SwissFinanceCouncil
Fostering International Dialogue

The EU & its Partners:

Defending Open Markets in Challenging Times

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[Foreword]

We are delighted to introduce you to the Swiss Finance Council (SFC) and its first Discussion Paper 'The EU and its Partners: Defending Open Markets in Challenging Times'. The aim of the SFC is ambitious: to foster international dialogue with regard to financial services-related matters. For our Brussels Representation Office, this centres on the dialogue between the EU and its partner countries, with a special focus on Switzerland.

This Discussion Paper therefore is the first of a series of initiatives the SFC will be undertaking to encourage debate and discussion, support policy-makers and legislators, and provide a platform for all who share an interest in the key economic and financial relations between the EU and its partners.

The aftermath of the subprime and European sovereign debt crises still weighs heavily on the world economy and on Europe in particular. The process of recovery is still not complete, and the SFC wants to engage in the discussion with a view to how the EU and its partner countries can work together to facilitate growth and investment, and ultimately to create jobs and raise living standards for all.

The election of a new Parliament and the appointment of a new Commission headed by a new President are an opportune moment to launch this initiative. Through the Investment Plan, the implementation of the Banking Union and the set-up of a Capital Markets Union, President Juncker has set out a vision to help get the economy moving again. Indeed, the Capital Markets Union is a significant opportunity to introduce reforms that get capital flowing to the real economy, not only from within the EU but also from all over the world. It has the potential to result in small businesses having a more diverse source of funding than they have hitherto had, and will help Europe better withstand future shocks. It also provides a good opportunity to enhance the collaboration between capital markets within the EU and those beyond, such as the financial centre Switzerland.

That is why the SFC's first Discussion Paper aims to demonstrate how partner countries can help make these initiatives a success. In this Discussion Paper, which has been prepared in collaboration with experts from our members Credit Suisse Group AG and UBS AG, with substantive input from Llewellyn Consulting, the positive impact that close economic and financial ties between the EU and its partner countries has had on growth and jobs is clearly shown. The Paper goes on to make several recommendations on how to maximise these benefits, as the CMU is devised and many other political and regulatory initiatives are being developed. It needs to be ensured that the financial sector, within the EU and across borders, can make a meaningful contribution to Europe's recovery.

We hope you enjoy reading this Discussion Paper, and find it a thought-provoking contribution to the crucial debates Europe is embarking on.

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[Executive summary]

Open markets and multilateral cooperation have been a central plank in Europe's post-war economic framework.

This arrangement has underpinned its economic growth, enhanced its economic development, and has served as an important 'shock absorber', not least during the global financial crisis.

Today, however, with many of Europe's economies not yet recovering as hoped, a rise in support for populist politics and retrenchment from open markets threatens to damage this framework that has served Europe so well.

Europe is thus at a critical juncture, not least in respect of the challenges facing the evolution of its banking sector and financial markets.

Efficient and resilient financial systems underpin financial stability and facilitate investment in growth and jobs. This requires markets that are open not only within the EU itself, but also in relation to its major partners.

These external partners are important, and some particularly so. They contribute to EU economic activity and welfare through trade, financial, and other linkages:

- About 40% of the EU's goods exports, and 45% of services exports, go outside the 28-country bloc, with the United States, Switzerland, and China being the top three destinations;
- An acceleration of 1 percentage point in Swiss GDP growth boosts EU exports there by 3.5 %, while a 1 percentage point in BRIC economies results in a 5-6% increase in EU exports to those countries.
- Non-EU countries are key sources of foreign direct investment (FDI) and technical expertise into the EU, and
- Partner countries contribute significantly to the European financial sector, accounting for a substantial part of both banking and capital market activity.

One area where partner countries stand to offer much today is contributing to the development and functioning of Europe's still-nascent capital markets. This is an area with huge development potential.

Had Europe's capital market issuance between 2009 and 2014 been similar to the United States' as a proportion of GDP, it would have been more than double its actual size, i.e. €9 trillion instead of €4 trillion. Thus, conceiving, developing and implementing both the Banking Union (BU) and Capital Markets Union (CMU) in conjunction with key partner countries – as interlocutors, contributors, and partners – would be of great mutual benefit.

Against this backdrop, this Discussion Paper offers a number of policy suggestions to help reap the benefits from cooperation with key partners.

The suggestions support four objectives, and are aimed at ensuring the financial sector makes a meaningful contribution to Europe's economic growth and job creation:

- Promoting open and transparent markets;
- Designing policies for banks and non-bank financial institutions that deliver *both* economic growth and financial stability;
- Attracting capital flows and investment from within and outside the EU to support the real economy, and particularly for SMEs, and
- Encouraging greater co-operation between the EU and its partner countries, such as the financial centre Switzerland.

[Introduction]

The Importance of open financial markets

Open markets and multilateral cooperation have been central to Europe's post-war development and integration. This institutional framework also served as an important 'shock absorber', not least at the peak of the recent sovereign-debt crisis in Europe. However, the recovery has not been as strong as hoped. High unemployment persists in many Member States. Populist politicians hope to encourage voters to turn their backs on integration.

In supporting the recovery, financial systems play a central role. This requires markets that are open, efficient, and robust, not only within the EU itself, but also in relation to its major partners. Looking ahead, the focus should be ensuring that the financial sector makes a meaningful contribution to the recovery, sustainable growth, and employment; and that the EU's partner countries play their full part.

The recently established Banking Union (BU) which, inter alia, gives the European Central Bank (ECB) authority for banking supervision in the euro area, will make an important contribution to this process. Meanwhile, the longer-term project of a Capital Markets Union (CMU) offers the opportunity to open up new non-bank sources of investment and increase resilience to shocks. The CMU is however fundamentally different from the BU, being more about creating new activities and funding channels than about regulating and supervising existing ones. Nor is it confined to the euro area, but to the wider EU and beyond.

The role of the EU's partners

In our view both the BU and CMU are best conceived, developed, and implemented in conjunction with key countries outside of the EU – as interlocutors, contributors, and partners. These countries are an important source of demand for the EU's products, and they are deep repositories of capital and technical expertise.

External partners contribute significantly to EU economic activity and welfare, bringing both direct and indirect benefits through trade, financial, and other linkages. About 40% of the EU Member States' goods exports and 45% of their services exports go outside the 28-country bloc. A small number of key partner countries are disproportionately important: The top three non-EU export destinations for both goods and services are the United States, Switzerland, and China. Non-EU countries are also significant sources of Foreign Direct Investment (FDI) into the EU. One-third of the bloc's FDI comes from outside the EU, with the United States and Switzerland being the two main sources.

It is thus in the EU's self-interest to succeed both with its own internal policy agenda and with those initiatives that strengthen its relationship with partner countries. Success in these two areas will jointly contribute to improved economic performance, while also doing much to reduce the risk of further fragmentation. This Discussion Paper brings out the basic data and analysis which underpin the importance of cooperation beyond the EU, and presents a range of policy recommendations to maximise the benefits this cooperation can bring.

Within Europe, the EU has led by example at showing what can be achieved through cross-border cooperation. The EU's institutions are to be congratulated for this. On a global level, however, such cooperation has proven more difficult, and there are a number of challenges to overcome.

Global challenges

The world economic and financial system has not yet returned to full health. Seven years on from one of the biggest financial crises in history, the world economy remains in a fragile state. The post-crisis healing process, outside the United States at least, is far from complete, while history shows that recoveries from such events are replete with risk.

Social pressures from an extended squeeze on living standards, and the loss of previously-perceived certainties on the part of disenchanted electorates, are creating a disposition to domestic, even autarkic, solutions, and a weakening of co-operation and multilateralism. Economically, and particularly in financial markets, there has been a retrenchment and tendency to think nationally first:

- **Trade barriers have been escalating** – more than 3,800 new impediments have been erected since 2008, with the EU27 as the worst offender with 510 discriminatory measures [1], ranging from anti-dumping investigations to increases in tariffs, subsidies, export incentives, and new rules on domestic content and government procurement. Agriculture, iron and steel, chemicals, autos, and telecoms have been the sectors most affected.

  "There have been three phases of crisis-era protectionism: a surge in 2008 and 2009, a fall in the rate of new measures imposed as the prospects for the global economy brightened in 2010 and 2011, and then an acceleration once the slowdown in global growth became apparent in 2012 and beyond." [2]

- **Cross-border capital flows have been shrinking** – from over $12 trillion in 2007 to around $7.5 trillion in 2013 for the banking sector, and there is an escalating home bias in financial activities in general:

  "There has been a well-documented decline in cross-border flows of capital ... such that total annual flows have fallen to around one-third of their size in 2007 ... The fall in ... cross-border lending by banks, has been particularly pronounced ... Data from the Bank for International Settlements (BIS) show that most of the fall in banking flows is likely to have been accounted for by a fall in interbank lending." [3]

- **Financial 'repression' is on the rise.** *Governments everywhere have, albeit for ostensibly worthy motives, increasingly resorted to forms of financial repression - policies that result in savers earning less than the rate of inflation so as to enable banks to provide cheap loans to sovereigns.*

  "... the combination of high public and private debts in the advanced economies (with the attendant pressures towards creating captive audiences for government debt) ... ...and the perceived dangers of currency misalignments ... interact to produce a "home bias" in finance and a resurgence of financial repression. It is not called financial repression but unfolds in the context of macro prudential regulation." [4]

- **Services, including financial services, are regulated by a patchwork of disparate supervisory institutions** and jurisdictions, often moving at different speeds and to some extent in different directions.

- Progress has been made towards a more consistent regulatory framework for the financial sector, in both banking and capital markets, under the auspices of international bodies including the Basel Committee, the Financial Stability Board (FSB), the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO).
- However, the process is far from complete. For instance, the experience with Basel III, with jurisdictions implementing divergent standards, highlights some of the challenges faced at the global level. As an example, third country regimes in the European Markets and Infrastructure Regulation and Dodd-Frank are not wholly compatible.

• **Extraterritoriality.** The tendency towards regulating global businesses nationally, rather than setting global standards, has led to often unintended and detrimental extraterritorial effects.

European context

As noted above, the EU has made considerable progress in recent years on the regulatory reform agenda. The establishment of the Banking Union has been especially impressive, all the more so given that tough economic times - as we have seen at the global level - make cooperation more difficult. Nevertheless, as persistently high unemployment and weak growth imply, structural problems run deep and economic performance is falling short.

Part of the solution will be completing Europe's own internal integration agenda. Much has been achieved since the inauguration of the Single Market. The total stock of EU market capitalisation has increased from €1.3 trillion in 1992, to €8.4 trillion in 2013, while the value of outstanding debt securities exceeded 171 per cent of GDP in 2013 compared with just 74 per cent twenty-years before.

But Europe is far short of having completed the process of financial market integration. Some market segments remain heavily-regulated and under-developed. Compared to the United States and Switzerland, for example, equity markets, as well as private placement markets, are considerably smaller as a percentage of GDP. This obstructs the flow of capital not only within the EU itself, but also between it and its major trading partners, both in the EU's immediate vicinity and more broadly.

Meanwhile, Europe risks becoming increasingly fragmented. Following years of integration, some elements in Europe today are turning inwards and want to reverse the process. The rise of anti-European parties in EU Member States, and the outcome of the immigration referendum in Switzerland a year ago – which we did not agree with – all illustrate this.

