Capital markets growth: impact from CMU

Introduction

The Chair observed that there are seven months left in the current political cycle. The renewal of the institutions in Europe will then lead to some delays in the adoption and implementation of new legislations.

A letter from the Finance Ministers of France and Germany (published in the Financial Times on 13 September 2023) advises that work must intensify on the Capital Markets Union (CMU) to close the EU capital markets gap. The letter draws comparisons with what is happening in the US and mentions listing, retail investment, securitisation, sustainable finance and building clearing infrastructure capacity in Europe as areas needing to advance. The letter states that 'Europe has made substantial progress but we have only laid the groundwork. We need a new dynamic if we are to build a genuine CMU worthy of the name for our citizens and businesses'. This statement shows that there is still political momentum behind the CMU, although the initiative was not mentioned in the latest State of the Union speech.

1. State of play of the CMU initiative and progress made in the growth of EU capital markets

1.1 Significant progress has been made on the CMU legislative agenda

A policy-maker stated that the Commission has delivered all the 16 legislative proposals of the CMU 2020 action plan. Eight of these proposals are still being negotiated by the co-legislators. The elaboration of these proposals, taking into account significant input received from the public and private sectors, has been a demanding but successful endeavour. There is no room for complacency however, as these proposals still need to be implemented through concrete actions, which will take time. The Commission has provided an enabling framework, but further engagement is required from the member states and the industry to transform these texts into meaningful actions. It is therefore crucial that member states play their part in implementation and complement measures taken at EU level with reforms in local markets. The letter from the French and German Finance Ministers is encouraging in this regard.

The policy-maker highlighted a number of deliverables under the three headings of the 2020 CMU action plan. With the Listing Act now under negotiations it will be easier and cheaper for companies, in particular SMEs, to raise capital in the EU stock markets, thus contributing to the first goal to support the diversification of company financing, which remains a matter of concern in the EU. The network of SME envoys at EU level is also expected to play a role in this regard. The Retail Investment Strategy (RIS) is expected to increase citizens' capital market participation in line with the second heading of the 2020 action plan. The third heading is about further integrating national capital markets. The agreement on the MiFIR review proposal is a success in this regard and notably the decision to implement a consolidated tape (CT) of trading data on secondary markets.

An official was also optimistic on the CMU and emphasised the commitment of the EU institutions to moving forward with its implementation. Capital markets are crucial to convey finance into the real economy, which is particularly important given the realisation that public funding will not be sufficient to finance the digital and sustainable transitions. In a statement made in the margins of the April 2023 ECOFIN meeting in Stockholm, the EU Council, Parliament and Commission committed to advance as fast as possible with the completion and implementation of the CMU 2020 action plan and, where possible, finalise negotiations on the main outstanding files before the end of the current legislature. Less than four months later, political agreements have been reached on four significant CMU proposals that will contribute to increasing the efficiency and transparency of EU capital markets: the European Single Access Point (ESAP), the Central Securities Depositories Regulation (CSDR), the review of MiFIR, and the review of the AIFMD and UCITS directives.

A regulator stated that the large number of CMU initiatives currently in progress are a very significant step towards making EU capital markets more attractive. There is no CMU silver bullet, so the progress will be incremental. In addition, political will, as demonstrated by the recent statement of the German and French Finance Ministers will help to drive the initiative forward. The agreements that have recently been achieved on the ESAP, and the ELTIF, AIFMD, UCITS and MiFIR review proposals are important milestones for the development of EU capital markets. The political agreement on the MiFIR review and the CT is a significant step forward in particular. These measures could be a gamechanger, bringing transparency to the markets via a CT, consolidating all the vital information from European capital markets and improving the integration and efficiency of the European markets. ESMA is committed to supporting these initiatives, not least by ensuring that the selection of different CT providers is completed in a very short timeframe.

1.2 EU capital markets remain under developed

A regulator commented that, unfortunately, European capital markets remain underdeveloped, as shown by market data. Despite significant progress on the legislative proposals of the CMU, much remains to be done to further develop EU capital markets. Market growth is limited, although this is partly driven by the current adverse macroeconomic environment. In 2022, there were just 44 new listings in the EU, worth €10.2 billion, with one IPO accounting for 90% of that amount. In 2021, only 11% of global IPOs took place in the EU, while 38% were in the US, 18% in China and 4% in the UK. In 2022, the amount raised in primary equity markets was reduced by 60% compared to 2021. There have also been a number of de-listings from public markets, although this trend is not specific to the EU. Work should focus on making the raising of capital on public markets more attractive and more of a focus point for companies.

