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Unlocking Europe's capital markets union

By Hugo Dixon

CENTRE FOR EUROPEAN REFORM

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Summary

★ Jean-Claude Juncker's European Commission should produce a detailed action plan for the creation of a capital markets union. It should secure the broad support of the European Council and the European Parliament for this plan in early 2015. The key building blocks should all be in place by the time this Commission leaves office in 2019.

★ The main goal of this union should be to develop healthy non-bank sources of finance that can drive economic growth and employment across the EU.

★ The emphasis should be on lifting barriers that prevent both the growth of capital markets within member-states, and the development of integrated pan-European markets.

★ The subsidiarity principle should be respected. This means, in particular, that there is no need to transfer the power to supervise capital markets from national authorities to EU institutions.

★ The UK should become an enthusiastic participant in the capital markets union.

Introduction

The creation of a 'capital markets union' should be one of the big initiatives of the Commission led by Jean-Claude Juncker. The president-designate has already backed the idea. In September, Juncker tasked Jonathan Hill, the incoming British commissioner, with "bringing about a well-regulated and integrated capital markets union, encompassing all member-states, by 2019, with a view to maximising the benefits of capital markets and non-bank financial institutions for the real economy".[1]

But what is a capital markets union? What would be its benefits? And how can such a union be created? At present, there are no definite answers to these questions. The European Commission did produce a helpful roadmap in early 2014 on how to boost long-term finance, which covers some of the ground.[2] But to a large extent the capital markets union is a slogan in search of a policy programme. This paper seeks to sketch such a programme.

A capital markets union should be seen as a set of initiatives designed to develop healthy non-bank sources of finance and to let capital flow freely across boundaries. Non-bank finance is needed because banks are on the back foot as a result of the credit crunch and the euro crisis. They are shrinking and being subjected to tougher regulation. As such, they will not be able to finance a European recovery on their own.

The term capital markets union is a conscious echo of the EU's new banking union, and is rooted in the idea that capital markets could be a source of funds for jobs and growth. But there are important differences between a capital markets union and a banking union. In particular, the banking union was envisaged primarily as a eurozone project, although non-euro countries can

1: Letter from Jean-Claude Juncker to Jonathan Hill, September 2014. http://ec.europa.eu/about/juncker-commission/docs/hill_en.pdf.

2: 'Long-term financing of the European economy', Communication from the Commission to the European Parliament and the Council, March 27th 2014. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014DC0168.

join it. The perceived need was to help shore up the single currency by reducing the linkages between banks and the governments of the countries where they were based. The key initiatives were the creation of a single supervisory mechanism for banks centred on the European Central Bank (ECB), and a single resolution mechanism for troubled lenders.

A capital markets union, by contrast, is needed to develop the single market, not to shore up the single currency. As such, it should be an EU-wide project rather than a eurozone one. Britain, which decided not to take part in the banking union, should become an enthusiastic participant in the capital markets union. The UK is home to the City of London, by far the largest capital market in Europe. Without Britain, the potential of a capital markets union would be much diminished.

The tools needed to develop the capital markets union are different from those needed to create the banking union. The barriers that prevent both the growth of capital markets within member-states and the development of integrated pan-European markets should be lifted. It will sometimes be necessary to agree on new EU rules, to break down the barriers that fragment the market. But approaches should be harmonised only when strictly necessary.

The principle of subsidiarity should be respected. This is particularly important in considering the supervision of EU capital markets. There has been some talk about making either the ECB or the European Securities and Markets Authority (ESMA) the single supervisor for EU capital markets. This would be a bad idea. The current system, whereby ESMA sets a rule book for the single market and ensures consistent supervision across the 28 states, with national supervisors responsible for policing the rules, should be continued.

"The main thrust of the capital markets union should be about liberating, not controlling markets."

Markets, of course, do need regulation. But the main thrust of a capital markets union should be about liberating, not controlling them. In fact, some of the regulations put in place in the wake of the financial crisis will need to be revised because they are preventing the healthy development of non-bank finance.

