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WHAT WILL HAPPEN WITH THE CAPITAL MARKETS UNION AFTER BREXIT?

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SUMMARY

When the European Commission drafted its plans for the Capital Markets Union (CMU), it was obvious that the United Kingdom (UK) would be part of a future CMU due to its fundamental importance in Europe's capital markets. Brexit may be a game-changer because it threatens to detach the European Union (EU) from the country that hosts its largest capital market.

The implications of Brexit for the CMU project are threefold:

First, it raises questions on the future financial ties between the UK and the EU. Can UK-based financial firms maintain their access to the Single Market and if not how does this impact different capital market segments? The UK's capital markets play a central role in the EU as they provide a refinancing and trading platform for other European financial centres. It looks currently unlikely that the UK will be able to secure access via financial passports as this would imply to recognize all obligations attached to the Single Market. The most affected capital market segments are those where relocation implies significant increases of fixed costs (e.g. asset management funds) or where UK platforms are no longer directly accessible across the Single Market (e.g. equity trading and clearing).

> "BREXIT CHANGES THE COST-BENEFIT CONSIDERATIONS AMONG THE EU27"

Second, the UK's exit process may affect the political support for the CMU as it has implications for the motivation behind and direction of the project. The UK has been an important intellectual and political sponsor of the CMU, assisting the Commission to keep it a priority on the agenda. The CMU strengthens the ability of investors to provide funds across the Single Market. No other country (especially no larger one) can expect benefits from the CMU to be as high as it would have been for UK's financial industry. Nonetheless, Brexit changes the cost-benefit considerations among the EU27. Several financial centres could benefit from a relocation of UK-based firms and activities. At the same time, the EU27 would have to compensate for the loss of market depth to cushion the economic consequences on capital market funding.

Third, the UK's departure may allow for a comprehensive reform of the institutional set-up. Brexit brings up an old debate about the question whether or not the integration of capital markets requires the transfer of supervisory competences from the national to the European level. The need to relocate the European Banking Authority (EBA) in the Brexit context opens a window of opportunity to reassess and adjust the framework of European supervisory authorities (ESAs) and thus could bring this debate back on the agenda.

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INTRODUCTION

The Capital Markets Union (CMU) was designed as a Single Market project and not a euro area project, not least because of the central role of the United Kingdom's (UK) capital markets for the EU financial system. The Commission's initiative for the CMU aimed to stimulate market-based alternatives such as equity finance, venture capital and corporate bonds. It was hoped that more capital market intermediation would widen the pool of funding instruments for companies and increase cross-border private risk-sharing in the European Union (EU).[1]

The outcome of the British referendum in favour of Brexit now raises doubts about the future of the CMU. The UK hosts Europe's largest capital markets and a majority of international investors who are active in the EU is headquartered in London. In some market segments the UK accounts for up to three quarters of total EU activity. If the UK leaves, EU capital markets depth would shrink by about 16%.[2]

The UK government plans to trigger Article 50 in March 2017. In the negotiations, trade of financial services will be a key topic with a direct effect on the future landscape of European capital markets. While details remain unclear, the European position is unambiguous on the point that access to the Single Market cannot be limited to certain areas. Thus, a disintegration of British and EU capital markets is a realistic scenario.

This paper analyses the economic and political implications of the Brexit referendum outcome for the CMU. Section one looks at different options for the UK to maintain access to the Single Market and analyses which capital market segments would be most affected when the UK loses this access. Section two compares political support for CMU before and after Brexit and assesses how the UK's retreat from the political process affects the CMU agenda.

1. Economic implications of Brexit for the CMU: a lose-lose situation?

Losing access to Europe's financial market could be one of the economically most costly consequences of Brexit for both sides. Over the last decades, the City of London established itself as the uncontested hub of European finance. London's importance is based on its role as wholesale financial centre for other financial markets in Europe. It provides a refinancing, trading and clearing platform for institutional investors across the EU. It is home to Europe's largest equity and derivative markets and hosts a wide range of related services such as rating agencies, data vendors as well as legal and auditing services.[3]

The high liquidity of London's capital markets and the network effect of having all services in one place put London in advantage over other EU financial centres.[4] Brexit threatens to detach the UK's highly developed capital markets from EU's markets. This could lead to lower efficiency and higher costs of capital market funding in the remaining EU27, not to speak of the detrimental effects for UK's financial industry. As CMU promotes, what London embodies today, Brexit would be a huge setback.

1. European Commission, Action Plan on Building a Capital Markets Union, COM(2015) 468 final, 30 September 2015.
2. W. Wright, Beyond Brexit: What next for European Capital Markets?, New Financial, June 2016.
3. K. Lannoo, EU Financial Market Access after Brexit, CEPS Policy Brief, September 2016.
4. D. Schoenmaker (2016) Written evidence for the House of Lords EU Sub-Committee on Financial Affairs on the future of Financial Services in the UK following the vote to leave the European Union, Bruegel, September 2016.

1.1. The City without passports

London has been a great beneficiary of the Single Market. The so-called financial passport allows a financial firm to offer services across the EU from a single location. Many non-EU banks use London as their headquarter to access other European financial markets, especially investment banks from the US and Switzerland. The five largest US investment banks, for instance, earn 92% of their turnover in the UK. Their staff is similarly concentrated in the City.[5]

There are at least 13 different passport regimes in place which cover different financial services such as banking, investment funds or clearing.[6] Banking passports for example are regulated under the Capital Requirements Directive (CRD IV). A financial passport is based on the licence by a supervisor from a member state of the Single Market where the financial firm is headquartered. Under CRD IV a bank with a financial passport can establish branches and provide services in other member states without additional approval by local supervisors. The financial passport also implies that the supervisor providing the licence is responsible for prudential supervision.

