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# Europe's proposed capital markets union: Disruption will drive investment and innovation


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The proposed EU capital markets union (CMU) aims to revitalise Europe's economy by creating efficient funding channels between providers of loanable funds and firms best placed to use them. This column argues that a successful CMU would deliver investment, innovation and growth, but it depends on overcoming difficult regulatory challenges. A successful CMU would also change the nature of systemic risk in Europe.


European firms – especially those in periphery countries – have a difficult time attracting funding as they depend on banks for around 80% of their external financing. Yet at the same time, there is no shortage of investable capital in Europe and savers suffer from a lack of investment choices and dismal returns.

The problem is that we have European capital markets – in the plural – but not a unified European financing system.

This malaise is what the capital markets union (CMU) aims to solve: to find new and innovative ways to channel funds efficiently from those enjoying surplus resources to those best able to make use of those funds.

Diverse tax regimes and national legislation pose a fundamental challenge to the existence of a CMU – and the necessary treaties and directives to solve this challenge are not on the horizon. For an overview of the main issues, see e.g. Véron (2014) and the recent European Commission 2015 Green paper.

In the absence of fundamental reforms of tax and legal regimes, it is hoped that some progress towards a CMU can be made by removing some of the myriad other obstacles that collectively form a barrier to achieving a truly European financing system. To achieve this, the EU and national authorities will need to adapt their regulatory systems, especially micro-prudential regulations and embrace disruptive technologies.

As the CMU emerges, it will lower systemic risk by reducing reliance on banking or other highly concentrated funding channels, thus cutting the regulatory costs of internalising systemic risk and future bailouts. But it will also create new systemic risks,


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and the relevant authorities need to understand those risks and adapt macro-prudential regulations to cope with them.

## The problem of smaller businesses

Over 80% of financing for small and medium-sized enterprises (SMEs) in Europe comes from banks. Since SMEs account for 99.8% of businesses and 67% of private sector employment in the EU, scarcity of bank financing is a concern. This compounds other problems facing SMEs, such as the flaws in their structure and governance discussed by Giovannini et al (2015).

## Is the banking system inefficient?

Europe's SME funding problem arises because banks are under pressure from regulations – not least Basel III – to build up their capital and to attach increasing risk charges to riskier investments, such as SMEs. Limited competition – and even oligopolies – in banking add further to European financing costs.

Might new sources of intermediation help? There is no inherent reason to believe that banks are fundamentally any less efficient than the alternative forms of intermediation – and they certainly have strong advantages, not least through relationship banking. This would seem to give little room for the new alternatives – yet if that were true, there would be little talk of the CMU.

Because of their systemic importance, banks are increasingly required to be individually safe. Ensuring this safety is costly, which makes Basel III, with its increases in capital buffers, a primary driver of the CMU. Since the new alternatives are not yet perceived to be systemically important, they do not have to bear this insurance cost. As a result, the banks' relative inefficiency may be the raison d'être for the CMU.

But the reason that the new alternatives have not been able to replace absent bank financing is that there are too many barriers in place.

## Challenges

There are many factors that might contrive to thwart the success of a CMU. While many are important, those that really matter are law, tax and regulations, some of which purposefully limit international flows of funding. These challenges are very sensitive and difficult to tackle, and some have been long discussed.

It seems unlikely that the CMU will attract sufficient priority from European authorities for the legislative and tax challenges to be addressed efficiently.

Instead, concrete moves towards the CMU are more likely to stem from the more malleable regulatory process. There are no explicit barriers that prevent the CMU from emerging, but there are a large number of tiny regulatory restrictions that in aggregate stifle innovation.

## A successful CMU must embrace disruption

The root of the problem is in those regulatory mandates that focus more on the status quo – the same status quo that is threatened by innovative technologies disrupting existing markets and creating new ones.

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The regulators need to have an explicit mandate to facilitate the birth of the alternative forms of intermediation that constitute the CMU. They should be removing complicated and costly micro-prudential regulations more appropriate to large banks.

They should also be developing novel regulations sympathetic to the new vehicles and structures that make up the CMU, including breaking down national barriers on clearing, settlement and custody services and reduce the cost of raising capital. Just one example is the technical obstacles on clearing and registration invoked by some countries to keep out competition mandated by Europe's Market in Financial Instruments Directive (MiFID).

A sensible approach is that taken by the UK's Financial Conduct Authority (FCA) whose mandate – 'ensuring markets work well for consumers and for firms' – welcomes innovation and disruptive technologies. This may well have helped the UK to achieve its roughly 200% annual growth in alternative funding models, such as crowd financing, which amounted to over £1.74 billion in 2014 and is predicted to double in 2015 (Nesta 2014).

It is not possible to regulate a successful CMU into existence – but it is possible to redesign regulations to allow it to emerge through market forces.

## Systemic risk

A key function of banks – and also a main source of their systemic risk – is maturity transformation. It is the hedge against this systemic risk that creates one of the motivations for the CMU.

If maturity transformation moves to alternative forms of investments, the systemic risk does not disappear: rather, it is more likely to re-emerge in the new institutions. These effects will be partially mitigated by the new technologies being more distributed, diverse and reliant on proper securitisation, without involving systemically important financial institutions (SIFIs).

But there will still be the danger of herding and correlated risk-taking that only becomes visible in crises, as discussed by Danielsson, Shin and Zigrand (2009). Such sudden coordination may be harder to detect in the emergent sectors, which is why it is important for oversight to be well funded and not be so onerous as to encourage opacity.

Furthermore, the successful CMU will create new systemic risks by establishing new links between countries and entities – links with fault lines that may only manifest themselves in times of significant stress. A CMU that finances productive investment also makes it easier for speculative investments across Europe, contributing to momentum build-up and pro-cyclical systemic risk.

From a systemic risk point of view, a well-functioning CMU will be a valuable addition to the existing banking-based regime, increasing the resilience of the system, provided that capital flows are monitored and the rules are robust while discouraging pro-cyclicality. By expanding the range of different financing routes and decreasing dependence on banks, a CMU ought to reduce systemic risk for any given level of debt.

## Conclusion

Europe needs the CMU because its banking system cannot adequately finance SMEs. Current regulatory, legal and tax structures favour the incumbents, and it will be almost impossible to make meaningful changes to the legal and tax regimes.

Therefore, the EU and especially national authorities must alter existing regulatory structures if the CMU is to be achieved, encouraging disruptive technologies and allowing market forces to match savings to investment opportunities more efficiently.

If successful, the CMU will lead to improved access to finance for those firms best placed to use it – and it will deliver innovation, competitiveness, reduced systemic risk and, ultimately, growth.

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