A New Vision for Europe's capital markets

Summary of the final report of the High-Level Forum on Capital Markets Union
June 2020

This is a short summary of the recent report by the High-Level Forum on Capital Markets Union on how to inject a new sense of urgency into the CMU project. It provides a headline appraisal of the report and summary of the HLF's main recommendations. You can read the full report of the HLF here and the interim report from February here.

For context, you can read our own report from November 2019 'A new sense of urgency: the future of capital markets union' here.

1) What is the High-Level Forum on Capital Markets Union?
The High-Level Forum on Capital Markets Union was set up by the European Commission in November 2019 to review the progress made by the CMU initiative since 2015 and to make specific recommendations to accelerate it. The group included 28 'wise men and women' from different sectors of the industry, policy experts, academics, industry professionals, and industry and consumer associations. The group was selected to reflect the perspectives of different stakeholders and specifically included representation from smaller and less-developed capital markets. The HLF was chaired by Thomas Wieser, who previously chaired the Economic and Financial Committee of the European Union and of the Eurogroup Working Group.

The work of the HLF was divided into four main areas, each with its own working group of experts:

- Financing for businesses
- Market infrastructure
- Retail investment
- Obstacles to cross-border investment.

The HLF report highlights 17 challenges and makes 'clusters' of more than 30 recommendations to address them (summarised on page 6 of this paper). These recommendations are not so much abstract ideas or grand visions but 'precise and clear' and potentially 'game-changing' measures: the report argues that the EU should not treat them as a menu from which to pick two or three courses and describes them as 'mutually reinforcing and dependent on each other'.

Between them the recommendations tackle many of the barriers to bigger, deeper and more unified capital markets by: enhancing the trust and confidence of EU citizens in capital markets; simplifying existing rules and reducing legal uncertainty from differences in their implementation and enforcement across member states; addressing the unintended consequences of existing legislation and high compliance costs; improving access to and reducing the cost of information; reviewing investment barriers; and embracing new technologies.

While the HLF was set up by the Commission it does not speak for the Commission and the report does not represent the Commission's position. The Commission will review the HLF's recommendations and incorporate its work into a revised action plan for CMU later this year.

In the interests of full disclosure, five New Financial member firms were involved in the HLF: Bank of America, BlackRock, Cboe Europe, JP Morgan and Schroders). A full list of the members of the HLF is available here.

2) Restating the case for CMU

The starting point for the report was that the EU needs an effective CMU now more than ever. The combination of Brexit and the Covid crisis will have a big impact on the EU economy for years to come that banks alone will not be able to address. The aim of CMU should be to make the EU economy 'stronger, more resilient and more dynamic' and the report highlights the vital role that capital markets - particularly equity markets - can play in supporting a recovery.

Deeper capital markets would help drive a recovery in a number of ways: they provide an additional source of funding for companies which complements bank lending and increases the capacity of the banking sector by freeing up capital; they bring diversification and flexibility to the financial system increasing financial stability; they boost the shock absorption capacity of the economy making recovery easier and faster; they allow innovative and risky firms to access more capital at a lower cost; they can help finance the transition to a sustainable economy and tackle climate change; they offer long-term investors such as pensions funds and insurance firms a wide range of assets to invest in and the ability to generate long-term returns; they can help EU companies to compete globally; and finally, they help democratise wealth creation and investment.

3) The right foundations for CMU

The original CMU has laid many of the foundations but to accelerate and complete it requires a clearer and more focused plan as well as strong political support at the highest level between EU-wide institutions and member states. The HLF report argues that CMU needs to avoid the mistakes of the past five years where many initiatives have become bogged down in political wrangling between institutions and by member states seeking to protect their national rules and structures.

The new plan must have a clear timetable, granular measures, strong monitoring and enforcement mechanisms - and must have full political support at the highest level. There needs to be clear endorsement of the new plan and a full agreement on a specific package of measures with a clear timetable from the presidents of the European Commission, the European Council, the European Parliament as well as national leaders, who should 'commit to swiftly and faithfully implement the agreed measures and pursue complementary measures at a national level'.