Financial passports are limited to the Single Market. When the UK leaves the EU and does not maintain access to the Single Market UK licences will no longer qualify for financial passports. UK-based financial firms will have to create subsidiaries in continental Europe and acquire licences from national supervisors. Similarly, some clearing and trading activities will have to move to the EU27.

The so-called Norway, Switzerland and Canada examples are often cited to illustrate potential scenarios of a future UK-EU relationship. The Norway model provides for the closest form of association as membership in the European Economic Area (EEA) would ensure access to the Single Market. However, the Norway model seems politically not feasibly as it includes obligations of EU membership, including free movement of labour, budget contributions and implementation of EU legislation, while having very little influence on what is decided in Brussels. The Swiss model also offers access to the Single Market, however, with important exceptions such as the trade in services. The relationship is based on obligations and fees but is more selective on the areas of cooperation and based on a framework of bilateral treaties which usually take years to negotiate. Finally, a Canada-style trade deal would come closer to the UK's desire for independent policy-making, however, it would not include free movement of capital.[7]

„ONLY THE NORWAY MODEL IS LIKELY TO SECURE PASSPORTS FOR UK'S FINANCIAL INDUSTRY"

It seems very unlikely that the EU would grant the UK access to its capital markets without honouring all other freedoms of the Single Market including enforcement through the Commission and the European Court of Justice (ECJ). Hence, only the Norway model is likely to secure passports for UK's financial industry. This outcome is, however, most at odds with the promise of the Leave campaign to 'take back control'.

Equivalence of regulation is often discussed as a fall-back option if access to the Single Market cannot be maintained. Yet, the equivalence regime has important downsides for the UK. First, it brings along high uncertainty for all institutions that rely on the long-term maintenance of equivalence to conduct business. The Commission can unilaterally revoke equivalence any day, which would put the UK in considerable disadvantage to financial centres in the EU27.[8] Second, it would limit the UK to develop a competitive edge through a more attractive regulatory framework and more advanced institutions.[9]

5. C. Goodhart & D. Schoenmaker, The United States dominates global investment banking: does it matter for Europe?, Bruegel Policy Contribution 2016/06, 2016.
6. K. Lannoo, EU Financial Market Access after Brexit, CEPS Policy Brief, September 2016.
7. T. Carpenter & G. Floater. Brexit: Impacts on UK and EU Trade, (Graduate Institute Geneva Policy Brief 002), 2016. and S. Dhingra and T. Sampson, Life after BREXIT: What are the UK's options outside the European Union? (London School of Economics, Centre for Economic Performance, Paper Brexit 01), 2016.
8. K. Lannoo, EU Financial Market Access after Brexit, CEPS Policy Brief, September 2016.
9. N. Véron, The City will decline - and we will be the poorer for it, Prospect Magazine, 18 August 2016.

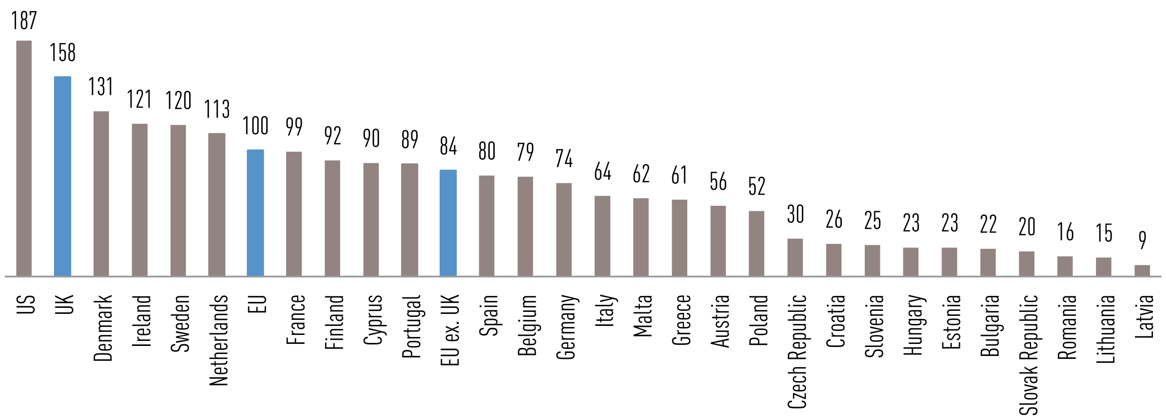
To conclude, neither the maintenance of financial passports nor aiming for equivalence seem to be political feasible or attractive options for the UK in the current political environment. Instead the City might rather want to establish itself as a global financial centre with an attractive regulatory framework and high-quality institutions. The services that rely on the financial passport would then have to move to continental Europe. Early estimates suggest that 15% to 30% of UK's financial service activities would relocate to the EU27.[10]

1.2. London's role in the EU's capital markets

The City of London plays a unique role in Europe's capital markets. While there are several local financial market places hosting important stock exchanges such as Frankfurt or Paris, London's function as wholesale or refinancing centre for other financial centres is special.[11] Wholesale markets cover trading and clearing activities of currencies, equity, derivatives, commodities as well as private and government bonds. In some capital market segments, London accounts for up to three quarters of the total EU activity.[12]

How would the EU's capital markets look like if the UK would leave the bloc? For 16 out of 21 capital market segments the UK is the most important location.[13] When the UK leaves the EU the depth of European capital markets relative to GDP would shrink by about 16% (see figure 1).[14] Nonetheless, there are differences among the various capital market segments. In some areas the UK has important cross-border functions in others the impact on the EU27 will be limited. The following (non-exhaustive) list elaborates on the Brexit consequences for the EU27 in five key capital market segments.

