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LlewellynConsulting
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Capital Markets Union

Dr John Llewellyn

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The EU has been moving towards a notional CMU for decades

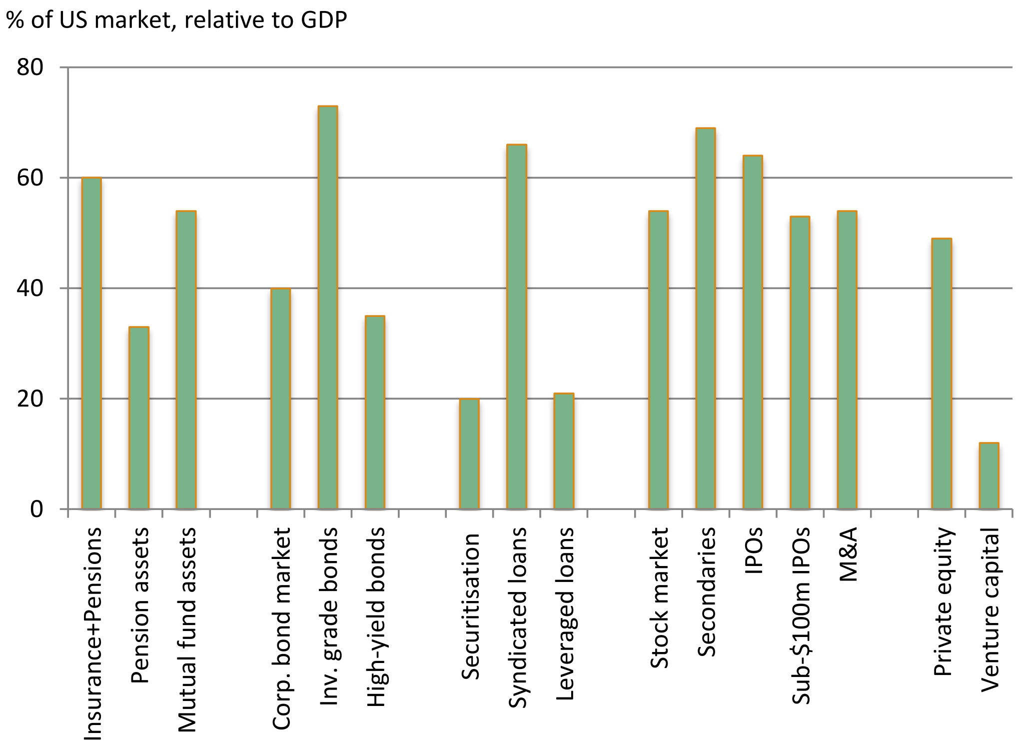
The 1999 Financial Services Action Plan was a precursor to the current initiative

- Major European legislative initiatives were launched in the 1970s, 1980s, and 1990s
- The early focus was in banking and insurance: initiatives concerning securities and investment management came later
- The Single Market Programme, launched in 1985, and the Single Market Act (1987) were important milestones
- The Financial Services Action Plan (FSAP), launched in 1999, was an attempt to give the single market in financial services another major push as the euro came into being
- The FSAP put forward a five-year timetable for the achievement of three strategic objectives:
  1. Establishing a single market in wholesale financial services;
  2. Developing more open and secure retail financial services markets; and
  3. Strengthening the rules on prudential supervision.
- Under the previous Commission, a whole host of initiatives were progressed
- In many ways, recent discussions on CMU echo those of the past. Key objectives:
  - Progressing the job that was started many decades ago;
  - Fixing deficiencies laid bare by the crisis;
  - Adapting to meet future challenges.

Europe has much untapped capital market potential

The gap with the US is large, across a range of areas

Long term pools of capital and market size: Europe vs. US



Source: Wright, W., and Bax, L., (2015). Decoding Capital Markets Union: Measuring the Potential for Growth Across Europe's Fragmented Capital Markets. New Financial.
Note: average between 2009 and 2014. Europe is EU plus Iceland, Norway, and Switzerland.