The tendency towards introversion runs deep, beyond trade in goods and services, through the labour market and free movement of capital, and well into the financial sector. Financial fragmentation has been particularly evident in cross-border lending and cross-border debt securities holdings. The ECB has observed that:

> *"[The] European economic and financial area appears substantially more segmented along national borders ... and balance sheets exhibit increased home bias, both on the asset and the liability sides.*
>
> *Cross-border interbank lending positions within the Euro area have halved from a peak of over €2,100bn in 2008 [...]"* [5]

Furthermore, the share of cross-border debt securities held by euro area banks (as a percentage of total debt securities) has fallen from 60% to below 40% [6]. That said, recent actions by the ECB may, in part, help to halt or even reverse that process, but the challenges are considerable.

Europe is at a critical juncture

The majority of Europeans and their leaders are determined to resist fragmentation, but there is no room for complacency. A sustainable recovery generating growth and jobs will be an important part of the effort to rebuild the integrationist consensus. No country in Europe, in or outside the EU, can afford to turn its back on open markets and cross-border engagement.

Rather, Europe can actively seek to prosper by taking a more expansive, multilateral approach, keeping markets open, and engaging particularly with major partners. In doing so, the decisions that the EU takes will thus be important not only for Europe and its own internal functioning; they will also be an important signal to Europe's key partners and the rest of the world.

We now turn to the economic and financial markets perspective, and the role the financial services industry can play in a sustained recovery, before looking at the contribution partner economies can make to Europe's economic success.

[#1] The EU's economic and financial market perspectives – trends and challenges

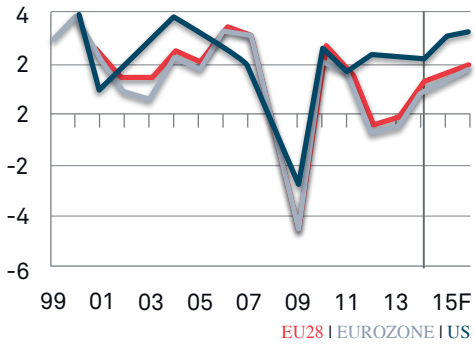
Economic activity

The peak of the crisis seems to have passed, but the euro area is still not in good shape. This has negative implications not only for the EU's 28 Member States (EU28), but also Europe more broadly and even the global economy.

Euro area growth remains weak: following a decline of 0.5% in 2013, real GDP grew by an estimated 0.8% last year, and is anticipated to expand by around 1.2% in 2015 and 1.4% in 2016 (Figure 1) according to recent IMF estimates. But the dispersion among euro area countries is likely to remain significant: while Ireland and Greece may well grow by around 3% by 2016, growth in France and Italy may be only around 1% or a little higher. Growth in the broader EU28 seems likely to be slightly higher than in the euro area – forecasters expect between 1.5% -2% in 2015 and 2016 –clearly lagging expectations for the United States (Figure 2).

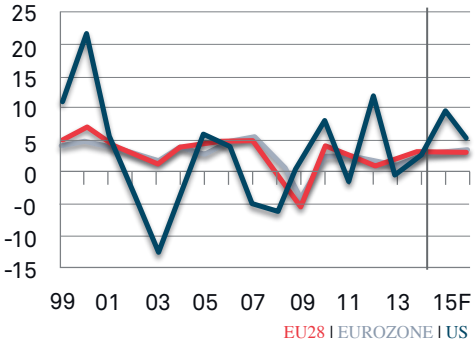
Meanwhile, inflation in Europe remains very low, with the euro area harmonised index of consumer prices (HICP) likely to grow by only around 0.7% in 2015 and 1.3% in 2016 according to the ECB's latest forecasts. The combination of low GDP growth and low inflation means that nominal GDP growth in the euro area, at perhaps 1.6% in 2014, stands to rise by only around 2.3% in 2015 and 3.3% in 2016 – slightly faster than in previous years, but leaving considerable room for improvement (Figure 3). Nominal GDP growth in the broader EU28 is likely to be a bit better, at around 3.5%.

Figure 1: Real GDP growth, %



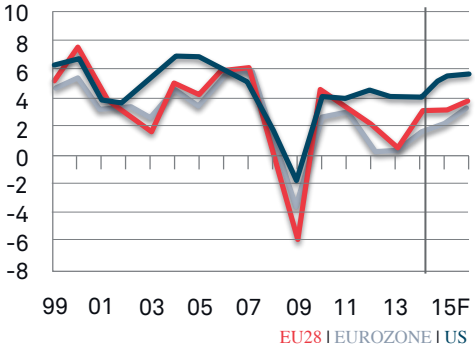
Source: European Commission, Haver

Figure 2: GDP per capita growth, %



Source: European Commission, Haver

Figure 3: Nominal GDP growth, %



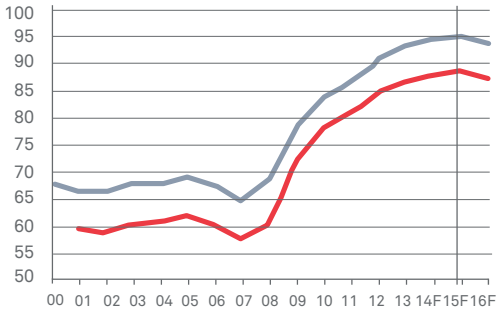
Source: European Commission, Haver

Excessive debt and slow deleveraging are constraining demand

At current rates, growth in Europe is too slow to speed up the process of debt deleveraging in the private and public sectors. Public debt in the euro area probably peaked last year, at 96% of GDP (88% of GDP in the EU28), but the debt burden is likely to decline only very slowly over the coming years (Figure 4). Should growth again fall short of expectations, or should sovereign yields rise from their currently very low levels, debt-to-GDP might well rise further. Moreover, while the aggregate debt stock in the EU is already rather high, the debt burden of some individual countries is much higher still, above all in Greece (175% of GDP in 2014) and Italy (132%), as well as in Portugal and Ireland at 128% and 111% of GDP respectively (Figure 5). In the view of many commentators, the final chapter on the euro area crisis will have been written only once the issue of debt sustainability has been addressed convincingly. In the meantime, new periods of heightened market concern about potentially unsustainable levels of public debt cannot be ruled out.

Europe's overall debt problem is however even bigger, given that in many countries the private sectors are also heavily indebted, and this is limiting the scope of corporates and households to invest, hire more employees and consume. Taken together, the heavy debt burdens of public and private entities in Europe limit the scope for domestic demand growth and hence overall GDP growth (Figure 6).

Figure 4: Government debt, % of GDP

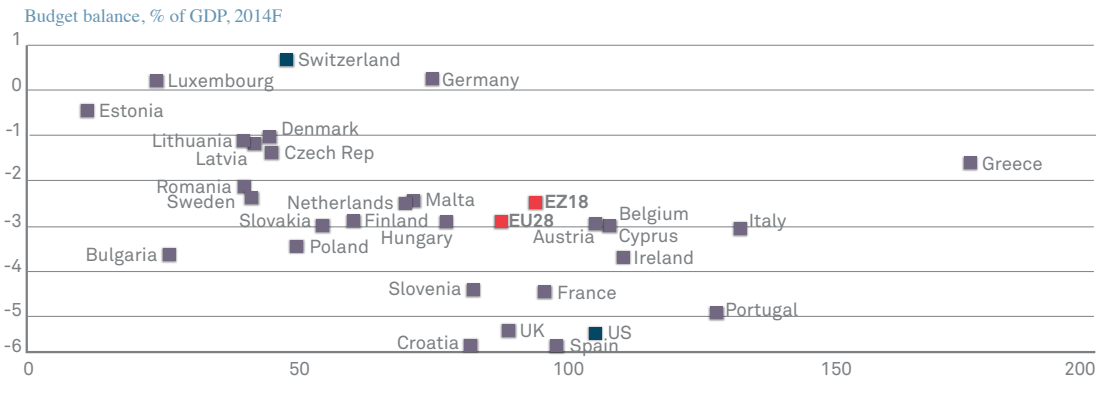


Source: European Commission, Haver

Structurally high unemployment

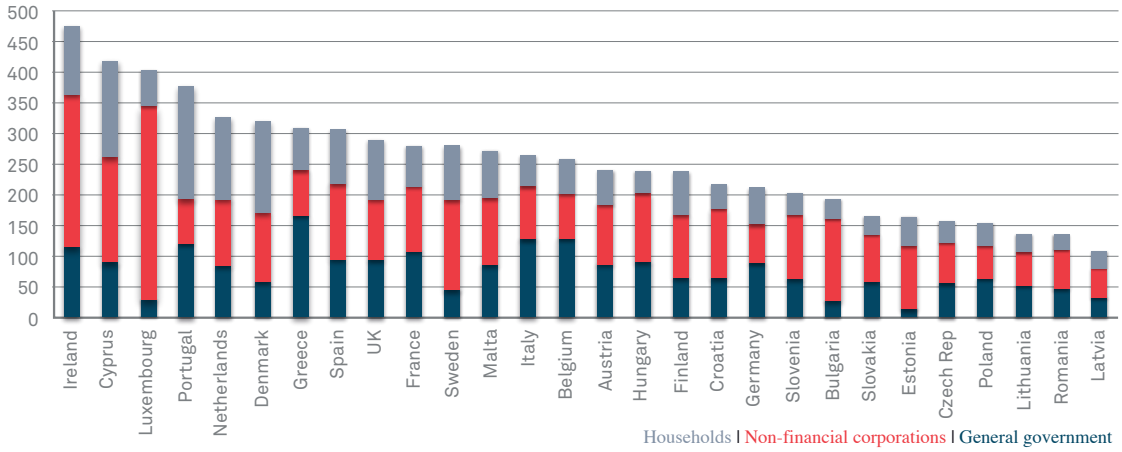
In the absence of significant progress in labour market reform, growth is likely to remain too slow to reduce unemployment significantly. The numbers are troubling: headline unemployment stands at 11.5% in the euro area (10% in the EU28), with national unemployment rates as high as 25.9% in Greece and 24% in Spain (Figure 7).

Figure 5: Budget balance and government debt, % of GDP, 2014



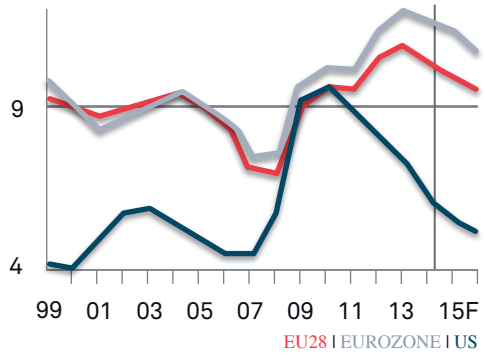
Source: European Commission, IMF, Haver

Figure 6: Total debt in EU28, % of GDP, 2012



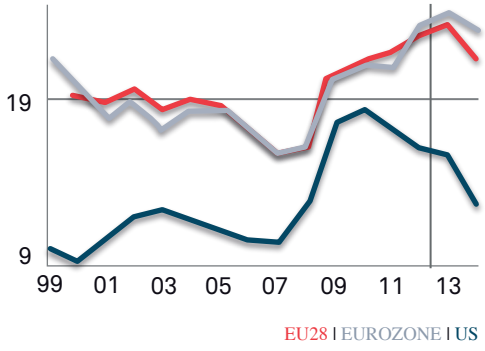
Source: Eurostat

Figure 7: Unemployment rate, %



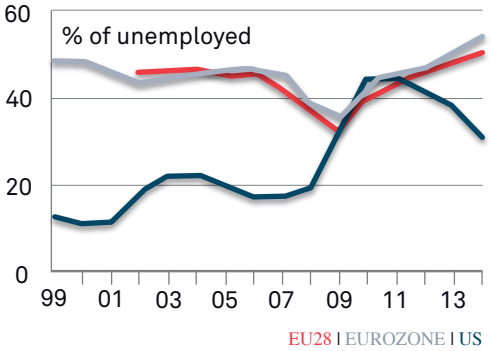
Source: European Commission, Haver

Figure 9: Youth unemployment, %*



Source: Haver
*Note: *Under 25 years old.*

Figure 8: Long-term unemployment*



Source: Haver
**European data defines long-term unemployment as 12 months and over, whereas the USA defines it as over 27 weeks.*

Furthermore, a significant proportion of the total consists of the long-term unemployed (out of work for 12 months or more), who risk dropping out of the labour market altogether.

