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The Capital Markets Union:

key driver to a "Genuine" Economic and Monetary Union

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1. Foreword: EMU and CMU

- The objective of a European EMU of stable prices, open markets, shared prosperity, employment and sustainable growth was defined in a Summit meeting of 1969, and has been actively pursued as a primary goal of the Union ever since.
- Significant results have been achieved – and notably the single European currency as from 1st January 1999 - but as the 5 Presidents' Report (5PR) of June 2015 frankly admits, a 'genuine' EMU remains an unaccomplished endeavour: divergences create fragilities for the whole Union which should be rapidly corrected.
- The 5 Presidents indicate a roadmap covering the next decade to ensure a genuine EMU: they argue that progress must be simultaneously made towards economic, financial, fiscal and political union.
- All Unions are mutually interdependent and must develop in parallel. Financial Union, which comprises the launching and achievement of the Capital Markets Union (CMU), receives special attention.
- CMU is not an end in itself: it is a key driver to a genuine EMU.

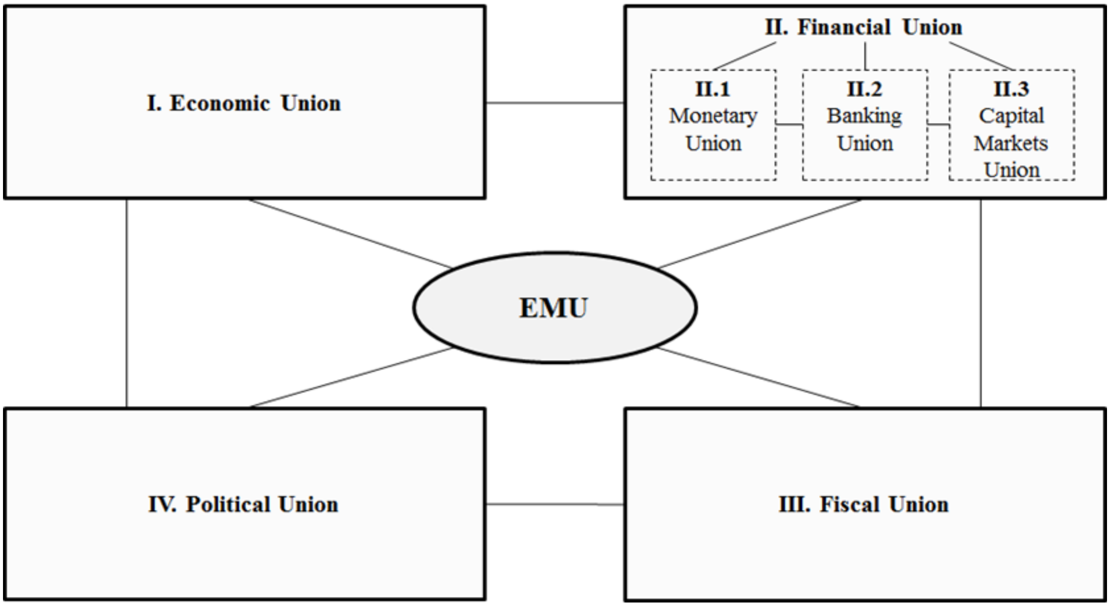
2. The difficult "traverse" to the 4-Union EMU

- The "traverse" to the 4-Union EMU is especially complex partly because it goes beyond economic analysis and policy. The crucial role of CMU requires clarification, notably in terms of the legal approach to be adopted, as will be indicated below.
- A graphical presentation of the integrated Union model is offered in Chart 1.
- It must be stressed that close interactions exist between BU and CMU. It is not the task of this presentation, but the point must be made that the satisfactory completion of BU is still missing*, notably in terms of:
    i. the completion of the Deposit Insurance Scheme,
    ii. the revision of the Resolution Framework,
    iii. the satisfactory implementation of CRR II/CRD V (notably with the effective introduction of proportionality in regulation and supervision),
    iv. key prudential rules to be reviewed, to foster EU capital markets activities (see below par. 5).
- More generally **BU and CMU should reconcile regulation and growth**.

* For an analysis and suggested remedies, see de Larosière and Masera, 2017.

Chart 1 - The Five Presidents' Four interdependent Unions to transform the euro area into a 'Genuine Economic and Monetary Union'*.

The Five Presidents approach can be synthetized as follows:



* *«All four Unions depend on each other. Therefore they must develop in parallel and all euro area Member States must participate in all Unions for the euro area to gradually evolve towards a genuine Economic and Monetary Union… After many years of crisis, governments and institutions must demonstrate to citizens and markets that euro area will do more than just survive»* (Juncker *et al.*, 2015 p.5).

