Capital Markets Union
Will it be a game-changer?

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How often can one say of something that it has the potential to be a game-changer?

It may seem a far cry from a general aspiration to create a more coherent and pan-European capital market to envisage the creation of a pan-European defined contribution pension market. One might even be forgiven for asking what the possible link may be, and one can feel a certain sympathy for the retirement, insurance, and pensions sector that asset management and financial markets are trying to "muscle in" in some way to their domain. And yet the process is a totally logical one.

We are however, getting ahead of ourselves. Capital Markets Union (CMU) is the title of a Green Paper issued soon after the Juncker European Commission took office.

The purpose of the Green Paper was to consult on the overall approach to put in place the building blocks for CMU by 2019, the underlying economic rationale of CMU, and possible measures that could be taken to achieve this objective.

The main areas that the Green Paper addressed were:

- Improving access to financing for all businesses across Europe and investment projects, in particular start-ups, SMEs and long-term projects
- Increasing and diversifying the sources of funding from investors in the European Union (EU) and all over the world
- Making the markets work more effectively so that the connections between investors and those who need funding are more efficient and effective, both within Member States and cross-border

The Green Paper and its subject are central to the ambitions and intentions of the Commission.

It has been entrusted to the Directorate-General Financial Stability, Financial Services and Capital Markets Union (rather strangely abbreviated to DG FISMA), which is the restructured and slimmed down DG that Lord Hill inherited from the previous larger organization headed by Michel Barnier.

In the foreword, there is a very clear and simple statement of intent: "In essence our task is to find ways of linking investors and savers with growth."

The initial premise is quite simple. When Europe as a whole is compared to certain other developed countries—and here the only real direct comparison is the United States of course, although other cases can illustrate points in microcosm—it becomes abundantly clear that whereas Europe is very heavily dependent on the banking sector for the financing of the economy, especially the grass roots economy of PMEs and SMEs, the U.S. model relies much more heavily on alternative non-bank channels.

The Green Paper sketches out a certain vision of this current landscape in capital markets, makes reference to observations from other countries or regions, previous or current European initiatives, and invites comment specifically on certain questions that arise from these observations.

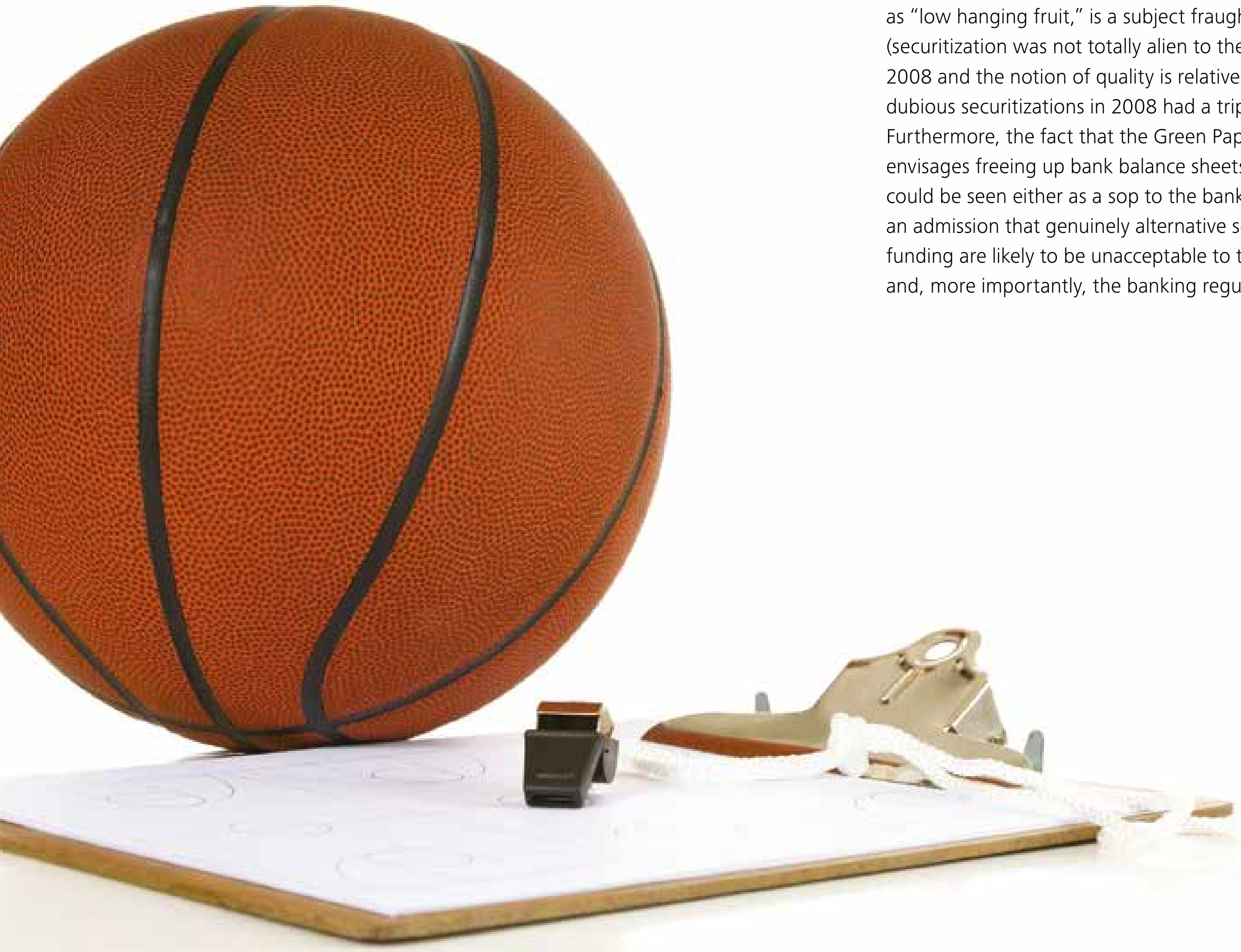
The reflection is articulated around five main themes (although one of the questions posed is if there is something significant that has been overlooked).