A second regulator agreed that, although much has already been done in the context of the CMU building, the length of the process and the slow growth of capital markets in Europe remain a source of frustration. Efficient European capital markets are critical to contribute to the huge financing needs of the green and digital transformations, but also to strengthen the strategic autonomy of the EU. Brexit has been a gamechanger in this regard. The European Union now has to develop its own markets and financial players to provide sufficient funding of the European economy. Recent geostrategic evolutions have emphasised further the importance of strengthening the EU's strategic autonomy in all areas of the economy, including finance.

Although the US are not necessarily a relevant reference point due to a different institutional setting and approach to finance, a comparison with the US markets shows that EU capital markets have significant room for development and that there is still a long way to go to achieve the objectives of the CMU. For example, securitisation has not picked up in the EU since the financial crisis, whereas it has increased in the US. Efforts must be made to 'close the gap', as suggested in the French and German Finance Ministers' joint letter of September 2023 (building on the Council conclusions of March). Listing is not sufficiently popular in Europe either, even though Paris has become the largest financial centre by market capitalisation in the EU, with approximately €3,000 billion in market cap, before London. It is hoped that the Listing Act will be a game changer, increase the incentive for listing on public markets and encourage listed firms to raise more capital on markets than they do at present.

There have also been several positive developments in the EU capital market in the last few years that are a source of optimism, the regulator added. Private equity has developed. The cross-border provision of financial services has increased. ESMA figures show that, in 2022, 7.6 million clients in the EU were using cross-border financial services. The diversification of financing has also improved to a certain extent. Debt financing from capital markets now accounts for almost 20% of non-financial corporates' credit financing, up from 10% in 2008. Another positive factor, at least in France, is retail investor participation which is slowly increasing and returning to levels seen before the financial crisis. Surveys indicate that younger investors are coming to the capital markets more. This is not a major trend, but demonstrates that investor culture is increasing, although there is still much to do in terms of retail participation. The CT and the amended ELTIF rules should indirectly contribute to this objective, including for investments in smaller caps, but financial literacy still needs to be further developed.

An industry representative stated that the success of CMU will ultimately be measured by market outcomes. If the number of IPOs and listings and the trading activity in Europe do not improve, not enough progress is being made. Although some CMU regulations will not be implemented before 2027 or 2028, and although there is progress in some areas, the figures previously referred to around numbers of IPOs and listings suggest that the CMU is far from being achieved and that European markets are becoming less competitive compared to the rest of the world. That is concerning, but the objectives of the CMU can still be achieved with sufficient commitment and if the right policy choices are made.

A second industry representative agreed with previous speakers that, while much has been achieved with the CMU in terms of policy framework in recent years, the market impacts are not yet convincing. Europe is clearly being outpaced by the Asia-Pacific region and the United States in terms of traded volumes in the secondary markets. This is less the case for primary markets. Since 2008, European GDP has grown by about 14%, whereas US GDP has grown by about 70%. In the same period of time, European trading volumes in equity options and index options, have been stable, while US volumes have grown by about 800%. This suggests that the EU capital market is insufficiently competitive and does not sufficiently favour efficient risk transfers.

A third industry representative observed that retail capital markets are particularly underdeveloped in the EU. Just under 44% of EU households' total financial assets are still in bank deposits. In the context of a 5% to 6% inflation rate, that is an issue that needs to be addressed.

2. Short term priorities for the CMU

2.1 Next steps under the current legislature

An official stated that the Spanish EU Presidency is strongly committed to advancing the adoption of the remaining proposals of the 2020 CMU action plan. Technical work is being finalised on the MiFIR and AIFMD reviews in particular, with the aim of formally adopting these initiatives by the beginning of 2024.

Three other important measures are still on the table, the official added. The EMIR review will be of utmost importance in strengthening clearing in the EU and mitigating financial stability risks posed by offshore clearing. Work is ongoing to reach general agreement in the Council on this proposal. Negotiations with the Parliament are scheduled to start at the end of November if a general agreement is reached in the Council. A consensus still needs to be found on several points on which there are diverging views, including the active account measure and the supervisory arrangements proposed. The Listing Act and the RIS are currently being assessed by the co-legislators. Both aim to increase the size and depth of capital markets. The Listing Act will simplify listing requirements to encourage enterprises to list and remain listed and remove obstacles to listing, for example with the proposal to implement multiple-vote share structures to address the reluctance of some company owners to lose full control when listing on public markets. An agreement was reached at the Council level on the Listing Act proposal in Spring 2023 and it is hoped that trialogues will start in October. The RIS was launched late during the Spanish Presidency. The aim is to reach a general agreement at the Council level before the end of the current legislature, but this will be challenging because of the complexity and length of the proposal.