2. The difficult "traverse" to the 4-Union EMU

- Under current circumstances, the concrete possibility of moving to Fiscal and Political Union in the Euroarea appears highly questionable. The creation of a European State/Federation is not on the political horizon.
- However, it must be reminded here that both President Mitterand and Chancellor Kohl indicated that they were necessary prerequisites for a successful operation of the Monetary Union.

- **François Mitterrand e Helmut Kohl, 1990:**

  Our aim is that these fundamental reforms - economic and monetary union as well as political union - should enter into force on 1 January 1993.

  (Letter by the German federal chancellor Helmut Kohl and French president François Mitterrand to the Irish Presidency of the EC . 19 April 1990. Source: Agence Europe, 20 April 1990)

- **Helmut Kohl, 1991:**

  It cannot be repeated often enough: Political union is the indispensable counterpart to economic and monetary union. Recent history, and not just that of Germany, teaches us that the idea of sustaining an economic and monetary union over time without political union is a fallacy.

  (H. Kohl: Protocol of the Deutsche Bundestag, 6 November 1991)

3. Focus on CMU

- We come now to the CMU itself (EC, 2015): the priorities and the complexities of the launching are well recognised and analysed, but key critical issues require clarification.
- The 5PR underlines that primary functions of an effective, integrated and balanced CMU are:
    i. to promote the well-functioning of the Single Market,
    ii. to permit risk diversification across countries of the euro zone and of the EU. The other side of the coin of free, unimpeded movements of capital through banks, insurance companies and capital markets is the reallocation of country-specific shocks across the whole area. This by itself reduces the burdens on fiscal policies which can used with clear limitations in the euro zone, given the institutional set-up of the various Compacts.

  Financial Union and CMU have therefore two main positive features which explain why it is of paramount importance to ensure their rapid completion.
- Another important type of argument is represented by the need to ensure a level common playing field for the external finance of the corporate sector, and notably for growing innovative medium-sized companies and for investment in infrastructure.

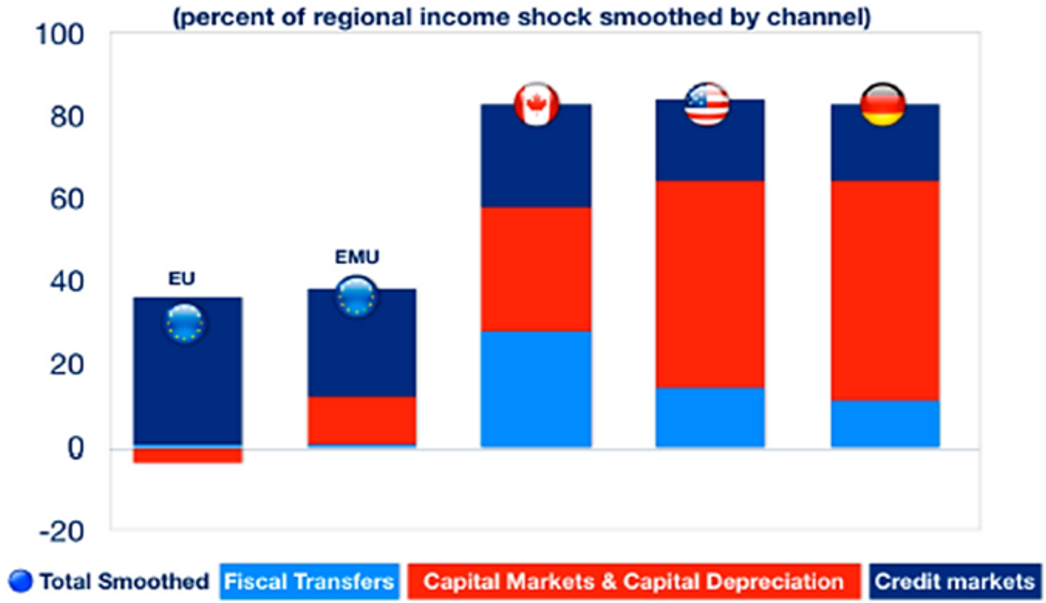
3. Focus on CMU

- In the eurozone a very large share of credit flows is intermediated by the banking system: more balanced sources of finance are necessary. This implies a greater role for capital markets in the financing process of companies and, in particular, more equity finance.
- The United States offer clear evidence that highly developed economic systems benefit from balanced and well-integrated relationships between credit markets and financial intermediaries. It must however be underlined that in the US, on the one hand, the largest banking/investment conglomerates play a fundamental role in the "market" sector (Cetorelli, 2013) and, on the other, local banks continue to account for a significant share of external finance of micro and small enterprises, largely because of a "tiered" approach to regulation and supervision of the banking system (Tarullo, 2015 and Yellen, 2014 and 2015).
- Due account should also be taken of the fact that in the U.S. official guarantee schemes for securitised bank loans, and notably for SMEs, have been and are being actively used (Fannie, Freddie and Small Business Administration) after 2008. These approaches are not part of the current CMU/BU schemes in Europe.

