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Europe's capital markets puzzle

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Creating an attractive framework for more market financing in Europe is proving to be an increasingly complex puzzle. The EU and other European states are battling on several fronts, but without the unity and vision that is needed to move forward. Brexit is one of the difficult pieces of the puzzle, but also problematic is the dominance of universal banks, even more in mainland Europe, and limited acquaintance with more market finance. Market financing is however paramount for Europe's competitiveness.

The EU Commission's latest action plan – the New CMU Action Plan – lacks workable solutions and gets lost in small items that will not allow for significant change or bring Europe's markets up to speed. Some weeks earlier, but why not as part of the plan is unclear, the EU Commission proposed amendments to three key measures from the earlier wave in the name of Covid-19: the Markets in Financial Instruments Directive (MiFID II), prospectus and securitisation regulations. A positive development on the horizon is the emergence of a euro safe asset, a crucial building block for European capital markets, but the issues it raises are not reflected in the action plan either. Six years after the launch, we are no closer to the benchmark set by the United States.

The real actionable items of the new plan are limited; several elements are intentions, proposals for studies or elements to strengthen existing frameworks. Of course, there is no need for an extensive new legislative agenda because the EU has been engaged in these issues since the announcement of the Financial Services Action Programme (FSAP) in 1998; much has been achieved and changed in the meantime. What is missing is a vision of what the EU wants to achieve, by when and how, on which there seems to be no agreement. The incremental approach followed over in recent years is now harming the EU's long-term interests.

To put this into context, we will discuss the EU from the perspective of global markets since the CMU was launched in 2014, and what this implies for the EU's attractiveness. In a second step, we will assess the key elements of the plan, and the other amendments that have been proposed recently. In a third step, we will look at elements that are missing in the plan, before concluding.

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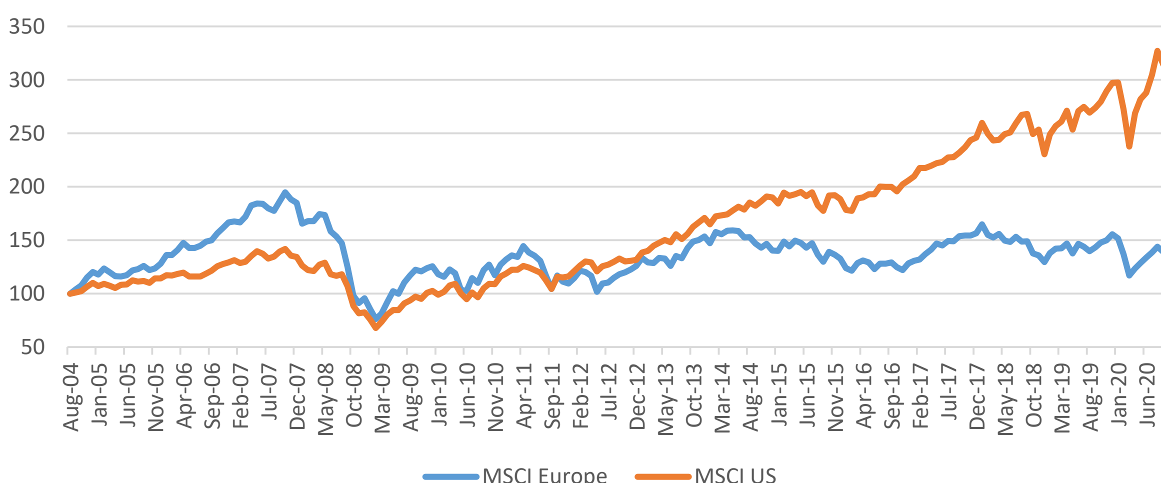
The EU's capital markets in perspective