These themes are:

- Develop proposals to encourage high-quality securitization and free up bank balance sheets to lend
- Review the Prospectus Directive to facilitate firms, especially smaller ones, to raise funding and investors cross-border
- Start work on the transparency of SMEs, especially on credit information, to make it easier for investors to invest
- Put in place a pan-European Private Placement Regime to encourage direct investment into smaller businesses
- Support the take up of the new European Long Term Investment Fund (ELTIF) to channel investment in infrastructure and other long-term projects

In addition, accompanying these major sections, there are sub-sets of questions around these themes that invite responses on points as diverse as how to increase retail purchases of UCITS on a cross-border basis, crowdfunding, and the effectiveness of the European Supervisory Authorities (ESAs). In many ways, it is the free expression that these questions invite that is the most interesting aspect of this exercise. For if one is to stop at the major themes as they are articulated, then the results could be far from those hoped for.

Securitization, which seems to be viewed in a way as "low hanging fruit," is a subject fraught with perils (securitization was not totally alien to the woes of 2008 and the notion of quality is relative—many of the dubious securitizations in 2008 had a triple A rating!) Furthermore, the fact that the Green Paper specifically envisages freeing up bank balance sheets for lending could be seen either as a sop to the banking sector or an admission that genuinely alternative sources of funding are likely to be unacceptable to the banking and, more importantly, the banking regulatory lobby.



Clearly it is the way people responded to these questions that is in the first instance of great interest and the way in which the Commission will look at those answers in another that can make or break the whole exercise. If the Commission is only prepared to consider a narrow spectrum of opinion around its analysis, and follow on the implicit assumption that this is fine-tuning rather than revolutionary, then the impacts will be relatively limited.

In many respects the language in which the questions are phrased is interesting, and begs the question how it should be interpreted. Take, for example, the question related to the two investment vehicles EuSEF and EuVECA:

"14) Would changes to the EuVECA and EuSEF Regulations make it easier for larger EU fund managers to run these types of funds? What other changes if any should be made to increase the number of these types of fund?"

Anyone coming to that question without prior exposure to the details of the EuSEF and EuVECA vehicles might be forgiven for assuming that we are talking about fine-tuning. The truth is that, if not exactly failures, both vehicles have a long, long way to go before they live up to anything like the hopes that accompanied their launch. Luxembourg is, to say the least, a recognized fund centre. It attracts funds across most asset classes and disciplines, from infrastructure to private equity, passing through all shades of alternatives and of course UCITS. As is often repeated, it is the second largest fund market in the world after the United States. It is never a laggard in adopting new legislation, nor is it tardy in seeing commercial possibilities.

The EuVECA regulation was enacted on the 17 April 2013 and came into force as from the 22 July 2013. We have had to wait until July 2015 to see the first EuVECA fund launched in Luxembourg. The picture is similar in EuSEFs. It is probably a little unkind to describe the two products as solutions looking for a problem, but certainly their scope of reference was so narrowly drawn, and in some instances with the introduction of a social dimension, bringing with it unnecessary levels of complexity, that they can hardly be described as a roaring success. This also alas despite some features that are very interesting and that could indeed be usefully transferred to other products in the promotion of the aims outlined by the Green Paper. The tone of the question, however, suggests everything is fine but just could be improved. The politically correct responses would have been—"yes, wonderful product, just needs nudging in this or that direction," hoping that the Commission would be ready to read between the lines. The true response would be as suggested above: it is not working, but here are the positive aspects and here is what is needed to make the product a success.

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If this is an issue already for these two specialized vehicles, it is true to the power of n for ELTIFs that also figure prominently in this consultation. These are considered a cornerstone to Commission policy, but so far have not exactly set the markets alight in anticipation (despite the fact that, once again, there are some very interesting features proposed).