Some people think the term capital markets union is a misnomer. Why not just call the initiative the creation of a 'single capital market'? This would underline the fact that it is supposed to apply to the whole EU, not just the eurozone and countries which wish to tag along. It would also clarify the links between this initiative and the fundamental principle of the free movement of capital, which stretch back to the Treaty of Rome. On this thinking, a single capital market would fulfil the goal set out in 1958 by removing the non-tariff barriers that fragment the EU's markets and saddle the region with a financial sector that is too dependent on banks. While there is a lot to be said for this argument, the name capital markets union is more catchy, and is now well established.

The rest of this paper looks in more detail at the benefits of a capital markets union and at the practical measures required to create it.

Capital benefits

A capital markets union would have five main benefits: providing finance for the economy; helping to absorb shocks; enabling more effective monetary policy; creating more competitive markets; and providing the UK with another good reason to stay in the EU.

Finance for the economy

The EU's biggest challenge is to pep up its sluggish growth rate. Among other things, that will require more investment. The Commission says €1 trillion is needed for transport, energy and telecoms networks of 'EU importance' by 2020. There is also the need for companies of all sizes to invest and grow.

But traditional sources of finance are drying up. Banks have to clean up their balance sheets. Before the credit crunch, European politicians used to congratulate themselves on having such a large banking system. Many of them thought lenders were better able to foster growth than markets, because they understood their clients. But since the crisis, a lot of lenders have been unable to provide credit – despite the fact that banking has been massively subsidised by the provision of cheap funding from central banks. In peripheral eurozone countries such as Italy, the situation is particularly acute.

More non-bank finance is needed to take up the slack. There is a vast array of possible alternatives: public equity; private equity; venture capital; loans made by entities that are not banks (often called shadow banks); loans which start on bank or shadow bank balance sheets but are then packaged and traded in financial markets – so-called securitisation; corporate bond issues; peer-to-peer lending; private bond placements; hedge funds and so on.

Although all of these already exist in the EU, its markets are typically much smaller than equivalent activities in the

US. Indeed, according to an analysis of 26 measures by the New Financial think-tank, Europe's capital markets are roughly half as big as they would be if they were as large, relative to GDP, as those in America.[3]

This is the flipside of the fact that the EU is much more 'bank-centric' than America. Its lenders' balance sheets are four times gross domestic product; in the US they are only 80 per cent of GDP.[4] Similarly, European non-financial corporations rely on banks for roughly 70 per cent of their funding, while US companies turn to banks for only 30 per cent of their finance.[5]

Shock absorption

Europe's bank-centricity does not just threaten to undermine the recovery. It has also magnified the original crisis.

Banks are highly leveraged entities. Meanwhile, their dependence on short-term funding, either via deposits or through the markets, makes them vulnerable to runs. Because of their vital role in the payments system and the need to protect depositors, it is risky to let them go bust. Governments feel compelled to ride to their rescue when they get into trouble. But, during the euro crisis, several governments were not themselves strong enough to do so. Attempts to rescue their banks, notably in Ireland, dragged down governments too.

When an economy hits difficulties, losses are of course incurred throughout the financial system. But these losses should not be concentrated in highly-leveraged vehicles that rely on short-term funding and may need to be rescued by the state. Investors who are more prepared to take a longer-term view should take the hit. The shock-absorbing capacity of capital markets is particularly high when funding is provided in the form of equity. An equity-financed company may still have to adjust its business plan when it runs into trouble, but it will not create damaging knock-on effects in the banking system, as happens when a bank is in trouble.

The ability of capital markets to act as shock-absorbers depends on risks really being transferred from bank balance sheets to the capital markets – and on the market vehicles not themselves being highly-leveraged and dependent on short-term money. These provisos did not apply in the run-up to the credit crunch. Shadow banks, which were intimately connected to the banking system, had proliferated. When they went bust, they infected the banking system too. There was also little transparency over who was ultimately responsible for the risks. Panic ensued. It is not possible to eliminate the herd instinct of the markets. But it is possible to reduce the negative macroeconomic impact of the swings between greed and fear, principally by reducing and controlling the links between banks and non-banks and by making markets more transparent.

