DEUTSCHE BÖRSE GROUP

Policy Paper

Principles for a European Capital Markets Union

Strengthening capital markets to foster growth

Contents

Executive summary

The Capital Markets Union, as put on the agenda of the European Commission by President Jean-Claude Juncker, encompasses the **next step towards the integration of European financial markets.**

Europe has gone through a severe financial and economic crisis in recent years, with much of the region **still struggling to make meaningful headway on reducing unemployment and stimulating economic growth.**

- Traditional monetary policy instruments have largely been exhausted by the ECB.
- Parts of the EU are still experiencing record high levels of unemployment.
- There continues to be social discontent related to economic conditions following the crisis in many EU Member States and economic growth suffers from lack of funding to support investments.

The current shift in political priorities (from crisis solving towards growth and job creation) mirrors the fact that the **EU is at a crossroads with decisive years ahead.**

The concept of a Capital Markets Union should provide part of the solution to these problems; its main objective is to enhance the **efficient allocation of capital** throughout the EU **by developing non-bank sources of funding to foster sustainable economic growth and innovation and drive employment across Europe.**

It represents an ambitious and necessary joint vision for policymakers, as well as industry and societal stakeholders, to **integrate and deepen European financial markets further.** This is crucial to **strengthen Europe's competitiveness** versus the US and Asia and increase its attractiveness for foreign investors.

In order to achieve this vision, a wide range of goals has been laid out under the umbrella of **improving access to funding for European companies, especially small and medium-sized enterprises (SMEs)**, to overcome the financing gap:

- **Promote alternative, non-bank funding sources** (both equity and debt), creating a more balanced funding structure for the overall European economy
- Restore the public's overall **trust and confidence in capital markets**, educating it on the positive function and value created for the economy (and therefore the people), especially in countries with a less developed capital markets culture
- **Enhance the stability and efficiency of these markets** (especially in the case of instruments transacting through market infrastructure) thanks to features such as **transparency, liquidity and neutrality**
- Reduce the present fragmentation of European capital markets through the **harmonisation of rules and standards**, eliminating many of the barriers preventing integration

Additionally, the aim of deepening existing capital markets should also and importantly include derivatives markets. **Derivatives play a crucial role throughout the capital markets value chain, ensuring that risks can be hedged.**

Deutsche Börse Group proposes the following principles to achieve a functioning Capital Markets Union:

1. Revive investor trust
2. Improve non-bank funding
3. Promote financial stability
4. Increase transparency
5. Foster harmonisation/remove barriers
6. Shape the supporting regulatory and supervisory environment

This paper aims to provide further details regarding the concept of a **functioning Capital Markets Union**, in terms of the policy initiatives that should be considered.

Exhibit 1
Summary of core principles of the Capital Markets Union

1. Revive investor trust	Development of initiatives to **revive investor trust in order to restore demand for new sources of funding**. Well-informed and well-educated investors are more willing to invest in EU companies. Well-informed companies will search for the best funding possibility.
2. Improve non-bank funding	Improving availability of non-bank funding is essential for driving economic growth in Europe. **A functioning Capital Markets Union should ensure a choice for investors and companies.**
3. Promote financial stability	Promotion of financial stability is a necessary prerequisite for growth and job creation; a lack of financial stability leads to economic instability. In order to minimise systemic risk and create well-functioning markets, both safety and integrity need to be ensured. **It is important that the G20 goals and the European regulation with a focus on increasing financial stability continue to be implemented and are truly applied.**
4. Increase transparency	Increasing transparency for investors as well as supervisors is an essential prerequisite for financial stability, as increased transparency improves the quality of price discovery and reduces investment risk. **Data provision to cater for transparency needs should only be required where it is necessary to avoid additional costs for investors and supervisors.**
5. Foster harmonisation/ remove barriers	Fostering the **harmonisation** of rules and standards **is essential to eliminate costly barriers and reduce complexity for investors and companies.** Initiatives in this area, building on the Single Rulebook as a harmonised regulatory framework, should increase the attractiveness and returns on investment, thereby stimulating economic growth.
6. Shape the supporting regulatory and supervisory environment	Continued **shaping of the supporting regulatory and supervisory environment**, both within the EU and globally, is essential to create conditions which support initiatives to fuel growth. The Capital Markets Union should **reduce the regulatory burden to what is essential, build up an efficient supervisory structure and ensure a global level playing field.**

1. Capital Markets Union – financial integration for the 28 EU Member States

European financial integration has been a primary objective for many years. Significant achievements have been made with the Customs Union, Monetary Union and, more recently, the Banking Union, already being established. The goal of these initiatives has been to promote economic growth and financial stability by removing barriers, complexity and unnecessary costs that result from a fragmented economic system.

The Capital Markets Union can be seen as the next step towards European financial integration, with the concept articulated by the President of the European Commission as follows:

> "To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding. This would also increase the attractiveness of Europe as a place to invest."
>
> Jean-Claude Juncker,
> European Commission President

At a high level, the main goals of the Capital Markets Union can be outlined as follows:[1)]

- To finance investments through non-bank funding, creating new jobs and stimulating economic growth
- To allow capital to be allocated where it is most efficient while reducing reliance on the banking system. To provide longer-term stable funding through increased cross-border investment, encouraging long-term investment and innovation
- To help the financial system absorb shocks more easily
- Ultimately, to strengthen the competitiveness of European capital markets on a global level

The Capital Markets Union will emphasise the **nexus of the economy and financial markets: a strong economy needs strong capital markets** to finance its growth.

"Examining the European experience, we provide evidence that **capital market size is positively correlated with economic development.** Moreover, we estimate that growing combined stock and bond markets by one third would increase the long-term real growth rate in per capita GDP by about one fifth, as stock and bond market liquidity allows for cost-efficient reallocation of capital across industries. Considering stock markets only, the relationship is estimated to be 1 to 1, i.e. a stock market growing by one third is estimated to raise real economic growth by one third. We argue that the positive impact of stock markets is related to two major channels: (1) the availability of funds for long-term risky investments; and (2) the incentives for improving corporate governance."[2)]

The Capital Markets Union should aim to widen and deepen European capital markets, across not only the euro countries, as in the Banking Union, but **across all 28 EU Member States**. It is important that all Member States actively participate in the initiatives, **taking joint responsibility** for the success of this essential project.

1) Cf. Hill 2014: Capital Markets Union – finance serving the economy
2) Kaserer and Rapp 2014: Capital Markets and Economic Growth. Long-Term Trends and Policy Challenges

2. Sustainable growth needs diversified financing

Financing is needed to drive economic growth and employment in Europe. Bank funding has been decreasing in response to higher capital and liquidity requirements. Intensified banking regulation has forced banks to clean up and strengthen their balance sheets, building up liquidity and capital buffers according to CRD IV.[3] To achieve this, many banks are deleveraging, in part by reducing lending to businesses, a trend which is set to continue into the future. **As a result, the economy must find ways to lower dependency on banking channels and tap into alternative financing and investment.**

As previously mentioned, much of Europe is still struggling to make meaningful headway on combating unemployment and stimulating growth (see Exhibit 2). For example, post-crisis growth in Europe has averaged –0.1 per cent annually, vs 0.9 per cent in the US and 4.4 per cent in the Asia-Pacific region.

In order to improve this situation, companies need access to new/additional funding to finance investments, innovate and expand their business. Companies face significant challenges when it comes to obtaining bank funding in weak regional economic conditions, particularly if they do not have a solid equity base.

In addition to a conscious reduction in lending, banks have also had difficulties refinancing themselves on a long-term basis (i.e. obtaining access to new capital). This is a result of the dramatic reduction of confidence in banks seen post-crisis. Consequently, the banking business model is expected to be significantly redefined in coming years.

Exhibit 2
Key macroeconomic indicators

		Pre-crisis					Post-crisis						
		2004	2005	2006	2007	2004–2007 avg.	2008	2009	2010	2011	2012	2013	2008–2013 avg.
Europe	Real GDP growth rate	2.3%	2.1%	3.5%	3.1%	**2.7%**	0.4%	–4.4%	2.0%	1.8%	–0.4%	0.1%	**–0.1%**
	Unemployment rate	8.1%	8.1%	7.6%	6.9%	**7.7%**	7.0%	8.8%	9.2%	9.3%	10.2%	10.6%	**9.2%**
United States	Real GDP growth rate	3.8%	3.3%	2.7%	1.8%	**2.9%**	–0.3%	–2.8%	2.5%	1.6%	2.3%	2.2%	**0.9%**
	Unemployment rate	5.5%	5.1%	4.6%	4.6%	**5.0%**	5.8%	9.3%	9.6%	8.9%	8.1%	7.4%	**8.2%**
Asia-Pacific	Real GDP growth rate	5.3%	5.1%	5.9%	6.9%	**5.8%**	3.8%	1.6%	7.3%	4.7%	4.6%	4.5%	**4.4%**
	Unemployment rate	6.9%	6.9%	6.8%	6.5%	**6.8%**	6.5%	6.7%	6.5%	6.6%	6.9%	6.9%	**6.7%**

Source: EIU, Eurostat, Oxford Economics

3) CRD IV is the implementation of the G20 and Basel III capital requirements regulation and directive for banks.

