FRANKLIN TEMPLETON INVESTMENTS
Beyond Bulls & Bears

In the Know: Europe's Capital Markets Union

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In the Know: Professionals at Franklin Templeton Investments offer a quick but insightful update on a pressing investment topic.

Today, Templeton Global Equity Group's Norm Boersma discusses the European Commission's newly unveiled proposals for Capital Markets Union.

What is Capital Markets Union?

The core idea of a capital markets union in Europe is to strengthen the financial system across the European Union (EU) by integrating regional capital markets to create robust and diverse financing options that more efficiently match supply of and demand for credit. Proponents hope to achieve this by removing barriers to cross-border investment to create a single market for capital for all 28 EU member states. They believe this should lower costs of funding within the EU.

Why is it in the headlines now?

A consultation process is underway, which is based on proposals unveiled in February by the European Commissioner for Financial Services Jonathan Hill. Lord Hill's policy is designed to complement Europe's banking union and enhance the strength and flexibility of the broader regional financial system. The consultation period closes on May 13, 2015, and an Action Plan reflecting the feedback is due to be published in the third quarter of 2015. It is important to note that these types of structural reforms take time. While it warrants discussion now, at the moment of its formal introduction to policymakers, this is not something that will be carried out overnight. We expect to see some initial progress in key areas in the short term, though we are cognizant that it will likely be years before a capital markets union could be fully implemented in the EU.

What is the European Commission trying to achieve?

European policymakers realize that reforms are needed to improve access to credit in the eurozone, particularly for small- and medium-sized enterprises. Smaller businesses are overly reliant on banks for access to capital, which impedes credit growth and economic activity when banking systems retrench or deleverage, as they have in Europe over the last several years. Europe has also taken note of the US financial system's relatively swift recovery from the brink of disaster and concluded that deeper, more liquid and diverse capital markets can act as a source of stability and support.

What implications does it have for investors?

We believe the initiative should help improve liquidity and expand investment options. In Europe, banks provide about 70% of external financing for corporations, with the remainder coming from securities markets. In the United States, it's the other way around: the bulk of corporate financing is market-based. As a result, financial markets are far more dynamic in the United States, providing companies access to more efficiently-priced credit and savers with more ways of investing their capital.

How are your strategies geared up to respond if it becomes reality?

As investors in European banks, we do like the captured pool of credit that they control. However, thinking more holistically, we realize that Europe's overreliance on banks is inhibitive to the growth and development of the corporate sector in the region. We are generally supportive of any “pro-European” measures that help improve systemic integration across the monetary union.

We believe investors should ultimately benefit from the enhanced liquidity and stability that a capital markets union in Europe is likely to provide. The US financial system has been very good at segmenting the market so that the appropriate type of investor is matched with the needs of the borrower. Venture capital and private equity are both robust industries in the United States that offer competitive financing in parts of the market that are not as efficiently serviced by banks.

Asset-backed securities can also help improve the provision of credit by taking loans off of banks’ balance sheets, freeing them up to lend more. There are risks to all this, of course, as the global financial crisis made clear; but when done judiciously, in a well-regulated financial system, we believe such market-based credit solutions can help encourage growth and stability. We expect that Europe, which remains a major focus in our equity portfolios, is likely to ultimately benefit from these initiatives.

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