Goldman Sachs

LSE The London School of Economics and Political Science

DIALOGUE ON CREATING AN EU CAPITAL MARKETS UNION

23 February 2015

Key Takeaways

Framing the discussion

Europe is at an inflexion point. The region's recovery from the financial crisis has been slower than in some other markets. Low economic growth has stifled job creation and corporate expansion, particularly for small and medium enterprises (SMEs). A strong SME sector is vital for the recovery of the European economy. Ensuring SMEs have access to the necessary funding to develop their businesses continues to be a key focus as Europe looks ahead.

Evidence suggests that economies with diverse and integrated capital markets are more resilient and recover more quickly from downturns. Deep, liquid and well-functioning capital markets can support growth, investment and job creation. As such, the European Commission is moving forward to create an EU Capital Markets Union (CMU) to expand the availability and accessibility of financing for businesses and households and to tap the full potential of market-based financing.

> “WE NEED FUNCTIONING CAPITAL MARKETS TO FOSTER GROWTH AND EMPLOYMENT, WHICH IS THE BIGGEST CHALLENGE TO EUROPEAN INTEGRATION.”
>
> **Steffen Kampeter,** Parliamentary State Secretary, German Federal Ministry of Finance

Against this back-drop, Goldman Sachs and the London School of Economics and Political Science (LSE) convened key thought leaders from the public and private sectors to discuss the opportunities and challenges associated with creating a European CMU, that will help grow the economy, create jobs and help all sectors, including SMEs. The meeting on 23rd February coincided with the recent launch of the Commission green paper on 'Building a Capital Markets Union'.

> “THE CAPITAL MARKETS UNION INITIATIVE… HAS THE POTENTIAL TO BE A REAL DRIVING FORCE UNDERPINNING ECONOMIC GROWTH AND JOB CREATION.”
>
> **Andrea Leadsom**, MP, Economic Secretary to the Treasury

Building from a strong base, but facing headwinds

As Jim Esposito of Goldman Sachs remarked at the event, in many ways European markets are functioning well. Large companies enjoy unfettered access to capital markets. The high yield bond market has grown significantly and is deep and liquid; and initial public offering volumes in Europe last year outpaced those in the United States. That is not to say Europe is without challenges, but overall there is a lot of evidence that Europe is building from a strong base.

Two particular headwinds were noted: First, the potential impact on market liquidity when the current accommodative monetary policy of the European Central Bank and other central banks is reversed. Second, further pressures for banks to delever to meet upcoming regulatory requirements, making it harder to finance European companies. Given its reliance on traditional bank sources of funding, the European SME sector would be particularly hard-hit by these phenomena. As Andrea Leadsom, MP, Economic Secretary to the UK Treasury explained, in a market where bank lending accounts for more than 80% of financing, other forms of financing must be identified.

Key takeaways from the dialogue

A CMU could unlock great opportunity for Europe

As was stated by many of the participants at our event, the CMU initiative has the scope to deliver real benefits in Europe. A senior European Commission official noted that much has been done for financial stability in Europe over the past five to six years, so current efforts toward a CMU are building off a solid regulatory platform.

Dialogue participants discussed how a CMU could help bring together the demand for higher investor returns in a very low interest rate environment and the need to finance long-term projects such as infrastructure. A CMU would also help foster growth and employment, promote innovation and competitiveness, while at the same time enhancing market efficiency, spreading risk around the system and improving the resiliency of the financial system against another crisis.

> “CAPITAL MARKETS UNION SHOULD BE SEEN AND JUDGED FROM THE EXTENT TO WHICH IT FACILITATES BETTER GROWTH, EMPLOYMENT CREATION, AND LEGITIMIZATION OF THE EUROPEAN PROJECT IN SOME SENSE.”
>
> **Huw Pill,** Chief European Economist, Global Investment Research, Goldman Sachs

Many panelists described SMEs as the engine of growth within Europe. According to Amundi’s Philippe Ithurbide, these companies account for two-thirds of employment in Europe and have been responsible for 85% of new job creation over the past decade. Diversifying sources of funding to this sector through CMU is critical to supporting growth in Europe going forward according to several participants.

