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Report

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Keynote speech

A markets perspective

by Louis Godron

Managing Partner and founder, Argos Wytui

For the EU to reduce at least 55 % of its emissions by 2030 and become climate-neutral by 2050, the amounts of capital that need to be invested in green, innovative and energy transforming projects, are massive. Given that the EU budget and public funding alone cannot be enough to tackle climate change, a big part of the funds required will have to come from private sector, including venture capital *(VC)* and private equity *(PE)*.

The VC and PE market has developed a lot over the past few years and evolved from being a rather unknown and niche market segment, to something that is much bigger today and plays a fundamental role in the European economy. This development is not only in terms of equity distributed and invested to businesses that needed it but also in terms of regulation as the sector has been the subject of increased scrutiny from regulators and policymakers.

As far as returns go, PE and VE provide much better returns than investments in mainstream instruments. On average the sector outperforms public markets and generates higher returns across multiple time periods, while the probability of experiencing a loss is very low, even when taking inflation into account. Other positive externalities related to the market are employment, innovation and entrepreneurship. For example, the sector strongly contributes to employment and job creation. Even in 2020, where unemployment rates rose in Europe, PE and VC portfolios contributed to a net job increase of 103 000 jobs – that is the working population of a small city such as Granada in Spain.

Regarding regulation, there is need for a more supportive regulatory framework. This means that the regulatory treatment of PE and VC should be reconsidered, including under banking and insurance rules, while its attractiveness to retail investors should be enhanced. For example, Solvency II treats PE as a high-risk asset class and requires (re)insurers to hold higher levels of regulatory capital *(39 %)* compared with holdings in certain other asset classes *(e.g. government bonds have a much lower capital ratio)*. This has a negative impact and hinders banks and insurance companies' participation in the capital markets overall, and the PE and VC market in particular.

Session .01

CMU
how to make it a reality?

In an increasingly uncertain world and with the risks of political and economic fragmentation on the rise, the Capital Markets Union *(CMU)* initiative remains essential for recovery, growth and resilience across the EU. Progress has proven difficult and slow, however. There is also a significant lack of awareness about the CMU initiative at both national and global level. The entire ecosystem remains underdeveloped while deeper and highly integrated capital markets have not yet been achieved.

How can we channel savings into investments more effectively and in an organic manner? Should the financial sector be more proactive in servicing the real economy? Is there a lack of market insights in EU policymaking? Is there a need for a regulatory/legislative pause or re-think? Is the lack of political support from Member States the main bottleneck? Are end objectives, such as financial strategic autonomy or international competitiveness, realistic?

Moderator

Fabrice Demarigny
Global Head of Financial Advisory Services and Capital Markets Activities, Mazars Group and Chairman of ECMI Board

Speakers

Isabel Benjumea
MEP, ECON Committee

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Report

The Capital Markets Union *(CMU)* initiative remains essential for recovery, growth and resilience across the EU but progress has proven difficult and slow. There is still a long way to go to stimulate private investments, the lessons of Brexit have not yet been drawn, and all the while the EU is losing out on opportunities compared to its competitors.

Although more commitment and more ambition is needed from the Council of the EU, this is currently lacking as Member States do not seem to fully grasp the benefits of capital markets and market financing. The next European Commission will therefore have to spend time bringing Member States onboard and building trust in Europe's capital markets. For example, and with the exemption of just a few Member States, SME listings need to improve and the SME Fund of the von der Leyen Commission requires more attention.

Concerning retail investors, the Action Plan was seen to be very important in making the EU market more attractive and thus fostering their participation in it. However, retail investors today occupy a very limited space in the EU's capital markets, partially due to the lack of cost-efficient options with a rewarding risk-return profile or because they struggle to understand the inducements and remuneration mechanisms between product manufacturers and advisors, as a recent study has shown. Retail investors can play a vital role in contributing to increased private investments in the EU, which are much needed for the digital and green transition.

On the supervisory side, the EU will need to further integrate and take the Banking Union as an example. More centralised supervision could also serve as a response to the UK, which after Brexit is now a new competitor from the outside. But to achieve this, it is equally important to have a stable regulatory framework in place. As changes and amendments are constantly made *(and more recitals are added to the rules)*, the proportionality of rules becomes all the more important. For financial institutions, the scale of the data collection required to comply with the rules is enormous and with the permanent review cycle – which Brussels has instituted – there seems to be no end.

There is a need for a fresh look at the regulatory process, taking into account the transparency, accountability and competitiveness of the industry, as well as considering the capacity to suspend rules *(e.g. with non-action letters)*. This is even more important as the passport is not working, hence rules apply in multiple ways. Having perhaps more general rules and then testing these rules in courts will eliminate complexity and contribute towards a more flexible regulatory corpus than the one we have today.

Last but not least, the most important missing element of the CMU is the creation of a risk-free asset. A well-developed government securities market provides the backbone for the development of other rate markets *(such as the corporate bond market)*, the better integration of capital markets, and the enhancement of private risk sharing. Although the EU has recently started to issue bonds under the NextGenerationEU *(NGEU)* programme, this remains very small when compared to the US market. The appetite for this market is massive, alongside green investments.