A regulator hoped that the co-legislators will make rapid progress on the Listing Act and RIS proposals. These will reduce administrative burdens for SMEs and encourage more retail investment.

2.2 Issues to be addressed concerning the RIS proposal and product complexity

An industry representative welcomed the RIS proposal recently put forward by the European Commission but advised that the priorities pursued should be adjusted. There is an excessive focus on product costs in the proposal, based on claims that investment product fees are too expensive in Europe. In reality, the price of UCITS equity funds decreased by an average of 6% during the last five years, which is quite significant in an inflationary context. The price of a UCITS fund in Europe, on average, is equivalent to the price of an actively managed mutual fund in the US. The focus should instead be on other essential objectives, such as improving financial education or product disclosures. A Eurobarometer study revealed that less than 20% of people have a high level of financial education in the EU. Product information, such as the key information document (KID) mandated by the packaged retail investment and insurance products (PRIIPs) regulation, is still too complex and insufficiently meaningful. There is also the challenge of encouraging risk-averse European retail clients to invest in capital market instruments in a context where the rise in interest rates means that they can now get 3 to 4% return on guaranteed capital products.

A regulator emphasised that, with the current low level of financial literacy in Europe, it is essential to protect investors from products that are insufficiently transparent or too difficult to understand, such as some structured products, in order to build customer trust. The RIS aims to ensure that retail investors can benefit from advice and that advice is provided in the interest of investors, but more should be done to protect investors from complex products in case of direct investment without advice.

A second industry representative noted that some measures aiming to enhance transparency for investors do not target the right products. Many member states have rightly used their product intervention powers to direct retail investors away from structured products, which lack transparency and may be relatively costly and risky. However, some simpler exchange-traded and listed products have inappropriately been grouped together with structured products in these measures. For example, futures and options are grouped in the same category as contracts for difference (CfDs), even though they are transparent on exchange products.

3. Priorities for the next steps of the CMU

3.1 Overall priorities for the future steps of the CMU

A policy-maker stated that a number of capital market directives will need to be reviewed as part of the future steps of the CMU, although there should be no need for a major overhaul. In addition, there should be a focus on initiatives that foster further growth of European capital markets in order to support the green and digital transitions. The European Green Deal, for example, a key initiative of the European Commission, will need to be strongly connected to the CMU in order to achieve the necessary transition aims by 2030. Improving pension schemes and taxation could also be gamechangers for the CMU, but will be challenging issues to address at the European level. Supervisory convergence and home-host aspects will also need further consideration to ensure that EU legislation is implemented in a consistent and effective way across the Union.

A regulator noted that measures around pension schemes and taxation have helped some local capital markets to develop successfully in the EU, for example in Sweden. However a few successful local markets are not sufficient to achieve the CMU. An objective ahead is to leverage these individual domestic success stories for the development of a broader European capital market, with the support of the Commission and member states.

An official emphasised the importance of supporting the financing of SMEs and start ups, which are the backbone of the European economy, in further work on the CMU. The funding mix of SMEs at different stages of their growth must be further diversified. Much remains to be done on this at the EU level and by member states domestically. Spain has been very active in this regard recently, with the Business Creation and Growth Act and evolutions of the securities law. A growth market has also been created by the Spanish stock exchange, as well as a new scale-up market.

An industry speaker stated that financial market infrastructures (FMIs) have an important role to play in achieving an efficient and robust functioning of capital markets and accelerating their growth. Strong FMIs can promote liquidity, increase transparency, and reduce risks within the EU capital markets as well as support investor confidence. FMIs can also help to address the needs of various issuers and investors. To support their competitiveness, FMIs need to invest in terms of digitalisation, products and services. More needs to be done for developing SME segments in particular. Stock exchanges are also investing heavily in blockchain technology to develop new types of trading venues. Legislators and regulators also need to embrace necessary changes and facilitate regulatory harmonization, streamlined procedures, and an alignment of national rules. Important examples of measures needed include efficient tax rules that do not favour one type of capital over another and allow for easy settlement even across national and European borders, or insolvency rules that ensure the same understanding and legal certainty across the EU. Another key issue is to establish a true level playing field between different types of trading venues such as stock exchanges, Multilateral Trading Facilities, and Systematic Internalizers. To realize the CMU's full potential, these issues must be tackled head-on.