> “CAPITAL MARKETS UNION IS JUST A HUGE OPPORTUNITY TO EXPAND ON WHAT WE ALREADY HAVE.”
>
> **Andrea Leadsom,** MP, Economic Secretary to the Treasury

It was generally agreed that CMU is an ambitious project and, according to a senior Commission official, there is a desire to get moving quickly. Some discussants thought that early priorities should include changes to the Prospectus Directive and efforts to revive the securitisation market. Building momentum was seen as key. This would help to build consensus across Europe as well as harness support for some of the longer-term, more ambitious aspects of CMU. As Steffen Kampeter, Parliamentary State Secretary, German Federal Ministry of Finance explained, CMU will be very much an incremental approach.

Financing European growth requires getting capital where it needs to be

Venture capital, private equity and private placements were all noted as mechanisms for providing deeper and more resilient sources of financing for SMEs. High-quality securitisation was also seen as an important part of any CMU solution, but current supply is fickle at best, in part affected by the current programme of quantitative easing by central banks.

Weaknesses in this market were also cited on the demand side. Philippe Ithurbide explained that although asset-backed securities are sound products and valuable funding tools, they have been tarnished by a lack of trust. Rebuilding trust will be key to getting this market going again. The UK Economic Secretary highlighted the importance of restoring securitisation markets in order to free up bank balance sheet capacity. In Europe alone this could unlock some €300 billion of funding for European businesses.

Another important element of the Dialogue was the retail investor perspective. While the EU is not short of savings, it is short of long-term savings and long-term investors. Unlike their US counterparts, Europe's retail savers typically invest in bank deposits or real estate. To unlock CMU's full potential, there is a need to diversify the products available to them. Currently retail investors in Europe can invest in a below investment grade rated high-yield bond but are not allowed to invest in a below investment grade rated loan, for example. Consideration should also be given to new platforms and distribution channels to widen choice in the retail market.

More generally a move away from a debt-based capital market to embrace a greater take-up of equity was encouraged. The difference in tax treatment was seen as one current barrier that should be explored, as well as measures at the Member State level to incentivise savings in equity products. More generally participants acknowledged that cultural and educational biases play an important role, and tackling these should form part of the CMU solution.

In order to better match investors and borrowers, participants noted that informational gaps must be addressed so that investors can make informed decisions. In this process, however, a balance must be struck such that SMEs are not over-loaded with disclosure requirements. Moves to consider changes to the Prospectus Directive were welcomed in this regard.

> "THE SINGLE BIGGEST ISSUE [RELATED TO SECURITISATION] IS WE HAVEN'T YET HAD A STEADY STREAM OF SUPPLY. IF WE CAN DEVELOP THAT, I THINK THE MARKET WILL GET ITS LEGS UNDERNEATH IT."
>
> **Jim Esposito,** Co-Head, Global Financing Group, Goldman Sachs

Collaboration amongst stakeholders will be essential to a European CMU

Collaboration was a consistent theme of the day and as was suggested, not everything can be achieved in Brussels. In a similar vein, not everything can be achieved by policy makers: industry will have an important role in identifying solutions and sharing examples of what might work well in one market or in identifying areas where there are barriers to the free flow of capital. Whilst the focus of the debate was very much on the need to develop deeper and more integrated capital markets, the UK Economic Secretary and others, were clear that banks would have an important role to play.

> "GERMANY AND THE U.K. ARE VERY CLOSE ON THE ISSUES ON CAPITAL MARKETS UNION."
>
> **Steffen Kampeter,** Parliamentary State Secretary, German Federal Ministry of Finance

Several examples of good practice from Member States were shared. In particular a senior Commission official pointed to the work France had done in relation to gathering and tracking SME credit scores. Germany's Schuldschein market was held out as a success story in mid- to long-term financing for SMEs. As too were the private placement markets in France and Germany.

Participants agreed that the correct way forward was for industry to work in partnership with the public authorities in developing the answers for how to create a well-functioning CMU. The Authorities could look to create the overall framework for CMU and set the necessary deadlines, with the industry bringing practical solutions to the table. The work of the Euro Private Placement Working Group to develop a pan-European guide for private placements was cited as one such example.

A successful CMU will leverage technology and innovation

During the day the discussion turned to the role of technology and how technology and innovation will have a key role to play in harnessing the potential of a CMU. The German Parliamentary State Secretary pointed out that European industries are innovative in their use of technology and suggested that spirit of embracing innovation can and should be emulated within the financial sphere.