Perhaps even more disturbing, the rate of youth unemployment (below the age of 25) is very high, at 23.5% in the euro area (21.6% in the EU28), and as high as 53.7%, 49.3% and 42.9% in Spain, Greece, and Italy, respectively, as illustrated by figures 8 and 9.

Europe is facing an economic, social, and political crisis

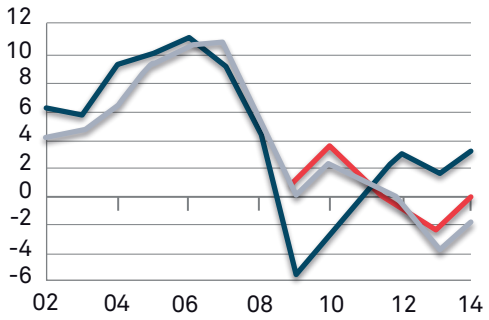
Parts of Europe are thus facing not only an *economic*, but also a social crisis, – and both combined could easily turn into a *political* crisis. The warning signs are already evident: populist parties of the far-right and far-left are enjoying growing support, as evidenced by the recent election in Greece, and many of those parties are opposed to immigration and sceptical about open foreign trade and international capital flows [7]. Rising political discontent could easily challenge what has arguably been the biggest achievement of the EU's integration efforts in recent decades: the European Single Market, based on the free movement of goods, services, capital, and labour.

Financial markets and banking

Problems in the banking sector tend to produce greater economic fallout in Europe than in the United States

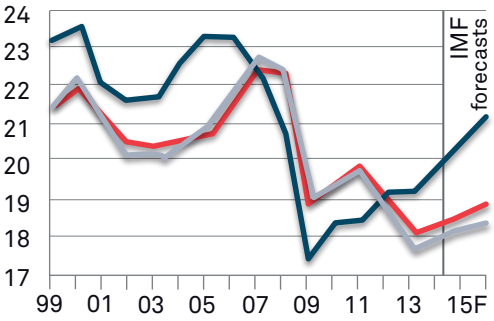
The global financial crisis and the subsequent sovereign debt crisis in Europe have created substantial challenges to the European banking sector, particularly in countries of the European periphery. The resulting economic damage was substantial, not least because the banking system is the main provider of capital to the private sector in Europe. In the United States, by contrast, the dominant source of corporate funding is the capital markets. This implies that, all else equal, problems in the banking sector tend to produce greater economic fallout in Europe than in the United States. Indeed, Europe has lagged the United States not only in terms of credit growth, but also investment, and – ultimately – the growth of potential output, as shown by figures 10 to 12.

Figure 10: Credit growth, %



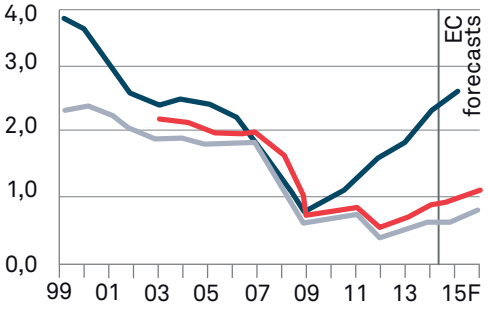
Source: Haver

Figure 11: Investment, % of GDP



Source: IMF, Haver

Figure 12: Potential GDP growth, %



Source: European Commission, Haver

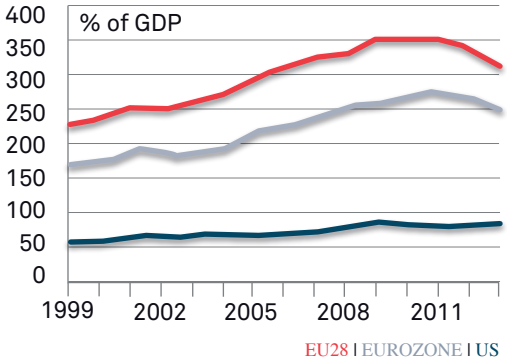
Significant efforts are under way to establish a pan-European framework for banking supervision and resolution

To break the "vicious circle" between banks and sovereigns – a situation where banking problems undermine public finances while sovereign debt problems increase the banks' funding costs – EU leaders pledged in 2012 to create a Banking Union, which would establish a pan-European framework for banking supervision and resolution. These efforts have already made significant progress: the Single Supervisory Mechanism (SSM), which has established the ECB as the dominant regulator of euro area banks, was launched on 4 November 2014. Building on the regime established in the Banking Recovery and Resolution Directive, a Single Resolution Mechanism and Resolution Fund to deal with failing banks will be launched in 2016, with the aim of putting less of the burden of future banking sector problems on the taxpayer, and correspondingly more on the banks' shareholders and creditors (see below box for an overview of recent regulatory developments in the EU).

However, while this is significant progress – indeed, unimaginable only a few years ago – there is more to do. As Mark Carney, Governor of the Bank of England and Chairman of the FSB has recently said of the euro area, "for complete solutions to current and potential future problems the sharing of fiscal risks is required."

In preparation for the SSM, the ECB has conducted a comprehensive assessment of euro area banks, comprising an asset quality review and stress test – the results of which were released in late October 2014. Banks that failed the test under the adverse scenario were given up to nine months – i.e. until Q3 this year – to bring their capitalisation up to required levels. Nevertheless, for reasons related both to supply and demand, credit growth seems likely to pick up only gradually.

Figure 13: Banking sector assets



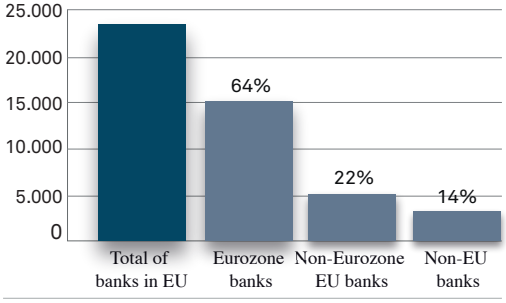
Source: European Commission, Haver

Financial institutions from outside the EU play an important role

Figure 14 shows the composition of bank lending in the EU by euro area and non-euro area banks. To the extent that there are different regulatory requirements on each types of bank, this will have broader implications for the provision and cost of credit within the euro area.

While the provision of credit to European firms and corporates is dominated by European financial institutions, non-EU institutions nevertheless provide a significant proportion of the total, arguably with a potential to provide an even bigger share in the future.

Figure 14: Bank loans in the EU
Eurozone vs non-Eurozone banks



Source: ECB consolidated banking data

BOX Key regulatory developments for the European Banking Sector

Changing regulatory requirements have been an important driver of structural change for the banking industry and, while there has been broad support from the financial industry to sensible regulatory tightening, it has also led to a need to reassess business models and corporate strategies in order to deliver returns that shareholders consider appropriate. Moreover, the scale of the change has been significant: according to FSB Chairman Mark Carney, since 2008, effective bank capital requirements have increased seven-fold [8].

These and other regulatory reforms have had a large impact on the pricing of financial services such as loans for corporations (particularly SMEs) and infrastructure projects. At the same time, the regulatory tightening continues, as summarised below.

Risk-weighted Capital

Following substantial adjustments to the risk-weighting of assets, the quality of eligible capital and the required risk-weighted capital ratio, the risk-based capital framework is still under pressure. There is pressure from various regulatory bodies (IMF, Basel Committee on Banking Supervision, Central Banks, and Prudential Regulatory Authorities) to review and adjust risk-weighted asset (RWA) calculations, including the use of standardised models as floors for international ratings based (IRB) banks.

Upward pressure on RWA calculations remains for operational, credit, and market risks. It would therefore appear that structural pressures on business models across the financial industry will continue. In order to keep overall RWA flat or limit the increase, we judge that, across the industry, banks could be obliged to convert productive RWA into non-productive RWA if overall levels of risk assets are to remain unchanged [9]. Furthermore, stress tests by region as a frequently-used supervisory tool are likely to become an unpredictable bottleneck for cash return to shareholders and growth plans. Not only are the balance sheet and the capital positions stressed, additional requirements to comply with processes and organisational set-ups in host countries limit banks' efficiency and add to fragmentation.

At the same time, the EU's capital framework deviates significantly from agreed global standards. In late 2014, the Basel Committee assessed the EU's implementation of the Basel framework of the nine EU Member States that are members of the BCBS as "materially non-compliant". Of the specific components assessed in the EU, the IRB approach for credit risk was rated as "materially non-compliant", primarily due to the treatment of exposures to SMEs, corporates and sovereigns. The EU counterparty credit risk framework was found to be "non-compliant" because of the exemption from the Basel framework's credit valuation adjustment (CVA) capital charge for certain derivatives exposures [10].

Leverage Ratios

Regulators have also called for the role of leverage ratios to evolve. As well as capital requirements based on risk-weighted asset calculations, regulators want leverage ratios to play a stronger role in the capital framework, with a ratio of total leverage exposure to T1 Capital of at least 3%, although this ratio is expected to increase over time.

The UK leverage ratio framework presented in the autumn of 2014 foresees a maximum leverage ratio requirement of 4.95% (based on CET and T1) for large banks [11], which is comparable to the Swiss figure of roughly 4.5%. United States banks/banks holding holding companies must operate with ratios of between 5 and 6% by 2018. But, owing to differences in capital market as well as mortgage market structures, leverage ratio requirements, and especially their impact on the

supply of credit to the respective economies, are not comparable. In the US, for example, mortgages are predominantly securitised with the support of the government-sponsored enterprises (GSEs) while similar mortgages in Europe tend to be kept on banks' balance sheets.

Implications for the pricing of financial services

Today's macroeconomic situation and increased regulatory requirements have produced a challenging environment for financial services. According to the 2014 EU comprehensive assessment and the ECB's asset quality review, the EU banking sector's profitability is very weak and stressed by additional capital requirements [12].

For many banks it is hard even to meet capital costs. For example, only 6% of German banks met their capital costs, and their average total return in 2013 was a mere 0.06% [13]. However, over the medium term the additional burden of the increased regulatory requirements will be transferred to customers. That is to say, the price of banking services will increase, and this could have a negative impact on the real economy and the banking sector. Cost adjusted pricing could result in higher non-performing loans and defaults, or a significant decrease in the demand for loans. Moreover, increased transparency requirements no longer allow cross subsidising or bundling of products [14], meaning each banking product will have to be priced relative to its costs.

