ANALYSIS

From Giovannini barriers to Capital Markets Union

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One of the priorities of Finland's autumn 2019 Presidency of the Council of the European Union was the Capital Markets Union initiative, which seeks to enhance and diversify financial intermediation in Europe. Although the initiative is not new, it has proven to be difficult to implement. No one right path or solution exists. Instead, EU-level regulation must be supported by a number of measures which belong to the purview of national decision-making. This article provides insights into the discussion on capital markets, which has been ongoing since the signing of the Treaty of Rome in 1957.

The views expressed in this article are those of the author and do not necessarily reflect the official view of the Bank of Finland.

From a fragmented and inefficient operating environment towards integrated capital markets

Underdeveloped capital markets have been seen as an important factor slowing economic growth in Europe. The following analysis presents a brief account of the development of European securities markets infrastructure in the 2000s, which can be summarised as the effort to move from a fragmented and inefficient operating environment towards the objectives of Capital Markets Union (CMU). The analysis is structured around the barriers to integration identified by the Giovannini Report and is primarily based on documents published by the European Central Bank (ECB) and the European Commission (COM).

The main conclusion of the analysis is that eliminating fragmentation and inefficiency is neither simple nor quick. Revising EU legislation will not by itself be enough to remove lingering barriers in capital markets. Infrastructure initiatives spearheaded by the ECB have contributed to supporting the creation of a pan-European capital market. Yet the majority of the barriers identified 20 years ago already belong to the purview of national powers, and their removal has remained unsuccessful as a result. What remains clear is that there is no one right path towards a solution. Instead, it will be achieved through a number of smaller measures and cooperation.

The Giovannini Reports as a compass towards capital markets integration

Well-functioning trading venues for securities transactions are a necessary component of efficient financial markets. Once a securities transaction has been agreed by its counterparties, a clearing process is initiated where the order is executed and the buyer receives all rights associated with the security and the seller their respective payment (settlement). Securities clearing and settlement systems are a cornerstone of the financial system, and they largely determine the efficiency and reliability of investment activities.

Free capital movement was already included as an objective in the Treaty of Rome, signed in 1957. However, interest in EU-wide financial activity did not gain prominence until the introduction of the euro in 1999. The costliness and inefficiencies associated with cross-border financial activities were particularly pronounced in securities clearing and settlement arrangements, which were largely based on domestic practices and systems. Although domestic operations were already fairly efficient, the same did not hold across borders, in an operating environment comprising over 30 different systems. A number of studies demonstrated that from the standpoint of an investor, the clearing and settlement of an equities transaction across national borders was two to six times more expensive than an equivalent transaction at home. On a systems level, the clearing and settlement of a domestic transaction within the EU was eight times more expensive than in the United States (DTCC).[1] Inefficiencies in clearing and settlement arrangements weaken the ability and willingness of market participants to engage in securities trading in the EU, they decrease liquidity in financial markets, and raise the cost of capital unnecessarily.

The European Commission has over the years established several working groups tasked with surveying the development and integration of securities trading in Europe. One such example, the Lamfalussy Group, highlighted in its report[2] the need for

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1. The Depository Trust & Clearing Corporation (DTCC).
2. European Commission (2001).

harmonising clearing and settlement systems. According to the report, authorities needed to take a more decisive approach to speeding up the integration process. As particular sticking points, the report identified the slowness of the legislature, differences in national legal and taxation systems, unclear legislation, and cultural barriers. At the proposal of the Lamfalussy Group, the European Securities Committee (ESC) and European Securities Regulators Committee (CESR) were established.[3] Meanwhile, on an international level, global cooperation in the area of securities markets infrastructure was being promoted by the G30[4] and CPSS-IOSCO[5], among others.[6]

The Giovannini Group, named after its chairman Alberto Giovannini, later published a report outlining even more concrete measures than the Lamfalussy report. The first Giovannini Report[7], published in 2001, identified 15 barriers to the efficient functioning and development of cross-border clearing and settlement. The barriers were subdivided into 1) barriers relating to national differences in technical requirements/market practice; 2) barriers related to taxation; and 3) barriers related to legal certainty. The second Giovannini Report[8], published in 2003, attempted to provide solutions and establish priorities for removing the barriers.

The Giovannini Reports created a bridge between complex technical issues and policy objectives. They clearly demonstrated that there is a need for action and drew the attention of infrastructure service providers and authorities to the fact that inefficiencies in clearing and settlement can have serious consequences for the EU economy.

