
Centre for International
Governance Innovation

CIGI Papers No. 140 – August 2017

European Capital Markets Union Post-Brexit

Miranda Xafa



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CIGI Masthead

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About the Author

Miranda Xafa is a CIGI senior fellow. She is also chief executive officer of EF Consulting, an Athens-based advisory firm focusing on euro-zone economic and financial issues. At CIGI, Miranda focuses on sovereign debt crises and drawing lessons from the Greek debt restructuring for future debt crises. From 2004 to 2009, she served as a member of the executive board of the IMF in Washington, DC, where she had previously worked as a staff member. Miranda served as chief economic adviser to Greek Prime Minister Konstantinos Mitsotakis, from 1991 to 1993. From 1994 to 2003, she was a financial market analyst and senior expert at Salomon Brothers/Citigroup in London. Miranda holds a Ph.D. in economics from the University of Pennsylvania and has taught economics at the Universities of Pennsylvania and Princeton. She has published several articles and papers on international economic and financial issues.

About the Global Economy Program

Addressing limitations in the ways nations tackle shared economic challenges, the Global Economy Program at CIGI strives to inform and guide policy debates through world-leading research and sustained stakeholder engagement.

With experts from academia, national agencies, international institutions and the private sector, the Global Economy Program supports research in the following areas: management of severe sovereign debt crises; central banking and international financial regulation; China's role in the global economy; governance and policies of the Bretton Woods institutions; the Group of Twenty; global, plurilateral and regional trade agreements; and financing sustainable development. Each year, the Global Economy Program hosts, co-hosts and participates in many events worldwide, working with trusted international partners, which allows the program to disseminate policy recommendations to an international audience of policy makers.

Through its research, collaboration and publications, the Global Economy Program informs decision makers, fosters dialogue and debate on policy-relevant ideas and strengthens multilateral responses to the most pressing international governance issues.

Acronyms and Abbreviations

AFME	Association for Financial Markets in Europe
BIS	Bank for International Settlements
CMU	capital markets union
CSD	central securities depository
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EEA	European Economic Area
EFSI	European Fund for Strategic Investments
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
ESAs	European supervisory authorities
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
IFRS	International Financial Reporting Standards
IPOs	initial public offerings
LCH	London Clearing House
MiFID II	Markets in Financial Instruments Directive II
MiFIR	Markets in Financial Instruments Regulation
NPLs	non-performing loans
OTC	over-the-counter
PEPP	Pan-European Personal Pension Product
QE	quantitative easing
SMEs	small and medium-sized enterprises
STS	simple and transparent securitization
T2S	TARGET2-Securities

Executive Summary

As Europe emerged in the early 2010s from its worst financial crisis since the 1930s, it sought to protect its economy and financial sector against future shocks. This challenge forced national governments and EU institutions to take extraordinary steps to stabilize their economies and to promote European integration, helping to preserve the integrity of the euro area and its internal market. At their June 2012 summit, euro-area leaders asked the European Commission and the president of the European Council to issue proposals “to develop a specific and time-bound road map toward a genuine Economic and Monetary Union (EMU),” including greater fiscal and financial integration, to ensure the irreversibility of the EMU (European Council 2012). This commitment was reaffirmed with the Rome Declaration, signed on March 25, 2017, in which EU leaders committed to “working towards completing EMU; a Union where economies converge. Now, this promise must be delivered. This requires political courage, a common vision and the determination to act in the common interest” (EU Leaders 2017).

The launch of the banking union in 2012 was the most important policy initiative to advance euro-area integration since the common currency was adopted in 1999. It involved the transfer of supervisory authority from the national level to the European Central Bank (ECB). Such a move had been strongly resisted by euro-area members until the global financial crisis demonstrated that effective crisis management requires stronger central oversight. Following a comprehensive assessment of capital adequacy, the ECB became the single licensing authority for all banks in the euro area and took over the direct supervision of 129 significant banks in November 2014. New bail-in rules took effect for loss sharing by shareholders, bondholders and ultimately depositors to deal with failing banks while protecting taxpayers. A single resolution board became operational as of January 2016, and a bank-funded single resolution fund that would permit burden sharing of bank losses is slowly being built up. The third leg of banking union, common deposit insurance, appears unlikely to be agreed until legacy issues are resolved.

Financial union is a necessary complement to economic and monetary union. Financial integration is necessary to transmit monetary policy signals uniformly across the union and to

diversify risk, in order to reduce the impact of country-specific shocks and lower the amount of fiscal risk sharing. Together with banking union, capital markets union (CMU) is a fundamental step toward completing the EMU architecture. Despite significant progress in recent decades to develop a single market for capital, there are still many long-standing and deep-rooted obstacles that stand in the way of cross-border investment. Ending the fragmentation of capital markets in Europe would contribute to a more efficient allocation of capital across member states.

The European Commission (EC) laid out its vision for CMU soon after president Jean-Claude Juncker assumed office in November 2014 (EC 2015a). Impetus for CMU was provided by Europe’s slow recovery from the global financial crisis and by the need to identify alternative sources of financing for companies at a time when banks were deleveraging to deal with non-performing loans (NPLs) and higher capital requirements. Compared to the United States, European businesses rely much more heavily on banks than on capital markets for funding. In the EC’s vision, deeper capital markets would help unlock more funding for investment, especially for small and medium-sized enterprises (SMEs) and infrastructure projects. They would also help attract portfolio investment to the European Union from the rest of the world, and make the financial system more stable by broadening the range of funding sources. Capital markets also offer an important channel for risk sharing, because the more geographically diversified is a portfolio of financial assets, including corporate bonds and stocks, the less volatile the returns and the less correlated with domestic income. When a country is hit by an economic shock, cross-border asset holdings help the residents to cushion the impact. Strong buffers created through private risk absorption were seen as a substitute for public risk absorption following large taxpayer-funded bailouts of banks in the aftermath of the global financial crisis.

The EC is currently pursuing an action plan aimed at identifying and removing obstacles to cross-border capital markets transactions. The Brexit vote in mid-2016 was a clear setback, as key elements of the project were delayed to avoid pre-empting the Brexit negotiations. The project’s mid-term review in June 2017 recorded some progress, notably on reviving the market for high-quality securitizations and simplifying prospectus requirements, but other

key initiatives were delayed, including harmonizing insolvency procedures across EU members. A true CMU requires far-reaching changes in national laws, including harmonization of accounting and auditing practices, and removal of bottlenecks preventing the integration of capital markets in areas such as insolvency law, company law, property rights and the legal enforceability of cross-border claims. The tax treatment of investments across jurisdictions can also play an important role in terms of providing a level playing field.

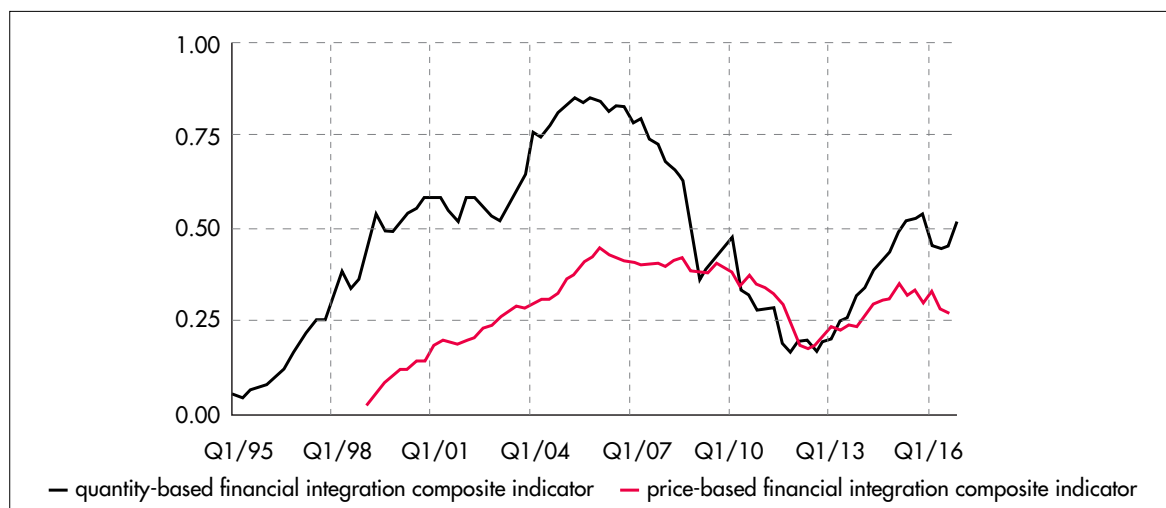
A few milestones in the process of building CMU have already been completed, but much remains to be done. The CMU agenda must ultimately include the transfer of authority over capital markets regulation and supervision to a pan-European authority. Unlike banking union, however, this objective was not part of the EC’s vision, largely because of UK opposition. The United Kingdom’s eventual exit from the European Union thus provides an opportunity to relaunch the CMU project with a more ambitious agenda that goes well beyond putting in place some of the necessary “building blocks” for CMU.

of Rome that established the European Economic Community in 1957, even as member countries maintained exchange controls. A single financial market where governments, private investors, banks and corporations operate seamlessly across national borders in Europe was at the heart of the single market project launched in the 1980s. This vision was embraced in theory by EU countries, but political backing for a clear road map remained elusive, as CMU is a massive project requiring surrender of national sovereignty and far-reaching changes in national laws. The global financial crisis provided the impetus for the CMU project by revealing the gaps in the euro area’s architecture. The crisis demonstrated a number of “unknown unknowns”: sovereigns can lose market access; contagion can propagate the crisis far more widely than was previously believed; and private sector borrowing costs can differ substantially across the union, despite a single monetary policy in the euro area. Addressing the gaps in the functioning of the monetary union would help prevent, or at least soften, such crises in the future. The loss of national monetary policy in a monetary union makes the economic rationale for a common risk-sharing mechanism more compelling. This paper therefore focuses primarily on the euro area, even though the CMU initiative refers more broadly to the single market regulations that apply to the entire European Union. Similarly, the banking union refers primarily to the euro area, with the ECB as supervisor but with a common regulatory framework throughout the EU.

Introduction

The debate on CMU is not new. Freedom of capital movements was enshrined in the Treaty

Figure 1: Price-based and Quantity-based Financial Integration Composite Indicators



Source: ECB (2017b).

