MEMO
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DEVELOPING CAPITAL MARKETS IN EUROPE

FÉDÉRATION BANCAIRE FRANÇAISE

What is the CMU?

Why is the Capital Markets Union essential to financing the European economy?

What are the essential requirements for the success of the CMU?

01

WHAT IS THE CMU?

The Capital Markets Union (CMU) is an initiative launched by the European Commission in 2015. Its objective is to create a single capital market, to establish a Financing Union.

Commission européenne

The six major goals of the European Commission's CMU project are to:

- **facilitate** access to financial markets for businesses;
- **invest** in infrastructure over the long term;
- **promote** institutional and retail investment;
- **strengthen** the banks' lending capacity;
- **facilitate** cross-border investment;
- **finance** innovation, start-ups, and non-listed companies.

Why is the CMU essential?

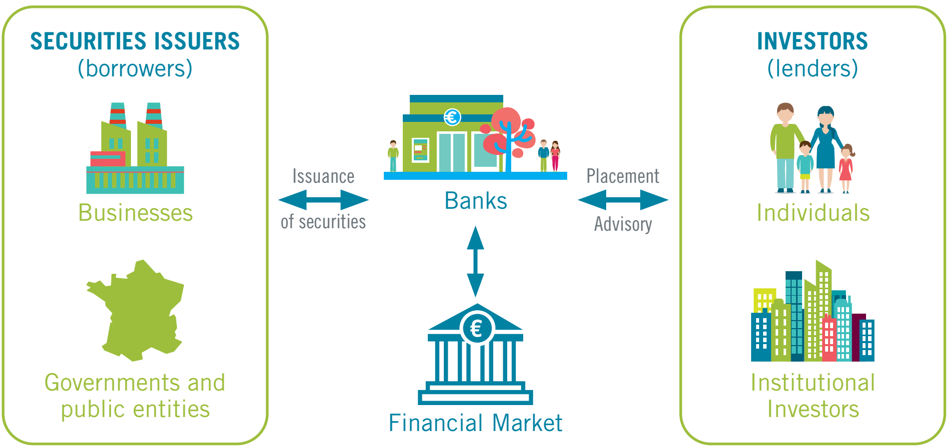
The CMU must **promote access for all businesses in the European Union** (foreign or European large caps, mid caps, SMEs, start-ups, and fintechs) **to market financing,** providing an effective alternative to bank loans.

As a result of the new prudential requirements restricting bank lending, **the capital markets** have been **called upon to play an increasing role** in financing Europe's economy. They must also make it possible to maintain the banks' capacity to lend via securitisation[1].

The CMU must make it possible for abundant **European savings** to **finance the economy** with players and financial circuits that are suitable and successful.

Just like the Banking Union, the CMU is also important for the **sovereignty and integrity of the eurozone**.

THE ROLE OF BANKS IN THE CAPITAL MARKETS



Concrete proposals from the FBF in 2015

Once the European Commission's work was launched in 2015, the banking profession supported the approach and developed proposals to:

- **create** a common label for securitisation methods[1] that are safe and transparent, supported by the European institutions; and create a public agency for European securitisation like Fannie Mae in cooperation with European public institutions;
- **develop** the emergence of a European private placement market in euro (Euro-PP);
- **promote** the creation of a euro-denominated negotiable debt instrument market;
- **encourage** the convergence of supervisory practices within the EU to create a real Capital Markets Union and remove barriers to cross-border investment;
- **define** a common framework that facilitates market access for small and medium enterprises;
- **develop** solid market infrastructures;
- **promote** long-term European investment; and
- **adapt** the Prospectus directive.

Against the backdrop of Brexit, there is an ever-growing need for strong European capital markets, and for an upgrade of political and technical market making skills. Today, London remains the primary financial centre in Europe for both trading and clearing (while France takes the first place in the eurozone). For the sake of its **sovereignty and financial stability**, Continental Europe must develop its capital markets.

(1) See glossary, p. 12

What is the status on Continental European capital markets?

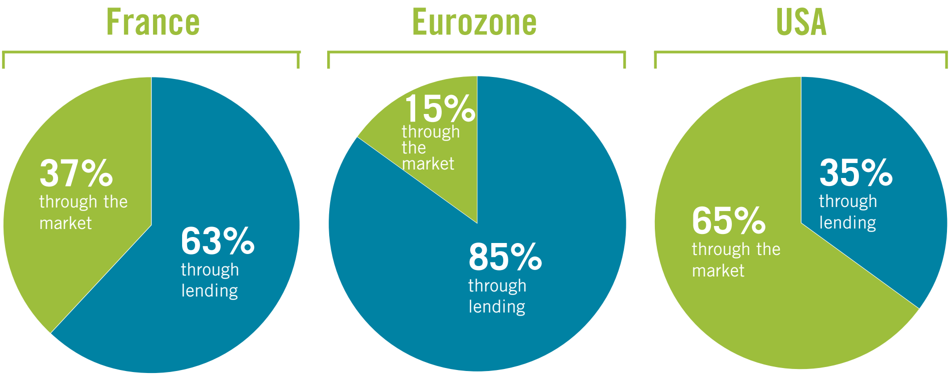
➤ **In Eurozone,** credit financing has a **85%** share, while market financing has 15%.