FIGURE 1 ► Depth of EU capital markets with and without the UK



The figure shows the relative depth of capital markets in Europe across 25 different sectors (Five years to 2014, relative to GDP, rebased to EU = 100).

Source: New Financial, Beyond Brexit What next for European capital markets?, June 2016.

1. Asset management: Household savings in Europe are highly concentrated in low yielding bank deposits. The CMU seeks to promote more market-based forms of saving such as investments in mutual funds or pension funds. 40% of such assets under management in the EU are located in the UK.[15]

While the CMU aims to widen the scope for Europe-wide available investment products, Brexit could lead to the opposite. UK-based asset management operates across the Single Market and can therefore offer more

10. D. Schoenmaker, Lost passports: a guide to the Brexit fallout for the City of London, Bruegel Blog Posts, 30 June 2016.
11. K. Lannoo, EU Financial Market Access after Brexit, CEPS Policy Brief, September 2016.
12. W. Wright and L. Bax, What do EU capital markets look like post-Brexit?, New Financial, September 2016.
13. W. Wright and L. Bax, What do EU capital markets look like post-Brexit?, New Financial, September 2016.
14. W. Wright, Beyond Brexit: What next for European Capital Markets?, New Financial, June 2016.
15. W. Wright, The potential impact of Brexit on European capital markets: A quality survey of market participants, New Financial, April 2016,

diversified and sophisticated products. Forcing these funds to spread the fund management over several countries will increase fixed costs and could result in less attractive products.

2. Venture Capital: Availability of risk capital is a key goal for the European Commission to foster entrepreneurship and start-up activity.[16] London is Europe's most important venture capital hub and the only one that operates across the entire EU and is not limited to a sub-region.[17] It hosts also the majority of international venture capital funds that invest in the EU. Currently, the UK venture capital market accounts for 36% of total EU activity. To compensate for the depth provided by the UK markets, the EU27 markets would have to expand by 30 percentage points or €2 bn.[18]

When UK-based venture capital funds lose direct access to the EU27, total provision of venture capital in Europe could decline. To relocate businesses or open subsidiaries is costly and spreading over several European financial centres could undermine important network effects.

3. Equity trading: The Single Market allows for the consolidation of trading platforms, which increases the efficiency of price discovery due to high liquidity and makes trading cheaper due to lower costs for market infrastructure. UK's trading platforms, for example, execute 40% of the EU27's trades.[19]

"UK STOCK MARKET CAPITALIZATION IS ALMOST TWICE AS HIGH AS THE EU28 AVERAGE"

Post-Brexit, European stock markets might face barriers to access UK-platforms, which could lead to lower liquidity. EU27 stock market capitalization would also shrink relative to GDP. UK's stock market capitalization of 121% of GDP is almost twice as high as the EU28 average of 64.5%.[20]

4. Debt securities: The revitalization of securities markets is one of the CMU's flagship initiatives.[21] While the UK accounts for the largest share in European securitization issuance (21%), it is important to note that securitization in the UK is concentrated in residential mortgages.[22] More relevant for European businesses is the securitization of non-financial corporate debt. Here the UK share is only 11% of outstanding securities. France and Germany account for 27% and 22%, respectively (see figure 2).[23]

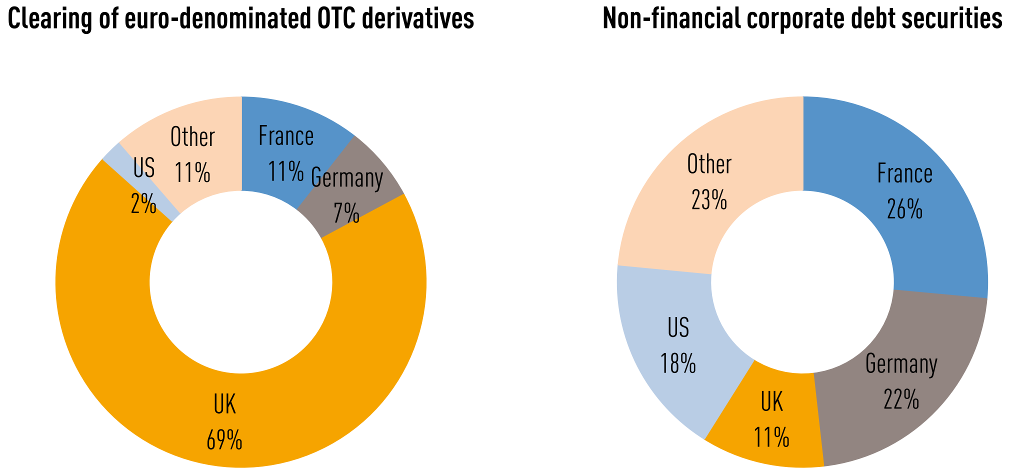
The limited role in corporate securitization suggests that the UK markets were no vital platform for securities trading and therefore larger markets such as France and Germany could drive European securitization at least in the segment of corporate securitization.

