2023 Annual Conference

Report

The Road to 2030: Setting Priorities Now for Europe's Capital Markets

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Europe's capital markets in perspective

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Europe is lacking scale compared to the US, which is a deeper and more seamless market, but also compared to Asia. In terms of global markets revenues, the US accounts for about 40 %, Europe 25 % and APAC 20 %. More importantly, European revenues in debt and equity markets are on a downward trend. Contrary to Europe, the US market has the advantage of deep fixed income markets and growing equity markets through technology and homogeneous regulatory rules. Moreover, and due to fewer friction (i.e. execution) costs in the US, equity returns are higher. The difference between the two jurisdictions is also illustrated by the less developed European securitisation market (10 times smaller than the US market). Securitisation improves the balance sheet velocity for banks, frees up capital that enables them to renew their capacity to distribute credit, as well as increases the transparency of pricing.

Due to the relative lack of depth and size of European capital markets, European investment banks (IBs) lack revenue scale in their home markets. The top American IBs generate roughly 50 % of the global revenue pools in both fixed income and equity sales and trading. This lack of revenue scale matters as it means lower returns, reflecting lower balance sheet velocity, which translates into lower valuations for European banks compared to their US peers. Given that investment needs are going up (due to technological and geopolitical challenges) and execution platforms become an increasingly differentiating factor for banks, the investment banking ecosystem would have to evolve and become execution oriented with a captive corporate client base. This will lead to a multiplier effect on revenues for IBs.

Europe is doing well in the environmental, social, and corporate governance (ESG) space and is a leader on the issuance of green bonds. However, volumes remain very small (EUR 216 billion in green bond issuance in 2022) when compared to the potential benefits that an efficient and well-functioning securitisation market could offer.
In addition, European banks operate with significant balance sheets and they are key counterparties to financial institutions globally.

Although some of the initiatives put forward by the European Commission are going in the right direction (e.g. the European Single Access Point, the Listing Act, the proposal on corporate insolvency), moving forward, more efforts are needed to increase the depth of its capital markets, reduce trading friction costs, and simplify the listing process for companies (especially in the tech sector).

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SESSION.01

A vision for Europe's capital markets in 2030

Moderated by

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

Speakers

Danuta Hübner
MEP, ECON Committee

Paul Tang
MEP, ECON Committee

Before creating a vision for the future of European capital markets, it's important to take a step back to the beginning of the current Commission mandate. Despite Brexit, the EU has failed to capitalise on the opportunity to create a rival European financial centre to London. A lack of resolve amongst Member States to transform the differing national regimes into a united whole is a major obstacle to the development of European capital markets. Instead of facilitating the emergence of one or a few European financial centres, Member States cling onto a fragmented approach rife with inefficiencies and lost opportunities of scale. The recent delisting trend across European exchanges serves as a reminder that failing to move forwards on the Capital Markets Union (CMU) project has very real consequences. This is not only of economic, but also of strategic importance.

Yet there is also progress to applaud. Securitisation is an area where the next Commission could drive real progress. Securitisation, when done correctly, allows for risk transfer across the financial system and frees up banks' balance sheets. Capital can thus be redeployed elsewhere, and as such can narrow the financing gap of the green and digital transitions. The upcoming Commission should look with earnest into reviving talks on increasing securitisation, while heeding the lessons learned in the wake of the 2007-09 global financial crisis.

An aspect of the CMU receiving much attention these days, and what will remain crucial in the upcoming years, is the engagement of retail investors. The Retail Investment Strategy (RIS) sets out to improve outcomes for retail investors and by doing so entice them to move money away from deposits and into the markets. The current proposal sets out to reduce conflicts stemming from information asymmetries between distributors and investors, as well as improve competition in the market, but is running into resistance from industry participants and the Council.

As with retail investment, sustainable finance is an area that is certain to (continue to) receive much attention in the coming years. It's imperative for Europe to hold on to its leadership position, both to reduce the impact of climate change as well as to finance European climate champions. Yet there is a chance that following the European Parliament elections, the Parliament's composition might swing hard to the right. This could potentially dampen institutions' ambitions regarding sustainable finance agenda.