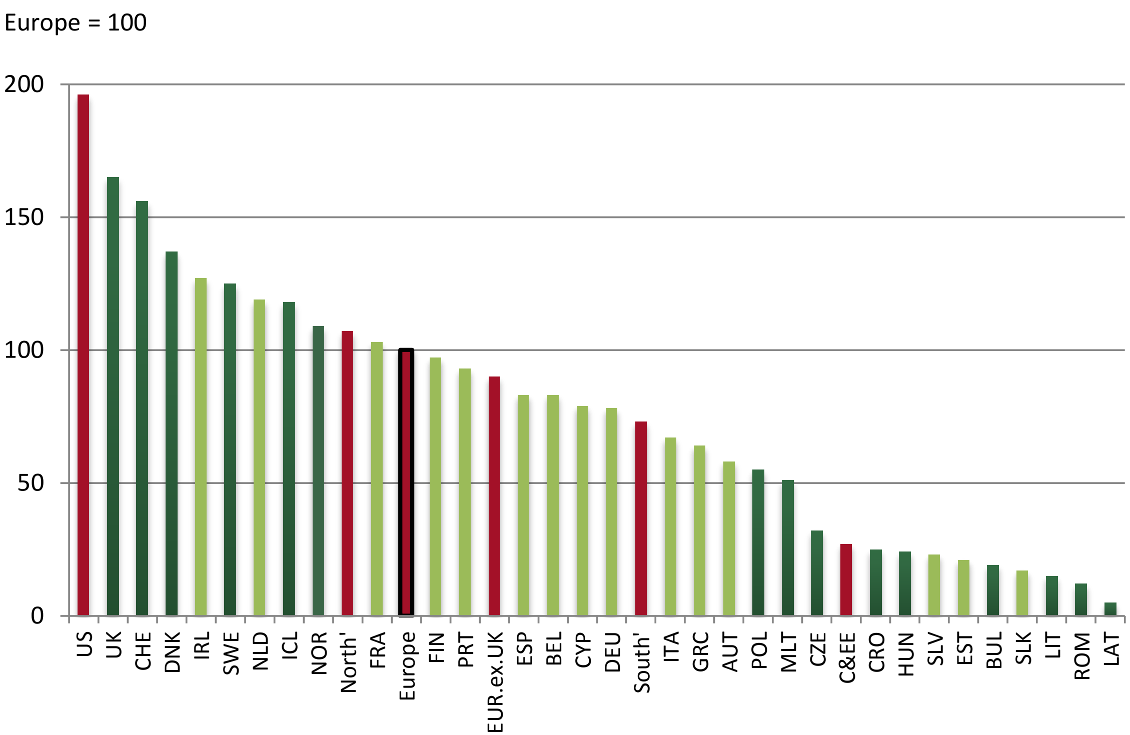
In Europe, on average over the past five years:

- Long term pools of capital have generally been much smaller than in the US, particularly pension assets (30% of US total)
- The corporate bond market has been around 40% the size in the US; with a larger 'shortfall' in the high-yield market
- Equity markets have generally been around half the size of the US
- Venture capital markets have been around one-eighth the size

The aggregate picture masks regional and cross-country variation

For most European countries, the 'gap' with the US is large

Size of US and European capital markets



Source: Wright, W., and Bax, L., (2015). Decoding Capital Markets Union: Measuring the Potential for Growth Across Europe's Fragmented Capital Markets. New Financial.

Note: 23 indicators, average 2009-2014 relative to GDP, Europe=100. Euro area economies shaded light green; non-euro EU economies shaded dark green; US and regional totals shaded red.