5. Post-trade clearing and settlement: UK clearing houses have a dominant role in European clearing and settlement of capital market activities. In the segment of over-the-counter derivatives trading, UK-based firms clear about 70% of euro-denominated trades (see figure 2).[24] The financial passports allows to offer such post-trade services to market places across the continent.

The ECB was uncomfortable with the lion's share of euro-denominated clearing out of its supervisory reach due to the potential risks for financial stability. However, the ECB lost its appeal that euro-denominated clearing needs to move to the euro area in front of the ECJ.[25] While euro area market places welcome the opportunity to take over clearing and settlement with a volume of about 1 trillion USD currently based in the UK, costs could increase as a consequence of the departure of the most competitive service providers.

16. European Commission, Building a Capital Markets Union: Economic Analysis, SWD(2015) 183 final, 30 September 2015.
17. European Investment Fund, The European venture capital landscape: an EIF perspective, EIF Working Paper 2016/34, 1 June 2016.
18. W. Wright and L. Bax, What do EU capital markets look like post-Brexit?, New Financial, September 2016.
19. W. Wright, The potential impact of Brexit on European capital markets: A quality survey of market participants, New Financial, April 2016,
20. Data refers to 2013, European Commission, Capital Markets in the EU, Infographics produced by the Commission. 18 February 2016.
21. European Commission, Action Plan on Building a Capital Markets Union, COM(2015) 468 final, 30 September 2015.
22. SIFMA, AFME Securitization Data Report, Second Quarter 2016, 7 September 2016.
23. Note, however, that this refers only to euro-denominated bonds, which means bonds from corporates from the euro area. Thus, London does play a role for euro-area bond and securities intermediation but not as significantly as in other wholesale activities.
24. D. Schoenmaker, Lost passports: a guide to the Brexit fallout for the City of London, Bruegel Blog Posts, 30 June 2016.
25. General Court of the European Union, Judgment in Case T-496/11 United Kingdom v European Central Bank, Press Release, 4 March 2015.

FIGURE 2 ► **Role of the UK in the EU's capital markets**



The right panel shows outstanding debt securities of non-financial corporations (euro-denominated) in Q1 2016.
The left panel shows the turnover of euro-denominated OTC single currency interest rate derivatives, daily averages in April 2013.

Sources: BIS, Debt securities issues and amounts outstanding, Table C3; BIS, Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013, September 2015. Author's calculation.

The five examples show how Brexit consequences for capital markets vary across different market segments. Limited access to UK trading platforms for euro-denominated activities is likely to result in higher costs of trading and clearing which will ultimately increase corporate funding costs. The most affected segments are those where investors can use the UK as single entry point to the EU and manage their operations without the need to domicile in each country of activity. This applies for example to investment banks, asset managers and venture capital funds.

The CMU aims to limit the fragmentation of European capital markets and promote economies of scale in order to lower funding costs and make market-based funding tools available to enterprises across the Single Market. Economically, Brexit will be a huge setback for the objectives of the CMU.

2. Political implications of Brexit: fading purpose versus new incentives

Different political scenarios are conceivable for the CMU after Brexit. The result depends primarily on the preferences of the EU27 member states but the UK's approach in the upcoming Brexit negotiations will also play a role. First, the EU could respond with accelerating its efforts and ambition in order to counter the detrimental effects of losing Europe's largest capital markets. Deeper integration of the EU27 could, however, result in new barriers with the UK. Second, interest in the project without the UK could gradually decline.[26] Third, the EU27 could try to maintain close ties to the UK and negotiate a deal that provides passporting rights for UK's financial industry.

2.1. Mapping political interest before and after Brexit

Interest in the CMU project is concentrated in a few countries. Responses to the Commission consultation indicate that financial market participants from the major European financial centers were most vocal in expressing their preferences (see figure 4). Consequently, most responses came from the UK. Also the UK's government expressed its strong support for CMU.[27] Responses from the governments of Ireland, the Netherlands, Sweden and Luxembourg were also very supportive, corresponding to their highly developed financial markets. Countries from Central, Eastern or Southern Europe were (when they responded) rather positive about the initiative, as they acknowledged the potential for improved financing conditions for businesses in smaller member states.[28] The governments of Germany and France reacted more cautiously to the CMU proposal, emphasizing the important role of banks in European financial systems and questioning the desirability of adopting the US model of financial intermediation.[29]

