# The CMU promises a joined-up approach to integrating EU capital markets

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**The Capital Markets Union (CMU) is the latest effort by the European Commission to fulfil its longstanding ambition of creating a single capital market capable of financing growth across the European Union, attracting investment from outside, and – importantly – redressing the structural imbalances within the post-crisis euro-zone. It is an ambitious and widely welcomed plan, for a single European capital market has proved remarkably elusive. The willingness of the authors of the CMU to re-visit previous work as well as add to it is a positive sign, says Natasha de Terán, Head of Corporate Affairs at SWIFT.**

A stated ambition of the Treaty of Rome of 1957 was the free movement of capital in Europe, but its realisation was long obstructed by exchange controls. These did not disappear until the 1990s. Technical, legal, regulatory and fiscal barriers have never completely disappeared, in spite of repeated efforts to clear them. Indeed, the Single European Act of 1986 was designed to leapfrog the barriers, by substituting mutual recognition of national regulatory regimes for the unattainable goal of harmonising them.

The Cecchini Report[1], published by the European Commission in 1988, proposed a bonfire of obstructions that was forecast to add 1.5 per cent to European Gross Domestic Product (GDP) once it was complete. But mutual recognition proved an ineffective tool in eliminating barriers. After another decade of disappointing progress, and with the single European currency just a year away, in 1998 the Commission adopted a Financial Services Action Plan. Its 42 measures were designed to accelerate the integration of European markets into a single pool of capital comparable with the United States.

## A capital market fit to compete with the US remains remote

More than a decade and a half later, the Commission confessed in the opening paragraphs of the Action Plan on Building a Capital Markets Union - the document by which it launched the CMU on 30 September 2015 - that "Europe's capital markets are still relatively underdeveloped and fragmented.

1 Paolo Cecchini, *The European Challenge 1992: The Benefits of a Single Market*, Commission of the European Communities, 1988.

The European economy is as big as the American one, but Europe's equity markets are less than half the size, its debt markets less than a third. The gap between member-states is even bigger than that between Europe and the United States."[2]

The CMU aims to address the most conspicuous of the differences between the European and the American capital markets: the continuing reliance of European business on bank, rather than equity or bond, financing. The fostering of a large and liquid securitised debt market is chief among the ambitions of the framers of the CMU, though it also launched consultations on how best to promote the growth of venture capital and covered bond markets.

## Regulatory obstacles up for review

A second striking feature of the CMU at its launch was a "call for evidence" on the cumulative impact of financial regulation. This last objective marked a recognition that the quantity of regulation imposed on the European financial markets since the acute phase of the financial crisis in 2007-08 might well have created burdens, inconsistencies, contradictions and unintended consequences that are suppressing rather than enhancing the further integration of the capital markets of Europe.

The invitation to contribute to the consultation also recognised that in some areas, regulation had made insufficient progress. The failure to clear the 15 specific barriers to cross-border securities clearing and settlement identified in the two Giovannini reports of 2001[3] and 2003[4] is an obvious case in point, made urgent by the current transition to TARGET2-Securities (T2S), the pan-European securities settlement system.[5]

But equally intractable barriers exist beyond market infrastructure. They include differences in national laws on securities issuance, the enforceability of collateral contracts, the ownership of property, and insolvency. Even apparently minor differences between fiscal, legal and regulatory rules create enough uncertainty to undermine the movement of capital across national borders.

In theory, EU institutional reforms such as T2S, and regulations and directives such as the Prospectus Directive, the Transparency Directive, the Market Abuse Regulation (MAR), the European Market Infrastructure Regulation (EMIR), the Benchmark Regulation, the proposed Credit Ratings Agencies Regulation (CRA), the Central Securities Depositories Regulation (CSDR) and the Markets in Financial Instruments Directives of 2007 (MiFID I) and 2017-18 (MiFID II), have and will between them remove barriers to the cross-border issuance, trading, clearing and settlement of securities.

Certain of these changes have already precipitated a restructuring of the post-trade infrastructure of the European securities industry, and have the potential to help integrate European capital markets. "CMU is a very high level policy initiative, yet huge amounts of harmonisation have already been achieved through CSDR, EMIR and T2S," points out Alan Cameron,

2 European Commission, *Action Plan on Building a Capital Markets Union*, 30 September 2015.

3 The Giovannini Group, *Cross-Border Clearing and Settlement Arrangements in the European Union*, November 2001.

4 The Giovannini Group, *Second Report on EU Clearing and Settlement Arrangements*, April 2003.

5 See Alberto Giovannini, "T2S will reverberate through the European capital markets," MI Forum magazine, issue 2, 2014, pages 76-80.

