EUROPEAN CAPITAL MARKETS INSTITUTE

Fostering capital market integration:
Is there a role for a CMU equity market index?

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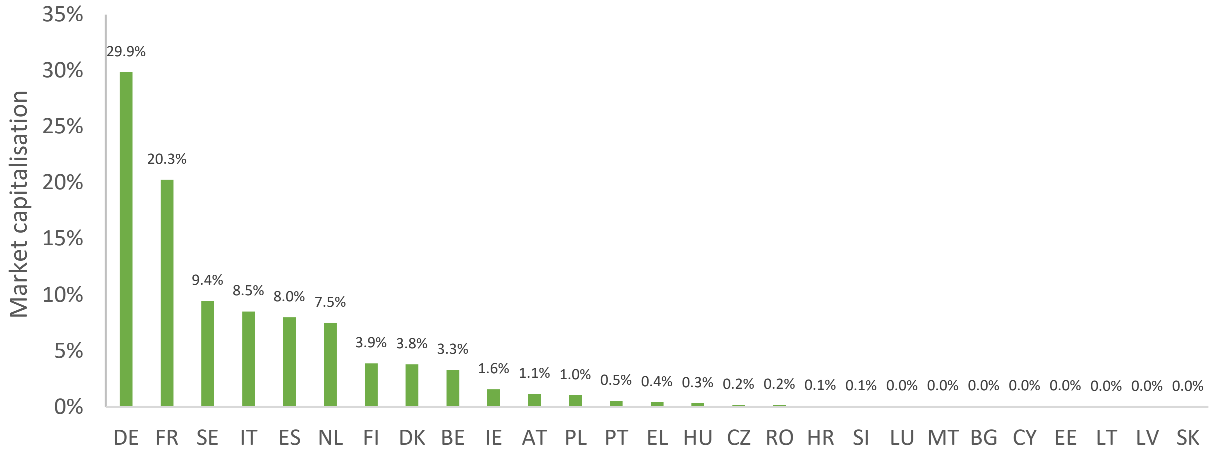
The EU has been struggling to integrate its capital markets for decades. Despite the broad public support shown for a Capital Markets Union (CMU) since its launch in 2015, progress in realising it has been very limited. European capital markets are both underdeveloped and fragmented for regulatory and economic reasons but also because of investors' preference and companies' established practices, which are *de facto* difficult to overcome by legislative initiative.

There are still 27 national capital markets, which do not function as one. Some of them are quite developed and large, but most are small and unable to provide a meaningful alternative to acquire sources of finance for capital expenditure and business combinations (see Figure 1). Such markets are often classified as 'frontier markets' and are only of marginal interest to international institutional investors.

**. This commentary is based on the study [Feasibility Study for the creation of a CMU Equity Market Index Family](#) authored by Willem Pieter De Groen, Cinzia Alcidi, Aleš Berk Skok, Igor Lončarski, Inna Oliinyk, Roberto Musmeci and Mattia Di Salvo.*

Figure 1. Geographical distribution by market capitalisation



Note: This figure is based on December 2019 free-float market capitalisation of companies listed at EU regulated markets and SME Growth Markets, which in total amounted to close to €5,400 billion.

Source: CEPS (2020).

What measures could reduce fragmentation and improve access to finance for companies, particularly for smaller companies in small countries with less developed capital markets?

A recent CEPS study, prepared at the request of DG FISMA, investigates the feasibility of a CMU Equity Market Index Family. The idea is that the creation of a CMU all-share index, as well as CMU sectoral and thematic sub-indices, entails the elimination of capital markets' geographical labels. These are typical of the current classifications of capital market and weigh negatively on small and new EU member states. Eliminating them could help to attract both large investors and more funds towards smaller capital markets. At the same time, a wide use of such new indices would foster EU capital market integration.

Data suggest that in the EU, only about half of the equity markets that are classified as developed markets are included in the indices provided by the most popular independent index providers, such as MSCI and FTSE Russell. In practice, only the large caps are part of such indices. Not being included in such indices puts the smaller markets in Central, Eastern and South Eastern Europe at a significant disadvantage.

On the one hand, of the 4,200 companies listed on EU-regulated markets,[1] only about one-third are mid-cap or large-cap, with the vast majority being micro caps or small caps. Larger companies, however, account for 96% of the total market capitalisation. On the other hand, EU-listed companies are included in approximately 5,000 indices provided by stock exchanges and independent providers (e.g. Stoxx and MSCI). The index issuers provide all-share as well as a variety of size, thematic and sectoral indices, but none covers the stock exchanges from all

[1] Before Brexit EU-listed companies were 6,300; the EU has lost its largest capital market.

EU countries. Almost all indices used by mutual funds and ETFs track indices covering stocks listed on developed markets.

The fact that an equity-based index covering all EU countries does not exist does not mean there is no demand for equity indices covering shares listed at regulated and growth markets across the entire EU. Yet in the current market structure, supply for such an index lacks demand.

Creating demand for such indices does not hold the same appeal for all investors. There are too many differences in EU equity markets for international institutional investors to think of the EU as a homogenous market landscape. Investments in EU markets classified as 'frontier markets' are hindered by limited liquidity and free float; limited market openness; specific local regulatory and infrastructural barriers; and unfamiliarity with markets and/or companies.

By contrast, domestic and regional investors (especially from the CEE region) see the potential of the CMU Index Family. They have, however, fewer assets under management and are less willing to pay for the use of indices.

On one-point domestic, regional and international investors' views converge: they all foresee a rise of index-based passive investment products and an increasing interest in ESG investments. This could imply that while there is a moderate interest in the CMU Index Family, the index could nevertheless have a significant impact on the development and integration of the smaller EU equity markets.

In the end, the extent to which the potential of the CMU Index Family can be realised largely depends on the index provider and the pricing. At the moment, it seems unlikely that any of the established index providers will issue the index family as their own private initiative, based only on investor demand. Increased awareness of opportunities among investors and index providers could help to change practices and perception, however. The European Commission has already set up a task force to gather parties interested in creating a CMU Index Family.

One important message about the CMU project is that unlike other EU initiatives, significant progress in capital markets development and integration is unlikely to be achieved through a specific policy or new legislation alone. Market participants shape market outcomes and change is driven by opportunities. But public authorities and the European Commission in particular can still play an important role in raising awareness of new opportunities and creating an environment that can foster change.

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