4) A valuable contribution

The work of the HLF is a hugely valuable contribution to the debate on the future of CMU in several ways. It is much more targeted and focused than the original CMU action plan, which was widely seen (we think unfairly) as being a 'laundry list' of measures. The report makes a more compelling economic and political argument as to why the EU needs a CMU than previous iterations (though we think there is still scope for more work on this at a national and EU level). It is less about grand visions and more about practical detail (less 'what' and more 'how'): the report includes roughly five pages per issue with a summary of the recommendation(s), the problem it is addressing, the justification, the legal changes required, the feasibility, expected benefits and a delivery timetable.

The report also includes some big and bold ideas that the previous version of CMU has avoided and which we think would have a potentially transformative impact on capital markets in the EU such as: a single platform for accessing company information (a sort of EuroEdgar); the need to encourage more member states to embrace auto-enrolment pensions (which we think would have a bigger impact on capital markets than any other measure); a pensions dashboard for member states to monitor the sustainability of their pensions system across all three pillars of state, workplace and private pensions; a big focus on the potential power of equity markets, including a new category of listed companies with a market value of less than €1bn and a more appropriate listings and disclosure regime for them; and a pragmatic approach to reviewing some areas of legislation under CMU 1.0 such as securitisation that clearly haven't worked as intended.

5) A constructive critique

There are several areas where we think the report could be improved. At the heart of CMU is the inherent tension between 'top down' measures to harmonise rules and drive change across the EU ('more union') and the 'bottom up' measures at a member state level to reform their own markets and boost capacity ('more capital markets') that we think in many sectors would have more impact. While these bottom up measures are by definition beyond the remit of the EU or the European Commission, the report could have included more ideas in this area. For example, in the summary of the 17 different clusters of recommendations, 'member states' are named as actors in just three areas. This is particularly important because it is far easier to get 28 market participants and policy experts to agree on what needs to be done than it is to get 27 member states to agree to actually do it.

Engaging EU citizens more directly in capital markets and encouraging more retail participation is a big focus of the report and will be a big part of the solution. But moving the dial on retail investment will take much longer and have less impact than moving the dial on institutional money: we estimate that retail investment assets are around 45% the value of pensions and insurance assets in the EU27 and as such a 10% increase in institutional assets would have more than twice the impact (and could probably be achieved more quickly) as an equivalent increase in retail.

We also think there is a risk of introducing some distractions from the core focus of CMU: for example, while a more harmonised approach to insolvency regimes across the EU would be a huge positive, it will also consume huge amounts of political capital and potentially take decades. And in some areas, the recommendations are not bold enough: for example, nearly 20 years after the initial Giovannini report on market infrastructure in Europe, the HLF report does not go far enough in addressing the inefficient patchwork of (predominantly) national exchanges, clearing houses and securities depositaries across the EU.

This section summarises the proposals in each of the four main areas outlined in the HLF report:

6) Financing for businesses: creating a vibrant and competitive business environment

The EU economy remains heavily reliant on bank lending due to inefficiencies in the EU ecosystem, a structural tax bias towards debt financing and, in many areas, the high costs of accessing other forms of financing. At a time when the EU economy needs much more equity, public equity markets are shrinking and the flow of equity to SMEs and growth companies has stalled. Investors do not have access to consistent information on companies in different countries which encourages domestic bias, start-ups can't easily find investors, many smaller firms avoid IPOs due to onerous listing and disclosure obligations, and some investment vehicles do not invest into SMEs and start-ups due to restrictive prudential requirements.