"Europe's capital markets are roughly half as big as they would be, if they were as large, relative to GDP, as those in America."

More effective monetary policy

When the US Federal Reserve engaged in quantitative easing (QE), it had a wide array of capital market instruments that it could buy. When the Bank of England embarked on QE, it had a much narrower range of securities it could purchase and so decided to acquire mainly UK government bonds. The European Central Bank faces an even poorer range of choices than the Bank of England but it has also been reluctant to buy government bonds because it is prohibited from 'monetary financing'. As a result, it waited until September 2014 and annual inflation dropping to 0.3 per cent before agreeing on any action – and, even then, it decided to buy only asset-backed securities and covered bonds. The snag is that there are not many of these instruments to buy.

A richer capital market could give central banks more macroeconomic tools to manage any future cases of uncomfortably low inflation. This would be especially valuable for the ECB. Developing such markets, though, takes time. So the capital markets union will be of more help in fighting any future bout of 'lowflation' than the current one.

Competitive markets

One of the problems with the EU's bank-centric financial system is that it is not as competitive as it should be. In half of the EU's member-states, the top five lenders have a combined market share of over 60 per cent. As a result, customers often do not have much choice. What is more, in several EU countries – and especially in Germany, Spain, Ireland, Greece, Portugal and Cyprus – there have been incestuous relationships between banks and companies. This has led to credit being provided to well-connected businesses rather than those with the best prospects.

A capital markets union could lead to a more competitive financial system. Large corporates can already access the capital markets. But, if the US is any guide, there should be scope to open up the markets to medium-sized enterprises. And the competition would, in turn, bring

3: 'Driving growth: Making the case for bigger and better capital markets in Europe', *New Financial,* September 2014.
4: 'Finance for growth', High Level Expert Group on SME and Infrastructure financing, 2013.
5: 'Funding the EU economy: The role of banks and financial markets', Association for Financial Markets in Europe, July 2014.

pressure on banks to improve their services. Insofar as pan-European markets can be developed, they will also benefit from economies of scale equivalent to similar US markets. This should lower the cost of capital, so boosting investment.

Market-based finance brings with it a rich ecosystem of new experts – equity and bond analysts, business angels, specialist debt investors, venture capitalists, hedge fund investors and so forth. In the right conditions, this should lead to greater discipline in the allocation and use of capital than some of the traditional cosy relationships between banks and companies. It can also spur innovation. See, for example, how crowdfunding and peer-to-peer lending platforms are using the internet to match investors with companies that need funding – without the need for expensive branch networks.

Of course, markets are not hives of virtue, any more than banks are. Therefore, market participants must be held to high standards of conduct, rules must be properly policed and those who disobey them must be punished.

Cut the risk of Brexit

The bonus of the capital markets union is that it would give the UK another strong reason to stay in the EU – so cutting the risk of a 'Brexit'. A drive to complete the single capital market would be a generational opportunity for the City of London similar to the 'eurodollar revolution' from the late 1950s onwards, and the explosion of activity unleashed by the Big Bang deregulation of 1986. This would be good for UK jobs, wealth creation and tax collection.

So far, the UK government has not shown particular enthusiasm for the project. This may be because it worries that the capital markets union could be used as a cover by the Commission to grab more powers for itself. It may also be because the Conservative Party, the leading party in the coalition, finds it hard to engage in any constructive thinking on the EU because of its powerful eurosceptic wing. However, some voices in the City, such as TheCityUK, which represents the UK financial services industry, are keen on the idea.

The City, of course, does not have many votes, and so would not directly swing the outcome of the referendum that David Cameron plans to hold by the end of 2017 on whether Britain should stay in the EU (assuming, of course, that he wins the 2015 general election). But money talks. The City will not wish to miss out on participating in a capital markets union and will make that clear to its friends in the Conservative party.

> *"The City will make clear to its Conservative party friends that it does not wish to miss out on the capital markets union."*

Juncker's decision to put Jonathan Hill in charge of creating a capital markets union is a clever one. Hill will be in an excellent position to ensure that the single market in capital becomes a reality, and to sell its benefits to his compatriots back home.