3. Focus on CMU

- As indicated, the Financial Union is also important as a cushion for asymmetric/ country-specific shocks, which command three main types of response: from intermediaries, capital markets, fiscal shock-absorbers.
- If intermediaries, markets and fiscal responses have mainly national features, the diversification of risks across countries is necessarily limited. There is therefore the need to encourage the development of a fully integrated CMU, but also to foster the development of truly pan-European intermediaries (as against national champions). Here again the US system of regulation and supervision should be carefully considered.
- Beyond fiscal buffers at the national level, according to the IMF (Allard *et al*., 2013) in the euro area only 40% of country-specific GDP shocks is smoothed by cross-country risk-sharing insurance mechanisms: 30% comes from the operation of banking and credit markets and 10% from capital markets; there is no "federal" fiscal cushion. In the US, instead, the corresponding figure is 80%: 45% coming from capital markets, 20% from banking and credit markets and 15% by federal stabilisers (Chart 2).

Chart 2 – Risk sharing: Insurance against income shocks in EMU remains low



SOURCES: Hepp and von Hagen (2012) for Germany; Sorensen and Yosha (1998) for the United States; Balli, Basher and Rosmy (2011) for Canada; and Afonso and Furceri (2008) for the Economic Monetary Union and the European Union.

In conclusion, the development of a truly integrated, effective and efficient CMU has positive macroeconomic effects and fosters economic/financial stability, thereby preventing and/or limiting systemic risk.

4. An effective and efficient CMU:
bottom-up or top-down?*

- A relevant open question concerning the creation of the CMU is whether a top-down (legislation based) approach should be followed or a bottom-up (market based) model should be adopted.
- A combination of the two schemes is required, but it should be underlined that the original Hill/EC Green Paper (February 2015) and the 5PR gave very different answers. The EC favoured a non-legislative model, apparently as requested by market operators.

* This and the following paragraphs, draw on the following documents:

- Febaf, 2017, *The Capital Markets Union for Growth in Europe*, Brussels, 17 March
- Italian Government, 2017, *Views in reply to the consultation document of the European Commission Services on Capital Markets Mid-Term Review 2017,* 23 March
- Eurofi, 2017, *Regulatory update*, Malta, 5-7 April
- Jacques de Larosière and Rainer Masera, 2017, Master Financial Regulation and Risk Management, SciencesPo, Paris.

4. An effective and efficient CMU:
bottom-up or top-down?

- The Report indicated, instead, that the objective should be to create a Single European Capital Markets Supervisory Authority, in analogy to the Banking Union approach (Single Supervisory Mechanism and Single Resolution Framework).
- Even before this medium-term objective, many important changes to be rapidly enacted require legal action:

  «A true Capital Markets Union also requires other improvements, some of which can only be achieved through legislation, such as simplification of prospectus requirements; a revived EU market of high quality securitisation; greater harmonisation of accounting and auditing practises; as well as addressing the most important bottlenecks preventing the integration of capital markets in areas like insolvency law, company law, property rights and as regards the legal enforceability of cross-border claims».

4. An effective and efficient CMU:
bottom-up or top-down?

- The lack of harmonisation of company and insolvency laws represents a crucial impediment to the full realisation of CMU, which feeds back on the Banking Union itself. A notable example is represented by the effective implementation of the Bank Recovery and Resolution Directive, especially with reference to the Intragroup Financial Support Framework (Lamandini, 2015 and Febaf, 2017, p. 17).
- The relevance of the choice between the two different approaches had been anticipated and rightly stressed by Véron (2014), who argued correctly in favour of addressing from a legal point of view the development of market segments, with policy initiatives graded according to impact and political difficulty.
- Most importantly, the CMU represents a platform – account being taken of the crisis in the past decade - for supporting the Juncker Investment Plan and for enhancing investment, inclusive economic growth and employment. "Finance for growth" – integrated finance for an integrated economy.

