EPFSF Briefing

“THE COMPETITIVENESS OF THE EU IN AN EVER MORE GLOBAL FINANCIAL MARKET PLACE”

4 DECEMBER 2018

Introduction

Large and deep capital markets are not an end in themselves. The value of deeper capital markets is that they support economic growth in several ways. Healthy capital markets diversify the range of financing for companies and offer various solutions (including via public equity and bonds), along with bank lending ; they boost the shock absorption capacity of an economy and strengthen financial stability, improve productivity through more efficient allocation of capital and provide more people with more opportunities to save towards their retirement.

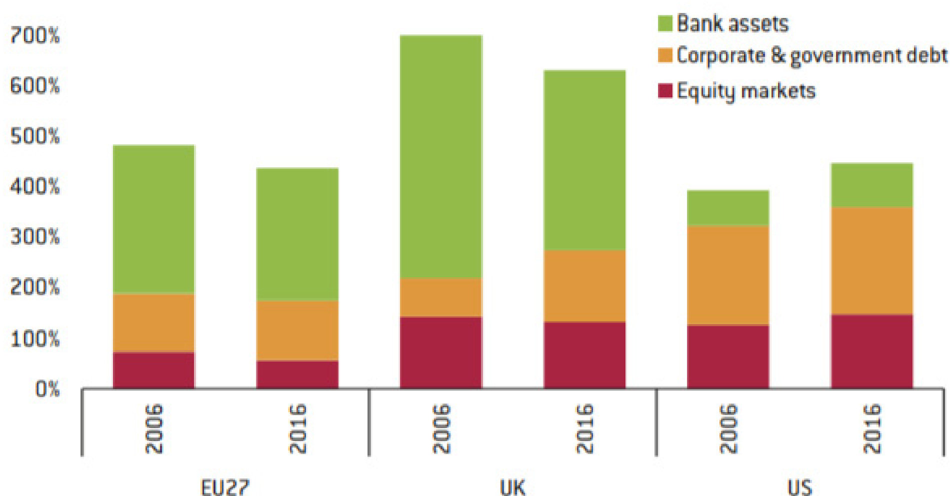
European capital markets are at a cross-road as the overwhelming dependency on the City of London’s financial hub is set to evolve post-Brexit.

The legislature which is coming to a close rightly placed Capital Markets Union at the heart of its ambitious growth agenda and sought to enhance investment opportunities, simplify rules and improve supervision.

The time has come to take stock of what has been achieved, consider what hasn’t and more fundamentally to reflect on the level of ambition the EU has in this matter. This briefing ambition’s to briefly present an outline of some defining trends of the EUs capital markets, take stock of where the Capital Markets Union has taken us and touch on some of the obstacles to further progress and what should be the way forward.

Some defining aspects of EU capital markets in 2018 taken from AFME’s September 2018 KPI report “Capital Markets Union: ensuring progress and planning for success”.

Figure 1: Size of the financial sector and capital markets, % GDP



Bruegel based on IMF World Economic Outlook, Bloomberg, Association for Financial Markets in Europe (AFME), Securities Industry and Financial Markets Association (SIFMA). EU27 is the EU excluding the UK.

The EU (28) continues to lag behind more developed capital markets such as the US

The US has by far the largest capital markets in the world if not the deepest. In many sectors - including the stock market, corporate bond market, and pension's assets - the US accounts for more that 40% of the global capital market activity. In every sector except IPOs, FX trading and derivatives trading, the Americas is the largest region in the world based on the value of the activity.

As regards equity markets, the gap between Europe and the US has been widening year after year since 2007. Over that period, European markets capitalization decreased by 1%, while US equities rose by 83%. In 2016, US market capitalization stood at € 25 trillion, while European markets capitalization stood at € 10.5 trillion.

As regards debt securities markets, governments and financial institutions are the largest providers while corporate debt securities represent only a small fraction of the market (8.4% in EU-28, representing € 1.81 trillion, compared to 16% in the US representing € 4.86 trillion).

The EU lacks large pools of long-term capital such as pensions and insurance assets, which are the starting point for developed capital markets

Although the availability of pools of capital for investment has improved in most EU countries in recent years, the fact remains that the EU lacks large pools of long-term capital. Over the last five years, the total amount of EU household savings in capital markets assets (listed equity, bonds, investment fund shares, life insurance and pension funds) has increased (114% of GDP to 118.2% of GDP), led by the accumulation of household retirement savings. However, although the average EU household accumulates savings at around twice the rate as the US, EU households invest 35% of those savings in low-yield conservative instruments like cash and deposits while the US households allocate only invest 15% in such instruments.

European companies continue to rely on bank lending compared to market-based instruments (bonds and equity)

Only 14% of new external funding by EU non-financial corporates (NFC) in 2017 was through bonds or public equity, with the remainder funded through bank lending. This proportion has increased from 13% on average during 2012-16 and risen significantly from 7% in 2007, most recently led by bond issuance in a low interest rate environment and continuing central bank quantitative easing measures.