Development of new, non-bank funding is essential in order to meet the widening funding gap. This will reduce reliance on banks and continue to help banks deleverage their balance sheets as some funding shifts to capital markets. Given their strategic importance in the EU economy, **SMEs in particular need access to capital in order to create jobs and growth**; they make up 99 per cent of all EU businesses and create two-thirds of all private sector jobs.[4] This is crucial to allow continued innovation, research and development.

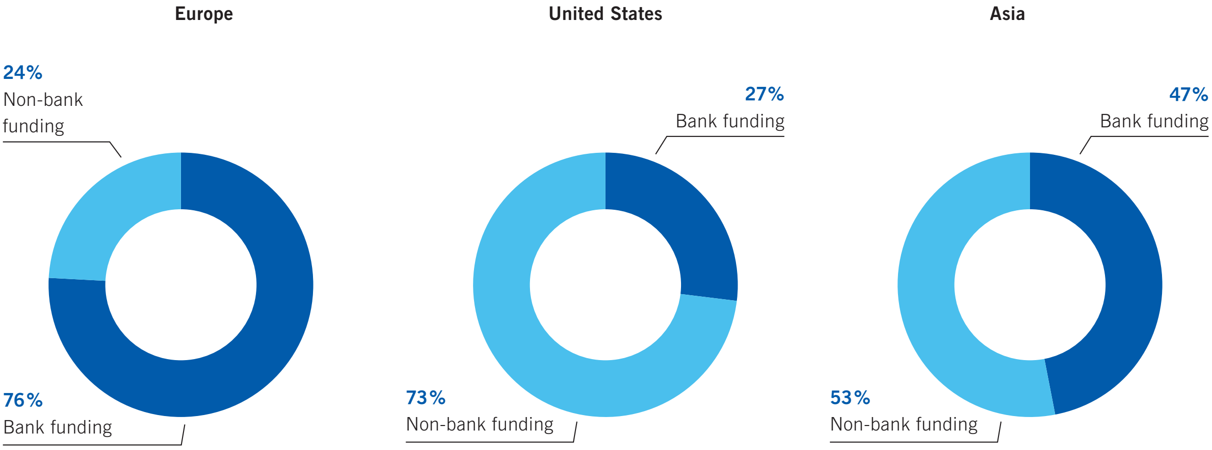
Capital markets funding will provide additional channels to help companies of varying sizes obtain access to capital. Efficient capital allocation is ensured by channelling the wealth of savers towards those who can put it to productive use. This can play a significant role in addressing the intermediation gap between supply and demand for long-term financing, given the many different funding sources available at varying costs.

Investors looking for opportunities should also find a variety of appropriate investment channels, according to their risk profile. It is important to increase the attractiveness of capital markets both for EU investors and for investors from outside the Union.[5]

In the long run, it must be "ensure[d] households provide adequate long term savings for the real economy."

Better Finance for All 2014: Better Finance Manifesto for the 2014 European Elections. Saving for Growth and Jobs

Exhibit 3
Comparison of bank funding vs non-bank funding in Europe, the US and Asia



Source: ECB, BIS, Federal Reserve, Fung Global Institute, Oliver Wyman (latest available figures; 2013 for Europe and United States, 2012 for Asia)

4) Cf. European Commission 2013: Fact and figures about the EU's Small and Medium Enterprise (SME) (http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/index_en.htm)
5) Cf. Maijoor 2014: Investor Protection and an integrated EU-Capital Market. Speech at the "Better Finance for All – International Investor's Conference 2014: Shareholder Rights in Europe 2020"

Though non-bank funding sources already exist within Europe, markets are typically much smaller than in the US or Asia. In 2013, **companies in Europe were reliant on bank funding for 76 per cent of all financing over the past decade, whereas US companies, by comparison, use banks for only around 27 per cent.** Asia sits somewhere in the middle, with bank lending accounting for 47 per cent of total financing in 2012 (see Exhibit 3).

The reasons for these discrepancies are largely cultural and historical, but also structural. Europe is more “bank-centric” than the US and Asia on a relative basis, with lenders’ balance sheets much larger in relative terms than those of their global counterparts. Banking is highly local across much of Europe, relationships are crucial to investment decisions and average company size tends to be much smaller than in the US and Asia.

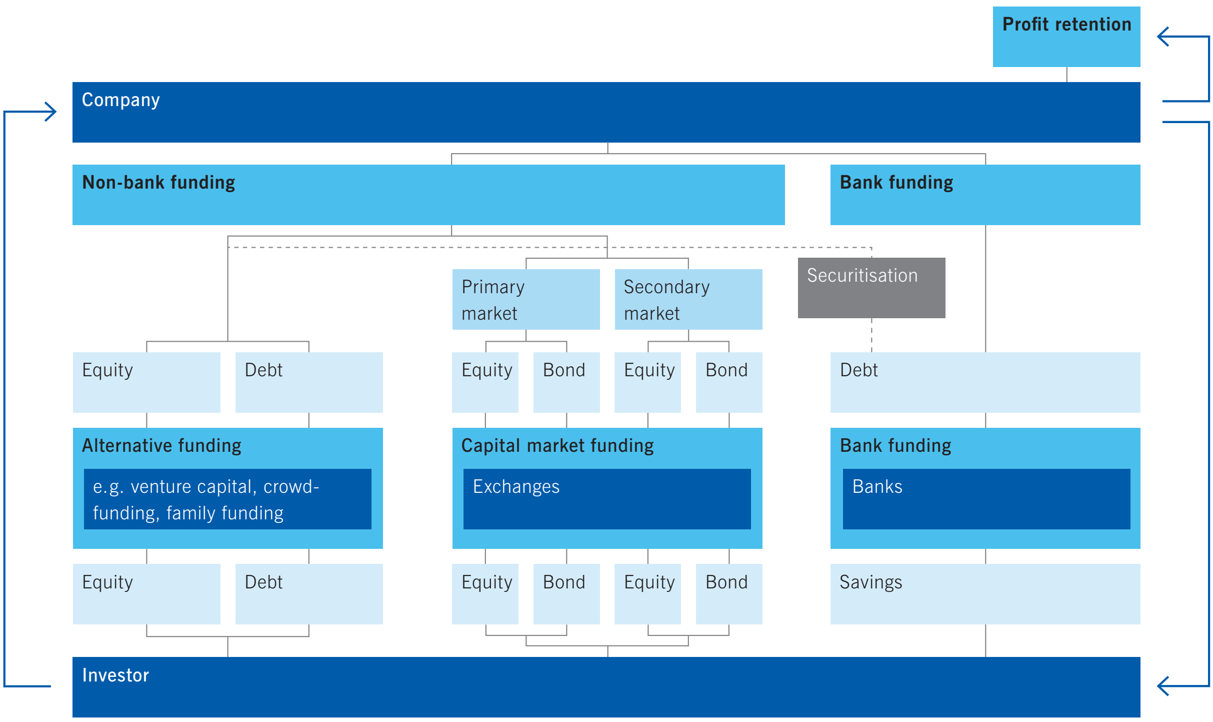
The fragmented nature of capital markets across European countries, the less attractive framework (taxation, legal differences etc.) and the lack of investor confidence have resulted in a slower uptake of funding alternatives.

Despite the divergent pattern in Europe vs the US, there is no “perfect balance” of bank vs non-bank funding. Both ways of obtaining financial resources for firms have their advantages (e.g. banks’ proximity to local clients, capital markets’ transparency and neutrality) and disadvantages (banks’ danger of instability, the public’s lack of understanding of capital markets). Ideally, **bank funding and non-bank funding should exist in parallel**, giving companies the choice of how to finance their necessary investments according to their requirements, and thereby lowering the cost of raising capital (the structure is illustrated in Exhibit 4).