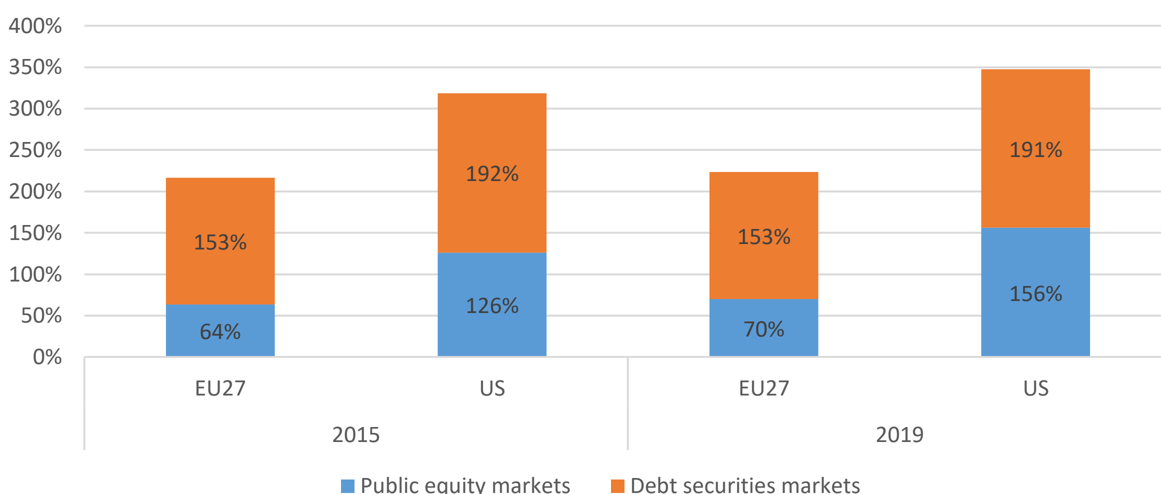
"Competitiveness is essential to make the European Union a more attractive location. A location for people, for investors", said Commission President Juncker in his 2014 State of the Union address, when announcing the CMU Plan. Six years later, it seems that we have not become more attractive – on the contrary. On the equity market side, the US capital market, as measured by the equity market index (MSCI), has advanced enormously over the last five years, while Europe has remained flat (see Figure 1). We have clearly not achieved what CMU was aiming to do in 2014 – become more market driven. The attractiveness of the equity markets as a source of financing remains low, at approximately half the size of that in the US (see Figure 2).

Figure 1: Performance of equity indices in Europe and the US



Notes: The graph plots the price of the MSCI Europe index and the MSCI US index for the period August 2014 to October 2020. The MSCI Europe captures large and mid-cap representation across 15 developed markets countries in Europe (i.e. AT, BE, DK, FI, FR, DE, IR, IT, NL, NO, PT, ES, SE, CH and UK. August 2014 prices were set to 100.
Source: authors' own calculations based on MSCI data.

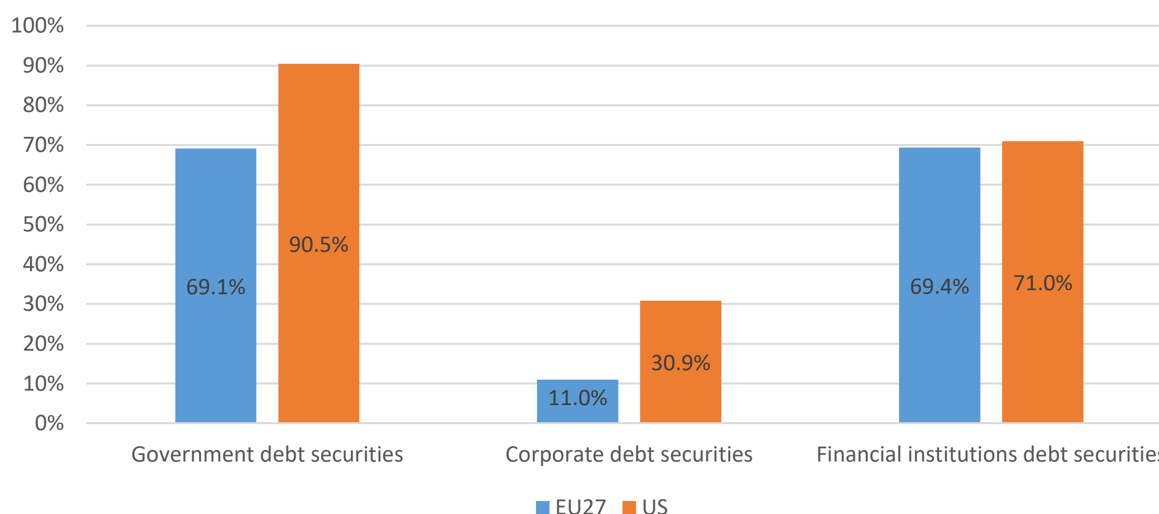
Figure 2: Capital market structure (% GDP, 2015 and 2019)