Financial Transaction Taxes

A Financial Transaction Tax (FTT) has already been implemented in Italy and France, and discussions continue about its broader EU implementation. There remains a variety of points of debate, including the scope of the tax. Overall, an FTT would further widen spreads and reduce liquidity already under strain from the pressures on banks from new regulations. Selective application of the tax could also generate asset price distortions (e.g. between equity and subordinated debt instruments, and potentially displace activity to outside of the FTT area.).

A FTT has potential impacts that extend across the banking sector and deep into the financial markets and thereby the users of financial services, including SMEs and pension funds. The policy, therefore, ought to be re-evaluated in the context of the proposed Capital Markets Union (CMU).

Structural Reforms

A number of European countries are seeking to implement programmes of reform in other areas of their banking sectors, including the UK, France, and Germany. Furthermore, in January 2014 the European Commission published its own proposals for such initiatives, building on the October 2012 "Liikanen Report". One key element is to give supervisors the power to require banks to separate certain activities from their deposit-taking business. However, if the new regime fails clearly to differentiate between proprietary trading and market-making, the latter, which has many benefits for all market participants, may be undermined.

The case for the Capital Markets Union to assist the recovery

For many reasons, it makes sense to diversify the funding base through the completion of the EU's internal market in capital. We therefore very much welcome the initiative to create a Capital Markets Union (CMU), and the European Commission's consultation.

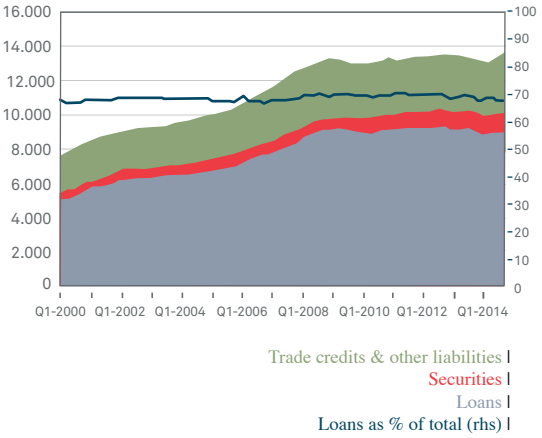
The sluggishness of the healing of the banking sector suggests that Europe will remain under pressure to develop alternative sources of funding to complement bank lending, and thereby speed up the cyclical recovery. However, more is needed beyond that: Europe needs to increase the efficiency of its capital markets by improving the structural fundamentals for future growth. This is the key aim of the planned CMU which is likely to become one of the biggest project of the European Union over the coming years.

ECB Executive Board member Yves Mersch put it pointedly when he said: *"[T]he euro area economy is like a plane flying only on one engine: bank financing. To increase the speed and stability of the plane, it would be good to add a second engine: capital markets financing."* [15]

Alternatively, as Jonathan Hill remarked in one of his first speeches as EU Commissioner: *"Mid-sized companies in the United States have roughly five times as much funding from capital markets as their counterparts in the EU"* [16]. As illustrated by figures 15 and 16, bank loans in the euro area constitute approximately 70% of total funding, whereas they constitute less than 30% in the United States.

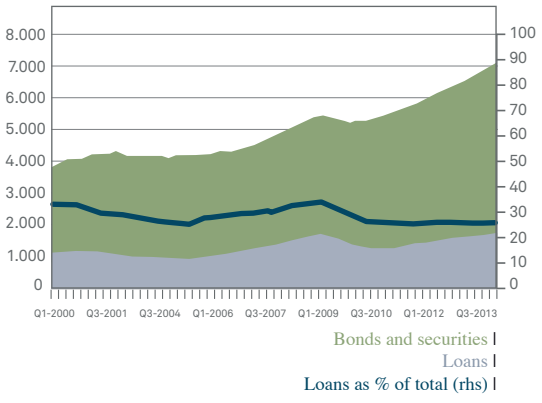
This is one of the reasons why the ECB, in cooperation with other European central banks, above all the Bank of England, is now trying to reinvigorate the securities markets, with a special focus on asset-backed securities, as well as relaxing the pressure on Banks' balance sheets through its recent announcement on quantitative easing [17].

Figure 15: Corporate borrowing in the euro area, €b



Source: Haver

Figure 16: Corporate borrowing in the US, $bn



Source: Haver

Looking for new, alternative, sources of funding, particularly for SMEs

The heavy reliance on bank funding is causing severe economic damage in Europe, especially for SMEs which contribute almost 60% of value added

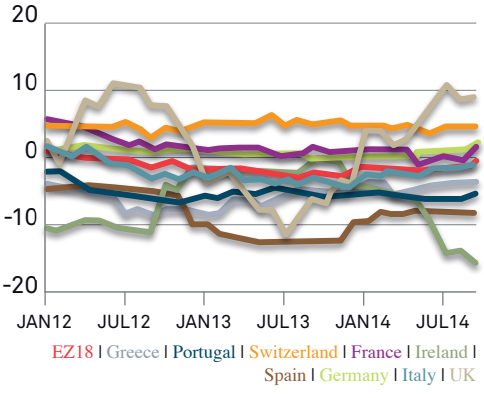
and two-thirds of employment, as shown by figure 17. In addition, SMEs play a particularly important role in the EU periphery, where banks were affected most severely during the crisis. In Europe, unlike the United States, securitisation is often thought of as a funding vehicle for large corporates. However, the United States demonstrates that SMEs can have access to the capital markets as well, if the appropriate institutional set-up is in place.

Data from the European Capital Markets Institute shows the significant growth in European capital markets since the inception of the Single Market over twenty years ago.

Figure 17: The role of SMEs in the European economy

Source: European Commission

Figure 18: Private sector credit growth, % y/y



Source: Haver

The combined stock of EU market capitalisation, for example, amounted to €8.4 trillion (around 65% of GDP) by end 2013, compared to €1.3 trillion in 1992 (22% of GDP). The total value of outstanding debt securities exceeded €22.3 trillion (171% of GDP) in 2013, compared to €4.7 trillion (74% of GDP) in 1992.

More efficient capital markets to support longer-term growth

The CMU is an opportunity to further strengthen the Single Market. However, despite the progress highlighted above, Europe's capital markets are still fragmented. Europe's challenge involves more than creating alternatives to bank lending to fund the recovery. It needs to make the structure of the financial system more competitive and efficient – and ultimately more growth-friendly.

To quote Commissioner Hill:

"*The situation at the moment is one of dis-unity; of fragmentation. Shareholders and buyers of corporate debt rarely go beyond their national borders when they invest. Savings are essentially compartmentalised in Member States, and are too concentrated in the banking system. This is holding back the size and depth of capital markets, making it difficult for investors to diversify. There are a number of reasons for this fragmentation. There are differing rules, documentation and market practices for products like securitised instruments, private placements or crowd-funding. There is the tax element, with a strong bias against equity and in favour of both corporate debt and mortgage debt. The national nature of insolvency law is another feature. And investors don't have access to comparable information on smaller businesses to assess the risk of investing across countries.*" [18]

Defining the Capital Markets Union

At this stage, the exact breadth and depth of the future Capital Markets Union – and the resulting policy action to be taken over the coming years – are still under discussion. The Commission is initiating a consultation process with the aim of developing an 'action plan' by the summer.

However, a few things already seem clear:

- Firstly, whereas the Banking Union focused on the euro area banking sector, the Capital Markets Union will focus more on the non-bank part of Europe's financial system, with the aim of developing a more diverse, competitive, and resilient financial system. [19]
- Second, while the Banking Union is essentially a project for the euro area members, albeit with an option for non-members to join, the Capital Markets Union will be a much broader European project, covering all Member States and potentially beyond.
- Third, the CMU will arguably be no less complex than the Banking Union, as it affects an even more diverse area of (nationally-dominated) legislation. National differences in the following areas have been frequently mentioned as factors standing in the way of a more integrated financial market in Europe: contract law, insolvency law, taxation, consumer protection, and payments and security settlement systems.

Against this background, it is no surprise that Commissioner Hill has called the CMU a "long-term project".

A comprehensive list of policy actions that the CMU would span still needs to be established.

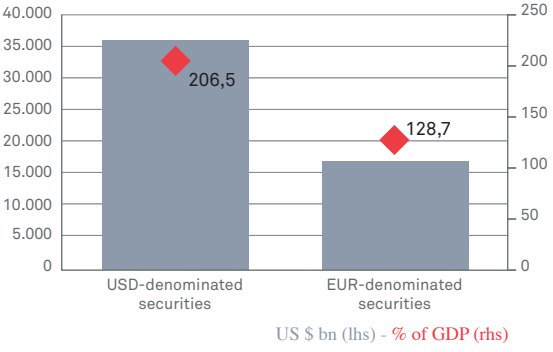
At this stage, however, we understand the Commission has identified five key principles upon which the CMU will be based:

1. It should maximise the benefits of of capital markets for the economy, growth and jobs;
2. It should be built on firm foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced;
3. It should create a single market for capital for all 28 Member States by removing barriers to cross-border investment within the EU;
4. It should ensure an effective level of consumer and investor protection, and
5. It should help attract investment from all over the world and enhance EU competitiveness.

Truly integrated European capital markets would have large upside potential

The upside of truly integrated capital markets in Europe could be significant. Precise quantification of the potential gains naturally is difficult, but a comparison of European and US capital markets is suggestive.

Figure 19: USA versus Europe debt securities



Source: Markit, iBoxx, SIFMA

With regard to the debt securities, the United States capital markets are more than a third bigger than European markets, at an estimated 206.5% of GDP against 128.7% of GDP in Europe (2014). In this respect, figure 19 is illustrative of the potential for growth of Europe's capital market.

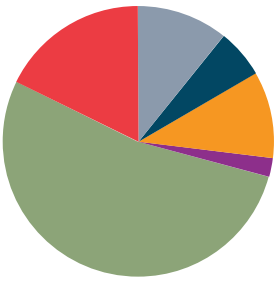
European corporate bond funding's potential

There are fundamental differences between the EU and the United States in terms of capital structure in general and for corporate debt funding in particular, as clearly shown by figures 20 and 21.

The issuance of corporate bonds (including HY) accounts for 22% of the total debt in the United States, whereas it accounts for approximately 12% in Europe. This illustrates that the issuance of corporate bonds in the United States far exceeds that in Europe, both on absolute and relative terms to GDP as highlighted by Figures 22 and 23.