The HLF make several proposals to address these issues. First, ESMA should set up a single access point for financial and sustainability-related information for companies (initially for companies with listed securities but potentially in future a platform for all companies and funds). Second, the Commission should propose targeted amendments to the European Long-Term Investment Funds (ELTIFs) framework while member states should simplify tax rules for ELTIFs and apply preferential tax treatment. Third, the Commission should proceed with a targeted review of Solvency II to allow more investment by insurance firms and pension funds and assess the impact on market making and long-term investment in SMEs by banks and non-banks when implementing Basel III. Finally, the Commission should simplify the securitisation framework as its too complex; change the prospectus, market abuse and MIFID regulations to make public listing more attractive to SMEs and introduce a new category of listed companies called SMCs (small and medium capitalisation companies with a market value of less than €1bn) with a more proportionate regime.

7) Building a strong and efficient market infrastructure
The fragmented and inefficient infrastructure behind EU markets limits the benefits from trading such as greater efficiency, higher liquidity, economies of scale, and lower costs. The post-trade infrastructure remains fragmented: central securities depositories face regulatory barriers in providing cross-border services while national rules on ownership rights and execution of entitlements differ across member states making it difficult for investors to exercise their ownership rights and increase costs. This raises the barriers at national borders and discourages cross-border investment and capital raising.

The report recommends that the Commission should change CSDR to strengthen the CSD passport and improve supervisory convergence, introduce a shareholder rights regulation with a harmonised definition of 'shareholder', and change the shareholder rights legislation to clarify the interaction between investors, intermediaries and issuers when it comes to voting rights and corporate action processing. National authorities should cooperate with the Commission to embrace technology with a view to increasing investor engagement and make corporate actions more efficient. The Commission should also improve the digital competitiveness and security of the EU by developing voluntary contractual standard clauses to improve how firms assess and manage risks related to cloud providers, by introducing legislation to ensure the secure use of the cloud, and by encouraging the emergence of EU cloud providers.

8) Engaging citizens and boosting retail investment
Households in the EU are just as dependent on bank deposits as firms are on bank lending. Retail investment in capital markets is relatively low and the benefits of investing in capital markets are reaped mainly by wealthy individuals. There is a political and cultural suspicion towards capital market in many European countries and citizens do not trust or understand financial markets. Greater retail participation would spread wealth creation, enable citizens to better save for their retirement, and help address future budgetary challenges associated with pensions.

The report recommends that the Commission should develop a dashboard to track member states progress on pension adequacy and sustainability, support a pension tracking system for individuals, and encourage member states to introduce auto-enrolment. It should also aim to align the inducement rules in sectoral legislation, improve the transparency of inducements, study their role in the adequacy of advice and sales processes, introduce a certificate and voluntary pan-European quality label for financial advisors, and encourage the development of digital comparison tools for different products and work with member states on financial literacy.

Finally, the Commission should change Mifid 2 to either create a category of non-professional qualified investors with tailored disclosure requirements or change the definition of professional investors, review PRIIPs disclosure rules, and develop a pan European open finance framework covering financial and non-financial information relevant to facilitating financial planning or encouraging investment.

9) Removing barriers to cross-border investments
One of the big reasons why capital markets in many EU member states are relatively small is the lack of cross-border investment and high level of domestic bias. The main barriers to cross-border investment and integration of capital markets in the EU are differences in taxation, insolvency law, supervision, regulation, and implementation of rules. The report recommends that the Commission should propose legislation for a standardised system for relief at source of withholding tax based on authorised information agents and withholding agents and for minimum harmonisation of some elements of corporate insolvency laws.

This section highlighted one of the few areas of disagreement within the HLF over whether it should recommend shifting towards a single EU-wide supervisor for larger firms (our view is that while a single supervisor would be beneficial, you cannot create a CMU by creating a single supervisor – but you can't have a proper CMU without one). Instead, the report recommended that the Commission should strengthen the role of ESMA and EIOPA by reforming their governance, strengthening their powers and toolkits, and giving them more resources and power in crisis management as well as simplifying the EU financial framework by turning directives to regulations.