Cross-border capital flows in the euro area rose sharply during the decade between the launch of the EMU in 1999 and the global financial crisis of 2008-2009 (see Figure 1). The flows consisted mainly of bank loans, while capital markets played less of a risk-sharing role than they do, for example, in the United States where cross-border ownership of assets is substantial. By 2008, nearly two-thirds of the large European banks' assets were abroad. The trend toward integration was abruptly reversed in the aftermath of the crisis, just when risk sharing within the euro area was most needed. The impact of the crisis was exacerbated, instead of being smoothed, by capital markets movements. Banking union and CMU will help reverse the recent financial de-integration, but this will take time.

Newly elected EC President Juncker and the new commission that took office in November 2014 set forth the CMU proposal as a matter of priority. An EC Green Paper was issued within months, setting out the key goals and priorities to receive feedback from stakeholders, including companies, investors and intermediaries (EC 2015a). A new commissioner, Lord Jonathan Hill,¹ led a restructured Directorate for Financial Stability, Financial Services and Capital Markets Union, successor to the Internal Markets and Services Directorate led by former commissioner Michel Barnier. The Green Paper set out the goal of achieving CMU for all 28 EU member states by 2019, in order to help restart growth and job creation. Capital markets would complement banks as a source of financing, and help: unlock more investment for all companies, especially for SMEs and for infrastructure projects; attract more investment into the European Union from the rest of the world; and make the financial system more stable by opening up a wider range of funding sources. The Green Paper proposed to kick-start the process through a €315-billion EU-funded investment package co-financed with the private sector (the “Juncker fund”). Following a three-month consultation with stakeholders, the EC issued an action plan in September 2015, setting out the building blocks of a “well-regulated and fully functioning Capital Markets Union” in the European Union by 2019.

This paper covers four main areas: the motivation for CMU and the expected benefits for the

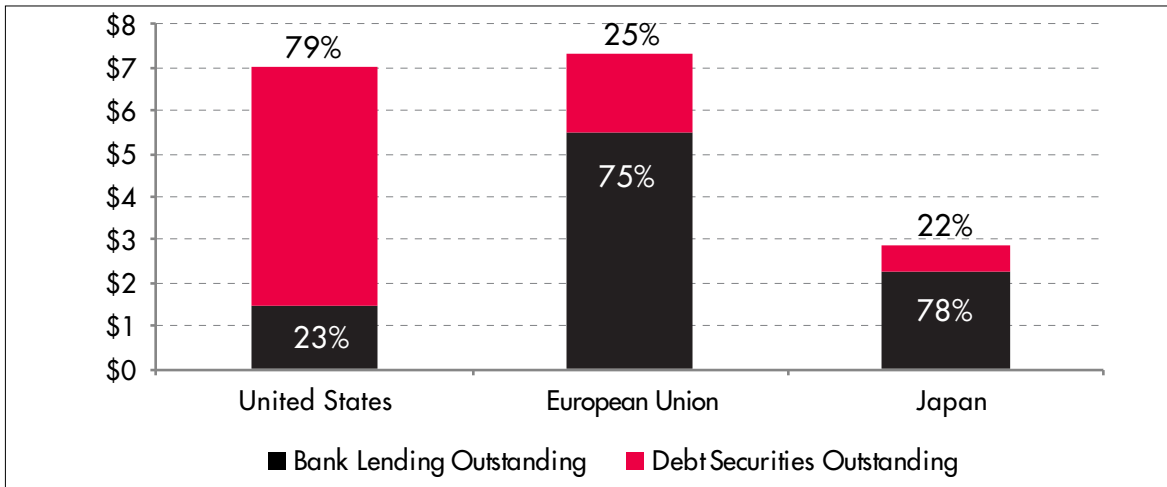
functioning of the European economy and financial system; the road map for its implementation and the obstacles and challenges the CMU project is facing in view of the Brexit vote; the role of the European Securities and Markets Authority (ESMA) versus national supervisors; and the steps taken so far in implementing the EC's action plan, as well as the policy priorities and the sequencing of reforms given the complexity of the task ahead. The paper concludes that Brexit clearly represents a setback, as the United Kingdom has by far the deepest and most liquid capital markets in the European Union, but it also provides an opportunity to launch a more ambitious CMU agenda encompassing the remaining 27 EU members.

Rationale for CMU

EC President Juncker first used the term CMU in a speech at the European Parliament in July 2014, shortly before taking office. As part of the effort to deepen the internal market, he noted that CMU “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” (Juncker 2014). In February 2015, the EC published a Green Paper that launched the CMU project (EC 2015a). The paper noted that European businesses remain heavily reliant on banks for funding, compared with other advanced countries and regions. The United States has the deepest and most liquid capital markets in the world, providing nearly 80 percent of debt financing for business investment, compared to just 25 percent in Europe and 22 percent in Japan (see Figure 2). Also, equity markets are larger in the United States, with a market capitalization of US\$29.7 trillion compared with US\$11.7 trillion in the European Union and US\$4.6 trillion in Japan (see Figure 3). Deeper capital markets in the European Union would help to unlock more funding for investment, attract capital from the rest of the world and make the financial system more stable by diversifying funding sources. It would also help raise much-needed equity financing that banks cannot provide, thus limiting SME and corporate leverage. To strengthen investment in the long run, Europe needs to build a CMU — a true single market for capital, replacing national stock exchanges, fixed

¹ Following the Brexit vote in June 2016, Lord Hill resigned and his portfolio was assigned to Valdis Dombrovskis, the EC vice-president responsible for the euro and social dialogue.

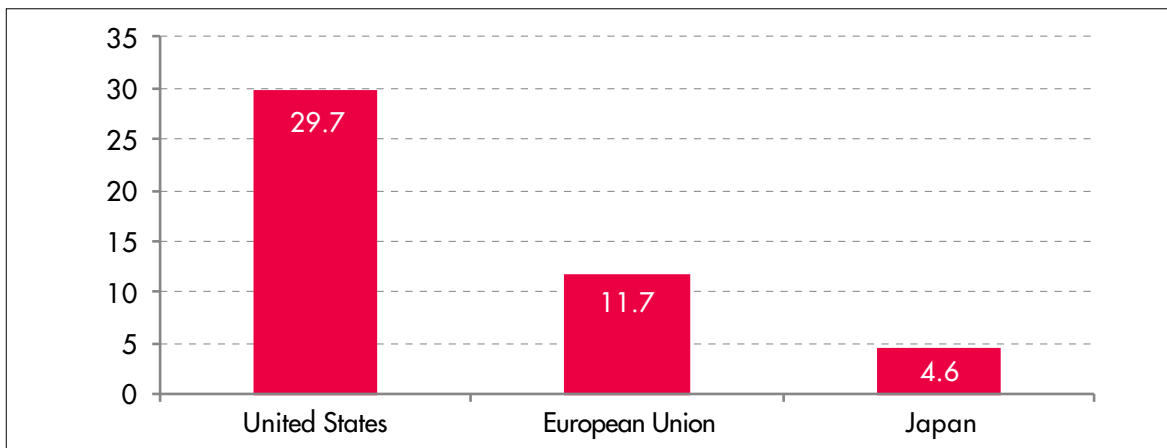
Figure 2: Corporate Debt Financing, 2015 (US\$ trillions)



Data source: SIFMA (2016a).

Note: Includes financing of non-financial corporations; EU includes the 28 European Union-member states.

Figure 3: Market Capitalization of Listed Share, 2016 (US\$ trillions)



Data source: Bloomberg.

Note: United States includes NY Stock Exchange (US \$21.5 trillion) and NASDAQ (\$US8.2 trillion).

income markets and risk capital for start-ups by a single European capital market. This task requires identifying and removing the obstacles that stand between savers and investors across the European Union, and making the markets that channel these funds as efficient as possible.

Following the release of the Green Paper, the EC's "Five Presidents' Report" included Europe's financial union among the key policy priorities for the future governance of Europe's EMU (EC 2015b). The report articulated the renewed ambition to strengthen and deepen the union as

the key to lifting the euro area's growth potential and shock-absorbing capacity. It outlined the actions needed to improve economic and fiscal governance and to promote financial integration in order to achieve full EMU by 2025 at the latest. According to the report, banking union should be completed by setting up a credible common backstop to the Single Resolution Fund, and by launching a European Deposit Insurance Scheme (EDIS) — the third pillar of a fully fledged banking union, alongside bank supervision and resolution. After banking union, launching CMU was seen as a priority in order to:

- ensure a truly single monetary policy in the euro area, with the impact of changes in interest rates transmitted uniformly across member states; and
- diversify risk across EU countries, to lessen the impact of country-specific shocks and lower the amount of risk that needs to be shared through fiscal means.

Risk sharing through cross-ownership of assets — a substitute for politically difficult fiscal transfers — is a central theme of the literature on monetary unions. The members of a union can share risk through cross-ownership of productive assets, facilitated by a developed capital market. Robert Mundell (1961) defined an optimum currency area as one where internal factor mobility is high. Factor mobility as a means of consumption smoothing in response to external shocks is even more important in the euro area, where national fiscal policies are constrained by common rules and the role of the central fiscal authority is limited. Mundell also argued that participating countries should ideally have similar business cycles. If countries in a currency union have idiosyncratic business cycles, then optimal monetary policy may diverge and member countries may be worse off with a joint central bank. Again, well-integrated capital markets can provide insurance against idiosyncratic shocks and thus enable countries to exploit their comparative advantage instead of diversifying their production base for insurance purposes. (Kalemli-Ozcan, Sørensen and Yosha 2003). The main mechanism for risk diversification among countries is geographical diversification of income sources achieved via capital markets.

