UNION OF CAPITAL MARKETS - AN INITIATIVE OF THE EUROPEAN UNION

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Abstract

The economic- financial crisis triggered in 2008 has shown the vulnerability of the banking system and also the impact that financial innovations have on globalized economies. In this context, the European Union has aimed at achieving a sustainable economy that can provide jobs for its citizens. A step in this respect is the new project of the European Union to make up an integrated stock market that can provide the supply and demand representatives new funding and diverse investment opportunities.

Key words: stock market, SME, accounting harmonization, financial instruments

JEL Classification: G12, M41, O16

1. Introduction

A capital market is an important part in everyone's life, it is the means by which companies increase their capital in order to expand their business, it is the solution that can the state and local authorities can resort to in order to finance their deficits or various investment projects, it is solution to earn more or to protect your savings from the negative impact of inflation (Panoiu L, 2008).

Capital markets are an attraction for an investor, whether legal or natural persons, due to the gains they can offer in the form of various investment instruments as compared to the banking system. Furthermore, capital markets are attractive for companies, public institutions and governments to the extent that they are regarded as financing sources others than those offered still by the banking sector.

Besides these benefits at microeconomic level, there are also macroeconomic benefits, namely: diversification of external financing sources, lowering the cost of capital, stimulating domestic enterprise management through private financing sources, assistance in the development and growth of the domestic capital market efficiency (Tudor C.).

The benefits provided by a capital market and also the impact of falls in this market on overall savings draw one's attention to the manner of operation and regulation.

The use of financial instruments has been growing particularly due to changes in the world economy. The instability of interest rates and foreign exchange rates worldwide as well as the US abandoning the gold standard have led to high volatility in global commodity and financial markets. Entities have had to face certain risks:

- interest rate risk - the risk that profit, assets and liabilities of an entity might be adversely affected by changes in interest rates;
- foreign currency risk - the risk that profit, assets and liabilities of an entity might be adversely affected by changes in exchange rates.

Additionally, the economic - financial crisis triggered in the banking system has also affected the sector of capital markets: thus, in the end of 2007, the value of financial assets globally reached a peak of 194 trillion US dollars representing 343% of global domestic product total and then in 2008, the value of global financial assets reached only 178 trillion US dollars (Lupu I, Horobet A. Dumitrescu D.G.).

World economy globalization has generated an unfavourable impact in the European Union, too, with European capital markets going down in terms of liquidity (e.g. the

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average daily value traded) and have become increasingly fragmented (instruments traded simultaneously in multiple trading venues, weaker operation of interconnections, increasing the number of certificates of deposit certificate type instruments, certificates of stake etc.) (Panait I.).

These elements have been the basis of the European Union's decision of establishing capital markets.

2. Union of Capital Markets

In February 2015, the European Commission launched a public consultation in the form of a Green Paper on the issue of creating a Union of Capital Markets. Supporting this idea was based on the economic and financial crisis and its impact upon the economy's financing and investment opportunities.

The goals of the Union of Capital Markets goals come together around three axes (Commission Staff Working Document, Economic Analysis-Accompanying the document, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Action Plan on Building a Capital Markets Union):

A) expanding financing sources namely increasing the use of capital markets as financing sources by shifting from the banking sector;
B) ensuring a more competitive and more liquid capital market;
C) ensuring financial stability and economic growth by increasing the access of companies especially SMEs to financing, as this will help achieve the strategic goal of economic growth, of providing new jobs.

The European Commission seeks diversification of financing sources regarded as elements complementary to financing by the banking sector as there are opinions according to which the markets that are based on bank financing benefit from slightly lower economic growth rates than on markets where stock exchange financing plays an important role (Dăncilă M, 2016).

Appreciating the importance that financial sector elements: banks or stock exchange institutions have upon the economy can be achieved by analyzing the share of bank loans in GDP, respectively the stock exchange capitalization/transaction value in GDP (Tables 1, 2 and 3).

I have chosen for illustration only EU Member States as the Union of Capital Markets is Europe's project.

Table 1 Share of Bank Loans in GDP (%)

	2010	2011	2012	2013
Euro Area	103.36	101.61	99.62	96.68
EU	114.66	111.15	109.12	105.10
France	95.70	96.75	96.63	96.03
Germany	88.09	84.72	83.67	82.15
Romania	39.51	39.49	38.02	34.02

Source: World Development Indicators 2016

Table 2 Stock exchanges Transaction Value in GDP

	2010	2011	2012	2013	2014
Euro Area	46.32	42.29	37.16	37.46	47.94
EU	57.16	51.34	44.46	39.36	50.76
France	51.00	46.46	40.07	39.36	41.30
Germany	43.73	41.87	35.31	35.04	32.80
Romania	0.99	1.58	1.16	0.56	0.11

Source: World Development Indicators 2016

Table 3 Stock Exchange Capitalization in GDP (%)

	2010	2011	2012	2013	2014
Euro Area	52.30	40.74	49.94	60.15	54.16
EU	50.79	39.37	49.04	58.88	52.79
France	72.21	54.28	67.43	81.93	73.72
Germany	41.83	31.52	41.99	51.59	44.94
Romania	8.45	7.56			

World Development Indicators 2016

It can be seen that the data highlight major differences in the development of financial markets, that is why it is believed that a union of capital markets will have to seek the harmonization of elements related to work organization and standardization of financial reporting.