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Head of Relationship Management at BNP Paribas Securities Services. "These all pre-date CMU." So far, so good, counter proponents of CMU. Where CMU will make a difference, they argue, is in reversing the law of unintended consequences.

## EMIR and CSDR prove unhelpful to integration

EMIR, for example, fulfils a Group of 20 (G20) obligation on derivatives market participants to report details of both exchange-traded and OTC transactions to a trade repository. But by permitting multiple trade repositories to compete for business, and by obliging both parties to a transaction to report it, the regulation has created problems of matching and reconciliation between the operators of the six repositories. The result is duplication, and fresh forms of fragmentation, without yet delivering in full the advertised benefits for the management of systemic risk.

So it is encouraging that CMU will likely accelerate a re-consideration of EMIR reporting obligations. "CMU is both a set of EU aspirations of what European capital markets should look like in 2019, and a set of specific initiatives," explains James Cunningham, Senior Adviser for Public Policy and Regulatory Affairs at BNY Mellon. "EMIR certainly falls within its scope. EMIR would have been reviewed in any event, but the CMU project is giving extra impetus to the EMIR review, encouraging European policymakers to look at rules and regulations such as EMIR holistically, and to focus on identifying unintended consequences. It is hoped that the increased focus that CMU will bring to this issue will lead to proposals from the EU authorities."



The implementation of EMIR has also struggled to keep abreast of the global reality of trading and clearing in derivatives, by insisting the European Securities and Markets Authority (ESMA) decide whether non-EU central counterparty clearing houses (CCPs) were regulated to a sufficiently high standard to be used by European counterparties. While it is reasonable for EU regulators to check the credentials of non-EU CCPs, the apparently extra-territorial extension of the regulation created some tensions with market participants.

Similar challenges had to be overcome in the implementation of CSDR, which subjects non-EU CSDs to authorisation by ESMA. Naturally, market participants were concerned this might obstruct the flow of securities transactions between EU markets and Asia, Switzerland and the United States. Likewise, the imposition by CSDR of fines for late settlement has prompted warnings of a negative impact on liquidity in the European bond and repo markets. A properly functioning CMU, one of whose stated aims is greater liquidity, will make it easier to solve problems of this kind.

## More progress needed on securities law

If EMIR and CSDR contained elements that were open to the charge of impeding rather than advancing progress towards a single European capital market, there are other fields in which more rather than less needs to be done. The most obvious barrier, apparent since at least the Giovannini Reports of 2001-03, is legal uncertainty over how securities can be held, cleared and settled across borders. Repeated initiatives aimed directly at this issue – the Settlement Finality Directive (SFD), the Financial Collateral Directive (FCD) and the Shareholders'

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Rights Directive (SRD) - have failed to resolve it. A proposed Securities Law Directive failed altogether.

In March 2016, the Commission established the European Post Trade Forum (EPTF) to help drive the CMU to a more successful outcome. "Most of the private sector barriers identified in the 2001 Giovannini Group report have been removed as a result of CSDR, T2S and EMIR," says Paul Symons, Head of Government Relations at Euroclear. "But public sector issues like conflicts of law and divergences in securities ownership law and structures remain. The EPTF working group is in its early stages and is looking at the current state of the post-trade industry, and then it will identify issues that could be addressed through CMU."

The divergence of national insolvency laws is likely to be an early target. The mission to solve the longstanding problem of what happens to securities belonging to third parties in an insolvency – especially those posted as collateral – was given additional impetus by the Alternative Investment Fund Managers Directive (AIFMD), which came into force in July 2014, and the fifth iteration of the Undertakings for Collective Investment in Transferable Securities Directive (UCITS V), which came into effect in March 2016.

This was because AIFMD and UCITS V increase custodian banks' liability for making investors whole if their assets are lost, including in insolvencies. "Harmonising the rules on insolvency and securities ownership is a really important issue for CMU," says James Cunningham of BNY Mellon. "Both because safety in the custody chain is a fundamental building block of a CMU, and because the approach taken by UCITS V and AIFMD, especially in relation to asset segregation, is flawed and incapable of generalisation to all types of investors."

As the CMU Action Plan acknowledged, it is obvious that a single EU capital market cannot develop as long as the ownership of securities cannot be determined with legal certainty when the issuer and the investor are located in different member-states, or when securities belonging to investors in one member-state are held on their behalf by custodian banks in a different member-state. That uncertainty is an obstacle to cross-border trading and investment in general, and collateralisation and securitisation in particular. In the EU, progress in securities law continues to lag behind the development of securities market infrastructure.

**"Single market and Capital Markets Union - the future role of Financial Markets Infrastructures" at Sibos**

Monday 26 September 2016
15.30-16.30
Conference Room 3