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Priorities for the CMU agenda*

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Abstract

The European Commission is trying to reboot the CMU project: The High-Level Forum on Capital Markets Union – a group of 28 selected experts from industry, academia and civil society – is expected to submit policy recommendations by the end of May 2020 which will feed into the Commission's new CMU agenda. This contribution is largely based on a letter to the High-Level Forum that gives feedback on the Interim Report published in February. There, we introduce a comprehensive approach to distinguish, from a functional finance perspective, between the 'game changers' and what is nice to have. We highlight the importance of common and consistent supervisory practices across Member States and recommend building up a European Securities and Exchange Commission (E-SEC) according to the American model.

I. Introduction

A move towards a more integrated and effective European capital market requires a fundamental reflection on the overall architecture of Europe's financial system. Based on a functional concept of financial markets, we distinguish between two levels of decisions that policymakers can choose to make:

- level-A decisions relate to the fundamentals of institutional development in financial markets, and
- level-B decisions relate to specific forms and features of financial instruments based on level-A institutional basics.

Most of the issues addressed in the 2015 Capital Markets Union (CMU) Green Paper by the European Commission and subsequent proposals are level-B themes as SAFE researchers pointed out. There is no doubt that level-B projects can make the capital market development in Europe more efficient, and more supportive with respect to financial stability and economic growth; safe assets, crypto assets,

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and the design of sovereign bond markets could be mentioned here. However, level-B proposals themselves will neither fix nor unify national capital markets. These will not trigger the emergence of a stronger capital market culture in Europe. Instead, a move towards more important capital markets requires a shift of emphasis from level-B to level-A issues. This is clearly shown by the fact that European capital markets remain highly fragmented although many reforms addressed in the 2015 Action Plan have actually been adopted.

II. Distinguishing between level-A and level-B proposals

To distinguish levels A and B, one may ask: why is the role of banking so prominent in Europe, whereas it appears to be significantly less important in the Anglo-Saxon economies? Conversely, one may ask why the role of Europe's financial markets in raising equity and debt for the corporate sector has remained so small, even after the banking crisis – again in contrast to the US? According to the academic literature, the reason why different markets for capital formation play more or less important roles are three, among others, level-A institutional design issues: **the insolvency regime, the pension system, and the regulatory and supervisory architecture**. For any given mix of the insolvency code (which may be creditor or debtor friendly), the pension system (which may be funded or pay-as-you-go) and the regulatory system (which may define and enforce rules at the national or the European level) one can expect a particular role for banks and capital markets to emerge endogenously. Accordingly, the observed financial system at any point in time is largely pre-determined by the basic infrastructural features characterizing the economy at that moment. For example, if pension systems are funded such that the claims are backed by a portfolio of stocks and bonds, one can expect the role of securities markets for households and firms to be important. Alternatively, reforming the European tradition of relatively strong creditor rights in the direction of more contestability in court would strengthen the role of market-based financial instruments at the expense of bank financing.

Therefore, marginal changes to level-B issues (i.e. institutions and products) in financial markets will not translate into a change in the financial system or the role of markets. Rather, the inherited legal, regulatory and institutional infrastructures largely pre-determine the relative roles of banks and markets. Any desired change of these roles must address the level-A institutional framework. A case in point: The global investment community will never perceive European capital markets as one large capital market if there are 27 national supervisors in charge. Much of the common basis rests on its regulatory and supervisory body, ESMA. However, up to the present day, ESMA is merely a rule-setting body, not a rule-enforcing institution. The current practice of, say, insider regulation or the role of dark pools, is still subject to national legislation, national courts and national interpretation of rules.

III. Creating a European capital market culture through a European SEC

If we had to set – quality over quantity – a single policy priority, our favorite would be clear: Copy the concept of a single, powerful Securities and Exchange Commission (SEC) and make it work within the boundaries defined by European law. A European SEC (E-SEC) would discuss and foster the development of primary and secondary capital market activity throughout the continent.

The SEC in the US has become the role model for developing a widely respected and highly effective capital market where investors from around the world can count on equal and trustworthy treatment. For example, shareholder rights in change-of-control transactions, like mergers, management buy-outs or hostile takeovers, have been vigorously developed over time. US markets for stocks and bonds have thus earned over the years the highest reputation for fair and efficient trading, and they have played a major role in corporate restructurings, and have enabled rapid growth of firms in, say, the digital sector. Moreover, the SEC as the competent authority has initiated directly and triggered indirectly a huge research program on the quality of their exchanges, the efficiency of price setting mechanisms (auctions versus dealer markets, the choice of minimum ticks sizes), competition with alternative venues (from pits to electronic trading platforms, and further to systematic internalizers), new trading technologies (high frequency and algorithmic trading), clearing and settlement systems (competing-for-profit institutions versus quasi-monopolistic cooperatives/utilities). The subsequent research findings have helped to improve regulatory and institutional policies.