Note: Debt securities markets include: government, financial institutions and corporate debt securities.
Source: authors' own calculations based on FESE, WFE, IMF, as well as data collected from national exchanges.

On the debt securities markets, in Europe the sector is about half the size of that in the US: in 2019 the amount outstanding of European debt securities was €19.5 trillion (€18.2 trillion in 2015) compared to €36.6 trillion (€32.2 trillion in 2015) in the US. Debt securities issued by governments and financial institutions have taken up the largest part of the financial system, with corporate debt securities representing a very small fraction. This is due to the heavy reliance of European non-financial corporations (NFCs) on bank lending and unlisted equity capital. As a result, European securities markets for corporations are almost one third of their US counterparts (see Figure 3).

Figure 3. Debt securities, amounts outstanding (% GDP, average 2015-2019)



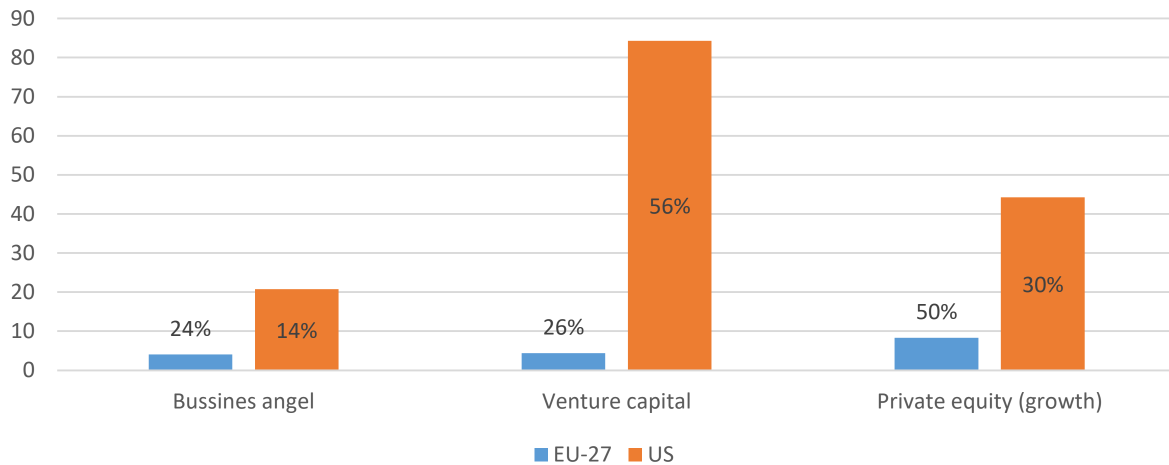
Source: authors' own calculations based on BIS and IMF data.

Other forms of market finance, such as crowdfunding, venture capital and private equity, are of very limited use in Europe – especially for young, small and innovative companies. The issuance of equity and bonds is not the preferred option and rarely considered by SMEs (Thomadakis, 2017), while crowdfunding, which is very limited in size, did not live up to expectations post-crisis. Business angel financing, which is of comparable size to venture capital funding, is usually under the radar of SMEs. Finally, private equity is the most preferred risk capital source of funding for more mature companies at the growth stage.

Despite encouraging recent progress in the availability of risk capital for European SMEs, the gap with the US is increasing. The average annual amount of risk capital in the US over the period 2015-18 was around €149 billion, almost nine times the amount invested in the EU-27 (€17 billion) (see Figure 4).[2] Compared to the size of the respective economies, the US pre-IPO risk capital represents 1.2% of GDP, while in Europe it represents 0.14% of GDP. The gap is even bigger when looking at the stage of VC investments, with European VCs investing more on seed and start-ups compared to their US counterparts, and less into companies that are in their later stage (AMAFI, 2020).