The Action Plan by which an attractive European capital market is being sought targets the following action directions: (European Financial Stability and Integration Review, 2016):

- financing innovative activities, start-ups/ s and unlisted companies,
- increasing companies' capacity of establishing or increasing their capital through capital markets,
- promoting long term investments by sustainable projects and infrastructure projects,
- stimulating the bank capacity of supporting wider economy,
- facility of cross/border type investment.

It is evident that these goals are subordinated to the objective of ensuring financial stability of the European Union.

The European Union wants the Union of Capital Markets to generate many financing opportunities to investors, to provide a viable connection between financing arrangements and economic development through a more viable, safer, more integrated financial system.

Achieving this goal of creating the Union of Capital Markets has imposed several steps aimed at legislative issues, too, for example: securitization and normalization of prospectus wording.

The European Commission defines securitization as a process by which a lender such as a bank repackages the loans they hold (e.g. mortgages) into securities that can be sold to investors. Subsequently, investors receive profits generated by underlying loans.

In Romania, securitization is defined by Regulation No.18/16/2010 as a transaction or scheme whereby the loan risk associated with an exposure or an exposure portfolio is segmented into installments having the following characteristics: the payments under a transaction or scheme are dependent on the performance related to the exposure or exposure portfolio; the subordination of installments determines the allocation of losses throughout the life of a transaction or scheme.

The Regulation distinguishes between traditional and synthetic securitizations. Thus, *traditional securitization* is defined as a technique by which the economic transfer of exposures subject to securitization is performed to an entity specially designed for securitization, issuing securities. This is achieved by transferring ownership of securitized exposures from the originator loan institution or by the sub-participation technique. The securities issued are not payment obligations of the originator loan institution;

Synthetic securitization is securitization in which segmenting a loan risk into installments is achieved by using loan financial derivatives or guarantees, where an exposure portfolio remains in the balance of the originator loan institution;

Banking units can use this technique as a source of ensuring financing capital.

Accessing financing through a capital market requires an issuer of financial instruments to ensure increased capitalization, multiplication of financing sources, national and international visibility (Ene S., 2010). Issuers', companies' or public institutions' accessing a capital market involves the development of public offer perspectives including sufficient information about an issuer, issued securities, so that an investor could make the right decision being informed. Due to the diversity of achieving issue perspectives in terms of their content, the Union of Capital Markets aims at harmonizing the content of issue perspectives and market access conditions.

It is also noted there is a need for accounting harmonization of financial instruments, so as to generate financial statements that can be objectively interpreted by people concerned.

3. Normalization of Financial Instruments Accounting

The main economic data to investors and other people concerned are provided by accounting through financial reporting.

The goal of financial reporting provided by IFRS is to provide financial information about a reporting entity, so that to be useful to accounting information users. Obviously, it is important that investors and other stakeholders should understand entity activities relating to financial instruments.

International rules referring to financial instruments are:

- IAS 32 "FINANCIAL INSTRUMENTS: PRESENTATION" AND
- IAS 39 "FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT"

IAS 32 "FINANCIAL INSTRUMENTS: PRESENTATION"

IAS 32 "Financial Instruments: Presentation" requires the presentation of information to:

- increase understanding of the impact that financial instruments have upon an entity's financial status and performance and upon its cash flows and
- help measure the size, timing and certainty of future cash flows associated with these instruments.

Apart from providing specific information regarding the balances of certain financial instruments and transactions with such instruments, entities are encouraged to disclose the extent to which they use financial instruments, related risks and the purpose for using such instruments. The types of risks covered are price risk (foreign currency risk, interest rate risk and market risk), loan risk, liquidity risk and cash flow risk. A discussion of control management policies for risks related to financial instruments offers interested users additional information and a vision independent of the specific instruments used by an entity at a certain time.

A **financial instrument** is any contract that simultaneously gives rise to a financial asset for one entity and a financial liability or own capital instrument for another entity. **Classic examples** of financial instruments are: cash, receivables and financial liabilities, demand and term deposits, commercial papers, debt instruments (bonds), capital instruments (shares), finance leases, rights and obligations of an employer in pension agreements, related assets (guarantees in loan agreements).

