Action Plan on Building a Capital Markets Union
Since the financial crisis of 2007–2008 the European Union has embarked on an ambitious project of regulatory reform, which has transformed the regulatory landscape of the Union. Although much has been accomplished, the Commission remains ambitious and its recently published Action Plan on Building a Capital Markets Union (CMU) sets out multi-layered proposals aimed at building a stronger European capital market. The Commission’s Action Plan builds on the Consultation commenced in February of this year.

The Commission’s Action Plan proposes a step-by-step approach to achieving the CMU. The intention is that the cumulative effect of the different measures will build the CMU brick by brick. The Commission has eschewed a legislative big bang. This is not surprising as the Commission’s proposals embrace both capital markets reform (e.g., reforming the EU’s prospectus rules) as well as many other matters which lie outside what would ordinarily be regarded as capital markets issues. For example, the Commission’s proposals cover topics as diverse as Fintech and Crowdfunding, as well as the reform of venture capital and infrastructure funds.

To this extent the term “Capital Markets Union” is something of a misnomer. There is plenty in the Commission’s proposals that will interest firms outside the corporate finance and investment banking sectors.

This briefing provides an overview of the proposals set out in the Commission’s Action Plan.

The Economic Case

The Commission’s proposals form part of a drive to strengthen investment in the EU and provide new sources of funding for businesses. This in turn is part of the agenda to strengthen the European economy, stimulate investment and create jobs.

Although the 28 Member States of the EU have an economy which is equivalent in size of the US, its equity markets are less than half the size of the US’ and its debt markets are less than a third of the size of the US’. The inevitable consequence of this is that European business is less able to access investment within the EU – interestingly EU firms raise more funding through private placements in the US than they do in the EU – and the cost of funding within the EU can be higher.
Overview of the Commission’s proposals

Providing more funding choices – peer-to-peer lending and crowdfunding

The Commission recognizes the recent growth of non-bank lending platforms, including peer-to-peer lending and crowdfunding. There are more than 500 such platforms providing these services across the EU. The structure of these platforms can vary. In some cases investors will invest indirectly through collective investment vehicles or, in other cases, investors may invest directly in the securities of the business seeking funding. Platforms structured in this way may fall within the scope of the Markets in Financial Instruments Directive (MiFID). As such, they will already be subject to EU level regulation and will be able to use a passport to provide services across the European Economic Area.

In contrast, lending based platforms are not presently subject to European level regulation but will be subject to a patchwork of national laws. This acts as a block to providing cross-border services across the EU.

The Action Plan more broadly recognizes the development of on-line and digitalized financial services – the so called “Fintech” – and the Commission is obviously keen to keep abreast of these developments.

Peer-to-peer lending and crowdfunding can only form a small part of the solution to improving access to funding by SMEs and other businesses. Nevertheless, the Commission clearly thinks that these are potentially significant channels for new businesses in the start-up phase. While recognizing the regulatory lacuna that exists by virtue of the fact that regulations on lending are not fully harmonized across the EU, the Commission acknowledges that there is a need to exercise some restraint in introducing new regulation, which may act as a restraint on developments.

The Commission is expected to issue a report on crowdfunding in the first quarter of 2016.
Venture Capital Funds

The Action Plan recognizes the role of venture capital in supporting growth. The Commission notes that venture capital funds in Europe are on average half the size of funds in the United States and that the industry is concentrated in 8 EU jurisdictions.

EU legislation exists in this area comprising the Regulation on European Venture Capital Funds (EuVECA) and the Regulation on European Social Entrepreneurship Funds (EuSEF). These funds can only be marketed to institutional and high net worth investors in Europe and passports are available only to smaller managers managing portfolios of less than Eur 500 million.

The Commission is considering proposals for:
- Pan-European venture capital fund-of-funds and multi-country funds (Q2 2016);
- Easing restrictions on the EuVECA and EuSEFs (Q3 2016); and

Supporting SMEs seeking finance

The Commission notes that there is an information gap between SMEs and investors which makes it difficult to obtain funding. On the one hand, small firms in need of financing need to be aware of available market based funding options and, on the other hand, firms need to be more visible to prospective investors.