[2] In the US, the amount invested increased by 32% between 2015 and 2018 (from €142 billion in 2015 to €188 billion in 2018), while in Europe by 27% (from €15 billion in 2015 to €19 billion in 2019).

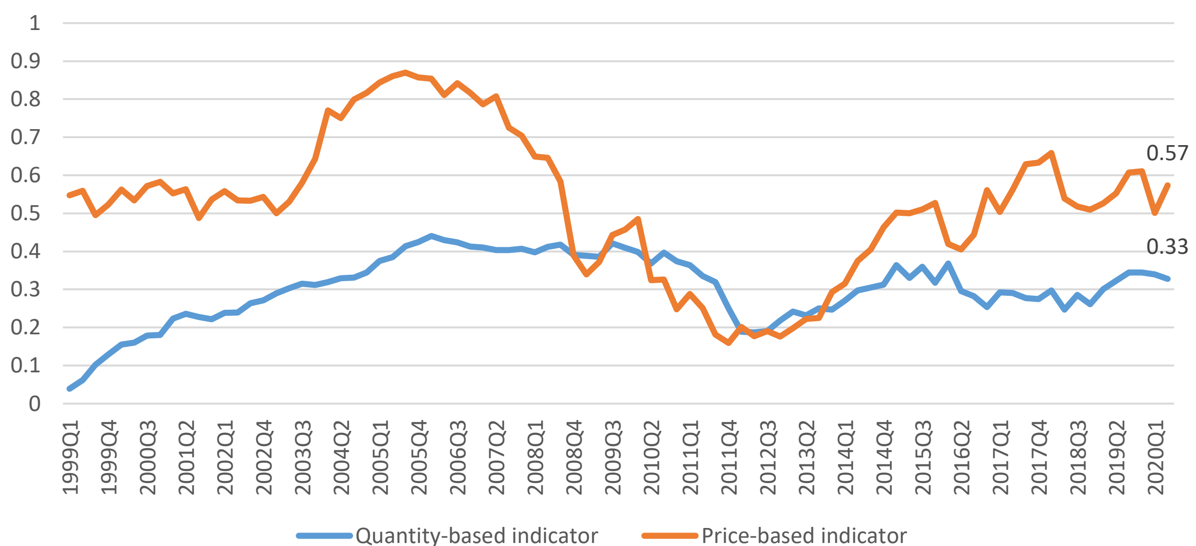
Figure 4. Pre-IPO risk capital investment by asset class (€ billion, average 2015-2018)



Source: EBAN, Invest Europe, NVCA, Center for Venture Research.

Overall, it may be useful to agree on some benchmarks that can be used to measure progress towards more market financing in Europe, and towards more market integration. On the latter, the European Central Bank's (ECB) indicator is well known, but not yet sufficiently referenced. According to the latest data, we are only half way from full integration when taking the price indicator into account, and just one-third away when considering the volume indicator (see Figure 5). In the retail domain, the figure is much lower, and it is commonly assumed that 1% of financial services provision is cross-border. This matters because, as for other products, price and quality competition does not work sufficiently. Indicators for more market finance were proposed by AFME, the association of large banks and operators in European capital markets. Its latest edition found little progress, except for bond financing in the first half of 2020, in response to the Covid crisis (AFME, 2020).

Figure 5. Financial integration indicators (1999Q1-2020Q2)



Notes: The price-based composite indicator aggregates ten indicators for money, bond, equity and retail banking markets, while the quantity-based composite indicator aggregates five indicators for the same market segments except retail banking. The indicators are bounded between zero (full fragmentation) and one (full integration).
Source: ECB.

Achievements of CMU 1.0

The Investment Firm Regime and the European Supervisory Authorities (ESAs) Review can be considered as the main achievements of CMU 1.0. Opinions on the impact of the securitisation, the prospectus and the Personal Pension Product (PEPP) regulations are divided – the first two will be revised, and the implementation of the third has only started. Overall, the views were that more could have been achieved, and that often good proposals were watered down in the decision-making process, as was the case for the PEPP, for example. But CMU was definitely put on the agenda as a key issue for the EU.