4. An effective and efficient CMU:
bottom-up or top-down?

- In the trade-off between bottom-up or top-down, account must be taken of the changes in the context within which the CMU had been designed. These developments tilt the balance towards well-defined top-down priorities.
- These changes affect not only the implementation of the Plan, but above all the concept itself and the strategic orientation of the CMU. This has happened to such an extent that much more than a simple mid-term review is now required. Rather, an in-depth rethink of the aims, objectives, time-table and priorities of the CMU should be undertaken.

4. An effective and efficient CMU:
bottom-up or top-down?

- The first key change in the context is clearly Brexit, which is taking out of the EU framework the most important financial center of the EU to date, i.e. the City of London.
- The UK capital market and its infrastructure currently represent a wholesale hub for the EU, and account for some 50% of European capital activities. Their role is especially relevant in key segments such as venture capital, equity trading and derivatives markets.
- Moreover, the CMU was meant from the start to be a European process moulded and inscribed in a global framework, as it was directed at promoting wider financial integration in the global economy, open systems and societies. The new Trump administration in the U.S. appears to be challenging the long-term tenets of global finance, alongside with trade liberalization and transatlantic relations. This is also a factor that should lead to a fundamental resetting of CMU, with a view to ensuring an appropriate set up to interact with global markets and major financial centers (including the complex issue of "offshore" entities).

4. An effective and efficient CMU:
bottom-up or top-down?

- Recently, and significantly, the President of the ECB Mario Draghi (31.01.2017) reaffirmed the concept that deep financial integration (as implied by the CMU) and the single currency are to be two sides of the same coin. He argued that integrated financial markets in Europe would be necessary for an effective single currency. The CMU project therefore not only affects the wide community of the 27 countries of the EU, but impacts more deeply into the Euro-zone. It represents a necessary ingredient for the stability and performance of the Euro-area, as a single currency area. It is a required complement of the Banking Union and an integral part of the inescapable strengthening of EMU. The operation of Target2-Securities (T2S) by the ECB (2015) lays one of the basic foundations for CMU, by providing the necessary market infrastructure. Therefore, the implications of CMU for, and its impact on, the Euro-area give CMU an added component of synergy, consistency and urgency.
- For the reasons above, the *Mid-term* Review must acquire a much broader significance, and must be placed it in the context of the revision and adaptation of the whole approach. CMU needs a new beginning and an overall redesign, moving from CMU mark 1 to CMU 2.0, and correspondingly re-adjust deliverables, priorities and methods of work.

5. A Blueprint for Action: refocusing and implementing the CMU

- The key points for reorientation of CMU are presented in this paragraph.
- A **Decalogue for Action** is summarized in Table 1. Many other important points are not taken up here for brevity's sake: the reference is to the four documents already indicated.
- The ten aspects analyzed here have close contacts with the broader considerations on the role of CMU to support the single currency and the Banking Union.
- The deadlock on the finalization/revision of Basel III/CRR and CRD is closely intertwined with some of the recommendations presented in the Decalogue.

5. A Blueprint for Action: refocusing and implementing the CMU

Table 1 - A Decalogue for CMU*

1. **Institutional/structural reforms**
2. **A single rule book**
3. **Multiple-speed Capital Market integration**
4. **Focus on retail/consumer markets**
5. **Complementary focus – with BU – on SME's**
6. **Proportionality**
7. **Recalibration of prudential rules on banks:**
    - Private equity
    - Venture capital
    - FRTB and NSFR
8. **Recalibration of Solvency II for investments** in:
    - Infrastructure
    - Innovation, start-ups and SMEs
9. **"Circular bonds"**: business value chains and green securities
10. **Securitisations and covered bonds**

* Beyond the 10 points outlined in this table, attention is drawn to the additional important issues spelled out in detail in Febaf, 2017, Italian Government, 2017, Eurofi, 2017, de Larosière and Masera, 2017.

5. A Blueprint for Action: refocusing and implementing the CMU

1. Institutional/structural reforms

- After Brexit, new institutional arrangements must be created in the EU. It is not only a question of the key operators but above all of infrastructures.
- The fundamental challenge for the EU integrated Capital Market is **to overcome fragmentation, duplication and overlap**. It is necessary to recreate the British highly efficient model. The negotiations with London should avoid a destructive approach.
- As already indicated, the EU institutional architecture must provide regulatory harmonization and supervisory convergence. Accordingly, the operational trade-off between bottom-up and top-down models has to be reconsidered.
- Insolvency regimes should be consistently harmonized also with the view to fostering the effectiveness and timeliness of jurisdiction of national courts (this is key also for the workings of the SRM).
- Structural reforms become also very important. In this respect, the disincentive of equity versus debt in the European Financial Markets should be addressed. This is key to foster financial and economic stability in Europe.
- Stronger capital foundations should not only be sought for banks and insurance companies, but also for the corporate sector (and, to the appropriate extent, for households as well).