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Moving forward, a European safe asset would be an important component in advancing the CMU project, while the Banking Union should overcome the political hurdles that it's currently facing. Overall, it's important for the next Parliament not to get bogged down into turf battles over little details, but rather to keep the 'big-picture' CMU in mind, as it's something members from across the political spectrum should strive for.

Of crucial importance to furthering the CMU is that the Council is fully on board. One way in which this can be realised is by moving discussions on the CMU from Brussels to the national capitals. As long as the CMU is a Brussels-only technical discussion, citizens and their political leaders will fail to grasp its significance. To the contrary, if citizens are made aware of the CMU's benefits, its relevance to their pensions and everyday life, their political leaders would be much inclined to push for change and invest time and energy in the file.

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Regulating the ESG rating providers

Moderated by

Karel Lannoo
CEO of CEPS and General Manager of ECMI

Speakers

Petr Wagner
Deputy Head of Unit, Corporate Reporting, Audit and Credit Rating Agencies, DG FISMA, European Commission

Neil Acres
Global Head of Government and Regulatory Affairs, MSCI

Stéphane Janin
Head of Global Regulatory Developments and Public Affairs, AXA Investment Managers

Lorenzo Sáa
Chief Sustainability Officer, Clarity AI

As the first on the international scene, the European Commission has proposed to regulate ESG rating providers in the EU. The intention is to improve the reliability, comparability and transparency in ESG ratings and how the rating providers operate. By doing this, the Commission aims to tackle conflicts of interest in the market for ESG ratings and improve their quality. However, the proposal does not deal with the use of ratings, nor does it regulate the methodologies used for the creation of ESG ratings.

Moreover, and although the proposal provides a definition of what an ESG rating, it falls short in differentiating it from an ESG score. In fact, it equates ESG ratings and scores. Regarding the fact that the industry is more than 50 % based outside the EU (but offers services in the EU), the proposal foresees a process of endorsement for ESG rating providers based in third countries. The proposal is now being discussed in the Council and European Parliament and may be adopted before the 2024 elections, although this is not certain.

The proposal has some similarities with the Credit Rating Agencies (CRA) Regulation, particularly in the licencing of agencies and the endorsement system, but the CRA Regulation also regulates the methodologies. In this proposal, methodologies are left to the provider, as there is wide diversity in the various approaches towards ESG ratings, which at the same time is the proposal's main downside. While the EU Commission may be respecting the independence of methodologies, and the diversity of views, it may create problems on the disclosure side. The 'same risks, same rules' principle should apply, but this will be difficult if not all relevant information is disclosed, which may give rise to greenwashing.

In contrast to the EU's approach, the UK – similar to the International Organization of Securities Commissions – has opted to also regulate ESG data products. They see that it's fundamental to have a methodology-neutral approach that is transparent, and facilitates switching between providers. It should cover the data, the scores, the regulated data and the platforms.

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Consolidated tape and the market for market data

Moderated by

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Principal Advisor, External Relations & Government Affairs, Bloomberg

Speakers

Fabrizio Planta
Head of Data Intelligence and Technology, European Securities and Markets Authority

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Susan Yavari
Senior Regulatory Policy Advisor, European Fund and Asset Management Association

Rainer Riess
Director General, Federation of European Securities Exchanges

A missing piece of the 2004 Markets in Financial Instruments Directive (MiFID), which aimed to pave the way for competition in trading venues, was a consolidated tape (CT). Although the discussion for a CT started in 2007, it didn't materialise until 2018 and MiFID II, which laid out a dedicated framework for such a tape to operate. Later, the 2020 CMU Action Plan also made CT a priority in an effort to integrate national capital markets into a genuine single market. The provisional agreement on the review of MiFID II that was reached earlier this June is a positive development and a step closer towards the establishment of EU-wide CTs for equity, bonds, derivatives and exchange-traded funds (ETFs).

