ShareAction Briefing: the European Commission's Capital Markets Union

What is the Capital Markets Union?

The Capital Markets Union (CMU) is best defined by the goal it seeks to achieve rather than the laws and regulations it will adopt and alter. A capital market itself refers to the buying and selling of equity and debt instruments. Capital markets allow businesses, governments or individuals to access finance from retail investors or institutional investors like pension funds instead of using bank loans. The savings of millions of European citizens underpin capital markets through their pension funds, insurance products and retail savings products. It is estimated that €12 trillion is held by the EU's pensions and insurance sector alone[i]. This means that the laws and regulations monitoring capital markets directly affect how the savings of everyday pension fund or retail savers are invested.

CMU is an initiative from the European Commission that seeks to improve the flow of finance (money and assets) for investment across European member states by creating a single European market for capital 'from the bottom up, identifying barriers and knocking them down one-by-one'[ii]. At the moment, European capital markets are disjointed and the free flow of capital, a fundamental principle of the EU enshrined in the Treaty of Rome more than 50 years ago, has still not been achieved.

The CMU seeks to stimulate Europe's ongoing recovery from the financial crisis by boosting jobs and growth, in particular to make it easier for SMEs to access long term financing. It also seeks to lessen the reliance that European businesses have on banks, especially compared with businesses in the USA who use capital markets far more frequently for funding. In practice, the CMU will involve many layers of regulatory and legal change to insolvency and securities laws, tax treatments and the creation of new financial instruments and vehicles.

What is good about the CMU initiative?

- This is an opportunity to change Europe's investment system for the better so that it works for savers and long-term, environmentally sustainable economic growth instead of the enrichment of financial intermediaries and fuelling bubbles and crashes.
- The CMU emphasises that for a sustainable economic recovery it is crucial that investors with long-term liabilities, like pension funds, pursue long-term investment opportunities in the productive economy. The CMU seeks to remove the barriers that restrict the flow of funds from investors of all sizes to long-term investment opportunities via new financial instruments and investment vehicles.
- The Commission recognises that 'restoring the trust of investors is a key responsibility and challenge for the financial sector'[iii] and it must be made easier for consumers to choose and compare financial products.

Key assumptions of the CMU project…and are they right?

- Businesses in the US receive far more funding from capital markets than their European counterparts, so if European capital markets were as developed, European businesses could access more finance, stimulating growth. The financial system will also be made more stable by opening up a wider range of funding sources.

ShareAction view: The bank-oriented EU and the capital market-oriented US are two different traditions that have developed for over a century. Many have argued that local, relationship based banking is a better way for SMEs to access finance instead of foreign investors who may quickly withdraw funds and retreat to domestic markets at the first sign of a market downturn. There is a risk that CMU may not be as influential on growth and jobs as claimed, but could instead increase trade and growth within the financial sector only if not carefully guarded against.

- The creation of European Long-Term Investment Funds (ELTIFs) and removal of restrictions in some member states around investing in certain asset classes will make investors with long-term liabilities adopt a genuinely long-term investment approach.
  ShareAction view: While this is a positive step, there remains a multitude of cultural and structural barriers to be tackled. The chain between a savers' money and the investee asset is heavily intermediated with misaligned incentives at every step.[iv] Institutional investors with long-term liabilities frequently judge performance and award mandates over short-term horizons. Therefore investment intermediaries are reluctant to pursue strategies whose benefits are only apparent over the long-term, like getting favourable rates by locking capital away for decades in infrastructure projects, or engaging with investee companies. Markets are inefficient when they do not properly recognise or reward companies who make long-term plans and investment, including on sustainability.

- Policy measures are needed to incentivise institutional investors to make investments in infrastructure and private financing of infrastructure projects is problem-free.
  ShareAction view: There is already significant appetite for high quality, long-term, illiquid investment opportunities, such as infrastructure, amongst European institutional investors. In fact too many investors are chasing too few of such assets. Institutional investors increased their investment in European infrastructure by 465% from 2010-13, compared with the 4 previous years[v]. The CMU must not fuel an infrastructure bubble or repeating costly mistakes which Public Private Partnerships have led to in other countries. For example, for PPP projects with a capital cost of €14 billion, the UK's National Health Service is due to pay back a total of €80.7 billion[vi].

What is missing from the CMU?

Responsible Investment

Responsible Investment (RI) is an investment approach which takes account of environmental, social and corporate governance (ESG) factors, recognising that they have a financially material impact on company and investment portfolio performance, particularly over the long-term. Responsible investors monitor and engage with investee companies, seeking to improve their performance rather than trading speculatively and basing decisions on the behaviour of other market participants. RI is rapidly gaining mainstream acceptance; signatories to the UN led Principles for Responsible Investment (PRI) manage assets worth $59 trillion.[vii]

The CMU does not address the need for comprehensive consideration and disclosure of ESG factors. Instead, 'ESG investments' are only mentioned as an afterthought; as a separate asset class, such as green bonds, rather than an inherent part of all investments. To ensure that ESG factors are properly considered in all investment practices and asset classes, institutional investors and asset managers should be required to produce Statements of Investment Principles (SIPs). These SIPs should include meaningful information on how investors are managing long-term risks, including ESG risks, their approach to engagement with investee companies and voting. Results of engagement and voting must also be disclosed. Although disclosure is not a panacea, the impact of mandating such disclosures by mutual funds in the US shows that if investors knowing their behaviour will be scrutinised by beneficiaries, civil society and the media catalyses more responsible behaviour.[viii]