➤ **In the United States,** conversely, most corporate finance is raised through the markets (**65%**), with bank lending accounting for only 35%[2].

➤ **In France,** most businesses use bank loans, even though the market financing / bank loan mix is developing quickly and **37%** of their financing now comes through the markets (compared to 31% in 2009).

(2) The capital markets equal 150% of GDP in the US compared to 70% in the European Union.

SOURCES OF FUNDING FOR BUSINESSES (first quarter 2019)



Source: Banque de France

Source: ECB

Source: Federal Reserve

There is an imbalance in the European Union between **surplus savings in certain countries and investment shortfalls in others**, caused by **fragmented markets**. The prudential rules, especially their application, may exacerbate this fragmentation.

In spite of sound knowledge of the markets and their customers' needs, **European corporate and investment banks (CIBs) do not have the advantage** of a unified domestic market. Therefore, European corporate financing costs are sub-optimal.

A competitiveness problem has been observed in the European banking industry, along with **distortions of competition** between EU banks and non-EU banks brought about by:

- the existence of an **integrated market in the US**;
- **international prudential treatment** promoting the highly disintermediated American financing model: US banks sell their outstanding loans to the agencies Fannie Mae and Freddy Mac, thereby reducing the size of their balance sheet;
- **regulatory differences** between the EU and third countries: the rules on separation of market activities adopted by the US (Volcker Rule) are less strict than those adopted by certain EU Member States (specifically under French law).

This regulatory pressure has prompted the banks to reduce their market-making activities and their equity holdings. On the European market, **the difference in market share between EU banks and US banks has fallen by more than 10 points since 2008** (see Bruegel Study). Crowding out of European players is a long-term risk for European companies.

CIBs[3] play a fundamental role in financing and hedging corporate, infrastructure, and public-sector risks. The FBF has made an educational film in which clients explain specifically how CIBs have met their different needs: IPOs, currency hedging, bond finance, private placement, green bond issues, etc.

Find the video on YouTube FBFFrance

The CMU, five years on: a mixed review

As part of the action plan for the CMU in 2015, several initiatives have been taken. However, they have not achieved the desired target of integrating capital markets:

- **the Securitisation[3] Regulation of 12 December 2017** introduces reduced regulatory capital charges for securitisations that are STS, i.e. **Simple** (the securitised portfolio must be uniform, for example with only mortgage loans), **Transparent** (the investor must be informed of the assets' historical performance), and **Standardised** (the bank must retain a share of the risk). This regulation, which has been in force since January 2019, is overly stringent and burdensome. It should be revised to encourage the revival of this activity;

(3) See glossary, p. 12

- **the Prospectus Regulation of 14 June 2017** is meant to facilitate market access for European SMEs/ISEs and clarify which information is to be published by an issuer when issuing equities or debt instruments, so that investors are fully informed. This is a positive regulation, but it will not remodel the issuance landscape. It is a limited response to the need for giving SMEs/ISEs easier access to market financing. It does not provide any real easing for large issuers and financial intermediaries that offer securities to the public;
- **the reform efforts of the European Supervisory Authorities (ESAs)** had an ambitious objective (increasing the convergence of regulatory and supervisory mechanisms) which, unfortunately, was not achieved in connection with the provisions adopted in December 2019;
- **the Directive of 27 November 2019 on the issue of covered bonds** makes it possible to harmonise existing national law in this area in the Union while preserving the French model for issuing these debt instruments which has proven to be effective.

02

OUR PRIORITIES

The main challenge facing the French banking industry is creating conditions for the actual development of European capital markets, which are key to supporting market financing for customers.

Some concrete proposals

To actually allow a genuine revival of the Capital Markets Union and to create the conditions needed for its development, several paths must be explored.

The creation of high-quality reference assets in the eurozone would help the CMU by providing the market with depth and liquidity. In the absence of euro-denominated government bonds, the introduction of reference assets might be considered in the form of:

- the securitisation of mortgage loans meeting the highest quality standards,
- the securitisation of debt issues that have a significant impact on the climate, which will promote development of market financing and support for sustainable finance,
- the securitisation of consumer credit or business loans.

The strengthening of the ESMA's convergence powers in the area of financial supervision and regulation is needed to avoid market fragmentation. Greater convergence among European supervisors still needs to be developed in the field of governance. In fact, the lack of European harmonisation could be a cause of competitive distortion among European market participants.

The easing of the conditions for marketing certain financial products (specifically in the MiFID 2, PRIIPs and IDD[1] regulations) might encourage the reallocation of savings to corporate financing. In fact, regulation has had a negative impact on the expansion of information provided to customers with no real benefit to their understanding.