United States capital markets are not just larger, they are also more liquid; and

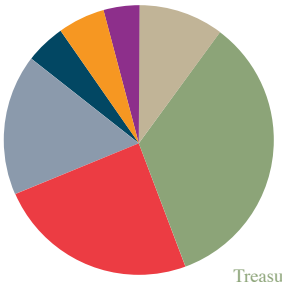
Figure 20: Breakdown of European debt securities



Sovereign bonds (53%) I Subsovereign bonds (18%) I
ABS (11%) I Covered bonds (6%) I
IG Corporate bonds (10%) I HY Corporate Bonds (2%) I

Source: Markit, iBoxx

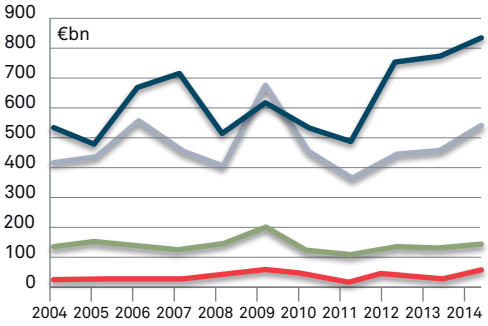
Figure 21: Breakdown of USA debt securities



Treasury (34%) I
Mortgage related (24%) I Municipal (10%) I
IG Corporate bonds (17%) I HY Corporate bonds (6%) I
Federal Agency securities (6%) I ABS (4%) I

Source: SIFMA

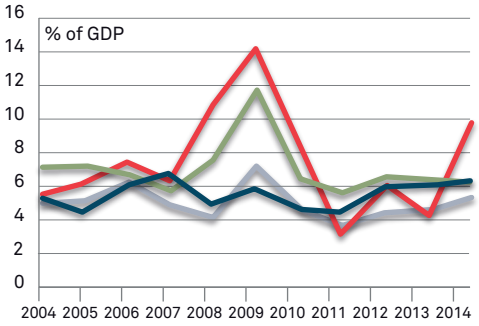
Figure 22: Corporate debt issuance by country of domicile



Switzerland I Eurozone I US I UK

Source: Dealogic. Note: Data inclues both IG and HY corporates (including financials) across EUR, USD and GBP - all converted back to euros.

Figure 23: Corporate debt issuance by country of domicile



Switzerland I Eurozone I US I UK

Source: Dealogic. Note: Data inclues both IG and HY corporates (including financials) across EUR, USD and GBP - all converted back to euros.

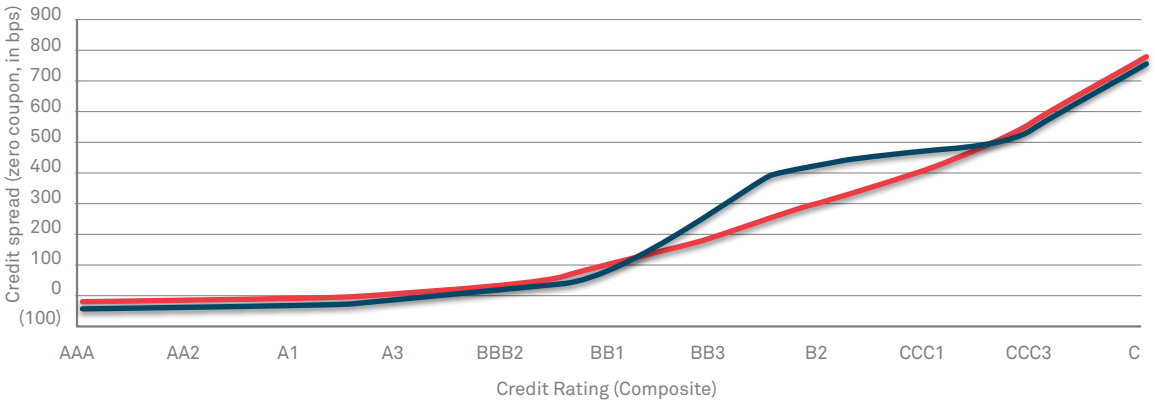
this should, all other things being equal, affect liquidity premia, and hence credit spreads.

In other words, United States companies should have cheaper access to funding than do European corporates [20]. Our analysis in figure 24 suggests that the funding advantage exists particularly for corporates in the lower credit spectrum (B to CCC).

European equity market's potential

Equity capital markets in the United States are also deeper than in Europe. Market capitalisation in the United States, at 92% of GDP, is much higher than in the euro area (42%), as shown by figure 25. The IPO market too is generally more vibrant in the United States than in Europe – although 2014 was an exception, several years of low activity being followed by a lot of European companies being floated in the markets (figure 26).

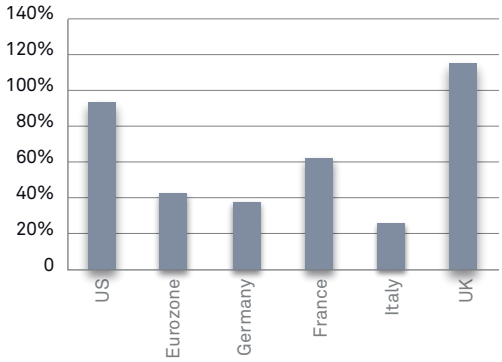
Figure 24: Industrial Credit Spreads by Region (5yr maturity)



Europe ex UK | United states |

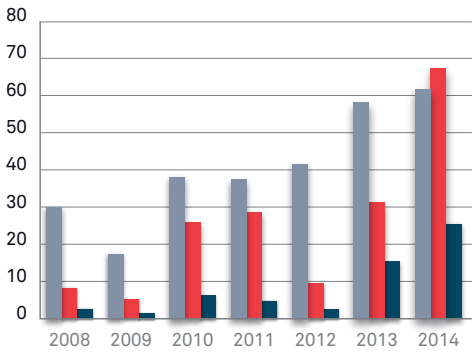
Source: UBS Delta, 5 Jan 2015

Figure 25: Equity market capitalisation, % of GDP



Source: Datastream, Haver
Note: 5-year average

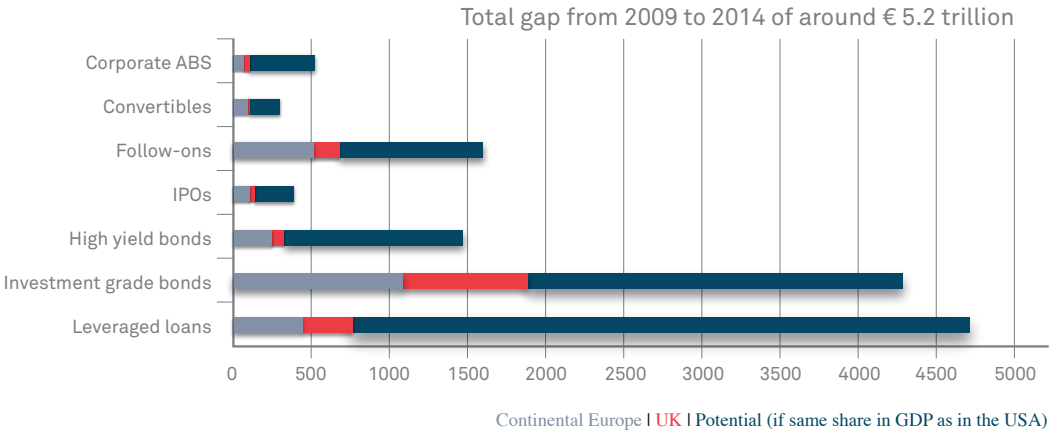
Figure 26: IPO deal value, $bn



US | Europe | UK |

Source: Dealogic

Figure 27: Size of European capital market new issuance versus their potential, 2009-2014, €bn



Source: Wright, W. (2014), Dealogic, National Statistical Offices. Note: Continental Europe includes the EU, Switzerland, Norway and Iceland.

As a conclusion, the potential of Europe's capital markets is huge

As illustrated above, the potential of European capital markets is huge. Had European capital market issuance between 2009 and 2014 been similar as a proportion of GDP as in the United States, it would have been more than double its actual size, i.e. €9 trillion instead of €4 trillion (Figure 27). The biggest potential is in the leveraged-loan segment, corporate ABS, and high yield bond markets. While the difference in capital market depth may have been further increased by the earlier adoption of a more active stimulus by the United States Federal Reserve compared with the European Central Bank after the crisis, the gap is undoubtedly significant, especially with regard to securitisation markets.
To conclude, then, there is huge unrealised potential in further opening up Europe's capital markets and facilitating investment.

However, the CMU is not envisaged as an EU project only. The inclusion of partner countries within Europe, such as Norway or Switzerland, and beyond could additionally enhance capital market depth. Therefore, it is crucial to keep markets open. As we will demonstrate in the next chapter, close economic and financial ties between the EU and its partner countries already have had a positive impact on the EU's growth and job creation. Transferring this fruitful relationship to a stronger collaboration in the capital market and financial sector areas has the potential to provide further benefits.

[#2] The contribution of the EU's major partners to its growth and jobs agenda

The benefits of open markets

The importance of international trade and capital flows to economic welfare has long been recognised [21]. The desire to reap these benefits was one of the most important drivers behind efforts at the global level to liberalise trade and capital movements through the successive tariff-reducing rounds conducted by the GATT and then the WTO pursuant to the Bretton Woods arrangements. At the regional level, the creation and then deepening of the EU's Single Market is certainly one of the most obvious examples.

This basic policy framework is widely credited with having contributed to the unprecedented growth in output, living standards, and welfare more generally in many parts of the world, including in Europe. Given the described challenges but also opportunities, such as the Capital Markets Union (CMU), the EU is confronted with, it is crucial to defend the openness of markets to trade and investment. This chapter considers a range of evidence in respect of what role the EU's partner countries can play. The broad conclusion is that the whole of Europe stands to benefit from further integration, both within the EU itself, and with respect to key partners outside the union.

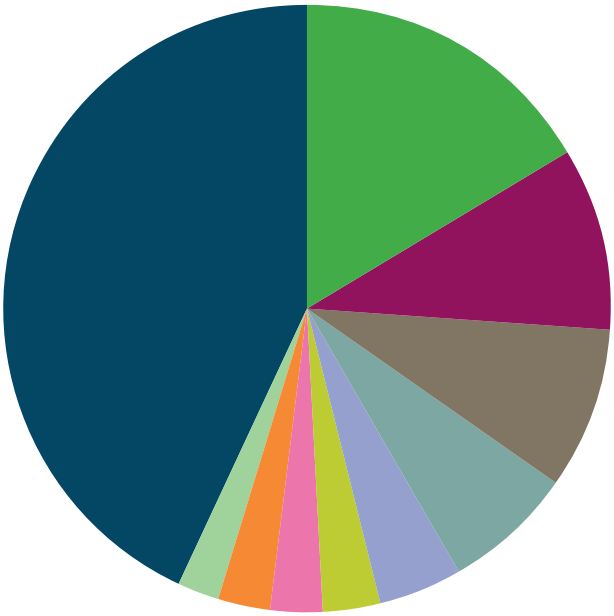
The EU countries' principal trading partners

Not surprisingly, the EU countries' main trading partners are other EU economies: 'intra-trade' in goods accounts for around 60% of total goods exports of the EU28. In 2013, the total value of intra-trade was more than €4.5 trillion. Beyond the EU, the largest destinations for exports of goods are the US, Switzerland, and China. Given its size and wealth, the most important of the non-EU export destinations is the United States: goods to the value of €290 billion were shipped to the United States in 2013, representing some 17% of all extra-EU exports (Figure 28).

It is more surprising that the runner-up is Switzerland, given that in GDP terms it is 25 times smaller than the US. The key drivers of this close trade integration are Switzerland's geographical proximity to major EU markets, as well as the shared languages, cultural affinities, and political ties which together have supported a long history of economic integration and trade relations. These ties have deepened further since the Free Trade Agreement between Switzerland and the EU was concluded in 1972, with the integration of parts of industry into joint supply chains - Swiss SMEs, for example, are an important supplier of the European motor industry. By 2013, EU goods exports to Switzerland totalled €170 billion, some 10% of the extra-EU total, and only €30 billion less than Italy's imports from the other 27 EU Member States.

As destinations for extra-EU exports, Switzerland is closely followed by China (9%) and then by Russia (7%). Figure 29 illustrates graphically the significance of this relationship. The scale used in this map is not geographical size, but importance as an export destination for the EU (areas in Figure 29 correspond to shares of exports in 2013).