- The **investment firm regime (IFR)** introduces a harmonised regime for non-bank investment firms in the EU, something that would not have been possible with the UK still as a member. Most of these investment firms are established in the United Kingdom (55%), followed by Germany, France and the Netherlands. Some of the European operations of large US banks, or parts of them, fell under the more lenient regime, which has now been added to bank regime (the Capital Requirements Directive (CRD) IV), and brought under the supervision of the Single Supervisory Mechanism (SSM) in the EU. The UK has already indicated that will go back to the former regime in 2021.
- The **ESA review** reinforces the role of the ESAs, above all for the European Securities and Markets Authority (ESMA) with new unique supervisory tasks (e.g. for central counterparty clearing houses (CCPs), data providers and benchmarks) but also for more direct interventions in the markets. This can be expected to expand further as a result of the amendments to Art. 9 regarding consumer and investor protection. The governance structure remains very much oriented towards the member states, which each of them having one vote in the supervisory board, but with a more central role for the chair.
- The **PEPP** is a missed opportunity for an EU-wide long-term savings product, not because of the Commission's proposal, but of the outcome in the EU Council and European Parliament. Key elements of the proposal were watered down or replaced in response to heavy pressure from member states and interest groups (Lannoo, 2019). Rather than a broad long-term savings product, it became a 3rd pillar insurance product only, as there is always a guarantee element involved. This narrowed the scope considerably. In addition, the role foreseen for the European Insurance and Occupational Pensions Authority (EIOPA) as a unifier of markets was greatly reduced.

The attractiveness of the prospectus and securitisation regulation were seen to be undermined by a lack of change, rules that were too demanding and hence without substantial impact. It will be further revised.

The CMU 2 Action Plan

In the introduction, the Commission says that *"a lot still remains to be done and it is now time to step up the level of ambition"*, and *"strong political support is now needed more than ever"*, but not much in the plan responds to this aspiration. The second CMU Action plan is composed of 16 actions, but none of these is expected to be controversial or require big changes (EC, 2020a). The overall themes are mainstream: adaptation to the green recovery and digitalisation, more disclosure, and better access to finance for SMEs. There is one exception: a proposed EU-wide system for withholding tax relief at source. This, if achieved, would be very welcome, as the diversity of tax systems is a major barrier to cross-border holdings, certainly at the retail level. But it concerns tax harmonisation, which requires unanimity in the EU Council.

What should then be the core elements? There was certainly no shortage of input from the private sector and member states with, for example, the report of the Next CMU High-Level Group (NextCMU, 2019), and the EU Commission's own High Level Forum (HLF, 2020). ECMI's Rebranding CMU task force report (Lannoo and Thomadakis, 2019) singled out a few areas that could bring major change:

- **Government bond markets:** they are an important building block for capital markets, and a benchmark for other segments. Primary markets for government bonds should be integrated on the basis of EU rules. A euro area safe asset would be a major step towards more integration in Europe's capital markets and further enhance private risk-sharing.
- **Start-ups, high growth companies and SMEs:** much remains to be done to bring SMEs to the markets. The SME Growth Market label requires exclusive focus on SMEs with less complex requirements/costs than the regimes for ordinary regulated markets. Consistent definitions of SMEs across different pieces of legislation are necessary, which however is far from easy, for tax and other reasons.
- **Investment fund markets and long-term savings:** further initiatives are required to reduce the costs of fund investments by households on the basis of a few clear benchmarks, and to channel the savings of European households into long-term assets. The importance of attractive long-term savings vehicles was also emphasised by NextCMU (2019).