Risk sharing is therefore key to improving the euro area's capacity to deal with shocks and avoid crises. Member countries can smooth their consumption by adjusting the composition and size of their asset portfolio in response to shocks — for example, through purchases and sales of equity in inter-regional stock markets. Empirical research focusing on the United States — a successful monetary union — found that the bulk of risk sharing is provided by market institutions rather than by the federal government. Pierfederico Asdrubali, Bent E. Sørensen and Oved Yosha (1996) found that 62 percent of shocks to the per capita gross product of individual states are smoothed, on average, through market transactions, 13 percent are smoothed by the federal tax-transfer and grant system, and 25 percent of shocks are not

smoothed. Using a similar methodology, Sørensen and Yosha (1998) found that factor income flows do not smooth income across countries in the European community, suggesting that European capital markets are far less integrated than US capital markets. Subsequent empirical research focusing on the euro area (Furceri and Zdzienicka 2015; Alcidi and Thirion 2016; Milano and Reichlin 2017; ECB 2017b) confirm these findings and indicate that the use of savings and access to international credit markets have been the main channel for shock absorption in the euro area, but also the least effective in times of crisis.²

These results provide a compelling argument for greater integration of European capital markets. Increased cross-border investment flows in the European Union should, in principle, lead to greater private sector risk sharing. This view was further elaborated in a seminal speech by Eurogroup President Jeroen Dijsselbloem (2015), who explained that private risk sharing through financial markets is a substitute for fiscal risk sharing through jointly issued Eurobonds:

Well-functioning capital markets will strengthen cross-border risk sharing through the deeper integration of bond and equity markets. It opens up a wider range of funding sources for our economy and it is therefore a key shock absorber of a kind we currently lack. In an economy largely financed by loans from the (domestic) banking system, as currently is the case in the eurozone, banks take a major hit in the event of an economic downturn. A more diversified cross-border capital market would mean that equity-investors also carry part of the burden. Europe's equity markets are less than half the size of the American ones, so you can only guess how much more vulnerable we were. More specifically, in the US

2 Saving and borrowing permit the smoothing of consumption over the business cycle, i.e., they can only deal with temporary shocks. Consumption smoothing constitutes "intertemporal" risk sharing, as households, companies and national governments can draw down their savings or borrow in the markets. This mechanism is distinct from "international" private risk sharing through cross-border ownership of assets that cushions the impact of a shock to a country. Private risk sharing can occur through income flows originating from either debt or equity holdings. For example, if domestic banks lend to foreign borrowers, the flow of interest payments from abroad provides a cushion in the lending country. However, risk sharing via international credit markets tends to be lowest when it is most needed, because credit markets have a tendency to freeze up during crises.

60% of the shocks are being absorbed by private market parties. This shows the importance of more integrated financial systems that help sharing risks and absorb the economic shocks we experience.

Dijsselbloem explained that there is a clear trade-off between a financial markets union on one hand, and the need for a fiscal capacity on the other. He expressed strong support for shock absorption through a strong and well-functioning banking union and a CMU, which would reduce the need for budgetary support. Nevertheless, Dijsselbloem recognized that private solutions cannot be the sole answer to crisis resolution. Even with a complete CMU, and the banking union's bail-in rules and privately financed resolution fund, a common backstop would still be needed in a systemic crisis. Public budgets would therefore need the capacity to deal with economic shocks by accumulating a buffer in good times as insurance.

Impediments to the Development of European Capital Markets

Drawing on a wide variety of sources, the key obstacles to a single EU capital market can be summarized as follows:

→ **Market fragmentation:** Each EU country has different laws governing the issuance of securities, listing requirements, investor protection, accounting and financial reporting standards, insolvency procedures and taxation of financial products. Financial market infrastructure remains heavily fragmented since the introduction of the euro, as the system was originally designed to meet the requirements of national financial markets (see Box 1). These barriers partly explain the existence of home bias in European investor portfolios, which is well documented.³ Divergent national rules and market practices regarding shareholder

protection or insolvency rules impede the flow of capital across the European Union. Despite ongoing efforts to improve European insolvency and restructuring procedures, large differences persist among member states. Differences in company law that are documented in the World Bank's report *Doing Business* provide good examples of the diversity in approaches across member states⁴ (World Bank 2016).

Europe also lacks a common information infrastructure. High-quality financial information based on a common accounting framework across the European Union is necessary for price discovery and risk evaluation across the European Union. Although the European Union adopted International Financial Reporting Standards (IFRS) more than a decade ago, the cross-country comparability of company data and credit risk information is low because of divergent asset evaluation methodologies, classification of balance sheet items (for example, "exceptional" or "probable") and supervisory practices. Diego Valiante (2016) has proposed narrowing the options available under IFRS and adopting a "comply or explain" approach to improve the comparability of financial data.

Earlier EU efforts to move toward a single rule book regarding capital markets regulation have been hampered by diverging practices in applying EU regulations at the national level, as member countries have the leeway to pursue their own versions of some EU regulations.⁵ Cross-border accounting and auditing consistency is necessary for CMU to function, as demonstrated in the process of implementing banking union.⁶ Feedback on the Green Paper provided by market participants suggests that national implementation and enforcement of EU rules results in diverging practices that add to compliance costs.

3 Finance theory suggests that investors should aim for international diversification of their investment portfolio to maximize returns given a certain risk profile. Nevertheless, empirical studies point to strong home bias in equity and bond portfolios globally (Schoenmaker 2014).

4 *Doing Business* measures regulations affecting 10 areas of the business environment, including starting a business, dealing with construction permits, registering property, getting credit, protecting minority investors, enforcing contracts and resolving insolvency. The rankings of EU member states vary widely in each of these areas.

5 A regulation is a legal act of the European Union that becomes immediately enforceable as law in all member states simultaneously. Regulations can be distinguished from directives, which need to be transposed into national law to take effect.

6 For example, national flexibility created big differences in the definition of bank capital due to disparities in the treatment of deferred tax credits.

Box 1: The Giovannini Barriers

Financial market infrastructure in Europe remains heavily fragmented even after the introduction of the euro in 1999. Each country typically has a stock exchange for trading, a central counterparty for clearing and at least one central securities depository (CSD) for settlement, to facilitate the transfer of securities in electronic form. The persistence of multiple stock exchanges and market infrastructure is clearly not optimal for a single-currency area, as different national rules and practices lead to domestically oriented trading activities. As a result, the euro area's financial market cannot reap the full benefits of risk diversification and competition that arise from the single currency. Consolidating legal entities would help reduce barriers and pool liquidity across various markets. Market infrastructure barriers were identified in a report by the Giovannini Group, a group of financial market experts who advised the EC in the early 2000s. The first Giovannini Group report (2001) identified inefficiencies in EU financial markets and the second Giovannini Group report (2003) proposed solutions that would promote financial market integration. The two reports identified the following 15 regulatory, fiscal and legal barriers that prevent efficient EU cross-border post-trading services (clearing and settlement):

- national differences in information technology and interfaces;
- national clearing and settlement restrictions that require the use of multiple systems;
- differences in national rules relating to corporate actions, beneficial ownership and custody;
- absence of an intra-day settlement finality;
- practical impediments to remote access to national clearing and settlement systems;
- national differences in settlement periods;
- national differences in operating hours/settlement deadlines;
- national differences in securities issuance practice;
- national restrictions on the location of securities;
- national restrictions on the activity of primary dealers and market makers;
- domestic withholding tax regulations serving to disadvantage foreign intermediaries;
- transaction taxes collected through a functionality integrated into a local settlement system;
- the absence of an EU-wide framework for the treatment of interests in securities;
- national differences in the legal treatment of bilateral netting for financial transactions; and
- uneven application of national conflict-of-law rules.

EU authorities have taken up initiatives to remove these impediments after the reports were published, but many barriers still remain. The most important initiatives from the EC are the Markets in Financial Instruments Directive, the European Market Infrastructure Regulation and the Central Securities Depositories Regulation, all of which predate the CMU action plan. The ECB recently introduced a new pan-European settlements platform, TARGET2-Securities (T2S), which is intended to complement existing initiatives by helping CSDs to become more efficient (ECB 2017a). T2S will considerably facilitate the mobility of collateral; for example, if a bank needs collateral in one market but only has eligible securities in another market, then only one T2S internal booking needs to be executed to transfer the corresponding securities to where they are needed. Previously, this was a lengthy and expensive procedure involving separate settlement systems.

→ **Investor base:** Pension fund assets are small compared to the United States, and thus the institutional investor base that would be the natural buyer of financial assets is absent. Pay-as-you-go systems dominate the EU pension system, while pension fund assets managed by institutional investors are limited. Pension fund and life insurance assets under management in the European Union amount to just €3.7 trillion (US\$4.0 trillion), compared with US\$28.1 trillion in the United States (see figures 4 and 5). Within this total, a single EU country, the Netherlands, accounts for more than one-half of the euro area's pension fund assets. Moreover, the United Kingdom, which also has significant pension fund assets under management, has voted to exit the European Union. To deal with these weaknesses, the remaining EU countries would need to address significant uncertainty about the state of the world decades from now, by gradually shifting away from the current pay-as-you-go, state-run pension system to a fully capitalized, privately managed pension system, as the United States has done. It will take decades before this shift significantly expands the EU institutional investor base. Similarly, European investment funds lack the size needed to reach economies of scale, thus providing lower returns than their US counterparts. As a result, they absorb less than 10 percent of household savings while 30 percent remain in low-yielding bank accounts instead of being invested in the markets.

→ **Firm size:** The dominance of bank financing in Europe versus the United States partly reflects the dominance of SMEs with limited or no access to market financing. According to the EC, more than 99 percent of all European non-financial businesses are SMEs (EC 2015a). They account for two-thirds of private sector jobs and contribute more than half of the value-added created by business activity in the European Union. Corporate finance theory suggests that market imperfections, such as those caused by information asymmetries or underdeveloped financial and legal systems, constrain the ability of firms to fund investment projects. Large firms have easier access to external financing than smaller firms because more information is publicly available about their activities and creditworthiness. Lack of timely information on a standardized basis makes it difficult for outside investors to monitor the

performance of an SME. Moreover, firm size is positively correlated with the development of a country's legal and financial institutions.⁷

The Green Paper

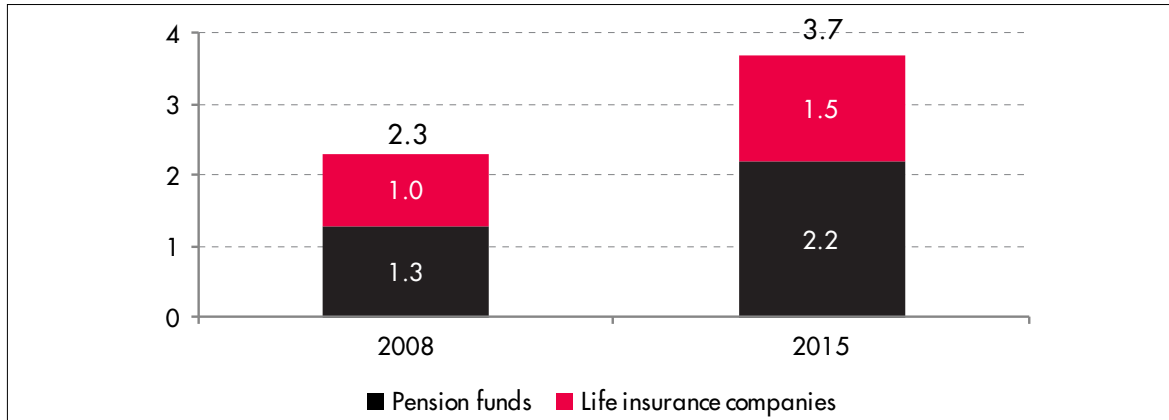
The Green Paper outlined a number of initiatives to get around these barriers (EC 2015a). It discusses the benefits of a single European capital market in terms of risk sharing, better allocation of capital, development of risk capital for start-up firms, as well as improved choices and returns for savers. It envisioned a single EU capital market in which:

- SMEs could raise financing as easily as large companies;
- costs of investing and access to investment products would converge across the European Union;
- obtaining finance through capital markets would be increasingly straightforward; and
- seeking funding in another EU member state would not be impeded by unnecessary legal or supervisory barriers.