5. A Blueprint for Action: refocusing and implementing the CMU

1. **Institutional/structural reforms**

- Taxation provides corporations an advantage for bond financing (interest payed is deducted from revenues).
- Financial and systemic stability is enhanced by less leverage and more equity throughout the enterprise sector. This is especially relevant now as a consequence of very low/negative interest rates on debt.
- National fiscal sovereignty requires the adoption of a **commonly agreed standard**, such as the Common Consolidated Tax Base (CCCTB) proposed by the Commission (EC, 2016), which should received full support of the Council and the Parliament.
- It is noteworthy – and somewhat paradoxical! – that the important Italian effort in this direction with ACE (*Allowance for Corporate Equity*) in 2011 could not go forward in 2014 with Super ACE. The new scheme had to be abandoned because the EC regarded this approach as non-compliant with State-Aid Rules (Italian Government, 2017, p. 16).

5. A Blueprint for Action: refocusing and implementing the CMU

2. A single rule book

- The CMU requires a uniform set of norms and regulations. In turn, this demands a strong single supervisory authority (as with SSM in the BU).
- A single rule book will replace national/sectoral mechanisms: consolidating legislative and harmonization initiatives represents an ambitious, difficult but necessary endeavour.
- The difficulty of this exercise is underline by the fact that the normative framework for Banking Union has not yet been fully adjusted, in spite of the efforts of EBA.
- Enactment of the single rule book philosophy is necessary in all areas relevant for banking and capital markets operations. The single rule book should incorporate the principle of subsidiarity, as will be highlighted, in point 6. below.

5. A Blueprint for Action: refocusing and implementing the CMU

3. Multiple-speed Capital Market integration

- The CMU is a key counterpart of the EU Single Market and is therefore closely related to the ultimate objective of Art. 3 of the Treaty on the European Union (promoting the well-being of the peoples of the EU).
- As indicated, the CMU is also an important component of the process leading to a more satisfactory EMU. It is essential to the success of the single currency, and to the effective operation of the ECB monetary policy.
- It follows from these two premises that every effort must be made to strive for a fully-fledged EU-27 CMU. But if certain countries delay the progress, the issue of two or multiple speeds cannot be avoided.
- It is not a question of double standards, but of the speed and effectiveness of implementation, which are crucial for the Euroarea.

5. A Blueprint for Action: refocusing and implementing the CMU

4. Focus on retail/consumer markets

- A fundamental question of design, presentation and education is represented by the role, protection and access of retail customers to the CMU, both as suppliers and users of capital.
- Capital markets are concentrated in few financial centers and are mainly wholesale, the CMU should be more inclusive, attentive to the needs and requirements also of individual investments. As is indicated in the Febaf (2017) Contribution, this "*should be a top priority of the whole CMU project*".
- Febaf also indicates its readiness to support the initiatives of dissemination, culture, education and information in Italy along these lines. The EC should broaden and deepen the approach to the European level.
- These issues are intertwined with the attention to increasing the availability/ reducing the cost of funds to smaller enterprises and the question of proportionality (see points 5. and 6. below).

5. A Blueprint for Action: refocusing and implementing the CMU

5. Complementary focus – with BU – on SME's

- The need to rebalance the flow of external finance in the EU towards the market is undisputed. But ways and means must be found to avoid the excessive rigidity of banking regulation and supervision recorded after 2008.
- In particular, the doubling of capital charges for all banks in a very short time span after 2009 without implementing effective securitization processes of bank loans (as was successfully done in the US) dried up credit supply in Europe and contributed to the double dip (Masera, 2012 and de Larosière, 2015). The negative effects were especially acute for SME's and in Italy.
- It is necessary to redress the balance. The line of analysis developed in Italian Government (2017) is correct and must be supported.

5. A Blueprint for Action: refocusing and implementing the CMU

5. Complementary focus – with BU – on SME's

*"The priority is to focus CMU progress on the needs of SMEs, these being the firms most affected by the current relatively scarce and expensive sources of finance. While the full set of measures should address in a comprehensive way the financing necessities of all firms, larger corporations already enjoy great opportunities in European capital markets unlike smaller firms. The latter with the potential to access capital markets should increasingly benefit from the development of various market segments, also through a transversal policy effort to enhance the cost effective availability, reliability and comparability of SME related information. This would benefit also bank financing, which will continue to be the main source of funds for smaller SMEs and therefore needs to be supported through the completion of the Banking Union." (*Italian Government, 2017, p. 5)

- Effective implementation of these lines of attack requires also adopting correct proportionality principles in financial regulation.