However, it remains clear that Europe could have considerable room to grow its non-bank funding, and that this is needed to bridge the gap that has developed as traditional sources of bank funding have become increasingly constrained.

Non-bank funding provides alternatives through equity and debt funding. The use of equity has advantages, given that companies well-funded by equity can afford to take a long-term view. Such companies tend to fare better in times of financial instability, with a lower probability of bankruptcy and higher shock-absorption capacity, because dividend payments can always be suspended whereas interest on debt must be paid. Secondary markets are another important component of non-bank funding, generating flexibility for investors to enter and exit investments whenever deemed appropriate.

Exhibit 4
Sources of bank funding and non-bank funding



In addition to funding, companies require capital markets for hedging and minimising the risks that arise from price fluctuations. Therefore, the related derivatives markets are essential for the Capital Markets Union, as derivatives allocate various risks to where they can be managed most efficiently and thus provide benefits. Derivatives provide risk protection with a minimum upfront investment and capital consumption. They allow investors to trade on future price expectations thus improving the efficiency of price discovery. As a consequence, derivatives markets reduce uncertainty and costs in economic activity.[6]

The Capital Markets Union should lead to a **broader and more efficient financial system, allowing for different channels for the allocation of capital** and increasing the use of equity capital in Europe. **Deutsche Börse Group has developed six core principles** to be followed to achieve a competitive European Capital Markets Union, addressing the shortcomings described above and identifying future opportunities for growth.

6) Cf. Deutsche Börse AG 2009: The Global Derivatives Market – a Blueprint for Market Stability and Integrity

3. Core principles and key policy messages

The Capital Markets Union is a wide range of initiatives with the combined aim of deepening existing markets and developing non-bank funding sources to allow the free flow of capital across all 28 EU Member States.

Deutsche Börse proposes six core principles at the heart of achieving the objectives of the Capital Markets Union, as shown in Exhibit 5.

Exhibit 5
Core principles of the Capital Markets Union

	1. Revive investor trust	2. Improve non-bank funding	3. Promote financial stability	4. Increase transparency	5. Foster harmonisation/ remove barriers	6. Shape supporting regulatory and supervisory environment
Definition	Regaining confidence and trust in capital markets	Increased access to alternative non-bank funding sources	Reducing risk in the system and increasing shock absorption capacity	Ensure adequate transparency for financial markets and supervisors	Harmonisation of rules/standards to reduce fragmentation and to remove barriers	Shaping the supporting regulatory environment and efficient supervision within EU and globally
Key elements	▪ Balanced investor protection ▪ Financial education ▪ Capital culture ▪ Corporate governance ▪ Shareholder rights	▪ "Ecosystem" for SMEs and securitisation ▪ Pre-IPO ▪ Debt financing ▪ Treatment of debt vs equity ▪ Public funding	▪ G20: reduce systemic risk ▪ Risk management ▪ Shock absorption capacity & capital requirements ▪ Safety/safeguards/safe IT systems	▪ Price discovery ▪ Reduce OTC trading and dark pools ▪ Market abuse/ fraud ▪ Trade repositories ▪ Shadow banking rules ▪ Account segregation	▪ T2S ▪ Securities law ▪ Insolvency law ▪ Single Rulebook ▪ Industry standards	▪ Regulatory fixing/reconciliation ▪ Efficient supervision ▪ Third-country regimes (reciprocity) ▪ Regulatory arbitrage
Path to growth	Restore confidence to revive investor demand and stimulate growth	Given reduction in bank funding, new sources needed to fill gap and lead to growth	Prerequisite for increasing investment activity and growth	Transparent price discovery and transparency towards supervisors to increase financial stability	Reduce costs and complexity, promote cross-border activities, and stimulate growth	Proportionate and efficient regulation a prerequisite for increasing investment activity and growth

The six principles and elements of the Capital Markets Union are designed to develop the broader picture for growth generation, not only focusing on SMEs but also on stimulating efficient capital allocation. This should complement and go beyond the existing components of the EU's Single Rulebook, which already aims to provide a single set of harmonised prudential rules to unify the regulatory framework for the financial sector and ultimately lead to an improved European single market.

Different stakeholder groups would benefit from these principles. For example, if trust in capital markets is reinforced, both the general public and professional investors will have improved confidence and be more willing to invest in companies; if non-bank funding channels are strengthened, companies will have a wider choice of financing options.

3.1 Revive investor trust

Since the global financial crisis in 2008, confidence in financial markets and financial institutions has fallen dramatically. This is partly due to the perception that profits are privatised, whereas losses are socialised, as governments and ultimately taxpayers have repeatedly shouldered the burden of failing banks. This lack of trust in the banking system, coupled with a lack of understanding around the cause of the crisis, has spilled over into a lack of trust in capital markets and more complex financial instruments. These perceptions were also articulated by Commissioner Hill in his first speech on the Capital Markets Union:

> "I want financial services to be seen as part of the economic mainstream, not cut off from society at large."
>
> Jonathan Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union

The key elements to focus on to revive investor trust include improved investor protection, financial education and capital culture in addition to adequate corporate governance and shareholder rights as prerequisites.

3.1.1 Investor protection

As alternative funding sources are opened up and use of capital instruments is promoted, **well-defined investor protection rules suited to the new landscape are crucial.** Investor protection is a key driver of EU financial legislation; if investor and consumer interests are appropriately protected, this will serve to inspire confidence in financial markets again. Only when investors feel sufficiently protected will they be willing to enter capital markets and participate.

For example, **distributors of capital market instruments should ensure that any investment products they recommend are suitable for investors**; in order to do this, they should obtain whatever information is necessary to adequately assess the suitability of an investment. This involves assuming the responsibility to ask clients the right questions, collect the right information, correctly interpret this information and ultimately recommend a suitable investment product, providing valuable options to diversify their portfolio.

Regulators are already aware that this type of investor protection is essential. As part of MiFID II, ESMA published guidelines to further enhance investor protection, especially in the area of suitability of investment advice. The publication was aimed at contributing further to fully integrated safeguards that would allow investors to benefit from the same levels of protection, regardless of which European country they are investing in.

As the Capital Markets Union leads to growth in alternative funding sources, regulators should require that providers of funding comply with these enhanced guidelines.

However, it is equally important that investor protection is well balanced. Regulators should be careful not to make investor protection requirements overburdening. Assessing the suitability of an investment should not be such a complex and resource-intensive process that it outweighs the benefits of providing that advice. Introduction of new or additional burdens for advisors could lead to financial institutions cutting their advisory desks or declining to offer investment advice, which ultimately leads to less investment. This has the added impact of disproportionately giving large advisory businesses the edge over smaller competitors (as seen in Germany and the UK). Consequently, amending the Prospectus Directive further could lower barriers to accessing equity capital, ensuring that the real-world application of these rules leads to the desired objectives.

3.1.2 Financial education and capital culture

Investor confidence in the markets remains low and there is still public mistrust in the financial sector. Lack of trust is especially problematic in Europe, where there is a preference for saving via deposits.

This is likely to act as a serious barrier to the goals of the Capital Markets Union, given that it will be impossible to open up non-bank funding sources without increasing the number of investors willing to provide capital. To achieve this, investors must be appropriately attracted and incentivised to invest, and companies will need to be aware of and willing to tap into capital markets funding possibilities to create value. Initiatives to tackle this problem are therefore an essential prerequisite to a functioning Capital Markets Union as envisaged by the European Commission.

Improvements in the quality and quantity of financial education are to be welcomed to counter this mistrust and change the attitudes of market participants. **The Capital Markets Union should advocate initiatives aimed at giving the wider public a greater understanding of the function of capital markets within the financial system, as well as of the benefits and attractive economics which can be achieved through non-bank financing.** Education regarding the different financial products that are available is essential in order to bring investors back into these markets.[7)]An emphasis on the fair, efficient, transparent and nondiscriminatory nature of markets that operate under the highest possible standards will help to revive confidence in capital market financing.

7) Good examples are recent initiatives such as the “Factbook Aktie” (factbook on the German capital market, only in German) developed by Handelsblatt Research Institute or seminars for all kind of investors offered by academic institutions, exchange organisations and investor protectors (like https://deutsche-boerse.com/cma/dispatch/de/kir/gdb_navigation/cma/20_Seminars/10_Trainings_for_Private_Investors).