Risk capital invested in SMEs has increased but remains significantly insufficient

The annual amount of pre-IPO risk capital invested into SMEs in the form of venture capital, private equity (at growth stage5), business angel investment, and equity crowdfunding has increased in the EU from €10.6bn in 2013 (1.4% of new external SME funding) to €22.7bn (2.5% of new external SME funding) in 2017. However, risk capital investments remain low relative to GDP and a significant gap continues compared with the US (0.8% of GDP vs 0.15% of GDP in the EU).

What are the achievements of Capital Markets Union?

A reminder of the CMU goals

The CMU Action Plan was launched in September 2015 and was composed of 33 policy actions and 16 legislative proposals targeting the following areas:

- The financing of SMEs and start-ups;
- Making it easier for companies to enter and raise capital on public markets;
- Fostering retail and institutional investment;
- Leveraging banking capacity to support the wider economy;
- Facilitating cross-border investing;
- Investing for the long-term, infrastructure and sustainable investment.

The Action Plan was reinforced with additional measures in the Commission's mid-term review of the CMU in 2017. In March 2018, the Commission also launched new proposals on covered bonds, investment funds and assignment of claims in addition to the introduction of Action Plans on sustainable finance and FinTech.

In his 2018 State of the European Union address, Jean-Claude Juncker reiterated his will to deepen European capital markets and insisted on pending Commission's proposals: "Recent events have brought into sharp focus the need to deepen our Economic and Monetary Union and build deep and liquid capital markets. The Commission has made a series of proposals to do just that – most of which now await adoption by Parliament and Council."

What measures have already been adopted?

Among the 19 legislative proposals, only 3 are readily adopted:

- The Prospectus Regulation, aimed at simplifying tools for companies looking for financing opportunities
- The Regulation on STS, aimed at strengthening banking capacity to support the economy
- The Regulation on EuVECA and EuSEF, aimed at boosting investments in risk capital.

How are the remaining measures supposed to contribute to the competitiveness of EU financial markets?

The remaining measures aim at reducing the fragmentation of financial markets across the EU, thus increasing economic convergence, at achieving a diversification of financing sources for businesses, and in particular SMEs, and at mobilizing finance for long-term investments. Most of the proposals are still being debated at co-legislators levels. In particular, the proposals should:

- Increase the offer of financial services and products, giving savers and investors more investment opportunities:
  - PEPP
  - European covered bonds framework
  - EU Framework for crowdfunding
  - Facilitating cross-border distribution of investment funds

- Simplify rules for financial players to increase access to financial markets :
  - More proportionate and effective rules for investment firms;
  - Simplifying rules for OTC derivatives markets;
  - Preventive restructuring frameworks;
  - SMEs financing;
  - Third parties effects of assignment of claims.

- Improve the supervision of EU Capital Markets to ensure better harmonization and less fragmentation:
  - ESAs review;
  - EMIR CCP Supervision ('EMIR 2.2')

Some obstacles to deeper and more integrated capital markets?

Impediments to free flow of liquidity, fragmentation of market infrastructures, legislative and supervisory fragmentation, and home-bias are some of the obstacles to more integrated and efficient EU capital markets.

Market fragmentation

European equity markets have experiences significant changes following MiFID II/MiFIR as regards concentration rules, transparency and increased competition. Whereas the advent of multilateral trading facilities (MTFs) following MiFID I fragmented European markets, MiFID II/MiFIR has caused further proliferation of other alternative platforms and systems, with liquidity now diffused across a larger number of venues and platforms.

While cross-border integration of European capital markets has increased in the 2000s, risk sharing continues to remain below values observed within the United States. The proportion of equity that is of domestic origin often exceeds 50 percent in EU countries, a strong home bias that effectively prevents risk-sharing across borders.

The lack of legislative incentives to the emergence of more cross-border banks also impedes the development of European capital markets: the prudential framework for banks does not take sufficiently into account the reality of the common supervision and should remove impediments to the free allocation of capital and liquidity in the EU.

Legislative and supervisory fragmentation

Supervisory integration remains extremely limited outside of the euro-area banking sector, with only small market segments directly supervised by ESMA and a still weak framework for ESMA-led supervisory convergence. Indeed, even if the rulebook is mostly harmonized, full convergence of supervision practices and outcomes has not been achieved.

Moreover, there is almost no convergence in broader legislative areas that shape operations on capital markets, such as in insolvency, taxation, housing finance and pensions. From a more general point of view, economic considerations are essential to generate growth opportunities and attract funding.

Finally, the structure of European financial markets will be strongly affected by Brexit

Between 40 and 80 percent (depending on the segment of the market) of all capital markets activity in the EU is conducted in the United Kingdom. London concentrates the issuing and trading of debt and equity securities, foreign exchange trading and derivatives. Following Brexit, EU-27 capital markets will have to ensure that entities located in the Union have an easy and competitive access to efficient market infrastructures and build tools to better allocate capital and risks across the 27 Member States.

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