Session .02

RETAIL INVESTORS
how to empower them?

The environment in which individuals make financial decisions is complex, regardless of whether they choose to engage directly or go through financial intermediaries. Retail investors need coherent and reliable information to participate in capital markets. They are often unable to easily find rewarding, cost-efficient options. This requires moving away from compliance debates about products and providers and instead towards focusing on solutions to meet specific financial objectives/needs.

Is the profile diversity of retail investors understood? Will the green and digital transition strengthen the link between their asset allocation and the real economy? Are future developments in manufacturing, distribution and advice going in the right direction? Is the financial industry delivering good value for money? Is there a need for further intervention *(prohibitions, pricing, restrictions etc.)* from policymakers and supervisors? Is investor protection actually achievable in practice at national and EU level?

Moderator

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CEO, CEPS and General Manager, ECMI

Speakers

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Martin Parkes

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Session .02

Report

Empowering retail investors, be it from a regulatory or industry perspective, is no easy feat. Retail investors are a heterogenous group spanning millennials, heads of households, retirees and others. Not only do these subgroups have different objectives when it comes to investing, they also – across groups – possess varying levels of experience and affinity with retail investing. From a regulator's perspective it is therefore challenging to strike a balance between the protection of retail investors on the one hand, and accessibility on the other. Furthermore, empowering retail investors through enhanced information disclosure while avoiding information fatigue is presenting a second challenge to regulators. The European Commission is currently working on a revised Retail Investment Strategy that will aim to address these issues and is expected to publish it in the first half of 2023.

Despite the challenges facing regulators, a recent CFA study shows that trust in financial services is at an all-time high amongst retail investors, yet differences exist between subgroups. The post-WWII generation, baby boomers, are for example more likely to seek out the advice of a trusted financial advisor, unlike the younger generation, who are most likely to seek advice through online research. The younger generation of retail investors is more likely to possess a trading account, a trend facilitated by the rise of apps and the ease of trading they bring about. While they may ease trading and bring investment opportunities to a new generation, these apps may also contain elements of gamification which can also bring risk to new retail investors.

Advice is a crucial part of the investment journey for many retail investors. Particularly given the limited knowledge of, and background in, investing some retail investors possess. Without advice, certain groups of retail investors may fail to address biases in their investment strategy and similarly fail to rebalance their portfolios to their needs. Advice can therefore be of value, and does not necessarily have to come in the form of in-person human advice as robo-advisors can also address issues of portfolio bias and disbalance. For human advice, it is important that advisors' incentives align with those of the investor they advise. If this is not the case, for example when investors are incentivised to advise certain products over others, retail investors' outcomes suffer and trust may be lost.

Some clear starting points in improving advice are identified. First, the current regulatory ecosystem is geared towards the baby boomer generation and their preferred way of obtaining advice: in person. Efforts to improve regulation surrounding digital and robo-advice would improve younger generations' ability to access advice. Secondly, more attention should be paid to sub-groups of advisors. For example, when average statistics for age groups are broken down across genders, large gaps in comfortability with investing are revealed. In turn, these gaps can drive differences in retail participation – where one observes that participation rates for males across age groups tend to be higher.

Empowering retail investors is key to higher retail investment participation rates. Through higher trust in financial services, more readily available advice and a regulatory ecosystem that both protects as well as informs investors, retail investment can be stimulated. With the challenges of the twin transitions, and retail investment's crucial role in it, addressing these challenges is of paramount importance.

Session .03

SUSTAINABILITY REPORTING how to find the balance?

Customers, employees, investors, policymakers, NGOs, and other stakeholders are increasingly demanding that companies act responsibly. To determine whether companies actually do this, larger companies need to report on their ESG performance. Considering that these sustainability aspects are extremely diverse, dynamic and less developed than financial reporting, it is challenging for policymakers to determine exactly what companies should report on. At the same time, reported information should not be too costly to collect, and it must be reliable and understandable for all stakeholders concerned.

Where does the development of sustainability standards in the EU stand? What are the main challenges in developing EU standards? How are these challenges addressed in both the standards and their implementation? How is it ensured that the standards will be straightforward for the various stakeholders? Will it be feasible for those responsible to report the requested information with a high level of quality? Are there possibilities to increase the net benefits of the standards?

Moderator

Apostolos Thomadakis

Research Fellow,
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Speakers

Sue Lloyd

Vice-Chair, International Sustainability Standards Board (ISSB)

Ulrike Sapiro

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Session .03

Report

As businesses across the world focus more intensely on incorporating sustainability into their strategies and expanding their sustainability footprint, having in place common reporting standards that provide much-needed transparency and standardisation on a global scale is very important. This is what the International Sustainability Standards Board *(ISSB)*, which was announced at COP26 in 2021, aims to do – build a global baseline language for sustainability reporting that will allow investors to have high quality and comparable information on a company's exposure to sustainability risks and opportunities.