This wish list includes some unrealistic elements, for example, the expectation that SMEs could have the same access to market financing as large companies, on which far more information is publicly available. Nevertheless, the paper provides a useful summary of the necessary components and the impediments to a single European capital market, including different prudential standards, securities regulation and supervision, company law and insolvency

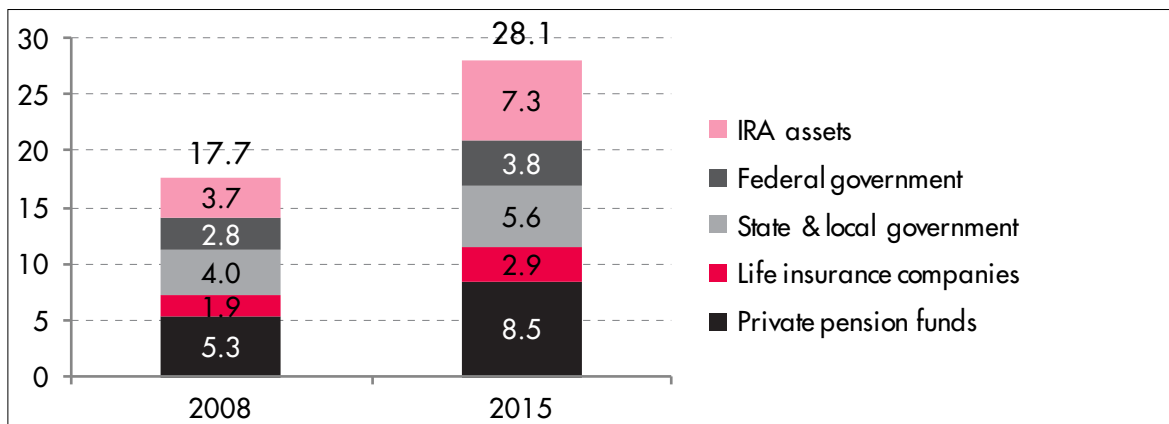
⁷ The corporate finance literature suggests that company analysts and rating agencies help to reduce information asymmetry through disclosure of new information, thereby significantly affecting firms' access to capital markets. Moreover, firm size is positively correlated with the level of development of a country's financial and legal system, because investor confidence requires well-functioning markets with strong investor protection and effective legal systems. Indeed, empirical research has found that countries with more developed financial institutions and higher stock market capitalization are associated with larger firm size. This finding is robust to controlling for the size of the economy and other country characteristics, reverse causation and the variation in sample size across countries, as well as to utilizing alternative size indicators and sample periods. More efficient legal systems and better property rights protection also are positively related to firm size, although this result is less robust to sensitivity tests (Beck, Demirgüç-Kunt and Maksimovic 2005).

Figure 4: Total Financial Assets of Euro-area Pension Funds and Life Insurance Companies (€ trillions)



Data source: ECB (2016a).

Figure 5: Total Financial Assets of US Pension Funds and Life Insurance Companies (US\$ trillions)



Data source: SIFMA (2016a, 86).

regimes. Cross-country differences in financial disclosure, infrastructure and taxation also are identified as barriers to free capital movements. Given the complexity of the task ahead, the Green Paper discusses the policy priorities and the sequencing of reforms, and sets out a number of proposals for consultation with stakeholders.

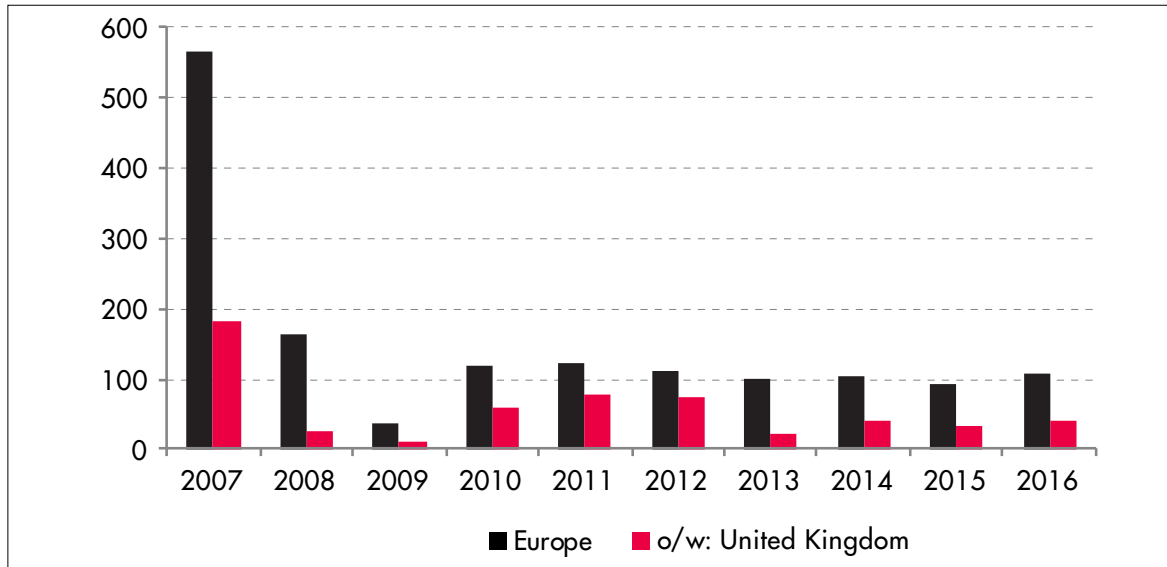
Early priorities in the CMU agenda included reviving securitizations of bank loans and mortgages that have plummeted post-crisis (see Figure 6),⁸ disseminating credit information

on SMEs, standardizing the private placement regime and strengthening the prospectus directive. The EC subsequently launched consultations on two of these priorities, by requesting feedback from market participants and industry bodies on creating a simple and transparent securitization (STS) market through greater standardization in its instruments; and amending the Prospectus Directive in order to simplify the information contained in prospectuses and to streamline the approval process.

Longer-term goals include improving access to finance for SMEs, increasing and diversifying the sources of funding from international investors, allocating risk more efficiently among investors and ensuring that financial markets work more effectively and at lower cost. To these ends, the

⁸ The US securitization market has rebounded more strongly than it has in the European Union, but the two markets differ structurally insofar as about 80 percent of securitization instruments in the United States benefit from public guarantees through the government-sponsored enterprises Fannie Mae and Freddy Mac.

Figure 6: Europe Securitization Issuance (\$ billions)



Data source: www.sifma.org/research/statistics.aspx.

EC sketches a number of policies that are still relatively vague. Among them are the development of an integrated market for covered bonds, and more support for alternative financing measures such as venture capital and private equity, but also environmentally conscious bond instruments. Further, the EC proposes to lower the costs for setting up and investing in investment funds as well as to reform rules on occupational pensions. Among the wider initiatives are plans to address obstacles to cross-border capital flows, such as insolvency, corporate, taxation and securities laws. Finally, the Green Paper seeks views on how EU markets can be made more attractive to international investors from outside Europe. Based on the outcome of this consultation, the EC was due to decide on the priority actions needed to put in place, by 2019, the building blocks for an integrated, well-regulated, transparent and liquid CMU for all 28 EU member states. The possibility of Brexit had not been anticipated.

What is missing from the Green Paper is any discussion of the role of the European Securities and Markets Authority, regulatory versus supervisory tasks and the relationship to the G20 agenda on regulatory reform. With the Brexit vote looming, the EC's proposals fell short of a fully integrated capital market across the European Union. Its incremental approach to reform risks running out of steam — especially after the Brexit vote — while the lack of commitment to a

centralized regulation and supervision mechanism undermines the objective of a fully integrated market. To the extent that CMU was a politically motivated project to help repair the relationship with the United Kingdom and regain support from the City of London for the single market project, it has obviously failed. The project's mid-term review this year provided an opportunity to reassess priorities, but the initiatives under way fall short of an ambitious CMU agenda.

Supervisory Framework

The failures in financial supervision exposed by the global financial crisis prompted the EC to ask a group of high-level experts, chaired by Jacques de Larosière, president of the European Savings Institute, to make proposals to strengthen European supervisory arrangements. Based on the recommendations of the so-called "Larosière Report" in 2008, a more efficient, integrated framework for the supervision of the EU financial system was established as of January 2011. The new framework consisted of the European Systemic Risk Board (ESRB), a new body responsible for macro-prudential supervision, with a secretariat function provided by the ECB; and three new supervisory authorities for the

banking, securities and insurance sectors: the ESMA, the European Banking Authority (EBA)⁹ and the European Insurance and Occupational Pensions Authority (EIOPA). These three European supervisory authorities (ESAs), working within a network of national competent authorities — the ESRB, and the Joint Committee that brings together the ESAs and ESRB — constitute the European System of Financial Supervision.

Although ESMA and the other ESAs were designed as largely autonomous supranational institutions, their autonomy is limited in practice. The current governance arrangements for each ESA include a board of supervisors responsible for policy decisions, made up of representatives from EU member state institutions, and a management board responsible for the operation of the ESA. Board members are expected to act in the overall interest of Europe, but this mandate may be inconsistent with the fact that they are each nominated by the respective national authority. Governance reforms aimed at increasing the responsibility and accountability of management boards would therefore help overcome the domination of national interests in decisions of the boards of supervisors (International Monetary Fund 2013; Valiante 2016). Also, funding sources for the ESAs should ensure that their budgetary positions and scope to manage their resources are not constrained to the point that their ability to carry out their mandates is compromised.