Financial instruments include primary instruments and derivatives.

Primary instruments: they are receivables or debts (bonds) or equity (shares).

Derivatives: are securities of risk transfer between two parties through the exchange of a financial instrument.

A derivative is a financial instrument whose fair value varies inversely with changes in fair value of a host instrument to be settled at a later date.

An entity should make the distinction between a derivative and a host instrument. It can therefore be stated that derivatives are a special type of financial instruments with the following characteristics:

- their value changes depending on the evolution of a specified interest rate, a price of a security, foreign exchange rate or any other similar variable element (sometimes called "base");
- they require no initial net investment or they require an initial net investment of a small amount compared to other types of contracts that have a similar response to changes in market conditions; and
- they are settled on a date set in the future.

The main difference between derivatives and other financial instruments is that when it comes to derivatives, the buyer pays only part of the value of an underlying asset, but they can take full advantage of this asset price variation.

For example, **forward contracts** (which allow companies to set the future prices of goods); **options** (which give a holder the right not the obligation to buy or sell something); **futures contracts** - forward contracts traded on the stock exchange.

IAS 32 also refers to disclosing financial instruments in the balance sheet of an issuer. The prevalence of business substance of a financial instrument, rather than its legal form, underlies its classification in an issuer's balance sheet. Although business substance is generally consistent with legal form, there are exceptions. For example, certain financial instruments have the legal form of own capital but, in fact, they are debts and others may combine features of own capital instruments with some features of financial debts. If a financial instrument includes both elements of financial liability and elements of own capital, each component must be classified separately in accordance with its nature and the value of the two components must be determined in a reasonable manner. Subsequently, such classification of components will not be revised until maturity of an instrument.

In accordance with IAS 32, the essential feature which distinguishes between a financial liability and an own capital instrument is the existence of a contract obligation of an issuer either:

- to deliver cash or another financial asset to another entity (to the holder of the instrument); or
- to exchange financial instruments with another entity (the holder of the instrument) under conditions that are potentially unfavourable to the issuing entity.

If such a contract obligation exists, the instrument meets the definition of a financial liability, irrespective of the manner of the obligation being settled. If the financial instrument does not generate a contract obligation for an issuer to deliver cash or another financial asset or to exchange financial instruments with another entity under conditions that are potentially unfavourable to them, then this is an own capital instrument.

IAS 32 was issued in 1995, three years before IAS 39 "Financial Instruments: Recognition and Measurement". IAS 39 sets standards for the recognition, measurement and disclosure of information on the financial assets and liabilities of an entity.

IAS 39 "FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT"

Initial recognition

IAS 39 provides the recognition of all assets and financial liabilities, including all derivatives in a balance sheet. Recognition is achieved only when an entity becomes a party to the contract related to a financial instrument.

Financial instruments are initially measured at their cost **which is:**

- *for assets,* the fair value of consideration transferred **(including transaction costs paid) to purchase a financial asset**
- *for liabilities***,** the fair value of consideration received **to purchase a financial liability (less transaction costs paid).**

In general, fair value is best reflected by published price quotations set on an active market.

Subsequent recognition

After initial recognition, all financial assets will be revalued at their fair value, except for the following items that must be reported at their depreciated cost:

- *loans and receivables generated by an entity* **which are not held for the purpose of trading;**
- *other fixed maturity investments* **such as securities and mandatorily redeemable preferred shares which an entity intends to and is able to hold to maturity; and**
- *financial assets* **whose fair value cannot be reliably measured.**

After acquisition, most financial assets will be revalued at their initially reported value minus principal payments and depreciation. Only derivatives and liabilities held for trading will be revalued at their fair value.

As to those assets and financial liabilities that are revalued at their fair value, an entity will have only one option:

- either fully recognize adjusting in net income or net loss for the period,
- or recognize in net income or in net loss for the period only those changes in the fair value corresponding to the assets and financial liabilities held for trading and include changes in the value of instruments in their own capital that are not held for trading until that financial asset is sold, when a gain or loss performed is to be included the net profit or net loss. To this end, one always believes that derivatives are held for trading unless they are part of risk coverage to which the accounting of risk coverage operations is added.

An entity shall derecognise a financial asset or an element of a financial asset only when an entity loses control of the contract rights generated by a financial asset (or an element thereof).

Conclusions

Creating a Union of Capital Markets can be a viable solution for ensuring a viable harmonized market to provide investors and issuers some adequate financial instruments to meet the needs of investment or financing.

The authorities supervising and regulating the capital market must be concerned with providing market participants with products, markets and regulations that meet various needs.

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