While the financial sector is partly responsible for restoring investors' trust by providing education, regulation should strongly support these efforts. Some recent regulatory initiatives (such as MiFID II, MAD II, the Shareholder Rights Directive and the Directive on disclosure of non-financial and diversity information by large companies and groups) are aimed at rebuilding investor confidence in financial markets; many of these go through the route of enhanced investor protection (see above). Moreover, on a global level, IOSCO members agreed on a strategic framework for investor education and financial literacy to be implemented.[8)]

This lack of confidence and knowledge also manifests itself on the demand side; many European SMEs are not confident in their ability to discuss growth-financing. A recent survey by the European Commission indicated that one in three SMEs is apprehensive about discussing financing options with banks. Even worse, only one in five is happy to negotiate with equity investors and venture capital firms,[9)] indicating that SMEs are more comfortable exploring bank funding options than non-bank funding options. Additionally, they are often not aware of the vast range of financing strategies available to them, and they may not have the aspiration to explore them, due to a lack of understanding. This can be changed only through financial education, as well as a shift in culture.

In order to achieve the growth objectives of the Capital Markets Union, an essential first step is for the industry to develop initiatives to **restore investor trust** and confidence, in order to revive demand for new sources of funding. Educated, **well-informed** (please also refer to section 3.4) and well-protected **investors** will make responsible investment decisions from the range of available capital markets products that are more adequately suited for their needs. **Well-informed companies** will search for the best funding possibility (please also refer to section 3.2).

8) Cf. IOSCO 2014: Strategic Framework for Financial Investor Education and Financial Literacy. Final Report
9) Cf. ECB 2014: Survey on the access to finance of enterprises in the euro area

3.2 Improve non-bank funding

The development of non-bank funding is at the core of initiatives to drive economic growth and employment in Europe, given that traditional sources have been decreasing. Investors searching for returns in a long-term low interest rate environment would welcome new investment opportunities.

The key elements that the Capital Markets Union could focus on here include the "ecosystem" for SMEs, revival of securitisation, pre-IPO, debt financing, treatment of equity vs debt and public funding (e.g. European long-term investment funds).

3.2.1 Equity financing

Improved access to equity financing could be another cornerstone of the Capital Markets Union, given the characteristics of equity. Many different types of equity financing exist, for example:

- Business angels – wealthy individuals (often entrepreneurs) financing start-ups
- Venture capital – specialist funds providing capital to early-stage, high-potential, growth start-up companies
- Crowdfunding – funding by collecting (small) monetary contributions from a large number of investors, typically via internet platforms
- Initial public offerings (IPOs) – the first issuance of equity by a company to the public

In comparison with the US, Europe is weak at raising capital through these channels and at helping small entrepreneurial SMEs to grow. For example, the amount raised through venture capital in Q2/2014 was five times higher in the US than in Europe.[10] It is estimated that some 36,000 additional companies could have been backed by venture capital firms in Europe between 2008 and 2013 if the venture capital market was as deep as it is in the US.[11]

The Capital Markets Union would be well placed to incentivise equity financing via venture capital firms, crowdfunding and business angels to help companies grow faster. This could be done through the careful provision of harmonised government support to start-ups to help them raise capital more easily (e.g. through tax breaks for investors).

At a more mature stage equity financing through an IPO becomes an option. The primary advantages of an IPO are that it enables companies to raise additional equity capital while giving the original venture capitalists the opportunity to exit through the secondary market. Moreover, it is a form of publicity for the company and serves to distribute the equity capital among a broader shareholder base.

In order to promote IPOs as an alternative funding source, and open it up to SMEs in particular, it will be necessary to better coordinate the pre-IPO phase. To help vitalise the IPO market for SMEs, particularly in countries such as Germany, the creation of a new exchange market segment is not the right answer. Instead, with exchanges increasingly broadening their roles as part of the capital market "ecosystem", **market infrastructure could be used to fill the existing transparency and efficiency gap between all relevant constituencies in the IPO set-up phase. One Capital**

10) Cf. Centre for European Reform 2014: Unlocking Europe's Capital Markets Union
11) Cf. New Financial 2014: Driving Growth: Making the Case for Bigger and Better Capital Markets in Europe

Markets Union initiative might be to introduce a pre-IPO information and "brokerage" platform connecting SMEs and investors (envisaged as something similar to a shop window display). This would be used to facilitate the process and promote IPOs as a viable and accessible funding option.

3.2.2 Debt financing

Despite the benefits of equity funding, debt financing will always represent an attractive option in many cases both for investors and corporates, and should therefore also be promoted under the Capital Markets Union. Some business owners (particularly smaller firms) do not wish to take on equity investment as a funding source, as they are unwilling to give up control of their company; something they do not have to do when financing through debt.

Issuance of corporate bonds directly to investors is a good method of debt funding which could be better utilised in Europe, given that bond markets can often provide financing when banks are unwilling to lend and companies do not have to give up shareholder rights. This can be done either through a public listing, or via a private placement, where companies issue bonds directly to a small number of specialist investors. In recent years, bond markets in Europe have naturally grown to counter the reduction in traditional funding, especially in Germany where bonds with a value of more than €7 billion have been issued by some 130 SMEs since 2010.

Initiatives to incentivise the continuation of this trend would be welcome, particularly for smaller companies for which lower amounts are raised and costs are more critical. For example, uniform bond issuance prospectuses could be developed, as seen in the US. **Access to standardised information like this is likely to increase investor appetite and bring about greater liquidity in the bond market, ultimately growing it as a funding source.**

Another important initiative to increase alternative debt financing might be to enable the free choice of issuance location. Through its initiatives to harmonise differences between Member States, the Capital Markets Union should look to break down barriers to debt-issuance across borders.

3.2.3 "Ecosystem" for SMEs

SMEs play a central role in terms of economic activity and employment in Europe. However, the sector's composition and its performance during the crisis varied considerably by geographic location. Non-bank funding has seldom been an option in the past, as SMEs have largely relied on bank loans for funding. Though some existing non-bank funding initiatives are trying to unlock financing for SMEs, the success of these efforts has been limited so far. This is attributable to many factors, including the lack of confidence in discussing alternative funding options coupled with the low level of financial sophistication as discussed above. This makes sense given that 90 per cent of SMEs are actually microenterprises with fewer than ten people. At the same time, SMEs in the countries hit hardest by recession and unemployment struggle the most in terms of access to bank credits, paying significantly higher lending rates than large enterprises.

There is a wide spectrum of initiatives that aim to support SMEs' access to funding in Europe. So far, however, these have mainly come from public institutions and have been aimed at expanding bank lending. Going forward, private-sector, non-bank involvement is crucial, as direct government lending or loan guarantees may result in significant costs to the taxpayer and may even serve to penalise creditworthy SMEs.

In this regard, it is important to consider that many capital market funding options would be eligible for taxation. A financial transaction tax would increase transaction costs in European financial centres and could therefore impede the goals of the Capital Markets Union. SMEs in particular would face higher capital-raising costs as a result of rising transaction costs. Retail investors would also suffer greater financial losses as the tax directly hits retirement provision products.

The development of the Capital Markets Union envisages the promotion of alternative funding sources in order to facilitate growth. The point is that there is not just one method through which to increase access to funding for SMEs in Europe. **Fostering a stable, positive environment and incentivising companies through attractive and diverse funding options is essential.**

3.2.4 Securitisation

One alternative method for dealing with falling bank lending could be the securitisation of (SME) loans. This would enable banks to refinance loans by pooling assets and converting them into securities that are attractive to investors. Revitalisation of securitisation is expected to be a top priority of the Capital Markets Union; however, the securitisation market has declined 30 per cent since 2008[12] in light of public distrust and lack of market confidence, given that it was inadequately regulated in the past and therefore misused. **Revitalisation will therefore likely present a challenge; however, it will be a constructive alternative provided that the lessons of the crisis have been learnt.**

Specific factors need to be considered and addressed in order to redevelop the European securitisation market, some of which are already underway.

Firstly, the European Commission is aiming to develop a differentiation of "high-quality" securitisation products (those with simple and easy-to-understand structures) with a view to possible preferential regulatory treatment across financial sectors. This was on the back of recommendations by the ECB and Bank of England that they might, indeed, benefit from less stringent regulation. **Securitisations might then benefit from being traded on clearly regulated and supervised markets with a high level of transparency, passing through expert risk management systems.** For further discussion on how the use of market infrastructure for transactions can significantly improve financial stability, see section 3.3.

12) Cf. Llewellyn Consulting 2014: Financing Europe's Investment and Economic Growth

Secondly, **pooling and standardisation of loans is needed to ensure transparency and comparability.** This would likely require the creation of an institutional framework, and greater willingness on the part of banks to develop and underwrite these markets. The European Commission is expected to work with international organisations, such as the Basel Committee and the International Organization of Securities Commissions (IOSCO), to develop global standards for "high-quality" structures and their related risk, in order to avoid regulatory arbitrage.