- Europe's capital markets are most developed in the region's northern economies outside the euro area:
  - The UK (in particular), but also Switzerland, Denmark, Sweden, Iceland, Norway
- Southern Europe has markedly less developed capital markets
- Central and Eastern Europe has very small markets

Capital Markets Union began with a wide-ranging agenda

Six broad areas, and latterly three themes, have been advanced

- A flavour of the breadth of the early agenda, from Nicholas Veron, 2014:[1]
  1. Regulation of securities and specific forms of intermediation
  2. Prudential regulation of financial institutions (banks and non-banks)
  3. Accounting, auditing, and transparency
  4. Supervisory frameworks for financial infrastructure firms
  5. Corporate insolvency and restructuring frameworks
  6. Tax regimes
- Lord Hill, has latterly placed three themes at the heart of the project:
  1. Increasing funding options for business;
  2. Creating more opportunities for investors; and
  3. Encouraging cross border investment.
- A range of policies have been proposed under themes 1 and 2
- They appear to largely fall under 1 (in particular) and 2 of the six broad areas above

[1]Veron, N. 2014. *Defining Europe's Capital Markets Union.* Breugel.

CMU now appears set on delivering in a few key areas

The wider agenda appears to have been scaled back somewhat

1. **Regulation of securities and specific forms of intermediation** (Veron area 1); or
   - Increasing funding options for business (Hill Theme 1): strengthen venture capital and other non-traditional finance; support the private placement market; review the Prospectus Directive; develop simple, transparent, standardised securitisation products …
2. **Prudential regulation of financial institutions** (Veron area 2); or
   - Creating opportunities for investment (Hill Theme 2): create opportunities for retail and institutional investors; encourage more investment in infrastructure; update calibrations for Solvency II and the Capital Requirements Regulation …

For the future:

- Accounting, auditing, and transparency; supervisory frameworks for financial infrastructure firms; corporate insolvency and restructuring frameworks; taxation regimes (Veron areas 3-6)
  - Encouraging cross border investment (Hill Theme 3): *"There are many long-standing and deep-rooted obstacles that stand in the way of cross border investment. These range from obstacles which have their origins in national law — insolvency, collateral and securities law — through obstacles in terms of infrastructure ..., right through to tax barriers. … On some of these issues, particularly those linked with taxation, the feedback suggests we should be pragmatic. In other words, we shouldn't risk making good progress in other areas by charging head long into some of the most intractable ones."*

    Lord Hill: *Next steps to Build a Capital Markets Union*, Brussels 8 June 2015.

Delivering a form of 'Big Bang' for the European Capital Markets

How should we assess the current state of play?

- The incremental nature of the current action plan contrasts somewhat with the more ambitious initial agenda for the proposed Capital Markets Union:
  - Nicholas Veron has suggested that the Commission's plan largely boils down to pruning existing rules and reversing some of the post-crisis regulatory overreach at the European Union level[1]
  - Lord Hill would perhaps argue that the pragmatic approach is best, with the focus on delivering some early 'wins', and in some key areas for growth that could make a real difference
- Political economy constraints abound: politics – and hence policy is the art of the possible
- In assessing the current state of play, a number of questions come to the fore:
  - Is it enough to try to develop some key markets such as securitisation; private placements etc.?
  - Or should the focus be on delivering a broader 'Big Bang'?
  - What is needed in addition?
  - Can most of what is needed be done within the current institutional set-up?
  - Is the UK renegotiation an opportunity as well as a threat?

There are many pre-requisites for structural change success

… not least in Europe

- Implementing any major structural reform is complex and challenging, particularly in Europe.
- Evidence shows that successful structural adjustment policies share a number of common features, which reach across the political spectrum and society, and across countries. These include:
  - Support of the main European institutions;
  - Support of heads of state;
  - Broad support across cabinets;
  - Opposition that is supportive, or at least insufficiently strong to make a difference;
  - Points of light across society that provide vocal and credible support;
  - Simplicity of purpose – an easily-understood agenda;
  - Positive message(s): the growth and stability case for Capital Markets Union
  - The ability to assess progress – targets, both quantitative and qualitative;
  - Initiatives to at least temporarily temper the costs and compensate losers; and
  - Sustained positive momentum: sequencing, while in principle desirable, is often impractical.

While it is not essential to have everything on this list, the more areas that are addressed, the more successful structural change is likely to be in delivering a Big Bang.