Supervision of capital markets may be more complex than bank supervision, insofar as it is inherently more difficult to supervise activities (capital market transactions) than entities (banks). EU-wide capital markets supervision would therefore need to rely, to some extent, on the expertise and resources of national authorities. Once the Markets in Financial Instruments Directive and Regulation (MiFID II/MiFIR) take effect in January 2018, ESMA will be responsible for monitoring and reporting on the implementation of certain provisions of the regulatory regime governing EU capital markets, for example, on the EU-wide commodity derivatives position

⁹ The European supervisory architecture created in 2011 was subsequently modified with the establishment of a single supervisory mechanism in the context of banking union. In November 2014, the ECB took over the supervision of banks established in the euro area, while the EBA moved away from the task of improving the coordination of supervision in the EU banking sector and focused instead on the development of a single rule book, i.e., it acted as a regulator rather than a supervisor.

limits regime.¹⁰ Nevertheless, there is room to strengthen ESMA's direct supervision in certain well-defined areas, such as accounting rules and practices for listed companies, harmonization of listed company filings, licensing procedures for EU passport rights and supervision of funds listed across borders. ESMA could also be responsible for the direct supervision of all EU-listed companies, or at least for entities that operate cross-border with an EU passport. A more centralized structure would reduce the regulatory and supervisory arbitrage that tends to shift activities to certain jurisdictions. An enhanced tool kit to deal with the build-up of risks in market-based activities and entities outside the regulated banking sector should be part of the CMU agenda (ECB 2016a). Also, as ESMA's chairman has pointed out, it is essential to strengthen ESMA's sanctioning powers, including the level of fines it can levy in order for ESMA to be seen by market participants as a credible supervisor (ESMA 2016). Finally, an EU-wide consumer protection agency would help overcome the fragmentation that arises from different national consumer laws governing retail service providers.

Action Plan for CMU

Based on feedback received from stakeholders on the Green Paper, the EC published an action plan in September 2015 (EC 2015c). Follow-up status reports were subsequently published semi-annually to help policy makers monitor progress and ensure that the reform momentum is maintained. The action plan is built around three key objectives:

→ **Creating more opportunities for investors:** CMU would help mobilize capital in Europe and channel it to companies, infrastructure projects and low-carbon green projects that need financing to grow and create jobs. On the supply

¹⁰ The revised MiFID II sets out licensing requirements, business conduct rules and reporting requirements for investment firms. Building on the rules already in place, MiFID II revises an earlier directive to improve the transparency and resilience of financial markets following the global financial crisis. The revised MiFID II and a related MiFIR were approved by the European Council in May 2014 and are scheduled to enter into force on January 3, 2018. MiFID II and MiFIR empower ESMA to issue draft technical standards, subject to approval by the EC, detailing how the regulations should be implemented. When implemented, the rules contained in the draft technical standards will bring the bulk of non-equity products into a robust regulatory regime and shift a significant part of over-the-counter (OTC) trading onto regulated platforms.

side, there is room for insurance companies and pension funds to invest more of their funds in risk capital, equity and infrastructure. Mobilizing private capital would also give households better options to meet their retirement goals. President Juncker placed the CMU agenda at the centre of his efforts to boost investment. Soon after taking office, he launched the European Fund for Strategic Investments (EFSI)¹¹ jointly with the European Investment Bank (EIB) to mobilize private investment through the targeted use of public funds.

- **Fostering a stronger and more resilient financial system:** By opening up a wider range of funding sources for companies and investment opportunities for retail and institutional investors across national borders, CMU would help ensure that EU citizens and companies are no longer as vulnerable to financial shocks as they were during the crisis.
- **Deepening financial integration and increasing competition:** The CMU should lead to more cross-border risk-sharing and more liquid markets, which will deepen financial integration, lower costs and improve European competitiveness.

The action plan identifies weaknesses in how the European capital markets function, and sets out a program of 33 measures that aim to set the foundation of an integrated capital market in the European Union by 2019 (see Table 1). It analyzes specific obstacles that currently hinder the development of European capital markets and prioritizes possible solutions. In line with the new EC's pragmatic approach involving more consultation and less legislation, the proposed reforms are incremental, first tackling the "low hanging fruit" and gradually building consensus to address more contentious issues in the longer term. The ultimate objective is to put in place the building blocks for CMU (rather than the conditions for a full CMU) by 2019, when the current legislative term of the European Parliament ends and a new Parliament and Commission will take office. The EC plans a mid-term review and reassessment of priorities in 2017.

As noted by some observers (Kenadjian 2015; Veron and Wolff 2015), the problem with this

approach is that it risks losing rather than gaining momentum — especially after the Brexit vote. The immediate aftermath of a crisis is the best time to undertake difficult reforms, such as banking union in Europe in 2012 and the Frank-Dodd regulatory reform in the United States in 2010, as well as the ongoing Basel III reform at a global level. As the memory of the crisis recedes, elements of these reforms are increasingly becoming contentious and may be revoked or not followed through.

The securitization initiative is an example of this tendency: after rapid progress in 2015, with the European Council approving in record time the EC's proposal for a regulation providing for a STS in December (EC 2015d), the regulation remained bogged down in the European Parliament until mid-2017 for two reasons. First, the regulation risked becoming the first casualty of the UK's Brexit vote amid disagreements over the extent to which non-EU countries should have access to the EU market (*Financial Times* 2017b). Second, financial market participants objected to several aspects of the initial securitization proposals on grounds that they "run counter to the objective of reviving securitization in Europe and, if adopted as currently proposed, will discourage the use of securitization as a funding and risk transfer technique" (Association for Financial Markets in Europe [AFME] 2016). The main problem was the proposed "risk retention" guideline requiring the issuer to retain 25 percent of each bond issue on its own balance sheet in order to align the incentives of the issuers with those of the investors. These issues were finally resolved by reducing the risk retention requirement to five percent and essentially delaying the decision on third-country access to a later date (EC 2017c). The agreement with the European Parliament included a more risk-sensitive regulatory treatment for STS securitizations, including lower capital requirements and the creation of a data repository system for securitization transactions aimed at increasing market transparency. Securitization of bank loans would open up new sources of funding to SMEs by creating room for new loans in bank balance sheets and by broadening the investor base to include institutional investors.

The ECB has strongly supported financial integration in capital markets across the European

11 The EFSI, also known "the Juncker plan," is an initiative launched jointly by the EC and the EIB Group to help overcome the current investment gap in the European Union by mobilizing private financing for strategic investments (EC 2016a).

Table 1: CMU Action Plan – List of Actions and Timeline

Financing for Innovation, Start-ups and Non-listed Companies		
Support venture capital and equity financing	Proposal for pan-European venture capital fund-of-funds and multi-country funds	Q2 2016
	Revise EuVECA and EuSEF legislation ¹²	Q3 2016
	Study on tax incentives for venture capital and business angels	2017
Overcome information barriers to SME investment	Strengthen feedback given by banks declining SME credit applications	Q2 2016
	Map out existing local or national support and advisory capacities across the European Union to promote best practices	2017
	Investigate how to develop or support pan-European information systems	2017
Promote innovative forms of corporate financing	Report on crowdfunding	Q1 2016
	Develop a coordinated approach to loan origination by funds and assess the case for a future EU framework	Q4 2016
Making It Easier for Companies to Enter and Raise Capital on Public Markets		
Strengthen access to public markets	Proposal to modernize the Prospectus Directive	Q4 2015
	Review regulatory barriers to SME admission on public markets and SME growth markets	2017
	Review EU corporate bond markets, focusing on how market liquidity can be improved	2017
Support equity financing	Address the debt-equity bias, as part of the legislative proposal on common consolidated corporate tax base	Q4 2016
Investing for Long-term, Infrastructure and Sustainable Investment		
Support infrastructure investment	Adjust Solvency II calibrations for insurers' investment in infrastructure and European long-term investment funds	Q3 2015
	Review of the cash reserve ratio for banks, making changes on infrastructure calibrations, if appropriate	Ongoing
Ensure consistency of EU financial services rule book	Call for evidence on the cumulative impact of the financial reform	Q3 2015
Fostering Retail and Institutional Investment		
Increase choice and competition for retail	Green Paper on retail financial services and insurance	Q4 2015
Help retail investors to get a better deal	EU retail investment product markets assessment	2018
Support saving for retirement	Assessment of the case for a policy framework to establish European personal pensions	Q4 2016
Expand opportunities for institutional investors and fund managers	Assessment of the prudential treatment of private equity and privately placed debt in Solvency II	2018
	Consultation on the main barriers to the cross-border distribution of investment funds	Q2 2016

12 The European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) are EU-wide collective investment schemes governed by regulations: (EU) No 345/2013 (EuVECA) and (EU) No 346/2013 (EuSEF). These regulations need to be revised to address restrictions (for example, on eligible assets) that have kept the funds small and concentrated in a few EU countries.

Leveraging Banking Capacity to Support the Wider Economy		
Strengthen local financing networks	Explore the possibility for all Member States to authorize credit unions outside the EU's capital requirements rules for banks	Ongoing
Build EU securitization markets	Proposal on STS securitizations and revision of the capital calibrations for banks	Q3 2015
Support bank financing of the wider economy	Consultation on an EU-wide framework for covered bonds and similar structures for SME loans	Q3 2015
Facilitating Cross-border Investing		
Remove national barriers to cross-border investment	Report on national barriers to the free movement of capital	Q4 2016
Improve market infrastructure for cross-border investing	Targeted action on securities ownership rules and third-party effects of assignment of claims	2017
	Review progress in removing remaining Giovannini barriers	2017
Foster convergence of insolvency proceedings	Legislative initiative on business insolvency, addressing the most important barriers to the free flow of capital	Q4 2016
Remove cross-border tax barriers	Best practice and code of conduct for relief-at-source from withholding taxes procedures	2017
	Study on discriminatory tax obstacles to cross-border investment by pension funds and life insurers	2017
Strengthen supervisory convergence and capital market capacity building	Strategy on supervisory convergence to improve the functioning of the single market for capital	Ongoing
	White Paper on ESAs' funding and governance	Q2 2016
	Develop a strategy for providing technical assistance to Member States to support capital markets' capacity	Q3 2016
Enhance capacity to preserve financial stability	Review of the EU macroprudential framework	2017

Source: EC (2015c). Measures highlighted in red were completed by the mid-term review of the action plan (see EC 2017b).

Union based on an adequate legal and regulatory framework. Members of the ECB executive board have suggested that such a framework should include bolder steps toward harmonization of bankruptcy law, company law and taxation of financial products that pose great political challenges (ECB 2015). The “Five Presidents’ Report” also listed insolvency law among the most important bottlenecks preventing the integration of capital markets in the euro area and beyond. For example, insolvency law could encourage out-of-court settlements and enhance the comparability of the ranking of creditor claims across the EU. The EC’s initiative to improve insolvency laws

is a necessary step toward CMU, although it is unclear how fast this initiative will progress.¹³

Regarding the Eurosystem, the ECB views securitization as a possible means of addressing large-scale NPLs in the banking system, by providing an intermediate option between internal workout and direct sale of impaired assets (ECB 2016b). A well-developed EU securitization market, relying

13 The EC’s insolvency initiative is a key deliverable of the CMU action plan (see Table 1). The 2015 Insolvency Regulation focused on resolving the conflicts of jurisdiction in cross-border insolvency proceedings, and ensured the recognition of insolvency-related judgments across the European Union, but did not harmonize the insolvency laws of member states (European Council 2015). A more ambitious proposal on a set of European rules on business insolvency was tabled in November 2016, including early restructuring procedures to avoid bankruptcy, and a second chance to start a business through a full discharge of distressed debt within three years at most (EC 2016b).