3.2.5 Treatment of equity vs debt

From a company/issuer perspective, equity is more heavily taxed than debt in most countries, which disincentivises equity investment. Interest payments on debt may be deducted from profits before they are taxed, whereas equity financing does not receive any form of tax relief (and indeed is subject to significant taxation both in terms of capital gains and dividend payments). This structural bias towards debt financing encourages companies to take on debt rather than equity; yet high debt-to-equity ratios increase the likelihood of bankruptcy and encourage risk-taking, often at the expense of creditors and governments (rather than shareholders).

Rebalancing the current bias towards debt financing could be an important initiative for the Capital Markets Union for two reasons. Firstly, it may encourage companies to strengthen their equity base and discourage levels of leverage that are too high, thereby improving their financial stability via increased loss absorption capacity. Secondly, it may result in investors paying lower taxes on their equity investments, incentivising provision of equity capital as an alternative funding source.

There is also wide variation in the gap between effective marginal tax rates on debt and equity-financed investments. According to the International Monetary Fund, this gap ranges from 10 to 50 per cent for European countries. Therefore, it is **not only important to rebalance this bias, but also to harmonise tax procedures within Europe, in order to create a level playing field.** An additional point to consider is that this bias is even more pronounced in the US than it is (on average) in Europe. As a result, rebalancing the bias across Europe in the form of a reduction in the tax on equity investments might serve to increase the attractiveness of investing in the region.

In order to **reduce the reliance on bank funding**, multiple funding alternatives exist. **A functioning Capital Markets Union should ensure a choice for investors and companies.**

3.3 Promote financial stability

The principle of promoting financial stability is centred on improving shock absorption capacity, reducing systemic risk and enhancing the resilience of financial markets. Shock absorption capacity has already been significantly improved through the tougher capital requirements introduced since the crisis, and certain aspects of the Capital Markets Union will serve to naturally reinforce this, such as the rebalancing of funding sources towards non-bank financing. Additionally, **promoting use of market infrastructure should play a significant role in direct management of systemic risks, as they are highly regulated entities and have crisis-proven effective risk management tools in place.**

Initiatives to increase financial stability include the reduction of systemic risk, general risk management, shock absorption capacity and capital requirements, efficient collateral management and safety/safeguards (including for IT systems). Some of these elements are detailed further below.

In recent years, regulators and policymakers have clearly understood and implemented the vital role of central counterparties (CCPs), central securities depositories (CSDs) and, in particular, exchanges in strengthening the safety and integrity of financial markets, specifically through systemic risk mitigation, permanent market supervision and efficient post-trade processes and collateral management. Recent global regulatory efforts are proof of this acknowledgement.

The G20 recently released a statement attesting to this viewpoint:

> "We are working to facilitate long-term financing from institutional investors and to encourage market sources of finance, including transparent securitisation, particularly for small and medium-sized enterprises… Our reforms to improve banks' capital and liquidity positions and to make derivatives markets safer will reduce risks in the financial system."
>
> G20 Leaders' Communiqué, November 2014

3.3.1 Reduce systemic risk and increase risk management through CCPs

A CCP acts as an intermediary between the parties involved in a securities or derivatives trade and acts as the seller to every buyer and the buyer to every seller, minimising the default risk and facilitating netting.

Firstly, **CCPs prevent excessive risk taking by being independent risk managers.** This is because they ensure a neutral valuation of risk exposures. By calling for collateral at current market prices, the CCP ensures a strict mark-to-market of risks and thus prevents excessive risk taking.

Secondly, **the position of a CCP at the centre of the market reduces the interconnectedness of market participants.** As a CCP legally steps into trades, replacing the original counterparties' exposure to each other, market participants face the CCP as counterparty. This allows multilateral netting, reducing overall risk exposure for market participants and reducing the interconnectedness of market participants, which fosters stability and integrity in times of market turmoil.

Thirdly, **CCPs also serve as shock absorbers to protect non-defaulting clearing members, thus avoiding domino effects and uncertainty caused by counterparty defaults.** To provide a secure guarantee of the contracts towards non-defaulting parties, CCPs employ the margins of the defaulter and its lines of defence – additional funds from the CCP and its members (who are obliged to contribute to the default fund) – to protect against extreme tail events. To rebalance the CCP, a robust default management process is undertaken.

The CCP therefore helps to mitigate the three root causes of risk, as shown in Exhibit 6.[13)]

CCPs need to adhere to the highest quality standards, so they can effectively and efficiently manage risks in the financial system. This has been a focus of regulation in Europe, resulting in market infrastructure entities being highly regulated. These standards should prevent disruption of CCPs themselves and ensure the continuation of the operations of CCPs at all times. **Where appropriate, Capital Markets Union initiatives should encourage wider use of CCPs and related market infrastructure services, in order to improve risk management and thereby increase financial stability.**

Exhibit 6
How CCPs reduce systemic risk in the financial system

Mitigation of systemic risk by central counterparty clearing		Root causes of systemic risk
CCPs as independent risk managers ▪ Neutral valuation of risk exposure at current market prices ▪ Enforcement of independently determined collateralisation levels	… prevents …	Excessive risk taking
Addressing interconnectedness with central clearing ▪ Novation of contracts to reduce interconnectedness ▪ Reducing risk exposure by multilateral netting	… lowers …	Interconnectedness of market participants
Protecting market participants from clearing member defaults ▪ Insuring against tail risks by robust lines of defence ▪ Reducing the impact of default by a transparent default management process	… mitigates …	Insufficient collateralisation of market and credit risk

13) Deutsche Börse Group 2014: How central counterparties strengthen the safety and integrity of financial markets

Despite the clear benefits of CCPs, an important lesson learnt from the crisis is that CCPs that clear derivatives should not be allowed to become interconnected. Should this happen, it would increase risk and endanger the functioning of CCPs, which would counter the positive effects of market infrastructure on financial stability.

3.3.2 Financial stabilisation through CSDs

Significant regulatory change, following the G20 commitments, has had an enormous impact on the way financial institutions have to **risk manage their financial exposures:** the whole market needs **better collateral management** to unlock collateral buffers and optimise the usage of this scarce resource. Regulators demand greater protection for banks against a liquidity crisis by setting aside good-quality liquid assets that can be sold quickly for cash. The challenge here is to make the right selection of "liquid" assets and to put in place necessary contracts as well as the procedures for selling these assets for cash.

Central securities depositories (CSDs), offering a wide range of post-trade services relating to issued securities, **are well positioned to provide support** in the field of **collateral management** as they already act as a central service point for both asset holdings and market connectivity, **whilst being a well-regulated and neutral trustee** that is not engaged in proprietary trading. To improve cross-border settlement and the efficient use of collateral, well-functioning and appropriately regulated and supervised CSDs are the relevant entities to look at. In order to ensure moving the liquidity of securities held by financial and non-financial entities, thus enhancing the efficiency of collateral, it is crucial to link liquidity and to allow securities lending and collateral management offers.

The "collateral value chain" would allow banks to reduce their Basel III equity capital requirements by up to 20 per cent, or €40 billion. Adequately securing risk via collateral provides appropriate risk mitigation in line with regulatory requirements and therefore reduces the quantity of equity capital to be allocated.[14]

CSDs have a stabilising effect and make settlement in Europe safe and efficient, in particular in the future **TARGET2-Securities (T2S)** environment (see also section 3.5.1).

Financial stability is a necessary prerequisite for growth and job creation; a lack of financial stability leads to economic instability, as seen in the recent crisis. In order to **minimise systemic risk and create well-functioning markets**, both safety and integrity need to be ensured. An important aim of the Capital Markets Union is to achieve the **G20 goals and continue to implement and truly apply** the European regulation (e.g. EMIR, CRD IV, CSDR) with a focus on increasing financial stability. This should be a joint effort of market participants and infrastructure providers, as well as regulators, supervisors and politicians. Stability is essential to build up trust for companies and investors using capital markets for investment and funding.

14) Cf. Clearstream and Elton Pickford 2014: Collateral optimisation – the value chain of collateral: Liquidity, cost and capital perspectives

3.4 Increase transparency

This principle is about ensuring adequate transparency of financial markets in order to both facilitate price discovery and provide information for the market and its supervisors.