Figure 28: Destination of EU goods exports (% of total)



USA (16.6%) I Switzerland (9.8%) I China (8.5%) I Russia (6.9%) I Turkey (4.5%)
Japan (3.1%) I Norway (2.9%) I U.A. Emirates (2.6%) I Brazil (2.3%) I Others (42.8%)

Source: Eurostat (2013)

Figure 29: The world scaled to EU export destinations

Source: Eurostat (2013), Credit Suisse

Neither the ranking of countries nor the relative distribution change significantly when we study trade in services rather than goods. Of total services exports of €684.4 billion, 55% were directed to EU28 Member States in 2013. The United States imported services worth €160 billion (23% of extra-EU service exports) followed by Switzerland with €83 billion (12%). China (including Hong Kong) and Russia imported 6% and 4%, respectively, as shown by Figure 30.

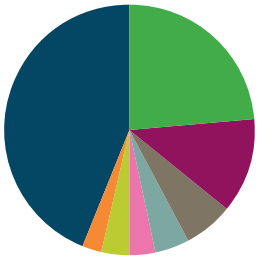
The large weight of EU services exports to Switzerland is particularly interesting since "transportation costs" for services are low, and geographical proximity should therefore be a less important factor. Moreover, Switzerland and the EU have only partial agreements on the free trade of services. While air traffic and transportation are covered in detail, mutual access to the financial markets is not fully liberalized. Nevertheless, cross-border trade in financial services, professional services, transportation and tourism, to name just a few, is intense.

The EU as a significant destination for FDI

Foreign direct investment (FDI) is the lubricant of regional and global integration. For companies with international ambitions, it is central. For countries, too, the ability to attract investment is an important indicator and determinant of their competitiveness. The global stock of FDI at the end of 2013 was around €19.3 trillion. The bulk of this was between OECD countries, with the EU28 the leading FDI destination (€6.5 trillion), followed by the United States (€3.7 trillion).

Two-thirds of all cross-border FDI in the EU27 (bilateral FDI data for Croatia was not available at the time of writing) originates from another Member State of the EU – a reflection of the integrative force of the EU's Single Market.

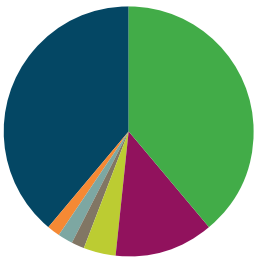
Figure 30: Destination of EU services exports (% of total)



USA (23.2%) I Switzerland (12.1%) I China (6.3%) I Russia (4.2%) I Norway (3.4%) I Japan (3.4%) I Singapore 2012 (2.4%) I Others (45%) I

Source: UN Service Trade (2013)

Figure 31: FDI imports from non-EU partners (% of total)



USA (38.9%) I Switzerland (12.8%) I Japan (4.1%) I China (1.9%) I Russia (1.9%) I Singapore (1.7%) I Others (38.6%) I

Source: Eurostat (2013)

The distribution of FDI across EU27 Member States is similar to that of trade flows. This is not surprising given that intensive trade, especially of an intra-industry nature, tends to boost FDI flows. Other factors that intensify relationships between countries, such as sharing a language or other political, cultural, and legal affinities have also been shown to facilitate FDI. This, along with its openness to trade and investment, explains why Switzerland is the second largest investor in the EU after the United States,

as illustrated by Figure 31, with FDI into the EU27 worth €505 billion; next comes Japan with €161 billion.

Economic gains from strengthened cooperation

Close political ties pave the way for fruitful trade relationships

The influence of politics and institutional ties on the volume of trade can be demonstrated by means of a 'gravity' model, which seeks to account for the size of trade flows by principal economic factors, such as market size, transport distance, or shared borders. The basic model can be enriched by including political variables, as well as variables for intra-EU trade and the general openness of the importing country.

Such a model was employed using data from 3,476 observed export flows from 18 OECD countries, as well as Brazil, China, Russia and Singapore from 2002 to 2012 [22]. The results suggest that the following are major influences:

- **Market size:** a 1% increase in the gross domestic product of an importing economy typically leads to its imports from its trading partners increasing significantly – by around 0.8%.
- **Geographic distance:** the greater the distance (taken for simplicity as the distance between the capitals of respective countries) the smaller, ceteris paribus, will be the trade flows between the two economies. On average, 1% greater distance is associated with 0.7% lower exports.
- **Borders:** if a country is contiguous with a trading partner, exports to that country are typically around 60% or thereabouts higher than they would otherwise have been.
- **Openness and political integration or association:** the more open a country is to trade (openness being measured as the ratio of the sum of exports and imports to GDP) – the higher the exports to that country tend to be. Yet, political ties which determine trade policies matter a lot: If both trading partners are part of the EU-28, exports are 52% higher than would be the case otherwise.

That these influences on trade are quantitatively so large suggests that strengthening political ties, for example between the EU and non-EU countries and other large trade areas, would stand to produce large trade-promoting effects. It thus makes economic sense for the EU to establish ties that are as close as possible with economically large countries - such as the United States – by means of the proposed free trade agreement (Transatlantic Trade and Investment Partnership, or TTIP) see box -, as well as with proximate, very open, economies in Europe, such as Switzerland and Norway.

In the case of Switzerland, a study by König and Ohr casts further light on the strength of the existing links between it and the EU [23]. Combining measures for the intensity of trade and investment ties, the similarity in economic cycles, and the convergence in economic variables (e.g. interest rates and per capita income), the authors construct a weighted index of integration with the EU. On this basis Switzerland ranked seventh in 2012 in the EU25 integration ranking, just behind France, Germany, and the Netherlands. And in respect solely of the intensity of trade and investment ties, Switzerland ranked third.

Non-EU countries as stabilizers in hard times

The increasing integration amongst the EU28 countries, and the resulting increases in trade between them, has already brought considerable "gains from trade." Although difficult to quantify, these include gains from exploiting natu-

BOX Switzerland's close ties to the EU face tough challenges

Economic Linkages

Economic linkages between Switzerland and the EU are close. Notwithstanding its small size, Switzerland is the EU's second biggest external trading partner, slightly ahead of China. Switzerland imported goods from the EU worth €170 billion in 2013. This is equivalent to three-quarters of Swiss goods imports. Switzerland imports more goods from the EU than it exports to it, posting a record bilateral trade deficit of €75 billion in 2013.

The intensity of the relationship between the two economies is also manifest in their growth and trade dynamics. It would appear, for example, that Swiss demand for EU goods increases by almost three and a half percent for each percentage point of additional growth of Swiss GDP. The sensitivity of Swiss exports to EU growth rates used to be somewhat smaller: before 2004, a one percentage point increase in EU GDP growth led to an increase in Swiss exports to the EU by two percent. Since 2004, however - two years after the first set of bilateral agreements came into force - Swiss exports to the EU have risen by three percent for every percentage point increase in the EU GDP growth rate. This shows how both sides can benefit from and reinforce growth in each other's economy, and suggests that abandoning the bilateral treaties poses a major risks to Swiss and EU exporters.

The Swiss National Bank (SNB) recently abandoned the minimum exchange rate of the Swiss Franc vis-à-vis the euro, which had been set at CHF 1.20 per euro (0.83 euro per CHF) since September 2011. Unsurprisingly, the Swiss Franc has appreciated sharply against all currencies – at the time of writing, it is trading close to parity against the euro. The stronger franc is likely to slow growth in Switzerland and thereby partly offset the positive effect on demand for imports from the EU. Yet, unless Switzerland falls into an extended recession, which seems unlikely given the domestic economic strength and the potential for fiscal counter-measures, the impact need not be only negative, as Swiss exporters are forced to adapt.

The EU-Swiss relationship is also tightly knit with respect to FDI. According to 2013 data, Swiss FDI into the EU amounted to €567 billion (3% of EU GDP), 43% of total Swiss foreign direct investment. Swiss companies employed 1,143,000 people in the EU, some 39% of all jobs at Swiss companies abroad, and 0.5% of all jobs in the EU. Conversely, EU companies made €674 billion of direct investments in Switzerland, and employed 229,000 people (5% of total employment in Switzerland)[24]. However, approximately half of this FDI stock originated in the US, and only passed through the EU, in particular the Netherlands, where many subsidiaries of United States companies are registered.

The ties between Switzerland and the EU extend also to other areas covered by the bilateral treaties, in particular air traffic and land transport, as well as public procurement, technical obstacles to trade, research and education among others. The economic benefits of all these bonds seem obvious, and although an allocation of benefits to the two "sides" is hard to quantify, it is clear that the EU runs a significant trade surplus with Switzerland,

and that Swiss companies are important employers in the EU, creating almost five jobs in the EU for every one created by EU employers in Switzerland.

The political context

For some time, exploratory talks have taken place between the EU and Switzerland with a view to defining an institutional framework for further developing bilateral and sectoral cooperation. The search for an agreed approach will clearly take more time.

On 9th February 2014 Swiss voters approved the so-called initiative "Against Mass Immigration "(MII) by a narrow majority. The initiative requests the Swiss government to reduce overall inward immigration by means of quotas. While the initiative does not specify the targets themselves and includes a statement that immigration is to be guided by "the interests of the Swiss economy", quotas contravene the very principle of free movement of persons, as enshrined in both the EU Treaties as well as in the related bilateral agreement between Switzerland and the EU.

At the time of writing, it remains to be seen if and how the political process in Switzerland and in the EU, as well as subsequent discussions and negotiations between the two sides, will evolve. While there is a risk that the bilateral treaties may have to be denounced, the clear benefits derived from the close economic relationships, constitute a strong incentive for both parties to prevent such an outcome and find a mutually acceptable solution.

Swiss voters have repeatedly confirmed their willingness to maintain, and even deepen, economic ties with the EU on the basis of the bilateral approach. The MII vote reflected a more general disquiet with immigration that, in particular over the past decade, has by far exceeded the levels and the pace of immigration seen in other European countries (except for Luxembourg) relative to their population. For comparison, immigration, as a share of the population, is about three times higher in Switzerland than in the United Kingdom.

Looking ahead

Over the coming years both the EU and Switzerland would certainly benefit from a further deepening of this unique relationship, especially if the bilateral process can be reinforced by agreed institutional rules and be extended, namely to financial services. Consumers of financial services both in the EU and Switzerland would benefit directly from a true level playing field, as the cross-border expansion would add to the efficiency of intermediation of savings, with the Swiss capital markets becoming an important component of the future European Capital Markets Union.

ral comparative advantage, economies of scale and specialization.

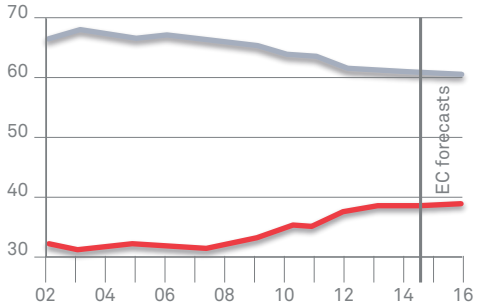
Trade with economies outside the EU brings similar gains, as well as additional benefits of a different type: when a region, such as the EU, is experiencing a period of quiescent activity, exporting to other, more buoyant, regions provides important support to aggregate output.