Market practices and regulatory requirements

The European Commission has actively promoted the creation of a single European capital market by adopting regulation for the harmonisation of market practices and regulatory requirements. One of the key regulatory initiatives was the Markets in Financial Instrument Directive (MiFID)[9], which harmonised the regulation of trading venues and created EU-wide authorisation requirements and practices. The European market infrastructure regulation (EMIR)[10] created a framework for the operation of central counterparties (CCP) and also promoted their cross-border activities. The

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3. European Securities Committee (ESC) and Committee of European Securities Regulators (CESR), later: European Securities Markets Authority (ESMA).
4. Consultative Group on International Economic and Monetary Affairs, Inc. (G30).
5. CPSS-IOSCO (2001) Recommendations for Securities Settlement Systems. Committee on Payment and Settlement Systems (CPSS); later Committee on Payments and Market Infrastructures (CPMI).
6. See e.g. Koskenkylä (ed.) Financial integration (A:107 / 2004), Pikkarainen and Suvanto (ed.) Bank of Finland, EMU and Financial Markets (A:109 / 2006) and Palva: Suomen Pankin rooli maksuliikkeen kehityksessä: kansallisista järjestelmistä yhteiseurooppalaisiin järjestelmiin (A:116 / 2015) (The Bank of Finland's role in the development of payments: from national systems to pan-European systems, in Finnish only).
7. European Commission Giovannini Group (2001) https://ec.europa.eu/info/publications/giovannini-reports_en.
8. European Commission Giovannini Group (2003) https://ec.europa.eu/info/publications/giovannini-reports_en.
9. Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.
10. Regulation of the European Parliament and of the Council on markets in financial instruments and amending regulation (EU) No 648/2012 on OTC derivatives, CCPs and trade repositories.

regulation on central securities depositories (CSDR)[11] enabled competition between depositories and supported their activities across borders as well. The Settlement Finality Directive (SFD)[12], which had come into force earlier, increased legal certainty related to settlement and reduced systemic risk.

These regulations and directives were preceded and anticipated by e.g. the two Communications[13] adopted by the European Commission, outlining the Commission's policies regarding post-trade processing of securities transactions. These communications assigned working groups, consisting of private and public sector representatives, with the responsibility of promoting the removal of barriers. For example, the CESAME Group published in 2008 a report on technical requirements and market practices.[14] At the same time, the Commission established the FISCO Group[15], which addresses issues related to taxation, and the Legal Certainty Group[16] for addressing issues involving legal certainty.

The Eurosystem as a developer of infrastructure

The Eurosystem has been active in developing an integrated financial market infrastructure in Europe. TARGET, the real-time interbank payment system, has been operational since 1999 (the new version, TARGET2, was introduced in 2007–2008). A decision on the introduction of a single European securities settlement platform—TARGET2-Securities (T2S)—was taken by the ECB Governing Council in 2008. The system was launched in 2015.

Central banks and central securities depositories (CSDs) joined T2S in five waves. The final migration wave was completed in September 2017. At present, there are 21 CSDs connected to T2S.[17]

T2S fulfils the idea embedded in the single market that integrated and harmonised systems are the most efficient way of producing reliable services for all.[18] Even though

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11. Regulation (EU) No 909/2014 of European Parliament and Council of 23 July 2014 of improving settlement systems in European Union and on Central Securities Depositories and amending Directive 98/26/EC and 2014/65/EU and regulation (EU) No 236/2012.
12. Directive 98/26/EC of the European Parliament and the Council of 19 May 1998 on settlement finality in Payment and Securities Settlement Systems.
13. European Commission Communications on Clearing and Settlement (2002, 2004) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX%3A52004DC0312%3AEN%3AHTML.
14. CESAME Report (2008): The work of the Clearing and Settlement Advisory and Monitoring Experts´ Group ("CESAME" Group).
15. Fiscal Compliance Experts' Group (FISCO), http://ec.europa.eu/internal_market/financial-markets/clearing/compliance_en.htm.
16. Legal Certainty Group (LCG), http://ec.europa.eu/internal_market/financial-markets/clearing/certainty_en.htm.
17. The Finnish CSD Euroclear Finland could not join the final migration wave due to factors related to its infrastructure reform, and has confirmed that it aims to join T2S in November 2022. Due to client needs, the Bank of Finland joined T2S in the third migration wave in September 2016.
18. See e.g. Korhonen – Rantalainen (2007) Target2-Securities tuo tehokkuutta arvopaperiselvitykseen ('TARGET2 increases the efficiency of securities settlement'), Euro & Talous 2/2007 and Korhonen – Myller – Rantalainen (2007) Target2 Securities – yhteinen infrastruktuuri euroalueen selvitysjärjestelmille

T2S has removed a range of—mostly technical—barriers listed by the Giovannini group, cross-border settlement has increased only marginally. There are still legal, regulatory and tax-related barriers to a single European capital market.

T2S has formulated its own agenda for monitoring progress towards its harmonisation standards. To date, 9 harmonisation progress reports have been published. According to the most recent report (January 2020[19]), 90% of T2S markets are in compliance with TS2 harmonisation standards.

After T2S, the Eurosystem launched three 'Vision 2020' projects aimed at integrating the Eurosystem's central bank services. These projects are designated for 2018–2022 and comprise the following:

- TARGET Instant Payment Settlement (TIPS), which enables real-time and around-the-clock settlement of payments in central bank money, every day of the year. The service was launched in November 2018.
- Consolidation of TARGET2 and T2S, which will update the technical aspects of TARGET2 and improve liquidity management among the participants.
- Introduction of a single Eurosystem Collateral Management System (ECMS).[20]

The purpose of the Vision 2020 projects is to create 'domestic markets' for central bank services in Europe. All three projects contribute to improving financial integration, thereby also supporting the objective of the EU's Capital Markets Union to foster the free movement of capital.