The Commission will instigate a comprehensive strategy to overcome information barriers through:
- working with European banking federations and business organisations to structure feedback given by banks declining SME credit applications;
- working with the Enterprise Europe Network to map existing local or national support across the EU to promote best practice; and
- investigating how to develop or support pan-European information services.

Loan Originating Funds

There has, of course, been considerable focus on the shadow banking sector and the risks that arise from this sector. In the context of the Action Plan, shadow banks are cast in somewhat more favourable light with the Commission noting that large institutional investors or investment funds invest directly in or originate loans to mid-size firms and therefore provide a further alternative source of funding.

The Commission notes that it will work with Member States and the European Supervisory Authorities (ESA) to assess the need for a coordinated approach to loan origination by funds and whether there is a case for a future EU level framework for such funds (Q4 2016).
Private placements

European companies raise more money in the United States through private placement than they do in Europe.

Accessing investment through private placements avoids the need for firms to incur the significant costs associated with preparing prospectuses and procuring admission to trading and listing. The difficulty that firms face, however, is that the private placement route is not available in all EU jurisdictions. While noting that there is a potential for the private placement route to develop, the Commission is not advancing any specific proposals in this area for the time being.

Making it easier for companies to enter and raise capital on public markets

As indicated, for SMEs, raising money on public markets will not be straightforward given the complexities of the process and the costs involved. The EU estimates that for IPOs with a deal size of less than Eur 6 million costs are in the region of 10–15% of the deal value. This percentage drops significantly for larger deals (5–8% for deals in the Eur 50–100m bracket).

In order to increase access to the public markets the Commission is considering:

- Revising the Prospectus Directive (making amendments to the circumstances in which a prospectus will be needed, changing the information required and streamlining the approval process). The idea is to construct a proportionate regime for SMEs (Q4 2015).
- Reviewing the regulatory barriers to small firms for their admission to trading on public markets (2017).
- Reviewing the functioning of the EU corporate bond market, focusing on how liquidity can be improved, the potential impact of regulatory reforms, market developments and voluntary standardization of offer documentation (2017).

Some steps for improving choice in this area have already been taken within the MiFID II Directive. This Directive provides for an SME Growth Market. The Commission will also examine ways to address debt-equity bias – the preferential tax treatment of debt due to the deductibility of interest payments in comparison to other financial instruments – as part of the broader work being taken forward on the Common Consolidated Corporate Tax Base (proposal due in 2016).
Improving the investment environment through the regulatory framework

Europe has had to absorb a wealth of new regulations including, most significantly, new prudential rules for banks (the Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR)) and for insurers (Solvency II). The Commission recognizes this and the fact that new regulations may have had the unintended consequence of restricting lending.

The Commission in July 2015 published a consultation paper on the impact of the CRD and CRR on banks’ lending to the economy. The Commission has also now issued a call for evidence to evaluate the interactions between regulatory rules and the cumulative impact of financial reforms on the investment environment.

As part of its efforts to improve the regulatory environment the Commission is also looking at the rules on regulatory capital that financial institutions are required to hold against infrastructure investments. As part of this the Commission is intending to revise calibrations in Solvency II to better reflect the risk of infrastructure investment and to consider the same issue in the context of the CRR.

Retail investment

There are many initiatives at the European level, which relate to retail investment into financial markets. The Second Markets in Financial Instruments Directive (MiFID II), for example, contains large tracts dealing with aspects of retail investment. An example of this is the new activity of “independent advice” and also the new rules on inducements and product governance, designed to procure fair outcomes for retail investors.

The Insurance Distribution Directive, for example, also addresses sales of retail insurance products and the disclosure that should be provided to customers in relation to such products.