Although the period covered is unavoidably comparatively short, the data in Figures 32 and 33 show these two broad phenomena as both having been at work – the first in the early part of the period, and the second thereafter:

- **Gains from intra-EU trade:** the introduction of the euro in 1999, and the associated perception of substantially reduced, if not entirely absent, currency/country risk and the intensification of cross-border capital flows that resulted, doubtlessly contributed to the rapid growth of intra-EU trade in the euro's early years.
- **Gains from extra-EU trade:** following the global financial crisis, and especially in the wake of the euro crisis from 2010 onwards, when these integrative forces gave way to fragmentation risks, the EU has benefited from the relatively strong growth in demand from trading partners outside the EU, which were not as severely affected by the crisis.

While this period is too short to permit definitive conclusions to be drawn, our analysis suggests that the volume of EU exports benefits disproportionately from GDP growth outside the EU: an accel-

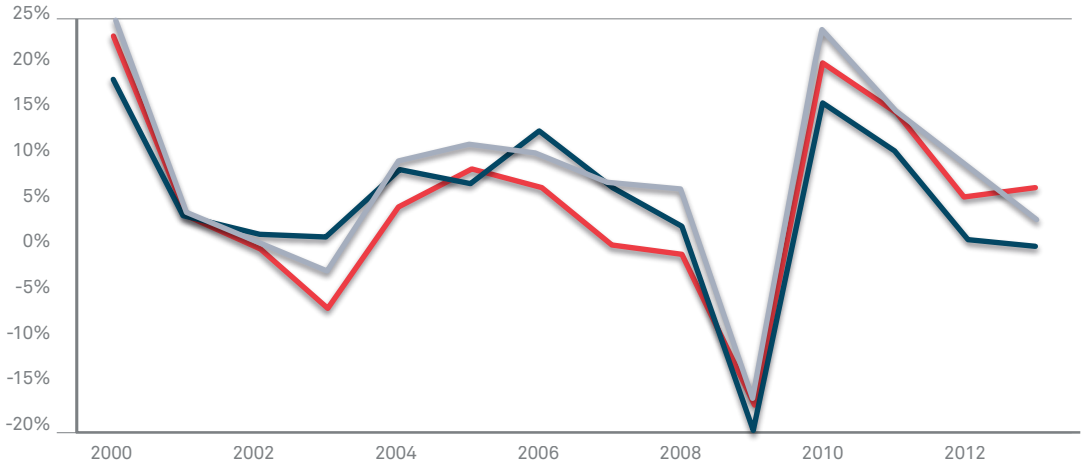
Figure 32: EU exports % of total



EU28 exports: intra-EU, % of total |
EU28 exports: extra-EU, % of total |

Source: European Commission, Haver

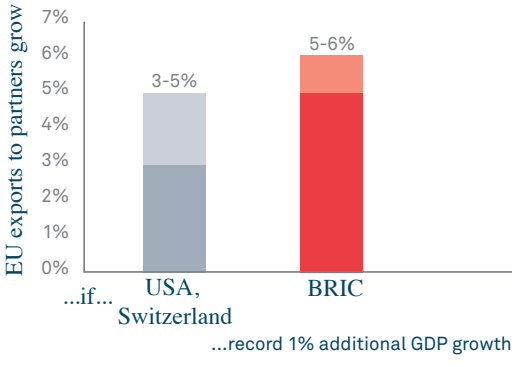
Figure 33: Growth of internal and external exports of the EU



Intra-EU | Extra-EU | Norway, Switzerland, USA & Canada |

Source: Eurostat

Fig. 34: EU export sensitivity to partners' GDP growth



Source: Eurostat

eration of one percentage point in US or Swiss growth boosts EU exports to these countries by 3% to 5%. This effect is even greater in respect of BRIC economies, where we find a 5% to 6% increase in EU exports for every 1 percentage point of local output growth (Figure 34). For Singapore, by contrast, the estimated effect is only around 1.5%, although this may well change once the Free Trade Agreement with the EU is fully operational.

Europe stands to benefit from further integration, both within the EU and with respect to key partner countries

The findings presented in this chapter lead to two broad conclusions:

- First, intra-EU trade brings considerable benefits. Hence while many such gains have now been 'pocketed', the EU would do well to continue to pursue further integration over the coming years, so as to benefit from further such gains.
- Second, trade with non-EU partners brings important and additional gains. Over the past years this was especially true as exports to partner countries supported EU aggregate output in a time when the EU itself has been experiencing a growth "soft patch."

We now turn to the policy considerations that stem from these conclusions, and what lawmakers in the EU and beyond can do to maximise these benefits.

TRANSATLANTIC TRADE AND INVESTMENT PARTNERSHIP (TTIP)

The EU and the United States are two of the world's largest economies, each accounting for some 16% of global economic activity. They maintain close economic ties, providing each other with huge markets in both goods and services, and copious sources of portfolio and foreign direct investment.

This relationship could be greatly strengthened to the advantage of both parties, however, if the negotiations on the Transatlantic Trade and Investment Partnership (TTIP) that began in June 2013 are successfully completed. Granting each other better market access through the reduction of various tariff and non-tariff barriers would deliver substantial benefits in terms of productivity and incomes.

Estimates by the German Ifo Institute suggest that a far-reaching agreement could potentially increase real income in EU Member States by anything from 2.6% (France) to 9.7% (United Kingdom), and in the United States by 13.4%. However, even after seven negotiating rounds, many controversial issues need to be resolved, and success remains uncertain.

[#3] Recommendations

Chapters one and two have shown that open financial markets, not only within the EU but also in relation to its external partners, have made –and can continue to make - an important contribution to the EU's economic growth and job creation. Attracting investment from all over the world rightly therefore should be one of the key principles that will guide work on the Capital Markets Union (CMU). We agree that as the EU implements the Banking Union (BU) and sets out to create the CMU, it is essential to make the most of this contribution by defending and promoting open markets.

All components of capital investment into the EU were lower in 2013 than in 2007, with the EU receiving only €5 trillion, of the €25 trillion global stock of cross-border investment. So while we agree that the CMU has significant potential to help Europe meet its growth and jobs agenda, this will only be the case if through the inclusion of non-EU partners, the EU reverses the trend towards fragmentation in global financial markets, and attracts investment from all over the world.

Based on the findings of this Discussion Paper, the Swiss Finance Council makes some suggestions to help ensure that the EU is internationally competitive and an attractive place to invest. In addition, it is important to facilitate access by EU firms to third countries.

We make these recommendations to help maximise the benefits of closer political ties and policymaking co-operation with key partner countries. Where relevant, we have divided our ideas into actions at the EU and international levels. Our recommendations underpin our central aim of encouraging a comprehensive contribution by the financial sector to Europe's economic recovery, and support the following four main objectives:

1. Promoting open and transparent capital markets.
2. Designing policies for banks and non-bank financial institutions that deliver *both* economic growth and financial stability.
3. Attracting capital flows and investment from within and outside the EU to support the real economy, and particularly for SMEs.
4. Encouraging greater co-operation between the EU and its partner countries, such as the financial centre Switzerland.

1. Promoting open and transparent capital markets

At the EU level

- Safeguard the progress that has been made in capital market integration, ensure proper implementation of new and existing rules, and properly police the level playing field. The post-crisis emphasis on strengthening financial stability, especially the highly prescriptive approach in third country regimes, needs to be better balanced against the goal of removing obstacles to the availability and free movement of capital.
- Take the opportunity of the forthcoming European Supervisory Authorities' (ESAs) review to ensure the ESAs fulfil their existing role as overarching system enforcers to ensure effective and consistent implementation of the Single Rule Book by national competent authorities. They need to help raise standards in regulation and supervision in the EU through monitoring financial stability, peer reviews and dissemination of best practice.

- Make consideration of the effect of new legislation on capital flows, as well as on the provision of financial services between the EU and partner countries an integral part of the impact assessment undertaken during the preparatory phase of legislation. By doing so, the EU can avoid legislating in a way that may unintentionally deter investment and instead capture opportunities to facilitate capital flows.

At the international level

- Reverse the trend towards capital market disaggregation, brought about as regulators have retrenched to better manage financial market risks in their own jurisdictions, by co-operating more closely. These risks should be managed with a view to preserving the benefits of free trade, free movement of labour and cross-border financial flows:
  - Continue to seek ambitious bilateral trade agreements with key partners to generate enhanced trade flows, with a strong push on financial services e.g. in TTIP. A more integrated financial services sector between the EU and US, or between the EU and Switzerland, will enhance the opportunities for investment for all sectors in the economy.
  - Work with partner countries to develop new international standards and implement them effectively and consistently – as was the case with the OECD standard on Automatic Exchange of Information in tax matters, but less so with the implementation of Basel III, which was not wholly consistent.
  - Building on the work of organisations like IOSCO, stick to common international agreements in the markets space as well, thus matching the progress that has been made in international tax and prudential regulation through the OECD and Basel Committee.

2. Designing policies for banks and non-bank financial institutions that deliver *both* economic growth and financial stability

At the EU level

- While implementing provisions of the Banking Union, minimise the chances of deviations between euro area and non-euro area countries, and aim to include partner countries willing to play a constructive role. We follow with interest the case before the European Court on the ECB's location policy for clearing euro-denominated instruments, and note the tension between free movement of capital and the needs of financial stability it illustrates.
- Use the fifth round of capital requirements legislation and a review of the Financial Conglomerates Directive to ensure banks, in addition to local standards, disclose their capital ratios under a definition truly compliant with the global Basel III standard, as well as addressing discrepancies between the global standard and the EU's Capital Requirements legislation.
- Address risk concentration in Central Counterparties (CCPs) through a common resolution regime. We would caution against making proposals at this stage for other types of non-bank resolution, and think a proper evidence base is needed before consideration of any further prudential restrictions.

At the International level

- Tackle the systemic risk of CCPs at the international level too, but it is important to draw the lessons from

the Dodd-Frank and EMIR approach, for example the potential problems caused by different margining requirements, and start on the basis of pre-agreed principles at the international level, thus ensuring regulatory dialogue, coherence, and mutual recognition.

- Enable intra-group capital and liquidity transfers to avoid distortions in the provision of lending between countries. At the moment, local regulators limit the transferability of capital and liquidity between subsidiaries of the same group, meaning banks in liquidity-rich countries place their excess liquidity with central banks, while banks in liquidity poor countries are left to rely on markets. This reinforces distortions in lending rates between countries, pushing up rates in liquidity poor countries, and suppressing them in liquidly rich countries. Larger banking groups can help level out this effect if regulators allow them to.
- Review leverage ratio requirements to enable banks to sustain the nascent economic recovery. The Bank of England estimates that a 1 per cent increase in capital requirements reduces secured lending by 0.9 percentage points, and that loan growth mostly only recovers three years after the announcement of regulatory measures [25]. Similarly, the Centre for Economic Policy Research (CEPR) estimates that EU bank assets need to fall by a further 6 per cent to meet market expectations of leverage requirements. The impact on bank lending is substantial and can hinder the banking sector's capacity to support growth. The Basel Committee and national authorities should review the impact of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) in light of the fragile recovery and eventual interest rate rises, to ensure it is fit for purpose.
- Clarify appropriate levels of permissible re-hypothecation, transparent collateral ownership, and co-operate to remove barriers to cross-border collateral use. An adequate supply of serviceable collateral plays a central role in market-based credit intermediation, is central to the functioning of the global financial system and is therefore key to the CMU. Insufficient collateral, or immobile collateral can lead to funding stresses that reverberate across financial markets.