On the first item, a major step was taken on the euro safe asset, with the EU Commission market borrowing, on the basis of its triple AAA rating, for the EU recovery fund, NextGeneration EU (NextGenEU). Together with the borrowing by the other EU entities, such as the European Stability Mechanism (ESM), the European Financial Stability Facility (EFSF) and the European Investment Bank (EIB), the total borrowing of the EU under the top rating could reach €1.4 trillion,[3] a major step towards a euro safe asset. This is a much more straightforward way than through the 'ESBies', the securitised portfolio of eurozone sovereign bonds, on which a Commission proposal was made in 2018, or E-bonds, potentially issued by the ESM. As an indication, the first tranches under the SURE programme that were placed on 23 October 2020 were about 10 times oversubscribed. The bonds are issued under Luxembourg law and listed on the local stock exchange. The advantage of these bonds is that they may form the reference yields over different maturities for other debt securities.

On access to market finance for the SME, several lines are pursued. The most important are the SME IPO fund announced by the EU Commission President in her inaugural speech for the EP in July 2019, and the EIB's €25 billion Pan-European Guarantee Fund in response to Covid-19 crisis.[4] The EU Commission will also attempt to simplify the listing rules for SMEs, to allow for immediate listing on an exchange platform without a formal initial public offering procedure, as Spotify did when it listed on the Nasdaq in April 2018. But reducing the listing burden for SMEs is difficult without undoing the necessary disclosure and investor protection. Related is the lack of proper research on listed SME stocks, on which controversy has been raging for some time. With the unbundling under MiFID II, sponsored research is no longer allowed, which for some is the reason for the insufficient coverage and take-off of SME stocks. The Commission therefore proposed to make an exemption for small caps in the MiFID 'quick fix' or limited amendments, proposed outside the action plan of 26 July (the reason for this is unclear), which

[3] Importantly, about half of that amount (€850 billion) is a one-off operation linked to this extraordinary crisis with a 30-year maturity. This means that coverage of different maturities is not assured. In addition, issuance of 'safe debt' by the various European institutions is not really harmonised or traded in an integrated way (Constâncio *et al.*, 2020).

[4] The latter can also be used for equity support for SMEs. This comes in addition to the already existing European Investment Fund (EIF), managed by the EIB.

may however do away with unbundling all together. ESMA found no evidence of the link between unbundling and SME research coverage; as ESMA Chair Maijoor said in a recent conference speech: *"I fail to see how undoing the research unbundling provisions, which began in 2018, can improve research availability for SMEs."* (Maijoor, 2020).

A major component of long-term savings is costs. Unbundling was introduced by MiFID II to also allow for a more transparent reporting of costs, and to tackle conflicts of interest. It has shown to contribute to lowering the costs of funds for retail investors, as data for the UK and the Netherlands – the countries that have had these rules in place for longer. An initiative to reduce the costs of funds, long highlighted by ESMA, is however missing from the CMU 2.0. As ESMA noted: "costs remain a critical component in final investor benefits, with retail investors paying higher costs than institutional investors" (ESMA, 2020). Moreover, the study highlights that UCITS have a highly variable gross annual performance (…), while costs remained broadly stable over time and only marginally declined in the analysed period (on average 1.5% in 2018 and 1.6% in 2017).

According to ESMA, a hypothetical 10-year retail investment of €10,000 in the period from 2009 to 2018 provided a value after costs of around €16,045, with costs amounting to about €2,627. Add to this the entry and exit cost of funds and this explains the much lower share of funds in household savings in the EU than the US, and the lack of a critical 'buy side' component for Europe's capital markets. In addition, the high variety of funds available makes it "complicated for investors to consistently identify outperforming UCITS", according to ESMA.

Moving beyond CMU 2.0

There is much more affecting the EU's capital markets that is not (sufficiently) covered in the latest action plan. It may be there between the lines, or it may not be there on purpose. Just take some important developments, such as the ECB with the European Distribution of Debt Instruments (EDDI), Brexit and its implications, the role of ESMA, and digital finance.

The ECB and EDDI

With its central role, even more with its massive bond purchase programmes, the ECB has an interest in well-integrated bond markets. In addition, in the execution of its monetary policy operations, it is confronted on a daily basis with the structural imperfections of European capital markets. Collateral sits in CSDs in the different eurozone states, and cannot be moved across countries easily – an issue that is as old as monetary union. It creates additional costs for banks and institutional investors.