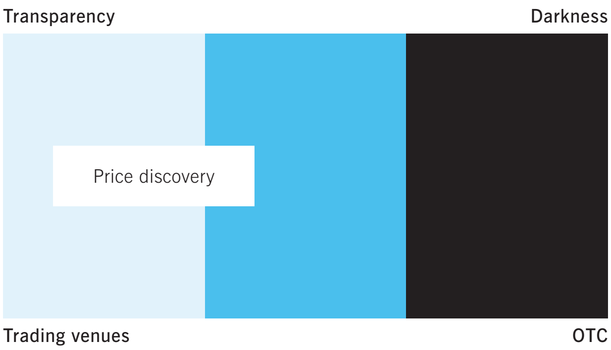
A lack of information on market price developments as well as risk exposures in various non-exchange traded asset classes accelerated the financial crisis. MiFID I had taken steps to strengthen competition through multiple equity trading venues, resulting in improved pre-trade transparency, thereby intending to reduce over-the-counter (OTC) transaction volumes. However, transactions carried out on an OTC basis still represent 36 per cent of the trading volume in European equity markets. In reality, trading activity currently reported as OTC activity is very different from the original MiFID I intention. **A significant share of these OTC transactions could have been executed on transparent trading venues without facing any market impact.** [15] While adequate transparency is deemed to be better for the efficiency of markets, single market participants sometimes benefit from a lack of transparency (see Exhibit 7).

MiFID II/MiFIR aim to improve transparency for equities and extend the scope beyond equities to all financial instruments.

While price transparency for all asset classes is crucial for investors in a stable financial market, **supervisors need additional data** (including private data) in order to be able to spot potential market abuse. Some of the elements related to the transparency principle are discussed below.

Exhibit 7
Conflicting preferences for equities transparency

- **General public** prefers knowledge of the current order situation/market prices
- Investors and dealers want to see each other's orders to get a comprehensive picture of the market situation



- **Individual market participants** prefer not to disclose their own orders because they do not want to reveal their information advantage, especially for large orders
- Therefore, the market tends to opaqueness, a natural equilibrium that would be realised if no regulation to establish transparency took place

Preference of the general public: Transparency

Individual preference: Lack of transparency

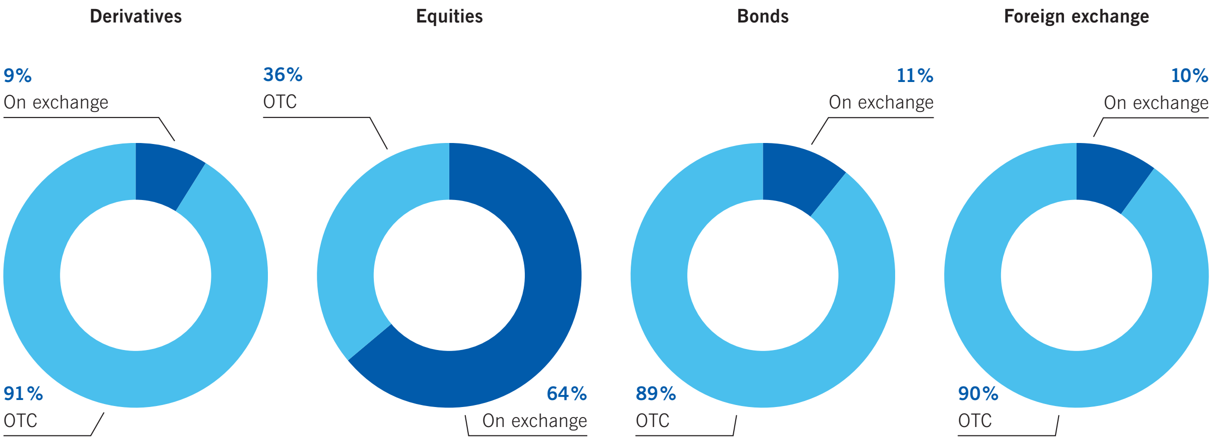
15) Cf. Gomber and Pierron 2010: MiFID – Spirit and Reality of a European Financial Markets Directive

3.4.1 Price discovery

Trading activity is not only limited to exchanges and multilateral trading facilities (MTFs); a large amount of trading takes place OTC in various asset classes. In contrast with exchanges, OTC markets are largely bilateral, decentralised, non-transparent markets. Transactions can therefore be executed between the buyer and seller without other market participants being aware of the price. Prices used in the dark are often still based on the price formation in lit markets, making a larger part of the market dependent on a smaller part of trading which could have adverse effects on the overall price formation. Estimates show that 91 per cent of outstanding derivatives notional is traded OTC (see Exhibit 8) compared to only 36 per cent of total equity trading. However, given that 89 per cent and 90 per cent of bond and foreign exchange (FX) trading, respectively, is also OTC, this indicates that the vast majority of these financial markets are operating under non-transparent conditions.

A lack of transparency can cause a serious threat to market stability during stressed periods, as seen in the recent crisis. Real price discovery for derivatives such as interest rate and credit default swaps, which were solely traded OTC, was impossible as liquidity dried up in the absence of buyers. The liquidity problem was then exacerbated as broker-dealers increasingly withdrew from their market-making functions, which ultimately led to the global credit crisis.

Exhibit 8
Derivatives, equity, bond and foreign exchange markets – exchange traded vs OTC



Note: Derivatives data global as of 2013; Equity data for Europe as of June 2014; Bonds data for Europe as of 2010; FX data for Europe as of 2013. Global figures used as a proxy for derivatives given European figures not available and proportional split is comparable
Source: FESE, ESMA, BIS, PwC

Ongoing regulatory initiatives such as MiFID II/MiFIR and EMIR addressed many of these issues and have increased transparency since the crisis. One particular initiative has been to use trading platforms and clearing houses for multilateral trading and central clearing of OTC trades where possible, which is a step in the right direction. **The Capital Markets Union should look to improve upon these existing initiatives, ensuring adequate transparency for functioning price discovery mechanisms where appropriate, keeping in mind that different data users (retail investors, institutional investors or regulators) clearly have different needs in terms of transparency.**

3.4.2 Dark pools and market abuse

A substantial amount of OTC equity trading takes place in unregulated dark pools, which have a complete lack of transparency and supervision. Dark trading on regulated trading venues in contrast has clear benefits in terms of facilitating large block trades by institutional investors who do not want to move the markets with their activity. However, if unregulated, this inherent lack of transparency in and supervision of trade execution can make trading of this kind vulnerable to conflicts of interest, predatory trading practices and market abuse. Unregulated OTC trading fails to contribute to price discovery by definition,[16] though MiFID II/MiFIR address this to some extent. Moreover, OTC trading as a whole is not covered by supervision.

The G20 raised concerns about this back in 2009, requesting that transparency be improved through use of market infrastructure by the end of 2012:

> "All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties … [They] should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."
>
> G20 Pittsburgh Summit Leaders' Statement, September 2009

As recommended above, supervisors must continue to regularly assess whether transparency in the derivatives markets is sufficient. **In general, OTC markets should be encouraged to "switch on the light" for dark pools where possible, while being conscious of maintaining the value proposition of OTC markets as feasible.**

16) Cf. Kwan, Masulis and McInish 2014: Trading Rules, Competition for Order Flow and Market Fragmentation

3.4.3 Trade repositories

Trade repositories collect and administer transaction data and market information as requested by G20 (see above) across multiple product classes and jurisdictions, as reported by their clients. **They provide supervisors with an overview of the trading situation** and report outstanding risk positions. In order to fully assess this reporting and derive benefit from it, further streamlining is needed, but the potential is clear.

EMIR, MiFID II and MiFIR have already addressed this initiative. However, it should be accompanied by the clear **commitment to request data only where it is necessary** and useful and where it will be meaningfully analysed in order to support stable financial markets. Otherwise it will only be costly without producing any added value.

Transparency for investors as well as supervisors is an essential prerequisite for increasing financial stability, as increased transparency in terms of execution, both pre- and post-trade, improves the quality of price discovery and reduces investment risk. It should be ensured that data provision to cater for transparency needs is only required where it is necessary to avoid additional costs for investors and supervisors.

3.5 Foster harmonisation – remove barriers

Despite significant progress towards the European single market, capital markets are still fragmented, creating barriers that hamper the free flow of capital. Those barriers across regions make cross-border investments complex and expensive, and therefore less attractive. The Single Rulebook has not yet been fully achieved. **Continued harmonisation of national rules and standards in order to eliminate costly barriers and reduce complexity for investors is essential.** In particular, many initiatives (e.g. TARGET2-Securities and industry-led initiatives) are aimed at reducing the "Giovannini barriers";[17] barriers related to the fragmentation of the European clearing and settlement markets and the resulting inefficiencies (see Exhibit 9). These are particularly relevant given that many capital market transactions touch various parts of the market infrastructure value chain. Over the longer term, further convergence of company laws, insolvency laws and taxation procedural rules is likely to be necessary and relevant to boost cross-border credit and investment flows and in some cases, it may be necessary to agree on entirely new "European" rules.