3. Attracting capital flows and investment from within and outside the EU to support the real economy, and particularly for SMEs

The CMU has the potential to be a game-changer in terms of facilitating the flow of investment from both EU and non-EU countries into growth and job creating activities. As previously shown, there exists very significant catch-up potential in capital market financing in Europe as the gap in market depth compared to the United States amounted to over € 5 trillion over the last six years. Therefore, the measures that make up the CMU need to be considered from the perspective of how they can best facilitate investment, and designed accordingly. Here, we suggest several potential priorities:

- Develop European debt and equity markets to effect a transition towards a corporate financing model that is more evenly split between the traditional banking sector and more 'capital market-based' sources, for example by reviving the European securitisation market and deepening capital markets in general:
  - Help develop simple, transparent

securitisation products, for example through a standardised legal framework for securitising SME loans, and thus facilitating a pan-European market (both cash and synthetic where genuine risk transfer criteria are met).

- Review the treatment of securitisation instruments in existing regulations, such as the Liquidity Coverage Ratio, capital requirements and Solvency II, to ensure equivalence with other asset classes. Properly regulated simple, standardised and transparent securities can incentivise investment and help finance growth, yet their current treatment in prudential regulation is disproportionately punitive.
- Harmonise where possible rules on risk retention between the different types of regulated investors – banks, insurers, AIFMs, etc.
- Make consistent, and streamline existing and upcoming reporting requirements in order to make compliance for originators easier, as well as assisting investors and other users of the data.
- Consider expanding use of the European Investment Fund guarantees to stimulate the SME securitisation market.
- Open up capital markets to the issuance and trading of more medium-sized company debt, such as pan-European Multilateral Trading Facilities regulation. A tailored SME market regime would ensure that EU regulation does not adversely impact small companies. This would help the trading of less liquid SMEs shares.

• Enable internationally active long-term investors, such as pension funds and insurers, as well as banks, to play a more direct role in funding the real economy. Collectively, insurers are Europe's largest institutional inves-

DO NO HARM…

At the same time, policy-makers need to avoid introducing measures which, although well intentioned, are likely to have a negative impact on capital flows and investment. For example:

- Recent proposals by the Financial Stability Board for a common international standard on Total Loss-Absorbing Capacity (TLAC) might further aggravate the trend towards local capital and liquidity requirements and result in unintended consequences on capital structures which could further increase financial market fragmentation.
- The Basel Committee on Banking Supervision plans to revise the capital framework for securitisations. When adopting the framework, the BCBS needs to make sure that it does not, undermine efforts to improve the attractiveness of the securitisation market.
- Similarly, the approach to securitisation in the draft Fundamental Review of the Trading Book is unnecessarily conservative, and will add further costs to banks who may otherwise help revive the market.
- Reconsider the introduction of an FTT, as the costs will have to be borne by end users such as savers, pensioners and SMEs trying to access the market. It will also distort markets between participating and non-participating countries.
- Take a fresh look at the Banking Structural Reform proposal in light of the ambition to create a CMU. For instance, and as the ECB pointed out in its opinion on the proposal, the approach to market making should be reconsidered given the important role of market making activities in providing liquidity to the users of financial services, including pension funds and retail investors.

tors with assets under management of €8.4 trillion. They are ready to support growth and jobs through long-term investments as such longer-term commitments match well with the term structure of their liabilities. However, the regulatory framework could do more to facilitate this source of financing.

- Avoid geographical bias in the design of funding vehicles and inconsistent implementation of EU standards that can deter investment from partner countries. For example, implementation of the Alternative Investment Fund Managers Directive (AIFMD) has in some cases closed borders to smaller-non domestic funds. Rather, design them in order to encourage investment from long-term investors.

- Solvency II could more easily promote long-term investment if the prudential requirements for insurers investing in infrastructure and high-quality securities were reviewed.

- Design conditions for infrastructure projects to attract institutional investors. Look for opportunities in the design of the forthcoming European Fund for Strategic Investments regulation to maximise its attractiveness for international long term investors.

- Encourage international investment in Europe's Private Placement markets by creating a harmonised framework, utilising standardised structures, practices, and, to the extent appropriate, documentation and definitions [27]. Consider drawing up a Private Placement "code of best practice" with investors and industry groups, with a view to 'industrialising' the placing process, and ultimately creating the conditions for investors to buy and hold such assets.

4. Encouraging greater co-operation between the EU and its partner countries, such as the financial centre Switzerland

At the EU level

- Strengthen and deepen ties with major non-EU partners such as Switzerland so as to foster collaboration and promote open markets and greater market cohesion. The EU could initiate bilateral engagements, or do so in multilateral fora, such as the IOSCO. EU policy makers should continuously include industry representatives and administration officials from partner countries within given consultation procedures in order to assess the impact of proposed EU legislation on cross-border capital and investment flows.

- Focus on completing outstanding equivalence assessments. The allocation of sufficient resources is crucial to prevent process delays that could hinder inflows of investment at this stage of the economic recovery.

- Within the context of internationally agreed guidelines, develop a principles-based regime for assessing equivalence with partner countries. This needs to be both pragmatic and predictable, providing a coherent approach in the equivalence determination. The regime should take account of the different regulatory environments in individual partner countries, hence providing for flexibility on the basis of the agreed principles, and eschewing a one-size-fits-all approach.

At the International level

- To make equivalence internationally effective, partner countries, too,

should collaborate in the working out of agreed guidelines, and, once agreed, adhere to them in their own assessments.

- Specifically with the US, the European Commission and US authorities need to set out how equivalence and substituted compliance will work in practice.
- Non-EU partner country authorities should be allowed to play an active and constructive role in the development of the CMU to help ensure regulatory coherence and avoid closing borders to investors and financial services.
- Explore opportunities for comprehensive financial services agreements between the EU and its key trading partners.

Endnotes

1 According to Global Trade Alert. See table 2.6 of the 16th GTA Report. http://www10.iadb.org/intal/intalcdi/PE/2014/14984.pdf. (Data for Croatia not available)

2 Global Trade Alert, (2014). The Global Trade Disorder: The 16th GTA Report. http://www10.iadb.org/intal/intalcdi/PE/2014/14984.pdf

3 Reserve Bank of Australia, 2014. Cross-border Capital Flows since the Global Financial Crisis. http://www.rba.gov.au/publications/bulletin/2014/jun/8.html

4 Reinhart, C., Kirkegaard, J., and Sbrancia, M., (2011). Financial Repression Redux. IMF. https://www.imf.org/external/pubs/ft/fandd/2011/06/pdf/reinhart.pdf See also http://www.bruegel.org/nc/blog/detail/article/1500-the-european-union-is-the-global-laggard-on-basel-iii/, where Bruegel's Nocolas Veron notes how the EU's non-compliance with the BaselII standards may be a form of 'mild financial repression.'

5 ECB, (2014). European Financial Stability and Integration Report, 2013.

6 See chart 1.1.1 on p12 of ECB, (2014). Financial Stability and Integration Report, 2013.

7 France's National Front leader Marine Le Pen said , for instance, in a 2013 interview with foreign media networks about her anti-EU analysis of Frances's problems that "border controls were important not just in terms of human traffic, but in terms of capital flow and products too" (http://rt.com/news/marine-le-pen-interview-448/).

8 Carney Mark, Regulatory work underway and lessons learned, speech at the 29th annual G30 International Banking Seminar, Washington D.C., 12 October 2014

9 'Non-productive RWA' are risk weighted assets that are not driven by actual revenue-generating assets in the business, but instead arise from e.g. regulatory floors, add-ons, risk-weight inflation, operational risk etc.

10 Basel Committee on Banking Supervision, Assessment of Basel capital regulations in the European Union concluded by the Basel Committee, 5 December 2014.

11 This would be comprised of (i) a 3% minimum (ii) up to a 1.05% supplementary SIB-buffer and (iii) up to a 0.9% countercyclical leverage ratio buffer. Bank of England, The Financial Policy Committee's review of the leverage ratio, October 2014.

12 IMF (2014), Global Financial Stability Report, October 2014. Washington DC.

13 Sinn, W.; Schmundt, W. (2014), Deutschlands Banken 2014: Jäger des verlorenen Schatzes. Bain & Company, München und Zürich.

14 European Banking Authority, Results of 2014 EU-wide stress test, 26 October 2014, European Central Bank, Comprehensive Assessment results, 26 October 2014; Bank of England, Quarterly Bulletin pre-release article: 'Bank funding costs: what are they, what determines them and why do they matter?' November 2014.

15 Capital Markets Union – the «Why» and the «How», speech in Brussels, 22 October 2014. See also Yves Mersch: «For a European Capital Markets Union – Securing stability, overcoming fragmentation», speech in Frankfurt, 10 September 2014.

16 See «Capital Markets Union – Finance serving the economy», speech given in Brussels, 6 November 2014.

17 European Central Bank and Bank of England: The impaired EU securitisation market: Causes, roadblocks and how to deal with them, 11 April 2014. And: BoE/ECB: The case for a better functioning securitisation market in the European Union, May 2014.

18 «Capital Markets Union – Finance serving the economy», 6 November 2014

19 See: Nicolas Véron: «Defining Europe's Capital Markets Union», Bruegel Policy Contribution, November 2014.

20 In practice, however, the ceteris paribus (everything else equal) assumption might not hold, as conditions in the US and Europe might differ, for multiple reasons, including: 1. Central bank monetary policy: The Fed's QE policy in recent years might have contributed to a narrowing in credit spreads which might now, as QE is coming to an end, be reversed – exactly at a time when the ECB, for its part, has kick-started QE. In addition, the expectation of Fed interest rate hikes starting this year might contribute to a widening in US credit spreads, whereas ECB interest rate hikes are not on the radar screen. 2. Scarcity value: Given that issuance of corporate bonds in Europe is relatively low, European corporate credit paper has scarcity value, which contributes to spread compression. Given greater capital market activity in the US, spread compression due to scarcity should be less of an issue. 3. Reasons related to business and profit cycle.

21 The 18th Century Swedish thinker Anders Chydenius, for example, was an early forerunner of the better-known Adam Smith. Working through a serious of arithmetical examples, he demonstrated painstaking how allowing hitherto-prohibited trade to take place between Swedish towns would increase the welfare of citizens generally.

22 The full data set includes Belgium, Brazil, Canada, China, Denmark, Finland, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Norway, Portugal, Russia, Singapore, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

23 König & Ohr: « Die Schweiz ist stärker integriert als viele Mitgliedsländer». http://www.nzz.ch/wirtschaft/die-schweiz-ist-staerker-integriert-als-viele-mitgliedslaender-1.18360889)

24 See http://www.snb.ch/en/iabout/stat/statpub/fdi/stats/fdi for more data on the Swiss-EU economic relationship.

25 Jonathan Bridges, David Gregory, Mette Nielsen, Silvia Pezzini, Amar Radia and Marco Spaltro (2014). The impact of capital requirements on bank lending. Working Paper 486. Bank of England.

26 Global Trade Alert, (2014). The Global Trade Disorder: The 16th GTA Report. http://www10.iadb.org/intal/intalcdi/PE/2014/14984.pdf

27 The U.S. market (underpinned by a 'safe harbour' exemption provided by Section 4(2) of the 1933 Securities Act) and the German Schuldschein market offer models for a pan-European private placement market.]

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