Towards the objectives of Capital Markets Union

The European Commission returned to the Giovannini barriers in 2015 when it announced an action plan on Capital Markets Union[21]. The action plan seeks to create, through a variety of measures, a single market for capital in Europe and increase the volume of funding channelled to the real economy by capital markets.

The CMU is a key element in the Commission's endeavours to promote employment and growth. The CMU action plan states that, despite significant progress, there are still barriers to a single market for capital, especially in the area of cross-border investments. A fundamental drawback of the absence of CMU is that the European capital markets are significantly smaller than the ones in the United States, even though the European and

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('TARGET2-Securities – integrated infrastructure for euro area settlement systems'), Bank of Finland, Financial Stability and Statistics department, Working Paper 11/2007.

19. 10th T2S Harmonisation Progress Report https://www.ecb.europa.eu/paym/intro/publications/pdf/ecb.tenth_t2sharmonisationprogressreport.en.pdf?89ceb7c4dbb5f7023a5557e4c880f202.
20. For more information on the Vision 2020 projects, see: http://www.ecb.europa.eu/paym/initiatives/html/index.en.html
21. Action Plan on Building a Capital Markets Union (30 September 2015) https://ec.europa.eu/info/publications/action-plan-building-capital-markets-union_en.

US economies are otherwise roughly equal in size.

The Giovannini barriers have not actually been revised over the years, despite the adoption of certain major regulations and standards. At the same time, the extent to which capital markets in different countries have already converged, in terms of legislation and market practices, has become unclear in the course of the years.

As part of the CMU action plan, the Commission set up an expert group in 2016, the European Post-Trade Forum (EPTF), to undertake a broad review of the progress made in the field of securities post-trading and in the removal of Giovannini barriers.

The expert group published its report in 2017.[22] Its main finding was that only 5 of the 15 Giovannini barriers identified at the beginning of the 2000s had been removed. Their removal has been the result of both EU-level regulation and the launch of T2S. Many significant and complex issues still need to be addressed.

The EPTF has reclassified the remaining Giovannini barriers and reformulated them to correspond to the present situation. Following this revision, 12 barriers still remain. The EPTF has also identified 5 issues to be closely monitored to ensure that they do not emerge as new barriers in the future (items on the EPTF's 'watch list').

Some of the remaining barriers are due to differences in national legislation and need to be addressed at the national level. The differences related to taxation, for example, are significant. Other barriers concerning, say, technical standards, can be addressed more readily—at least ostensibly. Of course, some of these may be underpinned by national interests, which again makes them all the more difficult to address.

It must be noted that the EPTF has listed barriers with wide implications. To avoid one-sided interpretation, the European Commission has actively communicated with the market participants. As it is already time for preparations of "CMU 2.0.", it is important that also the new Commission is committed to continue the dialogue with the markets.

While the Commission can only resolve some of the issues through its own action, it can propose solutions to others. With respect to withholding tax, for example, the Commission has compiled a list of best practices which could serve as a basis for improving national legislation. The list is however by no means binding. Nevertheless, it would be particularly desirable if Member States at the very least refrained from taking their national legislation in the opposite direction.

In addition to removing EPTF barriers (and former Giovannini barriers), other measures are also being pursued in relation to Capital Markets Union, such as the harmonisation of supervision, practices, definitions and technical solutions as well as the improvement and clarification of communication between countries. Even if a regulatory and technical framework for the CMU were eventually created, each investor and market actor would ultimately need to decide for themselves the extent to which they would wish to operate on a cross-border basis. As a result of Brexit, the EU will lose a significant share of its

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22. Report of the European Post Trade Forum (EPTF), 15 May 2017 https://ec.europa.eu/info/publications/170515-eptf-report_en.

capital markets. The remaining national markets are in many respects underdeveloped and relatively small by international standards. This vista may not prove especially appealing to international investors.

Building a single capital market more demanding than expected

Building a single capital market for Europe has proven to be an undertaking much lengthier and more demanding than harmonising its payment systems, for example. Of the 15 Giovannini barriers listed at the beginning of the 2000s, only five can be regarded as having been fully removed. With the identification of even new barriers, the EPTF has concluded that there are still 12 barriers to be dismantled to complete the CMU.

The Eurosystem has played a pivotal role in removing these barriers. The European Commission has, through its regulatory work, created an operating environment suitable for cross-border activities, but coordination between the ECB, national central banks and market participants has also been needed to ensure that the necessary practical arrangements have been in place. T2S and the 'Vision 2020' projects are an example of this. Going forward, it must be assessed whether completion of the CMU necessitates other common infrastructure projects. In any case, what remains clear is that there is no one right path towards a solution. Instead, it will be achieved through a number of smaller measures and cooperation.

Tags

Capital Markets Union (CMU), Giovannini reports, harmonisation, securities markets