5. A Blueprint for Action: refocusing and implementing the CMU

6. Proportionality

- In very general terms, the limits of EU competences are defined by three basic principles: conferral, subsidiarity and proportionality: *"the limits of Union competences are governed by the principle of conferral. The use of Union competences is governed by the principles of subsidiarity and proportionality"* (European Monitor, 2016).
- Proportionality is extremely important in the EU: under this principle the content and form of Union Action shall not exceed what is necessary to achieve the objectives of the Treaty (Art. 5 of the Treaty of European Union).
- In practice, in the area of financial regulation and supervision, this principle has often been disattended or neglected, partly because of the objective difficulty of application.
- The principle is very ancient; the notion in modern times was developed and adopted in Prussian administrative law as from the end of the 18th century. Currently the German Constitutional Court has advanced and broadened the principle.
- In the United States a similar legal approach has been established requiring "balancing" between competing values (Cohen-Eliya and Porat, 2010). This principle has been fully respected in financial and banking regulation, notably in the Dodd-Franck Act 2010.

5. A Blueprint for Action: refocusing and implementing the CMU

6. Proportionality

- This general principle has **three main aspects of application**, which will be reviewed in respect of the European financial system (the three points are interconnected but a useful distinction can still be made in terms of specific features).
  i. The first regards its application to all firms, entities and markets where financial activities are conducted. More specifically, this regards the operation of the so called "parallel banking system" (encompassing hedge funds, investment bank activities, other funds and fund managers, various off-balance sheet items, mortgage brokers, and securitization vehicles/conduits – SPV's). The need to close the gaps in regulation concerning the parallel banking system was already underlined in the de Larosière Report (2009), where it was recommended to extend appropriate regulation and supervision according to the principle of proportionality to the whole financial system.

5. A Blueprint for Action: refocusing and implementing the CMU

6. Proportionality

ii. The second refers to the issue of one-size-fits-all versus a tiered approach to banking regulation and supervision:

- The "narrow" definition of proportionality in respect of banking regulation and supervision shows very significant differences in declination of the Basel Capital Standards as between the EU and the US (see for instance Dodd-Frank, 2010; Guida and Masera, 2013; Yellen, 2014; Masera, 2016; Dombret, 2017).

  The distortions for the viability of small banks and the financing of micro and small enterprises have been highlighted. The EC appears now set to take full account of these considerations (EC, 23 November 2016).

iii. The third relates to the insurance sector:

- The Febaf Contribution (2017) documents also the compliance distortions of an unsatisfactory application of the proportionality principles for insurance companies. This requires calibrated regulatory requirements and actions in relation to the size of insurance companies and to the nature, scope and complexity of companies' exposures.

  So far the definition and application of a proportional framework have been appointed to national authorities. A more harmonized definition should be entrusted to EIOPA. The Italian insurance association (ANIA) is working on an operational proposal for the Italian market, consistent with a perspective European harmonized approach.

5. A Blueprint for Action: refocusing and implementing the CMU

7. Recalibration of prudential rules on banks

- European prudential rules on banks' private equity exposure (CRR/CRDIV) consider private equity riskier than other types of investment. The capital penalization led banks to reduce their role in this key market, with adverse consequences for economic activity (Febaf, 2017).
- The case is therefore made, in analogy to the SME Supporting Factor, to extend the 0.85 reduction coefficient to investments up to Euro 150 million in unlisted companies with yearly turnover of up to Euro 150 million.
- Similar adjustments are suggested for banks' investments in venture capital funds or start-ups, which stand to be penalized also by the coming into force of new accounting standards (e.g. IFRS9).
- Strong requests to recalibrate the current CRR/CRDIV framework come also from Eurofi, notably with reference to:
  i. the introduction of a binding net stable funding ratio (NSFR)
  ii. the fundamental review of the trading book (FRTB)

5. A Blueprint for Action: refocusing and implementing the CMU

7. Recalibration of prudential rules on banks

i. Introduction of a binding net stable funding ratio (NSFR):

- Several services and market functions of the banks are negatively impacted by the current framework. Specific concern has been expressed on costs for derivative transactions which appear disconnected from actual funding risk.
- The main criticism is levied at the cost for equity position which appears inconsistent with the CMU emphasis on capital.

ii. Fundamental review of the trading book (FRTB):

- It is amply recognized that the inherited framework based on Basel 2.5 should be reviewed. But concerns are expressed on the possible inconsistency between the usage of internal models and the extensive backtesting procedures.
- Moreover the recalibration is necessary at global level, to avoid the danger of a non-level playing field for large international banks.