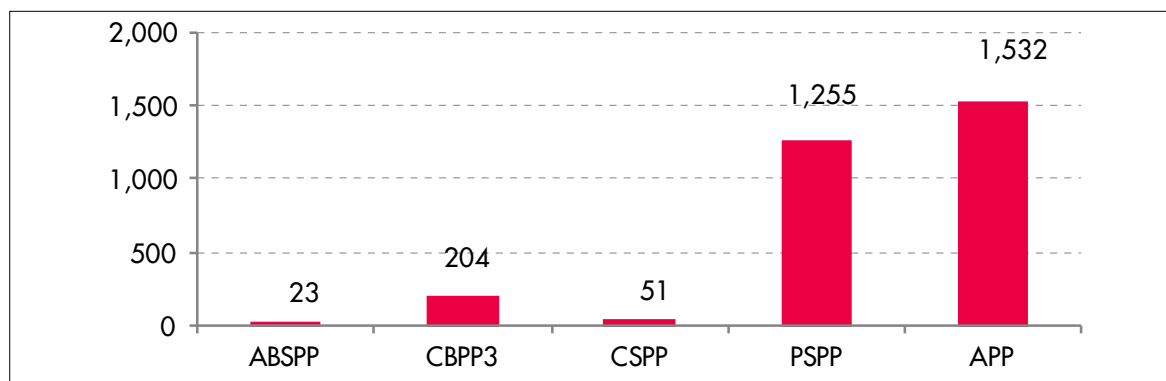
on transparent and standardized securitization instruments, would increase the capacity of banks to lend by creating room in their balance sheets. However, securitization most likely will remain marginal to the resolution of NPLs, as the securitization market is tiny (€80 billion issuance in 2016) relative to the size of NPLs (amounting to €1 trillion in the European Union). Moreover, the shortage of liquid private financial assets hampers the ECB's ongoing efforts to ease monetary conditions through quantitative easing (QE). In the euro area's bank-dominated financial system, the market for corporate bonds and securitized bank assets is small, leaving sovereign bonds as the only viable option for large-scale purchases (Figure 7). The ECB is working on identifying "high-quality" assets that could be securitized, but it is doubtful that the pace of securitization could accelerate significantly before the current QE program expires in 2018 or early 2019.

As noted above, financial markets integration is expected to improve Europe's shock-absorbing capacity and thus enhance financial stability. At the same time, however, the gradual removal of national barriers and the consequent increase in cross-border capital flows would pose new risks to financial stability that would require strong central oversight. Although the "Five Presidents' Report" recognized that CMU should ultimately lead to a single European capital markets supervisor, this objective was not included in the action plan for CMU (published before the Brexit vote), presumably to avoid antagonizing the United Kingdom, which was strongly opposed to surrendering financial market oversight to a pan-European body.

The Impact of the Brexit Vote on CMU

There is a strong case for the CMU project to continue with the remaining EU members (the "EU27") after the United Kingdom leaves, as capital market financing represents a lower proportion of total financing in the EU27 than in the United Kingdom, and the need to develop capital markets is correspondingly greater. Moreover, there is little doubt that Britain's vote to exit the European Union makes pan-European capital markets supervision in the EU27 more urgent because fragmented supervision gives rise to regulatory arbitrage. Nicolas Veron (2016) has even argued that the United Kingdom's departure from the European Union makes it comparatively less difficult to move toward stronger EU-level institutions for capital markets supervision and enforcement — a trend the United Kingdom had opposed. Along similar lines, Reza Moghadam (2017) notes that the likely splintering of capital markets, with some operations moved to Ireland or continental Europe and others (notably institutional investors) remaining in the United Kingdom, will have adverse implications for cost and efficiency. He argues that a single EU supervisor is necessary to avoid the current regulatory fragmentation and ensure that the common rules are consistently applied across the European Union. In his view, close collaboration between the pan-European and the UK regulator would lend stability and continuity to

Figure 7: ECB Asset Purchase Program Holdings, December 2016 (€ billions)



Data source: www.ecb.europa.eu/mopo/implement/omt/html/index.en.htm.

Note: ABSPP = asset-backed securities purchase program; CBPP3 = third covered bond purchase program; CSPP = corporate sector purchase program; PSPP = public sector purchase program; APP = asset purchase program.

European capital markets, including through the continued use of English law to enforce contracts.

While the UK's eventual departure from the European Union makes CMU more urgent, it also represents a clear setback in view of the dominance of the City of London as Europe's financial centre. Near term, the Brexit vote appears to have slowed the implementation of the action plan, as the attention of European institutions has shifted toward managing the future relationship with the United Kingdom. As noted above, the draft securitization directive came close to becoming the first casualty of the Brexit vote. While recognizing that most of the financial institutions that can help kick-start securitization are in the United Kingdom, France and Germany were reluctant to set a precedent on financial market access before Brexit negotiations had even started.

Brexit could have profound effects on the UK financial system, its status as a global hub and its contribution to the economy. Exit from the European Union will almost certainly reduce the market access of UK-based financial institutions to the EU market, subject them to regulatory uncertainty while the final status is under negotiation and force them to re-examine their corporate structure and location. The final result depends on Britain's relationship with the European Union and other jurisdictions post-exit, and on how financial institutions and markets adjust to the new circumstances.

The two-year countdown to Britain's departure from the European Union started on March 29, 2017, when Prime Minister Theresa May triggered Article 50 of the EU Treaty, but negotiations only began in late June, after the June 8 general election. Prime Minister May signalled a "clean and hard Brexit" by announcing in early 2017 that Britain would not seek membership to the EU's single market, but would renegotiate both its internal market and customs union agreements with the European Union.¹⁴ She expressed the hope that "we would have reached an agreement about our future partnership by the time the two-year

Article 50 process has concluded.¹⁵ The White Paper published soon after her speech confirmed that the British government intends to pursue a transitional arrangement to minimize economic disruption and avoid an even harder Brexit if the two-year period provided for in Article 50 ends without agreement on a future relationship, which would be subject to the approval of the UK Parliament (UK Government 2017). Controlling immigration, terminating UK contributions to the EU budget and ending the jurisdiction of the European Court of Justice appear to be the government's key priorities. Exiting the EU single market would leave financial services, automakers and aerospace industries most vulnerable. It is presumably with these sectors in mind that Prime Minister May said she would like to preserve "elements of the single market."

The outcome of the June 8 general election in the United Kingdom could be a game changer for the Brexit negotiations. May called the election hoping to win a larger majority to bolster her position in coming Brexit negotiations, but her Conservative Party was left with fewer seats and failed to hold on to its majority in Parliament. Moreover, the Independence Party, the leading Brexit advocate, lost more seats than expected. The inconclusive outcome provides Britain the opportunity to revisit the terms of its future relationship with the European Union. The hung Parliament could result in a decision to step back from the "hard Brexit" stance adopted by May and to revisit the decisions to exit both the customs union and the single market. Even before the June 8 election, the "hard Brexit" approach appeared to be a rather extreme interpretation of a close referendum result (52-48 percent). A business-friendly "softer Brexit" scenario would leave open the possibility of UK financial institutions maintaining their "passporting" rights after Brexit. The difficulty with this scenario is that access to the single market (through EEA membership or a special arrangement, such as the Swiss deal) is inextricably linked to free movement of labour, as EU leaders

14 The least disruptive option for the United Kingdom would have been to seek membership in the European Economic Area (EEA) prior to invoking Article 50, which would preserve the parts of EU law and regulations (the *acquis communautaire*) relevant to the EU's "four freedoms" (free movement of goods, persons, services and capital). Obviously, this option would be incompatible with controlling immigration from EU and EEA countries. EEA members (Norway, Iceland and Liechtenstein) are part of the European Union's single market, as is Switzerland, although neither are members of the European Union nor the EEA.

15 Article 50 of the Treaty on the Functioning of the European Union permits member states to withdraw from the Union. After Britain formally notified its intention to withdraw in March 2017, the European Union "shall negotiate and conclude an agreement with that state, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union." That agreement will be concluded on behalf of the European Union by the European Council, acting by a qualified majority, after obtaining the consent of the European Parliament. The EU treaties would cease to apply to Britain from the date of entry into force of the withdrawal agreement or, failing that, two years after Britain formally notifies its intention to leave. Extending the two-year period would require the unanimous agreement of the European Council.

insist that the four freedoms underlying European unification are inseparable (free movement of goods, services, labour and capital). But free movement of labour need not run counter to the objective of controlling immigration, if the United Kingdom were to negotiate a safeguard clause for intra-EU immigration similar to the one included in the agreement Switzerland has concluded with the European Union. The Swiss government recently activated the safeguard clause to limit immigration from Bulgaria and Romania (Reuters 2017).

Meanwhile, after the Article 50 notice of “intention to leave” was served by the United Kingdom, some UK-based financial firms — notably HSBC and Standard Chartered — announced a move of certain operations to Paris or Frankfurt. Faced with a loss of passporting rights, many UK-based insurers have been looking for a new EU base. QBE Insurance Group was the second major insurer to select Brussels after Lloyd’s announced that it would set up a base there. Similarly, AIG announced in March that it would set up a subsidiary in Luxembourg. At the same time, lobby groups for the City of London have dropped plans to pursue passporting rights for financial services firms post-Brexit, instead shifting their focus to an “equivalence” agreement with the European Union.¹⁶ Under such an agreement, firms under “equivalent” regulatory standards would be able to trade freely across borders under their home rules and regulations. The European Union currently has a similar deal with the United States on derivatives clearing. In this scenario, the UK regulatory authority would need to remain in close collaboration with ESMA to ensure that regulatory standards evolve in parallel over time. Equivalence rules also could apply to securitization, insofar as non-EU financial companies could be allowed to create STS-compliant packaged loans on the condition that their home country had strong regulation and supervision.