3.2 Moving towards a single rule book and a further integration of EU capital markets

An industry representative observed that there is a fundamental choice yet to be made between moving towards a fully harmonised and integrated European capital market or maintaining a conglomerate of different domestic markets that are somewhat connected. The present situation, with 20% of common rules and 80% of differing requirements across EU countries needs to evolve to 80% of common rules at EU level. For example, authorisation, supervisory reporting and information provision processes should be further streamlined, with a unified provision of information to local and European supervisors in a one-stop-shop approach.

A second industry representative agreed that progress towards a single rulebook is a key objective. There is currently often a single rulebook in name only, not in implementation.

A third industry representative concurred that capital market rules need to be further harmonized. From a buy-side and asset management perspective, there are still 27 different markets. The UCITS framework and its passporting regime are a great success but the European fund market remains very fragmented, with marketing documentation requirements that differ across the 27 member states for example. This is different to the situation in the US, where there are no differences in these rules across states. In addition, full consistency between Level 1 and Level 2 rules must be ensured when implementing the reviewed ELTIF framework so that retail investors can access these new products.

3.3 Enhancing convergence and the capacity to adapt to market evolutions

A regulator stated that European capital markets are still too fragmented to be successful. Efforts are being made at ESMA level to move towards further convergence of securities rules between the 27 member states. An active support of the national supervisors is also necessary to achieve significant progress in this regard.

A second regulator underlined that the EU legislative framework needs to be implemented in a homogenous way across all Member States. More consistency will alleviate the inefficiencies and costs of fragmented markets and avoid regulatory arbitrage and supervisory shopping, which are detrimental to investors' confidence. If there is not enough confidence in the markets, it will be difficult to develop retail investor participation in particular, which is one of the keys to developing the European markets. It is a crucial moment to make progress in this direction, as many Level 1 CMU texts are in the process of being adopted and will need to be implemented in the short to medium term.

Answering a question from the Chair about the possibility of granting ESMA new powers, the regulator noted that a more unified supervision would help to achieve a more consistent implementation of EU legislation, although it has unfortunately faced a lack of political appetite so far. Where there is room for ESMA to have more impactful powers, this should be encouraged however, as well as the efforts undertaken by ESMA to foster supervisory convergence. In the RIS there is also a welcome proposal to improve the equilibrium of powers between home and host supervisors in the cross-border retail investment space. In France, many complaints received by the regulator from retail clients stem from the cross-border provision of products and services. Therefore, host supervisors must be able to intervene to protect investors where necessary; cooperation mechanisms between home and host supervisor must be enhanced in this context. Some additional quick fix initiatives also need to be considered to help supervisors adjust regulation to new market developments, such as the possibility of using so called no-action letters at European and national levels.

An industry representative agreed with the suggestion of implementing no action letters. Supervisory tools should be adapted to be made more workable for supervisors.

A second industry representative concurred that enabling supervisors to make technical changes to regulations to adapt them to market circumstances, whether by changing technical standards or issuing no action letters, would improve the competitiveness of EU capital markets. Stronger centralised supervision is also necessary, certainly for the wholesale securities markets. ESMA is the logical place to locate that centralised supervision.

3.4 Focusing on measures that support the competitiveness and growth of European capital markets

An industry representative stated that the policy objectives that have been pursued by the Commission across the various CMU action plans, such as enhancing the transparency and competitiveness of capital markets, are the right ones. The problem is that the regulations and tools put in place do not always support these objectives. Regulations are often more prescriptive or restrictive than necessary detailing how and where products or instruments should be traded or cleared, which may hinder innovation and growth in the financial market. This may result in a one-size-fits-all approach being applied to a variety of market participants that share few commonalities, limiting the development of the most innovative firms. For example, the prudential rules for investment firms, the Investment Firms Regulation/Directive (IFR/IFD), apply banking rules to investment firms. This does not encourage investment firms to innovate and grow in Europe, potentially depriving Europe of strong players with international reach. Policy choices going forward should focus more on making Europe a growth area for financial firms, with more proportionate rules and a stronger focus on activity-appropriate and evidence-based requirements. This will support the objectives set out by the German and French Finance Ministers in their letter and help turn Europe into a global trading hub.

A second industry representative suggested that a competitiveness check should be systematically performed when new regulations are proposed to evaluate their impact on the competitiveness of EU capital markets and players. A strong CMU will not be possible without strong European market players and at present the number of EU players that are in a leading position at the global level is too limited.