Overall it was thought Europe must look to technology as a way to unlock savings and direct investment in SMEs. Specific suggestions focused on the development of a pan-European central repository to hold SME credit scores; the creation of electronic platforms to help distribution of a wider set of products to retail investors; and the creation of a pan-European peer-to peer platform.

> "RIGHT NOW, PEER-TO-PEER ELECTRONIC PLATFORMS IN EUROPE ARE REALLY SPECIFIC TO INDIVIDUAL COUNTRIES. THEY ARE NOT REALLY ABLE TO PLAY A ROLE IN PAN-EUROPEAN LENDING."
>
> **Jim Esposito,** Co-Head, Global Financing Group, Goldman Sachs

It's not all about regulation… but you need to get regulation right

Policy makers were in agreement that the focus in creating a CMU should be on redesigning existing regulation to allow market forces to develop. The high yield bond market was held up as an example of a market in Europe that has developed well over time without the need for regulatory measures.

One area that generated interest was the idea of the '29th regime'. This is an approach whereby a regulatory regime is recognised across Member States, although no county is obliged to use the regime. Such an approach was seen as central to the success of the UCITS (Undertakings for Collective Investment in Transferable Securities) regime in Europe and panelists suggested that a '29th regime' could be explored for pension regulation, as this is an area characterised by strong national interests.

> "OUR VIEW IS THAT IT IS PERFECTLY POSSIBLE TO CREATE A CAPITAL MARKETS UNION WITHOUT CREATING NEW REGULATORS TO OVERSEE THE WHOLE THING."
>
> **Andrea Leadsom,** MP, Economic Secretary to the Treasury

> "ONE CANNOT REGULATE THE MARKET INTO EXISTENCE, BUT WE CAN REGULATE THE MARKET OUT OF EXISTENCE."
>
> **Jon Danielsson,** Director, Systemic Risk Centre and London School of Economics

The need to create a new supervisory body that would oversee a European Capital Markets Union was not universally accepted. Indeed, as remarked by a senior Commission official, European Capital Markets are not currently operating in a vacuum. They are subject to oversight, supervision and regulation, with the European Securities and Markets Authority playing a coordinating role. The UK Economic Secretary suggested that EU regulators should be strategic-level regulators who are looking to ensure that there is a consistent level of regulation at a high level, not doing the day-to-day job of national competence regulators.

The path forward

Dialogue participants were united in the belief that a CMU holds much promise for Europe. It will require strong coordination and openness to new ways of operating on the part of both industry and government. An incremental approach, focused on identifying and executing on 'quick wins', should provide needed momentum and a base upon which to build. The four key planks of a capital markets union were agreed as:

- Creating a seamless market for capital across the European Union
- Providing all segments of the economy with the most efficient sources of financing to help companies expand
- Providing SMEs with more diversified sources of funding to enable them to grow their businesses
- Giving European savers and institutional investors broader options to put European savings to better and more productive use across all of the EU

The dialogue identified a number of specific areas as key near-term priorities:

- Restoring confidence and liquidity to securitisation markets
- Streamlining and standardising SME credit scoring mechanisms
- Consider the French and German approach as a potential model for broader reform of the private placement market
- Streamline documentation requirements for SMEs to alleviate unnecessary burdens
- Exploring new products, platforms and distribution channels for retail investors

The dialogue suggested the following course of action as the most efficient way to achieve the objectives of a CMU:

- Focus on improving existing regulation as opposed to introducing new measures
- Create early momentum across Member States
- Form a strong partnership between the Authorities and industry
- Leverage best practice in different Member States where possible
- Explore the concept of a '29th regime' especially for pensions reform

Dialogue co-hosts Goldman Sachs and the London School of Economics and Political Science concluded by reiterating that this discussion was just one element of what will continue to be a consultative process of collecting constructive insights on the path towards making a European CMU a reality.

> “WE NEED TO AVOID THE TRAP OF THINKING THAT THERE'S A SIMPLE SOLUTION OF COMING UP WITH SOME SIMPLE PAN-EU LEGISLATIVE FRAMEWORK THAT WILL MAGICALLY RESULT IN CROSS-BORDER TRADE.”
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> **Andrea Leadsom,** MP, Economic Secretary to the Treasury