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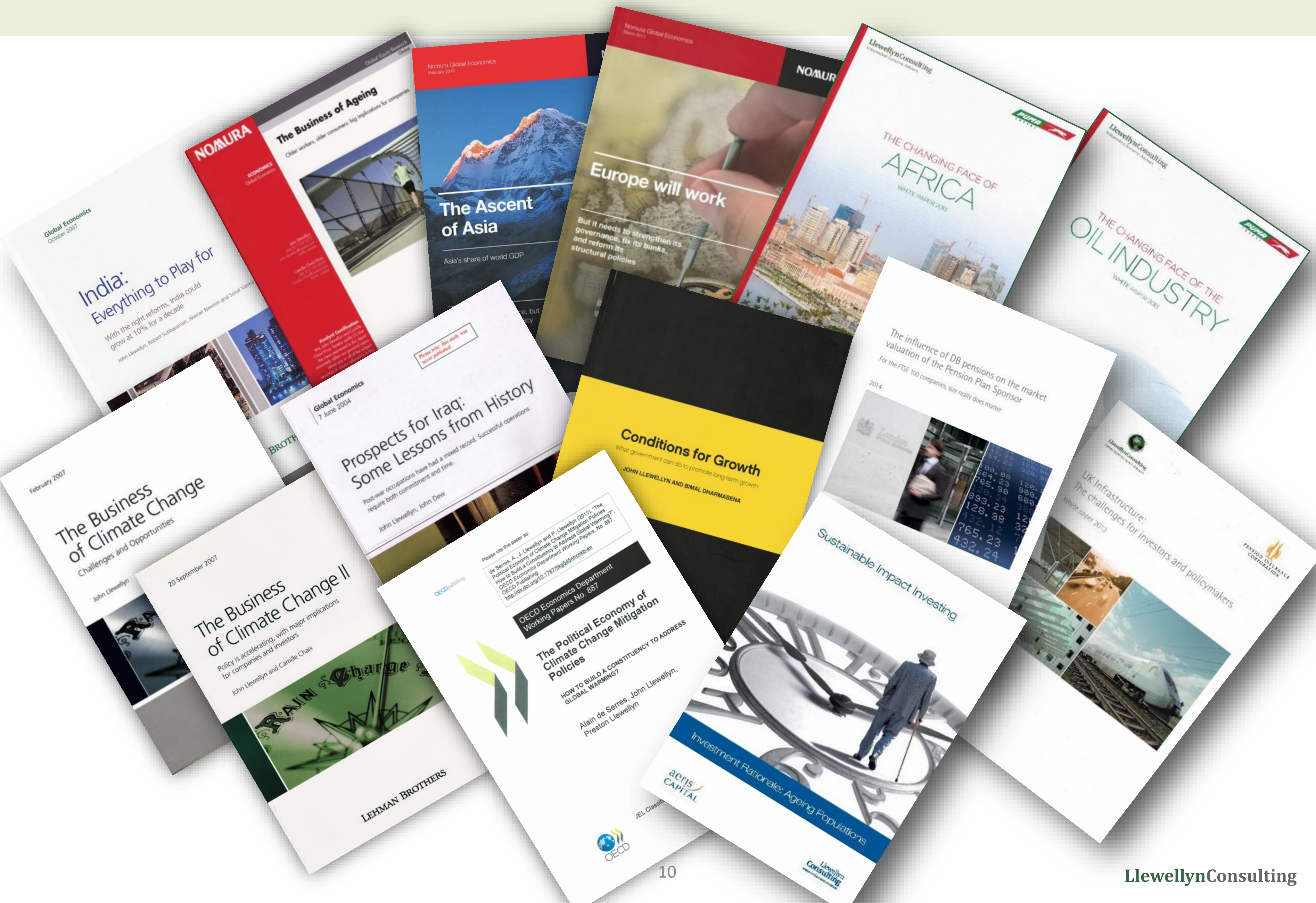

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