If this is a concern—how serious the Commission is in hearing the truth (or at least a truth that might not be that that has dominated much of recent debate) and doing something meaningful rather than being the guardian of the politically correct—with respect to detail such as the case quoted above, how much more fundamental it is with regard to some of the debates at the very heart of the question of capital market efficiency and scope— "shadow banking."

The whole issue of shadow banking lurks like Banquo's ghost throughout the consultation. Many of the positive examples and quasi-suggestions drawn from other countries fall directly within what the EBA, ECB, and probably a good part of EcoFin would probably term "shadow banking."

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This is hardly surprising; the analysis itself concludes that Europe is more dependent on banking for the medium- and long-term funding of the economy than other countries or regions.
It postulates that growth can be stimulated by copying such models and facilitating access to alternative sources of funding. Ergo—shadow banking by any other name. And that brings us to the crux of the matter. Is the Commission prepared to challenge some of the things that have become accepted wisdom by so much of the Brussels establishment or is this Green Paper merely an exercise in consultation?

So the Green paper is an exercise itself that tends to leave one a little dubitative. It looks ambitious, it covers much, but its language can be interpreted in many different ways. In some ways, it seems over self-congratulatory of what has gone before; perhaps that is inevitable as it could hardly be overtly critical of previous initiatives.

However, when one considers the references to EuVECA and EuSEFs as we have discussed, or to ELTIFs there is an inescapable feeling of "the Emperor's New Clothes." Some of the identified "low hanging fruit"—and most notably securitizations—are fraught with potential difficulties. At the same time, there is apparently a refreshing willingness to look at issues dispassionately, and to even tackle some of the "sacred cows" of recent years. The Green Paper does invite comment on Insolvency II and the levels of capital requirements it imposes; the Green Paper does venture into the minefield of shadow banking even if it does not use the name; and it does ask if some of those elements that have been anathema hitherto may not have a role to play in developing a capital markets union. What should one believe?

The timeline on this consultation is very ambitious. It is intended that having evaluated the responses received over the summer, the Commission will be in a position to publish a draft action plan when the institutions return from the summer recess sometime around September or October. If this timeframe can be maintained, then we shall not have long to wait to see which way the wind blows.

Technically that draft will be a plan; it is not intended that there should be one single big CMU Directive or piece of legislation but rather modifications and addenda to existing texts with some additional new ones as required. Among the 700 responses one can find a wide range of opinion. It will come as a surprise to noone that the ECB does not necessarily see things in exactly the same light as AIMA or, for that matter, the UK government. Choosing specific responses runs the risk of taking wishes for reality and focusing on subjects that may never get beyond the consultation phase. However, two themes of fundamental importance did seem to appear quite a lot.

The first of these was a desire to revisit, in as safe an environment as possible, the capital requirements of Solvency II, widely considered as a straitjacket that may have profound detrimental effects on insurance and, by association, pension investment in private equity. At least the issue is recognized and placed center stage.

The Commission asked the question:

"12) Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets? If so, which of these should the Commission prioritise in future reviews of the prudential rules such as CRDIV/CRR and Solvency II?"

It has received its response. It will be interesting to see what it does with it. The second, enticingly, is the suggestion that the best way to stimulate cross-border retail fund purchases is to implement a pan-European defined contribution pensions scheme. So let us dream for a moment. Let us imagine that the Commission takes on board the suggestions that a sponsored defined contribution retirement scheme should be a priority.

The arguments that may lead them to this conclusion are seductive; countries with such schemes in place see a marked upswing in investment in funds (around the low to mid 30 percent of retail investors—or even more versus Europe's current 11 percent); markets with such schemes tend to be more resilient and recover faster from upsets as there are committed flows, month in month out.

The arguments are many, the negations—save for the difficulty of formulating and launching such a scheme—few. The benefits of finally addressing the retirement/pensions issue huge.

The secondary benefits within growth aspirations are equally enticing. They would answer in a single strategy the Commission's concerns for ELTIFs, for example, if such a product were to find its natural and rightful place as only a small part of a savings market designed to serve the needs of over 460 million people. It might not be popular, but something coming from Brussels and seen as European, for all the disconnect that has set in between "Europe" and its citizens, is easier to implement for some somewhat paradoxical reason than homegrown reform.

Closing the funding gap on the pension time bomb cannot happen overnight. But that is hardly a reason for doing nothing. A Chinese proverb says that the best time to plant a tree was twenty years ago. The second best time is today.

A possible outcome or an impossible dream. Time will tell. Capital Markets Union may go down in history as the most important innovation since the Marshall Plan, or it may be relegated as a footnote to history as another experiment in integration that fell short of its anticipated objectives. In any event, the opportunity is too good to allow to pass in apathy, and if as an industry—however it is defined—does not throw itself heart and soul into this debate, it can only blame itself for a wasted opportunity.

To the point

- The first major plan since the Financial Services Action Plan from the 1970s
- Potentially forward looking planning rather than reactive legislation
- Openly recognises some key issues—Solvency II, CRD IV
- Has received over 700 responses
- Has the potential to positively shape European growth in the next decades
- Will require courage and perseverance to implement