The way forward

Action will be needed from the private sector. Developing markets often run into Catch 22-type situations. The investors do not come until there are securities to invest in; but companies do not want to issue securities until there are ready investors. Market participants will need to take the risk of investing in the necessary manpower and systems, in the belief that there will ultimately be a big opportunity. In some cases, they will also need to work collectively via their trade bodies to agree on, for instance, standardised contracts, so that markets can enjoy a critical mass.

But policy-makers must act as well. Many need to be involved: national governments, central banks and market supervisors; the European Central Bank and the three European Supervisory Agencies (ESAs); and last but not least, the Commission, the Council of Ministers and the Parliament. The subject matter is sometimes fairly technical. But policy-makers must not lose sight of the big picture: the opportunity to develop healthy non-bank sources of finance to fund jobs and growth.

Unlocking the EU's capital markets

In Europe, especially continental Europe, banks dominate the financial system so much that it is tempting to think that banking is finance. But one only has to look across the Atlantic to see this does not have to be the case. The United States has a rich cornucopia of alternative financing arrangements. Why the discrepancy? Largely because the EU's financial system is clogged up and fragmented. This section looks at some of the different financial instruments and how they could be used more effectively in a European capital markets union.

Securitised bank loans

One way to deal with the problem of banks' dwindling appetite to lend money is to 'securitise' their loans. This involves taking a bundle of loans and selling them to a special purpose vehicle (SPV). The SPV then issues securities and sells them to investors. Each SPV can issue different classes of security – from high-risk to low-risk – appealing to different types of investor. Mortgages, car loans, credit card advances and loans to small and medium-sized enterprises (SMEs) can be securitised in this way. The bank still 'originates' the loans, taking advantage of its knowledge of clients' credit track records. But it does not keep all the assets on its balance sheet, meaning it can make more loans without its capital ratios suffering.

Securitisation was an extremely important financing tool in the run-up to the credit crunch. Unfortunately, it was misused – especially in the US. The problem was not only that banks lent to so-called subprime borrowers, many of whom were unable to service their loans. Elaborate structures were also devised – sometimes securitisations of securitisations – which even professional investors found hard to understand. Their rationale was to boost returns. But when the subprime borrowers stopped paying, the structures magnified the losses.

What is more, many investors who bought the securities were not suitable owners. They sometimes relied on lots of short-term debt to buy the securities. Those who bought the securities could only do that because banks guaranteed to provide the SPVs with credit if investors could not roll over their short-term debt. When the market exploded, it dragged down the banking industry too.

Despite this unfortunate experience, securitisation could and should play a healthy role in the EU's capital markets – provided the structures are simple and clear – as the ECB and the Bank of England argued in a joint paper in early 2014.[6] It is worth noting that the problems of the credit crunch were almost entirely focused on the US. Default rates on EU securitisations between mid-2007 and mid-2014 were only 1.6 per cent, according to Standard & Poor's, the rating agency. The equivalent for the US was 19.3 per cent.[7]

However, while the US securitisation market has revived, the EU market is virtually dead in the water. This is partly because of tough new regulations that require European insurance companies (the main purchasers of securitised loans) to hold extra capital if they buy these assets. The fact that banks have found it so easy and cheap to finance themselves with central bank money in recent years has also provided a disincentive for them to securitise assets.

The ECB and Bank of England have recommended that 'high-quality' securitisations – those with simple and clear structures – could benefit from less stringent regulations. The Commission in October 2014 adopted regulations moving in the right direction.[8]

Shadow banking

It is not just banks that can make loans. Non-banks – also known as shadow banks – can also do so. The definition of shadow banking used by the Financial Stability Board (FSB), the international body set up to strengthen the global financial system since the credit crunch, is "credit intermediation involving entities and activities outside the regular banking system". This is a large business globally – worth $71 trillion, equivalent to 24 per cent of total financial assets and about half the size of the banking system. [9]

> *"Default rates on EU securitisations between mid-2007 and mid-2014 were only 1.6 per cent."*

The term shadow banking is a broad one since it covers all lending by any entity that is not a bank. In the EU, the most important categories are:

★ Loans by insurance companies, pension funds, hedge funds and other asset managers.