The issue of clearing euro-denominated derivatives came to a head soon after Article 50 was triggered. London dominates clearing of derivatives denominated in euros, mainly via the London Stock

Exchange’s London Clearing House (LCH) business¹⁷ — a dominance that the ECB has challenged in the past, only to find its attempt to move the euro-clearing business to a euro-area country blocked by the European Court of Justice. Proposals to move the multi-billion euro business to, say, Frankfurt, have gained new impetus since the Brexit vote, with advocates arguing that euro-denominated derivatives should not be cleared outside the European Union. But UK lobby groups, such as TheCityUK, have argued that keeping clearing in London is vitally important and should be one of the government’s core aims of negotiations with the European Union. Post-Brexit, UK-based financial firms will not be subject to EU law unless the United Kingdom agrees to surrender oversight to EU institutions (see Box 2). EU rules give the ECB joint oversight of London-based clearing houses, but do not allow for supervision of clearing houses outside the European Union. A possible way out of this problem is for the European Union to adopt the US approach, requiring foreign firms that carry out substantial US business to be registered with the US regulator, which thus has oversight of the major London clearing houses (*Financial Times* 2017a). If this happens, either the ECB or an EU-wide regulator (probably ESMA) would have supervisory powers over the euro-denominated activities of London clearing houses.

As the influx of businesses from the City of London to continental Europe continues, ESMA Chair Steven Maijor warned that they would not be allowed to use “letterbox” companies in Europe to preserve their market access after Brexit. In late May, ESMA set out principles for national regulators to observe regarding UK-based companies seeking to relocate, “to safeguard investor protection, the orderly functioning of financial markets and financial stability” (ESMA 2017). The principles are aimed at “fostering consistency in authorization, supervision and enforcement related to the relocation of entities, activities and functions from the UK.” Presumably, the aim is to avoid having companies relocate from

¹⁶ Under the equivalence approach, a country is considered equivalent when its rules are similar and compatible with EU rules. When the regulatory outcomes are determined to be equivalent, subject to certain conditions, an individual market participant can be recognized and provide its services in the European Union, subject to supervision by the home regulator.

¹⁷ LCH is a London-based independent organization that serves major international exchanges as well as a range of OTC markets. It clears about half of global interest rate swap transactions, as well as euro- and sterling-denominated bonds, repos and a broad range of other asset classes including commodities, foreign exchange and credit default swaps. Major investment banks, broker dealers and commodity traders use the services of LCH, which assumes the counterparty risk of a trade by guaranteeing settlement subject to collateral or margin requirements. Following the Brexit vote, the London Stock Exchange Group said there were no plans to relocate any of its main derivatives and clearing businesses on completion of its planned merger with Deutsche Börse.

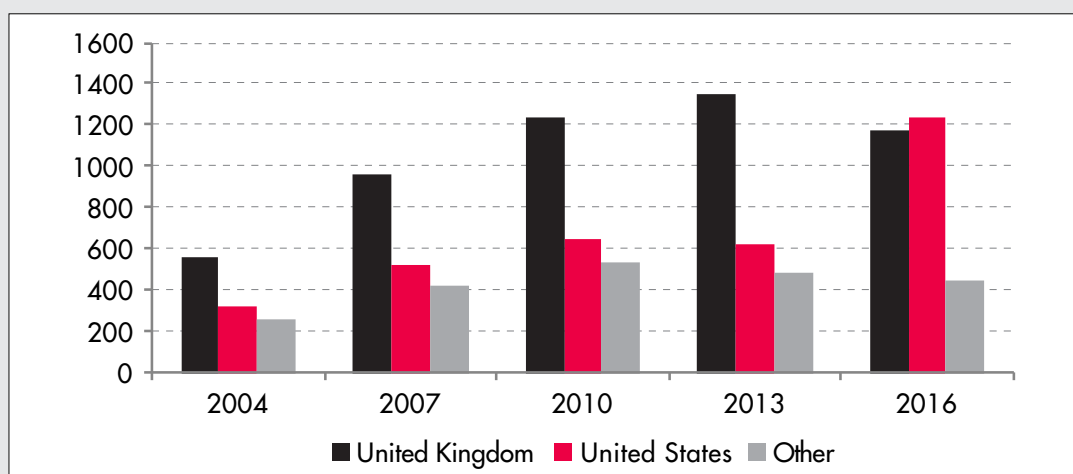
Box 2: Interest Rate Derivatives Trading

Traditionally, the United Kingdom had been the top global trading hub for interest rate derivatives, although turnover there fell by 12 percent from April 2013 to US\$1.2 trillion in April 2016 (39 percent of global turnover). According to the Bank for International Settlements (BIS), the drop largely reflected the fall in euro-denominated OTC interest rate derivatives contracts, three-quarters of which are executed by clearing houses in the United Kingdom.

A clearing house stands between the buyer and seller of OTC derivatives, ensuring that the trade is executed even if one of the two parties in the transaction defaults. Derivatives trades are widely used to hedge interest rate and exchange rate risk through options, swaps and forward contracts. The clearing house sets margin requirements based on the probability that a member will default on its debit balance. If a default happens, any residual cost not covered by collateral is distributed to all members. A Lehman-size default can trigger a market meltdown; this is why derivatives clearing is important for financial stability.

The EC initially wanted the clearing of euro-denominated securities to move to the euro area, but subsequently backed down from such a move (*Financial Times* 2017a). It is now considering a proposal requiring clearing houses located outside the European Union to meet tougher standards, including providing data sharing and allowing on-site inspections, similar to the standards imposed by US regulators on clearing houses located outside the United States. Non-complying clearing houses could be forced to relocate their euro-clearing business to the European Union or be barred from doing business there. From a systemic perspective, breaking up clearing houses would carry a cost: the more broad-based the membership of a clearing house in terms of markets, instruments and currencies covered, the more diversified the risks and the safer the financial system it covers. Pooling of risks requires service providers of significant size relative to the market.

Figure 8: Interest Rate Derivatives Turnover in the United Kingdom and other Centres (Average Daily Turnover, US\$ billions)



Data source: BIS (2016).

Note: "Other" refers mainly to non-EU centres, including Australia, Japan, Hong Kong SAR and Singapore. France and Germany combined accounted for US\$172 billion in 2016.

London without the requirement to have capital to back up their entities in continental Europe, but consistent application of the ESMA principles across the single market is left to national regulators. The Irish government complained earlier this year that rival financial centres were engaged in “regulatory arbitrage” in an effort to lure business from London. These issues underline the need to develop common supervisory standards across the European Union.

Steps Taken So Far

After a strong start in 2015, with the European Council approving, in record time, the EC’s proposal for a simple and transparent securitization procedure, implementation of the action plan slowed. Two key initiatives, the proposal for STS securitizations and the proposal for the simplification of prospectus rules for initial public offerings (IPOs) and secondary offerings languished in the European Parliament. Both were finally agreed after months of deliberations, but implementation will take time. The securitization initiative — one of the flagships of the CMU action plan originally due to be completed in the third quarter of 2015 — was bogged down with complex bargaining among various political factions over provisions linked to completion of European banking union and over access rights for non-EU members. The European Parliament finally reached agreement with EU governments in late May 2017, after more than a year of deliberations and delays triggered by objections raised by Members of the European Parliament (*Financial Times* 2017b). This is a crucial milestone in the development of the European capital market, although it is too soon to tell how STS securitizations, which benefit from lower capital requirements, will work in practice.

Initiatives relating to the prospectuses for the issuing and offering of securities also have moved forward, but the overall implementation momentum has slowed. The mid-term review of the CMU project in June 2017 reported good progress in completing 20 out of the 33 measures set out in the action plan¹⁸ (EC 2017a; EC 2017b). However, most of these measures were completed past their original deadlines; moreover, “completion” does not imply

implementation. While solid groundwork has been completed to advance these initiatives, in some cases implementation is far from complete and will take time. For example, the initiatives on both STS securitizations and the Prospectus Directive were considered “completed” (in September 2016 and December 2016 respectively), although they have not yet been implemented.

Moreover, some of the EC’s proposals are not sufficiently ambitious. For example, under the current proposal, an EU-wide IPO would still need to be approved by the supervisory authorities of each member country. An IPO by an issuer who wants to be listed on a larger, more liquid market in another member state would still need approval by its home supervisor. Also, the supervisory tasks created recently by the European Union, including supervision over benchmarks, derivative markets, ratings and data reporting agencies, have not been matched by increased supervisory powers by ESMA. ESMA has been tasked with additional supervisory powers in the areas of rating agencies and trade repositories, but not benchmarks and derivative markets (Lannoo 2016). In December 2016, agreement was reached in the European Parliament on a draft regulation that would simplify and standardize the prospectuses for the issuing and offering of securities. The draft regulation was adopted by the European Council on May 16, following a vote in the European Parliament, and would apply from mid-2019. As part of this initiative, ESMA was tasked with creating and maintaining a European online prospectus database accessible to the public free of charge. The new regulation simplifies the rules and streamlines the relevant administrative procedures to make it cheaper and easier for small businesses to access capital markets. Small issuers (below €8 million) were exempted from the obligation to publish a prospectus.

At the mid-term review, the EC complemented the original action plan with nine additional priority measures in response to the Brexit challenge and to the public consultation conducted in the first quarter of 2017. The timeline for implementation of these measures will be announced at a later date. The most important of the new measures was the commitment to strengthen the powers of ESMA to promote the effectiveness and consistency of supervision across the European Union in response to the influx of businesses from the United Kingdom. Other new measures are directed at simplifying the regulatory environment governing SME listings on public

¹⁸ Table 1 highlights the 20 measures that were completed by the mid-term review in early June 2017.

markets and cross-border investments, supporting secondary markets for NPLs, exploring ways to harness the transformative power of financial technology and shifting private capital toward infrastructure projects and sustainable investment.

The mid-term review noted that the recovery in the euro area is gaining momentum, but the contribution of investment remains low, and the investment rate remains below pre-crisis levels.

In line with the commitment to promote investment in infrastructure projects, the Solvency II prudential rules were revised in April 2016 to reduce the regulatory capital held by insurance companies against their exposures to infrastructure projects. The objective is to encourage them to raise the share of assets allocated for this purpose, which currently amounts to less than one percent. To further support infrastructure investments by insurance companies, the EC plans to extend risk calibrations in Solvency II for infrastructure projects to investments in infrastructure corporates. The mid-term review also included a commitment to mobilize private capital to fund sustainable investment in green projects, in line with the Paris climate agreement.