Even so, the Commission observes that direct investment by retail investors into securities has fallen significantly. In 1975, 28% of FTSE company shares were held by retail investors. In 2007, this figure had fallen to 10–11%. In contrast the proportion of savings held in banks has increased. This is despite the low interest rate environment of the last decade. The Commission’s desire is to unlock some of the funds held by retail investors in bank accounts and release them for investment into the European capital markets.

By the end of 2015, the Commission says that it will publish a Green Paper on retail financial services and insurance. The Commission intends that this will look at distribution channels, the digitalization of retail financial services and investment advice.

The objective, it appears, is to focus on disclosure, cost-effectiveness and fair terms. A primary focus of the Commission’s efforts in this area is to restore trust in the financial services industry so that retail investors may invest in markets with greater confidence. The Commission notes that while it is principally for the industry to restore confidence, regulation and supervision can help to establish the “rules of the game”.
Institutional investors

The Commission found that prudential regulation adversely affects the appetite of institutional investors to invest in specific assets through the calibration of capital charges. The Commission will assess the prudential treatment of private equity and privately placed debt in the context of the Solvency II review.

Fragmented investment funds market

At the same time that retail investment in markets has fallen, investment by funds has increased. Although funds are regarded as active cross-border investors, the funds market continues to be regarded as fragmented. Respondents to the Commission’s consultation on the CMU provided evidence that a number of factors restrict cross-border activity including:

• Discriminatory tax treatment;
• Varying national marketing requirements and restrictions; and
• Fees for cross-border notifications.

In Q2 of 2016 the Commission will conduct a consultation on the main barriers to the cross-border distribution of investment funds.

Pensions

As well as looking at the investment regime generally, the Commission is focusing on pensions reform. In particular, the Commission will consider whether there is any need for a policy framework to establish a European market for European personal pensions. Market fragmentation is perceived as preventing pension providers from maximizing economies of scale, risk diversification and innovation, thereby reducing choice and increasing costs. Amongst other things, the Commission is considering a template pension product that pension providers could opt into.
Facilitating cross-border investing

Property, insolvency and other laws across the EU have not been harmonized. The absence of harmonization in these areas creates obstacles to cross-border investment. For example, varying property laws can give rise to uncertainties relating to title to securities in a cross-border securities transaction. Uncertainties also arise in the case of a default owing to differing insolvency regimes.

While noting that much has already been achieved in this area, the Commission proposes to carry out further work.

Financial Stability and Supervisory convergence

The Commission recognises the need to be alert to financial stability risks emerging in capital markets. The Commission will work alongside the European Systemic Risk Board to assess possible risks and if additional macro prudential instruments need to be developed the Commission will make the necessary changes to the macro prudential framework.

The Commission will also look to strengthen supervisory convergence and work with ESMA to:

- identify areas where a more integrated approach could improve the functioning of the single market for capital;
- publish a White Paper on ESA’s funding and governance; and
- develop a strategy for providing technical assistance to Member States to support capital markets’ capacity.

Leveraging banking capacity to support the wider economy

The Commission is looking at a number of issues to ensure that bank lending to the wider economy is appropriately leveraged. This includes examining whether credit unions can play more of a role (e.g., by being authorized across the EU, outside the CRD framework for banks) and developing an EU framework for simple, transparent and standardized securitizations. The Commission has issued a proposal on simple, transparent and standardized securitizations and revision of the capital calibrations for banks.

The Commission is also carrying out a review of the regulation of banks to ensure an optimal balance between managing risk and enabling growth. It will also consult on the development of a pan-European framework for covered bonds and the use of similar structures to support SME loans.
Conclusion

The Commission’s proposals appear to be ambitious and certainly there is a broad range of proposals put forward. In some respects, the proposals represent only incremental advances on existing provisions – for example, proposals on retail investment seem to overlap with the work that the Commission has been doing on MiFID II and IDD. In other respects, such as in relation to securitizations and bank regulation, the Commission may be regarded as rowing back from laws put in place in the first batches of regulations following the financial crisis. Overall, however, the Commission’s Action Plan should produce interesting proposals in a range of different areas.