10) Other recommendations and next steps

The report also mentions some additional measures and initiatives that have been part of the debate around CMU and would help build bigger and better capital markets. These include introducing a European safe asset, strengthening anti-money laundering and tax avoidance frameworks, introducing a pan-European dispute settlement mechanism, regional cooperation in areas like market infrastructure, addressing the tax differential between debt and equity to boost equity investment, and developing key performance indicators and global comparators to measure and monitor progress on CMU.

The Commission will take into account the recommendations of the final report of the HLF and will seek feedback on the report by the end of June (click here to send feedback). In the autumn the Commission will publish a new action plan with a new package of initiatives to accelerate and complete CMU. The revised strategy will be central in the wider EU initiatives aiming to kick start the economy and support businesses across the EU to recover from the Covid crisis. The European Commission will propose measures both at the local level (bottom-up / more capital markets) and at the pan-European level (top-down / more union). It will look at building bigger and deeper capital markets in individual countries with a view to make integration of these markets easier in the future.

Summary of the HLF's recommendations

Here is a summary of the main issues identified by the HLF and its recommendations to address them.

Issues to be solved	Proposed recommendations	Actors	Timetable
1) Providing a wide range of financing and a competitive business environment for businesses			
Fragmented and scattered company data	Set up a European Single Access Point (ESAP) for company data	European Commission ESMA	COM proposal by mid-2021 Stage 1: by Q2 2023 Stage 2: by 2025 Stage 3: by 2028
Few investment vehicles available for late stage and long-term investment	Targeted review of the ELTIF framework and introduction of tax incentives	European Commission Member states	COM proposal for a review by end-2020
Insurers' underinvestment in equity	Targeted review of Solvency II and further work at the IASB	European Commission	COM proposal by mid-2021 IASB Resolution in 2021
Banks' withdrawal from market making activity and banks' underinvestment in equity	Implementation of Basel III rules in the prudential framework for banks	European Commission	COM proposal by end-2020
Limited capacity of banks' balance sheets to extend funding to SMEs	Targeted review of the securitisation framework	European Commission	COM proposal by mid-end 2021
Public listing is too burdensome and costly, especially for SMEs and the funding ecosystem for IPOs in the EU is underdeveloped	Alleviation of listing rules	European Commission, Member states, Industry	COM proposal by end-2020 (MiFID) and end-2021 (other relevant legislation)
Underused potential of crypto/digital assets	Legal certainty and clear rules for the use of crypto/digital assets	European Commission	COM to amend the existing legislation by end-2020 and propose new legislation by end-2021
2) Building a strong and efficient market infrastructure			
Fragmented provision of settlement services discourages cross-border trading	Targeted changes to CSD passport, supervision and cross-currency rules in CSDR	European Commission	COM proposal by mid-2021
Lack of harmonisation and standardisation across Member States of rules governing the attribution of entitlements to voting rights and shareholders' participation in corporate events prevent investors from the exercise of ownership rights and generally dissuade them from cross-border investment	Targeted review of SRD 2	European Commission	COM proposal by end-2023
Dependence of EU financial operators on providers of cloud services and risks stemming from it	Standardisation of contractual terms for the provision and use of cloud services by EU financial operators and new rules to enable firms and supervisors to monitor and contain risks	European Commission	COM to develop contractual clauses by end-2020 COM proposal on cyber resilience by end-2020