The mid-term review outlined the legislative initiatives the EC plans to undertake in coming months to advance the CMU agenda. These initiatives relate to three of the outstanding measures included in the action plan, which are central to the creation of CMU, as well as the new initiative to strengthen ESMA's supervisory powers:

→ **A Pan-European Personal Pension Product (PEPP), (end-June 2017):** This initiative aims at laying the foundations for a safe, cost-efficient and transparent market in personal pension savings that can be managed on a pan-European scale. It is intended to supplement existing national and occupational pensions by offering a standardized “third pillar” personal pension scheme that pools together a large number of investments across the European Union. EIOPA (2016) would impose regulatory and capital requirements on PEPP providers based on the Solvency II Directive.¹⁹

→ **Legal certainty for cross-border securities' ownership rights (Q4 2017):** The EC will propose

a legislative initiative to determine with legal certainty which national law shall apply to securities ownership and to third-party effects of the assignment of claims. This is a complex topic that the EC has been reviewing with stakeholders for several years. In 2001, the first Giovannini report (Giovannini Group 2001) identified the “uneven application of national conflict of laws rules” as one of the 15 barriers to efficient cross-border clearing and settlement (see Box 1). One of the obstacles identified is legal uncertainty surrounding securities ownership in cases when the securities issuer and the investor are located in different EU countries. Another barrier results from differences in the national treatment of third-party effects of assignment of debt claims that complicates their use as cross-border collateral. To address these barriers, the EC plans to propose a legislative initiative to remove the legal uncertainty that gives rise to costs and risks.

→ **EU framework for covered bonds (Q1 2018):**

The aim is to create a more integrated market for covered bonds²⁰ in the European Union, without undermining the quality of existing covered bonds. The EC also will explore the possibility of developing European Secured Notes as an instrument for SME loans and infrastructure loans.

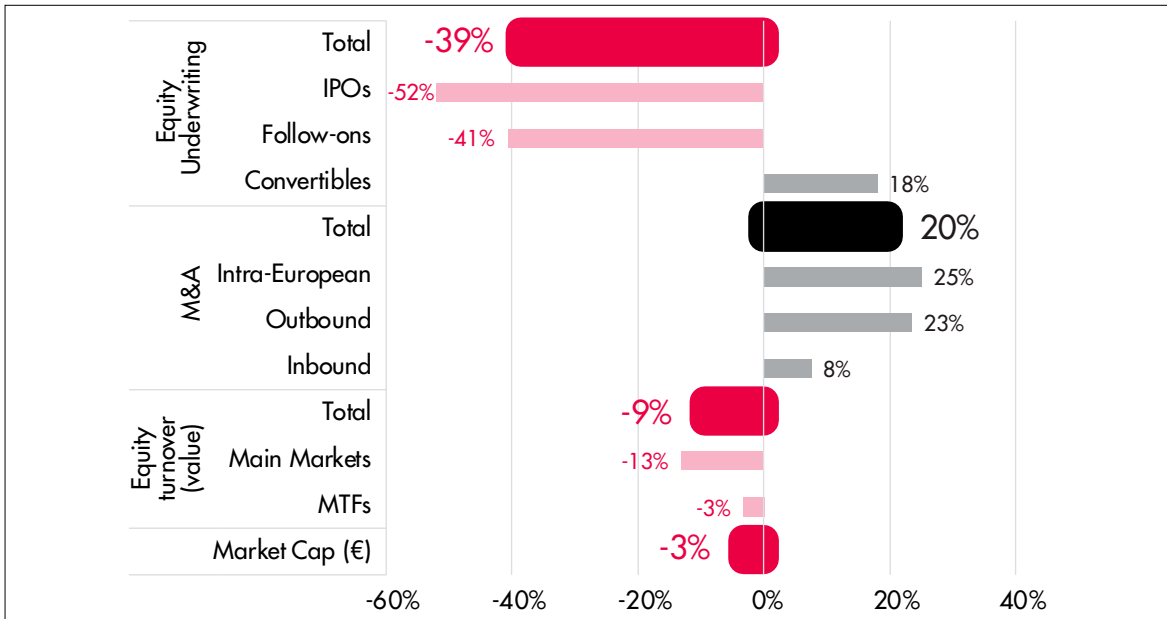
→ **Capital markets supervision (Q3 2017):** The mid-term review stressed the need to strengthen ESMA's ability to ensure consistent supervision across the European Union in order to ensure that the single rule book is implemented in a uniform way across the single market. The objective is to apply the same supervisory standard to financial entities with similar business size and risk profiles regardless of where they are located in the European Union, thus avoiding regulatory arbitrage. Impetus to this initiative was provided by the influx of businesses from the City of London to continental Europe, which highlighted the need for consistent application of ESMA's supervisory principles across the single market in order to avoid regulatory arbitrage.

EC Vice-President Valdis Dombrovskis, responsible for EU financial services and capital markets, reaffirmed the commitment to step up the effort to

19 Solvency II (2009/138/EC) is an EU Directive that codifies and harmonizes regulatory requirements on EU insurance companies, including minimum capital requirements to reduce the risk of insolvency. It was voted into law by the European Parliament on March 11, 2014, and came into effect on January 1, 2016.

20 Covered bonds are debt securities typically issued by a bank and collateralized against a pool of assets that can cover claims in case the bank fails. Unlike asset-backed securities created in securitization, covered bonds remain on the issuing bank's balance sheet subject to a capital charge, i.e., they do not create room for new lending.

Figure 9: Year-on-Year Variation of European Equity Activity (EU 28 Member Countries and Switzerland)



Source: Reproduced by permission from AFME (2017, 3).

integrate EU capital markets, and acknowledged the challenge of dealing with the departure of the largest EU financial centre from the block (Dombrovskis 2017). Acknowledging that respondents to the public consultation complained that the impact of measures had yet to be felt on the ground, he noted that it would take time to build the financial circuits, market conventions, and technical and legal infrastructures that will allow market participants to transact confidently on a pan-European scale. This would be a long-term process.

Data on capital markets activity confirm that the steps toward implementing the action plan so far have had no impact on the ground. Activity in European equity markets actually declined in 2016, according to the latest report by the AFME (2017). The report showed that equity underwriting in European exchanges decreased 39 percent in 2016, equity trading generated 9.4 percent less turnover and market capitalization of European listed shares decreased by 3.3 percent to €11.7 trillion. The only bright spot was mergers and acquisitions, which rose 20 percent, although this was in part due to two very large deals²¹ (see Figure 9).

21 Acquisition of BG Group plc by Royal Dutch Shell plc (€61 billion) and acquisition of SAB Miller plc by Anheuser-Busch InBev SA/NV (€119 billion).

Conclusion

CMU was motivated mainly by Europe's slow recovery from the balance sheet recession triggered by the global financial crisis. With banks deleveraging while facing higher capital requirements, capital markets were viewed as an alternative source of financing for business, especially SMEs that make up the majority of European businesses. While CMU was viewed as essential to delivering the Juncker Commission's priority to boost jobs and growth, this was more of a selling point than any instrument directly targeted at this objective. Stability considerations were not the primary driver, although integrated financial markets were expected to improve Europe's shock-absorbing capacity through cross-border risk sharing.

Recent political developments and the rebound in economic activity in Europe are conducive to accelerated implementation of the CMU agenda. At the same time, however, the incentive to seek alternative funding sources for investment is weakening as banks build capital and their balance sheets gradually recover. More importantly, Britain's vote to leave the European Union has diverted attention away from the CMU agenda toward the United Kingdom's post-Brexit relationship with the European Union. Reviving the CMU project thus

requires relaunching its agenda focusing on the objective of achieving capital market integration in continental Europe, including EEA countries. Such a project should be viewed as part of the EU long-term agenda, rather than as a short-term expedient to overcome the reluctance of banks to lend and boost investment. Progress toward CMU is possible without impinging on contentious issues involving a common fiscal backstop. Unlike prudential supervision, which needs to be accompanied by a resolution framework with fiscal implications, enforcement of capital market rules such as those governing authorization of funds for retail distribution or issuance of securities does not generate fiscal responsibilities.

While the functioning of capital markets in the euro area would clearly be improved by ongoing efforts to achieve common financial reporting standards and further harmonization of regulations, the current approach falls short of full capital markets union. The United Kingdom's exit from the European Union may provide an opportunity to tighten the rules governing EU-level supervision and enforcement, which the United Kingdom had opposed. Broadening ESMA's mandate to include greater supervisory convergence, capable of delivering a uniform implementation and enforcement of common rules, would be an important step forward. The draft legislation the EC plans to table later this year should help ensure the uniform and consistent application of the "single rule book" across the European Union. Prudential supervision of capital markets can remain a national responsibility for now, without preventing progress in enforcing common rules in other areas. For example, much progress would be made if IPOs and secondary cross-border offerings could be made subject to ESMA approval alone.

The EC's recognition in the action plan's mid-term review that "the future departure of the largest financial center from the European Union calls for stronger action, more effective supervision and measures to ensure the benefits of CMU are felt across the entire EU" is welcome (EC 2017a). At the current pace, however, the building blocks of CMU are unlikely to be in place by 2019. Priority should be placed on deepening financial market integration, as opposed to helping SMEs access market-based finance, tackling investment shortages and promoting infrastructure investment, green bonds or energy-efficient mortgages. These are valid objectives, but they are not central to the CMU project.

For EU shock-absorbing capacity to increase, more integrated capital markets are needed to enable households to lend and companies to borrow across national borders, thus creating a more diversified investor base. Capital market integration, in turn, requires eliminating national differences in accounting, auditing, regulatory, supervisory, tax and legal practices, as well as unifying the clearing and settlement infrastructure. STS securitization, the streamlining of rules for securities prospectuses, as well as efforts to improve data comparability, increase legal certainty and overcome the fragmentation of rules and procedures for marketing investment products, are all steps in the right direction. However, more effort has to be made in harmonizing insolvency proceedings, improving market infrastructure (Giovannini barriers), developing venture capital and harmonizing taxation of financial products. A fragmented financial sector is not only inefficient but also unable to attract investments from overseas. In addition, the CMU agenda needs to attract and incorporate more actively household and corporate sector savings in vehicles that will invest in capital markets and encourage them to diversify across the European Union, along the lines of the PEPP product.

Finally, in line with its objective of attracting investment from the rest of the world, the CMU agenda should be closely coordinated with global standard-setting bodies, such as the Financial Stability Board, the International Capital Markets Association and the International Organization of Securities Commissions to ensure compliance with global standards. International cooperation when developing regulations is a prerequisite for an open, efficient and nondiscriminatory international financial system. The global competitiveness of the EU regulatory framework is important in view of the priority attached by the new US administration to avoiding over-regulation of the financial sector.

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