5. A Blueprint for Action: refocusing and implementing the CMU

8. Recalibration of Solvency II

- As already indicated for the banking industry, effective and robust implementation of CMU should not involve unnecessary/distorting costs for the operation of the insurance sector.
- Insurers are the largest European institutional investors with an asset base of € 10 tn. Since most of the assets back long-term liabilities, there is a natural potential for insurance companies to invest with a long-term perspective, also in illiquid assets.
- Despite important adjustments, the Solvency II framework continues to suffer from the implicit assumption that insurers can be viewed as traders, exposed to short-term liquidity risks. Instead, insurers are characterized by an intrinsic resilience to the short-term volatility of assets.

5. A Blueprint for Action: refocusing and implementing the CMU

8. Recalibration of Solvency II

- Against this background, Febaf calls for action to recalibrate capital requirements, notably for certain types of equity and debt investments. The case is made that for rapid, effective action to support long-term and infrastructure investments, equities and SME's. CMU and the review process of Solvency II should be synergically linked.
- Debt-type assets are a natural choice for insurers to match their (often long-term) liabilities, and insurers have a key interest in diversifying their allocation between various types of debt assets, including corporate debt, but also SME debt and private placements. In the case of SME debt, the existing capital charge is the same as for any other unrated corporate bond and does not reflect higher recovery rates, not even if the debt is backed by embedded guarantees. A more appropriate calibration of the Solvency II framework would provide economic incentives for insurers to optimise their allocations and support the Commission's objectives.
- The effects of the "SME supporting factor" defined in the Capital Requirements Regulation for banks could be extended to insurance regulation, where the prerequisites of diversified portfolio obtained, i.e. essentially in the case of purchases of SMEs' STS securitization tranches. Offering insurance companies the right incentives through capital requirements aligned with those applying to banks and enhancing transparency and information on the securitizations and their underlying assets would significantly increase insurers' ability to finance SMEs, albeit indirectly.

5. A Blueprint for Action: refocusing and implementing the CMU

8. Recalibration of Solvency II

- Equity-type assets are clearly underweight in insurance portfolios as a result of unnecessarily conservative capital requirements. Therefore, there is a clear potential in the industry for higher allocations to equity assets.
- Funding for innovation and start-ups often comes in the form of private equity. Unfortunately, the current treatment of private equity is identical to that of hedge funds with a capital charge of 49%. This approach does not reflect the non-volatile nature of unlisted SME investments and creates unnecessary capital burden for insurance companies wishing to invest in SMEs. The capital charge on unlisted SMEs equity should be aligned with the capital charge on strategic participations (i.e. 22%) and unlisted equities, similar to listed ones, should benefit from the Solvency II transitional clause, which would allow for a phase-in of a standard capital charge over seven years from the beginning of Solvency II.

5. A Blueprint for Action: refocusing and implementing the CMU

9. “Circular bonds”: business value chains and green securities

- The CMU should combine sound standards with innovation. The Febaf contribution makes the interesting case of “circular bonds”, within the realm of circular economy models.
- Green bonds will be issued by companies fostering restorative or regenerative business models within and outside the energy sector.
- Similar financial instruments could be issued by supply chains/clusters of SME’s. These models are already tested in the market, notably with the support of guarantees issued by a lead company in the chain.
- Both types of innovative instruments are in line with the objectives and the instruments of the Juncker Plan. The EIB and the EFSI could develop a specific task force to assess projects of these two types, within a “circular bond” financial framework. Guarantee schemes offered by the European Promotion Banks could help overcome infant industry problems.

5. A Blueprint for Action: refocusing and implementing the CMU

10. Securitisations and covered bonds

- These two related issues are last, but certainly not least in this Decalogue.

  i. **Efficient, safe and deep securitisation markets for bank loans are the key link between banks and market finance**. They are also the bridge to long-term investors, notably insurance companies and pension funds.

  As has been argued, after the mistakes made in the deregulation phase in the Unites States – which greatly contributed to the onset of the Great Financial Crisis – new safer securitisation models were quickly enacted on the other side of the Atlantic. There was also an active public support in the initial phase not only with reference to performing but also to non-performing loans (see for instance Bassanini et al., 2014).

  In Europe the need for action was quickly recognized (de Larosière Report 2009), but effective measures are still in the pipeline. The ECB made the case to restart safe securitisation schemes in 2013. The ECB and the Bank of England joined forces in 2014 to present the case for a good functioning market.

5. A Blueprint for Action: refocusing and implementing the CMU

10. Securitisations and covered bonds

In 2016 the EC made a similar case in the context of the CMU and indicated that this was a primary avenue to channel funds to SME's. Enria (2017) added his voice to the chorus.