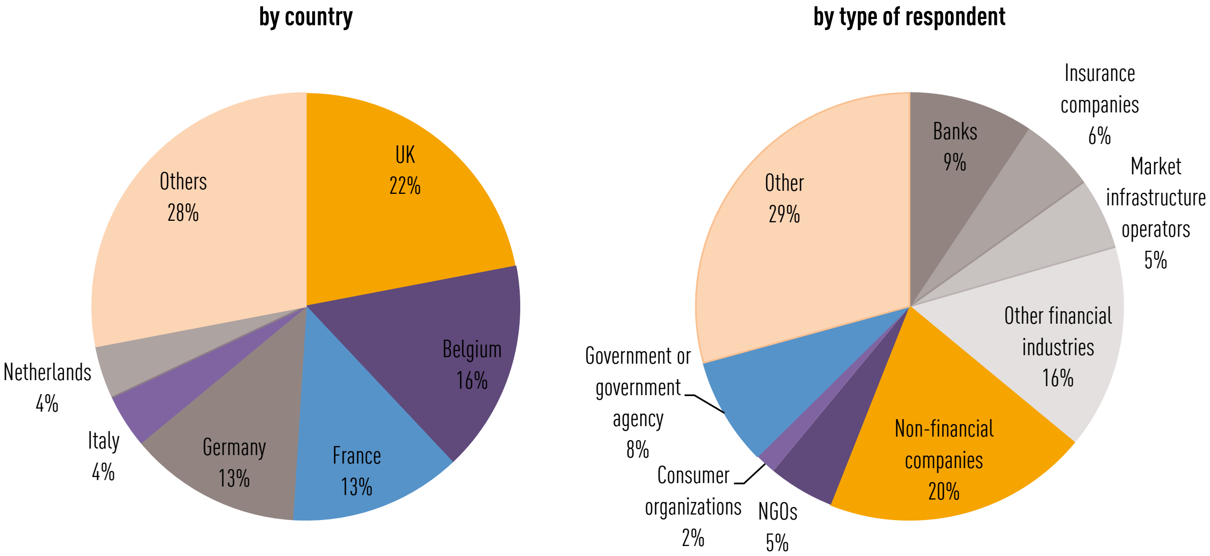
Respondents to the consultation were also rather concentrated in the financial and non-financial corporate sector, with the financial sector making up 36% of all responses. However, there is a clear divide between more locally oriented and more internationally oriented financial services. Savings banks as well as local market infrastructure providers who fear to lose out under increasing competitive pressure were critical towards the CMU.[30] Larger banks, insurances and providers of market-based funding (e.g. asset management funds) see, however, opportunities to enhance their cross-border business.[31]

„MEMBER STATES WITH MORE LOCAL FINANCING STRUCTURES WERE CONFRONTED WITH MIXED PAY-OFFS"

Since a large part of financial businesses that provide cross-border funding are located in the UK, the government's strong commitment to CMU is no surprise. Member states with more local financing structures and limited presence of foreign financial firms were confronted with rather mixed pay-offs of market participants.

26. W. Wright, The potential impact of Brexit on European capital markets: A quality survey of market participants, New Financial, April 2016,
27. UK Government, UK Response to the Commission Green Paper on Capital Markets Union: Building a strong Capital Markets Union, 2015.
28. L. Quaglia, D. Howarth and M. Liebe, "The Political Economy of European Capital Markets Union", *Journal of Common Market Studies* Vol. 54, Annual Review, pp. 185–203, 2016.
29. W. Schäuble and M. Sapin, Letter to Lord Jonathan Hill, 6 July 2015.
30. European Savings and Retail Banking Group, ESBG response to the European Commission's Green Paper on "Building a Capital Markets Union", May 2015. and N. Véron, Defining Europe's Capital Markets Union, *Bruegel Policy Contribution* Issue 2014/12, November 2014.
31. L. Quaglia, D. Howarth and M. Liebe, "The Political Economy of European Capital Markets Union", *Journal of Common Market Studies* Vol. 54, Annual Review, pp. 185–203, 2016.

FIGURE 3 ► Interest in CMU is concentrated in a few countries and stakeholders



Figures show participation in the Green Paper consultation procedure 'Building a Capital Markets Union' by country and type of respondent.

Sources: European Commission, Feedback Statement on the Green Paper "Building a Capital Markets Union", SWD(2015) 184 final, 30 September 2015 and L. Quaglia, D. Howarth and M. Liebe, The Political Economy of European Capital Markets Union, Journal of Common Market Studies Vol. 54, Annual Review, pp. 185–203, 2016.

The prospect of hosting parts of London's financial industry is a sweet temptation for EU27 governments. France, Germany, Ireland, Luxembourg and other member states actively lobby UK-based financial businesses to relocate their operations.[32] The French pitch to provide fast-track licencing, English speaking contact points and tax breaks has been the most pro-active move in this 'beauty contest'.[33]

> "DEEPER AND BETTER INTEGRATED CAPITAL MARKETS WOULD MAKE THE SINGLE MARKET MORE ATTRACTIVE FOR UK-BASED FIRMS"

Box 1 shows that financial centres in the EU27 (Germany and France as examples) could gain individually from a relocation of UK-based financial market participants and activities. This strengthens the case for CMU among the remaining EU27. Deeper, better integrated and consistently regulated capital markets would make the Single Market more attractive for UK-based firms that are confronted with the decision whether or not and to which extend they should relocate their business.

32. Bloomberg, Europe's Financial Hubs on Frankfurt "Catwalk" for Brexit Spoils, 14 November 2016.
33. Financial Times, France turns anglophone to woo UK businesses, 28 September 2016.

BOX 1 ► Examples of how Germany and France could benefit from Brexit

Germany:

- Supervisory institutions report increased interest of UK-based banks to move to Frankfurt
- Germany overtakes UK in FinTech investments: In the first three quarters of 2016 FinTechs in Germany raised 398 million USD, compared to 320 million USD in the UK.
- The merger of the London Stock Exchange and Deutsche Börse would facilitate the transfer of trading activities for example clearing activities in equity markets, where the UK currently clears 40% of EU27 trades.

France:

- Paris hosts a subsidiary of LCH, London's major clearing house. This entity could take over euro area government bond clearing that is currently conducted in London (the monthly trade volume amounts to €6 trillion).
- Insurers are already concentrated in Paris, which provides a good basis for further growth. They are, however, less affected by Brexit since they mostly operate through subsidiaries.