Europe lacks vibrant and dynamic markets. In 2022, the equity exposure of European funds to European equities stood at 35 %, while at US equities to 42 %. In addition, liquidity in European trading venues has contracted by 25 % since 2013, compared to growth of 23 % in the US. On top of this, Europe needs to finance the various transformations as well as its response to various ongoing challenges (e.g. digital, green, the war in Ukraine, and wider geopolitical challenges).

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More efforts are needed on many different fronts. The CT is one of them, as it will provide a more vibrant listing ecosystem and an efficient trading landscape. It will allow investors to have a comprehensive overview of trading activity and liquidity in the EU in one single place, as well as increase transparency, and boost investment activity, particularly from foreign investors.

One of the most challenging issues in the design of a CT is the number of providers per asset class. Both the EU and the UK seem to agree and favour a model with a single consolidated tape provider (CTP) as opposed to multiple ones. This will not only contribute to reducing the cost of market data for end users and the costs for trading venues, but it will also provide a more efficient governance structure (i.e. a single governance source). Another difficult task is the selection process for the CTP, where the right balance between price and value/quality should be found. The tape should be high-value, meaning high quality in a cost-effective way and not the lowest possible price.

The revenue model is also a concern, particularly for the impact that it will have to the exchanges. Even though this will largely depend on uptake and how the CT will be used, smaller exchanges that make much of their profit from selling data would be hurt the most. In contrast to the EU that will apply a revenue sharing model, the UK will employ a model that rewards data quality.

One way or another, the success of the CT will largely depend on the quality of data provided to the CTP. Thus, having consistent reporting and disclosure requirements in place, as well as regular monitoring and data quality controls is necessary. The European Securities and Markets Authority has been performing quite a number of these activities already in the context of the European Market Infrastructure Regulation and trade repositories by having established a data quality engagement framework with the National Competent Authorities for the supervision of the relevant entities.

Moving forward, it is crucial to ensure that a CT does not distort competition or disincentivise data contributors, nor that it hampers the consumption of data.

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Book-to-market, mispricing, and the cross-section of corporate bond returns

Moderated by

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The bond market is the largest securities market in the world. In 2022, the global bond market totalled EUR 125 trillion, compared to the equity market which reached a capitalisation level of EUR 114 trillion. Differences between the corporate bond and equity markets could influence their relative efficiency. Researchers have conjectured that the corporate bond market may be relatively more efficient because sophisticated institutional investors dominate its trading. Others believe that it is less efficient due to its over-the-counter market structure, engendering greater trading costs and less pre-trade price transparency.

To aid our understanding of market efficiency, the authors study the predictive power of book-to-market ratio on corporate bond pricing. They start by defining the 'bond book-to-market ratio' ('BBM') as the bond's book value divided by its market price. The sample ranges from 2003 to 2020 and is composed of about 9 000 US corporate bonds, 840 issuing firms and close to 460 000 monthly observations. The primary source of data is the Trade Reporting and Compliance Engine (TRACE), which reports transaction level information (e.g. price, transaction size, date and the time of execution) of over-the-counter transactions of fixed-income securities.

Results show that corporate bonds' book-to-market ratios predict returns computed from transaction prices. Senior bonds (even investment-grade) with the 20 % highest ratios outperform the 20 % lowest by 3-4 % annually. Moreover, findings indicate that an efficient bond market would not exhibit the observed decay in the ratio's predictive efficacy with implementation delays, small yield-to-maturity spreads, or similar-sized spreads across bonds with differing levels of risk.

The empirical evidence suggests that the US corporate bond market is not perfectly efficient. This may also be true for other markets, such as the European corporate bond market, but the fact that data is not readily available makes this difficult to prove. Finally, from an investor's point of view, there are opportunities that investors can exploit. For example, transaction costs (e.g. bid-ask spread, fees, short-selling constraints), holding periods and trade implementation, or portfolio tilts.

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European Capital Markets Institute

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