In particular, the ISSB will publish early next year two sets of standards. Under the general requirements for disclosure of sustainability-related financial information *(IFRS S1)*, companies will need to provide (on a voluntary basis) information on all of their significant sustainability related risks and opportunities *(and not just those related to climate)*. On the other hand, the climate-related disclosure *(IFRS S2)*, which builds on the recommendations of the Task Force on Climate-Related Financial Disclosures *(TCFD)*, covers physical risks, transition risks, and climate-related opportunities.

On the European side, currently, the European Financial Reporting Advisory Group *(EFRAG)* is finalising a set of European Sustainability Reporting Standards *(ESRS)* that will allow Europe to meet the ambitious targets of the Green Deal. These standards, which will become mandatory under the Corporate Sustainability Reporting Directive *(CSRD)*, will have a significant impact on companies doing business in the EU.

Interoperability is key. Aligning disclosure requirements between international standards and regimes that have been either developed or are about to be established – such as the ISSB, the ESRB, the Global Reporting Initiative (GRI) standard, the new climate risk reporting rules proposed by the US Securities and Exchange Commission (SEC), or other jurisdictional rules – is a rather challenging task. Comparability is fundamentally important to creating a system that maximises impact and achieves efficiency and harmonisation. Differences in definitions *(e.g. materiality)*, methodologies, as well as metrics used between the different reporting standards, present the risk that companies will spend time and resources developing separate disclosures concerning the same topics but for different jurisdictions. It would also make the use of standards more difficult for the readers and – above all – the investors.

Comparable disclosures require ambitious, specific, and prescriptive reporting standards. But, there is the need to ensure that the level of detail and specificity required does not go beyond standard reporting practices. For companies to be able to comply with them, they need to have in place the right processes and tools, good quality data, as well as suppliers that understand what is required to report. For example, although direct emissions *(i.e. Scope 1)* and emissions arising from the generation of purchased energy *(i.e. Scope 2)* may be easier to disclose, those that result from sources that are neither owned nor controlled by the company *(i.e. Scope 3)*, will be a real challenge to disclose. Thus, it is important that compliance does not overshadow the most decision-useful information, divert resources away from sustainability performance improvement or increase the cost of compliance, complexity and paperwork in a way that hinders its benefits. Europe and the world have a unique opportunity to drive forward and incentivise change in sustainability reporting. However, the risk of rising barriers and obstacles remains high.

From a company's perspective, implementing a sustainable strategy can be highly rewarding. Companies that are fully dedicated to sustainability and set up a business that is completely green greatly benefit and have a competitive advantage compared to those that do not. This is because the size of the market for sustainable investments is far higher than the number of sustainable investments available. Moreover, fully green companies usually significantly outperform the market. However, the issue is with those companies that are in non-sustainable industries and attempt to transition into becoming green. In fact, it may be more beneficial to split the company into two separate parts, one fully green and a less green part.

Best Paper

Information intermediaries and sustainability:

ESG ratings and benchmarks in the European Union

Moderator

Apostolos Thomadakis
Research Fellow, CEPS & ECMI

Presentation

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University of Genoa

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As sustainable finance has been steadily expanding over the past few years, so has the development and use of sustainability ratings, benchmarks and indices. Many investors rely, with variable intensity, on such firms, which belong to the broader category of information intermediaries. The growing importance of such intermediaries, have – and will – made them subject to specific rules in an effort to foster investors' trust in the quality of the financial products that are labelled as sustainable. The authors of the paper explore whether traditional financial law can, and should, be applied in the world of sustainable finance, as well as to what extent market failures affecting ESG ratings and benchmarks compare to those affecting their traditional equivalents.
An important element to consider in this comparison is that market mechanisms that work well in traditional finance may not work equally well when one factors sustainability considerations into investment decisions, and therefore into the dynamics of price discovery. In addition, regarding market failures, the paper argues that in the sustainability world there is a different, and possibly weaker, role that private enforcement can play in penalising misleading information or misguided assessment related to sustainability factors.

While the lack of a clear liability regime exacerbates the risk of market failures, regulatory failures are also more likely in the world of ESG information intermediaries, compared to traditional finance. Policymakers are also subject to most of the asymmetric information problems on the dynamics of ESG finance that also impact market participants. Misguided regulation can enhance misguided trust in ESG ratings, given their multivariate nature, the subjectivity in their methodologies and the lack of clarity on what it is actually measured. The authors conclude by suggesting that:

- more emphasis should be put on the disclosure duties on methodologies and conflict of interests of ESG ratings services, and
- the legal framework for financial analysts might be more suitable when it comes to ESG ratings, compared to that for credit rating agencies.

European Capital Markets Institute

ECMI conducts in-depth research aimed at informing the public debate and policymaking process on a broad range of issues related to capital markets. Through its various activities, ECMI facilitates interaction among market participants, policymakers, supervisors and academics. These exchanges result in commentaries, policy briefs, working papers, task forces as well as conferences, workshops and seminars. In addition, ECMI undertakes studies externally commissioned by the EU institutions and other organisations, and publishes contributions from high-profile guest authors.

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