member states. Better to adopt a dual track approach to the problem: start laying the groundwork now for these longer-term issues, but at the same time start work on the plenty of more practical and achievable projects.

One option could be for the Commission to develop a 29th regime for insolvency which companies could adopt. However, the limited adoption of European company structures (Societas Europaea) suggest this approach is unlikely to solve the problem.

9. It's not about boosting savings

Europe doesn't have a savings problem: it has an investment problem. Europe saves more of its income than the US (with gross savings running at 20% of GDP in the EU compared with 17% in the US). But the majority of these savings sit in the bank often earning a negative real return (European bank deposits of €22 trillion according to the European Banking Federation are nearly three times the value of bank deposits in the US) or under mattresses.

One of the biggest challenges is to encourage a shift from bank deposits to investments. Pensions assets in Europe are around one third the size of the US once you adjust for GDP, and they are only one fifth as large if you strip out more developed markets like the UK and the Netherlands. The mutual fund industry in Europe is scarcely half as big. Unless capital markets union addresses the relatively low levels of demand in Europe, it won't get very far.

As the Bank of England said in its recent paper on capital markets union:

…If more borrowers are to come to the market, then more funds will need to be made available to them. Bringing investors to the market has two key dimensions: directing more household and corporate-sector savings towards vehicles that will invest via capital markets; and encouraging more investors to allocate capital across the European markets as a whole….Diverting funds, particularly from retail savers, away from banks and towards mutual, and other, investment funds and equity instruments would improve the chances of the EU reaping the benefits of capital markets. But a range of reforms will be needed to achieve these benefits…

This could shift the focus of reform towards making the investment process cheaper and more efficient, for example by addressing the patchwork of market infrastructure across Europe. However, as the Bank warns, the success of practical reforms could be limited if 'cultural factors and risk aversion' are the main reasons for the lack of enthusiasm in Europe for investing in capital markets.

10. It's not about more regulation

The answers to more efficient and deeper capital markets are unlikely to be found in more regulation, particularly after the barrage of reform over the past five years. No-one can regulate a capital markets union into existence. Instead, policymakers and the industry should come together to identify the main inefficiencies and barriers to deeper capital markets in Europe and work out how to overcome or remove them – while retaining a strong focus on investor protection and market supervision.

Too much focus on regulatory structures and policy debate on whether Europe needs a new single regulator will exhaust political capital and sap the life and momentum out of capital markets unions. Re-calibrating existing regulation – and in some cases removing it entirely – could have a bigger and faster impact.

Note: over the past few months New Financial has been running a series of workshops for market participants from across the industry identify the barriers to deeper capital markets in Europe looking at equities, debt, market infrastructure and investing. We will be publishing a manifesto on 'Unlocking capital markets' in April.

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