★ Peer-to-peer lending. This is a small but fast-growing market, in which investors lend to borrowers over the internet. There are hundreds of special platforms matching lenders and borrowers.

★ Loans by SPVs. Some are set up with the intention of lending to companies. They raise funds by securitising their loans. Such securities are known as Collateralised Loan Obligations (CLOs).

The main advantage of shadow banking is that it brings new sources of funding, given that the formal banking system has been retreating.

However, there are many links between shadow banks and conventional banks – typically because the latter have lent the former money or provided them with the guarantee of credit in some way or another. As a result, if a shadow bank goes bust, it can infect the banking system.

Global policy-makers are understandably worried that they may end up regulating the banking system so tightly that financial activity migrates to the shadows where it is unregulated and can cause havoc. Policy-makers, both

6: 'The case for a better functioning securitisation market in the European Union', Bank of England and ECB, 2014.
7: 'Seven years on, the cumulative default rate for European structured finance is only 1.6%', Standard & Poor's, August 2014.
8: 'Commission adopts detailed prudential rules for banks and insurers to stimulate investment in the economy', European Commission press release, October 2014.
9: 'Global shadow banking monitoring report 2013', Financial Stability Board, November 2013.

globally and in the EU, have therefore been spearheading a series of initiatives to make sure this does not happen.[10] One involves putting fire-breaks between the banking system and the shadow banking system – so that banks are not excessively exposed to non-banks. The EU should pass legislation along these lines, although some interconnections are likely to remain.

However, there are four rules that are stifling the development of shadow banking. These need to be changed.

First, the 'passport' which allows investment firms to offer their services across the whole EU single market, provided they are regulated appropriately in their home state, does not apply to shadow banking. Many EU countries, such as France, stop non-banks lending money unless they also obtain a banking licence – something which is onerous and expensive. This is because lending is considered the exclusive role of banks. As a result, the EU does not have a passport for shadow banks and the single market for capital is fragmented.

A high-level expert group set up by the EU to look into SME and infrastructure financing noted this problem in 2013, and recommended the creation of such an EU passport.[11] It is a good idea, which the Commission should act on.

Second, non-banks do not have such good information on the track records of individual borrowers as banks. Since they are unable to assess credit risk well, they are less willing to lend. This harms SMEs in particular, since information on their finances is less available than for big companies.

The high-level expert group noted this problem, too. It advocated the creation of a robust, easily accessible credit risk database. While this is a good idea, further analysis is needed of how best to get it up and running – and in particular, on what role national central banks (some of which have the necessary information) should play, whether there should be a series of national databases or a pan-European one, and how private-sector information providers can best be involved. The Commission has promised to come up with some proposals this year.

Third, the high-level expert group said there were similar data problems with infrastructure lending. It recommended that governments should publish information on past public infrastructure projects so that markets could play a bigger role in supplying funds for future schemes. The Commission responded by saying it will evaluate this year the feasibility of doing this. It should make this happen.

Fourth, some countries, such as Germany and Austria, have rules which de facto limit pension funds from investing in infrastructure. In early 2014, the Commission proposed a directive which, among other things, would stop member-states banning occupational pension funds from investing in assets with a long-term profile such as infrastructure, unless the restrictions are justified on prudential grounds.[12] This suggestion is a good one.

"Shadow banks should be able to get a passport to operate across the whole EU single market."

Bonds

Borrowing money from a bank or shadow bank is not the only way of raising cash. Borrowers can also issue bonds directly to investors. As a result, the bond market can be used to provide finance, even when banks do not want to lend. Bonds often do not need to be repaid for many years, and can therefore supply longer-term finance than banks normally wish to provide.

But for a bond market to work properly, investors have to understand the risks they are running. They will not simply provide cash for an unknown company. A few specialist investors do their own analysis. But most are only prepared to invest in bonds with credit ratings. The snag is that credit ratings are expensive to procure and involve a lot of hassle. So they are used only by the largest borrowers.