Procedures for the issuance of government debt, and also other elements of the settlement systems for securities are not yet harmonised at EU level, which keeps EU markets fragmented. The second element is part of a consideration in the CMU 2.0 plan, but the first has never been formally addressed, which is surprising, given the NextGenEU issuance plans. This ECB jumped into the void in 2019 with the initiative in EDDI. For the ECB, the European securities settlement systems continue to be extremely fragmented, notwithstanding 20 years of discussions, causing higher costs and inefficiencies, and maintaining local monopolies and home bias.

With EDDI, the ECB plans to introduce a pre-issuance harmonised toolkit, and a post-trade standardisation and harmonisation of the 'Giovannini barriers', as identified in a 2000 EU Commission report. It includes a European debt instrument technical standard, a standardised term sheet template, harmonised rounding and day-count conventions, and revisiting withholding tax procedures initiatives.

"*Issuers face today procedures that have not changed for decades and still heavily rely on manual interaction and low level of automation. A standardised and innovative European solution is long overdue*', the ECB says in the inaugural presentation of the initiative (ECB, 2019). This simply indicates the level of change that is needed to bring Europe's capital markets up to speed.

Green and social bonds

The green transition gets a lot of attention in the CMU action plan, but the synergies with the Sustainable Finance agenda and recovery package need to be further enhanced. The EU is planning to publish a (voluntary) standard for green bonds in the first half of next year, but this is likely to meet resistance as the criteria are set too high. A target of 30% of the NextGenerationEU fund was set to be raised through green bonds. EU governments have already issued 'green' bonds, but they may be wary of having too much prescription that restricts their freedom. The first-ever German Green bond, issued in September, was allocated to already existing infrastructure projects. However, "this retrospective approach will not lead to any structural shifts in the budget to favour commitments that bring the country closer to fulfilling its emission-reduction commitments, for example. Under this framework, green bonds are little more than window-dressing" (Kraemer, 2020). This already indicates how problematic it will be to set a standard at EU level (or whether governments will be exempted, as is the case under the prospectus regulation). From a capital markets perspective, the segment of green bonds issued by corporates is increasing but has yet to reach its full potential, in particular due to the demand from asset managers and institutional investors.

Social bonds have been less on the radar, but this could change rapidly, as the Covid-19 crisis has already shown. In particular, market finance is an underdeveloped resource for dealing with research on vaccines. It is probably somewhat known on the equity side, but much less so on the bond markets side. Strong global collective action can achieve broad social goals, and social bonds are poised to play a crucial role in these endeavours. It may appeal to international institutions, national governments but also foundations and philanthropists. Some standards already exist in this domain, such as the ICMA social bonds, as used by the International Finance Facility for Immunisation (IFFM) for the development of vaccines (Karsenti, 2020). Much like greenwashing, the risk of social washing must be avoided, for example through the development of an EU Social Taxonomy. The €17bn inaugural bond under the SURE instrument was issued by the EU Commission as a social bond.

The impact of Brexit

As the trade deal discussions are not advancing smoothly, a solution will have to be found beyond ad hoc measures to ensure continued interaction between the EU and the UK, and not to descend into a lose-lose situation for both sides. London remains the biggest financial centre in the world; its role will therefore continue to be important for the EU. On access to clearing and share trading, temporary solutions were found, but no permanent structure exists for both to meet. In addition, the departure of the UK was already noted in the MiFID 'quick fix' amendments, which would not have been proposed otherwise.

Debates around the MiFID 'quick fix', as well as other regulatory matters, highlight another risk of Brexit – the far greater flexibility and rapidity the UK will have to change rules. Whereas EU rules have become continuously more detailed in level one (because of the level playing field) and level two (as changes need to go through amendments following different but lengthy procedures), UK regulators will allow greater discretion to supervisors implementing them, as happens in other sovereign jurisdictions. This

difference risks putting the EU's financial markets at a competitive disadvantage, and requires urgent attention by policymakers.