Sources: Spiegel, Brexit: Die Briten kommen, 14 November 2016; KPMG, The Pulse of Fintech, Q3 2016: Global Analysis of Fintech Venture Funding, 16 November 2016; D. Schoenmaker, Lost passports: a guide to the Brexit fallout for the City of London, Bruegel Blog Posts, 30 June 2016; Financial Times, Germany well-placed for post-Brexit migration of London business, 9 October 2016.

Does this imply that CMU will become top priority for the EU27? On the one hand, no individual EU27 member state can expect to benefit as much as the UK could have benefited from CMU since the financial industry is more likely to spread over several financial centres. On the other hand, the prospect of losing access to the major trading platforms for equities and debt instruments is also an incentive to accelerate efforts to deepen capital markets in the remaining EU27.

For those countries that already have rather developed capital markets such as Ireland, the Netherlands or Sweden as well as countries that fear for the availability of cross-border capital, Brexit increases the need to move forward with CMU. For member states that neither face problems in business financing nor have particularly large capital markets pushing CMU may not be an immediate priority.

At this point it is impossible to gauge which of the three scenarios ('accelerate', 'fading interest' or 'maintain close ties') will prevail. The Commission has already made clear that it wants to maintain the momentum and rather seeks to accelerate the CMU agenda.[34] Maintaining close ties seems the politically most unlikely outcome as French and German officials already made clear that the EU's financial intermediation cannot take place outside the Single Market.[35]

"UNCERTAINTY AND POTENTIAL DISAGREEMENT OVER THE FUTURE DIRECTION COULD UNDERMINE THE POLITICAL MOMENTUM OF THE CMU"

Nonetheless, EU27 member states have so far not given a clear signal whether or not they regard CMU still as a priority project after the Brexit vote. Uncertainty over the purpose of the CMU without the UK and potential disagreement over the future direction could undermine the political momentum created by the Commission.

34. European Commission, Capital Markets Union – Accelerating Reform, COM(2016) 601 final, 14 September 2016.
35. Financial Times, Wolfgang Schäuble sets out tough line on Brexit, 17 November 2016. And Financial Times, Hollande demands tough Brexit negotiations, 7 October 2016.

2.2. The debate about centralized supervision

The current policy agenda of CMU is not undisputed. Initially, there were two camps, who disagreed over whether or not the CMU should promote more centralized capital market regulation and supervision.

The **'institutional change' perspective** argues that a key barrier for cross-border investments is the fragmentation of EU capital market regulation and enforcement.[36] A true Single Market for capital requires a transfer of supervisory and regulatory competences to a "single European capital market supervisor".[37] There are three areas where a transfer of competences is deemed necessary:

- **Surveillance of systemic risks:** National supervisors may have insufficient experience with monitoring capital market risks. The more these activities cut across national jurisdictions the greater the benefits of a single supervisor. The European Systemic Risk Board (ESRB) could take over this role.
- **Regulatory standards and enforcement:** Despite harmonized regulation, national regulators often apply different standards ('regulatory gold-plating') and the legal frameworks differ across member states. This leads to cross-border barriers for investments as well as to varying stringency of supervision, which creates incentives among market participants for 'forum-shopping'. To ensure consistent application of EU regulation the European Securities and Markets Authority (ESMA), which today has only a coordinating role, needs to be upgraded to a true regulator with enforcement powers.
- **Accounting and auditing:** To achieve a standardization of financial information audit firms need to apply the same standards. A European institution like ESMA could ensure that accounting rules are developed and applied uniformly across member states.[38]

> "THE COMMISSION PROBABLY ABSTAINED FROM PROPOSING INSTITUTIONAL CHANGE TO AVOID TENSIONS WITH THE UK"

Without transferring these competences to EU level the advocates of institutional change fear that the impact of CMU will be limited as significant national barriers remain in place.[39] At the same time they had to accommodate political opposition, especially from the UK. Indeed, Nicolas Véron points out that the Commission probably abstained from including any measure that requires institutional change to avoid tensions with the UK prior to the Brexit referendum.[40]

The **'incrementalism' perspective** counters that centralization of competencies does not provide a substantive solution to the barriers to free movement of capital. It is a typical EU reflex but it wastes limited political capital. The fine-tuning of existing regulation and a convergence of national standards is the more practical approach.[41] As umbrella initiative the CMU creates a link between the rather technical policy activities and thereby provides the necessary political momentum.

Centralizing more competencies at the European level brings along two problems. First, it runs counter to the principle of subsidiarity. Common European standards do not necessarily need a European agency to enforce them.[42] It might be more practical to invest in supervisory convergence rather than introducing an additional layer of supervision. Second, the 'incrementalism' perspective sees the risk for the CMU of being overambitious and founder quickly due to political gridlock. For this reason, sensitive issues such as harmonizing

36. A survey of market participants found that diverse application of regulation and enforcement from one jurisdiction to the other is a significant barrier for cross-border investments. Association for Financial Markets in Europe, Bridging the growth gap: Investor views on European and US capital markets and how they drive investment and economic growth, February 2015.
37. J.-C. Juncker et al., The Five President's Report: Completing Europe's Economic and Monetary Union, 22 June 2015.
38. N. Véron and G. B. Wolff, Capital Markets Union: A vision for the long term, Bruegel Policy Contribution, Issue 2015/05, April 2015.
39. K. Lannoo, Eliminating the cost of non-Europe in capital markets, ECMI Commentary No. 43/2, November 2016.
40. N. Véron, Europe's Capital Markets Union and the new single market challenge, Bruegel Blog Post, 30 September 2015.
41. W. Wright, Capital markets union: managing high expectations, New Financial, March 2015.
42. H. Dixon. Unlocking Europe's capital markets union, Centre for European reform, October 2014,

insolvency procedures and abolishing tax barriers should be spared from immediate action.[43] Centralizing supervision should be avoided at all due to the UK's opposition.