The credit rating industry was guilty of bad practices in the run up to the credit crunch, and so needed to be regulated. But, because of the costs they are imposing on the industry, the slew of new rules adopted by the EU may have gone too far and be stifling the development of its capital markets. The Commission should review whether specific elements of the rules could be relaxed. The guiding principle should be to free up the rating agencies to give an honest view about the risks as they see them, but not to treat these views as sacrosanct.

In the EU, governments are extremely active users of the bond markets. Large companies are also fairly active – but not nearly as active as in the United States. In 2011, only 55 per cent of the debt of large German companies (those with annual revenue of over $500 million) was in the

10: 'Strengthening oversight and regulation of shadow banking: An overview of policy recommendations', Financial Stability Board, August 2013. Also 'Shadow banking: Addressing new sources of risk in the financial sector', European Commission to the Council and the European Parliament, September 2013.

11: 'Finance for growth', High Level Expert Group on SME and Infrastructure financing, January 23rd 2014.

12: 'Revision of the occupational pension funds directive', European Commission frequently asked questions, March 2014.

form of bonds, according to McKinsey, the management consultants. In France, the figure was 64 per cent, in the UK 25 per cent, Italy 32 per cent and Spain a mere 7 per cent. In America, the figure was 99 per cent.[13]

The last two years have seen a big shift into bond markets by large EU companies. This is partly because the eurozone banking crisis has restricted the traditional funding channel; and partly because companies see an opportunity to lock in today's exceptionally low interest rates for a long period of time. In 2012 and 2013, eurozone non-financial companies raised €215 billion of bonds (net of repayments), according to Deutsche Bank. This nearly matched the €242 billion drop in bank lending.

To a large extent, market forces can be allowed to play out naturally. However, there are two policy changes that might usefully accelerate the trend. One is to have a standardised template for prospectuses, as is the case in the US. The advantage of standardisation is that it makes it easier for investors to find their way around these vast documents. Lack of standardisation is not a problem when large sums of money are being raised. But it may hinder investment when smaller sums are required. A standard template would not just help more companies tap the bond markets; it would help them issue equity too.

The Commission should also attempt to discern whether banks are offering their largest corporate clients artificially cheap loans; they may be doing do so in the hope that they can recuperate the money via fee income on deals such as mergers. The Commission should ensure that such cross-subsidisation cannot happen. Without it, the largest companies would have a greater incentive to raise funds in the bond market. Banks would also use more of their limited balance sheets to lend to the smaller companies.

Private placements

In America, mid-sized companies issue bonds. They normally do this by selling bonds to a small number of sophisticated investors, through a vehicle known as a private placement, rather than marketing them to the public. The advantage is that the bonds do not have to be registered with the Securities and Exchange Commission, cutting issuance costs substantially. Nearly $50 billion of such bonds are issued each year, according to the International Capital Market Association (ICMA).[14]

In most EU countries, however, the private placement market is small. The exceptions are Germany and France, which between them accounted for €15 billion of issuance in 2013. As a result, many EU companies turn to the US private placement market to issue bonds. In 2013, they issued $15 billion (nearly €12 billion) of paper there.[15]

There are several reasons why the EU market is so much smaller than the US one. Indeed, it is a good illustration of the Catch-22 problem mentioned earlier. The EU does not have many institutions specialising in this type of investment. But such investors will not materialise until companies issue this type of debt in the EU – and, of course, they are reluctant to do so until there are ready investors. Meanwhile, institutions will only invest in private placements if they have a mandate from the ultimate investors to do this. But it is hard to get a mandate to invest in something that does not already exist.

> *"The EU should follow the US and introduce lighter touch regulation of private placements."*

ICMA set up a working group in mid-2014 to try to get around this chicken-and-egg problem. As well as various private-sector bodies, the Banque de France and the UK Treasury are involved. The main goal is to facilitate the emergence of common market practices, principles and standardised documentation for an EU-wide private placement market. It has set a deadline of the end of 2014 for coming up with a plan.