Concerning the development of the equity markets, the challenge is not so much one of facilitating the listing of European businesses but rather of broadening the investor base. In this respect, the different initiatives adopted to promote the development of European capital markets, specifically that of growth markets for SMEs, must be supported.

The financial literacy of the public, particularly regarding the capital markets, would allow Europeans to familiarise themselves with market products. The goal would be to develop a long-term investor base with a risk appetite that would allow investment in innovative initiatives, projects and businesses.

No CMU without a genuine Banking Union

The CMU cannot be dissociated from prudential rules and the Banking Union. The Banking Union must be more than a supervisory union: it must open up national markets to facilitate lending through the improved allocation of savings. So far, the insufficiently fluid circulation of capital and liquidity in Europe is holding back European consolidation and exacerbating European banks' lack of profitability.

In this respect:

- **recognising the eurozone as a single jurisdiction for banking supervisory purposes is crucial to reduce the fragmentation of the Banking Union**. This is a key condition for the success of the CMU. After creating a single supervisor and a single resolution board, this innovation would promote better circulation of liquidity and capital in Europe.

(1) See glossary, p. 12

➤ **enacting the Basel Accords into EU legislation must first consider the potential impact on the capital markets**. Currently, the criteria selected in the field of management of market risk (Fundamental Review of the Trading Book - FRTB[(2)]) restrict banks so heavily that their interventions in the market are likely to be reduced, which would affect market liquidity, reduce their appeal and stand in the way of the development of the Banking Union.

Preserving the integrity of the EU Internal Market

Today, Europe is a net importer of financial services. To preserve the integrity of the European financial markets, access to them by entities of third countries must be contingent on obtaining strict equivalences for sectors where the mechanism is in place. In terms of Brexit, this is a strategic issue.

(2) See glossary, p. 12

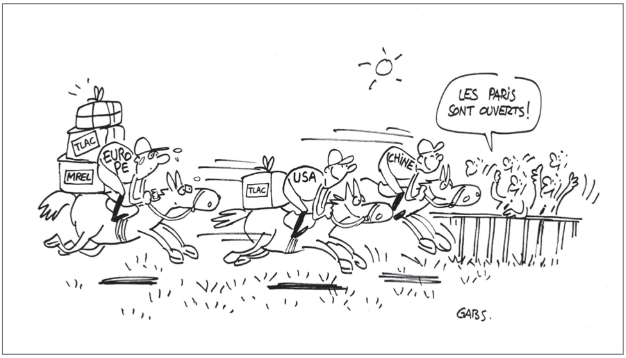


Illustration taken from Repères d'économie bancaire [Banking economy benchmarks] © RB Edition.

In this context, the position of the European Commission expressed in its communication of 29 July 2019 is worth mentioning. According to the Commission, equivalence decisions must:

- remain unilateral and discretionary measures under the control of the Commission,
- must be based on a rigorous analysis of third-country regulations,
- and be subject to regular in-depth assessment.

"Markets4Europe" for strong political leadership

The CMU cannot develop without strong political leadership and a change in approach. In this respect, the FBF initiated and supports **the European Banking Federation's (EBF) "Markets4Europe" project**. As part of this project, a Committee of Experts was organised, comprised of individuals from the highest level of the public sector and executives of large private sector businesses. It submitted proposals for the revival of the CMU to European institutions and authorities in its September 2019 roadmap.

This initiative is also accompanied by a series of conferences to raise the awareness of all participants about the key issues related to the CMU.

The French banking profession welcomes the following policy initiatives:

- **the announcement by the European Commission in October 2019 of the creation of a High Level Forum** at the European level, which demonstrates its determination to relaunch the CMU;

- **the mobilisation of seven European governments** (France, Germany, Italy, the Netherlands, Poland, Spain, and Sweden), which led to the release of the "Savings and Sustainable Investment Union" report on 9 October 2019.

Glossary

CIB Corporate and Investment Bank or Corporate and Investment Banking.

EMIR The European Market Infrastructure Regulation organises a more solid and transparent derivatives market. It has been modified to ease some constraints and to strengthen the supervision of clearing houses.

FRTB The Fundamental Review of the Trading Book is a project to reform the prudential treatment of market risks, led by the Basel Committee.

IDD The Insurance Distribution Directive offers a new framework that applies to the distribution of insurance products by intermediaries and to direct sales made by insurers.

MIFID 2 The second Markets in Financial Instruments Directive defines the new obligations in the distribution and marketing of financial instruments as well as in the organisation and transparency of the financial markets.

NSFR The Net Stable Funding Ratio is a long-term liquidity ratio.

PRIIPs The Packaged Retail Investment and Insurance Products Regulation defines the pre-contractual disclosure requirements for retail investment products and insurance-based products.

SECURITISATION consists of transforming a portfolio of loans or illiquid receivables into debt securities that are sold to investors.

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