TABLE 1 ► Competing approaches on ambition and political feasibility of CMU

	INCREMENTALISM	INSTITUTIONAL CHANGE
What should be the focus?	Improving regulatory framework, knock down barriers one by one	Pool supervisory and regulatory powers on EU level
How can CMU make a difference?	Steps will add up, create political momentum through umbrella initiative	Overcome cross-border barriers through harmonization and centralization
How to deal with national sensitivities?	Avoid them. The complex regulatory agenda cannot risk running into political roadblocks.	Confront them. Without institutional change CMU's potential will be marginalized from the beginning.

Source: author

The importance of getting the UK on board rendered centralization of supervision politically impossible and risked to fuel the Leave campaign.[44] Hence, the practical solution was to launch CMU without proposing any form of institutional change.

"THE NEED TO RELOCATE EBA OPENS A WINDOW OF OPPORTUNITY TO REVISE THE SUPERVISORY ARCHITECTURE"

With the UK preparing to leave the EU a major justification for the Commission to follow the 'incrementalism' approach has disappeared. In addition, the need to relocate the European Banking Authority (EBA), currently located in London, opens a window of opportunity to reassess and revise the European framework of financial market supervision. As there are numerous contenders for hosting the EBA after Brexit the decision will very likely involve a package deal that could lead to a rearrangement of all three European Supervisory Authorities (ESAs).

Proponents of a further centralization of capital market supervisory powers argue that the prospect of increasing capital markets activities such as trading and clearing in continental Europe could become a challenging task for national supervisors. To ensure a tightly integrated financial system among the EU27, ESMA should play a more prominent role in the supervisory architecture.[45]

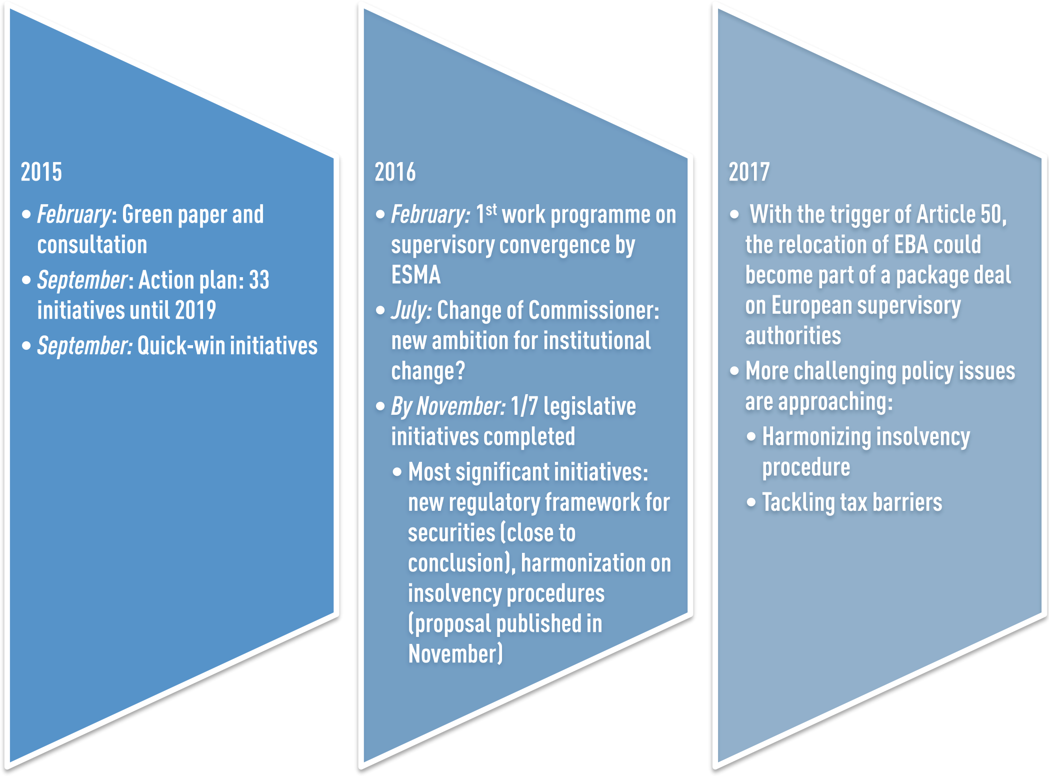
2.3. Current state of the CMU: mixed progress and a challenging outlook

The referendum outcome in favour of 'Leave' had an immediate political consequence for the work of the European Commission. The resignation of the British Commissioner Jonathan Hill, responsible for the CMU, and his replacement by Commission Vice-President Vladis Dombrovskis in July 2016 gave some insights whether the Commission plans to adjust its CMU agenda.

43. W. Wright, Capital markets union: be careful what you wish for..., New Financial, November 2014.
44. N. Véron, Europe's Capital Markets Union and the new single market challenge, Bruegel Blog Post, 30 September 2015.
45. D. Schoenmaker, Stealing London's financial crown would bring both benefits and responsibilities, Bruegel Blog Post, 17 November, 2016.