While this private-sector-led initiative is welcome, there is one public sector policy that would make a big difference: the EU should follow the US and introduce lighter touch regulation of firms that only want to raise a small amount of money and market themselves to sophisticated investors. That would give a big fillip to Europe's bond market for mid-sized companies.

Equity

Often when people think of non-bank finance, they think about non-bank debt. Yet equity is often a healthier form of finance than any type of debt. A company that is well funded with equity can normally afford to take a long-term view of its opportunities. If its business suffers a downturn, it is not threatened with bankruptcy because dividends, unlike interest payments, can be suspended. Equity finance is not just good for individual companies; it is good for an economy because it enables it to adjust better to shocks.

There are many types of equity finance. On the one hand, there are the public stock markets, which are highly regulated. But there are also other types of equity

13: 'Financial globalization: Retreat or reset?', McKinsey Global Institute, 2013.

14: 'Trade bodies join forces to promote EU Private Placement market', International Capital Market Association, June 12th 2014.

15: 'Finance for growth', High Level Expert Group on SME and Infrastructure financing.

finance: angel investing, where rich individuals, many of whom have a track record as entrepreneurs, put money into start-ups; crowdfunding, where businesses are matched with investors via internet platforms; venture capital, where special funds invest in young fast-growing entrepreneurial companies; and private equity houses, otherwise known as leveraged buyout (LBO) houses, which typically buy mature businesses and load them up with debt.

With the exception of LBO finance (which is more about debt than equity), the EU is light on all these types of funding. There are several reasons for this.

One is that company owners are reluctant to surrender or share control – something that happens when they sell equity to outsiders. Europeans lack a strong equity culture. It is particularly weak in Italy. However, it is encouraging that German companies, which have traditionally been wary of equity markets, seem to have started warming to them. For example, Zalando, the EU's largest online fashion retailer, announced plans for an initial public offering in September 2014.

Another reason is that equity is more heavily taxed than debt. In most countries (not just EU ones), interest payments on debt can be deducted from profits before they are taxed. Dividends seldom benefit from a similarly attractive tax regime.

One policy change that could have a big impact would be to remove the tax discrimination against equity. This could be done in two ways: either interest payments could no longer be deductible from taxable profits; or companies could be given a tax-deductible allowance for their equity.

The EU does not have the authority to force member-states to adjust their corporation tax regimes. However, it can play a useful role by encouraging countries to remove the current bias. The Commission has promised to do this as part of the European semester process, through country specific recommendations, "in particular for member-states with high debt bias in corporate taxation".[16] The Commission should work with the EU finance ministers in helping them to co-ordinate this reform. After all, it will be easier for states to move if they are not doing so alone.

Venture capital

Young companies and start-ups find it particularly hard to raise equity funding in the EU; investors are reluctant to put money into companies that they know little about and which could easily fail. By mid-2014, there were encouraging signs that the European venture capital market was picking up. In the second quarter, it was responsible for providing $2.8 billion to start-ups – the largest amount since the dotcom boom in 2001 according to Dow Jones VentureSource.[17] But this is still a relatively small sum of money.

"One policy change that could have a big impact would be to remove the tax discrimination against equity."

The contrast is stark with America, where start-ups raised $13.8 billion in the same quarter. Its venture capital market is extremely active, not only funding start-ups but also helping entrepreneurial companies grow rapidly. Specialist investors hunt for the best business ideas and then put not only cash but also expertise behind the company in order to maximise its potential. The venture capitalists take stakes in private companies with the aim of either selling them later to larger companies or floating them on the stock market.

The EU cannot hope to match America's thriving venture capital market in short order. But it could do several things to close the gap. One would be to push forward with an initiative already in the pipeline: the creation of European Long-term Investment Funds (ELTIFs). These would invest in illiquid assets such as venture capital, the shares of unquoted companies and infrastructure loans – provided they are diversified. As such, ELTIFs would help boost other capital markets as well as venture capital. ELTIFs would enjoy a pan-EU passport, allowing a fund based in one member-state to operate across the entire single market. At present, the EU's main investment vehicles – UCITS – are required to keep 90 per cent of their assets in listed securities, meaning they cannot channel money towards these illiquid but economically important investments.