The role of ESMA

ESMA's role was enhanced considerably in the 2019 ESA review, with additional unique supervisory responsibilities for data providers, benchmarks and third country CCPs. To cope with this, ESMA's staff will reach 380 persons by the year end, to become the largest of all the European supervisory agencies. ESMA can thus be expected to play an even more important role in Europe's securities markets. It is however not comforting to see that ESMA's positions often seem to be put aside by the European Commission, as indicated above.

The expansion of ESMA's tasks add to the existing specific tasks of the supervision of credit-rating agencies and trade repositories, and the generic product supervision and peer review of supervisors. The first tasks appear to have gone well, as 10 years after the start, business as usual prevails. There are no complaints from either side about the performance of these tasks; ESMA is thus in a good position to start new ones. ESMA's expansion can also be expected to lead to more generic supervisory tasks. The peer review of the Federal Financial Supervisory Authority (BaFin) and the supervision of the audit sector in Germany after the Wirecard crash gives an indication of what is to come. The audit sector lacks EU-wide supervision, something ESMA's chair has often pointed out.

ESMA's more central role in securities markets should thus also lead to a greater appreciation of its role in the EU Commission. But this is not really the case. To the outside world, the EU Commission should do the opposite if it wants to strengthen the case for a capital markets union. Only a unified approach can bring more capital market financing to Europe, not assorted conflicts.

Where is digital?

CMU 2.0 has little on digital aspects, while markets are steaming ahead. The EU issued its cryptocurrency proposal in September 2020, but this covers different grounds, from crypto-assets, stablecoins to e-money tokens (EC, 2020). Overall, it aims to create a harmonised regulatory framework for crypto assets in the EU and overcome the diversity of approaches that exist in EU member states. It also includes a mandate for ESMA to establish a register of all crypto-asset service providers.

Crypto-assets and the distributed ledger technology (DLT) that underpins them have attracted significant attention globally. DLT has the potential to deliver substantial benefits, both in financial services and other sectors. Crypto-assets are one application of DLT, and whilst it has grown in some EU markets, it remains small compared to other jurisdictions. But crypto-assets require a unified response to counter the use for illicit activity and to restrict the sale to retail investors.

To clarify that this concerns initial public offering of crypto-assets, it would have been better to package the Commission's proposal within the CMU plan, and to distinguish it clearly from the e-payment related parts of the proposal. This would also have facilitated the understanding and treatment of this proposal on the different legislative levels in the EU, and demonstrated that the EU is taking action in this field.

Conclusion

Efficient capital markets are characterised by: the depth of the intermediation system (including the availability and liquidity of credit, equity, debt, insurances, and other financial products); prices that reflect all available public information; the capacity to pool and manage risks through hedging; as well

as the tendency to effectively allocate savings to their most productive investment uses. This level of efficiency can only be achieved when capital markets are well-developed and fully integrated.

The first phase of the CMU project mainly focused on the development of capital markets (even only at national level), and significantly less on the clear and ambitious goal of the CMU, which is the removal of cross-border obstacles and the creation of a single unified capital market. Six years after the start of CMU, Europe has moved backwards rather than forwards towards a more balanced financial system. In fact, European capital markets remain highly fragmented, economic agents do not face identical rules and do not have equal access to financial instruments or services. Market participants are interacting in silos that are less liquid, less diverse and less competitive.

Fragmentation has led to smaller and disconnected liquidity pools with less efficient and more volatile pricing. Market financing is not advancing, Europe's competitiveness is under scrutiny, while euro's international role is close to historical lows. A major initiative from European policymakers is sorely needed.

The European Commission wants an industrial strategy for strategic autonomy, but the basis – the means of financing such investments – is not on the cards. To make a difference, Europe will need more pronounced initiatives, affecting the supply of market finance, the rules for the large and small issuers in capital markets, and a further strengthening of the role of the central market authority, ESMA. It will need to ensure that the massive amounts of household savings find their way to the markets, and do not languish in bank accounts.

Given the closer interaction with the private sector, and the challenging departure of the world's largest financial centre from the EU, it would be useful to create a permanent monitoring committee for the CMU-related initiatives, to agree on some indicators and set targets.

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