The Commission seeks to dissipate doubts that CMU without the UK is pointless. In his mission letter to Dombrovskis, Commission President Jean-Claude Juncker emphasizes the need to accelerate reforms under CMU and to prioritize the harmonization of insolvency law, taxation issues as well as institutional and supervisory matters.[46] This suggests that Hill's clear opposition to institutional change does no longer hold. Dombrovskis publicly stated that the outcome of the British referendum makes the CMU even more pressing for the remaining EU27.[47]

FIGURE 4 ► Current-state of CMU: Timeline of the most important developments



Source: author.

By November 2016, 14 months after launching the action plan, the Commission started seven legislative initiatives and started to work on all six priority areas.[48] Among the early quick-win initiatives, a new regulatory framework for securitization is probably the most important but also controversial issue. Securitization, a market-based instrument for bank lending, has been criticized after the financial crisis due to its role in the US subprime crisis but has in fact incurred very little losses in Europe.[49] Securitization would be one of three low-hanging fruits where the Commission could either create new common standards or amend existing legislation.[50]

In November 2016, the Commission made a proposal for a directive on insolvency and business restructuring, considered as one of the key barriers to cross-border investments.[51] Europe struggles with inefficient and

46. J-C. Juncker, Complementary Mission Letter to Vladis Dombrovskis Commissioner for Financial Stability, Financial Services and Capital Markets Union, Brussels, 21 September 2016.
47. V. Dombrovskis, What next for Europe's banking system?, Speech at Bruegel, 15 November 2016.
48. Counting based on European Commission, Capital Markets Union: First Status Report, SWD(2016) 147 final, 25 April 2016; European Commission, Capital Markets Union – Accelerating Reform, COM(2016) 601 final, 14 September 2016. and European Commission, Capital Markets Union: Implementation table (last updated on 20.10.2016), accessed 20 November 2016.
49. European Commission, Building a Capital Markets Union: Economic Analysis, SWD(2015) 183 final, 30 September 2015.
50. C. Odendahl, The low-hanging fruit of European capital markets, CER Bulletin Article, 8 April 2015.
51. European Commission, Proposal for a directive on Insolvency, Restructuring and Second Chance, European Commission – Fact Sheet, 22 November 2016.

diverse insolvency frameworks that lead to low asset recovery rates for investors and create uncertainties for cross-border investments.[52] Setting common standards has the potential to significantly reduce costs for cross-border investments but given the diversity of national frameworks could also become a lengthy and difficult legislative undertaking. In 2017, the Commission also plans to tackle tax practices that lead to unfavourable treatment of cross-border investments, another of the more challenging barriers for capital.

While the Commission is on track with its legislative agenda, some of the 2015 initiatives are still in the legislative process. Since the issues that are approaching in 2017 cut deeper in national competencies, initial predictions that building CMU could take much longer than the foreseen five years provide a more realistic outlook.[53]

The CMU could have made substantial progress in 2016. Instead Brexit left many puzzled about the future prospects of the initiative. With the UK's retreat from the political process, the CMU loses an important political sponsor. For the UK, the CMU was a key economic policy objective and a way to improve benefits from the Single Market. For the EU27 the CMU may be one among several important economic policy issues but it will certainly still be a pressing one: without the UK the EU will have to find new ways to offset the loss in capital market depth. If not it may weaken investment and growth.

52. European Commission, Building a Capital Markets Union: Economic Analysis, SWD(2015) 183 final, 30 September 2015.
53. W. Wright, Capital markets union: managing high expectations, New Financial, March 2015.

CONCLUSION

Even in a Brexit scenario where UK-based firms would lose passporting rights and equivalence status, which seems currently quite likely, London would remain a major global financial center and important trading partner for the EU27 financial industry. Substantial financial flows across the Channel require a continuation of the close cooperation between the EU and UK authorities also after Brexit. A regulatory race to the bottom would be dysfunctional and should be avoided.[54]

> „THE COMMISSION HAS TO NEGOTIATE IN THE VACUUM OF A FINANCIAL MARKET FRAMEWORK UNDER CONSTRUCTION"

The negotiations about the future of the UK-EU capital markets framework would benefit from a common position of the EU27 on how the future of the CMU should look like. This would help the Commission to negotiate with the UK in the vacuum of a financial market framework under construction. The EU27 member states could convey two clear messages in this context: First, the EU is determined to compensate the detachment from UK capital markets by developing deeper and better integrated capital markets in continental Europe, and second, the EU will build the necessary regulatory capacities to manage a potential influx of financial industry, regardless to which location in the EU27.

In the upcoming negotiations there are two things to watch: **First, Brexit renders new policy directions in the CMU possible.** Triggering Article 50 opens a window of opportunity to restructure supervisory competences. As political as the location of EU agencies is, this is also a chance to enhance the efficiency of supervision across different financial market segments. **Second, deepening the CMU will soon lead to complex questions about how to reduce barriers to free movement of capital** such as harmonizing insolvency frameworks and reducing tax barriers. The Commission will need the commitment of all member states to move forward on its agenda. A political deadlock would risk that the project fails to bring about significant change until 2019 when Brexit negotiations are supposed to be concluded. By then the EU27 should be prepared for substantive changes in European capital markets.

54. P. R. Lane, The European financial system after Brexit, Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, at Reuters Newsmaker Event, London, 28 October 2016.

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