There is also a case for more EU countries to provide government support so that young companies can raise capital more easily. One model that could be followed is that of the UK, where generous tax breaks encourage high net worth individuals to invest in venture capital. Another model is America, which provides guarantees for debt issued by small businesses: the money is channelled through specialist small business investment companies, which pay a fee to compensate the government for potential losses.

Ultimately, it is up to each member-state to decide whether to support venture capital with tax incentives or guarantees. But the Commission could play a useful role identifying and encouraging best practice.

16: 'Long-term financing of the European economy', Communication from the Commission to the European Parliament and the Council, March 27th 2014.

17: 'European start-ups raise highest quarterly VC financing since 2001', *Wall Street Journal*, July 28th 2014.

Securities trading

Vigorous capital markets do not just require companies to be able to issue debt and equity to investors; they also require investors to be able to sell those securities without suffering a big hit in the value of their investments. The ability to trade securities smoothly in the secondary market makes it more attractive to invest in the first place. It allows investors who do not necessarily want to lock up their money for the long term to provide permanent capital to companies in the form of equity, and to back long-term investment projects, such as those in infrastructure.

But there is one EU initiative that could gum up such trading: the Financial Transaction Tax (FTT), which ten EU countries including Germany, France and Italy plan to impose.[18] Details of the scheme have not been determined, because even those countries in favour cannot agree on how to design it. But if the tax is set at too high a level, it could reduce liquidity and so make EU capital markets a less attractive place for investors to put their money in.

Some advocates of the FTT point out that it may turn out not to be very different from the UK's stamp duty, under which people who buy shares have to pay tax equal to 0.5 per cent of the transaction value. Even if that is so, it is not a good argument: the UK should cut stamp duty to boost its equity market trading.

Others argue that the financial industry should pay more tax, given the mess it caused in the credit crunch. The snag is that the FTT would hit investors and companies, not banks. There are two better ways of taking money from the banking industry: levies, the amount of which could be determined by the degree to which a bank relies on short-term, 'hot' money; and a financial activities tax (FAT), which would tax a bank's profits and remuneration, and be justified since lenders are exempt from VAT.

"The ten countries that are still committed to the FTT should abandon it and switch to the FAT."

Many countries have adopted some form of bank levy. But there is a patchwork of different systems and rates. The EU should try to put some order into different countries' bank levies. Strict harmonisation would not be necessary. But an agreement on common principles and bands within which the tax rate is set would create a more level playing field. It would also be good to encourage more countries to adopt such a tax.

Meanwhile, the ten countries that are still committed to the FTT should abandon it and switch to the FAT, and invite the other 18 member-states, which do not like the FTT, to join them.

Conclusion

A genuine EU capital markets union would be a big prize. It would give the EU more ways of funding jobs and growth, help it to weather macroeconomic shocks, enable it to pursue more effective monetary policy and create more competitive financial markets. As a bonus, it would also cut the risks of Britain quitting the EU.

Given the size of the prize, policy-makers should embark on an ambitious programme to make the capital markets union a reality. The guiding principles should be freeing up capital markets, ensuring their healthy development and respecting the subsidiarity principle.

A top priority for the incoming Juncker Commission should be to produce a detailed action plan to create the capital markets union – and secure buy-in for it from the European Council and the Parliament in early 2015. The key building blocks should all be in place by the time this Commission leaves office in late 2019. The benefits will not all flow immediately. But over the coming decades, a capital markets union can make a significant contribution to improving the EU's economic prospects. Earlier Commissions were known variously for the single market, monetary union, enlargement and banking union. The Juncker Commission could go down in history as the creator of the capital markets union.

Hugo Dixon
Editor-at-large Reuters News

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18: Joint statement by ministers of member-states participating in enhanced co-operation in the area of financial transaction tax, May 2014. http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Internationales_Finanzmarkt/2014-05_06-ftt-statement-anlage.pdf?__blob=publicationFile&v=2.

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