Given that legal frameworks differ substantially, the task of harmonisation is not an easy challenge and it is not necessarily always a desirable one. Regulators must carefully weigh the costs against the benefits of harmonisation initiatives; if standardisation of a certain element of the financial system is going to be more costly to implement than the cost savings and future economic growth it will stimulate, it is not worth doing. This overarching "sanity check" must always be kept in mind when evaluating the initiatives discussed below.

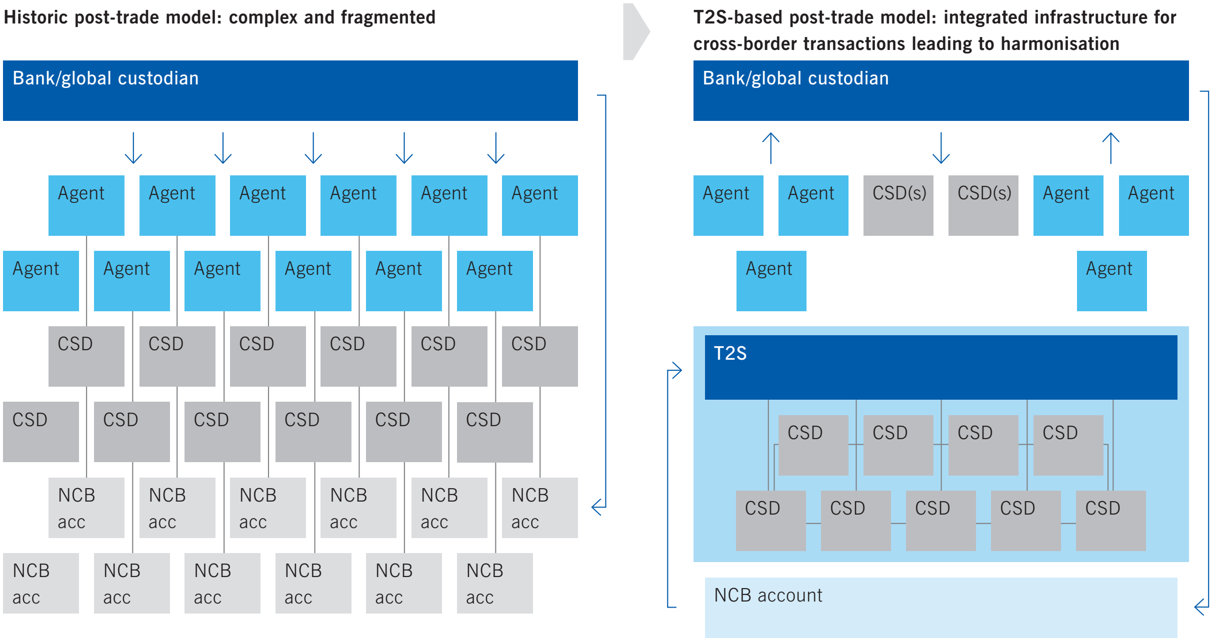
Regardless, the Capital Markets Union is likely to be a good vehicle through which to dismantle some of the cross-border barriers preventing the development of integrated European markets. Significant fragmentation still exists in the public domain, for instance in securities law, insolvency law, accounting standards for SMEs, and tax procedures (in the context of corporate actions: withholding tax procedures) and investment fund services.

3.5.1 TARGET2-Securities

The TARGET2-Securities (T2S) project aims to tackle European fragmentation and inefficiency by harmonising market infrastructure for securities settlement in Europe (see Exhibit 9).[18] When it goes live in mid-2015, it will perform real-time settlement of all securities transactions against central bank money across Europe. **Reducing the existing inefficiencies will play an important role in unleashing the wider macroeconomic benefits from integrating European securities markets, building on the creation of the Euro and a joint interbank payment system TARGET2.**

17) Cf. The Giovannini Group 2003: Second Report on EU Clearing and Settlement Arrangements
18) Deutsche Börse Group 2014: The T2S Opportunity – unlocking the hidden benefits of TARGET2-Securities

Exhibit 9
Process consolidation under the emerging post-trade model



NCB acc = national central bank account

The Giovannini Group's reports identified a total of 15 specific barriers that prevent efficient European cross-border clearing and settlement; **the ECB estimates that T2S will help eliminate at least six of the Giovannini barriers and the CSDR will further reduce barriers** either through direct elimination or by influencing it along with other factors (see Exhibit 10).[19]

19) ECB: Giovannini barriers to be reduced by T2S (https://www.ecb.europa.eu/paym/t2s/about/html/giovannini.en.html)

Exhibit 10
Giovannini barriers to be removed by T2S and CSDR

Giovannini barrier	T2S contribution in removal	CSDR contribution in removal
1. National differences in information technology and interfaces	Yes	No
2. National clearing and settlement restrictions that require the use of multiple systems	Yes	No
3. Differences in national rules relating to corporate actions, beneficial ownership and custody	Yes	Yes
4. Absence of intra-day settlement finality	Yes	Yes
5. Practical impediments to remote access to national clearing and settlement systems	Yes	No
6. National differences in settlement periods	No	Yes
7. National differences in operating hours/settlement deadlines	Yes	No
8. National differences in securities issuance practice	No	Yes
9. National restrictions on the location of securities	No	Yes
10. National restrictions on the activity of primary dealers and market makers	No	No
11. Domestic withholding tax regulations serving to disadvantage foreign intermediaries	No	No
12. Transaction taxes collected through a functionality integrated into a local settlement system	No	No
13. The absence of an EU-wide framework for the treatment of interests in securities	No	No
14. National differences in the legal treatment of bilateral netting for financial transactions	No	No
15. Uneven application of national conflict of law rules	No	No

■ Yes ■ No

Source: ECB 2014

3.5.2 Securities law

The overall legal framework for securities varies widely by country. For example, legal barriers make it much more complex to hold securities cross-border, and lead to higher costs for transactions. In addition, they cause difficulties and uncertainty among investors when they exercise their rights abroad.

Given that legal uncertainty of this nature acts as a barrier to financial stability and growth, the European Commission has been examining barriers within securities markets for several years, with the aim of creating a stable and efficiently functioning single market. This type of initiative is expected to be accelerated through the development of the Capital Markets Union.

Continued harmonisation of rules and standards is essential to eliminate costly barriers (especially the Giovannini barriers) and reduce complexity for investors and companies. Initiatives in this area, building on the Single Rulebook as a harmonised regulatory framework, should increase the attractiveness and returns on investment, thereby stimulating economic growth.

3.6 Shape the supporting regulatory and supervisory environment

Shaping the supporting regulatory environment around which the Capital Markets Union is built, both within the EU and globally, is essential to create sustainable conditions in which growth initiatives can prosper.

Important elements include regulatory fixing/reconciliation, efficient supervision, third-country regimes and reciprocity and avoidance of regulatory arbitrage.

3.6.1 Regulatory fixing/reconciliation

The previous European Commission launched important regulatory initiatives (e.g. CRD IV/CRR, MiFID II/MiFIR, EMIR, CSDR, AIFMD, UCITS V etc.) that should be integrated under the umbrella of the Capital Markets Union. Many of the above-mentioned principles and elements are addressed but need to be implemented and brought to life.

> "These new rules will improve the way capital markets function to the benefit of the real economy. They are a key step towards establishing a safer, more open and more responsible financial system and restoring investor confidence in the wake of the financial crisis."
>
> Michel Barnier, former European Commissioner for Internal Market and Services

In light of this, the Capital Markets Union should build on existing regulatory elements and ensure that these are fully implemented (for example, there were 400 delegated acts in 2014). Regulators and supervisors should see how existing and recently implemented regulation works in practice, understand the impacts and ensure any overlaps or misinterpretations are addressed, clearly defining the gaps and any market failures, before looking into creation of new regulation. Legal certainty is an important prerequisite for companies.

The various rules for financial market infrastructures (FMIs) sometimes lack harmonisation which starts with cross-referencing, duplicating and conflicting definitions across the various legislative texts on financial market regulations. Here, an omnibus regulation – as an overarching regulation – to define core terminology should be helpful. Furthermore, differences in corporate governance rules should be aligned and may be part of the same omnibus regulation.