3) Engaging citizens and boosting retail investment			
Unsustainable and inadequate pensions, little retail investor participation in capital markets, few long-term oriented institutional investors	Pension dashboard for Member States, pension tracking systems for individuals and auto enrolment in occupational pension schemes	European Commission	Best practices for auto enrolment by end 2021, dashboard and tracking systems by end 2022
Lack of understanding by and trust of retail investors and their low participation in capital markets	Legislative and non-legislative measures to foster financial literacy and engagement	European Commission Member states	A set of measures for delivery by 2022-2024
Distribution of inadequate investment products due to a conflict of interest or inadequate quality of advice, and inconsistent, non-intelligible, not comparable, and insufficient disclosures for investment products and services	Targeted amendments to IDD, MiFID II and PRIIPs Regulation to improve disclosure. Amendments to IDD, MiFID II to improve the fairness and quality of financial advice. Creation of a voluntary pan European quality mark (label) for financial advisors. Other non-legislative measures, including a study on the role of inducements for the adequacy of advice	European Commission	A number of COM proposals by end 2020-2022
Unexploited potential from data sharing	Regulatory framework for open finance	European Commission	COM proposal by end-2021
4) Removing barriers to cross border investments			
Lengthy and costly WHT reclaim processes deter cross border investment	Legislative proposal to harmonise tax definitions, processes, forms and put forward a proposal to introduce a standardised system for WHT relief at source	European Commission	COM proposal by mid-2022
Different and partly inefficient insolvency process across MS discourage cross border investment	Targeted harmonisation of central elements in corporate insolvency law	European Commission	COM proposal by early 2022
Differences in supervision across member states entails legal uncertainty	Legislative amendments to strengthen governance, powers and toolkit of ESMA and EIOPA	European Commission	COM proposal by mid-2021

Questions for national governments

For context, here are 10 questions for national governments from our report on the future of capital markets union in November to prompt discussion about what member states can do to build deeper capital markets. In light of the Covid crisis, we think these questions are more relevant than before:

1. **Access to funding:** do companies in your country who want and need capital to invest in their business have sufficient access to a diverse range of short- and long-term funding? How reliant are companies on bank lending to finance their business and how does this compare with other countries? Are you confident that your banks are healthy enough to provide that funding over the course of an economic cycle? What other sources of funding could step in to fill that potential gap?
2. **Savings vs investments:** how much of your citizens' financial assets are held in bank savings and how much is invested? Are you confident that bank savings are the best way to help drive wealth creation? What would be the potential impact (including the benefits and trade-offs) if a significant part of those savings were moved into other forms of investment?
3. **Pensions:** how sustainable is your current pension system across all three pillars (state, workplace and private pensions)? What is the balance between pay-as-you-go and funded pensions and how does that compare with other EU member states? What measures could you take over a 25 year timeframe to shift that balance? What impact would it have on your economy and public finances if more people were making annual contributions to their pensions and building a bigger pool of long-term capital that could be invested in your economy?
4. **Market infrastructure:** is your market infrastructure (stock exchanges, settlement, clearing etc) appropriate for an economy and market of your size? What barriers - if any - does your market infrastructure present to the future development of your financial markets and to cross-border investment in your economy?
5. **Venture capital & risk capital:** do high potential growth companies have enough access to early stage risk capital? Do they have sufficient access to other sources of risk capital and if so which sources? Is the level of equity funding through the stock market and IPOs in your economy sufficient to meet demand? And are there measures that you could take to boost demand?
6. **Cross-border investment:** how important is cross-border investment to your economy? Can domestic sources of capital provide all the funding your economy needs? What barriers - if any - do your tax, regulatory and legal systems present in terms of your economy's attractiveness to foreign investors?
7. **Regulation:** how well regulated is your economy and your financial system? On what metrics? And how does this compare to other countries in the EU and the rest of the world? What barriers - if any - does your regulatory system and implementation of EU law present to growth and investment?
8. **Tax:** what is the balance in your economy between the taxation of labour and capital? Do you have any tax measures that disincentivise investment? And without fundamentally changing your tax system, are there changes that you could make to incentivise more investment? And if so, which countries could provide examples of what does and doesn't work?
9. **Legal system:** How comfortable are you with where your country ranks in international rankings of the rule of law, complexity and timeliness of legal process, and issues such as corruption and transparency? What barriers - if any - does your legal system present in terms of investment and growth?
10. **Regional cooperation:** how could regional cooperation with other EU member states help boost your economy? What form might this co-operation take in the banking and finance sector? Do you have the right systems and structures in place to encourage and facilitate this sort of cooperation?