Climate change & sustainability

The Bank of England has acknowledged that future climate change would lead to a significant reduction in global economic output and the G20 has also instructed its Financial Stability Board to assess the risks posed to the global financial system by the need to reduce carbon emissions.[ix] Sustainability must be core to the CMU project. Policy initiatives seeking to "unlock investment in EU companies and infrastructure" and "improve the allocation of risk and capital" for job creation and growth must be aligned with other EU social, climate and energy objectives like the Europe 2020 Strategy for 'smart, sustainable and inclusive growth'; procrastinating this transition will be more costly in the long run.[x]

The CMU must ensure that the investment sector is properly aligned with the realities of climate change and supports the transition to a low carbon economy to protect the environment, and savers' money. The Commission should play a leading role in defining standardised definitions and measures, in collaboration with other globally recognised initiatives, to avoid 'greenwashing'. Robust definitions and requirements in relation to ESG factors will ensure that disclosure requirements for investors, corporations and other projects seeking investment are meaningful, useful and comparable.

Fixing the lack of trust in financial services

Improving public trust in financial services must be a priority to achieve the CMU. 'Investment products' and 'personal pensions and securities' were the lowest scoring services markets in the 2014 European Commission Consumer Markets Scoreboard[xi]. Although distrust is acknowledged, no concrete measures are proposed to tackle this. Transparency and accountability to clients and beneficiaries must become the norm in the investment sector, not just to retail investors but also to the end beneficiaries of institutional investors, such as pension fund savers.

Policy initiatives seeking to encourage the sustained participation of retail and institutional investors in new collaborative funds are unlikely to succeed unless they also include measures to restore trust by addressing governance, incentive and disclosure issues.

ShareAction's vision for a CMU that serves savers, society and the environment

The European Commission acknowledges that European "households are the main source of funds to finance investment". Therefore European retail savers and beneficiaries of institutional investors must be placed at the centre of the CMU. Public opinion is on the side of RI and investment in the real economy; 80% of Europeans believe that fighting climate change and using energy more efficiently can boost the economy and jobs in Europe for example[xii]. Although the public may not understand fully how the investment system works and are put off by the jargon, they care deeply about the key RI issues, like executive pay, climate change, human rights and labour rights abuses in company supply chains.[xiii]

When beneficiaries are given a voice or when institutional investors feel more accountable to them, a clearer and more rounded view of beneficiaries' best interests emerges, which drives demand for RI. The Commission should investigate and encourage use of new digital technologies to improve transparency and accountability to savers.

Retail savers and beneficiaries of institutional investors should have the right to know:

- where their money is being invested
- how ownership rights are being exercised on their behalf
- their scheme's investment policy, including any policies on responsible ownership or ethical investment, and how the policy is being implemented
- how the scheme is managing long-term risks to their money, including ESG risks.

They should have the right to participate by:

- being consulted on investment and voting policies
- attending annual meetings where they can question the board of their pension fund or other investment provider, as shareholders can attend the annual general meetings of listed companies
- receiving a substantive response to queries about specific decisions

About ShareAction

ShareAction is building a movement for Responsible Investment. We are the UK's leading civil society organisation promoting an investment system that better serves savers and the public interest. We believe that responsible investment helps to safeguard investment returns as well as securing environmental and social benefits. We bring together leading charities, unions, faith groups and individual investors to scrutinise the big investors in our economy and to remove barriers to RI. We are a membership organisation and our 18 members include some of the UK's largest trade unions and NGOs, such as Greenpeace, Friends of the Earth, WWF and Oxfam. We have over 40,000 individual supporters who took nearly 60,000 online actions in 2014, such as emailing their pension, via our online tools.

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[i] European Commission, 'Green Paper: Building a Capital Markets Union /* COM/2015/063 final *', 2015, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015DC0063
[ii] Ibid.
[iii] Ibid
[iv] Kay, J., 'The Kay Review of UK Equity Markets and Long Term Decision Making', For Department of Business Innovation and Skills, 2012, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf
[v] Linklaters, Set to revive: Investing in Europe's infrastructure, Full Report, 10 March 2014
[vi] BankWatch Network, 'UK hospital PPPs', http://bankwatch.org/documents/PPPs/PPP-case-UKhospitals.pdf
[vii] http://www.unpri.org/news/pri-fact-sheet/
[viii] Aggarwal, R., Erel, I., Starks, L., 'Influence of Public Opinion on Investor Voting and Proxy Advisors', Georgetown University McDonough School of Business, 2014
[ix] Bank of England, 'One Bank Research Agenda: Discussion paper', 2015, available at www.bankofengland.co.uk/research/documents/onebank/discussion.pdf and G20 Finance Ministers and Central Bank Governors, 'Communiqué' 17/04/2015, available at http://www.g20.utoronto.ca/2015/150417-finance.html
[x] Weyzig, F. et al., 'The Price of Doing Too Little Too Late: The impact of the Carbon Bubble on the EU financial system', Sustainable Finance Lab and Profundo, 2014
[xi] http://ec.europa.eu/consumers/consumer_evidence/consumer_scoreboards/10_edition/docs/cms_10_factsheet_en.pdf
[xii] Eurobarometer, 'Special Eurobarometer 409: Climate Change', 2014
[xiii] See for example, National Association of Pension Funds, 'What do pension scheme members expect of how their savings are invested?', 2014 and UKSIF, 'Attitudes to Ownership 2014: Exploring pension fund and public opinion on ownership and stewardship issues', 2014

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