Moreover, the SEC has taken a clear stance on many issues of trading system development based on its own research, as well as on academic findings. A whole new research field (market microstructure) has evolved in academia in financial economics as a consequence of increased transparency rules defined and enforced by the SEC, in collaboration with the FASB. The vast amount of research work on the performance of US stock exchanges has become, and continues to be, a major contributor to the trust the world puts into US securities markets – and a major reason for global investors to put their capital at work in the US economy.

Many of the features an E-SEC would require are already granted to the ESMA. In fact, ESMA has far-reaching, SEC-like competencies when it comes to short sales and product intervention. The 2012 Short Selling Regulation, for example, establishes an EU level emergency decision-making mechanism when actions taken by national authorities are considered as inadequate. However, ESMA is a rule-defining institution in general, leaving the interpretation of rules and their implementation to national bodies. Market data, for example, is compiled on the basis of what is collected and submitted by national authorities and often lacks comparability. It is therefore an essential step in the development of a European capital market to create an authority that takes over the competencies of national supervisors. Major changes of the market infrastructure make this an increasingly urgent step. Take, for example, the case of CCPs: Allocating the responsibility for supervision at the national level does not take adequate account of their systemically important role and potential risks. In our view, it is essential that the E-SEC would be mandated to

- set the rules (for primary markets, secondary markets, brokerage, clearing, settlement, repositories, accounting, reporting),
- supervise all infrastructure related to secondary markets, and to
- enforce these rules (role of police and judiciary, except for appeal).

Its first task will be to define a uniform, European standard for rule interpretation and enforcement that now is at a national discretion. As an esteemed byproduct of the creation of an E-SEC, its public discussions and decisions would receive strong international response – be it by institutional investors, private firms, academic institutions, or government (debt) agencies. Through its public activities, an E-SEC would greatly help the retail investors in becoming trustful to capital market products and intermediaries, thereby allowing capital markets to play the desired bigger role in corporate finance and household wealth accumulation.

As far as the institutional set-up is concerned, a new E-SEC could integrate the existing national supervisory agencies into a new European institution with offices in all relevant markets. The institution would from its start be designed as a distributed organization, paying tribute to the current non-centralized structure of securities markets in Europe. Over time, a policy of stepwise consolidation of functions and personnel could achieve a gradual move from decentralized to more integrated, European markets. An important, although political, decision will be whether the new E-SEC is implemented as an addendum to ESMA, or as an independent institution under the roof of the ECB, modeled on the SSM.

We are well aware of the political obstacles. The 2019 ESA Review has shown that Member States are reluctant to extend ESMA's powers and tools. Moreover, the enforcement of rules involves a certain margin of discretion to regulatory agencies that is not intended by the EU constitutional rules. These legal concerns provide Member States with a convenient excuse to block any delegation of powers to the European level. It now takes an unmistakable signal to policymakers that national responsibilities are incompatible with market integration. Yet more importantly, there are no 'low-hanging fruits' that could make up for this fundamental flaw in the European supervisory architecture.

IV. Conclusions

In this paper, we introduced a simple approach to distinguish the `game changers' in completing the CMU from what is nice to have. There are a number of level-B topics, we admit, that may spur the development of capital markets. What makes them level-B is the fact that by themselves they will not trigger the emergence of a stronger capital market culture in Europe. In our opinion, tackling too many of these level-B proposals without touching the more fundamental problems of European capital markets will do more harm than good.

Supervisory consistency is a key feature of unified capital markets accessed from 27 nodes. This is why European institutions should take over many of the responsibilities originally assigned to national authorities. CMU has always been a key Single Market project, and both Brexit and the financing needs arising from the low-carbon transition add a new urgency. We cannot wait until the political tide will have changed or Member States eventually agree to delegate some power out of economic necessity. With regard to the Commission's new agenda, we expect the High-Level Forum to take a strong and uncompromising stance: There is no Capital Markets Union without a European SEC. That said, the paper describes the steps policymakers then need to take.