The Capital Markets Union should ensure that the long-term goal is to reduce the regulatory burden to what is essential. Additionally, **loose ends need to be reconciled** with regard to finalisation, implementation and application of existing regulatory initiatives, making sure that these **avoid any unintended consequences**. Surplus or misdirected regulation raises costs for businesses, utilising valuable funds that could instead be turned towards innovation and growth creation. The overall aim should be to establish a **more attractive environment** for companies and investors.

3.6.2 Efficient supervision

The principle of subsidiarity aims at determining the level of intervention that is most relevant in the competency areas shared between the EU and the Member States. This may involve action at the European, national or local level, but the EU may only intervene if it is able to act more effectively than the Member States.

With regard to the reality of European financial supervision, the picture is twofold. On the one hand, each of the 28 Member States has its own national government, regulator and supervisory authorities that best know the local market. Whether it is necessary or desirable to transfer the power to supervise capital markets from national authorities to European institutions is an important consideration. Transferring national sovereignty to the supranational European level would be a major change and would require the acceptance of national policymakers and voters.
On the other hand, the Banking Union – 120 banks under the direct supervision of the ECB – has integrated and transferred supervisory powers to the ECB. The key rationale behind the move was to allow cross-border comparisons and to help identify risks at an earlier stage. Furthermore, the danger that national supervisors could be home-biased in their treatment of national entities is mitigated.

The European Securities and Markets Authority (ESMA) was established for capital markets, allowing national authorities to take decisions in the ESMA Board; in its current state, it is a combination of both national and European supervision.

European financial market infrastructures are currently supervised differently: exchanges and CSDs by national supervisory authorities; CCPs by national supervision in combination with supervisory colleges; trade repositories by ESMA.

The Capital Markets Union has to build on the basis of an efficient supervisory structure; as such, the **subsidiarity principle** with national competent authorities having primary responsibility should be kept and redundancies avoided. If European supervisory structures are introduced, **clear responsibilities, rules for decision making and procedures** are needed in order to allow for **efficient processes** with regard to market participants, as time matters.

3.6.3 Third-country regimes

Given that many regulatory initiatives are newly implemented in Europe, and taking into account that markets have become global, the topic of third-country recognition is important. In general, the same level of requirements for third-country enterprises providing their services in a European Member State should be maintained in order to preserve the desired standards of services in the EU. The potentially lower standards from third countries for the same services should not be introduced via recognition procedures. This is particularly sensitive with regard to foreign competition, affecting the growth potential for EU companies. Therefore, **a fair balance needs to be found to allow non-EU companies to provide their services in Europe.**

It should be noted that other countries may have high barriers of access to their markets, which is another reason to consider initiatives to ensure that EU market participants are able to offer their services outside the EU on a level playing field with non-EU providers. It should be ensured that, for example, high European risk management standards will be the benchmark for assessing whether third-country firms can offer their services. Failure to do so means that these risk standards will be undermined, allowing third-country players to operate in the EU based on the lower standards of their home jurisdictions. In this regard, reciprocity should be requested and maintained with regard to third-country regimes.

3.6.4 Regulatory arbitrage

Given the **global nature of capital markets**, coordination of supervision both within and outside Europe is important in order to ensure a global level playing field and maintain European competitiveness. Developers of the Capital Markets Union should be aware that capital markets business is more easily moveable overseas than traditional banking services. Therefore, **it is important to ensure that global standards and rules put in place by institutions such as the International Organization of Securities Commissions, the Bank for International Settlements and the Financial Stability Board are carefully considered when drafting regulation in order to avoid regulatory arbitrage that could have negative consequences for growth.**

Safety standards, risk mitigation measures and data protection rules, for example, should be put in place at the highest level possible. A **"race to the bottom" should be avoided**, so that individual players cannot exploit weak regulatory regimes. Isolated national regulation should be avoided as well.

Constant improvement of the **regulatory and supervisory environment**, both within the EU and globally, is essential to **create conditions** under which initiatives **to fuel growth** can prosper.

4. Conclusions

Realising a **Capital Markets Union across all 28 EU Member States** would be a major achievement for European integration. While this will no doubt be a complex task, now is the time to focus on initiatives to **develop non-bank sources of funding to foster sustainable economic growth and innovation and drive employment across Europe.**

Significant progress has been made, especially in terms of regulation (where a lot of the focus has been post-crisis). However, it will be crucial that the Capital Markets Union helps to move the pendulum towards more market orientation and to strengthen alignment with the Single Rulebook.

The elements of the Capital Markets Union can be grouped into six core principles, which together are essential to achieve the aims of the project;

1. **Developing initiatives to revive investor trust** in order to restore demand for new sources of funding. Well-informed and well-educated investors are more willing to invest in EU companies. Well-informed companies will search for the best funding possibility.
2. **Improving availability of non-bank funding** is essential for driving economic growth in Europe. A functioning Capital Markets Union should ensure a choice for investors and companies.
3. **Promoting financial stability** is a necessary prerequisite for growth and job creation; a lack of financial stability leads to economic instability, as seen in the recent crisis. In order to minimise systemic risk and create well-functioning markets, both safety and integrity need to be ensured. It is important that the G20 goals and the European regulation (e.g. EMIR, CRD IV, CSDR) with a focus on increasing financial stability continue to be implemented and are truly applied.
4. **Increasing transparency for investors as well as supervisors** is an essential prerequisite for financial stability, as increased transparency improves the quality of price discovery and reduces investment risk. Data provision to cater for transparency needs should only be required where it is necessary to avoid additional costs for investors and supervisors.
5. **Fostering the harmonisation of rules and standards** is essential to eliminate costly barriers and reduce complexity for investors and companies. Initiatives in this area, building on the Single Rulebook as a harmonised regulatory framework, should increase the attractiveness and returns on investment, thereby stimulating economic growth.
6. **Continuing to shape the supporting regulatory and supervisory environment**, both within the EU and globally, is essential to create conditions under which initiatives to fuel growth can prosper.

The upside of taking action in line with these principles and achieving deepened capital markets is likely to be large. The European Parliamentary Research Service estimates that **the potential efficiency gain from having a fully integrated and effectively regulated EU-wide set of financial markets could be around €63 billion per year.** Market integration implies lower costs and therefore lower prices. Estimates of the savings for SMEs are in the order of €53 billion, following the successful implementation of initiatives.[20]

Given the high proportion of funding on bank balance sheets, **there is room for non-bank funding to grow in Europe in order to fill the gap left by the deleveraging banking system.** Though Europe should not attempt to replicate the US model, the comparison is useful for understanding which initiatives could drive change, as well as estimating the size of the potential opportunity.

Research by the think tank New Financial estimates that **if Europe closed half of the gap in capital markets fundraising between themselves and the US by 2020, companies could raise over €1 trillion in additional capital.** This would help free up bank balance sheets and enable banks to focus their lending on SMEs that are too small to take advantage of alternative funding channels.

As a regulated provider of market infrastructure to global capital markets and marketplace organiser, Deutsche Börse Group is a key player within the establishment of the Capital Markets Union. **Market infrastructure providers are predestined and well positioned to contribute to the public consultation process on what features the Capital Markets Union should encompass.**

Consequently, the key elements and principles laid out in this paper have aimed to detail further the concept of what a **functioning Capital Markets Union** would look like in practice. **Acknowledging the potential monetary and efficiency gains from deepening capital markets, and the expected impact on growth and jobs, policymakers should not hesitate to generate an action plan and begin implementing a variety of initiatives to turn the concept into a reality.**

20) Cf. European Parliament 2012: Towards a genuine Economic and Monetary Union

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8. List of abbreviations

AIFMD	Alternative Investment Fund Managers Directive
BIS	Bank for International Settlements
CCP	Central counterparty
CRR/CRD	Capital Requirements Regulation and Directive
CSD	Central securities depository
CSDR	Central Securities Depository Regulation
ECB	European Central Bank
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
EU	European Union
FMI	Financial market infrastructure
FSB	Financial Stability Board
FX	Foreign exchange
G20	Group of 20 major economies in the world
GDP	Gross domestic product
IOSCO	International Organization of Securities Commissions
IPO	Initial public offering
MAD	Market Abuse Directive
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MTF	Multilateral trading facility
NCB	National central bank
OTC	Over-the-counter
SME	Small and medium-sized enterprise
T2S	TARGET2-Securities
UCITS	Undertakings for Collective Investments in Transferable Securities
UK	United Kingdom
US	United States of America

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