But, so far no effective securitisation market has been developed, and yet, according to the Commission itself, this could provide additional funding to the economy of more than € 100 billion, while enhancing financial stability and supporting SME's.

Long-term investors like insurance companies and pension funds have the size and the resources for significant investment in SME securitization. However, they face regulatory problems and information asymmetry. The information difficulties stem from the heterogeneity of the asset pool and the lack of standardized conditions for determining the structure of placements and their documentation.

Enhanced standardization, transparency and quality of securitizations (including risk retention requirements) will support insurers' access to and interest in this asset class.

5. A Blueprint for Action: refocusing and implementing the CMU

10. Securitisations and covered bonds

In sum, required interventions refer both to infrastructure building and recalibration of banks' and insurances' capital requirements. The Febaf documentation provides detailed, operational suggested solutions to the unresolved problems.

ii. **A second key recalibration process is required for covered bonds**:

from the investor's perspective, covered bonds offer diversification, low risk and good quality investment, in that they are typically rated higher than the unsecured senior debt of the same issuer. From the issuer's standpoint, covered bonds offer a cost-effective alternative form of wholesale funding, which according to the European Commission "*remained resilient against the background of stressed market conditions, in particular when compared in issuance volumes to unsecured debt and asset-backed securities*".

5. A Blueprint for Action: refocusing and implementing the CMU

10. Securitisations and covered bonds

Greater liquidity of covered bonds can be achieved by harmonisation, at EU level, of quality and information standards. In the framework of CMU, this could lead to the creation of a single market for covered bonds across the EU and would help enlarge the investor base as investment analysis would be easier to carry on a cross-border basis.

Any EU initiatives aimed at harmonising quality and information standards should leverage on existing national frameworks that have proven experience and a track record of high investor protection. In particular, existing and well proven standards and financial instruments should not be put at risk.

The harmonisation of Covered bond frameworks in the EU should be structured in a balanced way to be beneficial for both issuers and investors. It is important to consider the difference existing in term of structures and models of each country, promoting market integration without hurting the best practices adopted across the various jurisdictions.

5. A Blueprint for Action: refocusing and implementing the CMU

10. Securitisations and covered bonds

The role of Covered bond as a funding instrument is even more relevant in view of the implementation of the TLAC and MREL framework within the EU. This is especially crucial for smaller banks, which have more difficulties in raising funds throughout capital markets. In this light, it is of great importance that all authorised banks in the European jurisdictions would be allowed to issue covered bonds, regardless of their size and/or level of capitalization (proportionality principle).

The issuance of covered bonds is an ordinary mean of funding and therefore within the full control of banks' sound and prudent management policy. If a bank satisfies the prudential requirements, it should be allowed to issue covered bonds without any additional capital requirement condition.

6. Concluding remarks

- The vision of EMU in Europe initiated in 1969 in Hague. Significant results were achieved, but the road was paved with difficulties. The continuous quest for the right balance between monetary, economic, fiscal and political integration has been managed, de facto, in the new millennium by putting increasing burdens on and challenges for the ECB (Masera, 2017). This overstretched the monetary union which – to recall – remains a unique experiment of a single money without a state.
- The prospects of fiscal union and of a fully fledged political union appear distant and fuzzy. The steady state envisaged - not only by the “fathers of Europe”, but later also by Kohl and Mitterand in their official capacities - continues to be a will-o'-the-wisp.

6. Concluding remarks

- The survival and success of EMU in the foreseeable future rest therefore on a satisfactory operation of the economic and financial unions. In this perspective, **the correct definition and the effective implementation of CMU play a key role**. **The CMU is one of the most ambitious and significant projects of the EU**. It is a fundamental component of the European reform plan to re-launch investment, growth and jobs in the European economy, and can mark a leap forward in achieving the Single Market and promoting social and economic integration: i.e. "finance for growth".
- This requires a rethink of the original Action Plan 2015, and capability of carrying out the new building blocks outlined in this note, by 2019. In turn this entails creating a new EU infrastructure and fostering capital market activities currently centered in London. Legal, fiscal obstacles and insolvency frameworks should be harmonized. A different governance and more powers for ESMA (and EIOPA) are required.

6. Concluding remarks

- **It is a challenging, difficult, but not impossible task**. The Blueprint for Action and the list of upcoming priorities outlined in this ABI/Bocconi Capital Markets Forum - in the light of the Febaf Contribution, the Italian Government Reply and the Malta Eurofi Regulatory Update - hopefully can help achieve this fundamental objective.

Thank you

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